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Private Credit: The Evolution of Corporate Finance and The Firm

Narine Lalafaryan

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**PRIVATE CREDIT:
THE EVOLUTION OF CORPORATE FINANCE AND THE FIRM**

NARINE LALAFARYAN

UNIVERSITY OF CAMBRIDGE LEGAL STUDIES RESEARCH PAPER SERIES PAPER NO. 25/2023

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KEY WORDS: corporate finance, private credit, private debt, debt governance, corporate governance, direct lending, private credit funds, law and economics

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THE EVOLUTION OF CORPORATE FINANCE AND THE FIRM**

NARINE LALAFARYAN *

ABSTRACT

This paper aims to provide new insights into the role of modern debt (credit) capital in the firm, its relationship with equity (share) capital, and the implications of advances in debt markets for corporate finance and corporate governance. The thesis of this paper is that the role of debt and its relationship with equity in the firm, due to recent significant developments in the corporate finance markets after the global financial crisis of 2007-2008, has been transformed. The relatively new, but already very experienced non-traditional providers of debt finance, such as private credit funds, are aggressively competing with traditional finance providers, such as commercial banks, in a dynamic market which is full of unforeseen and large-scale risks.

To the best of our knowledge, this is the first academic paper in law to examine private credit funds and to compare them to commercial bank financing. The paper challenges the traditional legal and financial framework of corporate finance and corporate governance and shows that modern debt providers (i) do participate in capital growth, (ii) are interested in the firm's profit maximisation, (iii) there is not always a conflict between the interests of equity and debt providers in the firm, and (iv) corporate loan financing agreements are often expected to be renegotiated (repriced). Based on developments in the corporate finance markets, the paper argues that outside financial distress, often debt and equity simply can no longer exist in a vacuum from one another. The reliance of private credit funds on private (contractual) bargaining can also improve the economic efficiency.

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1. Introduction

Over the past twenty-five years the corporate finance landscape and, especially the corporate debt finance environment, has changed considerably.¹ The rise in innovative trends and techniques in corporate finance enhanced the essential role of debt in the firm.² Fuelled by the post-GFC banking regulation,³ there has been an increased competition among the traditional finance providers, such as commercial banks, and the non-traditional finance providers,⁴ in particular, private credit funds.⁵ This competition has been one of the main factors shaping the global debt financing markets in the past years.⁶

¹ For an overview of the global issues on corporate debt, see The Bank for International Settlements (BIS), 'Corporate debt: post-GFC through the pandemic' (June 2021) BIS Quarterly Review, available at: https://www.bis.org/publ/qrtpdf/r_qt2106b.pdf; The World Bank, 'Growth of Global Corporate Debt' (2020) Policy Research Working Paper 9394, available at: <https://documents1.worldbank.org/curated/en/570381599749598347/pdf/Growth-of-Global-Corporate-Debt-Main-Facts-and-Policy-Challenges.pdf> (noting that between 2008-2018, the global nonfinancial corporate debt increased from 56% to 96% of gross domestic product in emerging economies). For the European perspective, see PWC, 'Debt Watch Europe Q2 2023 Review' (2023), available at: <https://www.pwc.co.uk/services/audit/insights/debt-watch-europe.html>

² Some scholarship treats the terms "firm" and "corporation" as synonyms. These terms are also often used interchangeably in legal practice. However, the term "firm" is broader in its scope than the term "corporation". On a discussion of the difference of these terms, see Simon Deakin, David Gindis, and Geoffrey M. Hodgson, 'What is a firm? A reply to Jean-Philippe Robé' (2021) *Journal of Institutional Economics*, Vol. 17, No. 5, at 861-871, (noting at 869 that 'We are not convinced that one should refrain from viewing corporation as a type of firm. Business corporations are incorporated firms. A good reason to retain this taxonomy is that its use is widespread among social scientists and business practitioners. In addition, it conveys an important analytic message: just as firms are both economic and legal phenomena, corporations are also both economic and legal phenomena.'). See also, Simon Deakin, David Gindis, and Geoffrey M. Hodgson, 'A further reply to Jean-Philippe Robé on the firm' (2022), *Journal of Institutional Economics*, Vol. 18, No. 4, at 703-707; Jonathan Hardman, 'Fixing the misalignment of the concession of corporate legal personality' (2023) *Legal Studies*, at 1-18, doi:10.1017/lst.2022.44

³ The term "GFC" stands for the global financial crisis of 2007-2008. These post-GFC regulations (e.g., Basel 3 in Europe; The Dodd-Frank Act 2010 in the United States) aim to restrict banks' operational scope and ability by prescribing capital adequacy rules for them. A detailed analysis of the banking regulation is beyond the scope of this paper.

⁴ They are also known as shadow bankers. See The Financial Conduct Authority, 'Shadow banking – the potential risks and rewards' (2017), available at: <https://www.fca.org.uk/insight/shadow-banking-potential-risks-and-rewards>; Zoltar Pozsar, Tobias Adrian, Adam Ashcraft, and Hayley Boesky, 'Shadow banking' (2013), FRBNY Economic Policy Review, available at: <https://www.newyorkfed.org/medialibrary/media/research/epr/2013/0713adri.pdf>.

⁵ See Section 2. Private credit has been defined as 'lending bilaterally negotiated between borrower and lenders and typically arranged by non-banks.' See The Bank of England, 'Financial Stability Report' (July 2023), at 81, available at: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2023/financial-stability-report-july-2023.pdf>. See also, © The Alternative Credit Council, 'Private credit and the trade finance opportunity' (2021), available at: <https://acc.aima.org/research/private-credit-and-the-trade-finance-opportunity.html>. This paper focuses on private debt: a discussion of bond markets is beyond the scope of this paper.

⁶ See The Alternative Credit Council, 'Financing the Economy 2022' (2022), available at: <https://acc.aima.org/compass/insights/private-credit/financing-the-economy-2022.html>; Deloitte, 'Private Debt Deal Tracker' (Autumn 2022), available at: <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-pddt-autumn-2022.pdf>; The Alternative Credit Council, 'Borrower's guide to private credit – UK edition' (2021) available at: <https://acc.aima.org/research/borrower-s-guide-to-private-credit.html>; The World Bank and the Cambridge Centre for Alternative Finance, 'Regulating Alternative Finance: Results from a Global Regulator Survey' (2019), available at:

With the development of the primary and secondary markets for corporate loans, debtholders found innovative ways to minimise their risk exposure. Innovative legal tools to diversify risk, and to price it adequately and on a dynamic basis incentivise debtholders to think of alternative strategies and financing options for engaging with their borrowers. The growing interconnectedness of financial risks also influenced the development of debt markets and the incentives of debtholders.⁷ The changes driven by the urgent need for sustainable finance further enhanced the essential role of debt in the firm's life cycle.⁸

On top of that, the global corporate indebtedness reached unprecedented levels caused by the COVID-19-crisis.⁹ In this period, the debt of private non-financial sector reached its all-time high (approximately 170% of world GDP).¹⁰ In 2022/2023, the global corporate debt has reached its new record peak with \$456 billions of net new corporate debt incurred.¹¹

Other factors, influencing and reshaping the role of debt in the firm, include the advancement of digital lending and FinTech lending,¹² as well as the blurring lines between

<https://openknowledge.worldbank.org/bitstream/handle/10986/32592/142764.pdf?sequence=1&isAlloWed=y>

⁷ See section 2. See also, The Financial Stability Board, 'Global Monitoring Report on Non-Bank Financial Intermediation' (2021), at 17-25, available at: <https://www.fsb.org/wp-content/uploads/P161221.pdf>.

⁸ A market-led approach to sustainable debt finance has been an important factor in the debtholders' willingness to rely on additional mechanisms for price and risk adjustment, creating a new pool of debt financing products, such as sustainability-linked bonds or loans, social loans, green loans, and others. See, The European Leveraged Finance Association, 'The Evolution of Sustainability Provisions in the Private Debt Market' (2023), Issue No. 36, available at: <https://elfainvestors.com/wp-content/uploads/2023/02/ELFA-Insights-36-The-Evolution-of-Sustainability-Provisions-in-the-Private-Debt-Market.pdf>, see also The Association for Financial Markets in Europe, 'ESG Finance Report Q2 2023' (2023), available at: <https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Sustainable%20Finance%20Report%20-%20Q2%202023-1.pdf> and 'ESG Finance Report Q4 2022 and Full Year' (2023), available at: <https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ESG%20Finance%20Report%20Q4%202022%20and%202022FY-1.pdf>

⁹ The Parliament of The United Kingdom, House of Lords Library, 'UK corporate debt after Covid-19: what might the impact be?' (2022), available at: <https://lordslibrary.parliament.uk/uk-corporate-debt-after-covid-19-what-might-the-impact-be/>; The World Bank, 'International Debt Statistics' (2022), available at: <https://openknowledge.worldbank.org/bitstream/handle/10986/36289/9781464818004.pdf>.

¹⁰ The Bank for International Settlements, 'Private Sector Debt and Financial Stability' report (May 2022) CGFS Papers No 67, available at: <https://www.bis.org/publ/cgfs67.htm>.

¹¹ Reuters, 'Corporate net debt hit record in 2022-2023, but borrowing appetite to decline, Janus Henderson says' (2023), available at: [https://www.reuters.com/business/corporate-net-debt-hit-record-202223-borrowing-appetite-decline-janus-henderson-2023-07-11/#:~:text=LONDON%2C%20July%2012%20\(Reuters\),a%20report%20published%20on%20Wednesd](https://www.reuters.com/business/corporate-net-debt-hit-record-202223-borrowing-appetite-decline-janus-henderson-2023-07-11/#:~:text=LONDON%2C%20July%2012%20(Reuters),a%20report%20published%20on%20Wednesd) ay (referring to a report by Janus Henderson).

¹² The term "FinTech" stands for the application of digital technology to financial services. See The World Bank, 'Fintech and the Future of finance' (2022), available at: <https://www.worldbank.org/en/publication/fintech-and-the-future-of-finance>; See also, The British Business Bank, 'SME Finance Survey' (March 2022), available at: <https://www.british-business-bank.co.uk/wp-content/uploads/2022/02/SME-Finance-Survey-2021-Report.pdf>

private and public capital markets.¹³ Lately, the inflation has caused a surge in the interest rates worldwide.¹⁴ Higher interest rates result in a lower demand in risky leveraged loans, which, in its turn might negatively affect firms' refinancing chances.¹⁵ Finally, the 2023 collapse of several banks in the United States and Europe – providers of \$ billions of debt capital – is a strong reminder of debt's prominent role in supporting economic activity and of its significant role in the firm.¹⁶

Unlike equity, debt has not yet been in the *spotlight* of corporate governance. The notion of “debt governance” is an emerging and evolving one. The earlier influential literature highlighted the role of debt in interactive corporate governance¹⁷ and stressed that debt is the ‘missing lever’¹⁸ of corporate governance. It also examined, to a certain extent, the increasing potential of debt to influence the firm's performance.¹⁹

¹³ See The Bank of England, ‘How has net financing for UK businesses changed during the pandemic’ (2021), available at: <https://www.bankofengland.co.uk/bank-overground/2021/how-has-net-financing-for-uk-businesses-changed-during-the-pandemic>

¹⁴ The Bank of England, ‘Bank Rate increased to 5.25% - August 2023’ (2023), available at: <https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2023/august-2023>. See also The European Central Bank, ‘Monetary policy decision’ (July 2023), (raising the key ECB interest rates from 2 August 2023), available at: <https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.mp230727~da80cfcf24.en.html#:~:text=Key%20ECB%20interest%20rates,-The%20Governing%20Council&text=Accordingly%2C%20the%20interest%20rate%20on,effect%20from%202%20August%202023.>

¹⁵ The Bank of England, ‘Financial Policy Summary and Record – July 2023’ (2023), available at: <https://www.bankofengland.co.uk/financial-policy-summary-and-record/2023/july-2023> ; Financial Times, ‘US junk loan investors brace for increase in downgrades and defaults’ (2023) available at: <https://www.ft.com/content/742b1944-d1f5-40cb-a2c0-ee7d8c95a360>.

¹⁶ The New York Times, ‘Yes, You Should be Worried About a Potential Bank Crisis. Here's Why’ (2023) available at: <https://www.nytimes.com/2023/05/04/opinion/silicon-valley-bank-first-republic-financial-crisis.html>

¹⁷ George G. Triantis and Ronald J. Daniels, ‘The Role of Debt in Interactive Corporate Governance’ (1995) California Law Review, Vol. 83, No. 4, at 1073-1113.

¹⁸ Douglas G. Baird and Robert K. Rasmussen, ‘Private Debt and the Missing Lever of Corporate Governance’ (2006) University of Pennsylvania Law Review, Vol. 154, at 1209-1251.

¹⁹ See Frederick Tung, ‘Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance’ (2009) University of California Law Review, Vol. 57, at 117-181; John Armour, Brian Cheffins, and David Skeel, ‘Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom’ (2003) 55 Vanderbilt Law Review 1699; Greg Nini, David C. Smith, and Amir Sufi, ‘Creditor Control Rights, Corporate Governance and Firm Value’ (2012) Review of Financial Studies, Vol. 25, No. 6, at 1713-1761; Albert Choi and George Triantis, ‘Market Conditions and Contract Design: Variations in Debt Contracting’ (2013) New York University Law Review, Vol. 88, No. 1, at 52-80; Yesha Yadav, ‘The Case for a Market in Debt Governance’ (2014) Vanderbilt Law Review, Vol. 67, No. 3, at 771-835; John Armour, Antonia Menzes, Manesh Uttamanchandani, and Kristin van Zwieten, ‘How do creditor rights matter for debt finance? A review of empirical evidence’ in the Research Handbook on Secured Financing in Commercial Transactions (ed. Frederique Dahan, 2015), at 3-25; Charles Whitehead, ‘Debt and Corporate Governance’ in The Oxford Handbook of Corporate Law and Governance (ed., Jeffrey N. Gordon and Wolf-Georg Ringe) (2015), at 470-488; Sudheer Chava, Shunlan Fang, Praveen Kumar, and Saumya Prahbat, ‘Debt Governance and Corporate Governance’ (2019) Annual Review of Financial Economics, Vol. 11, No. 1, at 197-219; Judy Day and Peter Taylor, ‘The Role of Debt Contracts in UK Corporate Governance’ (1998) Journal of Management and Governance, Vol. 2, at 171-190; Ioannis Spyridopoulos, ‘Tough Love: The Effect of Debt Contract Design on firms' Performance’ (2020), Review of Corporate Finance Studies, Vol. 44, No. 9, 47. For further details, see Section 4.

Recently, there have also been several important contributions advocating for the significance of debt in corporate governance. Examples include investigating the role of debt stewardship in the context of ESG and The UK Stewardship Code,²⁰ examining debt governance effects of material adverse change/effect clauses in corporate debt financing agreements,²¹ studying the role of negative debt covenants in credit agreements,²² analysing the governance role of debt in the U.S.-based dual class ownership structures,²³ and proposing a theory of governance in the context of credit derivatives trading.²⁴

Yet, the role of debt in corporate governance²⁵ has predominantly been addressed in the context of debt covenants²⁶ and, in the majority of cases, with respect to the traditional bank financing.²⁷ The earlier scholarship has not addressed the increasing

²⁰ Suren Gomtsian, 'Debtholder stewardship' (2023) *The Modern Law Review*, Vol. 86, No. 2, at 395-435. The term "ESG" stands for Environmental, Social, and Governance.

²¹ Narine Lalafaryan, 'Orchestrating Finance with Material Adverse Changes?' (2022) *Legal Studies*, Vol. 42, No. 1, at 1-22.

²² Louise Gullifer and Graham Penn, 'The Boundaries of a Borrower's Freedom to Act: Negative Covenants in Loan Agreements', in *Contents of Commercial Contracts: Terms Affecting Freedom* (ed. P. Davies and M. Raczynska, Hart Publishing 2020), at 139-162. See also Louise Gullifer and Jennifer Payne, 'Corporate Finance Law: Principles and Policy' (2020, 3rd ed., Hart) at 87-97.

²³ Aiysha Dey, Valeri Nikolaev, Xue Wang, 'Disproportional Control Rights and the Governance Role of Debt' (2016) *Management Science*, Vol. 62, No. 9, at 2581-2614.

²⁴ Yesha Yadav, 'The Case for a Market in Debt Governance' (2014) *Vanderbilt Law Review*, Vol. 67, No. 3, at 771-835

²⁵ Andrei Shleifer and Robert Vishny define the term "corporate governance" as 'the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.' (See Andrei Shleifer and Robert Vishny, 'A survey of corporate governance' (1997) *The Journal of Finance*, Vol. 52, No. 2, at 737). Marc T. Moore, in 'Corporate Governance in the Shadow of the State' (2013, Hart Publishing), at 13 notes that 'corporate governance – analysed from a distinctly legal perspective – is first and foremost an enquiry into the causes and consequences of the allocation of power within large economic organisations.' Moore further notes at 14 that '[...] corporate governance can be defined as the social problem of holding powerful decision-makers in large economic organisation accountable for their actions, in order to legitimate their continuing possession and exercise of power.' Brian Cheffins, in line with the UK Cadbury Report, defines the term "corporate governance" as 'concerned with the systems by which companies are directed and controlled.' (See Brian Cheffins, 'Corporate Ownership and Control: British Business Transformed' (2008, Oxford University Press), in Ch.1, 'Setting the Scene', at 4, referring to 'The Cadbury Report (1992)'). See also The UK Corporate Governance Code (2018), at 1.

²⁶ Sudheer Chava, Shunlan Fang, Praveen Kumar, and Saumya Prabhat, 'Debt Covenants and Corporate Governance' (2019), *Annual Review of Financial Economics*, Vol. 11, at 197-219; Louise Gullifer and Graham Penn, (2020), at 139-162; Adam B. Badawi, 'Debt Contract Terms and Creditor Control' (2019) *Journal of Law, Finance, and Accounting*, Vol. 4, No. 1, at 1-34. Nicolae Garleanu and Jeffrey Zweibel, 'Design and Renegotiation of Debt Covenants' (2009) *The Review of Financial Studies*, Vol. 22, No. 2, at 749-781;

²⁷ One of the pioneering works in this area is Clifford Smith and Jerold Warner, 'On financial contracting: An analysis of bond covenants' (1979) *Journal of Financial Economics*, Vol. 7, No. 2, at 117-161. See also, Victoria Ivashina, Vinay B. Nair, Anthony Saunders, Nadia Massoud, and Roger Stover, 'Bank Debt and Corporate Governance' (2009) *The Review of Financial Studies* Vol. 22, No. 1, at 41-77; Eugene Fama, 'What is different about banks?' (1985) *Journal of Monetary Economics*, Vol. 15 No. 1, at 29-39; Christopher James, 'Some Evidence on the Uniqueness of Bank Loans' (1987) *Journal of Financial Economics*, Vol. 19, No. 2, at 217-235; Marcel Kahan and David Yermack, 'Investment Opportunities and the Design of Debt Securities' (1998) *Journal of Law, Economics, & Organization*, Vol. 14, No. 1, at 136-151; William W. Bratton, 'Bond and loan covenants, theory and practice' (2016) *Capital Markets Law Journal*, Vol. 11, No. 4, at 461-485; Raghuram G. Rajan, 'Insiders and Outsiders: The Choice between Informed and Arm's-Length Debt' (1992) *The Journal of Finance*, Vol. 47, No. 4, at 1367-1400; Gary Gorton and James Kahn, 'The Design of Bank Loan Contracts' (2000) *The Review of Financial Studies*, Vol. 13, No. 2, at 331-364; Hideki Kanda, 'Debt holders and Equity holders' (1992) *The Journal*

significance of private credit funds and of the modern debt governance mechanisms, including the new debtholder control tools requested by the private credit market.

These developments have important implications for the firm, as they materially impact the dynamics between the different corporate constituencies (e.g., directors, debtholders, shareholders), giving debtholders new control mechanisms to influence the firm also outside financial distress: to cope with the dynamic nature of corporate debt markets, which are full of unforeseen and large-scale risks.²⁸

In these areas of corporate finance and corporate governance *foundational legal questions require re-examination*. The urgency of addressing these issues is reinforced by the important changes in corporate finance markets over the past twenty-five years, including the increasing popularity of the private credit industry (that has recently been outperforming even the high-yield bonds and the syndicated loan markets),²⁹ and by the need to better understand the dynamic role of debt in the firm and its modern-day relationship with equity.

