UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF IOWA
WESTERN DIVISION

IN RE:

JAMES S. JOHNSTON | Chapter 11

Debtor. | Bankruptcy No. 03-03495S

DECISION RE: CLAIM OF U.S. BANK

The dispute before the court requires a determination of the interest component of the allowed secured claim of a creditor. U.S. Bank (hereinafter “Bank”) asserts that it is entitled to recover contractual default interest on Johnston’s promissory notes from March 4, 2002 to October 22, 2004. James S. Johnston, the debtor, contends that Bank is entitled to default interest only from July 24, 2002 to September 10, 2003.

Johnston’s Second Amended chapter 11 plan was confirmed on September 30, 2004. Bank had objected to Johnston’s plan treatment of its secured claim for the reason that Johnston had impermissibly proposed to cure Johnston’s default effective as of the date of his filing chapter 11, with a concomitant elimination of default interest after that date. Bank contested Johnston’s right to cure under the Bankruptcy Code. The plan proposed that upon the sale of certain of Johnston’s real property, Bank would be paid in full. The sale was completed, on motion, prior to the confirmation hearing. The sale yielded sufficient proceeds to permit full payment of Bank’s claim, irrespective of whether Bank or Johnston is correct on the interest issues. Consequently, the parties agreed that the plan could be confirmed, and the court would deal with the default interest dispute as a claims allowance issue. Hearing on the allowance of Bank's claim was held October 28, 2004. The parties have filed briefs. This is a core proceeding under 28 U.S.C. § 157(b)(2)(B).

Findings of Fact

Johnston is a farmer. Bank's claim against him is based on six promissory notes executed beginning in 1995. These are the notes:

Trial Exhibit #	Note #	Date Incurred	Original Principal	Maturity Date
2	26	2/6/95	$250,000.00	2/6/05
3	42	7/21/97	117,500.00	3/1/09
4	59	3/2/99	280,000.00	3/2/11
5	67	3/2/99	360,000.00	3/1/04
6	34	2/1/01	850,000.00	3/15/02
7	75	2/1/01	249,000.00	2/1/08

Johnston's spouse, Trudy, was also a borrower on the notes. She is not a debtor in the bankruptcy case.

All the notes, but number 34, required annual installment payments. Initially, the notes bore different interest rates. Most were variable rates based on Bank's prime rate. Each note provided for default interest. Three had a default rate set at a fixed percentage above the note's non-default rate. The other three set the default rate at 21 per cent. Each of the notes has cross default provisions, stating that the borrower's default as to any other note was default as to the subject note. All of the notes were secured by significant real and personal property rights owned by Johnston. It was undisputed throughout the case that the value of the collateral was significantly in excess of Johnston's debt to Bank under the six notes.

On February 3 and March 1, 2002, Johnston defaulted on annual installment payments for three notes–-numbers 42, 59, and 67 (Exhibits 3, 4 and 5 respectively). Bank delivered to Johnstons a Notice of Default dated March 4, 2002 (Exhibit 18). The letter notified the borrowers that the events of default were the past due payments on the three promissory notes and an unspecified "adverse change" in the borrowers' financial condition as shown in a financial statement dated December 31, 2001. Id.

In addition, the letter stated that Note 34 (previously numbered Note 0201; Exhibit 6) a Revolving Credit Note, would fully mature on March 15, 2002. This note was in the original principal amount of $850,000.00. Johnstons were informed that the payoff amount would be $910,386.96 plus daily interest thereafter (Exhibit 18). Bank also wrote: "IN ORDER TO CURE THE DEFAULT, ALL NOTES MUST BE BROUGHT CURRENT OR PAID." The letter told Johnstons of their right to cure the described defaults within 45 days, and that if the defaults were not cured in full, "all obligations payable under the Loan Agreements will become due and payable in full (unless otherwise agreed in writing by [Bank]." Bank stated also that "[t]he interest rate on all notes owing by the Borrowers will be increased to the default rate listed on each note effective the date of this letter until such time as all the defaults are cured." Id.

