ALERT MEMORANDUM

Rough Justice: Third Circuit Holds Subordination Agreements May Be Superseded in Cramdown

August 31, 2020

A senior creditor can't always get exactly what it wants, or what it thought was owed under a subordination agreement, according to the U.S Third Circuit Court of Appeals (the "Third Circuit" or the "Court") in its recent decision in *In re Tribune Co.*,[1] when it affirmed the cramdown of media conglomerate Tribune Company's Chapter 11 plan of reorganization.[2]

In its August 26, 2020 opinion, the Court rejected arguments that the plan violated § 510(a) and § 1129(b)(1) of the Bankruptcy Code by failing to fully enforce a series of pre-petition debt subordination agreements and, in the alternative, that the plan unfairly discriminated against certain Senior Noteholders. Instead, the Court held that the cramdown provision of § 1129(b)(1) supersedes § 510(a) and "supplants strict enforcement of subordination agreements."[3] Taking a pragmatic approach rooted in case law, the Court also upheld the decisions of two lower courts that the plan did not unfairly discriminate against the Senior Noteholders that stood to gain from enforcement of the intercreditor agreements, and set forth principles for evaluating unfair discrimination under § 1129(b)(1), focusing on the "materiality" of the difference in recoveries in the absence of enforcement of the subordination provision. While the Third Circuit left it to lower courts to develop the boundaries of materiality, its decision emphasized the need for flexibility and a context-specific approach to cramdown reorganizations. Importantly, the Court's decision demonstrates that in certain circumstances, parties to a plan may be able to re-allocate amounts due under subordination agreements, as long as they are not too greedy.

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[1] No. 18-2909, 2020 WL 5035797 (3d Cir. Aug. 26, 2020).
[2] Technically, the appellants in the case are the Delaware Trust Company and Deutsche Bank Trust Company America, acting as successor indenture trustees and representing the interest of the Senior Noteholders. *Id.* at *2 n.2.
[3] *Id.* at *1.

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Background and Procedural History

Tribune Company ("Tribune") was once the largest media conglomerate in the United States. It counted among its assets the *Chicago Tribune*, the *Los Angeles Times*, and many regional newspapers, television, and radio stations. Tribune filed for Chapter 11 protection in 2008, approximately one year after a failed leveraged buyout ("LBO"). Prior to the LBO, Tribune had about $4 billion in debt and a market capitalization of approximately $8 billion.[4] Following the LBO, Tribune was left with almost $13 billion in debt and a complex capital structure.[5]

Tribune had incurred a complex web of billions of dollars in debt both over the course of decades and through its failed LBO. Among other debts, and most relevant to the Third Circuit's decision, at the time of filing Tribune owed $1.283 billion to certain Senior Noteholders who had loaned Tribune unsecured debt between 1992 and 2005.[6] Tribune had also issued two other sets of unsecured notes prior to filing for bankruptcy, which were contractually subordinated to its "Senior Indebtedness" or "Senior Obligations."[7]

In 2012, four years after Tribune filed its petition, the Bankruptcy Court confirmed the Third Amended Plan of Reorganization. The Bankruptcy Court confirmed the plan over the objections of the Senior Noteholders through the cramdown provision of the Bankruptcy Code, § 1129(b)(1). In their objection to confirmation, the Senior Noteholders argued that the plan violated § 1129(b)(1) by failing to fully enforce the terms of the subordination agreements, and by unfairly discriminating against them.[8]

The Bankruptcy Court first rejected the Senior Noteholders' argument that the plan could not be confirmed under § 1129(b)(1) unless it fully enforced the terms of the subordination agreements.[9] Based on prior decisions of other courts, the Bankruptcy Court found that the Senior Noteholders' interpretation of § 1129(b)(1) was unsupported by applicable case law.[10]

