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ENFORCEMENT OF INTERCREDITOR AGREEMENTS IN BANKRUPTCY: CAUSE FOR CONCERN?

In a recent bankruptcy decision, In Re Tribune Co.*, the Third Circuit held that debt subordination agreements need not be "strictly enforced" when confirming a non-consensual chapter 11 plan. The authors discuss the* Tribune *case, the relevant debt tranches, the plan, and the dispute. They then turn to the lower court decisions and the Third Circuit ruling. They close with four reasons why the* Tribune *decision does not represent a "seismic shift" on the enforceability of subordination agreements in bankruptcy.*

By Martin Bienenstock and David M. Hillman *

In 2020, the Third Circuit Court of Appeals held that debt subordination agreements need not be "strictly enforced" when confirming a non-consensual chapter 11 plan (or called "cram-down plan").[1] The decision grabbed headlines and the attention of lenders who extend credit based upon expectations that lien and debt subordination agreements will be enforced by bankruptcy courts. Those expectations are justified based on 11 U.S.C. section 510(a), which states that subordination agreements are enforceable in bankruptcy, and on well-developed case law enforcing those agreements. In light of the *Tribune* decision, some commentators have suggested that lenders now face some degree of uncertainty and that distressed borrowers may have additional flexibility in their restructuring toolbox. Are those concerns justified or overblown? As explained below, those concerns appear to be exaggerated, and courts will continue to enforce subordination agreements. That said, *Tribune* does reveal a scenario where "strict enforcement" might be excused in a limited context where the prejudicial impact is immaterial. Admittedly, materiality is a subjective assessment. In *Tribune*, the court permitted some flexibility to reallocate $13 million (or 0.9% incremental recovery on account of a $1.3 billion claim) to be

[1] *See In re Tribune Co.*, 972 F.3d 228 (3d Cir. 2020).

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distributed to 700 retirees and small-business-trade creditors.

WHAT HAPPENED IN TRIBUNE?

Tribune filed its chapter 11 in 2008, only one year after a leveraged buyout ("LBO") that left it with roughly $13 billion of debt. The case has generated more than 12 years of highly contested litigation involving four competing reorganization plans, multi-billion fraudulent transfer ligation related to the LBO, dozens of reported decisions, and countless appeals.

Relevant Debt Tranches

Tribune had multiple tranches of unsecured debt, three of which are relevant here.

Senior Notes. Tribune issued roughly $1.3 billion of unsecured notes under an indenture, which included a covenant that such notes would be paid before any other debt subsequently incurred by the company (the "Senior Notes").

Subordinated Notes. After issuing the Senior Notes, Tribune issued roughly $1.5 billion of unsecured notes under two separate indentures, which provided that such notes were subordinate in payment to "Senior Indebtedness" of Tribune (the "Subordinated Notes"). There was no dispute that the Senior Notes constituted "Senior Indebtedness" and were therefore senior in right of payment to the Subordinated Notes.

Other Debt. Tribune also had other unsecured debt, including $151 million for damages arising from the termination of an interest rate swap agreement ("Swap Claims"), $105 million owed to certain retirees ("Retirees"), and nearly $9 million owed to trade creditors ("Trade"). As explained below, the parties disputed whether these unsecured claims constituted "Senior Indebtedness" entitled to payment before the Subordinated Notes.

Plan Treatment

The dispute centered on Class 1E (Senior Notes) and 1F (Swap Claims, Retirees, and Trade). The Plan treated Class 1E and 1F the same ─ creditors in both classes would receive distributions equal to roughly 34% of their allowed claims. The Plan also gave effect to the subordination agreements in the indentures governing the Subordinated Notes by reallocating distributions that would have otherwise been paid to the Subordinated Notes to Class 1E and Class 1F on a *pro rata* basis.[2] The Plan distributions were funded, in part, from settlements of certain LBO-related claims, and under Tribune's Plan, both classes (1E and 1F) would share the settlement consideration.

