The § 1111(b) Election: What It Is and Why You Should Care

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THE 1111(b) ELECTION – WHAT IS IT AND WHY YOU SHOULD CARE

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Statutory Review

Determination of Secured Status
Section 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. See 11 U.S.C. § 506(a)

In other words, § 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

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Non-Recourse to Recourse

§ 1111(b)(1)

▸ Allows a non-recourse creditors to participate as a recourse creditor (and potentially control the unsecured vote)
  ◦ Class vote, not an individual creditor election
  ◦ Applies unless property is sold via 363 Sales or through the Plan

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Secure Entire Amount of Claim

§ 1111(b)(2)

▸ Allows a Secured Creditor to elect to have its entire Allowed Claim treated as a single Secured Claim UNLESS:
  ◦ Inconsequential Value
  ◦ Property is being sold as part of a 363 sale or under a Plan

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1111(b)(1)(A)

▸ Allows non-recourse secured creditor to participate as a recourse creditor per Bankruptcy Code Section 506(a), unless class elects:
  ◦ To make the Section 1111(b)(2) election to retain non-recourse claim
  ◦ collateral is sold via Bankruptcy Code Section 363 Sale or through the Plan
▸ By holding a non-recourse unsecured deficiency claim, creditor can vote and potentially control the unsecured creditor class

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1129(b)(2)(A)(i)

▸ With respect to a class of secured claims, the plan provides:
  ◦ (I) that the holders of such claims <u>retain the liens </u>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 <u>receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim</u>, of a value, as of the effective date of the plan, <u>of at least the value of such holder's interest in the estate's interest in such property</u>.

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Making the Election

Key Points of Section 1111(b)

▸ 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

▸ The election gives an undersecured creditor the option to benefit from post-confirmation appreciation in value of its collateral.

▸ However, if election is made, the secured creditor abandons unsecured (deficiency) claim

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Key Points of Section 1111(b)

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

▸ The election cannot be made if secured claim is of inconsequential value

▸ The election decision is made by the class not the individual creditor, although secured creditors are generally separately classified.

▸ The election must be made no later than the conclusion of the Disclosure Statement Hearing unless the Court orders otherwise (FRBP 3014)

▸ Lender retains right to object to Plan on other grounds including Feasibility

▸ If election is made and Plan treatment is then materially altered, secured creditor is not normally bound by its prior election.

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Strategy-How the Election Works and the Common Remedy Secured Creditor <u>Does Not</u> Make Election

▸ Loan Amount: $110
▸ Collateral Value: $100
▸ Plan filed that:
  ◦ No (minimal) payments to the unsecured claim
  ◦ Bifurcates claim into a $100 secured claim and a $10 unsecured claim
  ◦ Interest on secured claim at 5%
  ◦ Total amount due in one year / Principal and interest payments total $105

Assuming Court finds the interest rate and other requirements are met, the Plan could be confirmed

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Two <u>*Independent*</u> Mathematical Requirements for Plan Payments

Present Value (1129)	Aggregate Payment Amount (1111(b))
The discounted value of all future payments must equal the present value of the creditor's security interest in the debtor's property	Total amount of <u>ALL</u> payments (principal and interest) must total <u>AT LEAST</u> amount of the Allowed Claim

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Four Possible Scenarios

	Fails Present Value Test	Passes Present Value Test
Fails Aggregate Payment Text	PV = Fail AP = Fail	PV = Pass AP = Fail
Passes Aggregate Payment Test	PV = Fail AP = Pass	PV = Pass AP = Pass

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Strategy-How the Election Works and the Common Remedy Secured Creditor <u>Makes</u> Election

▸ Secured Creditor now has a single secured claim in the amount of $110
▸ Debtor must still pay the Secured Creditor the present value of its Security Interest ($100), but also has the additional burden of paying the total amount of the Secured Claim ($110)
▸ Debtor meets the present value test required by 1129 – $100 plus $5 interest
▸ Debtor fails to meet the Section 1129(b)(2)(A)(i)(II) test of paying at least the amount of the (total) Secured Claim – $110 because the payments total only $105

> *The Plan is not consistent with the 1111(b)(2) and Section 1129(b)(2)(A)(i)(II) requirements and therefore cannot be confirmed*

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Strategy-How the Election Works and the Common Remedy Example Secured Creditor <u>Makes</u> Election

<u>Debtor Amends Plan to Pay More Interest</u>

▸ Debtor amends its Plan to pay the Secured Creditor interest for two years ($5 + $5 = $10) and then repay the principal ($100)

▸ Total payments now equal $110 meeting the Sections 1129(b)(2)(A)(i)(II) requirements

Assuming Court finds the interest rate and other requirements are met, the Plan could be confirmed

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1111(b) Election Effect on Plan Feasibility

So, if a Debtor passed the **1129(b)(2)(A)(i)(II)** test, but does this mean the Plan is feasible?

No, the Debtor must still meet all of the other Plan feasibility requirements. In most cases, by making the 1111(b) election, the secured creditor effectively "raises the bar" on the Plan's payment requirements and its ability to contest the Debtor's ability to make the Plan payments at the Confirmation Hearing.

