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To Subordinate or Not Subordinate?

How Tribune Media Co. *Implicates Subordination Agreements in Cramdown Plans*

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On July 30, 2018, the District of Delaware issued a decision in certain consolidated appeals in the *Tribune Media Co.* bankruptcy case.[2] The primary question in these appeals was whether the debtors' confirmed plan unfairly discriminated against certain impaired senior noteholder creditors, whose senior status was attributable to a pre-petition subordination agreement, in violation of § 1129(b)(1) of the Bankruptcy Code.[3] This decision instructs that a bankruptcy court may disregard any pre-petition subordination agreement and its provisions upon confirmation of a chapter 11 plan over an impaired class of creditors' objection.

Relevant Creditors and the Subordination Agreement

In 2008, a media debtor and its affiliates (collectively "Tribune") initiated a bankruptcy case by filing a petition following a completion of a leveraged buyout (LBO).[4] As of the petition date, Tribune had the following debt: (1) $10.2 billion in LBO debt; (2) $1.2 billion in "senior notes"; (3) approximately $1 billion in subordinated debt (the PHONES notes and EGI notes); and (4) roughly $265 million in "other parent claims or Class 1F claims,"[5] consisting primarily of $105 million in retiree claims, $151 million in a "swap claim" arising from the termination of an interest rate swap agreement tied to the LBO debt, and $9 million in trade and miscellaneous debt.[6]

Under the subordination agreement at issue, in the case of Tribune's bankruptcy, the holders of the senior notes (the "senior hoteholders" or "Class 1E creditors") held senior status oversubordinated the PHONES notes and EGI notes holders. According to the subordination agreement, the senior noteholders, as a Class 1E creditors, were to be paid in full prior to the holders of other parent claims.[7] Despite the subordination-agreement provisions, the bankruptcy court confirmed Tribune's plan providing a distribution to the subordinate PHONES notes and EGI notes holders on a *pro rata* basis with other contractually subordinate creditors.[8]

Although the difference in treatment between the terms of the plan and those of the subordination agreement represented only a 2.3 percent disparity (35.9 percent vs. 33.6 percent), the disparate treatment was far more significant in terms of actual dollars: $461 million vs. $431 million.[9] It is important to mention that the final distribution share of 33.6 percent to the senior noteholders was actually reduced from an initial distribution share of 34.5 percent based on the bankruptcy court finding that the swap claim comprising 57 percent by amount of all the other parent claims was a senior.[10]

The appeals followed, and the senior noteholders made three arguments to challenge the order confirming the plan over their objection: (1) Section 1129(b)(1) mandates enforcement of the subordination agreement; (2) alternatively, the plan "discriminate[d] unfairly" against them; and (3) the bankruptcy court erred in finding that the swap claim was "senior debt" under the relevant contracts. Unfortunately for the senior noteholders, none of these arguments won the day.

The Court's Textual Analysis of §§ 510(a) and 1129(b)(1)

Section 510(a) provides that a subordination agreement is enforceable in bankruptcy to the same extent that it would be outside of bankruptcy. While this proposition is straightforward, § 510(a) is explicitly carved out of the analysis regarding approval of a chapter 11 plan. Specifically, § 1129(b)(1) is applicable to confirmation of a chapter 11 plan, which impairs a class of creditors and reads as follows: "Notwithstanding section 510(a) ... the court, on request of the proponent of the plan, shall confirm the plan ... 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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2 *Law Debenture Trust Co. of New York v. Tribune Media Co. (In re Tribune Media Co.)*, 587 B.R. 606 (D. Del. 2018). The bankruptcy case is styled as *In re Tribune Media Co., et al.*, Case No. 08-13141 (KJC) (Bankr. D. Del. 2008).
3 *Law Debenture Trust Co. of New York*, 587 B.R. at 613.
4 *Id.* at 610.
5 *In re Tribune*, Case No. 08-13141 (KJC), 2014 WL 2797042, at *5 (Bankr. D. Del. June 18, 2014).
6 *Law Debenture Trust Co. of New York*, 587 B.R. at 613.
7 *Id.*
8 *Id.* at 611.
9 *In re Tribune*, 2014 WL 2797042, at *4. The authors believe that the dollar figure associated with the percentage disparity as it appears in *In re Tribune* is a typographical error. The recovery amounts should be $431 million (33.6 percent) and $461 million (35.9 percent).
10 *Id.*

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To avoid this carve-out, the senior noteholders argued that the text of § 1129(b)(1) singles out the only portion of § 1129(a) that does not apply in analyzing cramdown plans — paragraph 8 — and that "all" other requirements of § 1129(a) apply.[11] In essence, the senior noteholders tried to read out the "notwithstanding" clause of § 1129(b)(1) by arguing that the only requirements that must be met for cramdown are those of § 1129(a), other than paragraph 8.

