NYIC – Navigating Industry Trends/Insights From Women in Achievement
November 8, 2023
ArentFox Schiff LLP

<u>Supporting Materials</u>

1. Panelist Biographies

2. "Value and Risk Considerations for Intellectual Property Collateral" (American Bar Association, June/July 2022)

3. "Trends in Large Corporate Bankruptcy and Financial Distress" (Cornerstone Research - Midyear Update 2023)

4. "To Reinstate or Not to Reinstate Debt? That is the Question in a Rising Interest Rate Environment" (NY Law Journal, Sept. 27, 2023)

5. Memorandum Decision Concerning Whether Reinstatement of Accelerated Debt Under Bankruptcy Code §1124(2) Requires Payment of Default Rate Interest, *In re Golden Seahorse LLC d/b/a Holiday Inn Manhattan Financial District* (Bankr. Case. No. 22-11582-PB) (Bankr. S.D.N.Y. July 31, 2023)

6. "A Banker's Guide to the Bankruptcy Code's New Subchapter V" (Risk Management Association, August 2023)

NYIC/ArentFox Schiff –
Navigating Industry Trends/Insights from Women in Achievement
November 8, 2023 – 11:30 p.m. – 2:00 p.m.
ArentFox Schiff LLP

Speaker Biographies

Honorable Jil Mazer-Marino
United States Bankruptcy Court, Eastern District of New York

Jil Mazer-Marino is a judge of the United States Bankruptcy Court Eastern District of New York. She assumed office on October 23, 2020. Her current term ends on October 23, 2034.

Mazer-Marino earned a B.A. from the State University of New York (SUNY) at Albany and a J.D. from St. John's University School of Law.

Career: 2019-2020: Partner, Cullen and Dykman LLP, 2008-2019: Attorney, Meyer, Suozzi, English & Klein, P.C., 2003-2008: Attorney, Rosen Slome Marder LLP, and 1991-1999: Attorney, Willkie Farr & Gallagher LLP

Mazer-Marino was a law clerk to former Eastern District of New York Chief Bankruptcy Judge Conrad B. Duberstein.

Valerie Mason
Member of the firm and Co-Chair of the Lender Finance Group, Otterbourg P.C.

Valerie S. Mason is a member of the Banking and Finance department and specializes in the representation of domestic and foreign banks, commercial finance companies, and hedge funds, in the structuring and restructuring of financing transactions, including revolving credit facilities and term loans for acquisitions, refinancings, and restructurings and general working capital needs, workout arrangements, acquisition financing, lender finance transactions, and Chapter 11 debtor-in-possession and "exit" financing facilities.

Ms. Mason has represented financial institutions, in a variety of capacities, including as administrative and collateral agents, arrangers, letter of credit issuers, and members of bank syndicates in complex financing transactions for companies that are major national and international retailers, national grocery chains, steel companies, telecommunications companies, transportation companies, and manufacturers of a variety of products. Such financings often involve multiple layers of corporate debt and equity.

In addition to her firm activities, Ms. Mason serves on the Firm's Diversity Action Committee, is a member of the Women in Commercial Finance Committee of the Commercial Finance Association, the past president and a current member of the Board of Directors of the Women's

Prison Association & Home, Inc., serving as Chair of the Development Committee, and a member of the Audit Committee, and a Trustee of The Brick Presbyterian Church in the City of New York. In addition, Ms. Mason serves as a member of Manhattan Community Board 8, in New York City.

Education: B.A., Barnard College of Columbia University and J.D., Duke University School of Law

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Denise Albanese
Client Relations, Cost Reduction Solutions

Denise A. Albanese, owner of Cost Reduction Solutions, a national due diligence firm, assumes the role of business development for the company. Prior to joining the commercial finance industry, Denise led a major account team in the office equipment solutions industry for a $5.2 billion publicly held company. Denise has helped grow Cost Reduction Solutions' customer base by more than 75% in the past 10 years and helped CRS service more than 180 unique customers and commercial lenders.

Denise is active in the lending community, as the acting Chairman of SFNET's New Jersey Chapter. Denise served as SFNET's New Jersey Chapter President in 2016, as well as a committee member on the first ever "40 Under 40" recognition ceremony for the Secured Finance Network, formerly Commercial Finance Association,. Denise is a dedicated mentor for young professionals, actively encouraging networking growth, opportunities and promotions within the company and industry for the "Next-Gen/"YoPros." In 2015, Denise founded a not for profit 501C3, Paulie & Pals, which offers financial assistance to families who have children affected by autism. Denise has two children and is the proud grandmother of two granddaughters.

Elizabeth Aboulafia
Partner, Cullen and Dykman LLP, and Co-President, NYIC Women's Division

Elizabeth Aboulafia is a partner in the firm's Bankruptcy and Creditors' Rights department practicing in the areas of bankruptcy and restructuring as well as construction claims resolution and related complex commercial contract matters. She frequently advises companies in financial distress as debtors in Chapter 11 bankruptcy cases and out-of-court restructurings and workouts in a wide range of industries. In addition to company-side representations, Elizabeth has experience with all constituents in bankruptcy cases and workouts, frequently representing creditors, creditors' committees, equity holders and other key business stakeholders in debtor-creditor matters. Elizabeth approaches complex legal issues with practical-minded and business-oriented solutions.

With extensive experience in the construction industry, Elizabeth frequently assists contractors to resolve claims and other contract disputes through alternative dispute resolution proceedings and/or litigation in bankruptcy court and state court. Elizabeth has experience in a broad range of construction-related matters, including experience representing general contractors and subcontractors with regard to claims preparation, dispute resolution, contract negotiations, contract compliance, and M/WBE certification. Elizabeth often utilizes her combined knowledge of restructuring and construction to guide contractors through out-of-court workouts with sureties and banks. Her deep understanding of the financial aspects of contracting operations allows her to help contractors efficiently navigate the complex intercreditor relationships among sureties and banks.

Finally, she has particular experience providing non-consolidation, bankruptcy safe harbor and true sale legal opinions for commercial real estate and structured finance transactions.

Sheryl Giugliano
Partner, Ruskin Moscou Faltischek, P.C. and Co-President, NYIC Women's Division

Sheryl P. Giugliano is a Partner at Ruskin Moscou Faltischek, P.C., and a member of the Corporate Restructuring & Bankruptcy Practice Group and the Corporate and Securities Department. Her experience includes restructuring, bankruptcy, and litigation. Sheryl works with companies facing solvency issues to identify a solution and implement a strategic response, which includes negotiating with interested parties, creditors, and shareholders, and may also include filing for bankruptcy protection, or facilitating an out-of-court wind down.

She represents middle-market companies facing operational or litigation issues, guiding them through the Chapter 11 or Chapter 7 process to a successful reorganization or liquidation. Sheryl also represents trustees and receivers by assisting in the analysis and recovery of assets and prosecution of litigation claims, as well as secured and unsecured creditors identifying and enforcing their rights, assisting in their efforts to extend financing or consent to the use of cash collateral. In addition, Sheryl has represented contract counterparties negotiating for the highest possible cure payment or claim, defendants in preference and fraudulent conveyance actions (both in bankruptcy litigation and negotiating settlements to avoid protracted litigation), and purchasers in bankruptcy auctions.

As a member of the Corporate & Securities Department, Sheryl represents both early stage and middle market businesses on a variety of financial and other legal issues, including mergers and acquisitions, financings and other complex business transactions and agreements. Sheryl also advises clients with respect to corporate governance issues and related matters.

Sheryl's litigation experience includes representing parties in bankruptcy litigation and general commercial matters. She has represented parties engaged in contract disputes in state and federal court, as well as arbitration matters before AAA and JAMS, and mediation, successfully and efficiently represents clients to achieve the optimal outcome.

Sheryl was selected as a New York Metro "Rising Star" by Super Lawyers for 2015-2022 and received the Turnaround Management Association Long Island Chapter 2016 "Spirit Award" for Outstanding Service.

She earned her LL.M. degree in Bankruptcy from St. John's University School of Law, where she is also an adjunct professor for their ABI Writing Class. She will be teaching the Fall 2022 and Spring 2023 semesters. Sheryl has utilized her extensive experience in bankruptcy to expand her practice as a business-oriented lawyer.

Sheryl is admitted to practice law in the state of New York.

July 06, 2022 **WEBINAR FEATURE**

Value and Risk Considerations for Intellectual Property Collateral

Richard M. Assmus, Barbara M. Goodstein, and Sen "Alex" Wang

Share:

Increased technology innovation, content creation, and brand marketing have propelled the value of intellectual property (IP) in the global economy to a historical height. IP is a broad concept that encompasses a variety of intangible assets, including patents, copyrights, trademarks, trade names, domain names, know-how, and trade secrets. With IP's rising importance and value, companies are not only utilizing their IP for revenue generation in the ordinary course of business but also seeking to leverage their IP as collateral to secure funding to support business growth or, in difficult times, maintain liquidity. For example, in the summer of 2020 during the COVID-induced travel slump, United Airlines pledged its MileagePlus frequent flyer program, including important IP assets such as brands and member data, to secure a $5 billion loan.[1]

➪ Attend the corresponding webinar, "Understanding the Intricacies of Using Intellectual Property as Collateral," on July 19, 2022.

This article presents a brief overview of issues that arise in using IP as collateral, including overlapping federal and state law, the requirements for perfecting security interests in IP collateral, due diligence steps in assessing IP collateral, and considerations in drafting the applicable agreements, including a notable case illustrating how a lender's interests in IP, though perfected, may nevertheless be defeated.

Importance of IP as Collateral

There are several contributing factors to the rise of IP as collateral. First, according to a 2020 study, intangible assets, a majority of which are IP assets, are estimated to account for

90% of the total assets held by companies in the S&P 500.[2] This compares to 32% in 1985 and 68% in 1995.[3] A similar study estimates that, as of 2018, S&P 500 companies held over $21 trillion of intangible assets, compared to only about $4 trillion of tangible assets (e.g., inventory, real estate, and equipment).[4] Thus, it is only natural that both borrowers and lenders are increasingly looking at IP portfolios as a potential source of valuable collateral.

Moreover, for companies that have long-term secured credit facilities or have gone through multiple rounds of secured financings, most tangible assets have already been pledged as collateral, often leaving IP as the only remaining unpledged assets. Further, many companies are continuing to innovate and create new IP, thus increasing the size and value of their IP portfolio, which in turn raises the attractiveness to their lenders of that portfolio as collateral.

Indeed, the increasing popularity of IP as collateral is supported by public data. A review of the U.S. Patent and Trademark Office (USPTO) trademark assignment database reveals an accelerated increase in the number of security agreements recorded against unique trademarks in recent years. The data for patents is similar. In short, IP should always be considered when assessing collateral packages.

Pledged IP Assets and Governing Law

Categories of IP Assets and Relevant Statutes

IP is the subject of a number of statutes that require or provide for registration of rights or usage in respect of a variety of intangible assets. Among these are patents and patent applications, trademarks and trademark applications, copyrights and copyright applications, and trade secrets. Their respective governing federal statutes include:

- The Patent Act of 1952 (35 U.S.C. §§ 1 *et seq.*), protecting inventions in many technology areas, including pharmaceuticals, electronics, mechanical inventions, etc.
- The Lanham Act of 1946 (15 U.S.C. §§ 1051 *et seq.*), protecting trademarks and other source identifiers
- The Copyright Act of 1976 (17 U.S.C. §§ 101 *et seq.*), protecting all forms of creative expressions, including software, movies, books, and other media properties
- The Defend Trade Secrets Act of 2016 (18 U.S.C. §§ 1832 *et seq.*), which created a federal cause of action for trade secret misappropriation

Note that state law also applies in certain instances to, for example, the registration of trademarks and trade names and the protection of trade secrets (e.g., state statutes adopting the Uniform Trade Secrets Act). In addition, domain names, rights of publicity, and proprietary know-how that does not qualify as trade secrets are also regularly included in IP collateral packages, even though they are not governed directly by any federal law.

U.C.C. Article 9 and Federal Preemption

In general, secured transactions are governed by Uniform Commercial Code (U.C.C.) Article 9. However, it should be noted that the U.C.C. is a model statute that has been adopted in all 50 states (and D.C.), with each state introducing its own variations to the model version. Thus, it is important to check the specific version adopted by the state whose law will govern a specific transaction. Furthermore, U.C.C. Article 9 does not apply to the extent that it is preempted by federal statute, regulation, or treaty but defers to federal law "only when and to the extent it must."[5] This limited deference is critical to understanding the different requirements for perfecting security interests on different IP assets, as further explained below.

Creation, Perfection, and Priority of Security Interests in IP

Creation/Attachment of a Security Interest in IP

Under the U.C.C., a security interest in IP is enforceable against the debtor only if it has attached. To establish proper attachment, the following conditions must be met. First, value must be given to the debtor in exchange for the security interest. Second, the debtor must have rights in the IP pledged as collateral,[6] although its rights in the IP need not be ownership rights—licensed rights can also be pledged (subject to contractual limitations). Finally, the debtor must sign or otherwise authenticate a security agreement that reasonably identifies the collateral. This identification of collateral can be drafted broadly.[7] For example, language such as "all patents," "all copyrights," or even "all intellectual property" of the debtor could be sufficient.[8] In addition, the identification of collateral can also include after-acquired IP.[9]

Perfection of a Security Interest in IP

To obtain priority over others, including a trustee in bankruptcy, the security interest must be perfected. Perfection is the process that allows a secured creditor to potentially acquire priority in respect of pledged collateral over other parties who also have an interest in the collateral pledged by the debtor.

U.C.C. Article 9 classifies properties pledged as collateral into different categories, with IP falling within the "general intangibles" bucket.[10] As a general rule, the secured party perfects its security interest in most kinds of collateral, including general intangibles, by filing a U.C.C. financing statement (i.e., UCC-1 statement) "indicating" the collateral in the appropriate filing office in the applicable state or other jurisdiction as per Article 9.[11] This "indication" of collateral need not be specific, although if it does not cover all assets, it must, like a security agreement, "reasonably identify" the collateral.[12] Further, the filing is to be made where the debtor is "located," which for most U.S. entity debtors is the jurisdiction of formation or organization of the debtor.

However, as noted above, when IP assets are pledged as collateral, several federal statutes are potentially implicated. The critical issue becomes how the federal preemption rules affect the general method of perfection (i.e., perfecting by filing a UCC-1 financing statement) when the security interest covers IP. Although U.C.C. Article 9 contains a general rule that filing a UCC-1 financing statement is not necessary or effective to perfect a security interest in property subject to certain U.S. statutes, regulations, or treaties,[13] that preemption, at least in regard to IP, applies only to federal requirements relating to the priority of a security interest over the rights of a lien creditor, and so courts have not always found federal preemption of the U.C.C. filing requirements governing IP.

In particular, neither the Patent Act nor the Lanham Act addresses security interests. Thus, the state-specific U.C.C. Article 9 requirements apply to perfection in patents and trademarks, and security interests in those assets must be perfected by filing a UCC-1 financing statement.[14] Nevertheless, many secured parties with liens on patents and/or trademarks also record their security interests with the USPTO[15] to help put third parties on notice that a security interest exists against such assets.

Registered copyrights are situated differently. The Copyright Act, unlike the Lanham Act and the Patent Act, discusses recordation of "transfer of copyright ownership,"[16] which is a term explicitly defined to include "mortgage."[17] In the context of the Copyright Act, "mortgage" has been interpreted to be equivalent to "security interest."[18] As a result, federal copyright law preempts U.C.C. Article 9, and the secured party should perfect its security interest in *registered* copyrights by filing a document detailing the security interest with the U.S. Copyright Office.[19] Notably, a UCC-1 financing statement is still necessary to perfect a security interest in *unregistered* copyrights.[20] Nevertheless, most secured parties will also file a UCC-1 financing statement to perfect a lien in a registered copyright, the reason being, again, to better put others on notice of their security interest.

The chart summarizes the perfecting methods for different types of IP. Because debtors often pledge multiple types of IP as a collateral package, a single UCC-1 statement also commonly references all IP in the package. The *recommended practice* of perfecting a security interest in IP is to (1) file a UCC-1 financing statement with the secretary of state's office in the jurisdiction where the debtor is located, *and* (2) as applicable, record the security interest with the USPTO and/or the Copyright Office.

