

# CHAPTER 11 CRAMDOWN ISSUES

## TO (B) OR NOT TO (B) / THE PROS AND CONS OF THE 1111(B) ELECTION

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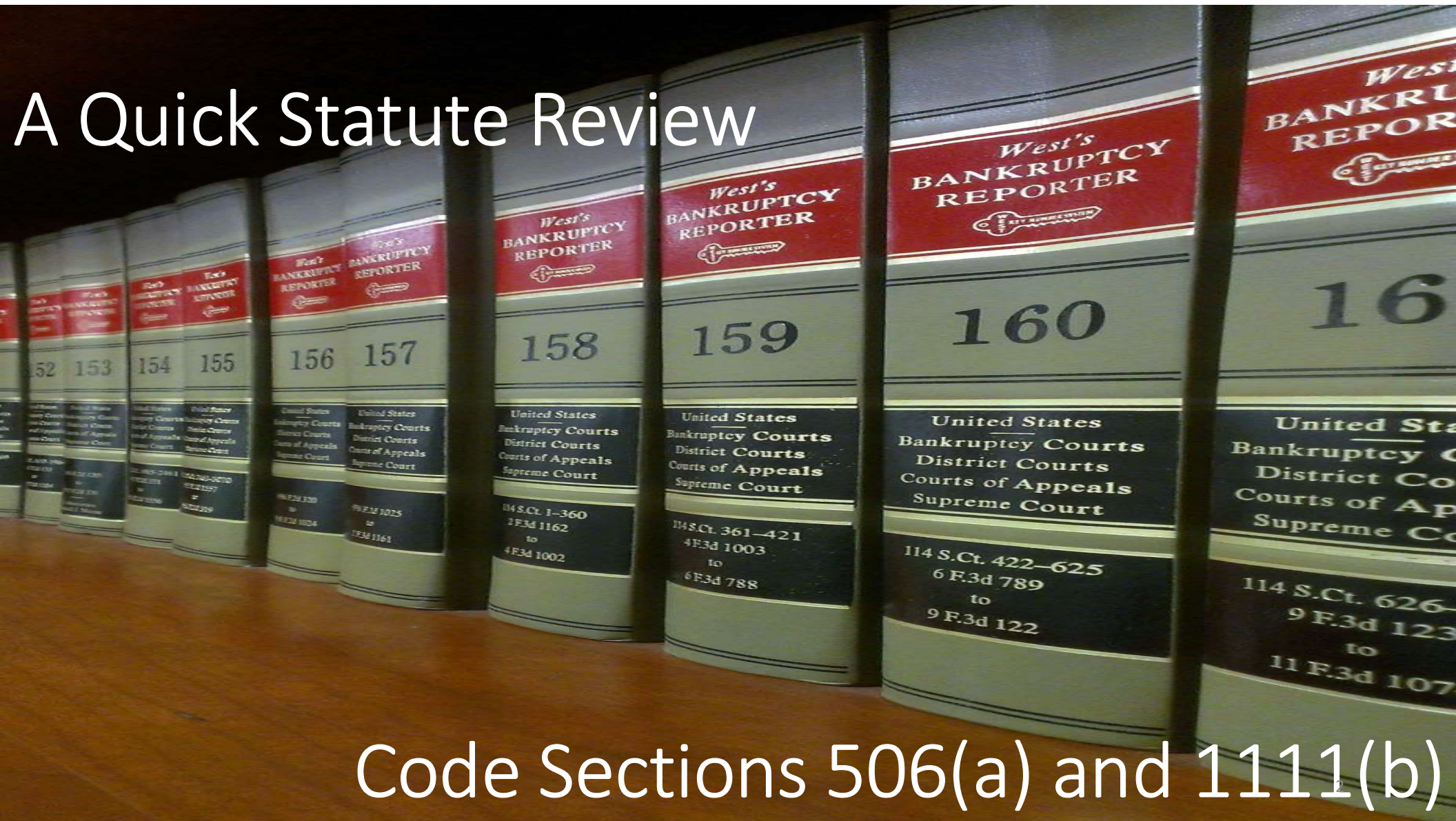
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# A Quick Statute Review



Code Sections 506(a) and 1111(b)