In light of this, the focus of this paper is the evolution of the role of corporate debt finance outside financial distress: how debt investment has influenced and could influence the firm in this timeframe. The paper proposes a novel conceptualisation of debt governance (*'modern debt governance'*). It does so by developing a model (taxonomy) of modern debt governance, comparing the influence of commercial banks and private credit funds when investing debt capital in a firm.³⁰

The term “debt governance” in this paper denotes (i) the influence of debtholders on the firm outside financial distress (e.g., cost of finance, directors’ incentives, decisions of the board, the firm’s flexibility to operate, entitlement to participate in capital growth and profit sharing, relationship between debtholders and shareholders) (*‘the domain of debt influence’*), and (ii) how debtholders through their decisions influence the firm (*‘the*

of Legal Studies, Vol. 21, No. 2, at 431-448; Loretta Mester, Leonard Nakamura and Micheline Renault, *‘Transactions Accounts and Loan Monitoring’* (2007) *The Review of Financial Studies*, Vol. 20, No.3, at 529-556; Michael Roberts and Michael Schwert, *‘Interest Rates and the Design of Financial Contracts’* (2022) NBER Working Paper 27195. But see the recent working paper by Victoria Ivashina and Boris Vallée, *‘Complexity in Loan Contracts’* (2022), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3218631 (who also look at non-bank financing and use novel data on 1,240 credit agreements from the leveraged loan market. The authors find at 1 that ‘sophisticated borrowers, and larger *non-bank funding* of a loan, are associated with more complex contractual terms.’)

²⁸ See Sections 3 and 4.

²⁹ Bloomberg, *‘Private Credit’s Dancing in the Streets Gets Wilder’* (2023), available at: https://www.bloomberg.com/opinion/articles/2023-07-18/private-credit-the-wild-ride-is-not-yet-over?in_source=embedded-checkout-banner (referring to Morgan Stanley)

³⁰ Private credit strategies include direct lending, mezzanine, special situations, distressed lending, venture debt, real estate debt, and infrastructure debt. The paper focuses on direct lending as it is the dominant private credit strategy.

mechanisms of debt influence'), and (iii) the impact that such debt governance decisions have also beyond the firm (i.e., externalities) (e.g., the society, other market participants, general availability of funding) (*the boundaries of debt influence*).

This paper argues that the profound developments in corporate finance markets over the past twenty-five years increased the ways in which the modern debt investment is used to influence the firm not only within, but also outside its financial distress. It challenges the traditional legal and financial framework of corporate finance and corporate governance and offers the following fundamental insights (discussed in detail in Sections 2 – 4):

Due to market changes, debt has come to play an important role in the firm *also outside financial distress*: the mechanisms of debt governance are and will be *evolving*, and the impact of debt on the firm's performance is of a dynamic nature. Both traditional (e.g., debt covenants), but also more modern mechanisms of debt governance (e.g., board representation, minimum return on debt investment, floating pricing, etc., as discussed later) are a result of a *market-driven* approach that aims to address the evolving nature of debt finance.

By actively seeking *board representation* and getting full access to the borrower-firm's management team, private credit funds play an essential role in the governance of the firm and, importantly, have a dynamic view on the firm's valuation. Board representation also helps private credit funds to achieve their investment strategy. This management aspect (influence on the board) speaks directly to the corporate governance role of debt and is different from the traditional bank financing.

Floating price in private credit (i.e., floating interest re-priced every 30-90 days), as opposed to relying only on debt covenants, is a new form of debtholders' influence. It drives the debtholders' control of the firm, enabling them (i) to influence and engage with the firm on an ongoing basis and prior to its financial distress, (ii) to have a dynamic view of the firm's valuation (which often corresponds to the interest rates), and, (iii) consequently, to develop an evergreen financing structure. As interest rates go up (as has been the case lately),³¹ the servicing of debt becomes more difficult for the borrower-firms (i.e., cost of

³¹ See The Bank of England, 'Official Bank Rate' (live chart) (2023), available at: <https://www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate> (showing the increase in interest rates e.g., from 0.1% on 20 March 2020 to 5.25% on 3 August 2023).

debt servicing is becoming high). This new form of debt governance has significant implications on the incentives of the firm's directors to take into account the interests of debtholders also outside financial distress.³² In modern markets, debtholders are increasingly interested in ex-ante accurately pricing and ex-post dynamically repricing their investments, as opposed to focusing only on their ex-post credit ranking. In a bank-originated debt market, repricing is also driven by the liquidity in the secondary loan markets.

The modern debt governance approach of repricing debt has further *implications on the understanding of the nature of debt financing*, in particular, that of loan financing (e.g., term, revolving and syndicated loans). This modern trend challenges the traditional position that loan financing deals are not expected to be renegotiated; it explains that they are expected to be continued and not ended. Yet, sometimes, they are expected to be ex-post repriced due to the dynamic nature of debt finance.

The contractual return provisions in the private credit market, entitling debt providers to a *minimum return* (i.e., return not in the form of a traditional interest rate, but in addition to this: a risk-adjusted return that is linked to the profitability of the firm) and carried interest on their debt investment, directly challenge the traditional conception of debt in corporate finance and corporate governance.³³ The conventional approach is that debt providers are interested in value-maintaining activities of the firm, whereas shareholders are interested in value-maximisation. The traditional approach is that unlike for equity investment, for pure type debt investment (e.g., loan finance), there is no capital growth (participation in profit sharing) for debt investors. The paper shows that this orthodox thinking is outdated. Private creditors invest for a long-term. These investors are interested in the firm's success and its capital growth in order to be paid back not only the main debt sum, the interest rate, but also a return on their debt investment and participate in profit sharing.

Private credit funds, as they continue to compete with commercial banks, are likely to play a *key role* in the evolving nature of corporate finance and corporate debt governance – reshaping and revolutionising debt markets.

³² See Section 3.

³³ See Section 3. This return is in addition to the main debt sum and the interest rate.

In the modern market environment (roughly post-GFC), *outside financial distress, often equity and debt governance complement each other: one cannot exist in a vacuum from one another.* This is especially relevant for private firms but has recently become important for public firms as well, as they also started to seek financing from private credit funds. This paper does not claim that debt governance is always in the interests of equity. Instead it argues that the significant changes to debt markets affect modern-day debt capital's relationship with equity, making the two more interconnected and overlapping, even more so in private firms.³⁴ Modern-day debt investors are interested in the success of their investments also outside the firm's financial distress, for instance, to participate in profit sharing through a return on their debt investment and to achieve the investment strategy (for private credit funds), or to be able to successfully market debt to the secondary loan market (for commercial banks).³⁵ Effective debt governance not only within, but also outside financial distress further minimises 'the firm's total competence and conflict costs'.³⁶

This paper aims to show that often debtholders through these modern debt governance mechanisms of private ordering (contractual bargaining) achieve and could achieve a degree of control also outside financial distress. This benefits both shareholders and debtholders, maximising the private benefits of the shareholders and aligning with the traditional idea of the purpose of the firm (i.e., shareholder wealthfare maximisation), but also providing adequate and dynamic control rights to its debtholders. It also maximises the overall size of the pie for all corporate constituencies.³⁷ By addressing this, the paper aims to show how the reliance of private credit funds on private bargaining can also improve the economic efficiency (i.e., *the link between contractual bargaining (private law) and economic efficiency*).³⁸

The remainder of this paper is organised as follows: Section 2 studies the important changes in corporate finance markets with respect to private debt. It further presents a taxonomy of the key features of private debt (loan) financing deals, comparing commercial banks with private credit funds (*Table 1*). Section 3 considers the implications of the market

³⁴ See Section 4.

³⁵ See Sections 4 and 5.

³⁶ Zohar Goshen and Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance* (2017) Columbia Law Review, Vol. 177, No. 3, at 767-829.

³⁷ Ronald Coase, *The Problem of Social Cost* (1960) The Journal of Law & Economics, Vol. 3, at 1-44.

³⁸ The paper does not oppose regulation (e.g., whether private credit funds should or should not be regulated, and to what extent). The question addressed in this paper is how debtholders protect themselves.

changes, discussed in Section 2, from a debt governance perspective. It develops a model (a new taxonomy) of modern debt governance mechanisms, analysing and contrasting commercial bank financing and private credit financing (*Table 2*). Section 4 then explains the implications of market changes for the modern-day relationship between equity and debt in the firm. It examines the general benefits of the interlinked equity-debt governance system outside financial distress, and also the advantages of symbiotic equity-debt governance for the firms with private credit financing. This section further highlights that the traditional delineation between equity and debt often no longer exists and emphasises the implications of this important development for corporate finance and corporate governance. Section 5 concludes.

2. Modern Debt: Dynamic, Parallel, Adaptable, and Market-Driven

This section addresses the first theme of this paper: *the evolution of corporate finance, in particular, of corporate debt finance*. It examines the significant patterns of change in the corporate debt finance markets over the past twenty-five years with respect to private debt. In doing so, this section also investigates the key features of modern debt: *dynamic, parallel, adaptable, and market-driven*.³⁹

The preceding analysis establishes the framework on which Sections 3 and 4 rely on (i) to analyse and, where relevant, also to propose new mechanisms of debt governance, and (ii) to investigate how debtholders influence or could influence the firm outside financial distress. Before doing this, the sub-section “A” offers an overview of the origins of the role of “debt” in corporate governance.

A. “Debt” in corporate governance

The term “debt governance” has not *often* been used in the corporate governance literature, or in the general corporate law scholarship.⁴⁰ In their seminal corporate governance paper, Shleifer and Vishny argued that large debtholders have incentives to

³⁹ The term “dynamic” means that debt is evolving, changing, moving. The term “adaptable” means that debt has the capacity and ability to change.

⁴⁰ A search on the Google Scholar platform of the term “debt governance” brings 1,170 results, out of which most of the results do not relate to corporate debt governance but are in the context of *sovereign debt*. The search of the term “creditor governance” brings 223 results, whereas the search of “lender governance” only 77 results.

improve the firm's performance because similarly to large shareholders, '[...] they want to see the returns on their investments to materialize.'⁴¹ It was the influential works by Triantis and Daniels (1995), and Baird and Rasmussen (2006), followed by later studies by Tung (2009), Whitehead (2009), Choi and Triantis (2013), Yadav (2014) that revolutionised the role of debt in the firm and highlighted the role of debt in corporate governance, exploring its importance in the context of the firm.⁴²

This earlier scholarship made very important contributions in advocating that debt has been a 'missing lever'⁴³ of corporate governance, as argued by Baird and Rasmussen, and that debtholders are in a position to monitor and detect managerial shirking, as advocated by Triantis and Daniels.⁴⁴ Choi and Triantis further demonstrated how the debtholders' certain decisions via signal-exchange and collaboration on penalising management have beneficial effects for the firm and its other stakeholders.⁴⁵ Economists Nini, Smith, and Sufi showed that efficient debtholder control can promote equity-focused corporate governance or even replace it.⁴⁶

Later, Gullifer and Payne argued that one should also consider the governance power given to the debtholders when they waive a breach or default by the borrower-firm.⁴⁷ Gullifer and Penn examined the role of negative covenants in credit agreements and their potential role in aligning the interests of directors with that of the firm.⁴⁸ More recently, Gomtsian offered a framework for understanding how debt holders can contribute to stewardship outside distress, exploring the role of debtholders in promoting responsible business practices through the stewardship of borrowers.⁴⁹

Nevertheless, the role of debt in the firm for a long time has traditionally been limited to when the firm becomes insolvent or is bordering insolvency.⁵⁰ Besides, by virtue

⁴¹ Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997) *The Journal of Finance*, Vol. 52, No. 2, at 757-758.

⁴² See Triantis and Daniels, (1995); George G. Triantis, 'Debt Financing and Motivation' (1997) *University of Richmond Law Review*, Vol. 31, at 1323-1343; Baird and Rasmussen (2006); Tung (2009); Yadav (2014).

⁴³ Baird and Rasmussen (2006); Yadav (2014).

⁴⁴ Triantis and Daniels (1995).

⁴⁵ See also, Albert Choi and George Triantis, 'Market Conditions and Contract Design: Variations in Debt Contracting' (2013) *New York University Law Review*, Vol. 88, No. 1, at 52-80.

⁴⁶ Greg Nini, David C. Smith, and Amir Sufi, 'Creditor Control Rights, Corporate Governance and Firm Value' (2012) *Review of Financial Studies*, Vol. 25, No. 6, at 1713-1761.

⁴⁷ See Gullifer and Payne (2020), at 92 and at 139-162; Judy Day and Peter Taylor, 'The Role of Debt Contracts in UK Corporate Governance' (1998) *Journal of Management and Governance*, Vol. 2, at 171-190.

⁴⁸ Gullifer and Penn (2020), at 139-162.

⁴⁹ Gomtsian (2023).

⁵⁰ In the United Kingdom, this position was developed through common law. See *West Mercia Safetywear v Dodd* [1988] 4 BCC 30 (CA). See also *BTI v Sequana* [2022] UKSC 25, per Lord Reed at para 8.1. The Supreme Court in *Sequana* [2022] held that real risk of insolvency is insufficient. ("I am satisfied that the rule in *West Mercia* does not apply merely because the company is at a real and not remote risk of insolvency at some point in the future." (para 14, per Lord Reed, emphasis added)). See also *Sequana* [2022] para 83, per Lord Reed;

of the times when the studies were made, many of them predominantly examined the role of debt covenants as corporate governance tools and mostly with respect to the traditional bank financing model.⁵¹ The times were different, so were the nature, complexity, and sophistication level of debt markets and of their participants. *The times have changed: the firm no longer has to be insolvent in order for its debtholders to have a significant impact on the firm, and their influence mechanisms do not have to be limited to debt covenants* (as discussed in Sections 3 and 4).

B. Two markets for private debt with different incentives and control rights

The important developments in corporate finance markets over the past twenty-five years, and, especially post-GFC, resulted in two *parallel markets for private debt* (i.e., markets where a firm can obtain private debt financing): the traditional bank market and the private credit market. As the proceeding discussion explains, in these two markets, there is a difference not only in the nature and identity of the providers of debt capital, but also in the incentives and the rights that they request to influence and control the firm.⁵²

The reason for such a divergence is that in a modern market (i.e., post-GFC) commercial banks have been mostly operating within the funding model of “*originate-to-distribute*”⁵³ to the secondary liquid loan market. This model is also known in the finance community as the “moving business”. By contrast, private credit funds have largely focused on the funding model of “*originate-to-suit-and-fit*”⁵⁴ the portfolio of the market that they operate in. This financing framework is also called the “storage business”. The distinction between these two funding models can additionally be described as “*trading the risk*” for commercial banks vs “*owning the risk*” for private credit funds.

The following sub-sections “i” – “iv” explore these two funding models (including their interconnectedness), the business nature of private credit funds and their future in

para 199, *per* Lord Briggs with whom Lord Kitchin agreed; para 306, *per* Lady Arden. The majority in *Sequana* [2022] also found that the “creditor duty” is engaged when the directors know, or ought to know, that the company is insolvent or bordering on insolvency, or that an insolvent liquidation or administration is probable. *See* para 203, *per* Lord Briggs with whom Lord Kitchin agrees; para 231, *per* Lord Hodge. Both Lord Reed and Lady Arden left open the question of whether it is essential that the directors know or ought to know that this is the case (*see* para 90 and 281).

⁵¹ For examples, *see* the influential scholarship mention in the footnotes 18-21 and 26.

⁵² For a discussion on the interconnectedness of risks in these two markets, *see* sub-section 2 “C” below.

⁵³ The term “*originate-to-distribute*” means that debt is originated and later sold to the secondary loan market. *See also* sub-section “ii” below. On the development of the originate-to-distribute model in the banking industry, *see* Vitaly M. Bord and João A. C. Santos, ‘*The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation*’ (2012) *Economic Policy Review*, Vol. 18, No. 2, 21-34.

⁵⁴ The term “*originate-to-suit-and-fit*” means that debt is originated and kept until its maturity or repayment.

debt markets, and the obstacles facing the banks post-GFC, preventing them from using the same business operational strategy as the private credit funds.

i. The private credit model – from outcasts to competitors to potential leaders

The corporate debt financing markets were slow developing markets with a strong relational finance element attached to them: commercial banks relied on their relationship with firms to originate and manage their portfolios.⁵⁵ In the loan markets, the banks simply knew the firms that they were dealing with: there was less information asymmetry between the providers and receivers of debt finance. As a result, there was not an urgent need to look into loan covenant packages to address borrower-opportunism and to facilitate information sharing regime, and the contractual framework (including debtholder protection provisions) was less detailed. Similarly, for the bond markets, there were covenants included in bond agreements; those, however, were a lot thinner than the covenants requested by banks in loan financing agreements.

From 1970s, when the syndicated loan market started to gather speed, not only the debtholders, but also the corporate borrowers became more sophisticated.⁵⁶ Prior to the GFC and, especially, in its aftermath, there has been a further important change in the nature of debt finance and of its providers. The traditional bank-financed debt market has withered away. In this market, there has been a gradual shift from relationship finance to a state where relational finance has become much less common. This change happened following the various economic scandals during the GFC⁵⁷ that involved several of the global financial players, such as the Lehman Brothers, the Royal Bank of Scotland and others, causing the financial regulators worldwide to introduce stricter rules for the banks.⁵⁸ The increased competition – as a result of the change to the landscape of debt providers and predominantly driven by banking regulation, which creates a capitally inefficient legal

⁵⁵ See The Bank for International Settlements, 'Structure changes in banking after the crisis' (2018) CGFS Papers No 60, available at: <https://www.bis.org/publ/cgfs60.pdf>; Edward P.M. Gardener, 'The Future of "Traditional Banking"' in the Recent Evolution of Financial Systems (1997, Palgrave Macmillan), at 33-56. See also, James Crotty, 'Structural causes of the global financial crisis: a critical assessment of the "new financial architecture"' (2009) Cambridge Journal of Economics, Vol. 33, No. 4, at 563-580.

⁵⁶ The Bank for International Settlements, 'The syndicated loan market: structure, development and implications' (2004) The BIS Quarterly Review, at 75-89, available at: https://www.bis.org/publ/qtrpdf/r_qt0412g.pdf.

⁵⁷ For an overview, see Edward J. Schoen, 'The 2007-2009 Financial Crisis: An Erosion of Ethics: A Case Study' (2017), Journal of Business Ethics, Vol. 146, at 805-830.

⁵⁸ E.g., Basel 3 and Basel 3.5 regulatory framework for banks in Europe; The Dodd-Frank Act in the United States. See also Stephen M. Bainbridge, 'Corporate Governance After the Financial Crisis' (2012, Oxford University Press), at 13.

framework for banks – continues to impact banks' ability to provide long-term relational finance and above a certain size.⁵⁹

In line with this, Gorton and Metrick suggest that the rise of nonbank lenders was facilitated by 'regulatory and legal changes that gave advantages to three main institutions: money-market mutual funds (MMMFs) to capture retail deposits from traditional banks, securitization to move assets of traditional banks off their balance sheets, and repurchase agreements (repos) that facilitated the use of securitized bonds as money.'⁶⁰ The shift from the traditional banking model into what is commonly known as market-based finance⁶¹ could also be attributed to developments in financing engineering, as well as the globalisation of funding and capital markets.⁶²

Driven by these changes, markets moved on: there is still the architecture for loans, but banks are typically selling or are aiming to sell them immediately to the secondary loan market.⁶³ They no longer retain dominant and monopolistic position of financing large-scale leveraged buyouts.⁶⁴ These developments in debt markets created a raft of opportunities for private credit funds,⁶⁵ changing the historic perception of private credit 'from dinosaur to dynamic funding model.'⁶⁶ Private credit funds have come to fill in the

⁵⁹ Although this paper does not focus on the banking regulation and supervision, it is worth mentioning that The United States Federal Reserve, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation proposed a new framework which would apply to banks with more than \$100 billion in assets and which could erase almost all of the \$118 billion in excess capital that banks put aside. According to this new proposal, banks will have to hold 16% more capital and will have time until the start of 2028 to comply with the new rules. See, Financial Times, 'Regulators announce 'Basel III endgame' rules for large US banks' (2023), available at: <https://www.ft.com/content/d4d15a2a-1568-47db-bd29-937a478dc768>; Bloomberg, 'Banks' \$118 Billion Buffer Likely Wiped Out by New Capital Rules' (2023), available at: https://www.bloomberg.com/news/articles/2023-07-26/banks-118-billion-buffer-likely-wiped-out-by-new-capital-rules?utm_source=twitter&utm_content=tv&cmpid%3D=socialflow-twitter-tv&utm_medium=social&utm_campaign=socialflow-organic#xj4y7vzkg

⁶⁰ Gary Gorton and Andrew Metrick, 'Regulating the Shadow Banking System' (2010) Brookings Paper on Economic Activity, at 261, available at: https://www.brookings.edu/wp-content/uploads/2010/09/2010b_bpea_gorton.pdf.

