

Navigating Disruption in the Private Credit Market

An expert Q&A on structural and legal risks highlighted by recent disruption in the private credit market, including liquidity mismatches inherent in certain business development company (BDC) structures, risks of back leverage, software sector concentration, and net asset value (NAV) opacity.



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Recent high-profile defaults in the private credit market and unprecedented redemption pressure on large private credit funds have placed the \$1.8 trillion private credit industry under wide public scrutiny for the first time since the industry's phenomenal rise following the 2008 global financial crisis. Additionally, JPMorgan's decision to mark down the value of collateral on software loans in private credit financing facilities, reducing the availability of funding for private credit lenders, has also led some observers to question portfolio valuations, particularly if exposed to the software sector. However, rather than signaling an imminent collapse of the asset class, these disruptions likely represent a market correction that may strengthen the private credit market and support continued and sustainable growth.

Practical Law asked Gabriel Yomi Dabiri and Cynthia Weiss of Squire Patton Boggs (US) LLP to discuss the structural vulnerabilities and legal risks behind disruptions in the private credit market, and steps that private credit funds, private equity sponsors, and banks can take to navigate the current disruption.

WHAT DO THE FIRST BRANDS GROUP, TRICOLOR HOLDINGS, AND MARKET FINANCIAL SOLUTIONS (MFS) COLLAPSES REVEAL ABOUT PRIVATE CREDIT RISK?

The recent high-profile collapse of certain borrowers in the private credit market cast a spotlight on concentration risk across private credit books exposed to auto-adjacent, late-cycle, covenant-lite borrowers and raised questions about underwriting discipline and portfolio monitoring standards across private credit as an asset class.

First Brands, one of the largest aftermarket auto parts manufacturers, filed for Chapter 11 bankruptcy in the US Bankruptcy Court for the Southern District of Texas in September 2025. In January 2026, First Brands' founder, Patrick James, and senior vice president Edward James were criminally indicted in the US District Court for the Southern District of New York on allegations of lender fraud exceeding \$3 billion, involving fabricated invoices, double- and triple-pledged collateral, and collateral that never existed. The bankruptcy court approved General Motors and Ford bridge financing for the debtors, and asset sales proceeded through February 2026. Also in September 2025, Tricolor Holdings, a subprime auto lender, filed for Chapter 7 liquidation. MFS, a UK mortgage lender, collapsed under allegations that approximately £1.2 billion in loans were backed by only £230 million of genuine collateral, with double-pledging allegations mirroring the accusations levied against First Brands.

The enforcement environment resulting from these incidents may:

- Raise the diligence standards investors expect from lenders.
- Increase scrutiny by regulators in the US and the UK, both at the point of loan origination and during ongoing covenant compliance. For example, in the UK, the Financial Conduct Authority has signaled heightened focus on private market liquidity practices in the wake of the MFS collapse.

The cross-border element of these developments raises distinct risks for multijurisdictional private credit structures. The gap between US and UK/EU standards on collateral documentation, enforcement rights, and investor disclosure is a source of transaction risk that requires coordinated legal advice across jurisdictions. Funds with UK or EU portfolio companies, limited partner (LP) capital from Alternative Investment Fund Managers Directive (AIFMD)-regulated vehicles, or cross-border credit facilities must navigate a materially different regulatory environment from their US counterparts. Similarly, in the EU, European Long-Term Investment Fund (ELTIF) 2.0 introduces retail access provisions for private credit vehicles that carry their own liquidity management and disclosure requirements, which differ in important respects from the Securities and Exchange Commission's (SEC's) framework for US retail-marketed funds.

WHY DID BLUE OWL'S OBDC II INVESTMENT VEHICLE DRAW MARKET ATTENTION?

Blue Owl's OBDC II is a \$1.6 billion BDC marketed to retail investors through broker-dealer networks. To understand what happened, it is helpful to understand the evolution of BDCs. A BDC is a type of closed-end investment company created under the Investment Company Act of 1940. BDCs serve as capital formation vehicles that channel investor capital into private credit markets, particularly through loans to middle-market companies that are often underserved by traditional banks.

The first phase of the private credit industry's growth was dominated by BDC 1.0 structures. These BDCs raise capital from institutional investors and trade on public stock exchanges. The BDC 1.0 structure allows for investment in a range of illiquid assets that are held over a relatively long term. Investors can achieve some degree of liquidity primarily by trading on exchanges in the secondary market, rather than by exercising redemptions with the fund itself.

BDC 2.0 refers to a newer generation of retail-oriented BDC structures that offer periodic investor liquidity (typically with quarterly repurchase rights) while investing primarily in illiquid private credit assets. While these BDCs should carry sufficient liquidity to meet redemption requests, there is a potential tension between the often shorter liquidity time horizon and the longer tenor of the underlying private credit loans.

