Make-Whole Litigation in Bankruptcy

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Make-whole provisions appear in more than eighty percent of corporate bond issuances. They emerged in the mid-1990s after traditional call provisions failed to protect bondholders from opportunistic refinancing. Outside bankruptcy, they are routinely enforced. But inside bankruptcy, they have generated extensive litigation over three issues: whether acceleration extinguishes the make-whole premium, whether the Bankruptcy Code disallows it as unmatured interest, and whether a solvent debtor must pay it regardless of statutory disallowance. This Note makes three arguments about how courts should treat make-whole provisions in bankruptcy. First, the apparent circuit split over make-whole-provision enforcement is illusory. Courts have reached different results because the underlying contracts have had materially different language, not because of conflicting legal principles or policy judgments. Second, the solvent-debtor exception is best understood as a corollary to the absolute priority rule rather than as a historical practice or equitable right. When a solvent debtor invokes § 502(b)(2) to deny creditors' postpetition interest while distributing value to equity holders, the statutory disallowance operates as a de facto priority violation. Third, the core problem with make-whole provisions in bankruptcy is their economic structure. Because the standard formula does not adjust for the issuer's default risk, the premium is largest when the borrower is in distress and the estate has the least capacity to satisfy other creditors. Therefore, this Note proposes that courts should subordinate bankruptcy-triggered make-whole premiums under § 510(c) rather than disallowing them or enforcing them at parity. This approach avoids the binary created by current doctrine. Disallowance eliminates the premium entirely and redirects the savings to equity holders, while the solvent-debtor exception pays the premium in full, which shortchanges junior creditors. Subordination would preserve the claim but pay junior creditors ahead of make-whole-provision holders.

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Introduction

A corporate bond is a bargain: the investor commits capital upfront, and the borrower promises to pay a predetermined stream of interest payments years into the future. However, in response to falling interest rates or a major corporate event such as a merger, borrowers often want to repay early. Make-whole provisions, which now appear in the overwhelming majority of corporate bond issuances, address that tension by letting the borrower prepay, but only at a price calibrated to the interest the investor forgoes.[1]

1. *See* Mitu Gulati & Marcel Kahan, Cash America *and the Structure of Bondholder Remedies*, 13 CAP. MKTS. L.J. 570, 578 (2018) (documenting the prevalence of make-whole provisions in corporate bonds from 1995 to 2017).

These provisions emerged as a sophisticated evolution of the traditional call provisions which have long been features of corporate debt. A callable bond gives issuers the right to redeem the debt before its maturity date by paying the principal amount plus a specified premium. Historically, callable bonds combined two features. First, a period of "call protection," typically five to ten years, during which the issuer could not redeem the bond at all. Second, once that protection period expired, a declining prepayment penalty schedule that set the price of early redemption.[2] These fixed-premium call options served primarily as interest-rate management tools. They allowed issuers to refinance when rates declined enough to justify paying the call premium and replacing higher-coupon bonds with cheaper financing.

However, early callable bonds created an asymmetric allocation of interest-rate risk that favored issuers. When rates fell, issuers could call the bond and refinance at a lower rate. When rates rose, bondholders received no corresponding benefit while the issuer simply left the bond outstanding and continued paying the fixed coupon. Therefore, bondholders bore the downside of rate increases while losing much of the upside of rate declines because declining rates made a call more likely.[3]

Despite these asymmetric dynamics, callable bonds with this fixed structure were the dominant debt structure throughout the 1970s and 1980s. Investors tolerated the risk because non-refunding clauses offered significant protection by disallowing issuers to redeem bonds for legitimate corporate purposes but prohibited the specific arbitrage of calling bonds with proceeds from cheaper debt.[4]

This protection started to weaken after 1986. Corporate issuers routinely sidestepped these restrictions by using alternative funding sources for redemptions while simultaneously issuing new debt at more favorable rates. Empirical evidence from this period shows that the vast majority of firms calling nonrefundable debt were issuing new, lower-cost debt at the same time.[5] Courts blessed this practice by adopting a source-of-funds test which required judges to

2. For example, a typical "10-year non-call 5" bond has a stated maturity of ten years but cannot be called for the first five. After year five, the issuer may redeem the bond at a price equal to par plus one year's coupon (e.g., 105% of par for a 5% coupon bond), with the premium declining by, for instance, one percentage point per year until it reaches par at maturity. For a general overview of call protection periods and declining premium schedules, see Jennifer Carpenter, *More on Callable Bonds* 2 (N.Y.U. Stern Sch. of Bus.), https://pages.stern.nyu.edu/~jcarpen0/courses/b403333/18callabh.pdf [https://perma.cc/PDX6-7GY3]; and William A. Klein, C. David Anderson & Kathleen G. McGuinness, *The Call Provision of Corporate Bonds: A Standard Form in Need of Change*, 18 J. CORP. L. 653, 657-58 (1993), which describes the historical structure of callable bonds.

3. Reinvestment risk is the risk that a bondholder whose bond is called early will have to reinvest the returned principal at lower market rates. For instance, if a bondholder earning 10% has her bond called when market rates have fallen to 6%, she loses 4% per year for the remaining life of the bond. This risk is highest when rates decline, because that is when issuers are most likely to call.

4. Francis Kerins, *Do Nonrefunding Provisions Constrain Corporate Behavior? Evidence from Calls*, 30 FIN. MGMT. 57, 59-60 (2001).

5. *Id.* at 66 (finding that of 84 calls of nonrefundable industrial bonds prior to the expiration of the refunding protection, 60 calling firms issued new debt within six months of the call); *id.* at 81 (reporting that across a broader group of 192 calls since 1983, at least 96 calls were made by firms whose contemporaneous debt issuance exceeded the face value of the called issue); *id.* at 61 tbl.I (showing that nonrefundable bond issuance peaked at 263 offerings in 1986 and fell to zero by 1994).

examine only the formal origin of redemption dollars, not what the issuer planned to do with the money.[6]

By the early 1990s, declining interest rates and rising bond market volatility made it even more attractive to redeem bonds early, and the collapse of non-refunding covenants as a meaningful constraint became impossible to ignore.[7] The market needed a mechanism that did not depend on the source of funds but on the price of exit.

Make-whole provisions represented a market-driven solution to these deficiencies. Unlike traditional call options with fixed premiums, make-whole provisions calculate the call price as the greater of par value or the present value of the bond's remaining payments, discounted at a rate typically tied to Treasury yields plus a modest spread.[8] This structure fundamentally altered the economic relationship between bondholders and issuers: it ensured that bondholders would receive compensation approximating the market value of the future cash flows they would forfeit upon an issuer's early redemption. Critically, the discount rate set to determine the present value is the yield of comparable-maturity Treasury securities *plus* a contractually specified "make-whole premium." This effectively eliminates any refinancing advantage for issuers from declining interest rates.[9]

The market rapidly embraced this innovation. Since 1999, the majority of corporate bonds have included make-whole call provisions.[10] As of 2016, over 80% of callable bonds issued contained such features.[11] These provisions provide issuers relatively more flexibility to refinance when credit conditions improve, and to clear existing debt off the balance sheet ahead of major corporate events like mergers, acquisitions, or spinoffs where old covenants would get in the way.[12] For investors, make-whole provisions raise the price of calling bonds

6. Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1532 (S.D.N.Y. 1983), *see infra* Part I.A (discussing Archer Daniels Midland in greater detail); Kerins, *supra* note 4, at 58 (describing the resulting precedent as holding that "a call of nonrefundable debt while issuing lower-interest-cost debt is legal as long as the lower-interest-cost debt is not identified as the source of funds used for the call").

7. Kerins, *supra* note 4, at 81 (observing that "the dramatic decrease in interest rates from the early 1980s to the early 1990s provided managers with significant incentives to circumvent the nonrefunding provision").

8. Steven V. Mann & Eric A. Powers, *Indexing a Bond's Call Price: An Analysis of Make-Whole Call Provisions*, 9 J. CORP. FIN. 535, 536 (2003).

9. Nandkumar Nayar & Duane Stock, *Make-Whole Call Provisions: A Case of "Much Ado About Nothing?"* 14 J. CORP. FIN. 387, 388 (2008) ("In other words, with a make-whole call, the bondholders are 'made whole' and any advantage that the borrowing firm might obtain by refinancing at lower rates is forgone by having to pay a much higher call price to consummate the make-whole call.").

10. *See* Scott Brown & Eric Powers, *The Life Cycle of Make-Whole Call Provisions*, 65 J. CORP. FIN., Dec. 2020, no. 101772, at 2 fig. 1 (2020) (documenting that since 1999, callable make-whole provisions have been the most common call protection feature in corporate bonds).

11. *Id.* (the 80% statistic comes from dividing the number of make-whole bonds (~440) by the total number of callable bonds (~520) which in turn is the sum of make-whole (~440) and fixed price bonds (~80)).

12. *Id.* at 101774 ("First, make-whole calls make it easier to retire and refinance debt prior to maturity when credit conditions are attractive. Second, make-whole call provisions make it easier to retire debt when major restructuring events such as mergers, acquisitions, and divestitures render the existing debt structure sub-optimal.").

when interest rates drop, which "substantially reduces the reinvestment rate risk that investors face in bonds with fixed-price call provisions."[13]

Interestingly, although make-whole provisions have been standard features of corporate debt for decades, they generated relatively little controversy until recently. As Gulati and Kahan observed in 2016, although "these types of exit provisions have been around for time immemorial, they have generated so little controversy over the years that the legal literature on them is so thin as to be nearly nonexistent."[14] Over the past decade, however, make-whole provisions have become the subject of extensive litigation, particularly in the bankruptcy context. Courts have increasingly scrutinized these provisions as their economic significance has grown in low-interest-rate environments and as financially distressed companies have sought to avoid substantial make-whole obligations during bankruptcy.[15]

The treatment of make-whole provisions becomes particularly contentious in bankruptcy proceedings. Outside bankruptcy, when solvent borrowers voluntarily prepay debt, courts generally enforce make-whole provisions without difficulty, viewing them as legitimate contractual mechanisms for preserving lenders' economic expectations.[16] However, bankruptcy resituates make-whole provisions in a fundamentally different framework, one centered on collective resolution and equitable distribution among creditors.[17]

In bankruptcy cases, make-whole litigation turns on three distinct questions. First, whether the make-whole provision is enforceable as a matter of state law and contract interpretation, focusing specifically on whether acceleration from bankruptcy filing affects the applicability of these provisions. Second, whether the prohibition on unmatured interest under § 502(b)(2) of the Bankruptcy Code disallows the make-whole payment, or whether that payment is instead a permissible liquidated damages claim.[18] And third, in cases where the debtor is solvent, whether the make-whole can be enforced even when it runs afoul of § 502(b)(2)—in essence, whether the "solvent-debtor exception" survives the Code.

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13. Mann & Powers, *supra* note 8, at 536.

14. Gulati & Kahan, *supra* note 1, at 571.

15. *See, e.g.*, *In re* Energy Future Holdings Corp., 842 F.3d 247 (3d Cir. 2016) (holding that the debtor company must pay the make-whole per the indenture language); *In re* MPM Silicones, LLC (*In re* Momentive), 874 F.3d 787 (2d Cir. 2017) (concluding, in part, that senior-lien notes holders are not entitled to make-whole premiums); *In re* Ultra Petroleum Corp., 51 F.4th 138 (5th Cir. 2022) (holding, in part, that creditors' claim for the contractual make-whole amount was subject to disallowance under the Bankruptcy Code; the solvent-debtor exception operated to suspend disallowance of the make-whole amount; and the make-whole amount constituted enforceable liquidated damages); *In re* Hertz Corp., 120 F.4th 1181 (3d Cir. 2024) (holding, in part, as a matter of first impression, the Bankruptcy Code's prohibition on claims for unmatured interest covered noteholders' make-whole fees).

16. *See Energy Future*, 842 F.3d at 251 (acknowledging the widespread enforcement of make-whole provisions outside bankruptcy).

17. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L. J. 857, 859-71 (1982).

18. 11 U.S.C. § 502(b)(2) (2024).

In light of these questions, this Note proceeds in six parts. Part I traces how the market moved from traditional fixed-premium call provisions to make-wholes in order to curb issuer opportunism. Part II examines how courts enforce these provisions as a matter of contract law and shows that despite apparent doctrinal divergence across circuits, courts are converging on a common textual approach. Part III analyzes whether § 502(b)(2)'s bar on unmatured interest disallows make-whole claims; it shows how *Ultra Petroleum* and *Hertz* inverted the once-dominant view that make-whole premiums are presumptively enforceable liquidated damages. Part IV surveys the solvent-debtor exception, which courts have revived to compel payment of otherwise disallowed claims when the debtor can pay all creditors in full. Part V argues that the solvent-debtor exception is best understood not as a historical artifact but as a mechanism for enforcing absolute priority. Building on Richard Squire's work on distress-triggered liabilities, it shows that make-whole provisions, when triggered by bankruptcy, function as embedded options on the debtor's credit spread that deliver their greatest value precisely when the estate has the least capacity to satisfy other creditors. Part VI proposes that courts subordinate these claims under § 510(c).

I. The Economic and Contractual Foundations of Make-Whole Provisions

This Part traces the evolution of call provisions from the fixed-premium structures of the 1970s and 1980s to the make-whole formulas that replaced them in the 1990s. Section I.A explains why issuers included call provisions in debt instruments and shows how fixed-premium calls created an asymmetric allocation of interest-rate risk that systematically favored borrowers. When courts adopted a source-of-funds test that gutted non-refunding covenants, investors lost the only meaningful constraint on opportunistic refinancing. Section I.B describes the make-whole formula that the market developed in response and uses a simple numerical example to demonstrate why it eliminates the refinancing arbitrage that fixed-premium structures created. That design choice—discounting at Treasury yields plus a small, fixed spread rather than the issuer's actual borrowing cost—is also what produces the distress-amplified payoff analyzed in Part V.

A. Why Do Issuers Include Call Provisions in Corporate Debt?

Corporate debt instruments typically contain two types of exit provisions. The first protects creditors. When a contractually defined "Events of Default" occurs (e.g., the borrower misses an interest payment), the lender may choose to "accelerate" the debt, which makes the entire principal immediately due and payable. The second type of exit provision protects the debtor. A firm that issued debt at a high interest rate and under tight covenants may want to change those terms. To allow this, indentures, contracts governing the bond's terms, often grant the issuer a "call" or "redemption" right, which permits early prepayment at a predetermined price. That price functions as a liquidated damages provision

that compensates the creditor for the lost stream of future interest payments. The creditor-side provisions become relevant again in Part II, where bankruptcy filing triggers acceleration and forces courts to decide whether the make-whole premium survives.

The most straightforward justification for callable bonds is interest-rate management.[19] Call provisions grant issuers the valuable option to refinance outstanding debt when market interest rates decline, allowing those issuers to replace higher-coupon obligations with less expensive financing. This classic rationale treats call provisions as explicit interest-rate options that shift refinancing opportunity from bondholders to issuers. In essence, the provision simply ensures the issuer against being locked into above-market interest rates for extended periods.[20]

Call provisions mitigate the problem of misaligned incentives between issuers and bondholders created by fixed-rate debt. The option to redeem early corrects those misalignments. Financial economists have identified at least four relevant mechanisms.

