Chapter 11 Cramdown Issues: To (b) or Not to (b): The Pros and Cons of the 1111(b) Election

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Quick Reference Sheet: Understanding the § 1111(b) Election

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I. Background

A. Bankruptcy Act – Prior to 1979, bankruptcy was governed by the Bankruptcy Act which allowed a Debtor to value a secured creditors claim and if the creditor was undersecured it could eliminate any further claim for amounts beyond the value of the creditor's interest in its collateral

B. Problem - This allowed and encouraged debtors to file bankruptcy when collateral values were low, reduce their secured debt to the collateral value, satisfy the claim and then receive all future appreciation of the collateral at the expense of the lender [See Major Case Citation: Great Nat'l Life Ins. Co. v. Pine Gate Associates, Ltd., 2 B.C.D. 1478 (N.D. Ga. 1976)]

C. Bankruptcy Code – The "new" Bankruptcy Code included provisions labeled § 506 and § 1111 that redefined a Debtor's ability to deal with undersecured creditors. These provisions define the amount of a secured claim and how it may be dealt with in a bankruptcy proceeding by both debtors and creditors. The language of 1111(b) was intended to compromise the position of these two parties.

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II. Statutes

A. Text of 11 USC § 506(a) -

An Allowed Claim . . . is a **secured claim** to the extent of the value of creditor's security interest in the estate's property (i.e., its collateral value) …and is an **unsecured claim** to the extent that the Allowed Claim exceeds the value of its security interest.

B. Text of 11 USC § 1111

(b) (1)

(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under § 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under § 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if—

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding § 506 (a) of this title, such claim is a secured claim to the extent that such claim is allowed.

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C. Text of 11 USC § 1129(b)(2)(A)(i)

With respect to a class of secured claims, the plan provides:

(I) that the holders of such claims **retain the liens** securing such claim, whether the property subject to such liens is retained by the debtor or transferred to an other entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim **deferred cash payments totaling at least** the allowed amount of such claim, of a value, as of the effective date of the plan, of at least **the value of such holder's interest in the estate's interest in such property**

III. Resolution: What § 1111(b) Does

A. § 506(a) bifurcates claims into two parts: a secured claim equal to the value of the collateral, and an unsecured claim for the remaining amount. It converts a portion of a secured (recourse) claim into an unsecured (non-recourse) claim.

B. § 1111(b)(1) allows a non-recourse creditor to participate as a recourse creditor. It brings the two pieces of the allowed claim back together into a single secured claim (albeit the secured claim amount exceeds the collateral value)

C. The election gives an undersecured creditor the option to benefit from post-confirmation appreciation in value of its collateral. However, if the election is made, the secured creditor abandons unsecured (deficiency) claim

IV. § 1111(b) "Rules"

A. The election must be made no later than the conclusion of the Disclosure Statement Hearing unless the Court orders otherwise

B. Election cannot be made if the claim is of "Inconsequential Value"

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C. Election cannot be made if the property securing the claim is being sold as part of a 363 sale or under a Plan

D. Allows a Secured Creditor to elect to have its entire Allowed Claim treated as a single Secured Claim

E. Class vote, not an individual creditor election

F. Applies unless property is sold via § 363 Sales or through the Plan

G. All liens must remain intact except in the case of a sale where liens may be permitted to attach to substitute collateral

V. Interaction Between § 1111(b) and § 1129(b)(2)(A)(i)

A. § 1129(b)(2)(A)(i) Remains in Full Effect

With respect to a class of secured claims, the plan provides:

(I) that the holders of such claims **retain the liens** securing such claim, whether the property subject to such liens is retained by the debtor or transferred to an other entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class **receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim**, of a value, as of the effective date of the plan, **of at least the value of such holder's interest in the estate's interest in such property**.

B. A Debtor Must Satisfy Both Statutes To Comply With the Code. The § 1111(b) election has no effect on the always-existent § 1129 requirement of repaying the creditor the present value of its collateral interest. However, upon the making of the § 1111(b) election by a creditor, a second requirement whereby the Debtor must also provide a stream of payments that totals to at least the amount of the creditor's allowed claim is added to confirmation requirements.

