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Third Circuit Requires Payment of Make-Whole Premiums and PPI, Joining Fifth and Ninth Circuits

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In the chapter 11 cases of The Hertz Corp. and its affiliated debtors, the Third Circuit expanded the solvent-debtor exception to require payment of post-petition interest (PPI) by a solvent debtor to creditors at the contract rate, rather than at the lower federal judgment rate.[1] This decision also included a holding that although make-whole premiums on unsecured debt are disallowed under § 502(b) of the Bankruptcy Code as unmatured interest, make-wholes must be paid on unsecured debt as a form of PPI under the solvent-debtor exception.[2]

The *Hertz* decision followed decisions by the Fifth Circuit in *Ultra Petroleum*[3] and the Ninth Circuit in *PG&E*,[4] both of which held that the solvent-debtor exception requires payment of PPI at the contract rate.[5] *Hertz* also followed *Ultra Petroleum* in enforcing make-whole premiums as PPI.[6]

Background and Procedural History

Hertz filed for chapter 11 protection in the U.S. Bankruptcy Court for the District of Delaware in May 2020, at the peak of the COVID-19 pandemic's disruption to the U.S. economy.[7] While the case was pending, pandemic restrictions were lifted, the economy began to recover, and Hertz ultimately emerged as a solvent debtor.[8]

Its plan purported to leave all creditors unimpaired and distribute approximately $1.1 billion to its pre-petition equityholders.[9] The plan preserved a dispute between the debtors and a group of unsecured noteholders over the appropriate treatment of the noteholders' claims: The noteholders had argued that "unimpaired" classification required payment of PPI at the contract rate, plus a make-whole premium, whereas Hertz had argued that the noteholders were entitled only to payment at the federal judgment rate, with no make-whole.[10] The additional amounts that the noteholders asserted they were owed were valued at approximately $270 million.[11]

PPI: Solvent-Debtor Exception and Absolute-Priority Rule

The solvent-debtor exception is a basic principle of bankruptcy that long predates the Bankruptcy Code and holds that PPI is not payable to any creditor unless sufficient assets exist in the bankruptcy estate to pay all pre-petition unsecured claims in full. In 2022, the Ninth Circuit in *PG&E* became the first circuit court to hold that the solvent-debtor exception creates an equitable right to payment of PPI on the allowed amount of all unimpaired creditors' pre-petition claims *at the applicable-contract rate* (or, in the absence of a specified rate, at the state law default interest rate), as opposed to the "much lower" federal judgment rate.[12] Shortly after the *PG&E* decision, the Fifth Circuit issued a parallel ruling in *Ultra Petroleum*.

Both the *PG&E* and *Ultra Petroleum* cases involved solvent debtors who had sought to pay

1 *In re Hertz Corp.*, No. 23-1169, 2024 WL 4132132 at *14 (3d Cir. Sept. 10, 2024).
2 *Id.* at *8.
3 *In re Ultra Petroleum Corp.*, 51 F.4th 138 (5th Cir. 2022).
4 *In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022).
5 *PG&E* at 1061; *Ultra Petroleum* at 157-58.
6 *Ultra Petroleum* at 156-57.
7 *Hertz* at *14.
8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.*
12 *PG&E* at 1051.

PPI to "unimpaired" classes of creditors at the federal judgment rate rather than at the contractual rate. Both found that pre-Bankruptcy Code practice required the payment of PPI at the contract rate by solvent debtors,[13] and concluded on the basis of U.S. Supreme Court precedent that pre-Code practice must be adhered to in the absence of a clear statement in the Code to the contrary.[14] As such, both courts found that the Code contains an equitable right to contract-rate PPI "before allocation of surplus value" to equityholders "absent compelling equitable considerations."[15]

The *PG&E* court also supported its analysis with the Code's "concept of impairment" as enacted in § 1124(1),[16] noting that provision of PPI to the relevant class at the federal judgment rate (*i.e.*, at the rate of PPI to which such class would be entitled as impaired creditors) was not "fair and equitable" under § 1129(b)(1), given that the plan characterized the class receiving this payment as *unimpaired*.[17] This outcome, the *PG&E* court concluded, would permit debtors to have it both ways, which would be to "pay [the unimpaired class] the same, reduced interest rate as impaired creditors, while depriving them of the statutory protections that impaired creditors enjoy."[18]

Similarly, the *Ultra Petroleum* court held that § 1124(1), which requires that a plan "leave ... unaltered the legal, equitable, and contractual rights" of unimpaired creditors,[19] requires payment of contract-rate PPI "as a matter of equity ... when a solvent debtor is fully capable of paying up."[20] On this basis, the Fifth Circuit concluded that the Code requires payment of PPI at the contract rate.[21]