The Bankruptcy Court also rejected the Senior Noteholders' argument that the plan unfairly discriminated against them. Under the plan, the Senior Noteholders were given an equal distribution to a similarly situated class of creditors—33.6% of their allowed claim amounts.[11] However, the Senior Noteholders contended that they were the only parties entitled to benefit from the subordination agreements, and thus this equal treatment unfairly discriminated against them by allocating a portion of their recovery under those agreements to another class of creditors.[12]

To evaluate the Senior Noteholders' argument, the Bankruptcy Court adopted the "rebuttable presumption test." Under this test, a presumption of unfair discrimination exists where there is: (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class, or (b) a materially greater risk to the dissenting class in connection with its proposed distribution.[13] Applying this test, the Bankruptcy Court evaluated the materiality of the decrease in the Senior Noteholders' recovery under the plan as compared to their recovery if the subordination agreements were fully enforced and found that the decrease was less than 4% and, therefore, was not material.[14] Accordingly, the Bankruptcy Court held that the plan did not unfairly discriminate against the Senior Noteholders.

After a circuitous journey through the District Court and the Third Circuit, the District Court affirmed the

[4] *In re Tribune Media Company*, 587 B.R. 606, 610 (D. Del. 2018).
[5] 2020 WL 5035797 at *2.
[6] 2020 WL 5035797 at *2.
[7] *Id.*
[8] *In re Tribune Co., et al.*, 472 B.R. 223, 238 (Bankr. D. Del. 2012).
[9] *Id.* at 241.
[10] *Id.*
[11] *Id.* at 238.
[12] *Id.*
[13] *Id.* at 241.
[14] *See id.* at 244 (showing a decrease in recovery of either 4% or 6.5%, depending on whether the recovery was viewed in terms of percentage of recovery or in terms of amount recovered, and concluding that neither was material).

Bankruptcy Court's opinion in 2018.[15] The District Court agreed with the Bankruptcy Court that § 1129(b)(1) did not preclude confirmation of a plan that did not fully enforce the terms of a subordination agreement and that the plan did not unfairly discriminate against the Senior Noteholders.[16] The Senior Noteholders subsequently appealed this decision to the Third Circuit.

The Opinion

Reviewing the lower courts' interpretations of the Bankruptcy Code *de novo*, the Third Circuit first addressed the interplay between § 510(a) and § 1129(b) of the Bankruptcy Code. § 510(a) provides that pre-petition subordination agreements are enforceable in bankruptcy,[17] while § 1129(b) allows a court to confirm a plan over the objections of a dissenting class of creditors.[18]

Looking to the text of § 1129(b)(1), the Third Circuit held that the introductory phrase "[n]otwithstanding § 510(a)" means that § 1129(b)(1) "overrides § 510(a) because that is the plain meaning of '[n]otwithstanding.'"[19] Therefore, so long as a plan met all other requirements, a court could cram it down on a dissenting class "in spite of" or "without prevention or obstruction from" § 510 (a).[20] In effect, a court is not strictly required to abide by the terms of a pre-petition subordination agreement to confirm a plan. The Court also stated that the purpose of § 1129(b)(1) supported this interpretation, because it was intended to "provide the flexibility to negotiate a confirmable plan even when decades of accumulated debt and private ordering of payment priority have led to a complex web of intercreditor rights."[21]

The Third Circuit next turned to the Senior Noteholders' argument that the plan unfairly discriminated against them. After noting that the Bankruptcy Code does not define "unfair discrimination," the Court surveyed the four tests commonly used by courts to determine unfair discrimination, including the "rebuttable presumption" test adopted by the Bankruptcy Court and applied by the District Court below.[22] Importantly, the Court also explained that while it reviewed the Bankruptcy Court's choice of legal test *de novo*, it reviewed the Bankruptcy Court's application of the law to the facts only for clear error.[23]

