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Hope for a "Cure"?

Entz-White *Was Superseded by Enactment of § 1123(d)*

'"Cure' is one of the most precious words in the English language. It's a short word. A clean and simple word. But it isn't so easy a thing as it sounds...."[1]

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The U.S. Supreme Court has consistently held that "property interests are created and defined by state law."[2] Yet for almost three decades, under *Great Western Bank and Trust v. Entz-White Lumber & Supply Inc. (In re Entz-White Lumber & Supply Inc.)*,[3] the law in the Ninth Circuit eschewed state law, adopting instead a bankruptcy-specific definition of "cure" that did not require a debtor to pay the contractually prescribed default rate of interest if the debtor proposed a cure and reinstatement of defaulted debt under a plan implemented under 11 U.S.C. § 1123(a)(5)(G).

The Ninth Circuit Changes Direction

In *Pacifica L 51 LLC v. New Investments Inc. (In re New Investments Inc.)*,[4] a Ninth Circuit panel has held that *Entz-White* was overruled by the 1994 amendments to § 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." *In re New Investments Inc.* holds that if state law and the parties' agreement require payment of a default rate of interest, any "cure" under a chapter 11 plan must provide for the same default rate of interest and/or any fees or penalties that must be paid under state law to cure and reinstate the loan.

The negotiated terms and conditions of a commercial loan agreement generally reflect a carefully crafted balance and form part of the consideration for the bargained-for interest rate and other terms for the financing offered to the borrower. Terms providing consequences for the borrower's default of a material condition of the loan agreement (such as late penalties, default interest or acceleration of the maturity date) reflect the real economic cost to a lender that is caused by the borrower's default and by the initiation of foreclosure proceedings. Likewise, state foreclosure laws, as well as local enactments of Article 9 of the Uniform Commercial Code, although providing a means for the borrower's cure of the defaults and restoring the parties to their predefault condition, also require the borrower to make cure payments to stave off the foreclosure and other consequences of default.

The Ninth Circuit under *Entz-White*

The Bankruptcy Code "incorporates the concept of cure,"[5] but the manner by which a cure must be made under § 1123(a)(5)(g) and whether a cure requires the borrower to pay default interest has resulted in significant circuit splits that have significant impact on the recovery of lenders, in particular commercial real estate lenders, in a bankruptcy proceeding. The amount of default interest can be quite significant in cases that linger in chapter 11 for many months or years prior to a confirmed plan. On the other hand, debtors in chapter 11 have utilized so-called "cure plans" under *Entz-White* to facilitate their reorganizations, denying the lender millions of dollars in interest that would have been payable but for the bankruptcy proceeding. That dichotomy between state law and bankruptcy law is no longer valid in the Ninth Circuit.

Pursuant to § 1123(a), a reorganization plan must "provide adequate means for the plan's implementation." Section 1123(a)(5) provides a series of nonexclusive examples of the practical means by which a plan might be implemented. Among these examples is § 1123(a)(5)(G), which provides for implementation by "the curing or waiving of any default." *Entz-White* was decided prior to addition to the Bankruptcy Code of § 1123(d), which directs that the *amount* of the cure must be determined in accordance with the "underlying agreement and applicable nonbankruptcy law." In *Entz-White*, the Ninth Circuit took note of the fact that Congress did not provide any definition of what it meant to "cure."[6] As such, it incorporated language from a Second Circuit case, *Di Pierro v. Taddeo (In re Taddeo)*[7]:

> A default is an event in the debtor-creditor relationship which triggers certain consequences. Curing a default commonly means taking case of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of "cure" used throughout the Bankruptcy Code.[8]

1 Lauren DeStefano, *Server* (Simon & Schuster 2013).
2 *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979).
3 850 F.2d 1338 (9th Cir. 1988).
4 840 F.3d 1137 (9th Cir. 2016).
5 *Id.* at *1.
6 850 F.2d at 1340.
7 685 F.2d 24 (2d Cir. 1982).
8 850 F.2d at 1340 (quoting *In re Taddeo*, 685 F.2d at 26-27).