The *Hertz* decision reached the same conclusion — that PPI must be paid to all creditors before any distribution is made to equity — but on a different basis. The *Hertz* court rooted its analysis in the absolute-priority rule.[22] The court first held that the Bankruptcy Code adopted the absolute-priority rule in its entirety, and noted that the Supreme Court in *Jevic* had overturned the Third Circuit itself in holding that the requirements of § 1129 — which articulates the absolute-priority rule — "appl[y] everywhere absent a clear statement authorizing a departure."[23]

The Third Circuit analyzed the "fair and equitable" test of § 1129 in the context of PPI owed by solvent debtors. The court quoted the *Ultra Petroleum* court in articulating a simple rule: "When a debtor can pay its creditors' interest on its unpaid obligations in keeping with the valid terms of their contract, it must."[24] In *Hertz*, this required payment of the contract rate of PPI to the relevant noteholders.

Critically, the *Hertz* court did not hold that the contract rate is necessarily required to be paid in all solvent-debtor cases. Instead, it held that the absolute-priority rule requires payment of "the *equitable* rate of post-petition interest, whatever that may be," and observed that this equitable inquiry might become relevant where there exist sufficient assets in the estate to pay PPI to some but not all creditors to whom it is contractually owed.[25] The court observed that under these circumstances, it would likely remand to the bankruptcy court to determine the equitable rate.[26] In this case, the Third Circuit did not do so, for two reasons.

First, as a procedural matter, Hertz did not request a remand as an alternative to awarding the noteholders their requested interest amount, and the Third Circuit stated that the "doctrine of forfeiture counsel[ed] against rewarding that choice."[27] Next, as an equitable matter, the court noted that typically the appropriate rate of PPI is determined at plan confirmation, before payments are made to creditors or equityholders.[28] However, because the Third Circuit's decision came more than three years after plan distributions were made (including the $1.1 billion payment to equity), it was impossible to "unscramble that egg," which the equitable calculus must take into account.[29] Therefore, it concluded that payment of the full contract-rate PPI was the only equitable outcome.

Make-Whole Premium

The Third Circuit in *Hertz* also required payment of the make-whole premium to noteholders. A make-whole premium is a variable payment designed to compensate lenders for lost profits where a borrower pays back what it owes ahead of schedule, and therefore does not make all of the anticipated stream of interest payments. In the *Hertz* case, if the debtors had redeemed the relevant notes on the petition date without filing for bankruptcy, they would have owed the noteholders approximately $270 million in contract rate interest plus the make-whole premium.[30] The Third Circuit observed that "the savings effectively went to the [pre-petition equityholders],"[31] and then some.

The Third Circuit held that the make-whole at issue fit the dictionary and case law definitions of interest and was the "economic equivalent" of unmatured interest, noting that the make-whole amount was comprised of interest coupons owed through the scheduled redemption date, plus a redemption fee, with a present-value discount.[32] It held that the make-whole was therefore disallowed by § 502(b)'s proscription against claims for unmatured interest or its economic equivalent.[33]

However, the *Hertz* court determined that the make-whole premium was payable *as PPI* on the grounds that the make-whole was "contractual interest accruing after the bankruptcy filing."[34] This was consistent with the Fifth Circuit's decision in *Ultra Petroleum*, which held that "the traditional solvent-debtor exception compels payment of the Make-Whole Amount."[35]

13 *PG&E* at 1053-55; *Ultra Petroleum* at 150-52.
14 *PG&E* at 1057-58; *Ultra Petroleum* at 153-54.
15 *PG&E* at 1064; *Ultra Petroleum* at 159-60.
16 *PG&E* at 1061.
17 *Id.* at 1055-56.
18 *Id.* at 1061.
19 11 U.S.C. § 1124(1).
20 *Ultra Petroleum* at 159.
21 *Id.* at 160.
22 *Hertz* at *2.
23 *Id.* at *11 (quoting *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451, 465 (2017)).
24 *Id.* at *13 (quoting *Ultra Petroleum* at 150).
25 *Id.* at *14.
26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.*
30 *Id.* at *1.
31 *Id.*
32 *Id.* at *6-8.
33 *Id.* at *8.
34 *Id.* at 40.
35 *Ultra Petroleum* at 160.

In supporting its conclusion that PPI must be paid at the contract rate (and that such PPI included the make-whole premium), the *Hertz* court observed that to hold otherwise would create "significant tensions with the Code's basic structure."[36] It observed first that per § 1129(a)(1), when only one class of creditors would suffer losses under a plan, the plan cannot be confirmed over their objection.[37] In *Hertz*, all other classes except for the noteholders would have received full recoveries such that the proposed plan (including payment of the noteholders' PPI at the federal judgment rate) would have benefited all parties at the noteholders' expense.