Bank sought mediation from the Iowa Mediation Service. Bank and Johnstons entered into a written Forebearance [sic] Agreement. The Johnstons' individual signatures to the agreement are undated; James Johnston signed the agreement on June 11, 2002 as Treasurer on behalf of a company called M & J Land, Inc. Duane Strempke, Vice President of Special Assets, signed the agreement on behalf of Bank on June 12, 2002 (Exhibit 1).

In the agreement's preamble, the parties concurred that the promissory notes were in default, in that certain notes had matured and all the notes contained cross-default provisions (Exhibit 1, page 3). It was also stated in the preamble that Johnstons were seeking certain extensions of the notes (id.), and that they desired that Bank forbear from exercising its rights of default concerning the existing defaults. Id. at 4. The preamble further stated that the parties were agreeing to an extension of the notes and forbearance by the Bank from exercising its rights to and including January 15, 2003. Id.

Johnstons agreed to take certain actions under the agreement. These actions included, but were not limited to, the execution of an adequate protection mortgage on real property, the execution of documents necessary for Bank to perfect a security interest in all of Johnstons' rolling stock, and the making of arrangements for the auction sale of all of their equipment. Id. at 4-8. Johnstons also waived various claims, defenses, and rights. Id. at 9-10. Bank agreed that it would take various actions including the execution of a subordination agreement and the retention of asset appraisers. Id. at 8-9.

Johnstons and Bank agreed that as to notes numbered 42, 59, 34, and 75 (Exhibits 3, 4, 6, and 7 respectively), the interest rate during the pendency of the agreement would be the Bank's prime rate plus 3 per cent, and that the rate for note number 67 (Exhibit 5) would continue to bear interest at the rate on its face. Id. at 10, ¶ 5. It was agreed that during the pendency of the agreement note number 26 (Exhibit 2) would bear interest at the Bank's prime rate plus 2.5 per cent. Johnstons agreed that the notes would be "completely cross-defaulted," so that a default under any of the agreements between the parties would be a default as to all of the agreements. Id., ¶ 7. Johnstons also agreed that their indebtedness to Bank "shall be deemed to be completely and unequivocally cross-collateralized." Id.

Bank and Johnstons agreed also that "from and after the execution of this Agreement, all default rates of interest on the Promissory Notes, in the event of any event of default as described and/or defined within said Promissory Notes, shall be 18% per annum." Id. at 10, ¶ 8. It was agreed that upon any event of default, Bank, in its sole discretion, could exercise all of its legal and equitable rights under the Forbearance Agreement and any of the loan documents. Id. at 12, ¶ 12.

Under the agreement's "Miscellaneous Provisions" is the following paragraph considered by Bank to be significant to its argument regarding the date of Johnstons' default under the Forbearance Agreement:

> Unless otherwise expressly provided herein, nothing in this Agreement shall modify, release or discharge the obligations of the [Johnstons] or any other person or entity under the Promissory Notes, the Security Agreements, the Real Estate Mortgages, the Loan Documentation, or any and all other loan documentation given by [Johnstons] in favor of [Bank] and [Bank] expressly reserves any and all rights and abilities to proceed under the Promissory Notes, the Security Agreements, the Real Estate Mortgages, the Loan Documentation or any and all other loan documentation given by [Johnstons] in favor of [Bank]. <u>Any forebearance</u> [sic] <u>by [Bank] to [Johnstons] or any other person or entity shall not modify any obligations to [Bank] under the Promissory Notes, the Security Agreements, the Real Estate Mortgages, the Loan Documentation or any and all other loan documentation given by [Johnstons] in favor of [Bank].</u>

Exhibit 1 at 9, ¶ 3 (emphasis added).

On November 1, 2002, Bank wrote a letter to Johnstons informing them that the Bank considered them in default of the terms of the Forbearance Agreement. The letter contained the following paragraph:

> Jim, your loans remain in a default status. The Bank has chosen to exercise one of the remedies under the default terms, the default interest rate of 18% since you were first notified of the default, July 24, 2002. It may also seek legal counsel to assist in the collection of your account, the cost of which you will be ultimately responsible.