The Dispute

The Senior Notes voted to reject the Plan and objected to confirmation, arguing that they alone were entitled recoveries otherwise allocable to the Subordinated Notes and that, as a consequence, the Plan unfairly discriminated against them by sharing those recoveries with Class 1F. If the Senior Notes were correct, their distribution in Class 1E would increase by roughly $30 million, which would increase their recovery by 2.3% from 33.6% to 35.9%.

The Lower Court Decisions

The bankruptcy court disagreed. First, it held that the Swap Claims constituted "Senior Indebtedness" under the indentures. Because the Swap Claims constituted nearly 60% of Class 1F, this determination reduced the disputed amount to $13 million, or 0.9% difference in recovery for Class 1E. The bankruptcy court never resolved the question of whether the Retirees or Trade claims also constituted "Senior Indebtedness." Instead, it assumed that such claims were *not* Senior Indebtedness and were *not* entitled to the benefit of the subordination agreements.

Nevertheless, the bankruptcy court confirmed the Plan, holding that: (a) a cram-down plan can be confirmed without "prevention or obstruction" of any subordination agreement based on the text of Section 1129(b), and (b) the unfair discrimination objection was rejected because the discriminatory effect on Class 1E (resulting in a 0.9% difference in recovery) was "immaterial." The district court affirmed.

[2] *Id.* at 9.

THIRD CIRCUIT RULING

The Third Circuit explained that "[c]ramdown plans are an antidote to one or more classes of claims holding up confirmation of an otherwise consensual plan" and provide an exception to the general rule that "all classes either vote to accept the plan or recover their debt in full under it."[3] The objecting class, however, has statutory safeguards in this context: the plan must be "fair and equitable" and must not "unfairly discriminate." These two important standards are not defined in the Bankruptcy Code, and only the unfair discrimination standard was at issue here.

Subordination Agreement in Cram-down *Context*

The Senior Notes argued that the Plan should not have been confirmed because it did not strictly enforce the subordination agreement under Section 510(a) of the Bankruptcy Code, which provides that "[a] subordination agreement is enforceable in [bankruptcy] to the same extent that such agreement is enforceable under non-bankruptcy law." The Third Circuit quickly dispatched this argument based on the statute's text. The plain language of Section 1129(b)(1) provides that a non-consensual plan may be confirmed "*notwithstanding section 510(a).*" (emphasis added) Thus, the Third Circuit held that Section 1129(b)(1) overrides section 510 because of the plain meaning of "notwithstanding."[4]

Unfair Discrimination

Turning to unfair discrimination, the Third Circuit held that this standard requires "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."[5] Generally speaking, the unfair discrimination standard ensures that a dissenting class will receive relative value equal to the value given to all other similarly situated classes. "'Discriminate unfairly' is simple and direct: you can treat differently (discriminate) but not so much as to be unfair. There is, as is typical in reorganizations, a need for flexibility over precision. The test becomes one of reason circumscribed so as not to run rampant over creditors' rights."[6] The standard ensures that "debtors and courts do not have *carte blanche* to disregard pre-bankruptcy contractual arrangements, while leaving play in the joints."[7]

The Third Circuit concluded that allocation of a "small portion" of the distribution that would have otherwise been allocated to the Senior Notes (0.9%) was discrimination, but not material enough in amount to rise to the level of "unfair discrimination."[8] "What constitutes a material difference in recovery when analyzing the effect of a plan on a dissenting class is a distinct and context-specific inquiry. . . . Wherever it may lie, the 9/10 of a percentage point difference in the Senior Noteholders' recovery is, without a doubt, not material."[9]

PRACTICAL IMPLICATIONS

The *Tribune* decision does not represent a seismic shift on the enforceability of subordination agreements in bankruptcy cases for at least four reasons. First, the Third Circuit did not eviscerate the subordination agreement. To the contrary, it endorsed some degree of flexibility and expressly held that "debtors and courts do not have *carte blanche* to disregard subordination agreements."[10]

Second, the claims that were clearly subordinated to the Senior Notes ─ the Subordinated Notes ─ received nothing as required by the subordination agreement. That result was also required by Bankruptcy Code section 1129(b)(2)(B)(ii), which provides that when a senior class rejects the plan, no holder of a junior claim can receive any distribution unless the senior claims are paid in full. Thus, the "[n]otwithstanding section 510(a)" language did not and could not signal subordination agreements need not be enforced because section 1129(b)(2)(B)(ii) enforces them when the class of senior claims rejects the plan.[11]

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3 *In re Tribune Co.*, 972 F.3d 228, 237 (3rd Cir. 2020).

