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No Mention of "Cure" in Section 363 Means Default Interest Rate Applies

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In *General Electric Capital Corp. v. Future Media Productions, Inc.*,[1] the Ninth Circuit addressed the issue of whether an oversecured creditor is entitled to the contracted-for default rate of interest when the creditor has been paid in full pursuant to an asset sale governed by § 363 of the Bankruptcy Code. Despite prior precedent to the contrary, the court answered the question in the affirmative. In its previous decision in *Great Western Bank & Trust v. Entz-White Lumber and Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)*,[2] where the debtor had paid the creditor in full pursuant to a chapter 11 plan (thus "curing" the default), the Ninth Circuit held that an oversecured creditor is not entitled to default interest. The *Future Media* decision, by drawing a distinction between asset sales conducted while a plan is pending and those conducted after a plan has been confirmed, is likely to bring even more confusion to an already perplexing area of the law.[3]

The Right of Oversecured Creditors to Collect Postpetition Interest Under § 506(b)

Generally, interest stops accruing once the bankruptcy petition has been filed.[4] Such is not the case with creditors who are "oversecured."[5] Section 506(b) of the Bankruptcy Code, which provides a limited exception to the basic rule, reads:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest

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> on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.[6]

Thus, a secured creditor may collect postpetition interest to the extent that the value of the collateral (the property that is subject to a lien or security interest)[7] exceeds the amount of the claim after any costs of preserving or disposing of the collateral have been deducted.[8] This exception, despite "bankruptcy law's ancient policy of equality of distribution," was intended to protect the basic bargain of the secured creditor.[9]

The Supreme Court, in *United States v. Ron Pair Enterprises, Inc.*,[10] addressed the issue of whether the exception in § 506(b), which clearly applied to consensual creditors, whose claim arose by contract, also applied to nonconsensual secured creditors (*e.g.*, tax collectors) whose lien arose by operation of law. The Court, in a 5-4 decision, found that the fifth of the seven commas in § 506(b) meant that while an award of "fees, costs, or charges" is dictated by the loan agreement, the award of interest is not.[11] However, the Court did not elaborate as to how the interest rate in the agreement should be treated.

Moreover, while § 506(b) permits an oversecured creditor to recover interest on his claim, neither the statute nor its legislative history specifies the rate of interest to be applied.[12] Most recent cases interpret this silence to mean that Congress did not intend to change pre-Code practice.[13] Prior to the enactment of the Code in 1978, the right to post-petition interest was determined by applicable nonbankruptcy law, "subject to equitable principles governing bankruptcy distribution."[14] Accordingly, while an oversecured creditor is ordinarily allowed under § 506(b) postpetition interest at the rate provided in the contract,[15] with regard to contracted-for *default* rates of interest, however, "most courts have emphasized that the

allowance of interest on claims in a bankruptcy case is a matter of bankruptcy law and that the adoption of applicable nonbankruptcy law for the rate of interest is subject to 'a balance of equities between creditor and creditor or between creditors and the debtor.'"[16]

Factors that courts have considered in determining whether to enforce a contracted-for default rate include: (1) the difference between the default and nondefault rates; (2) the reasonableness of the difference; (3) the relative distribution rights of other creditors and whether enforcement of the higher rate will do injustice to the concept of equitable distribution of the estate's assets; and (4) whether the default rate merely compensates the creditor for any loss resulting from the nonpayment of the principal at maturity or is actually a disguised penalty.[17]

Curing a Default Means No More Default Interest

The issue of whether an oversecured creditor is entitled to default interest becomes moot if the debtor "cures" the default. Section 1123(a)(5) states that a plan shall "provide adequate means for the plan's implementation, such as . . . curing or waiving of any default."[18] Additionally, § 1124 (2)(A) provides that a secured claim is not impaired if the chapter 11 plan cures any default. However, the Code does not specifically define "cure." The generally accepted definition of "cure" can be found in *DiPierro v. Taddeo* (*In re Taddeo*)[19]: "A default is an event in the debtor-creditor relationship which triggers certain consequences . . . . Curing a default commonly means taking care 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."[20] Because courts generally agree that a cure nullifies the default interest rate,[21] if a debtor cures, the pre-default interest rate will apply. Such was the holding in the Ninth Circuit's previous decision in *Entz-White*.

