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On the Edge

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Third Circuit's Warning Shot to Senior Creditors in *In re Tribune*

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Subordination agreements are a vehicle for implementing subordinated-debt financing, "an integral source of capital for the business community"[1] and often the centerpiece of complex chapter 11 cases. Subordination agreements typically take the form of either debt subordination, in which amounts that the subordinated creditor would otherwise be entitled to receive must be turned over to the senior creditor until the senior creditor's claim is fully satisfied, or lien subordination, which adjusts the priority of the respective liens of the parties and restricts a junior lienholder's lien-enforcement rights until payment of the senior secured debt.[2]

From the time of its enactment in 1979, the Bankruptcy Code has provided that a "subordination agreement is enforceable ... to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[3] For much of the past four decades, it was generally acknowledged that an intercreditor agreement containing a subordination provision was "an enforceable contract under § 510(a), and [bankruptcy courts] will not disturb the bargained-for rights and restrictions governing [subordinated] debt."[4]

Judicial reluctance to enforce subordination agreements has traditionally been limited to issues of the adequacy of definitions of the junior and senior debt; the "rule of explicitness" that makes the subordination complete to the full and final payment of the senior debt, including interest, fees and other charges that may accrue pre- or post-petition; and the enforceability of ancillary provisions, such as the grant to a senior creditor of the right to vote the junior creditor's claim in the plan process.[5] However, commentators[6] have noted that uncertainty remained as to the interplay between § 510(a) and the chapter 11 cramdown powers based on the introductory phrase "[n]otwithstanding section 510(a) of this title" in § 1129(b)(1).[7] Few courts had spoken to the issue in published decisions, with one being a Third Circuit bankruptcy court that relied on the "[n]otwithstanding" language to confirm a plan that ignored lien-subordination rights,[8] and a second bankruptcy court adopting the same interpretation in what is arguably *dicta*.[9]

In *In re Tribune Co.*,[10] the Third Circuit Court of Appeals weighed in on the issue, concluding that the cramdown provisions of § 1129(b) override § 510(a) and permit confirmation of a chapter 11 plan that deviates from strict enforcement as long as the deviation does not "unfairly discriminate" against the rights of the dissenting senior creditor class. The Third Circuit's ruling provides precedent to debtors within the Third Circuit, and a point of reference outside the circuit, for leveraging the position of senior subordinated creditors and altering the dynamics of prebankruptcy negotiations.

The *Tribune* Opinion

Tribune Co. was the largest media conglomerate in the nation and by the time of its chapter 11 filing in 2008 had amassed almost $13 billion of debt,[11] capped off by a failed 2007 leveraged buyout that

1 Cameron M. Fee, "Disenfranchisement Under Section 510(a) of the Bankruptcy Code," 90 *Am. Bankr. L. J.* 467, 468 (2016).
2 C. Edward Dobbs, "Negotiating Points in Second Lien Financing Transactions," 4 *DePaul Bus. & Com. J.* 189, 230 (2006).
3 11 U.S.C. § 510(a).
4 *Ion Media Networks Inc. v. Cyrus Select Opportunities Master Fund Ltd. (In re Ion Media Networks Inc.)*, 419 B.R. 585, 595 (Bankr. S.D.N.Y. 2009).
5 Dobbs, *supra* n.2 at 222, n.65.
6 *See* 4 Lawrence P. King, *Collier on Bankruptcy* ¶ 510.03[3] n.20 (16th ed. 2009); Kenneth N. Klee, "Adjusting Chapter 11: Fine Tuning the Plan Process," 69 *Am. Bankr. L. J.* 551, 561 (1995).
7 11 U.S.C. § 1129(a)(1).
8 *In re TCI 2 Holdings LLC*, 428 B.R. 117, 141 (Bankr D.N.J. 2010) (internal citations omitted).
9 *In re Croatan Surf Club LLC*, No. 11-00194-8-SWH, 2011 Bankr. LEXIS 4517, at *4-5 (Bankr. E.D.N.C. Oct. 25, 2011).
10 972 F.3d 228 (3d Cir. 2020).
11 Brief for Appellee Tribune Co. Retirees at 6, *In re Tribune Co.*, No. 18-2909 (3d Cir. Jan. 24, 2019).

more than doubled its debt load.[12] The result was a complex capital structure that included, among other debt, $1.283 billion of unsecured debt that was owed to the "senior noteholders" and required to be paid prior to the subordinated debt;[13] and approximately $1.48 billion of expressly subordinated debt (subordinated debt) and certain other unsecured debt, including (1) a $150.9 million "swap claim," (2) $105 million of unsecured claims held by "retirees," and (3) $8.8 million of debt owed to trade creditors (collectively the other unsecured claims).[14]

The *Tribune* case was famously contentious, marked by intensive litigation, more than a half billion dollars in professional fees, and the consideration of competing chapter 11 plans. The prevailing plan placed the senior noteholders' claims in Class 1E and the other unsecured claims in Class 1F,[15] paying each class a flat 33.6 percent of the claims. The 33.6 percent distribution to Class 1F was achieved through the reduction of the amount payable to the senior noteholders under their subordination rights.