⁶¹ Ross Levine, 'Bank-Based or Market-Based Financial Systems: Which is Better?' (2022) *Journal of Financial Intermediation*, Vol. 11, No. 4, at 398-428.

⁶² The Financial Conduct Authority, 'Market-Based Finance: Its Contributions and Emerging Issues' (2016), available at: <https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-18-market-based-finance-its-contributions-and>; Wladimir Kraus, 'The Rise of Market Based Finance' (2016), available at: <https://www.fca.org.uk/insight/rise-market-based-finance>.

⁶³ For more details on loan transfers, including mechanisms of transfer and reasons for transfers, see Section 3, sub-section "E".

⁶⁴ Financial Times, 'LBO finance: buyout groups push into lucrative private credit' (2022), available at: <https://www.ft.com/content/29f6cf4b-72ac-486d-a7cc-d772e92f5569>.

⁶⁵ See Deloitte, 'Private Debt Deal Tracker' (Autumn 2022), available at: <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-pddt-autumn-2022.pdf>. For an analysis of private debt from a practitioner's point of view, see also Stephen L. Nesbitt, 'Credit as a Separate Asset Class' Chapter 7 in *Private Debt: Opportunities in Direct Lending* (2019, Wiley); Stephen L. Nesbitt, 'Private Debt: Yield, Safety and the Emergence of Alternative Lending' (2023, Wiley).

⁶⁶ Fidelity International, 'Private debt: from dinosaur to dynamic funding model' (2022), available at: <https://www.fidelityinternational.com/editorial/article/private-debt-from-dinosaur-to-dynamic-funding-model-6b44ea-en5/>

gaps in the market where the commercial banks could no longer contribute.⁶⁷ Characterised as the ‘money market funding of capital market lending’,⁶⁸ private credit funds are financial intermediaries ‘[...] conduct[ing] maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees.’⁶⁹

During the course of the past fifteen years and, especially, since the start of the COVID-19-crisis, the private credit market has flourished.⁷⁰ The number of private credit funds has increased dramatically, so did their power and investment appetite.⁷¹ Over the period of 2003-2020, the market for corporate private debt has grown four times.⁷² The private credit market, specifically, expanded from \$250 billion in 2010, to \$1.5 trillion as of 3rd quarter of 2023,⁷³ making it a larger market than the venture capital market (which is estimated to grow to \$251.54 billion in 2023).⁷⁴ In 2022, private credit funds raised over \$200 billion globally.⁷⁵ The data provider Preqin projects the growth of the private credit market to reach \$1.8 trillion in 2023⁷⁶ (*Diagram 1*). In comparison, the high-yield bond

⁶⁷ Deloitte, ‘*Alternative Lender Deal Tracker*’ (Spring 2022).

⁶⁸ Perry Mehrling, Zoltan Pozsar, James Sweeney, and Dan Neilson, ‘*Bagehot was a Shadow Banker: Shadow Banking, Central Banking, and the Future of Global Finance*’ (2013) New York: Institute for New Economic Thinking, available at: <https://www.ccu.edu/sites/default/files/attachment/event/6574/nov05-perry-mehrling.pdf>

⁶⁹ The Federal Reserve Bank of New York, ‘*Shadow Banking*’ (2013) Economic Policy Review, Vol. 19, No. 2, at 1.

⁷⁰ Preqin, ‘*Preqin Global Report 2023: Private Debt*’ (2023). See also, Goldman Sachs, ‘*Understanding Private Credit*’ (2022), available at: <https://www.gsam.com/content/gsam/us/en/advisors/market-insights/gsam-insights/2022/understanding-private-credit.html>

⁷¹ Yale Insights, ‘*Can We Reduce Risk from the Shadow Banking System?*’ (2022) interview of Prof. Janet L. Yellen, available at: <https://insights.som.yale.edu/insights/can-we-reduce-risk-from-the-shadow-banking-system>; The Times, ‘*Shadow Banking: The Hidden Nasties Lurking in the Financial System*’, available at: <https://www.thetimes.co.uk/article/shadow-banking-the-hidden-nasties-lurking-in-the-financial-system-t8zvjr5>.

⁷² S&P Global, ‘*Private Debt: A Lesser-Known Corner of Finance Finds the Spotlight*’ (2021), available at: <https://www.spglobal.com/en/research-insights/featured/private-debt>. See also, The ECB, ‘*The rise of non-bank finance and its implications for monetary policy transmission*’ (2021), available at: <https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210824~9ab47b501b.en.html>; Financial Times, ‘*How the Biggest Private Equity Firms Became the New Banks*’ (2018), available at: <https://www.ft.com/content/ec43db70-ba8e-11e8-94b2-17176fbf93f5>.

⁷³ Preqin, ‘*Preqin Global Report 2023: Private Debt*’ (2023).

⁷⁴ Research and Markets, ‘*Venture Capital Investment Global Market Report 2023*’ (May 2023), available at: https://www.researchandmarkets.com/reports/5792967/venture-capital-investment-global-market-report?utm_source=GN&utm_medium=PressRelease&utm_code=r4l9v7&utm_campaign=1852737+-+Venture+Capital+Investment+Global+Market+Report+2023%3a+Sector+to+Reach+%24522.5+Billions+by+2027+at+a+20.1%25+CAGR&utm_exec=como322prd (noting that the size of the global venture capital market was \$207.74 billion in 2022, with projections to growth to \$251.54 billion in 2023). See also, S&P Global, ‘*Global venture capital deal value drops 68.9% YOY in January*’ (2023), available at: <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/global-venture-capital-deal-value-drops-68-9-yoy-in-january-74219521> (noting that ‘Global venture capital investment fell 68.9% year over year in January to \$18.18 billion from \$58.49 billion.’)

⁷⁵ This includes direct lending and other strategies of private credit. See Pitchbook, ‘*Global Private Debt Report*’ (2023), available at: [https://files.pitchbook.com/website/files/pdf/2022 Annual Global Private Debt Report.pdf](https://files.pitchbook.com/website/files/pdf/2022%20Annual%20Global%20Private%20Debt%20Report.pdf)

⁷⁶ The Bank of England, ‘*Financial Stability Report*’ (July 2023), at 81.

market has reached \$1.4 trillion, the leveraged loan market \$1.4 trillion, the Eurozone bank loans \$5.0 trillion, the US bank loans \$5.4 trillion, and the market for investment-grade bonds \$8.1 trillion.⁷⁷ The private credit market includes asset manager giants, such as Apollo, Blackstone, Ares, and KKR.⁷⁸

In the past fifteen years, private credit funds thrived and are no longer seen as finance providers to only short-term, small sum, non-investment grade firms, which used to be the traditional perception of private credit.⁷⁹ Private credit is active not only in the leveraged loan market and provides enough 'liquidity to fund larger and larger transactions, but also the flexibility to provide an array of financing structures – including unitranche and floating-rate notes.'⁸⁰

Such an advancement in the private credit market is evidenced, for instance, by the provision of private financing to a buyout group Carlyle as part of the largest-to-date direct lending club deal (\$5.5 billion) provided by the private credit funds on terms that commercial banks were not able to match.⁸¹ This trend also attests to the willingness of the private credit funds to cooperate amongst each other to finance larger (club) deals.⁸² Additionally, private credit has become even more relevant in helping commercial banks to push their liquidity, especially given the 2023 banking turmoil. A notable example of

⁷⁷ Bloomberg, 'Private Credit's Dancing in the Streets Gets Wilder' (2023), available at: https://www.bloomberg.com/opinion/articles/2023-07-18/private-credit-the-wild-ride-is-not-yet-over?in_source=embedded-checkout-banner (referring to Morgan Stanley)

⁷⁸ Apollo's assets under management ("AUM") (private credit) is \$438 billion, available at: <https://www.apollo.com/our-business/asset-management/yield> (last accessed: 14 August 2023); Blackstone's AUM (private credit) is \$295 billion, available at: <https://www.blackstone.com/our-businesses/credit/> (last accessed: 14 August 2023); Ares' AUM (private credit) as of 30 June 2023 is \$250.1 billion, available at: <https://www.aresmgmt.com/our-business>; KKR's AUM (private credit) as of 31 March 2023 is \$197 billion, available at: <https://www.kkr.com/businesses/credit>. See also, PitchBook, '10 largest private debt funds find opportunity in tight lending market' (2023), available at: <https://pitchbook.com/news/articles/private-debt-fundraising-funds-in-market-2023>.

⁷⁹ See Vitaly M. Bord, Victoria Ivashina and Ryan D. Taliaferro, 'Large Banks and Small Firm Lending' (2021) *Journal of Financial Intermediation*, Vol. 48, 100924. See also, Financial Times, 'Private credit finds its next big target: investment-grade debt' (2023), available at: <https://www.ft.com/content/271be286-ac12-449e-96f0-0d3ff9b4d6ee>

⁸⁰ S&P Global, 'Global Credit Outlook 2023: No Easy Way Out' (2022), at 26. See Jones Day LLP, 'Unitranche Finance: An Introduction, LexisNexis PSL', (2020), available at: <https://www.jonesday.com/en/insights/2020/11/unitranche-financing-an-introduction> (Unitranche facility is 'a single tranche term loan with a blended senior/junior interest rate. It is usually documented in a single loan agreement.')

⁸¹ Financial Times, 'Private credit edges out banks to offer Carlyle largest direct loan of its kind' (2023), available at: <https://www.ft.com/content/0d65e8d0-5354-40ed-9cb8-8c3fd1b0a31e> (noting that 'Private credit groups including Apollo, Ares and Blackstone are poised to write the largest direct loan on record as they continue to muscle in on a lucrative business traditional dominated by the Wall Street banks.')

⁸² On the other hand, a single private credit fund is also in a position to provide a large-scale financing. For example, Softbank obtained \$5.1 billion direct corporate credit facility from Apollo. See, Bloomberg, 'Apollo Increases SoftBank Loan to \$5.1 Billion from \$4 Billion' (2023), available at: <https://www.bloomberg.com/news/articles/2022-03-24/apollo-increases-softbank-loan-to-5-1-billion-from-4-billion#xj4y7vzkg>

this trend is Ares Management's acquisition of \$3.5 billion lender finance portfolio from Pacific Western Bank, where this portfolio consists of high quality, senior secured, asset-backed loans.⁸³ Private credit's commitment to green finance has also become more substantial. For instance, Blackstone recently raised \$7.1 billion (The Blackstone Green Private Credit Fund III) to finance clean-energy companies.⁸⁴ Another interesting development with regards to the involvement of private credit – which has traditionally been seen as a finance source for private firms – is the provision of large amounts of private credit financing to multinational public firms. An example of this is chipmaker Wolfspeed Inc. raising \$1.25 billion secured note financing from private credit providers, such as Apollo and others.⁸⁵ From the investors' side, a 2023 survey by Goldman Sachs shows that institutional family offices are also interested in investing in private credit.⁸⁶

This dramatic rise of private credit has been described as a 'parallel to the "privatisation" of equity markets.'⁸⁷ The data provider Preqin projects a growth for private credit between 2021-2027 to reach an all-time high in 2027 by reaching \$2.3 trillion (*Diagram 1*).⁸⁸ By contrast, the projections for bank financing are less optimistic. For instance, according to the latest EY European Bank Lending Economic Forecast, growth

⁸³ Ares Management, 'Ares Management acquires \$3.5 billion lender finance portfolio from Pacific Western Bank' (2023), available at: <https://ir.aresmgmt.com/news/ares-management-acquires-3-5-billion-lender-finance-portfolio-from-pacific-western-bank/8d2916c8-6669-4cbd-b1f7-60f976ea7cb0/>

⁸⁴ Blackstone, 'Blackstone Closes Record Energy Transition Private Credit Fund at Over \$7 Billion' (2023), available at: <https://www.blackstone.com/news/press/blackstone-closes-record-energy-transition-private-credit-fund-at-over-7-billion/>

⁸⁵ Wolfspeed Inc. raised \$ 1.25 billion from Apollo and other managers. See CNBC, 'New trend sees public borrowers turning to private credit for capital' (2023), available at: <https://www.cnbc.com/video/2023/06/26/new-trend-sees-public-borrowers-turning-to-private-credit-for-capital.html> Other examples of obtaining private credit financing by large public companies include the multinational telecom company AT&T, the airline company Air France-KLM, and multinational real-estate company Vonovia. See, Financial Times, 'Apollo chief warns private equity industry 'in retreat' as rates rise' (2023), available at: <https://www.ft.com/content/7d24db29-9046-42d3-a221-efb9e54db702>. See also, Sergey Chernenko, Isil Erel and Robert Prilmeier, 'Why Do Firms Borrow Directly from Nonbanks?' (2022) *The Review of Financial Studies*, at 1-46. An earlier example is Hertz Holding Inc. obtaining \$4 billion fleet financing from Apollo. See, S&P Global, 'Hertz nets \$4b commitment from Apollo Capital to finance 2021 fleet refresh' (2020), available at: <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/hertz-nets-4b-commitment-from-apollo-capital-to-finance-2021-fleet-refresh-61147912>

⁸⁶ Goldman Sachs, 'Eyes on the Horizon' (2023) report available at: https://www.gsam.com/content/dam/pwm/direct-links/us/en/PDF/onegs_familyoffice_eyesonthehorizon.pdf?sa=n&rd=n (surveying 166 institutional family offices, where a big number of family offices (30%) announced planning to increase their allocations to private credit).

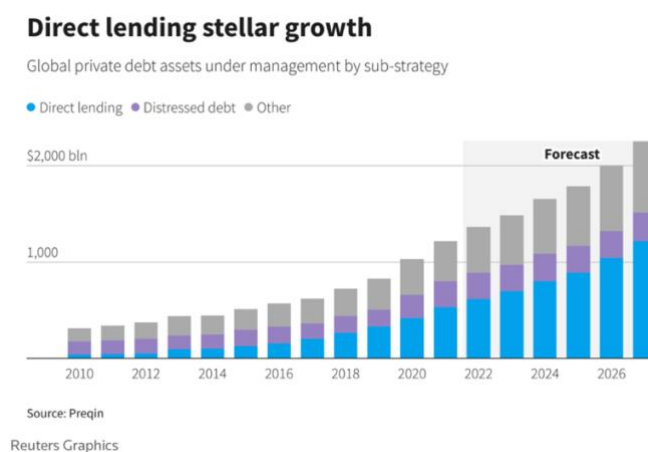
⁸⁷ Financial Times, 'The new LBO market: it's gone private' (2023), available at: <https://www.ft.com/content/0758d47f-ed50-47b5-bea1-20946271bc6a>

⁸⁸ Preqin, 'Preqin Global Report 2023: Private Debt' (2023), at 5.

in bank lending to businesses across the Eurozone area is estimated to slow down with growth of only 3% in 2023 and 0.9% in 2024.⁸⁹

The ongoing competition between commercial banks and private credit funds directly impacts borrower-firms.⁹⁰ This competition especially increased as leveraged loans and other sources of traditional capital have dried up, and buyout firms started to seek finance from private credit funds.⁹¹

Diagram 1



Source of diagram Preqin, taken from Reuters Graphics (2022)

ii. Private credit and its business model

The magnetic success behind private credit could be attributed to its different business model from that of commercial banks. This paper developed a taxonomy of private debt financing (*Table 1*) below, which aims to demonstrate the important characteristics of loan financing deals based on the type of the debtholder: commercial bank vs private credit.

⁸⁹ Ernst & Young, 'Eurozone bank lending growth forecast to fall this year and next, as rising interest rates drive a drop in loan demand' (2023), available at: https://www.ey.com/en_ro/news/2023/06/eurozone-bank-lending-growth-forecast-to-fall-this-year-and-next

⁹⁰ The Financial Stability Board, 'Global Monitoring Report on Non-Bank Financial Intermediation' (2021), available at: <https://www.fsb.org/wp-content/uploads/P161221.pdf>.

⁹¹ Heather Waters Borthwick, Tomasz Kulawik and Andrew Mavers, 'Rise of the jumbo unitranche: a continued trend in 2022?' (2022), Journal of International Banking and Financial Law, available at: <https://www.shearman.com/-/media/files/perspectives/2022/03/rise-of-the-jumbo-unitranche-a-continuing-trend-in-2022.pdf>. See also, The Wall Street Journal, 'Private Equity Turns to Direct Lenders as Leveraged Loans Dry Up' (2022), available at: <https://www.wsj.com/articles/private-equity-turns-to-direct-lenders-as-leveraged-loans-dry-up-11654682400>.

Table 1

Taxonomy of features of private debt (loan) financing deals: bank lending vs private credit

As shown in *Table 1*, there are several important differences in the business models of the providers of private debt. In the “*originate-to-distribute*” (bank-dominated) market, debt is being traded, and the two most important questions for the original debt investors are (i) who is going to hold these rights at a later stage, and (ii) whether it will be in a position to predictably sell the loan in the near future (e.g., three months).

For private credit funds, on the other hand, the main interest is *not* to originate debt in order to later distribute it; they are predominantly interested in “*suiting-and-fitting the portfolio*” of the market that they operate in and often self-originate loans by keeping them until their maturity.⁹² Institutional and retail investors in this market invest in loans and provide capital normally to small and medium-sized companies, where capital is essentially the provision of support to the firm by investing in it.⁹³ In terms of public counterparts for private credit, it has been suggested that ‘[for] private direct lending market, its public counterparts are the syndicated bank loan market and the high yield market.’⁹⁴

Unlike commercial banks, private credit funds do not have traditional depositors whose funds are covered by insurance. Instead, they raise short-term funds in the money markets,⁹⁵ including from commercial banks, relying on this type of financing to purchase assets that have a longer-term maturity.⁹⁶

Also differently from commercial banks, private credit funds typically provide high-risk loans which are not liquid.⁹⁷ The driver for them is a long-term relationship (e.g., eight years) with their borrower-firms. This leads to flexibility of how debt is touched upon and

⁹² See also Victoria Ivashina and Anna Kovner, ‘*The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking*’ (2011) *The Review of Financial Studies*, Vol. 24, No. 7, at 2462-2498. Private credit funds also buy debt in the secondary loan market.

⁹³ This has been the case for the past fifteen years, although very recently private credit funds also started provided financing to investment grade firms.

⁹⁴ Jeffrey Kramer, Texas Private Equity Conference 2022, ‘*The Role of Private Equity and Debt in Reshaping the Ownership, Valuation, and Governance of Private Companies*’, (2022) *Journal of Applied Corporate Finance*, Vol. 43, No. 3, at 66.

⁹⁵ An example is Ares Management Corporation raising about \$1.5 billion for its new fund for high-net-worth clients. See Ares, ‘*Ares Strategic Income Fund Launches with 1.5 Billion of Investible Capital*’ (2023), available at: <https://ir.aresmgmt.com/news/ares-strategic-income-fund-launches-with-1-5-billion-of-investible-capital/74a01fc8-505f-4bf0-ac0f-c966a0511c05/>

⁹⁶ The International Monetary Fund, ‘*What is Shadow Banking?*’ (2013) *Finance and Development*, Vol. 50, No. 2.

⁹⁷ See also, The Alternative Credit Council in partnership with Allen & Overy LLP, ‘*Financing the Economy 2022*’ (2022), available at: <https://acc.aima.org/compass/insights/private-credit/financing-the-economy-2022.html>

the returns that private credit funds negotiate to satisfy their investment model: risk-adjusted returns in addition to the traditional interest charged on debt. In other words, private credit provides better absolute returns to its investors in a form of a regular income (return premium and performance premium).⁹⁸

Compared to banks, private credit funds provide firms with access to non-amortising, bullet structures and offer more flexibility.⁹⁹ They also offer (i) a faster way of obtaining finance due to due diligence and underwriting process being shorter than the one conducted by banks, (ii) larger hold sizes for leveraged loans, and (iii) more creative solutions to finance the growth of the firm.¹⁰⁰ Yet, private credit funds request a higher cost of credit and are not in a position to provide clearing facilities and ancillaries.¹⁰¹ During the past years, the protective debt covenant package in bank provided financing has typically been covenant-lite, as opposed to the covenant protection package included in the direct lending deals originated by the private credit funds.¹⁰² The latter bargain for a stronger protection (e.g., the inclusion of financial maintenance covenants).¹⁰³

In terms of the seniority of private credit in capital structure, according to Deloitte's 2023 Spring Private Debt Deal Tracker, from Q4 of 2021 to Q4 of 2022, from 4,290 total European deals completed by 76 private debt lenders that participated in Deloitte's survey,¹⁰⁴ 83% of the private credit deals were first lien structured¹⁰⁵ (senior unitranche/stretched senior, super senior RCF,¹⁰⁶ super senior TL¹⁰⁷). Unitranche financing¹⁰⁸ in this period has been the most common structure for private debt deals, with

⁹⁸ For a further discussion on this, see Section 3.

