european corporate governance institute

The Credit Markets Go Dark

Law Working Paper N° 810/2024
October 2024

Jared A. Ellias
Harvard University
Elisabeth de Fontenay
Duke University and ECGI

© Jared A. Ellias and Elisabeth de Fontenay 2024. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-810-2024

european corporate governance institute

ECGI Working Paper Series in Law

The Credit Markets Go Dark

Working Paper N° 810/2024
October 2024

Jared A. Ellias
Elisabeth de Fontenay

© Jared A. Ellias and Elisabeth de Fontenay 2024. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

Over the past generation, conflicting trends have reshaped the ownership of corporate equity on the one hand and corporate debt on the other. In equity, the two great trends have been the shift from public markets to private ownership and the consolidation of American companies' stock in the hands of powerful investment funds. In debt, by contrast, the great trends have been a shift from private loans to quasi-public markets and dispersed ownership. In this Article, we chronicle the recent and dramatic reversal of these trends in the debt markets. Private investment funds executing a "private credit" strategy have become increasingly important corporate lenders, bringing into corporate debt the same forces of privatization, concentration, and illiquidity that have been reshaping the equity markets. We offer new data that illustrate the meteoric rise of the now $1.5 trillion private credit industry, and we explore the allure and implications of private credit. For many corporate borrowers, private credit offers a faster, more efficient, and more accessible source of financing than either banks or the public (and quasi-public) debt markets. Yet the transition from bank-intermediated finance to private credit will transform not only corporate finance, but also firm behavior and economic activity more generally. First, as the corporate debt markets follow the equity markets in going dark, information about many large firms will be lost to the investing public. For better or worse, these firms will act with unprecedented discretion - having been shielded from the discipline and scrutiny of regulators, the trading markets, and the general public. Second, corporate debt - like corporate equity - will become the dominion of investment funds, some of which are already unimaginably large. These funds will influence everything from firm operations and strategy to corporate distress, with uncertain consequences.

Keywords: bankruptcy, corporate finance, corporate debt, corporate governance, corporate law

Jared A. Ellias
Harvard University

Elisabeth de Fontenay
Duke University and ECGI

THE YALE LAW JOURNAL

JARED A. ELLIAS & ELISABETH DE FONTENAY

The Credit Markets Go Dark

ABSTRACT. Over the past generation, conflicting trends have reshaped the ownership of corporate equity on the one hand and corporate debt on the other. In equity, the two great trends have been the shift from public markets to private ownership and the consolidation of American companies' stock in the hands of powerful investment funds. In debt, by contrast, the great trends have been a shift from private loans to quasi-public markets and dispersed ownership.

In this Article, we chronicle the recent and dramatic reversal of these trends in the debt markets. Private investment funds executing a "private credit" strategy have become increasingly important corporate lenders, bringing into corporate debt the same forces of privatization, concentration, and illiquidity that have been reshaping the equity markets. We offer new data that illustrate the meteoric rise of the now $1.5 trillion private credit industry, and we explore the allure and implications of private credit. For many corporate borrowers, private credit offers a faster, more efficient, and more accessible source of financing than either banks or the public (and quasi-public) debt markets. Yet the transition from bank-intermediated finance to private credit will transform not only corporate finance, but also firm behavior and economic activity more generally. First, as the corporate debt markets follow the equity markets in going dark, information about many large firms will be lost to the investing public. For better or worse, these firms will act with unprecedented discretion—having been shielded from the discipline and scrutiny of regulators, the trading markets, and the general public. Second, corporate debt—like corporate equity—will become the dominion of investment funds, some of which are already unimaginably large. These funds will influence everything from firm operations and strategy to corporate distress, with uncertain consequences.

AUTHORS. Jared A. Ellias is Scott C. Collins Professor of Law, Harvard Law School. Elisabeth de Fontenay is Karl W. Leo Distinguished Professor of Law, Duke University School of Law. The authors thank Josh Clarkson, Cole Harten, Madeleine Hung, Nicole Fang, Russell Feinman, Michael Finkenbinder, Farrah Kalach, Alina Kilcoyne, Chinmay Pandit, Bo Roy, Johnathan Sun, and Vivian Zhang for their helpful research assistance. For helpful comments, the authors also thank William Birdthistle, Vince Buccola, John Coates, Jeff Ferris, Jeff Himstreet, Scott Hirst, Dan Kamensky, Dorothy Lund, Mariana Pargendler, Alex Platt, Elizabeth Pollman, Eric Pratt, Adriana Robertson, Mark Roe, David Smith, Roberto Tallarita, and Andrew Tuch; representatives of the LSTA, the Alternative Investment Management Association (AIMA), and the Alternative Credit Council (ACC); as well as seminar audiences at Harvard Law School, the 2024 BYU Winter Deals Conference, the 2024 American Law and Economics Annual Meeting, and the



2024 Penn/N.Y.U. Conference on Law and Finance, as well as the many industry participants who generously shared their insights.



ARTICLE CONTENTS

INTRODUCTION 783

I. A BRIEF (RECENT) HISTORY OF CORPORATE DEBT 792
- A. The Traditional Approach: Relationship Lending 793
- B. The Shift to Syndicated Lending and High-Yield Bonds—or "Quasi-Public" Debt 795
- C. Effects on Corporate Information and Bankruptcy 799
  - 1. Corporate Information Production 800
  - 2. Corporate Distress and Bankruptcy 801

II. THE RISE OF PRIVATE CREDIT 805
- A. Overview 805
- B. Data 816

III. THE ADVANTAGES OF PRIVATE CREDIT 822
- A. Advantages for Borrowers 823
  - 1. Speed 823
  - 2. Flexibility 823
  - 3. Easier Renegotiation with a Single Lender 824
  - 4. Confidentiality 825
  - 5. Firmer Lending Terms 826
- B. Advantages for Debt Investors 826
  - 1. Attractive Risk-Adjusted Returns 826
  - 2. Stronger Covenants 829
  - 3. Protection from "Creditor-on-Creditor Violence" 831
- C. Advantages for Asset Managers 833
  - 1. Attractive Fee Structures 833
  - 2. Relationship Lending Without Banking-Law Limitations 836
  - 3. Earning Returns to Scale 838
  - 4. Less Fire-Sale Pressure 839

IV. CONSEQUENCES OF THE RISE OF PRIVATE CREDIT 840



A. Corporate Governance: Investment Funds Own Everything 841
1. Corporate Equity in the Hands of Investment Funds 841
2. Corporate Debt Follows Suit 844
B. Corporate Information Production: Private Markets Cannibalize Public Markets 847
C. Corporate Distress and Bankruptcy: Private Credit Lenders Will Make Their Mark 851
1. Private Credit Lenders Bring New Capabilities and Incentives to Prebankruptcy Workout Negotiations 853
2. More Aggressive Tactics in Smaller Cases 854
3. More Judicial Responsibility in Larger Cases 856

CONCLUSION 857

INTRODUCTION

The ownership, governance, and financing of corporate America look radically different today than they did only a few decades ago. By now, we have become accustomed to the two key features of this new landscape—namely, (1) that companies increasingly choose to remain private, and (2) that the equity (stock) of both public and private companies is increasingly concentrated in the hands of powerful investment funds.[1] Over the past few decades, companies have increasingly chosen to remain, or become, private firms. Unlike public companies, private firms are not subject to the public-disclosure requirements of the securities laws, and their shares are not traded on a public stock exchange.[2] Instead, their shares are typically owned by private investment funds such as private equity or venture capital funds.[3] Meanwhile, the shares of the shrinking set of public companies are increasingly owned by public (or "registered") investment funds sponsored by a handful of the world's largest asset managers, rather than by individual investors or even smaller investment funds.[4] One could, accordingly, describe the two major trends in corporate equity ownership as *privatization*—the large-scale exit of companies from the public regulatory scheme and from information-rich markets—and *concentration* of ownership.

---

1. In the equity markets, a large literature has recently focused on the concerns raised by the rise of "megafunds." For some recent works on these concerns, see generally JOHN COATES, THE PROBLEM OF TWELVE: WHEN A FEW FINANCIAL INSTITUTIONS CONTROL EVERYTHING (2023); Lucian Bebchuk & Scott Hirst, *Big Three Power, and Why It Matters*, 102 B.U. L. REV. 1547 (2022) [hereinafter Bebchuk & Hirst, *Big Three Power*]; Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019) [hereinafter Bebchuk & Hirst, *The Specter of the Giant Three*]; Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771 (2020); and Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019).

2. *See* Mark J. Roe & Charles C.Y. Wang, *Half the Firms, Double the Profits: Public Firms' Transformation, 1996-2022*, J.L. FIN. & ACCT. (forthcoming) (manuscript at 2-3, 6), https://ssrn.com/abstract=4372070 [https://perma.cc/J6TH-VAY4] (documenting a decline in the number of public firms, but noting that the aggregate size of the public-firm sector by asset value is up significantly).

3. For a deeper discussion of private equity funds, see generally Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?*, 69 J. FIN. 1851 (2014), which analyzes the historical performance of private equity funds. For a discussion of the consequences of venture capital ownership, see Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 156-76 (2019).

4. *See* COATES, *supra* note 1, at 27-28; Bebchuk & Hirst, *Big Three Power*, *supra* note 1, at 1550-52; Bebchuk & Hirst, *The Specter of the Giant Three*, *supra* note 1, at 725-26; Kahan & Rock, *supra* note 1, at 1774; Fisch et al., *supra* note 1, at 19-20.

Within the world of corporate debt, however, opposite trends had been at work until recently.[5] Historically, firms both large and small borrowed on a secured basis from banks.[6] (Large firms also borrowed on an unsecured basis from investors in the public bond markets.[7]) With this form of secured lending, banks lent their own money—either internal funds or customer deposits—to corporations.[8] The 1990s saw secured lending evolve dramatically.[9] The role of banks shifted from originating loans to identifying corporations that needed capital and finding nonbank investors to supply it, building what became known as the "syndicated debt markets."[10] With the development of syndicated lending, secured debt began to resemble the world of public equity and public bonds: a liquid market dominated by dispersed, passive investors, with firm and market information reflected continuously in trading prices.[11]

To state it differently, while the trend in corporate equity has been for public companies to go private and for shared ownership to become concentrated in a smaller number of asset managers, the trend in corporate debt has been the opposite: large numbers of dispersed, passive investors supply the capital, and companies are disciplined by the trading markets rather than by active, expert intermediaries such as banks. Corporate debt ownership has thus been dispersing as corporate equity has been concentrating.

In this Article, we provide a comprehensive account of a startling reversal of this trend for corporate debt: since the 2010s, the same trends of privatization and concentration that reshaped corporate equity are now reshaping corporate debt. This ongoing shift is driven by an investment strategy known as "private credit."[12] While private credit lacks a strict definition, we define private credit

5. *See infra* Section I.A.

6. *See generally* Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242, 4251 (2010) (discussing heterogeneity in debt structure).

7. Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 413 (1986) (referring to the long-term, unsecured public bonds issued by large corporations).

8. For a discussion of secured finance, see Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1437-40 (1997).

9. *See* Lisa Lee, *Private Credit Is the Hot New Thing, but Its Roots Go Back to 1980s Junk Bonds*, BLOOMBERG (Dec. 16, 2023, 8:00 AM EST), https://www.bloomberg.com/news/articles/2023-12-16/private-credit-is-the-hot-new-thing-on-wall-street [https://perma.cc/4B9M-C7TT].

10. *See* Greg Nini & David C. Smith, *Leveraged Finance*, *in* HANDBOOK OF CORPORATE FINANCE 249, 260 (David J. Denis ed., 2024) (discussing the evolution of the syndicated lending market).

11. *See* Andreas Keßler & Thomas Mählmann, *Trading Costs of Private Debt*, 59 J. FIN. MKTS. art. no. 100644, at 1-3 (2022).

12. *See infra* Part II.

loans as commercial loans that are arranged and originated not by banks, but primarily by private investment funds.[13] Among other important features, private credit loans are not generally traded and are held to maturity by the private investment fund that makes the loan.[14] Collectively, private credit funds originate a major and accelerating share of all commercial loans.[15] Individually, private credit funds are often able to originate a given company's *entire* outstanding debt singlehandedly, rather than hold a small piece of the company's debt along with many other creditors. This has radically transformed firms' capital structure: such companies face a single loan from a single lender, instead of a complex web of different types and tranches of debt, each funded by large numbers of passive (and often warring) creditors.

Investment funds deploying private-credit investment strategies—such as secured lending, subordinated lending, and distressed investing, with senior secured lending making up the bulk of the strategy—managed $400 million in 2000, $300 billion in 2010, and an estimated $1.6 trillion in 2023.[16] These funds may be on their way to managing $3.5 trillion in 2028.[17] Large public retirement funds are currently allocating at least $100 billion into the asset

13. The rise of private credit is widely covered in the press. *See, e.g.*, Andres Gonzales & Pablo Mayo Cerqueiro, *As Golden Age for Capital Ends, 2024 Heralds More Consolidation*, Reuters (Dec. 20, 2023, 1:03 AM EST), https://www.reuters.com/markets/deals/golden-age-private-capital-ends-2024-heralds-more-consolidation-2023-12-20 [https://perma.cc/HGJ8-TXB7]; *see also* Lee, *supra* note 9 (discussing private credit); Ben Foldy, *How Risky Is Private Credit? Analysts Are Piecing Together Clues*, Wall St. J. (Nov. 10, 2023, 5:30 AM ET), https://www.wsj.com/finance/how-risky-is-private-credit-analysts-are-piecing-together-clues-79762038 [https://perma.cc/B5UV-BBL5] (discussing the emergence of private credit). Financial scholars have also begun to produce pioneering work on private credit in the financial literature. *See* Young Soo Jang, Are Direct Lenders More Like Banks or Arm's-Length Investors? 6 (Jan. 24, 2024) (unpublished manuscript), https://ssrn.com/abstract=4529656 [https://perma.cc/H46A-8P3S]; Joern Block, Young Soo Jang, Steven N. Kaplan & Anna Schulze, *A Survey of Private Debt Funds*, 13 Rev. Corp. Fin. Stud. 335, 336-40 (2024).

14. *See infra* Section III.A.3.

15. *See, e.g.*, Chris Cumming, *Private-Credit Surge Could Last for Years, Lenders Say*, Wall St. J. (Sept. 19, 2023, 5:35 PM ET), https://www.wsj.com/articles/private-credit-surge-could-last-for-years-lenders-say-40f8a616 [https://perma.cc/A724-R6CQ]; Jodi Xu Klein, *The $1.5 Trillion Private-Credit Market Faces Challenges*, Wall St. J. (Oct. 16, 2023, 7:30 AM ET), https://www.wsj.com/articles/the-1-5-trillion-private-credit-market-faces-challenges-1bb555ce [https://perma.cc/2Q54-DFXB] ("The boom in private credit has so far shown little sign of ebbing as bespoke corporate loans overtake more traditional sources of debt financing such as syndicated loans and high-yield bonds.").

16. Lee, *supra* note 9.

17. *Id.*

class.[18] As institutional investors stampede into private credit, corporate governance and corporate finance are transforming once again.

The rise of private credit has many drivers.[19] Borrowers are choosing private credit loans over alternatives because private credit funds can deploy capital quickly, flexibly, and with greater confidentiality and certainty than is possible in public debt markets.[20] Institutional investors are pouring money into private credit funds to earn handsome returns from investing in illiquid assets; to obtain priority in bankruptcy through secured debt and contractual protections that go beyond what has become typical in syndicated loan deals; and to protect themselves from the "creditor-on-creditor violence" that has become a feature of the public and quasi-public debt markets.[21] For their part, asset managers are drawn to sponsoring private credit funds for the opportunities to earn high compensation, to deploy capital with minimal regulatory constraints, and, in some cases, to profit from size while building gigantic funds.[22]

Although many commentators have remarked on the meteoric growth of private credit,[23] we argue that its impact has, if anything, been understated. Private credit should instead be understood as heralding a sharp reversal in the trend toward dispersed and traded debt, which will have transformative impacts on corporate governance and corporate finance along three dimensions.[24]

First, as private credit increasingly competes with traditional bank syndication for loans to large firms and reaches an ever-wider array of smaller firms, we should anticipate a world in which the entire capital structure—both the equity *and* the debt—of many or most American firms is held primarily by pri-

18. *See* Shruti Singh, *Private Credit Attracts Billions from U.S. Pension Plans*, BLOOMBERG (Dec. 18, 2023, 10:37 AM EST), https://www.bloomberg.com/news/articles/2023-12-18/calpers-other-us-public-pensions-pump-billions-into-private-credit [https://perma.cc/9WVQ-YNEB].

19. *See infra* Part III.

20. *See infra* Section III.B.

21. *See infra* Part III. In this Article, we define the public debt markets loosely as the set of securities exchanges, trading systems, and brokered transactions in which corporate bonds are freely tradable, trading prices are public and continuously updated, and the issuers and offerings are subject to extensive public-disclosure obligations. As discussed in Section I.B, *infra*, we define the "quasi-public" debt markets as the markets for corporate debt such as the syndicated loan and 144A note markets in which trading is relatively liquid, and trading prices are publicized and updated, yet public disclosure is not required and there may be some restrictions on trading.

22. *See infra* Section III.C.

23. S*ee infra* notes 268-269 and accompanying text.

24. *See infra* Section IV.A.

vate investment funds.[25] This means that the strengths, limitations, and incentives of these fund managers will take on the same outsize importance in the debt markets as in the equity markets.[26] Even the largest companies now have the option to forgo underwritten debt offerings to large syndicates of lenders or dispersed bondholders and instead have their entire debt arranged and funded by a single private credit fund, in record time. Yet it appears that private credit not only substitutes for existing sources of debt financing (such as traditional bank loans, syndicated loans, and high-yield bonds), but also expands the supply of credit, both by extending credit to new borrowers and by adding still more leverage to existing borrowers. In other words, private credit not only changes how the corporate-debt "pie" is split, but also expands the size of the pie. Crucially, the pie increasingly rests in the hands of a relatively small number of private investment funds.

Second, with the addition and expansion of private credit, information about firms, investors, and transactions will change, and, for larger firms, grow scarcer.[27] Among U.S. companies that take on outside capital, the modal firm may very soon be one that is owned by a private equity fund and financed by a private credit fund.[28] For some smaller firms that would have otherwise borrowed from traditional banks or not borrowed at all, this may lead to somewhat *more* disclosure about the firm, if the private credit lender is a business development company, as further described below.[29] But for larger firms that

---

25. One observer expects private credit's market share of corporate lending to double over the next few years, with the gains coming as syndicated lending continues to shrink. *See* Lee, *supra* note 9.

26. *See supra* note 1 and accompanying text.

27. *See infra* Section IV.B.

28. Importantly, the firm in this example would not have equity and debt from the same asset manager. Private equity sponsors do not normally use other funds under the management of the same sponsor to provide loans to their portfolio companies because this would create a conflict of interest.

29. *See infra* Section II.B (reporting information from business development companies' public filings). The additional disclosure may come from smaller companies that would have otherwise borrowed money from traditional banks that report details of their loan books to regulators but not to the public. For example, if borrower *A* borrows money from bank *B*, that information may only be known to the bank, its employees, and regulators. If the loan is secured, which it often is, the lender will also make required state filings to perfect the lien, which would create a public record of the loan. *See generally* Lynn M. LoPucki, Elizabeth Warren, Robert M. Lawless & Pamela Foohey, Secured Transactions: A Systems Approach (2023) (describing the law of secured transactions). To the extent this loan is now made by a private-credit asset manager using a business development company, they will be required to make the public filings reviewed in Section II.B, which would make public, for a subset of borrowers, the identity of their lender, the interest rate, the loan

would have otherwise accessed the public or quasi-public debt markets and made statutorily or contractually required disclosures to dispersed investors or even to the public, information will be shared far less widely and often will evade the eyes of both bank regulators and securities regulators. On the one hand, the lack of scrutiny by regulators, trading markets, rating agencies, and the public may promote economic activity by granting firms extraordinary flexibility in both their operations and their governance. On the other hand, it raises the potential for large-scale misallocation of capital and illiquidity in the long run. In the old equilibrium, the debt of large companies traded actively in the loan and bond markets, providing early signals of when companies were in trouble and giving investors and regulators visibility into challenged companies or industries. Now, many firms and even entire industries will seek capital instead from private credit funds. As a result, only certain asset managers will enjoy the high level of visibility into the economy that was previously more widely shared, making objective valuation by outsiders considerably more difficult.

Third, private credit will have a major impact on corporate insolvency and the process of restructuring corporate debt. The consequences will remain highly uncertain until the market is tested by a major correction. Nonetheless, we advance several hypotheses, based on the idea that private credit represents a tradeoff between (1) the benefits of potentially better monitoring of corporate borrowers and lower debt-renegotiation costs and (2) the costs of greater opacity and greater risk of misvaluation by outsiders.

Our three hypotheses are as follows. First, to the extent that private credit increases the size of the corporate-debt pie (by providing leverage to new borrowers and adding more leverage to existing borrowers), the rise of private credit should produce more episodes of corporate financial distress and insolvency. Second, however, among firms that *are* financially distressed, private credit should lead to fewer bankruptcies. The structure of private credit deals—with fewer lenders at the bargaining table—could solve some of the coordination problems and creditor conflicts that plague workout talks for large firms and require the bankruptcy process for resolution. In addition, some private credit lenders are more willing than traditional banks to take over ownership of distressed firms or their assets. To the extent that private credit replaces traditional banks for smaller loans to middle-market borrowers, therefore, it may offer a new bargaining counterparty that is better able to restructure deals, own assets, and inject new capital when necessary. Third, and counterintuitively, for some subset of corporate borrowers, private credit may *delay* resolution of the

amount and maturity, and the current book value of the debt. For larger firms that would have borrowed in the quasi-public or public debt markets, the information mix is likely to shrink.

firm's financial distress inefficiently. As discussed above, in most cases, private credit should result in *faster* renegotiation and restructuring than public and quasi-public debt by reducing collective-action costs. Unlike investors in public and quasi-public debt, however, private credit lenders sometimes have both the incentive and the ability to avoid taking or marking losses on their loan portfolio, and instead to forbear indefinitely in the hope that the borrower's condition improves. Such incentives raise the risk of so-called "zombie firms" among private credit borrowers. At this stage, we do not know enough to gauge the severity of this risk.

When bankruptcies *do* occur among private credit borrowers, the process of restructuring corporate debt will look very different from the market-based practices that dominated corporate financial distress in the prior world of dispersed and traded debt.[30] Over the course of the 2000s, investors in quasi-public debt embraced specialized roles, ushering in an industry of expert investors who specialized in buying distressed debt and helping firms reorganize.[31] Bankruptcy judges embraced a more passive, procedural role that relied on "market checks" and the presence of sophisticated investors to guide firms through Chapter 11 processes. In a world where debt no longer trades and where information on corporate borrowers is less widely shared, the core assumption that enabled this ecosystem and set of legal procedures to develop will unravel, and the biases and idiosyncrasies of private investment funds (and their sponsors) will dominate the landscape of financial distress. We argue that as markets fade, bankruptcy judges may need to assert a more muscular role in administering bankruptcy law as a safety valve to promote efficient asset reallocation.

This Article explores the reemergence of a new form of relationship-based lending, which promises profound consequences for the future of corporate governance and corporate finance. Before proceeding, however, we briefly review the extant literature on private credit, focusing particularly on the direct lending approach, whereby private credit funds originate and hold loans to companies themselves, rather than simply participating in bank-arranged financing.

Legal scholarship on private credit is surprisingly sparse. Most recently, Narine Lalafaryan directly examined the role of private credit in corporate gov-

30. *See infra* Section IV.C.

31. *See* Wei Jiang, Kai Li & Wei Wang, *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 513-15 (2012).

ernance and corporate finance.[32] She compared private credit to commercial banking along a variety of measures and concluded that private credit can be efficient for firms, notwithstanding potential conflicts with the interests of their equity holders.[33] Cathy Hwang, Yaron Nili, and Jeremy McClane briefly described some of the characteristics of direct loans, based on interviews with finance lawyers.[34] In early and prescient papers, William A. Birdthistle and M. Todd Henderson in 2009 and Andrew F. Tuch in 2017 observed that large private equity firms were increasingly sponsoring private credit funds, and they discussed the associated conflicts of interest.[35] Another strand of the legal literature, including recent work by Patrick M. Corrigan, examines the risks and opportunities of "shadow banking" generally, which under some definitions includes private credit.[36] Christina Parajon Skinner argued in favor of private credit in 2019, on the view that private investment funds can provide a countercyclical source of debt capital for businesses, while reducing some risk to the financial system associated with bank lending.[37]

The financial-economics literature examining private credit funds and their direct-lending investment strategy is more extensive but remains nascent. One strand of this literature focuses on the performance or other characteristics of private credit funds themselves.[38] Some scholars have used private data from

---

32. *See generally* Narine Lalafaryan, *Private Credit: A Renaissance in Corporate Finance*, 24 J. CORP. L. STUD. 41 (2024) (arguing that the growth of private credit has further intertwined outside financial distress, debt, and equity).

