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PERSPECTIVE

9th Circuit limits a borrower's ability to 'cure' in Chapter 11

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Default rate interest provisions are standard language in business loan agreements. A borrower's default on a loan triggers consequences, including higher default rate interest. A borrower can generally "cure" the default and reinstate the loan to its original terms. Disputes over claims for default rate interest arise in the context of bankruptcy cases filed by financially distressed borrowers.

Chapter 11 of the Bankruptcy Code provides a framework for business reorganization. The primary goals of Chapter 11 are rehabilitation of the debtor, equality of treatment of creditors holding claims of the same priority, and maximization of the value of the estate. A plan of reorganization is generally the vehicle for achieving the goal of rehabilitation. Moreover, the Bankruptcy Code incorporates the concept of "cure" under a plan. Section 1123(a)(5)(G) provides that means for implementing a plan may include the "curing" of any default. The 9th U.S. Circuit Court of Appeals has explained that this "means that a plan of reorganization may include a provision authorizing the debtor to remedy any breach of a loan agreement with a creditor and return to pre-default conditions." *Pacifica L 51 LLC v. New Investments, Inc.* (In re *New Investments, Inc.*), 2016 DJDAR 11072 (9th Cir. Nov. 4, 2016), citing *Great W. Bank & Tr. v. Entz-White Lumber & Supply, Inc.* (In re *Entz-White, Inc.*), 850 F.2d 1338 (9th Cir. 1988).

Chapter 11 plans place creditor claims into classes. Each class that is impaired is entitled to vote on the plan. A class that is not impaired under a plan is deemed to have accepted the plan. Bankruptcy Code Section 1124 sets forth two ways a claim can be left unimpaired under a plan. The first exception to impairment requires that there be no alteration of the creditor's legal, equitable or contractual rights. The second exception allows a Chapter 11 plan to cure defaults, reverse acceleration and reinstate the agreement, compensate the creditor

for any damages incurred as a result of the default, and not otherwise alter the creditor's legal, equitable or contractual rights.

In 1988, in *Entz-White*, the 9th Circuit held that a debtor who cures a default under a plan "is entitled to avoid all consequences of the default — including higher post default interest rates." The *Entz-White* court concluded that "the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest," even when the terms of the loan agreement called for a higher interest rate upon default.

The 9th Circuit addressed 'whether Entz-White's rule that a debtor may nullify a loan agreement's requirement of post-default interest remains good law in light of [Section 1123(d)].'

In 1994, however, the Bankruptcy Code was amended by enacting Section 1123(d), which provides that, if a plan proposes to cure a default, "the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law." Until this month, the 9th Circuit had not revisited the merits of *Entz-White*.

In *New Investments*, a borrower executed a promissory note for \$3 million, secured by real property. The note bore an interest rate of 8 percent. It also provided that in the event of default, the interest rate would increase by 5 percent. The borrower filed a Chapter 11 bankruptcy petition and proposed a plan that offered to cure its default by paying off the loan at the pre-default interest rate. The secured creditor objected to the plan on the ground that it was entitled to be paid at the higher post-default interest rate. Overruling that objection, the bankruptcy court confirmed the plan. The creditor appealed.

The 9th Circuit addressed "whether *Entz-White*'s rule that a debtor may nullify a loan agreement's requirement of post-default interest remains good law in light of [Section 1123(d)]." A three-judge panel, with one dissent, held that the rule is not. Among other things, the dissent asserts that stare decisis requires the continued application of *Entz-White*, stating that *Entz-White* had not been undermined by any en banc decision of the 9th Circuit, Supreme Court decision, or subsequent legislation.

The 9th Circuit's rejection of *Entz-White* is grounded in both the plain language of Section 1123(d) and its legislative history. The court said the plain language "compels the holding that a debtor cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure." Further, the court explained that the legislative history reveals that Section 1123(d) was designed to overrule the *Supreme Court decision in Rake v. Wade*, 508 U.S. 464 (1993) (requiring payment of interest to cure even if the underlying agreement did not provide for it), and to limit the secured creditor to "the benefit of the initial bargain with no court contrived windfall," as well as "to put the debtor in the same position as if the default had never occurred."

The 9th Circuit found that this primary target underlying the legislation does not limit the impact of Section 1123(d) on other scenarios, stating: "The fact that Congress had a particular purpose in mind when enacting a statute does not limit the effect of the statute's text. ... Rather, '[t]he fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning.' By its terms, § 1123(d) tells us to look to the promissory note and Washington law to determine what amount *New Investments* must pay to cure its default. Here, that analysis requires the payment of post-default interest."

The court found this result to be consistent with the intent of Section

1123(d) because it holds the parties to the benefit of their bargain. The 9th Circuit explained that Section 1123(d) governs how a debtor returns to pre-default conditions. In order to effectuate a cure, in addition to arrearages being paid, obligations under the agreement for interest, late charges, fees and costs must be satisfied. Further, the court emphasized that Section 1123(d) looks to the entire underlying agreement and not only to the pre-default interest provisions of the agreement. The 9th Circuit stated that "[h]ere the note provided that upon default, the interest rate on the loan would increase by 5 percent. Unfortunately for *New Investments*, the increased rate applies to the entirety of the note and not just to arrearages."

The court also found Section 1123(d) and its ruling in *New Investments* is consistent with the traditional concept of "cure," the concept of impairment under Section 1124, and the balance Chapter 11 was designed to strike between a debtor's interest in a reorganization and a fresh start and creditor rights. Moreover, if the agreement did not contain a higher post-default interest rate, such interest would not have to be paid. The 9th Circuit found that it was holding the debtor to its bargain by applying the terms of the loan agreement as required by Section 1123(d). Having bargained for a higher interest rate upon default, the secured creditor was entitled to receive payment of the loan at the post-default interest rate.

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