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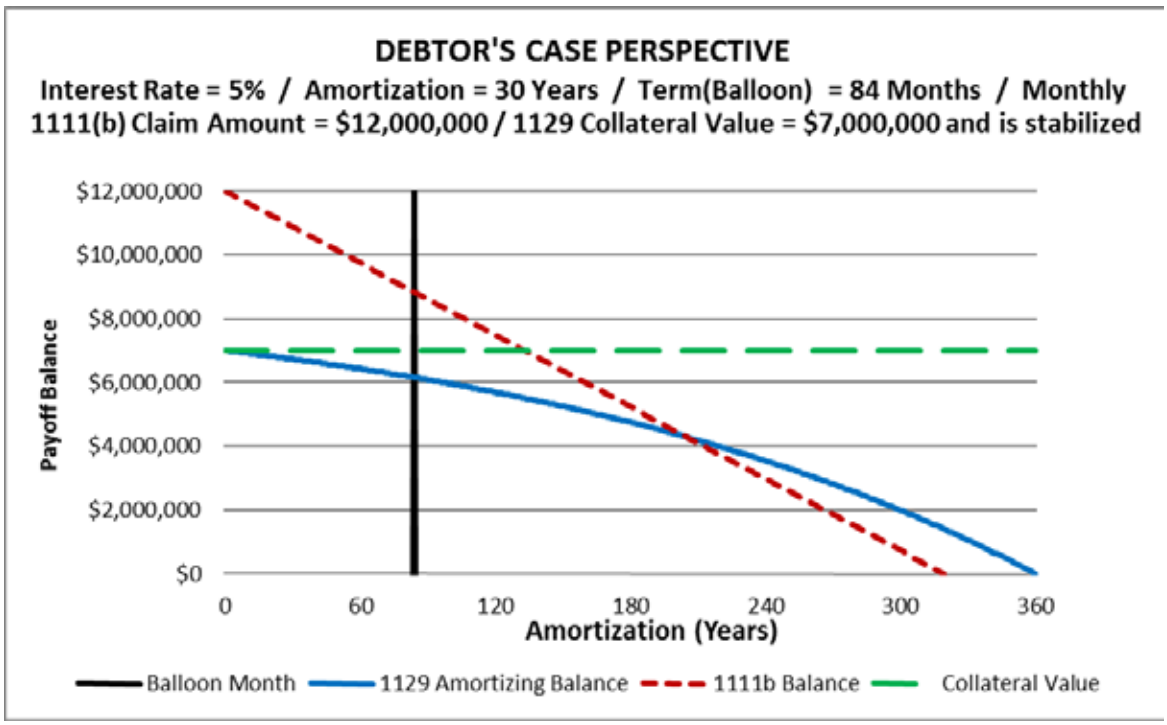
VI. Two Separate Tests for Confirmation

A. Present Value Test – the present value of the payments paid to the secured creditor by the Debtor must equal or exceed the value of the creditor's security interest in its collateral. Under a traditional amortization schedule, the repayment of the loan's principal under 1129 (the outstanding principal balance) will resemble the shape of the red dotted line in the neighboring graph.

B. Aggregate Payment Test – the total, aggregate payments paid to the secured creditor by the Debtor must equal or exceed the amount of the Allowed Claim. Under a traditional amortization schedule, the repayment of the loan's principal under 1111b (the outstanding principal balance) will resemble the shape of the blue solid line in the graph below.

C. The following example uses a loan being crammed down from an allowed claim of $12,000,000 to the secured creditors collateral's value of $7,000,000 whose value is not anticipated to change. It is being repaid on an amortization of thirty years with an interest rate of 5%. Lastly, the value of its collateral is not anticipated to change in value.



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With a loan term of seven years, the higher 1111b balance would be the applicable repayment amount. An extended term of about 18 years is required under these terms for the 1111b and 1129 balances to be equivalent. Naturally, these curves change dramatically based on the balances used, the differences between the allowed claim and the collateral value, the interest rate, and amortization.