33. *See id.* at 45-49.

34. *See* Cathy Hwang, Yaron Nili & Jeremy McClane, *The Lost Promise of Private Ordering*, 109 CORNELL L. REV. 1, 38-42 (2023).

35. *See* William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 45-49 (2009); Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315, 342-45 (2017).

36. *See, e.g.*, Patrick M. Corrigan, *Shining a Light on Shadow Banks*, 49 J. CORP. L. 1, 3-9 (2023); Tobias Adrian, *Shadow Banking and Market Based Finance*, INT'L MONETARY FUND (Sept. 14, 2017), https://www.imf.org/en/News/Articles/2017/09/13/sp091417-shadow-banking-and-market-based-finance [https://perma.cc/MA4Q-937C] (noting that shadow banking "is often thought to comprise private credit intermediation occurring outside the formal banking system"); Leah Downey, *If Shadow Banking Looks Like a Duck . . .* , FIN. TIMES (Feb. 5, 2024), https://www.ft.com/content/f6c1acf3-f100-4952-842d-f5adebb0fb24 [https://perma.cc/9JT7-J9DU] ("The new boom industry of 'private credit' is undeniably one form of [shadow banking].").

37. *See* Christina Parajon Skinner, *Nonbank Credit*, 9 HARV. BUS. L. REV. 149, 152 (2019).

38. *See* Isil Erel, Thomas Flanagan & Michael S. Weisbach, *Risk-Adjusting the Returns to Private Debt Funds* 4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 32278, 2024), https://www.nber.org/system/files/working_papers/w32278/w32278.pdf [https://perma.cc/Q2XW-397F].

the large institutional investors and analytics providers that allocate capital to them,[39] and others have conducted surveys of the asset managers that sponsor them.[40] A second strand focuses on the smaller set of private credit funds that are publicly traded business development companies (BDCs), using these funds' SEC filings to examine their behavior, as we do in Section II.B.[41] A third strand examines the characteristics of the loans extended by private credit funds that adopt a direct lending strategy.[42] A final strand ties the rise of direct lending to regulatory arbitrage around tighter bank regulation.[43]

This Article departs from the extant literature by situating private credit within the broader context of how our capital markets are evolving. Viewed in isolation, private credit can be described simply as an alternative source of financing for borrowers ranging from small middle-market firms all the way to very large firms. As we discuss, the success of private credit likely rests on certain efficiencies gained when corporate debt is funded by a single lender using long-term, locked-in capital from institutional investors, rather than by a bank

---

39. *See* Shawn Munday, Wendy Hu, Tobias True & Jian Zhang, *Performance of Private Credit Funds: A First Look*, 21 J. ALT. INVS., no. 2, 2018, at 31, 31, 36-39.

40. *See* Block et al., *supra* note 13, at 336.

41. *See, e.g.*, Tetiana Davydiuk, Tatyana Marchuk & Samuel Rosen, *Direct Lenders in the U.S. Middle Market*, 162 J. FIN. ECON. art. no. 103946, at 1-2 (2024) [hereinafter Davydiuk et al., *Direct Lenders*]; Tetiana Davydiuk, Tatyana Marchuk & Samuel Rosen, *Market Discipline in the Direct Lending Space*, 37 REV. FIN. STUD. 1190, 1191 (2024) [hereinafter Davydiuk et al., *Market Discipline*]; Sergey Chernenko, Robert Ialenti & David Scharfstein, Bank Capital and the Growth of Private Credit 1, 6-7 (Oct. 28, 2024) (unpublished manuscript), https://www.hbs.edu/ris/Publication%20Files/BDCs_8082ad4f-67b5-4ed1-bfb2-0f1798d5a9a8.pdf [https://perma.cc/SU5W-42G7].

42. *See, e.g.*, Maria Loumioti, Direct Lending: The Determinants, Characteristics and Performance of Direct Loans 1-6 (May 2022) (unpublished manuscript), https://ssrn.com/abstract=3450841 [https://perma.cc/2D6S-5T3Y]; Jang, *supra* note 13, at 1-4; Sergey Chernenko, Isil Erel & Robert Prilmeier, *Why Do Firms Borrow Directly from Nonbanks?*, 35 REV. FIN. STUD. 4902, 4905-06 (2022); Axel Buchner, Florencio Lopez-de-Silanes & Armin Schwienbacher, Private Equity Debt Funds: Who Wins, Who Loses? 6 (May 21, 2022) (unpublished manuscript), https://ssrn.com/abstract=4118522 [https://perma.cc/H9KE-RMRA].

43. *See, e.g.*, Chernenko et al., *supra* note 42, at 4906; Isil Erel & Eduard Inozemtsev, *Evolution of Debt Financing Toward Less-Regulated Financial Intermediaries in the United States* 2 (Fisher Coll. of Bus. Working Paper No. 2022-03-004, 2024), https://ssrn.com/abstract=4151880 [https://perma.cc/M2GL-3VLE]; Laura Fritsch, Wayne Lim, Alexander Montag & Martin C. Schmalz, *Direct Lending: Evidence from European and U.S. Markets*, 24 J. ALT. INVS., no. 3, 2022, at 80, 88-89, 93; Sooji Kim, Matthew C. Plosser & João A.C. Santos, *Macroprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance*, 34 J. FIN. INTERMEDIATION 17, 17 (2018); Greg Buchak, Gregor Matvos, Tomasz Piskorski & Amit Seru, *The Secular Decline of Bank Balance Sheet Lending* 3 (Nat'l Bureau of Econ. Rsch., Working Paper No. 32176, 2024), https://www.nber.org/system/files/working_papers/w32176/w32176.pdf [https://perma.cc/7DVU-QA2U].

using short-term customer deposits or by dispersed, passive creditors in the debt markets.

Viewed within the overall evolution of the capital markets, however, private credit is the final major step in the extraordinary movement of firms and capital out of the public trading markets and into the hands of private investment funds—a trend that began only a few decades ago. As yet, this particular version of the story has no conclusion. We do not know whether private capital will render the public markets largely obsolete, other than for the very largest companies, or whether firms and investors will cycle endlessly between public and private capital as regulation, efficiencies, and pathologies in each market ebb and flow. If private credit does emerge as a clear victor in the long run, perhaps firms will no longer require public disclosure or trading markets to function efficiently, thanks to the genius of the private-investment fund structure. Alternatively, perhaps letting all of corporate finance "go dark" will result in misallocated capital and less productive firms in the long run. It is too early to know. In the meantime, we should keep a close watch on private credit—the final piece of this puzzle.

This Article proceeds as follows. Part I briefly surveys the evolution of corporate debt *prior to* the rise of private credit, whereby relationship lending by banks transformed into syndicated lending.

Part II describes the explosive rise of private credit and presents new data documenting it. A key challenge to understanding the phenomenon is that, by design, private credit funds produce very little public information. To overcome that challenge partially, we have created new machine-reading models to examine evidence from one publicly visible slice of the market: the private credit loans held by publicly traded BDCs. Among other findings, we show that, between 2010 and 2022, the assets deployed by private-credit BDCs have increased by a factor of more than ten, and the number of private credit loans made by those funds grew from 1,395 to 20,182.

Part III considers the potential advantages of private credit relative to the public and quasi-public debt markets, focusing on the three key players in a private credit transaction: the borrower, the debt investors, and the asset manager. Part IV predicts the major consequences of the rise of private credit for corporate governance, corporate information production, and corporate finance. The Article then concludes.

I. A BRIEF (RECENT) HISTORY OF CORPORATE DEBT

After remaining stable in form for decades, if not centuries, the business of corporate lending changed dramatically in the last decade of the twentieth century. This Part describes how, from roughly 1990 to 2010, much of corporate

borrowing went from private to quasi-public, from illiquid to liquid, from relationship-based to market-based, and from bank-originated to dispersed. We begin in Section I.A by describing the traditional bank-dominated world of corporate debt. Then, in Section I.B, we discuss how that world gave way to traded loans and a capital market model for debt in the late twentieth century.

In Section I.C, we analyze the consequences of the shift from relationship lending by banks to quasi-public debt, with a focus on three consequences in particular. First, it allowed a much larger and more diverse group of investors to invest in corporate debt, which transformed corporate governance. Second, the machinery of those debt markets produced a great deal of information about firms and disseminated it among dispersed investors, especially by making trading prices visible. Third, tradable debt reshaped the administration of bankruptcy law.

A. The Traditional Approach: Relationship Lending

Until recently, the story of commercial lending was a story about banks. Businesses that needed capital and chose to borrow money rather than bring on new owners had traditionally looked to banks as their direct or indirect source of funds.[44] Firms come in different sizes, however, and the possible and desirable forms of debt financing for a very large, well-known company and for a small, family-owned business may differ greatly. As a result, debt financing was traditionally bifurcated into two distinct forms. Small private companies could only borrow from banks on a secured basis.[45] By contrast, large public companies could borrow cheaply by issuing unsecured bonds to the general public.[46] These large, public bond issuances were typically underwritten by major investment banks.[47]

In both cases, therefore, banks were at the center of corporate debt: in the first case as the direct source of capital, and in the second as the intermediary between firms and the bondholders who were the source of capital. But few firms ever grow large enough to issue bonds publicly, so the vast majority of debt financing was provided directly by commercial banks under the first mod-

---

44. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 379.

45. *See* William W. Bratton, *Bond and Loan Covenants, Theory and Practice*, 11 CAP. MKTS. L.J. 461, 477-78 (2016).

46. *See* Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 457-59 (1999).

47. *See id.*

el.[48] This approach—whereby a business obtains most or all the debt capital that it needs from a single bank—is often referred to as "relationship lending."[49] For decades, banking regulation and scholarship centered on relationship lending as the paradigm of corporate debt.

As with all methods of financing, relationship lending should be thought of as a financing technology that arose to solve a particular problem: in this case, the problem of risky businesses that needed capital to grow but provided outsiders with little visibility into their business models.[50] Banks could provide the needed capital at an acceptable cost to the business by reducing the lending risk in three main ways: (1) using the bank's expertise in commercial lending to screen and monitor the borrowing firm throughout the life of the loan (to ensure a creditworthy borrower); (2) taking a security interest in the firm's assets (to maximize the chances of recovery if the borrower ended up in financial distress); and (3) imposing tight covenants on the borrowing firm in the loan or credit agreement (to limit moral hazard by the borrower once the loan was extended).[51]

The basic paradigm of commercial banking in turn shaped the basic features of the loan market. By investing substantial time and resources in screening and monitoring a borrower, a bank acquired considerable private information about the borrower's business and creditworthiness, giving the bank sufficient comfort to extend the loan.[52] The knowledge gleaned from the relationship was specific to that company and to that bank, however, and could not be credibly transferred to another lender.[53] As a result, bank loans were traditionally *illiquid*: the bank would hold the loan to maturity, rather than selling some or all of it off to someone else. Bank loans were also at the far "private" end of the spectrum between private and public capital: each loan created a bilateral, bespoke, and often long-term relationship between bank and borrower.[54]

---

48. *See* Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393, 393 (1984).

49. *See* Arnoud W.A. Boot & Anjan V. Thakor, *Moral Hazard and Secured Lending in an Infinitely Repeated Credit Market Game*, 35 INT'L ECON. REV. 899, 913-14 (1994).

50. *See* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 473-74 (1992).

51. *See* Bratton, *supra* note 45, at 463, 470, 474.

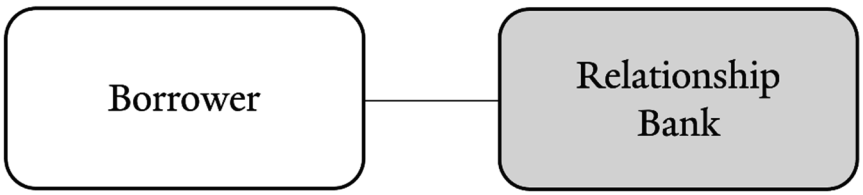
52. *See* Diamond, *supra* note 48, at 393.

53. *See id.* at 398.

54. *Id.* at 393.

In sum, the characteristic features of relationship lending are (1) close interactions and sharing of information between the borrowing company and the bank over a long period of time; (2) secured debt; (3) tight covenants; (4) expert screening and monitoring by the bank; and (5) illiquidity.[55]

FIGURE 1. RELATIONSHIP LENDING



Of course, the dominance of banks in commercial lending presented a tradeoff. Firms and regulators had to weigh the advantages of banks' expertise and bespoke tailoring of lending arrangements against the disadvantages of limited competition, opacity, and illiquidity. During the 1990s, however, the relationship lending model was rapidly replaced by liquid, quasi-public lending markets; the decline of banks and the rise of passive, nonbank lenders; and dispersed ownership. This shift, described in the next Section, is the story of how the relationship lending model that characterized secured borrowing came to be supplanted by something that more closely resembled its opposite, namely public bonds.

B. The Shift to Syndicated Lending and High-Yield Bonds—or "Quasi-Public" Debt

Financial innovation eventually upended the model of relationship lending that had endured for centuries, as the cloistered world of bank-dominated finance gave way to a more market-oriented and less clubby world of corporate debt. Over roughly the last four decades, a large swath of commercial lending has shifted from relationship lending to new debt markets, which came to be referred to as "syndicated lending" (for secured loans) and "high-yield bonds," each of which we explain below. This transition has allowed large sums of capital to be deployed for corporate loans, resulting in a debt market that could accommodate more borrowers and more debt. Most importantly for our purpos-

55. *See* Yener Altunbas, Blaise Gandanecz & Alper Kara, Syndicated Loans: A Hybrid of Relationship Lending and Publicly Traded Debt 100-04 (2006).

es, the transitions we describe in this Section pushed much of corporate borrowing from the private markets to quasi-public markets and toppled banks' monopoly on commercial lending.

Crucial changes to both the supply and the demand for commercial loans drove the shift from relationship lending to debt markets. On the supply side, deregulation blurred the lines between commercial lending and investment banking, and bank capital requirements changed, incentivizing diversification and liquidity in bank portfolios.[56] This pushed banks to develop a lending structure in which they could sell off all or part of the loans that they had originated, as well as buy into loans that others had originated.[57] It also allowed nonbank investors to enter the business of making corporate loans.[58] On the demand side, the explosion of mergers and acquisitions that began with the 1980s buyout boom—much of it driven by the private equity industry—created a need for massive, risky corporate debt that could be arranged relatively quickly and subsequently traded.[59] This demand contributed to two major innovations in corporate debt: the "high-yield" (or "junk") market for bonds and, eventually, syndicated loans for commercial lending.[60]

High-yield bonds are simply notes—most often unsecured—that are issued by highly leveraged borrowers and traded in the capital markets.[61] These borrowers do not retain control over trading in these notes, and the bondholders are passive investors who have no relationship with the borrower.[62] While high-yield bonds innovated in developing a market for the debt of high-risk borrowers, they were not particularly innovative in terms of lending structure, given that they very closely resemble typical public bonds.[63] Syndicated loans,

56. *See* Wilmarth, *supra* note 44, at 379.

57. *See* Katerina Simons, *Why Do Banks Syndicate Loans?*, New Eng. Econ. Rev., Jan.-Feb. 1993, at 45, 45.

58. *See id.* at 45-46.

59. *See* Ulf Axelson, Per Strömberg & Michael S. Weisbach, *Why Are Buyouts Levered? The Financial Structure of Private Equity Funds*, 64 J. Fin. 1549, 1570 (2009) (explaining why private equity funds finance each acquisition of a portfolio company with considerable new debt).

60. *See* Allison A. Taylor & Ruth Yang, *Evolution of the Primary and Secondary Leveraged Loan Markets*, *in* The Handbook of Loan Syndications and Trading 21, 22-23 (Allison Taylor & Alicia Sansone eds., 2007).

61. *See* Glenn Yago, Junk Bonds: How High Yield Securities Restructured Corporate America 20-26 (1991).

62. For more on the history of the high-yield bond market, see *id.*

63. *See* Hendrik Bessembinder & William Maxwell, *Markets: Transparency and the Corporate Bond Market*, 22 J. Econ. Persps. 217, 217-24 (2008).

on the other hand, represented a radical departure from traditional secured debt.[64]

A syndicated loan is funded by a potentially large group of lenders, rather than a single bank.[65] The syndicated loan market grew in tandem with the high-yield bond market but was originally a world in which banks originated loans for other banks.[66] This changed in 1989, when a bank found itself in need of additional participants for a risky loan and began marketing it to insurance companies, and then, even more radically, to *nonbank* institutional investors, such as loan mutual funds and securitization vehicles referred to as collateralized loan obligation (CLO) funds.[67] With syndicated lending, banks shifted from being loan *originators*, where their role is to monitor loans closely until maturity, to loan *underwriters*, where their role is to assemble and coordinate a large group of creditors and sell the loan to them. From the banks' perspective, the shift from relationship lending to syndicated lending is therefore a paradigm shift from "originate-to-hold" to "originate-to-distribute."[68]

64. *See* Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. Corp. L. 725, 727 (2014).

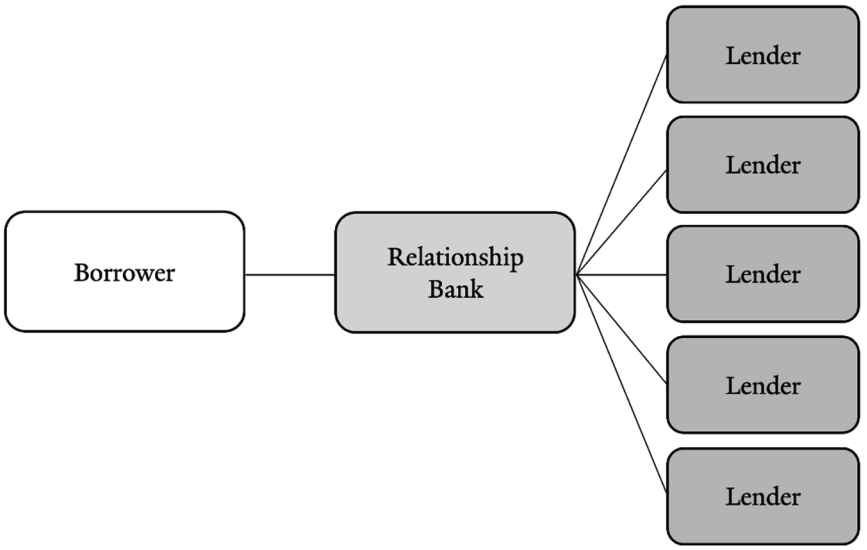
65. *See* Simons, *supra* note 57, at 45.

66. *See* Lee, *supra* note 9.

67. *See id.* (discussing Chemical Bank's need to find participants for a $1.72 billion leveraged buyout loan).

68. *See* Vitaly M. Bord & João A.C. Santos, *The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation*, 18 FRBNY Econ. Pol'y Rev., no. 2, 2012, at 21, 21. One banker who worked in the space at the time of the transition notes: "The old saying was [that banks] weren't [now] in the storage business, they were in the moving business." Lee, *supra* note 9.

FIGURE 2. SYNDICATED LENDING



By the onset of the late-2000s global financial crisis, syndicated lending had grown to be a multitrillion-dollar market, exceeding the bond market as a source of debt finance for large corporations.[69]

The large lender groups characteristic of syndicated lending necessitated fundamental changes to the commercial lending approach. Lenders became relatively more passive investors rather than active monitors.[70] Borrower covenants were loosened (and, in the case of maintenance covenants, largely abandoned) to avoid costly renegotiations of credit agreements.[71] Because these changes occurred during a period of declining and historically low interest rates, they were also accompanied by a surge in borrower bargaining power

69. *See* Seung Jung Lee, Lucy Qian Liu & Viktors Stebunovs, *Risk-Taking and Interest Rates: Evidence from Decades in the Syndicated Loan Market* 33 fig.1 (Int'l Monetary Fund, Working Paper No. 17/16, 2017), https://www.imf.org/-/media/Files/Publications/WP/wp1716.ashx [https://perma.cc/2QA4-ASDN] (showing the syndicated loan market far exceeding the corporate bond market in 2006-2007).

70. *But see* Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1716 (2012) (showing that syndicated lenders take actions that change firm behavior in the wake of covenant defaults).

71. *See* Cem Demiroglu & Christopher M. James, *The Role of Private Equity Group Reputation in LBO Financing*, 96 J. FIN. ECON. 306, 306-09 (2010) (describing the rapid disappearance and loosening of financial covenants in leveraged loans).

and control, a decline in underwriting standards, and a shift from lending against borrower assets to lending against borrower cash flows.[72]

How did these large lending groups of nonbank investors become comfortable lending under this new structure? In effect, syndicated lending succeeded by changing the primary means of reducing lender risk: it substituted liquidity and diversification for the close borrower monitoring and tight covenants that had characterized relationship lending.[73] Because syndicated loans could be traded in a liquid market, lenders could focus less on minimizing credit risk and more on simply ensuring that whatever credit risk a borrower presented was appropriately priced.[74] In any event, the model was wildly successful and took the secured debt markets from a model of private debt into a world of quasi-public debt. The combination of liquidity and large, diverse lending groups lowered the cost of debt capital, all else equal, allowing for more borrowing by more borrowers.[75] Most remarkably, with syndicated lending, the commercial loan market came to resemble its historical opposite, the bond market.[76] In both cases, corporate debt transformed into a liquid financial instrument, creditors became dispersed and passive, and the major banks' involvement was largely limited to assembling the creditor group and reading the markets—a stark departure from relationship lending. In retrospect, therefore, the late 2000s and early 2010s marked the historical high point of traded, dispersed leveraged credit.

C. Effects on Corporate Information and Bankruptcy

The shift from relationship lending to quasi-public debt did not just radically alter corporate finance. By dragging commercial lending into the trading markets and allowing more investors to participate, it had other profound but less discussed impacts on firms and investment. In this Section, we discuss the consequences for (1) the level of information in the markets and (2) corporate distress and insolvency. We focus on these two additional features of dispersed,

---

72. *See* Victoria Ivashina & Boris Vallee, *Weak Credit Covenants* 2 n.2, 9 (Nat'l Bureau of Econ. Rsch., Working Paper No. 27316, 2020), https://www.nber.org/system/files/working_papers/w27316/w27316.pdf [https://perma.cc/BK3T-9B6T].

73. *See* Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. Corp. L. 641, 643 (2009).

74. *See id.* at 662.

75. *See* Victoria Ivashina & David Scharfstein, *Loan Syndication and Credit Cycles*, 100 Am. Econ. Rev. (Papers & Proc.) 57, 57 (2010).

76. *See* Hugh Thomas & Zhiqiang Wang, *The Integration of Bank Syndicated Loan and Junk Bond Markets*, 28 J. Banking & Fin. 299, 300-01, 306 fig.2 (2004).

traded debt because the recent emergence of private credit calls each into question.

1. Corporate Information Production

First, firms that sought to borrow money from the syndicated loan market generated significantly more information and disseminated it more widely than firms borrowing from a single bank. When a loan is expected to be syndicated, an investment bank typically conducts a process to find investors for the loan, which usually means sharing proprietary financial information.[77] The borrower may also need to obtain a credit rating, requiring the borrower to share additional information and the rating agency to produce a rating for public consumption.[78] Additionally, research analysts have incentives to continue studying the company, as investors will trade the debt in an active secondary market even after the firm borrows the money.[79]

The active secondary market in democratized debt produces information in other ways as well. Investors can learn about firms and their prospects by studying the record of trading prices, which also informs how investors think about other companies in the same industry or with similar characteristics.[80] Regulators, too, can observe these price signals and identify sources of risk. Moreover, trading in debt can create spillovers to trading in other securities, as investors use what they learn about the borrower to trade in the equity or debt market.[81]

---

77. *See* Christophe J. Godlewski, Duration of Loan Arrangement and Syndicate Structure 6 (June 2008) (unpublished manuscript), https://ssrn.com/abstract=1152726 [https://perma.cc/4W2L-RLRV] (discussing the syndicated lending "roadshow" process, which involves sharing an "information memorandum").