	FEDERAL LAW PREEMPTS U.C.C. ARTICLE 9?	FINANCING STATEMENT (UCC-1)
PATENTS	No	Must File
TRADEMARKS	No	Must File
COPYRIGHTS (REGISTERED)	Yes	Recommended
COPYRIGHTS (UNREGISTERED)	No	Must File
TRADE SECRETS	No	Must File

General Rules of Priority under U.C.C. Article 9

Under U.C.C. Article 9, the priority of secured creditors is generally based on the first-to-file-or-perfect (FTFOP) rules. In short, barring certain exceptions, the first secured party to file or perfect its rights related to the collateral will have priority over competing security interests held by other parties.[21] The following common scenarios illustrate the general operation of the FTFOP rules:

- When no party perfects, the first party to have an attached security interest has priority. Thus, an unperfected security interest in IP has priority over (1) other unperfected security interests that attach later in time and (2) any unsecured claim against the debtor.

- When more than one party has an attached security interest, but only one party perfects, the perfecting party has priority over the other creditors. Thus, a perfected security interest in IP has priority over any unperfected security interest in such assets.

- When multiple parties perfect, the first party to file or perfect has priority. Thus, a perfected security interest in IP in most cases gives the creditor a prior claim over a subsequently perfected security interest in the same assets.

Of course, like many other general rules, there are always exceptions. The primary exceptions to the above FTFOP rules are:

- Purchase money financing—i.e., financing to a debtor to enable it to purchase certain property—is favored under the U.C.C. and, subject to certain notifications by the creditor providing such financing, can give such creditor priority over an earlier perfected security interest.[22]

- Under certain circumstances, third parties acquiring collateral subject to an existing security interest, including a buyer of goods in the ordinary course of business and a "licensee in the ordinary course of business," may take the collateral free of a prior perfected security interest.[23]

Due Diligence Considerations for IP Collateral

Common Risk Factors of IP Collateral

In conducting due diligence on IP collateral, lenders want to confirm that such assets have value, are properly protected (and, where applicable, registered), are marketable, and can be monetized in the event of a default. Common risks associated with using IP as collateral include:

- IP rights can be lost for various reasons, for example: (1) issued patents and registered trademarks can be invalidated or canceled by competitors or other third parties; (2) fraud on the USPTO during the prosecution or procurement process could cause IP rights to be unenforceable or invalid; (3) the debtor could, wittingly or unwittingly, abandon the IP by failing to prosecute or failing to maintain the rights or registrations; or (4) the debtor could, intentionally or involuntarily, disclose trade secrets or other valuable proprietary information (e.g., source code) that should be kept in confidence.

- The debtor could harm the IP's value by licensing or otherwise encumbering the IP without the lender's knowledge.
- The debtor could cause leakage of assets by transferring some or all of the IP assets out of the collateral package, i.e., the so-called "J.Crew trap doors" (discussed below) or variations thereof.
- Based on recent case law, lenders' remedies after a technical default may prevent the debtor from exercising certain IP ownership rights.[24]

Specific IP Diligence Steps

In view of the risks of accepting IP as collateral, lenders should take specific steps during the diligence process to assess the value and risk profile of the IP assets. A nonexhaustive list of diligence items includes:

1. Conduct domestic and international owner-based searches (in combination with requesting written disclosure from the debtor) to determine how much registered IP is available. Such searches should be inclusive of all databases, e.g., USPTO (patents, trademarks, applications), Copyright Office, WIPO, and WhoIs (domain names).
2. Inquire as to what material nonregistered IP (e.g., trade secrets, unregistered proprietary software) is owned by the debtor and available as collateral. If there are material trade secrets or proprietary know-how, then inquire as to the debtor's policies, procedures, and nondisclosure/confidentiality agreements protecting such confidential information. If there is proprietary software, then inquire as to any source code escrow agreement or open source license that might require disclosure of the source code to third parties.
3. Inquire as to what licensed IP is held by the debtor and potentially available as collateral. Are the licenses transferrable? Are there any restrictions on the debtor's right to use or exploit such licensed IP?
4. Verify ownership and encumbrances of the identified IP assets. Who is the owner of record of each piece of the identified IP assets? Are there any chain of title issues?[25] Are there any challenges to the ownership or claims of competing or superior interest? Are any of the IP assets already subject to security interests? Are any of the IP assets subject to any license or assignment obligations?

5. Inquire as to any infringement of the IP assets by third parties or infringement of third-party IP by the debtor.

6. Verify the validity and enforceability of the identified IP assets by conducting searches for any adversarial proceedings and requesting written disclosure of any third-party threats or demands challenging validity or enforceability.

7. Determine the projected lifetime of the identified IP assets. If specific rights in a substantial portion of the IP assets are expiring soon, then the collateral package might lose significant value upon such expiration.

8. When necessary, the lender should seek expert advice for valuation of the IP assets.

It is not uncommon for the debtor to conduct a preliminary review of its IP assets following the same steps above to anticipate and proactively address any potential issues that might arise during the lender's diligence process. In addition, having a clear grasp of its own IP portfolio helps the debtor to evaluate what and how many IP assets to include in the collateral package.

Key Issues in Drafting the Finance Agreement

Generally, the lender would want to define IP broadly to be all-inclusive of registered, pending, unregistered, and future IP. For example:

- "Patents" would be defined to include (1) pending applications, issued patents, continuations, continuations-in-part, divisionals, substitutes, reissues or reexaminations, foreign equivalents, and improvements; and (2) any later-filed applications that are related or claim priority to any of the foregoing.

- "Trademarks" would encompass (1) trademark registrations, applications, service marks, unregistered marks, trade dress, logos, designs, fictitious business names, and any business identifiers; and (2) any "goodwill of the business" associated with any of the foregoing.

- "Copyrights" would cover both registered and unregistered copyrights.

- "Trade secrets" and "know-how" would include all confidential and proprietary business and/or technical information.

Further, the lender would want to address situations where the IP is challenged or deemed infringing or invalid, for example, by requiring the debtor to supply additional collateral.

Moreover, as explained further below, the lender should also evaluate the risk of J.Crew trap doors and include mitigating blockers if necessary. In addition, the lender should also include notice and consent requirements when material IP is being transferred by the debtor.

By contrast, the debtor might want to pick and choose what IP assets to include in the collateral package. For example, it might exclude certain IP that it does not wish to be encumbered with a security interest or which might create issues during the diligence process. As another example, due to the prohibition by trademark law, the debtor might exclude from the collateral any trademark applications where no evidence of use has been filed and accepted by the USPTO, as such a pledge jeopardizes the underlying applications. Finally, the debtor should also make sure that the lender's rights in respect of the IP collateral are not drafted so broadly as to interfere with the debtor's ability to use such IP in its daily operations.

IP Representations and Warranties

To the extent possible, the lender would also want to get comprehensive representations and warranties from the debtor about the IP collateral, including:

1. the debtor is the proper owner of or has valid license rights to each piece of its IP assets;
2. there is no gap in the chain of title and the debtor has received proper assignment of IP from employees or contractors;
3. there are no actual or threatened challenges to the debtor's ownership or license rights;
4. the IP assets owned by the debtor are subsisting, valid, and enforceable;
5. the debtor is in compliance with the IP licenses received from third parties;
6. the debtor has used commercially reasonable efforts to protect its confidential and proprietary information, including trade secrets and know-how;
7. the IP owned by the debtor does not and has not infringed or otherwise violated the IP of any third party, and the debtor has not received any notice of infringement from any third party;
8. the IP owned by the debtor is not and has not been infringed or otherwise violated by any third party, and there is no contemplated, threatened, or pending litigation

against any third party; and

9. any proprietary source code is not subject to any escrow agreement or disclosure requirement under any open source licenses.

Model Intellectual Property Security Agreement (MIPSA)

A useful resource for drafting security agreements when the collateral includes IP, especially for practitioners who are new to this subject, is the MIPSA.[26] The MIPSA was created by a joint task force composed of the ABA's Commercial Finance Committee and Uniform Commercial Code Committee, with the goal of bridging the gap between U.C.C. and IP lawyers by offering and, more importantly, explaining the provisions lawyers should consider in an IP security agreement. The MIPSA assumes, and is intended to work with, a separate loan agreement that will contain the more general terms relating to the secured obligations.

It should be noted that, unlike certain other model agreements promulgated by ABA groups, the MIPSA does not purport to be a fully negotiated agreement reflecting the interests of both debtor and secured party. The task force confirmed that while some model agreement provisions can be used with only minimal changes, IP assets are so varied that a one-size-fits-all approach would not work.[27] Accordingly, the MIPSA is presented as a "teaching tool," with over 80 explanatory footnotes containing suggested alternative approaches to commonly negotiated provisions. Nevertheless, the provisions of the MIPSA itself are clearly lender favorable. For example, the representations, warranties, and covenants are presented generally without qualification or limitation.

Other notable aspects of the MIPSA include:

- Simplification of the security interest creation language, avoiding phrases such as "assign, transfer, pledge, hypothecate," the concern being that at least under patent and trademark laws, assignment language suggests transfer of ownership to the lender

- Adoption of broad and comprehensive granting language intended to cover all types of IP; the granting language also includes present and future rights and interest in the various forms of IP, and further includes (and requires itemization of) foreign intellectual property but does not provide for the protection or enforcement of that lien under foreign law

- Inclusion of a "savings" clause, typical in many security agreements, in the case of IP licenses—namely, that if there exists law or a contract that prohibits the grant of a security interest in such license (what it refers to as a "restrictive provision"), then the grant will not be effective if (but only so long as) such restrictive provision is effective and enforceable

Common Pitfall: J.Crew Trap Doors

From the lender's perspective, among the most recent high-profile pitfalls involving IP collateral are the so-called "J.Crew trap doors," which were first exploited by J.Crew and generated broad market attention.

In 2017, J.Crew made headlines for its approach to refinancing certain soon-to-mature debt. Challenging business circumstances forced J.Crew to look long and hard to find value in the company to secure indebtedness when substantially all existing assets, including IP, were already pledged as collateral for over $1.5 billion in term loans. Eventually, J.Crew carried out some then novel maneuvers to transfer the vast majority of its IP (including its well-recognized trademarks) outside the existing collateral structure to an unrestricted subsidiary and then have the unrestricted subsidiary use such IP to secure newly incurred indebtedness. These steps were referred to as the "J.Crew trap doors."

To better understand the J.Crew trap doors, it is important to note the following definitions and roles:

- "Loan parties," which are the debtors in respect of the original collateral (including IP) and are subject to the restrictive covenants of the original loan agreement
- "Restricted subsidiaries," which are *not* loan parties or guarantors of the original loans but *are* subject to the restrictive covenants of the original loan agreement
- "Unrestricted subsidiaries," which are *not* loan parties or guarantors of the original loans and are *not* subject to the restrictive covenants of the original loan agreement

The loan agreement prohibited certain investments by the loan parties and their restricted subsidiaries. There were exceptions to that prohibition in the form of permitted investment baskets. Those baskets were as follows:

A. a general permitted investment basket, which allows investments made by loan parties in any party capped by the greater of $100 million or 3.25% of total assets, plus an additional amount based on earnings;

B. a basket allowing investments made by loan parties in non-loan party restricted subsidiaries capped by the greater of $150 million and 4% of total assets, plus an additional amount based on earnings; and

C. a basket allowing investments of uncapped amount by non-loan party restricted subsidiaries in unrestricted subsidiaries if financed with the proceeds from an investment made under basket B above.

The combination of using baskets B and C above is commonly referred to as a "trap door.

So how exactly did J.Crew move some of its most valuable IP out of its existing collateral package, freeing up that collateral to secure additional financing? It involved a two-step process. First, under baskets A and B above, J.Crew transferred over 70% interest in its IP assets (including trademarks) that were part of the collateral package securing its existing $1.5 billion term loan to a restricted subsidiary named J. Crew Cayman. The transferred IP was valued at $250 million, equaling the combined cap of baskets A and B. Next, taking advantage of basket C, restricted subsidiary J. Crew Cayman then transferred the IP to J. Crew Brand Holdings, LLC, an unrestricted subsidiary, which was not subject to the terms of the original term loan facility and free to incur additional indebtedness secured by such IP. Indeed, the unrestricted subsidiary went ahead to secure additional loans using the transferred IP as collateral without having to worry about the security interest held by J.Crew's $1.5 billion term loan lenders. In addition, the unrestricted subsidiary then licensed the IP back to the loan parties such that the loan parties would have to pay royalties to use the trademarks they once owned just to continue daily operations.

Since J.Crew, many other parties followed suit and successfully exploited similar provisions in their preexisting credit facilities, which prompted the lenders to devise blockers to mitigate the trap door risk in subsequent transactions. Commonly included blockers are:

- restrictions on the transfer of material or "crown jewel" IP;
- restrictions on investments in or by non-loan party restricted subsidiaries; and
- restrictions on investments in unrestricted subsidiaries.

Final Takeaways

First, IP is an important asset class for almost all companies, and for many companies it is the most critical asset. And the companies are leveraging the value of their IP beyond simple utilization in providing products or services.

Moreover, the interplay between U.C.C. Article 9 and the federal statutes makes the perfection of a security interest in IP potentially risky for the unwary.

Furthermore, comprehensive IP diligence needs to be a standard operating procedure for lenders in view of the various risk factors associated with accepting IP as collateral.

Finally, the lender should carefully consider whether the debtor has the ability to frustrate the lender by moving IP assets out of the collateral package without consent (i.e., J.Crew trap doors).

Endnotes

1. United Airlines Holdings, Inc., Current Report (Form 8-K) (June 12, 2020), https://ir.united.com/node/23771/html; *see also* Tracy Rucinski, *United Airlines Pledges Loyalty Program for $5 Billion Loan*, Reuters (June 15, 2020), https://www.reuters.com/article/us-health-coronavirus-united-arlns/united-airlines-pledges-loyalty-program-for-5-billion-loan-idUSKBN23M1PB.

2. *Intangible Asset Market Value Study*, Ocean Tomo (2020), https://www.oceantomo.com/intangible-asset-market-value-study.

3. *Id.*

4. Ponemon Inst. LLC, 2019 Intangible Assets Financial Statement Impact Comparison Report (2019), https://www.aon.com/getmedia/60fbb49a-c7a5-4027-ba98-0553b29dc89f/Ponemon-Report-V24.aspx.

5. U.C.C. § 9-109(c)(1) and cmt. 8; *see also id.* § 9-311 (covering federal preemption regarding methods of perfection).

6. *See, e.g.*, *In re* Franchise Pictures LLC, 389 B.R. 131, 143 (Bankr. C.D. Cal. 2008) ("Since [the defendant] had no interest in the collateral, the Copyright Mortgages did not and do not encumber any property of the [defendant's] Estates.").

7. U.C.C. § 9-203.

8. *Id.* § 9-108.

9. *Id.* § 9-204.

10. *Id.* § 9-102.

11. *Id.* §§ 9-310(a), -501, -502(a).

12. *Id.* § 9-504.

13. *Id.* § 9-311(a)(1).

14. *See, e.g.*, Cathay Bank v. Gryphon Mobile Elecs., LLC, No. 2:21-cv-03909-SB-JEM, 2021 U.S. Dist. LEXIS 190237, at *3–4 (C.D. Cal. June 28, 2021) ("[F]ederal law does not apply to a dispute concerning a security interest simply because the interest is in a patent." (citing *In re* Cybernetic Servs., Inc., 252 F.3d 1039, 1057–59 (9th Cir. 2001) (concluding that "'the Patent Act does not cover security interests or lien creditors at all' and that a security interest in a patent was perfected upon compliance with California filing requirements, despite lack of recording of interest with PTO"))); Trimarchi v. Together Dev. Corp., 255 B.R. 606, 612 (Bankr. D. Mass. 2000) ("[T]he Lanham Act's registration provision does not preempt U.C.C. filing requirements for the perfection of a security interest in a trademark.").

15. *See* 35 U.S.C. § 261; 15 U.S.C. § 1060.

16. 17 U.S.C. § 205.

17. *Id.* § 101.

18. *In re* World Auxiliary Power Co., 303 F.3d 1120, 1126 (9th Cir. 2002) ("The Copyright Act's use of the word 'mortgage' as one definition of a 'transfer' is properly read to include security interests under Article 9 of the Uniform Commercial Code." (footnote omitted)).

19. *See, e.g.*, *In re* Franchise Pictures LLC, 389 B.R. 131, 141–42 (Bankr. C.D. Cal. 2008) (holding that the plaintiff failed to properly perfect its security interest in registered copyrights when it did not record its judicial lien at the Copyright Office against the motion pictures (citing *World Auxiliary*, 303 F.3d at 1128 ("[T]here can be no question that, when a copyright has been registered, a security interest can be perfected only by recording a transfer in the Copyright Office."))).

