Make-Whole Claim Lessons From Hertz Bankruptcy Ruling

By **Louis Chiappetta, Lucy Kweskin and Samuel Rabuck** (January 20, 2022, 3:35 PM EST)

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Given the uncertainty of their enforceability in a bankruptcy court, make-whole provisions have long been a source of contention for debtors and creditors alike.

Last month, the U.S. Bankruptcy Court for the District of Delaware offered some clarity, when U.S. Bankruptcy Judge Mary Walrath issued an opinion in Wells Fargo Bank NA v. Hertz Corp.[1] keeping alive claims for an approximately $136 million make-whole payment with respect to Hertz's 2026/2028 notes but dismissing make-whole claims of approximately $12 million for Hertz's 2022/2024 notes.

Additionally, the court dismissed the noteholders'[2] demand for contract-rate post-petition interest, which would have amounted to approximately $40 million for the 2022/2024 notes and approximately $87 million for the 2026/2028 notes compared to the merely $3 million of interest at the federal judgment rate.

Notably, the court declined to impose a bright-line rule that make-wholes are unmatured interest, which would require their disallowance under Section 502(b)(2) of the Bankruptcy Code, as courts in other jurisdictions have considered, including in the pending Ultra Petroleum Corp. case.[3]

The opinion adds to the growing collection of case law addressing make-whole premiums and has significant implications for both debtors and creditors when it comes to the drafting, triggering and enforceability of make-whole claims in bankruptcy cases.

Background

Hertz filed for bankruptcy in May 2020, citing the disruption to the car rental business caused by the COVID-19 pandemic. In June 2021, following a robust auction process, Hertz's Chapter 11 plan of reorganization was confirmed, with unsecured claimants receiving full recoveries plus a recovery for existing equity holders.

The plan deemed the 2022/2024 notes and the 2026/2028 notes unimpaired and did not permit the noteholders to vote to accept or reject the plan. However, the plan expressly preserved the rights of the noteholders to assert their make-whole claims.

Additionally, the plan provided that the noteholders would receive cash in full plus payment of post-petition interest at the federal judgment rate, which in this low-interest rate environment was only 15 basis points, but preserved the noteholders' rights to assert that they were instead owed additional interest at the contract rate — between 5.5% and 7.125% — under the notes in order for their claims to be deemed unimpaired.

Following the court's confirmation of the Chapter 11 plan, Wells Fargo, as indenture trustee for each series of notes sued, seeking payment of the make-whole amounts and post-petition interest at the contract rate. Hertz subsequently moved to dismiss the suit.

The Opinion

The court began its analysis by turning to the indenture agreements governing each of the 2022/2024 and 2026/2028 notes.[4] Hertz argued the acceleration clause in the indentures was the operative provision and that no make-whole was due because the acceleration clause only specified that principal and accrued unpaid interest were due but not the make-whole.[5]

The court was unpersuaded, finding instead that the indentures' redemption provisions, which do discuss the make-whole, govern, citing the U.S. Court of Appeals for the Third Circuit's 2016 decision in In re: Energy Future Holdings Corp.[6] as controlling precedent.[7]

In EFH, the Third Circuit rejected a similar argument when it held that the redemption provision "is the only provision that specifically addresses redemption" — and that the acceleration provision simply addressed different matters.[8]

Turning to the indentures' redemption provisions, Hertz first argued that for the make-whole to be due, the notes would have to be redeemed "at [Hertz'] option." Hertz maintained the notes were not redeemed at its option because Hertz was forced to file for bankruptcy due to business hardships caused by the pandemic.[9]

Hertz further argued that, upon its bankruptcy filing, the notes were automatically accelerated and required to be paid in full, thus redemption of the Notes was not at Hertz' option.[10]

In support of its argument, Hertz cited In re: MPM Silicones LLC,[11] where, in 2017, the U.S. Court of Appeals for the Second Circuit held that repayment of the debt was mandated by the automatic acceleration of the debt upon the bankruptcy filing, and, therefore, the debt there was not redeemed at the debtors' option.[12]

The court rejected Hertz' argument, noting that EFH had expressly rejected the argument that acceleration obviated an optional redemption.[13] Moreover, the court acknowledged that while MPM supports Hertz' argument, MPM is not the law in the Third Circuit.[14] Finally, the Court was unpersuaded by Hertz' attempt to distinguish EFH on the grounds that, unlike in EFH, Hertz did not file bankruptcy in a strategic effort to avoid the payment of a make-whole premium.[15]

