

ALERTS

Third Circuit Orders Solvent Debtor to Pay Noteholders Post-Petition Interest at the Contract Rate, Including Make-Whole Premiums

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On Sept. 10, 2024, the US Court of Appeals for the Third Circuit struck down a Delaware bankruptcy court ruling that a solvent debtor could pay its noteholders' interest at the lower federal judgment rate (a codified and typically lower interest rate), as opposed to a higher contract rate, and that the debtor need not pay contractual "make-whole" payments. The debtor, The Hertz Corporation, sought to uphold the bankruptcy court's ruling because the contractual default rate would require the company to pay unsecured noteholders \$260 million in post-petition interest, as well as additional "make-whole" premiums. The Third Circuit held that (1) make-whole premiums constitute post-petition unmatured interest, which is not typically allowed under the Bankruptcy Code, but (2) the Bankruptcy Code requires *solvent* debtors to pay unimpaired creditors' post-petition interest at an equitable rate – in this case, the contract rate, and all other contractual obligations, including the make-whole payments – before making payments to equity holders as a matter of equity and fairness. *See In re The Hertz Corporation, et al.*, No. 23-1169 (3d Cir. Jan. 27, 2023).

Background

Hertz, a car rental company, filed for Chapter 11 on May 22, 2020, in the middle of the COVID-19 pandemic. The economy recovered considerably over the next year, allowing Hertz to become solvent and propose a chapter 11 plan that purportedly paid all creditors "in full" and paid \$1.1 billion to its pre-bankruptcy stockholders.

Prior to filing for bankruptcy, Hertz issued nearly \$1.4 billion in unsecured notes. The notes' indentures contained make-whole premiums, each triggered upon the acceleration of the debt resulting from Hertz's bankruptcy filing. A make-whole premium is a contractually agreed-upon payment that is triggered when a borrower repays the loan prior to the maturity date. Make-whole premiums compensate lenders for the time they will not earn interest as a result of an early repayment.

The plan purported to leave the noteholders' claims unimpaired – which, under the Bankruptcy Code, requires their “legal, equitable, and contractual rights” to be “unaltered.” Moreover, under Bankruptcy Code section 1126(f), the Debtors deemed the Noteholders to automatically accept the plan based on their status as unimpaired creditors.

The plan proposed to pay creditors post-petition interest – at the federal judgment rate, rather than the contract rate provided under the notes – which resulted in the noteholders receiving approximately \$260 million less than what they were contractually entitled to receive. The plan provided that the noteholders were not entitled to receive any make-whole premiums.

The noteholders objected to the plan and argued that it impaired their claims. Once the plan was confirmed, the noteholders sought payment of post-petition interest at the contract rate and make-whole premiums.

The Bankruptcy Court dismissed the noteholders' make-whole claims on the grounds that section 502(b)(2) of the Bankruptcy Code disallows such claims as unmatured interest. The Bankruptcy Court also dismissed the Noteholders' request for contract rate interest, holding that the federal judgment rate was appropriate.

The Bankruptcy Court overruled the noteholders' objections, confirmed the plan and certified the case for direct appeal to the Third Circuit.

Decision

In a 2-1 ruling on Sept. 10, 2024, the Third Circuit Court of Appeals, in an opinion written by Judge Thomas Ambro, addressed two key issues: 1) “Does § 502(b)(2)'s prohibition on claims ‘for unmatured interest’ cover make whole fees” . . .” and 2) “[D]oes the Bankruptcy Code as a whole require solvent debtors to pay impaired creditors interest accruing post-petition at the contract rate?”

Are Make-Wholes Permitted Under section 502(b)(2) of the Bankruptcy Code?

First, the Third Circuit analyzed whether the noteholders' claim should include the make-whole premiums. Hertz argued that make-whole premiums must be disallowed under Bankruptcy Code section 502(b)(2). Section 502(b)(2) of the Bankruptcy Code states that a court will not allow claims for "unmatured interest." Hertz asserted that the make-whole premium serves the same economic function as interest by compensating for the risk and delay in repayment of the monies they owe to the noteholders but remains unmatured at the date of the bankruptcy filing and thus is prohibited under section 502(b)(2) of the Bankruptcy Code.

The noteholders argued that make-whole premiums should be allowed because the Bankruptcy Code does not define interest and make-wholes do not match the ordinary meaning of interest – compensation for the use or forbearance of money based on caselaw and the dictionary definition of the term.

