Expert Views
Bankruptcy Industry Update
Liability Management

Taking Both Roads to Recovery: History & Future of Double Dip Transactions

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*Editor's Note: The latest in Reorg's Expert Views series, an article written by Suzzanne Uhland, Senet Bischoff, Alfred Xue and Hugh Murtagh of Latham & Watkins, is below. Reorg's coverage of Double Dips is **HERE**.*

I. Introduction

The so-called "double dip" is a hot topic in the distressed investing community. Proponents of this structure describe it as a "new technology" that provides borrowers with cheaper credit by offering maximal credit support.

The double dip structure may be many things, but it is not new. Unbeknownst to many architects of current transactions, a variation of this credit structure is used in volumes of transactions, including a vast majority of European high-yield bonds. And while there is some conjecture regarding its enforceability and benefits, informed analysis of this structure is possible based on a review of decades-old Supreme Court jurisprudence. Understanding that background is key to understanding the double dip.

II. What Is a Double Dip?

Like many of the terms of art prevalent in the distressed investing community, "double dip" is used to describe different transactions.

A **"true" double dip** (*i.e.*, an "At Home" or "Wheel Pros") allows lenders to provide a secured loan to a borrower, the proceeds of which are then loaned to an affiliate of the borrower via an intercompany loan. The initial secured loan is then both (a) guaranteed by other entities in the corporate family (including the affiliate that is the borrower under the intercompany loan) and (b) supported by the pledge of that intercompany loan (which is typically guaranteed by the same entities in the corporate family). As a result, the lenders will have two claims against the **same entities**: one direct claim under their loan and guarantees thereof, and one indirect claim under the intercompany loan and guarantees thereof.

In a **"pari plus" double dip**, different (and additional) obligors that are not obligors under pre-existing debt incur or guarantee the new financing, and then lenders still benefit from the pledge of the intercompany loan (and guarantees thereof) from entities that continue to be obligors under pre-existing debt. As a result, lenders have structurally senior claims against the different (and additional) obligors and continue to share indirect claims against the original obligors vis-à-vis the pledge of the intercompany loan.

III. Reduction-of-Claim Approach Versus Limitation of Dividend Approach

Are multiple claims considered in a bankruptcy? Take, for instance, a lender that has a claim against a small company for $1 million and a corresponding personal guaranty from that company's owner, which is secured by the owner's house.[1] The borrower company then defaults and files for bankruptcy, and the lender forecloses on the owner's house with a $50,000 credit bid — even though the Zillow estimate of fair market value is $400,000. There is expected to be a recovery for unsecured claims in the borrower's chapter 11 case. The question is, does the lender have a claim against the company for:

a. $600,000,

b. $950,000, or

c. $1 million?

Based on a 1935 U.S. Supreme Court decision, the answer is (c). The lender may assert its full claim against *each* entity and need not reduce it by any prior recovery, though the recovery is capped at 100% of the full claim amount in the aggregate (*i.e.*, the $50,000 credit bid is taken into consideration only with respect to the overall recovery, such that the lender cannot obtain a recovery greater than $950,000 from the chapter 11 debtor).

In *Ivanhoe Bldg. & Loan Assn. v. Orr*, a creditor held an unsecured claim against a debtor, which was secured by real estate owned by a non-debtor third party.[2] The creditor foreclosed on the real property and credit bid $100 for it at the foreclosure sale. The debtor subsequently filed for bankruptcy, and the creditor then filed a claim against the debtor for the full value of the debt less $100, although the creditor and the debtor agreed the real property was worth $9,000. The debtor successfully argued that it should be permitted to reduce the amount of the claim against it by the full $9,000 of value the creditor had recovered (*i.e.*, the "reduction of claim" approach), not just $100. However, the Supreme Court ultimately reversed and found that the secured creditor could assert its full claim — albeit subject to a cap upon recovery. Specifically, the court held that the creditor did not have to reduce its unsecured claim against or recovery from the debtor unless it would otherwise recover more than the full amount of the original debt due, in which case the sum previously recovered would simply be credited against the total recovery up to the amount necessary to ensure no more than 100% recovery.

