Jevic Keeps on Gifting: Third Circuit Reaffirms Solvent Debtor Exception by Holding Unsecured Creditors of Solvent Debtor Entitled to Post-Petition Interest at the Contract Rate

September 12, 2024

On September 10, 2024, the U.S. Court of Appeals for the Third Circuit held in *In re The Hertz Corporation* that unsecured creditors of a solvent debtor are entitled to receive the contractual rate of interest, rather than interest accruing at the federal judgment rate.[1] The Third Circuit also held that while redemption premiums are the economic equivalent of unmatured interest, the unsecured noteholders were entitled to payment of the redemption premium because Hertz was solvent.

Background

The Hertz Corporation and its affiliates (the "Debtors") submitted a chapter 11 plan (the "Plan"), which purported to pay all creditors in full. Although the Debtors' liquidity improved during the course of their bankruptcy case, the Plan provided that unsecured creditors would receive only post-petition interest accruing at the federal judgment rate (which, as applied in this case, was 0.15% annually).[2] The Plan did not provide unsecured creditors with interest at the contract rate (which, in the case of the unsecured notes, accrued at approximately 6% per annum) or payment of any redemption premium.[3] In other words, the Plan offered unsecured creditors substantially less than what they were entitled to receive under their debt agreements. The Plan also offered prepetition stockholders a $1.1 billion distribution, consisting of stock, warrants, and cash.[4] Because the Plan purported to pay all creditors in full, the Debtors treated their unsecured noteholders (the "Noteholders") as unimpaired creditors who were not entitled to vote on the Plan. The Court confirmed the Plan in June 2021.

The Noteholders filed an adversary complaint seeking a declaration that they were entitled to payment of post-petition interest at the contract rate and to redemption premiums. The Bankruptcy

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

[2] *In re The Hertz Corp.*, 2024 WL 4132132 at *3.

[3] *Id.*

[4] *In re The Hertz Corp.*, 2024 WL 4132132 at *3.

This memorandum has been prepared by Cadwalader, Wickersham & Taft LLP (Cadwalader) for informational purposes only and does not constitute advertising or solicitation and should not be used or taken as legal advice. Those seeking legal advice should contact a member of the Firm or legal counsel licensed in their jurisdiction. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. Confidential information should not be sent to Cadwalader without first communicating directly with a member of the Firm about establishing an attorney-client relationship. ©2024 Cadwalader, Wickersham & Taft LLP. All rights reserved.

Court rejected those arguments, finding that the "solvent debtor" exception only required the Debtors to pay the Noteholders interest accruing at the federal judgment rate.[5] Thereafter, the Bankruptcy Court issued a separate decision holding that the redemption premiums were the economic equivalent of unmatured interest and therefore were disallowed under section 502(b)(2) of the Bankruptcy Code. The Noteholders appealed the Bankruptcy Court's decisions.[6]

The Majority Decision

In a comprehensive opinion authored by Judge Ambro, a majority panel of the Third Circuit reversed in part and affirmed in part the Bankruptcy Court's decisions. The majority agreed with the Bankruptcy Court that the redemption premiums were the equivalent of unmatured interest and therefore were subject to disallowance under the Bankruptcy Code. However, the Court reversed the Bankruptcy Court's determination that the Noteholders were not entitled to payment of interest at the contract rate, as well as the Bankruptcy Court's determination that the Noteholders were not entitled to payment of the redemption premiums.

I. The Redemption Premiums Are Disallowable Under Section 502(b)(2).

When a borrower prepays or redeems its debt prior to its stated maturity date, "lenders lose interest they otherwise would have received" under their debt agreements.[7] Indentures and credit agreements therefore often provide that a borrower may prepay or redeem the debt prior to its stated maturity date, but only if the borrower pays a fee known as a "make-whole" or "redemption" premium. This fee provides the lenders with a "minimum return on their investment . . . independent of when the debt instrument is repaid."[8]

The Bankruptcy Court determined that the redemption premiums in this case were the economic equivalent of interest and disallowed those redemption premium claims.[9] On appeal, the Noteholders argued that interest generally includes only fees that accrue "while borrowed money is used."[10] According to the Noteholders, the redemption premium was "not compensation for Hertz's ongoing use of the Noteholders' money," and instead was "compensation for the termination of Hertz's obligations to the Noteholders."[11]

---

[5] We previously summarized the Bankruptcy Court's decision here.