Exhibit A at 2. A copy of the letter was sent to Johnstons' attorney and to Bank's attorney. <u>Id.</u>

On September 10, 2003, James Johnston filed his chapter 11 petition. During the course of the case, Johnston received permission to complete pre-petition sales of real estate. After payment of the costs of the sales, Johnston paid the proceeds to Bank. Other payments were made to Bank after November 1, 2002, both before and after the bankruptcy filing (Exhibit 17). The parties have agreed that these payments were insufficient in and of themselves to cure all monetary defaults.

Johnston filed his Second Amended Plan on September 1, 2004 (docket no. 142). He proposed to treat Bank as a fully secured creditor. He recognized that there was a dispute as to the amount due. He proposed "to deaccelerate the debt to U.S. Bank from the date of filing the petition and pay their [sic] claim in full with interest at the rate of 8% per annum from the date of filing the petition." Second Amended Plan (docket no. 142, page 6). Debtor stated that he intended to invoke the provisions of "11 U.S.C. Section 1123(8)(a)(g)" to cure the default as of the date of filing the petition and to provide interest thereafter at 8 per cent. Id. It appeared that he had intended to cite to 11 U.S.C. § 1123(a)(5)(G), and this was borne out by his attorney at the hearing on confirmation.

The debtor's Second Amended Plan was confirmed on September 30, 2004 (docket nos. 155, 156). Johnston closed on the sale of real property. On October 22, 2004, Johnston wrote a check to Bank for $478,626.75. This was deposited with the Bank on October 25, 2004.

Issue

Johnston and Bank disagree over the amount of Bank’s claim because of different points of view as to the period during which the default interest rate applies to the debt. The differing views are functions of (1) the effective date of Johnston’s default under the Forbearance Agreement, and (2) whether Johnston may cure the default effective on the date of his bankruptcy filing, or whether he may cure at all.

Date of Default

Bank maintains that default interest should apply beginning March 4, 2002, the first default by Johnstons under the promissory notes. See Exhibit 18. Johnston contends that default interest should apply beginning July 24, 2002. This is the date referenced in Bank’s letter to Johnstons, dated November 1, 2002, notifying them that Bank considered them in default under the terms of the Forbearance Agreement (Exhibit A). The letter states that “Bank has chosen to exercise one of the remedies under the default terms, the default interest rate of 18% since you were first notified of the default, July 24, 2002.” Id.

At the time the letter was drafted, it was the position of the bank officer that the effective date of the application of default interest was July 24. Later, Bank was advised by its attorney that it could apply the default rate effective March 4, 2002, the date of Bank’s earlier notice of default (Exhibit 18). This is the position

Bank now takes, and it is based on a sentence in the miscellaneous provisions of the Forbearance Agreement (Exhibit 1). It states that

> Any forebearance [sic] by [Bank] to [Johnstons] or any other person or entity shall not modify any obligations to [Bank] under the Promissory Notes, the Security Agreements, the Real Estate Mortgages, the Loan Documentation or any and all other loan documentation given by [Johnstons] in favor of [Bank].

Exhibit 1, page 9, Section IV, ¶ 3. Bank contends that this part of the agreement permits it to revert to the date of initial default on the promissory notes in applying default interest to its claim. See Exhibit 18.

Johnston argues that the default date for such purpose is July 24, 2002, the date of default used by the Bank regarding the breach of the Forbearance Agreement. See Exhibit A. Essentially, Bank argues that under the above-contractual provision, its forbearance did not modify Johnstons' obligation to pay default interest under the notes, and that if Johnstons defaulted under the agreement, default interest would be applied retroactively to March 2002.

I agree that Bank's forbearance does not alter Bank's right to charge default interest in the event of default, but that does not mean that the Forbearance Agreement did not affect the Bank's right to declare when the default rate would first be applied. The notes provide for default interest, but the notes merely give Bank, at its option, the right to increase the interest rate upon Johnstons' default. In March 2002, Bank declared the notes in default and exercised its discretion to increase the interest rate on each note

(Exhibit 18).