20. *See, e.g.*, *World Auxiliary*, 303 F.3d at 1128–32 (holding that the appellee bank properly perfected its security interest on unregistered copyrights because (1) the Copyright Act does not preempt the California U.C.C. as to unregistered works, and (2) the bank properly filed a UCC-1 financing statement).

21. U.C.C. §§ 9-317, -322.

22. *Id.* § 9-324.

23. *Id.* §§ 9-320, -321.

24. From the debtor's perspective, a major concern with granting the lender too broad a right to the IP collateral is that it might deprive or materially interfere with the debtor's ability to use the IP in its ordinary course of business. This point is illustrated in a line of cases involving several Uniloc entities, which have a business model of acquiring patents and suing companies for infringement of those patents. To fund its extensive litigation activities, Uniloc obtained a loan from Fortress Credit Co. LLC secured by Uniloc's patents. Fortress received the right to sublicense the patents following an event of default in its "sole and absolute discretion," although it agreed not to "use" the license unless and until an event of default occurred. In 2017, Fortress's right to use the license was triggered because Uniloc failed to meet the target revenue of $20 million. In 2020, the defendants sued by Uniloc entities challenged Uniloc's standing to sue on the patents subject to the Fortress agreement, and three federal judges agreed, finding that the Uniloc entities lacked standing because they did not possess the exclusive rights to the patents in view of Fortress's broad rights triggered by the default. *See* Uniloc USA, Inc. v. Apple, Inc., No. C 18-00358 WHA, 2020 U.S. Dist. LEXIS 228257, at *19–24 (N.D. Cal. Dec. 4, 2020); Uniloc 2017 LLC v. Google LLC, 508 F. Supp. 3d 556, 572–75 (N.D. Cal. 2020); Uniloc USA, Inc. v. Motorola Mobility, LLC, No. 17-1658-CFC, 2020 U.S. Dist. LEXIS 244512, at *19–25 (D. Del. Dec. 30, 2020).

25. *See, e.g.*, Mayfair Wireless LLC v. Celico P'ship, No. 11-772-SLR-SRF, 2013 U.S. Dist. LEXIS 124206, at *28–34 (D. Del. Aug. 30, 2013) (holding that a gap in the chain of title exists when there is no written assignment between a parent and its subsidiary because "even between a parent and a subsidiary, an appropriate written assignment is necessary to transfer legal title from one to the other" (quoting Abraxis Bioscience, Inc. v. Navinta LLC, 625 F.3d 1359, 1366 (Fed. Cir. 2010))).

26. *Task Force Introductory Report and Background Considerations Model Intellectual Property Security Agreement*, A.B.A. (2016), https://www.americanbar.org/digital-asset-abstract.html/content/dam/aba/publications/business_lawyer/2016/71_3/report-mipsa-201607.pdf.

27. *Id.*

ENTITY:

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ANALYSIS

To Reinstate or Not To Reinstate Debt? That Is the Question in a Rising Interest Rate Environment

This article provides an overview of reinstatement, explores the facts that led the 'Charter' court to allow reinstatement and the 'Young Broadcasting' court to reject it and explains how the rising interest rate environment may affect Chapter 11 plan confirmations.

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Bankruptcy

By Stephen Selbst, Steven Smith and Luc Pierre-Louis | September 27, 2023 at 12:00 PM

With interest rates on the rise, and the availability of inexpensive credit diminishing, reinstatement under Bankruptcy Code §1124(2)—one of the two methods in the Bankruptcy Code to accomplish a "cram-up" Chapter 11 plan of reorganization—will again become an attractive restructuring strategy.

To formulate a reinstatement plan that will survive challenges, debtors and creditors should heed the lessons from two high-profile reinstatement cases from the Southern District of New York that were decided just months apart: *Charter Communications* and *Young Broadcasting*.

This article provides an overview of reinstatement, explores the facts that led the *Charter* court to allow reinstatement and the *Young Broadcasting* court to reject it and explains how the rising interest rate environment may affect Chapter 11 plan confirmations.

Overview of Reinstatement

In a reinstatement plan, the debtor continues using its pre-petition debt financing—maintaining the debt's maturity, interest rate, and other conditions in accordance with the pre-petition debt documents.

To reinstate prepetition debt under Bankruptcy Code §1124(2), a reorganization plan must satisfy four factors: (1) preserve the lender's legal, equitable, and contractual rights, (2) cure prepetition defaults (excluding ipso facto defaults), (3) reinstate the original obligation's maturity and terms and (4) compensate the lender for damages resulting from reasonable reliance on acceleration and actual pecuniary losses due to nonperformance of a nonmonetary obligation.

Because a loan that is reinstated is not treated as impaired, holders of claims in that class are deemed to have accepted the plan and cannot vote to reject it. The policy underlying reinstatement is that where a debtor can cure past defaults and perform under the original terms, the lender receives the benefit of its bargain. Reinstatement can thus be an effective remedy to preserve favorable pre-petition debt financing.

The Likely Resurgence of Reinstatement Cases

Reinstatement became popular after the Great Recession, when new financing to replace the cheap loans available before the recession became scarce. Until recently, interest rates had been at historically low levels since the 2009 financial crisis, reducing reliance on reinstatement as a Chapter 11 plan tool. But global inflation is now driving interest rates higher, posing challenges for financially distressed borrowers seeking refinancing.

Indeed, over the last three years, the Federal Reserve raised interest rates in several steps from 0.00-0.25% to 5.25-5.50%, the highest since early 2001. And, it has been predicted that interest rates may reach a target rate of 5.50-5.75% in September 2023. These rate increases have affected numerous industries—notably commercial real estate and commercial lending, where trillions of dollars of debt are coming due for repayment before the end of 2025, and both lenders and borrowers have been expressing concerns over the imminent maturity wall.

The rising interest rates will likely lead to more attempts to confirm reinstatement plans. As Congress noted when it enacted reinstatement, "[t]he holder of a claim or interest who under the plan is restored to his original position, when others receive less or nothing at all, is fortunate indeed and has no cause to complain." But lenders often do complain and did so in *Charter Communications* and *Young Broadcasting*.

'Charter Communications'

In 2008, commercial lending slowed down considerably. Charter Communications, the fourth-largest cable television broadcaster with approximately $22 billion in debt, spent months negotiating a consensual pre-packaged restructuring with its lenders to avoid a freefall bankruptcy.

In March 2009, Charter filed its prepackaged Chapter 11 plan in the U.S Bankruptcy Court for the Southern District of New York proposing to accomplish three objectives: (1) reinstate $11.4 billion in senior secured debt to preserve favorable pricing, (2) eliminate over $8 billion in debt and then-leader Paul Allen's equity stake, allowing him to retain a 35% voting interest to protect the company's net operating loss (NOL) tax benefits and (3) raise $1.6 billion in new equity capital through a rights offering.

After the restructuring agreement was finalized, however, a significant portion of the bank and bond debt traded to distressed buyers who objected to the prepackaged plan, seeking higher interest rates on their new debt. The case was assigned to Judge James Peck, who determined that the pre-petition negotiations had been conducted in good faith, resulting in an agreement among Charter, Paul Allen (Microsoft co-founder) and creditors that formed the basis of the plan.

Judge Peck considered two primary issues during the 19-day confirmation hearing: (1) whether defaults existed that precluded reinstatement of the senior secured debt and (2) whether the Charter/Paul Allen settlement should be approved.

Charter argued that reinstatement would leave the senior lenders unimpaired. JPMorgan, as senior agent, objected, relying on three non-monetary defaults that it argued precluded reinstatement: (1) certain holding companies were unable to pay their debts as they became due at the time when funds were borrowed under the senior lenders' credit agreement (an event of default, if true), (2) an acceleration of the debt of holding companies due to the bankruptcy filing caused a cross-acceleration default, and (3) the consummation of the plan would cause a change of control to occur.

JPMorgan admitted its goal was to obtain an increased interest rate and acknowledged that the senior secured lenders were being paid everything they were owed under the facility, including post-petition default interest.

Charter's most challenging issue was the change-of-control default. Under the senior credit agreement, the Paul Allen group was required to retain the power to vote at least 35% of the ordinary voting power for Charter's management.

The senior lenders argued that reinstatement violated the change-of-control provision because: (1) the credit agreement required Paul Allen to retain an ongoing economic interest in addition to the 35% voting interest, and (2) four of Charter's junior bondholders would hold more than 35% of the voting power, which they contended was a "group" under the federal securities laws.

The Charter/Paul Allen settlement was the cornerstone of the plan and how Charter avoided a change of control. Judge Peck determined that the settlement should be approved because: (1) it provided for reinstatement of $11.4 billion of debt at favorable interest rates, saving Charter hundreds of millions in interest expense, (2) Allen waived certain prepetition exchange rights, and his continuing 35% voting interest (stripped of economic rights) in Charter resulted in the preservation of $2.85 billion of NOLs, and (3) it provided for a $1.6 billion rights offering and the purchase of Allen's preferred units.

Judge Peck approved the reinstatement plan over the senior lenders' objections since they were being fully paid with default-rate interest. He ruled that the change-of-control covenant did not require an ongoing economic interest for Allen and the prohibition on a "group" acquiring a voting interest exceeding Paul Allen's didn't apply to bondholders due to a lack of proof that they constituted a "group" under federal securities laws. He also noted that the term "group" had different meanings in federal securities laws compared to the credit agreement.

At bottom, the *Charter* case, one of the largest and most complex prearranged bankruptcies, serves as a playbook for successful reinstatement.

‘Young Broadcasting’

Just five months after the *Charter* decision, Young Broadcasting Inc. (YBI), burdened with $338 million in secured debt and $484 million in senior subordinated notes, also filed for Chapter 11 in the Southern District of New York, and the case was assigned to Judge Arthur Gonzalez.

YBI pursued a dual-track process: (1) selling its business and (2) creating a consensual standalone plan. As the case progressed, YBI significantly improved its cash flow, leading the bankruptcy court to consider two competing reorganization plans: the YBI plan and the reinstatement plan proposed by the official committee of unsecured creditors (UCC).

The YBI plan proposed to deleverage its balance sheet by canceling senior notes and secured lenders’ claims, pay other claims in full, create a new company with lenders receiving all equity, allocate $1 million pro rata to general unsecured creditors, offer equity warrants to noteholders, and eliminate existing equity holders.

Conversely, the UCC plan sought to reinstate YBI’s $338 million senior secured debt, provide equitable treatment to all claimants and equity holders, give noteholders 10% of common stock with the opportunity for a preferred stock rights offering (up to $45 million) and 80% of common stock, and allocate an additional $45 million to cover defaults, fund payments, and ensure working capital for reorganized debtors.

Both the UCC who supported reinstatement and the lenders who opposed it relied on *Charter* as support for their respective positions. The UCC argued that reinstatement was proper because the plan complied with the credit agreement, including the provision that no change of control occur. To avoid triggering the change of control, the credit agreement required that Young and his affiliates retain more than 40% of the voting power.

The credit agreement also required that if any person or group owned more than 30% of the voting power, the Young group must own more than 30% or have the right to elect or designate a majority of the debtors’ board.

The lenders interposed three objections to the UCC plan. First, they argued that the plan did not satisfy the 40% control test—under the plan, Young had only a nominal number of votes for the election of Class A directors, and most of his votes only allowed him to vote for the one Class B director. Thus, Young could control the election of only one out of seven directors, far less than 40%.

Second, the plan violated the credit agreement by ceding control of over 30% of the voting stock to a group other than the Young group (*i.e.*, the lenders who agreed to backstop the rights offering).

Third, the default was not being cured, so the loan could not be reinstated.

Like Judge Peck in *Charter*, Judge Gonzalez began by analyzing the YBI change-of-control provisions and found that although the plain meaning required the Young group to retain the power to elect 40% of the board, Young, under the plan, retained the power to control less than 15% of the board.

By allowing Young to control a large number of votes that had no power to influence the board composition, the plan would violate the purpose of the change-of-control covenant—to prevent another group from gaining more control than the Young group. Accordingly, Judge Gonzalez denied reinstatement under the UCC plan and confirmed the YBI plan.

Reconciling 'Charter Communications' and 'Young Broadcasting'

The central issue in both *Charter* and *Young Broadcasting* was whether the plan would result in breach of change-in-control provisions. And each debtor formulated a structure to avoid a change in control by separating voting power from economic interest in the reorganized company. Why did reinstatement succeed in *Charter* but fail in *Young Broadcasting*?

Success in *Charter* hinged on two key factors: (1) robust pre-petition planning and (2) the objecting lenders' actions, which Charter leveraged to shape a favorable narrative. The *Charter* plan was carefully negotiated to establish the pre-petition framework and to avoid obvious monetary defaults. And Charter capitalized on the fact that the objecting lenders manufactured defaults to gain a seat at the table just to secure higher interest rates.

The UCC plan in *Young Broadcasting* failed for two principal reasons. First, the plan's approach to prevent a change-of-control default relied on an aggressive, overly technical interpretation of provisions, allowing lenders to claim they were not receiving the intended benefits. Second, the court found the UCC's feasibility case lacking—they had the potential to secure more capital in the rights offering, and the court observed that the cram-down requirements could have been met with sufficient evidence.

Recent Cases Have Begun To Acknowledge Such Trends

A recent case from the Southern District of New York illustrates how debtors seeking to confirm reinstatement plans continue to grapple with Bankruptcy Code roadblocks.

In *In re Golden Seahorse* (Bankr. S.D.N.Y.) (Case No. 22-11582 (PB)), Bankruptcy Judge Philip Bentley ruled that the payment of default interest is required to reinstate a defaulted loan to the extent provided by its loan document.

In this case, decided on July 31, 2023, the owner of the world's tallest Holiday Inn hotel located in downtown Manhattan filed a Chapter 11 plan proposing to reinstate its lenders' mortgage loan—approximately $137 million—and treat it as unimpaired.

The debtor proposed paying only the pre-default interest rate on the loan (5.259%)—an attractive rate in today's rising interest rate environment. Expectedly, the lenders opposed and asserted that reinstatement would require payment of the default-rate of interest (10.259%) plus various fees totally approximately $20 million.

The debtor responded that it did not have the financial ability to do so and, if required to pay such fees, would have to revise the plan, and explore the feasibility of a cram-down instead. The cram-down would leave the mortgage in place and give the lenders a restructured note paying interest at a market interest rate going forward.

Siding with the lenders, Judge Bentley—following an exhaustive analysis of the applicable statutes and scant jurisprudence on this subject—found that the Bankruptcy Code only excuses the satisfaction penalty rates and provisions triggered by nonmonetary breaches. As such, when a debtor's default arises from a monetary breach (*i.e.*, failure to pay principal and interest), the debtor must pay default interest and related fees to the extent required by its loan agreement and prevailing state law.

Further, Bentley also acknowledged that "the issue is particularly important in a rising interest rate environment such as the present, in which debtors with long-term debt at lower than current interest rates may seek to use reinstatement to lock in favorable rates on their pre-bankruptcy debt."

Golden Seahorse potentially strengthens lenders' leverage in plan negotiations by requiring that debtors carefully consider and allow for the additional costs of paying default interest and related charges in seeking reinstatement.

Conclusion

Rising interest rates and scarce affordable credit signal the return of reinstatement bankruptcy cases, as debtors and creditors seek to secure more favorable rates to reduce estate expenses. To pursue a successful reinstatement strategy, they should heed the lessons learned from *Charter*'s successful reinstatement and *Young Broadcasting*'s failure and how courts today, in a rising interest rate environment, evaluate reinstatement plans.

While case outcomes depend on specifics, they underscore the value of strategic planning and how lender behavior can sway court decisions on reinstatement approval. Given predictions that interest rates may continue to rise, the question of whether to reinstate or to not reinstate will likely persist for the foreseeable future.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK
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In re:

FOR PUBLICATION

Chapter 11

Golden Seahorse LLC,
d/b/a Holiday Inn Manhattan Financial District,

Case No. 22-11582 (PB)

Debtor. x

MEMORANDUM DECISION CONCERNING WHETHER REINSTATEMENT OF ACCELERATED DEBT UNDER BANKRUPTCY CODE
<u>§ 1124(2) REQUIRES PAYMENT OF DEFAULT RATE INTEREST</u>

<u>A P P E A R A N C E S</u> :

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Hon. Philip Bentley
U.S. Bankruptcy Judge

Introduction

The Debtor owns and operates a hotel in downtown Manhattan, which is subject to a 10-year mortgage at a fixed interest rate of about 5%. In May 2020, the Debtor defaulted on its mortgage by failing to make the required monthly payments, and its lenders subsequently accelerated the loan and began to charge interest at the contractual default rate (an additional 5%). The Debtor has now filed a chapter 11 plan that would reinstate the loan and treat it as unimpaired under § 1124(2). Before scheduling a vote or other proceedings on confirmation of that plan, the Debtor and its lenders have asked the Court to rule on a threshold issue: whether the Debtor is required to pay default-rate interest and fees, totaling about $20 million, as a condition of reinstatement.