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"Election vs. No Election" Strategy – Effect on Voting

No Election

▸ Secured Claim retains right to vote

▸ Unsecured Claim is merged into the Secured Claim; no unsecured vote

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Voting Strategy – Effect on Unsecured Claims

Imagine that you are the Secured Creditor and you want to "block" the Debtor's Plan.

You have two avenues to attack the Plan

1. By making the election and challenging the Plan's feasibility by creating a higher payoff requirement.

2. By not making the election and attempting to use your unsecured vote to control the Unsecured Class, or

Would you make the 1111(b)(2) election?

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1111(b) Mathematical Strategy *Plan Payments and Payoffs*

Potential Mathematical Variables

Claims	Collateral	Repayment Terms
1. Allowed Claim 2. Secured Claim	3. Collateral Value	4. Interest Rate 5. Amortization 6. Term 7. Payment Frequency

6 unique variable creates *720 different possibilities* that can affect the outcome of the mathematical analysis!

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Amortization of the Outstanding Balance Under 1129 and 1111(b)

- 506(a) bifurcates a secured claim into tow parts, a secured claim equal to the value of the collateral, and an unsecured claim for the remaining amount.

- If the 1111(b) election is made, this raises the Secured Claim balance to equal the amount of the Allowed Claim.

- 1129 continues to require the payments total AT LEAST the amount of the (increased) Secured Claim.

- 1129 also requires the secured creditor receive the present value of its interest in the Debtor's property.
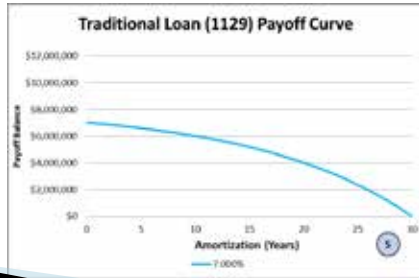
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Payment/Payoff Calculations

| 1129	1111(b)
‣ Balance – Value of Creditor's Security Interest in its Collateral ‣ Payment – includes an interest payment ‣ Payoff – Prior Period balance less amount of principal paid	‣ Beginning Balance – Amount of Allowed Claim ‣ Payment – specified by the terms of the Plan; all amounts paid to the secured creditor ‣ Payoff = Prior Period Balance less (total) Payment
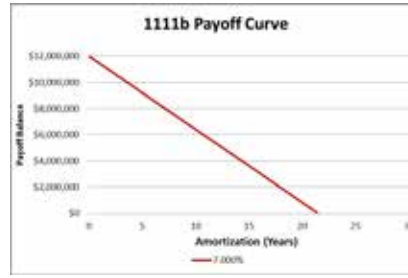
Traditional Loan (1129) Payoff Curve

1111b Payoff Curve

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Traditional Loan (1129) Payoff Curve
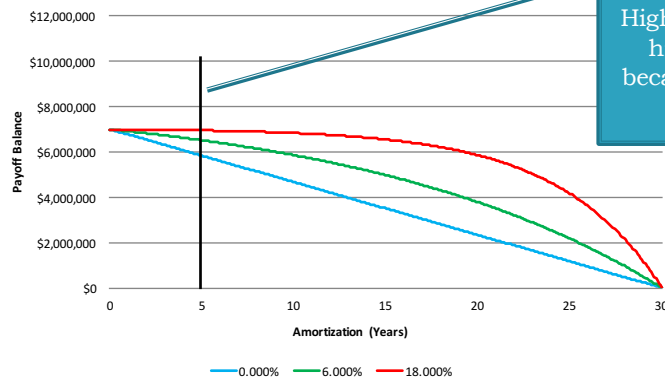
Higher interest rates create higher payoff balances because less payment goes toward principal

0.000%   6.000%   18.000%

Payment amount is higher for higher interest rate

Amortizing Balance	$ 7,000,000	$ 7,000,000	$ 7,000,000
Amortization (Years)	30	30	30
Interest Rate	0.000%	6.000%	18.000%
No. of Payments Per Year	12	12	12
Payment Amount	$ 19,444	$ 41,969	$ 105,496

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1111(b) Payoff Curve

Note that with a 5 year amortization period, it takes longer (approximately 7 years) to pay off the 1111(b) balance

Note that with a 30 year amortization period, it takes less time (approximately 22 years) to pay off the 1111(b) balance

Allowed Claim	$	12,000,000	$	12,000,000	$	12,000,000
Appraised/Present Value	$	7,000,000	$	7,000,000	$	7,000,000
Amortizing Balance	$	7,000,000	$	7,000,000	$	7,000,000
Amortization (Years)		5		15		30
Interest Rate		7.000%		7.000%		7.000%
No. of Payments Per Year		12		12		12
Payment Amount	$	138,608	$	62,918	$	46,571