The *Ivanhoe* decision gave rise to the "limitation on dividend" approach, which is the foundation for double dip recovery. Instead of aggregating all potential sources of recovery (both debtor and non-debtor, borrower and guarantor) into a single pool as the reduction of claim approach effectively requires, the limitation on dividend approach allows a creditor to approach each obligor with the full value of the claim owed, thereby allowing a creditor to recover from multiple sources until its entire debt is repaid. As noted above, however, double recovery is not allowed. In contrast, the reduction of claim approach would require the creditor to reduce its claim against later-approached obligors by any amount previously recovered from other obligors.

Courts have infrequently, but favorably, cited *Ivanhoe* in this century. In *In re Nat'l Energy & Gas Transmission, Inc.*, the U.S. Court of Appeals for the Fourth Circuit aligned with *Ivanhoe* in holding that "a creditor need not deduct from his claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation."[3] As a result, a creditor who first partially recovered from a non-debtor guarantor was allowed to claim the full amount of unpaid principal against the debtor to recover up to the full amount of unpaid principal, excluding interest. (The court noted that state law regarding sureties — expansively defined to include any secondary obligor bound to pay for a debt or answer for the primary obligor's default — would compel the same result). The bankruptcy court in *Del Biaggio* clarified the import of such overlap between the federal approach based on *Ivanhoe* and state law, holding that, notwithstanding state law that would otherwise apply the reduction of claim approach and thereby limit the claim permitted under *Ivanhoe*, the limitation of dividend approach should be applied to determine claims in a federal bankruptcy case.[4] Note that all three cases (*Ivanhoe*, *Nat'l Energy*, and *Del Biaggio*) dealt with assessing a claim in which a creditor had a recovery from a non-debtor (as opposed to claims against two debtors).

IV. Distressed Debt Strategies

Fast forward to the Great Recession, when distressed debt traders began looking for opportunities to recover a "double dividend" in complex capital structures of bankrupt companies — for instance, where there were foreign subsidiaries. In the *Lehman* bankruptcy, debtor Lehman Brothers Holdings Inc. raised more than $36 billion through indirect Dutch and Netherlands subsidiaries, with the amounts guaranteed by a U.S. parent company. Claim holders at the Dutch and Netherlands subsidiaries argued that the double dip structure entitled them to a direct claim against both Lehman Brothers Holdings Inc. (through Lehman Brothers Holdings Inc.'s guarantees) and the applicable Lehman subsidiary issuer. In response, Lehman's senior bondholders threatened to seek substantive consolidation to eliminate the potential double dip.[5] However, this fight was never decided by a court: the parties settled the dispute through a consensual plan that provided the double dip claimants with most of the double dip claim that they were seeking.

Today's double dip appears to be a continuation of the *Lehman* distressed debt strategy. First, a borrower entity is identified (or formed) outside the existing credit group and a loan is made to that entity and guaranteed by the existing credit group (the "***first dip***"). Then, the proceeds from that financing are loaned on an intercompany basis to an entity in the credit group, and that intercompany loan is typically guaranteed by the credit group. The intercompany receivable is subsequently pledged to secure the loan (the "***second dip***"). The lender thus has a double claim against the credit group — one directly on account of the credit group guarantees, and one indirectly on the intercompany loan (and guarantees thereof).

The transactions completed by At Home Group and Wheel Pros followed the same general structure, through which the lenders benefitted from duplicate intercompany claims and new-money guarantee claims against the existing credit group. More specifically, in the At Home Group transaction, the company received $200 million of new private placement notes funded into a new foreign non-guarantor subsidiary, and the notes were guaranteed by the credit group. This subsidiary then loaned the proceeds of the new debt to the parent. Consequently, the debt was supported by (i) guarantees of new private placement notes from the existing credit group (the first dip) and (ii) an intercompany obligation from the existing credit group (the second dip). The former created a direct claim against the existing credit group on account of the guarantees, while the latter created an indirect claim against the existing credit group by virtue of the intercompany loan receivable (and guarantees thereof).

