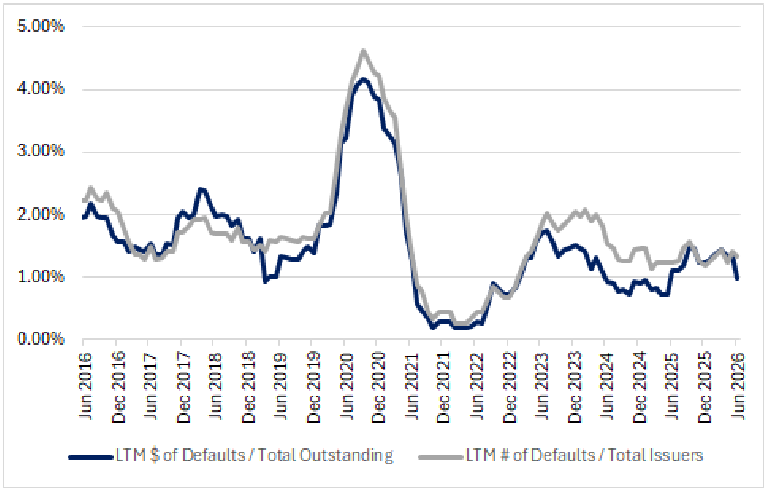
Are LMEs Being Put to Bed?

Defaults by Dollars and Count[1]



Credit fundamentals are a continuing topic of discussion in the CLO and wider credit space. With credit, the focus always anchors on mitigating downside and how that interacts with the wider market environment. Traditional metrics of credit health have been very benign for some time now. Trailing twelve month defaults are running below 1% most recently, below historical averages. For context, for the several years preceding the pandemic, the average loan default rate was just below 2%.[1]

Furthermore, the trailing twelve month defaults and distressed exchanges combined by count reached a three year low by the end of June 2026. Further good news can be found in leverage and cashflow metrics among leveraged borrowers. Loan borrowers have seen 22 consecutive quarters of EBITDA growth with the first quarter of this year topping 8.9%, the largest reading since Q3 of 2022. Senior leverage trends are also favorable moving from 4.8x in July of 2025 to 4.3x in June of 2026.[2] Overall, credit conditions remain strong, but the same cannot always be said for Private Equity Funds' behavior.

One of the capital markets tools developed recently by Private Equity ("PE") Sponsors for troubled portfolio companies is known as an "LME". Liability management exercises ("LMEs") are out-of-court loan restructurings that have become more prevalent in the CLO market compared to traditional bankruptcies. As a reminder, LMEs are transactions where loan borrowers (at the direction of their PE owners) restructure their existing loans by negotiating—often coercively—with a majority of the lender group (instead of filing for bankruptcy and going through in-court proceedings). A CLO manager's size, scale, and active loan market participation can often be meaningful in securing a voice among lender cooperation groups ("Co-Ops"). Unlike in a normal bankruptcy where all lenders of the same instrument would receive the same treatment and recovery value, LME recoveries can differ depending on whether a lender is able to participate in these majority groups or Co-Ops. These restructurings can become coercive as the first majority group to vote in favor of the restructuring, which often includes concessions to lower the total amount of debt, receives the best "deal" features (collateral package, priority of repayment, economics, etc.). These types of coercive restructurings can often be referred to as "lender on lender violence".

[1] Pitchbook LCD, as of June 30, 2026.
[2] Pitchbook LCD, as of June 30, 2026.

Collectively the lender group fights among itself for betterment within the capital structure, and the only real beneficiary is the PE sponsor who obtains a lower debt balance, extraction of a "crown jewel" asset, and/or more flexibility to attempt a turnaround of the portfolio company.

When a company begins to underperform or show signs of stress, the likelihood of a PE sponsor using an LME increases as a tool to lower the company's debt burden and improve operating liquidity. CLO managers (lenders) can proactively pre-empt the potential risk of LMEs by collectively organizing, which can often be more than a simple majority of lenders (a Co-Op). This can help improve outcomes not only for large CLO managers, but also for smaller platforms. However, in instances where a minority group of lenders are left out of the Co-Op or majority group, those lenders often receive much lower recoveries as a result. LMEs have been a way for PE sponsors to approach a majority of the lenders to rework the existing capital structure—avoiding a bankruptcy—and achieve potentially better outcomes for the PE sponsor and participating lenders at the expense of some lenders who are left out.

