August 31, 2020

"Rough Justice": The Third Circuit Weighs in on Unfair Discrimination and Enforcement of Subordination Agreements under Cramdown Plans

In a decision arising out of Tribune's 2008 bankruptcy, the United States Court of Appeals for the Third Circuit recently issued a decision affirming confirmation of the media conglomerate's chapter 11 plan over objections raised by senior noteholders who contended that the plan violated their rights under the Bankruptcy Code by not according them the full benefit of their prepetition subordination agreements with other creditors. In reaching this conclusion, the Third Circuit sided with the Bankruptcy and District Courts, finding that the text of the "cramdown" provision, section 1129(b)(1)[1] of the Bankruptcy Code, "supplants strict enforcement of subordination agreements." Rather, in such circumstances, the Third Circuit held that "when cramdown plans play with subordinated sums, the comparison of similarly situated creditors is tested through a more flexible unfair-discrimination standard."

Background

Following a failed leveraged buyout transaction, Tribune filed for chapter 11 relief in 2008. In addition to $1.283 billion owed to its senior noteholders, whose indenture included covenants requiring that their claim be paid before any other debt of the company, Tribune had also issued approximately $1.2 billion of unsecured debentures and $225 million of unsecured notes. Tribune's other unsecured debt included $150.9 million of swap claims (the "Swap Claims"), $105 million of claims by certain retirees (the "Retirees") and $8.8 million of trade and miscellaneous creditors (the "Trade Creditors"). While these unsecured creditors would otherwise be of equal priority vis-à-vis each other, the indentures for the unsecured debentures and unsecured notes included subordination provisions that limited their repayment until all "Senior Obligations" (including the senior notes) were paid in full.

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[1] Judge Ambro, writing for the three-judge appellate panel, explained that section 1129(b) – the so-called "cramdown" provision – provides (with "explanatory annotations") as follows:

> Notwithstanding section 510(a) of this title [making subordination agreements enforceable in bankruptcy to the extent they would be in nonbankruptcy law], if all of the applicable requirements of subsection (a) of this section [1129] other than paragraph (8) [. . . , this paragraph requires that each class of claims has accepted the plan] are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph [8] if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

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After years-long litigation, many of Tribune's creditors united behind a plan which provided the senior noteholders and certain other unsecured creditors, including the Swap Claims, Retirees and Trade Creditors (which were placed together in one class) with a 33.6% recovery on their outstanding claims from the initial distributions under the plan (which included amounts re-allocated because of the subordination of the unsecured debentures and unsecured notes).

The senior noteholders objected, arguing that the proposed plan disregarded the prepetition subordination agreements by allocating more than $30 million of their recovery to the Swap Claims, Retirees and Trade Creditors.

Ultimately, the Bankruptcy Court overruled the senior noteholders' objection and confirmed the plan, holding that "[section] 1129(b)(1) does not require that the subordination agreements be strictly enforced for a plan to be confirmed." Notably, the Bankruptcy Court also concluded that the Swap Claims were "Senior Obligations" and thus entitled to benefit from the subordination agreements. Consequently, the senior noteholders' "unfair discrimination" claim was reduced by over $17 million, thereby leaving approximately $13 million in dispute (as compared to the senior noteholders' $1.283 billion claim) – a 0.9% difference in their recovery. The senior noteholders appealed.[2]

The Third Circuit's Decision

The Third Circuit first examined whether the plain language of section 1129(b)(1) requires strict compliance with the terms of the subordination agreements. In line with the prior decisions of the Bankruptcy and District Courts, the Third Circuit concluded that it does not. Rather, the Third Circuit emphasized that section 1129(b)(1) expressly provides that a "nonconsensual plan may be confirmed ***notwithstanding*** section 510(a)" (which provides that "a subordination agreement is enforceable in bankruptcy to the same extent that such agreement is enforceable under nonbankruptcy law"). *Id.* at 15 (emphasis supplied). Consequently, the Third Circuit found that the senior noteholders could be "crammed down" under section 1129(b)(1) so long as the unfair discrimination test was satisfied.

