
PE Pathways* — State of Play in Navigating Distressed Middle Market M&A*Speakers: Jeremy Levy, Brian Rose, Jonathan Young****Recorded: October 16, 2025****Aired: October 30, 2025****Jeremy Levy (00:04):**

Welcome to *PE Pathways*, our podcast series where experienced deal makers share their thoughts on current private equity and M&A trends and developments. Today is the first episode of a series of discussions around private equity and distressed assets with our friends from our Bankruptcy + Restructuring practice group. The focus of the series will be ways to unlock value in distressed M&A. My name is Jeremy Levy. I'm a partner in the Private Equity practice of Troutman Pepper Locke. Joining me is my fellow partner from the PE practice Brian Rose, and Jonathan Young, our partner from our Bankruptcy + Restructuring practice group. Welcome to you both.

Brian Rose (00:44):

Thanks, Jeremy. Great to be here.

Jonathan Young (00:46):

Appreciate it, Jeremy. Hello.

Jeremy Levy (00:48):

Distressed M&A or Mergers and Acquisitions involving financially troubled companies is an area where private equity firms are increasingly active. This first podcast in the series will focus on the state of play in navigating distressed middle market M&A. Let's set the scene for our listeners. What are you seeing in the distressed M&A market today?

Jonathan Young (01:08):

Well, Jeremy, for starters, we're seeing some stressed and distressed portfolio companies that either need to find a recapitalization or refinancing or potentially an early exit. What that means from the M&A perspective is these are going to be tougher deals at lower valuations. The timing is not being driven by what's optimal in the industry or for the platform. The timing is being driven by the default under the credit facility, the operational stress or whatever's pushing this portfolio to an earlier exit that might be ideal. And therefore we're seeing numbers that are pricing in risk, legacy liabilities, and that overall uncertainty. We're also seeing situations where unfortunately, sometimes the senior debt is the fulcrum, and at least on paper, the sponsor's out of the money. So you've got some interesting timing issues here. Sponsor might want to move a little more slowly and try to rescue some value. The lender sees problems and risk ahead and wants to expedite the exit. Brian, from your perspective, similar, different?

Brian Rose (02:24):

Yeah, I think similar. I think just like in non-distressed M&A, these deals tend to move and are moving pretty slowly. I think the lenders tend to be reluctant to exercise their remedies fully, and valuations are down and these processes just sort of are dragging.

Jeremy Levy (02:43):

So how have we seen sponsors and senior lenders respond to indications of interest and other valuation data suggesting that the sponsor is out of the money?

Jonathan Young (02:52):

Oh, it's definitely a tricky balance to strike for the sponsor. On the one hand, if they're going to rescue some value or try to find a strategic alternative, they very much want to maintain their control position. They want to dictate timing. They want to make all the strategic choices that got them into the investment in the first place. But at the same time, as the portfolio company heads towards stress and potential insolvency, there's certainly some risk to the fiduciaries that are sitting on the board or in a management position. So one thing we see a lot of our sponsor clients consider in this position is if not a governance change outright, it's a good time to consider appointing an independent. It's a good time to consider bringing in an outside advisor who could serve as chief restructuring officer or chief liquidating officer, and it's really an opportunity for the lender or some independent advisors to participate in the solutions.

Conversely, the lenders sometimes in these situations aren't going to wait, and to the extent they're holding equity pledges and proxies, they may consider putting in their own independents, or I should say independents that they've selected or brought to the table. And sometimes it's a very cooperative process. The sponsors and the lenders will have a conversation and say, we both think it would be beneficial to bring in some additional voices on the board. We're also seeing increasingly the use of specialty distressed investment banks to run the process. These are players that are particularly experienced at monetizing a distressed company, navigating the debt and litigation issues that may accompany that transaction and frankly, navigating the difficult timing that sometimes comes with those kinds of transactions.

Brian Rose (04:55):

I've worked on two transactions in the last 12 months that had the characteristics that you're describing where lenders exercised their proxy, replaced the board. The board then put the company into Chapter 11, and then the Chapter 11, debtor engaged a specialty distressed investment bank to market the assets in a bankruptcy setting. So I think my view of the market is very consistent with what you're describing.