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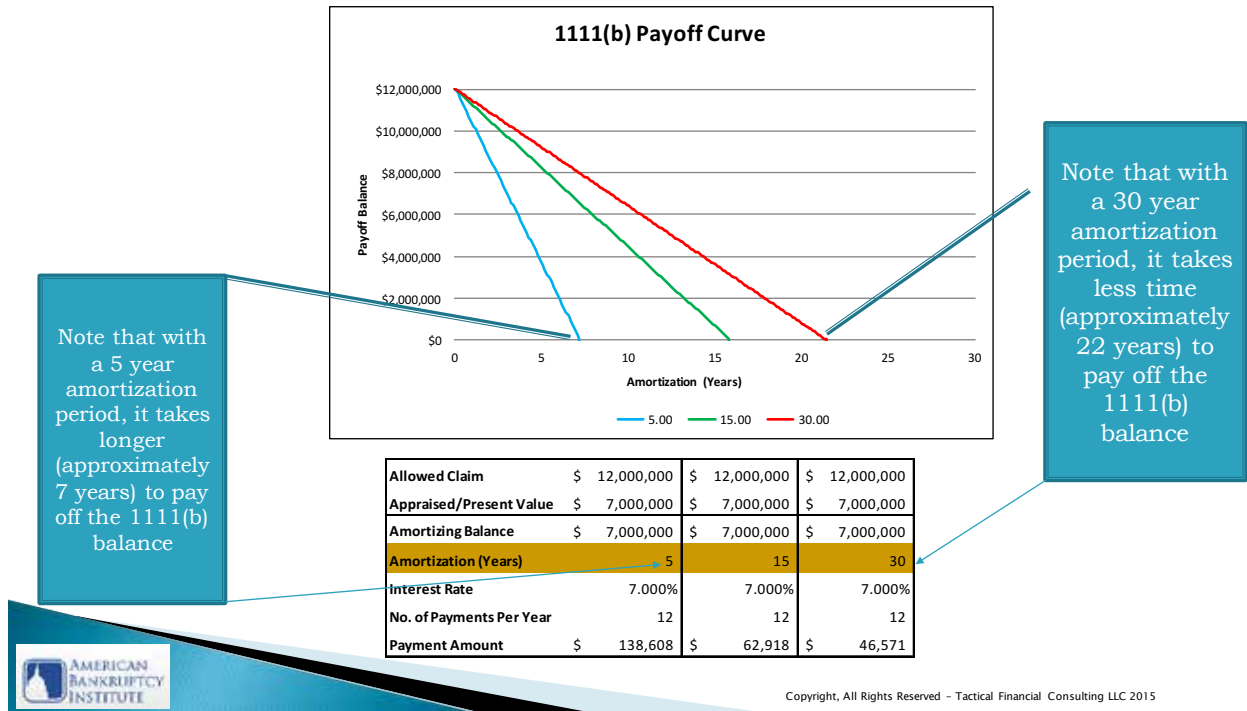
The intersection of the 1129 and 1111(b) Payoff Curves is the "*1111(b) Balance Inflexion Point*"

Payoff Balance: 1129 v. 1111(b)

Balance Inflexion Point

When the repayment term for the secured claim is to the left of the Balance Inflexion Point, the difference between the two values that the red line and blue line represent is referred to as the "1111(b) Premium"

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Traditional Loan (1129) Payoff Curve

Shorter amortizations create lower payoff balances because the payment goes up

Amortizing Balance	$ 7,000,000	$ 7,000,000	$ 7,000,000
Amortization (Years)	5	15	30
Interest Rate	7.000%	7.000%	7.000%
No. of Payments Per Year	12	12	12
Payment Amount	$ 138,608	$ 62,918	$ 46,571

Payment amount is higher for shorter amortization

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Collateral Value

Collateral can change in value during the term of the Plan or it can remain stable.