Background of *Future Media*

In August 2004, GECC loaned Future Media $10.5 million with a $5 million revolving line of credit, secured by a perfected, first priority security interest in substantially all of Future Media's assets.[22] The loan agreement provided for a pre-default interest rate of the Index Rate plus 1.5% per annum and a default rate of an additional 2% per annum.[23] After an event of default, the loan began to bear interest at the default rate.[24] In February 2006, after additional events of default occurred, Future Media filed for chapter 11 protection.[25] Subsequently, Future Media needed cash to wind down its operations and prepare for the sale of its assets.[26] GECC agreed to allow Future Media to use GECC's "cash collateral," subject to the terms of a stipulation to which the Creditors Committee objected.[27] To stop the accrual of interest, the parties agreed that GECC would be paid in full at the default interest rate and that any dispute about the interest rate would be resolved at a later time.[28] The Creditors Committee challenged GECC's right to default interest and the bankruptcy court, relying on *Great Western Bank & Trust v. Entz-White Lumber and Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)*,[29] agreed and ordered GECC to return the difference.[30]

The Court's Ruling

On appeal, the Ninth Circuit reversed and remanded.[31] The court acknowledged that § 506(b) allows an oversecured creditor to recover postpetition interest.[32] Because the parties did not dispute that GECC was an oversecured creditor entitled to interest, but only what type of interest it was due, the court determined that there were three issues: 1) whether the *Entz-White* rule applied, 2) if it did not apply, how the bankruptcy court should evaluate the case on remand, and 3) whether GECC was entitled to attorneys' fees and costs under § 506(b).[33]

Because the facts were distinguishable, the *Future Media* court found that the bankruptcy court had erred in extending the *per se* rule from *Entz-White* to the case at bar.[34] The court found that "'[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code,'"[35] and that such a Code provision was present in *Entz-White*, but not in Future Media's case.[36] In the former case, the oversecured creditor was paid in full pursuant to a chapter 11 plan and the Ninth Circuit held that the oversecured creditor was not entitled to interest at the default rate.[37] In contrast, Future Media had paid GECC in full through a § 363[38] asset sale *outside* of a chapter 11 plan.[39] The difference is that § 1124(2)(A) of the Bankruptcy Code allows a debtor to "cure" defaults under a chapter 11 plan, while § 363 does not.[40] The court reasoned that "[a] creditor's claim is considered 'impaired' for purposes of voting on a Chapter 11 plan unless the plan leaves the creditor's legal, equitable, and contractual rights unaltered, or the debtor 'cures' any default that occurred prior to or during the bankruptcy case"[41] and in Future Media's case, "there was never any question of whether the debtor needed to cure a default to render it unimpaired for voting on a Chapter 11 plan."[42] A finding of two lower courts in other cases—the fact that the concept of "cure" is not exclusive to chapter 11 plans—was unpersuasive to the Ninth Circuit; those courts had improperly "transposed" the concept of "cure" from §§ 1124 and 365 into § 363.[43] Thus, the court concluded, "[b]ecause a Chapter 11 plan implicates provisions of the Bankruptcy Code that an asset sale outside of a plan does not," the bankruptcy court had improperly extended *Entz-White*.[44]

Because *Entz-White* did not apply, the court then instructed the bankruptcy court on remand to apply the majority rule: There is a presumption of allowability for default rates of interest, "provided that the rate is not unenforceable under applicable nonbankruptcy law."[45] In a

footnote, the court observed that the majority rule is consistent with the Supreme Court's decision in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.* and 11 U.S.C. § 1123(d) as promulgated in the 1994 amendments to the Bankruptcy Code.[46] The court declined to create a bright line rule to accept GECC's default rate differential of 2% as reasonable and rejected GECC's argument that any argument as to the enforceability of the default rate under New York law had been waived.[47] Finally, because GECC may ultimately prevail, the court remanded for a determination of whether GECC was entitled to attorneys' fees, costs, and expenses under § 506(b).[48]

Is *Entz-White* Still Good Law?