OBDC II is structured as a BDC 2.0. In mid-February 2026, in response to investor redemption requests fueled in part by concern about the fund's concentration in software investments, Blue Owl permanently halted quarterly redemptions for the fund (see [What is the software concentration problem?](#) below). Blue Owl opted to sell approximately \$600 million in loans at 99.7 cents on the dollar to repay a Goldman Sachs revolving facility and fund a special cash distribution of approximately 30% of the fund's NAV. While this transaction was framed as evidence that the underlying portfolio was sound, the market quickly sold off the fund's equity. By early March, similar redemption pressure had spread to other major private credit funds.

BDC 2.0 sponsors and fund managers operating semi-liquid vehicles should review their governing documents, gate provisions, and tender offer mechanics to ensure familiarity with the provisions that would come into play if faced with redemption pressures. This review may be complex because gate and tender mechanics are governed by a layered set of documents, including the fund's charter, offering memorandum, subscription agreements, and applicable broker-dealer selling agreements. These documents may contain conflicting provisions or impose disclosure obligations that were not triggered when originally drafted but would become operative once a gate is imposed.

Investors and regulators may push for greater disclosure and transparency for retail-marketed private credit vehicles going forward. Funds considering or pursuing conversion to closed-end or listed structures should engage counsel on the structural, tax, and regulatory implications before committing to a strategic path.

HOW DO BDC 1.0 AND BDC 2.0 STRUCTURES GENERALLY PERFORM IN PERIODS OF MARKET DISTRESS?

Middle-market private credit loans carry three- to seven-year maturities, are not publicly traded, and, in periods of market stress, have a relatively limited secondary market. The lender's return is predicated on holding the loan to maturity. Selling under pressure often means accepting a discount, not because the credit is impaired but because the buyer assumes illiquidity risk and demands compensation for it.

BDC 1.0 vehicles are closed-end structures that generally lack redemption rights and have a ten-year fund life. Investors in BDC 1.0 vehicles (typically pension funds, sovereign wealth funds, and insurance companies) opt for a long-term buy-and-hold strategy that aligns with the illiquidity of the underlying loans.

By contrast, BDC 2.0 vehicles combine quarterly redemption rights for investors with an illiquid asset base of private credit loans that are not publicly traded. This combination creates a liquidity mismatch. In normal conditions, the mismatch generally goes unnoticed.

However, when market sentiment turns negative in response to news of a gate closure at a peer fund, reports of fraud in the market, or any other credit scare, retail investors (including some who may not fully appreciate the illiquidity of their investment) move to exit simultaneously. Redemption queues build faster than new capital can replace them. Fund managers must choose whether to impose a gate or sell assets into a thin, stressed market at the worst possible time.

Note that the risk presented by BDC 2.0 vehicles is fairly limited. Goldman Sachs estimates that 80% of the direct lending market sits in long-duration drawdown funds, separately managed accounts, and listed BDCs (CNBC: Private Credit Could Be the Next Crisis on Wall Street. How Worried Should Investors Be? (Mar. 11, 2026)). These are BDC 1.0 structures without on-demand redemption mechanisms. The retail evergreen fund segment, including BDC 2.0 structures, is where the structural vulnerability is concentrated. That segment represents approximately \$220 billion, or about 20% of total industry lending exposure.

WHAT RETAIL PARTICIPATION RISKS EXIST BEYOND CURRENT BDC 2.0 STRUCTURES?

US life insurers have increased their exposure to private credit, allocating close to one-third of the \$5.6 trillion they hold in total assets to the private credit market, up from 22% one decade ago (Financial Advisor: Life Insurers Boost Private Debt Investments in Grab for Yield (June 27, 2025)).

The Trump administration's August 2025 Executive Order 14330, Democratizing Access to Alternative Assets for 401(k) Investors, directed regulators to facilitate access to alternative assets, including private credit, in 401(k) and other retirement plans covered under the Employee Retirement Income Security Act of 1974 (ERISA). If not properly structured, this could replicate the liquidity mismatch seen in BDC 2.0 structures at a dramatically larger scale, given that US defined contribution workplace retirement plans held \$14.2 trillion at the end of the fourth quarter of 2025 (Investment Company Institute: Release: Quarterly Retirement Market Data, Fourth Quarter 2025 (Mar. 26, 2026)).

WHAT DO BANKS FINANCING PRIVATE CREDIT FUNDS NEED TO UNDERSTAND ABOUT BACK LEVERAGE?

Back leverage refers to borrowing by a private credit fund against its own loan portfolio. The fund pledges its middle-market loans as collateral to a lender, often a traditional bank, which extends a credit facility based on the assessed value of that collateral. The fund can then deploy this additional capital into new loans, potentially increasing returns to investors.

