

When Sponsors Subordinate: The New Rules of Liability Management Exercises

Introduction

"You show me a hero, and I'll write you a tragedy." - The Big Short (2015)

In a previously discussed article titled "When Creditors Collide: The Tug of War for Distressed Assets," we examined the history, mechanics, and initial wave of creditor-on-creditor violence. LMEs (liability management exercises), driven by ultra-low interest rates and quantitative easing (QE), emerged in the mid-2010s as an effective tool in the debt restructuring arsenal for distressed firms. LMEs are employed to restructure existing debt (typically due to upcoming maturities) and require creditors to purchase new debt instruments to retain a similar position in the capital structure. This has an obvious advantage for the distressed firm as it receives necessary cash infusions. The creditor(s) who provide the debt also benefit due to the gain of seniority over the claims of other creditors (who did not participate in the process either by choice or unknowingly). While beneficial, this is a shotgun marriage that stems from necessity rather than actual investment rationale. Financiers want to maintain control and security over the past loans, thus coercing them to provide new loans. The victims of this predatory process are the lenders who were not included in the LME process who, through no fault of their own, drop down in the repayment hierarchy, often losing access to previously accessible collateral (see [here](#) for further context).

Following the 2008 financial crisis, central banks (CBs) implemented expansionary monetary policies to prevent a total economic collapse. Following the failures of the Bank of Japan in the 90s, most CBs lowered rates and enacted QE to unprecedented levels. This ease of access to capital created an issue in the credit markets. Firms had access to a vast supply of cheap debt, thereby increasing competition among creditors. This competition led creditors to loosen covenants (credit agreements). Simultaneously, this enormous supply of cheap debt led to highly leveraged firms with dubious cash flows, which were reliant on capital growth for their continuation. This perfect storm allowed these overleveraged firms in need of capital (which lets firms focus on growth rather than profitability) to conduct LMEs and secure debt. The second wave of LMEs emerged from different structural reasons. In 2022, rates began to rise in response to inflation, leading to increased demand for profitability. Sponsors and investors abruptly viewed cash flows as more valuable than capital growth. Leveraged firms were facing maturity walls without the soft cushion of low rates. LMEs shifted from focusing on buying time for growth to prioritizing survival. Clarified by judicial rulings, such as the protection of an "uptier" LME, as seen in Serta Simmons Bedding (later reversed on December 31, 2024), private credit (PC) funds, and equity sponsors have established playbooks in this niche of restructuring. PC funds can "prime" (when a creditor has debt placed above it on the capital structure) other lenders and improve their position. Sponsors, mainly private equity (PE) firms, can preserve their investment through this preferential treatment of a single financier. One unique aspect of this new wave of LMEs is its widespread use. Initially, this restructuring technique was primarily applied to a few industries, such as healthcare and retail. This new wave has now spread to the whole market as PE firms have learnt its benefits. Specifically, tech and SaaS have become a new battleground for this controversial strategy.

The Case of Quest Software

Quest Software (listed as [NASDAQ: QSFT] pre-2012 buyout) emerged in 1987 in California with a simple thesis: provide high-level software products to complex IT systems. Throughout the 1990s, it focused on database performance, monitoring, and management, and went public in 1999. The IPO led to vast expansion through M&A and a change in the philosophy of the product offering to become an end-to-end suite for IT firms. This change led to an acquisition by Dell in 2012, which integrated Quest's offerings to create an enterprise stack (hardware, software, and additional services). In 2016, Quest was sold to Francisco Partners & Elliott Management,

who later sold the firm to Clearlake Capital in 2021 for \$5.4bn. Clearlake's motives were clear: establish Quest as a **leader in data management, security, and IT modernization** while expanding into SaaS.