⁹⁹ Deloitte, 'Alternative Lender Deal Tracker' (2022), at 1-71.

¹⁰⁰ Deloitte (2022)

¹⁰¹ Deloitte (2022).

¹⁰² Oaktree Capital Management, 'Direct lending: benefits, risks and opportunities' (May 2021), available at: https://www.oaktreecapital.com/docs/default-source/default-document-library/direct-lending.pdf?sfvrsn=347d7e66_4#:~:text=These%20include%20maintenance%2Dbased%20covenants,EBITDA%20below%20a%20specific%20level.

¹⁰³ Unlike covenant-lite loan financing, in private credit financing, the financing includes financial maintenance covenants are tested regularly (e.g., quarterly at the end of each fiscal quarter).

¹⁰⁴ Deloitte, 'Private Debt Deal Tracker' (Spring 2023), at 25 (also noting that from 4,290 total deals, 1,472 deals were completed in the UK, whereas 2,818 were completed in the rest of Europe).

¹⁰⁵ First lien debt structure means that the holders of the first lien debt are entitled to be paid back prior to all other debtholders.

¹⁰⁶ "RCF" stands for a revolving credit facility.

¹⁰⁷ "TL" stands for a term loan.

¹⁰⁸ Linklaters LLP, 'Unitranche facilities: a growing role in the European loan market?' (2015), available at: https://www.linklaters.com/media/files/linklaters/pdf/mkt/london/gc5945_unitranche_facilities_bafs_final_screen.ashx?rev=ff80572f-8abd-467f-b113-ae001a4a81f0 (noting at 1, that 'A unitranche facility [...] avoids the need to take separate senior and mezzanine facilities, simplifying the layers in the borrower's capital structure. It typically sits alongside the borrower's other financing, for example revolving credit facility [...]').

57% of the UK deals and 48% of the European deals structured this way.¹⁰⁹ In comparison, subordinate structures represent only 17%.¹¹⁰

In sum, in the private credit market the trade-off for the firm is a higher price and more control on its business decisions by the debtholders, but more scope for relational finance with the debtholder, and innovation, creativity, and growth for the borrower-firm.

Despite their increasing numbers and growing significance, there has been little scholarly research carried out specifically on private credit funds. Notable exceptions from *economics* and *finance* are mentioned below. Buchner et al., using proprietary deal data (for the period of 1982-2015) of private-debt funds from the Centre for Private Equity Research, among other things, find that private credit deals without venture capital and private equity sponsors generate premium, and that this sponsorless premium compensates debt investors for higher risk and costs of risks mitigation.¹¹¹ Jang uses a proprietary dataset of credit agreements to study the US market of nonbank direct lending to private equity middle market buyouts.¹¹² Jang's study shows that similarly to banks, direct lenders actively rely on covenants for monitoring the borrower-firm; by contrast to bank financing, direct lending is more expensive, because private credit funds bargain for higher interest rates and request tighter debt covenants; compared to bank financing they also provide finance more against cash flow to smaller firms, offer more flexibility in ex-post distress situations, and require more involvement from private equity ("PE") sponsors.¹¹³ A study by Block et al., surveys the US and European investors, primarily direct lending funds, with private debt assets under management of over \$300 billion.¹¹⁴ Among other things, the authors find that the US and European funds share many similarities, but that the European private credit funds are less dependent on PE sponsors and are more in a competition with banks.¹¹⁵ Earlier, Böni and Manigart¹¹⁶ collected data on 448 private debt funds (1986-2018) and examined their net-of-fees internal rate of

¹⁰⁹ Deloitte, 'Private Debt Deal Tracker' (Spring 2023), at 25.

¹¹⁰ From the unitranche deals (> euro 300 million) reported since the inception of Deloitte's Deal Tracker, the largest private credit deal (unitranche financing) in the amount of £3,5 billion was to the borrower Access Group in the UK in June 2022. It was provided by a private club of lenders (Park Square, Bain, SMBC, Blackstone Credit, Apollo, HPS, Arcmont), see Deloitte, 'Private Debt Deal Tracker' (Spring 2023), at 30.

¹¹¹ Axel Buchner, Susanne Espenlaub, Arif Khurshed and Abdulkadir Mohamed, 'Private Debt and the Role of Venture Capital and Private Equity Sponsors' (2023) *Management Science*, 1-24.

¹¹² Young Soo Jang, 'Five facts about direct lending to middle-market buyouts' (2022) (working paper), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3741678.

¹¹³ Young Soo Jang, (2022).

¹¹⁴ © Joern Block, Young Soo Jang, Steven N. Kaplan, Anna Schulze, 'A Survey of Private Debt Funds' (2023 January) NBER working paper 30868, available at: <https://www.nber.org/papers/w30868>

¹¹⁵ © Block et al., 'A Survey of Private Debt Funds' (2023).

¹¹⁶ Pascal Böni and Sophie Manigart, 'Private Debt Fund Returns, Persistence, and Market Conditions' (2022) *Financial Analysts Journal*, Vol. 78, No. 4, 121-144.

return (“IRR”) (private debt fund performance), finding that on average the net-of-fees IRR was 9.19% and highlighting that private credit funds offer attractive returns to their investors.¹¹⁷

iii. Cost-benefit trade-off

The costs and benefits of the nonbank financing system have been a subject of great debate. The empirical evidence suggests that nonbank financing creates value by ‘[...] provid[ing] commercial banks with sources for increased loanable funds and assumes some of the risks associated with loan origination.’¹¹⁸ Chernenko et al., – who analysed hand-collected credit agreements (filed with The US Securities and Exchange Commission) for a random sample of 750 publicly traded US-based middle-market firms that appear in Compustat financial dataset at least once for the time period between 2010-2015 – find that one-third of all loans are provided by nonbank financial intermediaries.¹¹⁹ This is especially true when there is less competition between the banks and nonbanks, as the latter see this as an opportunity to charge a higher interest rate.¹²⁰ Chernenko et al., also show that ‘nonbanks improve access to capital for firms that are observably risky and that are unable to borrow from banks because of bank regulations.’¹²¹ A study by Davydiuk et al., finds that borrower-firms’ access to direct lending, in particular, funding by business development companies, stimulated economic growth and innovation.¹²²

¹¹⁷ For an earlier work on the performance of private credit funds, see Shawn Munday, Wendy Hu, Tobias True, Jian Zhang, ‘*Performance of Private Credit Funds: A First Look*’ (2018), The Institute for Private Capital, 1-36 (Munday et al., study absolute and relative performance of private credit funds by relying on a private database of institutional quality private credit funds).

¹¹⁸ Ridoy Nath and Mohammad Chowdhury, ‘*Shadow banking: a bibliometric and content analysis*’ (2021) *Financial Innovation*, Vol. 68, referring to CL Culp and AM Neves, ‘*Shadow banking, risk transfer, and financial stability*’ (2017) *Journal of Applied Corporate Finance*, Vol. 29, No. 4, at 45-64.

¹¹⁹ Sergey Chernenko, Isil Erel and Robert Prilmeier, ‘*Why Do Firms Borrow Directly from Nonbanks?*’ (2022) *The Review of Financial Studies*, at 1 (finding that ‘Firms with negative EBITDA and debt/EBITDA greater than six are 32% and 15% more likely to borrow from nonbanks. These firms pay significantly higher interest rates, especially following the 2013 leveraged loan guidance revisions. Nonbank borrowers also receive different nonprice terms compared to firms borrowing from banks.’). The firms in Chernenko et al.’s (2022) study are middle-market firms, which are defined as firms with sales between \$10 million and \$1 billion.

¹²⁰ Chernenko et al., (2022) at 1-46.

¹²¹ Chernenko et al., (2022), at 1.

¹²² Tetiana Davydiuk, Tatyana Marchuk, Samuel Rosen, ‘*Direct Lenders in the U.S. Middle Market*’ (2022) (working paper), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3568718. See also, Pascal Böni and Sophie Manigart, ‘*Private Debt Fund Returns, Persistence, and Market Conditions*’ (2022) *Financial Analysts Journal*, Vol. 78, No. 4, at 121-144. See further, Emmanuel T. De George, John Donovan, Matthew A. Phillips and Regina Wittenberg-Moerman, ‘*Do Private Lenders Learn from Public Equity Markets?*’ (2022), available at: <https://www.herbert.miami.edu/assets/pdfs/faculty-research/business-conferences/winter-warmup/2022/donovan-winter-warmup2022paper.pdf>

According to The UK Financial Conduct Authority, this non-traditional finance model ‘offers the prospect of significant welfare gains for society – if we monitor it carefully.’¹²³ Similarly, a recent study by The World Bank highlights the benefits for firms of obtaining new finance from non-traditional sources, in particular, the advantages with respect to diversification of their financing sources and improvement of resilience to financial crises.¹²⁴ Along the same lines, S&P Global Credit Outlook 2023 mentions that ‘[p]rivate credit anchored the debt markets in 2022, supporting not only the traditional direct lending market *but also large corporate borrowers* unable to tap the bond or broadly syndicated loan (BSL) markets.’¹²⁵ At the same time, nonbank lenders are also an important source for obtaining syndicated financing for non-financial firms.¹²⁶ Ivashina and Valée show that ‘a larger non-bank funding for the loan, and a smaller skin in the game of the arranging bank, are [...] associated with more complex contractual terms.’¹²⁷

On the other hand, the increasing shift from the bank-dominated model to private credit has raised concerns over the transparency of the firms that are being financed by private credit funds and of their debt.¹²⁸

The costs of the lack of regulation in this sector were also raised by the International Monetary Fund.¹²⁹ The uncertainty behind the concept of “shadow banking entity” prompted the European Banking Authority to publish the final draft regulatory technical standards. These standards specify the criteria necessary to identify what a shadow banking entity is for the purposes of reporting large exposures.¹³⁰ Recently, a draft EU legislation

¹²³ The Financial Conduct Authority, ‘*Shadow banking – the potential risks and rewards*’ (2017), available at: <https://www.fca.org.uk/insight/shadow-banking-potential-risks-and-rewards>.

¹²⁴ The World Bank, ‘*Growth of Global Corporate Debt: Main Facts and Policy Challenges*’ (2021) at 2, available at: <https://openknowledge.worldbank.org/handle/10986/34480>

¹²⁵ S&P Global, ‘*Global Credit Outlook 2023: No Easy Way Out*’ (2022), at 26, available at: <https://www.spglobal.com/assets/documents/ratings/research/101570029.pdf> [emphasis added]

¹²⁶ The Bank for International Settlements, ‘*Non-bank lenders in the syndicated loan market*’ (2022) The BIS Quarterly Review, at 1-29, available at: https://www.bis.org/publ/qtrpdf/r_qt2203c.pdf.

¹²⁷ Victoria Ivashina and Boris Vallée, ‘*Complexity in Loan Contracts*’ (2022) (working paper), at 4.

¹²⁸ Financial Times, ‘*The new LBO market: it’s gone private*’ (2023), available at: <https://www.ft.com/content/0758d47f-ed50-47b5-bea1-20946271bc6a>

¹²⁹ The International Monetary Fund, ‘*Shadow Banks: Out of the Eyes of Regulators*’, available at: <https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Shadow-Banks>. See also, The European Central Bank, ‘*The rise of non-bank finance and its implications for monetary policy transmission*’ (2021), available at: <https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210824~9ab47b501b.en.html>.

¹³⁰ The European Banking Authority, ‘*Draft Regulatory Technical Standards on Criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013*’ (final report), (2022) available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2022/EBA-RTS-2022-06%20RTS%20on%20shadow%20banking/1033406/Draft%20RTS%20on%20Shadow%20Banking%20Entities.pdf.

was also put forward to restrict the activities of private debt funds, specifically on the amount of borrowed money that private debt funds can invest.¹³¹

iv. *Private credit is here to stay*

Described as the ‘new force in finance’,¹³² private credit is becoming one of the key, if not the key, source of modern debt finance. An important question, however, is whether the boom behind credit is here to stay.¹³³ In the context of European deals,¹³⁴ on the one hand, in contrast to 2020, during 2021 there was an 89% increase in deals by alternative (nonbank) lenders.¹³⁵ By contrast, in Q3 2022, the number of European private debt deals fell by 15.7% in comparison to the same period in 2021.¹³⁶ On the other hand, according to the data provider Preqin, in the second quarter of 2023 alone private credit funds raised \$71.2 billion globally, which is more than twice the amount compared to the first quarter of 2023, with a fundraising increase in Europe (\$33.8 billion raised in Europe out of \$71.2 billion globally) and with direct lending being the most dominant private credit strategy.¹³⁷

Besides, the surge in the interest rates to combat inflation has its costs and benefits for the providers of private credit. This is because some firms will struggle accessing public markets for finance, helping private credit providers to gain further clientele. It has been suggested that such a development may be advantageous for private credit funds, as it gives them a stronger position to bargain for more protection and favourable conditions.¹³⁸

¹³¹ Financial Times, ‘EU tightens rules on leverage for private credit funds’ (2023), available at: <https://www.ft.com/content/2ab74817-5b14-4110-9815-a7549621b521> (According to Financial Times, reporting on this draft legislation, ‘[l]everage for funds which do not allow investor withdrawals until the underlying loans have matured will be capped at 300 per cent, while funds that permit redemptions will be allowed 175 per cent leverage. The rules also include a pledge to bar private credit funds from allowing investor withdrawals before the loans they hold have matured, unless they meet as of yet unspecified criteria which will be outline by EU regulators.’)

¹³² Financial Times, ‘The real risk of private credit does not lie in misbehaviour on Wall Street’ (2023), available at: <https://www.ft.com/content/06bb4967-7d38-46f1-9078-f8761814c8af>. See also, Bloomberg, ‘Private Credit’s Quiet, Unstoppable Rise Comes with Unknown Risk’ (2023), available at: <https://www.bloomberg.com/news/articles/2023-06-16/wall-street-s-hot-new-thing-is-private-credit-a-cousin-of-private-equity?leadSource=uverify%20wall>

¹³³ Bloomberg, ‘Private Credit’s Dancing in the Streets Gets Wilder’ (2023), available at:

https://www.bloomberg.com/opinion/articles/2023-07-18/private-credit-the-wild-ride-is-not-yet-over?in_source=embedded-checkout-banner

¹³⁴ Including the private debt deals in the UK.

¹³⁵ Deloitte, ‘Alternative Lender Deal Tracker’ (2022), at 1-71, available at: <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-aldt-spring-2022.pdf>.

¹³⁶ Deloitte, ‘Private Debt Deal Tracker: Q3 2022 key findings’ (2023), available at: <https://www2.deloitte.com/uk/en/pages/financial-advisory/articles/private-debt-deal-tracker.html>

¹³⁷ Preqin, ‘Private Debt Q2 2023: Preqin Quarterly Update’ (2023), available at:

<https://www.preqin.com/insights/research/quarterly-updates/q2-2023-private-debt>

¹³⁸ PitchBook, ‘Private-debt market braces for stormy seas’ (2023), available at: <https://pitchbook.com/news/articles/private-debt-market-downturn-weekend-analysis>

Rising interest rates, however, also entail problems for the borrower-firms that have already incurred and, at times, even piled a lot of private debt: they now will be facing debt repayments with a higher rate and will need to continue honouring their financial obligations.¹³⁹

Despite the ongoing recession, there is a strong demand for private credit, ‘[...] even as dealmaking wanes.’¹⁴⁰ This is because private credit provides attractive returns. It could also help with hedging against rising inflation and diversifying borrowing portfolio of the firms.¹⁴¹ Moody’s 2023 study on private credit and associated risks highlights that ‘[...] when managed within a robust risk framework, [it] provides opportunity for growth and can improve the portfolio’s overall risk-adjusted return.’¹⁴²

As economic conditions globally deteriorate, the private credit model is in a good position to attract even more share of a market from commercial banks, as private credit funds are experienced in operating in an illiquid market: that is their business model.¹⁴³ Finally, as mentioned earlier, while private credit market originated as a finance provider for small and medium-sized companies, in the past years (especially post-COVID-19), private credit industry has provided multi-billion \$ finance also to investment grade private companies,¹⁴⁴ and recently also public companies – a substantial improvement in the landscape of corporate borrowers which rely on private credit. Given the current strains

¹³⁹ PitchBook (2023).

¹⁴⁰ Bloomberg, ‘*Private Credit Funds Get Pickier as Downturn Fears Intensify*’ (2023), available at: <https://www.bloomberg.com/news/articles/2023-01-05/private-credit-funds-get-pickier-as-fears-of-recession-intensify?leadSource=verify%20wall>. See also, Financial Times, ‘*The private credit ‘golden moment’*’ (2023), available at: <https://www.ft.com/content/42297b43-7918-4734-b6d5-623c6d6fa00f>; Bloomberg, ‘*Wall Street’s Hot New Thing is Private Credit, a Cousin of Private Equity*’ (2023), available at: <https://www.bloomberg.com/news/articles/2023-06-16/wall-street-s-hot-new-thing-is-private-credit-a-cousin-of-private-equity#xj4y7vzkg>

¹⁴¹ Moody’s Analytics, ‘*Private Credit: How Much is Too Much in a Credit Portfolio?*’ (2023), available at: <https://www.moodyanalytics.com/articles/2023/private-debt-how-much-is-too-much-in-a-credit-portfolio>

¹⁴² Moody’s Analytics (2023).

¹⁴³ S&P Global, ‘*When Rates Rise: Risks to Global Banks Could Emerge From the Shadows*’ (2023), available at: <https://www.spglobal.com/assets/documents/ratings/research/101572746.pdf> (referring to Prequin’s December 14 2023 Outlook Report). See also, PitchBook, ‘*Private debt delivers calm waters in storm of volatility*’ (May 19, 2023), available at: <https://pitchbook.com/news/articles/private-debt-returns-fundraising-opportunity>; PitchBook, ‘*Global Fund Performance Report (as of Q3 2022 with preliminary Q4)*, (2022), <https://pitchbook.com/news/reports/2022-global-fund-performance-report-as-of-q3-2022-with-preliminary-q4-2022-data>; Goldman Sachs, ‘*Private credit may outperform public bonds as defaults rise*’ (11 May 2023), available at: <https://www.goldmansachs.com/intelligence/pages/private-credit-may-outperform-public-bonds-as-defaults-rise.html>. See further, Deloitte, ‘*Private Debt Deal Tracker*’ (Spring 2023), available at: <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-pddt-spring-2023.pdf>

¹⁴⁴ See also Financial Times, ‘*Private credit finds its next big target: investment-grade debt*’ (2023), available at: <https://www.ft.com/content/271be286-ac12-449e-96f0-0d3ff9b4d6ee>

on bank financing, the question arises whether the corporate borrowers that are unable to obtain private credit are self-screening themselves.

C. Interconnectedness of risks

The flourishing of private credit creates more competition in debt financing markets; competition in itself is a positive phenomenon. Although, as the previous sub-section explained, there are two parallel markets for firms to obtain private finance (i.e., from private credit funds and from banks), *the private credit model is not entirely separate from the rest of the private debt market (i.e., bank-originated debt)*. Why? There is an economic link between these two parallel markets because of various intercreditor issues which often arise as commercial banks and private credit funds both borrow from and lend to each other and generally do business with each other, including, for instance, by participating in syndicated financing.¹⁴⁵ This sub-section highlights the interconnectedness of risks in these two markets.

On the one hand, since typically the private credit capital is “locked in”, it is less susceptible to fluctuations in the market and, therefore, less likely to cause a systemic crisis by itself.¹⁴⁶ On the other hand, as private credit funds also often borrow money from commercial banks for their business and the availability of bank capital has been limited since especially the banking turmoil of 2023,¹⁴⁷ such a development may also affect private credit funds.¹⁴⁸ Moreover, if the borrower-firms cannot repay due to rising interest rates, this may also negatively impact the private credit industry. This is not only a problem for those lending and doing business with the providers of private credit, but also for those firms which, as a result, may not be able to borrow from them.