As noted above, the Wheel Pros transaction similarly followed a "true" double dip structure. It consisted of a new-money $235 million loan that existing borrower Wheel Pros Inc. incurred, as well as a refinancing of existing debt. Notably, the transaction differs from other double dip transactions in that the new-money loan does not directly benefit from the double dip structure. Rather, the lenders improved the position of their existing debt through exchanges and open-market purchases, exchanging existing first lien and unsecured positions with new first lien and second lien loans from a non-guarantor subsidiary that were guaranteed by the parent (the first dip). The borrower then advanced $1.3 billion in loan proceeds to its parent (which it "recycled" to repay existing debt), and the resulting intercompany receivable (and guarantees thereof) was then pledged to the lenders (the second dip). Ultimately, these transactions may improve the position of existing lenders by providing two potential avenues of recovery against an existing obligor.'

V. Double Dip Versus Other Liability Management Considerations

Double dip transactions are more similar to a "J. Crew" asset drop-down than a "Boardriders" or "Serta" up-tiering. In the well-known "J. Crew" family of liability management transactions, the borrower uses its covenants and baskets to move assets to a subsidiary outside the credit group, and then obtains additional financing secured by those assets. The borrower neither seeks consents from existing lenders nor (according to the borrower) is it required to. In contrast, in the "Boardriders" and "Serta" family of liability management transactions, a group of existing lenders agrees to modify existing covenants to permit a new priming facility and then relies on exceptions to the pro rata payment provisions or assignment provisions of the credit documents to refinance the group's existing debt with the priming debt. In the contemporary parlance of the restructuring community, this is often characterized as "lender-on-lender violence" because a subset of lenders benefits from the liability management transaction at the cost of the other lenders. These two concepts can sometimes be combined to achieve majority lender consent to amend covenants and move assets out of the credit group, and subsequently use exceptions to the pro rata treatment or assignment provisions to support refinancing the lenders who support the amendment (for instance, as occurred with Envision).

The oft-seen current form of the double dip transaction is frequently more similar to a J. Crew-type transaction, because the borrower works within its existing covenants and baskets so that a subsidiary that is not an existing loan party (perhaps because it is a foreign subsidiary) incurs new debt. Then, the borrower must have availability within its debt, lien, and investment covenants (or baskets) so that the credit group can (i) guaranty the new financing of the non-credit group subsidiary and (ii) incur the intercompany loan arising from the proceeds of the new loan. The ability of a borrower to engage in a double dip liability management transaction turns on these key covenants, the nature of the debtor's businesses and corporate structure (and its ability to transfer / segregate assets), and any exceptions or baskets negotiated by the parties.

VI. Conclusion

In the field of liability management, novel structures are always in demand. But, as always, it is important to study your history — that which is old often becomes new again.

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1. This is close to (but not quite as beneficial to the lenders) as a "pari plus" double dip, as we assume the other creditors of the company don't also have the benefit of the personal guarantee. If the current restructuring community had been involved in the original deal, they would likely have structured the deal as (a) a personal loan to the owner (secured by his house), which is guaranteed by the company, and (b) the owner then on-lends the proceeds to the company, and that loan is pledged to secure the original personal loan.
2. *Ivanhoe Bldg. & Loan Assn. v. Orr*, 295 U.S. 243 (1935).
3. *In re Nat'l Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301 (4th Cir. 2007).
4. *In re Del Biaggio*, 496 B.R. 600 (Bankr. N.D. Cal. 2012).
5. Substantive consolidation would have effectively merged the two entities, eliminating the intercompany claim and leaving the bondholders with a single claim against the combined entity.