Collateral value often determines the feasibility of a Plan. Collateral values can behave in a myriad of ways often associated with the type of collateral and its economic life.
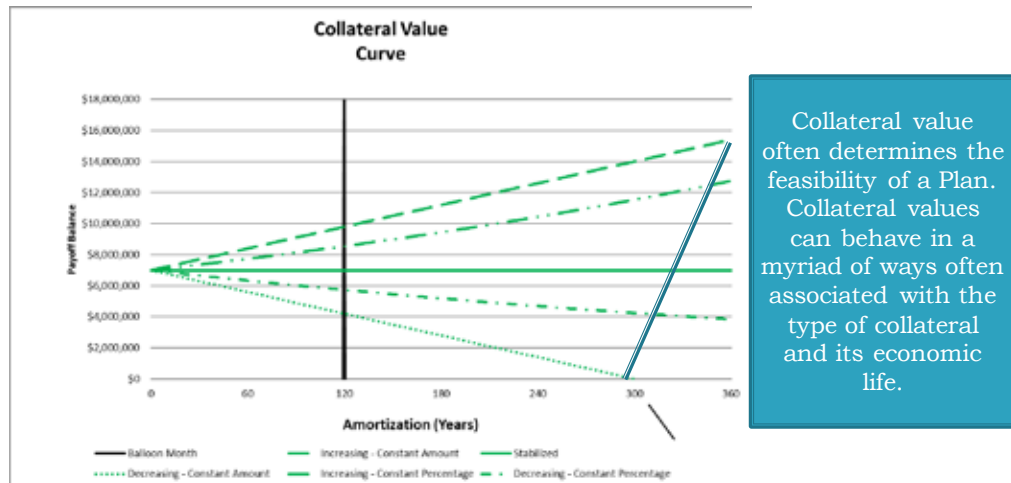
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Elements of the 1111(b) Analysis
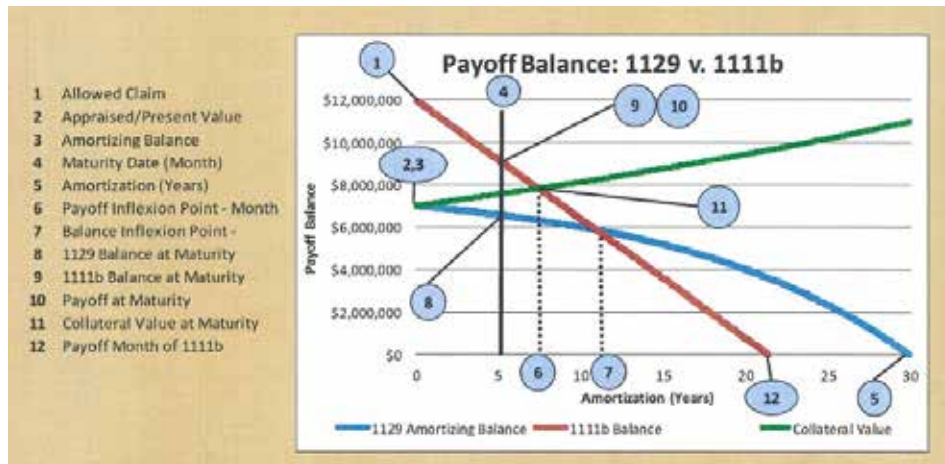
1	Allowed Claim
2	Appraised/Present Value
3	Amortizing Balance
4	Maturity Date (Month)
5	Amortization (Years)
6	Payoff Inflexion Point - Month
7	Balance Inflexion Point -
8	1129 Balance at Maturity
9	1111b Balance at Maturity
10	Payoff at Maturity
11	Collateral Value at Maturity
12	Payoff Month of 1111b

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DYNAMIC CASE PERSPECTIVE

Interest Rate = 9% / Amortization = 25 Years / Term(Balloon) = 60 Months/ Monthly Payment = $58,744

1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is decreasing by -10% Per Year
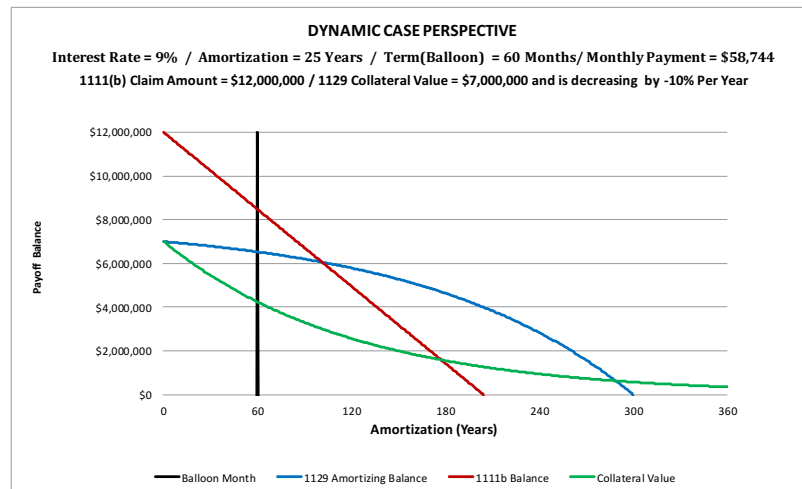
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Voting Strategy – Audience Question

<u>Plan Terms</u>

- Loan Amount: $110

- Collateral Value: $50

- The Plan bifurcates the Secured Creditor's allowed claim into secured claim and an unsecured claim

- There are 4 other unsecured creditors all in favor of the Plan whose claims total $40

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SCENARIO	"Elect"	Don't "Elect"
Secured Creditor: Allowed Claim	$110	$110
Secured Creditor: Secured Claim	$110	$50
Secured Creditor: Unsecured Claim	$0	$60
Other Unsecured Creditors	$40	$40
VOTES		
Secured Creditor: Number of Unsecured Votes	0	1
Other Unsecured Creditors: Number of Unsecured Votes	<u>4</u>	<u>4</u>
Total Number of Unsecured Votes	4	5

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Audience Polling Question

If the Secured Creditor does not make the 1111(b)(2) election will allow it to block the Plan via its Unsecured Votes?