These propositions are in line with the Bank of England’s (“BoE”) July 2023 Financial Stability Report, highlighting that ‘Any crystallisation of risks in [private credit] markets could spill over to the UK given the role of riskier credit markets in financing UK

¹⁴⁵ See Financial Times, ‘Marc Rowan’s ‘great times’ private credit speech’ (2023), available at: <https://www.ft.com/content/aa982bca-5696-45f2-9141-b07194b3f972> (Rowan noting that ‘We have gone from not only being a great customer, a partner of the banking system, to a true collaborator.’ He further notes that ‘In short, our model is highly complementary to the banking system.’)

¹⁴⁶ Cambridge Associates LLC, ‘Private Credit Strategies: An Introduction’ (2017), available at: <https://www.cambridgeassociates.com/insight/private-credit-strategies-introduction/>

¹⁴⁷ Greg Feldberg and Carey Mott, ‘The 2023 Banking Crisis: Lessons about Bail-in’ (2023) Yale School of Management, available at: <https://som.yale.edu/story/2023/2023-banking-crisis-lessons-about-bail>

¹⁴⁸ Bloomberg and Ares Management, ‘Kipp deVeer on the Impact of Bank Disruptions on Private Credit | Ares Management’ (2023), available at: <https://www.youtube.com/watch?v=yO94Kd1sUjI>

businesses, and through UK financial institutions' exposures to affected global counterparties, including foreign banks.¹⁴⁹

On the other hand, the same BoE report also mentions that, 'Private credit exposures of UK banks are limited. The closed-ended nature of funds investing in private credit, their low leverage, and extended lifespan, may help to limit fire sale risks. The [US] Federal Reserve has therefore noted that risks to US financial stability from private credit funds appear low. Nonetheless, parts of the US market use riskier fund structures with greater leverage to boost returns compared to the UK.'¹⁵⁰

The web of interconnected risks in these two parallel markets for private debt may, nevertheless, present systemic risks for the global economy.¹⁵¹ This type of risk interconnection is in addition to more general correlation of financial risks as a result of the COVID-19-crisis.¹⁵² While this paper does not aim to discuss the macroeconomic implications of these interconnected risks, it is important to flag that the debtholder controls rights in each market have been different over the past years (covenant-lite or more aggressive).¹⁵³ In covenant-lite packages, the control rights inserted vary in their nature from those in non-leveraged finance.¹⁵⁴

The empirical results also confirm that in modern debt markets there is an ever-growing interconnectedness between these different types¹⁵⁵ of debtholders and the capital that they provide.¹⁵⁶ At the same time, their incentives are different. For instance,

¹⁴⁹ The Bank of England, 'Financial Stability Report' (July 2023), at 81 (also noting at 9, that 'Riskier corporate borrowing in financial markets – such as private credit and leveraged lending – appears particularly vulnerable [...].')

¹⁵⁰ The Bank of England, 'Financial Stability Report' (July 2023), at 81, referring to The Federal Reserve's 'Financial Stability Report' (May 2023), available at: <https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf>

¹⁵¹ The Financial Stability Board, 'Global Monitoring Report on Non-Bank Financial Intermediation' (2021), at 17-25, available at: <https://www.fsb.org/wp-content/uploads/P161221.pdf>. See also, Financial Times, 'Why private credit still needs public markets' (2023), available at: <https://www.ft.com/content/3195192c-1a2b-46b1-9a26-c8f74b1985aa>

¹⁵² The World Bank, 'Finance for an Equitable Recovery: World Development Report' (2022), at 3, available at: <https://documents1.worldbank.org/curated/en/408661644986413472/pdf/World-Development-Report-2022-Finance-for-an-Equitable-Recovery.pdf>.

¹⁵³ For a further discussion of debtholders' rights in these two markets, see Section 3, including Table 2.

¹⁵⁴ Sarah Paterson, 'The Rise of Covenant-lite Lending and Implications for the UK's Corporate Insolvency Law Toolbox' (2019) Oxford Journal of Legal Studies, Vol. 39, No. 3, at 654-680.

¹⁵⁵ There is also the difference between the level of regulation of these two groups. Commercial banks are highly regulated. Private credit funds are not subject to the banking regulation. They, however, are regulated as asset managers.

¹⁵⁶ Isil Erel and Eduard Inozemtsev, 'Evolution of Debt Financing Toward Less Regulated Financial Intermediaries' (2022) Fisher College of Business Working Paper No. 2022-03-004, at 1-71, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4151880. See also, Calebe de Roure, Loriana Pelizzon, and Anjan Thakor, 'P2P Lenders versus Banks: Cream Skimming or Bottom Fishing?' (2022) The Review of Corporate Finance Studies, Vol. 11, No. 2, at 213-262. See further, Rustom M. Irani, Rajkamal Iyer, Ralf R Meisenzahl, and José-Luis Peydró, 'The Rise of Shadow Banking: Evidence from Capital Regulation' (2021) The Review of Financial Studies, Vol. 34, No. 5, at 2181-2235; Mitchell Berlin, Greg Nini, and Edison G. Yu,

compared to bank lenders, nonbank syndicate participants have a higher likelihood of exiting the syndicate than agreeing to renegotiate the syndicated deal.¹⁵⁷

The changes in debt markets, resulting in two competitive parallel markets for private debt,¹⁵⁸ have important consequences for the relationship of debtholders and their borrower-firms. Modern-day debtholders have more mechanisms, experience, and more diverse interests to control their investments on a continuous basis, including prior to the firm's financial distress. The implications of these changes from the perspective of the corporate governance role of debt form the discussion of Section 3.

3. Modern Debt Governance

This section addresses the second theme of this paper: *the implications of the changes in debt financing markets for modern debt governance*. It develops a new taxonomy of debt governance ("modern debt governance") (Table 2), categorising it based on the type of the debtholder (banks vs private credit funds), which aims to demonstrate how changes in private debt markets have shaped modern debt governance.

This section also shows that these debt governance mechanisms reflect (i) the *parallel* nature (i.e., banks vs private credit funds) of the market reality in which modern day debtholders and their borrower-firms operate in, (ii) are *driven by the competition* between the providers of debt capital, (iii) and are *adaptable* – directed by the need to keep pace with the *dynamic* nature of modern debt finance.

This section further explains *why debtholders are interested in the governance of the firm when the firm is solvent*. By doing so, it aims to show that the traditional position in corporate finance and corporate governance on the role of debt in the firm is outdated.

'Concentration of control rights in leveraged loan syndicates' (2020) Journal of Financial Economics, Vol. 137, No. 1, at 249-271.

¹⁵⁷ Mehdi Beyahaghi, Ca Nguyen, and John K. Walk, 'Institutional Investors and Loan Dynamics: Evidence from Loan Renegotiations' (2019) Journal of Corporate Finance, Vol. 56 (C), at 482-505.

¹⁵⁸ This section examined the parallel competitive nature of banking financing and of private credit. Additionally, there is also a competition among the funds: some funds, unlike others, are in a position to provide both equity and debt finance to their clients.

A. Taxonomy of Modern Debt Governance

This sub-section develops a new taxonomy – shaped by the modern market practices – which provides a summary of the modern debt governance mechanisms forming the basis of the discussion in the proceeding sub-sections B - D.

Table 2

[Taxonomy of modern debt governance based on the type of the debtholder]

B. Participation in capital growth, equity upside, and being lead investor

One of the interesting features of loan financing provided by private credit funds is the direct participation of debt investors in capital growth of the firms in which they inject debt capital. Such a participation in capital growth and profit sharing is achieved through a contractual mechanism stipulating for an internal rate of return ('IRR').¹⁵⁹

The return consists of two components. The first one known as “preferred return” (also hurdle rate) [is] a minimum annual return that the limited partners are entitled to claim before the fund manager starts receiving carried interest.¹⁶⁰ In this regard, compared to private equity, where investors should not expected a return on capital or distributions for typically several years, in private credit, investors are entitled to receive this part of their income quickly.¹⁶¹ The second one “carried interest” [is] the amount (profits) which is above the preferred return rate that the fund manager receives as compensation which is based on the performance of the investment.¹⁶²

In a loan financing agreement, it is a contractual entitlement to a return on their debt investment: return not in the form of a traditional interest rate, as it is in bank financing,

¹⁵⁹ Corporate Finance Institute, available at:

<https://corporatefinanceinstitute.com/resources/valuation/internal-rate-return-irr/> ('IRR is the discount rate that makes the net present value (NPV) of a project zero. In other words, it is the expected compound annual rate of return that will be earned on a project or investment.')

¹⁶⁰ Deloitte, *Private Debt Deal Tracker* (2023), at 55.

¹⁶¹ Institutional Investor, *Ares Faces its Biggest Decision Yet: Stick with Private Credit or Become an Alts Supermarket* (2023), available at: <https://www.institutionalinvestor.com/article/2bstrc8107qz1gd5rxpts/portfolio/ares-faces-its-biggest-decision-yet-stick-with-private-credit-or-become-an-alt-supermarket>

¹⁶² Deloitte, (2023), at 55.

but in addition to this. Depending on the private credit strategy (senior debt, subordinated capital, credit opportunities/distressed debt, specialty finance) the IRR is different, with senior debt having the lowest (but still a higher IRR than investment grade bonds or higher yield bonds) and distressed debt having the highest IRR.¹⁶³

This new development in private credit challenges the traditional conception of debt investment in corporate finance and corporate governance. The established position is that debt providers are interested in value-maintaining activities of the firm, whereas shareholders are interested in value-maximisation.¹⁶⁴ The conventional approach for loan finance (as opposed to, for instance, convertible debt) is that there is no capital growth for debt providers.¹⁶⁵ Yet, in private credit, debt investors' participation in profit (i.e., through a return on their debt investment) disqualifies the orthodox position.

In private credit, debt investment is typically for a long-term (these debt investors, are locked in a relationship for a long time), and the investors in this market are interested in the firm's successful performance: to be paid back not only the main sum, the interest, but also a return on their investment. Debtholders' participation in capital growth in private credit also aligns their incentives with those of the firm's shareholders. It presents a united front for shareholders and debtholders, as both groups of capital providers are interested in the firm's wealth maximisation.

In addition to participation in profit sharing via return on debt investment as discussed above, private credit investors participate in control and upside risk through equity stakes and warrants. When they do so, they benefit in their capacity as shareholders and not debtholders, but it is their bargaining for these rights contractually as debtholders that later allows this level of control.

In this regard, Buchner et al., find that 'the average deal in [their] sample [deals between 1982-2015] comprises an equity stake (*Direct Equity*) of almost 7% upon conclusion of the deal. Through their exercise of warrants included in the deal, debt

¹⁶³ Cambridge Associates LLC, available at: https://publishedresearch.cambridgeassociates.com/wp-content/uploads/2017/09/201709_PrivateCreditIntro_3.png (IRR ranging from minimum 6% to maximum 20% depending on the private credit strategy). See also, Institutional Investor, 'It's the Summer of Private Credit – And Goldman Sachs Wants In' (2023), available at: <https://www.institutionalinvestor.com/article/2by9dghc1wyxj2mwibny8/portfolio/its-the-summer-of-private-credit-and-goldman-sachs-wants-in> (noting that 'Yields have increased from 5 to 8 percent to well more than 10 percent and creditors have the upper hand in negotiations [...]').

¹⁶⁴ A search on the Google Scholar platform for 'shareholder value maximization' brings approximately 167,000 results.

¹⁶⁵ The traditional approach in corporate finance theory is that debt providers are entitled to receive the main debt sum and an interest on top of their debt investment, but unlike shareholders, who participate in profit sharing, if the borrower-firm does well creditors will not benefit from this (i.e., no entitlement to share in firm profits).

investors acquire a further equity stake, averaging 4% upon warrant exercise. ([...] *Postdeal Equity*)¹⁶⁶ Buchner et al., further find that in approximately 63% of the private debt deals in their sample, private credit funds reported to act as lead investors in the given deal, with private credit funds in sponsor-less deals (i.e., without venture capital, private equity) more likely to act as lead investors in their portfolio (borrower) companies than in the sponsored (i.e., venture capital, private equity) deals.¹⁶⁷

C. Dynamic control through floating pricing

This sub-section focuses on the repricing trend in private credit. It argues that the floating price phenomenon in private credit is a new way of debtholder influence – driving debtholders’ control of the firm. This type of control enables debtholders to have a significant impact on the firm: to influence the firm not only in a more traditional sense, when the firm is in financial distress, but also beyond this timeframe. It is also different from traditional debt governance through debt covenants.¹⁶⁸

i. Pricing and barriers to accurate pricing

This sub-section explores the important aspects to an accurate calculation of credit risk and pricing of debt, and the typical barriers to their accurate completion. Many notions, including that of credit risk and pricing of debt, are a response to imperfect markets and market failures.¹⁶⁹

From the debtholders’ perspective, credit risk has been defined as ‘the possibility of losing money due to the inability, unwillingness, or nontimeliness of a counterparty to honor a financial obligation.’¹⁷⁰ It has been suggested that main issues with respect to risk are the non-guaranteed nature that the event will materialise, the latter’s impact on the

¹⁶⁶ Axel Buchner, Susanne Espenlaub, Arif Khurshed, Abdulkadir Mohamed, ‘*Private Debt and the Role of Venture Capital and Private Equity Sponsors*’ (2023) *Management Science*, at 7.

¹⁶⁷ Buchner et al., (2023) *Management Science*, at 16-17.

¹⁶⁸ Gullifer and Payne (2020), Gullifer and Penn (2020).

¹⁶⁹ Eugene F. Fama, ‘*Efficient Capital Markets: A Review of Theory and Empirical Work*’ (1970) *The Journal of Finance* Vol. 25, No. 2, at 383-417; Eugene F. Fama, ‘*Efficient Capital Markets II*’ (1991) *The Journal of Finance*, Vol. 46, No. 5, at 1575-1617.

¹⁷⁰ Sylvain Bouteillé, Diane Coogan-Pushner, ‘*Fundamentals of Credit Risk*’ in *The Handbook of Credit Risk Management: Originating, Assessing, and Managing Credit Exposures*, (Wiley, 2013), at 3.

firm's value, and that there are both positive and negative implications that could be caused by the materialisation of the event.¹⁷¹

Debtholders price risk in different ways, such as through interest rate, contractual creditor protection, and through proprietary creditor protection. When pricing risk, they also rely on borrower's past financial statements. Financial statements, however, rely on historical data, and, therefore, their usefulness is limited to a certain extent. Contractual representations and warranties are also not useful in the longer term. This is due to the fact that except for a few repeating (evergreen) representations,¹⁷² the majority of contractual representations and warranties in loan financing are given by the firm at the time of entering into the agreement. Risk is also priced by relying on various risk-diversification (debt decoupling) mechanisms (e.g., loan transfers). Risk exposure becomes a bigger concern for debtholders when the provided finance is medium or long-term. This is especially the case in private credit, where in addition to the long-term nature of financing the market is illiquid.¹⁷³ There are several reasons for debtholders' concern in long-term financings.

First, the longer the time-period of exposure, the higher the chances that the borrower-firm might not be able or willing to pay. In other words, time is a risk.¹⁷⁴ Debt investors look for optimal mechanisms to quantify types of risks, including credit risk. Yet, quantification of credit risk is a complicated and not an exact science. Relying heavily on a single number or a fixed criterion might not necessarily be useful. Several barometers of risks have been suggested in the literature, such as the credit exposure, the probability of default, the recovery rate in case of default, and the tenor of the provided loan.¹⁷⁵

Second, the predictability or precise calculation based on one or only several figures (e.g., by relying on financial covenants: debt/equity ratio, EBITDA,¹⁷⁶ etc.) is often impractical. This is because specifically quantified numbers mainly account for borrower-opportunism (e.g., endogenous events/idiosyncratic risks), whereas external events (e.g., exogenous risks/risk externalities, such as inflation, market crash, or COVID-19) can also significantly influence a borrower-firm's behaviour.

¹⁷¹ Mark Laycock, 'Risk Oversight' in the *Risk Management at the Top: A Guide to Risk and its Governance in Financial Institutions* (Wiley, 2014), at 11-13.

¹⁷² Repeating representations will be expressed to be by reference to the facts and circumstances prevailing at the time of the repetition.

¹⁷³ Bouteillé and Coogan-Pushner (2013), at 4.

¹⁷⁴ Bouteillé and Coogan-Pushner at 4.

¹⁷⁵ The term "credit exposure of a loan" denotes the notional amount of the loan.

¹⁷⁶ The term "EBITDA" stands for earnings before interest, tax, depreciation, and amortisation.

Third, an exact quantification of the debtholder's exposure is typically calculated at "Day 1". This is one of the main issues for *bank-originated loan financing* (e.g., term loans, revolving loans, syndicated loans) and is also true for bonds. When the firm enters into the agreement with the debtholder, the firm makes representations and warranties about its business. Except for very few repeating representations, however, the rest of representation and warranties are typically made at "Day 1" of entering into the transaction. Setting the price at "Day 1" typically does not reflect what might happen, for instance, in a year. Such a quantification of risk is thus often not up to date; it does not necessarily consider the long-term nature of finance and unpredictable future.¹⁷⁷ There are also other types of risks relevant for credit pricing, such as liquidity risk, market risk, operation risk, that should ultimately be reflected in the pricing of corporate debt. In *private credit*, these issues are addressed through a floating interest, which is repriced every 30-90 days.

In the past years, another new debt pricing component has been the factoring of the ESG requirements in the price of corporate debt (e.g., sustainability-linked loans, social loans, green loans).¹⁷⁸ The inclusion of ESG-based criteria in sustainability-linked loans, green loans, social loans, is an example of the ex-post incentive alignment (reward) legal strategy.¹⁷⁹ In the *private credit market*, this is achieved through ESG-linked margin ratchets.¹⁸⁰ The loan interest margins are reduced when the borrower-firm achieves certain predefined sustainability targets.

In the context of the calculation of credit price, a firm's credit rating often provides certain guidance to its debt investors. In the *private credit market*, however, borrower-firms

¹⁷⁷ Gârleanu and Zwiebel (2009), at 749–781 (finding that, '[...] 15%-20% (depending on the type of covenant) of outstanding loans are in violation during a typical quarter, and conditional on violating a covenant, a loan is delinquent about 40% of the time.')

¹⁷⁸ The Loan Market Association ("LMA") and The Loan Syndications and Trading Association ("LSTA"), 'Sustainability Linked Loan Principles' (February 2023), 'Guidance on Sustainability Linked Loan Principles' (February 2023); 'Social Loan Principles' (February 2023), 'Guidance on Social Loan Principles' (February 2023); 'Green Loan Principles' (February 2023), 'Guidance on Green Loan Principles' (February 2023), all available at: <https://www.lsta.org/app/uploads/2023/02/LSTA-Sustainable-Lending-Library-Feb-2023.pdf> See further, the LMA, 'The LMA Members' Survey: Outlook for the Syndicated Loan Market 2022' (2022) available online at: https://www.lma.eu.com/news-publications/press-releases?id=194&search_str=secondary%20markets.

