ALERTS

Split Ninth Circuit Requires Default Interest to Cure Default

December 2, 2016

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.

Relevance

Courts have regularly wrestled with lenders' asserted claims to contractual default interest. In the Ninth Circuit, eight months before the Court of Appeals 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).

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"[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 percent, but "specifically provided that in the event of default, the interest rate would increase by 5 [percent]." *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.*

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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

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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 §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. 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 percent with an additional 3 percent 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 percent and eliminated other loan covenants. *Id.* at 823, 827. It also removed the

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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.

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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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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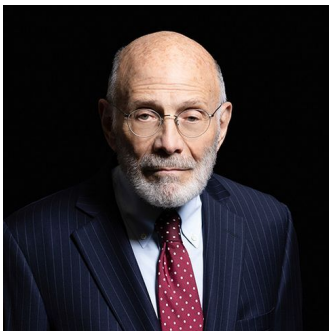

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