▸ A – "Elect", give up your unsecured vote, and attempt to defeat the Plan based on a lack of feasibility based on the higher payoff requirement

▸ B – "Don't Elect", retain your unsecured vote because it allows you to block the Plan

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"Elect" (& Vote Against the Plan)

	NUMBER TEST		DOLLAR TEST				
	Potential "#" of Votes	"FOR" "#" Votes	Allowed Claim	Secured Claim	Unsecured Claim	Potential "$" Votes	"FOR" "$" Votes
Secured Creditor*	-	-	$ 110	$ 110	$ -	$ -	$ -
Other Unsecured Creditors	4	4	$ 40	$ -	$ 40	$ 40	$ 40
Total	4	4	n/a	n/a	$ 40	$ 40	$ 40
TEST RESULTS	100%	Pass				100%	Pass

Result: The Secured Creditor cannot block the Plan's confirmation based on voting

* Secured Creditor's Holds No Deficiency Claim

that hold at least two-thirds in amount and more than one-half in number of the (voting) allowed claims of such class held by creditors

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"Don't Elect" (& <u>Vote Against</u> the Plan)

	NUMBER TEST		DOLLAR TEST					
	Potential "#" of Votes	"FOR" "#" Votes	Allowed Claim	Secured Claim	Unsecured Claim	Potential "$" Votes	"FOR" "$" Votes	
Secured Creditor*	1	-	$ 110	$ 50	$ 60	$ 60	$ -	
Other Unsecured Creditors	4	4	$ 40	$ -	$ 40	$ 40	$ 40	
Total	5	4	n/a	n/a	$ 100	$ 100	$ 40	
TEST RESULTS	80%	Pass				40%	Fail	

Result: The Secured Creditor blocks the Plan's confirmation with its Unsecured "$" Votes

* Secured Creditor's Deficiency Claim

> that hold at least two-thirds in amount and more than one-half in number of the (voting) allowed claims of such class held by creditors

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Recap on Voting Example

▸ In this example, the Secured Creditor could not have affirmatively "knocked out" the Plan by making the election and casting its unsecured vote against the Plan.

▸ Had the Secured Creditor controlled the unsecured class, it may not have chosen to make the 1111(b)(2) election and make feasibility more difficult for the Debtor.

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Retail Center

- Debtor filed a Chapter 11 bankruptcy for a 20,000 s.f. unanchored retail center
- The Secured Creditor has an allowed claim of *$12,000,000*
- The Secured Creditor has a collateral interest valued at *$7,000,000*
- The Debtor believes the Value of the collateral is expected to *increase by 3% per year and the Secured Creditor expects the value to remain stable*
- The Center has an expected *remaining economic life of 30 years*

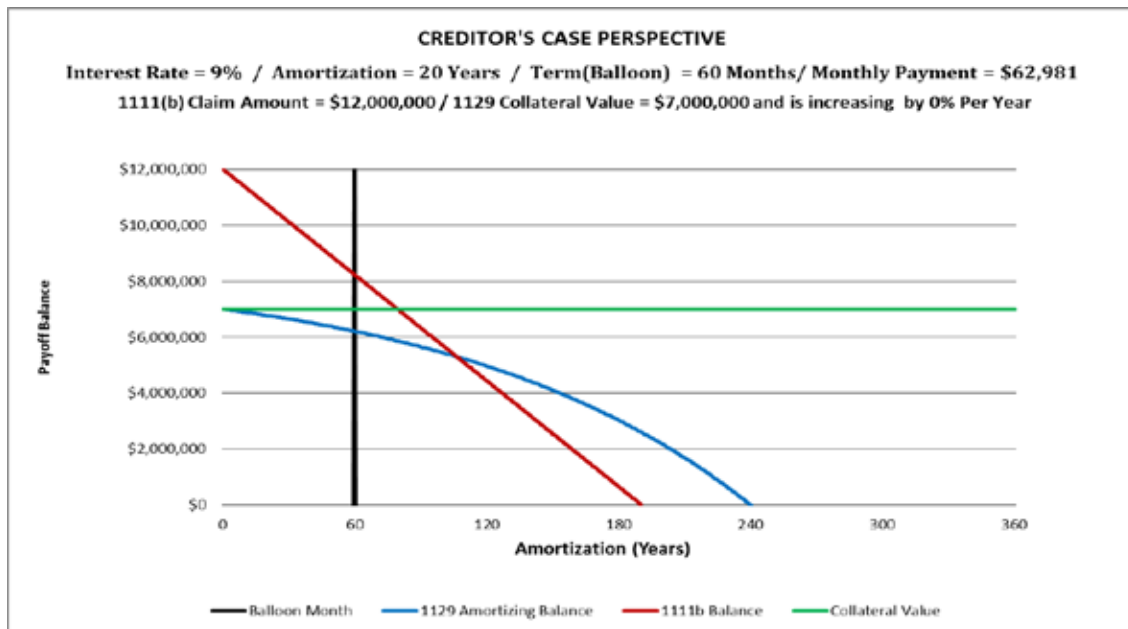| Debtor's Position	Creditor's Position
Interest Rate: 5.0% Term: 15 years Amortization: 30 years Monthly Payment: $37,578	Interest Rate: 9.0% Term: 5 years Amortization: 20 years Monthly Payment: $62,981