In *Entz-White*, the debtor proposed in its chapter 11 plan to pay the oversecured creditor in full at the pre-default interest rate even though the debtor was in default when the loan matured.[49] The plan treated the oversecured creditor's claim as unimpaired under § 1124(2)(A), which would mean that the creditor would have been "conclusively presumed to have accepted the plan . . . ,"[50] as only impaired parties have the right to vote on a reorganization plan.[51] The court pointed to § 1123(a)(5)(G), which states that a chapter 11 reorganization plan shall "provide adequate means for the plan's implementation, such as . . . curing or waiving of any default."[52] The court determined that "plans may cure all defaults without impairing the creditor's claim, and . . . such defaults include, but are not limited to, those defaults resulting in acceleration."[53]

Two amendments to the Code enacted in 1994 have led some courts and commentators to conclude that *Entz-White* has been legislatively overruled.[54] First, subsection (d) was added to § 1123. Section 1123(d) provides: "Notwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7), and 1129(b) of this title, 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."[55] Second, subparagraph (2)(D) was added to § 1124 in 1994 (which became (2)(E) when it subsequently amended § 1124 to remove subsection (3)) to provide that a creditor is impaired unless the chapter 11 plan "does not otherwise alter the [creditor's] legal, equitable, or contractual rights . . . ."[56] In other words, a creditor is considered impaired if it "is not receiving everything for which it contracted."[57]

The Ninth Circuit itself seems to think that Entz-White is no longer valid. In the *Future Media* decision, the court amended its original opinion to remove a footnote in which it questioned *Entz-White's* validity.[58] Moreover, the court pointed out that the majority rule it was now choosing to apply is consistent with the Supreme Court's decision in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.* and the new 11 U.S.C. § 1123(d).[59] One wonders why the court chose not to address the issue and instead chose not to extend the holding of *Entz-White*.

The Timing of a Sale Should Not Determine the Rate of Interest

The Ninth Circuit should not have made a distinction between asset sales conducted during the pendency of a plan and those conducted after a plan has been confirmed.[60] The timing of an asset sale should not determine whether an oversecured creditor is entitled to interest at the contractual default rate. Pursuant to the court's ruling, whereas a creditor that is paid in full from the proceeds of a § 363 sale during the course of a chapter 11 proceeding will receive default interest, a creditor who is paid pursuant to a chapter 11 plan will receive interest at the pre-default rate. Given that default interest is meant not to be a penalty, but to compensate the creditor for its actual losses,[61] and that "interest accruing at the default rate can quickly exceed several hundred thousand dollars,"[62] it is senseless to think that a creditor who is paid sooner

rather than later would receive that much more in compensation for its losses.

The court's emphasis on the fact that section 363 does not mention "cure" does not excuse the inequities that will result from its decision. Such a strict reading of that provision leads to a result that few would believe Congress actually intended. In fact, one study found that "[bankruptcy] cases adopting textualist methods of statutory interpretation are disproportionately found within the universe of cases overruled by statute."[63] Thus, statutory interpretation that ignores "legislative history, other extrinsic evidence of legislative intent, historical background, or most especially, consideration of the social consequences of one interpretation or another"[64] is hardly as wise or as necessary as the Ninth Circuit believes it to be.

Even though the court did not want to decide whether *Entz-White* has been overruled by the 1994 amendments and did not believe that the debtor could "cure" under the Code despite the fact that the creditor had been paid in full, the court could have chosen still another route. In her concurrence in *Casa Blanca Project Lenders, L.P. v. City Commerce Bank (In re Casa Blanca Project Lenders, L.P.)*[65] Judge McKeag suggested that, in deciding whether to award default interest, the court on remand should consider as a factor the fact that the creditor has been fully repaid, "thus receiving the equivalent of a 'cure' of its defaulted loan obligation."[66] While the loan agreement in that case was entered into before the 1994 amendments were enacted, thus obviating the need to determine whether they overruled *Entz-White*, such a result in the *Future Media* case would have been preferable to the decision actually reached by the court.

Conclusion

In 1991, the late Professor Kathryn R. Heidt wrote: "Because the issue of the rate of post-petition interest concerns the vast majority of all business bankruptcy cases and can have a significant impact on some reorganizations, Congress or the United States Supreme Court needs

to resolve this matter in the near future."[67] Unfortunately, little has changed in the past 18 years, as we are still in need of clarification in the area of the right of oversecured creditors to default rates of interest.

The Ninth Circuit is correct that § 363 does not mention "cure." However, the court should not have created a distinction between asset sales conducted while a chapter 11 plan is pending and asset sales conducted pursuant to a chapter 11 plan. The decision ignores the real-life consequences of such a result and only serves to perpetuate the confusion in this area of bankruptcy law.