78. *See* Amir Sufi, *The Real Effects of Debt Certification: Evidence from the Introduction of Bank Loan Ratings*, 22 REV. FIN. STUD. 1659, 1662-63 (2009) (discussing the importance of bank credit ratings for borrowers).

79. *See* Frank J. Fabozzi, Sven Klingler, Pia Mølgaard & Mads Stenbo Nielsen, *Active Loan Trading*, 46 J. FIN. INTERMEDIATION art. no. 100868, at 1, 4 (2021) (describing the bank-loan trading market).

80. For example, observers noted the fall in PG&E's public bond prices as reflecting financial distress. *See* Allison McNeely, Claire Boston & Mark Chediak, *PG&E Gets Second Junk Grade After Moody's Credit Downgrade*, BLOOMBERG (Jan. 10, 2019, 5:36 PM EST), https://www.bloomberg.com/news/articles/2019-01-10/pg-e-gets-second-junk-grade-after-moody-s-downgrades-on-wildfire [https://perma.cc/N6T9-55UJ].

81. *See* Victoria Ivashina & Zheng Sun, *Institutional Stock Trading on Loan Market Information*, 100 J. FIN. ECON. 284, 285 (2011) (discussing trading in the equity market based on information that investors learn in their capacity as lenders).

The debt markets created by the shift from relationship banking to loan syndication and high-yield bonds therefore generate and disseminate considerable information about U.S. companies to investors, the general public, and regulators. These markets cannot truly rival the public securities markets, where corporate disclosure is mandated by law. Nor will the bonds, and especially loans, trade as actively as public equities, making the former markets less informationally efficient than the latter.[82] Nonetheless, we can fairly describe them as "quasi-public" by virtue of their capacity to produce information and to invite broad participation by investors.

2. *Corporate Distress and Bankruptcy*

Perhaps the most important way that democratized debt finance has changed the life cycle of American corporations is through its impact on the process of financial distress. The days when large companies would simply call their relationship bank to discuss their financial troubles are long past. Instead, what has emerged is a market-based process for resolving financial distress.

As a threshold matter, the number of firms encountering financial distress is likely higher now than it was in earlier periods when debt was more precious. As secured debt became tradable and large pools of capital participated in the lending process, credit became more available.[83] In response, firms in certain industries have taken on higher and higher levels of debt, doing so for shareholder returns (that is, boosting risk and return), rather than operational reasons (like temporarily bridging low-cash periods).[84] At the same time, as firms wind up filing for bankruptcy because of investor miscalculations about firms' debt capacity rather than deep failures at the core of their business models, the bankruptcy system has become more central to corporate finance.

Subsequently, when firms fall into financial distress, their tradable, dispersed debt complicates the bargaining environment. Investors and borrowers have devised increasingly intricate capital structures that go far beyond the simple model of a firm with a single bank lender.[85] For example, a highly lever-

---

82. *See generally* M. Konrad Borowicz, *The Mechanisms of Loan Market Efficiency*, 41 Rev. Banking & Fin. L. 195 (2021-2022) (noting the connection between loan market efficiency and the degree to which traders are informed).

83. *See* Ivashina & Scharfstein, *supra* note 75, at 57 ("The process of syndication leads to an expansion of credit because it enables banks to share risk, which lowers their risk threshold for originating a loan.").

84. *See* Axelson et al., *supra* note 59, at 1551.

85. *See, e.g.*, Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 Yale. L.J.F. 363, 363, 366 (2021).

aged borrower may be financed with an elaborate combination of senior secured loans (divided into multiple facilities and multiple tranches, and with liens of different priority on the same collateral) and unsecured high-yield notes (both senior and subordinated). The proliferation and increasing complexity of debt have made resolving a firm's financial distress costly. Complex capital structures with numerous creditors create collective-action problems and conflicting incentives, often leading to fierce intercreditor battles in distressed firms.[86]

Given the complexity of distress, investors who directly fund corporate loans at the origination stage often anticipate selling their claims if the firm falls into financial distress.[87] Accordingly, a new industry of expert distressed investors emerged alongside the syndicated loan market.[88] These experts specialize in buying pieces of distressed loans, aggregating those pieces into larger "positions," and then bargaining with the debtor to achieve investment goals.[89] The rise of expert distressed investors dramatically changed the contours of negotiations when firms fell into financial distress, as they brought a level of aggression and sophistication that was previously uncommon in the more genteel world of money center banks.[90]

Bankruptcy judges have reacted to the entrance of sophisticated and specialized distressed investors by dialing back traditional oversight and relying much more on "market checks."[91] This is an important shift in the administration of bankruptcy law, which relies (as a matter of statutory design) on em-

86. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 692-93 (2010); Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, 8 J. LEGAL ANALYSIS 493, 494-96 (2016); Ayotte & Scully, *supra* note 85, at 373-76; Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 512-13 (2009).

87. *See* Jiang et al., *supra* note 31, at 513.

88. *See* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25 AM. BANKR. INST. J., no. 10, 2006/2007, at 24, 24.

89. *See* Victoria Ivashina, Benjamin Iverson & David C. Smith, *The Ownership and Trading of Debt Claims in Chapter 11 Restructurings*, 119 J. FIN. ECON. 316, 317 (2016) (describing claims trading); Jared A. Ellias, The Law and Economics of Investing in Bankruptcy in the United States 6 (Feb. 10, 2020) (unpublished manuscript), https://ssrn.com/abstract=3578170 [https://perma.cc/49JG-JKNH] (describing the rise of distressed debt investors as part of the ecosystem of corporate finance); Jared A. Ellias, *Bankruptcy Claims Trading*, 15 J. EMPIRICAL LEGAL STUD. 772, 795 (2018) [hereinafter Ellias, *Bankruptcy Claims Trading*].

90. *See* Baird & Rasmussen, *supra* note 86, at 651-53.

91. For a discussion of different strategies investors have developed to break the bankruptcy regulatory paradigm, see generally Kenneth M. Ayotte & Jared A. Ellias, Bankruptcy Teams (Dec. 2024) (unpublished manuscript) (on file with authors).

powered federal judges and the adversarial system to work through questions.[92] Claims trading has allowed activist distressed investors to pioneer tactics like aggressive bankruptcy financing packages, specialized independent directors, and aggressive uses of settlement powers that reduce the bankruptcy judge's role from aggressive oversight to procedural box-checking.[93]

For an example of how judicial oversight has yielded to markets, consider the way bankruptcy law now treats a central question in most cases: how a restructuring should be financed.[94] In recent years, the lenders who fund reorganizations have used the loan contract essentially to dictate the outcome of the case, making both the economic terms of the loan and the contractual requirements extremely important.[95] For example, the drugstore chain Rite Aid filed for bankruptcy in 2023 with a financing package that required the company to explore selling certain assets and closing certain stores.[96] Bankruptcy law would seem to require rigorous judicial oversight of any proposed financing that provides the new lender with a senior claim to prebankruptcy creditors, as nearly all bankruptcy financings do.[97] A debtor is obligated to prove, among other things, that the proposed financing is the best possible loan the company could get and that the interests of the prebankruptcy creditors are protected.[98] The problem, previously recognized by other commentators, is that it is very difficult to obtain the information necessary to satisfy these requirements,

92. *See* Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 653, 662-63 (2019) (describing this statutory structure).

93. *See, e.g.*, Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083, 1089 (2023) (discussing the use of independent directors to shield conflicted transactions from judicial scrutiny).

94. *See* Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. 1, 4-7 (2022); George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 902-04 (1993).

95. *See* Kenneth M. Ayotte & David A. Skeel, *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1585-87 (2013).

96. *See* Debtors' Motion for Entry of Interim and Final Orders (i) Authorizing the Debtors to (a) Obtain Postpetition Financing and (b) Utilize Cash Collateral, (ii) Granting Liens and Superpriority Administrative Expense Claims, (iii) Granting Adequate Protection, (iv) Modifying the Automatic Stay, (v) Scheduling a Final Hearing, and (vi) Granting Related Relief at 18, *In re* Rite Aid Corp., No. 23-18993 (Bankr. D.N.J. Oct. 16, 2023).

97. *See* 11 U.S.C. § 364(d) (2018); Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REGUL. 651, 653 (2020).

98. *See* 11 U.S.C. § 364(d) (2018).

which provides the existing prebankruptcy creditor with near-monopoly power over the opportunity to lend.[99]

Bankruptcy judges have made peace with this problem, in part because they can count on the active market in the claims of Chapter 11 debtors to bring interested investors to the table without the law needing to do very much.[100] There are three reasons for this. First, active trading means that, in theory, investors with the wherewithal to fund a reorganization process or to invest in the company could find a seat at the table by buying claims.[101] Second, by acquiring even a small amount of debt, an interested investor could gain a seat at the table during prebankruptcy talks, which would allow that investor to perform due diligence on the company and consider providing financing.[102] Third, latent competition from other creditors means that the financing that a debtor presents to a bankruptcy judge is reasonably likely to be a good offer, making the approach of the bankruptcy courts—that is, permissive and quick approval of the debtor's proposed financing package—a defensible one, even if not ideal. Brokerage desks at banks therefore play an important role in modern corporate restructuring by creating liquidity in the debt claims of firms prior to any Chapter 11 filing.[103]

In other words, claims trading allowed bankruptcy law to be administered with the assumption that the investors who valued the debtor's business the most highly would have a seat at the table for a restructuring process. Investors who did not want to finance a reorganization would sell their claims to those who did.[104] As a result, a judge could assume that a debtor who arrived in bankruptcy without financing to reorganize was truly hopeless and deserved to liquidate. And a judge could both trust that a proposed financing was commercially reasonable and assume that investors would be in a position to propose restructuring transactions even without the support of the debtor's management team. As such, the move to dispersed, tradable debt has contributed to a

99. *See, e.g.*, B. Espen Eckbo, Kai Li & Wei Wang, *Loans to Chapter 11 Firms: Contract Design, Repayment Risk and Pricing*, 66 J.L. & Econ. 465, 470 (2023).

100. *See generally* Ellias, *Bankruptcy Claims Trading*, *supra* note 89 (arguing that bankruptcy claims trading has a minimal effect on bankruptcy governance).

101. *See generally* Ivashina et al., *supra* note 89 (arguing that claims trading during bankruptcy proceedings influences ownership concentration).

102. *See* Frederick Tung, *Confirmation and Claims Trading*, 90 Nw. U. L. Rev. 1684, 1686 (1996).

103. Empirical research demonstrates that trading tends to increase creditor concentration, and this concentration amplifies the likelihood of liquidity at the end of the restructuring process. *See* Ivashina et al., *supra* note 89, at 317.

104. *See* Baird & Rasmussen, *supra* note 86, at 660 (discussing the mechanics of claims trading).

dramatic shift in the administration of the bankruptcy system and the broader machinery of debt restructuring.

II. THE RISE OF PRIVATE CREDIT

As quick as the transition from relationship lending to quasi-public markets was, the transition back to private debt has been even more rapid, courtesy of the rise of private credit. This Part first defines private credit and describes its basic features in Section II.A. In Section II.B, it presents data on certain private credit loans, providing an indirect glimpse at an asset class known for its lack of data.[105]

A. Overview

Over the 2010s, a small group of large asset managers began to raise massive funds for an investment strategy that is sometimes referred to as "direct lending" but is often described using a broader term that also encompasses other strategies: "private credit."[106] In this Article, we use "private credit" to describe loans to companies that are originated and funded directly by an investment fund, without a bank or any other financial intermediary playing a role in the transaction.[107] A key feature of private credit is that the originating fund typically intends to hold the loan to maturity, such that the loan is not designed with an eye toward trading.[108] In its structure, then, private credit looks virtually identical to relationship lending as depicted in Figure 1, with a private investment fund substituting for the bank.

---

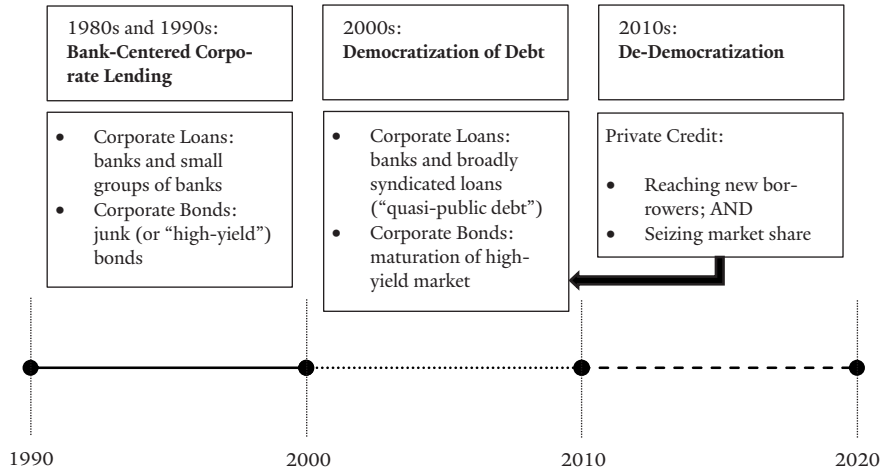
105. *See* IMF, *The Last Mile: Financial Vulnerabilities and Risks*, Global Financial Stability Report 53 (Apr. 2024) (calling attention to the financial stability risks posed by private credit but lamenting that "the data needed to fully analyze these risks are unavailable").

106. *See, e.g.*, Matt Wirz, *The New Kings of Wall Street Aren't Banks. Private Funds Fuel Corporate America.*, WALL ST. J. (Oct. 8, 2023, 9:00 AM ET), https://www.wsj.com/finance/fed-rate-hikes-lending-banks-hedge-funds-896cb20b [https://perma.cc/3BPB-LDAC]; Nicole Melwood & Vincent Kravec, *Private Credit Today*, COMMONFUND (Oct. 31, 2023), https://www.commonfund.org/blog/private-credit-today [https://perma.cc/GLX9-GYEZ].

107. *See* Wirz, *supra* note 106.

108. *See* Melwood & Kravec, *supra* note 106 (asserting that private credit resembles "a 'storage business' not a 'moving business'").

FIGURE 3. RECENT EVOLUTION OF CORPORATE DEBT



To be sure, private credit has existed in some form for several decades. Private investment funds and other nonbank lenders have long engaged in debt investing, including by making loans directly to corporations. For example, mezzanine debt funds—so named because they extend credit that sits between senior debt and equity in terms of risk, or "intermediate" capital—have long extended unsecured loans or issued notes to middle-market companies,[109] while other types of investment funds and private capital vehicles have purchased and held loans or high-yield bonds that were issued to large companies in underwritten offerings.[110]

What distinguishes the contemporary incarnation of private credit is its size and scope.[111] First, private investment funds are making vastly larger loans to

109. Sameer Jain & Phillip Myburgh, *Mezzanine Capital*, *in* ALTERNATIVE INVESTMENTS: INSTRUMENTS, PERFORMANCE, BENCHMARKS, AND STRATEGIES 263, 264-65 (H. Kent Baker & Greg Filbeck eds., 2013).

110. *See Syndicated Loans*, MFA [2] (Oct. 2023), https://www.mfaalts.org/wp-content/uploads/2024/07/MFA_One-Pager_Syndicated-Loans.pdf [https://perma.cc/DQK7-AHWJ]; *High-Yield Bonds: An Issuer's Guide (U.S. Edition)*, MAYER BROWN 20 (2016), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2016/12/high-yield-bonds--an-issuers-guide-us-edition/files/download-guide/fileattachment/mb_high_yields_notes_guide_2016.pdf [https://perma.cc/V82N-X47X].

111. *See* Wirz, *supra* note 106.

companies and reaching far more borrowers than ever before.[112] Accordingly, both the number of private credit funds and their aggregate assets under management have grown exponentially.[113] Second, the scope of these debt investments has changed. In prior decades, private credit might have represented a relatively insignificant share, if any, of a company's debt capital. For example, a private credit fund might have been called in to lend a small amount to a company on a highly subordinated, unsecured basis—the last piece of the debt puzzle after the bulk of the company's debt was put into place by its senior lender, the bank. Today, however, the private credit fund may be the company's primary or even sole lender and may have arranged the company's entire debt capital structure.[114] For this reason, most direct loans by private credit funds today are senior secured loans, which were formerly the sole province of banks.[115] Whereas private credit previously was a complement to bank loans, syndicated loans, or high-yield bonds, it is now a substitute for these sources of funding.

Essentially, a small club of private-credit asset managers raised an extraordinary amount of capital, enabling them to make very large, direct loans to corporations that in some cases have pushed out commercial banks, the syndicated loan market, and the high-yield bond market.[116] While the total number of funds engaged in the industry is high, the small club of "elite" private credit lenders includes names better known for their private equity businesses, such as Apollo (which has raised $268 billion in private-credit investment funds as of October 2023), Ares ($241 billion), Blackstone ($206 billion), and KKR ($78 billion).[117] There are also many smaller funds whose fundraising does not reach the level of the titans but who also play a growing role in corporate credit provision. By some measures, private credit is now a $1.5 trillion industry.[118]

---

112. *See, e.g.*, Lisa Lee, *Record $4.8 Billion Private Loan Refinances Vista's Finastra*, Bloomberg (Aug. 14, 2023, 5:43 AM EDT), https://www.bloomberg.com/news/articles/2023-08-14/vista-nears-record-4-8-billion-private-loan-for-finastra-refi [https://perma.cc/ERD6-UHS2].

113. *See, e.g.*, Peter Madigan, *The Inexorable Rise of Private Credit*, Aerial View (June, 27, 2024), https://bk.bnymellon.com/Aerial-View---Long-Read-The-Inexorable-Rise-of-Private-Credit.html [https://perma.cc/YZN6-7DH6].

114. Matthew P. Kremer, Glen K. Lim & Brian S. Stern, *The Intersection of Private Credit and Restructuring*, O'Melveny (Nov. 7, 2024), https://www.omm.com/insights/alerts-publications/the-intersection-of-private-credit-and-restructuring [https://perma.cc/3UCH-FEBL] ("Typically, in a private credit transaction, the financing comes either from a single direct lender or from a 'club' of lenders.")

115. IMF, *supra* note 105, at 65.

116. *See* Lee, *supra* note 9.

117. *See* Wirz, *supra* note 106.

118. *See* Klein, *supra* note 15.

Although it is impossible to identify with perfect accuracy the size of the industry, many observers believe that the aggregate value of assets under management for private credit strategies is now as large, and perhaps even larger, than the syndicated loan market.[119]

Why this shift began in the 2010s can be explained in large part by the global financial crisis of 2008 and 2009. In its aftermath, banks significantly retreated from originating corporate loans, particularly the riskiest ones.[120] This was due, first, to the comparatively stringent regulatory regime applied to banks.[121] Increased bank regulation in the wake of the global financial crisis chilled lending from regulated banks,[122] providing nonregulated investment firms the opportunity to fill gaps left by banks, especially for midmarket borrowers.[123] While this shift is not solely attributable to regulatory changes, a key driver of growth in private credit has been an attempt by regulators to rein in the risks taken by commercial banks,[124] including by requiring banks to hold additional capital against commercial loans.[125]

Second, banks also retreated from corporate lending because the market began balking at the inherent risks of banks funding long-term loans with short-term customer deposits.[126] By contrast, the asset managers who deploy private credit strategies raise capital from outside investors to fund loans to

---

119. *See, e.g.*, Bill Alpert, *Move Over, Banks. Alternative Asset Giants Plunge into Private Credit.*, BARRON'S (Oct. 29, 2024, 12:49 PM EDT), https://www.barrons.com/articles/banks-alternative-assets-private-credit-of76bdbd [https://perma.cc/SY62-4466].

120. *See* Madigan, *supra* note 113 ("It was the Global Financial Crisis of 2007-2009 that helped accelerate the growth of private credit and the post-crisis regulatory changes that followed.").

121. *See id.*

122. *See, e.g.*, Buchak et al., *supra* note 43.

123. *See* Erel & Inozemtsev, *supra* note 43.

124. *See* Evan Gunter, Abby Latour, Joe Maguire, Patrick Drury Byrne, Marina Lukatsky, Matt Carroll, Elizabeth Campbell, Sebnem Caglayan & Ramki Muthukrishan, *Private Debt: A Lesser-Known Corner of Finance Finds the Spotlight*, S&P GLOB. (Oct. 12, 2021), https://www.spglobal.com/en/research-insights/featured/special-editorial/private-debt [https://perma.cc/E6R8-K97V].

125. *See* Thomas Kennedy, Chris Seter, Jay Serpe & Rachel Cascio, *Can Private Credit Continue to Perform?*, J.P. MORGAN PRIV. BANK (Sept. 12, 2023), https://privatebank.jpmorgan.com/nam/en/insights/markets-and-investing/ideas-and-insights/can-private-credit-continue-to-perform [https://perma.cc/38AH-846G].

126. *See generally* MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2016) (explaining the inherent risks associated with banks funding long-term loans with short-term obligations such as customer deposits and commercial paper).

companies.[127] Like other private funds (e.g., private equity funds and venture capital funds), private credit funds receive a large proportion of their capital

127. *See* Kat Hidalgo, *Why Private Credit Is Booming and Banks Are Fighting Back*, Bloomberg (July 12, 2024, 9:44 AM EDT), https://www.bloomberg.com/news/articles/2024-02-20/what-is-private-credit-how-does-it-work-and-what-are-the-risks [https://perma.cc/YA52-D7MW]. We can generalize the structure of these investment vehicles as following one of two standard forms. First, the traditional model is to put money in locked-up "drawdown" vehicles with limited liquidity and fixed redemption times. *See* Andrew Snyder, Linge Sun & Nicholas Reade, *The Potential Trade-Offs of Private Market Fund Structures: Part One*, CAIS (Apr. 6, 2023), https://www.caisgroup.com/articles/the-potential-tradeoffs-of-evergreen-fund-structures [https://perma.cc/V4NE-65E3]. In this fund structure, investors—known as "limited partners"—make a commitment to fund investments for a set number of years. *Id.* As the asset managers—known as "general partners"—make investments, they "draw down" the capital—hence the name. *See id.* At the end of the investment period, the general partners sell the assets and return the capital to the limited partners. *See id.* A new type of fund structure also plays an important role in the private credit world: the so-called business development company (BDC). *Id.* BDCs are "evergreen" vehicles that have no fixed life. *Id.* They raise equity commitments from limited partners and make investments with this money. *See id.* Limited partners can redeem their investments by selling the equity to another investor or by selling the equity back to the BDC. *See id.* Returns are distributed to limited partners in the form of dividends based on owning equity in the BDC. *See id.* Just as public companies do not need to worry about investors pulling their capital at a fixed date, general partners in a BDC do not need to worry about limited partners pulling their money. *See id.* As a result, BDCs are particularly attractive fund structures for private credit strategies, where the asset manager intends to operate a lending business with no fixed time horizon. *See id.* BDCs have become particularly prominent after a 2018 spending bill increased BDCs' ability to invest with borrowed money. *See* Cindy Ma, Timothy Kang & Chris Cessna, *Direct Lending Update–The Evolving BDC Environment Under 2:1 Leverage*, Houlihan Lokey 1 (Oct. 22, 2018), https://cdn.hl.com/pdf/2018/direct-lending-update-2018.pdf [https://perma.cc/ULA6-E626]. As of today, there are two primary types of BDCs. *See An Introduction to Business Development Companies*, CAIS (Aug. 22, 2023), https://www.caisgroup.com/articles/an-introduction-to-business-development-companies [https://perma.cc/5A6H-J85L]. The first are publicly traded BDCs, closed-end funds that raise equity and provide debt financing to corporations. *See id.* For example, Ares Capital Corporation trades on the NASDAQ and, as of September 30, 2024, has a market capitalization of $13.53 billion. *Ares Capital Corporation (ARCC): Valuation Measures*, Yahoo! Finance, https://finance.yahoo.com/quote/ARCC/key-statistics [https://perma.cc/KGV8-JTHA]. In recent years, asset managers have also utilized a nontraded BDC structure, the most famous of which is Blackstone Private Credit Fund (BCRED), which manages approximately $54 billion. *See Blackstone Private Credit Fund (BCRED)*, Blackstone (Nov. 30, 2023), https://www.bcred.com/wp-content/uploads/sites/11/blackstone-secure/BCRED-Fact-Card.pdf [https://perma.cc/THN7-FYVU]. Nontraded BDCs get capital from institutional investors and high-net-worth individuals. *See* Hidalgo, *supra*. A key advantage of this structure is that general partners are not exposed to share-price volatility risk; therefore, they can raise new equity on terms they choose rather than what public markets decide. *See* Robin Blumenthal, Andy Thomson & Christopher Faille, *How Well Are BDCs Navigating the Challenges?*, Priv. Debt Inv. (Mar. 1, 2023), https://www.privatedebtinvestor.com/how-well-are-bdcs-navigating-the-challenges [https://perma.cc/2GGD-SHLF]. Investors may be

from institutional investors, such as pension funds, endowments, foundations, and sovereign wealth funds.[128] For example, in 2022, a $2.35 billion Apollo direct lending fund received a $150 million investment from the Indiana Public Retirement System and a $100 million investment from the Ohio School Employees Retirement System.[129] In another example, a $1.2 billion Blue Owl direct lending fund received a $275 million investment from the Regents of the University of California.[130] Yet unlike private equity and venture capital funds, private credit funds can also have as major investors financial institutions—such as banks and insurance companies—that are restricted by regulation from owning equity in companies but are allowed to own corporate debt.[131] Pension funds, insurance companies, and other institutional investors that invest their capital in private credit funds have long-term horizons and so are typically content to make illiquid investments for long periods of time.[132] Private credit funds therefore "lock in" their investors' capital for years.[133] This "closed-end" fund structure with no redemption rights for investors was a natural fit for making medium- to long-term corporate loans in banks' stead.[134]

worse off in this structure, however, as they lose the benefit of easy liquidity and trading. Rather than trading their equity stakes on the secondary market, they must redeem their stakes during fixed windows dictated by the BDC. *See Blackstone's Credit Fund Reaches Withdrawal Limit*, REUTERS (Dec. 6, 2022, 8:12 PM), https://www.reuters.com/business/finance/blackstones-credit-fund-reaches-withdrawal-limit-2022-12-07 [https://perma.cc/UH33-G52X].