# 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

# 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

## 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

## 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

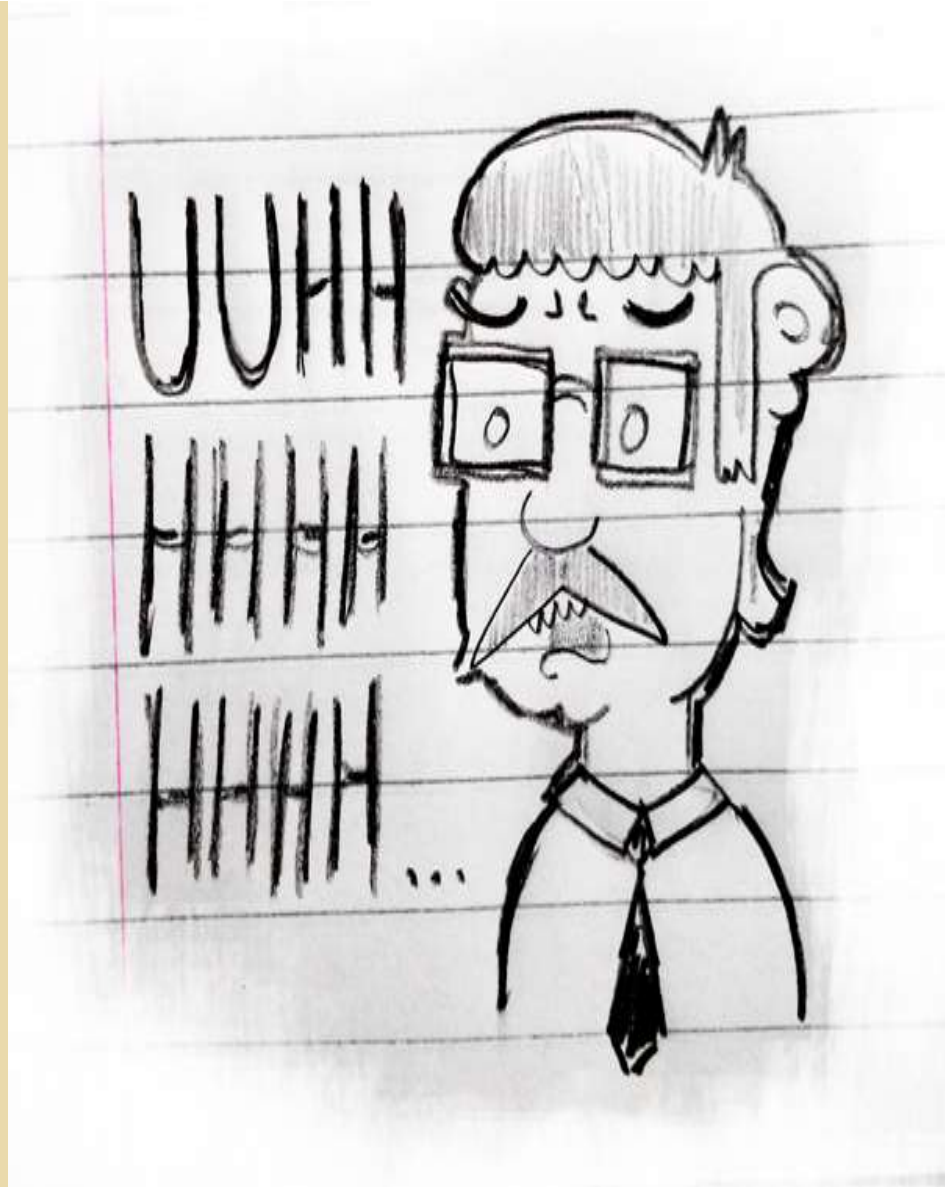
## 1129(b)(2)(A)(i)

- 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.**



# Why Make the Election?

*General Strategy*





## 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

## 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

## Key Points of Section 1111(b)

- The election must be made no later than the conclusion of the Disclosure Statement Hearing unless the Court orders otherwise
- Lender retains right to object to Plan on other grounds including Feasibility

## Strategy – How the Election Works and the Common Remedy Secured Creditor Does Not 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*

# Two Independent Mathematical Requirements for Plan Payments

## Present Value (1129)

The discounted value of all future payments must equal the present value of the creditors security interest in the debtor's property

## Aggregate Payment Amount (1111)

+

Total amount of ALL payments (principal and interest) must total AT LEAST amount of the Allowed Claim

