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Locke Lord QuickStudy: The Double Dip: Guacamole Faux Pas ?or Liability Management ?Technique??

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Jerry Seinfeld and Larry David taught us that you can't double dip a chip—"it's like putting your whole mouth right in the dip."[1] However, the credit markets have recently been focused on a different type of double dip, one that is being increasingly considered as a legitimate "liability management" tool to improve a borrower's liquidity. In certain cases, the use of a double dip can result in new money lenders obtaining increased collateral coverage at the expense of existing secured creditors—a dynamic market participants have come to refer to as "creditor-on-creditor violence". Let's take a look at how this mechanism works in practice, as well as how it might be justified or challenged by other parties in the capital structure.

The Double Dip Defined and Explained

A double dip transaction allows a lender to make a single loan which, if structured correctly, results in two separate claims against a borrower group—each in the same amount but with a putative different basis for liability (hereinafter, a "***Double Dip transaction***" or "***Double Dip***"). The goal of the Double Dip Lender is not to be paid double the amount of its claim. That outcome would run afoul of the legal principle commonly referred to as the single satisfaction rule, which generally provides that a creditor is only entitled to have its claim satisfied once. Rather, the Double Dip Lender is seeking to enhance its recovery vis-à-vis otherwise *pari passu* secured creditors of the debtor.

For example, consider the situation where a secured lender (the "***Double Dip Lender***") is owed $100, and another secured creditor of equal priority is owed $100 by the same debtor. Ordinarily, these two secured creditors would share equally in the proceeds of the debtor's collateral upon a liquidation of the debtor's assets—all on a *pari passu* basis. However, by utilizing the Double Dip, the Double Dip Lender would effectively double the size of its claim for distribution purposes, and would be treated as holding two claims for $100. Accordingly, the proceeds of the debtor's collateral would be split 2/3 in favor of the Double Dip Lender, and 1/3 in favor of the other creditor.

Structuring the Double Dip

Consider a capital structure whereby a parent company ("***Parent***") has an existing operating subsidiary ("***Opco***"), with Opco having incurred secured debt in favor of a third-party lender, and Parent having provided a secured guaranty in favor of such lender. In a simplified example, a Double Dip transaction can be accomplished in three steps:

1. Opco forms a new subsidiary (the "***Double Dip Borrower***"). The Double Dip Lender makes a secured loan to

the Double Dip Borrower (the "***Double Dip Loan***").

2. Parent and Opco each provide a secured guaranty of the Double Dip Borrower's obligations under the Double Dip Loan. The Double Dip Lender's claim against Parent and Opco created by this guaranty is the "first dip".

3. The Double Dip Borrower uses the proceeds of the Double Dip Loan to make a secured intercompany loan to Opco, and such intercompany loan is guaranteed on a secured basis by Parent. The intercompany loan receivable held by the Double Dip Borrower is pledged to the Double Dip Lender, and this indirect claim held by the Double Dip Lender against Parent and Opco is the "second dip".

Loan Document Flexibility

The consummation of a Double Dip requires that Opco's existing credit documents allow for the classification of the Double Dip Borrower as either an *unrestricted subsidiary* (i.e., the Double Dip Borrower is neither bound by the covenants of the existing credit documents nor required to guaranty Opco's debt under those documents) or as a *non-guarantor restricted subsidiary* (i.e., the Double Dip Borrower is bound by the covenants of the existing credit documents, but is not required to guaranty Opco's debt under those documents).

If the Double Dip Borrower is a non-guarantor restricted subsidiary, then Opco's existing debt documents must provide for adequate debt and lien capacity in order for the Double Dip Borrower to incur the Double Dip Loan. However, if the Double Dip Borrower is an unrestricted subsidiary, then no such capacity is needed.

Since a guaranty is considered "debt" under most credit documents, the provision of the secured guaranties by Parent and Opco in favor of the Double Dip Lender must also be permitted under the debt and lien covenants of Opco's existing debt documents. In many cases, the provision of these guaranties must also be permitted under the investment covenant of Opco's existing debt documents.

Finally, the incurrence of the intercompany loan by Opco will also require additional debt and lien covenant capacity. Note that many credit agreements provide for an intercompany debt basket, which could theoretically be used by the Double Dip Borrower to the extent it is a non-guarantor restricted subsidiary. However, it is most often the case that such intercompany debt baskets expressly require that such debt be subordinated to the debt outstanding under the credit agreement. Assuming that is the case, the intercompany loan would need to be incurred using a debt basket other than the intercompany debt basket.

Justifying and Challenging a Double Dip

A borrower group utilizing a Double Dip technique would almost certainly offer two principal justifications for this approach: (i) the proposed transaction is in full compliance with the terms and conditions of the applicable credit agreement and (ii) the transaction provides the borrower group with needed liquidity. A senior lender challenging this structure would argue that it unfairly dilutes the existing secured creditors, without supplying a corresponding amount of new liquidity. To the extent that the transaction indeed complies with the terms of the credit agreement (and any related intercreditor agreements), the diluted lender would not be able to assert a breach of contract action. Any challenge would instead have to take the form of a business tort claim.

Challenges to Double Dip Based on Business Tort, Insolvency or Bankruptcy of Borrower

Assuming that the Double Dip comports with the plain language of the credit agreement and related intercreditor agreements, an objecting creditor would need to argue that the transaction violated some other legal or statutory duty. For example, the objector might contend that the borrower's board of directors breached fiduciary duties in approving the transaction. Or, the objector might argue that Opco and/or Parent were insolvent at the time of the transaction, and did not receive reasonably equivalent value for their guaranties—thereby rendering the transaction avoidable as a fraudulent transfer. In a bankruptcy proceeding filed by (or against) Opco and its affiliates, the objector might also argue that Opco and Double Dip Borrower should be substantively consolidated (or treated as alter egos), such that the Double Dip claims are treated as one claim. Finally, the Objector might also argue that the Double Dip claim arose under inequitable and unfair circumstances, such that the Double Dip claim should be equitably subordinated or recharacterized as equity.

Of course, all of these claims would be factually intensive, and would stand or fall based on the strength of the particular facts of the Double Dip transaction at issue. Generally speaking, a Double Dip may be defensible if it infuses critical liquidity not otherwise available, and otherwise enhances the operations and strategic progress of the borrower group. Conversely, a Double Dip will be vulnerable if it merely "round trips" money without enhancing the borrower group's big picture financial prospects. We do note that Double Dip claims have been asserted and, in several cases, allowed or successfully resolved in prior Chapter 11 proceedings, including those of General Motors, Lehman Brothers and Latam Airlines, among others. The Double Dip structure is not *per se* impermissible, and may well be defensible under the facts and terms of the applicable agreements. As long as the relevant credit agreement and intercreditor agreements permit the technique, we can expect to see more liquidity strapped borrowers pushing their chips back toward the guacamole for a second swipe.

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[1] For our readers who were not aware of this faux pas, we direct you to Season 4, Episode 19 of the classic TV sitcom, *Seinfeld.*

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