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Split Ninth Circuit Requires Default Interest To Cure Default

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A Chapter 11 debtor "cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure," held a split panel of the U.S. Court of Appeals for the Ninth Circuit on Nov. 4, 2016. *In re New Investments Inc.*, 2016 WL 6543520, *3 (9th Cir. Nov. 4, 2016) (2-1). Reversing the bankruptcy court, the court's majority relied on a 1994 amendment of Bankruptcy Code § 1123(d) (" … the amount necessary to cure [a] default [under a reorganization plan] shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.") *Id.* at *2. In effect, the amended § 1123(d) overruled the Ninth Circuit's earlier holding that "a debtor who cures a default, thus 'nullify[ing] all consequences of' that default, may repay arrearages at the pre-default interest rate." *Id.* at *5, quoting *In re Entz-White Lumber & Supply, Inc.*, 850 F.2d 1338, 1342 (9th Cir. 1988). According to the Ninth Circuit, the "plain language of §1123(d) compels" the result it reached. *Id.* at *3.

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Relevance

Courts have regularly wrestled with lenders' asserted claims to contractual default interest. In the Ninth Circuit, eight months before the court handed down *New Investments*, a Bankruptcy Appellate Panel (BAP) held that a "bankruptcy court should apply a presumption of allowability for the contracted for default rate, 'provided that the rate is not unenforceable under applicable nonbankruptcy law.'" *In re Beltway One Development Group, LLC*, 547 B.R. 819, 830 (9th Cir. BAP 2016), quoting 4 Collier, Bankruptcy ¶506.04[2][b][ii], at 506-105 (16th ed. 2015).

"[A] minority of courts, relying on [[*Entz-White*,] issued prior to the [1994 amendment] of 1123(d), hold that payment of a contractual post-default interest rate is not required to cure a default," 7 Collier, *supra*, ¶1123.04, at 1123-2 a (16th ed. 2016), citing *In re Geared Equity, LLC*, 2014 U.S. Dist LEXIS 108170, at *9 (Dist. Ariz. Aug. 6, 2014). The "majority of courts," though, require the payment of default interest. 7 Collier, *supra*; citing *In re Sagamore Partners*, 610 Fed. App'x 922, 927 (11th Cir. 2015) (" … where, as here, 'the underlying agreement' calls for default-rate interest and the 'applicable nonbankruptcy law' permits it, a party cannot cure its default without paying the agreed-upon default-rate interest."); *In re 139-41 Owners Corp.*, 313 B.R. 364, 368 (S.D.N.Y. 2004) (no "statutory basis for judicial nullification of a contract right to default rate interest.").

Facts

The lender in *New Investments* made a $3.05 million loan to the debtor, secured by a hotel property. The underlying note bore interest at an annual rate of 8%, but "specifically provided that in the event of default, the interest rate would increase by 5%." *Id.* at *2. After the debtor defaulted and the lender had commenced foreclosure proceedings, the debtor filed a Chapter 11 petition. Its reorganization plan "proposed to cure the default by selling the [lender's collateral] and

using the proceeds of the sale to pay the outstanding amount of the loan at the pre-default interest rate." *Id*. Although the lender objected, arguing that it was "entitled to be paid at the higher, 'post-default' interest rate," the bankruptcy court confirmed the debtor's plan and authorized the sale of the lender's collateral, but allowed the lender only its "'pre-default' interest rate and extinguish[ed] any other late penalties." *Id*. Nevertheless, because of the possibility of appeal, the "bankruptcy court ordered that "$100,000 of the proceeds be reserved for [the lender's] attorney's fees on appeal and that $670,000 be set aside as a disputed claim reserve for [the lender]." *Id*.

The Ninth Circuit

The court first stated its 1988 holding in *Entz-White*: "a debtor who cures a default is entitled to avoid all the consequences of the default — including higher post-default interest rates." 850 F.2d at 1342. Thus, a debtor whose plan proposed to cure a default would allow it to avoid having to pay a higher, post-default interest rate called for in the loan agreement. *Id*.

The Ninth Circuit then went on to hold that "*Entz-White's* rule … is no longer valid in light of §1123(d)," as amended in 1994. *Id*. Specifically, the 1994 Congressional amendment of Code § 1123(d) "renders void *Entz-White's* rule that a debtor who proposes to cure a default may avoid a higher, post-default interest rate in a loan agreement." *Id*. at *3. Here, "'the amount necessary to cure [the debtor's] default' is governed by the deed of trust and Washington law, which respectively require and permit repayment at a higher, post-default interest rate." *Id*. In short, the "plain language of §1123(d)" governed. *Id*. at *3.

The court also rejected the debtor's reliance on the legislative history accompanying the amended § 1123(d). According to the debtor's reading of the legislative history, "Congress was primarily concerned with overruling the Supreme Court's decision in *Rake v. Wade*, 508 U.S. 464 (1993)" where "a Chapter 13 debtor who proposed to cure a default was required to pay interest on his arrearages to a secured creditor." *Id*. "Congress viewed this as an untoward result that allowed for 'interest on interest payments'," giving a secured lender "an unbargained-for windfall … ." *Id*. In the Ninth Circuit's view, though, the "particular purpose" of Congress in amending the statute did not "limit the effect of the statute's text … ." *Id*. at *4. Code § 1123(d) tells a court to look at the underlying agreement and applicable nonbankruptcy law "to determine what amount [the debtor] must pay to cure its default," which here required "the payment of post-default interest." *Id*.