VII. Key Points of § 1111(b)

A. Undersecured Creditor has two options: Retain its Secured Claim and an Unsecured Claim totaling the amount of the Allowed Claim, or elect to have one Secured Claim equal in amount to the Allowed Claim,

1. If no election is made, Bankruptcy Code section § 1111(b)(1) permits a non-recourse creditor to participate as a recourse creditor by having an unsecured claim for its deficiency that potentially controls unsecured creditor class
2. The election gives an undersecured creditor the option to benefit from post-confirmation appreciation in value of its collateral
3. If election is made, the secured creditor abandons unsecured (deficiency) claim

B. Liens - All liens must remain intact except in the case of a sale where liens may be permitted to attach to substitute collateral

C. Timing - The election must be made no later than the conclusion of the Disclosure Statement Hearing unless the Court orders otherwise

D. Voting and Objections: -

1. Contrary to popular belief, the making of the election is not a vote against the Plan. A creditor retains it right to vote, it may make the election and still vote for the Plan if it so chooses. (Voting is by Class. Nothing in § 1111(b) effects the voting rights of the Creditor contained in § 1126)
2. Creditor retains its right to vote only its secured claim as, by virtue of the Election, its unsecured claim merges into the secured claim.

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3. Lender retains right to object to Plan on other grounds including Feasibility

VIII. Election and Voting Strategies

A. No Election Made – Retain both unsecured and secured claims and make traditional voting decision to support or fight proposed plan

1. May support the Plan and vote Yes
2. May attempt to defeat plan by voting No against both the secured impaired claim/class and the unsecured claim/class. A common strategy is to not make the election and retain (or contribute to) a No vote that dominates the unsecured class of the plan and precludes a confirmation cramdown.

B. Election Made –

1. Vote Yes for the Plan, this allows the creditor to let the Debtor manage the asset, repay the claim and possibly share in possible appreciation of the collateral.
2. Vote No Against the Plan in (a) class of secured creditors hoping that the plan has no consenting unsecured class, setting up a "feasibility fight" caused by the extra provisions of § 1111(b)(2), or a better settlement opportunity.

IX. Considerations for Both the Debtor and Secured Creditor

A. Will collateral appreciate or depreciate over the life of the Plan?

B. Will collateral require additional cash to maintain or will collateral through off cash that will support the business?

C. Has the collateral been over or under valued? Is that collateral worth more to the Debtor than to the market?

D. In the case of a strategic lender, is the collateral worth more to the lender than to the market?

E. What is likelihood the Debtor will default?

F. Are there special turnover provisions in the Plan if the Debtor defaults?

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G. What is the likelihood the Debtor can or will sell or refinance the collateral during the Plan?

H. What is the likelihood of receiving payments on the unsecured claim? Is it speculative, or guaranteed? Is it capped or a percent of returns?

I. Will the Secured Creditor's rejecting votes make it impossible for the Debtor to have an impaired accepting class at confirmation?

J. Will the election require the Debtor to have a plan term so long as to make the plan so speculative that feasibility is in doubt?

K. Will the election require the Debtor to have a plan term so long as to make the plan fail the "fair and equitable" standard?

X. Debtor Case Strategy

A. Since the election is by class, creditors might be "gerrymandered" into classes to avoid/ minimize the liability created by the § 1111(b) election

B. Negotiate a deal with Secured Creditor to become an accepting class

C. Lengthen Plan term to enhance feasibility by increasing total amount paid under aggregate payment test

XI. Secured Creditor Case Strategy

A. Willing Lender

1. Attempt to negotiate a better payout through threat of § 1111(b)
2. Use § 1111(b) and become the consenting impaired class

B. Unwilling Lender

1. Block Class via voting
2. Block the Plan through Feasibility Challenge
   a) Create Payments that are too high to repay
   b) High Ending Balance making retirement of debt at end of plan not feasible

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De-complicating the 1111(b)(2) Election: There is No Such Thing as an Undersecured Claim In A Cramdown

By Franklind Lea, CIRA

Over the past few years, the consideration and use of the U.S.C. 1111(b)(2) election by lenders has grown considerably. In approximately one third of the eighteen cases that I have been involved in over the last two years, secured creditors have seriously considered or used the election in interest rate and feasibility matters.

