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It never *Hertz* to ask: Court declines to dismiss make-whole claims, limits post-petition interest

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In *Hertz*, the Delaware Bankruptcy Court declined to dismiss certain claims for make-whole premiums pending a factual determination as to whether the make-whole amounts were the economic equivalent of unmatured interest. However, claims for post-petition interest were limited to the federal judgment rate. The decision reflects a deepening circuit split with respect to make-whole premiums and the post-petition interest rate.

On December 22, 2021, Hon. Mary F. Walrath of the U.S. Bankruptcy Court for the District of Delaware ruled in a memorandum opinion in *Hertz*[1] that make-whole premiums on certain of the Hertz Debtors' unsecured notes were not payable upon a bankruptcy default under the express terms of their indentures, but that make-whole premiums on two other series of unsecured notes were expressly payable upon a bankruptcy default but nonetheless may potentially be disallowed under the Bankruptcy Code as unmatured interest. The Delaware Bankruptcy Court also ruled that unimpaired unsecured creditors in a solvent chapter 11 debtor case are entitled to post-petition interest accruing at the federal judgment rate, not the applicable contract rate. The decision in *Hertz* relied heavily on Third Circuit precedent in analyzing acceleration and redemption provisions in debt documents and foreshadows a potential departure from the line of *Ultra Petroleum* cases pending in the Fifth Circuit.

This client update follows our previous client updates[2] discussing the treatment of make-whole premiums in bankruptcy.

Background

In 2012, 2016 and 2019, The Hertz Corporation (Hertz) issued multiple series of unsecured notes (due in 2022, 2024, 2026 and 2028) totaling $2.7 billion in principal amount. Hertz and certain of its subsidiaries and affiliates (the Hertz Debtors) filed for bankruptcy in the U.S. Bankruptcy Court for the District of Delaware (the Delaware Bankruptcy Court) on May 22, 2020 (the Petition Date). Following an auction process and selection of a group of plan sponsors, the reorganization of the Hertz Debtors was effectuated through a confirmed plan of reorganization that provided creditors – including the unsecured noteholders – with unimpaired treatment in the form of payment in full in cash of their allowed claims as well as a material recovery to equity holders, a rarity in chapter 11. However, the plan did not provide for payment of make-whole premiums to the noteholders and provided that interest payable on the unsecured noteholders' claims accrued post-petition at the federal judgment rate, not the rate set forth under the applicable indentures. The Delaware Bankruptcy Court's order confirming the Hertz Debtors' plan expressly preserved the rights of noteholders to assert that their unimpaired treatment entitled them to payment of the make-whole premiums as well as post-petition interest on their claims at the applicable contract rate. On the day following the Hertz Debtors' emergence from bankruptcy, Wells Fargo Bank, N.A. and US Bank, N.A., the trustees for the unsecured notes (the Trustees), commenced an adversary proceeding seeking (i) payment of make-whole premiums of approximately $147 million and (ii) post-petition interest on the unsecured noteholder claims at the contract default rate, rather than the federal judgment rate, in an incremental amount of approximately $125 million. The Hertz Debtors filed a motion to dismiss the Trustees' claims.

Make-whole analysis pre-*Hertz*: *Momentive*, *EFH* and *Ultra Petroleum*

In the Second Circuit's *Momentive* decision[3] and the Third Circuit's *EFH* decision,[4] the allowability of a make-whole claim in bankruptcy began and ended with an analysis of the terms of the applicable indentures. In determining whether the make-whole premiums were payable, courts addressed, first, whether there was a "redemption" of the notes and, second, whether the redemption was "optional."

In *Momentive*, the Second Circuit determined that a redemption of notes that occurred after the notes had automatically accelerated on account of a bankruptcy default was not a redemption that triggered the make-whole payment under the indenture. The Second Circuit reasoned that the make-whole payment would only be payable if a redemption occurred prior to the notes' maturity date, and automatic acceleration of the notes accelerated the maturity date, foreclosing the possibility of a redemption occurring prior to maturity. Moreover, the Second Circuit held that even if the redemption had occurred prior to maturity, the redemption would not have been "optional" because the redemption would have been mandatory by operation of the automatic acceleration clause.[5]

By contrast, in *EFH*, the Third Circuit found that a redemption of notes in bankruptcy was both a "redemption" and "optional," thus triggering payment of the make-whole premium. The Third Circuit, in analyzing a make-whole premium that became due upon redemptions prior to a date specified in the indenture (rather than prior to maturity), determined that acceleration of the notes by itself would not affect whether a "redemption" had occurred. In addition, the Third Circuit held that the redemption was "optional," and that the occurrence of an automatic acceleration had not deprived the debtors of the option to reinstate the notes instead of redeeming them.[6]