The court noted that

the EFH court did not conclude that the voluntariness of the redemption was dependent on a finding that the debtor filed bankruptcy to avoid the obligation to pay the noteholders a [make-whole] premium.[16]

Further, per EFH, a redemption is voluntary because once in bankruptcy, the debtor has the option to reinstate the debt.[17]

Despite Hertz' assertion that reinstatement was not actually an option because they had not

received any offers that permitted reinstatement, the court held that Hertz had voluntarily filed bankruptcy, the bankruptcy filing was not Hertz' only option, and "at numerous junctures in any bankruptcy case, a debtor in possession has multiple paths from which to choose."[18]

The court then reviewed in detail the terms of the indentures' redemption provisions.[19] Section 6(a) provides that the

Notes will be redeemable, at the Company's option, in whole or in part, at any time and from time to time on or after [a specified date] and prior to maturity at the applicable redemption price set forth below."[20] The Court's decision hinged on the interpretation of the undefined term "maturity."[21]

However, the indentures did contain a defined term — the "Stated Maturity" — specifying the date certain when each of the notes was originally due.[22] Wells Fargo argued "maturity" referred to the notes' original 2022/2024 maturities, and, thus, the debtors had redeemed the notes prior to "maturity."[23]

The court disagreed, concluding that the use of the undefined term "maturity" in Section 6(a) referred to the common meaning of maturity, which included the new maturity date triggered by the automatic acceleration upon the bankruptcy filing, and not the already defined term "Stated Maturity."[24]

Supporting this position was the use of lowercase "maturity" in other sections of the indentures in reference to acceleration of the notes upon bankruptcy or default.[25]

Accordingly, the court dismissed the make-whole claim with respect to the 2022/2024 notes because they were not redeemed both after the specified date and prior to "maturity," as required under Section 6(a), when the maturity had been accelerated as a result of the bankruptcy filing.[26]

With respect to the 2026/2028 notes, Wells Fargo argued that Section 6(a) did not apply because these notes were not redeemed after the date certain — the first requirement in Section 6(a).[27] Instead, Wells Fargo argued that Section 6(c) applied, which provides, "[a]t any time prior to [a date certain], the [Notes] may also be redeemed ... in whole or in part, at the Company's option, at ... the Redemption Price."[28]

Hertz argued that 6(c) was incorporated into Section 6(a) and thus did not apply.[29] The court disagreed, citing principles of contract interpretation and noting that Sections 6(a) and 6(c) provide redemption options under different scenarios — i.e., Section 6(a) is only applicable if redemption occurs after a specified date, while Section 6(c) only applies if redemption occurs before that date, and each section provides a different redemption price.[30]

Thus, the court found that the 2026/2028 Noteholders' make-whole claim under Section 6(c) survived.[31]

The court then addressed Hertz' arguments that even if a make-whole premium was due under the 2026/2028 notes, it would be disallowed under Section 502(b)(2) of the Bankruptcy Code, which disallows claims for "unmatured interest."[32]

The court declined to make a wholesale legal conclusion that make-wholes constitute unmatured interest and are thus disallowed.[33] Instead, the court determined it is a

factual question — one that requires a court to determine on a case-by-case basis whether a make-whole is the "economic equivalent of unmatured interest."[34]

Because Wells Fargo had presented some evidence that the make-whole was not the economic equivalent of unmatured interest — via a presentation that suggested the redemption price was not simply the present value of unmatured interest — the court declined to dismiss the claim.[35] The court noted that the make-whole was unmatured as of the bankruptcy filing because the make-whole was not due until the redemption occurred when Hertz's Chapter 11 plan went effective.[36]

However, the court allowed the claims to continue while indicating that Wells Fargo would have to provide additional evidence that the redemption premium did not constitute the economic equivalent of unmatured interest.[37]

Finally, the court addressed the noteholders' demand for payment of interest at the contract default rate rather than the federal judgment rate.[38]

The court dismissed this claim, finding that Sections 1129(a)(7) and 726(a)(5) of the Bankruptcy Code require payment of post-petition interest at the federal judgment rate — and, thus, the noteholders were not impaired because it was the Bankruptcy Code, as opposed to Hertz's Chapter 11 plan itself, that impaired the noteholders' claims for post-petition interest at the contract rate.[39]

The court also declined to use the "solvent debtor exception" to impose the higher interest rate. While the Bankruptcy Code does permit creditors to receive post-petition interest where the debtor is solvent — and creditors must receive interest to be considered unimpaired — the court concluded there is no requirement that such interest be paid at the full contract rate.

