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Hertz Ruling Could Help Debtors Avoid Make-Whole Premiums

By **Theresa Foudy and Alexander Severance** (January 18, 2023, 4:23 PM EST)

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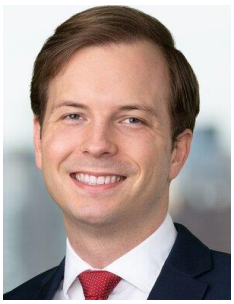

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In October, the U.S. Court of Appeals for the Fifth Circuit released its long-anticipated decision in In re: Ultra Petroleum Corp., or Ultra III, affirming that make-whole premiums and contract rates of post-petition interest can be collected in bankruptcy when the debtor is solvent.[1]

Ultra III came on the heels of In re: PG&E Corp. in August, in which the U.S. Court of Appeals for the Ninth Circuit also held that creditors of a solvent debtor are entitled to collect post-petition interest at the contractual default rate.[2]

Notwithstanding Ultra III and PG&E, on Nov. 9, the U.S. Bankruptcy Court for the District of Delaware issued its most recent decision in In re: Hertz Corp., affirming its prior decision rejecting the solvent-debtor exception relied upon by the Fifth and Ninth Circuits, and disallowing claims for make-whole premiums and post-petition interest at the contract rate under any circumstances.[3]

With the most recent Hertz decision, the bankruptcy court initially sided with the Fifth Circuit in finding that the make-whole premium at issue was the economic equivalent of unmatured interest and thus unrecoverable under Section 502(b)(2) of the U.S. Bankruptcy Code.

It then departed from Ultra III and PG&E to hold that the so-called solvent-debtor exception to disallowance did not survive the Bankruptcy Code's enactment, adding to the already significant split in authority on these issues.

Recognizing this, the bankruptcy court certified these two issues for a direct appeal to the U.S. Court of Appeals for the Third Circuit, whose decision on these oft-litigated issues will be much anticipated.

This article provides an overview of this most recent Hertz decision and the potential takeaways therefrom.

Fifth and Ninth Circuit Opinions

The most notable recent opinions on make-whole premiums, post-petition interest, and the solvent-debtor exception have come out of the Fifth and Ninth Circuits.

In the Fifth Circuit, the controlling opinion is currently Ultra III, in which that court held that the make-whole premium at issue in that case was the economic equivalent of unmatured interest and thus disallowed under Section 502(b)(2) of the Bankruptcy Code.[4]

However, the Fifth Circuit also concluded in a split opinion that the solvent-debtor exception had survived the enactment of the Bankruptcy Code, and thus, the creditors were entitled to recover the make-whole premium and post-petition interest at their contractual default rate — insofar as the debtors' credit agreements provided for this.[5]

In the Ninth Circuit, the most recent precedent on the solvent-debtor exception is PG&E.

There, the Ninth Circuit agreed that the solvent-debtor exception had survived the enactment of the Bankruptcy Code, thus preserving those creditors' ability to claim post-petition interest at their contractual default rate.[6]

The PG&E debtors had argued that creditors could be deemed unimpaired while being paid the federal judgment rate of interest.[7]

Rejecting this, the Ninth Circuit held that, insofar as a solvent debtor is involved, an unsecured creditor is only unimpaired if it is to be paid post-petition interest at the contractual — or state law — default rate.[8]

History of Hertz

With international borders closed and remote work policies implemented, demand in the travel industry — and in particular, for car rentals — declined precipitously at the onset of the COVID-19 pandemic.

Hertz was not spared, absorbing a net loss of $847 million and seeing revenue drop 67% in the second quarter of 2020 alone.[9] Owing to these financial pressures, the company filed for bankruptcy in May 2020, even though it ultimately proved to be solvent.

After a year of negotiation, Hertz and its affiliated debtors filed a plan of reorganization that both was confirmed and went into effect June 2021. Under this plan, Hertz's noteholders were to be paid the principal amount of their notes in full, along with post-petition default interest at the federal judgment rate — currently, about 4.75%.

The plan also preserved the noteholders' right to seek allowance of their make-whole premiums and payment of post-petition interest at their contractual default rate so that their claims could be deemed unimpaired if the bankruptcy court ultimately determined that the noteholders were entitled to those amounts.