The Court then articulated eight "principles" of unfair discrimination: (1) a subordination agreement need not be strictly enforced in a cramdown, so long as the allocation is not presumptively unfair (and, if so, the presumption is not rebutted); (2) unfair discrimination applies only to classes that dissent; (3) unfair discrimination is determined from the perspective of the dissenting class; (4) classes must be aligned correctly; (5) a court should measure recoveries in terms of net present value of all payments or the allocation of materially greater risk in connection with the proposed distribution; (6) a court should include subordinated sums in the plan distribution when comparing recovery between classes; (7) there is a presumption of unfair discrimination where there is a materially lower percentage recovery for the dissenting class or a materially greater risk to the dissenting class in connection with the proposed distribution, and; (8) a presumption of unfair discrimination may be rebutted.[24]

Applying those principles, the Court agreed with the Senior Noteholders that ordinarily, to determine whether a difference in recovery is "material," such that a presumption of unfair discrimination would exist, courts should compare the recovery percentages

[15] The Senior Noteholders' first appeal to the District Court was dismissed as moot. The Third Circuit subsequently overturned that dismissal and remanded the case to the District Court. On remand, the District Court affirmed the Bankruptcy Court's confirmation order. *In re Tribune Media Co.*, 587 B.R. 606 (D. Del. 2018).
[16] *Id.*
[17] 11 U.S.C. § 510(a).
[18] 11 U.S.C. § 1129(b)(1).
[19] 2020 WL 5035797 at *6.
[20] *Id.*
[21] *Id.*
[22] *Id.* at *8-9.
[23] *Id.* at *9. The Court did note however that even if it had applied *de novo* review, the result would have been the same.
[24] *Id.* at *9-11.

of the dissenting and preferred classes. However, the Third Circuit stated that was not required by the text of § 1129(b)(1).[25] The Court explained that in cases where a class-to-class comparison is difficult, as was true here, courts may opt to be "pragmatic" and compare the desired and actual recovery of the dissenting class.[26] Emphasizing that the Bankruptcy Court had departed from the preferred comparative approach, the Third Circuit nonetheless allowed that courts may have significant leeway in deciding how best to determine materiality given the circumstances of the case.[27] In affirming the Bankruptcy Court's decision that the difference was not material and there was no unfair discrimination, the Third Circuit stated that materiality "is a distinct and context-specific inquiry."[28]

Implications

The Third Circuit's decision makes clear that when a plan is crammed down under § 1129(b)(1), creditors may not be able to rely on strict enforcement of pre-petition subordination agreements and could be left with lower recoveries than they had contracted to receive. Indeed, the Court specifically states that the Bankruptcy Code does not require courts to enforce the terms of subordination agreements strictly. The safeguard the Court left open, however, is that creditors may assert unfair discrimination when a plan disregards the terms of a subordination agreement in a material way. Although the Court declined to set clear boundaries on materiality here, at the very least its decision suggests that a difference of a few percentage points is likely immaterial and would be acceptable. Indeed, the Bankruptcy Court considered the outer limit of a material difference to be 4% and the Third Circuit did not overturn that as per se unreasonable.[29]

The Third Circuit stated that unfair discrimination is "rough justice" and its decision is meant to balance the flexibility required to increase the likelihood of plan confirmation with the rights of creditors, both within Chapter 11 and under pre-filing contractual arrangements. Ultimately, the Court embraces a pragmatic approach to unfair discrimination and materiality considerations. As a result, so long as a plan proponent does not attempt to push beyond the bounds of reasonability in attempting to reallocate amounts due under subordination agreements, courts are likely to accept some deviation if it moves a plan a step closer towards confirmation. The decision may have lasting implications for pricing and expectations for creditors who may seek to rely on and enforce pre-petition subordination agreements in reorganization proceedings for companies with complex capital structures.

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[25] *Id.* at *11.
[26] *Id.*
[27] *See id.* at *12.
[28] *Id.*
[29] *See In re Tribune Co., et al.*, 472 B.R. 223, 244 (Bankr. D. Del. 2012).