Confusion over to implement this little used section of the Code into a bankruptcy plan is rampant and exists throughout the restructuring world. U.S.C. 1111(b)(2) may be best understood by knowing its history. In 1975 a case named Pine Gate appeared before the bankruptcy court in the Northern District of Georgia (In re: Pine Gate Associates, Ltd., 2 B.C.D. 1478). Pine Gate was a residential apartment complex that had fallen on hard times. As you might imagine, Pine Gate's valuation was considerably lower than its original mortgage amount.[1]

Unlike the Bankruptcy Code of today, the Bankruptcy Act then in effect allowed debtors to value an asset, pay this amount to the secured creditor in full satisfaction of its claim, and thereby wipe out any possibility of additional recovery to the secured creditor. In fact, this is precisely what happened in the Pine Gate case. Pine Gate filed and confirmed its plan to pay the secured creditor the valuation on its secured claim. Shortly thereafter, the value of Pine Gate's assets recovered and provided a windfall to the owners at the expense of the lender.

In response, in 1978 Congress addressed the unfair nature of the existing Act and incorporated U.S.C. 1111(b)(2) language into the new Code. Congress's intention was to protect lenders from the type of windfall events that can occur as a result of

[1] Pine Gate actually had two secured creditors and mortgages, but for simplicity we refer to them in a combined manner.

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significantly changing market values, such as in Pine Gate's case, and also from potentially faulty valuations by a bankruptcy court. Although well intended and like much of the language in the bankruptcy code, the language in U.S.C. 1111(b)(2) and its interaction with other parts of the Code isn't always the easiest to interpret.

Under both the former Code and the current Acts, the debtor must treat the entire allowed claim as secured if the value of a secured creditor's security interest exceeds the amount of the secured creditor's allowed claim. In contrast, when the secured creditor's security interest is valued at less than the amount of its claim, both the former and the current Code allow the debtor to break the secured creditor's allowed claim into two claims and create a secured claim equal to the value of the security interest and an unsecured claim for the remainder.

However, under the current Code a secured creditor also receives "1111(b)(2) rights" which provide the secured creditor the additional right to elect to "reassemble" these two claims into a single claim. The amount of this reassembled claim is the creditor's allowed claim and it is secured by the existing lien(s) securing claim. The Code also requires the debtor to pay the secured creditor payments that equal or exceed the amount of this secured claim (i.e., the amount of its allowed claim).

Interpretation of U.S.C. 1111(b)(2) is complicated by the commonplace misuse of key bankruptcy terms, definitions and Code requirements. Somewhat surprising, the Code does not define some of the simplest terms that restructuring professionals use each day. Before reading further, consider the meaning of the terms: allowed claim, claim, secured claim, unsecured claim, undersecured claim, creditor, secured creditor, unsecured creditor, and undersecured creditor. Of these, only claim and creditor are provided formal definitions within the Code.[2]

[2] 11 U.S.C. 506(a) provides informal definitions of allowed claim, secured claim and unsecured. Formal code definitions can be found in 11 U.S.C. 101.

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Because U.S.C. 1111(b)(2) deals specifically with these ideals of creditor and claims, the lack of formal definitions for most of these terms has likely caused much of the confusion over this code section and its interaction with other Code sections. The most common confusion is over the meaning of secured claim, as many practitioners continue to associate the lower bifurcated dollar amount with the term secured claim even after the 1111(b)(2) election is made, instead using the higher amount of the reassembled claim for the secured claim.

In these instances, undersecured claim is usually attached to the full amount of the allowed claim. Having worked through several of these scenarios in the last two years, it is clear to me that using very precise terms can eliminate much of the confusion. Fortunately, the Code does give us some starting points as it defines both claim and creditor. Claim means "right to a payment…" Creditor means an "entity that has a claim against the debtor…" Unfortunately neither of these terms speaks to the relationship among the creditor, its claim and the value of its security interest in its collateral.

Consider the use of the undefined, commonly used term "undersecured creditor". Every restructuring practitioner understands this to mean a creditor holding a claim that is greater than the value of its collateral. This term makes sense to us in our everyday language. Now, consider the meaning of "secured claim" "and "unsecured claim". Each of us would agree that a secured claim holds a security interest in the debtor's collateral. Thankfully, "security interest" is defined by the Code as meaning a "lien created by an agreement". So applying this definition, a creditor holding a security interest possesses a secured claim, thereby making it a secured creditor. Any creditor not holding a security interest possesses an unsecured claim and is an unsecured creditor. Importantly, neither term speaks to the value of the security interest, but only as to whether or not a security interest exists. This is the important distinction.