First, under the signaling framework, firms with positive private information about their future prospects may issue callable debt to differentiate themselves from lower-quality competitors.[21] By incorporating call provisions, management effectively signals its confidence that future performance improvements will enable advantageous refinancing, a position that would be irrational for weaker firms to mimic.[22]

Second, callable bonds serve as effective tools for mitigating agency conflicts between shareholders and bondholders.[23] Myers identifies an underinvestment problem when existing debt disincentivizes firms from pursuing value-enhancing projects because a portion of the benefits would accrue to bondholders rather than shareholders.[24] Call provisions address this inefficiency by allowing firms to retire existing debt and issue new securities that reflect the improved investment outlook, thereby preserving appropriate investment incentives.[25]

Third, call provisions mitigate the problem of information asymmetry that arises when debt markets conservatively price bonds due to uncertainty about

19. Alan Kraus, *The Bond Refunding Decision in an Efficient Market*, 7 J. FIN. & QUANT. ANALYSIS 793, 794-95 (1973).

20. Klein et al., *supra* note 2, at 671-72.

21. Edward Henry Robbins & John D. Schatzberg, *Callable Bonds: A Risk-Reducing Signalling Mechanism*, 41 J. FIN. 935, 935 (1986).

22. *Id.* at 941.

23. For an overview of bondholder and shareholder conflict, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 333-43 (1976).

24. Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149-55 (1977).

25. Zvi Bodie & Robert Taggart, *Future Investment Opportunities and the Value of the Call Provision on a Bond*, 33 J. FIN. 1187, 1188-90 (1978).

firm quality. When a firm's true value becomes apparent over time, call provisions help correct this initial mispricing through redemption.[26]

Fourth, callable structures can constrain risk-shifting behavior. As a general matter, shareholders have an incentive to pursue excessively risky projects that transfer value from bondholders to equity holders.[27] Call provisions mitigate the problem because the issuer's call right is an option to repurchase the bond at a preset price, and a riskier corporate strategy lowers the value of the underlying bond itself. If the bond trades at $105 under the safe investment policy and $95 under the riskier one, a fixed call at $100 is valuable in the first scenario and worthless in the second because (in the second scenario) the issuer could repurchase the bond in the market for $95 rather than exercise the call at $100. In sum, the risky switch may raise equity value, but it also destroys the value of the issuer's call right, so when the call price is set so that these two effects offset each other, shareholders no longer gain from asset substitution.[28]

B. The Evolution of Modern Make-Whole Provisions

This Section traces the shift from fixed-premium call structures to make-whole provisions. I start by showing how fixed-premium calls allocated interest-rate risk asymmetrically and allowed a wealth transfer from bondholders to issuers whenever rates fell. This led to the rise of non-refunding covenants, which ultimately failed due to court decisions in the mid-1980s. Finally, it explains why make-whole provisions emerged as the market's solution in the 1990s.

Fixed-premium call provisions allocated interest-rate risk asymmetrically. When rates fell, the issuer captured the gain by calling the bond and refinancing. When rates rose, the bondholder received no corresponding benefit. The bondholder wrote a call option for the issuer and was compensated only through a modest yield premium at issuance. From a theory perspective, a callable bond is simply a regular bond minus a call option written by the bondholder for the issuer. When interest rates decline, the issuer exercises its option, transferring wealth from lenders to shareholders.

To make this more concrete, consider a bond with a face value of $100 and a 10% annual coupon, issued at par when market interest rates are 10%. The bond is callable at a fixed premium of $105. At issuance, the call option is worthless

26. David S. Allen, Robert E. Lamy & G. Rodney Thompson, *Agency Costs and Alternative Call Provisions: An Empirical Investigation*, 16 FIN. MGMT. 37, 39 (1987).

27. After issuing debt, shareholders may prefer riskier projects than bondholders anticipated. If a gamble pays off, shareholders capture the upside because their returns are uncapped. If it fails, bondholders absorb most of the loss because their claims are fixed. This is the classic asset-substitution problem: equity's payoff is convex in firm value, so shareholders can increase their expected returns by simply taking on riskier projects at bondholders' expense. For more discussion, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 346-48 (1976), which explains that, once debt is outstanding, equity holders may prefer higher-variance projects because they capture most of the upside while creditors bear much of the downside.

28. Amir Barnea, Robert A. Haugen & Lemma W. Senbet, *A Rationale for Debt Maturity Structure and Call Provisions in the Agency Theoretic Framework*, 35 J. FIN. 1223, 1225-27 (1980).

to the issuer. The bond trades at par, the call price exceeds market value, and there is no refinancing gain to capture.

When rates fall, the market value of a fixed-rate bond rises above par. For instance, a 10%-coupon bond might trade at $120 in a 6% rate environment. If that bond is callable at a fixed premium of $105, the issuer can call the debt for $15 less than its value on the market. The bondholder suffers twice. First, she surrenders an asset worth $120 for $105, a $15 loss. Second, she must reinvest the $105 proceeds at the prevailing market rate, 6% in this case, rather than the original 10%, forgoing four percentage points of annual interest for the bond's remaining life. Empirical research confirmed this wealth transfer hypothesis by documenting negative abnormal returns for bondholders and positive returns for shareholders around call announcements.[29]

Investors recognized this vulnerability and began to demand "non-refunding" covenants. These provisions permitted early redemption for legitimate corporate purposes but prohibited the specific arbitrage of swapping expensive debt for cheaper financing. The issuers could redeem bonds using operational cash, asset sales, or equity offerings, but they could not borrow at lower rates simply to capture the interest differential.

This protection eventually proved illusory. In *Morgan Stanley & Co. v. Archer Daniels Midland Co.*, the United States District Court for the Southern District of New York adopted a formalistic source-of-funds test that gutted non-refunding covenants.[30] The court held that as long as redemption dollars could be traced to a permissible source—such as a contemporaneous equity offering—the simultaneous issuance of lower-cost debt was irrelevant. Issuers quickly learned to transact through permissible funding sources while borrowing at favorable rates on the side.[31]

Interestingly, market evidence already bore this out because investors do not significantly discount callable bonds compared to those with refunding-protection provisions—which prevent calls when interest rates decline.[32] The likely explanation was not that investors ignored call risk but that they saw through the non-refunding covenant because such a clause only bars one funding route for redemption.[33] Call restrictions do not prevent the issuer from calling with equity, asset-sale proceeds, or internal cash, and then borrowing at lower rates on the

29. Ying Fan, Bondholder Wealth Effects Surrounding Bond Offering Announcements 2 (Aug. 27, 2013) (unpublished manuscript), https://ou.edu/dam/price/Finance/CFS/paper/pdf/Fan_Chen_Paper.pdf [https://perma.cc/LTQ9-QA4X].

30. Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1532 (S.D.N.Y. 1983).

31. Kerins, *supra* note 4, at 66 (documenting that a majority of firms calling nonrefundable bonds issued new debt within six months during the 1980s).

32. Allen et al., *supra note* 26, at 43.

33. *Id.* at 39 (making the theoretical point that the "effectiveness of [call features] (and all) bond covenants in aligning the interests of stockholders and bondholders rests squarely on the enforceability of the covenant. Indeed, suspicion regarding the enforceability of bond covenants has surfaced from both public and private sectors. The non-refundable provision seems particularly vulnerable during periods of falling interest rates . . . [i]f potential bondholders perceive that the firm will cheat and call the outstanding issue . . . .").

side. If investors expected that workaround, the covenant had little incremental value even though true no-call protection did.[34]

The implementation of these issuer-side exit provisions has changed three times. In the 1970s, indentures relied on "no-call" covenants, which disallowed any early repayment and required the issuer to pay interest until maturity at the original interest rate. Starting in the late 1970s, fixed-premium clauses became the dominant structure. These allowed early repayment but required payment of a preset premium that declined as maturity approached. The Second Circuit examined the enforceability of those premiums in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*[35] From a contract law perspective, the fixed-premium call is an agreed-upon alternative to performing the original contract.[36] The debtor may either pay as scheduled through maturity or redeem early and pay the premium.[37]

By the early 1990s, fixed-premium calls and non-refunding covenants had both failed as investor protections. The first created extractive dynamics that courts approved. The second depended on restrictions that issuers could sidestep with minimal effort. The market needed a mechanism that did not depend on the "source" of funds but on the "price" of exit which make-whole provisions provided.

C. The Make-Whole Formula and the Price of Early Exit

This Section explains how make-whole provisions calculate the call price and why that formula eliminates the refinancing arbitrage that fixed-premium structures created. I describe the formula and use a numerical example to demonstrate why make-whole provisions protect bondholders more effectively relative to fixed-call provisions. I then identify two important economic properties of this structure that become relevant again in Part V.

By the mid-1990s, fixed-premium calls gave way to modern make-whole provisions. Unlike fixed-premium call options that require issuers to pay a

34. Later empirical evidence confirmed this view as well. *See* Kerins, *supra* note 4, at 58 ("My evidence suggests limited protection against calls following interest rate decreases, particularly for investment-grade issues. These events are consistent with the abandonment in the early 1990s of the use of the nonrefunding provision, which identifies actions firms cannot take to call debt, and the adoption of prescriptive covenants, like make-whole and clawback provisions, which identify actions that firms must take to call debt.").

35. Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1052-54 (2d Cir. 1982) (holding that fixed-premium call clauses in indentures are enforceable and that a debtor cannot evade the redemption premium by deliberately defaulting rather than voluntarily redeeming the debentures).

36. *See* Theresa Arnold, Amanda Dixon, Madison Sherrill & Mitu Gulati, *The Myth of Optimal Expectation Damages*, 104 MARQ. L. REV. 141, 149 (2020) ("And because courts, at least outside the bankruptcy context, treat prepayment clauses as alternative performance obligations and not damages provisions . . . .")

37. The value of a fixed-premium call option is inversely related to prevailing market interest rates. When market rates fall below the bond's fixed coupon rate, the option becomes more valuable to the issuer, who can redeem the outstanding bond, pay the fixed premium, and refinance the debt at a lower rate. Conversely, when market rates rise, the fixed-rate bond becomes comparatively cheaper for the issuer to maintain, reducing the attractiveness of early redemption. For further discussion, see *id.* at 154.

predetermined amount above par value upon early redemption, make-whole provisions calculate the redemption price as the greater of par or the present value of remaining principal and interest payments discounted at a rate typically based on Treasury yields plus a modest spread.[38] This structure fundamentally alters the economic relationship between issuers and bondholders by creating a dynamic pricing mechanism for early redemption.

The shift toward make-whole provisions addressed significant limitations in traditional callable bonds. Conventional fixed-premium call structures created a dynamic where issuers could exploit interest-rate declines at bondholders' expense, leaving investors exposed to reinvestment risk precisely when market conditions were least favorable for reinvestment.[39] By contrast, make-whole provisions effectively neutralize the issuer's financial incentive to redeem bonds solely to capitalize on lower interest rates, as the redemption price adjusts to approximate the market value of future cash flows.[40] This design preserves the issuer's flexibility to restructure liabilities when strategically necessary while protecting bondholders from opportunistic refinancing.

Notably, make-whole provisions are deliberately structured to be supracompensatory to the lender in most circumstances.[41] Because the discount rate used in calculating the premium—typically Treasury yields plus a fixed spread—is generally well below the issuer's actual cost of capital, the resulting present-value calculation produces a redemption price that exceeds the bond's market value at the time of redemption.[42] This creates a powerful deterrent against opportunistic refinancing while ensuring bondholders receive compensation that approximates the value of their forgone cash flows.

The premium's relationship to the issuer's credit quality introduces additional complexity. Since the spread over Treasuries remains fixed, the make-whole amount becomes relatively less burdensome when the issuer's borrowing costs increase (due to credit deterioration) and more punitive when they fall (due to credit improvement).[43] This asymmetry reinforces the supracompensatory nature of make-whole provisions in many scenarios while still allowing issuers to

38. Mann & Powers, *supra* note 8, at 536.

39. As discussed in Section I.B, after the bond is called in a low-interest-rate environment, the bondholder is forced to reinvest at a time when interest rates are lower across the board.

40. Nayar & Stock, *supra* note 9, at 388-89 ("This is because the make-whole call price accounts for the lower interest rate extant in the financial markets when the bond might otherwise be called. In other words, with a make-whole call, the bondholders are 'made whole' and any advantage that the borrowing firm might obtain by refinancing at lower rates is forgone by having to pay a much higher call price to consummate the make-whole call.").

41. Mann & Powers, *supra* note 8, at 542-44; Arnold et al., *supra* note 36, at 160 ("[W]hen the discount rate used to calculate the make-whole premium is set at a small spread above the treasury rate, the make-whole is (almost always) supra compensatory—meaning that it is higher than the amount the debtor would pay if it were paying expectation damages (the price it would pay to replace the bond with one of the same maturity, coupon, and risk profile).").

42. Zhaohui Chen, Connie Mao & Yong Wang, *Why Firms Issue Callable Bonds: Hedging Investment Uncertainty*, 16 J. CORP. FIN. 588, 590-92 (2010).

43. Nayar & Stock, *supra* note 9, at 390-91.

exit debt relationships when other strategic imperatives outweigh premium costs.[44]

The following numerical example shows why make-whole premiums are an improvement. Consider two bonds with identical terms—$100 face value, 8% coupon, five years to maturity—that differ only in their call structures. One is callable at a fixed price of $104. The other has a make-whole provision that requires the issuer to pay the present value of the remaining coupons and principal discounted at the five-year Treasury yield plus fifty basis points. Now, suppose yields on comparable noncallable five-year debt fall from 8% to 4.75%, while the five-year Treasury yield is 4.25%. In this scenario, the bond's market value then rises to $114.17.[45]

Under the fixed-call provision, if the issuer can call at $104, it can retire a bond worth $114.17 by paying only $104. The issuer captures $10.17 per bond, and the bondholder is forced to reinvest the money with someone else in this new low-market-rate environment. Under the make-whole call, however, the call price is $114.17, because discounting the remaining payments at the make-whole rate—the treasury rate (4.25%) plus fifty basis points—is equivalent to discounting at the new market rate (4.75%).[46] The issuer, therefore, has no incentive to refinance because the redemption cost roughly equals the bond's market value. The call remains "out of the money" (i.e., not worth exercising because the benefit of exercising the option is equal or lower than staying with the bond), so the bondholder will continue receiving her contracted yield.

In conclusion, the difference in the price of exercising the call option when interest rates fall makes the make-whole more attractive for bondholders. It eliminates the arbitrage opportunity that fixed-premium structures create. Bondholders receive protection that tracks economic reality, and they avoid predetermined schedules that become increasingly inadequate as rates move.

II. Contractual Enforcement of Make-Whole Premiums

Having described the economic rationale for make-whole premiums, I turn to how courts enforce them under contract law. Make-whole provisions generate almost no controversy out of the context of bankruptcy. A solvent issuer that wanted to prepay calculated the formula, paid the premium, and moved on.[47] Bankruptcy, however, changes this calculation because most modern bond agreements automatically accelerate the debt, causing the entire principal to

44. Mann & Powers, *supra* note 8, at 548-49.

45. The $114.17 figure is the present value of five annual $8 coupon payments and the $100 principal payment due at maturity, all discounted at 4.75%. This requires applying the present value formula:

$$P_{MW} = \frac{8}{1.0475} + \frac{8}{(1.0475)^2} + \frac{8}{(1.0475)^3} + \frac{8}{(1.0475)^4} + \frac{108}{(1.0475)^5} = \$114.168$$

46. Of course, the numbers here are picked to have these values be equivalent. In reality, as discussed above, make-wholes are priced *above* par.

47. Gulati & Kahan, *supra* note 1, at 571.

become due immediately, upon filing. The question then becomes whether the make-whole premium survives that acceleration or disappears along with the original maturity date. This is purely a question of state-law contract interpretation. Courts must determine what the sophisticated actors actually bargained for when they drafted the acceleration and redemption clauses, which bankruptcy throws into sudden tension.

Practitioners have characterized the relevant decisions as in conflict with one another. After the Second Circuit denied the make-whole in *Momentive* and the Third Circuit required it in *Energy Future Holdings*, Davis Polk's client alert declared that *Momentive* "creates a circuit split."[48] Other law firms and legal commentators reached the same conclusion.[49] The perceived conflict relies on the facts that both cases involved automatic acceleration of senior notes upon a bankruptcy filing and that both asked whether the make-whole premium survived that acceleration. The courts reached opposite conclusions.

