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Third Circuit Rules on Allowance of Make-Whole Fees and Post-Petition Interest in Solvent-Debtor Cases in *In re The Hertz Corp*.

On September 10, 2024, the U.S. Court of Appeals for the Third Circuit issued its opinion in *Wells Fargo Bank, N.A.* v. *The Hertz Corp. (In re The Hertz Corp.)*, Case No. 23-1169, 2024 WL 4132132 (3d Cir. Sept. 10, 2024), regarding payment of make-whole fees and post-petition interest in solvent-debtor cases. In a 2-1 decision, the Third Circuit held that pursuant to the absolute priority rule, the debtors' unsecured noteholders are entitled to receive payment of over $270 million in (i) post-petition interest at the applicable contract rate and (ii) make-whole fees due under certain of the debtors' unsecured notes. The Third Circuit reached this conclusion despite its holding that the make-whole fees constitute a claim for unmatured interest under section 502(b)(2) of the Bankruptcy Code.[1]

The Third Circuit's decision overturns in part and affirms in part the Bankruptcy Court for the District of Delaware's (the "Bankruptcy Court") prior decision in the Hertz Corporation's chapter 11 cases. Notably, the Third Circuit's decision conforms to similar rulings from the Fifth and Ninth Circuits, which upheld the solvent-debtor exception (described below) with respect to claims for post-petition interest at the applicable contract rate and make-whole fees.[2]

1. Relevant Background

On May 22, 2020, the Hertz Corporation and certain of its affiliates and subsidiaries (the "Company") filed chapter 11 petitions following a liquidity crisis caused by the COVID-19 pandemic. Over the course of its chapter 11 cases, the Company's liquidity position improved and it sought to confirm a chapter 11 plan (the "Plan") that left all of its creditors unimpaired, including its unsecured noteholders. Notwithstanding this proposed treatment, the Plan did not contemplate paying the unsecured

[1] *See Wells Fargo Bank, N.A.* v. *The Hertz Corp. (In re The Hertz Corp.)*, Case No. 23-1169, 2024 WL 4132132, at *8, *15 (3d Cir. Sept. 10, 2024).

[2] *See Ad Hoc Comm. of Holders of Trade Claims* v. *Pac. Gas & Elec. Co. (In re PG&E Corp.)*, 46 F.4th 1047, 1064 (9th Cir. 2022) ("Because PG&E was solvent, however, plaintiffs' claims did entail an equitable right to receive postpetition interest under the solvent-debtor exception. . . . This equitable right entitled plaintiffs to recovery of interest pursuant to their contracts, subject to any countervailing equities, before PG&E's shareholders received surplus value."); *see also Ultra Petroleum Corp.* v. *Ad Hoc Comm. of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, 51 F.4th 138, 160 (5th Cir. 2022) ("Creditors' Make-Whole Amount is disallowed "unmatured interest" under the Bankruptcy Code. But the traditional solvent-debtor exception compels payment of the Make-Whole Amount because it is a valid contractual debt under applicable state law. For similar reasons, Ultra cannot avoid payment of contractual default-rate interest in favor of the much-lower Federal Judgment Rate . . ."); *see also* our Client Alert here for a discussion of the Fifth Circuit's decision in *In re Ultra Petroleum Corp.*, 51 F.4th 138; *see also* our Client Alert here for a discussion of the Ninth Circuit's decision in *In re PG&E Corp.*, 46 F.4th 1047.

noteholders the make-whole fees, which were triggered by the debtors' voluntary prepayment of certain of their unsecured notes, and further proposed to pay such noteholders post-petition interest at the federal judgement rate (roughly 0.17%) rather than the higher contract rate (between 5.50% and 7.125% depending on the bond). The Bankruptcy Court confirmed the Plan and held that the unsecured noteholders could be classified as unimpaired so long as the Company paid the unsecured noteholders post-petition interest at the federal judgment rate.[3] Further, the Bankruptcy Court held that the make-whole fees constituted the "economic equivalent" of unmatured interest and denied the unsecured noteholders' claim for such fees.[4] Following confirmation, and in accordance with the Plan, the Company paid its equity holders a dividend valued at $1.1 billion.

The Bankruptcy Court's decision was certified for direct appeal to the Third Circuit.[5] Two issues were considered on appeal: (i) must the make-whole fees be disallowed under section 502(b) of the Bankruptcy Code as unmatured interest; and (ii) were the noteholders, who were unimpaired unsecured creditors under the Company's Plan, owed interest at the contract rate and the make-whole fees pursuant to the Bankruptcy Code?