128. *See* Hidalgo, *supra* note 127. Interestingly, asset managers are also working to increase the proportion of capital they raise from retail investors. *See* Sujeet Indap, *Apollo Defends Push to Retail Investors Amid Blackstone Storm*, FIN. TIMES (Dec. 13, 2022), https://www.ft.com/content/2084e80d-8bac-4c3a-89d5-0c3eace67e32 [https://perma.cc/KZ8P-FW5Q].

129. *See Apollo Origination Partnership Fund I*, PITCHBOOK, https://my.pitchbook.com/profile/22145-32F/fund/profile [https://perma.cc/QE89-SDCH].

130. *See Blue Owl First Lien Fund*, PITCHBOOK, https://my.pitchbook.com/profile/16674-85F/fund/profile [https://perma.cc/L3DG-6AEC].

131. *See, e.g.*, *Private Credit—A Rising Asset Class Explained*, FLOW (Oct. 9, 2024), https://flow.db.com/trust-and-agency-services/private-credit-a-rising-asset-class-explained [https://perma.cc/XLH7-RCCF]; CONG. RSCH. SERV., IF12642, PRIVATE CREDIT: TRENDS AND POLICY ISSUES 1 (2024).

132. CONG. RSCH. SERV., *supra* note 131, at 1, 2.

133. Albane Poulin, *Private Credit: The Pros and Cons of Different Investment Structures*, GRAVIS (Aug. 19, 2024), https://www.graviscapital.com/news/private-credit-the-pros-and-cons-of-different-investment-structures [https://perma.cc/HJ2L-RCR3].

134. *See id.*

In a prototypical private credit loan, the corporation's ability to borrow is constrained by the lender's appraisal of the firm and its future prospects.[135] For example, consider a company that a lender believes is worth $80 based on the company's ability to earn money in the future.[136] Most private credit lenders may have an informal rule of lending only against a percentage of the value of that company—referred to as the "loan-to-value ratio"—of perhaps 50%.[137] Thus, this company could borrow $40 from a private credit lender, and the loan would typically require the borrower to pledge a first lien on substantially all of its assets to the lender, providing the lender with the first claim on the firm in the event of a bankruptcy.[138] The private credit lender would make this loan hoping that, if something went wrong, the firm could be sold as a going concern. While comprehensive evidence on this point is hard to identify, it appears that a key aspect of private credit is making a "deeper loan"—a loan that has a higher loan-to-value ratio than traditional first-lien secured credit and is therefore riskier.[139] In a sense, private credit lending combines aspects of the traditional commercial banking products of "first-lien loans" and mezzanine finance, where mezzanine lenders traditionally extended credit that came at a high interest cost and sat just above equity in the capital structure.[140]

---

135. Lenders typically appraise companies using various methodologies that allow the lender to guess how much the firm would be worth if it was sold as an operating asset. *See generally* Tim Koller, Marc Goedhart & David Wessels, Valuation: Measuring and Managing the Value of Companies (5th ed. 2010) (discussing value creation and elaborating different valuation methods). While some firms are valued based on their liquidation value, most companies are appraised based on an educated guess about how much money the firm will generate using its assets. *See* Kenneth Ayotte & Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 166 U. Pa. L. Rev. 1819, 1825-30 (2018) (discussing methods of appraising large companies).

136. *See id.*

137. David Scigliuzzo & Michelle F. Davis, *Blackstone-Led Group Provides $5 Billion of Debt for Zendesk*, Bloomberg (June 24, 2022, 7:36 PM EDT), https://www.bloomberg.com/news/articles/2022-06-24/blackstone-led-group-provides-5-billion-of-debt-for-zendesk [https://perma.cc/D829-MAH2].

138. *See generally* Scott, *supra* note 8 (discussing the benefit of secured lending for the lender).

139. For private credit lenders, this loan product is called a "unitranche" loan. *See* Mark Vernallis, *Your Guide for Understanding Mezzazine [sic] and Unitranche Debt*, FocusCFO (Jan. 2020), https://www.focuscfo.com/blog/mezzazine-and-unitranche-debt-explained [https://perma.cc/RR7V-TKF5].

140. *See id.*

Another key aspect of the private-credit direct lending strategy is fund-level debt, which industry participants call "back leverage."[141] Direct-lending investment vehicles can raise additional debt at the fund level alongside their equity. Because this debt is raised at the fund level, asset managers can borrow at investment-grade levels and then deploy their capital at a much higher return.[142] For example, as of September 30, 2023, Ares Capital Corporation had $11.5 billion in fund-level debt against $21.9 billion in loans outstanding.[143] This borrowing is supported by equity with a book value of about $10.8 billion,[144] which is mostly raised from institutional investors.[145] In effect, by borrowing at the fund level, private-credit asset managers are able to take investment-grade loans and deploy them into relatively illiquid and riskier situations and earn the difference between the cost of investment-grade credit and speculative illiquid debt.[146] Thus, to some extent, banks have not disappeared from corporate lending entirely in a private credit structure; rather, they have shifted away from their traditional business of lending to companies, in favor of lending to the private credit funds that now in turn lend to companies. This structure may offer banks a risk profile preferable to making loans themselves, as they can take portfolio risk and lend against a basket of assets as opposed to a single company's assets. As such, loans to private credit funds offer relatively low administrative costs for banks seeking to diversify their credit exposure.

141. *NXT Capital: Under the Hood of Fund-Level Leverage*, PRIV. DEBT INV. (Sept. 2, 2019), https://www.privatedebtinvestor.com/nxt-capital-hood-fund-level-leverage [https://perma.cc/JXK5-GFSG].

142. *See* Eric Platt, *Blackstone Borrows to Boost Lending Power of $52bn Credit Fund*, FIN. TIMES (Nov. 16, 2023), https://www.ft.com/content/32dbf11f-0254-496c-8c77-c813987febeb [https://perma.cc/L6P9-FG8A].

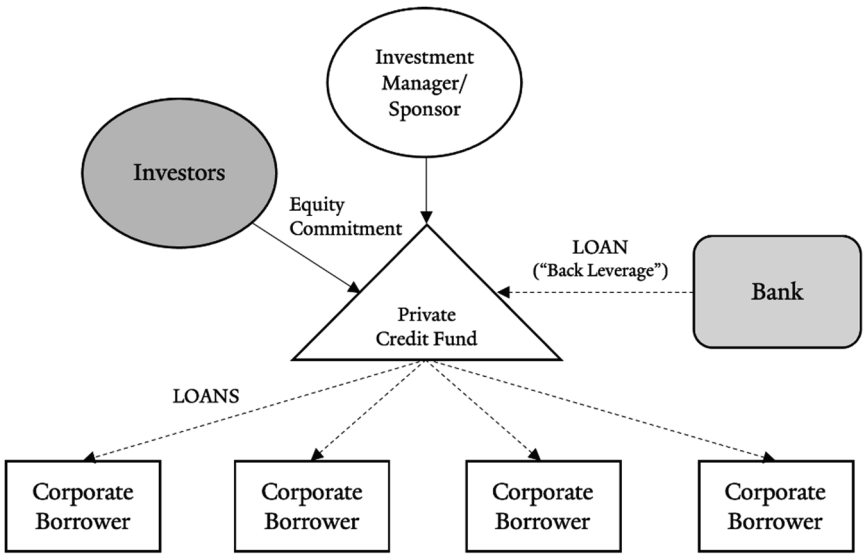
143. *Ares Capital Corporation Announces September 30, 2023 Financial Results and Declares Fourth Quarter 2023 Dividend of $0.48 Per Share*, BUS. WIRE (Oct. 24, 2023, 7:00 AM EDT), https://www.businesswire.com/news/home/20231023501381/en [https://perma.cc/8DMG-F62Z].

144. *Id.*

145. *See* Block et al., *supra* note 13, at 344, 347 fig.4 (finding that institutional investors are the largest investors in private credit funds).

146. *See How Debt Fund Managers Can Make Back Leverage Work Amid Volatility*, REAL EST. CAP. EUR. (Feb. 15, 2023), https://www.recapitalnews.com/how-debt-fund-managers-can-make-back-leverage-work-amid-volatility [https://perma.cc/8C88-SXXM].

FIGURE 4. STRUCTURE OF A PRIVATE CREDIT FUND



Over the years, direct lending has grown from highly bespoke opportunistic financing chiefly for middle-market borrowers into a new way to finance massive corporate transactions.[147] For example, in July 2021, Blackstone Credit committed $1.8 billion of a $2 billion first-lien term loan used for a shareholder dividend of a large education-software business.[148] As the size of the checks has grown, the market is gradually transitioning to feature more "club deals," transactions where multiple private-credit asset managers join together to make a bigger loan than would otherwise be possible.[149] For example, in 2023, Vista Equity, a private equity sponsor, arranged a direct loan of $4.8 billion

147. *See Large Private Credit Transactions Are on the Rise with Blackstone at the Forefront of the Trend*, BLACKSTONE 1 (2021), https://www.bcred.com/wp-content/uploads/sites/11/2021/09/Trend-Towards-Large-Private-Financings.pdf [https://perma.cc/PW8Y-KR96].

148. *Portfolio*, BLACKSTONE (2024), https://www.bcred.com/portfolio [https://perma.cc/7H7T-KYZ9] (discussing the Cambium transaction).

149. *See* Lisa Lee & John Sage, *Private Credit Loans Are Growing Bigger and Breaking Records*, BLOOMBERG (Aug. 17, 2023, 2:43 PM EDT), https://www.bloomberg.com/news/articles/2023-08-17/private-credit-loans-are-growing-bigger-and-breaking-records [https://perma.cc/888P-77SC] (providing figures on financing raised for the refinancing of a broadly syndicated loan to Finastra Group Holdings).

from four different lenders to fund the acquisition of a financial services company.[150]

When discussing private credit, this Article mostly envisions the prototypical case of a closed-end, private investment fund that directly originates loans to companies and holds them to maturity. Yet we acknowledge the folly of generalizing about private credit, as the reality is far messier, and private credit itself is changing so rapidly. As this Article goes to print, we note five significant trends that may alter the future of the industry.

The first is the proliferation of smaller funds as new entrants move into the field.[151] While the same alternative asset managers that sponsor private equity funds extend the majority of private credit lending, a number of traditional asset managers and financial institutions have launched direct lending funds to move into the space, underscoring the increasing centrality of private credit to corporate finance.[152] For example, Allianz, an insurance company, has launched a $1.6 billion direct lending fund.[153] Wells Fargo has partnered with Centerbridge, a private equity fund known for distressed investing, to launch a $5 billion direct lending fund.[154] In January 2023, JP Morgan announced a $10 billion direct lending fund.[155]

Second, at the same time as the number of smaller funds is increasing, the largest funds are growing and becoming capable of making extraordinarily large loans.[156] For example, Apollo's private credit business increased from $75 billion in 2018 to $268 billion in October 2023.[157] In the same period, Ares's

150. *See id.*

151. *See* Huw van Steenis, *Private Credit Boom Will Trigger a New Squeeze*, FIN. TIMES (Nov. 28, 2023), https://www.ft.com/content/b8e151c7-7302-4464-bc49-5091df86ec40 [https://perma.cc/63N4-X4RX].

152. *See id.*

153. *See* Pablo Mayo Cerquerio, *Allianz Bolsters Private Credit Bet with New $1.6 Bln Fund*, REUTERS (Aug. 18, 2023, 12:38 PM EDT), https://www.reuters.com/business/finance/allianz-bolsters-private-credit-bet-with-new-16-bln-fund-2023-08-18 [https://perma.cc/U7SB-RBUN].

154. *See* Matt Tracy & David French, *Wells Fargo Teams with PE Firm Centerbridge for $5 Bln Lending Fund*, REUTERS (Sept. 26, 2023, 10:36 PM EDT), https://www.reuters.com/business/finance/centerbridge-teams-up-with-wells-fargo-launch-direct-lending-fund-2023-09-26 [https://perma.cc/5ENA-RERA].

155. *See JPMorgan Begins Private Lending Drive with $10 Billion – Source*, REUTERS (Jan. 19, 2023, 12:25 AM EST), https://www.reuters.com/business/finance/jpmorgan-begins-private-lending-drive-with-10-billion-source-2023-01-19 [https://perma.cc/ZB9J-PT9U].

156. *See* Wirz, *supra* note 106.

157. *See id.*

private credit grew from $75 billion to $241 billion, and Blackstone's private credit grew from $64 billion to $206 billion.[158]

Third, at least some portion of the industry appears to be converging with practices more familiar in syndicated lending. Some investment banks are considering building trading businesses to promote liquidity in private credit loans.[159] To support this effort, Moody's, a major rating agency, plans to open a private-credit rating desk.[160] Finally, a commercial loan originated by a single private credit fund may occasionally be refinanced in the quasi-public markets by a broad syndicate of lenders, depending on conditions in each market. To the extent these efforts are successful, they will erode some of the key features distinguishing private credit from syndicated finance.

Fourth, and similarly, syndicated lending appears to be winning back at least some of the market share it had been losing to private credit, suggesting that the two forms of debt finance may be headed for a future of competition, coexistence, and perhaps convergence.[161] Opinions on the future of this competition vary widely, with some attorneys skeptical that private-credit asset managers will cede much ground.[162]

Fifth, although the private credit industry benefits from the light-touch regulation that applies to investment funds offered only to institutional investors and high-net-worth individuals, it continues to push for greater access for retail investors[163] (especially through BDCs, as discussed below). This could prompt more regulation in the long run. In their pursuit of retail investors, private credit sponsors are even devising open-ended fund structures, thereby re-

158. *See id.*

159. *See* Lisa Lee & Paula Seligson, *JPMorgan, Goldman Plan to Start Trading Private Credit Loans*, Bloomberg (Mar. 29, 2023, 10:51 AM EDT), https://www.bloomberg.com/news/articles/2023-03-29/jpmorgan-goldman-plan-to-start-trading-private-credit-loans [https://perma.cc/YC2T-FY67].

160. *See* Tatiana Bautzer, *Moody's Creates Private Credit Rating and Research Group*, Reuters (Nov. 6, 2023, 8:32 AM EST), https://www.reuters.com/markets/moodys-creates-private-credit-rating-research-group-2023-11-06 [https://perma.cc/MT2H-5BMH].

161. *See* Telis Demos, *Banks Strike Back Against Private Credit,* Wall St. J. (Apr. 10, 2024, 6:30 AM ET), https://www.wsj.com/finance/banking/banks-strike-back-against-private-credit-47de92eb [https://perma.cc/4PRC-TZB7].

162. *See* Dan Roe, *How to Win at Restructuring in the Gilded Age of Private Credit*, N.J. L.J. (Aug. 19, 2024, 10:00 AM), https://www.law.com/njlawjournal/2024/08/19/how-to-win-at-restructuring-in-the-gilded-age-of-private-credit [https://perma.cc/NF7Y-N6LK].

163. Matt Wirz, *First Private-Credit ETFs Launch*, Wall St. J. (Dec. 3, 2024), https://www.wsj.com/livecoverage/stock-market-today-dow-sp500-nasdaq-live-12-03-2024/card/first-private-credit-etfs-launch-s0032D60wa2zgI2uy7pY [https://perma.cc/QRP6-96NC].

introducing some of the financial stability concerns that existed with bank loans.[164]

To summarize, private-credit asset managers are transforming the landscape for corporate debt, taking market share from commercial banks and the syndicated lending and high-yield bond markets, while also reaching new borrowers that these traditional intermediaries viewed as too risky.[165] Private credit is split into two market segments: (1) an elite club comprised of a dozen or so massive asset managers who play an increasingly critical role in corporate finance, and (2) a much larger number of smaller funds that are nonetheless able to make significant loans. Before the late-2000s financial crisis, these asset managers were far less important—their role was mostly to raise capital from institutional investors and put it to work in syndicated loans originated by traditional banks.[166]

B. Data

As we will discuss further in Part IV, a defining feature of private credit—bemoaned by market participants, regulators, and the financial media alike—is the near-total absence of truly reliable and comprehensive data, both for the market in the aggregate and for the individual loans made by private credit funds.

In this Section, we employ an indirect method of gathering descriptive data for one portion of this elusive asset class. Specifically, we extract and analyze data from the public Securities and Exchange Commission (SEC) filings of BDCs. BDCs are investment funds that are intended to lend primarily to "small, developing, financially troubled and middle market companies."[167] Unlike private investment funds, public BDCs may take on retail investors, but they face mandatory-disclosure obligations under the Investment Company Act of 1940.[168] A small portion of the money that private-credit asset managers deploy to make loans is raised in the form of BDCs. BDCs are required to file cer-

164. *See* Brooke Masters, Eric Platt & Will Schmitt, *Apollo and State Street Join Forces on Public-Private Credit Fund*, FIN. TIMES (Sept. 10, 2024), https://www.ft.com/content/bc73a9f2-7603-4094-8f3e-7710928e044c [https://perma.cc/CZ9K-4LYY].

165. *See* Wirz, *supra* note 106.

166. *See id.*

167. Jennifer Daly, Sheel Patel, Jack Fitzpatrick & Zachary Strother, *Business Development Companies* (Westlaw Practical Law, Practice Note 9-584-8625).

168. *See* Tess Virmani, *The ABCs of BDCs: A Primer on the PC Market's SEC-Registered Funds—Part 2*, LSTA (Apr. 25, 2024), https://www.lsta.org/news-resources/the-abcs-of-bdcs-a-primer-on-the-pc-markets-sec-registered-funds-part-2 [https://perma.cc/4CZD-9HVK].

tain information each quarter, such as their balance sheets and a summary of their investments; for BDCs that deploy direct lending, this means a list of borrowers and basic information about the loan.[169] We use these filings to learn more about the otherwise-opaque world of private credit.[170]

Two important qualifications are necessary before proceeding. First, as BDCs are only a small part of the private credit world,[171] the story that these filings reveal may not fully represent the universe of all private credit. Second, as BDCs file information in similar, but not identical, formats, we were not able to recover information from all the BDC regulatory filings, which means that we have missing data. We deployed machine-reading algorithms that extracted some, but not all, of the information the BDCs provide to SEC. Nonetheless, the study offers significant insight into the world of private credit and how it has changed over time.

We began by assembling a sample of documents filed by registered BDCs with SEC. We downloaded documents filed between 2006 and mid-2023 and extracted information from SEC files of the 335 BDCs flagged in our initial search that had accessible documents.[172]

---

169. *See* Evan M. Gunter, *Credit Trends: Business Development Companies' Assets Provide a Glimpse into the Private Credit Market*, S&P Glob. (Oct. 2, 2023, 6:10 PM), https://www.spglobal.com/ratings/en/research/articles/231002-credit-trends-business-development-companies-assets-provide-a-glimpse-into-the-private-credit-market-12865113 [https://perma.cc/CG2B-M9GP].

170. For excellent recent scholarship in financial economics that employs a similar strategy, see generally Davydiuk et al., *Direct Lenders*, *supra* note 41, which uses firm-level data to document how BDC funding affects employment growth and patenting activity; Davydiuk et al., *Market Discipline*, *supra* note 41, which uses a hand-collected database of BDC investments to model employment growth; and Chernenko et al., *supra* note 41, which uses financial statements, portfolio holdings, and instrument-level financing data from BDCs to analyze the role of banks in financing private credit funds and explain why there has been an increase in bank lending to nonbank financial intermediaries.

171. S&P estimates that about ten percent of the private credit assets under management of approximately $1.5 trillion are invested in BDCs. *See* Gunter, *supra* note 169.

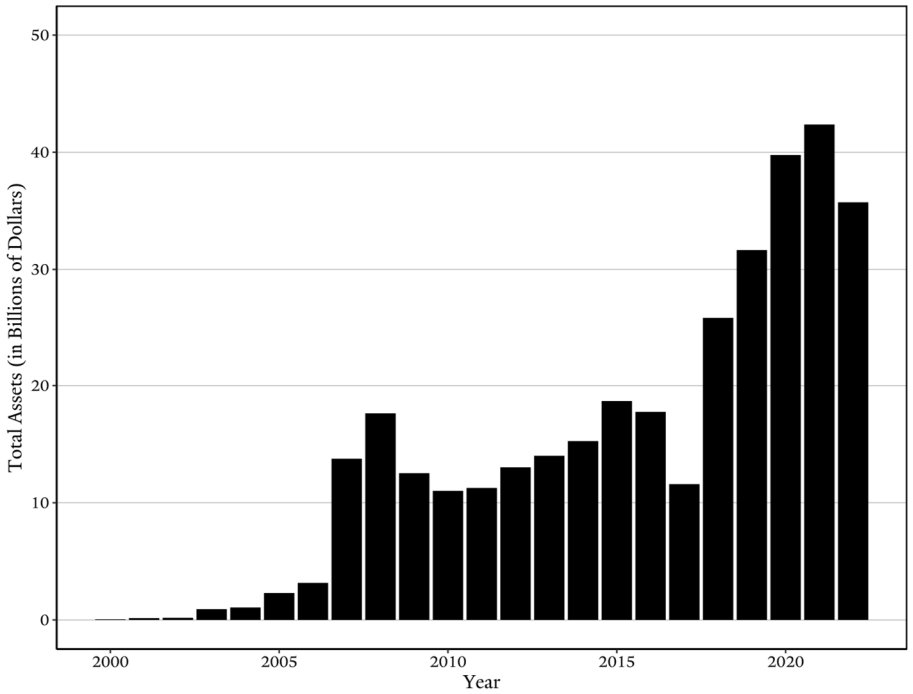
172. We took multiple approaches to identify BDCs and downloaded all their filings for analysis. First, in May 2023, we searched all SEC files for Forms N-6F and N-54A, which SEC uses to identify BDCs. *See Business Development Company Report*, U.S. Sec. & Exch. Comm'n, https://www.sec.gov/open/datasets-bdc [https://perma.cc/L2J6-ZAAS]. This yielded an initial sample of 390 firms with filings between April 1, 1996 and May 5, 2023. We supplemented this initial, machine-identified list with a list of BDCs issued by SEC, which is available on SEC's website. *See id.* Doing so increased the sample size to 396. We then supplemented this list with a financial data provider's list of public BDCs, dated as of July 8, 2019. *See* Sourav Srimal, *Full List of Public Business Development Companies (BDC)*, AdvantageData (July 8, 2019, 10:45 AM), https://think.advantagedata.com/full-bdc-list-public [https://perma.cc/EAT6-S8TP]. This did not increase the sample size. We supplemented

Our sample consisted of 1,471 annual reports and 209 quarterly reports filed by these funds. From an initial corpus of 7,335 quarterly and annual reports, we first selected the annual reports and discarded any overlapping quarterly reports. In the absence of an annual filing from a fund in a specific year, we selected the quarterly report from the year that was most recently filed. We searched each filing for balance-sheet information and the schedule of investments that many of the private credit funds presented, which described (in varying levels of detail) their investment portfolio. From those files, we machine-read information from 1,680 of 2,062 total reports (81% of them). Our machine-reading efforts produced 1,639 balance sheets and 835 schedules of investments.