¹⁷⁹ John Armour, Henry Hansmann, and Reiner Kraakman, 'Agency Problems and Legal Strategies' Ch. 2 in *The Anatomy of Corporate Law* (3rd ed., 2017, Oxford University Press). At the same, there is also the risk of greenwashing. See John Armour, Luca Enriques, Thom Wetzer, 'Mandatory Corporate Climate Disclosures: Now, but How?' (2022) *Columbia Business Law Review*, Vol. 2021, No. 3. See also, Sehoon Kim, Nitish Kumar, Jongsub Lee, Junho Oh, 'ESG Lending' (2023) ECGI Working Paper No 817/2022, available at: https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=3865147

¹⁸⁰ The European Leveraged Finance Association, 'The Evolution of Sustainability Provisions in the Private Debt Market' (2023), Issue No. 36, available at: <https://elfainvestors.com/wp-content/uploads/2023/02/ELFA-Insights-36-The-Evolution-of-Sustainability-Provisions-in-the-Private-Debt-Market.pdf>

used to be and many of them still are typically unrated firms. In *bank financing*, a firm's credit rating is determined by credit rating agencies based on historical data, and it is often the borrower-firm that initiates a dialogue with a credit rating agency to appraise its credit rating. At times a part of the undetected risk could be attributed to the willingness of credit rating agencies to "over-rate" borrower-firms. It has been argued that this was the case during the 2008 sub-prime crisis.¹⁸¹ One explanation for this could be that there is not enough competition among the credit rating agencies. This sub-section will not discuss the credit rating issue further. For the purposes of the proceeding analysis, it is sufficient to note that credit rating in private credit is not a requirement and in bank financing it represents a backwards-looking approach that does not necessarily and accurately reflect what will happen to the firm. This is especially concerning for long-term revolving loans.¹⁸² This position is in line with a proposition that 'the probability of default with the potential for credit ratings to migrate over time adds a dynamic element to credit risk estimation.'¹⁸³

Credit risk is further influenced by the decisions of the firm's directors. Directors, as fiduciaries of the company,¹⁸⁴ are the ones to make most decisions. Their decisions also impact the firm's debt financing decisions and its credit risk profile. According to Merton, three variables plus a discount factor are used to determine the likelihood of default. Those are 'the time to maturity (lessens the likelihood), the volatility of the company's operations (increases the likelihood), and the existing distance between the assets and debt (lessens the likelihood).'¹⁸⁵

The empirical evidence in the context of *bank financing* suggests that renegotiated debt agreements following a violation of covenants have interesting pricing implications. For instance, Nini et al., find that such debt agreements 'provide less fundings, have a shorter maturity, and carry a higher interest rate spread compared with the contracts prior to the violation.'¹⁸⁶ Roberts shows that the typical loan provided by a commercial bank reprices corporate loans five times or every nine months.¹⁸⁷ Gârleanu and Zweibel find

¹⁸¹ Claire Hill, 'Why did rating agencies do such a bad job rating subprime securities?' (2010) University of Pittsburgh Law Review, Vol. 71, at 585-608.

¹⁸² Long-term revolving loans are typically for a period of up to five years.

¹⁸³ Laycock (2014), at 13 [emphasis added].

¹⁸⁴ In the UK, this position was affirmed in *BTI 2014 LLC v Sequana SA and others* [2022] UKSC 25.

¹⁸⁵ See Robert C. Merton, 'On the Pricing of Corporate Debt: The Risk Structure of Interest Rates' (1974), The Journal of Finance, Vol. 29, No. 2, at 449.

¹⁸⁶ Greg Nini, David C. Smith and Amir Sufi, 'Creditor Control Rights, Corporate Governance, and Firm Value' (2012) The Review of Financial Studies, Vol. 25, No. 6, at 1713-1761.

¹⁸⁷ Michael R. Roberts, 'The role of dynamic renegotiation and asymmetric information in financial contracting' (2015) Journal of Financial Economics, Vol. 116, No.1, at 61-81, (noting at 61, that 'The pricing, maturity, amount, and covenants are all significantly modified during each renegotiation, whose timing is governed by the financial health of the contracting parties and uncertainty regarding the borrowers' credit quality.')

that the median covenant violation occurs one year from the inception of the loan.¹⁸⁸ Repricing of corporate debt is sometimes caused not necessarily by a violation of the terms by the borrower-firm, but as a consequence of an exogenous risk affecting the financial relationship or because the firm wishes to have more flexibility in its operations.

ii. Dynamic element to pricing and valuation

This sub-section argues that floating pricing in private credit is a new form of debt governance, directly impacting the firm and addressing the dynamic nature of debt. Often pricing and repricing of debt has nothing to do with the low quality of the borrower-firm. Rather, it is driven by the firm's wishes to be more flexible in its day-to-day operations, especially in the context of bigger deals.

As the proceeding discussion explains, the capital providers in the private credit market are not looking to a control in the traditional sense, and they still acquire information often because of the relational nature of finance. These debt investors charge a floating rate spread above the reference rate. The floating interest provides private credit investors with the opportunity to reflect the current market cost of lending in their long-term relationship with the firm.

In the past twenty-five years, there has been a shift in the corporate debt market from escalating and exiting a financial relationship to ex-post repricing it. For banks, it is important for their debt investment to reflect the current cost of lending and the up-to-date position of the borrower-firm: to be able to sell this debt to the liquid secondary loan market. Unlike banks, private credit funds typically operate in an illiquid market: they price their illiquidity, including by charging an illiquidity premium. With regards to the illiquidity premium, BlackRock reports that “For investors, private senior and unitranche loans typically deliver an illiquidity premium of between 150bps and 300bps, compared with publicly-traded leveraged loans.”¹⁸⁹ Dynamic pricing has become an essential part of the private credit financing, as it allows private credit funds to price their illiquidity more

¹⁸⁸ Gârleanu and Zweibel (2009); Chava and Roberts (2006). *See also*, Sudheer Chava and Michael R. Roberts, ‘How Does Financing Impact Investment? The Role of Debt Covenants’ (2008) *The Journal of Finance*, Vol. 63, No.5, at 2085-2121.

¹⁸⁹ BlackRock, ‘Private Credit: Evolution and Opportunity in Direct Lending’ (2022) at 2, available at: <https://www.blackrock.com/institutions/en-zz/literature/investment-guide/private-credit-evolution-and-opportunity-in-direct-lending.pdf>.

adequately and to keep up with the market changes (e.g., the rise in the interest rates to combat inflation) affecting the cost of finance.¹⁹⁰

Firms are normally provided with financing based on debtholders' ex-ante calculation of (i) the profitability of the project and (ii) the overall credit risk of the borrower-firm.¹⁹¹ Consequently, pricing is the flipside of the expected profit from the loan. Debtholders typically calculate the risk of a firm's default in advance and price debt accordingly. Such a pricing strategy is beneficial for them as it allows to offset the risk of potential default on the part of the firm. Generally, they are also careful about terminating financing because a wrongful acceleration might result in payment of a substantial amount of damages and might also negatively affect their business reputation.

Pricing/repricing debt is useful not only for countering the renowned information asymmetry problem and the inter-connected 'market for lemons'¹⁹² issue embedded in debt financing markets; arguably, it is equally important for addressing the problem of lending to the borrower-firm when the debtholders have made a "pricing mistake". In this context, the term "pricing mistake" means that the price (i.e., the margin) does not reflect the risk or the market cost of lending. In other words, it is no longer profitable for the lender to lend to the firm on such price as agreed previously. The COVID-19-crisis is a practical example of such situation where debtholders were forced to reconsider the price of corporate debt. This proposition is in line with the earlier empirical evidence, which suggests that many long-term debt contracts are renegotiated prior to their stated maturity.¹⁹³

Repricing results in changes to the amount, maturity and other terms of financing, and sometimes these changes are caused not necessarily by financial distress of the firm.¹⁹⁴ This allows debtholders to directly and significantly influence the firm and is a new form

¹⁹⁰ For a discussion, among other issues, on pricing illiquidity and behavioural shifts for sophisticated investors in private credit markets, see Walker & Dunlop 'Alternative Investment Outlook with Michael Arougheti, President of Ares Management' (2023) available at: <https://www.youtube.com/watch?v=DrHbk0nCc0A> (Ares CEO Michael Arougheti noting that there has been a mindshift in the investment community with regards to not overpaying for liquidity. He notes that sophisticated (retail and institutional) investors shifted to think about how to maximise their return on illiquidity: on illiquid part of their portfolio. Arougheti notes this has been the big catalyst for growth in private credit market.)

¹⁹¹ The credit risk of the firm may also be influenced by macro and micro-environment.

¹⁹² George A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and The Market Mechanism' (1970) Quarterly Journal of Economics, Vol. 84, No. 3, at 488-500.

¹⁹³ Garleanu and Zweibel (2009); Greg Nini et al. (2012). See also the sub-section on debt covenants and empirical evidence in Section 3.

¹⁹⁴ Michael R. Roberts and Amir Sufi, 'Renegotiation of financial contracts: Evidence from private credit agreements' (2009) Journal of Financial Economics, Vol. 93, No. 2, 159-184 (noting at 159 that, 'Using a large sample of private credit agreements between U.S. publicly traded firms and financial institutions, [the authors] show that over 90% of long-term debt contracts are renegotiated prior to their stated maturity.')

of debt governance, which is different from the traditional influence of debtholders via breach of debt covenants. It drives the debtholders' control of the firm. Floating price enables debtholder to influence and engage with the firm on an ongoing basis and to be in a good position to dynamically value the firm. As interest rates go up, the servicing of debt becomes more difficult for the borrower-firms (i.e., cost of debt servicing is becoming high). This new form of debt governance has significant implications on the incentives of the firm's directors and puts pressure on them to take into account the interests of the debtholders also outside financial distress.

D. Board representation and relational finance

As mentioned earlier, there is little academic scholarship on private credit funds. This is even more the case in the context of a phenomenon in private credit, where private credit funds sit on the board of directors of their portfolio companies,¹⁹⁵ and the implications of this development for the borrower-firms from debt governance perspective.

This sub-section argues that this management aspect (representation on the board) speaks directly to the corporate governance role of debt and is different from bank financing. It also helps to establish a more informed relationship between the debtholders and the firm, and gives them a dynamic view of the firm's valuation. The debtholders' involvement in this way, moreover, adds value to the firm, contributes to establishing relational finance, and helps private credit funds to achieve their investment strategy. From the firm's side, private credit financing is also beneficial for the firm in terms of knowing and trusting who owns the risk of its debt.

Private credit funds have enhanced information rights, as they actively seek board representation. These debt investors have formal and informal meetings with the board of their portfolio (i.e., borrower) firms. Driven by the relational nature of finance provided in this market, private creditors actively participate in the running of the firm. They get full access to the management team and directly influence the decisions made by the board. Such access also helps to establish relational finance. This type of involvement channels a continuous flow of information, enabling private credit funds to do firm valuations on a dynamic basis – valuations that reflect the true value of the firm at the time.

¹⁹⁵ Notable exceptions are Block et al., (2023), and Jang (2022).

This development has lately been studied empirically. An empirical study on private credit funds by Block et al., surveys the degree of board representation when private credit funds sit on the board of their borrower-firms.¹⁹⁶ The survey finds that outside financial distress, private credit funds do seek board representation both in the US and in Europe, where 41% and 22% participants of their survey responded to remaining as passive participants.¹⁹⁷ The authors also find that during financial distress, there is more active participation on the borrower-firm's board (in the US 35% and in Europe 29%).¹⁹⁸ Their results are in line with the empirical findings by Jang (2022),¹⁹⁹ suggesting, among other things, that private credit funds have a strong influence on the board (actively seeking board observation rights) during renegotiation process post-covenant violation.²⁰⁰ As shown in *Table 2*, compared to private credit, in modern-day *bank financing*, there is less opportunity for relational finance, the debtholders have less enhanced information, and there is less scope for dynamic valuation of the firm.

E. Liquidity and incentives

Since the GFC, there has been a further development in the secondary loan markets. There is more liquidity in the secondary loan market, and banks no longer always hold on to debt until its maturity. This sub-section focuses on the changes in the secondary markets for corporate loans, and the impact of the liquidity in the secondary loan markets on debt investors' incentives to divest and transfer risk. It argues that such a change has its implications on their behaviour and engagement with borrower-firms from a debt governance perspective.

i. Evolution, but revolution?

When making financing decisions, debt investors provisionally calculate the riskiness of the firm in their cost of finance. These investors (predominantly banks) that are interested in minimising their risk exposure from the default of an individual borrower-

¹⁹⁶ © Joern Block, Young Soo Jang, Steven Kaplan, Anna Schulze, '*A Survey of Private Debt Funds*' (January 2023) University of Chicago, Working Paper No. 2023-10, at 18, available at: https://bfi.uchicago.edu/wp-content/uploads/2023/01/BFI_WP_2023-10.pdf.

¹⁹⁷ © Block et al., (2023) at 19.

¹⁹⁸ © Block et al., (2023), at 19.

¹⁹⁹ Jang (2023).

²⁰⁰ © Block et al., (2023), at 19, referring to Jang (2023).

firm might look for techniques to transfer their loans and diversify their risk. This is especially typical for syndicated loans.²⁰¹

There are different reasons for loan transfers, which include, but are not limited to risk diversification, subsequent syndication, and the defaulting nature of the loan. For banks, this could also be the result of capital adequacy rules imposed by banking regulation.²⁰² When banks offset risk because there is a problem with the borrower-firm, they may write down a loan or transfer it, or enter into a credit default swap, or a repo transaction.

In debt finance, there used to be a distinction between a tradable debt and other type of debt.²⁰³ However, these other types of debts that used to be non-tradable, for instance, syndicated loans, have now come to be transferred on a frequent basis. This creates liquidity for the secondary markets for loans. The buyers used to be banks, but nowadays the buyers of transferred loans can also be specialised distressed debt traders and vulture funds. For loans that are not syndicated, the interest in a loan can also be sold to the secondary market. Alternative means of creating liquidity also involve collateralised loan obligations and credit default swaps. As a result, there is a shift from ‘assets that are held to creation of assets that are tradable similar to securities’.²⁰⁴ The strict distinction between these two classes of debt is no longer as important as it used to be.

Although this paper focuses on private debt, it is worth mentioning that, in relation to the bond markets, bondholders also used to hold on to debt until the maturity of the bonds, relying on payments on the principal amount and interest. In the past years, bondholders typically sell their bonds prior to their maturity.²⁰⁵ Schwarcz argues that this makes bondholders similar to equity investors, as they are now more interested in pricing their debt as opposed to securing a priority in the creditor rank.²⁰⁶

²⁰¹ Rasmussen and Baird (2006), at 1209-1251 (noting at 1244 that, ‘Most large loans are arranged by a lead bank, but financed by a syndicate of banks. This allows banks to spread their risk. The lead bank does not typically sell its interest. There is, however, a secondary market for those portions of the loan held by other members of the syndicate. The possibility of creditor control may matter as much as whether it is actually exercised, and even more than the threat of a hostile takeover. Any new lender has to worry about the private information held by the existing lender. The existing lender may want to withdraw for reasons that are not yet plain to outsiders. Any new lender is in any event bound to insist upon its own control rights to protect itself.’)

²⁰² E.g., Basel 3 regulation.

²⁰³ Gullifer and Payne (2020), at 435-438.

²⁰⁴ Gullifer and Payne (2020), at 435.

²⁰⁵ Steven L. Schwarcz, *Rethinking Corporate Governance for a Bondholder Financed, Systematically Risky World* (2017) William and Mary Law Review, Vol. 58, at 1335-1363.

²⁰⁶ Schwarcz (2017), at 1344-1345. *See also*, Steven L. Schwarcz, *Rethinking a Corporation’s Obligations to Creditors* (1996) Cardozo Law Review, Vol. 17, at 647-690.

For bank financing, historically banks sold their participations in loans, but that they also kept most of their loans until maturity and, by negotiating a loan, used to protect their assets.²⁰⁷ Nowadays, banks typically originate loans to sale those to the secondary loan market, and they buy and sell credit risk in order to manage their risk exposure more efficiently.²⁰⁸ In this regard, the maturity of loan has been argued to also affect corporate governance.²⁰⁹

The secondary market for loans consists of the primary (syndicated) loan market, where portions of a loan are placed with several banks, and the secondary category for the seasoned or secondary loans, where it is a single bank selling off an existing loan or a part of it.²¹⁰ These secondary loan markets have grown in their size and act as an important channel for managing credit risk.²¹¹ As a result, there is more liquidity not only in the context of public, but also private debt markets. Such a development in secondary trading has been argued to possibly even overtake the important role of debt covenants, including financial covenants, and monitoring in corporate governance.²¹²

At the same time, in the past years corporate borrowers started to restrict the use of sub-participation for lenders, and this development has had an immediate impact on the liquidity in the secondary loan market.²¹³ Penn argues that the reason for this is because borrowers no longer view sub-participation as a mechanism of transferring economic risk. Rather, they see it as a '[...] method of transfer which potentially impacts rights and obligations under the underlying loan and also its relationship with the [l]ender.'²¹⁴

ii. Liquidity and transferred debt

The liquidity in the secondary loan market, some might argue, weakens the incentives of the original debt investors to actively monitor the firm. Along these lines,

²⁰⁷ Phillip Wood, 'Bondholders and banks—why the difference in protections?' (2011) *Capital Markets Law Journal*, Vol. 6, No. 2, at 188-196.

²⁰⁸ Loan selling by banks, however, is becoming more difficult given the economic recession. See *Financial Times*, 'Banks prepare to hold \$12.7 bn Twitter debt on books until early 2023' available at: <https://www.ft.com/content/d1879d0c-c52e-4f48-82f0-09458add4ace>.

²⁰⁹ Charles Whitehead, 'Debt and Corporate Governance' Ch. 18 in *The Oxford Handbook of Corporate Law and Governance* (2018) (eds. J. Gordon and G. Ringe, OUP),

²¹⁰ Sandeep Dahiya, Manju Puri and Anthony Saunders, 'Bank Borrowers and Loan Sales: New Evidence on the Uniqueness of Bank Loans' (2003) *The Journal of Business*, Vol. 76, No. 4, at 563-582.

²¹¹ Steven Drucker and Manju Puri, 'On Loan Sales, Loan Contracting, and Lending Relationships' (2009) *The Review of Financial Studies*, Vol. 22, No. 7, at 2835-2872.

²¹² Whitehead (2018) Ch. 18.

²¹³ Graham Penn, 'Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit For Purpose?' (2022) *Journal of International Banking Law and Regulation*, Vol. 37, No. 3, at 85-102.

²¹⁴ Penn (2022).

some might argue that the traditional mechanisms of engaging with the firm (e.g., debt covenants), thus, might be less relevant.²¹⁵ This sub-section argues that since in the past years there has been a lot of competition in the secondary loan markets, it is in the original debt investors' interests to monitor the original loan package and invest in the relationship with the firm. Otherwise, the original debt investor (typically a commercial bank) might not be able to successfully market this debt to the secondary loan market, or be able to market it but only with a substantial discount to its original price, meaning that it will incur losses.²¹⁶

Despite the changes in the market from “originate-to-hold” to “originate-to-distribute”,²¹⁷ *first*, the original banks will not be in a strong position to distribute the debt if it does not reflect the true position of the borrower-firm at the time.

Second, the lead arranger/manager in syndicated facilities often hold on to debt, even if the other members of the consortium market it to the secondary debt market. On the one hand, an information asymmetry exists between the original and the new debtholder. On the other hand, these new investors can benefit from the involvement of the original banks and the information that they hold on the firm.

Third, the borrowers sometimes successfully manage to restrict some types of transfer, for instance, sub-participation.²¹⁸ Moreover, the empirical evidence in the context of bank loan financing suggests that there are negative stock returns for the firm on the loan sale announcement.²¹⁹

The liquidity in the secondary loan markets, and the option to market the debt to the secondary market is also profitable for the firm. This is because, especially in times of recession and as shown by the Twitter deal, the investors in the secondary market will not be willing to buy an overpriced debt, or will buy it, but at a huge discount to the original price. By making either decision, the secondary debt investors, also contribute to debt

²¹⁵ Jeremy McClane, *Corporate Non-Governance* (2020) Delaware Journal of Corporate Law, Vol. 44, No. 2/3, at 1-59.

²¹⁶ Recent practical examples of banks having troubles to offload debt and incurring losses as a result, include the debt deals of Twitter Inc., Nielsen Holdings Plc, and Citrix Systems Inc. See Bloomberg, *Banks Stuck with \$42 Billion Debt Seize Chance to Offload it* (2022), available at: <https://www.bloomberg.com/news/articles/2022-11-29/banks-stuck-with-42-billion-debt-seize-chance-to-offload-it#xj4y7vzkg>, See also Section 4.

²¹⁷ McClane (2020).

²¹⁸ Penn (2022).

²¹⁹ See Sandeep Dahiya, Manju Puri and Anthony Saunders, *Bank Borrowers and Loan Sales: New Evidence on the Uniqueness of Bank Loans* (2003) The Journal of Business, Vol. 76, No. 4, at 563-582 (noting that at 563 that '[...] a large proportion of these borrowers file for bankruptcy after the loan sale. The evidence supports the hypothesis that the news of a bank loan sale conveys negative certification, which is validated by the subsequent performance of the firms whose loans are sold.')

governance (“lender governance”).²²⁰ Moreover, the longer the original debt investors are forced to hold their debt and are not able to sell it, the longer the loan market will be frozen, causing further negative externalities.