From this, the Ninth Circuit in *Entz-White* concluded that the power to cure under the Bankruptcy Code "nullifies ... default penalties such as higher interest."[9] In other words, a debtor's cure of its default returned the parties to the *status quo ante*, meaning that creditors lost any contractual right to recover default-rate interest.[10]

Six years later, Congress amended § 1123 to add subsection (d). Subsequently, numerous bankruptcy courts and two courts of appeals[11] have expressed the view that the addition of § 1123(d) to the Bankruptcy Code in 1994 overruled *Entz-White*'s denial of default interest. Somewhat surprisingly, however, the continued vitality of *Entz-White* has not been directly confronted by the Ninth Circuit in the 22 years since Congress amended the statute.[12] The only hint given by the Ninth Circuit that *Entz-White* may no longer be good law appeared in *GE Capital Corp. v. Future Media Prods*.[13]

In *Future Media*, the issue was whether the "cure" provisions of § 1123(a)(5)(G) applied outside of a plan. Ruling that they did not, the Ninth Circuit did not have to determine whether *Entz-White* was still good law. Nonetheless, in a curious footnote (which was changed three times in subsequent amended decisions), the Ninth Circuit stated, in *obiter dicta*, that the "plain language of § 1123(d) as promulgated in the 1994 amendments" requires that "[t]he bankruptcy court should apply a presumption of the allowability for the contracted for default rate, provided that the rate is not unenforceable under applicable nonbankruptcy law."[14]

In re New Investments Explained

In *In re New Investments*, the borrower had taken out a mortgage to finance a hotel property in Kirkland, Wash. The loan agreement was governed by Washington law and provided for a default interest rate of 5 percent. The borrower defaulted on the note, and, after the lender commenced nonjudicial foreclosure proceedings, the debtor filed for chapter 11. The debtor's plan proposed to sell the property to a third party for significantly more than the outstanding amount of the loan, then use the proceeds to pay the outstanding amount of the loan balance minus the default interest, giving the balance of the proceeds to the debtor's equityholders. After the bankruptcy court confirmed the plan over the lender's objection, the lender appealed. The only issue on appeal was "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 11 U.S.C. § 1123(d)."[15]

The Ninth Circuit first reviewed the language of § 1123(d) and determined that it was not ambiguous. Then, the Ninth Circuit proceeded to interpret the statute in accordance with its plain meaning — that a debtor "cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure."[16] In the alternative, the Ninth Circuit noted that the legislative history would also require overruling *Entz-White*. The Ninth Circuit noted that the legislative history of § 1123(d) expresses that Congress's concern was to overrule the Supreme Court's decision in *Rake v. Wade*,[17] which had imposed a noncontractual default rate of interest on a chapter 13 debtor who had proposed to cure a default.

Relying upon the Supreme Court's opinion in *Union Bank v. Wolas*,[18] which holds that "[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," the Ninth Circuit also rejected the argument that the purpose behind Congress's enacting § 1123 should limit the effect of the text.[19] The text of § 1123(d) required it to look to Washington law and the promissory note. Thus, it looked first to the state of Washington's deed of trust law, which provides that a cure required the payment of "[t]he entire amount then due under the terms of the deed of trust and the obligation secured thereby, other than such portion of the principal as would not then be due had no default occurred."[20] Thus, "it is *only once these penalties are paid* that the debtor can return to pre-default conditions as to the remainder of the loan obligation."[21]

Next, it looked at the note. Since the note provided that the interest on the *loan* would increase by 5 percent upon default, the Ninth Circuit found that the debtor was required to pay the default interest rate on the entirety of the note — not just on the amount in arrears — in order to cure the default.[22]

The Ninth Circuit also analyzed the relationship of § 1123(d) to the provisions of § 1124 of the Bankruptcy Code that define the treatment that is required under a reorganization plan to leave a creditor "unimpaired." The Ninth Circuit noted that a "common law treatment of cure is consistent" with the requirements of § 1124(2)(E), which provides that a creditor is impaired unless the cure under the plan does not "otherwise alter the legal, equitable, or contractual rights" of that creditor. Much to the contrary, the Ninth Circuit in *Entz-White* had reasoned instead that "[t]he natural reading of these sections is that plans may cure all defaults without impairing the creditor's claim" and that "[t]he more natural reading of [§ 1124] is that the interest awarded should be at the market rate or at the pre-default rate provided for in the contract."[23] As such, the holding in *In re New Investments* not only revises the Ninth Circuit's construction of the amount needed to cure under § 1123(a)(5)(G), it also works a significant repudiation of *Entz-White*'s formulation of the interrelationship of §§ 1123 and 1124 relating to impairment and a creditor's right to vote on the plan. The decision significantly revises not only the meaning of cure, but also the meaning of "impairment." Therefore, the decision should have a significant impact on chapter 11 practice in the Ninth Circuit.[24]

9 *Id.* at 1342.