[6] The Bankruptcy Court *sua sponte* certified its decisions for a direct appeal to the Third Circuit. *In re The Hertz Corp.,* 2024 WL 4132132 at *3.

[7] *In re The Hertz Corp.,* 2024 WL 4132132 at *5.

[8] *Id.* at *5 (citations omitted).

[9] Section 502(b)(2) disallows claims for "unmatured interest," which includes post-petition interest. 11 U.S.C. § 502(b)(2).

[10] *Id.* at *7.

[11] *Id.*

The Court agreed with the Bankruptcy Court that the redemption premiums were the equivalent of unmatured interest. The Court disagreed with the Noteholders' contention that interest included only fees accruing while borrowed money is used by the debtor. The Court noted that other courts have found that interest includes "compensation for the use or forbearance of money" and the "cost of having the use of another person's money for a specified period."[12] According to the Court, these "definitions of interest do not require that a charge . . . be contingent on 'ongoing' use of money."[13]

The Noteholders also contended that the redemption premium was a fee that compensated them for reinvesting their prepaid principal "in a less-advantageous market environment."[14] The Court held that the "reinvestment costs are the unmatured interest the Noteholders will not recover in the market" and are therefore the "economic equivalent of interest."[15] Consequently, the Court held that the redemption premiums were disallowable under section 502(b)(2) as unmatured interest.

II. The Solvent Debtor Exception Required Payment of Unmatured Interest at the Contract Rate.

Although the Third Circuit agreed with the Bankruptcy Court that the redemption premiums were the equivalent of unmatured interest, the Court reversed the Bankruptcy Court's determination that a solvent debtor only needed to pay unsecured creditors post-petition interest at the federal judgment rate. The Court held that the Noteholders were entitled to payment of unmatured interest (including the redemption premiums) at the contract rate.

At the center of the *Hertz* dispute is the common law "solvent debtor" exception.[16] That exception was born out of pre-Code jurisprudence applying the absolute priority rule, which prevents equity holders, "the most junior claimants, from recovering anything unless creditors . . . are paid in full or consent."[17] The absolute priority rule was incorporated into section 1129(b) of the Bankruptcy Code, which protects "impaired creditors from overreaching plans."[18] This rule is applicable in "cramdown" plans, where plan proponents seek to confirm a plan over the objection of an impaired class of creditors.

---

[12] *Id.* (citing *Deputy v. du Pont*, 308 U.S. 488, 498 (1940) and *Love v. State*, 383 N.E.2d 1296, 1298 (N.Y. 1991).

[13] *Id.* at *7.

[14] *Id.* at *8.

[15] *Id.*

[16] We previously discussed the history of the solvent debtor exception here.

[17] *In re The Hertz Corp.,* 2024 WL 4132132 at *10.

[18] *Id.*

The Court rejected the Bankruptcy Court's conclusion that the absolute priority rule is inapplicable to unimpaired creditors. Although section 1129(b) only addresses impaired creditors, the Court held that the absolute priority rule applies to all creditors, regardless of whether they are impaired.[19] The Court found support for this conclusion in the Supreme Court's decision in *Czyzewski v. Jevic*.[20] In *Jevic*, an appellate court affirmed the approval of a structured dismissal order that purported to pay junior creditors while giving nothing to hostile creditors with higher priority.[21] The appellate court reasoned that the absolute priority rule applied only where the Bankruptcy Code explicitly mentions it. The Supreme Court reversed that decision, holding that the absolute priority rule applied "everywhere absent a clear statement authorizing a departure" from that rule.[22] The Supreme Court determined that the "importance of the [Bankruptcy Code's] priority system leads us to expect more than simple statutory silence if, and when, Congress were to intend a major departure."[23] In so holding, the Supreme Court rejected the use of structured dismissals as a "backdoor means to achieve the exact kind of nonconsensual priority-violating final distributions" that the Bankruptcy Code prohibits in chapter 11 plans.[24] Applying *Jevic*, the Third Circuit held that allowing "Hertz to cancel more than a quarter billion dollars of interest while distributing a massive gift to Stockholders" would deviate from the Bankruptcy Code's priority rules.[25]

The Court also held that impairment is intended to be defined in the "broadest possible terms."[26] To qualify as an unimpaired creditor, a chapter 11 plan must pay that creditor's claims in full. Noting that other courts have found that a small delay in payment in full qualifies as impairment under section 1124 of the Bankruptcy Code, the Court determined that a creditor that stands to lose hundreds of millions of dollars in post-petition interest and fees should qualify as an impaired creditor. The Court found that if it held otherwise, creditors would be forced to accept—"without even the chance to vote or explicit statutory authorization"—treatment that falls short of the cramdown requirements.[27]

The Debtors argued that the absolute priority rule does not require full payment of post-petition interest because that rule (as incorporated in section 1129(b)) is silent on post-petition interest. The Court disagreed, noting that section 1129(b) requires plans to be "fair and equitable" with

---

[19] *Id.*

[20] *Id.* at *16. (citing 580 U.S. 451 (2017).