I argue that the cases that seem to split the circuits—namely *AMR*, *Momentive*, and *Energy Future Holdings*—are best understood not as reflecting different judicial philosophies about make-whole premiums but rather as examples of courts applying the same ordinary contract principles to materially different contractual language and factual settings.[50]

This Part proceeds in two steps. Section II.A explains how redemption, acceleration, and remedial clauses interact and shows why *AMR*, *Momentive*, and *Cash America* reject make-whole recovery when the contract treats the debt as already matured or otherwise excludes the premium. Section II.B then examines the drafting techniques that produce the opposite result. *Energy Future Holdings*

48. *But see Second Circuit Holds Momentive Noteholders May Be Entitled to Market Interest Rate on Replacement Notes, Not Entitled to Make-Whole Premium*, DAVIS POLK 4 (Oct. 23, 2017), https://www.davispolk.com/sites/default/files/2017-10-23_second_circuit_holds_momentive_noteholders_may_be_entitled_market_interest_rate_replacement_notes.pdf [https://perma.cc/7TTF-2MXU] ("The Second Circuit's make-whole decision [in *Momentive*] creates a circuit split with the Third Circuit which, in *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016), held that noteholders were entitled to payment of an optional redemption premium at the make-whole price as a result of the repayment of their notes in a bankruptcy proceeding.").

49. Kaitlin R. Walsh, *A Momentive Decision: Second Circuit Splits with Third Circuit on Make Whole Premiums; Adopts Sixth Circuit's Two-Step Approach in Selecting an Interest Rate in Chapter 11 Cramdowns*, MINTZ (Oct. 25, 2017), https://www.mintz.com/insights-center/viewpoints/2017-10-25-momentive-decision-second-circuit-splits-third-circuit-make [https://perma.cc/6ZPD-K39J] (stating that the Second Circuit "expressly rejected" the Third Circuit's analysis and took the "opposite position"); Stanley Tarr, *Momentive: Key Second Circuit Decision Tackles Make-Whole Premiums and Cramdown Interest*, JD SUPRA (Oct. 31, 2017), https://www.jdsupra.com/legalnews/momentive-key-second-circuit-decision-86558 [https://perma.cc/W86M-UZZB] ("The Second Circuit also affirmed after considering and rejecting multiple arguments raised by the respective senior lien noteholders. In doing so, the Second Circuit appears to split from the Third Circuit and its recent ruling dealing with similar make-whole premium issues in the Delaware-based case of *In re Energy Futures Holdings Corp*."); A&O Shearman, *Splitting with the Third Circuit, the Second Circuit Upholds Ruling Denying Noteholder's Entitlement to a Make-Whole Premium*, MONDAQ (Feb. 22, 2018), https://www.mondaq.com/unitedstates/securities/675968/splitting-with-the-third-circuit-the-second-circuit-upholds-ruling-denying-noteholders-entitlement-to-a-make-whole-premium [https://perma.cc/HW3Q-3TTS].

50. *See In re* AMR Corp., 730 F.3d 88, 96-100 (2d Cir. 2013); *In re* MPM Silicones, LLC (*In re* Momentive), 874 F.3d 787, 798-803 (2d Cir. 2017); *In re* Energy Future Holdings Corp., 842 F.3d 247, 251-257 (3d Cir. 2016).

and *1141 Realty* show how parties can preserve the premium by tying it to optional redemption or by deeming post-default payment a voluntary prepayment.

A. When the Indenture Disallows the Make-Whole Premium

This Section identifies the three contract provisions that control whether a make-whole premium survives bankruptcy. Redemption clauses give the borrower a voluntary right to prepay at a set price. Acceleration clauses give creditors the right to demand immediate payment after a default. Remedial clauses, where they exist, specify what the lender may recover. *AMR* and *Momentive* illustrate that when these provisions are read together, they exclude the make-whole premium from the acceleration payment.

Redemption clauses allow a borrower to discharge its debt before maturity. As outlined above, make-wholes allow redemption only if the issuer also pays a "redemption premium" or "make-whole" amount which approximately equals the present value of the foregone interest stream. The make-whole amount thus functions as a contractual yield-maintenance device which essentially prices the issuer's option to refinance or restructure on better terms. As Judge Winter observed in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, "[t]he purpose of a redemption premium is to put a price upon the voluntary satisfaction of a debt before the date of maturity."[51] A redemption, in other words, also presupposes voluntariness.

The borrower thus bargains for flexibility and may retire the bonds early, but only by paying the price fixed in advance for the lender's lost future yield. Because redemption is elective, the premium is not a penalty, but rather the agreed upon cost of choosing the alternate performance. The indentures in *Sharon Steel* contained precisely this structure—optional redemption at fixed percentages of par declining toward maturity—reflecting the plain purpose of the redemption provisions.[52] The court enforced the redemption premium even against a liquidating debtor that had tried to avoid it by triggering default instead of a formal redemption notice.

Acceleration operates from the opposite end of the debtor-creditor relationship. After an event of default, the trustee or noteholders may (and in some cases automatically must) declare the principal and accrued interest immediately due and payable. Acceleration essentially moves the maturity date forward and converts the debt from a future to a present obligation. Once that happens, there is no longer an "early" payment made by the issuer which would trigger a make-whole, unless the indenture explicitly preserves it.

The *AMR* decision illustrates this point. The dispute in *AMR* arose after American Airlines filed Chapter 11 in 2011 and then sought postpetition financing to refinance three aircraft-backed notes with U.S. Bank.[53] After continuing

51. Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1053 (2d Cir. 1982).
52. *Id.* at 1042-43.
53. *AMR Corp.,* 730 F.3d at 95.

its principal and interest payments, American moved in October 2012 to obtain $1.5 billion in new financing and to use the proceeds to repay the notes without a make-whole premium.[54] The *AMR* indentures made the aforementioned transformation explicit. Section 4.02(a)(i) provided that upon an event of default, including the filing of a voluntary petition in bankruptcy, "the unpaid principal . . . together with . . . all other amounts due . . . (but for the avoidance of doubt, without Make-Whole Amount), shall immediately and without further act become due and payable."[55]

As the Second Circuit explained in *In re AMR Corp.*, acceleration "changes the date of maturity from some point in the future . . . to an earlier date based on the debtor's default."[56] Once accelerated, the debt is no longer being prepaid early as it has already matured. As *AMR* put it, "[p]repayment can only occur *prior* to the maturity date."[57] Thus, acceleration normally extinguishes the make-whole provision because it advances the maturity date and converts any later payment from an optional prepayment into payment of an already matured obligation.

Faced with such language, the court enforced the indenture as written. Because the bankruptcy filing automatically accelerated the notes, the later refinancing payment was not a voluntary redemption, and Sections 4.02(a)(i) and 3.03 therefore foreclosed any make-whole claim. The bankruptcy filing had automatically accelerated the notes; the later payoff therefore occurred "post-maturity" and outside the scope of the optional-redemption clause.[58] Thus, *AMR* establishes that when the indenture expressly excludes the make-whole provision from acceleration, that language ends the inquiry.

The *Momentive* decision confirmed this default rule and showed how it applies when the indenture makes a distinction between optional redemption and automatic acceleration.[59] Before getting into the weeds, it's worth spelling out the difference between the two. Optional redemption occurs when the issuer chooses to retire its debt early by paying a contractually specified premium. Automatic acceleration arises, as noted above, when an event of default advances the maturity date and makes the entire debt due immediately, leaving the borrower no choice at all.

Momentive Performance Materials issued senior-lien notes under 2012 indentures that contained both an "Optional Redemption" clause and a bankruptcy-acceleration clause.[60] The Optional Redemption provision allowed the company

54. *Id.* at 92-96.

55. *Id.* at 94 (emphasis omitted).

56. *Id.* at 99 n.13 (2d Cir. 2013) (quoting Analytical Surveys, Inc. v. Tonga Partners, L.P., 684 F.3d 36, 44 (2d Cir. 2012)).

57. *Id.* at 103 (quoting *In re* Solutia Inc., 379 B.R. 473, 488 (Bankr. S.D.N.Y. 2007)).

58. *Id.* at 109.

59. *In re* MPM Silicones, LLC (*In re* Momentive), 874 F.3d 787, 801-04 (2d Cir. 2017) (holding that because bankruptcy filing automatically accelerated the notes, any subsequent repayment was post-maturity and therefore not a voluntary redemption triggering the make-whole premium).

60. *Id.* at 801-02.

to redeem the notes "'at its option' prior to October 15, 2015" at a price equal to 100 percent of principal plus the "Applicable Premium"—the make-whole amount.[61] The acceleration clause, by contrast, provided that if the debtor filed for bankruptcy, "the principal of, premium, if any, and interest on all the Notes shall ipso facto become and be immediately due and payable without any declaration or other act on the part of the Trustee or any Holders."[62]

When Momentive filed for Chapter 11 bankruptcy in April 2014, this second clause operated automatically, and the debt matured by contract on the petition date.[63] Under its reorganization plan, Momentive proposed to satisfy the notes either with cash or with new replacement notes, prompting the indenture trustee, on behalf of the noteholders, to claim entitlement to the make-whole premium included in the Optional Redemption clause.[64] The court rejected that claim, focusing on the "plain meaning" of the word "redeem": "to repay[] . . . a debt security . . . *at or before* maturity."[65] Because Momentive's bankruptcy default had already advanced the maturity date, any later payment by Momentive was necessarily "*post*-maturity, not 'at or before' maturity," and thus not a redemption.[66] Even if one could colloquially call the payoff a redemption, the court added, it was not optional, as "a payment made mandatory by operation of an automatic acceleration clause is not one made at [Momentive]'s option."[67] The company had no choice in the matter because it was merely discharging an already-matured obligation.

The noteholders urged the court to allow them to rescind the acceleration, that is, to "decelerate" the notes so that payment could once again be treated as an optional redemption. The court refused, holding that any postpetition attempt to modify the contractual maturity date would violate Chapter 11 bankruptcy's automatic stay.[68] Once Momentive filed the petition, acceleration became irrevocable, and the debt remained due immediately. The Second Circuit panel likewise rejected the argument that the phrase "premium, if any" in the acceleration clause imported the make-whole provision into the bankruptcy-triggered payment obligation. The only premium recognized by the contract was the one attached to optional redemptions, which the court had already concluded had not been triggered.[69] Like *AMR*, the result turned on what the contract said, not on a policy preference for or against make-whole premium recovery.

Cash America International, Inc., though not in bankruptcy, illustrates the importance of traditional contract analysis since it involved language found to

61. *Id.* at 801.
62. *Id.* at 803 n.15.
63. *Id.* at 792, 803.
64. *Id.* at 792-93.
65. *Id.* at 802-03 (quoting Brief for Appellees Momentive Performance Materials Inc., Apollo Global Management, LLC, and Ad Hoc Committee of Second Lien Holders at 39, *Momentive*, 874 F.3d 787 (No. 15-1682)).
66. *Id.*
67. *Id.*
68. *Id.* at 803-04.
69. *Id.* at 803.

allow the lender to decelerate after an event of default.[70] There, the indenture's default-remedy structure left acceleration permissive, not exclusive. Section 6.02(a) provided that "the Trustee . . . *may* . . . declare . . . the Notes to be immediately due and payable," while Section 6.03 preserved other remedies, including specific performance.[71] When Cash America breached a covenant by spinning off its subsidiary Enova, the trustee elected not to accelerate and instead sought specific performance of the issuer's optional-redemption obligation.[72] Because the breach was voluntary and outside bankruptcy, the court viewed it as the economic equivalent of an early payoff and required the company to pay the make-whole premium.[73]

In each of these cases, the indenture either excluded the premium from the acceleration payment or failed to connect the two provisions.

B. When the Indenture Allows the Make-Whole Premium

The previous Section showed how express exclusion of the make-whole provision from the acceleration clause ends the inquiry. This Section examines two drafting techniques that achieve the opposite result. The first, illustrated by *Energy Future Holdings*, ties the premium to "redemption" and relies on the debtor's voluntary choice to repay. The second, illustrated by *1141 Realty*, deems every post-default payment a voluntary prepayment and makes the timing of maturity irrelevant.

In *In re Energy Future Holdings Corp.*, the United States Court of Appeals for the Third Circuit confronted indentures with both an "Optional Redemption" clause and an automatic acceleration clause triggered by bankruptcy.[74] The Optional Redemption section allowed the bond issuer, EFIH, to redeem "[a]t any time prior to December 1, 2015" at a price equal to principal plus an "Applicable Premium."[75] The acceleration clause in the first lien indenture made "all outstanding Notes . . . due and payable immediately" upon a bankruptcy filing.[76] The second-lien version added that "all principal of and premium, if any, interest . . . [,] and any other monetary obligations on the outstanding Notes shall be due and payable immediately."[77] EFIH filed for bankruptcy in 2014 after publicly announcing a plan to refinance its debt on more favorable terms.[78] The

70. Wilmington Sav. Fund Soc'y, FSB v. Cash Am. Int'l, Inc., No. 15-CV-5027, 2016 WL 5092594 (S.D.N.Y. Sep. 19, 2016).

71. Charles T. Doyle, *The Name Is Bond, Corporate Bond: Remedies for Breach of Bond Indentures After the Alarming* Cash America *Ruling*, 108 IOWA L. REV. 1403, 1415-16 (reproducing Section 6.02(a) and 6.03 of the indenture) (emphasis added).

72. *Cash Am.*, 2016 WL 5092594 at *3-6.

73. *Id.* at *6-8.

74. *In re* Energy Future Holdings Corp., 842 F.3d 247, 251 (3d Cir. 2016).

75. *Id.*

76. *Id.*

77. *Id.* (emphasis omitted).

78. *Id.* at 251-52.

bankruptcy and district courts concluded that acceleration had extinguished the make-whole provision.[79]

The Third Circuit reversed. It held that "redemption" under New York law includes repayment "*at* or before maturity," which means that a payment after acceleration can still qualify as a redemption.[80] EFIH's refinancing was therefore an "optional redemption," not a compelled payoff.[81] The court observed that EFIH had voluntarily chosen to redeem to take advantage of lower rates, and that its act was "in the same position within bankruptcy as it would be outside."[82] The redemption remained optional, so the Applicable Premium remained due.

The Third Circuit also rejected the argument that acceleration and redemption provisions are mutually exclusive. It explained that "§ 6.02 causes the maturity of EFIH's debt to accelerate on its bankruptcy, and § 3.07 causes a make-whole to become due when there is an optional redemption."[83] The two provisions "form the map to guide the parties through a post-acceleration redemption."[84] The inclusion of the words "premium, if any" in the second-lien acceleration clause linked the sections together and preserved the premium.[85] The court emphasized that New York law does not presume that acceleration wipes away other contractual rights. Instead, "in New York the consequences of acceleration . . . depend on the language chosen by the parties."[86] If the debtor wanted its obligation to end upon acceleration, "it needed to make clear that § 6.02 trumps § 3.07."[87] Because EFIH's indenture did not say so, the court held that the make-whole provision survived acceleration.[88]

The difference between *Energy Future Holdings* and the cases discussed in Section II.A comes down to drafting, not judicial philosophy, as a comparison to *AMR* demonstrates. In *AMR*, the indenture expressly provided that the notes would become due and payable "without Make-Whole Amount," and that "[n]o Make-Whole Amount shall be payable . . . in connection with . . . acceleration."[89] The Second Circuit enforced that exclusion as written. Thus, the *AMR* indenture eliminated the premium through specific language, whereas the *Energy Future Holdings* indenture preserved it by cross-reference and debtor choice.

A second example comes from *In re 1141 Realty Owner LLC*, a commercial mortgage case decided under New York law.[90] The loan agreement there

79. *Id.* at 252-53.

80. *Id.* at 259 (quoting Chesapeake Energy Corp. v. Bank of N.Y. Mellon Tr. Co., N.A., 773 F.3d 110, 116 (2d Cir. 2014)).