In addition, the absolute-priority rule holds that where a debtor is solvent, impaired rejecting creditors "may receive contract rate interest through the absolute-priority rule"[38] — a principle that would have been turned on its head in the event of the result sought by Hertz. This would have resulted in the noteholders, as ostensibly unimpaired creditors, receiving the federal judgment rate (and no make-whole), which would not have met the "fair and equitable" standard given that the debtors were solvent. The *Hertz* court further observed that it could not be the case that creditors who were unimpaired (as Hertz claimed the noteholders were) were treated worse than impaired creditors, "who at least get to vote."[39]

Petition for Rehearing

Subsequent to the issuance of the Third Circuit's decision, Hertz sought *en banc* consideration of the panel's decision, arguing that the court's ruling was inconsistent with its holding in *PPI Enterprises*.[40] In *PPI Enterprises*, another solvent-debtor case, a landlord filed a claim for more than $4 million due under the terms of a long-term lease.[41] The Bankruptcy Code limits an allowed claim by a lessor to three years.[42] As such, the debtor proposed a plan that classified the landlord as unimpaired, and limited his allowed claim to three years' rent.[43]

The Third Circuit rejected the landlord's argument that he should receive the full amount owed to him under the contract, even though lower-priority claimants (including equityholders) received distributions under the plan.[44] It also held that the landlord was not impaired because the limitation on his allowed claim was imposed by the Code itself — not by the plan.[45]

Hertz argued in its petition for rehearing that *PPI Enterprises* should have controlled the Third Circuit's decision in *Hertz* because the noteholders' claims for contract-rate PPI and the make-whole premium are disallowed not by the debtors' plan, but by § 502(b)(2). It further argued that the decision's reliance on the absolute-priority rule could not be squared with relevant Supreme Court precedent.

Legacy of *Hertz*

If the petition for rehearing is denied, or if it is granted and the panel's decision is upheld, it will substantially solidify the circuit-level consensus that PPI must be paid at the contract rate by solvent debtors, including payment of make-wholes. On the other hand, a decision by the full Third Circuit to overturn the panel's decision would create a circuit split that would be a prime candidate for *certiorari* in the next Supreme Court term. The debtors in both *PG&E* and *Ultra Petroleum* previously sought *certiorari* of the circuit decisions and were denied.

Unless it gets overturned, the decision leaves open one main area for further development in the case law: namely, a scenario in which the "equitable" rate of PPI might differ from the contract rate (for example, where there exist sufficient assets in the estate to pay a portion of contractually owed PPI but not the full amount to all parties). The *Hertz* court suggested that it might, under other circumstances, have remanded to the bankruptcy court for a compromising, equitable solution rather than award the full contract rate of PPI to the noteholders. In the wake of *Hertz*, any debtor seeking such an outcome in the alternative to its primary preferred outcome is unlikely to receive it in the absence of explicitly requesting remand for this reason in its appellate papers.

Under circumstances like those in *Hertz*, it is unlikely that any court in the Third, Fifth or Ninth Circuits would uphold the awarding of a substantial return to equity while paying less than the contract rate to any class of creditor, and it is possible, if not likely, that other circuit courts will follow. Hertz expressly attacked this aspect of the Third Circuit's holding in its petition for rehearing, and if the petition is granted, the Third Circuit would likely examine this aspect of the holding closely.

Implications of the *Hertz* Decision for Debtors and Creditors

After *PG&E*, *Ultra Petroleum* and *Hertz* (unless reversed), solvent debtors in the relevant circuits may no longer argue that creditors receiving less than contract-rate PPI and make-whole premiums are unimpaired for plan-confirmation purposes, and such an argument is increasingly likely to be rejected — even in districts where the circuit courts have not yet ruled on the issue.[46] This will result in an increase in leverage during the plan process for unsecured creditors of solvent or near-solvent debtors, potentially triggering valuation disputes and resulting in reduced returns to equity where debtors are in fact solvent at emergence. abi

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36 *Hertz* at *14.
37 *Id.*
38 *Id.*
39 *Id.* (quoting *Ultra Petroleum* at 158).
40 *See* Petition for Rehearing *En Banc*, *In Hertz Corp., et al.*, Nos. 23-1169, 23-1170 (3d Cir. Oct. 15, 2024); *In re PPI Enters. (U.S.) Inc.*, 324 F.3d 197 (3d Cir. 2003).
41 *In re PPI Enters. (U.S.) Inc.*, 228 B.R. 339, 347-48 (D. Del. 1998).
42 11 U.S.C. § 502(b)(6).
43 *PPI Enters.*, 324 F.3d at 202.
44 *Id.* at 202-04.
45 *Id.* at 204.

46 The Second Circuit has held that appellant noteholders' claims were "not impaired simply because they did not receive post-petition interest, [a]lthough they had a contractual right to such interest." *In re LATAM Airlines Grp. S.A.*, 55 F.4th 377, 385 (2d Cir. 2022). It also examined the issue of whether PPI is owed by solvent debtors, but did not rule on the issue in light of its affirmation of the bankruptcy court's finding that the debtor in that case was insolvent.