In July 2021, the note trustees filed a complaint seeking a declaratory judgment that the noteholders were owed $272 million in make-whole premiums and $147 million in post-petition interest at their contractual default rate. Shortly thereafter, in August 2021, Hertz moved to dismiss the complaint.

In December 2021, the bankruptcy court issued a decision in which it agreed with the debtors that any interest was to be paid at the federal judgment rate, not the contract rate.

However, with respect to the make-whole premium, bankruptcy court found that there was a factual

issue as to whether the premium at issue was the "economic equivalent of unmatured interest."[10] Consequently, the noteholders' trustees and the debtors each filed motions for summary judgment that teed up that narrow factual issue.

Subsequent to that decision by the Hertz bankruptcy court, the Ninth Circuit's August ruling in PG&E, as well as the Fifth Circuit's October decision in Ultra III, both relying upon the solvent-debtor exception, disagreed with the Hertz court's conclusion on the applicable rate of interest for unimpaired creditors of a solvent debtor.

In September, the Hertz trustees filed a motion for the bankruptcy court to reconsider its December 2021 decision in light of the Ninth Circuit's ruling.

The trustees argued that the intervening PG&E decision had "confronted — and rejected — key aspects of [the bankruptcy court's] reasoning" used to reject the noteholders' claim to be paid post-petition interest at their contractual default rate.[11]

Because the PG&E decision "would have played a significant role in the [bankruptcy] Court's analysis[,]" the trustees argued, "[t]hese extraordinary circumstances justif[ied] reconsideration of [that] Court's decision on [the debtors'] motion to dismiss."[12]

The bankruptcy court was insufficiently swayed by the Ninth Circuit's reasoning, issuing a decision in November denying the trustees' motion to reconsider and again holding that the noteholders were entitled to post-petition interest only at the federal judgment rate.[13]

The bankruptcy court also addressed in the same opinion the summary judgment motions on whether the make-whole premium was the economic equivalent of unmatured interest disallowed under Section 502(b)(2) of the Bankruptcy Code.

In doing so, the bankruptcy court held that the make-whole premium in the noteholders' credit agreement — a so-called redemption price — amounted to the economic equivalent of unmatured interest, and thus, disallowed under Section 502(b)(2) of the Bankruptcy Code, and that the solvent-debtor exception had not survived the enactment of the Bankruptcy Code to change either of these outcomes.[14]

Decision

In its decision, the bankruptcy court first addressed the issue of the redemption price, affirming the general and well-recognized principle that Section 502(b)(2) of the Bankruptcy Code disallows not just unmatured interest but also any economic equivalent thereof, "because to find otherwise would make the provision susceptible to end-runs by canny creditors."[15]

The bankruptcy court recognized that, generally, the purpose of make-whole premiums is to "compensate creditors for damages incurred by the repayment of the notes prior to maturity," and that "[t]hose damages typically are incurred when the noteholders are required to reinvest their funds in a market with lower prevailing interest rates."[16]

The court held that "the economic substance of a transaction governs" whether a make-whole premium should be disallowed as the economic equivalent of unmatured interest, and here, the bankruptcy court believed the substance of the redemption price formula clearly pointed toward disallowance.[17]

Rejecting the trustees' argument that the redemption price was merely compensation for reinvestment costs, the bankruptcy court emphasized that "each of the three components of the redemption price is the economic equivalent of unmatured interest[.]"[18]

Specifically, the redemption price consisted of "unmatured interest as of the Redemption Date ... the present value of all remaining interest ... [and] the equivalent of one semi-annual interest payment."[19]

The bankruptcy court found that

the redemption price is not at all tied to the reinvestment costs that Wells Fargo or the Noteholders may incur in reinvesting their money upon early payment of the Notes, such as the costs associated with marketing or finding a replacement borrower. Instead, the formula is tied entirely to the unpaid interest on the Notes at the time of redemption.[20]

The bankruptcy court also rejected the trustee's argument that the redemption price was a post-petition claim, finding that the right to the redemption price was a contingent claim that "arose on the petition date."[21]

Turning to the applicable post-petition interest rate, the bankruptcy court denied the trustee's motion to reconsider and affirmed that, even in solvent debtor scenarios, creditors are entitled to post-petition interest only at the federal judgment rate.[22]

The bankruptcy court rejected the trustee's assertion that intervening decisions, such as Ultra III and PG&E, had brought new considerations to light, reasoning that the court had made the same considerations as the Fifth and Ninth Circuits but had simply reached a different conclusion.[23]

Moreover, the bankruptcy court highlighted that both the Fifth and Ninth Circuit opinions were split decisions in which the dissenting judges made similar, or identical, arguments to also conclude that creditors were not entitled to post-petition interest at a contractual default rate.[24]

Citing these dissents, the bankruptcy court also rejected the trustees' argument that the solvent-debtor exception survived the Bankruptcy Code's enactment to create an exception to the rules above.