While *Momentive* and *EFH* resulted in opposite outcomes as a result of the Courts' focus on the express terms of the applicable indentures, neither decision addressed the question of whether, if payable under the express terms of an indenture, a claim in bankruptcy arising from a make-whole premium may nevertheless be disallowed as "unmatured interest" under section 502(b)(2) of the Bankruptcy Code. In *Ultra Petroleum I*, the U.S. Bankruptcy Court for the Southern District of Texas held that unimpaired creditors were entitled to receive whatever they were contractually owed under applicable state law, including a make-whole premium, even if their claims would be disallowed by operation of section 502(b)(2) of the Bankruptcy Code.[7] On appeal in *Ultra Petroleum II*, the Fifth Circuit disagreed and held that creditors are impaired only if the terms of the plan itself alters creditors' rights, and that disallowance of a claim by operation of the Bankruptcy Code does not result in impairment.[8] The Fifth Circuit remanded the case to the Bankruptcy Court to decide whether the make-whole premium constituted "unmatured interest" and, if so, whether the equitable doctrine of the "solvent debtor exception" would nonetheless require the make-whole premium to be paid.[9]

On remand in *Ultra Petroleum III*, the Bankruptcy Court ruled that the make-whole premium was not "unmatured interest" or its economic equivalent, and that the solvent debtor exception exists and entitles unimpaired creditors in solvent debtor cases to post-petition interest at the contractual default rate.[10] *Ultra Petroleum III* is currently on appeal before the Fifth Circuit, which heard oral argument on October 4, 2021 and took the case under advisement, with a ruling expected to be forthcoming.

Hertz Bankruptcy Court's analysis

Claim for make-whole is allowed only if payable under the terms of the indentures

Consistent with prior decisions that have addressed make-whole premiums, the Delaware Bankruptcy Court began its analysis by examining the contractual terms of the indentures and concluded that the Hertz Debtors were liable for payment of the optional redemption premium only with respect to a series of notes due in 2026 and 2028 (the 2026/2028 Notes), but not with respect to a separate series of notes due in 2022 and 2024 (the 2022/2024 Notes).

The indentures' optional redemption provisions obligated the Hertz Debtors to pay a premium in the event of a redemption "at the [issuer's] option" and the Delaware Bankruptcy Court held that the redemption here was "optional." The Hertz Debtors relied upon the Second Circuit's decision in *Momentive* to argue that the repayment of the notes was not "optional" because the Hertz Debtors had been forced to file for bankruptcy (and accelerate the notes) due to a deterioration in market conditions stemming from COVID-19, and once in bankruptcy any option that the Hertz Debtors had to reinstate the notes (and avoid redemption) was never economically realistic. The Hertz Debtors further argued that reinstating the notes would have been inconsistent with their fiduciary obligation to pursue a value-maximizing transaction. The Delaware Bankruptcy Court rejected these arguments and, citing to *EFH*, found that the Hertz Debtors

always had the option to avoid the premium by reinstating the notes in bankruptcy, and the debtors' good faith decision against reinstating the notes was voluntary and rendered repayment of the notes "at the Debtors' option."

While the Delaware Bankruptcy Court found that there was an "optional" redemption, whether the "redemption" was of a kind that triggered the make-whole premium turned on the precise language in the applicable indentures. Differences in the drafting of the redemption provisions resulted in divergent outcomes. With respect to the 2022/2024 Notes, the Delaware Bankruptcy Court concluded that a "redemption" could only trigger payment of the make-whole premium if it occurred prior to the actual maturity date of the notes, and that the actual maturity date was the Petition Date, because the notes were automatically accelerated upon the Hertz Debtors' bankruptcy filing. Because the redemption of such notes occurred after the Petition Date (i.e., on the effective date of the plan of reorganization, when the notes were repaid), there was no "redemption" prior to maturity that would have triggered the make-whole premium. With respect to the 2026/2028 Notes, the redemption under the Hertz Debtors' plan occurred prior to the specified date provided in the indentures for when redemption would trigger payment of the make-whole premium. As such, the Delaware Bankruptcy Court found that the make-whole premium was potentially payable under the terms of the indenture governing the 2026/2028 Notes, but not the indenture governing the 2022/2024 notes.