The senior noteholders objected to the plan on the grounds that it contravened both §§ 510(a) and 1129(b)(1) by not enforcing the subordination agreements and allowing certain unsecured creditors to reap benefits of subordination to which they were not entitled. If confirmed, they argued that creditors in Class 1F would ultimately receive $30 million that would otherwise have been paid to the senior noteholders.[16]

The U.S. Bankruptcy Court for the District of Delaware confirmed the plan, ruling first that the swap claim was a senior obligation (reducing the amount of arguably diverted funds to $13 million) and second, as to the retirees and trade creditors, that the introductory clause to the cramdown provisions of § 1129(a) did not require strict enforcement of subordination rights and the increased distribution to these claimants complied with the cramdown provisions of § 1129(a) in that it did not "unfairly discriminate" against the rights of the dissenting senior noteholders. The district court ultimately affirmed the decision by adopting the same reasoning, and the opinion was appealed to the Third Circuit.

On appeal, the senior noteholders argued that the lower court's exclusionary interpretation resulted in "textual anomalies" and was the type of "hyperliteral" reading rejected by the U.S. Supreme Court in *RadLAX Gateway Hotel LLC v. Amalgamated Bank*[17] when construing a different portion of § 1129(b)(1).[18] The exclusionary interpretation was argued to conflict with the next phrase in the statute that requires compliance with all aspects of § 1129(a) other than (a)(8) (the consent of impaired classes) and requires that "the plan complies with all applicable provisions of the title," including enforcement of subordination agreements under § 510(a). The senior noteholders noted that "[t]here is no basis in Section 1129(b)(1)'s text for reading it to excuse cramdown plans from enforcing subordination agreements while at the same time requiring courts to consider whether failing to enforce those agreements constitutes unfair discrimination."[19]

The point was made that it was an "absurd result to read Section 1129(b)(1) to excuse the enforcement of subordination agreements if and only if their beneficiaries dissent from a reorganization plan,"[20] the very situation in which enforcement is meaningful. Offering an alternative, "holistic" construction, the senior noteholders argued that the natural and ordinary meaning of the word "notwithstanding" was that it modified both the "unfair discrimination" and "fair and equitable" tests to make clear that a plan's enforcement of a subordination agreement — which reallocates recoveries among creditors and calls for a departure from otherwise applicable priorities — does not cause such plan to fail either test.[21] Affirming the district court and rejecting the senior noteholders' argument, the Third Circuit held:

> [Section] 1129(b)(1) overrides § 510(a) because that is the plain meaning of "[n]otwithstanding." Thus our holding becomes simple: Despite the rights conferred by § 510(a), "if all of the applicable requirements of [11 U.S.C. § 1129(a)] are met with respect to a plan, the court ... shall confirm the plan ... if [it] does not discriminate unfairly, and is fair and equitable," for each impaired class that does not accept the plan.[22]

The court concluded that cramdown "provides the flexibility to negotiate a confirmable plan"[23] and also "attempts to ensure that debtors and courts do not have *carte blanche* to disregard pre-bankruptcy contractual arrangements, leaving play in the joints."[24]

Applying the cramdown provisions, the Third Circuit first concluded that the fair-and-equitable test was not applicable because no secured claims were involved,[25] although the senior noteholders argued that the plan "blatantly violated" this test unless the vertical priorities established under the subordination agreement were ignored.[26] Narrowing the focus to the unfair-discrimination test, the Third Circuit surveyed four tests historically used by courts and derived its own eight guiding principles, which included: relief from strict enforcement of subordination agreements; applicability to dissenting classes, not individual creditors; determination from the perspective of the dissenting class; need for proper class alignment; measurement based on net present value of all payments; establishment of a *pro rata* baseline and then comparison to what entitlement would occur under full enforcement of subordination; a presumption of unfair discrimination if there is a materially lower percentage of recovery or a materially greater risk to the dissenting class; and the right to rebut the presumption.[27]

The Third Circuit rejected the need to conduct a class-to-class comparison of distributions, given the uncertainty over which creditors in Class 1F would have qualified as senior obligations under the subordinated notes. In such cases where a class-to-class comparison would prove dif-

12 *Id.*
13 *In re Tribune Co.*, 972 F. 3d 228, 2020 U.S. App. LEXIS 27157, at *2 (3d Cir. Aug. 26, 2020).
14 *Id.* at *6.
15 *Id.* at *7.
16 *Id.* at *8; *see also In re Tribune Co.*, No. 08-13141, *slip op.* at 2 (Bankr. D. Del. April 9, 2012).
17 566 U.S. 639 (2012).
18 Brief for Appellants Delaware Trust Co. & Deutsche Bank Trust Co. Americas at 21, *In re Tribune Co.*, No. 18-2909 (3d Cir. Dec. 11, 2018); Transcript of Oral Argument at 11, *In re Tribune Co.*, No. 18-2909 (3d Cir. Nov. 12, 2019).
19 Brief for Appellants, *supra* n.16 at 22.
20 *Id.* at 32.
21 *Id.* at 23.
22 *In re Tribune Co.*, 2020 U.S. App. LEXIS 27157, at *14.
23 *Id.* at *15.
24 *Id.* at *17.
25 *Id.* at *14.
26 Brief for Appellants, *supra* n.16 at 25, n.4.
27 *In re Tribune Co.*, 2020 U.S. App. LEXIS 27157, at *19 (quoting *In re Armstrong World Indus. Inc.*, 348 B.R. 111, 121 (D. Del. 2006)).