81. *Id.* at 261.

82. *Id.* at 255 (quoting Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 537, 552 (2007)).

83. *Id.* at 256.

84. *Id.*

85. *Id.* at 257-58.

86. *Id.* at 258 (quoting NML Cap. v. Republic of Argentina, 952 N.E.2d 482, 492 (N.Y. 2011)).

87. *Id.* at 261.

88. *Id.*

89. *In re* AMR Corp., 730 F.3d 88, 99-100 (2d Cir. 2013).

90. *In re* 1141 Realty Owner LLC, 598 B.R. 534, 538 (Bankr. S.D.N.Y. 2019).

contained a "Yield Maintenance Default Premium" clause which stated that "[i]f, following an Event of Default" the borrower tendered any payment, "such tender . . . shall be deemed a voluntary prepayment . . . and Borrower shall pay . . . the Yield Maintenance Default Premium."[91] When the lender accelerated the loan after default, the borrower argued that acceleration made prepayment impossible.[92] The court disagreed. It explained that the contract "imposes the make-whole premium in connection with any *payment* made after an Event of Default, not just a *prepayment* made after an Event of Default but before acceleration," and that the deeming clause rendered acceleration "irrelevant."[93] The premium was therefore enforceable as liquidated damages because it approximated the lender's loss of its expected interest stream and was not a penalty.[94] The court noted that under New York law, "parties . . . are free to include provisions directing what will happen in the event of default or acceleration of the debt," and that courts must respect those choices.[95]

These decisions reflect two drafting methods that achieve the same result. First, under the *Energy Future Holdings* model, a premium tied to "redemption" survives because redemption may occur at or after maturity, and the debtor has voluntarily chosen to repay. Second, under the *1141 Realty* model, the agreement itself deems every post-default payment a voluntary prepayment, making the timing of maturity irrelevant. Both operate within the same interpretive framework. When a clause expressly preserves the premium or renders acceleration irrelevant, the make-whole remains enforceable. When a clause expressly excludes it, as in *AMR* or *Momentive*, the make-whole does not survive.

The lesson from these cases is that the text decides. If the indenture states that acceleration occurs "without Make-Whole Amount," that language ends the inquiry. If it connects acceleration to "premium, if any" or deems post-default payments to be voluntary prepayments, the premium survives. Courts have let the market draw these distinctions by contract rather than imposing them by judicial rule. Now that I have established the contractual framework for make-whole provision enforcement, Part III examines whether § 502(b)(2)'s prohibition on unmatured interest independently bars the recovery of make-whole premiums in bankruptcy, even where contract law would otherwise permit it.

III. Statutory Treatment of Make-Whole Claims

Part II showed that whether a make-whole premium survives bankruptcy is, in the first instance, a question of contract drafting. But even where the indenture preserves the premium, § 502(b)(2) of the Bankruptcy Code, which disallows claims for "unmatured interest," remains an obstacle for enforcement. If a make-whole premium constitutes unmatured interest, it is disallowed regardless of

91. *Id.* at 538-39 (emphasis omitted).
92. *Id.* at 539.
93. *Id.* at 541, 543.
94. *Id.* at 541-44.
95. *Id.* at 541 (quoting NML Cap. v. Republic of Argentina, 952 N.E.2d 482, 491 (N.Y. 2011)).

what the contract says. For most of the provision's history, courts treated this argument as a nonstarter. The substantial majority characterized make-whole premiums as liquidated damages and moved on.[96] The Fifth Circuit's 2022 decision in *Ultra Petroleum* and the Third Circuit's 2024 decision in *Hertz* rejected that majority view.[97] Both courts held that a make-whole premium can be liquidated damages and the economic equivalent of unmatured interest at the same time, and that § 502(b)(2) requires disallowance when it is both.[98] This Part traces that doctrinal shift. Section III.A frames the liquidated-damages-versus-unmatured-interest debate and explains why courts long treated the two categories as mutually exclusive. Section III.B examines the Fifth Circuit's substance-over-form analysis in *Ultra Petroleum*. Section III.C shows how the Third Circuit consolidated that approach in *Hertz*. Section III.D assesses the practical implications of these decisions for creditors, drafters, and future litigation.

A. The Liquidated Damages vs. Unmatured Interest Debate

Section 502(b)(2) of the Bankruptcy Code disallows claims "for unmatured interest."[99] Although the Code does not define "unmatured interest," courts have interpreted it to mean interest that had not accrued as of the petition date.[100] Some circuits have expanded this prohibition to encompass the "economic equivalent" of unmatured interest, reasoning that otherwise, creditors could easily circumvent § 502(b)(2) through creative drafting.[101]

In analyzing make-whole provisions under § 502(b)(2), courts have developed two principal approaches: (1) a definitional test that examines whether make-whole premiums fit the technical definition of "interest" and "unmatured," and (2) a substantive test that looks to the economic reality of the payment to determine whether it functions as a substitute for unmatured interest.[102] Both approaches have been employed by courts that have disallowed make-whole premiums.

The tension between characterizing make-whole premiums as liquidated damages or unmatured interest lies at the heart of much of the litigation in this area. This distinction is critical because liquidated damages are generally allowable in bankruptcy, while unmatured interest is expressly disallowed under

96. Michael Friedman & Craig M. Price, *Make-Whole Provisions Continue to Cause Controversy*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 3, 2014), https://corpgov.law.harvard.edu/2014/08/03/make-whole-provisions-continue-to-cause-controversy [https://perma.cc/5JTN-5ZFA]; *see also In re* Trico Marine Servs., Inc., 450 B.R. 474, 480 (Bankr. D. Del. 2011) (reporting that "the substantial majority of courts considering this issue have concluded that make-whole . . . obligations are in the nature of liquidated damages rather than unmatured interest").

97. *In re* Ultra Petroleum Corp., 51 F.4th 138, 150-56 (5th Cir. 2022); *In re* Hertz Corp., 120 F.4th 1181, 1196-1201 (3d Cir. 2024).

98. *Ultra Petroleum*, 51 F.4th at 146-48; *Hertz*, 120 F.4th at 1196-97.

99. 11 U.S.C. § 502(b)(2) (2024).

100. *In re* Pengo Indus., Inc., 962 F.2d 543, 545-46 (5th Cir. 1992).

101. *Ultra Petroleum*, 51 F.4th at 145-46 (first citing *Pengo*, 962 F.2d at 546; and then citing *In re* Chateaugay Corp., 961 F.2d 378, 380-81 (2d Cir. 1992)).

102. *Hertz*, 120 F.4th at 1194.

§ 502(b)(2).[103] Traditionally, many bankruptcy courts treated these characterizations as mutually exclusive, creating what some recent decisions have called a "false dichotomy."[104] Under this view, if a make-whole premium constituted enforceable liquidated damages under state law, it could not simultaneously be unmatured interest for purposes of § 502(b)(2).[105] This approach allowed creditors to circumvent the Code's prohibition on unmatured interest through contractual engineering.

One possible way to distinguish between a make-whole provision that serves as liquidated damages and one that constitutes unmatured interest is to focus on what the provision actually compensates for.[106] The Fifth Circuit in *Ultra Petroleum* drew on Professor Baird's framework by asking whether the make-whole amount merely compensates the issuer "for the search and transaction costs of 'seek[ing] to find someone else to use the capital,' or goes further and compensates creditors for the loss of future interest 'through the guise of a make-whole premium.'"[107]

Some make-whole premiums may legitimately function as liquidated damages for anticipated transaction costs that do not constitute unmatured interest. For example, when a lender must find a replacement borrower, it may incur broker fees, legal costs, or other expenses. A liquidated damages provision compensating for these costs would not run afoul of § 502(b)(2).

However, when make-whole premiums attempt to provide lenders with their full expected yield regardless of when repayment occurs, they function as disguised unmatured interest. As the bankruptcy court in *Hertz* observed, "[i]f it were enough to just label a make-whole claim liquidated damages, . . . then a contract providing that on default or redemption 'all unmatured interest' would be immediately due and payable could avoid the effect of [S]ection 502(b)(2) completely."[108]

Baird further distinguishes between make-whole clauses in fixed-rate versus variable-rate environments. In a stable, fixed-rate environment, a make-whole amount calculated as the present value of future interest payments better reflects unmatured interest. In contrast, in a variable-rate context, a make-whole provision might be more appropriately characterized as compensation for a "bad bet" on interest rate movements.[109] This distinction, though conceptually important, has not been widely adopted in judicial decisions.

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103. 4 COLLIER ON BANKRUPTCY ¶ 502.03[3][a] (16th ed. 2022).

104. *In re* Drs. Hosp. of Hyde Park, Inc., 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014).

105. *See, e.g.*, *In re* Trico Marine Servs., Inc., 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) (holding that a make-whole premium was "akin to a claim for liquidated damages, not a claim for unmatured interest").

106. Douglas G. Baird, *Making Sense of Make-Wholes*, 94 AM. BANKR. L.J. 567, 568, 587-88 (2020).

107. *In re* Ultra Petroleum Corp., 51 F.4th 138, 149 (5th Cir. 2022) (quoting DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 84-85 (6th ed. 2014)).

108. *In re* Hertz Corp., 637 B.R. 781, 791 (Bankr. D. Del. 2021).

109. Baird, *supra* note 106, at 579-80 ("An obligation owed on a bad bet—involving changes in the rate of interest or anything else—is not in and of itself an obligation to pay unmatured interest.").

The case law on make-whole premiums has shifted sharply in recent years. As recently as 2014, practitioners could confidently assert that arguments characterizing make-whole provisions as unmatured interest were "of limited merit as make-whole provisions have typically been held to be valid liquidated damage provisions enforceable as a matter of state law."[110] This view was supported by significant case law, including the Delaware bankruptcy court's ruling in *In re Trico Marine Services, Inc.,* which found that "the substantial majority of courts considering this issue have concluded that make-whole . . . obligations are in the nature of liquidated damages rather than unmatured interest."[111] Previously, a make-whole premium was not classified as unmatured interest, but instead as "more akin to a charge or a fee, or to liquidated damages, than to interest not yet due."[112] Such decisions contributed to a strong presumption among practitioners that properly drafted make-whole provisions would be enforced in bankruptcy as liquidated damages. The recent decisions in *Ultra Petroleum* and *Hertz* represent a significant departure from this once-prevailing view.

B. Substance Over Form: The Fifth Circuit's Analysis in Ultra Petroleum

The United States Court of Appeals for the Fifth Circuit's decision in *In re Ultra Petroleum Corp.* marked a turning point in make-whole premium law.[113] Ultra Petroleum, a natural gas exploration company, filed for Chapter 11 protection in 2016 due to declining gas prices. During bankruptcy proceedings, natural gas prices rebounded dramatically, rendering Ultra "massively solvent."[114] The debtor proposed a plan that would pay creditors their outstanding principal, accrued prepetition interest at the contractual rate, and postpetition interest at the federal-judgment rate. However, the plan did not include payment of approximately $201 million in make-whole amounts that would have been triggered under the Master Note Purchase Agreement (MNPA) upon Ultra's bankruptcy filing.[115]

The make-whole amount in *Ultra Petroleum* was calculated as "the excess, if any, of the Discounted Value of the Remaining Scheduled Payments with respect to the Called Principal of such fixed rate Note over the amount of such Called Principal."[116] This formula essentially provided noteholders with the present value of all future unmatured interest payments that would have been due through the notes' stated maturity.

110. Friedman & Price, *supra* note 96.

111. *In re* Trico Marine Servs., Inc., 450 B.R. 474, 480 (Bankr. D. Del. 2011).

112. *See* 4 COLLIER ON BANKRUPTCY, *supra* note 103, at ¶ 502.03[3][a].

113. *In re* Ultra Petroleum Corp., 51 F.4th 138, 145-56 (5th Cir. 2022) (holding that a make-whole premium is disallowed unmatured interest, but solvent-debtor exception compels payment).

114. *Id.* at 143.

115. *Id.* at 144.

116. *Id.* at 144 n.3.

The bankruptcy court initially ruled that the make-whole amount was an enforceable liquidated-damages provision rather than unmatured interest.[117] However, the Fifth Circuit reversed, reasoning that because the make-whole amount was expressly designed to compensate noteholders for lost future interest payments, it was "*precisely* the 'economic equivalent' of . . . unmatured interest."[118]

The Fifth Circuit rejected the noteholders' arguments to the contrary. First, it dismissed their claim that the make-whole amount was not interest. The court explained that even though the payment did not compensate for past money use, it did "compensate[] Creditors for the future use of their money, albeit use that w[ould] never actually occur because of Ultra's default."[119] This made it unmatured interest.[120] Second, the court rejected the noteholders' argument that the make-whole amount had matured upon Ultra's bankruptcy filing pursuant to the MNPA's acceleration clause. The court found that because the bankruptcy petition triggered the premium, the premium could not logically have matured prior to the triggering event.[121] Third, the court dismissed the attempt to distinguish make-whole premiums from original-issue discount (OID), which had previously been held disallowable under § 502(b)(2).[122] The noteholders argued that OIDs are "assured payment[s]," whereas make-whole premiums are "contingent."[123] The court found this distinction irrelevant, as both ultimately serve as the economic equivalent of unmatured interest.[124]

Most importantly, the Fifth Circuit dismantled lower courts' longstanding assumption that "liquidated damages" and "unmatured interest" are mutually exclusive buckets. Until *Ultra Petroleum*, many bankruptcy courts reasoned that once a premium qualified as enforceable liquidated damages under state law, it could not also be unmatured interest, thereby sidestepping § 502(b)(2).[125] That

117. *In re* Ultra Petroleum Corp., 624 B.R. 178, 185-86 (Bankr. S.D. Tex. 2020).
118. *Ultra Petroleum*, 51 F.4th at 148.
119. *Id.* at 146.
120. *Id.*
121. *Id.* at 147.
122. *Id.* (citing *In re* Pengo Indus., Inc., 962 F.2d 543, 546 (5th Cir. 1992)).
123. *Id*.
124. *Id.* at 147-48.
125. *See In re* Trico Marine Servs., Inc., 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) ("Research reveals that the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages rather than unmatured interest, whereas courts taking a contrary approach are distinctly in the minority. . . . This Court is persuaded by the soundness of the majority's interpretation of make-whole obligations, and therefore finds that the Indenture Trustee's claim on account of the Make-Whole Premium is akin to a claim for liquidated damages, not a claim for unmatured interest."); *In re* Sch. Specialty, Inc., No. 13-10125, 2013 WL 1838513, at *5 (Bankr. D. Del. 2013) (agreeing with *Trico* and holding that make-whole premiums should not be disallowed as unmatured interest); *In re* 360 Inns, Ltd., 76 B.R. 573, 576 (Bankr. N.D. Tex. 1987) ("[T]he prepayment penalty was not unmatured interest as contemplated in § 502(b)(2), inasmuch as the prepayment penalty was activated and *matured* once the plan of reorganization proposed to prepay [the lender's] debt."); *In re* 1141 Realty Owner, LLC, 598 B.R. 534, 541-43 (Bankr. S.D.N.Y. 2019) ("[T]he Yield Maintenance Default Premium must be analyzed as a liquidated damages provision."); *In re* Lappin Elec. Co., 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000) ("[T]his court is in agreement with a majority of courts that view a prepayment charge as liquidated damages, not as unmatured interest or an alternative means of paying

formalistic binary invited creditors to draft around the statute by rechristening future-interest coupons as "make-whole" or "yield-maintenance" fees.

Ultra Petroleum rejects that safe harbor and substitutes a substance-over-form test. Echoing the treatment of original-issue discount, the panel explained that "[l]ike interest masquerading as 'principal,' interest labeled 'liquidated damages' is still interest."[126] The inquiry, therefore, turns on economic reality: does the payment replicate the lender's lost yield? If so, § 502(b)(2) disallows it *even though* the same dollars may satisfy state-law liquidated-damages doctrine.

