Expert Views
Bankruptcy Industry Update
Liability Management

‘Double-Dip’ Financings: Subrogation and Setoff Risks

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Editors’ Note: The latest in Reorg’s Expert Views series, an article written by Shai Schmidt of Glenn Agre Bergman & Fuentes LLP, is below. Reorg’s coverage of double dips is HERE.

Introduction

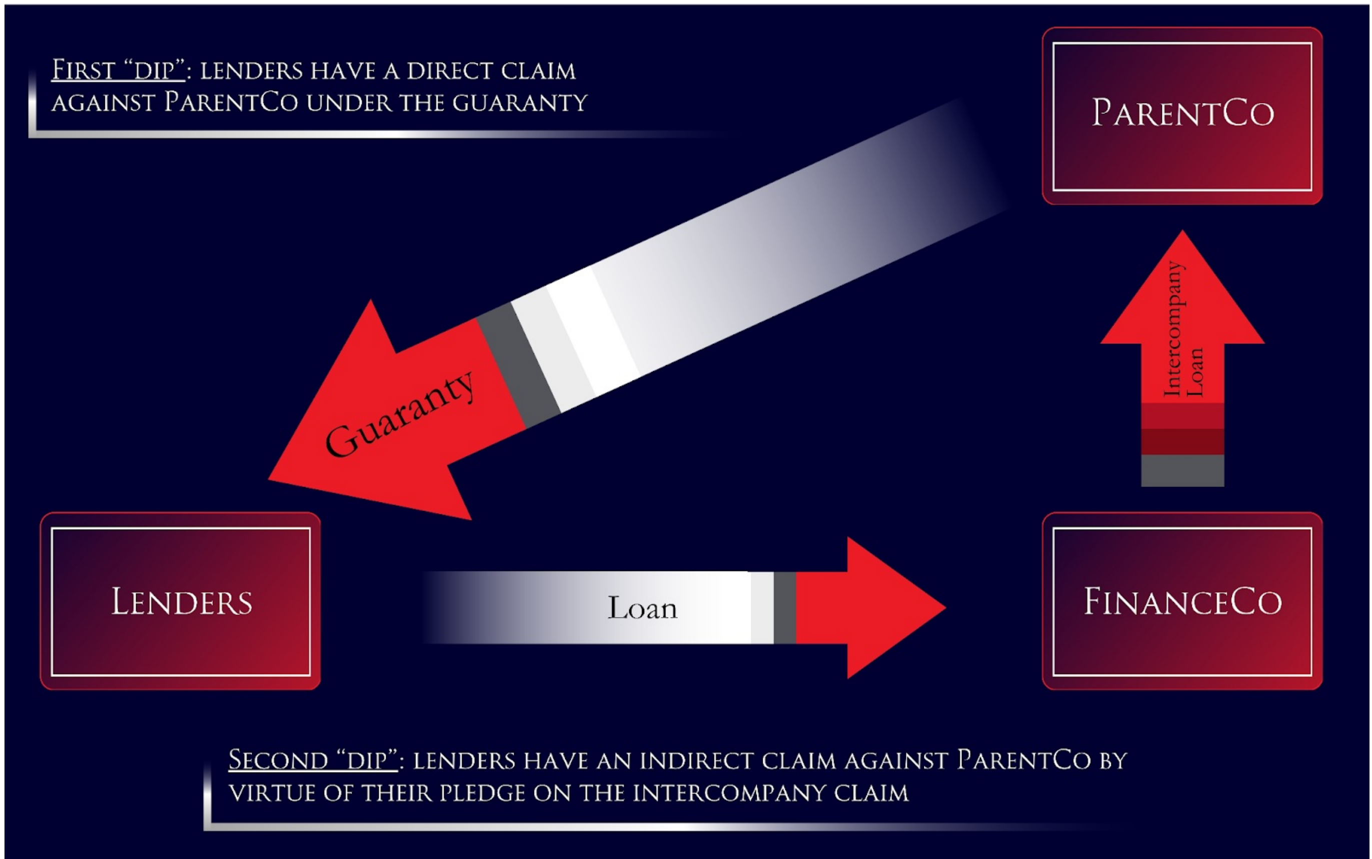
Companies seeking to address their capital needs often consider various liability management structures including priming (or “uptiering”) transactions and drop-down financings. Those structures have been criticized - particularly by excluded lenders left with newly subordinated liens or diminished collateral - and often resulted in litigation concerning their permissibility under the relevant debt documents. While companies, sponsors and participating lenders have touted those transactions as necessary to bolster liquidity and deleverage the company’s balance sheet, they have often failed to avoid a bankruptcy filing - and continued litigation - not long thereafter (see *Serta*, *Wesco* and *Envision Healthcare*, to name just a few examples).