In a 50-bps environment, PE firms can easily increase leverage; in a 450-bps climate, it becomes nearly impossible. When Clearlake acquired Quest, the firm had \$2.1bn in debt. COVID-fueled low rates enabled it to leverage up to 15x EBITDA, exceeding \$3.5bn. However, as rates increased, it hindered Quest's ability to invest in the AI boom. Adding fuel to the fire, revenue had declined YoY for the last three years after the acquisition. As a result, Quest underwent an LME in March 2025, which included refinancing first-lien and second-lien loans due in February 2029 with a new debt issuance totaling \$350mn, also maturing in February 2029. Participating lenders bought into this at 92 cents on the dollar (\$1 of old debt equals 92 cents of new, higher-tier debt). Non-participating lenders either became fifth (last) in the capital structure or opted in at 77 cents for junior debt. Before the LME, the debt structure was simple, with a revolver, first-tier, and second-tier loans (in order of priority). It is essential to note that Clearlake held both equity and debt in Quest, initially subordinating its debt to that of all other debt holders. Afterwards, the capital structure grew more complex, including a revolver, new debt issuance/exchanged debt for participating lenders, non-participating opted-in debt, Clearlake debt, and finally holdouts (non-participating lenders who did not opt in), arranged in order of priority. This restructuring enabled Quest to deleverage its balance sheet to 11x EBITDA, improve liquidity, and fund AI investments. In August 2025, to clarify and reconcile the capital stack, Quest underwent a second LME. This LME allowed non-participating lenders who opted out to move, at a discount, their repayment priority above Clearlake's debt, which is now fully subordinated. This peculiar mix of LMEs has resulted in a complex capital stack and unusual sponsor concessions from Clearlake. If these events persist and creditor-on-creditor violence continues, the cost of capital may increase, especially in the asset-light SaaS industry.

What Makes Quest Different

Quest Software's approach to restructuring in 2025 diverged sharply from typical liability management exercises. Instead of a one-off fix, Quest executed two back-to-back LMEs within three months. The May transaction was initially presented as a comprehensive refinancing, the company raised \$350m in new term loans from existing lenders and extended the maturities of its debt. This deal was implemented with the support of a majority of first-lien and second-lien holders, capturing roughly \$200m of discount from the debt's traded price in an exchange offer. Crucially, it left Quest's capital structure distributed across an unusually broad five-tier tranche hierarchy - commonly termed first-out through fifth-out loans. At the time, this was seen as a one-time solution to Quest's overleveraging, but by August, it became clear that one round of liability management was not enough. The second time, Quest effectively adopted an iterative strategy: the new exchange invited the remaining fifth-out lenders (those last in line after the May deal) to swap their positions into a higher-ranking '3.5-out' term loan, albeit at a steep discount (approximately 85 cents on the dollar). In essence, what began as a single-shot refinancing evolved into a two-step restructuring, with the August transaction layering an additional tranche on top of the May structure.

This iterative LME clearly shows the depth of Quest's financial stress and the evolving toolkit for distressed sponsors. An initial uptier or drop-down may only buy time, with further exchanges needed if performance doesn't rebound. Indeed, despite the May infusion, Quest's leverage remained around 11x EBITDA - prompting S&P to warn in mid-2025 that the capital structure could be unsustainable without a turnaround. The near-immediate follow-up exchange in August effectively acknowledged this risk. We have seen a similar multi-step approach before: Envision Healthcare (a KKR [NYSE: KKR] backed company) executed two major out-of-court restructurings within 3 months as well, layering a \$300m first-out loan and new priming tranches on top of a prior drop-down transaction. Envision's multi-step restructuring preceded Quest's strategy, though the company ultimately filed Chapter 11 in 2023 to address \$7.4bn of debt. By contrast, Quest's iterative exchanges (so far) have kept it out of court and allowed the sponsor to pursue other options (exploring asset sales or mergers, such as a possible combination of Quest with Clearlake's RSA Security unit). This shift from one-off LMEs to iterative "layered" restructurings suggests a new chapter for creditor-on-creditor dynamics. Sponsors and majority lender

groups are becoming more cooperative, and they may continually refine the capital structure in real time, rather than relying on a single transformative transaction.

Clearlake's Sponsor Subordination: Desperation or Strategic Control?

A highly unusual aspect of Quest's LMEs is Clearlake Capital's willingness to subordinate its own debt position as the equity sponsor. In the May 2025 deal, Clearlake rolled its first-lien loan holdings into a new "fourth-out" tranche at par. This meant the sponsor voluntarily moved behind the new money and higher-ranking debt held by other lenders. While Clearlake's fourth-out piece did receive a preferential interest rate, the act of relegating itself below other first-lien creditors is a rare concession. Then, in the August follow-up, Clearlake's tranche was pushed further down - the new 3.5-out loan was inserted above the sponsor's claim, expressly subordinating Clearlake's position to facilitate the exchange. In both instances, the sponsor sacrificed priority to enable the LME, a striking contrast to the more common scenario of sponsors fighting to extract value or securing their equity at creditors' expense.