Requiring the payment of default interest in New Investments is "consistent with the intent of §1123(d) [as amended] because it holds the parties to the benefit of their bargain." *Id*. A debtor cannot cure merely by paying past-due installments of principal at the pre-default interest rate. *Id*. A debtor who has defaulted must also pay "late charges, attorneys' and trustee's fees, and publication and court costs" so that it "can return to pre-default conditions as to the remainder of the loan obligation." *Id*., citing Restatement (Third) of Property (Mortgages) § 8.1 cmt.

The holding in *New Investments* "is consistent with the … Code's protections for creditors who have been entitled to receive accelerated payment on a defaulted loan … . [Under Code] §1126(f), the debtor must cure the default but may not 'otherwise alter the legal, equitable or contractual rights' of the creditor … ." *Id*., quoting Code § 1124(2)(E). In other words, for the debtor to cure a defaulted loan, payment of post-default interest is part of the cure. *Id*. In *New Investments*, the note "provided that upon default, the interest rate on the loan would increase by five percent," which "applies to the entirety of the note and not just to arrearages." *Id*.

" … Congress wanted to protect debtors against unbargained-for interest requirements in enacting §1123(d)," but the Supreme Court has noted that "Chapter 11 strikes a balance between a debtor's interest in reorganizing and restructuring its debts and the creditor's interest in maximizing the value of the bankruptcy estate." *Id*. at *5, quoting *Fla. Dept. of Revenue v. Piccadilly Cafeterias, Inc*., 554 U.S. 33, 51 (2008). Here, the Ninth Circuit held the debtor "to its bargain by adhering to the terms of its loan agreement

with [the lender], as required by §1123(d) … . The parties bargained for a higher interest rate on the note in the event of default, and [the lender] is entitled to the benefit of that bargain under the terms of §1123(d)." *Id*.

The Dissent

The dissent accused the majority of rejecting Ninth Circuit precedent (*i.e., Entz-White*). In its view, "neither the text of the [Code] nor [its] legislative history … support the majority's departure." *Id*. Moreover, "both the statutory text and the legislative history of such §1123(d) support the continuing viability of *Entz-White's* holding." *Id*. at *6. Finally, argued the dissent, the "majority opinion … wrongly imposes a severe penalty on debtors in [this] situation." *Id*.

Comments

1. The debtor in* New Investments *will probably seek en-banc review of the decision. It will likely argue that the majority not only improperly rejected binding Ninth Circuit precedent, but also that Congress never intended to overrule *Entz-White* when it amended § 1123(d).

2.* New Investments *is consistent with more recent sensible appellate decisions. *In re Sagamore Partners*, 610 Fed. App'x 922, 927 (11th Cir. 2015) (" … because [debtor's loan documents require the payment of default-rate interest and those provisions comply with Florida law, [debtor] must pay default-rate interest to cure its default."); *In re Southland Corp.*, 160 F.3d 1054, 1059 n.6 (5th Cir. 1998) ("Apart from the doubtfulness of adapting [the Ninth Circuit's 1988] *Entz-White* [decision] or extending its reasoning in this Circuit, we note that Congress, in bankruptcy amendments enacted in 1994, arguably rejected the *Entz-White* denial of contractual default interest rates"). *See also In re Moody Nat'l SHS Houston H LLC*, 426 B.R. 667, 676 (Bankr. S.D. Tex. 2010) (held, plan must provide for payment of default interest); *In re Sweet*, 369 B.R. 644, 648-51 (Bankr. D. Colo 2007) (held, when default interest rate not a penalty, it was appropriate to effect cure).

***3. The recent BAP decision in* Beltway, *noted above, while relevant, distinguished* Entz-White**. In *Beltway*, the debtor conceded that it was creating a new loan by restructuring its obligation to the secured lender, not curing a loan default. 547 B.R. at 827. In that case, the underlying loan documents provided for interest of LIBOR plus 2.4% with an additional 3% upon default. The debtor's reorganization plan, however, not only extended the maturity of the loan, but imposed a cramdown interest rate of only 4.25% and eliminated other loan covenants. *Id*. at 823, 827. It also removed the default interest on pendency interest, late fees and other related charges from the new loan under the plan. *Id*. at 823. In reversing and remanding to the bankruptcy court, the BAP in *Beltway* required the bankruptcy court to show why the lender was not entitled to pendency interest at the default rate.

4. Equitable Discretion. Courts have allowed secured lenders only their non-default contract rate of interest in circumstances where imposing a contractual default rate on the lender's claim would result in prejudice to unsecured creditors (*e.g.*, a reduced distribution). *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 166 (1946) (secured creditors "would have been enriched and subordinate creditors would have suffered a corresponding loss" if secured creditors received post-petition "interest on interest" imposed as a result of debtor's default; held, default "interest on interest" denied). *But see In re Urban Communicators PCS LP*, 394 B.R. 325, 340 (S.D.N.Y. 2008) (reversed bankruptcy court's improper reduction of contractual post-bankruptcy interest for benefit of solvent debtor's shareholders).

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