In its Preamble, the Forbearance Agreement recognizes that the notes were in default and that the amounts due and owing included default interest (Exhibit 1, second and eleventh unnumbered “Whereas” clauses). It is also clear from the Preamble that Johnstons were bargaining for an extension of the notes (twelfth “Whereas” clause) and for Bank to “forebear [sic] from exercising [its] rights of default concerning the defaults which exists [sic] pursuant to the terms and provisions of the Promissory Notes” (sixteenth “Whereas” clause). Bank agreed to forbear from exercising its legal rights under the notes, including the right to charge default interest based on the defaults which existed prior to the execution of the agreement in June 2002.

The parties agreed to new non-default rates of interest for each of the notes, during the pendency of the agreement. The agreement began upon execution. See Exhibit 1 at 10, ¶ 8. It was to continue to January 15, 2003, at which time it was to “expire.” Id. at 13, ¶ 17. After that date, notwithstanding whether there was a new default, Bank had no further obligation to forbear. Id. The agreement provided also for a new uniform default rate on all the notes.

> [Johnstons] and [Bank] covenant and agree that from and after the execution of this Agreement, all default rates of interest on the Promissory Notes, in the event of any event of default as described and/or defined within said Promissory Notes, shall be 18% per annum.

Exhibit 1 at 10, ¶ 8 (emphasis added).

I interpret the agreement to mean the following: Johnstons were in default as to all of the notes, and although two of the notes had matured, the remaining four notes had not been accelerated because of default; that the Johnstons obtained an extension to and including January 15, 2003 to pay off the notes in full; that Bank was agreeing to forbear application of the default rate based on the default date of March 4, 2002; that the parties agreed to new non-default rates of interest for the notes from the date of the execution of the agreement, and to a new uniform default rate for all the notes if Johnstons defaulted after the execution of the agreement. I do not find, as Bank argues, that Johnstons agreed to a mere suspension of the default rate, and that if there were default under the agreement, the new default rate would be applied retroactively to March 4. Such an interpretation is contrary to the language contained in paragraph 8 on page 10 of the agreement, which states that the application of the new default rate is temporally established to be after the execution of the agreement based on future default.

I construe the agreement to mean that Bank may apply the default rate to the notes beginning on July 24, 2002. This is the date referred to in the Bank’s letter to Johnstons dated November 1, 2002 (Exhibit A). Bank argued in closing that there was an earlier notice of default date upon which Bank could rely for application of the default rate. No evidence of that date was presented at trial. Evidence supports use of the July 24 date as the date of default for application of the default rate of interest.

Cure

Johnstons' plan proposes to cure the default effective the date of the bankruptcy filing by paying off the entire indebtedness after confirmation of the plan. According to the plan, Bank's claim would draw interest at 8 per cent per annum after the filing date until payment in full. Notwithstanding the 8 per cent interest rate specified in the plan, Johnstons agreed with Bank that the interest rate which would be applied after the effective date of cure would be the non-default rates for the notes as agreed in the Forbearance Agreement.

However, Bank contends that Johnstons cannot cure at all under the Bankruptcy Code, but must pay the debt off in full. Alternatively, Bank argues that even if Johnstons can "cure" the default, they can do so only by paying Bank's claim in full, as of the date of payment. Until then, Bank argues, the default rate of 18 per cent should apply.

Johnstons assert that they are curing under 11 U.S.C. § 1123(a)(5)(G), and that the cure, by paying the debt in full, can be made after confirmation, but be effective as of the date of the bankruptcy filing which was September 10, 2003. Such a cure, they argue, would have the effect of nullifying all consequences of default and placing the parties in the *status quo ante* as of September 10. One such consequence of default would be the application of the default interest rate after September 10, 2003.

