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***PE Pathways* — Unlocking Value in Distressed Companies: Debt-for-Equity and Loan-to-Own Strategies**

**Speakers: Rachel Fitzgerald, Jason Ulezalka, and David Fournier**

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**Rachel Fitzgerald (00:05):**

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 fourth episode of a series of discussions around private equity and distressed assets with our friends from Debt Finance and Bankruptcy and Restructuring practice groups. The focus of this series will be ways to unlock value in distressed M&A. My name is Rachel Fitzgerald and I am a partner in the Corporate practice of Troutman Pepper Locke. Joining me is Jason Ulezalka, a partner in their Debt Finance practice group and David Fournier, a partner in our Bankruptcy and Restructuring practice group. Gentlemen, welcome.

**Jason Ulezalka (00:40):**

Hey, Rachel. Thank you.

**David Fournier (00:41):**

Hello, Rachel.

**Rachel Fitzgerald (00:42):**

Prior episodes in this distressed asset series covered the state of play of distressed M&A, Article 9 sales versus 363 sales, and acquiring assets via an assignment for the benefit of creditors. If you have not listened to those episodes, we encourage you to do so. Today, we will be discussing how to unlock value in distressed situations using two powerful tools in the distressed investing and restructuring world, debt for equity and loan to own strategies. We'll explore how debt for equities transactions can reduce a company's leverage by turning lenders into owners. And we'll unpack loan to own strategies where investors intentionally come in through the debt side with an eye toward taking control. Let's set the scene for our listeners. What are these strategies and why are they used?

**Jason Ulezalka (01:24):**

Hey, thanks, Rachel. This is Jason Ulezalka. I'm a partner in our Debt Finance Practice. And so we're talking about debt for equity loan to own. A debt for equity swap is a transaction, which is just what it sounds like. Existing debt is exchanged for equity or an equity-like instrument in the company. And so from the company's perspective, the company that issued the debt, doing debt for equity swap is a way to reduce leverage, reduce the interest burden, and it can help the company avoid a formal bankruptcy process. From the investor's perspective, the creditor's

perspective, you are effectively trading a fixed income position for an ownership stake in the company, and ideally you're doing so at a discounted entry price. When we talk about loan to own, it really refers to more of an overall strategy rather than a single transaction. But here, the investor is acquiring a significant portion in the company's debt, and they're doing so with the clear goal of converting that position into control of the equity, control the assets, and whether that's through a restructuring or sale process.

(02:42):

And so loan to own as an overall strategy, it may involve additional financing, taking an active role in a restructuring plan, and ultimately some type of credit bid or a swap where you are doing this debt for equity exchange. At a high level, these strategies are used because they're a way to potentially preserve going concern value, try to avoid a fire sale type outcome, and create a structure where the folks providing the capital are also invested in the long-term success of the business. And so as an investor entering into a debt for equity swap, you're giving yourself some downside protection. You start as a creditor with priority in the waterfall, and then you're using that to convert into equity. So that offers downside your position as a creditor, but then upside, trading that into an equity position where if the business can be stabilized and improved, you can earn a nice return.

(03:43):

This is ultimately a way to control a company without paying full cash value that you would in a traditional M&A deal. And from the company's perspective or the private equity sponsor, these debt to equity exchanges, when looking at them just kind of in isolation, are a way to provide a potentially faster, more flexible alternative to a full-blown bankruptcy process. It's a way to stabilize the balance sheet, preserve liquidity, and finally align the interests of your key financial stakeholders by turning lenders into owners.

**Rachel Fitzgerald (04:20):**

David, what do market participants mean when they use the term fulcrum security?

**David Fournier (04:24):**

The fulcrum security in these loan to own and debt to equity transactions is going to be the most senior level of secured debt that is not fully secured. It's the position in which you are going to be converting either all or a portion of that tranche of debt to equity.

