Make-Whole Premiums in Bankruptcy: A Decision that Hertz Creditors

January 18, 2023 Scott Night, Laura Shapiro

PRACTICES Finance, Restructuring

Two recent court decisions may indicate more uncertainty with respect to the enforceability of "make-whole" premiums in bankruptcy. Make-whole or prepayment premiums are common within loan agreements, bond issuances and other debt instruments. Such provisions put a price tag on a borrower's ability to prepay outstanding indebtedness before its maturity date.[1] A make-whole premium is often negotiated for an initial period following closing, ensuring the lender will receive the negotiated interest and fees for a minimum amount of time under the relevant agreement or if the debt is repaid early, such lender receives compensation, in the form of payment of the premium.

Historically, a majority of bankruptcy courts considered prepayment provisions to represent a fee charged by the lender as compensation for the early termination of the applicable loans or notes. Such charges were often considered to be liquidated damages for the interest and other amounts that would have been earned during the remaining period the debt was expected to be outstanding, especially when the market interest rates at the time of prepayment had decreased compared to the contract rates initially negotiated.

However, a growing split among circuit courts on this issue was sparked by the bankruptcy case of Ultra Petroleum Corp ("***Ultra***").[2] Following a legal battle spanning more than five years, in October of 2022, the Fifth Circuit ruled that the make-whole premium in that case was "the economic equivalent of unmatured interest." Pursuant to Section 502(b)(2) of the Bankruptcy Code, the payment of post-petition unmatured interest is generally disallowed. Unmatured interest under the Bankruptcy Code is the interest on the pre-petition debt that is not yet due and owing at the time of the petitioner's bankruptcy filing.

Ultra initially filed for bankruptcy relief in April of 2016. Its New York law-governed master note purchase agreement represented approximately $1.5 billion in unsecured notes. The agreement provided for the right to prepayment, conditioned on payment of 100% of principal, in addition to a make-whole amount, which was calculated by reference to the value of the future principal and interest payments. In its opinion, the Fifth Circuit concluded that the calculation of the prepayment premium "stripped of the contract's financial jargon, is simply the value of all future unmatured interest payments on the Notes, expressed in today's dollars."[3] It was this reliance on the interest calculation that the court referenced, noting that nothing "transformative" had occurred in the calculation that turned the premium into something other than the "economic equivalent" of unmatured interest.[4]

It is worth noting, however, that due to improving market conditions, Ultra's financial condition had changed during the course of its bankruptcy case such that Ultra was solvent at the time of its emergence from bankruptcy. It was on the basis of a revitalized "solvent-debtor exception" that the Fifth Circuit ultimately determined that the creditors had an equitable right to receive post-petition interest in that case. The court held that the adoption of the 1978 Bankruptcy Code did not abrogate solvent-debtor doctrine arising from English common law. Such doctrine indicates that

when the debtor's assets exceed its liabilities and a debtor has the ability to pay contractual interest to its creditors, as was the case in Ultra, then it must. As a result, the Fifth Circuit ordered payment of the make-whole amount in Ultra as a valid contractual debt.

The decision in Ultra represented the beginning of a circuit split[5], which has continued into the jurisdiction of the Third Circuit court with respect to the 2020 bankruptcy of Hertz Global ("***Hertz***")[6]. Merely a few weeks after the ultimate decision in Ultra, in November 2022, the U.S. Bankruptcy Court for the District of Delaware ruled to disallow a $223 million make-whole premium in the Hertz case.

Hertz was a COVID-19 pandemic-related bankruptcy. The company filed for protection under the Bankruptcy Code in the spring of 2020 following a sharp decline in revenue from its car rental services. A number of issues were litigated with respect to its Chapter 11 Plan, but as it related the prepayment premium on its unsecured notes, the Hertz court found that the make-whole premium merely consisted of post-petition interest. Similar to the reasoning in Ultra, the court noted that "[i]f everything that goes into the formula is interest, what comes out has to be interest." However, the judge in Hertz noted that there is a circuit split on this issue and immediately certified the decision for a direct appeal to the Third Circuit. Debtors and creditors alike will eagerly await the Third Circuit's decision to see if it will join the Fifth Circuit or provide additional clarity on the enforceability of make-whole premiums.

In the meantime, lenders should consider provisions that clarify the trigger of a make-whole premium occurs whether the prepayment was voluntary or involuntary (i.e. following a default and acceleration of the underlying debt) and prior to the bankruptcy filing. Such premiums should be clearly identified as liquidated damages, with the agreement explaining the financial justification for the claim and identifying an estimate of damages caused by a prepayment. Although somewhat self-serving, creditors should also consider requiring their borrowers to stipulate that the premium is reasonable and payable despite market rates at the time of payment. The agreement should also indicate that the premium was a material inducement for the lender to enter into the agreement and provide the underlying financing.

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[1] Make-whole premiums or prepayment penalties can be in the form of a flat fee or a percentage (e.g. 1%) of the amount prepaid. They can also be based on an often complicated formula that purports to approximate the amount of the lender's loss of yield.

[2] *See Ultra Petroleum Corp. v. Ad Hoc Comm. of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, 51 F.4th 138 (5th Cir. 2022) (*affirming In re Ultra Petroleum Corp.*, 624 B.R. 178 (Bankr. S.D. Tex. 2020)), *reh'g denied*, No. 21-20008 (5th Cir. Nov. 15, 2022).

[3] *In re Ultra Petroleum Corp.*, 51 F.4th 138, 144 (5th Cir. 2022).

[4] The cases described in this article are not usury cases, which are beyond the scope of this article. However, we note that, under the *Texas Finance Code*, any prepayment premium, make-whole premium, or similar fee or charge, whether upon the voluntary or involuntary prepayment or acceleration of a commercial (as opposed to consumer) loan, is defined to not constitute interest. TEX. FIN. CODE ANN. § 306.005. Although the Ultra case arises from the Fifth Circuit, the governing law for the underlying indebtedness was New York law. It would be interesting to see how the court would rule in a case governed by Texas law given the provisions of the Finance Code.

[5] See, e.g., *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016); *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017), *cert. denied sub nom BOKF N.A. v. Momentive Performance Materials Inc.*, 138 S. Ct. 2653 (2018).

[6] *See Wells Fargo Bank, N.A. v. Hertz Corp. (In re Hertz Corp.)*, 637 B.R. 781, 785 (Bankr. D. Del. 2021) and *See In re Hertz Corp.*, Adv. Proc. No. 21-50995 (Bankr. D. Del. Nov. 9, 2022).