Perhaps reacting to the criticism leveled against those transactions, market participants have devoted considerable attention to the “double-dip” structure - recently utilized by At Home, Wheel Pros and others - which does not typically require the outright subordination of lenders or the transfer of collateral to unrestricted subsidiaries. The double-dip structure can therefore appear to be less punitive to excluded lenders than other types of liability management transactions. It raises, however, unique (and perhaps overlooked) legal questions that have yet to be fully tested in litigation. One such open question is the potential effect of subrogation and setoff rights on the structure’s efficacy in a bankruptcy proceeding.

The Mechanics of a Double Dip

In its simplest form, the double-dip structure involves a secured loan to a borrower (“FinanceCo”), which on-lends the loan proceeds to a parent company (“ParentCo”) via an intercompany loan. The initial loan is (i) guaranteed by ParentCo, and (ii) secured by a pledge of FinanceCo’s intercompany claim against ParentCo. As reflected in Diagram 1, this creates two claims - or a “double dip” - against ParentCo.

DIAGRAM 1



Where ParentCo is solvent, there is typically no need for the lenders to utilize both "dips." In most cases, they can simply enforce the guaranty against ParentCo and receive payment in full. In a ParentCo bankruptcy, however, where creditors may be forced to accept partial recoveries from an insolvent estate, having two claims against ParentCo - each for the full amount of the loan - can significantly enhance the lenders' recoveries.

A creditor's ability to assert its full claim against a bankrupt obligor regardless of any previous partial recovery from other sources was established by the Supreme Court in *Ivanhoe Bldg. & Loan Ass'n v. Orr*, 295 U.S. 243 (1935). There, the high court held that a creditor who had recovered a portion of its claim against a debtor via a foreclosure of property owned by a nondebtor could still file a claim for the full amount against the debtor (and recover up to an aggregate 100% of its claim from all sources). Accordingly, in a ParentCo bankruptcy, a partial recovery by the lenders via their lien on FinanceCo's intercompany claim will likely not preclude them from asserting their full guaranty claim against ParentCo.

A separate question, however, is whether a partial payment by ParentCo on the guaranty gives rise to a reimbursement or subrogation claim against FinanceCo. As explained below, the existence of such a claim can significantly impact the double-dip structure.

ParentCo's Potential Reimbursement and Subrogation Claims Against FinanceCo

Following payment on a guaranty, a guarantor typically has a state law right of indemnity or reimbursement against the primary obligor to the extent of the payment.[1] Pursuant to Section 502(e)(2) of the Bankruptcy Code, if a guarantor makes a payment to a creditor after the petition date, the guarantor's reimbursement claim against the primary obligor will be allowed as if it had become fixed before the bankruptcy. Additionally, under the doctrine of equitable subrogation and Section 509(a) of the Bankruptcy Code, a guarantor may step into the shoes of the creditor as a subrogee and assert a claim against the primary obligor following such a payment.[2]