And it's the position in which if there is senior debt, the senior debt will presumably go paid in full, and any tranche of debt below that fulcrum security is going to be debt that is at least technically out of the money in a restructuring or a debt equity swap. One key important element when a private equity firm or other participant is looking at acquiring a fulcrum security and trying to identify what that security is, is ensuring that that security is truly a valid, properly perfected, secured tranche of debt within the overall capital structure, because it's that secured position, even though under-secured, that the acquirer of the debt is going to be relying on to exercise its rights and exercise the leverage to convert that debt into equity.

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**Rachel Fitzgerald (05:40):**

Jason, can you explain how debt for equity swaps are deployed in an out-of-court context versus in-court?

**Jason Ulezalka (05:46):**

Sure. Yeah. I'll cover the out of court part. At a high level, the steps are first, the company and its advisors need to diagnose the capital structure. Specifically, how much debt needs to come out, where does the fulcrum securities sit in the debt stack, and try to identify which creditor group is most likely to become the new owner of the company based on where the fulcrum sits. Once that background work is done, you have engagement with the key creditors. This can be just a single lender in some circumstances, or it could be an ad hoc group of lenders or note holders, but discussion has to be had about the business plan and financial projections, and ultimately the terms for a swap and any new money coming into the business. In terms of the actual exchange terms, the parties will certainly cover the exchange ratio, which is how much equity per dollar of debt is being issued.

(06:45):

The instrument mix, will it be common stock, preferred stock, warrants, some mix, any governance issues, so covering things like board seats, veto rights, voting agreements, and finally whether new money is being provided and the related terms for that part of the financing. So once these terms are generally agreed upon in the out-of-court context, it's largely a matter of contract law. What do the existing debt and equity documents say? For larger deals, at this point, there may be a bond exchange or loan exchange offer where holders can voluntarily swap into new securities, and that very often may be paired with a consent solicitation to amend covenants or other terms for the holders that are participating. Finally, the documents are executed and the transaction is effectuated. If all goes well, the parties have accomplished a balance sheet restructuring without the cost and uncertainty and publicity of an extended court process.

**David Fournier (07:50):**

And let me address how that process would play out if you do have to go into a court process to effectuate the restructuring. And a bankruptcy may be necessary for a number of reasons. It may be necessary because the fulcrum security sits at a level in which the debt is held by multiple entities, some of whom are not consenting out of court to the restructuring. Bankruptcy may be necessary because the restructuring of the balance sheet through the debt for equity swap is not the only thing that needs to be done to restructure the business enterprise. It may be that an operational restructuring in addition to the financial restructuring is in the best interest of the company. So there are a few different reasons why you may decide or have to go down a bankruptcy path, but in these transactions, if you're going to go into bankruptcy, you're going to do it really one of two ways.

(08:45):

You're going to have a prepackaged case, in which case the restructuring is going to be negotiated pre-filing, it's going to be voted on pre-filing by the fulcrum class with the idea being that any more senior classes would be left unimpaired. Any junior classes in a true prepack typically would be left unimpaired. And the only class that you are, whose rights you're altering through the prepackaged plan will be that fulcrum class of securities that's being converted from debt into equity, either entirely or partially through prepackaged plan. The alternative would be a pre-negotiated plan where the overall structure of the restructuring is being agreed upon in advance of filing, but you're actually going to go through a solicitation process post-bankruptcy. In either of those instances, you are going to have a restructuring support agreement that is agreed upon and signed up immediately prior to the filing of that bankruptcy case, and the debtor, the company is going to go into the bankruptcy with the support of that RSA to guide the restructuring process.

(09:55):

Some reasons why you may want to pursue or have to pursue a pre-negotiated plan versus a prepackaged plan may include the need for an operational restructuring, that is the need to assume or reject contracts, for example. There may be certain aspects of the business that need to be restructured through rejection of contracts that may be disadvantageous for the company. It may also be that the company has a more significant level of unsecured debt that is debt that falls below the fulcrum class that cannot be simply assumed as part of a restructuring. There may be a need to cram down the unsecured debt that is the debt that falls below the fulcrum security. That debt may be sufficiently high, that simply allowing that to pass through unimpaired as you would in a true prepackaged plan is not a viable option.

