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WHITE PAPER

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Double-Dip Financings: The Next Wave in European Liability Management?

A “double-dip” structure is considered a way to allow some creditors to have multiple claims against key obligors arising out of the same underlying transactions. These additional claims could improve their position relative to other creditors in a bankruptcy or liquidation.

Although historically the double-dip was considered a potential argument that could be used in certain preexisting debt structures, recent liability management transactions in the United States and Europe have deliberately built double-dips into new debt structures with the goal of maximizing recovery in a downside scenario.

This *White Paper* identifies the key characteristics of a double-dip financing and provides detailed examinations of two recent case studies. It considers potential obstacles to double-dips appearing in Europe and provides guidance on potential areas for expansion.

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Although "double-dipping" may constitute bad dining etiquette and a potential health hazard, some lenders to distressed borrowers have found double-dips to be an irresistible approach to improving their position in a liquidation or bankruptcy by means of multiple independent claims against the same obligors in respect of the one underlying transaction.

Historically, there have several notable restructurings in which distressed debt investors argued that the existence of a double-dip in the original capital structure should enhance their returns.[1] In recent years, there has been a growing trend to raise new debt that is *intentionally* structured to give rise to a double-dip.[2]

This *White Paper* will explain how double-dips work, whether they are likely to appear soon in Europe, and potential areas for expansion.

HOW IT WORKS

A double-dip financing is typically structured as follows:

A parent company ("Company A") incorporates a new special-purpose wholly owned subsidiary ("Company B"), which issues notes or borrows funds (the "New Debt") from third parties (the "New Creditors"). The New Debt may be secured or unsecured depending on whether the existing debt is secured or unsecured.

First Dip: Company A guarantees the New Debt, giving the New Creditors a direct claim against Company A (and any other guarantors).

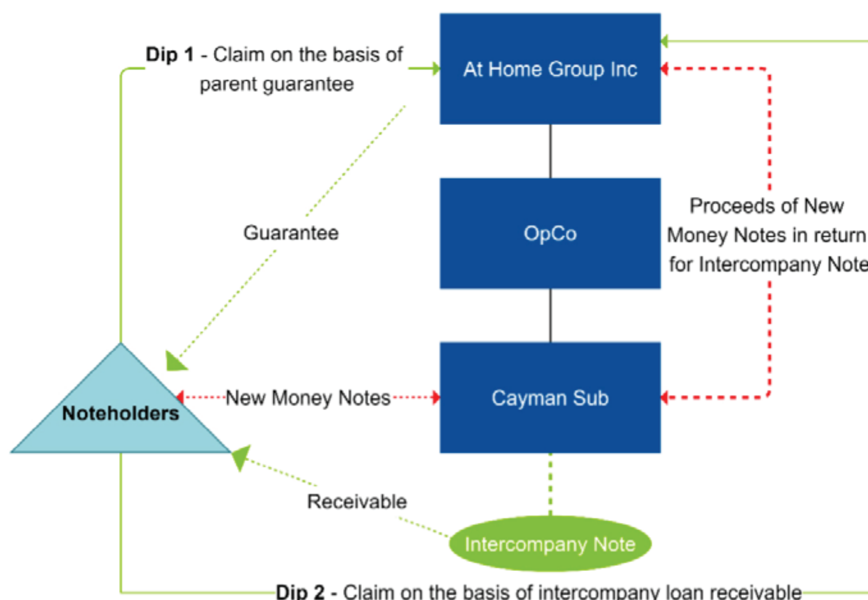
Second Dip: Company B on-lends the proceeds of the New Debt to Company A, creating an intercompany receivable owned by Company B, which is pledged to the New Creditors to secure the New Debt. On enforcement, the New Creditors would step into Company B's shoes as another creditor of Company A.

The goal is not to be able to claim an amount in excess of the outstanding obligations, but to allow for multiple claims at multiple entities to maximize the return in bankruptcy or liquidation. For example, imagine that Company A had existing secured debt of $100 million and the New Debt has a face amount of $100 million. By allowing the New Creditors to claim up to $200 million instead of $100 million via the double-dip structure, the theory is that the New Creditors could receive a two-thirds share of the *pari passu* secured creditors' recoveries instead of half.

