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Building Blocks

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Risky Reinstatement

Understanding the Interplay Among §§ 1124, 1123 and 365, and What It Means to Cure a Default

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Bankruptcy affords debtors legal strategies and benefits to address financial distress. Concepts such as the automatic stay, the rejection of executory contracts, § 363 sales and the restructuring of debts through chapter 11 are commonly utilized benefits and strategies for debtors. However, one lesser-known tool available in chapter 11 financial restructurings is a debtor's plan that treats a defaulted class of claims as unimpaired through the reinstatement of pre-petition debt while avoiding repayment of that debt at the stated default rate of interest.

In certain circumstances, unimpairment and reinstatement as part of a chapter 11 restructuring plan can be an extremely valuable tool for debtors. For example, in an adverse credit market, a debtor may retain, deaccelerate and reinstate a previously accelerated loan when cheaper and less restrictive exit financing is unavailable. The debtor may choose this strategy despite the fact that this type of reinstatement is unfavorable to the lender because the lender is thereby prevented from voting on the plan.

For a debtor to reinstate a previously accelerated loan while simultaneously treating the lender as unimpaired, the Bankruptcy Code requires a chapter 11 debtor to cure the pre-petition defaults. While the determination of whether a claim is unimpaired appears relatively straightforward, statutory ambiguity in the Code, along with diverging case law and scholarly articles, have made these issues confusing. This article examines these issues.[1]

Interplay Between §§ 1123 and 1124

Section 1124 of the Bankruptcy Code addresses the concept of impairment, providing that a class of claims is presumptively considered to be impaired under a plan unless one of two exceptions applies. The first exception is where the plan "leaves unaltered the legal, equitable, and contractual rights" of the holder of a claim.[2] Even minor changes to a claimant's rights would cause the claimant to be impaired under § 1124(1).[3] The second exception to impairment, outlined in § 1124(2), is very narrow and excludes from impairment the modification of a "contractual provision or applicable law" that entitles a holder of a claim "to demand or receive accelerated payment of such claim ... after the occurrence of a default."[4]

As the preamble to § 1124 makes clear,[5] § 1124 does not provide a debtor with a substantive right to nullify the consequences of default. Instead, the exception to impairment contained in § 1124(2) operates exclusively to permit a debtor to deaccelerate a previously accelerated debt.[6] However, as a condition to reinstating a previously accelerated debt, § 1124(2)(A) requires that a debtor cure "any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in § 365(b)(2) of this title or of a kind that § 365(b)(2) expressly does not require to be cured."[7] Consequently, in rendering a claim unimpaired under § 1124(b)(2)(A),

1 The issue of whether an oversecured creditor is entitled to payment of interest at the default rate in order to be deemed unimpaired is directly related to the discussion herein. This specific issue will hopefully be addressed in more detail in a later article.

2 *See* 11 U.S.C. § 1124(1); *see also In re GSC Inc.*, 453 B.R. 132, 177 (Bankr. S.D.N.Y. 2011).

3 *See L & J Anaheim Assocs. v. Kawasaki Leasing Int'l Inc.*, 995 F.2d 940, 942 (9th Cir. 1993).

4 *See* 11 U.S.C. § 1124(2); *see also In re NNN 3500 Maple 26 LLC*, No. 13-30402-HDH-11, 2014 WL 1407320, at *5 (Bankr. N.D. Tex. April 10, 2014) ("[A] plan may cure a default by de-accelerating the note, but *any* other change in the arrangement between the debtor and creditor constitutes impairment." (citation omitted) (emphasis in original)).

5 The preamble to § 1124 provides "Except as provided in § 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan...."

6 *In re 139-141 Owners Corp.*, 313 B.R. 364, 368 (Bankr. S.D.N.Y. 2004) ("Subsection (2) on its face is concerned only with a contract provision requiring 'accelerated payment' upon a default, and the statute permits the debtor to de-accelerate and reinstate the pre-default maturity of the loan only if the plan [(E)] 'does not otherwise alter' the secured creditor's contractual rights.").

7 *See* 11 U.S.C. § 1124(2)(A).

the Bankruptcy Code expressly permits a debtor to avoid having to cure the defaults identified in § 365(b)(2), which include defaults concerning, among other things, breaches of provisions relating to the satisfaction of a "penalty rate" or "penalty provision."[8]

Although the concept of impairment is addressed in § 1124, the determination of how to cure a default in connection with a plan is specifically addressed in § 1123 of the Bankruptcy Code. In particular, § 1123(d), which was added by Congress in the Bankruptcy Reform Act of 1994, specifically addresses the requirements to cure a default, stating that "if it is proposed in a plan to cure a default, the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law."[9] Despite the Code's plain language, the interplay between §§ 1123 and 1124 remains confusing and presents issues that continue to confound the courts.[10]

What Does It Mean to Cure a Default?