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DEBTOR'S CASE PERSPECTIVE

Interest Rate = 5% / Amortization = 30 Years / Term(Balloon) = 180 Months / Monthly Payment = $37,578

1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is stabilized at 3% Per Year

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CREDITOR'S CASE PERSPECTIVE

Interest Rate = 9% / Amortization = 20 Years / Term(Balloon) = 60 Months/ Monthly Payment = $62,981

1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is increasing by 0% Per Year
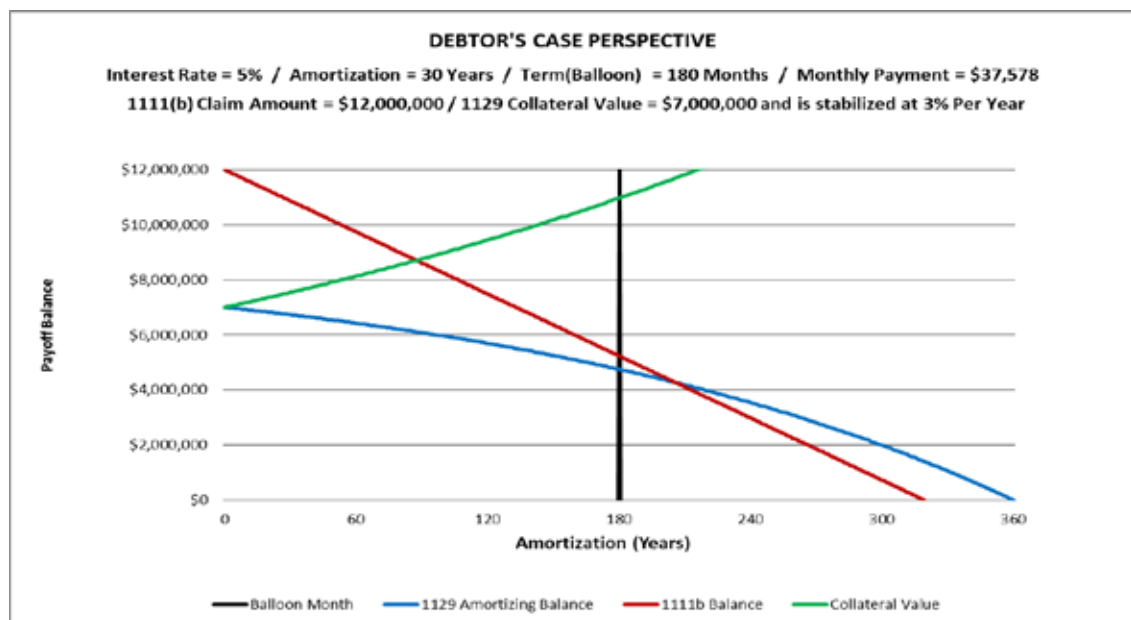
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Printing Company

- Debtor filed a Chapter 11 bankruptcy for a _Printing Company_
- The Secured Creditor has an _allowed claim of $1,200,000_
- The Secured Creditor and Debtor _disagree on the value_ of the collateral
- The collateral is expected to remain _decreasing in value_
- The Center has an expected _remaining economic life of 10 years_

Debtor's Position	Creditor's Position
Collateral Value: $600,000	Collateral Value: $900,000
Interest Rate: 6.0%	Interest Rate: 12.0%
Term: 10 years	Term: 5 years
Amortization: 15 years	Amortization: 8 years
Monthly Payment: $5,063	Monthly Payment: $14,628

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DEBTOR'S CASE PERSPECTIVE

Interest Rate = 6% / Amortization = 15 Years / Term(Balloon) = 180 Months / Monthly Payment = $5,063

1111(b) Claim Amount = $1,200,000 / 1129 Collateral Value = $0,600,000 and is decreasing at 10% Per Year

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CREDITOR'S CASE PERSPECTIVE

Interest Rate = 12% / Amortization = 8 Years / Term(Balloon) = 60 Months/ Monthly Payment = $14,628

1111(b) Claim Amount = $1,200,000 / 1129 Collateral Value = $0,900,000 and is decreasing by 10% Per Year