Jonathan Young (05:20):

And I think what is helpful about those specialty bankers is they take what would be potentially a drag on value, the financial distress, the portco's experiencing, and if not turning it into an asset, they turn it into a pressure point that generates value and competition. They make a market for

the asset by suggesting that the lender and the sponsor are aligned, aligned, and there's a rapidly closing window in which these assets are going to be monetized, and it creates a bit of an auction dynamic, which is helpful.

Brian Rose (05:56):

Even in industries, there may not be much of a market outside of a bankruptcy setting when you have a distressed investment bank. They could at least if they have two bidders, they've got a market. And I actually was involved in a transaction this year where it seemed like there was no market for this business, and all of a sudden we had a bidding warrant in an auction setting.

Jonathan Young (06:13):

Yeah, relatedly, on the auction point, one of the things we've seen of late is the opportunity to market the assets on a whole company basis and also on a divisional or sub lot basis. And it just creates an auction dynamic within the auction dynamic because you have bidders for individual lots competing with whole code bidders, and it can sometimes really create value where you wouldn't have expected to find it.

Brian Rose (06:42):

Yeah, I think the Chapter 11 setting is particularly conducive to those kinds of lot type auctions because the bankers do just an excellent job of sort of carving things up and creating sub packages that are competitively bid on.

Jonathan Young (06:56):

Yeah. One other quick add on to this topic, Jeremy, is the defaulted credit facility itself is a factor in the process of the negotiations and the lender is going to have a strategic fork in the road. Do they do an amendment and in essence help take the company out of covenant default? Or do they do a forbearance and keep all their powder dry and reserve all their default rights and remedies and just create time and space and milestones to run the process? No right or wrong. I mean, it depends on the situation, but sometimes the existence of the forbearance and the milestones creates a finding pressure that could cut either way. A well-resourced strategic might say, "hey, I'm just going to wait out the milestone period and they can come talk to me after the default." Conversely, you might have a situation where the lender decides to end the default altogether and position the company in a stronger place to do a transaction. And especially if that's a stock deal rather than an asset deal, there might be very good reasons to do that.

Jeremy Levy (08:03):

We have some clients who have been in this situation, as you've described, and we've been negotiating some forbearance arrangements on their behalf. How frequently are you seeing just bridge capital just to buy time injected by sponsors?

Brian Rose (08:17):

I have a handful of private debt fund clients where I think 30% of the time in some of their distressed deals, they're putting in some type of bridge capital, whether it be a loan or in some cases a preferred equity instrument just to give the company a little more time to see if they can turn things around.

Jonathan Young (08:36):

Yeah, it's interesting guys. I mean, some of it is driven by because the sponsor feel like it's a little out of the money or a lot out of the money, and the closer they are to getting back into the money, the more likely they're going to be to consider bridge capital. On the lender side, I find it's almost psychological more than it's economic. It's not like that 2 million the sponsor's going to put in is going to be the difference between coming out whole or not. But fresh money in is an important signal from the sponsor that they're going to ride along with this process and be a productive part of unlocking the value.

Jeremy Levy (09:14):

So we've danced around it a little bit as we've talked about the process of determining whether or not the company is going to move forward. When you reach the point where you know that the sponsor is out of the money, how have you seen sponsors and lenders address that situation?

Brian Rose (09:30):

I actually have seen a kind of interesting transactional structure recently where out of the money sponsors are negotiating with their lenders to buy back the debt either at par or at a discount to par, and then they'll put the company on a forbearance program. So I've had that happen a couple times this year. What about you, Jonathan?

Jonathan Young (09:50):

Now we've seen that approach, and I think that's one creative solution. I think that's a little harder to do once the company is in a Chapter 11. I mean, insider transactions are not prohibited, but they're certainly scrutinized on a higher level. I think the key to navigating this moment in the process is alignment and collaboration between the lender and the sponsor. The sponsor may be out of the money, but the sponsor has lived with this investment, knows the management, knows the players, and can really use those productive relationships to help the lender achieve a smooth monetization. So there are really good reasons to keep the sponsor aligned and participating, even if they're not going to see an equity return. And from the sponsor's perspective, it's good if the investment is not going to pan out, it's good to do the right thing by management and not have the monetization crash and burn.

So what we normally see is an aligned wind down process where assets are monetized, management is provided for, the lender is going to agree to fund specified expenses like payroll and taxes and other obligations that could bounce back and hit the sponsors of their fiduciaries.