[21] *Id.*

[22] *Id.* at *17 (citing *Jevic*, 580 U.S. at 465).

[23] *Jevic*, 580 U.S. at 465.

[24] *Id.*

[25] *In re The Hertz Corp.,* 2024 WL 4132132 at *2.

[26] *In re The Hertz Corp.,* 2024 WL 4132132 at *12.

[27] *Id.* at 12.

respect to an impaired rejecting class. The "fair and equitable" standard existed under the Bankruptcy Act, and thus the Court found that Congress deliberately incorporated the common law absolute priority rule into the Bankruptcy Code. Further, section 1129(b) notes that the fair and equitable test "includes" certain requirements, but the Bankruptcy Code makes clear that the term "includes" is "not limiting."[28] Thus, the Court concluded that what qualifies as "fair and equitable" is "located elsewhere," including specifically "in pre-Code absolute priority caselaw and practice."[29] And under pre-Bankruptcy Code jurisprudence, courts applying the absolute priority rule required solvent debtors to pay interest at the contract rate before equity could receive any distributions.[30]

The Court also held that the Debtors' position that unimpaired creditors are entitled only to payment of unmatured interest at the federal judgment rate was fundamentally at odds with the Bankruptcy Code for at least two reasons.[31] First, section 1129(a)(10) provides that if a class is impaired under the plan, then the plan cannot be confirmed without the consent of at least one impaired accepting class. According to the Court, section 1129(a)(10) ensures that "plan proponents cannot force one unlucky class to bear the entire brunt of the bankruptcy against its will."[32] Determining that a creditor class is impaired by payment of interest at the federal judgment rate "makes [section 1129(a)(10)] effective in this case by protecting them from a plan that, at their expense alone, pays everyone else."[33] Second, the Court held that the Debtors' position conflicted with section 1129(b)(2), because payment of interest at the federal judgment rate would provide creditors with "significantly less than is fair and equitable."[34]

The Court held that unimpaired creditors should not be treated any worse than impaired creditors, "who at least get to vote."[35] The Court concluded, however, that not every solvent debtor case will require payment of the contract rate of interest. If, for example, there is not enough money to pay all creditors their full rate of interest, a court may be required to consider any "compelling equitable considerations" that would counsel against awarding an unsecured creditor its contract rate of interest.[36]

---

[28] *Id.* at 13; 11 U.S.C. § 102(3).

[29] *In re The Hertz Corp.,* 2024 WL 4132132 at *13.

[30] *Consol Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 527-28 (1941).

[31] *In re The Hertz Corp.,* 2024 WL 4132132 at *14.

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.* at *14 (citing *In re Ultra Petroleum Corp.*, 51 F.4th 138, 158 (5th Cir. 2022)

[36] *Id.* at *9.

In addressing the partial dissent (discussed below), the Court disagreed that its decision fails to give meaning to section 502(b)(2). The dissent's position, according to the majority, ignored the distinction between "payment of interest *on an allowed claim* as opposed to *as an allowed claim*."[37] While section 502(b)(2) prohibits the inclusion of unmatured interest as part of an allowed claim, there are certain circumstances in which the debtor may nevertheless be required under the Bankruptcy Code "to pay post-petition interest on an allowed claim."[38] The Court noted that Bankruptcy Code sections 1129(a)(7)(A)(ii) and 726(a)(5) "expressly allow post-petition interest *on* claims."[39]

The Court therefore determined that, in this case, the solvent debtor exception and absolute priority rule required that the Noteholders receive payment of interest (including the redemption premiums) at the contract rate. According to the Court, paying the Noteholders a fraction of what they were owed while distributing a billion dollars to equityholders violated the Bankruptcy Code's priority scheme.