The Court also stopped short of declaring every liquidated-damages clause a form of interest. It acknowledged that a provision compensating genuine transaction costs—broker's fees, hedge unwind expenses, or the like—may fall outside the interest bar.[127] But where, as in *Ultra Petroleum*, the formula simply discounts unpaid coupons to present value, the premium's dual character is irrelevant: that component is unmatured interest and must be struck from the claim unless another Code exception intervenes.

The *Ultra Petroleum* court thus transformed the inquiry from "liquidated damages or interest?" to "does this clause substitute economically for yet-to-accrue interest?"—a question that looks past contractual labels and treats overlapping categories as no defense to § 502(b)(2).

C. Further Consolidation in Hertz

The Third Circuit's decision in *In re Hertz Corp.* further solidified this approach to make-whole premiums as unmatured interest. Hertz filed for bankruptcy in May 2020 due to the COVID-19 pandemic, but later experienced a significant financial recovery. After emerging from bankruptcy, Hertz redeemed senior notes before their scheduled maturity dates in 2026 and 2028, triggering make-whole premiums under the governing indentures.[128]

These make-whole premiums were calculated as "the present value at [the] Redemption Date" of: (1) the principal and redemption fees due at the redemption date, plus (2) "all required remaining scheduled interest payments" through that date, minus (3) the principal amount.[129] This formula, like the one in *Ultra Petroleum*, sought to compensate noteholders for the present value of future interest payments they would lose due to early redemption.

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under the contract."); *In re* Outdoor Sports Headquarters, Inc., 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("Prepayment amounts, although often computed as being interest that would have been received through the life of a loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract."); *In re* Skyler Ridge, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987) ("Liquidated damages, including prepayment premiums, fully mature at the time of breach, and do not represent unmatured interest.").

126. *Ultra Petroleum*, 51 F.4th at 148.

127. *Id.* at 149 ("Liquidated damages certainly *can* compensate for anticipated transaction costs that are *not* unmatured interest. But the Make-Whole Amount, unlike the transaction-costs liquidated damages in the hypothetical, is *both* liquidated damages *and* the 'economic equivalent of unmatured interest'—indeed, that is its whole point.").

128. *In re* Hertz Corp., 120 F.4th 1181, 1188-89 (3d Cir. 2024).

129. *Id.* at 1193 n.8.

The Third Circuit identified and applied both the definitional test and the substantive test to determine whether the make-whole premiums constituted unmatured interest. Under the definitional test, the court considered various definitions of "interest," ultimately adopting the definition in Black's Law Dictionary: "The compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use; esp[ecially] the amount owed to a lender in return for the use of borrowed money."[130] The court found that the make-whole premiums fit this definition because they compensated the noteholders for Hertz's use of their funds.

Importantly, the Third Circuit also held that claims can fit multiple characterizations simultaneously. The fact that the make-whole premiums reflected "reinvestment costs" did not preclude them from also constituting interest.[131] The court analogized to previous decisions holding that the original-issue discount was disallowable under § 502(b)(2) because it compensated for the delay and risk associated with loaning money.[132]

Under the substantive test, the Third Circuit found that the make-whole premiums were "mathematically equivalent to the unmatured interest the Noteholders would have received had Hertz redeemed the notes on their Redemption Dates."[133] Breaking down the premiums into their component parts—(1) interest coupons through the redemption dates, (2) the redemption fee, and (3) the present value discount—the court analyzed each separately.

The interest coupons were readily identifiable as interest. The redemption fee, though not explicitly tied to interest rates, was still interest because it represented "a fee for the Noteholders' profit that Hertz agreed to pay as a condition for issuing the Notes."[134] Finally, the present value discount did not transform the other components into something other than interest; rather, it rendered the make-whole premiums "even more mathematically equivalent to the disallowed unmatured interest by correctly pegging its actual worth."[135]

The Third Circuit expressly disagreed with the noteholders' argument that disallowance would produce "entirely arbitrary" results, clarifying that § 502(b)(2) disallows unmatured interest of any amount, regardless of how it is calculated or characterized.[136]

D. Implications of the Ultra Petroleum *and* Hertz *Decisions*

The evolution of judicial treatment of make-whole provisions shows how rapidly an entrenched doctrine can shift. As recently as 2014, practitioners and

130. *Id.* at 1195 (quoting *Interest*, BLACK'S LAW DICTIONARY (12th ed. 2024)).
131. *Id.* at 1196.
132. *Id.* at 1196 n.12.
133. *Id.* at 1196.
134. *Id.*
135. *Id.* at 1197.
136. *Id.* at 1196-97 ("[Section] 502(b)(2) would disallow unmatured Redemption Fees of $0.01 and $1 billion alike.").

scholars widely accepted that make-whole provisions would typically be enforced as liquidated-damages provisions. This consensus was so strong that bankruptcy courts regularly cited to the "substantial majority" of courts that had reached this conclusion.[137] However, this conventional wisdom began to erode as courts increasingly questioned whether sophisticated financial instruments should be evaluated based on their labels or their economic functions.[138] Judge Drain's comment in *Chemtura* that the minority position characterizing make-whole payments as "proxies for unmatured interest" was "rather persuasive" signaled an inflection point in this doctrinal shift.[139] The Fifth Circuit's decision in *Ultra Petroleum* crystallized this emerging skepticism, rejecting a false "dichotomy" between liquidated damages and unmatured interest and laying out a novel analytical framework that viewed these characterizations as not mutually exclusive but complementary.[140] This reconceptualization allows courts to acknowledge that make-whole premiums may simultaneously constitute both liquidated damages and the economic equivalent of unmatured interest, with § 502(b)(2) requiring disallowance regardless of this dual characterization.[141] The Third Circuit's subsequent adoption of similar reasoning in *Hertz* has solidified this once-marginal view into what now appears to be the dominant approach, particularly at the circuit-court level.[142] This shift tracks a broader move in bankruptcy law toward substance-over-form analysis of complex financial instruments, where contractual labels matter less than economic reality.[143]

It is important to note that *Hertz* and *Ultra Petroleum* do not foreclose all possibility of make-whole enforcement. First, although it characterized make-whole premiums as unmatured interest, the *Ultra Petroleum* court did not establish a categorical bar against their recovery. Instead, the Fifth Circuit's analysis turned on precisely when the premium was triggered. As the court observed, had the make-whole premium matured before the debtors' bankruptcy filing, it would have "narrowly escape[d] § 502(b)(2)'s gaping maw" and become "an allowable claim for (barely) matured interest."[144] This timing-focused approach suggests

137. *See, e.g.*, *In re* Trico Marine Servs., Inc., 450 B.R. 474, 480 (Bankr. D. Del. 2011) ("Research reveals that the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages rather than unmatured interest.").

138. *See, e.g.*, *In re* Drs. Hosp. of Hyde Park, Inc., 508 B.R. 697, 705-06 (Bankr. N.D. Ill. 2014) ("Both OID and [make-whole premiums] are one-time charges to compensate the lender for lending: that is, the price of money received now in terms of money received later. If an original issue discount is interest, then so is a [make-whole payment].").

139. *In re* Chemtura Corp., 439 B.R. 561, 604 (Bankr. S.D.N.Y. 2010).

140. *In re* Ultra Petroleum Corp., 51 F.4th 138, 149 (5th Cir. 2022) (explaining that a make-whole premium can be "both liquidated damages *and* the 'economic equivalent of unmatured interest'").

141. *Id.* at 148 ("Like interest masquerading as 'principal,' interest labeled 'liquidated damages' is still interest.").

142. *In re* Hertz Corp., 120 F.4th 1181, 1196 (3d Cir. 2024) (agreeing that the fact that a make-whole claim might reflect "reinvestment costs" does not preclude it from also constituting interest).

143. *See, e.g.*, Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1248-49 (2013) (showing that bankruptcy priority disputes can turn on economic substance rather than formal characterization, as when repurchase transactions styled as sales were "functionally" loans).

144. *Ultra Petroleum*, 51 F.4th at 147.

that make-whole premiums triggered prior to bankruptcy filing remain potentially recoverable, providing a critical distinction for secured creditors who accelerate debt obligations prepetition.

Second, the courts' analyses introduce greater precision to the "unmatured interest" inquiry by separating it into two distinct components: (1) whether a make-whole premium constitutes interest and (2) whether that interest is "unmatured."[145] This bifurcated analysis allows for more nuanced treatment of make-whole premiums in different factual scenarios. In *Ultra Petroleum*, the disallowance hinged specifically on the fact that the premium was triggered by an *ipso facto* clause, thus necessarily postdating the bankruptcy filing.[146] However, where make-whole provisions are drafted such that they trigger under different circumstances or upon earlier events of default, they may avoid classification as unmatured interest.

Third, by affirming that make-whole premiums and default interest compensate for distinct harms, the Fifth Circuit undermined arguments that such amounts should be disallowed as duplicative or punitive. The court expressly recognized that "[s]eparate harms warrant separate recoveries," with make-whole premiums representing liquidated damages for the debtor's breach and postpetition interest compensating for delay in payment.[147]

Fourth, these decisions still leave pathways for recovery of make-whole premiums in appropriate circumstances. For secured creditors, "the collateral's capacity to satisfy the [claim] is analogous to a solvent debtor's capacity to pay its debts."[148] Even where a premium is disallowed as part of a prepetition claim, it may be recoverable by an oversecured creditor under § 506(b), provided the reduced prepetition claim creates a sufficient equity cushion.[149]

Finally, both the *Ultra Petroleum* and *Hertz* decisions acknowledge that make-whole premiums can be characterized as liquidated damages and unmatured interest simultaneously, rejecting the previously common "false dichotomy" approach.[150] While this dual characterization ultimately resulted in disallowance under § 502(b)(2), it also preserves arguments for the enforcement of make-whole premiums as valid liquidated damages where the unmatured-interest prohibition might not apply.[151]

The *Ultra Petroleum* and *Hertz* decisions essentially hold that make-whole premiums now face a serious statutory obstacle. Section 502(b)(2) disallows them as unmatured interest regardless of their contractual label. But disallowance

145. *Id.* at 145-46; *Hertz*, 120 F.4th at 1194-97.

146. *Ultra Petroleum*, 51 F.4th at 147.

147. *Id.* at 157.

148. Michael P. Cooley, Ultra Petroleum *Brings Some Good News to Lenders and Servicers*, 42 AM. BANKR. INST. J. 60, 94 (2023).

149. *Id.* at 61.

150. *Hertz*, 120 F.4th at 1196; *Ultra Petroleum*, 51 F.4th at 149 (stating that a make-whole premium can be "both liquidated damages and the 'economic equivalent of unmatured interest'").

151. Cooley, *supra* note 148, at 94 (noting that the Fifth Circuit unquestionably rejected the notion that make-whole premiums are categorically disallowable—whether as penalties or as unmatured interest).

raises another question: what happens when the debtor has enough money to pay every creditor in full and still return value to shareholders? In that scenario, the statutory bar does not allocate a shortfall among creditors. It hands a windfall to equity holders at the creditors' expense. Part IV examines the doctrine courts have developed to address that problem: the solvent-debtor exception.

IV. The Solvent-Debtor Exception

The solvent-debtor exception addresses what happens when a company that filed for bankruptcy in genuine distress becomes solvent before the case ends. The general rule in bankruptcy is that interest stops accruing at the petition date, and make-whole premiums, as discussed above, are disallowed as unmatured interest under § 502(b)(2). The solvent-debtor exception overrides that suspension. When the estate can pay every creditor in full, courts require payment of postpetition interest at the contract rate and enforcement of otherwise disallowed claims. Over the past several years, the Fifth, Ninth, and Third Circuits have each recognized this exception through different analytical routes.

This Part proceeds in two steps. Section IV.A traces the doctrine's historical roots, from eighteenth-century English bankruptcy practice through its adoption by American courts. Section IV.B then examines the three circuit-court approaches in detail and explains why the Third Circuit's approach is preferable.

This reading supports the argument this Note develops in Parts V and VI. If the solvent-debtor exception exists to enforce absolute priority, it raises the question of which claims deserve senior treatment in the first place. The absolute priority logic, which requires solvent debtors to pay their creditors in full, also supplies a reason to subordinate claims whose economic structure conflicts with that scheme. Part V shows that bankruptcy-triggered make-whole premiums have the payoff structure of distress-contingent equity claims, not ordinary senior debt, and then Part VI turns that insight into a concrete proposal for bankruptcy courts considering these claims.

A. Historical Roots of the Solvent-Debtor Exception

The solvent-debtor exception originated in eighteenth-century English bankruptcy practice. English courts recognized that when a bankrupt estate had enough assets to pay every creditor, denying interest on their claims would produce an absurd windfall for the debtor. In *Bromley v. Goodere*, the court established the basic principle that "suppos[ing] . . . there should be a surplus, it would be absurd to say the creditors should not have interest."[152] American courts adopted this doctrine, with the Supreme Court acknowledging in *American Iron & Steel Manufacturing Co. v. Seaboard Air Line Railway* that "if, as a result of good fortune or good management, the estate prove[s] sufficient to discharge the

152. Bromley v. Goodere (1743) 26 Eng. Rep. 49, 52; 1 Atk. 75, 80 (Ch.).

claims in full, interest as well as principal should be paid."[153] The *Ultra Petroleum* court also observed the principle: "For some three centuries of bankruptcy law, courts have held that an equitable exception to the usual rules applies in the unusual case of a solvent debtor."[154] The exception established that when a debtor is solvent, "bankruptcy's ordinary suspension of post-petition interest is itself suspended."[155]

The exception's rationale is straightforward. The general rule disallowing postpetition interest exists to ensure equitable distribution of limited assets among creditors, but when a debtor has sufficient resources to pay all creditors in full, this rationale disappears. As Judge Posner explained in *In re Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*:

> The only good reason for refusing to give a creditor in reorganization all that he bargained for when he extended credit is to help other creditors, the debtor's assets being insufficient to pay all creditors in full . . . . [But] if the bankrupt is solvent the task for the bankruptcy court is simply to enforce creditors' rights according to the tenor of the contracts that created those rights . . . .[156]

The solvent-debtor exception is also aligned fundamentally with the absolute priority rule, which "requires that creditors be 'made whole' before junior interests"—especially equity holders—"take from the bankruptcy estate."[157] As the *PG&E* court noted, "[w]ithout a solvent-debtor exception, a solvent bankrupt could reap a windfall at their creditors' expense, pocketing 'money which the debtor had promised to pay promptly to the creditor.'"[158]

B. Recent Circuit Court Approaches

The Fifth, Ninth, and Third Circuits have each recognized the solvent-debtor exception but justified it differently. The Fifth Circuit traced the exception's historical survival and held that Congress never clearly abrogated it. The Ninth Circuit grounded it in the Code's impairment provisions, reasoning that § 1124(1)'s protection of creditors' "equitable rights" necessarily incorporates the exception. The Third Circuit anchored it in the absolute priority rule itself. I discuss each in turn and explain why the Third Circuit's approach is preferable.

