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New York Law Journal

When a Portfolio Company is Under Stress: Preparing for Liability Management and Other Capital Solutions

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August 17, 2026

As liability management exercises (LMEs) continue to evolve in both sophistication and frequency, private equity sponsors and their advisers are increasingly focused on preparing for financial stress before it becomes acute.

Taking stock of key governance, structural and creditor-related issues can help sponsors navigate how best to position a portfolio company—and the sponsor itself—for flexibility and optionality. Early missteps can significantly constrain available options or otherwise magnify risks.

As a portfolio company begins to show signs of financial stress, a valuable window in which to evaluate potential constraints and alternatives emerge. The following are several considerations for sponsors when an LME or other creative capital solutions may be on the horizon.

Laying the Groundwork Early

Among the first areas sponsors should examine is the governance and organizational framework surrounding the portfolio company. Decisions made at this stage can affect both transaction flexibility and litigation risk later in the process. A natural starting point includes assessing whether sponsor professionals are serving as directors or officers of entities within the credit group.

If they are, sponsors should consider stepping back from those roles and/or insulating themselves from conflicts by way of appointing independent directors

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4 keys to determining product liability | Products liability law has already been applied to many types of famous litigation involving automobiles, including the Ford Pinto's fuel system, Firestone tires and Takata air bags. As such, existing liability frameworks exist to assist in resolving the legal issues that will arise in connection with autonomous vehicles. Fortunately, modern products liability law is adequately developed to allocate fault for injuries and damages stemming from autonomous vehicle accidents, which will allow litigants to utilize the current law to answer the question of whether an autonomous vehicle is at fault for a collision. Moving forward, the legal framework for autonomous vehicle accident liability will be segmented into strict product liability, breach of warranty liability, misrepresentation liability and negligence liability.

and granting such directors some or all decision making authority.

LMEs can involve intra-creditor conflict, selective participation, and value transfers within the group. Sponsor representatives wearing fiduciary hats at the operating company level can create unnecessary exposure to claims for the sponsor and its employees and transaction execution risks—particularly where non-participating creditors later challenge the transaction.

Thoughtful planning around management or governance roles in entities where creditors may have claims helps preserve deal flexibility and mitigate litigation risk. Beyond governance, sponsors should also take stock of key structural and administrative considerations that can influence both transaction execution and stakeholder outcomes.

Sponsors should promptly determine whether the portfolio company sits in a flow-through structure (e.g., partnerships or LLCs taxed as partnerships). If so, cancellation of debt income (CODI) can flow directly to equity holders in a recapitalization—both losing an asset and then getting hit with a tax bill can be a tough pill to swallow.

Early identification of this risk allows sponsors and advisers to explore mitigation strategies—such as timing considerations, structural and terms adjustments, or alternative transaction paths—before CODI becomes unavoidable or mitigation strategies are less effective or available.

Sponsors should also ensure that advisory relationships are structured appropriately from the outset. Outside counsel engagement letters – particularly for restructuring counsel – should be carefully structured to ensure they are entered into by the appropriate entities within the credit group. This is not merely a formality.

Proper engagement alignment helps preserve privilege, reduces challenges from creditors, reduces execution risks and ensures that professional fees are treated appropriately under the relevant credit documents. Getting this right at the outset avoids distractions and disputes later in the process while ensuring the portfolio company has appropriate legal guidance.

These early planning considerations should also extend to the company's governing framework.

Sponsors and counsel should review formation and governing documents to assess the scope of any fiduciary duty waivers. In stressed situations, fiduciary claims often become a primary litigation tool for excluded or disadvantaged creditors and other stakeholders. Even if there are fiduciary duty waivers, sponsors should ensure that the Company undertakes good corporate governance measures.

Where appropriate, sponsors may consider whether converting corporate entities to LLCs (with a "check-the-box" tax election) could reduce fiduciary duty exposure by enabling broader contractual waivers. While such conversions must be carefully analyzed for tax, regulatory, and contractual implications, they can meaningfully reduce litigation risk in the right circumstances.

Understanding the Playing Field

Sponsors should conduct a detailed review of the credit documents to understand what liability management tools are available taking into account the latest technology and creativity of the LME world. A thorough understanding of the documents can help identify available tools, potential constraints and considerations that may shape any future transaction.

In some cases, the documents may be highly restrictive, leaving limited room to maneuver. Identifying those constraints early allows sponsors to recalibrate expectations, assess refinancing alternatives, or engage constructively with creditors before leverage shifts. A full scrub of the documents allows for more thoughtful planning at the outset as you start your 3-D chess with creditors.

Understanding the creditor base is equally important. A grasp of holdings and concentration levels of creditors, as well as the price they bought into the credit, can be helpful in identifying pressure points and formulating groups with whom the portfolio company can work.

In many situations, the identity and incentives of creditors may prove just as important as the literal wording of the governing documents and striking the right tone and strategy at the outset is of premier importance. Similarly, sponsors should also assess intercreditor arrangements, collateral waterfalls and guarantee structures early in the process.

A clear, early understanding of where value sits within the enterprise – and which creditors have enforceable claims to it—can mitigate execution risk and reduce the likelihood of post-transaction disputes while incentivizing company-friendly behavior with "sticks" and "carrots".

Evaluating Litigation Risk, Not Just Documentation Risk

Selective liability management transactions invite scrutiny. Sponsors should work with counsel to assess what disclosures may be required to lenders, investors, and other stakeholders, and to structure communications in a way that preserves flexibility without creating waiver, estoppel, or implied covenant arguments.

Importantly, the roll out of communication will be heavily scripted alongside of NDA's which encourage the kind of collaboration that will help the process while reducing the risk of leak and managing group dynamics.

This planning also plays an important role in mitigating litigation risk. Even transactions that are technically permitted under the credit documents may trigger threats of litigation.

Sponsors should evaluate not only whether an LME can be executed, but whether it can be defended—based on the transaction process, disclosures, valuation support, and overall fairness—if challenged by excluded creditors.

Although many LME structures have been tested, a significant number of disputes are resolved through settlement, leaving important areas of the law less developed than sponsors might expect. As such, integrating litigators to assess and mitigate litigation risk is crucial to striking the right balance of objectives.

Keeping the Broader Investor Picture in View

Finally, sponsors should also consider the implications of any proposed transaction beyond the portfolio company itself, including alignment across sponsor-controlled vehicles, co-investors and continuation funds. LMEs can produce divergent outcomes across the capital structure, and sponsors should ensure that fiduciary and disclosure obligations at the fund level are carefully considered alongside portfolio company objectives.

Ultimately, when signs of financial stress begin to loom, early and thoughtful planning around a portfolio company's capital structure is critical to preserving flexibility and expanding the range of options available to sponsors.

By addressing key governance, structural, creditor and process-related considerations in advance, sponsors can better position themselves for a more seamless, coordinated and well-executed process should an LME or other capital solution become necessary.

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