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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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For additional information please contact Franklind Lea at 770-573-9366

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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.

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.

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.