The natural inclination is to carry over the word "undersecured" from creditor to claim and create the term "undersecured claim", but it is technically incorrect and can create considerable confusion when analyzing the U.S.C. 1111(b)(2) election. On closer

examination, the words "undersecured" and "claim" should not be conjoined when analyzing the creditor's decision of the 1111(b)(2) election. Most of us think of the amount of the secured claim as synonymous with the value of the creditor's security interest on its collateral, but this is incorrect in the context of 1111(b)(2). "Secured" merely conveys the existence of a security interest and "claim" merely conveys a right to payment. Neither word speaks to value.

Once the U.S.C. 1111(b)(2) election is made the secured creditor holds a single (secured) claim with a lien on collateral which is worth less than the amount of its claim. (In making the election, the secured creditor has also given up its unsecured claim.) This is the most important distinction in the U.S.C. 1111(b) language and it is often misunderstood or not considered carefully and therefore is the source of many errors when analyzing the election. In a cramdown under 1129 of the Code, a secured creditor is entitled to receive the present value of its security interest in its collateral, not the present value of the amount of its secured claim.

Importantly, the election of U.S.C. 1111(b)(2) does not change the repayment requirements under other parts of the Code that require a debtor to repay the secured creditor the present value of its collateral interest. U.S.C. 1111(b) in conjunction with U.S.C. 1129(b)(2)(A)(i)(II) add an additional condition to the Code requirements that a debtor must repay the secured creditor the full amount of its allowed claim. In other words, the plan payments made to the secured creditor must equal a present value of the secured creditor's security interest in its collateral and the payments must aggregate to at least the amount of the allowed claim. Both principal and interest payments are counted when determining the aggregate payments under the 1111(b)(2) election.

As an illustration of these requirements, presume that a creditor held an allowed claim for $110[3]. Its claim is secured by a lien on collateral valued at $100. In its plan, the

[3] For simplicity, this example ignores the adequate protection argument of negative amortization, the Code's requirement that the claim not be of inconsequential value, and that the interest rate obligations satisfy the Code's requirements.

debtor bifurcates this claim into a secured claim of $100 and an unsecured claim of $10. The Plan will repay the secured claim through a single payment of at the end of the first year of the bankruptcy plan. The plan provides no payment for the unsecured claim. The end of the year payments will consist of $100 of principal plus interest at 5% ($5) totaling $105. With these plan payments, the Debtor satisfies its obligation to repay the secured creditor the present value of its secured claim, i.e., the $100 of current value plus the $5 of interest to account for the time value of money and the Plan can be confirmed.

However since the creditor holds a lien on collateral whose worth is less than the amount of the allowed claim, it has rights under U.S.C. 1111(b)(2). Now presume that the secured creditor has affirmatively elected to require the Debtor to treat its bifurcated claim as a single secured claim. The amount of the secured claim now becomes $110 and the Debtor now has the additional obligation to make payments on account of the secured claim of at least this amount. Under the Plan the payments to the secured creditor total only $105, leaving a $5 deficiency of the Code's requirement of at least $110. As a result of the deficiency, the Debtor's reorganization plan cannot be confirmed.

To satisfy the Code's requirements and make the Plan viable, the Debtor will need to amend its plan to repay the secured creditor at least another $5 of total payments while making payments whose present value continue to be at least $100. One simple solution would be to raise the interest rate paid to the secured creditor to 10%. This would create an interest payment of $10, which along with the $100 principal payment, would total $110 now meeting aggregate payment test of $110 and continuing to meet the Code's present value test. Another solution might be to stretch out the repayment over a longer period, for instance two years of interest only payments which balloon at the end of the second year. This would generate two years of interest at $5 per year ($10 total) plus the $100 principal repayment at the end of year two to total $110, thereby satisfying the Code's requirements.

