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Your Subordination Agreement Need Not Be Enforced Strictly in a Cram-Down Plan, Says the Third Circuit Court of Appeals[1]

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Synopsis

The US Third Circuit Court of Appeals, in the latest decision stemming from lengthy chapter 11 bankruptcy cases of the Tribune Company ('Tribune'),[2] provided guidance on the enforceability of intercreditor agreements in the context of a 'cramdown' plan of reorganisation (where the plan is binding on a dissenting class of creditors) under the US Bankruptcy Code (the 'Bankruptcy Code').[3] The Court held that subordination provisions, like those found in many intercreditor agreements, 'need not be strictly enforced' under the terms of cram-down plans, provided that the other statutory requirements for approval (referred to as 'confirmation') of cramdown plans are met, including that such plans do not 'unfairly discriminate' against dissenting classes of creditors. The Court further held that courts are not required, when conducting an analysis of unfair discrimination, to compare recoveries under a plan of reorganisation on a class-to-class basis, but rather, in certain circumstances, may compare the desired recovery of the dissenting class to its actual recovery.

I. Background

A. Intercreditor agreements

When a borrower has different debt obligations to two or more different groups of creditors, such creditors will often enter into an intercreditor agreement. The intercreditor agreement sets forth the respective rights and obligations of each creditor group with respect to the borrower and its assets. In addition to addressing lien subordination (in the case of secured creditors) or payment subordination among groups of creditors, intercreditor agreements may include a number of other provisions, such as those relating to the right to declare defaults and grant waivers, amendments to the financing agreements, foreclosure (in the case of secured creditors), and certain bankruptcy waivers. Such agreements are generally entered into by the parties in connection with a borrower's financing transaction and are in effect prior to a borrower's bankruptcy filing.

B. Relevant US Bankruptcy Code provisions

At the core of an intercreditor agreement are the subordination provisions entitling a certain group of creditors to priority over another group of creditors. Such provisions generally take the form of lien subordination and/or payment subordination in intercreditor agreements, resulting in a higher ranking of a senior creditor group's claims with respect to payment. Courts routinely enforce the subordination provisions of intercreditor agreements in the bankruptcy context pursuant to section 510(a) of the Bankruptcy Code, which provides that a subordination agreement is enforceable in bankruptcy to the same extent it is enforceable under applicable nonbankruptcy law.[4] Practically, this means that a subordinated group of creditors may not receive any recovery under a plan of reorganisation, even if it would otherwise be entitled to it, if the intercreditor agreement prohibits any such recovery – for example, where subordinated creditors can only be paid if the senior creditors are first paid in full. The Third Circuit's latest ruling, however, creates some uncertainty about the extent of the enforcement of subordination provisions in a cram-down plan scenario.[5]

Cram-down plans of reorganisation can be confirmed over the objection of a dissenting class of creditors if certain statutory requirements have been met (*i.e.*, the terms of the plan are 'crammed down' on the dissenting class). Specifically, section 1129(b)(1) of the

Notes

1 The views expressed herein are solely those of Maja Zerjal Fink and Ginger Clements, and not necessarily the views of Arnold & Porter Kaye Scholer LLP or any of its attorneys.
2 *In re Tribune Company*, 972 F.3d 228 (3rd Cir. 2020).
3 11 U.S.C. §§ 101, et al.
4 *See* 11 U.S.C. § 510(a).
5 *Tribune*, 972 F.3d at 233.

Bankruptcy Code provides if all of the requirements for confirmation of a plan under the Bankruptcy Code are met, *except for acceptance of the plan by each class* of impaired creditors,[6] a plan can still be confirmed if such plan does not 'discriminate unfairly' and is 'fair and equitable' for each class of dissenting impaired creditors under the plan.[7] Essentially, the cram-down provision in section 1129(b)(1) waives the Bankruptcy Code's 'mandate that all classes vote to accept the plan or recover their debt in full under it.'[8]

As it relates to intercreditor agreements, the cram-down provision in section 1129(b)(1) provides that a cram-down plan can be confirmed '[n]otwithstanding section 510(a).'[9] Despite the common use of the cram-down mechanism to confirm plans of reorganisation, only one court had reviewed its interplay with section 510(a) prior to the *Tribune* decision – and no Circuit court had done so.[10] Thus, in its decision, the Third Circuit court provided new instruction as to the enforcement of intercreditor agreements in the cram-down plan context, as detailed below.