RECENT U.S. EXAMPLE: AT HOME GROUP INC.

At Home Group Inc. ("At Home") was one of the first transactions to be structured *intentionally* to enable a double-dip. In July 2021, the private equity firm, Hellman & Friedman, acquired At Home for approximately $3.1 billion. By late 2022, At Home's revenues and profits were hit by higher supply chain and labor costs.

As of the 2021 acquisition, At Home had issued $300 million of 4.875% Senior Secured Notes due 2028 (the "Secured Notes") and $500 million of 7.125% Senior Notes due 2029 (the "Unsecured Notes"). At Home made the holders of the Unsecured Notes a proposal that would extend its note maturities, de-lever existing debt, and raise new funds, which was approved by 89.4% of the holders (the "Consenting Noteholders"):



At Home would exchange Unsecured Notes for new 7.125%/8.625% Cash/PIK Toggle Senior Secured Notes due 2028 issued by At Home with a face value equal to 90% of the exchanged notes. As a "parting kiss," the Consenting Noteholders would approve a covenant strip allowing At Home to incur more debt under the Unsecured Notes.

Consenting Noteholders were also able to participate in a new $200 million private placement of 11.5% Senior Secured Notes due 2028 (the "New Money Notes") issued by a newly formed Cayman Islands subsidiary ("Cayman Sub") that was not a guarantor of At Home's debt.

Cayman Sub then on-lent the proceeds of the New Money Notes to At Home in exchange for an intercompany note (the "Intercompany Note"), which was pledged to secure Cayman Sub's obligations under the New Money Notes.

Both Cayman Sub's obligations under the New Money Notes and the Intercompany Note were guaranteed by At Home and some of its subsidiaries ("Restricted Group") on a secured basis ranking *pari passu* with At Home's existing secured debt.

As a result, the holders of the New Money Notes would potentially have two independent claims against the Restricted Group resulting from the one transaction:

- A direct claim under the guarantee of the New Money Notes; and
- An indirect claim via the pledge of the Cayman Sub's interest in the Intercompany Note.

ARE DOUBLE-DIPS LIKELY TO REACH EUROPE?

The likelihood of similar double-dip structures appearing in European jurisdictions will depend on three key factors:

- A creditor-friendly environment with tighter terms and higher interest rates;
- Flexible existing debt documents that permit double-dip structures; and
- A legal jurisdiction that permits and gives effect to the double-dip structure.

Creditor-Friendly Environment

After the global financial crisis, low interest rates became the norm, and debt investors seeking above-market returns would often agree to flexible debt terms in exchange for moderate yields. Debt terms continued to loosen during the COVID-19 crisis as various governments kept defaults low by providing economic support to businesses. However, the recent tougher economic and geopolitical climate featuring higher interest rates, supply chain issues, constrained GDP growth, and reduced consumer spending has resulted in a more creditor-friendly environment.

The higher costs of raising debt and lower asset valuations have led to debt investors being more selective. As a result, companies that have higher leverage are finding it harder to refinance or raise new debt (or to do so on acceptable terms) and are considering alternatives to the traditional debt markets, such as structured financings, special situation lenders, and liability management transactions.

Flexible Existing Debt Documents

Each step of the proposed transaction needs to be analyzed separately to ensure that it is permitted under the existing debt documents, or if an amendment would be required. Unless the double-dip transaction involves an exchange of sufficient debtholders to approve the amendment, the requirement for an amendment could be fatal.

Typically, the special purpose subsidiary borrower should not be a guarantor of the existing debt. So, does it make sense for it to be a non-guarantor restricted subsidiary or an unrestricted subsidiary? The non-guarantor restricted subsidiary will typically require more lien and debt basket capacity than an unrestricted subsidiary, which is typically not subject to the covenants at all. However, the ability to designate unrestricted subsidiaries may be constrained by maximum leverage tests or requirements that no obligor provide guarantees or credit support to the unrestricted subsidiary.

If the double-dip is in the context of a drop-down transaction in which valuable assets are going to be invested into the special purpose subsidiary, the investment baskets and any

"J.Crew" blockers (limiting the ability of unrestricted subsidiaries to own certain assets) or "Envision" blockers (limiting the amount that can be invested in unrestricted subsidiaries) will need to be considered.