Prior to the enactment of the 1994 Bankruptcy Reform Act, the Bankruptcy Code did not define "cure," leaving the question of what exactly § 1123(a)(5)(G) meant when it authorized "curing or waiving of any default" under a chapter 11 plan.[11] A few years earlier, the Ninth Circuit Court of Appeals, in *In re Entz-White Lumber & Supply Inc.*, recognizing that the Code did not define "cure," concluded that "[c]uring a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified."[12] The Ninth Circuit in *Entz-White* held that "by curing the default, [the debtor] is entitled to avoid all consequences of the default — including higher post-default interest rates."[13] In so holding, the *Entz-White* court borrowed language from the Second Circuit's opinion in *In re Taddeo* interpreting § 1322 of the Bankruptcy Code on the theory that the concept of "cure" is the same throughout the Code, irrespective of contravening state law.[14] In extending this chapter 13 concept, the Ninth Circuit held that a chapter 11 plan may cure all defaults, leaving a creditor unimpaired — even when the plan deaccelerates and reinstates the original maturity of a loan without provision for payment of "consequences of default," such as late fees and default interest.[15]

After § 1123(d) was added to the Code in 1994, a bankruptcy court within the Ninth Circuit again considered the issue of whether a debtor could retroactively nullify the consequences of a default and, following the *Entz-White* rationale, held that "the Ninth Circuit has uniformly followed the *Entz-White* interpretation of 'cure' since 1988 and it remains the law of the circuit today."[16] In dutifully following *Entz-White*, as a precedential decision, the *Phoenix Bus. Park* court considered the 1994 amendments to the Bankruptcy Code and determined that Congress did not legislatively overrule *Entz-White*.[17] Ultimately, the court concluded that the default interest rate imposed by the creditor after default was a "penalty rate" under § 365(b)(2)(D) and an exception to impairment that did not need to be cured under § 1124(2).[18]

Approximately 15 years later, the Ninth Circuit, in *In re New Investments Inc.*,[19] revisited the issue previously decided in *Entz-White* when considering whether a debtor was required to pay the default rate of interest under a plan. Given the fact that the underlying agreement provided for an increased default rate of interest, and because applicable nonbankruptcy law allowed for this higher rate of interest after a default, the Ninth Circuit reconsidered its prior decision in *Entz-White*. The Ninth Circuit determined that § 1123(d) (which had not been in effect when the Ninth Circuit decided *Entz-White*) "compels the holding that a debtor cannot nullify a pre-existing obligation in a loan agreement to pay post-default interest solely by proposing a cure."[20]

In so holding, the Ninth Circuit concluded that Congress's addition of § 1123(d) effectively overruled *Entz-White* by providing that the amount necessary to cure a default is to be determined in accordance with the underlying agreement and applicable nonbankruptcy law.[21] However, the dissenting opinion disagreed, focusing primarily on the legislative history of § 1123.[22] The dissent concluded that "neither 11 U.S.C. § 1123(d) nor any other provision of the Bankruptcy Code provides a definition of 'cure' contrary to the one this Court announced in *Entz-White*."[23]

Consistent with the dissent's contentions in *New Investment* that *Entz-White* remains good law, there have been various scholarly articles suggesting that *Entz-White* continues to remain good law.[24] However, many courts have declined to fol-