There are cases which support Johnstons' position. The most similar factually to Johnstons' case is In re Johnson, 184 B.R. 570 (Bankr. Minn. 1995). In that case, the court permitted debtor, under his plan, to cure a default in the payment of a fully secured promissory note to an insurance company. The debtor had defaulted on the note. Five months after the default date, the note matured on its own terms. After maturity of the note, debtor filed chapter 11 in July 1993, and proposed in his plan to pay the debt in full on or before the latter of March 31, 1995 or the plan's effective date. The plan was confirmed. The debtor objected to the creditor's claim. The parties disagreed over whether the insurance company was entitled to default interest after the bankruptcy filing date. The court held that the debtor could "cure" the default, notwithstanding that the debt had not been accelerated, but rather had matured, and that payment in full effectuated such a cure. Payment in full, according to the court was payment of all matured principal and all prepetition default interest and charges. Id. at 574. The court held that the "payment returned the parties to the *status quo ante* as of the petition date, and is therefore a true cure." Id. The court further held that "[b]ecause the payment under the Plan is a full cure, it nullifies all consequences of the default, and accordingly [the insurance company] is unable to accrue interest postpetition at the default rate." Id. at 574-75.

The Minnesota bankruptcy court recognized case authority for the proposition that a fully secured creditor's right to default interest is generally determined under 11 U.S.C. § 506(b) based on equitable considerations. Id. at 573. However, because debtor was curing the default by payment in full, such an equitable analysis was not necessary. Id. at 574. Nonetheless, the court found that the equities favored the debtor. Id. at 575. The court held also that because the debt had matured prepetition, the debtor could not deaccelerate the debt under section 1124(2). Id. at 574. That did not mean that the debtor could not cure. The court ruled cure had been accomplished under 11 U.S.C. § 1123(a)(5)(G), and disallowed the application of the default rate after the bankruptcy petition date. Id. at 575.

I recognize many cases, including circuit court cases, support the proposition that a cure deprives a fully secured creditor of default interest from the date of default. I respectfully disagree with these cases and with the result in In re Johnson, as applied to a case filed after October 22, 1994, the effective date of the 1994 amendments to the Bankruptcy Code.

In the pending case, Johnston argues that he can cure the default effective September 10, 2002, by a payment to the creditor made on October 25, 2004. The result, he says, is to nullify default interest from September 10 to the date of payment, a period of more than two years. I cannot conclude that the debtor may effectuate such a cure, under the notes themselves or the Bankruptcy Code.

I conclude that 11 U.S.C. § 1123(d) controls this issue. Congress amended the Bankruptcy Code by adding the section in 1994. Bankruptcy Reform Act of 1994, P.L. No. 103-394, 108 Stat. 4106, § 305. Section 1123(d) states:

> 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).

I interpret the promissory notes to provide that cure of default after the institution of default rates must include payment of the default rates to the date of cure. An often cited case on the effects of a cure is Di Pierro v. Taddeo (In re Taddeo), 685 F.2d 24 (2nd Cir. 1982). The case stated that

> [a] default is an event in the debtor-creditor relationship which triggers certain consequences–-here, acceleration. 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.

Id. at 26.

I agree that a cure must take care of the triggering event and that cure can nullify consequences. Certainly one such consequence is acceleration, and this may be so regardless of the date of acceleration. But I do not agree that all consequences are necessarily nullified. One consequence of default may be, as here, an increase in the interest rate. But it seems to me that that consequence must be, under the notes, part of the cure.

Section 1123(d) directs us to look at nonbankruptcy law also to determine the amount necessary to cure under a plan. The agreement between Bank and Johnstons is to be construed under Iowa law. Default interest rates are enforceable in Iowa. Federal Land Bank of Omaha v. Wilmarth, 218 Iowa 339, 252 N.W. 507, 510 (1934).

Johnstons' cure must include the payment of default interest to October 25, 2004, the date of payment in full.

ORDER

IT IS ORDERED, ADJUDGED AND DECREED that under the Forbearance Agreement and the promissory notes, Bank is entitled to the application of the default interest rate from July 24, 2002 until October 25, 2004. The parties shall calculate the amount of the claim based on this decision and submit an order to the court allowing the claim of U.S. Bank in the calculated amount.

DATED & ENTERED: December 20, 2004

W L Edmonds

William L. Edmonds, Bankruptcy Judge