ficult, the Third Circuit said that a bankruptcy court could "opt to be pragmatic and look to the discrepancy between the dissenting class desired and actual recovery to gauge the degree of its different treatment."[28] Applying this analysis, the Third Circuit noted the disparity between the value of the senior noteholders' claims ($1.283 billion) compared to the retirees' claims ($105 million) and the trade creditors' claims ($8.8 million). This disparity meant that "increases in the recovery percentage for the Retirees' and Trade Creditors' claims from reallocated subordinated amounts [11.7 percent] result in only a minimal reduction of the recovery percentage for the Senior Noteholders [0.9 percent]."[29]

Based on this disparity, the Third Circuit concluded that the difference in the senior noteholders' recovery under strict enforcement of the subordination provisions and under the plan was "not material," and "[a]lthough the Plan discriminates, it is not presumptively unfair when understood ... that a cramdown plan may reallocate some of the subordinated sums."[30] The Third Circuit declined to address the outer boundaries of what constitutes a "material" difference in a creditor's recovery, ruling narrowly that "nine-tenths of a percentage point ... is, without a doubt, not material."[31]

Significance of *Tribune*

The *Tribune* decision has significance for both the billions of dollars of existing subordinated debt in the marketplace and the future availability, structure and pricing of funding that is premised on contractual subordination. Within the Third Circuit, chapter 11 debtors may reallocate the benefits of debt-subordination agreements through cramdown if the deviation does not result in material unfairness based on a "context-specific inquiry." The range of acceptable measures for determining the "magnitude of damage" to the dissenting class has no definite boundaries and is premised on the existence of "certain circumstances" that are open to interpretation. All of this creates an option for a chapter 11 debtor to reallocate benefits to some degree, and uncertainty for lenders who have historically relied on subordination agreements in offering secured and unsecured financing.

Future judicial development will have to address the application of *Tribune* to lien-subordination agreements. When the issue is the relative priority of liens under a plan, questions exist as to if and how the *Tribune* analysis will excuse strict enforcement while still limiting deviation from such priorities under either the unfair-discrimination test, which by design only compares classes with identical priority, or the fair-and-equitable test, which is arguably violated unless one ignores the contractual vertical priorities created by subordination. Prior to the *Tribune* opinion, the bankruptcy court's solution in *In re TCI 2 Holdings LLC*[32] was to ignore the lien-subordination agreement in confirming the plan, expressly leaving the first and second lienholders to sort out their priority dispute outside of bankruptcy.[33] Does *Tribune*, which stated that *TCI 2* was aligned with its opinion,[34] require a different analysis? Does a disregard of contractual lien priorities in cramdown potentially lead to conflicting determinations of the relative lien priorities in the pre- and post-confirmation periods of the case? Does a plan that disregards lien priorities potentially trigger constitutional limitations on the taking of property? Furthermore, does the cramdown of the plan have any impact on private rights of action, which were expressly left intact in *TCI 2* but not addressed in *Tribune*?

As we await further judicial development, lenders will be left to evaluate responsive measures. Lenders may act to strengthen provisions in subordination agreements requiring turnover of recoveries received by subordinated creditors and enhance lien-subordination language that subordinates the junior secured party's right to payment from proceeds of a first lienholder's collateral until the first lienholder is paid in full. The issue of forum-selection may become a significant negotiation point when a debtor seeks cooperation from the senior creditors in advance of filing. Once a chapter 11 is filed, senior creditors' strategy may place greater emphasis on pre-confirmation action in bankruptcy and third-party actions outside a bankruptcy to blunt the potential for cramdown of subordination rights.

The *Tribune* case also provides food for thought for debtor's counsel in planning a chapter 11 filing. Loosening enforceability of subordination agreements offers the debtor additional leverage in prebankruptcy negotiations. However, the *Tribune* case is an abject lesson that such a battle involves considerable cost to obtain confirmation when a less drastic option might achieve the desired result. The necessity and wisdom of the tactic may also be difficult to assess at the outset of the case when the ultimate requisites of a confirmable plan are unclear. Any potential benefit gained from a subordination fight is also diminished if the private rights of action remain intact, perhaps making involuntary reallocation a pyrrhic victory that neither achieves equity nor efficiency. Time and judicial development will tell whether any of these concerns are overstated or understated. abi

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28 *Id.* at *28-29.
29 *Id.* at *30.
30 *Id.*
31 *Id.* at *31.
32 428 B.R. 117 (Bankr D.N.J. 2010).
33 *In re TCI 2 Holdings LLC*, 428 B.R. at 139-41.
34 *In re Tribune Co.*, 2020 U.S. App. LEXIS 27157, at *15.