Clearlake's behavior can be interpreted in two ways. On one hand, it may signal some sponsor desperation to avoid bankruptcy or loss of the company. By subordinating its debt, Clearlake essentially bet that keeping Quest afloat with fresh capital and lender buy-in would preserve some value for its equity stake in the long run. In distressed situations, equity sponsors typically recover nothing unless the business survives; Clearlake's moves suggest it was willing to defer its own claims and "sweeten the pot" for other lenders to ensure Quest's survival. This level of sponsor pain-sharing is uncommon and could indicate that Clearlake felt cornered.

On the other hand, the subordination could be viewed as a strategic play for control. By having some of its own debt in the restructuring and aligning itself with the creditor group, Clearlake helped drive the LME process and likely secured governance concessions or extensions of financing that protect its equity interest. Notably, the May transaction involved moving Quest's valuable One Identity software business into a structurally senior entity - facilitating potential asset sales or new financing. Clearlake's cooperation and loss of priority in that move earned the support of 100% of first- and second-lien lenders and came with creditor-agreed protections around how that business could be transacted. In essence, Clearlake traded a near-term economic position for a longer runway and continued control over the restructuring narrative.

Whether driven by necessity or calculated risk, Clearlake's bet is being closely watched. If Quest's performance improves sufficiently to avoid insolvency, the sponsor's subordinated debt could still be repaid, and its equity could retain upside. If the company ultimately fails, however, Clearlake has effectively placed other creditors ahead of itself in line, potentially forfeiting recoveries. Nevertheless, Clearlake has expanded the LME playbook: it has shown a willingness to be both sponsor and lender in order to get a deal done. It remains to be seen whether this will become a trend in other distress scenarios, or if it's a hallmark of just how pressured the Quest situation is.

LMEs Enter the SaaS Sector: Asset-Light Recovery Dynamics

Quest Software's case is also particularly noteworthy because it brings the LME phenomenon into the enterprise software/SaaS sector. Historically, the most famous creditor-on-creditor maneuvers clustered in industries with tangible assets or traditional cash flows: brick-and-mortar retail (e.g. J.Crew, Neiman Marcus), manufacturing and consumer goods (Serta Simmons bedding), or healthcare services (Envision Healthcare). These sectors had leveraged buyouts and faced downturns where sponsors resorted to transferring collateral (as in J.Crew's intellectual property drop-down) or issuing new priming debt (as in Serta's uptier) to raise liquidity. By contrast, pure software companies are asset-light - they lack substantial hard assets to serve as collateral.

The nature of a software business changes the dynamics of creditor recoveries. Quest's value lies largely in its intangible assets - software products, customer relationships, and recurring subscription revenues - rather than plant, property, or equipment. In case of distress, such asset-light companies can see enterprise value evaporate quickly if they cannot continue operations. There is little physical collateral to sell off for repayment; instead, creditors' best hope of maximizing recovery is often to keep the business as a going concern (maintaining customer

contracts and product support). This reliance on forward cash flows and platform value means that creditors might be even more incentivized to support out-of-court fixes. Filing for bankruptcy could be especially destructive for a SaaS company: customers might flee due to uncertainty, and software maintenance or R&D could be disrupted. Therefore, Quest's lenders had a strong collective interest in avoiding a drawn-out insolvency process and instead opted for the complex exchange transactions to stabilize liquidity. The new capital infusions and extended maturities gave Quest time to execute its pivot to a cloud subscription model and capitalize on growth areas like cybersecurity and AI (as highlighted by management's optimistic commentary). In essence, the LME strategy in SaaS is about buying time for growth, whereas in retail or industrial cases it was often about monetizing specific assets or brands.

However, asset-light restructurings also mean that non-participating creditors face stark outcomes. If a holdout lender is left in a junior or unsecured position after an LME, the lack of hard collateral could mean their recovery in a worst-case liquidation is minimal. This dynamic, with essentially all value tied to future performance, raises the stakes for creditors considering an exchange. It might explain why Quest achieved very high participation. In contrast, in asset-rich sectors a holdout creditor might calculate that even as a subordinated lender they could recover something from liquidation (e.g. inventory, real estate, or hard assets securing their debt).