The Dissenting Opinion

Judge Porter authored a partial dissenting opinion, disagreeing with the majority that unsecured creditors are entitled to receive payment of post-petition interest at the contract rate. Judge Porter largely agreed with the dissenting opinions in the Circuit Court decisions in *Ultra Petroleum* and *PG&E*. Those dissenting opinions found that because section 502(b)(2) of the Bankruptcy Code eliminates claims for unmatured interest, it is not plausible to read section 1124 of the Bankruptcy Code to require payment of post-petition interest to render a creditor unimpaired.[40] Because section 1124 only addresses whether *claims* are unimpaired under a plan, Judge Porter concluded that section does not address whether a creditor's equitable rights must also be unaltered to qualify as unimpaired.[41] Moreover, section 1124 only addresses whether a class of claims is impaired "under a plan."[42] Judge Porter noted that section 502(b)(2) of the Bankruptcy Code, not the Plan, altered the Noteholders' claims for the redemption premiums and post-petition interest.

Judge Porter also disagreed that *Jevic* supports the conclusion that unsecured creditors of a solvent debtor are entitled to payment of post-petition interest at the contract rate. Judge Porter found *Jevic* to be inapposite because that decision addressed a situation in which a bankruptcy

---

[37] *Id.* at *15

[38] *In re PG&E Corp.*, 46 F.4th 1047, 1059 (9th Cir. 2022) (noting that while "interest as part of a claim ceases to accrue upon the filing of a bankruptcy petition . . . in some circumstances, creditors may demand post-petition interest on their claims").

[39] *Id.* (emphasis in original); *see also In re Dow Corning Corp.*, 244 B.R. 678, 685 (Bankr. E.D. Mich. 1999) (finding that section 502(b)(2) "does not rule out the possibility of interest *on* allowed claims pursuant to § 1129(b)").

[40] *See, e.g.*, *In re PG&E Corp.*, 46 F.4th at 1074-75 (Ikuta, J., dissenting).

[41] *In re The Hertz Corp.,* 2024 WL 4132132 at *16.

[42] 11 U.S.C. § 1124.

court exercised power "without any express basis in the Code, thereby violating absolute priority."[43] Here, by contrast, Judge Porter concluded that section 502(b)(2) disallows post-petition interest, and therefore there is no absolute priority rule violation.[44] Because the Plan paid the Noteholders' *allowed* claims in full, Judge Porter found that the Debtors did not violate the absolute priority rule. Although agreeing with the majority that the Debtors' position could permit unimpaired creditors to be treated worse than impaired creditors, Judge Porter found that the Court's role was to enforce the Bankruptcy Code's express terms, regardless of any policy considerations.

Key Takeaways

The Third Circuit has now joined the Ninth and Fifth Circuits in concluding that the solvent debtor exception survived the enactment of the Bankruptcy Code. In light of that position, the Third Circuit—like the Ninth and Fifth Circuits—has determined unsecured creditors of a solvent debtor are generally entitled to receive payment of the contract rate of interest before equity may receive any distributions. However, as the Third Circuit made clear, payment of the contract rate of interest is not guaranteed, as equitable considerations may counsel against awarding an unsecured creditor its contract rate of interest. The majority's decision in *Hertz* appears to be driven in part by the windfall received by equity at the expense of higher priority creditors. That result, in the majority's view, violated the absolute priority rule.

While a clear consensus has emerged on the solvent debtor exception among the appellate courts that have addressed that doctrine thus far, the existence of a dissenting opinion in each of those three circuits demonstrates that this issue is not entirely settled. Other appellate courts may not ultimately agree with the Third Circuit's conclusion in *Hertz*, depending on the philosophy of those courts and the facts of those cases. Those courts could conclude that a bankruptcy court's ability to utilize equitable principles may be constrained by express provisions of the Bankruptcy Code that disallow post-petition interest. Moreover, a court could reach a different result if, unlike in *Hertz*, equity is not receiving a windfall at the expense of higher priority creditors.

---

[43] *Id.* at *18.

[44] *Id.*

* * *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Gregory Petrick	+1 212 504 6373	gregory.petrick@cwt.com
Ingrid Bagby	+1 212 504 6894	ingrid.bagby@cwt.com
Michele Maman	+1 212 504 6975	michele.maman@cwt.com
Casey Servais	+1 212 504 6193	casey.servais@cwt.com
Thomas Curtin	+1 212 504 6063	thomas.curtin@cwt.com