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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

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Editor-in-Chief, Editor & Board of Editors

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Sponsor Capital Infusions in Distressed Portfolio Companies: Key Considerations for Lenders

By Evan Palenschat, James A. Snyder, Kelly A. Lazaroff, Allison J. Satyr and James E. Croke*

In this article, the authors outline potential structures for private equity sponsor capital infusions and highlight key considerations for lenders evaluating these transactions.

In today's uncertain economic climate, tight liquidity is a growing concern for many businesses. Private equity sponsors face difficult decisions when their portfolio companies are underperforming. One such decision is often whether to inject additional capital into a struggling company and, if so, how to structure that infusion to protect and maximize their interests.

Typically, lenders view sponsor capital support as a positive development, but it can introduce complexity; how the investment is structured can significantly affect existing lenders' rights and recoveries, especially in a future restructuring or insolvency scenario. This article outlines the potential structures for sponsor capital infusions and highlights key considerations for lenders evaluating these transactions.

TO INJECT CAPITAL OR NOT TO INJECT CAPITAL, THAT IS THE QUESTION

When a portfolio company faces a liquidity crisis, the sponsor's decision of whether to support the company often depends on whether there is a credible path to a turnaround that will ultimately benefit the equity investors. If the sponsor believes the company can stabilize and that such stabilization will result in incremental value to the equity investors, then it may agree to inject new capital or promise future support.

From the lenders' perspective, the critical questions are these:

- How will the sponsor's new capital investment be structured?
- Will such investment meaningfully improve the company's financial position without threatening the lenders' recovery or undermining the lenders' rights and remedies?

* The authors, attorneys with Sidley Austin LLP, may be contacted at epalenschat@sidley.com, james.snyder@sidley.com, klazaroff@sidley.com, asatyr@sidley.com and james.croke@sidley.com, respectively.

STRUCTURING SPONSOR CAPITAL INFUSIONS

There are several common structures used in the market for sponsor capital infusions in times of distress, each with different considerations for a company's existing lenders.

1. Equity Injections

The most straightforward approach is a direct equity investment into the subject company. Sponsors could structure new investments as common equity or preferred stock to preserve flexibility and alignment with the company's existing capital structure. In some instances, a sponsor may choose to generate the proceeds for an equity contribution through a structurally subordinated sponsor loan to a super holdco that sits above the loan parties, thereby giving the sponsor priority over other equity holders at the top of the structure.

- *Use of Proceeds*: While lenders may want all or a portion of the equity infusion to be used to pay down existing senior debt rather than simply fund working capital, a paydown reduces much needed liquidity. As such, in a liquidity crisis there may be other uses necessary to keep the company afloat, such as payroll or other ordinary course expenses.
- *Equity Cure Treatment*: To the extent the sponsor is not injecting equity via any pre-agreed "equity cure" provisions in the loan documentation, then lenders should consider whether the equity proceeds qualify as an "equity cure" under the loan documents, which may allow the borrower to retroactively satisfy financial covenants by increasing earnings before interest, taxes, depreciation, and amortization in the amount of the equity investment.
- *Covenant Capacity*: Lenders should consider whether the equity infusion should be permitted to build capacity under negative covenants whether by increasing the "available amount" or "contribution debt", among others, since this could give the company greater flexibility at a time when lenders might prefer tighter controls. Lenders' counsel should be careful when drafting to avoid this result.

2. Loan Participations

Lenders may also allow that the capital infusion be structured as a sponsor (or a sponsor-affiliated entity) purchase of a "last out" participation in the company's existing senior credit facility.

- *Advantages*: The advantages of this structure include that (1) the existing lenders retain administrative control over the loan and company relationship, and (2) the sponsor gains only an economic interest, without direct voting rights. Preserving lender control ensures that future restructuring decisions remain in the hands of creditors rather than equity owners whose incentives may diverge from those of the lenders.

- *Considerations*: With this structure, lenders should carefully review participation agreements to ensure that the sponsor (or its affiliated entity) does not acquire any material voting or information rights that could limit the lenders' ability to restructure the loan or exercise remedies.

3. Direct Sponsor Loans

Another structure sometimes used in the market is the sponsor extending a direct loan to the portfolio company, typically on a subordinated basis.