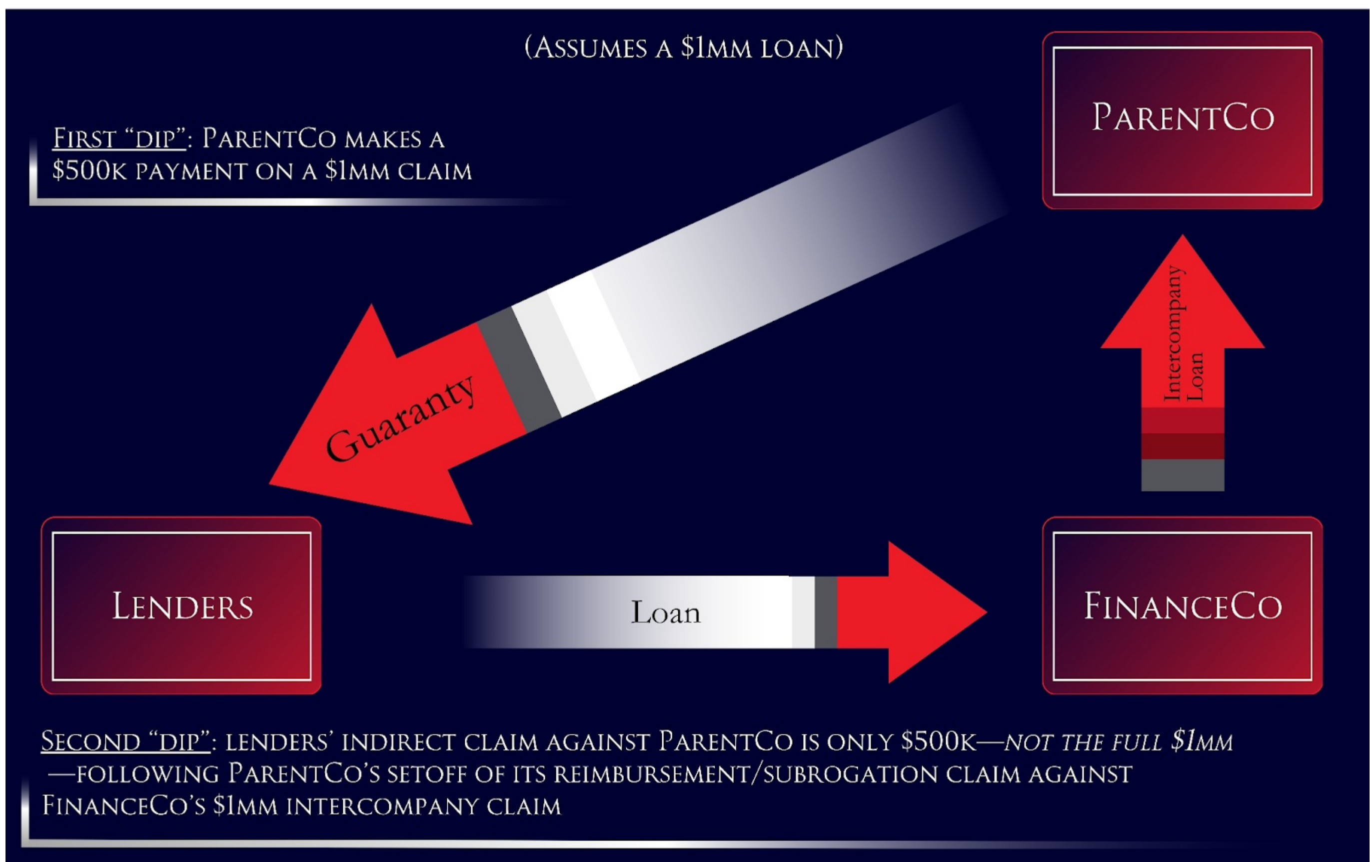
But there's a caveat. Under Section 509(c) of the Bankruptcy Code, a guarantor's reimbursement or subrogation claim against the debtor is subordinated to the primary creditor's claim "until such creditor's claim is paid in full." Therefore, in our example, if ParentCo makes a partial payment to the lenders during a bankruptcy, its reimbursement and subrogation claims against FinanceCo will be subordinated to the lenders' claim against FinanceCo until the lenders are paid in full.

Can ParentCo Offset Its Subordinated Reimbursement/Subrogation Claim Against FinanceCo's Intercompany Claim?