Quest's restructuring may be a bellwether for other highly leveraged software companies. The late 2010s and early 2020s saw many software and tech firms taken private by PE funds at high multiples, often financed with significant debt on the expectation of high growth. As economic conditions changed, some of these firms are encountering stress on their cash flows. The fact that Quest had to resort to two uptier exchanges in 2025 indicates that sponsor-backed SaaS companies are not exempt from distress cycles. Going forward, we may see more sponsors in the tech space using LME tactics (debt exchanges, new money from select lenders, collateral reorganization) to extend runways. Notably, Rackspace Technology, another software/cloud services company, undertook a complex out-of-court deal in 2023 involving a new \$275m first-out loan and transfer of assets to a new subsidiary, creating priming liens for participating lenders. That deal was described as the first of its kind for moving essentially all company value to a new "structurally senior" entity to facilitate financing - a strategy mirrored by Quest's carve-out of One Identity. These examples suggest a trend: tech companies with mostly intangible assets will get creative with corporate structure to raise secured debt, and they will lean on tiered financing (first-out, second-out, etc.) to entice new funding while pushing existing debt maturities out.

Broader Implications and Conclusion

As already highlighted, Quest's LMEs are part of an increasingly popular niche, where new situations and ideas become case studies and points of reference for future debt exchange or uptier transactions procedures. For example, Serta's (2020) uptier serves as a case where non-participating lenders immediately sued over the use of the "open market" provision, which allowed initially subordinated creditors to effectively swap their old loans with newly issued, higher-ranking debt instruments and left non-participating lenders at the bottom of the stack after what the company defined as an "open market" transaction. Neiman Marcus and J.Crew (2017) pioneered the collateral-transfer playbook. The first moved its luxury e-commerce subsidiary MyTheresa out of the restricted group of the credit agreement and into an unrestricted subsidiary outside of the existing creditors' collateral package, while J.Crew transferred the brand itself into an unrestricted entity. In both cases, the move preserved value for the sponsor and potential new financing at the unrestricted level, while weakening recovery prospects for existing lenders. These cases, together with Envision's LME with its iterative process, all introduce a new element into these out-of-court restructuring proceedings and lay the foundation for creditors and sponsors to treat these tactics as available tools in future instances.

As for Quest's LME, it represents a rare case of sponsor subordination. Clearlake's willingness to accept junior status for its own debt while still controlling the equity is the first clear precedent of this behavior in sponsor-led restructurings. By pushing its first-lien claims beneath participating lenders first and the new tranche after, Clearlake

successfully made the deal more attractive for its creditors, securing high participation. But while the rationale is clear, the consequences of setting this precedent are unclear and potentially disadvantageous for sponsors involved in future exchanges. Indeed, the risk is now that creditors might expect similar concessions in future exchanges, potentially reshaping negotiations. Sponsors who resist subordinating could face a higher chance of litigation as creditor groups might become less willing to cooperate. Additionally, sponsors could decide to use subordination as leverage to demand better deal terms, such as stronger governance rights, protective covenants, and overall more elements of control.

Sponsor subordination might affect software and other asset-light sectors beyond the actual LMEs. If creditor-on-creditor violence becomes common for firms like Quest, investors might begin to price the risk upfront. As previously mentioned, LMEs are a more accepted tool for more asset-heavy sectors since the chance that junior creditors are left with no recovery is lower with tangible collateral. The uncertainty created by the availability of debt exchanges for software companies could reflect on spreads and terms for sponsor-backed SaaS firms. Creditors might demand stronger covenants around asset transfers, limits on layering, or even higher upfront yields to compensate for the possibility of being pushed down in a future exchange. From the perspective of the equity owners, this translates into a structurally higher cost of capital and a potentially lower future availability of leverage.

Quest Software's LME signals a potentially new phase for out-of-court restructurings. Transactions have become layered and iterative, and Clearlake's decision to subordinate its own tranche is a concession that might reshape future procedures. Whether Quest proves to be an exception or the new blueprint will determine how the next phase of LMEs will unfold.

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