This issue—whether reinstatement of defaulted and accelerated debt requires payment of default-rate interest and fees—has divided courts across the country for decades. The issue is particularly important in a rising interest rate environment such as the present, in which debtors with long-term debt at lower than current interest rates may seek to use reinstatement to lock in the favorable rates on their pre-bankruptcy debt. Yet the case law on this issue leaves much to be desired. No court has conducted a comprehensive analysis of the three interrelated Bankruptcy Code provisions—§§1123(d), 1124(2)(A) and 365(b)(2)(D)—that bear directly on the issue. Most surprisingly, only a handful of decisions have even mentioned all three of these provisions.[1]

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[1] The incompleteness of the courts' analyses was noted several years ago by Judge Robert Drain, who in comments from the bench in the Frontier Communications bankruptcy expressed surprise at the underdeveloped state of the case

The Court has attempted to fill this gap in the case law by undertaking a careful analysis of the three relevant provisions, using the standard interpretive tools: examination of the text of each provision, supplemented by consideration of context, canons, and legislative history. The analysis is not simple. For starters, the text of the three provisions leaves many questions unanswered. Compounding the problem, the statutory and historical context complicates, rather than clarifies, the picture. These provisions, in their current form, were not part of the Bankruptcy Code when it was enacted in 1978. Instead, each provision was added or amended by one or both of the omnibus bankruptcy reform statutes that Congress passed in 1994 and 2005, and the congressional purposes underlying these amendments are not always discernable. As Professor Ralph Brubaker observed in connection with his extensive review of these issues, "[g]iven the immense complexity (intensified by perplexing ambiguity) of the Code provisions at issue, as well as the large dollar amounts that can be at stake, we may not have heard the last of" these issues. 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* ("*Default Rates of Interest, Part II*"), 37 BANKR. L. LETTER No. 1 (2017), at 2 [https://perma.cc/4CBK-4268].

A proper analysis requires the Court to answer three questions:

1. To determine the amount required to cure defaults and de-accelerate debt, should the Court apply § 1123(d)'s plain terms, which require payment of all cure amounts required by the parties' agreement and permitted by non-bankruptcy law? Or should the Court instead limit the

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law and urged counsel to undertake a comprehensive review of the relevant Bankruptcy Code sections. *In re Frontier Communications*, Case No. 20-22476, tr. of June 29, 2020 hearing at 78-79. However, because Frontier Communications and its lender subsequently settled, these issues were not brought back to Judge Drain for further consideration.

scope of that section, such as by recognizing an exception for any cure amounts excused by virtue of § 1124(2)'s incorporation of § 365(b)(2)(D)?

2. Should the Court read § 365(b)(2)(D)'s cure carve-out, as incorporated by § 1124(2)(A), to apply to loan agreements, or instead to executory contracts and unexpired leases?

3. What scope should the Court give to § 365(b)(2)(D)'s cure carve-out? In particular, should it apply that carve-out to all "penalty rates," or only to penalty rates triggered by non-monetary defaults?[2]

For the reasons explained below, the Court rules for the Debtor on the first and second of these questions but against it on the third question. Specifically, based on a close review of the governing statutory provisions, the Court concludes that (i) §§ 1124(2) and 365(b)(2)(D) create an exception to § 1123(d)'s otherwise absolute mandate; (ii) § 365(b)(2)(D)'s cure carve-out, as incorporated by § 1124(2)(A), applies to loan agreements; but (iii) § 365(b)(2)(D)'s cure carve-out extends only to penalty rates triggered by non-monetary defaults. Consequently, when the debtor's default arises from its failure to perform monetary obligations, as it does here, the debtor

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[2] The Debtor's lenders raise a fourth issue as well: They argue that not all default rates are "penalty rates," and that the default rate required by their loan agreement should not be deemed a penalty rate. This contention may have merit. As the Second Circuit has observed, a default rate is not always "a penalty, nor should it be considered unconscionable." *Ruskin v. Griffiths*, 269 F.2d 827, 832 (2d Cir.1959) (a default rate "can be beneficial to a debtor in that it may enable him to obtain money at a lower rate of interest than he could otherwise obtain it, for if a creditor had to anticipate a possible loss in the value of the loan due to his debtor's bankruptcy or reorganization, he would need to exact a higher uniform interest rate for the full life of the loan"); *see also In re Phoenix Bus. Park Ltd. P'ship*, 257 B.R. 517, 521 (Bankr. D. Ariz. 2001) (holding that not all default rates are "penalty rates"); *In re Sweet*, 369 B.R. 644, 650 (Bankr. Colo. 2007) (same). On the other hand, there is evidence in the legislative history suggesting that Congress may have intended to equate the terms "default rate" and "penalty rate." *See* H.R. Rep. No. 103-835, at 50 (1994) ("[S]ection 365(b) is clarified to provide that when sought by a debtor, a lease can be cured at a nondefault rate (i.e., it would not need to pay penalty rates)."). Given the Court's resolution of the issues noted above, the Court need not and does not reach this additional issue.

must pay default interest to the extent provided by its agreement and permitted by non-bankruptcy law in order to reinstate its defaulted debt under § 1124(2).[3]

Factual Background

The relevant facts are simple and not disputed.

The Debtor owns and operates a full-service hotel located at 99 Washington Street in downtown Manhattan. The hotel operates under the Holiday Inn flag and, at 50 stories tall, is billed as the tallest Holiday Inn in the world. The Debtor constructed the hotel between 2010 and 2014, and it opened for business in October 2014.

In September 2018, the Debtor refinanced its existing indebtedness by obtaining a loan in the approximate principal amount of $137 million. The loan has a non-amortizing 10-year term and bears interest at the rate of 5.259%. As security for the loan, the Debtor executed and delivered a first-lien mortgage on the property. Shortly thereafter, the loan was split into four separate tranches, which were assigned to two new lenders (together, the "Lenders").

The Debtor was current on all payments under the loan until May 2020, when it failed to make the interest payment due that month following the hotel's closure at the outset of the Covid-19 pandemic. The Lenders subsequently exercised the rights afforded them by the loan documents upon default, including accelerating the loan and charging the Debtor default interest at 5% above the non-default interest rate. The Lenders also sought and obtained the appointment of a receiver

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[3] To aid the reader in parsing the three operative statutory provisions, the Court has prepared an Appendix, annexed to this decision, which reproduces the relevant language of §§ 365(b), 1123 and 1124(2)(A) and shows the changes made to each of these provisions by the 1994 and 2005 amendments.

in state court.

Before the receiver could take possession of the hotel, the Debtor commenced this chapter 11 case on November 29, 2022. The Debtor has continued to operate its business and manage the hotel as a debtor in possession. The Lenders have filed proofs of claim totaling approximately $179 million (exclusive of legal fees) as of the petition date.

The Debtor has filed a plan of reorganization that would reinstate the loan and treat it as unimpaired under § 1124(2). This would allow the Debtor, following its emergence from bankruptcy, to continue to pay interest under the reinstated loan at the non-default rate of 5.259%, which is significantly below current market rates of interest. To reinstate the loan, the Debtor proposes to pay all the outstanding amounts it owes other than those triggered by its default. By the Debtor's estimates, the default amounts that it proposes *not* to pay total approximately $20 million, consisting of $17.8 million of default-rate interest, a $1 million liquidation fee, and late charges and a special servicing fee totaling about $500,000 and $660,000, respectively.

The Debtor has said that, if the Court concludes that reinstatement of the loan would require the Debtor to pay default-rate interest and related fees, it may not have the financial ability to pay these arrearages. In that event, its plan of reorganization provides for an alternate treatment of the loan: instead of reinstating the loan under § 1124(2), the Debtor would "cram down" the loan under § 1129(b) by leaving the mortgage in place and giving the Lenders a restructured note paying interest at a market interest rate going forward.

The Debtor and the Lenders have informed the Court that they believe an up-front ruling on the default interest issue, prior to voting on the Debtor's plan of reorganization or briefing of other confirmation issues, will facilitate the efficient administration of this case, as it will enable the Debtor to file an amended plan consistent with the Court's ruling. The Court agrees that this approach promotes efficiency. Consequently, the parties have briefed the default interest issue — whether to cure and reinstate the loan under §§ 1123 and 1124, the Debtor is required to pay default interest and fees to the extent required by its loan agreement and New York law—and the Court heard oral argument on this issue on July 6, 2023.[4]

Statutory Background

Cure and reinstatement of defaulted debt, along with the related concepts of cure and assumption of defaulted executory contracts and unexpired leases, have been integral to chapter 11 reorganizations since the enactment of the Bankruptcy Code. When it is beneficial for a chapter 11 debtor to keep in place a loan on which it has defaulted, such as a long-term loan bearing interest below current market rates, the Code permits the debtor to reinstate that loan under its plan of reorganization. Even if the lender has already accelerated the loan, the debtor may "de-accelerate" it—that is, reinstate the loan's original maturity and other terms—so long as the plan cures defaults, compensates the lender for certain losses, and does not otherwise alter the lender's legal rights. *See* 11 U.S.C. § 1124(2); *see also id.* § 1123(a)(5)(G) (plan of reorganization may provide for the curing of any default).

Similarly, the ability of a debtor to preserve its valuable defaulted contracts and leases by curing existing defaults and providing adequate assurance of its future performance has been a

[4] The Debtor reserves the right to argue that, as a matter of New York law, it does not owe default interest or fees because the doctrines of impossibility and frustration of purpose excused its performance following the onset of the Covid-19 pandemic. The Debtor also reserves the right to challenge the specific amounts of default interest and fees owed.

core feature of chapter 11 since its inception. To the extent a debtor has ongoing contracts and leases (referred to in the Code as "executory contracts" and "unexpired leases") that it wishes to keep in place going forward, the Code permits the debtor to assume those contracts and leases, so long as it cures defaults, compensates the counterparty for losses caused by its defaults, and provides adequate assurance that it will continue to meet its contractual obligations going forward. *See* 11 U.S.C. § 365(b)(1).

Certain types of defaults have always been carved out of the cure requirements for both reinstatement and assumption—namely breaches of so-called *ipso facto* clauses, which provide that a bankruptcy filing, or a related development such as insolvency or the appointment of a trustee, by itself ("*ipso facto*") terminates the parties' agreement. Defaults of these sorts, by their nature, are impossible for a debtor in bankruptcy to cure, since it cannot rewind the clock. Consequently, unless these defaults were excused, parties could use *ipso facto* clauses to "bankruptcy-proof" their agreements—that is, to ensure against their reinstatement or assumption. The Bankruptcy Code therefore has always excused cure of these defaults – both in § 365(b)(2), which exempts *ipso facto* clauses from the cure requirements for assumption of contracts and leases, and in § 1124(2), which exempts "default[s] of a kind specified in 365(b)(2)" from the cure requirements for de-acceleration of defaulted debt. *See* 11 U.S.C. §§ 365(b)(2)(A)-(C), 1124(2)(A); *see generally* 3 COLLIER ON BANKRUPTCY ¶ 365.06 (16th ed. 2018) ("The bars to the enforcement of *ipso facto* clauses in subsections 365(b)(2) and (e) are intended to prevent a party to a contract from opting out of bankruptcy through the use of such clauses."); 7 COLLIER ON BANKRUPTCY at ¶ 1124.04.

The Bankruptcy Code's scheme for addressing the cure requirements for reinstatement and assumption was straightforward until 1994, when the passage of the Bankruptcy Reform Act threw a wrench into the works. That Act—a sprawling set of largely unrelated amendments to a host of Bankruptcy Code sections[5]—amended both§ 365(b) and§ 1123 in ways that have confounded courts ever since.

First, the 1994 Reform Act added a new subsection (D) to§ 365(b)(2), supplementing the existing cure carve-outs for *ipso facto* provisions contained in subsections (A) through (C). With this amendment, § 365(b)(2) now read in its entirety as follows:

> (2) Paragraph (1) of this subsection [requiring cure, compensation and adequate assurance with respect to any defaults] does not apply to a default that is a breach of a provision relating to--
>
> > (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> >
> > (B) the commencement of a case under this title;
> >
> > (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or
> >
> > (D) the satisfaction of any penalty rate or provision *relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease*.

11 U.S.C. § 365(b)(2) (emphasis added).

As discussed further in Point II.C below, the wording of the new subsection 365(b)(2)(D) is ambiguous and has generated conflicting case law and commentary as to its meaning. At bottom,

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[5] According to Congressional Quarterly Almanac, the Act "read more like a disjointed series of revisions than an overhaul with a distinct legislative mission. 'Generally the bill does not have a theme,' said Samuel Gerdano, executive director of the American Bankruptcy Institute, which supported the legislation. 'It's virtually an in-box stapled together, with some provisions that favor debtors and some which favor creditors.'" *Congress Revises Bankruptcy Code*, *in* CQ ALMANAC 1994, at 175-77 (50th ed., 1995), *available at* http://library.cqpress.com/cqalmanac/cqal94-1103120 [https://perma.cc/75CR-JK87].

the debate is over whether the "relating to" clause of this subsection (italicized above) modified only the word "provision" or, instead, modified the words "penalty rate" as well. Courts and commentators adopting the latter reading construed the new subsection to create a single exception to the cure requirements of subsection 365(b)(1)—namely, an exception for a failure to pay a penalty rate or a penalty provision arising from a nonmonetary default.[6] Other courts and commentators adopted the former reading and interpreted the new subsection to create two distinct exceptions—one for failure to pay a penalty rate arising from contractual breaches of *any* sort, including payment defaults, and a second exception covering any breaches of nonmonetary obligations.[7]

Second, for reasons unrelated to the amendment of § 365, the 1994 Reform Act also amended § 1123, the Bankruptcy Code section addressing the provisions required or permitted to

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[6] CHARLES J. TABB, LAW OF BANKRUPTCY 844 (5th ed. 2020) ("If the default arose from the debtor's failure to perform nonmonetary obligations, the trustee will not have to satisfy 'penalty' rates or penalty provisions in order to assume."); Grant T. Stein & Ralph S. Wheatly, *The Impact of Cure and Reinstatement on Default Interest*, 16 AM. BANKR. INST. J. 1 (Jul./Aug.1997) ("Section 365(b)(2)(D) is now clear that part of cure under § 1124(2) requires the payment of default interest associated with monetary defaults."); *In re Shangra-La, Inc.*, 167 F.3d 843, 848, fn. 3 (4th Cir. 1999) ("Recent amendments also provide that the landlord may not charge the debtor the default rate of interest under the contract or lease when the default with which the debtor is charged is nonmonetary in nature.") (citing 11 U.S.C.A. § 365(b)(2)(D)); *1 Ashbury Court Partners, L.L.C.*, 2011 WL 4712010 at *4 (Bankr. D. Kan. 2011) ("[B]oth the 'penalty rate' and the 'penalty provision' language refer to and modify the words beginning with 'relating to,' meaning that only penalty rates that punish non-monetary default need not be cured.").

[7] *See* Brubaker, *Default Rates of Interest, Part II*, at 7 (§ 365(b)(2)(D) "was arguably enacted to *codify Entz-White*") (emphasis in original); Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR.L.J. 551, 558 (Fall 1995) (the amendments appear to "codify applicable Ninth Circuit precedent that construed the Code as not requiring a default or penalty rate to be paid"); *Claremont*, 113 F.3d at 1034 (reading 365(b)(2)(D) to excuse from cure "penalty rates which are commonly imposed where a debtor's breach was monetary in nature" and "penalties under liquidated damages provisions where the debtor's breach was nonmonetary in nature."); *In re Zamani*, 390 B.R. 680, 686 (Bankr. N.D. Cal. 2008) (following *Claremont* and holding that penalty rates need not be paid as part of cure); *Phoenix*, 257 B.R. at 521 (similarly following *Claremont*); *Matter of GP Exp. Airlines, Inc.*, 200 B.R. 222, 233–34 (Bankr. D. Neb. 1996) (holding that the "relating to" clause applied only to "penalty provision" because "[b]y definition, there is no interest accrual on a nonmonetary obligation.").

be included in a plan of reorganization. This amendment added a new subsection 1123(d), which provided:

> 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.