LMEs as a % of Defaults[3]

Lenders in the Co-Op groups (or any large, first mover lender including larger CLO managers who may represent a lot of voting power among the lenders) have benefited from LMEs through better outcomes like exchanging existing debt for more senior debt (often priced higher in the marketplace) and tighter (more restrictive) loan documentation. The market has witnessed a meaningful uptick in LMEs and distressed exchanges when compared to defaults. From 2020 through June 2026, the traditional loan default rate by count has been 1.68% on average. This loan default rate increases to 3.21% by count when including LMEs over that same time period.[3] For every 1 default there has been roughly 1 LME over that time period. This has become a new challenge for the CLO market. When the possibility of an LME becomes more likely, loans will often decline in price as sellers look to exit, and buyers of that loan become more limited, which can compound the early signs of loan stress. However, more recently, a new court decision may prove to be a positive development for the loan market and CLO managers.

A New "Burning Bed?"

Readers of a certain vintage may remember the term "burning bed" as a famous $457 million bridge loan made by First Boston Corp. in 1989 for the leveraged buyout (LBO) of the Ohio Mattress Co. (which later became Sealy Corporation). Merchant banking firm Gibbons Green

[3] Pitchbook LCD, as of June 30, 2026.

Van Amerongen took Ohio Mattress private in an April 1989 LBO. First Boston provided a massive bridge loan expecting to refinance it quickly through high-yield junk bonds. The junk bond market suddenly froze and collapsed, leaving First Boston stuck holding hundreds of millions in un-refinanced debt. The near-disastrous financial entanglement contributed to a sharp slowdown in the 1980s LBO boom, forced First Boston into a close rescue embrace with Credit Suisse, and etched the term "burning bed" into Wall Street lore.[4]

Roll forward to today and mattress LBOs continue to make news. In 2020, Serta Simmons went through an LME with a minority of the lender group getting primed (having incremental debt placed above them in the capital structure) by the majority who were part of the Co-Op group. The minority lender group fought back when the company filed for Chapter 11 bankruptcy in 2023 challenging the legality of the 2020 LME transaction. The case dragged on for over 3 years, but on July 7th of this year, a Houston Bankruptcy Court Judge awarded the excluded lenders $400 million in a settlement that included $261 million in damages and $142 million in interest. Furthermore, the judge ruled that the majority lender group who participated in the LME transaction were liable for the damages—not simply the borrower. Each lender in the Co-Op group would be held accountable for their pro-rata share of the award. The majority group of lenders unsuccessfully argued that the LME was legal and constituted an open market purchase, which was ultimately rejected (the judge ruled the exchange was privately negotiated and not conducted on the secondary market).[5,6]

Setting a Precedent and Future Implications

This ruling may slow the pace of these coercive restructurings by PE sponsors. While circumstances may differ across LME transactions, this ruling sets a precedent that could incentivize PE sponsors to coordinate their actions to benefit all lenders (or at least reduce the coercive nature of these restructurings). This could limit the number of future coercive LMEs in the loan market as PE sponsors and lenders consider the additional litigation risks. Although still too early to tell, this appears to be a positive for the loan market. We've already seen anecdotally that PE firms that are repeat users/abusers of coercive LMEs develop a negative reputation in the loan market, and this may impact the cost of debt funding for their next buyout loan. Moreover, certain CLO managers may quietly blacklist or underweight portfolio companies managed by highly aggressive PE sponsors. If major players refuse to anchor a debt syndication, the PE sponsor may be forced to turn to alternative, more expensive private credit providers or accept harsher terms from the remaining syndication market. If this recent Serta Simmons court ruling shifts the market towards more cooperative LME outcomes for all lenders, there may be more buyer support for loans with early signs of stress (and therefore support higher loan prices as the risk of bifurcated recovery outcomes lessens). A reduction in coercive restructurings should improve recoveries across the board and encourage cooperative solutions among lenders and PE sponsors.

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[4] Reuters, as of February 24, 2015. "Fresh flames rise from Sealy's ever-burning bed."

[5] Pitchbook LCD, as of July 9, 2026. "Excluded Serta Simmons lender group awarded $400M in damages and interest"

[6] NY Post, as of March 4, 2004. "KKR GOES TO THE MATTRESS FOR SEALY"