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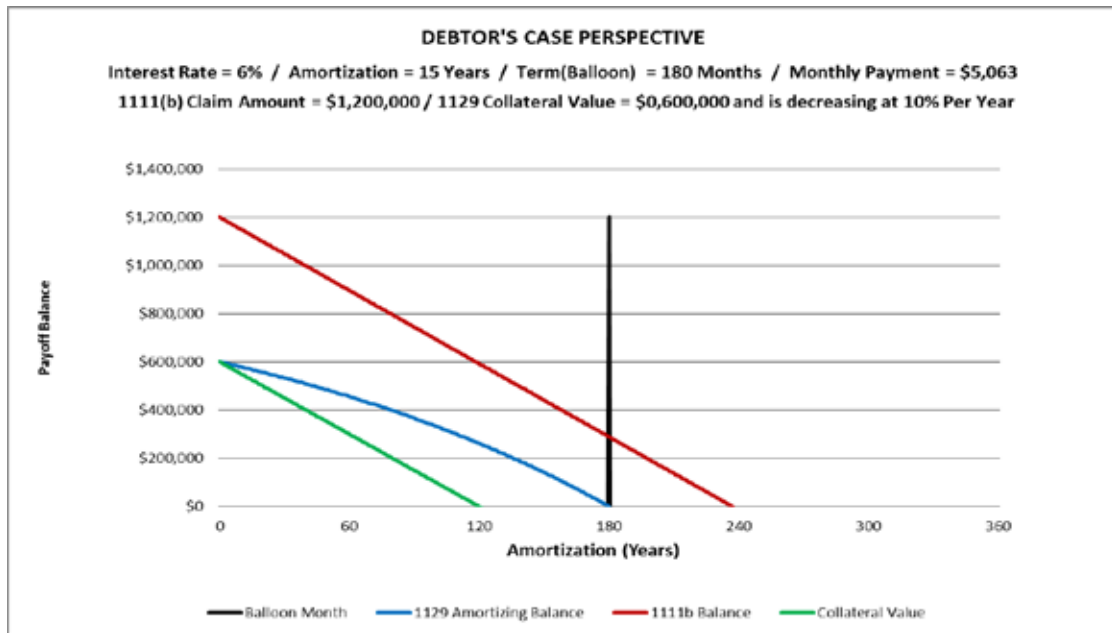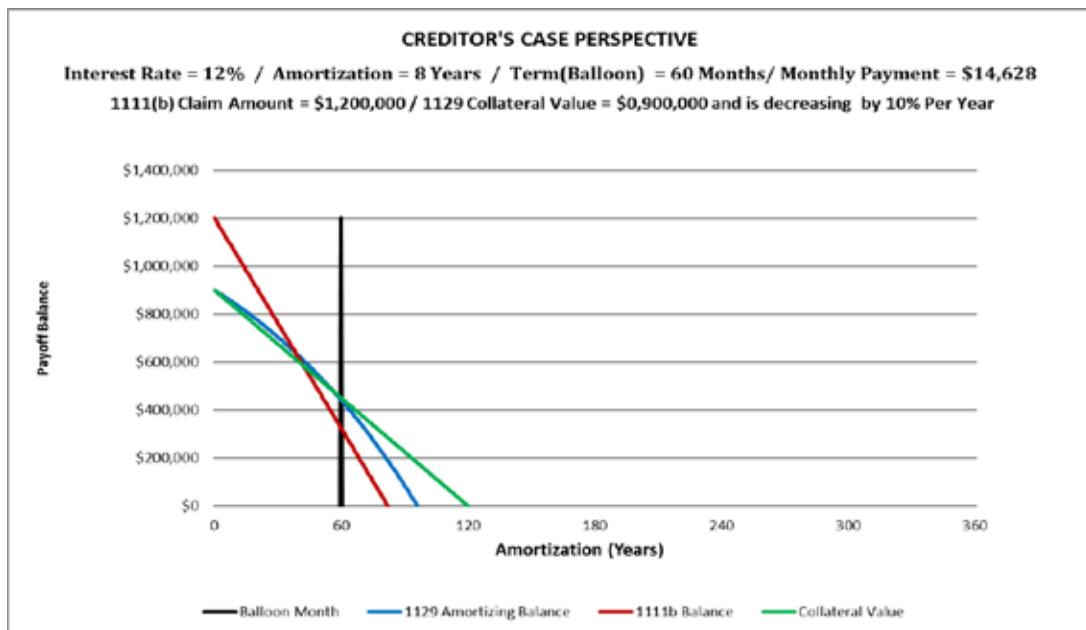
1111(b) Considerations and Negotiating Points

1. Will collateral appreciate or depreciate over the life of the Plan?
2. Will collateral require additional cash to maintain or will collateral throw off cash that will support the business?
3. Has the collateral been over or under valued? Is that collateral worth more to the Debtor than to the market?

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1111(b) Considerations and Negotiating Points

4. In the case of a strategic lender, is the collateral worth more to the lender than to the market?
5. What is likelihood the Debtor will default?
6. Are there special turnover provisions in the Plan if the Debtor defaults?

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1111(b) Considerations and Negotiating Points

7. What is the likelihood the Debtor can or will sell or refinance the collateral during the Plan?
8. What is the likelihood of receiving payments on the unsecured claim? Is it speculative, or guaranteed? Is it capped or a percent of returns?

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1111(b) Considerations and Negotiating Points

9. Will the Secured Creditor's rejecting votes make it impossible for the Debtor to have an impaired accepting class at confirmation?
10. 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?
11. Will the election require the Debtor to have a plan term so long as to make the plan fail the "fair and equitable" standard?

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Potential Debtor Strategies

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

▸ Negotiate a deal with Secured Creditor to become an accepting class

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

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Potential Secured Creditor Strategies

Willing Lender	Unwilling Lender

▸ Attempt to negotiate a better payout through threat of 1111(b)
 ▸ Use 1111(b) and become the consenting impaired class
	◦ Block Class via voting
	 ▸ Block the Plan through Feasibility Challenge
	   ◦ Payments Too High
	   ◦ High Ending Balance

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Case Law – General Standard

▸ A court is allowed to confirm a plan under Section 1129(b) if it determines that the plan does not discriminate unfairly, is fair and equitable with respect to each class of impaired claims or interests which have not accepted the plan, and all provisions of Section 1129(a) except for paragraph (8) have been met.