The bankruptcy court placed particular weight on the fact that "[b]oth the majority and the dissenting opinions rel[ied] on Supreme Court precedent," with the dissenting opinions citing the U.S. Supreme Court for the proposition that courts must enforce congressional intent where "Congress [clearly] says in a statute what it means and means in a statute what it says[.]"[25]

For the bankruptcy court, Section 502(b)(2) of the Bankruptcy Code was no exception.

The "prohibition on the allowance of post-petition interest is clearly stated," and the solvent-debtor exception was codified "only in three limited circumstances: (1) when a secured creditor is over-secured .... (2) when a Chapter 7 debtor is solvent, and (3) when an impaired creditor has not accepted the debtor's Chapter 11 plan" and is entitled to interest at the federal judgment rate in order to meet the best interests test under Section 1129(a)(7) of the Bankruptcy Code.[26]

Recognizing the significance of these issues for plans of reorganization and the split in court authority, the bankruptcy court concluded its opinion by certifying its decision for a direct appeal to the Third

Circuit.[27]

Implications

For the time being, the Hertz decision would appear to incentivize solvent debtors to file their Chapter 11 petitions in the Third Circuit.

The difference between calculating post-petition interest at the federal judgment rate and a contractual rate, for example, can account for hundreds of millions of dollars in additional recoveries flowing to creditors: $186 million in Ultra III, for example, or the $147 million at issue in Hertz.

Absent a Third Circuit decision to the contrary, future solvent debtors may well seek to rely upon Hertz to sidestep make-whole provisions and contractual interest rates in their credit agreements, which, depending on the specific facts at issue, could potentially provide hundreds of millions of dollars in additional recoveries for equity holders.

Further, the bankruptcy court's certification of its decision for appeal to the Third Circuit will generate important precedent that may give rise to a clear circuit split on these issues and provide fodder for the Supreme Court to grant certiorari, thus resolving these decades-old issues.

Conclusion

Hertz, and the myriad cases that precede it, demonstrate the continued importance of issues surrounding the recoverability of make-whole premiums, the appropriate rate for the recovery of post-petition interest, and the solvent-debtor exception — issues both creditors and debtors have continued to litigate.

Regardless of the outcome, many will anticipate the Third Circuit's forthcoming decision.

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[1] See In re Ultra Petroleum Corp., 51 F.4th 138 (5th Cir. 2022).

[2] See In re PG&E Corporation, 46 F.4th 1047 (9th Cir. 2022).

[3] See In re Hertz Corp., No. 21-50995 (MFW) (Bankr. D. Del. Nov. 21, 2022) [Docket No. 71].

[4] Ultra, 51 F.4th at 149.

[5] See id. at 160.

[6] PG&E, 46 F.4th at 1057.

[7] See id. at 1051–52.

[8] See id. at 1064.

[9] Hertz Global Holdings Reports Second Quarter 2020 Financial Results, Hertz, https://ir.hertz.com/news-releases/news-release-details/hertz-global-holdings-reports-second-quarter-2020-financial.

[10] See In re Hertz Corp., No. 21-50995 (MFW) (Bankr. D. Del. Dec. 22, 2021) [Docket No. 28] at 46.

[11] See In re Hertz Corp., No. 21-50995 (MFW) (Bankr. D. Del. Sept. 19, 2022) [Docket No. 59] at 2.

[12] Id. at 3.

[13] See In re Hertz Corp., No. 21-50995 (MFW) (Bankr. D. Del. Nov. 21, 2022) [Docket No. 71] at 20.

[14] See id. at 10–11, 17.

[15] See id. at 7.

[16] Id.

[17] Id. at 10.

[18] Id. at 11.

[19] Id.

[20] Id.

[21] Id.

[22] Id. at 17.

[23] Id. at 14.

[24] Id. at 14–15.

[25] Id. at 16 (internal citations omitted).

[26] Id. at 16-17.

[27] See id. at 19.