

CHAMELEON CAPITAL

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ABSTRACT

Would you like ‘debt’ that looks a lot like ‘equity’? Or would you prefer ‘equity’ that looks a lot like ‘debt’?

Would you like both? There is no set menu. Welcome to the chameleon capital era.

There has been a quantum leap in corporate finance: a momentous change in investment structure and incentives. Over the past sixteen years the corporate finance markets have been undergoing a dynamic redesigning.

First, such an evolution and remodelling of corporate finance markets is due to the substantial rise of private capital (private credit, private equity, venture capital). *Second*, the 2023 banking crisis and the ongoing macroeconomic environment further stress the importance of debt capital and its dynamic relationship with equity capital in general, but, especially, in private companies. This link is even more nuanced in the context of distressed investments and special capital solutions. With the significant rise of corporate debt levels and higher interest rates, there is a lot of scope for private credit investment, including for rescue financing and capital solutions financing. *Third*, on the one hand, there has been an increased competition not only between banks and private credit funds, but also between banks, private credit funds, and institutional investors (e.g., sovereign wealth funds). On the other hand, banks have started partnering with private credit funds to provide financing. The power, appetite, and experience of private equity funds and private credit funds – the latter being a more recent, but the fastest-growing phenomenon in the private investment world – have skyrocketed. *Finally*, because of the changes in the corporate finance markets post 2007-2008 global financial crisis, modern debt investment in the private capital domain looks a lot like equity, and, where necessary, modern equity may also be designed to look a lot like debt. Sophisticated debt investors, such as

private credit funds, negotiate bespoke measures, including by negotiating for equity upside and board observer rights (or even board representation), or for debt-like or equity-like hybrid instruments (e.g., synthetic payment-in-kind (PIK), debt-like pref equity and others). Operating in a market where information asymmetry is the game, these sophisticated investors bargain for modern hybrid investments, crafting bespoke and complex investments with long term interests and objectives in mind (*'chameleon capital'*).

In light of these major developments, this paper studies how in commercial practice – law in action, as opposed to law in books – the traditional distinctions between ‘equity’ and ‘debt’ investment in the private capital domain (private credit, private equity, distressed investments) have been blurring over the years. Building on this evolution, from a *corporate law* perspective, the paper aims to show that the conventional division between ‘equity’ and ‘debt’ investment is only relevant in the context of collective proceedings. For a single investor, or a small group of associated/affiliated investors, such as private credit firms and private equity firms, the distinction between ‘equity’ and ‘debt’ has become further blurred and, arguably, disappears altogether as per the Modigliani-Miller theorem. The legal characterization of what is ‘equity’ and what is ‘debt’ in corporate law and also in insolvency law is very important, including in the context of restructuring of these arrangements.

Why is the blurring question important especially now? *First*, investigating the issue of the disappearing distinction in commercial reality (law in action) between ‘equity’ and debt’ in the private capital domain is relevant from a legal point of view when it comes to the incentives, behaviour, and accountability of directors in the context of directors’ duties. The distinction between ‘equity’ and ‘debt’ shines a microscope on corporate law because of the different levels of protection that corporate law offers to a firm’s capital providers: shareholders and debtholders. *Second*, the blurring between ‘equity’ and ‘debt’ investment is also interesting when analysing the controlling investor’s duty (typically controlling shareholder’s duty), but also other related issues, such as shadow directorship, shareholders’ agreements, the reflective loss principle, legal capital rules, wrongful trading, and others. *Third*, over the past years, there have been various important developments impacting the corporate law framework worldwide, including when it comes to the corporate law’s treatment of ‘equity’ and ‘debt’. Four significant developments inform the discussion in this paper: (i) the UK Supreme Court’s ‘momentous decision for company law’: *Sequana* [2022], (ii) the English High Court’s decision in *Wright v Chappell* [2024] (the ‘BHS decision’) – the largest award for wrongful trading (insolvency) with important implications for directors’ duties in corporate law, (iii) the Delaware Court of Chancery’s

decision in *Moelis II* [2024], and (iv) the amended Delaware General Corporation Law, essentially overturning *Moelis II*.

The paper takes a comparative approach and studies the implications of the evolution of corporate finance, and the treatment of ‘equity’ and ‘debt’ in English corporate law, comparing and contrasting it with Delaware law. The paper concentrates on these two legal systems as there have been recent significant developments in English law and Delaware law and because the two systems often produce different legal results to the same questions, but where from a functional point of view some of the outcomes are similar.

The paper focuses on the implications of the blurring of ‘equity’ and ‘debt’ in commercial practice (i.e., mismatch between law in action and law in books) for corporate law and how the change in the relationship between ‘equity’ and ‘debt’ influences the fight for corporate control. The paper aims to answer (i) what the role of corporate law is in addressing the issue of ‘chameleon capital’ and (ii) whether in particular contexts the distinction between equityholders and debtholders remains justifiable in corporate law.

The paper contributes to the growing legal literature on private investments, as well as to the general corporate finance theory. By exploring the disappearing distinction between ‘equity’ and ‘debt’ in the private capital domain, the paper highlights the interesting questions about the extent to which legal characterization in corporate law still plays a residuary role. The paper provides several normative recommendations.

Key words: private capital, private credit, distressed investments, capital solutions, corporate control, corporate finance, English law, Delaware law.