We report four trends evident from aggregating the public filings. First, as Figure 5 shows, the total assets of the BDCs that engage in direct lending strategies have increased dramatically over the past fifteen years.

again with the list of BDCs in the S&P BDC index. *See S&P BDC Index*, S&P GLOB., https://www.spglobal.com/spdji/en/indices/equity/sp-bdc-index/#overview [https://perma.cc/SM9Q-GM38]. This yielded a final sample of 400. For 54 of the 400, we could not obtain any Form 10-Qs or 10-Ks from their online SEC files. All replication materials are available at the *Yale Law Journal*'s Dataverse at the following link: https://dataverse.harvard.edu/dataset.xhtml?persistentId=doi.org/10.7910/DVN/DWEWBG.

FIGURE 5. TOTAL REPORTED ASSETS FOR BDCS EXECUTING PRIVATE-CREDIT INVESTMENT STRATEGIES, BY CALENDAR YEAR[173]

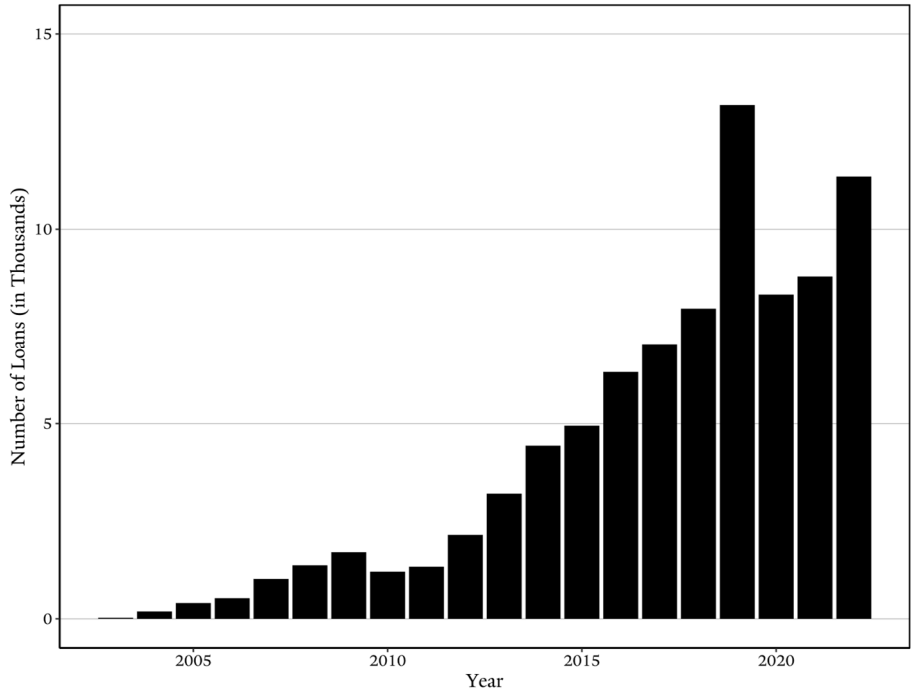


Second, the filings also revealed significant growth in the number of loans outstanding in each calendar year, consistent with press reports about the increasing market share of private-credit asset managers in corporate loans.[174] As Figure 6 shows, we observe 4,434 loans outstanding in 2014 and 11,350 in 2022, a nearly threefold increase across nine years.

173. Figure 5 shows the total assets under management for BDCs that report investments in corporate loans, by calendar year. These numbers were drawn from 1,471 filings from 335 issuers over the sample period.

174. *See, e.g.*, Fang Cai & Sharjil Haque, *Private Credit: Characteristics and Risks*, FEDS NOTES (Feb. 26, 2024), https://www.federalreserve.gov/econres/notes/feds-notes/private-credit-characteristics-and-risks-20240223.html [https://perma.cc/G35S-GAH3].

FIGURE 6. NUMBER OF LOANS OUTSTANDING, BY CALENDAR YEAR[175]

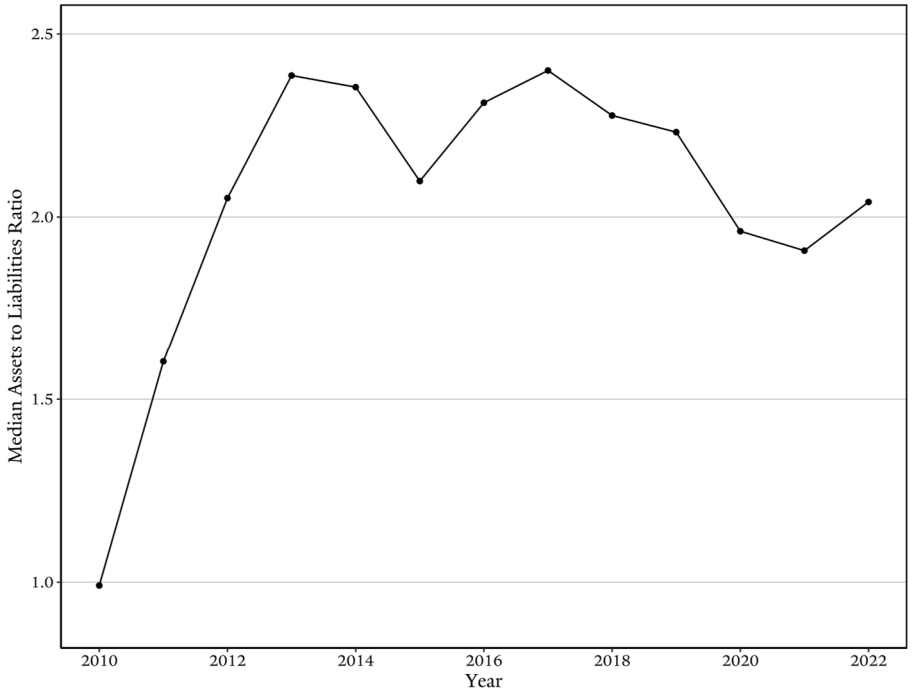


Third, as Figure 7 shows, for the 1,674 private-credit asset managers that use debt, the ratio of assets to liabilities over the sample period has remained at approximately three to one, suggesting that 25% or so of the capital invested in private credit lending is borrowed money at the fund level, which industry participants call "back leverage."[176] Importantly, for the 1,626 fund years in the sample, 415 (or 25% of the fund years in the sample) had no or minimal fund-level liabilities (defined as less than 1% of the total amount of assets). Fifty-six issuers (out of 170) had minimal fund-level liabilities in any year observed in the sample period.

175. Figure 6 shows the number of loans outstanding in 1,253 annual and quarterly reports filed by 170 SEC-registered BDCs over the sample period, aggregated at the calendar-year level.

176. *See supra* note 141 and accompanying text.

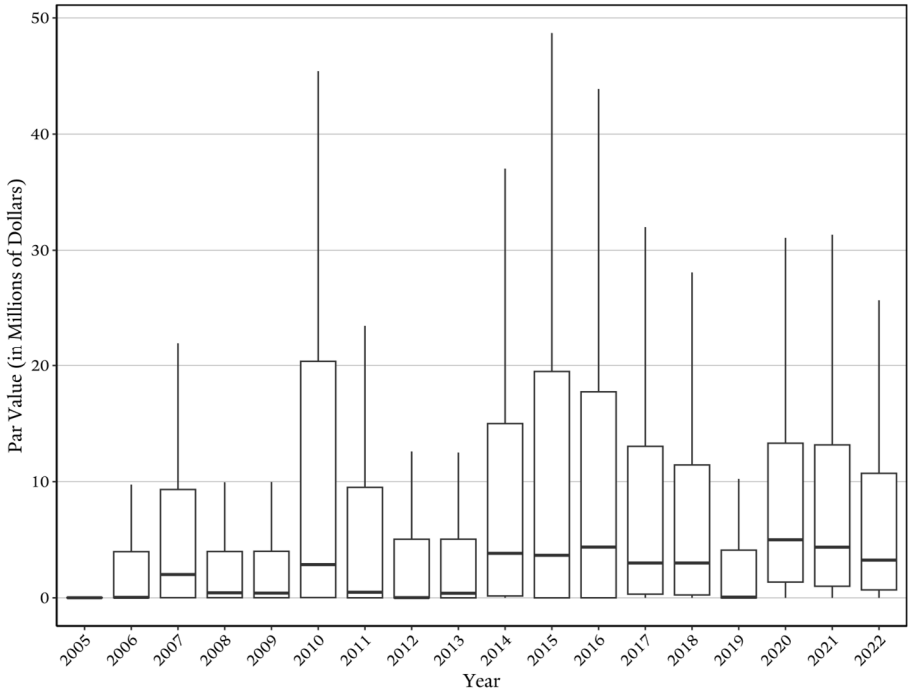
FIGURE 7. RATIO OF ASSETS TO LIABILITIES FOR BDCS, BY YEAR[177]



Fourth, as Figure 8 shows, the median balance-sheet value of the loans is relatively constant over the past ten years, suggesting that the size of the average loan has remained steady over that period, even as the number of loans has exploded. The median loan is of a relatively modest size.

177. Figure 7 shows the ratio of assets to liabilities from 1,112 filings from 283 filers across the sample period. We begin in 2010 because the data are more reliable in the more recent period.

FIGURE 8. BOX PLOT OF PAR VALUE OF LOANS OVER SAMPLE PERIOD[178]



III. THE ADVANTAGES OF PRIVATE CREDIT

Why is private credit gaining so much ground in the corporate debt markets, and why now? As we discussed in Part II, over the 2010s, private equity firms began to emphasize an old strategy that suddenly presented new opportunities: making loans to corporations that they originated themselves. In this Part, we explain why the quasi-public syndicated loan and high-yield bond markets became, in many cases, less appealing than private credit. We focus on the advantages of private credit relative to syndicated lending from the perspective of the three key parties in the transaction: (1) the borrowers who receive direct loans from private credit funds; (2) the debt investors who ultimately provide capital for direct loans by investing in private credit funds; and (3) the asset managers who manage the private credit funds and run the investment

178. Figure 8 shows the change in loan par value over the sample period. For example, in 2022, the median loan size was approximately $3.25 million, with a twenty-fifth percentile of approximately $690,000 and a seventy-fifth percentile of approximately $10.72 million.

strategy. In some cases, the advantages we describe are absolute; in other cases, they are relative to the state of play in the public and quasi-public debt markets. No single factor best explains the rise of private credit. Instead, as we explain, many aspects of this apparent return to private, relationship-based lending appeal to borrowers, investors, and the asset managers mediating their relationships.

A. Advantages for Borrowers

The private credit borrowing process offers the corporations seeking loans at least five key advantages over borrowing in the public debt markets: speed, flexibility, trust, confidentiality, and price certainty. We explain each advantage in turn.

1. Speed

First, borrowers can obtain capital through private-credit asset managers far faster, on average, than they can through traditional syndicated loans.[179] Loan syndications typically take at least ten to twelve weeks from launch to closing; for more complicated financings, the timeline may extend much longer.[180] Private-credit asset managers, in contrast, can move significantly faster if warranted, because they are subject to fewer regulatory requirements and need not rely on other parties, such as credit agencies and other lenders, to close loans.[181] Private-credit asset managers already have committed capital to lend and do not need to raise money from investors for specific loans. For borrowers with an urgent need for capital, private credit offers a viable pathway to negotiating terms and receiving funds on a tight turnaround.

2. Flexibility

Second, private-credit asset managers can offer loans to corporate borrowers on flexible, bespoke terms because they do not need to produce a standard-

179. Goldman Sachs Exchanges, *The Boom in Private Credit*, GOLDMAN SACHS, at 02:06 (July 12, 2022), https://www.goldmansachs.com/intelligence/podcasts/episodes/07-12-22-karoui-reynolds.html [https://perma.cc/2SQD-VQ3G].

180. *What Is the Syndication Process?*, SEECE, https://seece.org/knowledge-point/what-is-the-syndication-process [https://perma.cc/292J-EFJD].

181. *See* Gunter et al., *supra* note 124.

ized product for syndication to groups of investors.[182] Unlike public market investors, private credit lenders do not require credit-rating assessments[183]—which are heavily influenced by rigid cash-flow metrics[184]—thus offering an avenue to access debt capital for borrowers with less established financial histories.

3. Easier Renegotiation with a Single Lender

Third, borrowers can expect private-credit asset managers to be more willing and better able to negotiate with them in the event of financial trouble.[185] Syndicated loans, in contrast, are funded by fragmented and dispersed groups of investors, and borrowers can anticipate that the substantial trading in their loans will accelerate if they run into financial distress.[186] As a result, financial distress may lead a trusted investor to sell their position to a distressed-debt hedge fund, who may be a more challenging negotiating partner.[187] Private credit lenders and borrowers, on the other hand, can cultivate a collaborative working partnership, which may benefit a borrower when faced with financial hardship during the loan term.[188] At the same time, as discussed in Part IV, a single private credit fund may have more bargaining leverage over a borrower in times of distress than would a potentially warring group of dispersed creditors.

---

182. Goldman Sachs Exchanges, *supra* note 179, at 03:00.

183. *See* John Carlin & Jeffrey Kung, *What Should Business Leaders Know About Private Credit?*, CITIZENS (Oct. 2024), https://www.citizensbank.com/corporate-finance/insights/private-credit-market-outlook.aspx [https://perma.cc/79RK-GLDQ].

184. Taylor Begley, The Real Costs of Corporate Credit Ratings 2 (Aug. 11, 2015) (unpublished manuscript), https://ssrn.com/abstract=2404290 [https://perma.cc/8ZTN-N997].

185. *See* Gunter et al., *supra* note 124 (noting the close relationship between lender and borrower in private credit transactions).

186. *See* Ellias, *Bankruptcy Claims Trading*, *supra* note 89, at 772-74.

187. *See, e.g.*, Baird & Rasmussen, *supra* note 86, at 666-71 (discussing the rise of distressed hedge funds); Jiang et al., *supra* note 31, at 554-56 (discussing the role of hedge funds in the Chapter 11 bankruptcy process).

188. Jessica Hamlin, *Private Equity Funds Fuel Growth in Private Credit*, INSTITUTIONAL INV. (Nov. 10, 2021), https://www.institutionalinvestor.com/article/2bswsphkclc75samrsikg/portfolio/private-equity-funds-fuel-growth-in-private-credit [https://perma.cc/V6NG-JNSA].

4. Confidentiality

A fourth benefit of private credit is the confidentiality that it offers borrowers relative to the lending process in the public market.[189] In a public debt process, an investment bank must find investors for the loan, which typically requires sharing the borrower's proprietary financial information with a large group of potential lenders.[190] Public and quasi-public market borrowers usually have to disclose their financial information during the loan period to lenders, and even private information shared with syndicated lenders often finds its way into the public domain.[191] Private credit borrowers, on the other hand, share information with the private-credit asset manager alone.[192] There is also no need to share information with a rating agency, since private credit loans, due to their lack of trading, are not typically rated.[193]

Similarly, certain borrowers may benefit from the lack of trading in private credit, which further limits the market's insight into the borrower's financial performance. When the value of a borrower's public debt falls, the market may reasonably assume that the company is in financial distress.[194] But the market does not have the same level of access to private credit valuations, as only the lender and borrower are privy to the loan performance. Without daily market-price signals, market analysts cannot easily look to private loan valuations as a proxy for a borrower's health, which benefits borrowers that want to limit their

189. Goldman Sachs Exchanges, *supra* note 179, at 03:30.

190. *See* Godlewski, *supra* note 77, at 6 (discussing the syndicated lending "road show" process, which involves sharing an "information memorandum").

191. *See* Benton Lewis, Christopher Machera & Samantha Patel, *The Rise of Private Credit & Its Impact on Acquisition Dynamics*, Bloomberg L. (Sept. 2023), https://www.bloomberglaw.com/external/document/X8GKQD10000000/m-a-professional-perspective-the-rise-of-private-credit-its-impa [https://perma.cc/9Q6B-MVB6] ("While the financial information of a syndicated loan borrower is not required to be publicly available, financial statements and other reports delivered under the credit agreement governing a widely held loan are nonetheless often disclosed to trade publications such that competitors, customers, and suppliers have access to a company's financial performance data. Rating agency reports, including notices of downgrade, only exacerbate this distinction. It is far less common for a private credit borrower's financial information to be leaked to financial news organizations.").

192. *See* Kennedy et al., *supra* note 125.

193. *See* Deborah J. Enea & Tricia McNeill, *Recent Trends in Private Credit*, Troutman Pepper 2 (Aug. 12, 2024), https://www.troutman.com/print/v2/content/526710/Recent-Trends-in-Private-Credit.pdf?q=render_mode%3Dpdf [https://perma.cc/4A7U-9WRM].

194. *See, e.g.*, Harriet Clarfelt, *Credit Suisse Bonds Sink Further into Distress*, Fin. Times (Mar. 16, 2023), https://www.ft.com/content/56108086-cdbf-4874-b827-4adec7f2cd4c [https://perma.cc/CX4Z-PNQ8] (inferring corporate distress from Credit Suisse's bond prices).

public exposure and, in some cases, keep hostile acquirers and business competitors at bay.

5. *Firmer Lending Terms*

Fifth, private-credit asset managers are able to offer borrowers firm pricing conditions and terms without having to change that offer following investor feedback.[195] In a syndicated lending process, the investment bank that is lead arranger may offer tentative terms to the borrower that may ultimately be changed after a lengthy investor-consultation process.[196] Private credit allows borrowers to negotiate and lock in their cost of debt directly with the eventual funder of the loan instead of an intermediary, providing certainty and, as mentioned above, speed.

B. Advantages for Debt Investors

In this Section, we summarize three features of private credit relevant to the debt investors who entrust private-credit asset managers with their money, which the asset managers then lend to corporations. These features can make private credit a more attractive option for debt investors than deploying their capital in the quasi-public debt markets. First, with private credit, debt investors reportedly receive better returns on their investment compared to investing in quasi-public debt.[197] Second, private credit investors receive, on average, stronger contractual covenants than the quasi-public debt market currently offers.[198] Third, debt investors are protected from "creditor-on-creditor violence," which has created risk and increased the monitoring costs associated with investing in public corporate debt.[199] We explain each benefit in turn.

1. *Attractive Risk-Adjusted Returns*

Private credit investing promises handsome returns with relatively low risk.[200] It is important to qualify this claim by noting that private credit is, by

195. Goldman Sachs Exchanges, *supra* note 179, at 02:44.

196. *See* Godlewski, *supra* note 77, at 6 (describing the investor-consultation process).

197. *See infra* Section III.B.1.

198. *See infra* Section III.B.2.

199. *See infra* Section III.B.3.

200. *See* Jeffrey Diehl, *Will Private Credit Returns Surpass Private Equity, Even as Risk Declines?*, Adams St. Partners (Feb. 22, 2023), https://www.adamsstreetpartners.com/insights/will

definition, private, so much of what we know about the economic rewards of the asset class relies on representations from the private credit industry, which entails some bias. However, a review of the voluminous materials produced by the industry indicates that private credit is marketed as an opportunity to earn robust debt investment returns[201] while providing "senior secured" status, which protects against downside risks in the event of bankruptcy.[202]

While not all pricing on private credit is public, asset managers have generally marketed low-double-digit returns for their private credit investments.[203] Investors in private credit funds are thought to earn more than investors in quasi-public debt because of the illiquid nature of the asset class (and also as a reward for the other benefits that private credit lenders provide to borrowers, which are described in greater detail below).[204]

Illiquidity offers two key benefits for debt investors.[205] Most importantly, private credit investors can charge borrowers a premium to compensate for li-

-private-credit-returns-surpass-private-equity [https://perma.cc/9SZN-X96E] (discussing private credit risk and reward).

201. Underscoring the risk-reward pitch to investors, in September 2023, an executive in Blackstone's private credit business spoke publicly about his firm's views on the opportunity that private credit presents: "Particularly in today's elevated base rate environment—and given the senior-secured structure of many of our [private loans]—we believe it is currently the best risk-adjusted environment for this asset class in decades." Press Release, Blackstone, Blackstone Integrates Leading Credit and Insurance Businesses to Form Blackstone Credit and Insurance (BXCI) in Push Toward Next $1 Trillion (Sept. 13, 2023), https://www.blackstone.com/news/press/blackstone-integrates-leading-credit-and-insurance-businesses-to-form-blackstone-credit-and-insurance-bxci-in-push-toward-next-1-trillion [https://perma.cc/C5GA-TUX5].

202. *See Blackstone Private Credit Fund (BCRED): Institutional Caliber Private Credit for Income-Focused Investors*, BLACKSTONE, https://www.bcred.com [https://perma.cc/2B58-XFHX].

203. *See* Will Louch, *Private Equity Firms Pivot Away from Traditional Buyouts*, FIN. TIMES (Sept. 24, 2023), https://www.ft.com/content/84409cde-1197-49c9-bf88-dbe371e44313 [https://perma.cc/XPW3-6M58].

204. *See Across the Spectrum: Understanding Public and Private Credit*, PIMCO (Sept. 2020), https://www.pimco.com.au/en-au/resources/education/across-the-spectrum-understanding-public-and-private-credit [https://perma.cc/XL7C-HWRZ].

205. In recent years, a "secondaries" market has developed in private credit that provides some level of liquidity to debt investors in private credit funds, but it does not compare favorably to the more liquid public debt markets. *See Understanding and Investing in Private Equity Secondaries*, MORGAN STANLEY (Nov. 3, 2022), https://www.morganstanley.com/ideas/private-equity-secondaries-volatile-markets [https://perma.cc/H98R-A4ZN]. In a secondaries market, a limited partner in a private credit fund sells its investment to an investor who specializes in buying interests in private credit funds. *See id.* In other words, the liquidity is at the level of the fund investment, not any specific loan. But the price for liquidity can be steep. One study of secondary-market sales from 2006-2014 revealed an average discount of fourteen percent of net asset value. *See* Taylor D. Nadauld, Berk A. Sensoy, Keith Vorkink &

quidity risk.[206] Unlike syndicated loans and high-yield bonds, private credit loans do not trade on secondary markets, making them difficult to offload on short notice.[207] As such, private credit lenders typically hold the loans to maturity—generally three to six years[208]—because they have both the financial wherewithal and the strategic mandate to hold illiquid assets. Investors in closed-end private credit funds typically do not have the right to demand their capital back on a moment's notice, reducing the risk of a bank run on the asset manager and allowing the private-credit asset manager to manage the liquidity risk. To compensate for the liquidity risk, private-credit asset managers can charge borrowers an illiquidity premium.[209] Thus, although illiquidity poses risks, discussed below, private lenders can capture a return premium as compensation for assuming those risks.[210]

There is no systematic way to compare, loan by loan, what a private credit borrower pays for capital and what the same firm would have paid for syndicated financing. However, industry sources suggest that the annualized illiquidity premium is around an additional 1.5 to 3 percentage points above comparable traded syndicated loans.[211] An academic study recently came to similar conclusions, finding that private credit loans are approximately 1.89 percentage points more expensive than syndicated loans for borrowers, a number that falls slightly to 1.61 percentage points with control variables.[212] Thus, the best evidence suggests that a loan that might cost a borrower 6% annual

Michael S. Weisbach, *The Liquidity Cost of Private Equity Investments: Evidence from Secondary Market Transactions*, 132 J. FIN. ECON. 158, 165 (2019). Excluding "fire sales" from 2007-2009 resulting from the financial crisis, the average discount on secondary-market sales was nine percent. *Id.* at 159.

206. *See* Yakov Amihud & Haim Mendelson, *The Pricing of Illiquidity as a Characteristic and as Risk*, 19 MULTINATIONAL FIN. J. 149, 150 (2015) (discussing the pricing of illiquidity).

207. *See* Carlin & Kung, *supra* note 183.

208. *See* Rorie A. Norton, *Forming Private Credit Funds: Key Differences in Fund Lifecycle and the Use of Subscription Facilities Versus PE Funds (Part One of Two)*, PRIV. EQUITY L. REP. 2 (May 12, 2020), https://www.srz.com/images/content/1/7/v2/172012/051820-PELR-Breslow-Hunter.pdf [https://perma.cc/U3LJ-P2FN].

209. *See Private Debt Illiquidity Premium*, PEMBERTON CAP. ADVISORS LLP [1] (June 2017), https://pembertonam.com/wp-content/uploads/2020/05/pemberton_perspectives_illiquidity_premium.pdf [https://perma.cc/DVD8-KCEW].