Back leverage has been a core driver of private credit's growth. According to Federal Reserve data analyzed by Moody's, Wall Street lenders had provided approximately \$300 billion in financing to private credit funds as of late June 2025 (Moody's, US Banks' Private Credit Loan Exposure Nears \$300 Billion (Oct. 21, 2025)).

Banks with the unilateral right to revalue the collateral of private credit fund borrowers are better positioned to manage back leverage risks. Banks that did not reserve this right in their credit agreements may find their exposure is larger than their collateral valuations suggest.

Private credit funds with existing back leverage facilities should review:

- The bank's unilateral revaluation rights, including any applicable cure periods and notice requirements.
- Borrowing base and advance rate definitions, including sector concentration haircuts for software-heavy portfolios, which were not prevalent in facilities that originated between 2021 and 2023.
- Collateral substitution mechanics allowing substitution of other assets for software.

If a fund's back leverage facility lender also participates in a tranche of the fund's portfolio loans, any unilateral revaluation rights the lender holds may be constrained, or the exercise of those rights may create conflicts with the fund's obligations to other investors or counterparties. Identifying and managing these structural conflicts requires independent legal review. Banks negotiating new credit facilities should consider advance rate step-downs triggered by software sector concentration exceeding defined thresholds to provide structural protection for the facility.

WHAT IS THE SOFTWARE CONCENTRATION PROBLEM?

Private equity-backed software, including Software as a Service (SaaS) companies, represent a significant share of many private credit portfolios. Recently, the rise of AI competitors in the sector has diminished the pricing power and, consequently, the revenue projections of many of these companies. While mission-critical enterprise software remains resilient, commodity SaaS providers facing AI-driven profit-margin erosion are seeing significant downgrades to revenue projections. When a lender sizes a loan based on specific projections, any material shortfall or decline in EBITDA (earnings before interest, taxes, depreciation, and amortization) can cause the credit to quickly shift from performing to impaired.

In mid-March 2026, JPMorgan became the first major bank reported to have marked down the value of software loans held in the financing portfolios of private credit clients (Reuters: JPMorgan's Markdown to Restrict Lending to Private Credit Firms, Source Says (Mar. 12, 2026) (subscription required)). JPMorgan CEO Jamie

Dimon characterized the action as prudent financial discipline rather than a response to actual loan losses. However, by cutting the assessed value of this collateral, JPMorgan directly reduced the borrowing capacity of those private credit clients and, in some cases, created the potential for margin calls requiring funds to post additional collateral. The markdowns have not triggered material margin calls, but they represent a preemptive structural tightening of the back leverage market, with significant implications for fund liquidity management.

HOW DOES NAV OPACITY CREATE LEGAL ISSUES FOR PRIVATE CREDIT FUNDS?

Private credit loans are not priced by a public market. Unlike broadly syndicated loans, which typically have observable secondary market prices, private credit loans are typically valued through internal models and periodic third-party valuations. The opacity of NAV calculations and limited access to information on the underlying investments can complicate pricing. In normal conditions, this opacity is manageable. However, under AI-driven margin compression in software and SaaS, it is unclear whether private marks are adjusting appropriately as public software multiples decline. This uncertainty has direct legal consequences across the capital structure because:

- For borrowers, stale marks can obscure covenant breaches. A loan covenant defined by reference to enterprise value or EBITDA multiples may already be tripped on a mark-to-market basis, even if the borrower has not yet formally declared, or even is aware of, a default.
- For lenders providing back leverage facilities, inflated collateral values can directly inflate reported advance rates and understate actual leverage, potentially masking a breach of borrowing-base thresholds that would trigger an event of default.
- For fund managers, investor claims premised on inaccurate or misleading NAV pricing are a foreseeable next step if marks diverge materially from realized values on exit or restructuring.

The intersection of fund governance obligations, timing of NAV calculations, credit agreement mechanics, and regulatory exposure requires coordinated legal review across multiple practice areas. Counsel for private credit funds should review valuation policies and procedures against SEC guidance on private fund valuation, focusing on software and SaaS positions. Where back leverage facilities reference fund NAV or borrowing-base calculations tied to internal marks, counsel should assess whether current valuations would survive independent stress-testing and whether disclosure to LPs and facility lenders remains adequate. Valuation policies and procedures should also be back-tested for accuracy.

IS THERE GENUINE CAUSE FOR CONCERN ABOUT RISKS IN THE PRIVATE CREDIT MARKET (INCLUDING LAX UNDERWRITING, ILLIQUIDITY, AND SOFTWARE CONCENTRATION)?