1. The Fifth Circuit's Historical Approach

Ultra Petroleum, a natural gas exploration company, filed for Chapter 11 protection in April 2016 after a "sharp decline in natural gas prices" that rendered

153. 233 U.S. 261, 266 (1914).
154. *Ultra Petroleum*, 51 F.4th at 150.
155. *Id.*
156. 791 F.2d 524, 527-28 (7th Cir. 1986).
157. *In re* PG&E Corp., 46 F.4th 1047, 1054 (9th Cir. 2022).
158. *Id.* (quoting Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp., 679 F.2d 264, 269 (1st Cir. 1982)).

it unable to service its substantial debt obligations.[159] However, "[d]uring the bankruptcy proceedings, the same volatile commodity prices that hurled Ultra Petroleum into insolvency propelled the debtors back into solvency."[160] Indeed, Ultra Petroleum became "massively solvent"—so financially healthy that it proposed a plan that would pay creditors in full and deliver substantial value to equity holders.[161] Ultra Petroleum proposed a plan that would pay creditors their outstanding principal and accrued prepetition interest at the contractual rate, plus postpetition interest at the federal-judgment rate. But crucially, the plan excluded approximately $201 million in make-whole amounts that would have been triggered under the MNPA upon filing.[162]

The Fifth Circuit began the analysis with a threshold question: had Congress abrogated the solvent-debtor exception when it enacted the Bankruptcy Code?[163] Drawing on Supreme Court precedent, the Fifth Circuit explained that "abrogation of a prior bankruptcy practice generally requires an 'unmistakably clear' statement on the part of Congress."[164] This "substantive canon of Bankruptcy Code interpretation"[165] reflects the Court's recognition that Congress legislates against a background of established judicial practices and is presumed to be aware of existing legal doctrine.[166] The court then surveyed the exception's historical development, starting with *Bromley v. Goodere* (1743).[167] The precedents established that creditors should receive interest when a surplus exists after paying all debts. The court noted that this principle has carried forward into American law, with the Supreme Court acknowledging the exception's continued vitality in *American Iron & Steel Manufacturing Co. v. Seaboard Air Line Railway*.[168]

The court's historical analysis also revealed that Congress never explicitly abrogated the exception despite having multiple opportunities to do so. The Fifth Circuit emphasized that § 502(b)(2)'s disallowance of unmatured interest was not novel; the Bankruptcy Acts of 1898 and 1938 contained similar language, yet courts consistently applied the solvent-debtor exception throughout this period. The court found particularly instructive its own precedent in *Johnson v. Norris*, where the Fifth Circuit concluded that the 1898 Act's prohibition on

159. *Ultra Petroleum*, 51 F.4th at 143.

160. *Id.* at 143.

161. *Id.*

162. *Id.* at 144.

163. *Id.* at 151-55.

164. *Id.* at 153-54 (first citing Cohen v. de la Cruz, 523 U.S. 213, 221-22 (1998); then citing Midlantic Nat'l Bank v. N.J. Dep't of Env't Prot., 474 U.S. 494, 501 (1986); and then citing Kelly v. Robinson, 479 U.S. 36, 46, 53 (1986)).

165. *Id.* at 155.

166. *Kelly*, 479 U.S. at 46.

167. *Ultra Petroleum*, 51 F.4th at 151 (quoting Bromley v. Goodere (1743) 26 Eng. Rep. 49, 52; 1 Atk. 75, 80 (Ch.)).

168. *Id.* (quoting Am. Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266 (1914)).

unmatured interest "was not intended to be applied to the case of a solvent estate."[169]

The Fifth Circuit ultimately concluded that the Bankruptcy Code's provisions "do not clear th[e] high hurdle" of unmistakable clarity required for abrogation.[170] The court found Congress's silence regarding the exception—particularly given its careful attention to other aspects of solvent-debtor treatment—strong evidence that Congress intended to preserve existing practice.[171] By grounding its decision in centuries of judicial precedent and congressional acquiescence, the court established a robust foundation for the exception's continued vitality under the modern Bankruptcy Code.[172]

2. The Ninth Circuit's Impairment-Focused Analysis

PG&E sought Chapter 11 protection in January 2019 to address "massive potential liabilities related to a series of wildfires in Northern California."[173] PG&E was technically solvent at filing, with $71.4 billion in assets compared to $51.7 billion in known liabilities, but the company faced tens of billions of dollars in uncertain wildfire liabilities that threatened its viability.[174] During the bankruptcy proceedings, California enacted Assembly Bill 1054, which created a multi-billion-dollar safety net to compensate future fire victims and which required PG&E to have its reorganization plan confirmed by June 30, 2020, to participate in the fund.[175] By the time of plan confirmation, PG&E had sufficient resources to pay all creditors in full, yet it sought to pay certain creditors postpetition interest at the federal-judgment rate rather than at their contractual rates, which would have saved hundreds of millions of dollars at creditors' expense.[176]

Relative to the Fifth Circuit, the Ninth Circuit in *PG&E* placed greater emphasis on the Code's impairment provisions. It reasoned that § 1124(1), which requires a plan to leave "unaltered the legal, equitable, and contractual rights" of unimpaired creditors, necessarily incorporates the solvent-debtor exception as an "equitable right."[177] According to the court, the solvent-debtor exception "fits comfortably within the text of the Code" and maintains creditors' prebankruptcy expectations that they will be paid in full when the debtor can afford to do so.[178]

The Ninth Circuit also identified a structural problem with the debtor's position. Under the Code, impaired creditors receive significant procedural safeguards. They can vote on a plan, and they have access to the "fair and equitable"

169. 190 F. 459, 462 (5th Cir. 1911).
170. *Ultra Petroleum*, 51 F.4th at 154.
171. *Id.* at 154-55.
172. *Id.* at 154-59.
173. *In re* PG&E Corp., 46 F.4th 1047, 1051 (9th Cir. 2022).
174. *Id.*
175. *Id.*
176. *Id.*
177. 11 U.S.C. § 1124 (2024); *PG&E*, 46 F.4th at 1060.
178. *PG&E*, 46 F.4th at 1060.

requirements of § 1129(b).[179] In contrast, unimpaired creditors receive none of these protections (nor do they need them) since their rights remain unaltered. PG&E tried to classify its creditors as unimpaired while paying less than contract-rate interest. The court rejected this move; letting debtors designate creditors as unimpaired while simultaneously denying them contractual entitlements would create an inequitable contradiction because those creditors would suffer the economic consequences of impairment without receiving the corresponding procedural protections. PG&E's approach would have effectively permitted solvent debtors to "have it both ways" by "pay[ing] [unimpaired creditors] the same, reduced interest rate as impaired creditors, while depriving them of the statutory protections that impaired creditors enjoy."[180] The Ninth Circuit rejected this "end-run" around the Code's structural safeguards as fundamentally inconsistent with the Code's design, which assumes that creditors whose rights remain unaltered will not need procedural protections because they are receiving everything to which they are contractually entitled.[181]

3. The Third Circuit's Absolute Priority Approach

The *Hertz* case arose from circumstances similar to *Ultra Petroleum* and *PG&E*. Hertz filed for Chapter 11 protection in May 2020 at the height of the COVID-19 pandemic, when travel restrictions devastated its business. As the economy recovered, so did Hertz's finances, and the company proposed a plan that would pay creditors in full and distribute approximately $1.1 billion to prepetition shareholders.[182] Like PG&E and Ultra, Hertz sought to pay postpetition interest at the federal-judgment rate rather than the contract rate and to avoid paying make-whole premiums, which would have saved the company approximately $270 million at the noteholders' expense.[183]

The Third Circuit rejected Hertz's plan.[184] Unlike the Fifth Circuit, which focused on whether Congress had abrogated a historical practice, or the Ninth Circuit, which emphasized the Code's impairment provisions, the Court here anchored its decision squarely in the absolute priority rule—"bankruptcy's most important and famous rule."[185] The absolute priority rule requires that creditors be paid in full before equity holders receive anything from the estate. Allowing Hertz to cancel more than a quarter-billion dollars of interest otherwise owed to its noteholders while distributing $1.1 billion to shareholders would violate that rule.

This approach represents a crucial distinction from the Fifth and Ninth Circuits' analyses. While those courts largely relied on the presumption that pre-

179. 11 U.S.C. § 1129(b) (2024).
180. *PG&E*, 46 F.4th at 1061.
181. *Id.*
182. *In re* Hertz Corp., 120 F.4th 1181, 1188 (3d Cir. 2024).
183. *Id.* at 1189.
184. *Id.* at 1181.
185. *Id.* at 1190 (quoting Czyzewski v. Jevic Holding Corp., 580 U.S. 451, 465 (2017)).

Code practices survived, the Third Circuit relied on the Code's substantive commitment to priority. The solvent-debtor exception, under this view, is not merely a historical artifact that Congress tacitly preserved but a necessary corollary of the absolute priority rule that is expressly embedded in the Code.

The court grounded its analysis in the Supreme Court's decision in *Czyzewski v. Jevic Holding Corp*. In *Jevic*, the Court held that bankruptcy courts cannot approve structured dismissals that distribute estate value in a way that deviates from the Code's priority rules without affected creditors' consent.[186] In *Hertz*, the Third Circuit read *Jevic* broadly and concluded that the absolute priority rule applies "everywhere absent a clear statement authorizing a departure," not just in scenarios where § 1129(b) is explicitly invoked.[187] On this reading, § 502(b)(2)'s disallowance of unmatured interest cannot be used to siphon value from creditors to equity holders in a solvent estate, because doing so would produce exactly the kind of priority-skipping distribution that *Jevic* prohibits.

The Third Circuit's absolute priority focus is preferable because it gets to the core issue. The Fifth Circuit's historical approach and the Ninth Circuit's impairment analysis both serve as proxies for what is fundamentally a priority concern. The Third Circuit names that concern directly and connects it to bankruptcy's most basic distributional principle. That connection also highlights a problem: if the solvent-debtor exception exists to enforce absolute priority, then courts need a way to determine which claims deserve senior treatment in the first place. Part V takes up that question and shows that bankruptcy-triggered make-whole premiums have the payoff structure of distress-contingent equity claims, not ordinary senior debt.

V. The Case for Subordinating Make-Whole Premiums in Distress

The previous Parts have described the current doctrinal landscape for analyzing make-whole provisions—how courts interpret these provisions under contract law, how the Bankruptcy Code's statutory framework applies through § 502(b)(2), and how the solvent-debtor exception can, in limited circumstances, force issuers to pay make-whole claims. This Part argues that the solvent-debtor exception is best understood as preserving bankruptcy law's commitment to absolute priority and that this reframing tells us something important about make-whole provisions themselves. Specifically, when triggered by bankruptcy, make-whole provisions function as distress-triggered, equity-like claims whose economic structure conflicts with the very priority principles that the solvent-debtor exception protects.

It proceeds in three steps. Section V.A argues that the solvent-debtor exception is best understood as a mechanism for enforcing absolute priority. That

186. *Jevic*, 580 U.S. at 455, 464-65 (explaining that bankruptcy courts should not "deviate from the basic priority rules . . . the Code establishes for final distributions of estate value in business bankruptcies" without clear statutory authorization).

187. *Hertz Corp.*, 120 F.4th at 1208 (citing *Jevic*, 580 U.S. at 465).

reconceptualization serves as motivation for asking what kinds of claims are entitled to senior treatment in the first place. Section V.B applies that framework to the make-whole formula and demonstrates that the premium functions as an embedded option on the debtor's credit spread—a payoff structure that delivers its greatest value when the estate has the least capacity to satisfy other creditors. Section V.C illustrates this structure through a stylized numerical example and traces its distributional consequences in bankruptcy. It also explains why treating bankruptcy-triggered make-whole premiums as ordinary senior claims is inconsistent with the priority principles the solvent-debtor exception protects.

A. Reconceptualizing the Solvent-Debtor Exception as Preserving Absolute Priority

The solvent-debtor exception is best understood as a mechanism for preserving absolute priority when bankruptcy's rules would otherwise let equity holders keep money that belongs to creditors. In ordinary Chapter 11 cases, the estate cannot pay creditors everything promised, so bankruptcy law classifies,[188] allows,[189] and pays claims under a specific priority structure.[190] The Code classifies equity holders as the last to get paid, so these interests are typically wiped out. If the debtor becomes solvent during the proceedings and there is value left after paying senior claims in full, there is no longer a shortfall to ration, so the only question is whether equity holders can take value before creditors are paid.

The "allowed amount" is the dollar figure that a creditor can claim against the estate. Section 502(a) starts by deeming filed proofs of claim "allowed" automatically unless a party objects. Section 502(b) then lists exceptions that reduce or eliminate claims. As noted above, the most relevant restriction here is § 502(b)(2), which strips out "unmatured interest."

To illustrate why the allowed amount matters in solvent cases, suppose a debtor owes an unsecured creditor $100 in principal and owes $10 in interest that would accrue during the bankruptcy case at the contract rate. Outside bankruptcy, the creditor would receive $110. But § 502(b)(2) disallows the $10 as unmatured interest, so the creditor's allowed amount is $100. Now, suppose the estate is worth $115 at plan confirmation. If the court distributes $100 to the creditor (the allowed amount) and sends the remaining $15 to equity holders, those equity holders have captured $10 that, outside bankruptcy, would have gone to the creditor.

So, the dispute is about whether bankruptcy's allowance rules can be used to preserve value for equity holders that would otherwise go to creditors. The solvent-debtor exception can be thought of as a doctrine about when equity holders may take from the estate.

188. 11 U.S.C. § 1122(a) (2024).
189. *Id.* § 502(a)-(b).
190. *Id.* §§ 507(a), 1129(a)(9), 1129(b)(2)(B)(ii).

When the estate can pay every creditor in full, the only function of bankruptcy's allowance rules is to allocate a shortfall that does not exist.[191] Denying creditors their contractual entitlements in that setting does not help other creditors, it only serves to give equity holders a windfall. Consequently, Posner concluded, the bankruptcy court's job in a solvent case is to enforce contracts as written. In *Dow Corning*, the United States Court of Appeals for the Sixth Circuit observed:

> [I]n solvent debtor cases, rather than considering equitable principles, courts have generally confined themselves to determining and enforcing whatever pre-petition rights a given creditor has against the debtor . . . . [T]he bankruptcy judge does not have "free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness."[192]

The First and Second Circuits have applied this principle to prepayment penalties, holding that "[w]here the debtor is solvent, the bankruptcy rule is that where there is a contractual provision, valid under state law, . . . the bankruptcy court will enforce the contractual provision."[193] In *Ruskin v. Griffiths*, the Court held that "where there is no showing that the creditor entitled to the increased interest caused any unjust delay in the proceedings, it seems to us the opposite of equity to allow the debtor to escape the expressly-bargained-for" contractual interest.[194]

Section 502(b)(2) disallows unmatured interest, meaning that the interest stops accruing at the petition date except where the Code supplies an express entitlement. Much of what sophisticated debt instruments label as a "premium" or "make-whole" is essentially interest, and some circuits accordingly treat make-whole amounts as unmatured interest.[195] So, a problem arises when a solvent debtor's plan distributes value to equity holders while paying creditors only the allowed amount, stripped of postpetition interest. In *Hertz*, the Third Circuit held that make-whole premiums were disallowable as unmatured interest, but the court still concluded that noteholders had a right to payment because the debtor was solvent and equity holders received substantial value. That combination of disallowance plus required payment seems like a contradiction if "allowed amount" is the only measure of what a creditor may receive. The contradiction goes away once we observe that in insolvent-debtor cases, § 502(b)(2) allocates scarcity among creditors. But in solvent-debtor cases, where equity holders stand

191. *In re* Chi., Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 527-28 (7th Cir. 1986) ("The only good reason for refusing to give a creditor in reorganization all that he bargained for when he extended credit is to help other creditors, the debtor's assets being insufficient to pay all creditors in full. . . . [But] if the bankrupt is solvent the task for the bankruptcy court is simply to enforce creditors' rights according to the tenor of the contracts that created those rights . . . .").

192. *In re* Dow Corning Corp., 456 F.3d 668, 679 (6th Cir. 2006) (quoting *Chi., Milwaukee*, 791 F.2d at 528).

193. *Id.* (quoting Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp., 679 F.2d 264, 269 (1st Cir. 1982)).

194. 269 F.2d 827, 832 (2d Cir. 1959).

195. *See supra* notes 118-125, 133-142.

to receive a distribution, the disallowance becomes the means by which equity holders capture the time value of money during bankruptcy. When that happens, the problem is no longer whether a claim is "allowed." It is whether equity holders are receiving value before senior creditors are paid.