210. *See* Joshua Anderson & Tom Collier, *Earning an Illiquidity Premium in Private Credit*, PIMCO (July 7, 2015), https://www.advisorperspectives.com/commentaries/2015/07/07/earning-an-illiquidity-premium-in-private-credit [https://perma.cc/B3LB-K7MS].

211. James Keenan, *Private Credit: Evolution and Opportunity in Direct Lending*, BLACKROCK ALTS. 2 (Nov. 2022), https://syncappartners.com/wp-content/uploads/2023/06/private-credit-evolution-and-opportunity-in-direct-lending.pdf [https://perma.cc/F6CY-P7HR].

212. *See* Jang, *supra* note 13, at 22-24.

interest in the syndicated loan market might cost 7.5% to 9% if borrowed from a private-credit asset manager, reflecting compensation for illiquidity risk (as well as the other potential benefits of private credit, discussed above).[213]

While the reported returns to private credit investors are indeed alluring, it is unclear whether such returns are in fact market beating, after adjusting for risk.[214] As money continues to pour into private credit and new private credit funds are continually formed, time will tell whether private credit continues to offer equity-like returns on a relatively safe debt investment, or only debt-like returns on an equity-like risk.

The second benefit of illiquidity is that it mitigates on-paper volatility.[215] Unlike traditional public debt, private loan valuations are not marked-to-market daily because they do not trade openly on a secondary exchange.[216] Because of the infrequent valuations (discussed in Section III.C), private credit offers a smoother day-to-day asset class to capital providers compared with public debt. Some investors value the smoothness of private funds because it alleviates concerns about timing the market and makes their investment performance look less volatile.[217]

2. *Stronger Covenants*

Relative to syndicated loans, private credit loan contracts appear more likely to contain covenants protecting investors from borrower opportunism and providing the investor with options if the borrower's business deteriorates.[218] Loan covenants are specific promises that borrowers make in their loan contracts to take (or not to take) specific actions over the course of the loan term, in order to lower the risk that the borrower would not pay the lender back.[219]

---

213. *See id.*

214. *See* Erel et al., *supra* note 38, at 4-5.

215. Matt Levine, Opinion, *People Will Pay for Illiquidity*, BLOOMBERG (Nov. 1, 2022, 1:52 PM EDT), https://www.bloomberg.com/opinion/articles/2022-11-01/people-will-pay-for-illiquidity [https://perma.cc/8QJT-PQNP].

216. Randy Schwimmer, *What a Downturn Might Mean for Private Credit*, CHURCHILL FROM NUVEEN (Aug. 4, 2016), https://www.churchillam.com/downturn-might-mean-private-credit [https://perma.cc/7VNV-6PM8].

217. *See* Levine, *supra* note 215.

218. *See* Baird & Rasmussen, *supra* note 86, at 1231 (discussing covenants generally). *See generally* Jang, *supra* note 13 (discussing the role of covenants in senior loans originated by direct lenders).

219. *See generally* Thomas P. Griffin, Greg Nini & David C. Smith, *Losing Control? The Two-Decade Decline in Loan Covenant Violations*, J. FIN. (forthcoming), https://ssrn.com/abstract

For example, a borrower may promise to maintain its business, to use the money from the loan for a specific purpose, not to sell any significant assets, or not to borrow additional money without prior permission.[220] A borrower's breach of a covenant may trigger a default, which allows a lender to use the threat of foreclosure to renegotiate the loan if foreclosure is not immediately warranted.[221]

Over the past generation, investors in quasi-public debt have largely lost the ability to protect themselves with covenants as investor demand for debt investments has exceeded supply, giving borrowers the power to negotiate for more contractual freedom.[222] Private credit investors have, at the same time, protected themselves with strong covenants.[223] Young Soo Jang studied a sample of direct loans to private equity sponsors and found that private-credit asset managers were far more likely to benefit from certain types of covenants, as compared to public debt investors.[224]

Thus, loan covenants are, in this generation, a distinguishing feature of private credit loans as compared to quasi-public debt.[225] Such control is far less common in the syndicated loan market, which has, by and large, become a

=3277570 [https://perma.cc/FDZ7-9W72] (discussing the evolution of contractual covenants in the public loan market); Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 1117 (1979) (discussing the role of covenants in reducing conflicts between borrowers and lenders).

220. *See* Nini & Smith, *supra* note 10, at 276-77 (discussing the types of covenants commonly found in loan agreements).

221. *See generally* Griffin et al., *supra* note 219 (discussing how lenders use covenants to monitor and discipline borrowers).

222. *See* Bo Becker & Victoria Ivashina, *Covenant-Light Contracts and Creditor Coordination* 4 (Sveriges Riksbank, Working Paper No. 325, 2016), https://ssrn.com/abstract=2871887 [https://perma.cc/6RV4-3CFK].

223. Jang, *supra* note 13, at 2-3. Sengal Selassie, the CEO and Managing Partner of Brightwood Capital Advisors, LLC, a middle-market private credit sponsor, explained the difference as follows: "Brightwood is typically lead in the majority of our deals, allowing us to control documents and put in strong downside protections including covenants that you typically won't see in the public market or upstream deals." Email from Jeff Ferris, Portfolio Manager, Brightwood Capital Advisors, LLC, to Elisabeth de Fontenay, Karl W. Leo Distinguished Prof. of L., Duke L. Sch. (Sept. 19, 2024, 11:59 AM ET) (on file with authors).

224. Jang, *supra* note 13, at 2-3.

225. *See* Griffin et al., *supra* note 219, at 7 (documenting the relationship between a decline in loan-covenant violations and a shift toward private credit lending); Gunter et al., *supra* note 124 (documenting the use of loan covenants in private credit lending).

lending market that places very few ongoing financial requirements on borrowers.[226]

3. Protection from "Creditor-on-Creditor Violence"

Finally, private credit investors benefit from the reduced need to monitor the opportunistic behavior of other debt investors in fractured loan syndicates. Over the past ten years, investors in the syndicated debt market have bemoaned what has become known as "creditor-on-creditor violence," or what one of us has called "bankruptcy hardball."[227] In short, in the 2010s, members of loan syndicates developed a set of strategies that allowed majority investors in syndicated loans—typically in collusion with the borrower—to engage in transactions that harmed minority investors.[228] This increased the need for investors to monitor and guard against value expropriation by fellow investors.[229]

The private credit structure protects investors from these "hardball" transactions in two ways. First, because the asset manager has governance rights over the loan, there is no structure that would allow some limited partners to

---

226. Some scholars have argued that the "covenant lite" trend is overstated, pointing out that revolving loans continue to have covenants. *See* Mitchell Berlin, Greg Nini & Edison G. Yu, *Concentration of Control Rights in Leveraged Loan Syndicates* 30 (Fed. Rsrv. Bank of Phila., Working Paper No. 19-41, 2019), https://ssrn.com/abstract=3494154 [https://perma.cc/AH4R-SZLP].

227. *See* Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 Calif. L. Rev. 745, 759-62 (2020); *see also* Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. Chi. L. Rev. 1, 15 (2023) (discussing the tension between creditors and the board of a distressed company); Daniel B. Kamensky, *The Rise of the Sponsor-in-Possession and Implications for Sponsor (Mis)Behavior*, 171 U. Pa. L. Rev. Online 19, 28-31 (2024) (illustrating the conflict between equity sponsors and creditors); Diane Lourdes Dick, *Hostile Restructurings*, 96 Wash. L. Rev. 1333, 1336-37 (2021) (discussing the rise of "lender-on-lender violence"); Ayotte & Scully, *supra* note 85, at 371-73 (analyzing debt covenants in the J. Crew bankruptcy); Mitchell Mengden, *The Development of Collateral Stripping by Distressed Borrowers*, 16 Cap. Mkts. L.J. 56, 57-61 (2021) (discussing collateral stripping by J. Crew and Neiman Marcus).

228. *See, e.g.*, Jared A. Ellias & Elisabeth de Fontenay, *Law and Courts in an Age of Debt*, 171 U. Pa. L. Rev. 2025, 2036-46 (2023) (discussing the TPC Group "uptiering").

229. As one bankruptcy judge wrote in adjudicating a dispute between a majority group of syndicated lenders and minority lenders who were cut out of a lucrative opportunity, "There is nothing in the law that requires holders of syndicated debt to behave as Musketeers." *In re* TPC Grp. Inc., No. 22-10493, 2022 WL 2498751, at *12 (Bankr. D. Del. July 6, 2022); *see also* Samir D. Parikh, *Creditors Strike Back: The Return of the Cooperation Agreement*, 73 Duke L.J. Online 1, 30-33 (2023) (discussing efforts by investors to reduce the likelihood of being on the wrong side of value expropriation).

harm other limited partners without the asset manager agreeing to do so, which would be highly unlikely and in violation of the asset manager's fiduciary duties.[230] Second, the asset managers who negotiate private credit loans can include covenants that restrict borrower opportunism, including through transactions that have come to be associated with aggressive debt market transactions.[231]

It is important to note that market dynamics are constantly changing, and many observers see private credit covenants decreasing as lender competition and deal size increase.[232] In a prominent recent transaction, a private-equity-owned firm with private credit lenders engaged in an aggressive transaction

---

230. *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1239 (2014) (noting that in investment funds, the asset manager has "sole authority to direct the fund's operations and investment strategy").

231. A common example of an aggressive borrower transaction that works to the detriment of existing lenders is the transfer of an asset to another corporate entity in order either to provide shareholders with a dividend or to create new collateral for a refinancing. For an example, consider the Neiman Marcus transaction discussed in Ellias et al., *supra* note 93, at 1099-1106, where the private equity sponsor extracted what many considered to be Neiman Marcus's best asset in hardball bargaining with creditors. In a review by Moody's, all private credit loans since 2022 prohibited borrowers from transferring intellectual property to unrestricted subsidiaries. Paula Seligson, *Private Credit Lenders Giving Up Protections to Win Bigger Deals*, BLOOMBERG (Oct. 26, 2023, 7:30 AM EDT), https://www.bloomberg.com/news/articles/2023-10-26/private-credit-lenders-giving-up-protections-to-win-bigger-deals [https://perma.cc/5ALQ-AN36]. Just two out of three broadly syndicated loans contained similar protections. *Id.* Another dangerous borrower and co-creditor practice that private lenders can protect against is known as uptiering. *See* Vincent S.J. Buccola & Greg Nini, *The Loan Market Response to Dropdown and Uptier Transactions*, 53 J. LEGAL STUD. 489, 490 (2024). Uptiering, like dropdowns, is a strategy that borrowers employ to issue more debt. *Id.* However, rather than moving assets from one entity to another, a borrower instead persuades a bare majority of existing lenders—often by granting them additional benefits and favorable treatment vis-à-vis the other nonfavored lenders—to amend the loan agreement such that the borrower can permissibly issue new debt. *Id.* Dropdowns and uptiering drew widespread attention (and criticism) after J. Crew and Serta Simmons utilized these strategies in their recapitalizations within the past few years. *See id.* at 498, 502-03; Ayotte & Scully, *supra* note 85, at 372. Private lenders, concerned about the risks posed by these strategies, responded by inserting strict covenants to prevent their borrowers from partaking in these risky moves. *See* Ian K. Walker, *Is Pluralsight the Proverbial "Canary in the Mine" of Liability Management Exercises ("LMEs") in Private Credit?*, CREDITSIGHTS (Oct. 30, 2024), https://know.creditsights.com/is-pluralsight-the-proverbial-canary-in-the-mine-of-liability-management-exercises-lmes-in-private-credit [https://perma.cc/XDW8-NE9K] (discussing the use of Serta blockers in private credit loans and other protections that private credit investors have against liability management transactions). As a result, private credit loans are significantly less susceptible to lender-on-lender violence and thus require far less active monitoring of harmful borrower and co-lender behavior. *See* Kremer et al., *supra* note 114.

232. Seligson, *supra* note 231.

with its lenders, suggesting that private credit investors may face similar risks to their public counterparties—but it is still too early to tell.[233] As of now, however, the presence of strict covenants in private loans remains a differentiating factor from publicly traded secured debt.

C. Advantages for Asset Managers

Asset managers of all sizes benefit in four ways from deploying private-credit investment strategies. They benefit from attractive investment returns and fees; investment flexibility without the burdens of banking law; opportunities to earn returns to scale as they build larger funds; and reduced fire-sale risk because the debt does not trade and because they are very lightly regulated. We explain each benefit in turn.

1. Attractive Fee Structures

First, as discussed above in the capital-provider context, asset managers can earn their share of the handsome coupons that borrowers pay, as well as loan-level fees. While asset managers in this space have a range of compensation arrangements, it is typical for them to follow the model of private equity managers and earn roughly 15% to 20% of the investment profits ("carry") above a certain return threshold ("hurdle") of typically 7% to 8%.[234] In the private credit context, therefore, asset managers earn profit by negotiating robust loan coupons and capturing deal fees. To be sure, these types of fees are a typical

---

233. This transaction is both unusual and difficult to explain. *See* David Brooke, Max Frumes & Shubham Saharan, *Private Credit-Backed Pluralsight Looks to Try on a J. Crew-Style LME*, 9FIN (May 30, 2024), https://9fin.com/insights/private-credit-backed-pluralsight-lme [https://perma.cc/4RZ4-46B9] (noting that this transaction is "'pretty unprecedented' for a market that touts more stringent credit agreements compared to its public counterpart, especially when it comes to collateral leakage"). Commentators were puzzled by the maneuver, which may have been a bridge to a more typical lender debt-for-equity swap. One news source suggested that it might have been driven by, among other reasons, a desire to avoid marking down the Pluralsight loan that was held by different BDCs. Sami Vukelj, Shubham Saharan, Max Frumes & Rachel Butt, *Pluralsight Postmortem – More Than Meets the Eye?*, 9FIN (July 29, 2024), https://9fin.com/insights/pluralsight-postmortem-eye [https://perma.cc/26BY-7AV8]. A market participant wondered why the private-credit asset manager would hurt its reputation as a constructive counterparty for what appeared to be little gain. *Id.* The long-term consequences of this "hardball restructuring maneuver that breached protocol for private credit" remain to be seen. *Id.*

234. *See* David Brooke & Andrew Hedlund, *U.S. Direct Lenders Modify Fee Structures as Private Lending Loses Luster*, YAHOO! FIN. (July 28, 2020), https://finance.yahoo.com/news/us-direct-lenders-modify-fee-182201233.html [https://perma.cc/W8DV-S349].

feature of any form of investment management, but they are also an important aspect of why private credit strategies are attractive for asset managers.

Borrowers appear to pay a premium loan spread (the interest rate charged in excess of the base rate) for private credit deals because of the flexibility, speed of execution, and other unique benefits that private credit offers.[235] Asset managers are able to capture their share of those gains to the extent the profits of the fund exceed the hurdle rate.[236]

Large credit funds further enhance their loan-level returns by capturing loan fees that banks would otherwise claim in the syndicated loan market. One common fee is the origination fee,[237] which is typically paid up front to the lender as compensation for underwriting the loan,[238] and usually sized to one to five percent of the loan amount.[239] Other costs may include a prepayment fee—intended to ensure a minimum return rate for the lender in case of early loan repayment[240]—or an exit fee, which serves as a final charge levied at maturity.[241]

Altogether, from 2012 to 2022, private credit investments generated a three to six percent higher yield than broadly syndicated loans, producing valuable profits for asset managers.[242] As discussed above, asset managers will further

---

235. *See supra* Section III.A.

236. Kat Hidalgo & Silas Brown, *Private Credit's Lavish Profits Are Coming Under Scrutiny*, Bloomberg (Oct. 5, 2023, 7:00 AM EDT), https://www.bloomberg.com/news/articles/2023-10-05/private-credit-s-lavish-profits-are-coming-under-scrutiny [https://perma.cc/APS9-GPCK]. Private credit funds performed so strongly in 2023 that asset managers have quickly reached and surpassed their hurdle rates, leading many capital providers to seek to increase their managers' hurdle rates or peg them to central-bank rates. *Id.*

237. *See How Can Private Credit Opportunities Generate Return for Investors?*, Yieldstreet (July 12, 2022), https://www.yieldstreet.com/resources/article/how-can-private-credit-opportunities-generate-return-for-investors [https://perma.cc/KKB6-NLQT].

238. *An Introduction to Private Debt*, CAIS (May 27, 2022), https://www.caisgroup.com/articles/giving-credit-to-private-debt [https://perma.cc/ZB4L-V4L8].

239. *Ultimate FAQ: Private Credit Investments, What, How, Why, When*, FasterCapital (June 24, 2024), https://fastercapital.com/content/Ultimate-FAQ-private-credit-investments--What--How--Why--When.html [https://perma.cc/464A-X84T].

240. *See Private Credit Deep Dives – Call Protection (United States)*, Proskauer (Nov. 13, 2023), https://www.proskauer.com/alert/private-credit-deep-dives-call-protection-united-states [https://perma.cc/YA6H-CB3B].

241. Anthony Macpherson & Anna Shonfeld, *The A-Z of Secured Lending*, Kingsley Napley, https://www.kingsleynapley.co.uk/resources/download/398/the-a-z-of-secured-lending.pdf [https://perma.cc/F796-PKDJ].

242. *Understanding Private Credit*, Goldman Sachs Asset Mgmt. (Oct. 20, 2022), https://am.gs.com/en-lu/advisors/insights/article/2024/understanding-private-credit [https://perma.cc/RDN6-UP94].

boost their rate of return via fund-level leverage—through either asset-backed credit facilities or subscription facilities and by using their loan portfolio as collateral.[243]

Thus, between the robust floating-rate coupons and loan-level fees (and the additional returns boost from fund-level leverage), private credit offers asset managers a highly profitable investment strategy. This sentiment was recently captured by private-equity titan and Blackstone founder Steve Schwarzman: "If you can earn 12 percent, maybe 13 percent . . . in senior secured bank debt . . . with almost no prospect of loss, that's about the best thing you can do."[244]

Asset managers can profit further through management fees. Asset managers typically charge annual management fees of one to two percent of investors' committed capital.[245] By capitalizing on investors' growing appetite for private credit exposure, asset managers can expand the assets they manage to generate significant recurring management fees.[246] Management fees represent a substantial source of income for asset managers. Blackstone, for example, generated $5 billion of management and advisory fees through three quarters in 2023 alone, compared with $1.4 billion of realized performance revenues (that is, carried interest) over the same time period.[247] Private credit offers a path to expand massively this vital source of revenue for asset managers.[248]

---

243. *See supra* notes 122-125 and accompanying text; *see also NXT Capital: Under the Hood of Fund-Level Leverage*, *supra* note 141 (explaining forms of fund-level leverage).

244. Louch, *supra* note 203.

245. Larry Rothman, *Private Credit Fund Management Fees Increase*, Pensions & Invs. (Aug. 17, 2023, 12:59 PM), https://www.pionline.com/interactive/private-credit-fund-management-fees-increase [https://perma.cc/2QCC-FS6W].

246. Fareed Sahloul & Swetha Gopinath, *The Rise of Private Equity's One-Stop Shops*, Bloomberg (Sept. 6, 2023, 1:09 PM EDT), https://www.bloomberg.com/news/newsletters/2023-09-06/the-rise-of-private-equity-s-one-stop-shops [https://perma.cc/C439-LRPD].

247. *See Blackstone's Third Quarter 2023 Earnings*, Blackstone 3 (Oct. 19, 2023), https://s23.q4cdn.com/714267708/files/doc_financials/2023/q3/Blackstone3Q23EarningsPressRelease.pdf [https://perma.cc/T72Q-KTUZ].

248. Recent moves by KKR and Carlyle to forgo carried interest and only charge management fees in their so-called "evergreen credit funds" signal the growing importance of aggregating capital to generate management-fee income. *See* Katharine Hidalgo & Silas Brown, *KKR and Carlyle Take No Carry on New Private Credit Funds*, Bloomberg L. (Oct. 11, 2023, 7:30 AM EDT), https://news.bloomberglaw.com/mergers-and-acquisitions/kkr-and-carlyle-take-no-carry-on-new-private-credit-funds [https://perma.cc/6Y6F-G6Y5].

2. *Relationship Lending Without Banking-Law Limitations*

Private-credit asset managers can invest strategically and with great flexibility, especially as compared to heavily regulated commercial banks, which face myriad restrictions in deploying capital.[249] Asset managers typically have the flexibility to invest anywhere along the capital structure—including senior secured, junior liens, large unitranche, and other types of loans—while also having the freedom to originate loans ranging in size from $2 million to $200 million.[250] Regulated commercial banks do not have nearly the same flexibility to put capital to work, and they must confront regulators and regulations that, since the late-2000s financial crisis, generally have pushed the industry to take on less risk.[251] Likewise, investors in the syndicated loan market do not typically have the opportunity to make the same sort of expansive investment choices.

For example, in 2018, a large private-credit asset manager originated multiple forms of debt capital in a single transaction with a childcare software company. The private-credit asset manager provided a $1.5 million first-lien senior secured revolving loan, a $200,000 first-lien senior secured term loan, a $32.4

---

249. Private debt as an asset class expanded dramatically in the wake of the late-2000s financial crisis, as regulators in the United States and Europe rigorously tightened regulations through Dodd-Frank and Basel III, among other initiatives, which continue to limit commercial banks' ability to lend. *The Rise of Private Markets: Secular Trends in Non-Bank Lending and Their Economic Implications*, ARES 6 (Feb. 2020), https://www.arescapitalcorp.com/sites/default/files/2020-04/The-Rise-of-Private-Markets-Whitepaper-vF.pdf [https://perma.cc/YP97-5WMZ]; *see also* Sayee Srinivasan & Jeff Huther, *The Basel III Endgame Proposal: Yet Another Gift to Private Credit Funds*, ABA BANKING J. (Nov. 3, 2023), https://bankingjournal.aba.com/2023/11/the-basel-iii-endgame-proposal-yet-another-gift-to-private-credit-funds [https://perma.cc/CL5Z-CSKG] (discussing recently proposed Basel III banking regulations that will further shrink banks' lending footprint while allowing private credit to expand).

250. *See* Capital Allocators with Ted Seides, *Kipp deVeer—The World of Private Credit at Ares*, YOUTUBE, at 36:40 (July 24, 2023), https://www.youtube.com/watch?v=eUC4dHaT3dw [https://perma.cc/UQP4-FMEC].

251. In the latest proposed revision to global banking rules, regulators are proposing a 21% increase in capital requirements for globally systemically important banks and a 10% increase for smaller banks, which will further inhibit commercial bank lending. *See* David Wessel, *What Is Bank Capital? What Is the Basel III Endgame?*, BROOKINGS (Mar. 7, 2024), https://www.brookings.edu/articles/what-is-bank-capital-what-is-the-basel-iii-endgame [https://perma.cc/7JTG-GKN9]; *see also* Srinivasan & Huther, *supra* note 249 (explaining how increased capital requirements incentivize investment in private credit); *Basel III Endgame: The Next Generation of Risk-Weighted Assets*, PWC (Aug. 15, 2023), https://www.pwc.com/us/en/industries/financial-services/library/basel-iii-endgame.html [https://perma.cc/3K2X-VQHM] (predicting "globally systemically important banks experiencing an increase of 21% in capital requirements vs. 10% increase at regional banks").

million second-lien senior secured loan, and $800,000 of equity.[252] Three years later, the asset manager injected an additional $29 million of second-lien secured capital and $100,000 of first-lien secured capital.[253]

Presumably, this structure allowed the private-credit asset manager to obtain a risk and return profile that fit its investment criteria, without needing to incur the due-diligence costs associated with underwriting different companies. In this example, the asset manager established deep familiarity with a borrower's financial and operational profile from the first investment round in 2018,[254] which later gave it sufficient comfort to provide additional capital to the borrower. A private-credit asset manager's ability to hold equity positions in companies in addition to debt provides a unique opportunity to offset loan losses elsewhere in the firm's loan portfolio.[255] The asset manager here estimated that its equity investment in this company had increased in value by seventy-five percent since 2018.[256] Banks, by contrast, are restricted in their ability to hold equity in companies.