De-complicating the 1111(b)(2) Election: There is No Such Thing as an Undersecured Claim In A Cramdown

In addition to the potential to receive additional payments, there are several other reasons that a secured creditor may decide to make the U.S.C. 1111(b)(2) election. Three of the most popular reasons are to: allow the secured creditor the opportunity to participate in the future appreciation of its collateral, create a balloon balance at the end of the bankruptcy term that is too high for the Debtor to repay, thereby making the Plan infeasible; and to make the economic rewards to the Debtor's equity so inconsequential that it loses interest in retaining the asset as part of its bankruptcy plan or abandons its plan altogether. In the final analysis, the secured creditor has to strategically balance these prospects with the condition of giving up its unsecured claim which may allow it a blocking vote to the plan.

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1111(b) ELECTION QUICK REFERENCE SHEET

OVERSECURED CREDITOR

The following example utilizes an initial loan amount of $110.00 with lender's collateral valued at $125.00 (or any amount of $110.00 or greater).

Loan → Debtor's Bankruptcy Filing → Claim → Debtor's Claims Reconciliation → Allowed Claim → Debtor's Valuation & Bifurcation → • Secured Claim • Unsecured Claim

Balances :										
Loan Amount	$	110		n/a		n/a				n/a
Claim Amount		n/a	$	110		n/a				n/a
Value of Lender's Collateral	$	125	$	125	$	125			$	125
Value of Lender's Security Interest		n/a		n/a	$	110			$	110
Allowed Claim Amount		n/a		n/a	$	110			$	110
Secured Claim Amount		n/a		n/a		n/a			$	110
Unsecured Claim		n/a		n/a		n/a			$	-
Amortizing Balance	$	110		n/a		n/a			$	110
Minimum Payment Requirement	$	110		n/a		n/a			$	110
Creditor's Plan Voting Rights :										
Secured Claim Amount										Yes
Unsecured Claim										n/a
Lien Rights :										
Debtor's May Extinquish Secured Claim By Selling Property (Outside of Plan) thru §363 Sale										Yes
Debtor's Plan May Extinquish Secured Claim By Paying the Value of Security Interest										Yes
Lender Retains Right to Credit Bid Sale of Property (Outside of Plan or Thru Plan)										Yes
Debtor May Modify Liens or Substitute Collateral										Yes

UNDERSECURED CREDITOR

The following example utilizes an initial loan amount of $110.00 with lender's collateral valued at $50.00 (or any "consequential" amount less than $110.00).

1111(b)(2) Election Not Made

Loan → Debtor's Bankruptcy Filing → Claim → Debtor's Claims Reconciliation → Allowed Claim → Debtor's Valuation & Bifurcation → • Secured Claim • Unsecured Claim → Creditor's 1111(B)(2) Election Made → Secured Claim (1111(b)(2))

Balances :												
Loan Amount	$	110		n/a		n/a				n/a		n/a
Claim Amount		n/a	$	110		n/a				n/a		n/a
Value of Lender's Collateral		50	$	50	$	50			$	50	$	50
Value of Lender's Security Interest		n/a		n/a	$	50			$	50	$	50
Allowed Claim Amount		n/a		n/a	$	110			$	110	$	110
Secured Claim Amount		n/a		n/a		n/a			$	50	$	110
Unsecured Claim		n/a		n/a		n/a			$	60	$	-
Amortizing Balance	$	110		n/a		n/a			$	50	$	50
Minimum Payment Requirement	$	110		n/a		n/a			$	50	$	110
Creditor's Plan Voting Rights :												
Secured Claim Amount										Yes		Yes
Unsecured Claim										Yes		No
Lien Rights :												
Debtor's May Extinquish Secured Claim By Selling Property (Outside of Plan) thru §363 Sale										Yes		Yes
Debtor's Plan May Extinquish Secured Claim By Paying the Value of Security Interest (i.e., Collateral Value)										Yes		No
Debtor's Plan May Extinquish Secured Claim By Paying the Amount of the Secured Claim(i.e., the Allowed Claim)										Yes		Yes
Lender Retains Right to Credit Bid Sale of Property (Outside of Plan or Thru Plan)										Yes		Yes
Debtor May Modify Liens or Substitute Collateral										Yes		No

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