11 U.S.C. § 1123(d). According to the House Report for the bill that became the 1994 Reform Act, Congress added this subsection for the specific purpose of overruling a Supreme Court decision of the year before, *Rake v. Wade*, 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424 (1993). That decision held that a Chapter 13 debtor who proposed to cure a default was required to pay interest on arrears to a secured creditor even if the underlying loan agreement did not provide for such interest. *Id.* at 465–66. The House Report characterized *Rake* as providing a windfall to oversecured creditors, which the amendment eliminated by limiting secured creditors' rights to those provided by their contracts and permitted by state law. *See* H.R. Rep. No. 103-835, at 55; *see also* S. Rep. No. 103-168, at 53 (1993) (discussing parallel provision in Senate bill).

This amendment, too, has generated significant debate. By its plain terms, § 1123(d) requires the debtor to pay all contractually required amounts, including default-rate interest and fees, in order to cure defaults and reinstate debt under a plan.[8] However, as discussed further in Point II.A below, that directive conflicts with § 1124(2)(A)'s incorporation of § 365(b)(2)(D)'s

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[8] *See*, e.g., *In re New Invs., Inc.*, 840 F.3d 1137, 1140 (9th Cir. 2016) ("The plain language of § 1123(d) 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."); *In re Sagamore Partners, Ltd.*, 620 F. App'x 864, 869 (11th Cir. 2015) (the "'straightforward statutory command' in § 1123(d) . . . 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.'"); *In re Depietto*, No. 20-CV-8043 (KMK), 2021 WL 3287416 at *6-7 (S.D.N.Y. Aug. 2, 2021) (quoting *New Investments*); *In re Moshe*, 567 B.R. 438, 444-46 (Bankr. E.D.N.Y. 2017) (same).

cure carve-outs. To conform § 1123(d) to Congress's supposedly "pro-debtor" intent in enacting it or to harmonize this section with § 1124(2)(A), a few courts have construed § 1123(d) narrowly so as not to require payment of default interest.[9]

Congress added yet another set of complications to the Bankruptcy Code's cure requirements in 2005, when it enacted another omnibus bankruptcy reform statute, the Bankruptcy Abuse Protection and Consumer Protection Act ("BAPCPA"). While this act was aimed principally at perceived abuses in consumer bankruptcies, it also contained a grab-bag of amendments to the Bankruptcy Code's business bankruptcy provisions. As with the 1994 Reform Act, these business bankruptcy amendments were not linked by much of an overarching theme. *See generally* Tracy Whitaker, *Congressional Changes to Business Bankruptcy*, 54 UNITED STATES ATTORNEYS' BULLETIN, No. 4 (July 2006), at 27-28.

Three of BAPCPA's business bankruptcy amendments—to §§ 365(b)(1), 365(b)(2) and 1124(2)—address the Code's cure requirements. The apparent catalyst for these three interrelated amendments was a circuit court split over an issue *not* before this Court: whether § 365(b)(2)(D) carved out from § 365(b)(1)'s cure requirements only penalties triggered by nonmonetary defaults, or also the nonmonetary defaults themselves. In 1997, the Ninth Circuit had adopted the former of these readings, holding that § 365 required cure of nonmonetary defaults, even though many

[9] *See Zamani*, 390 B.R. at 687 ("[T]he legislative intent behind the enactment of § 1123(d) was a pro-debtor intent to preclude creditors from demanding payment of interest on interest to cure a loan default; it was not enacted to promote or endorse the imposition of default interest rates."); *Phoenix*, 257 B.R. at 521 ("[T]he incorporation of new section 365(b)(2)(D), as interpreted by the Ninth Circuit, into section 1124(2)(A) squarely suggests a congressional intent directly contrary to the Trust's interpretation of section 1123(d), a section added at exactly the same time."); *see also* 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* ("*Default Rates of Interest, Part I*"), 36 BANKR. L. LETTER No. 12 (2016), at 7 (arguing that § 1123(d), by its terms, does not require payment of default interest).

nonmonetary defaults are by their nature incapable of cure. *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029 (9th Cir. 1997). The First Circuit subsequently adopted a contrary reading, holding that § 365(b)(2)(D) excuses cure of all nonmonetary defaults. *In re BankVest Cap. Corp.*, 360 F.3d 291, 298 (1st Cir. 2004).

Congress responded by adopting a "split the baby" resolution: it added provisions applicable to unexpired real estate leases—but not to executory contracts or unexpired personal property leases—exempting incurable nonmonetary defaults, as well as related penalty rates and provisions, from § 365(b)(1)'s cure requirements.[10] To implement this somewhat curious resolution, BAPCA amended §§ 365(b)(1), 365(b)(2) and 1124(2):

- To § 365(b)(1)(A), Congress added language that, while far from a model of clarity, has generally been read to exempt incurable nonmonetary defaults under real property leases from the cure requirements. *See* 3 COLLIER ON BANKRUPTCY ¶ 365.06[3][c].
- To § 365(b)(2)(D), Congress added the word "penalty" before "provision," so that the subsection now reads: "the satisfaction of any penalty rate or **penalty** provision . . . ." (emphasis added). This revision clarified that the carve-out created by subsection (D) did not extend to nonmonetary defaults (which were now addressed in 365(b)(1)(A)), but only to penalty rates and penalty provisions triggered by such defaults.[11]

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[10] The legislative history sheds no light on why Congress chose to provide a solution to the problem of incurable nonmonetary defaults for real estate leases but not for executory contracts or personal property leases.

[11] As the Collier treatise observes, these two amendments to § 365 together had the effect of overruling the substance of the Ninth Circuit's *Claremont* holding, while at the same time ratifying *Claremont*'s semantic analysis of the pre-2005 statutory language. 3 COLLIER ON BANKRUPTCY ¶ 365.06[3][c]; *see also In re Empire Equities Cap. Corp.*, 405 B.R. 687, 690-91 (Bankr. S.D.N.Y. 2009) (same).

- In § 1124(2)(A), Congress clarified the clause that incorporates § 365(b)(2)'s cure carve-outs, expanding it to read: "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**." (emphasis added on amended language).

Not surprisingly, because these 2005 amendments were crafted as responses to the circuit court split over the scope of § 365(b)(2)(D)'s carve-out for *nonmonetary* defaults, they did not resolve the separate controversy now before the Court: whether that section excuses cure of penalty rates for *monetary* defaults.

Discussion

I. The Case Law

Before turning to an analysis of the relevant statutory provisions, the Court briefly reviews the case law, beginning with the Second Circuit's seminal – but now outdated – ruling on the issue of cure. The Court concludes that the case law, both within this circuit and elsewhere, provides little help in resolving the difficult statutory construction issues facing the Court. While many courts have touched on one aspect or another of the various statutory provisions, none has conducted the sort of rigorous and comprehensive review of the three interrelated Bankruptcy Code sections that is needed.

A. The Second Circuit's *Taddeo* Decision

The Debtor contends that the default interest issue before the Court is controlled by the Second Circuit's decision in *DiPierro v. Taddeo (In re Taddeo)*, 685 F.2d 24 (2d Cir. 1982). The Court does not agree. Although the court in *Taddeo* enunciated principles that arguably could be read to support the reinstatement of debt under a Chapter 11 plan without payment of default-rate interest, *Taddeo* pre-dated the 1994 Reform Act, and any application it might otherwise have to this case has been legislatively overruled by that Act.

Taddeo was a chapter 13 case, in which the Second Circuit (in an opinion by Judge Lumbard, joined by Judges Friendly and Newman) held that § 1332(b), by permitting a chapter 13 plan to "provide for the curing of any default," by implication authorized such a plan to "de-accelerate" and reinstate defaulted and accelerated debt. *Id.* at 26. The court reasoned:

> [T]he power to cure must comprehend the power to 'de-accelerate.' This follows from the concept of 'curing a default.' . . . 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.

685 F.2d at 26-27. The court added, "'curing a default' in Chapter 11 means the same thing as it does in Chapters 7 or 13: the event of default is remedied and the consequences are nullified." *Id.* at 29; *see also id.* ("'The holder of a claim or interest who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain.'") (quoting S. Rep. No. 95-989, at 120 (1978)).

The Debtor contends that *Taddeo*'s reasoning—that cure "return[s the parties] to pre-default conditions" and "nullifies" the consequences of default, 685 F.2d at 27, 29—compels the conclusion that cure does not require the payment of default interest. This might be true had Congress not subsequently enacted the 1994 and 2005 amendments to the Bankruptcy Code provisions bearing on this issue.[12] But those later amendments materially changed the governing

[12] Or maybe not. As Professor Brubaker has pointed out, the conclusion that cure returns the parties to the pre-default status quo does not answer the question of whether cure is retroactive or merely prospective with respect to the applicable interest rate—that is, whether cure requires payment of interest at the default rate, instead of the non-default

statutory provisions. Most obviously, § 1123(d) mandates the payment of default interest to the extent required by the parties' contract and permitted by non-bankruptcy law. The Second Circuit in *Taddeo* not only did not address default interest (which was not at issue); it did not address, and could not have addressed, how to construe § 1123(d) or how to harmonize that section with the conflicting provisions of §§ 1124(2) and 365(b)(2)(D).

B. Lower Court Decisions in the Second Circuit

Since the enactment of the 1994 amendments, there have been few decisions of note within the Second Circuit. Several decisions by lower courts in this circuit have held that, under §§ 1123 and 1124, reinstatement of debt requires payment of default interest to the extent provided by the parties' agreement and permitted by state law – but curiously, none of these decisions makes any mention of § 1124(2)'s incorporation of the cure carve-out created by § 365(b)(2). *See In re Depietto*, No. 20-CV-8043 (KMK), 2021 WL 3287416 at *6-8 (S.D.N.Y. Aug. 2, 2021); *In re 139-141 Owners Corp.*, 306 B.R. 763 (Bankr. S.D.N.Y. 2004), *aff'd in part and vacated in part*, 313 B.R. 364, 368 (S.D.N.Y. 2004); *In re Moshe*, 567 B.R. 438, 443-47 (Bankr. E.D.N.Y. 2017).[13]

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rate, during the period between default and cure. *See* Brubaker, *Default Rates of Interest, Part I*, at 7-8. *Taddeo* did not involve default interest, and the Second Circuit therefore had no occasion to address this issue.

In any event, Congress subsequently addressed this issue, and supplied an answer to it, in its 2005 amendment of § 1124(2)(A). As noted above, that amendment clarified that the debtor must cure all defaults "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.*" (emphasis added on amended language). As discussed in Point II.B below, the reference to defaults "of a kind that section 365(b)(2) expressly does not require to be cured" can only be a reference to the "penalty rates and penalty provisions" carved out from the cure requirements by § 365(b)(2)(D). It follows that a debtor's failure to pay penalty-rate interest is itself a default that must be cured (except to the extent it is excused from cure by § 365(b)(2)) *before* a defaulted loan can be reinstated.

[13] A review of the briefs filed in these cases suggests that this oversight was due to the fact that counsel in these cases failed to alert the court to § 1124(2)(A)'s incorporation of § 365(b)(2)(D)'s cure carve-outs.

In another case, *In re General Growth Properties, Inc.,* 451 B.R. 323, 327 (Bankr. S.D.N.Y. 2011), the court noted the conflict between §§ 1123(d) and 1124(2) but declined to resolve it. Instead, the court held that, because the debtor in that case was solvent, the secured creditor was entitled to payment of default interest under the so-called solvent debtor exception—an equitable doctrine entitling creditors to post-petition interest, including default interest, in those rare bankruptcy cases where the debtor is able to pay its debts in full. *Id.* at 327-28.[14]

C. Case Law in Other Circuits

The case law outside the Second Circuit also provides only limited assistance in resolving the default-rate interest issue. Prior to the 1994 amendments, the leading case on the default interest issue was *Great Western Bank and Trust v. Entz-White Lumber and Supply, Inc. (In re Entz-White Lumber and Supply, Inc.)*, 850 F.2d 1338 (9th Cir. 1988) ("*Entz-White").* Relying on *Taddeo*, the Ninth Circuit held that the payment of default-rate interest is not required to cure and reinstate defaulted debt under a Chapter 11 plan because cure effectively nullifies all aspects of the default and returns the parties to the *status quo ante*. *Id.* at 1342 ("[T]he 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.").

Since the passage of the 1994 amendments, most courts have held that § 1123(d) compels the opposite conclusion: that cure must include payment of any default-rate interest, to the extent

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[14] In a footnote in *In re LATAM Airlines Grp. S.A.*, 55 F.4th 377, 386, fn. 5 (2d Cir. 2022), the Second Circuit cited *DePietto*, *Moshe* and *General Growth* as examples of cases within the circuit that have applied § 1123(d) to require a debtor to pay post-petition interest to reinstate defaulted debt under § 1124(2). However, this was a mere passing reference, in a case that involved issues of post-petition interest, not default interest. The Second Circuit's *LATAM* decision contains no other discussion of default interest.

required by the parties' agreement and permitted by nonbankruptcy law. The leading case is the Ninth Circuit's decision in *In re New Investments, Inc*, 840 F.3d 1137 (9th Cir. 2016), which held that Congress' enactment of § 1123(d) had legislatively overruled *Entz-White*. *Id.* at 1141. Curiously, though, the *New Investments* decision makes no mention at all of either § 1124(2)(A) or § 365(b)(2)(D), an omission that appears to be due to the parties' failure to address the effect of those two subsections in their briefs.[15] *See* Brubaker, *Default Rates of Interest, Part II*, at 8.

Notwithstanding *New Investments*, a few lower court decisions outside the Second Circuit have addressed the interrelationship among §§ 1123(d), 1124(2) and 365(b)(2), and these courts have reached varying conclusions. For example:

- In one leading case, *In re Phoenix Bus. Park*, an Arizona bankruptcy court held that § 1123(d) must be read together with §§ 1124(2) and 365(b)(2), and that the only way to harmonize those provisions is to read the latter two sections to create an exception to the former. 257 B.R. at 521. The court further held that § 365(b)(2)(D) excused payment of default interest for monetary, as well as nonmonetary, defaults. *Id.*
- Another leading case, *In re Moody Nat. SHS Houston H, LLC*, reached the opposite conclusion, holding that the debtor must pay default interest to the extent required by contract and permitted by state law. 426 B.R. 667, 672-73 (Bankr. S.D. Tex. 2010). The court found that § 1123(d)'s plain terms require payment of all such amounts, and that §

[15] As Professor Brubaker has noted, the *New Investments* panel instructed counsel to "be prepared at oral argument to discuss the opinions in [*Phoenix* and *Moody*], particularly as they relate to the relationship between 11 U.S.C. §§ 1123(a)(5)(G), 1123(d), 1124(2)(A), and 365(b)(2)(D)." However, "in deciding the case, the panel obviously decided not to go beyond the issues and arguments briefed by the parties . . . as was their prerogative." Brubaker, *Default Rates of Interest, Part II*, at 8.

1124(2) is not to the contrary because § 365(b)(2)'s carve-out applies only to executory contracts and unexpired leases, not to loans. *Id.* at 673-75.

- Another court, with little analysis, held that § 1124(2) creates an exception to § 1123(d)'s mandate, but only for payment of default interest associated with nonmonetary defaults. *Ashbury Court Partners*, 2011 WL 4712010 at *4 (stating, without elaboration or any supporting citations, that "the majority view considers that both the 'penalty rate' and the 'penalty provision' language refer to and modify the words beginning with 'relating to,' meaning that only penalty rates that punish non-monetary default need not be cured.").

As discussed below, the Court agrees with some of the conclusions just noted and disagrees with others. However, none of these decisions rest on a thorough analysis of the three operative Bankruptcy Code sections and how they intersect, and the Court therefore must undertake its own analysis.

II. Statutory Analysis

A comprehensive analysis of the default interest issue requires the Court to address three questions: (i) do §§ 1124(2) and 365(b)(2)(D) create an exception to § 1123(d)'s otherwise absolute mandate?; (ii) does § 365(b)(2)(D)'s cure carve-out, as incorporated by § 1124(2)(A), apply to loan agreements?; and (iii) does § 365(b)(2)(D)'s cure carve-out extend to all penalty rates, or only to those triggered by non-monetary defaults? The Court considers those issues in turn below.