**Rachel Fitzgerald (10:57):**

Thanks, David. Recognizing that a pre-negotiated bankruptcy may involve greater time, cost, and risk than a true prepack, are there any benefits that offset those negatives?

**David Fournier (11:07):**

Yeah, the principal benefit is the operational restructuring that I mentioned. So in a pre-negotiated plan, you have the ability to look at the overall business enterprise and determine what tools and bankruptcy you're going to employ during a bankruptcy case to improve the operations of the company as opposed to simply the balance sheet of the company. Let's take a retailer, for example. If the investment is in a retailer, a restaurant chain, any entity that has sort of a large geographic base of leased operations, for example, there may be some that are profitable, some that are unprofitable. And when you're going through a restructuring, it may be beneficial to be able to excise certain portions of that geographic footprint and to close those unprofitable locations. That is something that is very difficult to do in an out-of-court restructuring because you can jettison those unprofitable leases only through negotiations with your landlord, or you're going to incur potentially very significant damage claims for breaching those leases.

(12:17):

In bankruptcy, you have a lot of flexibility to get rid of contracts and leases that are not beneficial to the business. So if you're going through a restructuring that is a loan to own or debt for equity based restructuring, and you can't do it in a true prepackaged fashion, typically you're going to want to take advantage of the opportunity to eliminate contracts and leases that are unprofitable, that aren't beneficial going forward, particularly where the unsecured class is not being paid in full. In a pre-negotiated case, you may be throwing a bone to the unsecured class simply to get that class to go along with a plan without having to fight through a contested confirmation process, but you're not going to be paying them in full. And so the ability to restructure your operations at the same time that you're structuring your balance sheet may be very beneficial.

**Rachel Fitzgerald (13:15):**

Jason, is there a typical loan to own playbook that is used by private equity funds?

**Jason Ulezalka (13:21):**

These strategies can be a bit bespoke. I don't think there's a one size fits all playbook, but there are some common themes that you'd expect to see in the process. And I guess I would break down the process into four general phases. First, sourcing and underwriting, second, building the position, third, exercising your leverage in the capital structure, and fourth, actually converting to equity and taking control. And so diving into some of those a little bit, I think first, the investor will look to identify a business where the underlying operations are viable, but it's just a capital structure issue. There's too much debt, particularly situations where the fulcrum security is attractive. This is often the senior secured or first out tranche. Once the investment target is identified, the investor will do a deep dive into the credit documents, collateral documents, any intercreditor agreements, and at this point they're looking to understand consent thresholds, transfer restrictions, enforcement rights, and really any blocks to potentially gaining control that are presented by the debt documents.

(14:38):

Once that stage is cleared, the investor will look to acquire a meaningful position in the key tranches of debt, and they need to get enough to be able to influence decisions, block amendments, and potentially lead a restructuring of the company. With the position established, the investor will then engage with management, the board, other stakeholders, and all this might happen somewhat contemporaneously, but the investor is, in a best case scenario, trying to position itself as a solution provider, not just a distressed buyer. So parties will talk about things like new money coming into the business, covenant relief, some type of structured path to a transaction. And then finally comes the execution part, which take the form of either an out-of-court exchange, a prepack or pre-negotiated bankruptcy plan, foreclosure, or UCC sale. Once ownership is obtained, it starts to look more like a traditional PE play, operational improvements, governance changes, strategic repositioning, and ultimately an exit for the investor.

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**Rachel Fitzgerald (15:49):**

What are some key pitfalls or hurdles to be aware of in working through these processes?

**Jason Ulezalka (15:54):**

Yeah, I'd say generally the overarching message is that these strategies can be powerful tools to unlock value, but they're certainly not plug and play solutions. They really require tight coordination amongst the legal, financial, and operational advisors. And from the investor's perspective, following a fairly disciplined approach to overall process and governance, diving into some specifics there to hit a few points, one specific pitfall or risk area is valuation and fairness risk. Debt for equity and loan to own transactions often hinge on what the business is actually worth. And so if you have minority creditors or existing equity holders that have a strong belief, the valuation being provided is too low, you can see litigation risk increase, holdouts, blocking positions, that type of thing. Another general risk area is fiduciary duties and conflicts. And so when existing sponsors, management, or board members are involved on both sides of the transaction, for example, as an equity holder and as a new money provider, conflicts of interest can arise.