The Third Circuit found that make-whole premiums "fit both the dictionary definition of interest and are its economic equivalent." In reaching this conclusion, the majority agreed with Hertz's reasoning that the make-whole premiums "are mathematically equivalent to the unmatured interest the Noteholders would have received had Hertz redeemed the Notes on their Redemption Dates." The Third Circuit further explained that make-whole premiums fall within the definition of interest because make-whole premiums "are among the suite of fees [the noteholders] extracted from Hertz in return for their credit[,]" such that "Hertz's commitment to pay them was 'compensation' for its use of [the noteholders'] funds." Therefore, the Court held that the make-whole premiums constitute disallowed unmatured interest.

Does the Bankruptcy Code as a whole require payment of all post-petition interest?

Next, the Third Circuit turned to the issue of whether the noteholders should receive post-petition interest at the contract rate under the notes, including the make-whole premiums, because Hertz was a solvent debtor. Judge Ambro characterized the issue as, "Can [solvent] Hertz use the Bankruptcy Code to force Noteholders to give up nine figures of

contractually valid interest and spend that money on a massive dividend to Stockholders? The answer is no.”

The Third Circuit grounded its analysis of this issue in the “absolute priority rule,” which requires that all creditors must be paid in full prior to there being any return to equity. This is “bankruptcy’s most important and famous rule[.]” The Third Circuit referred to the Supreme Court’s 19th Century decision in *Chi Rock Island & Pac R.R.* to reiterate that “the rule is well settled that stockholders are not entitled to any share . . . until all the debts of the corporation are paid.”

The absolute priority rule exists in the bankruptcy Code in section 129(b). However, the Supreme Court in 2017 made clear that the absolute priority rule applies to all aspects of bankruptcy. In *Jevic Holding Corp.* the Supreme Court (reversing the Third Circuit) made clear that the absolute priority rule “entitles every creditor . . . to treatment consistent with absolute priority.” For a solvent debtor to comply with the absolute priority rule, before the debtor can make any distribution, creditors must recover everything that they are entitled. This policy preceded implementation of the bankruptcy Code in 1978, and therefore remains in place because the Bankruptcy Code does not expressly reject it.

Here, the Third Circuit applied this reasoning to declare that the debtors must pay the noteholders the full amount of their post-petition interest – make-wholes included – in a solvent debtor case before making any distributions to equity.

Hertz nevertheless argued that, irrespective of the absolute priority rule, the noteholders are entitled to post-petition interest at the federal judgment rate, rather than the contract rate. Hertz argued that Bankruptcy Code section 726(a)(5), which allows unsecured creditors of solvent debtors to be paid post-petition interest “at the legal rate[.]” mandates this result.

The noteholders argued that the pre-Bankruptcy Code’s “solvent debtor exception” when read with the absolute priority rule, required solvent debtors, such as Hertz, to pay post-petition interest to creditors at the contract rate (here including the contractual make-wholes”). The solvent debtor exception is an equitable remedy requiring that a solvent debtor pay post-petition interest to dissenting unsecured creditors in chapter 11 proceedings, which arises out of caselaw from before the Bankruptcy Code.

Case law under the “solvent debtor exception” “required solvent debtors to pay contract rate interest before making distributions to equity.” The Third Circuit noted: “That makes sense. . . . The absolute priority rule requires creditors’ obligations to be paid before owners . . . take anything at all. So it should be no surprise that several thoughtful decisions conclude that the Bankruptcy Code’s absolute priority rule, which incorporates common law and Bankruptcy Act jurisprudence, can require payment of contract rate interest in solvent debtor cases.”

The Third Circuit stressed that the appropriate rate is actually the “equitable rate of post-petition interest, whatever that may be[,]” rather than the contract rate specifically. However, this is due to concerns that “paying one creditor contract rate interest might give it an inequitable leg up over its peers if there is not enough to pay everyone their full rate.” Here, with equity holders receiving \$1.1 billion in value, there is no such concern. “It would be profoundly unfair to scrimp on the Noteholders’ interest when the junior Stockholders already received a billion dollar distribution.”

Takeaways

- The Third Circuit joined other courts, including the Fifth Circuit in *Ultra Petroleum Corp.* and the Ninth Circuit in *Gas & Elec. Co.*, in finding that make-whole premiums constitute “unmatured interest” that is not allowable under Bankruptcy Code section 502(b)(2).
- *Hertz* offers precedential support for the “solvent debtor exception,” allowing creditors of a solvent debtor to reclaim the full value of their claims.
- Lenders to solvent debtors in the Third Circuit are likely to recover make-wholes even though lenders to insolvent debtors may not.
- Creditors of solvent debtors are not guaranteed to receive post-petition interest at the contract rate. Rather, the appropriate post-petition rate of interest is subject to equitable considerations depending on the facts of the case.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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