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[1] 547 F.3d 956 (9th Cir. 2008).
[2] 850 F.2d 1338 (9th Cir. 1988).
[3] *See* Craig H. Averch, Michael J. Collins & Stephen A. Youngman, *The Right of Oversecured Creditors to Default Rates of Interest from a Debtor in Bankruptcy*, 47 BUS. LAW. 961, 961 (1991) ("Few legal issues have created more confusion or spawned more litigation than the rights of secured creditors in bankruptcy cases. One of the more significant issues presently facing the bankruptcy courts is whether an oversecured creditor is entitled to interest at its contractual default rate as part of its prepetition and postpetition claims. The published decisions reveal that the courts have struggled with the issue without developing a consistent framework.") (footnote omitted); Kathryn R. Heidt, *Interest Under Section 506(b) of the Bankruptcy Code: The Right, the Rate and the Relationship to Bankruptcy Policy*, 1991 UTAH L. REV. 361, 361 (1991) (noting that courts "have applied widely differing analyses and have reached widely disparate results" with regard to the appropriate rate of postpetition interest under section 506(b)).
[4] 11 U.S.C. § 502(b)(2) (2006) (prohibiting claims for unmatured interest); *see also* Dean Pawlowic, *Entitlement to Interest Under the Bankruptcy Code*, 12 BANKR. DEV. J. 149, 155 (1995) (identifying section 502(b)(2) as codifying pre-Code law).
[5] "An oversecured creditor is a secured creditor whose collateral is worth more than the amount of the debt to it." Orix Credit Alliance, Inc. v. Delta Resources, Inc. (*In re* Delta Resources, Inc.), 54 F.3d 722, 724 n.1 (11th Cir. 1995).
[6] 11 U.S.C. § 506(b) (2006).
[7] Heidt, *supra* note 3, at 363.
[8] Pawlowic, *supra* note 4, at 157.
[9] 3 COLLIER ON BANKRUPTCY, ¶ 506.02, at 506-8 (Alan N. Resnick et al. eds., 15th ed. rev. 2006) (citing H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 338-40 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 49, 53-54 (1978)).
[10] 489 U.S. 235 (1989).
[11] Daniel J. Bussel, *Textualism's Failures: A Study of Overruled Bankruptcy Decisions*, 53 VAND. L. REV. 887, 896 (2000).
[12] Bradford v. Crozier (*In re* Laymon), 958 F.2d 72, 74 (5th Cir. 1992), *cert. denied*, 506 U.S. 917 (1992).
[13] Pawlowic, *supra* note 4, at 167 (citing *In re* Laymon, 958 F.2d at 74–75; Foss v. Boardwalk Partners (*In re* Boardwalk Partners), 171 B.R. 87, 91–92 (Bankr. D. Ariz. 1994); Building Techs. Corp. v. Hannibal (*In re* Building Techs. Corp.), 167 B.R. 853, 858–59 (Bankr. S.D. Ohio 1994)).
[14] *Id.*
[15] 3 COLLIER ON BANKRUPTCY, ¶ 506.04[2][b][i], at 506-109 (Alan N. Resnick et al. eds., 15th ed. rev. 2006) ("The great majority of courts to have considered the issue since *Ron Pair* have concluded that postpetition interest should

be computed at the rate provided in the agreement, or other applicable law, under which the claim arose—the so-called 'contract rate' of interest.").
[16] Pawlowic, *supra* note 4, at 167 (citing Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 165 (1946)). *See In re* Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 360 (1994); *In re* Laymon, 958 F.2d at 74–75; *In re* Building Techs. Corp., 167 B.R. at 858–59.
[17] *In re* Johnson, 184 B.R. 570, 573 (Bankr. D. Minn. 1995) (citing *In re* Kalian, 178 B.R. 308, 316 (Bankr. D.R.I. 1995); Invex Holdings, N.V. v. Equitable Life Ins., 179 B.R. 111, 115 (N.D. Ind. 1993), *aff'd sub nom. In re* Terry Ltd. P'ship, 27 F.3d 241 (7th Cir. 1994); *In re* Hollstrom, 133 B.R. 535, 541 (Bankr. D. Colo. (1991)).
[18] 11 U.S.C. § 1123(a)(5) (2006).
[19] 685 F.2d 24 (2d Cir. 1982).
[20] *Id.* at 26–27.
[21] *In re* Johnson, 184 B.R. at 574 (citing Florida Partners Corp. v. Southeast Co. (*In re* Southeast Co.), 868 F.2d 335, 338 (9th Cir. 1989); *In re* Entz-White, 850 F.2d at 1342; *In re* Countrywood Inv. Group, Ltd., 117 B.R. 338, 339 (Bankr. M.D. Tenn. 1990); Levy v. Forest Hills Assocs. (*In re* Forest Hills Assocs.), 40 B.R. 410, 414 (Bankr. S.D.N.Y. 1984)).
[22] *Future Media*, 547 F.3d at 958.
[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.* at 959.
[29] 850 F.2d 1338 (9th Cir. 1988).
[30] *Future Media*, 547 F.3d at 959.
[31] *Id.* at 958.
[32] *Id.* at 959; 11 U.S.C. § 506(b) (2006).
[33] *Future Media*, 547 F.3d at 959–60.
[34] *Id.* at 960.
[35] *Id.* (quoting *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 444 (2007)).
[36] *Id.*
[37] *Id.*
[38] Section 363 states: "The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . . 11 U.S.C. § 363(b)(1) (2006).
[39] *Future Media*, 547 F.3d at 960.
[40] *Id.* Section 1124 provides:

> [A] class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
>
> (1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; or
>
> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default--
>
> (A) cures 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 section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured;
>
> (B) reinstates the maturity of such claim or interest as such maturity existed before such default;
>
> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;
>
> (D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and

(E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

11 U.S.C. § 1124 (2006).

[41] *See id.*

[42] *Future Media*, 547 F.3d at 960.

[43] *Id.* at 961 (discussing Casa Blanca Project Lenders, L.P. v. City Commerce Bank (*In re* Casa Blanca Project Lenders, L.P.), 196 B.R. 140 (B.A.P. 9th Cir. 1996), *abrogated by* Gen. Elec. Capital Corp. v. Future Media Prods., Inc. 547 F.3d 956 (9th Cir. 2008), and *In re* 433 South Beverly Drive, 117 B.R. 563 (Bankr. C.D. Cal. 1990), *abrogated by* Gen. Elec. Capital Corp. v. Future Media Prods., Inc. 547 F.3d 956 (9th Cir. 2008)).

[44] *Id.* at 960.

[45] *Id.* at 961.

[46] *Id.* at 961 n.3.

[47] *Id.* at 962.

[48] *Id.*

[49] *In re* Entz-White, at 1340.

[50] *In re* Entz-White, 850 F.2d at 1340 n.3 (citing 5 COLLIER ON BANKRUPTCY ¶ 1124.03, at 1124-10 (15th ed. 1988)).

[51] David Gray Carlson, Rake*'s Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization*, 13 BANKR. DEV. J. 273, 283 (1997) ("Only impaired creditors may vote in chapter 11. Unimpaired creditors are deemed to accept the plan.").

[52] *In re* Entz-White, 850 F.2d at 1340; 11 U.S.C. § 1123(a)(5)(G) (2006).

[53] *In re* Entz-White, 850 F.2d at 1341.

[54] *See, e.g.*, Hassen Imports P'ship v. KWP Financial VI (*In re* Hassen), 256 B.R. 916, 924 n.13 (B.A.P. 9th Cir. 2000).

[55] 11 U.S.C. § 1123(d) (2006).

[56] 11 U.S.C. § 1124(2)(E) (2006).

[57] Bruce H. White & William L. Medford, *Cure and Reinstatement Under 11 U.S.C. § 1124: Does the Bankruptcy Code Provide for a Default Interest Do-Over?*, 27 AM. BANKR. INST. J. 36, 83 (2008).

[58] *Future Media*, 530 F.3d 1178, 1181 n.2. Unfortunately, this opinion has been withdrawn from the bound volume.

[59] *See supra* note 47.

[60] Asset sales pursuant to a chapter 11 plan are authorized by 11 U.S.C. § 1123(a)(5)(D): "[A] plan shall provide adequate means for the plan's implementation, such as sale of all or any part of the property of the estate, either subject to or free of any lien . . . .").

[61] *In re* Casa Blanca Project Lenders, L.P., 196 B.R. at 146.

[62] White & Medford, *supra* note 57, at 36.

[63] Bussel, *supra* note 11, at 889.

[64] *Id.* at 890.

[65] 196 B.R. 140 (B.A.P. 9th Cir. 1996).

[66] *Id.* at 150 (McKeag, J., concurring).

[67] Heidt, *supra* note 3, at 361.