(17:10):

These processes need to be carefully structured using special committees, independent advisors, robust marketing practices. All these are tools to help withstand that type of scrutiny. Another general risk area to touch on is lender liability and conduct risk. Overly aggressive behavior by creditors, for example, overreaching on controls, materially interfering with operations or exerting excessive day-to-day influence can give rise to lender liability lawsuits. It's important for investors to use their contractual rights appropriately and just be thoughtful about how they engage with management. Finally, just overall execution risk and timing. Any distressed process is by nature very often time sensitive and liquidity runways are finite. If there's a misalignment between stakeholders, slow negotiations or some missed milestone, that can push a company from a controlled out-of-court solution into a more chaotic in-court process.

**David Fournier (18:18):**

And in the in-court process, particularly where you're dealing with a restructuring involving a pre-negotiated versus a prepackaged plan, there are unique risks associated with the bankruptcy process. And a key issue is going to surround the fulcrum debt that the party pursuing the loan to owner strategy holds. And as I said before, really key there is ensuring that that debt is valid, properly perfected, and truly sits at the fulcrum level. As Jason said, the issue of valuation may very well be in play. All parties may not agree, in fact, typically don't agree in a Chapter 11 process as to what the value is. But as long as you hold properly perfected debt, and if there is an M&A process, an auction process run through a bankruptcy case, the party holding that debt is going to be able to credit bid that debt in most instances.

(19:19):

And one risk in a bankruptcy scenario is that there may be a challenge to the ability to credit bid, but in most cases, the party holding that data is going to be able to credit bid it. And if it is acquired that debt at a discount from the face value, it's going to be able to bid the spread in the value of that debt as well if there's an auction process. Other risks in bankruptcy, if it is a pre-negotiated case, there almost certainly will be a creditors committee appointed. And the creditors committee's job is to represent the holders of unsecured creditors who sit below that fulcrum security. And it may very well be that as part of that process, there are negotiations that have to be had to deal with that unsecured class and to provide compensation to that unsecured class to make the process go more smoothly, more efficiently, get the deal consummated when it needs to be consummated.

(20:17):

There may be certain types of assets in a bankruptcy scenario that can't be transferred over absent agreement of the other party. IP licenses in certain jurisdictions may be difficult to transfer over if you don't have the consent of the other party. There may be, in a Chapter 11 scenario, a need for additional financing to carry the company from the point of filing to a closing, that DIP financing may very well have to be provided by the party advocating for that restructuring the holder of that fulcrum security. In many cases, if the fulcrum is not the most senior level of debt, the most senior level of debt may itself be providing DIP financing, but that's going to need to be negotiated and worked out prior to filing any of those cases. If the restructuring is being done not through a bankruptcy, but through an Article 9 process, some additional issues that parties are going to need to think about, success or liability issues.

(21:18):

In a bankruptcy process, you don't have no worry of success or liability or getting a court order that's protecting the restructuring. In an Article 9 sale, the party acquiring the company through that sale needs to think about what liabilities are going unpaid, what risks there are of those unpaid creditors of the seller pursuing claims against the buyer on successor liability theories under the laws of whatever states are involved. There may also, in an Article 9 context, be an inability to transfer over certain key contracts. So really in that non-bankruptcy out-of-court Article 9 strategy in the loan down, you really need to vet the company very carefully and be certain of what it is that you're truly able to acquire through the Article 9 sale.

**Rachel Fitzgerald (22:09):**

This has been a great discussion and I am looking forward to feature installments in our series of private equity and distressed assets podcasts. The next episode in this series will cover traps for the unwary in distressed M&A transactions. Be on the lookout, it should be a great discussion. Thank you to our audience for listening today. Please keep your eyes open for future episodes of PE Pathways or you 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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