Such a risk diversification strategy could affect debtholders’ incentives and the extent of their involvement in monitoring the borrower.²²¹ This additionally raises the question of socially optimal renegotiation of the financing agreement and the debt investor’s incentives to transfer the loan. It also touches upon an important tension between ‘the right of the borrower to prevent or limit the transfer of the debt and the right of a lender to alienate its own property, namely the debt or the proceeds.’²²²

It is also possible for debt investors to provide finance to firms, with an option for the former to transfer the loan at any point in time.²²³ This typically happens especially with high-risk (non-investment grade) firms. Depending on the type of a loan transfer (e.g., novation, assignment, sub-participation),²²⁴ the original debt investor will either cease its relationship with the firm or will continue to be involved in a limited way. While one might argue that the liquidity in the secondary loan markets might dis-incentivise debt investors, including syndicate lenders, to monitor and enforce the firm’s compliance,²²⁵ the empirical evidence suggests the contrary.²²⁶ Additionally, the original debt investors will be concerned about the restrictiveness of the initial financing terms. This is because they may otherwise be concerned that they will not be able, for instance, to transfer the loans in the secondary loan market without appropriate debtholder protection mechanisms.²²⁷

²²⁰ See also Section 4, sub-section A “i”.

²²¹ Gullifer and Payne (2020), at 95. This is called the “empty creditor problem”. See, Patrick Bolton and Martin Oehmke, *Credit default swaps and the empty creditor problem* (2011) *The Review of Financial Studies*, Vol. 24, No. 8, at 2617-2655.

²²² Gullifer and Payne (2020), at 486; Penn (2022).

²²³ Gullifer and Payne (2020), at 220 (noting that ‘Where loans are transferable, however, the ability to transfer the loan for a good price may be more important to the lender than the absolute credit risk, since the lender may have little intention of keeping the loan until it is due to be repaid.’)

²²⁴ Some of the loan transfer mechanisms (e.g., assignment or novation), but not all (e.g., sub-participation) enable lenders to cease their relationship with the borrower. For further details, see Gullifer and Payne (2020), at 437-438 and at 478. See also, Rafal Zakrzewski and Geoffrey Fuller, *McKnight and Zakrzewski on the Law of Loan Agreements and Syndicated Lending* (2019, Oxford University Press), at 234-237.

²²⁵ See Jeremy McClane, *Reconsidering Creditor Governance in a Time of Financial Alchemy* (2020) *Columbia Business Law Review*, Vol. 2020, 101-195.

²²⁶ Tung (2009) at 166 (noting that, ‘Overall, the evidence suggests that while syndication and secondary loan trading might theoretically dampen bank’s monitoring incentives, lead banks and selling banks anticipate and address this concern for the benefit of syndicate members and loan purchasers, respectively. Lead banks have reputational stakes in refraining from opportunism in a syndication, and both lead banks and selling banks take steps to bond themselves as monitors.’)

²²⁷ A practical example of such a situation is The Twitter deal. *Financial Times*, *Elon Musk’s Twitter takeover saga: a timeline of tweets* (2022), available at: <https://www.ft.com/content/b0b49bc2-9d6e-4e0d-8962-a0f60185947c>. A detailed discussion of this deal is beyond the scope of this paper.

4. Equity and Debt Governance Complement Each Other

This section addresses the third theme of this paper: *the implications of the evolution of corporate debt finance for the modern-day relationship between equity and debt*. It argues that outside financial distress, equity and debt governance often complement each other. Due to the changes in corporate finance markets and the increased importance of the role of debt financing, often one type of governance simply cannot any longer exist in a vacuum.²²⁸

This section does not claim that debt governance is always in the interests of equity. Instead, it argues that the significant changes to debt markets affect modern-day debt capital's relationship with equity, making the two more interconnected and overlapping. Additionally, the traditional delineation between equity and debt capital especially in private firms, but also in public firms is no longer always relevant.

A. 'Equity' and 'debt' can no longer exist in a vacuum from one another

The preceding discussion showed the evolution of the role of debt in the firm. The way that debt operates today implies that the firm's directors are often incentivised and influenced to take into account the debtholders' interests also outside financial distress. Depending on the type of debt financing (bank or private credit), the influence mechanisms may differ (*Table 2*). This sub-section argues that the firm benefits when its equity and debt capital providers are involved and that such symbiotic governance minimises the firm's 'total competence and conflict costs'.²²⁹

Before exploring the benefits of symbiotic equity-debt governance, one should consider why there should be an interest in the relationship between modern-day equity and debt. Three inter-connected justifications are presented below.

First, according to the data provided by the UK Companies House, private limited companies (with a share capital) accounted for over 92.7% (↑4,929,778) of all corporate

²²⁸ This is also in line with the recent literature, advocating for the role of debt in dual class share structures. See Aiyesha Dey, Valeri Nikolaev, Xue Wang, 'Disproportional Control Rights and the Governance Role of Debt' (2016), *Management Science*, Vol. 62, No. 9, at 2581-2614.

²²⁹ Goshen and Squire (2017).

bodies on the total register at the end of March 2023²³⁰ – up from 2022 (4,713,538)²³¹ and from 2021 (4,539,191).²³² By contrast, the number of public limited companies in the UK in 2021-2022 in the same time period was ↓5,951 (0.1% of all corporate bodies registered in the UK):²³³ down from 2020-2021 (6,103).²³⁴ For 2022-2023, unlike for the previous years, there is no separate number provided for public limited companies; the UK Companies House only mentions that ‘public limited companies have been declining in number since 2008. They now make up only 0.1% of the register.’²³⁵

Second, Ellias and de Fontenay, referring to a study by Kaplan and Strömberg, note that a significant number of the US firms are owned by private equity funds, rather than public shareholders.²³⁶ Ellias and de Fontenay also note that even in public companies in the US the modern shareholder base is ‘increasingly concentrated, institutional, and activist.’²³⁷

Third, in private companies, that are increasing in their numbers, there is a significant increase in debt capital (driven also by the post-GFC lower interest rates policy until recently and the COVID-19 pandemic).²³⁸ As mentioned earlier, in 2022/23, the global corporate debt reached a record high: \$456 billions of net new debt.²³⁹

²³⁰ The UK Companies House, ‘*Companies register activities: 2022 to 2023*’ (2023), available at: <https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2022-to-2023/companies-register-activities-2022-to-2023>

²³¹ The UK Companies House, ‘*Companies register activities: 2021 to 2022*’ (2022), available at: <https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2021-to-2022>

²³² The UK Companies House, ‘*Companies register activities: 2020 to 2021*’ (2021), available at: <https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2020-to-2021>

²³³ The UK Companies House, ‘*Companies register activities: 2021 to 2022*’ (2022).

²³⁴ The UK Companies House, ‘*Companies register activities: 2020 to 2021*’ (2021).

²³⁵ The UK Companies House, ‘*Companies register activities: 2022 to 2023*’ (2023).

²³⁶ Jared A. Ellias and Elisabeth de Fontenay, ‘*Law and Courts in An Age of Debt*’ (forthcoming, University of Pennsylvania Law Review 2023), at 29-30, referring to Steven N. Kaplan and Per Strömberg, ‘*Leveraged Buyouts and Private Equity*’, (2009) 23 J. Econ. Persp. 121.

²³⁷ Ellias and de Fontenay (2023), at 30, referring to Zohar Goshen and Richard Squire, ‘*Principal Costs: A New Theory for Corporate Law and Governance*’ (2017) Columbia law Review 767.

²³⁸ The International Monetary Fund, IMF Datamapper, ‘*Nonfinancial corporate debt, loans and debt securities*’ (2021), available at: https://www.imf.org/external/datamapper/NFC_LS@GDD/SWE; White & Case LLP, ‘*Global IPO markets pause to take a breath*’ (2023), available at: <https://www.whitecase.com/insight-our-thinking/global-ipos-markets-pause-take-breath>

²³⁹ Reuters, ‘*Corporate net debt hit record in 2022-2023, but borrowing appetite to decline, Janus Henderson says*’ (2023), available at: [https://www.reuters.com/business/corporate-net-debt-hit-record-202223-borrowing-appetite-decline-janus-henderson-2023-07-11/#:~:text=LONDON%2C%20July%202012%20\(Reuters\),a%20report%20published%20on%20Wednesd](https://www.reuters.com/business/corporate-net-debt-hit-record-202223-borrowing-appetite-decline-janus-henderson-2023-07-11/#:~:text=LONDON%2C%20July%202012%20(Reuters),a%20report%20published%20on%20Wednesd) [ay](#) (referring to a report by Janus Henderson).

B. General advantages of symbiotic governance

There are general advantages of symbiotic governance both in private and in public firms. The differences between equity and debt governance do not mean that they are or should be exclusive. The opposite: they complement each other. Debt governance is exercised to the extent and in relation to those aspects of the firm's business for which the debtholders have more control rights to influence the firm and to impact change, and for which they are more competent to do it. The firm's existing shareholders and its prospective equity investors benefit to a certain extent from debtholders' competence and effective debt governance.²⁴⁰

One example of this is when a firm pays dividends to shareholders out of retained earnings and then raises debt capital.²⁴¹ Debt not only has a disciplining (incentivising) effect on the firm's directors, therefore also controlling how much the directors shirk; arguably, debt investors – by scrutinising the firm and pricing debt accordingly – also effect positive externalities on others. For instance, debtholders' power to intervene or to price and ex-post also to reprice the risk and, accordingly, to signal to the market the firm's idiosyncratic risks and characteristics, has a disciplining effect on the borrower-firm. This disciplining effect of debt governance is applied *against* directors and for the benefit of all the stakeholders, including the firm's employees, customers, and the society in general (positive externality). Effective debt governance provides an information sharing regime.

Another example is when in private credit deals, the availability of debt capital provides more flexibility to the firm, including a breathing space to undertake risky ventures and to maximise shareholders' wealth. Existing shareholders, the prospective equity investors, and other stakeholders, moreover, benefit from the signalling function of the firm's and its debtholders' hedging prices. These corporate constituencies, including the firm's employees and the society, also benefit from the existence of ESG-priced debt finance, such as sustainability-linked bonds and loans. In this vein this paper agrees with Lund, who argues that '[...] the insight that the individuals with the strongest interest in

²⁴⁰ See Oliver Williamson, 'Corporate Governance' in *Economics of Corporate Law* (Vol. I) (ed., Claire A. Hill and Brett H. McDonell, 2016).

²⁴¹ Frank Easterbrook, 'Two Agency-Cost Explanations of Dividends' (1984) *The American Economic Review*, Vol. 74, No. 4, at 653.

seeing corporations act responsibly are not *always* the company's shareholders has consequences for corporate law and corporate governance.²⁴²

This paper's argument of the beneficial effects of debt governance is directly connected to Michael Jensen's original idea that there are '[...] benefits of debt in motivating managers and their organization to be efficient', which Jensen calls the 'control hypothesis for debt creation.'²⁴³ It is because of these various effects of debt governance, some of which have been caused by the evolution of debt markets, that this paper argues that the firm's effective corporate governance is a combination of equity and debt governance, where one type of governance complements the other, creating an information sharing regime for all its stakeholders and a disciplining regime against the potential shirking of its directors.

In modern-day private firms, but also recently in public firms, the interests of capital providers are often interlinked and overlapping. For instance, if the firm does not perform well, its original debt providers (typically banks) in a syndicated financing may not be able to sell the debt to the secondary loan market, where the investors in this secondary market are nowadays in a position to choose to buy this debt or to buy it at a huge discount. This will also create negative externalities for those firms that are waiting to receive financing from these debt providers. These debt investors want the firm to be successful to be able to market the original debt. In private credit, debt investors are interested in the firm's success to be paid back the debt sum, interest and return on their debt investment.

Prior to the changes in debt markets, in particular, with respect to the added experience and appetite of private credit funds, and the developments in the banking regulation, it used to be the case that exiting a financial relationship was predominantly seen as a negative sign for the market, because it meant that the borrower-firm was in trouble. This, is, however, not always the case in the modern debt market, where sometimes the banks transfer debt because of the capital adequacy rules (and not necessarily because there is a problem in the firm), or where the successful marketing of debt to the secondary market is also a signal of the secondary investors' confidence in the borrower-firm.

In the traditional debt market ("originate to hold") there might have also been more conflict of interests between equity and debt capital providers (value maximisation vs value

²⁴² Dorothy S. Lund, 'Corporate Finance for Social Good' (2021) Columbia Law Review, Vol. 121:5, at 1618-1658 [emphasis added].

²⁴³ Michael C. Jensen, 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers' (1986) The American Economic Review, Vol. 76, No. 2, at 324.

maintenance). Nowadays, this does not necessarily always have to be the case. As mentioned, in private credit, the most important reason for shared interests between equity and debt capital providers, is the interest of private credit funds in profit maximisation. In bank financing, the original debt providers also want the firm to do well in order to market the product to the liquid secondary loan market.

The modern secondary loan market also has a direct influence on the debt governance of the firm, as its decision to buy the firm's debt or not, or to buy it at a discount, also affects the firm. In principle, the original debtholders could transfer this debt to the secondary market, but the price of debt will reflect the borrower-firm's position (i.e., there will be a discount, and the original debtholders may incur losses). In some firms, debt capital providers also buy equity stake in the firm, making them also interested in the firm as its shareholders.

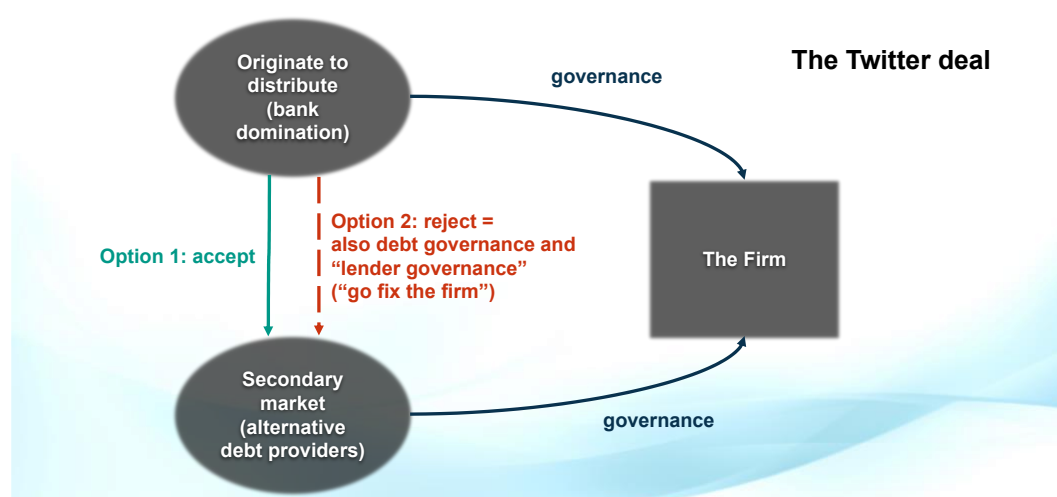
The competition, appetite, and expertise of debt investors in the secondary loan market acts as a strong incentive for the primary market to monitor and engage with the firm. The option for the debt investors in the secondary loan market to choose to accept or reject the product is a powerful debt governance mechanism: *the secondary loan market contributes to the debt governance of the firm ("lender governance")* (*Diagram 2*). In its turn, the original debtholders are especially incentivised to engage in debt governance to be able to market the product to the secondary market. The decision of the secondary debt investor to accept or reject the offer from the original debtholders, moreover, entails powerful information sharing regime to the market about the firm and its prospective.

In sum, as shown in *Diagram 2* below, these developments allow for three steps of debt governance for "originate-to-distribute" type of debt: original debt governance when pricing debt, (Step 1), and secondary debt governance when the secondary market buys the debt (Step 2). But there could also be another step between Step 1 and Step 2, which this paper calls "*Fix the Firm*" step, where the secondary loan market rejects to buy the debt of the original holders (e.g., as was the case in the Twitter deal).²⁴⁴ This new phenomenon is only possible due to the development of the secondary loan markets and the increased competition between various debt capital providers (i.e., traditional and non-traditional). It impacts the incentives of the original debtholders to monitor the firm and engage in effective debt governance, which includes, where relevant, also the selling of debt.

²⁴⁴ Financial Times, *Banks prepare to hold \$12.7bn Twitter debt on books until early 2023*' (2022), (noting that "They are [...] contending with one of the largest "hung" financing ever. [...] Twitter's bankers are hoping a period of market stability could mitigate losses on the financing package that could stretch to \$1bn. If markets were to become much more hospitable, they could choose to try to offload the debt quickly.")

Effective debt governance, arguably, also increases the value of equity. For instance, if the original debt providers do not effectively engage with the firm in order to be able to sell its debt to the secondary loan market, the unsuccessful debt transfer will not only affect the debtholders (i.e., they will lose money), but it will also impact the borrower-firm's share price (or also potentially of its interconnected entities' share price) in the market, as it may be seen as a sign of no confidence from the secondary debt investors.

Diagram 2



C. Advantages of symbiotic governance with private credit funding

There are several advantages of symbiotic governance, where debt is provided via private credit. *First*, in the private credit market, debt looks a lot like equity when it comes to the requested control rights (e.g., participation in capital growth, influence on the board), although what remains different is debt's ranking in the firm's capital structure. Both groups of capital providers often have a similar agenda: maximising the firm's profits. *Second*, the interests of shareholders and debtholders are aligned (i.e., no conflict of interest) when debt providers simultaneously own an equity stake in the same portfolio borrower-firm, or when the private credit fund and the deal sponsor (venture capital, private equity) are affiliated.²⁴⁵ On the other hand, there still may be scope for misalignment with other shareholders. *Third*, private credit provides for better incentive alignment for fund

²⁴⁵ Buchner et al., (2023), at 4 and 21. See also, Lily Fang, Victoria Ivashina, and Josh Lerner, 'Combining banking with private equity investing' (2013) Review of Financial Studies, Vol. 26, No. 9, 2139-2173.

managers. Why? This is because they typically do not look for syndication of debt; instead, they are invested in debt origination and keeping it until its maturity or repayment (also charging an illiquidity premium for this). They are also more focused on stronger debtholder protection. In this regard, Buchner et al., note that the borrower-firms with private credit financing in a sponsored (venture capital, private equity) deal, ‘may expect reputable [venture capital, private equity] sponsors to reduce the conflicts of interests between shareholders and debt holders.’²⁴⁶ They also point out that in sponsored private credit deals, equity sponsors could be expected to act in the interests of debtholders, such as through monitoring and involvement in corporate decision making.²⁴⁷

Although not in the context of private credit funds and loan financing, Keswani et al., studying the US-based mutual funds, find that two out of five fund families hold corporate bonds of the firms in which they also injected equity capital, and that the rise in debt investment in a fund that a family holds increases the likelihood of investors of the firms during shareholder meetings to vote in the interests of themselves as debtholders, even if this is against the recommendation of Institutional Shareholders Services (ISS).²⁴⁸ They mention that ‘voting has direct policy consequences as firms that receive more votes in favor of creditors make corporate decision more in line with the interests of debtholders.’²⁴⁹ Keswani et al., further note that, ‘[i]ntuitively, there is limited conflict between debt and equity when a firm is far from financial distress: what is the interests of creditors is likely also to be in the interests of shareholders and changes in firm policy have a very small effect on the value of debtholders’ stakes. However, we would expect this conflict to be magnified close to financial distress, when corporate policies are likely to have a larger effect on the market value of debt.’²⁵⁰

In the context of private credit funds, specifically, the advantage when private credit funds also own equity stake in the borrower-firms is that largely the interests of shareholders and debtholders in these companies are aligned – both interested in value maximisation. Shareholders are interested in wealth maximisation, whereas investors of private credit in these cases are also interested in the borrower-firm doing well to be able to generate return on their debt investment, as discussed previously. As a result, there is not always a conflict of interest between the interests of shareholders and debt providers

²⁴⁶ Buchner et al., (2023), at 4.

²⁴⁷ Buchner et al., (2023), at 4.

²⁴⁸ Aneel Keswani, Anh Tran, Paolo Volpin, ‘*Institutional Debtholder Governance*’ (2021) *Journal of Financial and Quantitative Analysis*, Vol. 56, No. 6, at 2103-2135 (in particular, at 2103-2107).

²⁴⁹ Keswani et al., (2021), at 2103.

²⁵⁰ Keswani et al., (2021), at 2103-2107.

in these types of firms. Such an alignment in interests also minimises incentive alignment costs for directors. It could be argued that such an alignment in interests of equity and debtholders de-risks the firm in the interest of debt with the result that the firm is less innovative. On the other hand, private credit is typically provided on terms and conditions (firm-specific, project-specific) that are designed to foster innovation and growth.

