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3rd Circ. Hertz Ruling Highlights Flawed Bankruptcy Theory

By **Matthew McGill and David Casazza** (October 9, 2024, 3:07 PM EDT)


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In a typical bankruptcy, interest stops accruing on the date the debtor files its bankruptcy petition. That rule preserves an equitable distribution among creditors receiving only a fraction of what they are owed.

But what happens when a debtor has more than enough assets to pay its debts in full? Can the debtor use bankruptcy to freeze its interest obligations and distribute that unpaid interest as a windfall to shareholders?

In In re: Hertz Corp., on Sept. 10, the U.S. Court of Appeals for the Third Circuit became the third circuit court to hold that "[t]he answer is no."[1]

The COVID-19 pandemic put Hertz, a car rental company, in an untenable financial situation. It sought Chapter 11 protection in 2020. But as the pandemic eased and the economy shifted, Hertz found that its assets significantly exceeded its debts.

Hertz proposed an unusual Chapter 11 plan that repaid its creditors the full amount owed on the date of its bankruptcy filing. But — pointing to Section 502 of the Bankruptcy Code, which declares that claims for unmatured interest are excluded from the allowed portion of a claim — Hertz refused to make two other payments to creditors.

First, Hertz refused to pay interest that accumulated after it filed its petition at the full rate stated in its contracts, offering instead to pay interest at the lower federal judgment rate.

Second, Hertz refused to pay make-whole premiums designed to compensate creditors for interest that would not accumulate because of the premature repayment.

Despite these creditor losses, Hertz's plan treated all its creditors as unimpaired, which left them unable to vote on the plan or invoke the substantive and procedural protections that the Bankruptcy Code guarantees creditors whose rights are altered.

The U.S. Bankruptcy Court for the District of Delaware confirmed Hertz's plan over its creditors' objections.

A divided panel of the Third Circuit reversed. The court of appeals unanimously agreed that both the contract interest and the make-whole premiums were disallowed by the code. And the panel further held that Hertz's refusal to pay disallowed interest, standing alone, did not render the creditors impaired, because it was the code, rather than the plan, that disallowed the interest.

But that view of impairment, known as "code impairment," was not the end of the story. The majority went to hold that "stockholders are not entitled to any share … until all the debts of the corporation are paid."[2]

That underlying principle, the absolute priority rule, has been a bedrock of bankruptcy law for more than a century. The majority acknowledged that the code's express reference to priority deals only with impaired creditors,[3] but nevertheless held that "the Bankruptcy Code incorporates the common law absolute priority rule."[4]

This meant that Hertz had to repay both the interest owed under the contracts and the make-whole amounts triggered by its early repayment before it could distribute excess value to its shareholders.

The Third Circuit's reasoning mirrors that of the U.S. Courts of Appeals for the Fifth and Ninth Circuits, which similarly held in 2022 in In re: Ultra Petroleum Corp. and In re: PG&E Corp., respectively, that a solvent debtor must repay the interest that accumulates after the bankruptcy petition at the contract rate — including make-whole premiums — before distributing value to shareholders.[5]

Only the U.S. Court of Appeals for the Second Circuit has disagreed. In a passage characterized by the Third Circuit as "dicta," the Second Circuit reasoned in its 2022 In re: Latam Airlines Group SA decision that "the Code's treatment of absolute priority 'is so different from the prior Bankruptcy Act that the old practice simply cannot be imported'" under the new code.[6]

Therefore, the Second Circuit concluded that a debtor could distribute value to shareholders without paying creditors the interest that accumulated during the bankruptcy. It allowed this result based on the bankruptcy court's calculation that, in a book-value sense, Latam's debts exceeded its assets.

But the Second Circuit agreed with the Third, Fifth and Ninth Circuits that the refusal to pay that interest alone did not render creditors impaired.

Hertz, PG&E and Ultra Petroleum ultimately reached the correct result based on the creditor's right to absolute priority, but those decisions risked going astray by invoking the flawed theory of code impairment.[7] Though harmless in those cases, that flaw cost creditors millions of dollars in Latam.

The code offers an easier and more consistent path to protecting creditors. Unless a plan leaves unaltered the rights arising from a claim, the plan impairs the claim.[8] The holder of that impaired claim can invoke all the substantive and procedural protections of the code. As Hertz itself recognized, "Congress define[d] impairment in the broadest possible terms."[9]

And the code's definition of impairment, set out in Section 1124, does not rest on whether the altered rights are or are not allowed by Section 502. Congress made that clear by repealing the only reference to impairment in Section 1124 after a bankruptcy court relied on that provision to treat a creditor as unimpaired despite a solvent debtor's refusal to pay post-petition interest.[10]

To be sure, this does not mean creditors can or should demand post-petition interest in every reorganization. Section 502's disallowance rules set the metric for other crucial provisions, including the distribution waterfall of Section 726, that, unlike Section 1124's discussion of impairment, expressly reference allowed or disallowed claims.

But if courts recognize that refusal to pay post-petition interest causes impairment, they will restore the rule Congress enacted in Section 1124.

Correctly applying Section 1124 will arm creditors with powerful tools against the shareholder windfall attempted in Hertz, PG&E, Ultra Petroleum and Latam. And it will give debtors notice of their own obligations — debtors can disenfranchise creditors by designating them unimpaired, but a debtor that chooses disenfranchisement must make the affected creditor whole.

Clearing up the mess caused by the code impairment theory will better protect creditors' rights, revitalize the congressionally enacted text and produce more consistent reorganization outcomes.

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Disclosure: The firm represented creditors in PG&E and LATAM.

[1] --- F.4th ---, 2024 WL 4132132, at *8 (3d Cir. Sept. 10, 2024).

[2] Id. (quoting Chi., Rock Island & Pac. R.R. v. Howard, 74 U.S. 392, 409-10 (1868)).

[3] 11 U.S.C. § 1129(b)(2).

[4] Hertz, --- F.4th ---, 2024 WL 4132132, at *12.

[5] In re Ultra Petroleum Corp., 51 F.4th 138 (5th Cir. 2022); In re PG&E Corp., 46 F.4th 1047 (9th Cir. 2022).

[6] In re LATAM Airlines Grp. S.A., 55 F.4th 377, 388 (2d Cir. 2022) (quoting In re Coltext Loop Cent. Three Partners, L.P., 138 F.3d 39, 43 (2d Cir. 1998)).

[7] See, e.g., Solow v. PPI Enters. (U.S.), Inc., 324 F.3d 197, 203 (3d Cir. 2003).

[8] 11 U.S.C. § 1124(1).

[9] Hertz, --- F.4th ---, 2024 WL 4132132, at *12 (quoting L&J Anaheim Assocs. v. Kawasaki Leasing Int'l, Inc., 995 F.2d 940, 942 (9th Cir. 1993)).

[10] See In re New Valley Corp., 168 B.R. 73, 77-80 (Bankr. D.N.J. 1994).