A. Do Sections 1124(2)(A) and 365(b)(2)(D) Create an Exception to Section 1123(d)'s Plain Terms?

Section 1123(d) 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." 11 U.S.C. § 1123(d). The meaning of this provision is plain, and most courts have applied § 1123(d) as written, looking to the underlying loan agreement and state law to determine whether a debtor must pay interest at the default rate to cure and reinstate its agreement under a chapter 11 plan. *See*, e.g., *New Invs.*, 840 F.3d at 1140-42; *In re Sagamore Partners, Ltd.*, 620 F. App'x 864 (11th Cir. 2015); *Depietto*, 2021 WL 3287416 at *6-7; *Moshe*, 567 B.R. at 444-46; *Moody*, 426 B.R. at 674.[16]

The Debtor urges the Court not to follow these cases, but instead to follow the few courts that have construed § 1123(d) narrowly so as not to require payment of default interest. *See Phoenix*, 257 B.R. at 521; *Zamani*, 390 B.R. at 686; *see also New Invs.*, 840 F.3d at 1143-46 (dissenting opinion). The Debtor argues that such a reading is required, first, to conform § 1123(d) to the supposedly "pro-debtor" intent behind its enactment, and second, to harmonize § 1123(d) with §§ 1124(2)(A) and 365(b)(2)(D).

The Debtor bases its first argument on the House Report for the bill that became § 1123(d), H.R. Rep. No. 103-835, at 55, which states that Congress was primarily concerned with overruling the Supreme Court's holding in *Rake v. Wade*, 508 U.S. 464 (1993). The Supreme Court there had held that a chapter 13 debtor who proposed to cure a default was required to pay interest on arrears

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[16] In this case, there is no dispute that the Debtor's loan agreement requires the payment of a higher interest rate (5% above the pre-default rate), and certain fees, upon an event of default. Moreover, applicable non-bankruptcy law—here, New York law—allows for a higher interest rate upon default when provided for in the loan agreement. *See Jamaica Sav. Bank, FSB v. Ascot Owners, Inc.*, 245 A.D.2d 20, 665 N.Y.S.2d 858, 858 (N.Y. App. Div. 1st Dep't 1997); *see also Dominion Fin. Corp. v. Haimil Realty Corp.*, 546 B.R. 257, 265 (Bankr. S.D.N.Y. 2016) (awarding interest at 24% default rate and stating that "New York courts have enforced agreements that provide for similar default rates."). As noted, the Debtor has reserved the right to argue that New York law excuses its defaults because the Covid-19 pandemic rendered its continuing performance impossible.

to a secured creditor even if the underlying loan agreement did not provide for such interest. *Id*. at 472. According to the House Report, this result "provid[ed] a windfall to secured creditors at the expense of unsecured creditors," which § 1123(d) would eliminate by "limit[ing] the secured creditor to the benefit of the initial bargain with no court contrived windfall." H.R. Rep. No. 103-835, at 55.

This argument fails for several reasons. When the meaning of a statutory provision is plain, as it is here, courts are required to apply that plain meaning even if Congress's stated or apparent purpose was more limited. As the Ninth Circuit observed in *New Investments*, "The fact that Congress had a particular purpose in mind when enacting a statute does not limit the effect of the statute's text." 840 F.3d at 1141; *see also id.* ("'The 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'") (quoting *Union Bank v. Wolas*, 502 U.S. 151, 158 (1991)); *accord General Growth,* 451 B.R. at 328; *Moshe*, 567 B.R. at 446; *Moody*, 426 B.R. at 674.

Moreover, Congress's stated intent for enacting § 1123(d) was not merely to prevent windfalls to secured creditors. As Judge Isgur noted in *Moody*, the House Report framed Congress's intent more broadly than simply overruling *Rake*: "the Congressional repair to *Rake* solved the issue by a broader declaration—*Thou shall look to state law when determining cure amounts*." *Id*. at 674 (emphasis in original); *see also In re New Invs.*, 840 F.3d at 1141 (requiring payment of default interest is "consistent with the intent of 1123(d) because it holds the parties to the benefit of their bargain."). Applying § 1123(d) as written furthers that intent.

The Court therefore concludes that § 1123(d), *if looked at in isolation*, requires payment of all contractually-required amounts. But this does not end the analysis, because § 1124(2)(A) sets forth a conflicting, and equally unambiguous, directive: to de-accelerate defaulted debt and render it unimpaired, the debtor need *not* cure "a default of a kind specified in § 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured." Section 365(b)(2)(D), in turn, provides that penalty rates and penalty provisions relating to nonmonetary defaults need not be cured. The conflict with § 1123(d) is unavoidable: either *all* amounts required by the parties' contract and permitted by state law must be paid, or this facially absolute rule is subject to an exception for whatever penalty rates and provisions § 365(b)(2)(D) excuses.

Settled statutory interpretation principles supply the answer to this conflict. "'[I]t is a commonplace of statutory construction that the specific governs the general.'" *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645-47, 132 S. Ct. 2065, 2070-72, 182 L. Ed. 2d 967 (2012) (quoting *Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 384, 112 S.Ct. 2031, 119 L.Ed.2d 157 (1992)); *accord Davis v. Shah*, 821 F.3d 231, 251 (2d Cir. 2016) ("[A] 'specific provision takes precedence over a more general' one.") (quoting *United States v. Torres–Echavarria*, 129 F.3d 692, 700 n. 3 (2d Cir.1997)).

Here, there can be no doubt that the carve-out created by § 1124(2)'s incorporation of § 365(b)(2)(D)—excusing payment of penalty rates and penalty provisions triggered by non-monetary defaults—is more specific than § 1123(d)'s general command that the amount needed to cure be governed by the parties' agreement and non-bankruptcy law. This carve-out therefore must be treated as an exception to § 1123(d)'s facially absolute mandate.

This result has the additional virtue of avoiding an interpretation that would nullify § 1124(2)'s incorporation of § 365(b)(2)(D). *See Corley v. United States*, 556 U.S. 303, 314, 129 S. Ct. 1558, 173 L.Ed.2d 443 (2009) ("[A] statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant.") (cleaned up); *Pharaohs GC, Inc. v. United States Small Bus. Admin.*, 990 F.3d 217, 227 (2d Cir. 2021) (same). Whereas a contrary reading would render meaningless § 1124(2)'s incorporation of § 365(b)(2)(D), the Court's reading does not nullify 1123(d), but merely makes it subject to a limited exception. § 1123(d) remains effective in all other contexts, including the specific context—overruling *Rake v. Wade*—that, according to the House Report, motivated its enactment.

For both of these reasons, the carve-out created by § 1124(2)'s incorporation of § 365(b)(2)(D) must be treated as an exception to § 1123(d)'s otherwise absolute mandate.

B. Does Section 1124(2)(A)'s Cure Carve-out Apply to Loan Agreements or to Executory Contracts and Unexpired Leases?

The Lenders contend that § 1124(2)(A) does not excuse any defaults arising under loan agreements, but only defaults arising under executory contracts and unexpired leases. Specifically, they argue that § 1124(2)(A)'s exemption for defaults "*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" (emphasis added) must apply only to defaults arising under executory contracts and unexpired leases, since those are the only types of contracts that § 365 addresses. In *Moody*, the bankruptcy court adopted this construction of § 1124(2)(A), holding that "[i]t would stretch the language of § 1124(2)(A) far beyond its plain meaning to believe that it refers to any default rate of interest on any type of agreement." 426 B.R. at 673-74.

The Court respectfully disagrees with this interpretation. In the first place, it rests on a strained reading of § 1124(2)(A)'s "of a kind" reference. § 1124(2)(A) refers to "*default[s]* of a kind specified in section 365(b)(2)," not "default[s] in *contracts and leases* of a kind" governed by that section. Thus, the most natural reading of the "of a kind" reference is that it refers to the kinds of *default provisions* addressed in § 365(b)(2), not to the kinds of contracts and leases governed by that section. That is, it refers to any *ipso facto* default, and any failure to satisfy a penalty rate or penalty provision relating to a non-monetary default, regardless of the nature of the underlying contract.

A second, and more fundamental, problem with the Lenders' interpretation of § 1124(2)(A)'s cure carve-out is that it would deprive that carve-out of any effect. The Lenders would interpret that carve-out to apply only to executory contracts and unexpired leases. However, § 1124 does not apply to such contracts and leases. Consequently, the Lenders' interpretation would strip § 1124(2)(A)'s reference to § 365 of any meaning, a result that is strongly disfavored. *See Puello v. Bureau of Citizenship & Immigr. Servs.*, 511 F.3d 324, 330 (2d Cir. 2007) ("'[A] statute must, if reasonably possible, be construed in a way that will give force and effect to each of its provisions rather than render some of them meaningless.'") (quoting *Allen Oil Co. v. Comm'r*, 614 F.2d 336, 339 (2d Cir. 1980)).

By its terms, § 1124 applies only to "class[es] of claims or interests" that the debtor seeks to treat as unimpaired under its plan of reorganization. Claims for cure amounts owed under assumed contracts or leases are not claims that may be classified under a plan. Instead, such cure claims are administrative priority claims under §§ 503(b) and 507(a)(2), which are entitled to be paid in full on the plan's effective date, *see* 11 U.S.C. § 1123(a)(1), and are not classified under the plan. *See id*. § 1129(a)(9)(A); *see also In re George Washington Bridge Bus Station Dev. Venture LLC*, 65 F.4th 43, 50-52 & n. 4 (2d Cir. 2023) ("because a debtor must 'cure' a default under § 365(b)(1)(A) before assuming an executory contract, '[c]laims arising under contracts or leases so assumed are afforded administrative priority' under Sections 503 and 507 of the Bankruptcy Code.") (internal citation omitted); *see generally* TABB, LAW OF BANKRUPTCY, at 1103-04 & n. 407.

Yet another problem with the Lenders' interpretation of § 1124(2)(A) is that, by nullifying the effect of that section's cure carve-out, the Lender's interpretation would risk making § 1124(2) itself a dead letter. Under the Lenders' reading, *ipso facto* default clauses would be excused in executory contracts and unexpired leases, but not in loan agreements. As discussed above, *ipso facto* provisions are inherently incapable of cure. Consequently, the Lenders' reading would enable any lender to prevent its borrower from using § 1124(2) to reinstate the loan following a bankruptcy filing, simply by including an *ipso facto* clause in its loan agreement. *See* 3 COLLIER ON BANKRUPTCY ¶ 365.06. It is difficult to believe that Congress, having enacted multiple Bankruptcy Code provisions that override *ipso facto* provisions, would have meant to allow lenders to use such provisions to defeat the reinstatement right enshrined in § 1124(2).[17]

The Court need not adopt an interpretation that has consequences of this sort. Instead, the

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[17] At oral argument, Lenders' counsel advanced a variation on the argument discussed above, contending that even if subsections (A) through (C) of § 365(b)(2) apply to loan agreements when incorporated by § 1124(2)(A), subsection (D) does not. This is a more plausible reading of the statute, since subsection (D), unlike the other subsections, does specifically mention executory contracts and unexpired leases. A further virtue of this reading, in contrast to the one just discussed, is that it would not nullify § 1124(2)(A)'s cure carve-out in its entirety, nor would it allow the use of *ipso facto* default provisions to defeat a debtor's ability to reinstate its debt.

However, this interpretation suffers from a flaw of a different sort: It would render meaningless the language that Congress added to § 1124(2)(A) in 2005—specifically, the reference to any "default . . . of a kind that section 365(b)(2) expressly does not require to be cured." As Lenders' counsel acknowledged at argument, this added language appears to refer only to subsection (D); no other reading of this language makes sense. Consequently, reading subsection (D) to apply only to executory contracts and unexpired leases, and not also to loan agreements, would strip this added language of any meaning—because, as discussed above, § 1124(2) does not apply to executory contracts or unexpired leases, but only to loans and other claims that can be classified under a plan of reorganization.

Court adopts the more natural reading of § 1124(2)(A): that it excuses defaults arising under loan agreements, so long as the defaults are "of a kind" addressed by § 365(b)(2) – that is, *ipso facto* defaults, and failures to satisfy penalty rates and penalty provisions relating to non-monetary defaults.

C. Does Section 365(b)(2)(D) Excuse Payment of all Penalty Rates and Provisions, or just Those Associated with Non-Monetary Defaults?

The analysis so far has led to two conclusions: first, that §§ 1124(2) and 365(b)(2)(D) must be read to create an exception to § 1123(d)'s otherwise absolute mandate; and second, that § 1124(2)(A)'s cure carve-out applies to loan agreements, not to executory contracts and unexpired leases.

This leaves us with a final question: What is the scope of subsection 365(b)(2)(D), which exempts from § 365(b)'s cure requirements "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease"? Should this provision be read as a single phrase, in which the "relating to" clause modifies both penalty rate and penalty provision, or should it instead be read to create two separate and distinct exceptions? Stated differently, does § 365(b)(2)(D) only excuse the satisfaction of penalty rates and penalty provisions relating to breaches of nonmonetary obligations, as the Lenders contend? Or does it excuse the satisfaction of (i) penalty rates relating to both monetary and non-monetary defaults *and* (ii) penalty provisions relating to non-monetary defaults, as the Debtor contends?

As discussed above, courts and commentators have disagreed on the proper reading. Some have adopted the former interpretation, construing § 365(b)(2)(D) to excuse only penalties triggered by non-monetary breaches, while others have adopted the latter construction of this provision, reading it to create two separate cure carve-outs. However, the analysis presented by the courts is sparse, with few decisions providing extensive analysis.

This issue is not simple, and a proper resolution requires a thorough analysis. We start with a close review of the text of § 365(b)(2)(D), viewed in its historical and statutory context. We then consider the legislative history of the amendments to this section made by the 1994 Reform Act and the 2005 BAPCA amendments, as well as the Debtor's argument that the Court should construe this section in a way that furthers chapter 11's broader purposes. Based on this analysis, the Court concludes that § 365(b)(2)(D) creates a single cure exception, excusing penalty rates and provisions triggered by nonmonetary defaults. It does not also create an exception for penalty rates that arise from monetary defaults.

1. Statutory Text

We start with the text of § 365(b)(2)(D), which reads as follows:

> (2) Paragraph (1) of this subsection [requiring cure, compensation and adequate assurance with respect to any defaults] does not apply to a default that is a breach of a provision relating to--
>
> > . . .
> >
> > (D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

11 U.S.C. § 365(b)(2).

This provision is not a model of clarity. As the First Circuit has observed, "the text of § 365(b)(2)(D) is awkward and ungrammatical on any reading." *BankVest*, 360 F.3d at 297-98. The fact that multiple courts and commentators have adopted one reading of the provision and others have adopted a contrary reading reinforces the point.[18] Nevertheless, the Court believes that one of the two competing readings of this provision—to create a single exception to § 365(b)(1)'s cure requirements, rather than two distinct exceptions—is far more natural than the other. This is not just the Court's subjective view. The conclusion is rooted in conventions of ordinary speech, to which courts properly look for guidance when construing statutory language.[19]

Assume you're negotiating a contract that includes penalty rates and other penalty provisions, and you want to propose that such penalties be excused for any non-monetary defaults, but not for monetary defaults. It would be natural to say, "Let's excuse performance of any penalty rate or penalty provision relating to a non-monetary default." And this, in essence, is what the text of § 365(b)(2)(D) says.

Now assume, alternatively, that you want to propose that *all* penalty rates be excused, as

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[18] It is worth noting, though, that the leading cases that have read § 365(b)(2)(D) to create two exceptions, rather than one, appear to have simply assumed this conclusion, rather than basing it on any reasoned analysis. In particular, the Ninth Circuit in *Claremont* has been repeatedly cited for its statement that § 365(b)(2)(D) excuses from cure all penalty rates, as well as all non-monetary defaults. However, in that case, only the latter issue—whether all non-monetary defaults are excused—was before the court, and the briefs filed by both sides simply assumed that 365(b)(2)(D) excused all penalty rates. *See*, e.g., Brief of Appellant Cal Worthington and Worthington Dodge, Inc., *In re Claremont Acquisition Corporation, Inc.*, 1996 WL 33418817 (9th Cir. Jan. 26, 1996); Brief of Appellee and Cross-Appellant General Motors Corporation, *In re Claremont Acquisition Corporation, Inc.*, 1996 WL 33485752 (9th Cir. Mar. 20, 1996). As a result, the Ninth Circuit appears to have merely accepted the parties' shared assumption on this issue, without any analysis of its own. See *Claremont*, 113 F.3d at 1034. Courts within the Ninth Circuit have uncritically cited *Claremont Acquisition* for this point, with no apparent recognition that the penalty rate issue was not in dispute before the Ninth Circuit. *See Phoenix*, 257 B.R. at 521; *Zamani*, 390 B.R. at 686.