4 *Id*. at 237-38.

5 *Id*. at 232.

6 *Id*. at 242.

7 *Id.* at 238.

8 *Id*. at 245.

9 *Id*.

10 *Id*. at 238.

11 *Tribune* did not need to discuss the scenario under which the class of senior claims accepts a plan that does not pay senior claims in full, but nevertheless pays a distribution to subordinated claims. Because the "[n]otwithstanding section 510(a)" language is not triggered in that scenario, holders of senior debt may be able to enforce their claims against holders subordinated debt based on Bankruptcy Code section 510(a), which provides that subordination agreements are enforceable

Third, the flexibility to deviate from strict enforcement only exists in the context of confirmation of a cram-down plan where a class of claims is not clearly subordinate. Based on reported decisions, the last time this issue arose was more than a decade ago when the New Jersey bankruptcy court in *In re TCI 2 Holdings*, 428 BR 117 (Bankr. D. N.J. 2010), confirmed a cram-down plan that allegedly violated an intercreditor agreement ─ similarly relying on the "notwithstanding Section 510(a)" in the lead-in to Section 1129(b). In *TCI*, the court declined to determine whether the intercreditor agreement was breached and struck a release from the plan, thereby allowing the creditors to fight about the breach and damages outside of the bankruptcy court. Litigation over the breach of the intercreditor agreement was subsequently settled. But, consistent with the language of section 510(a), the senior creditors had been allowed to enforce their subordination agreement outside the bankruptcy case.

Fourth, *Tribune* addressed *debt* subordination among unsecured creditors arising under an indenture and not *lien* subordination, which is ordinarily memorialized in an intercreditor agreement or agreement among lenders. Whatever limited flexibility exists to deviate from a debt subordination agreement in a cram-down plan likely does not exist with respect to lien subordination. If a cram-down plan sought to reallocate *collateral value* from a senior secured creditor to a junior secured creditor in breach of a lien subordination provision, then the senior lien lender should have recourse against the junior lien lender by enforcing the turnover provisions in the inter-lender agreement, whether in bankruptcy court or in state court. This remedy was unavailable to the Senior Noteholders in *Tribune* because it had no contractual relationship to the Retirees or Trade creditors that received a small portion of their recovery.[12] Alternatively, if a cram-down plan sought to reallocate *collateral value* from a secured creditor to an unsecured creditor (as opposed to a junior secured creditor), then the plan would likely violate the absolute priority rule unless the secured creditor was paid in full.

While *Tribune* does reveal a circumstance where a debt subordination agreement was not strictly enforced, the ruling is limited and will likely not have any impact on *lien* subordination agreements, which are critically important to lenders that finance companies with multi-lien capital structures. ■

footnote continued from previous page…

in a Title 11 case to the same extent as they are enforceable outside Title 11 cases.

[12] In the event that parties pursue damages for breach of the intercreditor agreement it is unclear whether the action could be successfully challenged under the theory of federal preemption. Neither *Tribune* nor *TCI 2* addressed whether section 1129(b) of the Bankruptcy Code, a federal statute, would preempt the senior lenders' rights to enforce that agreement against the junior lender, although TCI 2 expressly allowed the senior lenders to try to enforce their seniority rights To the extent section 1129(b)(1) does alter subordination agreements, and it is not clear that it does, the subordination agreement would be deemed to include section 1129(b)(1) because all new contracts are deemed to incorporate law existing when the contract is made. *Ogden v. Saunders*, 25 U.S. 213, 263 (1827).