Payment of post-petition interest and claims for make-whole fees in solvent-debtor cases has come under much scrutiny in recent years. Typically, when a debtor files for bankruptcy, interest ceases to accrue as of the petition date, and claims for "unmatured interest" are disallowed.[6] One historical exception to this general rule, however, arises in the context of a solvent debtor. This solvent-debtor exception allows unsecured creditors to assert claims for post-petition interest when a debtor is financially solvent.

Whether or not make-whole fees constitute claims for unmatured interest is also up for debate. At a high-level, make-whole fees are prepayment premiums that lenders charge when a borrower pays off a loan before the loan comes due to compensate the lender for the interest it otherwise would have received over the course of the loan. Provisions providing for make-whole fees are a common feature in debt financing agreements and can be costly. Debtors often dispute the legality of making such payments in bankruptcy.[7] A growing number of courts, however, have held that while make-whole fees may be the equivalent of a claim for unmatured interest, solvent debtors should nonetheless be required to pay such claims.

2. The Third Circuit's Decision

In *In re Hertz Corp*., the Third Circuit focused on whether the make-whole fees constituted claims for "unmatured interest." The noteholders conceded that as a matter of law, the make-whole fees were unmatured since they did not accrue before the Company filed for bankruptcy.[8] But, the noteholders argued, the make-whole fees were not interest and thus, not disallowed under section 502(b) of the Bankruptcy Code. The Third Circuit analyzed the applicable language in the governing documents to

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3 *See generally Wells Fargo Bank, N.A.,* v. *The Hertz Corporation (In re The Hertz Corp.)*, 637 B.R. 781 (Bankr. D. Del. Dec. 22, 2021).

4 *See Wells Fargo Bank, N.A.*, v. *The Hertz Corporation (In re The Hertz Corp.)*, Case No. 21-50995, Docket No. 71 (Bankr. D. Del. Nov. 21, 2022) ("Because all the components of the [make-whole fees] are unmatured interest or its economic equivalent, the Court concludes that the claim is disallowed under the provisions of section 502(b)(2).").

5 *See* our Client Alert here for a discussion of the Bankruptcy Court's decision in *In re The Hertz Corp.*, 637 B.R. 781.

6 11 U.S.C. § 502(b)(2).

7 Of note, while the debtors' argument (and the Third Circuit's analysis) in *In re The Hertz Corp*., focused on disallowing the make-whole fees under the Bankruptcy Code, debtors have also attempted to disallow such claims by focusing on specific contract terms instead. For example, in *In re Energy Future Holdings Corp*., 842 F.3d 247 (3d Cir. 2016) the debtors argued that they were not liable for certain make-whole fees arising from a payment of debt made after their bankruptcy filing because the filing triggered the acceleration of the debt under the relevant contract. The argument followed that because the debt became due upon filing, any payment of the debt made thereafter could neither be voluntarily nor a redemption. The Third Circuit disagreed holding that any payment made before the contract's stated maturity date was a voluntary redemption. *Id.* at 261.

8 *See In re The Hertz Corp.*, 2024 WL 4132132 at *6.

determine if the make-whole fees either (i) fit the dictionary and caselaw definition of interest or (ii) were the economic equivalent of interest.[9] The noteholders argued that the make-whole fees could not be considered interest because the fees (i) were due and payable in one instance, rather than accruing steadily over the life of the loan, (ii) were not contingent on the debtors' ongoing use of the noteholders' money, and (iii) served only to compensate the noteholders for the "reinvestment costs" they realized as a result of the debtors' prepayment.[10]

The Third Circuit disagreed with the noteholders' reasoning. In doing so, the Third Circuit explained, among other things, that there is no requirement that interest accrue daily or be contingent on the borrower's ongoing use of money and that the make-whole fees had been mathematically calculated to compensate the noteholders for the interest they otherwise would have received absent prepayment of the loan.[11] In light of its findings, the Third Circuit held that under both the definitional and economic tests, the make-whole fees were effectively claims for unmatured interest, which would generally be impermissible under section 502(b) of the Bankruptcy Code.[12]

The Third Circuit next examined whether the Company was required to pay the noteholders post-petition interest at the contract rate before it paid its equity holders (a class with claims junior to those of the noteholders) a dividend.[13] The Third Circuit reviewed rulings from cases in the Fifth and Ninth Circuits with similar fact patterns and found the decisions persuasive. In *In re Ultra Petroleum Corp*., and *In re PG&E Corp*., the Fifth and Ninth Circuits, respectively, upheld the solvent-debtor exception for payment of post-petition interest to unsecured creditors and required the applicable debtors to pay such interest at the contract rate.[14] Moreover, in *In re Ultra Petroleum*, the court also required the solvent debtors to pay certain make-whole fees despite concluding that the make-whole fees were disallowed as claims for unmatured interest.[15]