- *Considerations*: Direct sponsor loans can complicate a restructuring even when such loans are subordinated, as the sponsor lenders may be able to assert competing interests in bankruptcy proceedings. Lenders and their counsel should pay close attention to information rights, reimbursement obligations, indemnities, and the designation of administrative agents to ensure that sponsor-related lenders do not gain leverage over the senior lender group.
- *Intercreditor Agreements*: Poorly negotiated intercreditor terms may result in restructuring hurdles or other unintended issues. As such, lenders' counsel should draft the intercreditor arrangements to include clear subordination of the sponsor obligations and clear restrictions over sponsor enforcements rights, sponsor challenges of bankruptcy plans, or sponsor claims in a restructuring scenario.
- *Pari Passu Sponsor Debt*: Further, loan documentation will frequently permit the sponsor affiliate to make direct loans that are secured on a pari passu basis with the existing secured facility. Where permitted, loan documentation (if properly drafted) should cap this potential exposure (typically 25% to 30% of aggregate facility size and no more than 49% of the lender group) and limit the sponsor affiliate's information and voting rights. While these protections are typical as it relates to sponsor loans under the existing secured facility, much of the sponsor-backed loan documentation in the middle and upper markets permit pari passu "sidecar" debt that typically will not be subject to these limitations. Any such structure should also be carefully considered, including with respect to minimizing unfavorable "insider risk" for the lenders in a bankruptcy.

FUTURE SUPPORT COMMITMENTS

In situations where liquidity is more stable and immediate cash proceeds are unnecessary, a lender and sponsor may negotiate future support arrangements such as sponsor guarantees, capital call agreements, equity commitment letters, and/or letter of credit (LC) arrangements.

1. Guarantees, Capital Calls, and Equity Commitment Letters

These arrangements will require the sponsor to inject capital into the company in the future upon the occurrence of some specified trigger event or events (e.g., breach of a leverage ratio, liquidity thresholds, or a date certain).

- *Enforceability Risk*: Such promises may be unenforceable if the company files for bankruptcy before the obligation becomes due. Under U.S. bankruptcy law, a future funding obligation in the company's bankruptcy may not be easily enforceable against the sponsor, reducing its practical value. As a consequence, lenders should resist structuring these arrangements in the form of capital call agreements or equity commitments in favor of the company and instead create a direct obligation of the sponsor to the lender, whether in the form of a guarantee or an obligation to purchase a last-out participation in the lender's senior loan position. At a minimum, any such agreement should provide that an injection by the sponsor during the pendency of an insolvency proceeding will take the form of payment to the agent for distribution to the lenders rather than investment into the company.
- *Sponsor Credit Risk*: Even outside of bankruptcy, lenders bear the risk that the sponsor may not fulfill its promise, due to either insolvency or strategic decision-making. In some cases, this risk may be mitigated by contractual covenants of the sponsor to maintain available callable capital in its fund that can be used to satisfy the obligation.

2. LC Alternatives

A more lender-friendly form of future support involves the sponsor arranging for a third-party bank to issue an LC, often secured by the sponsor's capital commitments under a subscription facility.

- *Independent Bank Obligation*: The issuing bank must honor the draw conditions regardless of the company's financial condition so there is no company credit risk.
- *Elimination of Sponsor Credit Risk*: The lender has a direct right to payment from a highly rated financial institution and therefore need not rely on the sponsor's solvency or willingness to perform its contractual obligations.

- *Simplified Enforcement*: Drawing on an LC avoids the complexities of enforcing a capital call or filing a claim against the sponsor.

CONCLUSION

While lenders may welcome a private equity sponsor stepping up to provide additional capital to a distressed company, the devil is in the details.

Equity infusions, properly deployed, can deleverage the borrower, offer needed liquidity, and preserve lender flexibility. Loan participations offer sponsors a path to support companies without disrupting lender control. Direct sponsor loans and future capital commitments must be negotiated carefully, with thoughtful attention to bankruptcy risks, enforcement rights, and intercreditor dynamics. Letters of credit, when available, offer the strongest security for lenders.

Ultimately, lenders should approach sponsor capital infusions not simply as good news – but as transactions requiring close analysis, active negotiation, and strategic foresight.