And at the end of the process, there's going to be an exchange of releases with the sponsors. So it's a clean walkaway, and we've seen those collaborative arrangements many times they work well. I think the sponsor's challenge is going to be they're on to other investments and their time and attention or money. So it's painful to put that effort and time into a failed investment. But I think if there's a good peace treaty and the amount of time and effort is reasonable, it's worthwhile both for the sponsor and the lender to run that process.

Brian Rose (11:47):

Yeah, I think collaboration in those circumstances is key. I've worked on a few transactions where a lender and a sponsor have gotten together. The sponsor has agreed to an Article 9 strict foreclosure in exchange for sort of an equity tip in the new co. So that's another dynamic I've been a part of.

Jonathan Young (12:05):

Yeah, that can work. And it really, again, like so much of these issues, it's driven by where the valuation and where the fulcrum sits, but certainly if the sponsor is not that far out of the money and their relationships and institutional knowledge and connection with management is really a driver of value, then there may be real benefit to giving them some equity level upside on the other end. Now, whether the lender wants them in the new capital structure, that's a whole separate question, but I think you're right. Keeping the sponsor incented can definitely be a value add.

Jeremy Levy (12:43):

What about scenarios where the sponsor is not ready to walk away? What are some alternative structures that you're seeing?

Jonathan Young (12:49):

Well, it really depends if this is going to become a fight or not. I mean, if there's a fundamental disagreement on value and the lender is convinced that they're the fulcrum and they're losing recovery every month this operates and the sponsor thinks there's a substantial equity recovery, that's where you see a potential Chapter 11 scenario because somehow some way you got to test those competing views of value. And there's actually, from a fiduciary perspective, I think some degree of obligation to try to protect and rescue that value if an early foreclosure is going to take it away. So certainly there could be a contested Chapter 11. What we also see is the idea of a toggle where the parties say, alright, we need to recapitalize or monetize this company. We're going to go into Chapter 11. We're going to run a sale process, and we're going to look at the bids that come in and the is that come in, and that's going to set the values and the markers in terms of what this new capital structure looks like.

And if we think we can do better collectively just going ahead with a sale, that's what we'll do. But if there's a disappointing outcome to the sale process, then we're going to flip the toggle and we're going to agree to a recapitalization that uses the information we got in the sale process to peg the different positions in the new capital structure. Either way, it comes down to there needs

to be a correction of the balance sheet and it's either going to be collaborative or it's going to be a fight likely in Chapter 11. Brian, how about you?

Brian Rose (14:39):

I agree with everything you said. I don't think I've seen that toggle before, but where a sponsor's unwilling to walk away, I think Chapter 11 is probably the best tool, and that's where I've seen it deployed most often.

Jonathan Young (14:52):

Yeah. I've had scenarios where there was a fundamental disagreement on value, and sponsor had one view, lender group had another, and they ran a sale process, and it turned out that the sponsor was completely correct on what the valuation of the assets was, and they then went ahead and did their deal. And what the lender communicated was, look, the market has spoken, and I'm comfortable with this because we market tested it, and this number is where we landed. And sometimes the same answer feels different after a market check than it would simply if a knowledgeable sponsor says, "Hey, I think this is where it's going to land." So it's regrettable because it takes time and money and effort to run the market check and run the process. But sometimes psychologically parties need to take in that data before they walk away or before they accept that lower number.

Brian Rose (15:51):

And the lenders funding that exploratory phase through their forbearance. Is that how that works?

Jonathan Young (15:56):

I mean, it certainly can and often does, and that's why I think the added time can be a double-edged sword. I mean, you're getting more information and you're also burning more value. It's a negotiation between the lenders funding under the existing facility and the sponsor potentially topping up or putting in more.

Jeremy Levy (16:19):

Well, thank you Jonathan, and thank you, Brian. This has been a great discussion and I'm looking forward to our future installments and our series of private equity and distressed assets podcasts. Future episodes in this series will cover topics such as an Article 9 versus a 360 3 sale, the benefits and pitfalls of acquiring assets via an A, B, C, debt for equity and Loan to Own strategies and potential traps for the unwary and distressed M&A transactions. Thank you to our audience for listening today. Please keep your eyes open for future episodes of PE Pathways where we bring experienced deal makers on to share their thoughts on current private equity and M&A trends and developments. You can find the latest episodes wherever you get your podcasts.

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