Private credit is facing its first substantial stress period. In a brief period, redemption stress has spread to multiple private credit funds. JPMorgan's decision to unilaterally revalue downward certain software-related collateral supporting back leverage loans has introduced a surprising bank-to-fund deleveraging move. Recent disclosure by traditional banks suggests that private credit risk is embedded in the regulated banking system more deeply than prior disclosure suggested. Software sector concentration under AI-driven margin compression remains the most structurally significant risk, and NAV opacity (that is, whether private marks are following public software multiple compression) remains an active concern for the market.

That said, available data and current market activity suggest that concerns about the private credit market may be overstated. As discussed above, Goldman Sachs estimates that 80% of direct lending sits in vehicles without on-demand redemption, meaning that this structural vulnerability is contained to roughly 20% of the market. Additionally, loans secured by more tangible assets, such as infrastructure, railcars, aircraft, and other hard assets producing durable cash flow, remain well secured and continue to perform well. We have seen numerous examples of capital redeemed from distressed private credit funds and immediately redeployed into other funds making loans secured by more tangible assets. Specialty lending, driven primarily by asset-based finance, overtook direct lending as the most common strategy for new private credit fund launches in the first three quarters of 2025 (With Intelligence: Private Credit Fundraising Report 2025 (Apr. 16, 2026)).

The fundraising and deal flow outlook is bifurcated, not collapsing. The retail channel faces years of reputational and possible regulatory repair. RA Stanger forecasts a 40% year-over-year decline in BDC capital formation (Investment News: From Boom to Bust: BDC Sales Tank in the Midst of Market Turmoil for Private Credit (Feb. 27, 2026)). However, asset-based lending, infrastructure credit, credit secondaries, and distressed strategies are all scaling in this environment. Some market participants have attributed the extraordinary growth of the private credit market, at least in part, to bank retreat from certain middle-market lending due to regulatory constraints on banks imposed under Dodd-Frank and Basel III/IV in the aftermath of the 2008 global financial crisis. The long-term structural case for this paradigm remains largely intact.

In our view, this disruption is the beginning of a correction leading to a cleaner, more disciplined, institutional, and tangible asset-based private credit market. Those who recognize this and act on the resulting opportunities will be best positioned for what comes next.

Priority Actions by Client Type

PRIVATE CREDIT FUNDS

Private credit funds should:

- Review gate provisions against current BDC governance standards. Compare the fund's governing documents, offering memorandum, and selling agreements to identify conflicting terms or newly operative disclosure obligations.
- Audit back leverage facility agreement revaluation rights, advance rate concentration haircuts, and collateral substitution mechanics.
- Audit intercreditor and subordination agreement terms for first-out/last-out provisions that may no longer reflect current market realities or anticipated workout complexity, paying particular attention to whether the back leverage lender is also a participant in the portfolio loans. These structural conflicts can constrain enforcement options.
- Review fund valuation policies and procedures against SEC guidance on private fund valuation, focusing on software and SaaS positions, and assess LP and lender disclosure obligations where current marks may diverge from stressed market values.
- For funds with UK or EU LPs or portfolio companies, assess cross-border structuring exposure under AIFMD and ELTIF 2.0 with dual-qualified counsel.

PRIVATE EQUITY SPONSORS

Private equity sponsors should:

- Review intercreditor and subordination provisions across portfolio companies' private credit capital structures, focusing on first-out/last-out split-lien arrangements originated between 2020 and 2023 where payment waterfalls and enforcement rights may be ambiguous in partial-default scenarios.

- Audit maintenance covenant headroom across portfolio companies with covenant-lite or covenant-loose agreements originating between 2020 and 2023, focusing on software and SaaS portfolio companies whose revenue and revenue projections have been negatively impacted by AI competitors.
- Analyze liability management options for portfolio companies approaching a maturity wall on payment in kind (PIK)-heavy or interest-deferral structures. Solutions such as amend-and-extend, uptier exchange, and out-of-court restructuring narrow materially once a payment default occurs.

BANKS AND OTHER LENDING INSTITUTIONS

Banks should:

- Review back leverage and credit facility agreements, focusing on unilateral revaluation rights, software concentration haircuts, and cure period mechanics. Confirm whether revaluation triggers conflict with obligations owed to other fund counterparties.
- Assess Federal Reserve and SEC regulatory capital and disclosure implications of private credit fund financing exposure, including the adequacy of current internal classifications of bank-to-fund facilities under applicable capital rules and existing public disclosure.
- For insurance company lenders, engage counsel on insurance regulatory capital treatment of existing private credit allocations and the implications of any portfolio reallocation toward asset-based or infrastructure lending.
- Formulate a strategy to reallocate new facility origination toward asset-based, infrastructure, and tangible-asset lending. Engage counsel on documentation standards for these structures, which differ materially from the covenant-lite templates prevalent in recent years.