Takeaways

The lesson from this decision for both debtors and creditors is simple: Draft carefully. A bankruptcy filing will accelerate debt, which in turn advances the debt's maturity to the bankruptcy filing date, rather than the original stated maturity. In this case, the use of "maturity" as opposed to "Stated Maturity" was critical to the court's dismissal of the 2022/2024 notes' make-whole.

Creditors and debtors alike should also take note that in the Third Circuit, a bankruptcy filing, even one made in the utmost good faith, will likely constitute a voluntary redemption of notes and trigger provisions addressing redemption and corresponding make-whole payments.[40]

This contrasts with the Second Circuit, which, following MPM, appears to have more onerous requirements for an entitlement to make-wholes when it comes to defining optional redemption and determining the interplay between acceleration and make-whole provisions.[41]

In planning for a bankruptcy filing, forbearance or out-of-court restructuring, all stakeholders should carefully review the underlying documentation to understand the circumstances that will trigger a make-whole and any additional requirements.

Additionally, the court left open the question of whether make-whole premiums constitute unmatured interest. This argument gained traction in the U.S. Court of Appeals for the Fifth

Circuit's 2019 decision in Ultra Petroleum, when it found that make-wholes constitute unmatured interest and are therefore disallowed under Section 502(b)(2) of the Bankruptcy Code.[42]

However, the Fifth Circuit later vacated its prior decision and remanded to the Ultra Petroleum bankruptcy court, where that court subsequently held the make-whole was not unmatured interest. The Ultra Petroleum bankruptcy court's ruling is currently on appeal once again before the Fifth Circuit.

The argument that make-whole provisions constitute unmatured interest may continue to arise as courts evaluate these prepayment premiums and may shape best practices in formulating clauses to avoid such arguments.

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[1] Wells Fargo Bank, N.A. v. Hertz Corp. (In re Hertz Corp.), No. 20-11218 2021 WL 6068390 (Bankr. D. Del. Dec. 22, 2021).

[2] Capitalized terms used but not otherwise defined in this article have meaning ascribed to them in the Opinion.

[3] That appeal stems from the Southern District of Texas Bankruptcy Court's October 2020 ruling that make-wholes do not constitute unmatured interest. In re Ultra Petroleum, 624 B.R. 178, 188 (Bankr. S.D. Tex. 2020) ("The Make-Whole Amount is neither interest nor unmatured interest.").

[4] Hertz, 2021 WL 6068390 at *3.

[5] Id.

[6] In re Energy Future Holdings Corp., 842 F.3d 247 (3d Cir. 2016).

[7] Hertz, 2021 WL 6068390 at *3.

[8] EFH, 842 F.3d at 256.

[9] Id.

[10] Id.

[11] In re MPM Silicones, L.L.C., 874 F.3d 787 (2d Cir. 2017).

[12] Id. at 803.

[13] Hertz, 2021 WL 6068390 at *4.

[14] Id.

[15] Id.

[16] Id.

[17] Id.

[18] Id. at *5.

[19] Id.

[20] Id.

[21] Id. at *6.

[22] Id.

[23] Id.

[24] Id.

[25] Id.

[26] Id.

[27] Id.

[28] Id.

[29] Id.

[30] Id. at *7.

[31] Id.

[32] Id.

[33] Id. at *8.

[34] Id.

[35] Id. at *9.

[36] Id.

[37] Id.

[38] U.S. Bank intervened in this action as plaintiff and joined Wells Fargo in this count of the complaint.

[39] Id. at *12.

[40] See, e.g., In re Energy Future Holdings Corp., 842 F.3d 247 (3d Cir. 2016); Wells Fargo Bank, N.A. v. Hertz Corp. (In re Hertz Corp.), No. 20-11218 2021 WL 6068390 (Bankr. D. Del. Dec. 22, 2021).

[41] In re MPM Silicones, L.L.C., 874 F.3d 787, 803 (2d Cir. 2017).

[42] Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Inc. (In re Ultra Petroleum Corp.), 913 F.3d 533, 547 (5th Cir. 2019) vacated, Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Inc. (In re Ultra Petroleum Corp.), 943 F.3d 758 (5th Cir. 2019).