Make-whole premiums might constitute the economic equivalent of unmatured interest and be disallowed by the Bankruptcy Code

Having determined that the make-whole premium was potentially payable under the terms of the indentures for the 2026/2028 Notes, the Delaware Bankruptcy Court turned to whether the Trustees' claim for payment of the make-whole was nonetheless disallowed as "unmatured interest" under section 502(b)(2) of the Bankruptcy Code. The Delaware Bankruptcy Court observed that although a majority of courts have declined to characterize make-whole premiums as "unmatured interest" (including, most recently, the Bankruptcy Court in *Ultra Petroleum III*), it was "not prepared to conclude, as a legal matter, that make-wholes cannot be disallowed as unmatured interest."[11] Rather, the Delaware Bankruptcy Court concluded that whether a make-whole is "the economic equivalent of unmatured interest" is a factual question, and declined to grant dismissal of the Trustees' claim for payment of the make-whole premium on the 2026/2028 Notes.[12]

Notably, the Delaware Bankruptcy Court found it "significant" that the make-whole premium was calculated in large part based on the present value of remaining interest payments on the notes, but also was convinced that evidence raised at oral argument suggesting that the make-whole premium was "much less than a simple present value of the unmatured interest" because it was tied to the Treasury Rate might demonstrate that the redemption premium was not the economic equivalent of unmatured interest.[13]

In solvent debtor cases, unimpaired unsecured creditors are only entitled to post-petition interest at the federal judgment rate

The Trustees relied on two arguments in support of their claim seeking post-petition interest at the applicable contract rate. First, the Trustees argued that section 1124(1) of the Bankruptcy Code requires a plan to leave all "legal, equitable and contractual rights" of creditors unaltered in order for such creditors to be considered unimpaired, and because the unsecured noteholders have a contractual right to payment of interest at the rate set forth in the indenture, they must be paid interest post-petition at such rate in order for them to be validly unimpaired. This argument, which was considered and rejected by the Fifth Circuit in *Ultra Petroleum II*,[14] was also rejected by the Delaware Bankruptcy Court in *Hertz*. The Delaware Bankruptcy Court cited to Third Circuit precedent,[15] as well as the Fifth Circuit in *Ultra Petroleum II*, to hold that impairment under section 1124(1) applies only when creditors' legal rights are being altered by the plan of reorganization; there was no impairment under section 1124(1) if their legal rights were being modified by operation of the Bankruptcy Code itself (i.e., the disallowance of claims for unmatured interest under section 502(b)(2)), rather than by operation of the plan.

Next, the Trustees argued that under the unique circumstances of the *Hertz* case, where the plan paid all creditors in full and provided a substantial return on equity, the equitable doctrine known as the "solvent debtor exception" entitled unimpaired creditors to their full contractual right to payment (including post-petition interest at contractual default rates). The Delaware Bankruptcy Court disagreed and reasoned that the solvent debtor exception applies to a more limited extent than the Trustees contended. The Delaware Bankruptcy Court first observed that section 1129(a)(7) of the Bankruptcy Code entitles *impaired* creditors to post-petition interest at the federal judgment rate in solvent debtor cases. Under section 1129(a)(7), commonly known as the "best interests test", each impaired class of claims must either accept the plan or each creditor in such impaired class must receive under the plan at least what it would have received in a liquidating chapter 7 case. 11 U.S.C. § 1129(a)(7). Section 1129(a)(7)'s reference to chapter 7, in turn, incorporates section 726(a)(5) of the Bankruptcy Code, which provides for the payment of post-petition interest on unsecured claims at the federal judgment rate in a liquidating chapter 7 case before any value can be distributed to shareholders. 11 U.S.C. §

726(a)(5).

The Delaware Bankruptcy Court went a step further and found that, under the solvent debtor exception, section 1129(a)(7) also applies with equal force to *unimpaired* creditors in light of the Bankruptcy Code's silence as to the treatment of unimpaired unsecured creditors in solvent debtor cases and section 1129(a)(7)'s previous applicability to unimpaired creditors. The Bankruptcy Court cited to legislative history to infer that Congress's intent in limiting the application of section 1129(a)(7) to impaired creditors was not to cut off any pre-existing right that unimpaired creditors had to post-petition interest. Rather, Congress only intended for this amendment to modify the Bankruptcy Code such that plan voting rights would be afforded to impaired creditors, but not to unimpaired creditors.

In adopting a narrower view of the solvent debtor exception, the *Hertz* Bankruptcy Court expressly rejected the Bankruptcy Court's decision in *Ultra Petroleum III*, finding it to be "not persuasive."[16] Rather, the Delaware Bankruptcy Court's ruling is consistent with the United States Bankruptcy Court for the Northern District of California's recent *PG&E* decision,[17] which also held that unimpaired unsecured creditors in a solvent debtor case were only entitled to post-petition interest at the federal judgment rate. The *PG&E* decision is on appeal before the Ninth Circuit, which heard oral argument on December 7, 2021.