In the recent Trinseo restructuring, for example, part of the new money that was lent to the special purpose borrower was on-lent to a holding company that would then contribute the proceeds as equity. In turn, the equity contribution expanded the investment basket by enough to facilitate the investment of the "Styrenics" business into an unrestricted subsidiary. Similarly, in the recent Sabre restructuring, in order for the non-guarantor foreign subsidiaries to provide additional guarantees for the new money debt, the guarantees needed to be capped at a level that would not exceed the applicable debt baskets.

The key takeaway here is that it is not enough for the existing debt documents to be flexible—they need to have the *right amount* of covenant basket capacity to enable all the steps of the proposed double-dip structure to be effected.

Legal Framework

The final ingredients for double-dip structures to work are the laws of the jurisdictions in which the double-dip claims are to be enforced and the courts or other means by which the laws are enforced.

Does the jurisdiction rigorously apply the principle of corporate separateness? If not, there is a greater likelihood that a court will consolidate the group for insolvency purposes, thereby undermining the effectiveness of the double-dip structure during insolvency or liquidation proceedings.[3] In what circumstances will a court try to recharacterize a debt as something else? In what circumstances will a court permit obligors to make claims against each other?[4] Will a court permit multiple claims for the same underlying obligations? Or multiple claims against the same entities? Are the laws generally more favorable to recovery by the creditor? Each of these questions must be determined on a jurisdiction-by-jurisdiction analysis.

Although there are multiple examples of double-dip claims being asserted or approved in previous U.S. restructurings (such as National Energy & Gas,[5] which allowed for multiple claims of the full amount of the obligations against different estates as long as the creditor did not receive more than 100% of its claim; General Motors; Lehman Brothers; Delta; LatAm Airlines; and others), U.S. courts have not yet tested whether a double-dip structure that was deliberately implemented will be approved. Similarly, although the Trinseo restructuring used Luxembourg entities, and the contemplated LYCRA transaction described below involved a Dutch co-issuer, we are not aware of any European court approving or disallowing double-dip structures.

However, below are some factors to be considered:

- **Substantive Consolidation:** This allows bankruptcy courts to combine the assets and liabilities of two or more debtor (and sometimes non-debtor) entities, in effect creating a single debtor entity.[6]

- **Equitable Subordination**: This allows bankruptcy courts, based on misconduct of a creditor, to lower the priority of a claim and delay its payment until other creditors are paid.[7] It is unlikely that a court would treat the "aggressive" nature of the structure alone as constituting bad conduct by the new money creditors.

- **Claim Disallowance**: Each jurisdiction has its own rules for determining whether a loan or an intercompany receivable is enforceable.[8] Any formal requirements for the loans will need to be put in place when structuring the double-dip transaction.

- **Recharacterization**: Many jurisdictions allow a bankruptcy court to recharacterize a debt transaction as equity if the true character of the transaction was an equity infusion rather than debt. Usually, courts are more likely to do so if the counterparty is a direct or indirect equity holder rather than a subsidiary upstreaming money to its parent that it received from a third-party creditor.[9]

- **Setoff/Subrogated Claims**: Subrogation allows one entity to exercise the legal rights and interests (and in some instances, the obligations) of another person. In the context of a double-dip, the amount due under the intercompany note could be subject to set off on the basis of a subrogation claim against the borrower for the amounts paid on the secured guarantee given by the parent/group companies.[10]

Before entering into a double-dip structure, these and similar rules and procedures would need to be considered in the applicable jurisdictions in which the double-dip claims are expected to be made.

A RECENT EUROPEAN CASE STUDY: LYCRA

The LYCRA Company ("LYCRA") appears to be one of the first European transactions to contemplate an intentional double-dip structure. Although that structure was not used in the end, it likely foreshadows the future implementation of double-dip structures in Europe.

LYCRA is a global textiles manufacturer that struggled with weaker financial performance and mounting debt problems following its acquisition by Ruyi Technology Group in 2019. After the holding company defaulted on its debt, its creditors took over all of LYCRA's equity.