The Third Circuit recognized that the pre-Bankruptcy Code practice requiring solvent debtors to pay creditors the contract rate of interest before making any distributions to equity is embodied in the absolute priority rule. The Third Circuit also considered the absolute priority rule's application to unimpaired creditors, noting that had the noteholders been impaired under the debtors' Plan, the debtors would not have been able to confirm a plan that paid its equity holders a dividend without paying the noteholders post-petition interest at an equitable rate because such treatment would have violated the absolute priority rule.[16] Accordingly, the Third Circuit determined that the absolute priority rule must apply to unimpaired creditors and impaired creditors alike because a contrary outcome would lead to an unjust result where *unimpaired* creditors are treated worse than *impaired* creditors, who enjoy a host of protections under the Bankruptcy Code that are not available to unimpaired creditors.[17] Finally, the Third Circuit held that in the case at hand, the equitable rate of interest was the contract rate because it would be

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9 *See id*. at *2.

10 *See id*. at *7.

11 *See id*. at*7-8.

12 *See id.* ("To sum up, § 502(b)(2) disallows a claim for unmatured interest if it is either definitionally interest or its economic equivalent. Because the [make-whole fees] are both, the Bankruptcy Court correctly disallowed the Noteholders' claims for those Premiums.").

13 *See* 11 U.S.C. § 1129(b)(2) (in order for a plan to be confirmed, section 1129 of the Bankruptcy Code proscribes that higher priority claims must be paid in full before junior claimants receive any recovery. This concept is often discussed in cases where creditors are impaired and is commonly referred to as the absolute priority rule).

14 *See In re PG&E Corp.*, 46 F.4th at 1064; *In re Ultra Petroleum Corp.*, 51 F.4th at 160.

15 *See In re Ultra Petroleum Corp.*, 51 F.4th at 160.

16 *See In re The Hertz Corp.*, 2024 WL 4132132 at *14 ("[T]he absolute priority rule requires creditors' obligations be paid in full before owners, with junior rights to the business, take anything at all.").

17 *See id*. (quoting *In re Ultra Petroleum Corp.*, 51 F.4th at 158) ("[C]reditors who are unimpaired ... cannot be treated any worse than impaired creditors, who at least get to vote[.]").

"profoundly unfair" for the debtors' equity holders to receive a windfall to the tune of $1.1 billion while forcing its noteholders to forgo hundreds of millions of dollars that they had validly contracted for pre-petition.[18] In connection with this reasoning, the Third Circuit also required the Company to pay the noteholders the make-whole fees despite its previous finding that the fees constituted unmatured interest.[19] Importantly, the Third Circuit highlighted that while it was applying the contract rate of interest in this particular case, it need not do so in every case. The Third Circuit reasoned that determining the correct "equitable rate" is a fact-specific inquiry that should be made on a case-by-case basis.[20]

3. Conclusion

In *In re The Hertz Corp*., the Third Circuit made clear that a solvent-debtor must pay unimpaired claimants post-petition interest at an "equitable rate," and any applicable make-whole fees, before any junior stakeholders receive a recovery. The Third Circuit's decision brings the circuit in line with similar rulings from the Fifth and Ninth Circuits on the payment of make-whole fees and post-petition interest in solvent debtor cases but leaves open the question of what constitutes an "equitable rate" of interest. While the Third Circuit applied the contract rate in *In re The Hertz Corp*., it held that such applied rate can vary on a case-by-case basis. This may be especially significant in cases unlike *In re The Hertz Corp*. where equity holders have not received a substantial recovery. Moreover, it is important to highlight that the Third Circuit's decision and the decisions in *In re PG&E Corp*. and *In re Ultra Petroleum Corp.* featured a dissenting opinion. It remains to be seen whether other circuits will adopt their reasoning.

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18 *See id.* ("It would be profoundly unfair to scrimp on the Noteholders' interest when the junior Stockholders already received a billion dollar distribution.").

19 *See id.* at *15 ("To comply with the absolute priority rule . . . Hertz must pay the post-petition interest at the Notes' applicable contract rate, including the [make-whole fees] on the 2026 and 2028 Notes.").

20 *See id*. at *14.

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:

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