II. Case background

Prior to the filing of its bankruptcy in December 2008, Tribune was the largest American media conglomerate.[11] At the time of its filing, it was the largest bankruptcy in the history of the American media with debt of nearly $13 billion.[12]

While Tribune's capital structure was complex, only unsecured claims were at issue on appeal. Tribune's capital structure contained several different types of unsecured claims, including certain senior debt, consisting of senior noteholders (the 'Senior Noteholders') and a swap claim, subordinated notes, trade claims, and retiree obligations. The subordinated notes consisted of two separate issuances of unsecured notes, and the indentures for each of those issuances of notes contained subordination provisions, which subordinated their repayment to that of senior obligations (collectively, the 'Senior Obligations') (subject to certain nuances).[13] The Senior Noteholders' claims constituted Senior Obligations, and thus, their recovery was senior to that of holders of the subordinated notes.[14]

The Senior Noteholders' claims comprised one class under the plan of reorganisation (Class IE), and the swap, trade, and retiree claims comprised a separate class under the plan (Class IF).[15] A summary of the recovery (measured as a percentage of total claim amount) for Classes IE and IF under the plan, as stipulated by the parties, is as follows:[16]

Stipulated Recovery Percentage	Class 1E (Senior Noteholders)	Class 1F (Swap)	Class 1F (Trade and Retirees)
Under the plan (Classes 1E and 1F benefit from subordination)	33.6%	33.6%	33.6%
Before subordination of junior unsecured notes	21.9%	24.4%	21.9%
If only Class 1E and swap claim benefit from subordination	34.5%	36.9%	21.9%

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6 '"Impaired" means a creditor whose rights under a plan are altered (obviously adversely).' *Id.* at 232.

7 11 U.S.C. § 1129(b)(1).

8 *Tribune*, 972 F.3d at 237.

9 11 U.S.C. § 1129(b)(1).

10 *See Tribune*, 972 F.3d at 238 ('To date, we are aware of only one court that has spoken in a published opinion to the effect of § 1129(b)(1)'s notwithstanding proviso.') (citing *In re TCI 2 Holdings*, 428 B.R. 117, 141 (Bankr. D.N.J. 2010)).

11 *Tribune*, 972 F.3d at 233 ('Prior to its bankruptcy, Tribune was the largest media conglomerate in the country, reaching 80% of American households each year. It owned the *Chicago Tribune* and the *Los Angeles Times*, as well as many regional newspapers, television and radio stations.').

12 David Carr, *At Sam Zell's Tribune, Tales of a Bankrupt Culture*, The New York Times (Oct. 5, 2010) (retrieved Feb. 24, 2020).

13 *Id.* at 233–34.

14 *Id.* at 235. The District Court found that the swap claim was a senior obligation whose recovery was also senior to that of holders of the subordinated notes, which the Senior Noteholders did not contest on appeal. *Id.* at 236.

15 *Id.* at 234. *See also Fourth Amended Joint Plan of Reorganization for Tribune Company and Its Subsidiaries Proposed by the Debtors, the Official Committee of Unsecured Creditors, Oaktree Capital Management, L.P., Angelo, Gordon & Co., L.P., and JPMorgan Chase Bank, N.A. (As Modified July 19, 2012)*, Case No. 08-13141 (KJC) § 3.

16 *See Tribune*, 972 F.3d at 235.

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Under the plan, both Class IE and Class IF received a 33.6% recovery on their claims. Due to the subordination provisions in the subordinated notes indentures, the subordinated notes received no recovery since the senior claims were not paid in full, and the amount of recovery that holders of subordinated notes would have received (if not for the subordination provisions in the indentures) was allocated to Class 1E and Class 1F.[17]

The allocation of the recoveries of holders of subordinated notes to Class 1E and Class 1F increased the recovery to Class 1F (Trade and Retirees) from 21.9% to 33.6%.[18] However, if only Class 1E (Senior Noteholders) and the swap claim (in other words, only holders of Senior Obligations) received the subordinated note recoveries, in line with a strict enforcement of the intercreditor agreement, then the Senior Noteholders' recovery would have increased 0.9%: from 33.6% to 34.5%. In other words, the allocation of the subordinated noteholders' recoveries between Class 1E and Class 1F resulted in a larger percentage recovery increase to holders of trade and retiree claims than to the Senior Noteholders because of the difference in size of the claim pool for each – the Senior Noteholders held nearly $1.3 billion in claims while the trade and retiree creditors held nearly $114 million in claims.[19]

In light of these facts, the Senior Noteholders maintained that the plan of reorganisation violated section 1129(b)(1) because (1) it did not strictly enforce the subordination provisions of the subordinated notes indentures pursuant to section 510(a) of the Bankruptcy Code by allocating subordinated notes recovery to holders of trade and retiree claims – which the Senior Noteholders maintained were not Senior Obligations – as well as holders of Senior Obligations,[20] and (2) in the alternate, it unfairly discriminated against the Senior Noteholders.[21]