Further, without any intermediaries or other third parties like credit-rating agencies involved in the process, private credit lenders have the flexibility to select opportunities that might otherwise score poorly under traditional valuation criteria.[257] For example, an asset manager might think highly of a small borrower with a weak cash-flow profile because the company shows signs of strong future growth potential. Whereas the public market intermediaries may decline to lend to such a borrower, a private-credit asset manager could still structure an attractive deal by allocating part of its investment into equity, thereby reducing the borrower's debt load while compensating the asset manager's investors for the credit risk.[258]

In addition to this flexibility, private-credit asset managers benefit from dramatically lower compliance costs relative to commercial banks because private credit lenders are not subject to the same level of regulatory oversight as are commercial banks. According to one study, large banks report spending an

---

252. *See* Ares Cap. Corp., Annual Report (Form 10-K) F-12 (Feb. 7, 2023), https://www.sec.gov/Archives/edgar/data/1287750/000128775021000005/arccq4-202010k.htm [https://perma.cc/CW4M-XK2S] (reporting Ares investments in Genesis Acquisition Co. and Genesis Ultimate Holding Co. between 2018 and 2021).

253. *Id.*

254. *See id.*

255. *See* Capital Allocators with Ted Seides, *supra* note 250, at 37:40.

256. *See* Ares Cap. Corp., *supra* note 252, at F-12.

257. *See* Goldman Sachs Exchanges, *supra* note 179, at 03:19.

258. *See* Capital Allocators with Ted Seides, *supra* note 250, at 38:45 ("In a lot of our nonsponsored deals, what we find is we're the only real institutional capital.").

average of $10,000 per employee to maintain compliance with today's complex banking regulation scheme.[259] Total bank spending on regulatory compliance is estimated to have increased by sixty percent over pre-financial-crisis levels.[260] As private-credit asset managers are not subject to these rules,[261] they have a significant cost advantage in competing for opportunities with traditional lenders.[262]

3. Earning Returns to Scale

Private credit also allows asset managers to earn returns to scale as they raise megafunds.[263] In many investment strategies, investors must be cautious about raising more money than they can deploy in profitable investment opportunities.[264] Private-credit asset managers, on the other hand, gain the ability to make larger loans as they scale, and a larger pool of capital also allows them to take on the more idiosyncratic risk associated with large loans.[265] This is because the core investment product—a senior secured loan—is familiar to corporations and there is vast demand for this type of capital.[266] Historically, private-credit asset managers have raced to raise capital to meet this demand.[267] While

259. *See* Shakeel Lone, *The Creeping Cost of Compliance*, FORBES (Apr. 21, 2022, 8:19 AM EDT), https://www.forbes.com/sites/servicenow/2021/10/21/the-creeping-cost-of-compliance [https://perma.cc/4L8J-5JR3].

260. *Id.*

261. *See* Laura Benitez, *Pimco Sounds Alarm on Under-Regulated Private Credit Markets*, BLOOMBERG (Nov. 2, 2023, 10:00 AM EDT), https://www.bloomberg.com/news/articles/2023-11-02/pimco-sounds-alarm-on-under-regulated-private-credit-markets [https://perma.cc/D72Y-EGXB].

262. *See* Srinivasan & Huther, *supra* note 249 ("Private credit funds operate outside the regulatory perimeter . . . . Hence their competitive advantage over banks.").

263. *See* Golub Cap., *Expert Q&A: Scale Matters for Private Debt*, PRIV. DEBT INV., June 2023, at 17, 17, https://golubcapital.com/wp-content/uploads/2023/06/Private-Debt-Investor-The-Decade-QA-with-David-Golub-1.pdf [https://perma.cc/PDZ6-UUQC].

264. *See id.*

265. *See id.* at 17-18.

266. *See* Sarah Limbach, *Credit Trends: Global State of Play: Debt Growth Diverging by Credit Quality*, S&P GLOB. RATINGS (Sept. 6, 2023), https://www.spglobal.com/ratings/en/research/articles/230906-credit-trends-global-state-of-play-debt-growth-diverging-by-credit-quality-12835732 [https://perma.cc/CX7J-EVU5].

267. *2022 Annual Global Private Debt Report*, PITCHBOOK 4 (Mar. 15, 2023), https://pitchbook.com/news/reports/2022-annual-global-private-debt-report [https://perma.cc/XZ6A-GB5B].

it may one day change, for now the story of megafunds has been, as far as we can tell, a happy one.[268]

4. Less Fire-Sale Pressure

Finally, the lack of trading in private credit loans means that asset managers are less likely to engage in costly fire sales.[269] While private-credit asset managers typically report investment valuations to their investors at specified intervals, these valuations need only be provided on a quarterly basis, and they leave significant room for the asset manager's discretion.[270] Notably, the asset managers analyze the loan values in-house, with review by an external auditor conducted just once a year.[271] As a result, asset managers are less likely to be forced into selling their loans—perhaps at depressed prices—after a pricing change or a credit-rating downgrade, reducing the risk associated with investing in debt.[272]

---

268. Moreover, even the largest funds retain the flexibility to invest in smaller companies. *See* Capital Allocators with Ted Seides, *supra* note 250, at 42:17. Note, however, that large credit funds may ultimately prefer to lend to large borrowers because they tend to be more resilient than smaller companies in withstanding economic headwinds. *See id.* at 39:38. For example, companies with $100 million or more in earnings before interest, taxes, depreciation, and amortization (EBITDA) have grown earnings more than seven times faster while defaulting at a five-times lower rate than companies that earn $50 million in EBITDA or less. *See* Joe Zidle & Jonathan Bock, *Private Credit, Meet "Higher for Longer,"* BLACKSTONE MKT. VIEWS (Nov. 16, 2023), https://www.blackstone.com/insights/article/private-credit-meet-higher-for-longer [https://perma.cc/ELU3-YJ55].

269. *See* Schwimmer, *supra* note 216.

270. *See* IMF, *supra* note 105, at 65; Laura Benitez, *Private Credit Valuations Worry World's Financial Watchdogs*, BLOOMBERG (Oct. 23, 2024, 10:24 AM EDT), https://www.bloomberg.com/news/articles/2024-10-22/top-regulators-call-out-valuation-risks-in-private-credit [https://perma.cc/63PC-MRY7].

271. *See* Alicia McElhaney, *Everyone Wants to Know What Private Assets Are Really Worth. The Truth: It's Complicated.*, INSTITUTIONAL INV. (Dec. 14, 2022), https://www.institutionalinvestor.com/article/2bstlvcy8lgwufev71kao/portfolio/everyone-wants-to-know-what-private-assets-are-really-worth-the-truth-its-complicated [https://perma.cc/6NVB-GF8D].

272. *See, e.g.*, Shohini Kundu, *The Externalities of Fire Sales: Evidence from Collateralized Loan Obligations* 6-7 (Eur. Systemic Risk Bd., Working Paper No. 141, 2023), https://ssrn.com/abstract=4375357 [https://perma.cc/XEY2-VD9Z] (describing forced selling by investment entities organized as collateralized loan obligations (CLOs)). For example, CLO managers must adhere to covenants that outline strict interest and overcollateralization tests for the portfolio. *See* Laila Kollmorgen & Steven Oh, *Seeing Beyond the Complexity: An Introduction to Collateralized Loan Obligations*, PINEBRIDGE INVS. (Jan. 18, 2022), https://www.pinebridge.com/en/insights/clo-beyond-the-complexity [https://perma.cc/8VA9-4XK3].

IV. CONSEQUENCES OF THE RISE OF PRIVATE CREDIT

The rise of private credit has not gone unnoticed. Market participants have marveled at the sheer amount of capital that has shifted to this asset class, while regulators and others have expressed some concern over the surge in corporate borrowing[273] and the potential impact on banks from this major incursion into their traditional lending and underwriting businesses.[274]

Yet the commentary to date has missed what matters most about this development and has, if anything, understated its impact. The surge in private credit and direct lending represents far more than a simple change in the delivery of debt capital. Indeed, it represents a key turning point for corporate governance, corporate finance, and the resolution of financial distress. Properly understood, private credit both responds to and accelerates two fundamental trends in the capital markets. First, private credit represents perhaps the final major step toward investment funds owning most of U.S. firms' capital structure—both the equity and the debt. Second, private credit represents a critical

---

If the CLO fails any of the tests, then the manager is required immediately to retire the highest tranches to bring the portfolio into compliance. *Id.*

273. *See, e.g.*, Michael J. Hsu, Acting Comptroller of the Currency, Off. of the Comptroller of the Currency, Remarks at Vanderbilt University: Preventing the Next Great Blurring 9-12 (Feb. 21, 2024), https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-17.pdf [https://perma.cc/9XZM-MTE3].

274. *See, e.g.*, Steven Kelly, *Does Private Credit Really Reduce Systemic Risk?*, WITHOUT WARNING (Jan. 17, 2024), https://www.withoutwarningresearch.com/p/does-private-credit-really-reduce [https://perma.cc/PYT8-HSJE]. For example, European Union regulators have begun reining in this opaque asset class, with new rules aimed at curbing leverage among private credit funds by limiting the amount of borrowed money that they can invest. *See* Costas Mourselas & Will Louch, *EU Tightens Rules on Leverage for Private Credit Funds*, FIN. TIMES (July 21, 2023), https://www.ft.com/content/2ab74817-5b14-4110-9815-a7549621b521 [https://perma.cc/4B3L-Q65C]. In the United Kingdom, financial regulators have announced a sweeping review of private market valuations processes, concerned that the lack of daily mark-to-market valuations in private credit may mask initial signs of weakness in the sector. *See* Laura Noonan, *UK Regulator to Launch Review of Private Market Valuations*, FIN. TIMES (Sept. 27, 2023), https://www.ft.com/content/ee008ac7-2f0f-4b65-a016-0e2ec00e8c26 [https://perma.cc/4HA9-3NS3]. And in the United States, SEC recently voted to require asset managers to provide investors with more detailed quarterly reports on investment performance and expense disclosures. *See* Brooke Masters, *US Regulators Impose Tougher Disclosure Rules on Private Funds*, FIN. TIMES (Aug. 23, 2023), https://www.ft.com/content/7b31f328-27b0-4a96-8477-1aa2b6bd3ae4 [https://perma.cc/5Z4Y-KW6Z]. Senators Sherrod Brown and Jack Reed recently warned of the risks associated with private credit, pointing to continuing regulatory uncertainty. *See* Press Release, Sen. Sherrod Brown, Brown, Reed Warn Regulators of Risks Posed by Private Credit Market (Nov. 29, 2023), https://www.brown.senate.gov/newsroom/press/release/sherrod-brown-reed-warn-regulators-risks-posed-private-credit-market [https://perma.cc/J3YK-P4SS].

milestone in the movement of firms and capital away from the public markets and into the private markets. These two developments have profound consequences, not only for firms and investors, but also for economic growth and the functioning of the capital markets.

A. Corporate Governance: Investment Funds Own Everything

1. Corporate Equity in the Hands of Investment Funds

The last half-century has witnessed an extraordinary shift in how companies are governed and financed. The rise of investment funds has radically altered the behavior, and even the number, of both public and private companies in the United States. This is because, over time, investment funds have come to own the largest share of the equity of large and middle-market companies.

An investment fund is simply a pool of capital that is raised from passive investors and used to make investments.[275] The fund's "investment manager" selects the fund's investments and decides when and how the fund will deploy its capital.[276] There are at least as many types of investment funds as there are asset classes, and within a given type, investment funds adopt myriad investment strategies. There are also regulatory distinctions among funds. "Registered" or "public" investment funds such as mutual funds and exchange-traded funds (ETFs) are permitted to raise capital from retail investors and are therefore very tightly regulated by the securities laws.[277] Among their numerous regulatory obligations, registered funds must invest almost exclusively in liquid instruments, including public company equity and debt.[278]

Private investment funds, by contrast, largely set their own terms through negotiation with their investors and are very lightly regulated.[279] In exchange for this generous regulatory treatment, private funds may raise capital only from institutional investors and high-net-worth individuals.[280] They are per-

---

275. *See* Morley, *supra* note 230, at 1235-36.

276. *Id.* at 1238-40.

277. *See* Elisabeth de Fontenay & Gabriel Rauterberg, *The New Public/Private Equilibrium and the Regulation of Public Companies*, 2021 COLUM. BUS. L. REV. 1199, 1216 n.62 (describing the numerous regulatory obligations applicable to registered funds).

278. *See* I.R.C. § 851(b) (2018).

279. IMF, *supra* note 105, at 54, 56.

280. The Investment Company Act of 1940, the federal securities statute that governs investment funds, exempts from public registration funds whose investors are large institutional investors and high-net-worth individuals. Investment Company Act of 1940, ch. 686, § 3, 54 Stat. 789, 797 (codified as amended at 15 U.S.C. § 80a-3(c)(7)).

mitted to make highly illiquid investments, such as acquiring large and even controlling stakes in private companies.[281]

Prompted by a revolution in corporate finance that favored passively diversifying one's investments over trying to pick high-performing investments, investment funds have become an extraordinarily popular way for investors of all types and sizes to channel their savings to companies.[282] Over time, this has dramatically changed the ownership of both public and private companies.

Fifty years ago, the stock of a typical public company would likely have been owned by a very large and dispersed set of shareholders, each holding only a small stake in the business.[283] Many or most of these shareholders would have been unsophisticated retail investors holding their shares in the company directly, rather than through an intermediary.[284] Historically, therefore, corporate law and corporate finance were consumed by the fear that self-interested corporate managers could harm firm value—whether through laziness, incompetence, or self-dealing—because dispersed, unsophisticated shareholders prone to collective-action and information problems would be powerless to stop them.[285] This problem, referred to in corporate law as "the separation of ownership and control" and in financial economics as "managerial agency costs," dominated corporate governance for nearly three-quarters of a century.[286]

Today, rather than fret over weak shareholders dominated by strong managers, we grapple with concerns over excessive shareholder power.[287] How did this happen? The answer is that the ownership of both public and private com-

---

281. *See* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSPS. 121, 123-25 (2009).

282. *See* WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 5-9 (2016).

283. *See generally* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (describing the classic governance structure of large corporations).

284. *See* Kobi Kastiel & Yaron Nili, *In Search of the "Absent" Shareholders: A New Solution to Retail Investors' Apathy*, 41 DEL. J. CORP. L. 55, 57 (2016).

285. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 61-62.

286. *See* BERLE & MEANS, *supra* note 283, at 277-79; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (introducing the concept of managerial agency costs).

287. *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 769-70 (2017) (arguing that corporate-law scholarship has focused too much on the agency costs of corporate managers, when powerful shareholders also impose "principal costs").

panies today is not just highly concentrated—it is concentrated *in the hands of investment funds*.

The largest share of the equity in *public* companies today is owned by registered investment funds—specifically, by massive "index" funds and other funds managed by a mere handful of behemoth asset managers, such as Vanguard, BlackRock, and State Street (the "Big Three").[288] Excessive managerial power in public companies has given way to undeniable shareholder power.[289] As a result, corporate governance today debates whether these index fund managers wield too much economic and political power.[290]

The rise of investment funds has led to a similar result for the equity ownership of *private* companies. While registered funds are severely limited in their ability to invest in private companies,[291] private investment funds are not similarly constrained. This is because they are open only to high-net-worth individuals and institutional investors such as pension funds, endowments, foundations, sovereign wealth funds, and so forth. Moreover, significant loosening of the securities laws applicable to private capital and private funds in the 1980s and 1990s has allowed private investment funds to grow extraordinarily large individually and to raise astronomical amounts of capital collectively.[292] This in turn has allowed private funds to invest ever-greater amounts in private companies. In particular, private equity funds and venture capital funds taken together have become the primary source of outside equity capital for private companies.[293]

Considering these developments together points to the conclusion that, while comprehensive statistics are hard to find, the bulk of the *equity* of both public and private companies today may be held primarily by investment funds.

---

288. *See* Bebchuk & Hirst, *Big Three Power*, *supra* note 1, at 1550.

289. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889, 896 (2013).

290. *See supra* note 1.

291. *See* de Fontenay & Rauterberg, *supra* note 277, at 1216 n.62.

292. *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 448 (2017); Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs*, 33 REV. FIN. STUD. 5463, 5464 (2020).

293. *See, e.g.*, Pollman, *supra* note 3, at 157; Kaplan & Strömberg, *supra* note 281, at 122.

2. *Corporate Debt Follows Suit*

With the rise of private credit, the very same phenomenon is now occurring with the *debt* of U.S. firms. In lieu of high-yield notes or syndicated loans, companies are increasingly borrowing in the form of loans from private credit funds, as we saw in Part II. More revolutionary still, as private-credit asset managers grow in size, even large firms can borrow entirely from a *single* private credit fund.[294] A large private company, for example, may have all its equity in the hands of a single private equity fund, while all of its debt is held by a single private credit fund. As a result, we are approaching a world in which most firms' capital structure—both the equity and the debt—may be funded and held entirely by private investment funds. This is a radically different way of owning companies.

What is this likely to mean for corporate governance? What do we know about the behavior of private investment funds generally and of private credit funds in particular? Most private credit funds are formed as private investment funds. They are also often sponsored by the same investment firms that sponsor private equity funds. We therefore begin our inquiry with what is known about private investment funds, including and especially private equity.

There is now a large literature on the structure and behavior of private investment funds and their effect on the companies in which they invest.[295] Private funds differ from retail-oriented registered funds such as mutual funds and ETFs in crucial ways. They are very lightly regulated, and they are actively managed.[296] Their investment managers (sponsors) are incentivized to generate high returns because of their compensation structure.[297] Unlike managers of registered funds, managers of private funds typically take a large share of all profits from the fund's investments (say, twenty percent), which encourages them to take big risks and work for big gains.[298] Finally, they have extraordi-

294. *See supra* Section II.A.

295. For reviews of this literature, see, for example, Tim Jenkinson, Hyeik Kim & Michael S. Weisbach, *Buyouts: A Primer* 97-106 (Fisher Coll. of Bus., Working Paper No. 2021-03-018, 2022), https://ssrn.com/abstract=3964770 [https://perma.cc/7WQJ-HXKF]; Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. Econ. Persps. 145, 152-62 (2001); Shai Bernstein, *The Effects of Public and Private Equity Markets on Firm Behavior*, 14 Ann. Rev. Fin. Econ. 295, 304-07 (2022); and Martin Olsson & Joacim Tåg, *Private Equity, Layoffs, and Job Polarization*, 35 J. Lab. Econ. 697, 698-702 (2017).

296. *See* Kaplan & Strömberg, *supra* note 281, at 121-22.

297. Axelson et al., *supra* note 59, at 1551.

298. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1, 3 (2008).

nary discretion in their hunt for returns compared with both registered investment funds and public companies.[299]

In practice, then, what would it mean for a firm if both its equity and its debt were held by a very small number of private investment funds? On the one hand, we should expect this to drive firms to operate with striking efficiency in generating returns for such funds' investors. Firms owned and financed entirely by private investment funds are likely to prioritize economic returns above all else, and they have the flexibility and resources to do so.[300] Overall, this may be a positive development for the economy in terms of firm productivity and growth.

On the other hand, most private investment funds are not overly concerned with *how* their returns are generated, because they are less scrutinized than actors in the public and quasi-public markets. Therefore, the returns from such funds' increasing control of U.S. companies may come in part at the expense of noninvestor stakeholders or impose negative externalities, as compared to (1) other models of corporate ownership, such as public companies or family-owned private companies,[301] and (2) other models of corporate financing, such as bank loans or public and quasi-public debt. Private funds appear to be uniquely skilled at determining what particular combination of operational shifts, strategic moves, and capital-structure changes in their portfolio companies will yield the greatest returns for the fund, but there is no guarantee that these changes would maximize social welfare.[302] All else equal, a company owned and financed solely by private investment funds might be more likely to engage in anticompetitive behavior, to shrink consumer surplus, or to sell dangerous, addictive, or even illegal products than an otherwise-comparable company, though the literature exploring these questions is still nascent.[303]

---

299. Registered investment funds and public companies are both subject to onerous securities regulation that necessarily constrains their behavior to some degree. Specifically, registered investment funds are governed by the Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80-64), while public companies are governed by the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78rr), among other rules.

300. *See* Jenkinson et al., *supra* note 295, at 97-106.

301. *See id.* at 100-01.

302. *See id.* at 97-101.

303. *See, e.g.*, Divya Kirti & Natasha Sarin, *What Private Equity Does Differently: Evidence from Life Insurance*, 37 Rev. Fin. Stud. 201, 224-28 (2024); Peter Morris, Ludovic Phalippou & Betty Wu, How Deadly Is Financial Leverage? Evidence from Care Homes During the COVID-19 Crisis 3 (Oct. 13, 2024) (unpublished manuscript), https://ssrn.com/abstract=4017507 [https://perma.cc/HGT5-K4RC]; Yasmin Rafiei, *When Private Equity Takes Over a Nursing Home*, New Yorker (Aug. 25, 2022), https://www.newyorker.com/news/dispatch/when-

The shift from quasi-public debt to private credit could even alter the behavior of a company whose equity is already owned by a private equity fund. This is because the major investment banks that arrange quasi-public debt have far different reputational and other incentives than private credit funds do, due to such banks' role in the financial system and their status as public companies. In recent years, these banks' investments have been highly influenced by societal pressure—albeit often in conflicting directions—on environmental, social, and governance (ESG) issues like climate policy and corporate diversity, equity, and inclusion.[304] Thus, an increasing share of syndicated loans contain covenants and other terms tied to ESG factors, including at large companies such as Dell, Hewlett-Packard, and Lululemon.[305] By contrast, private credit funds that are private investment funds have a greater ability to evade public opinion.

Third, ownership of a firm's equity and debt by private investment funds contributes to the concentration of corporate power and wealth in a small number of hands. There is already growing concern over the power of the "Big Three" asset managers that collectively hold most of the equity of U.S. public companies.[306] Yet this problem has the potential to become even more severe with the rise of private credit—as private funds will now hold *both* parts of the firm's capital structure and may continue to concentrate.

Fourth, we may worry about the resilience and long-term performance of firms whose only outside investors are private investment funds—all having the same life cycles, the same ultimate investors, the same decision-making by private equity sponsors, the same liquidity constraints, and the same incentives. For example, both case law and academic research find that private investment funds' limited lifespans, fundraising pressures, compensation schemes, and tax preferences affect what investments they make, when they

private-equity-takes-over-a-nursing-home [https://perma.cc/D83J-MHCX]; Cameron McWhirter & Zusha Elinson, *The Selling of America's Most Controversial Gun*, WALL ST. J. (Sept. 22, 2023, 5:42 AM ET), https://www.wsj.com/us-news/the-selling-of-americas-most-controversial-gun-3c86127f [https://perma.cc/76TG-WA9S]; *cf.* Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 398-400 (2017) (discussing how "regulatory entrepreneurs"—startups that seek to change the law as part of their business plan—"strategically operat[e] in a zone of questionable legality or break[] the law until they can (hopefully) change it").

304. *See generally, e.g.*, *2024 Climate Report*, JPMORGAN CHASE & CO. (2024), https://www.jpmorgan.com/content/dam/jpmc/jpmorgan-chase-and-co/documents/Climate-Report-2024.pdf [https://perma.cc/YQ6F-UCP5] (providing information on climate-related efforts at JPMorgan Chase & Co., including those related to corporate governance and risk management).

305. Nakita Q. Cuttino, *Private Debt for Public Good*, 76 FLA. L. REV. 637, 678-89 (2024).

306. For discussions of these concerns, see generally sources cited *supra* note 1.

make and exit them, and at what price they do so.[307] Therefore, we may find that shocks to the U.S. economy are even more severe and more correlated when there is less diversity among owners of U.S. companies and less liquidity.

Fifth, the increasing ownership and financing of U.S. companies by private investment funds will ultimately shape the entire U.S. economy because such funds can finance only certain types of firms and on particular terms. This is due to such funds' (typically fixed) lifespans, their illiquidity, their incentives, and other features. For example, it is well recognized that venture capital funds overwhelmingly invest in specific rapid-growth industries such as tech,[308] while private equity buyout funds typically invest in mature companies that have positive and stable cash flows and can bear high debt loads.[309] Companies and industries falling within such funds' investment set therefore raise capital with ease, while others find capital to be scarce.

B. Corporate Information Production: Private Markets Cannibalize Public Markets

Private credit raises the prospect of a world in which consumers, most investors, the general public, and even regulators and policymakers know little about the governance, financial results, or prospects of most companies that sell the goods and services on which we rely. Indeed, private credit represents a major new milestone in the movement of firms and capital from the public and quasi-public markets to the private markets. A defining feature of recent history in the capital markets is the long-term decline in both the number of public companies and the share of capital raised in the public markets.[310] More companies choose to remain private indefinitely or to defer their IPO for as long as possible. They are able to do this because raising capital in the private markets has never been easier or cheaper.[311] Multibillion-dollar companies such as

---

307. *See, e.g.*, *In re* PLX Tech. Inc. S'holders Litig., C.A. No. 9880, 2018 WL 5018535, at *1-3 (Del. Ch. Oct. 16, 2018); Firefighters' Pension Sys. v. Found. Bldg. Materials, Inc., C.A. No. 2022-0466, 2024 WL 2795026, at *1-2 (Del. Ch. May 31, 2024); Alexander Ljungqvist, Matthew Richardson & Daniel Wolfenzon, *The Investment Behavior of Buyout Funds: Theory and Evidence*, 49 Fin. Mgmt. 3, 3-5 (2020).