10 In *Entz-White*, the loan fully matured pre-petition, so "[i]t makes no sense to reinstate the maturity of a claim that has already matured." *In re Ace-Texas Inc.*, 217 B.R. 719 (Bankr. D. Del. 1998) (Walsh, J.). Cure of a matured loan also would not generally be allowed under state law.

11 *See In re Southland Corp.*, 160 F.3d 1054, 1059 n.6 (5th Cir. 1998) ("Congress, in bankruptcy amendments enacted in 1994, arguably rejected the *Entz-White* denial of contractual default interest rates."); *In re Sagamore Partners Ltd.*, No. 14-11106, 620 Fed. App'x. 864, 867 (11th Cir. Aug. 31, 2015).

12 In *Platinum Capital Inc. v. Sylmar Plaza LP (In re Sylmar Plaza LP)*, 314 F.3d 1070, 1075 (9th Cir. 2002), the Ninth Circuit determined that the use of a cure plan to eliminate default interest was in good faith. However, there was no analysis of whether *Entz-White* was still good law in light of 11 U.S.C. § 1123(d).

13 547 F.3d 956 (9th Cir. 2008).

14 *Id.* at 961 and n.3. The footnote containing this observation was revised three times by the Ninth Circuit before the decision was made final.

15 *In re New Invs.*, 2016 WL 6543520 at *2.

16 *Id.* at *3.

17 508 U.S. 464 (1993) (citing H.R. Rep. No. 103-835, at *55 (1994)).

18 502 U.S. 151, 158 (1991). The Ninth Circuit also pointed to similar language in *Entz-White*. 2016 WL 6543520 at *4.

19 2016 WL 6543520 at * 4.

20 *Id.* at *3 (citing Wash. Rev. Code Ann. § 61.24.090(1)(a)).

21 *Id.* at *4 (emphasis added).

22 *Id.* The Ninth Circuit did not opine on whether this might constitute an unenforceable penalty.

23 850 F.2d at 1341.

24 For example, *In re New Investments* also overrules *Florida Partners Corp. v. Southeast Co. (In re Southeast Co.)*, 868 F.2d 335 (9th Cir. 1989), which interpreted § 1124 to require payment of only interest on overdue installments at the contract nondefault rate.

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The Ninth Circuit did not discuss the import of the debtor's solvency. Some courts make a distinction between a solvent debtor and an insolvent debtor in respect to the lender's entitlement to default interest, both under a cure plan and generally as part of the allowance of a secured creditor's claim.[25] The rationale of *In re New Investments* and the text of § 1123(d) would suggest that the debtor's solvency should have no bearing on the lender's entitlement to default interest, at least in the context of a cure effected under § 1123 or 1124. Rather, the only factors that should determine the lender's entitlement to be paid a default rate of interest under these statutes is the language of the parties' agreement and the payment that is required under applicable state law, including whether such is a legal rate of interest under state law.

Conclusion

The decision in *In re New Investments* finally brings the law of the Ninth Circuit into conformity with Supreme Court precedents, such as *Butner v. United States*[26] and *Travelers Casualty & Surety Co. of America v. Pacific Gas and Electric Co.*[27] In *Travelers*, the Supreme Court reversed the Ninth Circuit, reiterating its holding in *Butner* that "the determination of property rights in the assets of a bankruptcy's estate [is left] to state law." In *Travelers*, the question presented was whether the "*Fobian* rule," which denied fees incurred in litigating issues governed by federal bankruptcy law, should be struck down.

The Supreme Court initially noted that the *Fobian* rule had no support in the Bankruptcy Code, nor did it have any support in state law, but was instead federal common law. As a result, the Court held that the absence of textual support was "fatal for the *Fobian* rule."[28] The principle here is the same: The Bankruptcy Code does not provide a definition of "cure." Moreover, § 1123(d) requires that the amount needed to cure must be determined in accordance with applicable state law and the parties' agreement, *not* federal common law. The Ninth Circuit finally got it right. abi

25 *See, e.g., In re Sagamore Partners Ltd.*, 2012 Bankr. LEXIS 3224 (Bankr. S.D. Fla. July 10, 2012) (holding that plan was unconfirmable because it failed to provide payment of default interest as element of cure where lender was oversecured, debtor was solvent and unsecured creditors would be paid in full in any event).

26 440 U.S. 48.

27 549 U.S. 443 (2007).

28 *Id.* at 444.