The Third Circuit then addressed whether the plan unfairly discriminated against the senior noteholders. Noting that the Bankruptcy Code does not define "unfair discrimination," the Third Circuit examined the various standards that courts have used to determine what "unfairness" means and distilled such analyses into eight principles, including that: (i) in determining whether unfair discrimination exists, courts should establish a "*pro rata* baseline" by adding up the proposed plan distributions from the debtor's estate and dividing by the number of creditors sharing the same priority and comparing the results based on including subordinated sums in the plan distributions, (ii) "to presume unfair discrimination, there must be a materially lower percentage recovery for the dissenting class or a materially greater risk to the dissenting

[2] Tribune consummated the plan while the senior noteholders' appeal was pending. Nevertheless, the Third Circuit held that the senior noteholders' claim was not equitably moot and could proceed.

class in connection with its proposed distribution" and (iii) if a court finds that a plan materially discriminates against a dissenting class and follows a rebuttable presumption test (or sum variation), such finding is "by definition presumptive and can be rebutted."[3]

Applying these principles to the senior noteholders' claims, the Third Circuit concluded that, while the plan discriminates, "it is not presumptively unfair when understood . . . that a cramdown plan may reallocate some of the subordinated sums." While the Third Circuit noted that what constitutes a "material difference" is "a distinct and context-specific inquiry," "[w]herever it may lie, the nine-tenths of a percentage point difference in the Senior Noteholders' recovery is, without a doubt, not material."

Conclusion

In acknowledging that "[u]nfair discrimination is rough justice," the Third Circuit noted that the Bankruptcy Code's "tendency to replace stringent requirements with more flexible tests that increase the likelihood that a plan can be negotiated and confirmed" is balanced by its "inherent concern with equality of treatment." In this case, the Third Circuit endorsed the "pragmatic approach" taken by the lower courts in *Tribune*, noting that "the right result" was reached with respect to the senior noteholders' claims, which were impacted by a mere 0.9% as a result of the reallocation of subordinated sums. How other courts within the Third Circuit will interpret and apply *Tribune's* eight-part set of principles to evaluate "unfair discrimination" – and, moreover, whether other circuits will adopt such an approach – remains to be seen.

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3 The remaining principles cited by the Third Circuit include: (i) as is typical in reorganizations, there is "a need for flexibility over precision . . . as long as that allocation is not presumptively unfair (and, if so, the presumption is not rebutted)," (ii) as per the plain text of the "cramdown" provision, unfair discrimination applies only to dissenting classes of creditors (as opposed to individual creditors that comprise such classes), (iii) unfair discrimination is determined from the perspective of the dissenting class, (iv) the classification requirements proscribed by the Bankruptcy Code should be satisfied (including for example, by separating beneficiaries of subordination agreements from those whose claims do not benefit from such agreements) and (v) proposed recoveries should be "measured in terms of the net present value of all payments or the allocation of materially greater risk" to ensure that future distributions are made "reasonably equivalent to the actual value distributed at the time of the unfair-discrimination comparison."

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Jacob A. Adlerstein
+1-212-373-3142
jadlerstein@paulweiss.com

Paul M. Basta
+1-212-373-3023
pbasta@paulweiss.com

Robert A. Britton
+1-212-373-3615
rbritton@paulweiss.com

Kelley A. Cornish
+1-212-373-3493
kcornish@paulweiss.com

Alice Belisle Eaton
+1-212-373-3125
aeaton@paulweiss.com

Brian S. Hermann
+1-212-373-3545
bhermann@paulweiss.com

Kyle J. Kimpler
+1-212-373-3253
kkimpler@paulweiss.com

Alan W. Kornberg
+1-212-373-3209
akornberg@paulweiss.com

Elizabeth R. McColm
+1-212-373-3524
emccolm@paulweiss.com

Andrew M. Parlen
+1-212-373-3141
aparlen@paulweiss.com

Andrew N. Rosenberg
+1-212-373-3158
arosenberg@paulweiss.com

Jeffrey D. Saferstein
+1-212-373-3347
jsaferstein@paulweiss.com