308. *See* Josh Lerner & Ramana Nanda, *Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn*, 34 J. Econ. Persps. 237, 238 (2020).

309. *See* Kaplan & Strömberg, *supra* note 281, at 129.

310. *See* Craig Doidge, G. Andrew Karolyi & René M. Stulz, *The U.S. Listing Gap*, 123 J. Fin. Econ. 464, 466 (2017); Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. Fin. & Quantitative Analysis 1663, 1667-69 (2013).

311. *See* de Fontenay, *supra* note 292, at 448; Ewens & Farre-Mensa, *supra* note 292, at 5466.

SpaceX, OpenAI, Publix, and PetSmart are private companies today, whereas decades ago they would almost certainly have had to go public to reach such valuations.

This matters because private companies behave very differently from public companies. They are subject to far fewer external constraints on their behavior: they disclose little to regulators and the general public under the securities laws; their governance is left almost entirely up to private ordering; they avoid the threat of class-action shareholder lawsuits; and their stock is not tracked by traders, analysts, or the media because it does not trade in a liquid market.[312] If one were skeptical that this could truly alter a firm's behavior, one need only compare the trajectory of X Corp. (formerly Twitter, Inc.) when it was still a public company and now that it is a private company owned primarily by Elon Musk.[313]

Of these distinctive features of private companies, the lack of disclosure is worth discussing in detail. A fundamental fact about private companies is that, in contrast to public companies, little information about them is available to outsiders. Unlike public companies, private companies are typically not required by law to disclose to the public or even to their own investors any of the following: their financial statements; conflicts of interest involving their managers or their insiders; the compensation of their managers and insiders; their corporate structure; their capital structure; the details of corporate transactions such as mergers and acquisitions and major equity and debt financings; the nature of their business and their assets; or their earnings projections and corporate strategy.[314] Nor are they required to disclose major changes to the business, legal actions and regulatory risks, or other events affecting the company, no matter how significant.[315]

The shroud of secrecy surrounding private companies has not been impenetrable, however. Until now, information about many private companies—particularly the larger ones—could trickle out to the markets as a result of their debt financing.[316] For example, only a decade ago, a large private-equity-owned company would typically finance itself with syndicated loans, high-yield bonds, or a combination of both.

---

312. *See* de Fontenay, *supra* note 292, 466-67.

313. *See* Ann M. Lipton, *Every Billionaire Is a Policy Failure*, 18 VA. L. & BUS. REV. 327, 373-87 (2024) (describing the radical changes in culture, strategy, and operations at X Corp. since Elon Musk took the company private).

314. *See* de Fontenay & Rauterberg, *supra* note 277, at 1212.

315. *See id.*

316. *See supra* Section I.C.1.

A surprising feature of the capital markets is that private companies that choose to issue high-yield bonds file regular public disclosures with SEC, similarly to public companies, due to longstanding practice in this market.[317] Yet syndicated loans also generate important information that reaches a wide audience, even in the absence of public disclosure. Both types of quasi-public debt impose some information obligations on firms, typically by requiring that the company obtain audited financial statements and report certain material developments affecting it to investors.[318] Furthermore, corporate borrowers of syndicated loans and high-yield bonds typically must agree to have their debt rated by a credit-rating agency, a process that yields additional information for the market.[319]

To be sure, this information is generally not disclosed to the general public, but instead to the large group of creditors that hold the company's debt. Nonetheless, because quasi-public debt is traded in a relatively liquid market, information available to creditors can indirectly inform the rest of the market through the pricing of the debt. Empirical evidence suggests that members of lender groups trade on the information they learn from their debt investments, meaning that even thinly traded syndicated loans likely produce information leakages that show up in market transactions and inform the public's view of the health of the economy.[320] Finally, to the extent that banks are among a corporate borrower's creditors or underwriters, the information would also find its way into the hands of bank regulators.

Now, however, with the rise of private credit, corporate debt is increasingly held in purely private hands, even for some very large firms. As a result, the entire chain of ownership and investment from the company to the ultimate investor is private, on both the equity side and the debt side. The consequences of this are significant and potentially troubling: a segment of the U.S. economy may simply go dark.[321]

---

317. *See* Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-Private Decisions*, 76 U. CHI. L. REV. 7, 9 (2009).

318. *See* Matthew T. Gustafson, Ivan T. Ivanov & Ralf R. Meisenzahl, *Bank Monitoring: Evidence from Syndicated Loans*, 139 J. FIN. ECON. 452, 474 (2021).

319. *See generally* Lawrence J. White, *Markets: The Credit Rating Agencies,* 24 J. ECON. PERSPS. 211 (2010) (discussing the role of credit rating agencies in the debt markets).

320. *See* Ivashina & Sun, *supra* note 81, at 302.

321. Notwithstanding these consequences, we note that for smaller companies, private credit may, counterintuitively, make more information available to outsiders. This is because, as discussed, private credit not only substitutes for existing types of quasi-public debt such as syndicated loans and high-yield bonds, but it also likely expands access to credit to *new* borrowers that previously did not take on any outside capital.

In other words, for many or most U.S. companies, we may eventually have little or no information at all about the company itself, including its assets, size, governance, and valuation; the company's capital structure; the company's equity owners and creditors; the terms of the company's equity and debt; any transactions involving the company; and much more. We have not truly reckoned with what this means for economic output, capital allocation, and regulation in the U.S. economy, but the effects will be profound.

Perhaps the most obvious change is that corporate valuation may become increasingly difficult.[322] By incorporating material information into trading prices, the public and quasi-public markets serve the crucial role of helping outsiders value firms.[323] In turn, this ensures that capital is allocated to its most efficient uses.[324] The rise of private credit and especially direct lending means that, going forward, opaque firms will from now on be held exclusively by private owners and private creditors, with no robust trading market to provide discipline and a measure of objectivity as to valuation. Firms will trade hands in transactions involving severe information asymmetries between buyers and sellers.[325]

This opacity will likely have two consequences. First, we should expect more examples of wildly mistaken or misleading valuations of private companies—already a serious problem for the private markets.[326] Second, we should also expect a greater incidence of corporate fraud, given that private companies that go dark are by definition subject to less scrutiny, oversight, and enforcement.[327] Third, both corporate debt and equity will be less liquid, which has

322. *See* IMF, *supra* note 105, at 64 ("Private credit loans tend to suffer from stale valuations because of the absence of secondary markets, limited comparable transactions, and irregular appraisals.").

323. *See* Holger Spamann, *Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings*, 14 J. LEGAL ANALYSIS 16, 18 (2022).

324. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 565-67 (1984).

325. *See* Ali Sanati & Ioannis Spyridopoulos, Comparing Capital Allocation Efficiency in Public and Private Equity Markets 37 (Aug. 30, 2024) (unpublished manuscript), https://ssrn.com/abstract=4403578 [https://perma.cc/B3C7-P8N9] (finding that capital is allocated substantially more efficiently in the public markets than in the private markets).

326. For example, when WeWork, a private company, sought to go public in 2019, public market investors balked at its purported $50 billion valuation, eventually causing it to abandon its IPO plans. *See* D Satish, *Financial Statement Analysis and Valuation Dilemma of WeWork (The We Company)*, 20 IUP J. ACCT. RSCH. & AUDIT PRACS. 496, 497 (2021).

327. *See* IMF, *supra* note 105, at 65 (noting that the lack of market prices for corporate debt "can increase the potential for managerial manipulation"); *see also* Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353, 354-58 (2020) (describing notable examples of fraud by

implications for the ultimate investors in these private funds.[328] In sum, all of the advantages of market efficiency in the public and quasi-public markets are lost in a world in which everything is private all the way down. We do not yet know whether the advantages of potentially greater monitoring and flexibility from private capital are enough to offset this. We also do not yet know whether the market can adapt and solve its many information problems solely through private ordering, or whether, going forward, we should expect our economy to be more susceptible to large market distortions and the painful market corrections that eventually follow.

C. *Corporate Distress and Bankruptcy: Private Credit Lenders Will Make Their Mark*

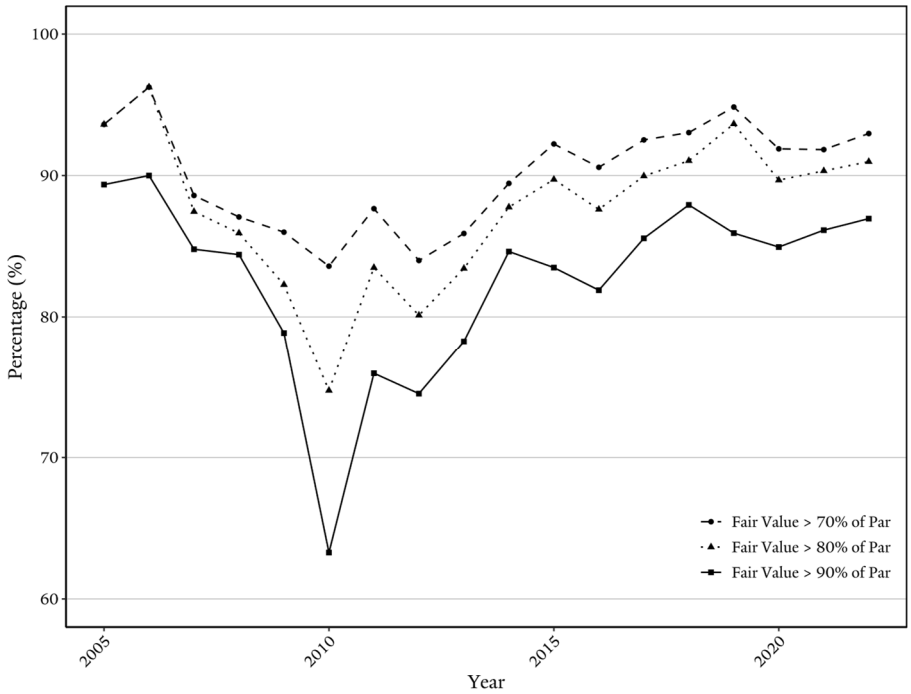
In this Section, we consider how the primary body of law regulating financial distress—bankruptcy law—should adapt to private credit transforming the debtor-creditor paradigm.

As depicted in Figure 9, our BDC data show that even with the accounting flexibility inherent in the structure, a significant portion of loans are held on the books of BDCs at levels consistent with conventional metrics of financial distress. For example, in the 2022 sample, approximately 10% of loans were held at a fair value (for accounting purposes) equivalent to 70% or less of face value, suggesting that the borrowers were financially distressed.

private companies, such as Theranos); Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663, 669 (2020) (arguing that the decline of public companies reduces the information needed to detect fraud); Brian J. Broughman & Matthew T. Wansley, *Risk-Seeking Governance*, 76 VAND. L. REV. 1299, 1303 (2023) (arguing that venture-capitalist behavior follows a "risk-seeking model").

328. *See* Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 532-34 (2012).

FIGURE 9. THE PROPORTION OF SAMPLE LOANS HELD AT DISCOUNTS TO PAR VALUE[329]



As a result, we anticipate that private credit will play a major role in corporate financial distress going forward. While we are still in the early stages of private credit, we see at this point three ways in which bankruptcy law may need to adapt. First, private credit lenders will bring different capabilities and incentives to prebankruptcy negotiations, shaping the population of Chapter 11 firms. In some cases, this may lead to a very fast workout, and in others it may lead to a very delayed bankruptcy filing; which effect will dominate is not clear at this point. Second, in smaller and midmarket Chapter 11 cases, bankruptcy judges may now confront some sophisticated private-credit asset managers who are more eager to own assets—or to liquidate them—than the regulated

329. Figure 9 shows the proportion of loans in each sample year that are marked for accounting purposes at a fair value that is at a discount to the par value of the loan. For example, in the 2020 B-Cred 10-K, a loan to Polymer Additives, Inc. of $29,752,000 was held at a fair value of $24,248,000, indicating that the BDC viewed the fair value of the loan as much lower than its face value. Blackstone Secured Lending Fund, Annual Report (Form 10-K) 125 (Mar. 3, 2021).

banks that once provided credit to those companies. Third, in larger Chapter 11 cases where private credit investors make loans that once would have been funded on the syndicated loan market, the major shift may be the lack of claims trading, which might require judges to do more to promote disclosure and fair sales processes than the law currently provides for. The lack of claims trading may also mean that bankruptcy proceedings slow down, as bankruptcy judges may need to create space for exploring restructuring options and weighing different alternatives. We explain each of these issues in turn.

1. *Private Credit Lenders Bring New Capabilities and Incentives to Prebankruptcy Workout Negotiations*

Private credit lenders bring different capabilities than other investors to the workout negotiations. Generalizing here is challenging, as not all private credit funds are the same. However, as compared to traditional banks that lend to midmarket firms, many private credit lenders are likely to have a greater range of capabilities. They are likely to be more active monitors of the borrower than traditional banks—perhaps even more so than syndicated lenders, who also engage in active monitoring[330]—which may allow them to act quickly to salvage investments by providing advice, capital, or both. As compared to dispersed groups of corporate bondholders or syndicated lenders, private credit lenders will suffer fewer coordination issues and will therefore be able to take quick actions.

However, in at least some cases, they will have strong incentives to give maturity-date extensions and forbearances to borrowers, even when those decisions may not be in the best interests of the corporation as a whole.[331] Consider a corporation that is distressed. If the corporation owes money to a regulated bank, that bank will be required to assess potential loan losses and realize losses. The bank's workout decisions will come in the context of losses that regulators require the bank to account for. If the corporation owes money to investors in syndicated debts or bonds, those investors may be subject to rules that require them to mark liquid investments to market, which forces investors to take losses when the market price of liquid claims falls in value. If, instead, the corporation owes money to a private credit lender, that lender can essentially

330. *See* Nini et al., *supra* note 70, at 1715.

331. A challenge to the generalizability of this prediction is that, as described below in Section IV.C.2, private-credit asset managers may also be *faster* in some cases to liquidate troubled firms, relative to what a midmarket commercial bank might have done. The prediction outlined here is likely to be true in some cases, but not in others; the average effect of the rise of private credit on the population of zombie firms remains to be seen.

choose when and where to take losses in many situations. As a result, private credit lenders may simply delay taking losses to avoid informing limited partners of potential problems with their portfolio. A private lender can accomplish this by agreeing to extend the terms of repayment or by providing forbearances. As a result, the economy may have more so-called "zombie firms," or companies that have too much debt but that delay taking actions to reduce their debt,[332] even though their debt forces the company to pass up profitable investment opportunities. As a result, the core business of these firms may erode, leaving little value for bankruptcy law to try to maximize.[333] These zombie firms may encounter bankruptcy at a relatively late phase in their financial distress, leaving bankruptcy judges with little to do other than preside over liquidations.[334]

To be sure, not all private credit lenders will have skill in monitoring borrowers, and not all will have incentives to delay—but these are attributes of private credit lending that make these types of lenders different from traditional banks, which may change the quantity and quality of firms that enter formal bankruptcy proceedings. At this point, it is not obvious exactly *how* the population of Chapter 11 debtors will change in the aggregate. Will private credit lenders that replace loan syndicates come to faster conclusions about troubled firms and act more decisively, or will we see a type of stalling bankruptcy not dissimilar from some of the recent liability management transactions? Will the incentive of private credit lenders to delay be more important? The only certain thing is that the capabilities and incentives of private credit lenders will soon be incredibly important for determining which firms file for Chapter 11 and how they look when they get there.

2. *More Aggressive Tactics in Smaller Cases*

For smaller and midmarket cases, the arrival of private credit lenders—a more sophisticated replacement for traditional commercial lenders—may confront borrowers with a very different contractual counterparty. The biggest change is that traditional commercial lenders like Citizens Bank are much less likely to deploy aggressive strategies than are private investment funds, which may be more sophisticated at dealing with bankruptcy. Regulated banks are

332. *See* Edward I. Altman, Rui Dai & Wei Wang, *Global Zombie Companies: Measurements, Determinants, and Outcomes*, 55 J. INT'L BUS. STUD. 723, 725 (2024).

333. Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 865 (2014).

334. *See id.*

generally forbidden by law from owning equity,[335] and banks and their employees rarely have strong incentives to act aggressively when borrowers run into trouble. Investment funds deploying private credit strategies, on the other hand, are not subject to significant limitations on equity ownership and can deploy aggressive strategies that look very much like those of "loan-to-own" lenders.[336] To be sure, the private credit space is diverse, and different asset managers have different levels of capabilities, but at least some of the larger ones offer workout capabilities and sophistication that are considerably higher than the median midmarket bank.

For an example of how this looks in practice, consider Red Lobster's recent bankruptcy filing.[337] In 2021, the restaurant chain borrowed more than $250 million in senior-secured private-credit term-loan debt from a major private credit lender, Fortress Investment Group.[338] When Red Lobster fell into distress, Fortress exercised its rights under its term-loan agreement to acquire shareholder voting power, which allowed the private credit lender to replace the company's managers and directors and acquire full control of the borrower prior to any bankruptcy filing.[339] A law firm subsequently described the private credit lender's move as

> short-circuit[ing] the traditional restructuring process. Rather than negotiate with their borrower on the terms of a forbearance or more holistic capital structure solution, certain middle-market private credit lenders have turned to previously underutilized provisions in security documents—the exercise of voting rights given to a collateral agent

335. Mitchell Berlin, *Why Don't Banks Take Stock?*, BUS. REV., May/June 2000, at 3, 3.

336. *See* Robert W. Miller, *Loan-to-Own 2.0*, DREXEL L. REV. (forthcoming) (manuscript at 22-31), https://ssrn.com/abstract=4506061 [https://perma.cc/GM5K-WGRF] (discussing how loan-to-own strategies work).

337. *See* Gretchen Morgenson, *How Private Equity Rolled Red Lobster*, NBC NEWS (May 24, 2024, 12:00 PM EDT), https://www.nbcnews.com/business/consumer/private-equity-rolled-red-lobster-rcna153397 [https://perma.cc/YT5Q-A3TY]; *see also (Blood) Red Lobster*, PETITION (May 22, 2024), https://petition.substack.com/p/red-lobster-bankruptcy [https://perma.cc/8GTN-FF7N] (describing the fall of Red Lobster).

338. *See* Declaration of Jonathan Tibus in Support of Debtors' Chapter 11 Petitions and First Day Relief at 12, *In re* Red Lobster Mgmt., No. 24-02486 (Bankr. M.D. Fla. May 19, 2024).

339. The lending structure worked as follows: Red Lobster had pledged the right to vote its shares—essentially, a pre-filled-out shareholder voting card—to Fortress as part of the loan. *See id.* at 17. When Red Lobster defaulted under the loan agreement, Fortress gained the right to use this voting card (or proxy) to replace the company's board. *See id.*

through a voting proxy as part of the pledge of a borrower's equity, otherwise known as pledged equity proxy rights.[340]

In other words, the private credit lender used a legal right that traditional lenders had previously hesitated to exercise even when they had the contractual right to do so. This type of legal creativity and aggressiveness may come to characterize an increasing proportion of major commercial bankruptcy cases as private-credit-backed firms make up an increasingly large share of Chapter 11 debtors.

3. More Judicial Responsibility in Larger Cases

Finally, for larger Chapter 11 cases, the key change will be the absence of claims trading. As discussed above, the great trends in bankruptcy law have depended on an active market in corporate debt that may no longer be there. In a world without claims trading, the expert distressed investors who would finance a reorganization or purchase a company's assets may not already have a seat at the table. To the extent that the business would be more valuable alive than dead, the investors who might seek to save it may need time and the opportunity to perform due diligence.[341]

For example, bankruptcy lawyers have developed a practice of proposing restructuring plans to judges that have "toggle" features. In a toggle structure, the debtor proposes implementing a restructuring transaction—for example, a debt-for-equity swap—while also leaving open the possibility that another investor might come in to buy the company at a higher price than the appraised value of the proposed plan of reorganization.[342] For example, the retail giant JCPenney proposed a reorganization transaction to the bankruptcy judge and

340. David Griffiths & Alex Cohen, *Pledged Equity Proxy Rights and the Rise of the Board Flip*, Weil Restructuring (May 14, 2024), https://restructuring.weil.com/corporate-governance/pledged-equity-proxy-rights-and-the-rise-of-the-board-flip [https://perma.cc/88AH-TDQA].

341. We note that an appointment trading market for some private credit loans may be developing, but this is still a far cry from the liquidity that exists in the broadly syndicated loan market. *See, e.g.*, Carmen Arroyo & John Sage, *JPMorgan Sounds Out Buyers for Discounted Pluralsight Deb*t, Bloomberg (Aug. 8, 2024, 2:04 PM EDT), https://www.bloomberg.com/news/articles/2024-08-08/jpmorgan-sounds-out-buyers-for-discounted-pluralsight-debt [https://perma.cc/6TBH-N4ZR]. In particular, direct loans often require the consent of the debtor to trade, which syndicated loans typically do not. *See id.*

342. *See* David M. Feldman & Michael S. Neumeister, *Sale Toggles in Chapter 11 Plan Processes*, Financier Worldwide (Nov. 2021), https://www.financierworldwide.com/sale-toggles-in-chapter-11-plan-processes [https://perma.cc/7NN8-2NET].

simultaneously sought permission to reimburse the due-diligence expenses of prospective buyers who might short-circuit the reorganization process with a higher bid.[343] This process is designed to provide the bankruptcy judge with comfort that there is no "better deal" out there than the proposed Chapter 11 plan.[344] However, this will work significantly worse for companies that, pre-bankruptcy, had both private equity and private credit loans, as prospective purchasers and financial intermediaries will be far less familiar with the assets.

As a result, bankruptcy judges may need to reorient bankruptcy law back toward one of its traditional roles: promoting disclosure.[345] In recent years, the disclosure requirements of the Bankruptcy Code have fallen by the wayside as judges have deferred to "market terms" and have looked for serious flaws in deals crafted by private parties instead of using their position to create robust competition for financing opportunities and to protect the integrity of auction processes.[346] In a world where single lenders have outsize power, the law should do more to check the power of lenders and police opportunism in insolvency.

CONCLUSION

Over the past ten years, private credit has grown from a relatively small part of the corporate credit markets to equal or perhaps surpass the aggregate size of the syndicated loan and high-yield bond markets. As a result, commercial loans have moved from the quasi-public era to a new period of private relationship lending, where the information that public debt trading once provided about firms and industries is retreating from public view. This period has also witnessed the rise of powerful investment firms that are replacing traditional banks as the originators and underwriters of corporate loans. This shift has many contributing factors, and it raises significant questions about the future of corporate governance and corporate finance. Bankruptcy law, among other bodies of law, must soon respond to a world in which part of the once-roaring credit markets goes dark.

---

343. *See id.*

344. *See id.*

345. Ilona Bastiaansen, Alina Lerman, Frank Murphy & Dushyant Vyas, *Court Disclosures of Firms in Chapter 11 Bankruptcy*, J. ACCT. RSCH. (forthcoming) (manuscript at 2-3), https://onlinelibrary.wiley.com/doi/pdfdirect/10.1111/1475-679X.12576?download=true [https://perma.cc/B4TG-LBQS].

346. *See* Ayotte & Ellias, *supra* note 94, at 4-5.

european corporate governance institute

About ECGI

ECGI is an international non-profit membership organisation that provides a platform for debate and dialogue among academics, policymakers, and business leaders, with a focus on major corporate governance, ESG, and stewardship issues.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

www.ecgi.global

european corporate governance institut

ECGI Working Paper Series in Law

Editorial Board

Editor
Amir Licht, Professor of Law, Harry Radzyner Law School, Reichman University

Consulting Editors
Hse-Yu Iris Chiu, Professor of Corporate Law and Financial, Regulation, University College London
Martin Gelter, Professor of Law, Fordham University School of Law
Geneviève Helleringer, Professor of Law, ESCP and Oxford Law Faculty
Kathryn Judge, Professor of Law, Columbia Law School
Wolf-Georg Ringe, Professor of Law & Finance, University of Hamburg

Series Manager
Asif Malik, ECGI Working Paper Series Manager

https://www.ecgi.global/publications/working-papers