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8 *See* 11 U.S.C. § 365(b)(2)(D).
9 *See* 11 U.S.C. § 1123(d); *see also In re Sagamore Partners Ltd.*, 620 Fed. App'x 864, 869 (11th Cir. 2015) (1994 amendments expressly "provided the previously missing definition of 'cure'"); *In re Moody Nat'l SHS Hous. H LLC*, 426 B.R. 667, 674 (Bankr. S.D. Tex. 2010) ("*Thou shall look to state law when determining cure amounts.*") (emphasis in original).
10 *See In re Sagamore Partners Ltd.*, 620 Fed. App'x at 869 (quoting *In re Moody Nat'l SHS Hous. H LLC*, 426 B.R. 667, 676 n.5. (Bankr. S.D. Tex. 2010)) (under § 1124, any outstanding default-rate interest is ignored when determining whether claim to loan is impaired, but, as previously explained, under § 1123, outstanding default-rate interest, if called for in underlying agreement, precludes reinstating original terms of the loan; "*This tension merely demonstrates that the Bankruptcy Code does not precisely equate curing a default for the purposes of reinstating a loan with unimpairment of a claim*"; it does not allow us to ignore clear mandate of § 1123 that allows creditor to demand default-rate interest as a condition for reinstating loan) (emphasis added).
11 *See* 11 U.S.C. § 1123(a)(5)(G).
12 *In re Entz-White Lumber & Supply Inc.*, 850 F.2d 1338, 1340 (9th Cir. 1988).
13 *Id.* at 1342.
14 *Id.* at 1340 (citing *In re Taddeo*, 685 F.2d 24, 27 (2d Cir. 1982)).
15 *Id.*
16 *In re Phoenix Bus. Park Ltd. P'ship*, 257 B.R. 517, 520 (Bankr. D. Ariz. 2001).
17 *Id.* at 520-22.
18 *Id.*
19 840 F.3d 1137 (9th Cir. 2016).
20 *Id.* at 1141.
21 *Id.* at 1139.
22 *Id.* at 1143-45 (Berzon dissenting).
23 *Id.* at 1143 (Berzon dissenting).

low this logic, instead relying on § 1123(d) in determining the proper standard for "cure." For example, the Eleventh Circuit has held that "the current iteration of the Bankruptcy Code ... require[s] a debtor to cure its default in accordance with the underlying contract or agreement, so long as that document complies with relevant nonbankruptcy law."[25] Similarly, other courts have concluded that § 1124(2) does not affect the contractual right to interest at the default rate but instead merely serves to nullify the acceleration upon a cure of the default.[26]

Takeaways

In attempting to reinstate pre-petition debt that has been accelerated, crafty debtors may propose plans that nullify the consequences of the defaults, treating the lender as unimpaired while avoiding paying the stated default rate of interest. Until courts fully and finally resolve these issues, there will be continuing litigation on the topic. abi

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24 *See, e.g.*, Ralph Brubaker, "Default Rates of Interest and Cure of a Defaulted Debt in a Chapter 11 Plan of Reorganization (Part I): *Entz-White*'s Overlooked Choice of Law Dimension," 36 *Bankr. L. Letter NL* 12 (2017); Ralph Brubaker, "Default Rates of Interest and Cure of a Defaulted Debt in a Chapter 11 Plan of Reorganization (Part II): *Entz-White* and the 'Penalty Rate' Amendments," 37 No. 1 *Bankruptcy Law Letter NL* 1 (2017).

25 *In re Sagamore Partners Ltd.*, 620 Fed. App'x at 869 (citing *In re Southland*, 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.")); *see also In re Moshe*, 567 B.R. 438, 444 (Bankr. E.D.N.Y. 2017); *In re 1 Ashbury Court Partners LLC*, No. 11-10131, 2011 WL 4712010, at *5 (Bankr. D. Kan. Oct. 5, 2011) (finding that debtor must cure using default interest rate in light of § 1123(d)); *In re Moody*, 426 B.R. at 674 (holding that in order to cure default and reinstate loan, lender is entitled to default rate of interest in accordance with underlying agreement and applicable state law).

26 *See In re 139-141 Owners Corp.*, 313 B.R. at 368; *Hepner v. PWP Golden Eagle Tree LLC*, 338 B.R. 450, 461 (Bankr. D. Colo. 2005); *In re Frank's Nursery & Crafts Inc.*, No. 04-15826(PCB), 2006 WL 2385418, at *4 (Bankr. S.D.N.Y. May 8, 2006) ("[A] plan that cures a mortgage default and deaccelerates the mortgage impairs the mortgagee's secured claim if it fails to provide for the payment of interest at the contractual default rate."); *In re Sultan Realty LLC*, No. 12-10119 (SMB), 2012 WL 6681845, at *9 (Bankr. S.D.N.Y. Dec. 21, 2012); *In re Johnston*, No. 03-03495S, 2004 WL 3019472, at *19 (Bankr. N.D. Iowa Dec. 20, 2004); *In re 1 Ashbury Court Partners LLC*, No. 11–10131, 2011 WL 4712010, at *4 (Bankr. D. Kan. 2011) (holding that denial of default rate interest upon reinstatement "where it is otherwise legally enforceable would be to write § 1123(d) out of the Code").