There are two additional points that should be highlighted. *First*, as mentioned above, in the context of debt capital provided by private credit funds, it shares several characteristics of equity. From the legal and accounting point of views, nevertheless, this investment is characterised as debt investment. Ellias and de Fontenay note that the protection offered to equity investors in the United States (“US”) is dealt through the lens of fiduciary duties – doctrines embedded in equity.²⁵¹ This position is similar in the United Kingdom (“UK”).²⁵² Ellias and de Fontenay further emphasise that by contrast to equity investors, debt investors in the US often protect themselves contractually, and in case of disputes judges rely on contractual interpretation of legal terms, which are derived from law, as opposed to equity.²⁵³ This general approach to the treatment of equity and debt investors is similar in the UK. As Lord Reed noted in *Sequana*, outside financial distress, the traditional approach to the treatment of debt providers regards them as guardians of their own interests.²⁵⁴ Ellias and de Fontenay argue that this distinction of the legal protection of equity and debt providers is outdated and predominantly based on ‘[...] an antiquated paradigm of a single bank lender and dispersed shareholders and incorrect assumptions about the risk tolerance of creditors versus shareholders.’²⁵⁵ This paper agrees with their position and further argues that the conventional position does not take into account the evolution of corporate finance: the rise of debt finance, development of private credit, liquidity in the secondary loan markets, the increased control rights that debtholders bargain for also outside financial distress of the firm, and the blurring lines

²⁵¹ Jared Ellias and Elisabeth de Fontenay, ‘*Law and Courts in an Age of Debt*’ (forthcoming 2023, University of Pennsylvania Law Review), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4387437

²⁵² See David Kershaw, *The Foundations of Anglo-American Corporate Fiduciary Law* (2018, Cambridge University Press). See also The UK Companies Act 2006, ss. 170-177; examples from the case law: *Re Smith and Fawcett* [1942] Ch 304 (CA); *BTI 2014 LLC v Sequana SA and others* [2022] UKSC 25; *West Mercia Safetywear v Dodd* [1988] 4 BCC 30 (CA); *Fulham Football Club v Cabra Estates plc* [1994] 1 BCLC 363 (CA); *Re City Equitable Fire Insurance Company Ltd* [1925] 1 Ch 407; *Bray v Ford* [1896] AC 44 (HL); *Gvembe Valley Development Company v Koshy* [2004] 1 BCLC 131; *Eclairs Group v JKN Oil & Gas Plc* [2015] UKSC 71; *Isaac v Tan Cardiff City Football Club (Holdings) Ltd* [2022] EWHC 2023 (Ch).

²⁵³ Ellias and de Fontenay (2023), at 1-4.

²⁵⁴ *Sequana* [2022] at [52], per Lord Reed.

²⁵⁵ Ellias and de Fontenay (2023), at 35. See also, Elisabeth de Fontenay, *The Use of Debt in Corporate Finance* in Encyclopedia of Law and Economics (Edward Elgar, forthcoming).

between ‘equity’ and ‘debt’ capital in terms of their characteristics.²⁵⁶ Although outside the scope of this paper, this also shows that the modern statutory and common law approach in the UK on directors duties is outdated and does not reflect the current market reality in which the firm’s and their interconnected constituencies operate in.²⁵⁷ *Second*, and connected to the first point, is the question of if debt in these types of private credit financings looks a lot like equity, then are the capital providers and borrower-firms interested in characterising it as debt for tax purposes?²⁵⁸ These two points merit a separate discussion and are a subject of future research.²⁵⁹

5. Conclusion

This paper provided new insights into the role of modern debt (credit) capital in the firm, its relationship with equity (share) capital, and the implications of advances in debt markets for corporate finance and corporate governance. The thesis of this paper is that the role of debt and its relationship with equity in the firm, due to recent significant developments in the corporate finance markets after the GFC, has been transformed.

This paper also challenged the traditional legal and financial framework on corporate finance and corporate governance and showed that (i) modern debt providers do participate in capital growth, (ii) are often interested in the firm’s profit maximisation, (iii) there is not always a conflict of interest between the interests of equity and debt providers

²⁵⁶ The ranking of debt in the capital structure remains ahead of equity in the UK. This was recently additionally reaffirmed by The Bank of England as a clarification of the position of creditors in the UK, after the Swiss regulator allowed to wipe out AT1 bondholders of Credit Suisse. See The Bank of England, ‘*Bank of England Statement: UK creditor hierarchy*’ (2023), available at: <https://www.bankofengland.co.uk/news/2023/march/boe-statement-uk-creditor-hierarchy>

²⁵⁷ See also the following sub-section “B”. This proposition is in line with Moore’s earlier argument that “[...] there is cause to question whether the basic normative impetus of the UK’s company law framework is as complementary to its surrounding economic and socio-political context as might first appear.” See Marc T. Moore, ‘*Shareholder primacy, labour and UK company law*’ Chapter 6 in the Research Handbook on the History of Corporate and Company Law (ed. H. Wells, ElgarOnline, 2018), at 143.

²⁵⁸ See The British Private Equity and Venture Capital Association, ‘*Guide to Private Equity Debt Funds*’, available at: <https://www.bvca.co.uk/Portals/0/library/documents/Guide%20to%20PE%20Fund%20Finance/Debt%20Fund%20Guide-May14-web.pdf> (noting at 8 ‘*Tax topics for debt funds*’, that ‘These taxes, if they arise, often represent investment return ‘leakage’, which means even if the fund’s investors may in principle qualify for exemptions from relevant withholding taxes (e.g., as tax-exempt or treaty-protected investors) or for relief under a foreign tax crediting system (e.g., as taxable investors), in practice it may be difficult to utilise those exemptions or credits. *A debt fund thus prefers, where possible, to have a strategy to minimise or eliminate these taxes without having to look to the particular status of its investors, and to back this up with contractual gross-up in the deal documents for withholding tax on interest.*’) [emphasis added]. See also, Bloomberg opinion Nir Kaissar, ‘*Looks Like Cash and Acts Like Stocks, But It has a Catch*’ (2023), available at: <https://www.bloomberg.com/opinion/articles/2023-06-23/personal-finance-direct-lending-looks-like-cash-acts-like-stocks-but-has-catch#xj4y7vzkg> (noting that ‘Imagine an investment with stock-like return and cash-like stability, or close to it. Many investors believe they have found such a thing. It’s called direct lending [...]’)

²⁵⁹ Narine Lalafaryan, ‘*Modern Capital Providers and The Firm*’ (working paper)

in the firm, and (iv) corporate loan financing agreements are often expected to be renegotiated.

Based on developments in the corporate finance markets, the paper further argued that outside financial distress, debt and equity simply can no longer exist in a vacuum from one another. The reliance of private credit funds on private (contractual) bargaining can also improve the economic efficiency.²⁶⁰

It is clear that the significant changes in corporate finance markets over the past twenty-five years mean that there is an urgent need to *re-evaluate foundational legal questions in this area* to ensure that the legal framework (i) reflects the market reality, (ii) helps to improve it, and (iii) is fit to counter harmful practices.

The paper concludes by putting forward the following inter-connected questions – a subject for our future research:²⁶¹

- (i) do these significant developments in corporate finance markets affect the legal (statutory and common law) framework on directors duties and mean that outside financial distress directors de facto promote and should promote the value of the firm's capital structure?
- (ii) while directors owe their duties to the company, how should directors exercise their duties (on a sliding scale), when equity and debt investors are the same, or where equity and debt investors have the same interests? and
- (iii) how do these developments in corporate finance markets affect the ongoing policy debate on corporate purpose?

6. Taxonomies

²⁶⁰ There is scope for interesting research in behavioural economics to understand behavioural changes of modern-day institutional and retail debt investors and their increasing interest in private credit.

²⁶¹ Narine Lalafaryan, “*Modern Capital Providers and The Firm*” (working paper)

***Table 1* in the paper | Taxonomy of private debt (loan) financing based on the type of the debtholder**

<i>Important features of a loan financing deal</i>	Deal execution	Uncertainty about market volatility (between terms sheet and closing)	Typical business model	Risk exposure	Market type
Bank lending (including syndicated)	Slow underwriting, long due diligence	High: price might be subject to change by the time of underwriting (state of market)	“originate- to-distribute” (short-term)	Low	liquid secondary loan market* *Although in the recent economic turmoil the availability of liquidity has been tested.
Private credit (direct lending)	Speedy underwriting, short due diligence	Low: no uncertainty about market volatility, price predictable	Typically “originate-to-suit and fit” (self-originating) (long-term) Sometimes also buying loans from banks.	High	illiquid market* *illiquidity premium charged by the debt investor

Taxonomy of loan financing based on the type of the debtholder [Part I]

<i>Important features of a loan financing deal</i>	Numbers of lenders	Type of relationship	Credit rating	Transparency/confidentiality	Investor return
Bank lending (including syndicated)	<p>Bilateral loan: one lender but subject to change (transfer)</p> <p>Syndicated loan: a group of several lenders typically larger than a club deal</p>	<p>Typically non-relational finance (but with smaller and micro-firms relational finance might still exist)</p> <p>Borrower might not know well and/or trust the holder of its debt, especially post-transfer of its debt</p>	<p>Credit rating required</p> <p>Predominantly investment grade borrowers</p>	<p>More transparency about deal, less confidential (e.g., involvement of credit rating agencies)</p>	<p>Fixed interest rate</p>
Private credit (direct lending)	<p>Typically a bilateral loan: one lender stays till maturity</p> <p>Club deals, including unitranche, for larger deals: several lenders, not as many as in a syndicated loan (less information asymmetry)</p>	<p>Relational finance:</p> <ul style="list-style-type: none"> - stability - safety - borrower knows and trusts who owns their debt. <p>Disadvantage: hold-up problem</p>	<p>Unrated/credit rating not required</p> <p>Leveraged market predominantly, but recently also investment grade borrowers</p>	<p>Less transparency, highly confidential</p>	<p>Inherently floating interest rate (re-priced 30-90 days)</p> <p>Higher return, risk-adjusted return, return typically 10-12%, could be as high as 20%</p>

Taxonomy of loan financing based on the type of the debtholder [Part II]

<i>Important features of a loan financing deal</i>	Borrower base	Contractual creditor protection (in particular, covenants)	Proprietary creditor protection (rights in rem)	Regulation	Funding model
Bank lending (including syndicated)	<p>For bilateral lending: 200mln and below</p> <p>For syndicated lending: 200mln - 5bln of EBITDA</p> <p>Bigger companies, investment grade firms</p>	<p>Cov-lite*</p> <p>*might be subject to change due to 2023 banking crisis</p>	Depends on the type of the borrower-firm, but not always asset-backed financing	Highly regulated (e.g., Basel III – capital adequacy rules)	Reliance on deposits - demand for liquidity
Private credit (direct lending)	<p>20mln - 5bln of EBITDA, recently also larger</p> <p>Typically middle market firms</p> <p>Recently also large unitranche or privately placed financing</p>	<p>Tighter covenants:</p> <ul style="list-style-type: none"> - financial maintenance covenants, - stronger protection, - higher call premiums 	Predominantly asset-based credit (tangible collateral)	Subject to a certain regulatory framework as asset managers, but not subject to banking regulation	Capital model raised – long term funding

Taxonomy of loan financing based on the type of the debtholder [Part III]

<i>Important features of a loan financing deal</i>	Information speed on the borrower	Cost of capital	Board representation	Business environment and risks	Mismatch between assets and liabilities of debt provider
Bank lending (including syndicated)	Typically quarterly	Lower than private credit	No ex-ante board representation (outside financial distress)* *Lender might negotiate/gain board representation ex-post during severe financial distress	Macro-environment	High
Private credit (direct lending)	Within weeks	More expensive than bank financing	Actively seeking ex-ante board representation also outside financial distress Active involvement during financing distress	Typically micro-environment connected to the specific borrower-firm	Low: debt capital is locked in

Taxonomy of loan financing based on the type of the debtholder [Part IV]

<i>Important features of a loan financing deal</i>	Lender incentives	Transaction costs	Deal documentation	Dealing with incompleteness of information
Bank lending (including syndicated)	<p>Incentivised as long as its helps with “originate-to-sell”</p> <p>Monitoring the borrower</p>	<p>Typically: search costs, monitoring costs, drafting costs, renegotiation costs, debt transfer costs, costs arising from inability to transfer debt</p> <p>Lower costs < than private credit due to higher standardisation of terms</p>	<p>Standard market documentation (LMA, LSTA) with some flexibility to amend</p> <p>Low transaction costs</p>	<p>Fixed interest rate – valuation fixed (fixed-term income)</p> <p>There is a link between the credit rating of the firm and the interest rate it is charged.</p>
Private credit (direct lending)	<p>Highly incentivised private credit managers (return directly linked to performance; “originate-to-suit and fit”)</p> <p>Not only monitoring the borrower, but also adding value through expertise</p>	<p>Typically: search costs, monitoring costs, information costs, drafting costs, investment costs (adding value, know how), enforcement costs, evergreen valuation costs, renegotiation/restructuring costs</p> <p>Higher costs > than bank lending</p>	<p>Privately negotiated documentation (business-tailored and deal specific): structural flexibility, scope for creativity and innovation</p> <p>High transaction costs</p>	<p>Dynamic valuation (evergreen), valuation of assets often corresponding to the interest rate</p>

Taxonomy of loan financing based on the type of the debtholder [Part V]

Taxonomy of Modern Debt Governance based on the type of the debtholder

<i>Important features of debt governance</i>	Incentives (engagement with borrower)	Scope for relational finance	Effect of dynamic valuation	Debt investor return
Bank	<p>“originate-to-distribute”</p> <p>Short-term influence on the borrower; liquid secondary loan market</p> <p>Interest in maintaining borrower’s value to be able to market the product to the secondary loan market</p>	<p>Low unless this a micro and small firm</p> <ul style="list-style-type: none"> - exit to distribute (cannot keep on balance sheet) [exit connected to market efficiency?] - borrower might not know/trust the subsequent owner of its debt 	N/A	<p>Fixed interest rate</p> <p>Interested in the borrower-firm’s value maintenance.</p>
Private credit (direct lending)	<p>“originate to suit and fit”</p> <p>Long-term influence on the borrower; illiquid market</p> <p>Interest in adding value, maximising borrower’s value</p>	<p>High</p> <ul style="list-style-type: none"> - no exit (locked in) - relational finance - borrower knows and trusts the owner of its debt 	High – dynamic valuation of the borrower	<p>Inherently floating interest rate (re-priced every 30-90 days). Minimum return on investment:</p> <ul style="list-style-type: none"> - 8-12% (in the past months) - as high as 20% in better economic conditions <p>Directly participating in capital growth, actively interested in the borrower-firm’s success and wealth maximisation.</p>

Taxonomy of Modern Debt Governance based on the type of the debtholder [Part I]

<i>Important features of debt governance</i>	Board representation	Incentives to renegotiate/restructure	Risk exposure	Pricing
Bank	No Only during financial distress – when debtholders take control of the firm	Low - exit to distribute (cannot keep on balance sheet) - but might have to renegotiate to be able to exit later - borrower might not know/trust the subsequent owner of its debt	Low - liquidity* *recent developments in the markets show that it has become more difficult to market the product to the secondary loan market (i.e., risk exposure increased)	Mostly ex-ante
Private credit (direct lending)	Yes Also outside financial distress Debtholders are actively seeking board representation from Day 1 (outside financial distress) - board observer rights (active or passive involvement, depending on the situation of the firm)	High - no exit (locked in) - relational finance - borrower knows and trusts the owner of this debt	High - illiquidity (locked in)	Ex-ante and ex-post Continuously renegotiating (floating pricing)

Taxonomy of Modern Debt Governance based on the type of the debtholder [Part II]

<i>Important features of debt governance</i>	Control rights	Covenants	Parallel equity ownership	Cost of finance
Bank	<p>Mostly ex-ante, and for a short-term for traded debt</p> <ul style="list-style-type: none"> - contractual control rights (covenants, mostly covenant-lite in the past years) 	<p>Covenant-lite Covenant-loose</p>	<p>No</p> <ul style="list-style-type: none"> - Only when the borrower defaults and the financing agreement contains conversion rights (debt converts into shares or if debt/equity swap as a result of restructuring) - Typically conflict of interest between equity and debt investors 	<p>Low</p>
Private credit (direct lending)	<p>Strong and dynamic control (re-pricing every 30-90 days)</p> <ul style="list-style-type: none"> - contractual control rights (strong covenant protection) - proprietary control rights (asset-backed finance is increasingly predominant in direct lending) - board representation 	<p>Covenants generally</p> <ul style="list-style-type: none"> - financial covenants, including financial maintenance covenants <p>agreeing to operate within restrictions or not is governance</p>	<p>Yes</p> <ul style="list-style-type: none"> - private credit capital providers often also provide the equity capital (private equity and private credit) - no conflict of interest between equity and debt investors if both equity and debt are provided by the same provider 	<p>High</p> <p>Higher % rate than in bank financing Illiquidity premium</p> <p>Higher pressure on the borrower to service debt than in bank financing</p>

Taxonomy of Modern Debt Governance based on the type of the debtholder [Part III]

<i>Important features of debt governance</i>	Effect on directors' incentives	Positive/negative effects of debt governance on the firm	Positive/negative externalities
Bank	<p>Outside financial distress: shareholders – value maximisation vs debtholders – value maintenance Directors have to deal with this.</p> <p>Agency costs > than in private credit</p>	<p>Positive:</p> <ul style="list-style-type: none"> - signalling to the market that the firm obtained bank financing (went through costly underwriting, due diligence, etc.) - skilled debt finance provider <p>Negative:</p> <p>N/A, or in certain cases a hold-up problem</p>	<p>Positive:</p> <ul style="list-style-type: none"> - liquidity, many firms get financing <p>Negative:</p> <ul style="list-style-type: none"> - if not successfully traded to the secondary market, this blocks the other firms in need of finance - macro-risks to the economy
Private credit (direct lending)	<p>Outside financial distress reduced agency costs: shareholders and debtholders interested in value maximisation (aligned interests, profit maximisation)</p> <p>Directors have a united front from the firm's capital (equity and debt) providers. Directors invested in debt origination and keeping it until its maturity or repayment (also charging an illiquidity premium for this), and also in better debtholder protection.</p> <p>Often as shareholders and debtholders are the same no costs arising from profit-sharing issues</p> <p>Reduced or no agency costs.</p>	<p>Positive:</p> <ul style="list-style-type: none"> - flexibility - certainty - trust - adding value and expertise to help the firm grow - no conflict or minimised conflict between shareholders and creditors outside financial distress - borrowers knows who owns its debt <p>Negative:</p> <ul style="list-style-type: none"> - higher cost of capital than bank financing - locked in relationship (scope for a hold-up problem) 	<p>Positive:</p> <ul style="list-style-type: none"> - small and medium-sized companies getting access to financing (middle-market companies) - debtholders adding value to the firm through their skill and knowledge <p>Negative:</p> <ul style="list-style-type: none"> - lack of transparency on the quality of borrower-firms (traditionally used to be unrated firms) and financing conditions - locked in a relationship

Taxonomy of Modern Debt Governance based on the type of the debtholder [Part IV]

<i>Important features for debt governance</i>	Number of lenders	Firm's flexibility to operate and transaction costs	Effect of competition in private debt lending market	Valuation of the firm by the secondary debt markets
Bank	<p>1 lender in a bi-lateral loan</p> <p>Many lenders in syndicated financing, bargaining/collective action problem</p> <ul style="list-style-type: none"> - coordination costs - information asymmetry - conflict costs 	<p>Less flexibility as the agreement is based on a standard documentation (LMA, LSTA), also debt is transferred.</p> <p>Low transaction costs</p>	Increases bank's monitoring of debt to be able to sell it	<p>Typically yes</p> <p>Originate-to-distribute</p>
Private credit (direct lending)	<p>1 lender in a bi-lateral loan</p> <p>Recently for bigger loan financing deals – club deals, unitranche – no conflict</p> <p>Club deals – several lenders, not as many as in syndicated financing</p>	<p>Flexible as the financing terms are specifically tailored to the firm's business and the project in question (business-tailored financing documentation)</p> <p>High transaction costs</p>	Ongoing monitoring to be able to add value to the borrower-firm and to attract more clientele	<p>Sometimes yes: when bought from banks</p> <p>Predominantly self-originating debt</p>

Taxonomy of Modern Debt Governance based on the type of the debtholder [Part V]