The strongest objection to this view is that priority is already satisfied once the debtor pays the "allowed amount." On this view, § 502(b)(2) supplies an express statutory ceiling on what counts as part of the claim. In *LATAM*, the Second Circuit reasoned that the absolute priority rule is "housed" in § 1129(b) and "comes into effect only when a class of impaired creditors votes to reject a plan."[196] Judge Porter's dissent in *Hertz* presses harder, arguing that *Jevic* polices exercises of unmoored equitable power but does not authorize courts to "wield power that the Code expressly withholds."[197] These objections capture an intuition many bankruptcy judges share. The Code's allowance rules are statutory text, and calls to preserve "priority" should not become an incantation that defeats clear disallowance.

Although this "allowed amount" intuition works well for insolvent estates, it becomes untenable where the plan contemplates a distribution to equity holders—because the only reason there is value left for equity holders is that the Code disallowed interest during the case. The "allowed amount" is not an immutable measure of what the creditor is owed. It is bankruptcy's measure of the creditor's share when there is not enough to go around. That is why the Code specifies when postpetition interest is nevertheless paid (as in § 726(a)(5)) and why the pre-Code tradition treated solvent estates differently. Allowing § 502(b)(2) to siphon money from the solvent estate to equity is the kind of backdoor priority distortion against which *Jevic* warned. A solvent plan that gives equity holders value while using § 502(b)(2) to deny postpetition interest, therefore, uses a technical disallowance to give a windfall to parties who normally would not be entitled to it.

Statutory history reinforces this reading. Former § 1124(3) treated a class as unimpaired if it received "cash equal to . . . the allowed amount,"[198] and Congress repealed that subsection after it was used to deny postpetition interest to an "unimpaired" creditor in a solvent-debtor case.[199] If Congress had been comfortable with the idea that paying the allowed amount (with no postpetition interest) was always enough, even in a solvent case, former § 1124(3) would have been an elegant vehicle for that policy. But Congress went the other way. As the court in *PG&E* recognized, "[w]ithout a solvent-debtor exception, a solvent bankrupt could reap a windfall at their creditors' expense."[200]

196. *In re* LATAM Airlines Grp. S.A., 55 F.4th 377, 388 (2d Cir. 2022).

197. *In re* Hertz Corp., 120 F.4th 1181, 1209 (3d Cir. 2024).

198. 11 U.S.C. § 1124(3) (1993), *repealed by*, Bankruptcy Reform Act of 1994, Pub. L. 103-394, § 213, 108 Stat. 4106, 4126.

199. *See In re* PG&E Corp., 46 F.4th 1047, 1060 (9th Cir. 2022); *see also* H.R. REP. NO. 103-835, at 47-48 (1994) (explaining the repeal of § 1124(3) as designed to "preclude" the "unfair result" reached in *In re* New Valley Corp., 168 B.R. 73 (Bankr. D.N.J. 1994)).

200. *PG&E*, 46 F.4th at 1054.

The Fifth Circuit's historical approach and the Ninth Circuit's impairment analysis both serve as proxies for what is fundamentally an absolute priority concern. The Third Circuit's explicit grounding in absolute priority is preferable because it connects the exception to bankruptcy's most fundamental distributional principle, clarifies that the exception prevents strategic exploitation of technical provisions, and prevents debtors from using § 502(b)(2) to create what amounts to a priority violation by another name. The doctrine should apply when value flows to equity holders while senior creditors are not made whole. That is why *Hertz* treated the $1.1 billion equity distribution as central to its analysis. When no value returns to equity holders, the solvent-debtor exception does not do any work.

Once a make-whole premium is characterized as unmatured interest, the question is not whether the creditor lost on claim allowance but whether denying payment gives equity holders a windfall. Framing the question this way also resolves the apparent contradiction in *Ultra Petroleum*, where the court held that the make-whole premium was the economic equivalent of unmatured interest disallowed under § 502(b)(2) yet ordered payment under the solvent-debtor exception.[201] That combination reflects an implicit recognition that technical statutory provisions must yield to absolute priority when a debtor is solvent and equity holders stand to receive a distribution.

Absolute priority blocks junior stakeholders from taking value that ought to belong to seniors. That principle explains why solvent-debtor cases are different, because denying postpetition interest while distributing value to equity holders looks like a priority violation by another name. But the same principle forces a second-order question that the solvent-debtor cases largely ignore: what counts as a senior entitlement in the first place?

That question matters for a make-whole premium because the premium is not simply "more debt." Outside bankruptcy, a make-whole operates as the price of an issuer option. The borrower can voluntarily redeem early, but only if it pays for the lender's forgone yield. In bankruptcy, acceleration and the plan process convert what the parties drafted as a voluntary-redemption price into a mandatory, estate-funded payment that balloons precisely when the firm is weakest. The key normative issue then becomes: what kind of claim is the make-whole provision when bankruptcy itself triggers it?

In subsequent parts, I will argue that the payoff structure of the make-whole formula matters for priority analysis. If a provision delivers zero or trivial value in good states, and large incremental value in bad states, then treating it as ordinary senior debt is problematic. Allowing such a claim means that a subset of creditors are able to hold a distress-contingent upside claim that gets paid ahead of creditors with the same priority who did not bargain for such a windfall.

The same priority logic that makes solvent-debtor cases feel intuitive—no equity windfall due to technical disallowance—also supplies a test for the harder

201. *In re* Ultra Petroleum Corp., 51 F.4th 138, 160 (5th Cir. 2022).

cases. The test is whether enforcing the make-whole premium at parity respects bankruptcy's baseline ordering among similarly situated creditors or instead allows a contingent, distress-triggered premium to leapfrog that ordering. The remainder of this Section shows that bankruptcy-triggered make-whole premiums have exactly that distress-amplified structure.

B. Option-Like Structure of the Make-Whole Formula

This Section builds on Professor Squire's insight that the make-whole premium has a distress-amplified structure.[202] A canonical make-whole indenture pegs the call price at the present value of remaining coupons plus principal, discounted at Treasury yields plus a modest fixed spread (typically twenty to fifty basis points).[203] Because this spread is fixed *ex ante*, the formula does not update to reflect the issuer's own default risk. When the firm enters distress and its market yield widens from, for example, the Treasury rate + 150 basis points to the Treasury rate + 800 basis points, the call price barely budges[204] even though the bond's market value collapses. The wedge between these two values, the make-whole premium, grows dramatically.

This arrangement creates a structural asymmetry in bankruptcy. While make-whole provisions typically remain dormant when firms are healthy (as refinancing at market rates is unattractive), they become valuable when firms enter financial distress. From a financial perspective, the make-whole provision is economically identical to a call option with the following structure:

- Spot price of underlying asset: the present value of fixed remaining coupons
- Strike price: the bond's market price at the postpetition "mandatory" redemption (bankruptcy)
- Exercise trigger: automatic acceleration upon bankruptcy
- Pay-off: the greater of the price of the make-whole amount (P_{MW}) minus price of the bond on the open market (P_{Market}), or zero (i.e., the maximum of ($P_{MW} - P_{Market}$) and 0)

In a typical callable bond, the issuer holds the option to redeem the bond early at a predetermined price. The issuer voluntarily calls the bond, usually when doing so benefits the company financially. A make-whole provision, when triggered by bankruptcy, inverts this relationship. The "option" is effectively triggered involuntarily—by bankruptcy acceleration—rather than through the

202. Richard Squire, *Distress-Triggered Liabilities and the Agency Costs of Debt*, *in* RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW 124, 133-35 (Barry E. Adler ed., 2020).

203. Mann & Powers, *supra* note 8, at 536 ("[A] make-whole call price is calculated as the present value of the bond's remaining cash flows with a floor price equal to par value. The discount rate used to determine the present value is the yield of comparable maturity Treasury securities plus a contractually specified 'make-whole premium.'").

204. The call price depends on the Treasury rate and time to maturity of the bond. Even though the call price might change, it does not respond to a firm's credit risk.

issuer's strategic choice. The "strike price" of this (non)option is the make-whole amount, calculated using Treasury rates plus a small spread, which is unrelated to the market's assessment of the firm's actual credit risk.

C. A Stylized Model of Value Extraction in Bankruptcy

The underlying asset is effectively the bond's market price, which typically plummets in distress. Thus, in economic terms, the make-whole clause gives the creditor the benefit of a call option on the issuer's credit spread:

- In good financial states (when credit spreads are low), the option remains out of the money, no redemption occurs, and no premium is paid.
- In distressed states (when credit spreads widen dramatically), the bond's market value drops, but the creditor still receives the full make-whole amount, effectively siphoning value from other creditors.

To illustrate this option-like behavior, consider a bond with 3 years to maturity, a 10% annual coupon, and a $100 face value. Let's say the Treasury rate is 2%, and there is a 50-basis-point credit spread that reflects the default risk at the time of issuance of the bond. At these rates, the make-whole provision would yield a call price of approximately $120 if the bond is redeemed today, representing the present value of remaining payments discounted at a Treasury rate plus 50 basis points (2.5%).[205]

In a healthy state, when the firm's market yield might be around 7%, the bond would trade at approximately $108.[206] The make-whole option remains out of the money, as the issuer would have no incentive to voluntarily pay $120 to retire a bond worth $108. The premium effectively yields no value in this scenario.

However, in a distressed state, when the market yield spikes to 15%, the bond's market value falls to approximately $90.[207] Here too the issuer has no

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205. I calculate the present value of the remaining payments using the present-value formula below.

$$P_{MW} = \frac{Annual\ Coupon}{1 + Discount\ Rate} + \frac{Annual\ Coupon}{(1 + Discount\ Rate)^2} + \frac{Principal + Annual\ Coupon}{(1 + Discount\ Rate)^3}$$

$$P_{MW} = \frac{10}{1.025} + \frac{10}{(1.025)^2} + \frac{110}{(1.025)^3} = \$121.42, \text{rounded to } \$120 \text{ for convenience.}$$

206. The $108 figure is the approximate present value of the bond's remaining cash flows in the healthy state. With three years remaining, a 10% annual coupon, and $100 principal, the bond pays $10 in year one, $10 in year two, and $110 in year three. Discounting those payments at roughly 7% yields

$$\frac{10}{1.07} + \frac{10}{1.07^2} + \frac{110}{(1.07)^3} = \$107.87, \text{rounded to } \$108 \text{ for convenience.}$$

207. The $90 figure is the approximate present value of the same bond in distress. Using the same remaining cash flows and discounting them at roughly 14.5% to 15% produces a value near $90. At 14.5%, the bond is worth $89.64, and at 15% it is worth $88.58, so I round to $90 for ease of exposition.

incentive to retire the bond voluntarily; in fact, doing so is even worse for the issuer than before. But if bankruptcy occurs, acceleration forces immediate redemption, and the make-whole clause suddenly requires payment of approximately $120—a premium of $30 above current market value. This premium emerges not because bondholders have suffered greater economic damage (they suffer no damage—provided they receive the make-whole payment) but rather because the formula ignores the market's assessment of increased risk deliberately.

This comparison reveals the option's asymmetric payoff structure. In the healthy state, the make-whole provision remains out of the money, so the issuer continues paying coupons and never triggers the clause. In the distressed state, bankruptcy acceleration makes the bond due and payable immediately, and the clause suddenly makes the bond worth $30 more than its market value ($120 – $90).

Under this asymmetric structure, creditors with make-whole protection always win. If the company performs well, make-whole creditors receive their expected interest and principal.[208] But if the company falters and files for bankruptcy, these creditors receive the make-whole premium on top of their recovery. This arrangement gives the creditor all the downside protection of traditional debt while adding an upside option that materializes specifically in distress scenarios.

A make-whole premium in bankruptcy thus provides debtholders a fixed return under normal circumstances but grants them additional upside potential in distress. Lenders retain priority over the $100 principal and also capture an additional windfall when the estate has limited resources to satisfy other creditors' claims. This asymmetric benefit—the right to extract supplemental value beyond principal and contractual interest—conflicts fundamentally with bankruptcy's distributional priorities, particularly because it delivers its greatest returns when other creditors face the most significant losses.

The key point is that the indenture locks in a static spread over Treasuries that never adjusts to reflect the issuer's changing credit quality. Meanwhile, the market's required yield for holding the debt increases substantially as default risk rises. The divergence between the fixed make-whole formula and actual market conditions results in explosive premium growth during periods of financial distress. When the issuer is healthy, the difference between the contractual call price and the market price is relatively modest. However, when the issuer enters distress and market yields surge, the bond's market value plummets even though the make-whole formula still calculates the call price using the same modest spread over Treasuries.

Thus, the make-whole premium functions as a value-extraction mechanism by capturing value that would otherwise flow to junior creditors under absolute

208. There is, of course, the possibility that the make-whole provision is actually exercised if a firm's prospects improve dramatically. In that case, the creditor earns a supracompensatory spread, as discussed earlier. *See* Arnold et al., *supra* note 36, at 160.

priority. The claim balloons in distress when the creditor is able to capture every dollar between the principal amount and the principal amount plus the make-whole premium. Under absolute priority, this value would otherwise be available for unsecured creditors or constitute residual equity if the firm reorganized.

It is worth going through a simple numerical exercise to demonstrate the point. Let V be the estate value at time of filing, F the face value of the debt, and MW the premium due upon acceleration. Three scenarios illustrate the distributional effect of make-whole premiums in bankruptcy:

- Case 1 ($V \geq F + MW$): The estate pays $F + MW$ to senior creditors; equity holders still receive $V – F – MW$.
- Case 2 ($F \leq V < F + MW$): The estate pays all of V to senior creditors, leaving equity holders with nothing.
- Case 3 ($V < F$): The outcome is the same as in Case 2; senior creditors take the entire estate.

When the estate value falls within the critical zone—sufficient to cover principal but insufficient to pay the full make-whole premium—the provision acts to redirect value that should flow to junior stakeholders. This value-shifting effect becomes most pronounced precisely when the absolute priority rule should be protecting the distributional scheme.

VI. A Framework for Subordinating Distress-Triggered Make-Whole Claims

The preceding Part described how bankruptcy-triggered make-whole provisions siphon value away from junior creditors. This Part turns that insight into a proposal that judges can implement. Section VI.A proposes that a make-whole premium triggered solely by automatic bankruptcy acceleration should be presumptively subordinated to all general unsecured claims. Section VI.B explains why subordination is superior to disallowance under § 502(b)(2). Section VI.C addresses why these arguments should override contractual freedom.

A. The Core Proposal

The proposed rule is straightforward. A make-whole premium that becomes due solely by operation of an automatic-acceleration clause triggered by a bankruptcy filing is presumptively subordinated to all general unsecured claims. This presumption applies regardless of whether the debtor is solvent or insolvent, and regardless of whether the creditor is secured or unsecured.

Outside bankruptcy, a make-whole premium is the price the borrower pays for choosing to redeem early. When acceleration in bankruptcy converts that voluntary option into a mandatory obligation, however, the nature of the payment changes. The creditor receives the premium not because the borrower chose to

redeem the note but because financial distress triggered an *ipso facto* clause. The rule targets that conversion.

The presumption comes with three safe harbors. First, if the debt was accelerated before the bankruptcy filing, following a payment default, covenant breach, or other nonbankruptcy event of default, the make-whole premium is presumptively not subject to subordination. In simple terms, if the creditor would have been entitled to the make-whole premium regardless of whether bankruptcy ensued, the premium should not be subordinated.