In May 2023, LYCRA proposed a new double-dip/drop-down structure to refinance €250 million of 5.375% Senior Secured Notes due May 2023 (the "Secured Notes"), which were near maturity. The transaction was structured as follows:

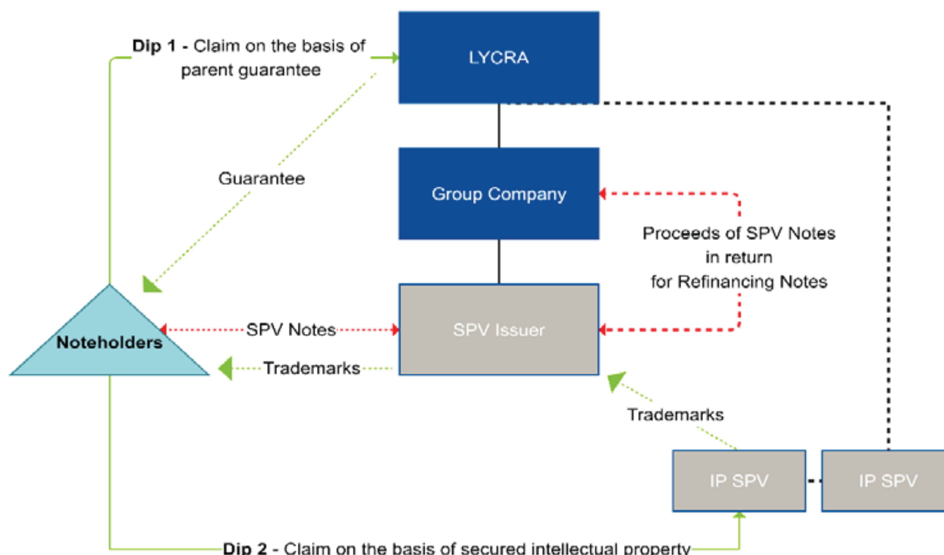
LYCRA would form a UK special purpose subsidiary outside of the restricted group ("SPV Issuer").

LYCRA would offer to exchange the Secured Notes for €300 million of 16% Senior Secured Notes due 2025 (the "SPV Notes") issued by the SPV Issuer at a 20% discount to face value. These would be guaranteed by LYCRA and its restricted group.

The proceeds of the SPV Notes would be used to purchase intercompany notes ("Refinancing Notes") issued by a LYCRA group company within the restricted group, which purchase price would then be upstreamed to repay the Secured Notes at par.

To further incentivize participation in the transaction, LYRCA agreed to use commercially reasonable efforts on a post-closing basis to drop down trademark assets valued at $75 million into a new unrestricted subsidiary to be used as security for the SPV Notes using existing investment basket capacity. This would result in the release of the security over the trademarks in favor of the existing *pari passu* senior secured debt.

Under this proposal, the holders of the SPV Notes would have had three independent claims against LYCRA's capital structure: (i) a double-dip in the two forms of (A) a direct claim against the



restricted group guarantors of the SPV Notes, and (B) an indirect claim under the Refinancing Notes that were pledged to the holder of the SPV Notes; and (ii) a direct claim against the unrestricted subsidiary that held the trademarks as guarantor. However, in the end, there was a negotiated settlement, and the proposed double-dip transaction did not proceed.

POTENTIAL AREAS FOR EXPANSION

The LYCRA and Trinseo restructurings combined the double-dip with a J.Crew-style intellectual property drop-down transaction. Trinseo and Sabre included guarantees from entities that were non-guarantor restricted subsidiaries under the existing debt structure. Some transactions have the special purpose borrower structured as a non-guarantor restricted subsidiary under the existing debt, whereas others have the special purpose borrower as an unrestricted subsidiary. In some structures, the double-dip is used to effect an exchange, while in others, it is to incur new funds. So there is clearly plenty of room for flexibility.

One further consideration is whether there could be an elusive third or other subsequent dip that would allow for even more claims that could potentially dilute the claims of existing creditors.

Some double-dip structures in the past (for example, General Motors, Smurfit-Stone, and Hexion) had an arguable third dip resulting from the fact that the special purpose borrower was a Nova Scotia Unlimited Liability Company ("ULC"). The argument was that the third dip would result from the pass-through obligations of the shareholders with respect to their ownership of the ULC.