The US Bankruptcy Court for the District of Delaware confirmed the company's plan of reorganisation in 2012 over the dissenting votes of the Senior Noteholders. The Senior Noteholders first appealed confirmation of the plan in 2012 and, since that time, have been engaged in a protracted appeals process, culminating in their second appeal to the Third Circuit Court and the ruling discussed herein.[22]

III. Third Circuit Court's analysis

A. 'Notwithstanding section 510(a)'

As mentioned above, the cram-down provision in section 1129(b)(1) provides that a plan can be confirmed '[n]otwithstanding section 510(a).'[23] The Senior Noteholders contended that this clause meant subordination agreements cannot be interfered with in cram-down cases. The Third Circuit Court flatly rejected this argument, holding the plain meaning of section 1129(b)(1) to be that 'subordination agreements need not be strictly enforced for a court to confirm a cram-down plan.'[24] The Court noted that the purpose of the cram-down mechanism in the Bankruptcy Code affirms its holding – the cram-down provision in section 1129(b)(1) allows a court to confirm a plan, despite a dissenting class, if it protects the interests of such dissenting class.[25]

B. Unfair Discrimination

The protections afforded a dissenting class in the context of a cram-down plan include that the plan cannot 'discriminate unfairly' against the dissenting class and that 'it is fair and equitable' with respect to such class.[26] As 'fair and equitable' relates to 'priority among classes of creditors having higher and lower priorities' (without giving effect to subordination agreements) it was not at issue in this case – all debt at issue on appeal were unsecured claims.[27] 'Unfair discrimination', however, is a 'horizontal comparative assessment applied to similarly situated creditors (here unsecured creditors) where a subset of those creditors is classified separately, does not accept the plan, and claims inequitable treatment under it.'[28] The unfair discrimination standard is meant to ensure 'that a dissenting class will receive

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17 *Id.* at 234.

18 'Understandably, Class 1F voted overwhelmingly for the DCL Plan.' *Brief for Appellants Law Debenture Trust Company of New York & Deutsche Bank Trust Company Americas*, Case No. 14-3333 [Docket No. 1] at 5.

19 *Id.* at 244–45.

20 The retirees contended that their claims were Senior Obligations as well, and thus, entitled to payment prior to the subordinated notes claims; however, the Court did not need to resolve this issue or to remand for its resolution. *Id.* at n. 8.

21 *Id.* at 232.

22 *Id.*

23 § 1129(b)(1).

24 *Tribune*, 972 F.3d at 239.

25 *Id.* at 238.

26 *Id.*

27 *Id.* at 232, 238.

28 *Id.* at 232 (citing Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 Am. Bankr. L.J. 272, 227–28 (1998)).

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relative value equal to the value given to all other similarly situated classes.'[29]

1. Standard

The Bankruptcy Code itself does not prescribe a means of evaluation for the unfair discrimination standard. The Third Circuit Court analysed each of the four tests that courts have used to date,[30] as well as the principles framing the unfair discrimination standard before ultimately applying the 'rebuttable presumption' test.[31] Under the rebuttable presumption test, the following circumstances give rise to a presumption of unfair discrimination:

i. a dissenting class;

ii. another class of the same priority; and

iii. a difference in the plan's treatment of the two classes that results in either of the following:

    a. a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or

    b. regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.[32]

The presumption of unfair discrimination can be rebutted under the rebuttable presumption test if the court finds that 'a lower recovery for the dissenting class is consistent with the results that would obtain outside of bankruptcy, or that a greater recovery for the other class is offset by contribution from that class to the reorganization [of the company].'[33] A presumption of unfair discrimination based on differing risk profiles for recovery may be rebutted if a court finds that 'the risks are allocated in a manner consistent with the prebankruptcy expectations of the parties.'[34]

2. Application in *Tribune*

The rebuttable presumption test for assessing unfair discrimination requires a court to determine if the dissenting class received a *materially* lower percentage recovery than that of similarly situated creditors in other classes.[35] In *Tribune* the Senior Noteholders asserted that the original analysis conducted by the bankruptcy court to determine unfair discrimination was flawed. In that analysis, the bankruptcy court compared the Senior Noteholders' recovery under the plan of reorganisation to the recovery they would receive if the subordinated notes' recovery was allocated only to their class and the swap claim.[36] Finding a difference in percentage recovery of *only 0.9%* (33.6% versus 34.5%), the bankruptcy court determined that such difference was not a materially lower, and thus, there was no unfair discrimination.[37] The Senior Noteholders maintained that the bankruptcy court should have compared their recovery to that of the junior creditors in Class 1F (trade and retirees) to assess whether the difference in treatment is material.[38]

In reviewing the bankruptcy court's analysis, the Third Circuit Court found that in circumstances where a class-to-class comparison is difficult (as was the case in *Tribune* where the swap claim in Class 1F was entitled to benefit from subordination but the other claims in Class 1F were not to benefit from such subordination), a court may be 'pragmatic' and evaluate instead a dissenting class' desired recovery against its actual recovery under the plan to determine the magnitude of its differing treatment.[39] The Court cautioned that such an approach is not the preferred means of assessing unfair discrimination, however.[40]

The Court agreed with the lower courts that the difference in the Senior Noteholders' desired recovery and actual recovery (0.9%) is not material. Therefore, the Court held that the plan does not unfairly discriminate against the Senior Noteholders. Notably, the court expressly declined to opine on the threshold for

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29 *Tribune*, 972 F.3d at 240 (quoting *In re Armstrong World Indus., Inc.*, 348 B.R. 111, 121 (D. Del. 2006)).