[19] *See* WILLIAM N. ESKRIDGE, JR., INTERPRETING LAW: A PRIMER ON HOW TO READ STATUTES AND THE CONSTITUTION 41 (2016) (courts should "read statutes in accord with the ordinary meaning their words and phrases would have for the typical English-speaking citizen"); *id.* at 55 (the inquiry should take into account "widely accepted and understood conventions of word usage and grammar"); Frank H. Easterbrook, *The Role of Original Intent in Statutory Construction*, 11 HARV. J.L. & PUB. POL'Y 59, 65 (1988) (courts should try to "hear the words [of the statute] as they would sound in the mind of a skilled, objectively reasonable user of words."); Oliver Wendell Holmes, Jr., *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417, 417-18 (1899) (the primary task for statutory interpreter is to determine "what [the statutory] words would mean in the mouth of an ordinary speaker of English, using them in the circumstances in which they were used").

well as penalty provisions triggered by non-monetary defaults. Would you say (to repeat the above paraphrase of § 365(b)(2)(D)), "Let's excuse performance of any penalty rate or penalty provision relating to a non-monetary default"? Presumably not—that would not convey your intended meaning. More likely, you'd say something like, "Let's excuse performance of any penalty rate, and any penalty provision relating to a non-monetary default." If you wanted to be even clearer, you might say, "Let's excuse performance of any penalty rate, whether relating to monetary or non-monetary defaults, and also penalty provisions relating to non-monetary defaults."

The point is that the language Congress used in § 365(b)(2)(D) largely mirrors the language one would use in everyday speech—or, for that matter, in everyday writing—if one meant to create one exception, rather than two, to the § 365(b)(1)'s cure requirements. This pattern of language use is reflected in an interpretative canon known as the series-qualifier canon, which provides that, when a series of nouns are followed by a modifying clause, that clause modifies every noun in the series, not just the last. *See* ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS, 147 (2012) ("When there is a straightforward, parallel construction that involves all nouns or verbs in a series," a modifier at the end of the list "normally applies to the entire series.").[20]

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[20] Professor Brubaker contends that the language of § 365(b)(2)(D) falls within an exception to the series-qualifier canon: that "'the insertion of a determiner [such as the word "any" or "a"] before the second item tends to cut off the modifying phrase so that its backward reach is limited.'" Brubaker, *Default Rates of Interest, Part II,* at 3 (quoting SCALIA & GARNER, READING LAW, at 149). According to Professor Brubaker, the insertion of the word "penalty" before "provision" serves as a determiner, thereby causing the "relating to" phrase to modify only "penalty provision," and not also "penalty rate." *Id.*

This argument rests on a misunderstanding of the nature and use of determiners. Determiners are not adjectives; typically, they are either articles or pronouns. *See* SCALIA & GARNER, READING LAW, at 148-49 (listing "a, the, [and] some" as typical determiners); *see also Teva Pharms. USA, Inc. v. Sandhu*, 291 F. Supp. 3d 659, 672 & n. 21 (E.D. Pa. 2018) ("'Any' is a determiner that quantifies the noun it modifies."); *see also id.*, at 672-73 (under series-qualifier

Had Congress instead meant to create two exceptions, it presumably would have used quite different language. Most simply, the addition of a comma and the word "any" after the words "any penalty rate"—to make the phrase read "the satisfaction of any penalty rate**,** or **any** penalty provision relating to a [nonmonetary] default"—would have made this meaning much more apparent. Even better, the addition of a few more words—to make the phrase read "the satisfaction of any penalty rate**,** or **the satisfaction of any** penalty provision relating to a [nonmonetary] default"—would have left little doubt that Congress intended to create two distinct exceptions.

Consideration of the historical context underscores the significance of the word choices Congress made when it enacted § 365(b)(2)(D). As discussed above, Congress added both that section and § 1123(d) to the Bankruptcy Code at the same time, as part of the 1994 Bankruptcy Reform Act, and Congress's stated purpose for adding the latter section was to overrule the Supreme Court's 1993 *Rake v. Wade* decision. *Rake*, in turn, rested heavily on the reasoning of a then-recent Supreme Court decision, *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989), which had drawn extensive criticism for its "hyper-textualist" reading of § 506(b)—in particular, the decisive weight the Court gave to the placement of a comma and the word "any" in

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canon, modifier applied only to the second series of words "because the determiner 'any' signals the start of the second series"). Whereas an adjective modifies a noun, a determiner "determines the use of a noun without essentially modifying it," *Webster's New World College Dictionary*, 4th ed. (2010). The use of determiners also differs from that of adjectives: Determiners must be placed *before* the noun (and any descriptive adjectives), while adjectives can modify the noun even if placed after the noun. *See id.*; *see also* RODNEY HUDDLESTON & GEOFFREY K. PULLUM, THE CAMBRIDGE GRAMMAR OF THE ENGLISH LANGUAGE 253 (2002). In both of these respects, "penalty" is not a determiner: It modifies "provision," and it can be placed either before or after that word (e.g., "a penalty provision" or "a provision that is a penalty").

that section.[21] Having enacted § 1123(d) to overrule *Rake*, Congress presumably was aware of the importance the Supreme Court gave to syntactical details of this sort, yet it chose not to add a comma, or the word "any," or to use any other grammatical device to set off the words "penalty rate" and make clear that those words were not modified by the "relating to" phrase that followed.

Finally, consideration of § 365(b)(2) as a whole provides still further support for the conclusion that subsection (D) creates one exception, rather than two, to § 365(b)(1)'s cure requirements. Each of § 365(b)(2)'s three other subsections addresses a single type of default provision—relating either to the debtor's financial condition, or to the filing of a bankruptcy case, or to the appointment of a trustee or custodian. *See* 11 U.S.C. § 365(b)(2)(A), (B) & (C). Had Congress intended subsection (D) to create cure exceptions for two separate and distinct sorts of default provisions, one might reasonably expect Congress to have put each of these exceptions in a subsection of its own, to maintain the parallelism of this structure. Congress's decision to create only a single new subsection (D), rather than two new subsections, suggests that it intended to create only one new cure carve-out, not two.

2. Legislative History of the 1994 Amendments

When a statute is ambiguous, as it is here, consideration of legislative history can aid in

[21] Overturning long-settled case law and practice, *Ron Pair* held that a nonconsensual lienholder was entitled to post-petition interest under § 506(b) to the extent it was oversecured. 489 U.S. at 237. The Court based this holding on a close reading of the text of § 506(b)—in particular, the phrase "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement." *Id.* at 241. The Court held that the modifier at the end of this phrase (the words "provided for under the agreement") modified only "any reasonable fees, costs, or charges," and not also "interest on such claim." *Id*. at 241-42. In so holding, the Court gave primary weight to the fact that the words "interest on such claim" were followed by a comma and the word "any," which to the Court indicated an intent to make these words independent of the modifier. *Id*.; *see also* Charles J. Tabb & Robert M. Lawless, *Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jurisprudence of the Rehnquist Court*, 42 SYRACUSE L. REV. 823, 843-46 (1991) (criticizing *Ron Pair* as "textualism at its most extreme").

determining the statute's meaning. *Auburn Hous. Auth. v. Martinez*, 277 F.3d 138, 143–44 (2d Cir. 2002); *United States v. Dauray*, 215 F.3d 257, 264 (2d Cir. 2000) ("When the plain language and canons of statutory interpretation fail to resolve statutory ambiguity, we will resort to legislative history."). Care must be taken, however, to ensure that the legislative history is relevant, reliable, and useful. *See* ESKRIDGE, INTERPRETING LAW, at 237-40; *see also id.* at 240-45 (discussing application of these criteria to committee reports).

The Debtor, citing to Professor Brubaker's article, argues that its reading of § 365(b)(2)(D) is supported by the legislative history—in particular, the House Report for H.R. 5116, the bill that became the Bankruptcy Reform Act of 1994. That House Report stated, in relevant part: "section 365(b) is clarified to provide that when sought by a debtor, a lease can be cured at a nondefault rate (i.e., it would not need to pay penalty rates)." H.R. Rep. No. 103-835, at 50. To the Debtor and Professor Brubaker, this report—which did not limit the carve-out to non-monetary defaults—shows that Congress intended § 365(b)(2)(D) to excuse payment of penalty rates of all sorts, whether triggered by monetary or non-monetary defaults. *See* Brubaker, *Default Rates of Interest, Part II*, at 6-7.

At first blush, the House Report does appear to support this conclusion. The problem, however, is that the language of the Judiciary Committee's bill—the bill the House Report addressed—differed in key respects from the language of the statute that Congress passed two days later.[22] Most significantly, the carve-out language in the Judiciary Committee's bill was not limited

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[22] The bill was reported out of the House Judiciary Committee, together with the House Report, on October 4, 1994. Later that day, an amended version of the bill – the version that was ultimately enacted – was presented on the House floor. The House voted to approve that amended bill on October 5; the Senate voted to approve it, with no further amendments, on October 6; and President Clinton signed the bill into law later that month. Actions - H.R.5116 - 103rd

to non-monetary defaults, as the eventual statutory language was, but instead appeared to excuse penalty rates and provisions relating to defaults of any sort. Specifically, the Judiciary Committee bill would have added a new subsection (D) to § 365(b)(1), causing it to read as follows:

> (b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
>
> . . .
>
> (D) satisfy [sic] any penalty rate or provision relating to a default arising from any failure by the debtor to perform *the obligations under the contract or executory lease* after the order for relief.

H.R. 5116 [Report No 103-835], 103d Cong., 2d Sess. (Oct. 4, 1994) (emphasis added) (PDF) [https://perma.cc/9ZHY-L8MY].[23]

This language is poorly drafted, and its meaning is far from clear. But it is amenable to a reading consistent with the House Report: By requiring the debtor to satisfy any penalty rate or provision relating to any default after the order for relief—*i.e.*, any *post*-petition default—it can be read to excuse the debtor's satisfaction of any penalty rate or provision relating to any *pre*-petition default. This reading jibes with the House Report, which as noted described the bill as allowing the debtor to cure defaults of all sorts, monetary as well as nonmonetary, without paying penalty rates.

Congress (1993-1994): Bankruptcy Reform Act of 1994, H.R.5116, 103rd Cong. (1994), https://www.congress.gov/bill/103rd-congress/house-bill/5116/all-actions [https://perma.cc/Y4RT-LS4F].

[23] It is curious that the Judiciary Committee bill, unlike the ultimately-enacted version of the bill, would have added the new subsection (D) to § 365(b)(1), rather than to § 365(b)(2). However, the choice between adding the new subsection to (b)(1) or instead to (b)(2) made little difference: Either way, the new subsection (D) specified the sorts of penalty rates and provisions that the debtor was not required to cure.

However, the bill was amended on the House floor, later on October 4, to change "*the obligations* under the contract or executory lease" to "*nonmonetary obligations* under the contract or executory lease" (emphasis added), the language that was ultimately enacted. That is, the carve-out language was narrowed, perhaps because the broader version of that language in the Judiciary Committee's bill could not command sufficient votes to secure approval on the House floor. The House Report, having been addressed to the earlier version of the bill, sheds no light on the intent behind this crucial amendment, nor does any other part of the legislative record illuminate the specific political dynamics or negotiations that resulted in this amendment.[24] As a result, we can only speculate about what happened behind the scenes.[25] The sole conclusion we can safely draw is that the House Report cannot be relied upon to accurately reflect the meaning of § 365(b)(2)(D) as ultimately enacted.

[24] None of the House floor statements on October 4 or 5 make any mention of the amendment, or even of § 365. 140 Cong. Rec. D1199-01, 1994 WL 545726; 140 Cong. Rec. H10726-08, 1994 WL 545701; 140 Cong. Rec. H10752-01, 1994 WL 545773. Moreover, because the Senate on October 5 voted to approve an identical bill, no conference report was needed. Actions - H.R.5116 - 103rd Congress (1993-1994): Bankruptcy Reform Act of 1994, H.R.5116, 103rd Cong. (1994), https://www.congress.gov/bill/103rd-congress/house-bill/5116/all-actions [https://perma.cc/Y4RT-LS4F].

[25] The bill's drafting history gives some clues as to the special interests that may have been involved. Specifically, the amendments to § 365(b) were part of a section of the bill—Section 219, entitled Leases of Personal Property—principally aimed at protecting personal property lessors, such as equipment lessors and airplane manufacturers. In addition to amending § 365(b), Section 219 amended *§ 365(d)* to require debtors to begin performing their obligations under personal property leases within 60 days after the petition date. *See* Pub. L. No. 103-394, tit. II, § 219, 108 Stat. 4106 (Oct. 22, 1994). The bulk of the House Report's discussion of Section 219 addressed these amendments to § 365(d). *See* H.R. Rep. 103-835, at 50. Only the final sentence of that discussion mentioned the amendment of § 365(b), and (oddly) even that sentence referred only to cure of leases, not to cure of executory contracts. *See id*.

Viewed in this context, it appears that the amendment to § 365(b) may have been included in the bill as a *quid pro quo*—a bone thrown to lessees (e.g., manufacturers that lease equipment, airlines that lease planes) to partially compensate them for the benefits that equipment and other lessors got from the 60-day-performance requirement. If that is indeed what happened, then the scaling back of the penalty-rate carve-out after the bill left the Judiciary Committee (so that it covered only nonmonetary defaults, not all defaults) may have been due to the lessee lobby having less support, relative to the lessor lobby, on the House floor than it had on the Judiciary Committee.

3. Legislative History of the 2005 Amendments

The Debtor, citing Professor Brubaker, argues that the 2005 BAPCPA amendments—which added a second "penalty" modifier to the text of § 365(b)(2)(D)—provide further confirmation that Congress intended that section to create two exceptions, not one, to § 365(b)(1)'s cure requirements. *See* Brubaker, *Default Rates of Interest, Part II*, at 2-3. However, as discussed in Point II.C.1 above, a review of the text of § 365(b)(2)(D) does not support this conclusion. This was true before the 2005 amendments to § 365, and it is no less true thereafter.

Moreover, the context of the 2005 amendments makes clear that Congress's focus in making these amendments was not on whether § 365(b)(2)(D) carved out penalty rates triggered by monetary defaults. Rather, as discussed in the Statutory Background section above, Congress's focus was on the scope of that section's carve-out with respect to *non-monetary* defaults—specifically, whether the carve-out covered only penalty provisions triggered by non-monetary defaults, or also the non-monetary defaults themselves. To resolve the circuit split over that issue, Congress added the second "penalty" qualifier, thereby making it impossible to read the word "provision" to include all non-monetary default provisions, as the First Circuit had read it in *BankVest*. *See* 360 F.3d at 300. Nothing in the context of the 2005 amendments suggests that Congress also intended to clarify the separate issue before this Court: whether § 365(b)(2)(D) carves out penalty rates triggered by *monetary* defaults.

The Debtor contends that the House Report for the 2005 BAPCPA amendments does address this issue, albeit in a single sentence. H.R. Rep. 109-31(I), at 83 (2005). Specifically, that House Report states, without further explanation, that the second "penalty" modifier was added to § 365(b)(2)(D) "to clarify that [this section] applies to penalty provisions." *Id.* at 83. On its face, this statement does appear to support the Debtor's reading. However, the statement is in a section of the House Report bearing the title "Defaults Based on Nonmonetary Obligations." *See id.* Viewed in that context, the statement in the House Report appears to refer only to penalty provisions for non-monetary obligations. And this conclusion is confirmed by consideration of the larger context: As just discussed, Congress's focus in enacting the 2005 amendments to § 365(b)(2)(D) was to make clear that that section excused cure only of penalty provisions, and not also of the underlying defaults.

Thus, there is no basis to conclude that the legislative history of the 2005 amendments supports the Debtor's reading of § 365(b)(2)(D).