Second, if the debtor-in-possession affirmatively elects to redeem bonds under an optional-redemption provision—rather than simply satisfying an already-accelerated obligation through a plan—the make-whole premium is not presumptively subordinated. This preserves the *Energy Future Holdings* pathway, where the court treated voluntary refinancing during bankruptcy as an "optional redemption."[209] This triggered the make-whole premium in such a way that is consistent with its intended function. The debtor should not be able to choose redemption to capture a refinancing benefit. Courts, however, should require clear evidence that payment constitutes voluntary redemption rather than satisfaction of an accelerated claim. For instance, a court may consider the following three factors. First, did the debtor comply with the indenture's redemption mechanics, such as issuing a formal notice of optional redemption? Second, what triggered the repayment? A refinancing undertaken to retire notes before their stated maturity looks like voluntary redemption, while payment made only after bankruptcy or another event of default accelerated the debt looks like satisfaction of a matured claim. Third, how did the debtor describe the transaction in contemporaneous documents such as financing materials, board minutes, or tender documents? Documents that characterize the transaction as a call or as refinancing support redemption, while documents treating the noteholders simply as holders of accelerated claims point the other way.

Courts should consider one final safe harbor: if the make-whole formula uses a discount rate approximating the debtor's cost of capital, rather than merely constituting the sum of Treasury yields plus a de minimis spread, the subordination presumption does not apply.[210] A make-whole premium calculated at the debtor's market borrowing rate would produce a call price approximately equal to the bond's market value, so it would compensate for actual losses rather than delivering a distress-contingent windfall. Granted, operationalizing a market-

209. *In re* Energy Future Holdings Corp., 842 F.3d 247, 255-61 (3d Cir. 2016) (holding that EFIH's postpetition refinancing was an "optional redemption" that triggered the make-whole provision because redemption includes repayment "at or before maturity"). The court noted that EFIH voluntarily filed for Chapter 11 bankruptcy, that it could have reinstated the accelerated notes rather than paying them off immediately, and that it had announced before filing that it planned to refinance. *Id.* It also emphasized that the noteholders did not seek immediate payment and that EFIH "redeemed the First Lien Notes at its option" before the contractual cutoff. *Id.* at 261.

210. Cost of capital here refers to the debtor's market borrowing rate for comparable debt at the time of redemption or acceleration—not the coupon fixed at issuance. A rate fixed at issuance is out of date by the time a firm faces distress, while a contemporaneous market rate should produce a call price close to the bond's market value.

based discount rate that actually captures firm-specific credit risk is much harder than using a Treasury-plus formula, because the issuer's contemporaneous borrowing cost is not directly observed, especially for distressed firms. But it may be administrable if the indenture uses an objective proxy, such as the secondary-market yield on the notes themselves or dealer quotations for a new issue of comparable debt.

The presumption of subordination is rebuttable. A creditor may overcome it by demonstrating that the make-whole premium does not materially exceed actual economic loss from early termination. Relevant evidence may include transaction costs associated with redeploying capital[211] or demonstrated reinvestment losses at the time of redemption.[212] Evidence that does not rebut the presumption includes the mere fact that the provision was negotiated at arm's length, that it satisfied state-law enforceability requirements, or that the formula is "standard" in the market. Market-standard formulas are designed to be supracompensatory in distress; that is their economic function.

B. Why Subordination Instead of Disallowance

As noted above, several recent decisions have characterized make-whole premiums as "unmatured interest" disallowable under § 502(b)(2).[213] Some commentators have urged courts to follow this approach categorically, treating bankruptcy-triggered make-whole premiums as per se disallowed.[214] I argue that subordination under § 510(c) is the superior remedy for four reasons.

First, disallowance creates a binary that does not actually solve the problem. If a make-whole premium is disallowed, the creditor's make-whole claim drops to zero and the saved dollars flow to equity holders or the reorganized debtor. *Ultra Petroleum* and *Hertz* recognized this problem and resurrected the solvent-debtor exception to compel payment. But that exception operates as an all-or-nothing override. Either the debtor is "solvent" and must pay the full make-whole premium at parity, or the debtor is "insolvent" and the creditor receives nothing. Subordination turns this binary into three possible outcomes depending on the solvency of the estate. In solvent estates, everyone recovers before equity holders, so subordination changes nothing. In partially solvent estates, general unsecured creditors recover first, then make-whole creditors, then equity holders. In

211. A lender can show transaction costs by pointing to broker fees, legal fees, or execution expenses associated with finding and booking a replacement investment they actually incur. *Ultra Petroleum* itself used the example of a broker charging the lender a 2% fee to locate a replacement borrower, and it treated that sort of out-of-pocket expense as analytically distinct from future interest. *See In re* Ultra Petroleum Corp., 51 F.4th 138, 149 (5th Cir. 2022).

212. Reinvestment loss is observable at the redemption date because the creditor can either show the difference between the note's contract yield and the yield then available on comparable instruments with similar maturity and risk or point to the actual replacement investment they purchased.

213. *See supra* Part III.

214. Kathryn G. Berman, *Consider This: Make-Whole Premiums as Unmatured Interest*, 93 FORDHAM L. REV. 1787, 1792, 1815-20 (2025) (arguing that courts should "treat make-whole premiums not triggered pre-bankruptcy petition as unmatured interest or as its economic equivalent and therefore [as] disallowed under § 502(b)(2)").

deeply insolvent estates, subordinated creditors participate only after senior claims are paid.

Second, disallowance forces courts into a characterization fight that subordination avoids. To disallow a make-whole premium, courts must decide whether it is "interest" or the "economic equivalent" of interest. Such conclusions require considerable analytic work, and courts have reached conflicting results. Subordination asks a different and simpler question: does the claim's payoff structure (distress-contingent, asymmetric, supracompensatory) justify treating it as junior to ordinary unsecured debt? That question is fundamentally about absolute priority, not claim allowance, and § 510(c) is the right statutory vehicle for it.

Third, disallowance eliminates make-whole premiums entirely and destroys their legitimate functions even when they operate as intended. Make-whole provisions deter opportunistic refinancing, compensate for genuine reinvestment costs, and allocate prepayment risk. The aforementioned proposal preserves these functions through its safe harbors while targeting the mechanism—automatic acceleration upon bankruptcy—that transforms make-whole premiums from consensual exit fees into involuntary wealth transfers.

Fourth, §§ 502(b)(2) and 510(c) address different problems, and the make-whole premium is about claim priority—not claim allowance. Section 502(b)(2) asks whether a claim should be recognized at all. Section 510(c) asks where a recognized claim sits in the priority scheme. A bankruptcy-triggered make-whole premium is not an illegitimate claim by design. After all, make-whole premiums are bargained for and often enforceable as a matter of contract law,[215] so declaring that they are disallowed in all circumstances is inappropriate. The problem is that a make-whole premium's economic structure is inconsistent with treating it as ordinary senior debt. Subordination addresses that inconsistency.

The aforementioned framework is also relatively easy to implement. It relies on clear triggers where courts answer three questions. (1) Was the make-whole premium triggered by automatic bankruptcy acceleration? (2) Does a safe harbor apply? (3) Has the creditor rebutted the presumption? Each question can be answered on the basis of evidence—the indenture's acceleration clause, the timing of any prepetition default, and the creditor's evidence of actual economic loss. Courts need not evaluate whether a make-whole formula is "reasonable," "excessive," or "supracompensatory" as an abstract matter.

This approach offers predictability for both creditors and debtors. Creditors can determine before filing for bankruptcy whether their make-whole premium will be subordinated by examining the triggering mechanism. If they want to ensure recovery at parity, they can accelerate prepetition payments after a non-bankruptcy default, structure the provision to trigger only on voluntary redemption, use a market-rate discount formula, or document actual redeployment costs to rebut the presumption. Debtors can predict that bankruptcy-triggered premiums will be subordinated and plan accordingly.

215. For extensive discussion on when courts allow make-wholes, see *supra* Part II.

Subordinated make-whole claims would sit below general unsecured claims but above equity interests. Administrative expenses under § 507(a)(2) would be paid first, followed by priority claims under § 507(a)(3)-(10), then general unsecured claims, then subordinated make-whole claims, and finally equity. This placement pays creditors who bargained for fixed returns ahead of creditors whose make-whole provisions deliver a distress-contingent windfall that bears no relation to the refinancing deterrent the provision was designed to create. Subordinated make-whole creditors still recover ahead of equity, which preserves the debt character of their principal and interest claims. In solvent cases, the subordination has no practical effect because all creditors receive payment before equity holders receive anything.

C. Responding to Concerns About Contractual Freedom

The most serious objection to subordination is that it impermissibly overrides freely negotiated contracts between sophisticated parties. Judge Easterbrook captured this principle in *Kham & Nate's Shoes*, observing that "firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of 'good faith.'"[216]

A separate objection is about equitable-subordination case law. The doctrine of equitable subordination traditionally requires inequitable conduct by the claimant, injury to other creditors, and consistency with the Bankruptcy Code.[217] Professor Pardo has argued that no-fault subordination constitutes "impermissible judicial activism" undermining commercial certainty and amounting to judicial legislation.[218] Under this view, a creditor who merely enforces contractual rights, such as collecting a make-whole premium, has not engaged in misconduct warranting subordination. And *Noland* cautioned against categorical subordination contravening the Code's priority scheme.[219]

Noland, at least, does not foreclose this approach. There, the Court's concern was specifically with subordination that would override express statutory priorities—the tax penalties at issue enjoyed priority under § 507(a)(8).[220] Make-whole claims do not enjoy such statutory priority. More importantly, *Noland* deliberately left open whether creditor misconduct is always required for subordination.[221] The Court required only that subordination rest on an "examination of

216. Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990).

217. *See In re* Mobile Steel Co., 563 F.2d 692, 699-700 (5th Cir. 1977) (establishing this three-part test).

218. *See* Rafael I. Pardo, Note, *Beyond the Limits of Equity Jurisprudence: No-Fault Equitable Subordination*, 75 N.Y.U. L. REV. 1489, 1489 (2000).

219. *See* United States v. Noland, 517 U.S. 535, 543 (1996).

220. *See id.* at 543.

221. *See id.* at 538-39.

the circumstances" rather than on categorical rules that contravene congressional priorities.[222]

Courts have recognized limited exceptions where subordination may be appropriate absent creditor misconduct. These "no-fault" applications of equitable subordination have been applied to three categories of claims historically—tax-penalty claims, claims arising from stock redemptions, and punitive-damage claims.[223] In these instances, courts have focused on the inherent nature of the claim and its effect on other creditors, rather than the claimant's behavior. The Seventh Circuit explicitly endorsed this approach in *In re Virtual Network Services Corp.*, holding that § 510(c)(1) "authorizes courts to equitably subordinate claims . . . on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor."[224] Similarly, in *In re Envirodyne Industries*, the court subordinated the claims of noteholders who were former shareholders, despite no finding of fraud, because allowing these equity-derived claims to rank equally with general creditors would undermine bankruptcy's distributional fairness.[225] Make-whole premiums triggered by bankruptcy resemble these categories. Similar to punitive damages, they do not compensate for actual losses but rather extract additional value from the estate at other creditors' expense.

The contractual-freedom objection, however, warrants more discussion. After all, sophisticated parties bargained for make-whole provisions at arm's length. Why should bankruptcy courts refuse to honor what the parties agreed to?

This framing mischaracterizes what bankruptcy does. Outside bankruptcy, the make-whole clause binds two parties who agreed to it. Inside bankruptcy, however, the clause reaches the entire estate and affects every creditor's recovery. A trade supplier who shipped inventory never reviewed the make-whole contract. A tort victim holding a judgment never consented to a make-whole formula pegged to Treasuries plus fifty basis points. Yet both now compete for the same pool of assets against a premium that swells when that pool is smallest. The appropriate question, therefore, is whether a term negotiated bilaterally should take value from parties who were not at the table in this way. Bankruptcy transforms a two-party lending relationship into a collective proceeding. The proposal here does not override the bondholders' bargain. Rather, it protects third-party creditors who never agreed to the make-whole clause and who extended credit on the assumption that they would share pro rata with claims of equal priority. When a distress-triggered premium extracts supracompensatory recoveries, these creditors receive less than the Code's distributional scheme contemplates. The contractual-freedom objection, in other words, runs in both directions.

222. *Id.* at 538.

223. *See* David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157, 217-20 (2003) (situating no-fault subordination within a unified structural theory of equitable subordination).

224. *In re* Virtual Network Servs. Corp., 902 F.2d 1246, 1250 (7th Cir. 1990).

225. *See In re* Envirodyne Indus., Inc., 79 F.3d 579, 582-83 (7th Cir. 1996).

Moreover, parties bargained for call protection against voluntary early redemption, not to earn a windfall from bankruptcy. Make-whole provisions emerged to deter issuers from refinancing opportunistically when rates fall. They serve this function whether or not the issuer enters bankruptcy. But automatic acceleration upon bankruptcy is not about refinancing—it is merely a consequence of distress that eliminates debtor choice. The safe harbor for voluntary redemption would preserve what creditors actually contracted for, so subordination would apply only to premiums triggered by a mechanism the bondholders did not primarily seek and that the issuer did not voluntarily exercise.

Subordination does not eliminate make-whole claims or take a stance on their validity. Make-whole creditors would still recover after general unsecured creditors but before equity holders. In solvent estates, this ordering would have no practical effect because the creditor receives the full premium before equity holders take anything. And parties who wish to avoid subordination can do so in ways discussed earlier. Bankruptcy law routinely establishes default rules around which sophisticated parties can draft. The subordination framework operates the same way. The Code itself exhibits a policy preference for compensatory claims over penalties and windfalls, as evidenced by § 726(a)(4), which subordinates penalty claims in Chapter 7 cases.[226] Subordinating distress-triggered make-whole premiums extends this principle to claims that function as penalties even if not labeled as such.

In summary, subordination of distress-triggered make-whole premiums is a workable compromise between contractual rights and bankruptcy's distributional rules. It neither prohibits make-whole provisions nor eliminates creditors' recoveries. It adjusts priority for claims that should not be treated as ordinary senior debt because of their economic structure, while preserving their validity and providing clear pathways to avoid subordination. This approach recognizes the dual nature of make-whole premiums—they may constitute valid liquidated damages under state law while simultaneously functioning as the economic equivalent of equity claims from a bankruptcy perspective.[227]

Conclusion

This Note has examined the evolving jurisprudence of make-whole provisions in bankruptcy. Despite an apparent circuit split between the Second and Third Circuits regarding contractual enforcement, courts are substantively converging on a common textual approach. The Note identifies three key developments: first, courts increasingly focus on the economic substance of make-whole provisions rather than their contractual labels; second, the Fifth Circuit in *Ultra Petroleum* and the Third Circuit in *Hertz* have established that make-whole premiums can simultaneously constitute both liquidated damages under state law

226. *See* 11 U.S.C. § 726(a)(4) (2024) (subordinating claims "for any fine, penalty, or forfeiture" to general unsecured claims in Chapter 7 distributions).

227. Berman, *supra* note 214, at 1817 (acknowledging that make-whole premiums can simultaneously be liquidated damages and unmatured interest, categories that are "not mutually exclusive").

and disallowable unmatured interest under § 502(b)(2); and third, courts are using the solvent-debtor exception to enforce bankruptcy's fundamental commitment to absolute priority, ensuring that creditors receive contractual entitlements before equity holders capture value.

In light of these developments, I argue that make-whole premiums should be subordinated to general unsecured-creditor claims given their fundamental economic structure and distributional consequences. The standard make-whole formula—discounting future payments at Treasury rates plus a minimal spread while ignoring the issuer's actual credit risk—creates an asymmetric payoff structure that resembles an embedded call option rather than traditional debt. This structure ensures that make-whole provisions remain dormant in healthy states but generate substantial claims when firms enter distress, extracting value that would otherwise flow to other creditors under absolute priority. By subordinating these claims, courts would preserve make-whole provisions' legitimate function—deterring opportunistic refinancing by solvent borrowers—while preventing them from serving as vehicles for value extraction at other creditors' expense in bankruptcy. This approach would better align with bankruptcy's foundational commitment to equitable distribution and prevent sophisticated creditors from effectively circumventing priority rules through contractual engineering.