30 *See Tribune*, 972 F.3d at 240–44. These four tests are the mechanical test, the restrictive test, the broad test, and the rebuttable presumption test. 'The "mechanical" test prohibits all discrimination, that is, it requires that similarly situated creditors' recoveries be 100% pro rata.' *Id.* at 240. 'The "restrictive" approach narrowly defines unfair discrimination such that, "[i]n the absence of subordination … no disparate treatment of similarly situated creators would qualify."' *Id.* (internal citations omitted). The broad test 'considers whether: (1) a reasonable basis for discrimination exists; (2) the debtor cannot consummate its plan without discrimination; (3) the discrimination is imposed in good faith; and (4) the degree of discrimination is directly proportional to its rationale.' *Id.* at 240–41. The rebuttable presumption test is described in more detail *infra*.

31 *Id.* at 244.

32 *Id.* (citing *Markell*, *supra*, at 228, 249).

33 *Tribune*, 972 F.3d at 241 (quoting *Markell*, *supra*, at 228).

34 *Id.*

35 *Tribune*, 972 F.3d at 244 (emphasis added).

36 *Id.*

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

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materiality though – instead instructing that courts should consider it on a case-by-case basis.[41]

IV. Potential implications of the Third Circuit's decision

The *Tribune* decision has interesting potential implications in the realm of intercreditor agreements. The Court's holding that cramdown plans of reorganisation need not strictly enforce subordination agreements is couched in the limits of the unfair discrimination and fair and equitable standards of section 1129(b)(1). The Court stressed the pragmatism of this approach, a sort of 'rough justice', and noted the Bankruptcy Code's propensity toward flexibility, when such flexibility increases the odds of negotiating and confirming a plan of reorganisation.[42] But the extent of such flexibility remains uncertain for both debtors in trying to craft confirmable plans, as well as lenders in seeking to enforce their pre-bankruptcy intercreditor arrangements.

For example, from the perspective of a borrower in bankruptcy contemplating its plan of reorganisation, subordination via intercreditor agreements may present a large source of potential recovery for senior creditors. Given the *Tribune* decision, the borrower may now strategically consider the allocation of this pool of subordinated recovery among similarly situated creditors – whether senior pursuant to the intercreditor agreement or not. As the Senior Noteholders cautioned in their appeal to the Court, a 'Robin Hood' system could arise, in which a large amount of the subordinated recovery pool may be reallocated from a large dissenting creditor class to a smaller creditor class without violating the unfair discrimination standard of the cram-down mechanism of the Bankruptcy Code.[43] Essentially, such a system permits a debtor to favor a smaller creditor class (which receives a larger percentage recovery increase) at the expense of a large dissenting creditor class (which experiences a relatively small reduction in recovery).

Additionally, the *Tribune* decision leaves open the question of materiality with respect to differing percentage recoveries under the unfair discrimination test. If 0.9% wasn't material in *Tribune*, would it be material in a different set of circumstances? And what would be obviously material, 5%, 10%? Complicating this further, the Third Circuit Court dismissed the materiality analysis undertaken by the bankruptcy court, in which it looked to other cases comparing the differences in recovery between the dissenting class and the preferred class as a baseline for its materiality determination, as inapplicable to the framework used by the bankruptcy court to determine such differences.

The *Tribune* decision also paves the way for changes in the negotiation of intercreditor agreements entered into prebankruptcy. Senior creditors will likely endeavor to include protective provisions in intercreditor agreements in light of the *Tribune* decisions; meanwhile, borrowers will likely aim to limit any such protections and remove any other barriers in intercreditor agreements that could impede a smooth application of the cramdown mechanism as interpreted by *Tribune*.

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41 *Id.*

42 *Id.* 'It provides 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. It also attempts to ensure that debtors and courts do not have carte blanche to disregard prebankruptcy contractual arrangements, while leaving play in the joints.' *Id.* at 238.

43 *See Brief for Appellants Law Debenture Trust Company of New York & Deutsche Bank Trust Company Americas*, Case No. 14-3333 [Docket No. 1] at 43.

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