4. The Purposes of Chapter 11

The Debtor urges the Court to construe § 365(b)(2)(D) in a manner that furthers the overarching purposes of the Bankruptcy Code, and Chapter 11 in particular, such as facilitating reorganization and maximizing creditor recoveries. Those purposes, Professor Brubaker has argued, would be promoted by reading § 365(b)(2)(D) to excuse payment of default interest, because default interest provisions can operate in a fashion similar to *ipso facto* clauses: If sufficiently extreme, they can be impossible for a debtor to cure. Moreover, this problem could snowball if parties began to put exorbitant default interest provisions into their agreements, pre-bankruptcy, as a means of preventing assumption or reinstatement in the event of a bankruptcy filing. *See* Brubaker, *Default Rates of Interest, Part II*, at 2 & n. 7; *see also BankVest*, 360 F.3d at 301 (noting "similar interests" served by excusing cure of *ipso facto* clauses, non-monetary defaults and penalty rates).

This policy argument is not frivolous. As the First Circuit observed in *BankVest*, "'Congress's basic purpose in [enacting] § 365 [was] to promote 'the successful rehabilitation of the business for the benefit of both the debtor and all its creditors,'" and Congress therefore presumably did not intend to make a debtor's assumption of essential contracts contingent on cure of default provisions that may be incurable. *Id.* at 300 (construing § 365(b)(2)(D), prior to the 2005 amendments, not to require cure of incurable nonmonetary defaults) (internal citation omitted).

However, the argument ultimately is unpersuasive for a number of reasons. First, default interest provisions are not the same as *ipso facto* clauses or incurable nonmonetary defaults. As the Second Circuit observed in *Ruskin v. Griffiths*, a default rate "can be beneficial to a debtor in that it may enable him to obtain money at a lower rate of interest than he could otherwise obtain it." 269 F.2d at 832. Moreover, in contrast to *ipso facto* clauses or incurable nonmonetary defaults, default interest provisions do not in fact appear to pose an appreciable threat to debtors' ability to reorganize. Courts have been requiring payment of default interest as part of cure for decades, yet the Court is unaware of any instances of default interest provisions hamstringing reorganizations, as nonmonetary default provisions had sometimes done before Congress addressed that issue through its 2005 amendments to § 365. *See BankVest*, 360 F.3d at 299-300.

Second, as discussed above, a natural reading of the text of § 365(b)(2)(D) runs strongly counter to the Debtor's interpretation. While the statute's text is not unambiguous, it is clear enough to set a high bar for any policy argument advanced in support of a contrary reading.

Finally, section 365(b)(2)(D) was the product of a messy legislative process, which had little to do with the Bankruptcy Code's broader purposes. Recall that § 365(b)(2)(D)'s final wording (including the crucial insertion of the word "nonmonetary") was a last-minute addition. It was not part of the Judiciary Committee's bill, nor was it the product of any recorded debate, much less any committee hearings, over competing policies or principles. Instead, the key language appears to be the product of behind-the-scenes haggling among special interests, who for reasons of their own agreed to the cryptic language that appears in the final bill. As some commentators have observed, unrecorded compromises of this sort can be particularly ill-suited to a "purposivist," or policy-based, interpretation. *See* John F. Manning, *What Divides Textualists From Purposivists*, 106 COLUM. L. REV. 70, 74 (2006) ("[T]he final wording of a statute may reflect an otherwise unrecorded legislative compromise, one that may—or may not—capture a coherent set of purposes."); Frank H. Easterbrook, *Statutes' Domains*, 50 U. CHI. L. REV. 533, 548 (1983) ("[W]hen logrolling is at work the legislative process is submerged and courts lose the information they need to divine the body's design."). In circumstances of this sort, the Court should be particularly reluctant to depart from a natural reading of the statute's text.

Conclusion

For the foregoing reasons, the Court rules that, to cure and reinstate its loan under a plan of reorganization, the Debtor must pay default interest and fees to the extent required by its loan agreement and New York law. The Debtor has reserved its right to argue that it does not owe such interest and fees as a matter of New York law, as well as its right to challenge the amount of any default interest and fees it may owe, and the Court therefore has not addressed those reserved issues.

Counsel for the Lenders shall email an order consistent with this ruling to chambers, copying counsel for the Debtor. The parties shall consult and schedule a status conference with the Court in the next three weeks.

Dated: New York, New York
July 31, 2023

/s/ Philip Bentley
Honorable Philip Bentley
United States Bankruptcy Judge

Appendix

11 U.S.C. § 365(b)

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--

> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;[26]
>
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
>
> (C) provides adequate assurance of future performance under such contract or lease.

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to--

> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title;~~ ***or***~~
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement~~.~~***; or***
>
> ***(D) the satisfaction of any penalty rate or*** penalty ***provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.***

[26] Key: 1994 amendments are in bold and italic. 2005 amendments are underlined.

<u>11 U.S.C. § 1123</u>

(a)Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall—

(5) provide adequate means for the plan's implementation, such as—

(G) curing or waiving of any default; . . . .

. . .

(d) 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.

11 U.S.C. § 1124(2)

Except as provided in section 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—

. . .

(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; ~~and~~
>
> (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.

A Banker's Guide to the Bankruptcy Code's New Subchapter V

By Christian George / Jason Alpert, CRC

8/2/2023

'The pitfalls of Subchapter V do outweigh the benefits for creditors. There is

significant risk that they may not have time to properly perfect their claims or object to a plan because of the expedited process.'

Most bankers understand the major chapters of the bankruptcy code: Chapter 7 (liquidation) and Chapter 11 (reorganization). But what about the relatively new Subchapter V form of bankruptcy?

Enacted just before the COVID-19 pandemic under the Small Business Reorganization Act (SBRA), it provides qualified small business debtors a less expensive, more streamlined process to reorganize debts. While this benefits an important part of the U.S. economy—**small businesses comprise 44% of economic activity, create two-thirds of net new jobs, and contribute to American innovation and competitiveness**—it poses challenges for banks. By failing to prepare for a possible influx of Subchapter V filings, lenders could incur larger loan losses, higher servicing costs on bankruptcy loans, and higher reserves on their balance sheets. That would especially be the case in a recession when there are more bankruptcy filings by small businesses and other customers. Because they are less capitalized and more concentrated with respect to revenue streams, geography, and management than larger firms, small businesses can be disproportionately affected by downturns and disruption. We saw this a few years ago with the pandemic and related supply chain problems and labor shortages, and we are seeing it now with inflation.

It is anticipated that these types of filings will become more prevalent than Chapter 11 filings. This article explains how banks can mitigate their potential risks by proactively understanding Subchapter V and creating systems and processes to work through its nuances.

Eligibility

Let's first discuss who is eligible to file under the SBRA. Originally, any person or entity engaged in commercial or business activities that had aggregate noncontingent liquidated debts, both unsecured and secured, no higher than $2,725,625 could—as long at least half of that debt arose from the debtor's commercial or business activities. However, Congress, which originally passed the law in 2019, increased the debt ceiling to $7.5 million through the 2020 CARES Act —and has extended the sunsetting of that modified amount once. While not entirely clear at this point, many predict the $7.5 million amount will become permanent law.

Eligibility is quite broad and could cover personal guarantors on commercial loans, as long as their debts originate from business operations. This is important because the SBRA could effectively render an unsecured personal guarantee on a commercial loan relatively worthless. These particular personal guarantors could attempt to modify the treatment of their home loans if they qualify for a Subchapter V.

There are specific exclusions from who or what may qualify as a small-business debtor. Public entities do not qualify, nor do individuals or entities that classify as single-asset real estate (SARE) entities. A SARE debtor generates substantially all gross income from a single property or project. Examples include shopping center operators or companies managing office buildings. Most hotels are not considered SARE entities because they tend to generate additional income from gift shops, valet parking, restaurants, or other ancillary activities. Of course, a determination of this is highly fact-specific. Lenders should consult with an attorney for a thorough analysis of individual situations.

How Subchapter V Is Different

Subchapter V reorganizations are significantly different from typical Chapter 11 bankruptcies. First, only the debtor may file a plan in an SBRA case. The code eliminates a creditor's ability to file a competing plan. That eliminates a tool that, in a Chapter 11 case, allows a creditor to propose plan treatment that may be more attractive than a debtor's plan, and to obtain confirmation despite the objection of the debtor.

Second, a debtor under Subchapter V may obtain confirmation of a plan without any consenting creditors, which leaves creditors reliant on the law and the judge to prevent confirmation. Typically, a Chapter 11 debtor needs at least one class of accepting creditors to confirm a plan. In an SBRA case, a debtor can literally confirm a plan despite the objections of every creditor.

As a corollary to this significant difference, the absolute priority rule does not apply in a Subchapter V case. The absolute priority rule protects Chapter 11 creditors by requiring the claims of a dissenting class of creditors to be paid in full before any class of creditors junior to the dissenting class receives any value for its claim. Under the SBRA, this protection does not exist. As a result, the equity owners of a debtor could retain their interest in a debtor company—in other words, their equity retains monetary value—despite the fact that the dissenting unsecured creditors do not get paid one penny.

Instead of having to comply with the absolute priority rule, an SBRA bankruptcy debtor must satisfy a "fair and equitable" test as to unsecured creditors, which the debtor can satisfy in one of two alternative ways. First, it could pay its "disposable income" to the standing trustee over a three-to-five-year period. Notably, the definition of "disposable income" is quite narrow, so creditors could get paid very little on their unsecured claims. Specifically, "disposable income" in this application means income received by the debtor that is not reasonably necessary to (1) maintain and support the debtor or a dependent; (2) satisfy domestic support obligations that become first payable post-petition; or (3) ensure the continuation, preservation, or operation of a business. Because the SBRA is relatively new, there is very little case law that clarifies how courts will determine the amount of "disposable income." But it is apparent that debtors' lawyers will have plenty of ground to argue that there is very little "disposable income" in most cases due to the definition under the SBRA.

Alternatively, a debtor could distribute some of its property to satisfy the "fair and equitable" test. The debtor would have to prove the property's value is higher than the value of the "disposable income" over three to five years. For example, if a debtor owned personal property that was no longer needed to operate the business, such as excess land, obsolete inventory, or idle machinery, it would be possible to turn that property over to the Subchapter V trustee to distribute to unsecured creditors and meet the "fair and equitable" test—allowing the debtor to retain its equity interest.

As noted at the beginning of this article, SBRA actions allow debtors to save significant expenses compared to other types of bankruptcy. These fees and costs can range into hundreds of thousands, and even millions of dollars, depending on the bankruptcy's complexity. Under Chapter 11, creditor committees are often tasked with investigating and litigating potential claims against secured creditors. Since creditor committees do not exist under Subchapter V, debtors will avoid the occasional substantial costs associated with paying professional and legal fees that creditor committees incur. Subchapter V cases are also less expensive for debtors because they do not have to pay the fees of the U.S. Trustee, the independent attorney commonly tasked with protecting the rights of the unsecured class of creditors. (This class usually consists of creditor claims that are too minor to be litigated in bankruptcy court, such as those related to trade payable suppliers or individual employees.)

In addition, unlike with Chapter 11, a debtor does not have to pay all administrative costs when the plan is confirmed under Subchapter V, and a court-approved disclosure statement is not required. Under Chapter 11, disclosure statements are required to provide adequate information about a debtor's financial affairs so a creditor can decide whether to accept or reject the proposed plan. In addition to saving costs, forgoing a disclosure statement requirement allows debtors to confirm plans much more quickly than in Chapter 11 cases, where a statement typically must be approved 28 days before any confirmation hearing. This difference greatly expedites the bankruptcy process, so creditors must act quickly when dealing with Subchapter V filings.

Subchapter V means differences in the trustee's role as well. An SBRA proceeding's standing trustee is appointed to assist all parties, including the debtor, during the bankruptcy. The standing trustee's duties include:

1. Accounting for all the property received by the company
2. Examining and rejecting any claims against the company
3. Conducting a review of the company's financial condition and business operations
4. Reporting any fraud or misconduct to the bankruptcy court
5. Appearing at the status conference and materially significant hearings
6. Producing a final report of the case for the bankruptcy court
7. Assisting, as necessary, facilitation of a reorganization plan

8. Distributing certain company property in accordance with the reorganization plan
9. Confirming the company's adherence to the court-approved reorganization plan during the payment period

How To Approach a Subchapter V Case

While a general primer on the law, such as this article, should help bankers manage the Subchapter V process, creditors should immediately contact a qualified creditors rights lawyer to advise from the onset of a case. They should also immediately prepare and file a proof of claim.

Lenders and their attorneys should discuss if the borrower qualifies for SBRA and discuss the possibility of moving to have the case dismissed if there is evidence that it does not. The creditor's attorney should swiftly contact the standing trustee to obtain any information that has been received from the borrower. The creditor should immediately review the borrower's loan application and other financials the bank relies on, and identify any basis to except the bank's debt from discharge. The bank should also analyze the borrower's projected cash flow and balance sheet to analyze the potential for discharge of the borrower's unsecured debt. All this should take place relatively quickly so that the creditor's attorney can attempt to negotiate favorable terms prior to the 90-day deadline to file a plan under Subchapter V.

Creditors should also determine, with legal counsel, whether to make what is known as a "1111(b) election" under the bankruptcy code. This tool can protect unsecured and undersecured (where the value of the collateral is less than the balance of the loan) creditors in certain situations. While there are many complexities to making this election and attorney involvement is critical in certain situations, we believe 1111(b) elections may become more common in Subchapter V bankruptcies. In making the election, the entire claim becomes a secured claim. Second, the election entitles creditors to retain the liens on their collateral until they are paid in full. Third, it entitles creditors to specific plan treatment: A debtor must include payments to the creditor with a present value equal to the amount of the creditor's secured claim had it not been for the election. Finally, the plan must propose to pay the entire claim in full, over time. (**This article** from the American Bar Association details the upsides and downsides of a 1111(b) election.)

To manage the likely increase in Subchapter V bankruptcy filings, banks must be diligent. As is normally the case regarding all bankruptcy risk, obtaining and periodically examining collateral is key because of the significant risk of being paid nominally on unsecured debt. Banks should identify any distressed buyer that may qualify as a small business debtor. When negotiating a workout, they should consider utilizing forbearance agreements to incorporate provisions that require debtors to classify expenses in a way that takes advantage of the definition of "disposable income." Going forward, banks might also consider revising the underwriting standards for loans and loan modifications to incorporate SBRA risk. Proactive steps would include establishing a calculation of "disposable income" in the loan application or during underwriting, and disclosing that calculation to the borrower for confirmation during the origination process. Establishing this at origination or during annual reviews would help in the event the borrower files under the SBRA and tries to claim a much lower disposable income figure to achieve a larger discharge of debt by the court. The bank's attorneys would have prior calculations that could force better discovery of the true operating capacity of the debtor at the time of bankruptcy.

Conclusion

It is not our intention to make bankers feel like doomsday is upon us as a result of the SBRA. There are some positive items for banks as well as debtors. The SBRA provides a quicker route to rehabilitation for small businesses burdened by unsecured debt. That allows debtors to emerge from bankruptcy with an increased capacity to pay secured debt. And it reduces legal expenses for the debtor due to the expedited process. The SBRA also provides a mechanism to except certain debt from discharge in cases of corporate debtors that obtained loans using fraudulent application.

However, the pitfalls of Subchapter V do outweigh the benefits for creditors. There is significant risk that they may not have time to properly perfect their claims or object to a plan because of the expedited process. This risk is exacerbated because there is no committee of creditors or requirement for a disclosure statement as in a typical Chapter 11 case. It is also likely that any unsecured deficiency claim will be discharged with no distributions based on "disposable income," leaving many banks facing increased charge-offs and losses. Similarly, individual guarantees that are otherwise unsecured will have remote value since they can be eliminated in an

SBRA proceeding, further impairing loans and eliminating other sources of repayment and collection.

Since there is very little SBRA case law to date, it is impossible to predict the law’s full effect. However, bankers should be aware of the process and potential implications, and leverage the knowledge and expertise of legal counsel to help navigate this unexplored legal area. They should also review their portfolios and exposure for any concentration of bankruptcy risk, and consider ways to proactively work with customers to mitigate risks inherent in the SBRA process—or even liquidate at-risk portfolios today.

As a side note, banks should always consider loan sales as an efficient resolution mechanism to minimize losses today (your first loss is sometimes your best loss). Portfolios that have SBRA characteristics may be considered for sale today, even if they are still performing. There are buyers that would be interested in buying these portfolios, albeit price adjusted for the higher risk factor. (**This RMA Journal article provides some tips.**) Finally, banks should consider factoring potential SBRA losses into forecasting and risk rating systems to ensure they are appropriately recognizing the loss given default and have appropriate loan loss reserves established on their balance sheets.

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