A future financing or debt exchange could theoretically be effected along those lines by intentionally using an unlimited liability vehicle as the special purpose borrower. For example, the borrower could be owned by an entity that is not permitted to incur any debt under the terms of the existing debt documents, which would allow a claim to be made through the equity of the unlimited liability entity instead (i.e., a contingent shareholder liability claim instead of a debt claim). Close attention would need to be paid to the legal nature of the underlying liability. For example, is it a joint and several obligation (such as the liability of a general partner) that always applies or is it a contingent liability that applies upon the winding up of the entity?

Maybe there are other dips out there, such as a claim under a derivatives instrument like a credit-default swap or a liquidated damages claim related to matters connected with the restructuring that is contingent on certain events occurring and will be forgiven upon the repayment or refinancing of the debt. The possibilities are limited only by the imagination and the vagaries of commercial negotiations.

CONCLUSION

The double-dip liability management tool is quickly becoming a useful financing tool in the United States and may be in the process of crossing the Atlantic. It is an attractive tool to the extent that it can improve recovery, decrease risk, and preserve priority for creditors, and it can supplement existing liability tools such as drop-down and up-tiering transactions. However, the devil is definitely in the details.

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ENDNOTES

1 For example, Lehman Brothers, General Motors, and LATAM Airlines.

2 A similar structure was considered for a European restructuring, but it ultimately was not implemented.

3 Following the UK Supreme Court decision in *Prest v. Petrodel Resources Ltd* [2013] UKSC 34, it is clear that the concept of separate legal personality is a cornerstone of UK company law, which can be disregarded only in very limited circumstances. Therefore, in the United Kingdom, it is unlikely that a court would consolidate the group for insolvency purposes. However, there are varying degrees to which the "single economic entity" doctrine is recognized across Europe.

4 For example, under section 509 of the U.S. Bankruptcy Code, a guarantor's claim for reimbursement against the principal obligor is effectively disallowed or subordinated until the creditor is paid in full.

5 *In re National Energy & Gas Transmission, Inc.* 492 F.3d 297 (4th Cir. 2007); *see also Ivanhoe Building & Loan Ass'n of Newark, N.J. v. Orr*, 295 U.S. 243 (1935).

6 In the United States, substantive consolidation is a judicially created doctrine derived from the court's general equitable powers under section 105(a) of the Bankruptcy Code. Absent statutory guidance, each case will turn on the facts. In *Lehman Brothers*, the senior noteholders threatened to seek substantive consolidation in response to double-dip claims. However, the eventual consensual plan gave the creditors most of the claimed double-dip. In practice, however, substantive consolidation is uncommon, especially if it involves non-debtors, and a claim for substantive consolidation will not usually succeed.

7 In the United States, an interested party could seek to equitably subordinate the intercompany claim guarantee to other claims against the guarantor under section 510(c) of the Bankruptcy Code.

8 Section 502(b) is a provision of the Bankruptcy Code that outlines the rules for determining the allowable and disallowable claims in bankruptcy cases. Existing creditors may seek to disallow the intercompany loan guarantee on the basis that "such claim is unenforceable against the debtor and property of the debtor" under section 502(b)(1). Whether a claim is unenforceable against a debtor and property of a debtor is determined by reference to the relevant state law. New York courts have already considered whether intercompany loans can be disallowed, and confirmed that as long as the loan documentation contained the essential elements of a loan and created a binding enforceable debt between a lender and a borrower, it would not look beyond the four corners of the contract or undertake analysis of its "true character" for the purposes of section 502(b)(1). See *LATAM Airlines Grp. S.A.*, 2022 20-11254 (JLG) (Bankr. S.D.N.Y. Apr. 29, 2022).

9 *See id.; see also* "Bankruptcy Court Recharacterizes Purported Loan as Equity," Jones Day *Business Restructuring Review*, May–June 2021.

10 In *Re Kaupthing Singer and Friedlander Limited (in administration)* [2011] UKSC 48, the UK Supreme Court approved a double-dip claim that arose from the existence of a special purpose finance subsidiary that issued bonds and had on-lent the proceeds on an unsecured basis to its parent guarantor, as long as the bondholders' recovery was capped at 100% of the claim.

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