Section 553 of the Bankruptcy Code recognizes setoff rights that exist under applicable law subject to certain conditions, including that the relevant debts be "mutual." Courts have interpreted this to mean, among other things, that the claims must exist between the same parties (i.e., "triangular" setoffs are not allowed).[3] As a further implication of the mutuality requirement, it may intuitively seem that a subordinated reimbursement or subrogation claim cannot be used for setoff. Perhaps surprisingly, that intuition may be incorrect. Courts in several jurisdictions have held that the priority of a claim is irrelevant under Section 553, such that subordinated claims are eligible for setoff *notwithstanding their subordination to other claims against the debtor*.[4] Consequently, a guarantor's reimbursement or subrogation claim against the debtor is eligible for setoff regardless of its subordination to the primary creditor's claim under Section 509(c).[5]

Following a payment to the lenders under its guaranty, ParentCo may therefore be able to offset its reimbursement or subrogation claim against FinanceCo's intercompany claim. As described in Diagram 2, this can significantly reduce the lenders' recoveries in a double-dip structure.

DIAGRAM 2



The precise impact of ParentCo's setoff right on the lenders' recovery depends, among other things, on the degree of ParentCo's insolvency. It is clear, however, that it can severely impact the effectiveness of the double-dip structure where ParentCo's creditors are vying for a limited pool of assets and the size of a claim can dictate eventual recoveries.

A Subrogation Waiver May Not Salvage the Double Dip

Many guaranty agreements contain a waiver of any guarantor reimbursement or subrogation claim until the primary creditor is paid in full. This is typically meant to ensure that the guarantor does not compete with the creditor over the debtor's potentially limited assets. In our example, would such a waiver preclude ParentCo from offsetting its claim against FinanceCo's intercompany claim? The answer to this question may also be surprising.

Several courts have held that subrogation waivers are unenforceable in a bankruptcy as a matter of public policy. Those courts reasoned that such waivers improperly seek to eliminate the guarantor's creditor status to shield it from preference liability in the event the debtor makes a prepetition payment to the primary creditor, thereby reducing the guarantor's liability.[6] At the same time, subrogation waivers have no economic substance because if the debtor does not pay the primary creditor, the guarantor can step into its shoes simply by acquiring the claim instead of paying on the guaranty and asserting a subrogation claim.[7]

The validity of subrogation waivers in the double-dip context has yet to be tested in litigation. Given the courts' depiction of such waivers as a "sham provision," however, the risk appears to be significant.

Conclusion

The double-dip structure can provide much-needed liquidity to companies in a world of tightening credit and higher interest rates. But when this bolstered liquidity proves insufficient to stave off bankruptcy, this construct - like most other liability management exercises - is susceptible to challenges by nonparticipating creditors seeking to enhance their recoveries. When negotiating and pricing the terms of a double-dip loan, investors should consider not only the structure's potential benefits but also the significant risks lurking in the dark corners of the Bankruptcy Code.

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1. *See In re AOG Ent., Inc.*, 558 B.R. 98, 109 (Bankr. S.D.N.Y. 2016) ("a guarantor has a right of indemnity against the principal obligor.").
2. *See* 11 U.S.C. § 509(a) ("an entity that is liable with the debtor on … a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment."); *Chem. Bank v. Meltzer*, 93 N.Y.2d 296, 304 (N.Y. 1999) ("Rooted in equity, the purpose of the subrogation doctrine is to afford a person who pays a debt that is owed primarily by someone else every opportunity to be reimbursed in full.").
3. *See* 5 Collier on Bankruptcy ¶ 553.03[3][b] (collecting cases).
4. *See id.*, ¶ 553.03[3][e][vi] (collecting cases).
5. *See Lambert v. Callahan (In re Lambert Oil Co., Inc.)*, 347 B.R. 508, 519 (W.D. Va. 2006) (holding that "§ 509(c) does not destroy mutuality under § 553" and "subordinated claims are eligible for setoff.").
6. *See In re USA Detergents, Inc.*, 418 B.R. 533, 542 (Bankr. D. Del. 2009) (holding that "were a guarantor's waiver to eliminate creditor status, it would contravene the policy considerations of the preference sections of the Code"); *Russell v. Jones (In re Pro Page Partners, LLC)*, 292 B.R. 622, 631 (Bankr. E.D. Tenn. 2003); *Telesphere Liquidating Tr. V. Galesi (In re Telesphere Commc'ns, Inc.)*, 229 B.R. 173, 176, n.3 (Bankr. N.D. Ill. 1999).
7. *See id.*

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