Franchise Group Intercreditor Dispute Results in More Lender vs. Lender Litigation

The Franchise Group, Inc. (the "Debtors") bankruptcy case in the District of Delaware has been a battleground for lender-on-lender skirmishes involving the Debtors' first- and second-lien lenders. Over the course of the case, the second-lien lenders have, among other things, moved to terminate exclusivity, grant relief from the automatic stay, or appoint a chapter 11 trustee (Docket No. 192), objected to the DIP motion (Docket No. 274), and taken appeals of various bankruptcy court orders (Docket Nos. 466-469). In the latest chapter of this dispute, on March 23, 2025, Wilmington Trust, the first-lien agent, filed a complaint (Docket No. 1157, the "Complaint") against Alter Domus as second-lien agent, arguing that the second-lien agent had violated the 2021 intercreditor agreement (the "Intercreditor Agreement") between the two parties by seeking allowance of a $158.4 million superpriority administrative claim as protection against alleged diminution in value of the second-lien lenders' collateral (the "Admin Claim Motion"). Regardless of how the court rules on the Complaint and the Admin Claim Motion, this Complaint reflects the reality today of increasing lender on lender litigation.

Case Background

Franchise Group, a retail company that owns Vitamin Shoppe and Pet Supplies, among other brands, filed for bankruptcy in November 2024. Franchise Group entered bankruptcy with almost $2 billion of secured debt, including a $248.7 million asset-based loan, a $1.097 billion first-lien term loan, a $125 million second-lien term loan and a $514.7 million holdco term loan facility.

Since the filing, there have been multiple disputes between the first- and second-lien lender groups. The Debtors' latest plan, which is scheduled for a confirmation hearing on May 12, 2025, aims to equitize the first-lien debt, with the second-lien lenders slated to receive little to no recovery.

On December 11, 2024, the Court approved a final DIP order (the "Final DIP Order") authorizing a $250 million new money DIP loan (extended by the first-lien lenders) over the objections of the second-lien agent. Importantly, the Final DIP Order both acknowledged that the Intercreditor Agreement would not be modified as a consequence of the Debtors' bankruptcy and that the bankruptcy court retained jurisdiction to enforce the terms of the Intercreditor Agreement. The Intercreditor Agreement broadly subordinates the second-lien lenders' interest in the collateral pledged by the Debtors (the "Collateral") to the liens of the first-lien lenders. Among other things, the Intercreditor Agreement prohibits the second-lien lenders from initiating any "Enforcement Actions" or, more broadly, collecting any proceeds of the Collateral prior to payment in full in cash of the first-lien lenders.

On February 13, 2025, the second-lien agent filed the Admin Claim Motion, asserting that, on the petition date, the second lien lenders were fully secured, and that the value of the second-lien lenders' collateral has substantially eroded during the bankruptcy such that the second-lien lenders are now wholly unsecured.

First-Lien Lenders' Complaint

The Complaint hinges on whether the Admin Claim Motion constitutes an Enforcement Action. Under the Intercreditor Agreement, an Enforcement Action is broadly defined to include "any action to . . . exercise [a] right or remedy, as a secured creditor or otherwise, pertaining to the Collateral at law, in equity, or pursuant to the . . . Second Lien Loan Documents." The first-lien lenders assert that the Admin Claim Motion breached the Intercreditor Agreement by improperly seeking to recover from the Collateral prior to the first-lien lenders being paid in full in cash. The first-lien lenders ground their claim in the fact that payment in full in cash can never occur due to the debt-for-equity swap that is proposed under the plan.

Interestingly, the Complaint fails to fully address how the terms of the Final DIP Order interact with the relief sought in the Admin Claim Motion. The Final DIP Order explicitly permits the second-lien lenders to seek adequate protection for the diminution in value of their Collateral in the form of a superpriority administrative claim. The Final DIP Order also preserves the priority scheme dictated by the Intercreditor Agreement. That agreement requires that the first-lien lenders be paid in full in cash prior to the second-lien lenders receiving any recovery, including on their alleged superpriority administrative adequate protection claim. Accordingly, notwithstanding any order granting the Admin Claim Motion, the second-lien lenders presumably would have to comply with the priority scheme in the Final DIP Order and the Intercreditor Agreement, each of which prohibits any payment to the second-lien lenders prior to the payment in full in cash of the first-lien lenders.

Notwithstanding that priority scheme, any order granting the Admin Claim Motion would provide the second-lien lenders with additional leverage in the form of a large administrative claim that the Debtors must satisfy or otherwise address in order to confirm their plan. The first-lien lenders are therefore motivated to oppose the Admin Claim Motion, since the administrative claim would need to be paid in full in cash to confirm the debt-for-equity plan that the first-lien lenders negotiated.

Impact

This Complaint represents a preemptive move by the first-lien lenders to prevent the second-lien lenders from pursuing certain adequate protection rights that arguably violate the Intercreditor Agreement and Final DIP Order. It is clear that, under the Intercreditor Agreement and Final DIP Order, prior to the payment in full in cash of the first-lien lenders, any payment to the second-lien lenders on account of their adequate protection superpriority claim is prohibited. What is less clear is whether merely *requesting* such a claim (but not receiving and retaining the proceeds of that claim) violates the priority scheme dictated by those documents.

Through the Complaint, the first-lien lenders allege that simply *seeking* an administrative claim for adequate protection qualifies as an improper Enforcement Action in violation of the Intercreditor Agreement. If the court rules in favor of the first-lien lenders, it could encourage senior creditors to broadly and preemptively take actions to bar junior creditors from taking *any* actions to protect their collateral in the course of a bankruptcy. However, if the court rules in favor of the second-lien lenders, such a ruling will embolden junior creditors to take actions in a bankruptcy to protect their interests in such a way that will not violate their obligations under any intercreditor agreement. The outcome of this dispute could impact not only confirmation of the Debtors' plan, but also the way that secured lenders draft intercreditor agreements going forward.

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