Takeaways

Hertz follows closely the Third Circuit's decision in *EFH* on matters relating to the contractual interpretation of make-whole language. The divergent outcomes between the series of notes in *Hertz* based on differences in contractual language also highlights the importance (from the noteholders' perspective) of drafting clear and express make-whole provisions to minimize bankruptcy enforceability risks. *Hertz* also continues the Third Circuit's split with the Second Circuit's decision in *Momentive* on the question of whether redemptions that follow automatic acceleration triggered by bankruptcy defaults are optional or involuntary decisions. This split might further incentivize forum shopping by debtors with significant make-whole premium exposure.

Perhaps more importantly, *Hertz* addresses questions that were not fully considered in *Momentive* or *EFH* and which are being actively litigated in the Fifth Circuit and the Ninth Circuit. In the event the Fifth Circuit upholds *Ultra Petroleum III*, the split between *Hertz* and *Ultra Petroleum III* on the question of whether a make-whole premium constitutes unmatured interest may increase uncertainty among market participants with respect to their recoveries on account of make-whole claims. The opposite outcomes between *Hertz* and *Ultra Petroleum III*, with unimpaired creditors receiving post-petition interest at the federal judgment rate in *Hertz* (and an outcome consistent with bankruptcy court decisions in the Ninth Circuit) and post-petition interest at the contract default rate in *Ultra Petroleum III*, underscore the challenge of applying Bankruptcy Code provisions to rare circumstances where chapter 11 debtors are solvent on a liquidation and going-concern basis. With the *Ultra Petroleum III* decision currently on appeal before the Fifth Circuit, and certain counts in the adversary proceeding in *Hertz* surviving the Hertz Debtors' motion to dismiss, it remains to be seen the extent to which a judicial consensus will emerge on these questions and, if so, how debt markets and debtors will respond.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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1 *Wells Fargo Bank, N.A. v. The Hertz Corp., et al.*, Adv. Proc. No. 21-50995-MFW (Bankr. D. Del. Dec. 22, 2021) [ECF No. 28].

2 *See* Fifth Circuit Questions the Enforceability of Make-Whole and Postpetition Interest Claims in Bankruptcy (January 28, 2019); Second Circuit Holds Momentive Noteholders May Be Entitled to Market Interest Rate on Replacement Notes, Not Entitled to Make-Whole Premium (October 23, 2017); Third Circuit Finds Noteholders Have Right to Payment of Make-Whole Premium After Bankruptcy Acceleration (November 28, 2016).

3 *Matter of MPM Silicones, L.L.C. ("Momentive")*, 874 F.3d 787 (2d. Cir. 2017).

4 *In Re Energy Future Holdings Corp. ("EFH")*, 842 F.3d 247 (3d. Cir. 2016).

5 *See Momentive*, 874 F.3d at 802-3.

6 *See EFH*, 842 F.3d at 255-57.

7 *See In re Ultra Petroleum Corp. ("Ultra Petroleum I")*, 575 B.R. 361, 373 (Bankr. S.D. Tex. 2017).

8 *See In re Ultra Petroleum Corp. ("Ultra Petroleum II")*, 943 F.3d 758, 763 (5th Cir. 2019).

9 *See id*. at 765. In an initial opinion issued by the Fifth Circuit, *In re Ultra Petroleum Corp.*, 913 F.3d 533, 537 (5th Cir. 2019), the Fifth Circuit had suggested that the make-whole premium did constitute "unmatured interest" and that the solvent debtor exception may not have survived enactment of the Bankruptcy Code in 1978. However, the unsecured creditors requested rehearing *en banc* of this decision, and on *en banc* review, the Fifth Circuit withdrew the initial option, superseding it with the decision in *Ultra Petroleum II*, which left these issues to be determined by the Bankruptcy Court in the first instance.

10 *See In re Ultra Petroleum Corp. ("Ultra Petroleum III")*, 624 B.R. 178 (Bankr. S.D. Tex. 2020).

11 *Hertz*, Adv. Proc. No. 21-50995-MFW at 20.

[12] *Id*. at 21-23.

[13] *Id*. at 22. The Delaware Bankruptcy Court noted that even if the make-whole premium were to be characterized as unmatured interest, the question of whether such interest is capped at the federal judgment rate would be analyzed in the same manner as the Trustees' claims for post-petition interest on the principal amount of their notes claims. *Id*. at 25. As described below, the Delaware Bankruptcy Court held that the solvent debtor exception provides that in a solvent debtor case, post-petition interest is payable at the federal judgment rate.

[14] *See Ultra Petroleum II*, 943 F.3d at 764.

[15] *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 204 (3d Cir. 2003).

[16] *Hertz*, Adv. Proc. No. 21-50995-MFW at 39.

[17] *See In re PG&E Corp.*, 610 B.R. 308, 316 (Bankr. N.D. Cal. 2019).