Both the bankruptcy and district courts rejected this argument, looking to the "notwithstanding" clause as being dispositive, thus holding that "notwithstanding" meant that a bankruptcy court could apply § 1129(b) without prevention or obstruction of any applicable subordination agreement.[12] Although the term "notwithstanding" can be a source of contention and confusion among jurists and practitioners alike, both courts found that there was no ambiguity within § 1129(b)(1).[13]

Looking to the interpretation given to phrases beginning with "notwithstanding" in other provisions of the Bankruptcy Code,[14] the district court determined that "notwithstanding" in § 1129(b)(1) means "in spite of" or, more plainly, "irrespective of section 510(a) of this title."[15] The district court further refused to look to statutory history, as it found the language of the statute to be plain and unambiguous.[16]

Under this plain reading of § 1129(b)(1), a cramdown plan can ignore the priority set forth by a contractual subordination agreement, as long as the resulting plan does not discriminate unfairly against the dissenting creditor.[17] Accordingly, the district court determined that the senior noteholders could not rely on the subordination agreement as the sole basis for overturning the cramdown plan.[18]

Senior Noteholders' Unfair-Discrimination Arguments Could Not Save Them

The senior noteholders' second argument asserted that the plan "discriminated unfairly" against them and should therefore be rejected.[19] As with their primary argument, this argument was also rejected by both the bankruptcy and district courts.

At the outset, since the Bankruptcy Code does not define unfair discrimination and the Third Circuit has not adopted a determination of unfair discrimination against a dissenting creditor, both courts had to decide what test should be applied in this case.[20] Various courts addressing this issue developed a number of different tests to ascertain unfair discrimination.[21]

In 1979, Prof. Emeritus Kenneth N. Klee of UCLA School of Law established one test for determining whether a cramdown plan "unfairly discriminates." He summarized the test as follows: "[I]f the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, then the plan does not discriminate unfairly with respect to the dissenting class."[22]

Numerous courts have applied a more objective approach by adopting the four-part test from chapter 13's analogous "unfair-discrimination" test. As set forth in *In re Aztec Co.*,[23] these courts look to the following factors: (1) whether the discrimination is supported by a reasonable basis; (2) whether the debtor can confirm and consummate a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) the treatment of the classes being discriminated against. This test has been met with some resistance, with critics arguing that different treatment of separate classes is only appropriate if "supported ... by a legally acceptable rationale ... [that is] necessary in light of that rationale" — hence, whether the discrimination is both reasonable and necessary.[24]

Other courts have adopted a more recent test, first suggested by Prof. **Bruce A. Markell** of Northwestern University School of Law (a former bankruptcy judge for the District of Nevada and a member of the ABI Commission on Consumer Bankruptcy),[25] to determine whether the discrimination is "unfair." The "Markell Test" begins with the following:

> [A] rebuttable presumption that a plan is unfairly discriminatory will arise when 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 (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.[26]

Under the Markell Test, if a presumption of unfair discrimination arises, it might be rebutted through a showing that "outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization, which [would] offset its gain."[27]

Regardless of the test being utilized, courts look to the disparity of treatment proposed in the cramdown plan and how it might be justified in the Bankruptcy Code.[28] Both courts in *Tribune* adopted the Markell Test. Under the district court's Markell Test analysis, the court focused on the differ-

11 *Id.* at 613.
12 *Id.*
13 *Id.*
14 Citing *Erlenbaugh v. U.S.* for the proposition that Congress "generally uses a particular word with a consistent meaning in a given context." 409 U.S. 239, 243 (1972).
15 *Id.*
16 *Id.* at 614-16.
17 *Id.* at 614.
18 *Id.*
19 *Id.* at 616.
20 *Id.* at 617.
21 *Id.*
22 Kenneth N. Klee, "All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code," 53 Am. Bankr. L.J. 133, 142 (1979).
23 107 B.R. 585, 590 (Bankr. M.D. Tenn. 1989).
24 *In re 203 N. LaSalle St. Ltd. P'ship*, 190 B.R. 567, 585-86 (Bankr. N.D. Ill. 1995), *reversed by Bank of Am. Nat'l Trust & Sav. Ass'n v. 203. N. LaSalle St. Ltd. P'ship*, 526 U.S. 434 (1999).
25 Bruce A. Markell, "A New Perspective on Unfair Discrimination in Chapter 11," 72 *Am. Bankr. L.J.* 227 (1998).
26 *In re Dow Corning Corp.*, 244 B.R. 705, 710-11 (Bankr. E.D. Mich. 1999).
27 *In re Armstrong World Indus. Inc.*, 348 B.R. 111, 122 (D. Del. 2006).
28 7 *Collier on Bankruptcy* ¶ 1129.03 (16th 2018).

ence between senior noteholders distribution share under the plan versus the distribution share that the senior noteholders would receive under the subordination agreement.[29]

The district court concluded that the 2.3 percent difference was immaterial. Accordingly, the district court affirmed the bankruptcy court's order confirming the plan despite the significant monetary disparity in the distributions to senior noteholders, as the percentage difference was slight.[30]

29 *Id.* at 618.
30 *Id.*

Protecting Creditors' Rights in Bankruptcy

The *Tribune* case is a striking reminder of a bankruptcy court's power to alter the parties' contractual rights, even under subordination agreements. Even though § 510(a) allows for the enforcement of subordination agreements during the pendency of a bankruptcy case, that protection alone is not sufficient to sustain an objection of a dissenting impaired creditor class unless they can show unfair discrimination. abi

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