▸ The consequence of an election is that a plan is required to "pay an amount equal to the greater of the present value of the secured portion of the creditor's claim or the full amount of the claim without interest, whichever is the larger amount." *In re Scruggs*, 342 B.R. 571, 575 (Bankr. E.D. Ark. 2006). When a creditor has made the election, a plan must provide for the following: (1) retention of electing secured creditor's lien on the property in the full amount of the claim, (2) deferred cash payments with a present value of the creditor's claim; and (3) deferred cash payments totaling at least the allowed amount of the total creditor's claim. *In re Brice Road Developments*, 392 B.R. at 285.

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Case Law – Changing the 1111(b) Election

▸ A secured creditor may change its decision regarding a § 1111(b)(2) election even after a court has approved a disclosure statement where the plan is subsequently modified in a manner which is materially adverse to the creditor. *In re Elmwood, Inc.*, 182 B.R. 845, 854 (D. Nev. 1995); *see also In re Scarsdale Realty Partners, L.P.*, 232 B.R. 300, 301 (Bankr.S.D.N.Y.1999); *In re Paradise Springs Associates*, 165 B.R. 913, 918 (Bankr. D. Ariz. 1993); *In re RBS Industries, Inc.*, 115 B.R. 419, 421 n. 2 (Bankr. D. Conn. 1990); *In re Century Glove, Inc.*, 74 B.R. 958, 961 (Bankr. D. Del. 1987); *In re Keller*, 47 B.R. 725, 730 (Bankr. N.D. Iowa 1985).

▸ 11 U.S.C. § 1129(b)(2)(A)(i)(II) requires that the present value of the electing creditor's stream of payments need only equal the present value of the collateral, which is the same amount that must be received by the non-electing creditor, but the sum of the payments must be in an amount equal [to] at least the creditor's total claim. *In re Brice Road Developments*, 392 B.R. 274, 285 (6th Cir. BAP 2008); *see also In re Weinstein*, 227 B.R. 284, 295 (9th Cir. BAP 1998) ("the electing creditor receive its 'true' secured claim, i.e., the value of its collateral, in full at the time of plan confirmation or in deferred payments with interest so that the present value of the secured claim is provided . . . [t]he electing creditor should also receive payments on the unsecured portion of its claim without interest, if necessary, so that, at a minimum, the total payments received is equal the creditor's total claim").

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"Inconsequential Value" Analyzed

▸ *In In re McGarey*, 529 B.R. 277 (D. Ari 2015).

▸ In this case, the secured creditor had a total claim of approximately $2.335 million. The debtor and the secured creditor stipulated that the equity in the property subject to the lien was $80,000. The total property value was approximately $480,000. The secured creditor made the Section 1111(b)(2) election. The debtor objected to the election on the grounds that the value was inconsequential pursuant to the terms of the statute. The Bankruptcy Court denied the debtor's motion and an appeal ensued. The District Court affirmed the Bankruptcy Court's denial of the debtor's motion, holding that in order to determine inconsequential value, Section 1111(b) directs that the court compare the lien value to the asset value, not the lien value to the secured creditor's overall claim amount.

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Secured Creditor Can't Carve Out Claims From Election

▸ Secured creditor filed a single secured proof of claim in the amount of $9.3 million. The creditor made the Section 1111(b)(2) election. In its election notice, the secured creditor attempted to carve out a portion of its claim related to claims for alleged breach of a noncompete agreement. The Court noted that it could not locate any authority permitting a secured creditor to except out portions of its secured claim from the election. The court found that Section 1111(b)(2) specifically provides that if an election is made, notwithstanding Section 506(a), such claim is a secured claim. As such, the Bankruptcy Court held that the election applied to the entirety of the secured claim. *In re Couture Hotel Corporation*, 536 B.R. 712 (N.D. Tex. 2015).

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Sale in Plan Defeats Election

▸ A secured creditor by virtue of a prepetition mechanic's lien made the Section 1111(b)(2) election. The plan recognized the secured creditor's lien on certain assets. The plan provided for the sale of the assets pursuant to Section 363.   The secured creditor did not participate in the confirmation hearing. The plan was confirmed. Thereafter, the secured creditor argued that it had either the right to credit bid at a sale or be granted it's Section 1111(b)(2) election. The Bankruptcy Court denied the election.   That denial was affirmed by the District Court and by the Fifth Circuit Court of Appeals. The Fifth Circuit held that because the secured creditor had the right to credit bid for sale but failed to exercise that right and because Section 1111 denies the election in that situation, the Bankruptcy Court and the District Court both correctly rejected the claim. *Baker Hughes v. Morton* (*In re R.L. Adkins Corp.*), 784 F. 3d 978 (5th Cir. 2015).

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THANK YOU

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