# Four Possible Scenarios

	<b>Fails Present Value Test</b>	<b>Passes Present Value Test</b>
<b>Fails Aggregate Payment Test</b>	PV = Fail AP= Fail	PV = Pass AP= Fail
<b>Passes Aggregate Payment Test</b>	PV = Fail AP= Pass	<b>PV = Pass AP= Pass</b>

## Strategy – How the Election Works and the Common Remedy

### Secured Creditor Makes the 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***



## Strategy – How the Election Works and the Common Remedy Example Secured Creditor Makes the Election

### Debtor Amends Plan to Pay More Interest

- 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*

# 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.**

# “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



# Voting Strategy – Effect on Unsecured Claims

In the following example, imagine that you are the Secured Creditor and you want to “block” the Debtor’s Plan.

You have two avenues to attack the Plan –

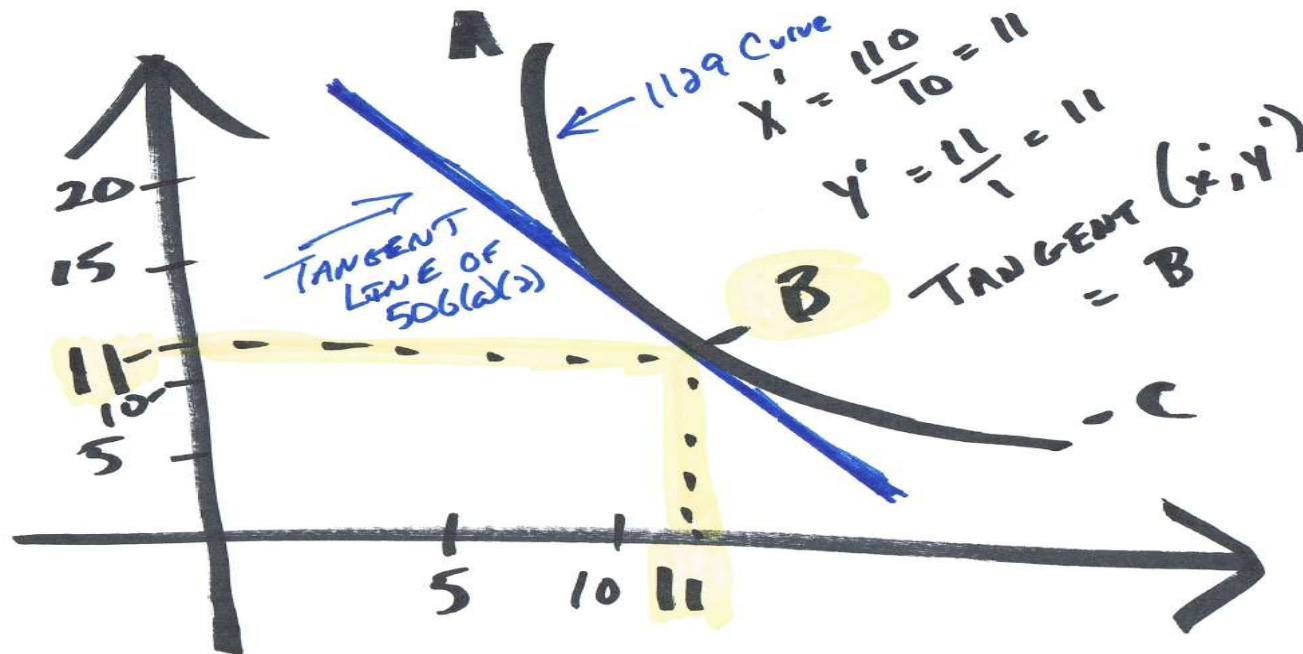
- (1) by making the election and challenging the Plan’s feasibility by creating a higher payoff requirement.
- (2) by not making the election and attempting to use your unsecured vote to control the Unsecured Class, or

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



*Strategy*





Therefore, if  $(506(a))^2 = f(1129(b)(2)^3$ ,  
 then  $f(y) = 1111(b)(2)$

# 1111(b) Mathematical Strategy Plan Payments and Payoffs

# Potential Mathematical Variables

## Claims

1. Allowed Claim
2. Secured Claim

## Collateral

3. Collateral Value

## Repayment Terms

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!



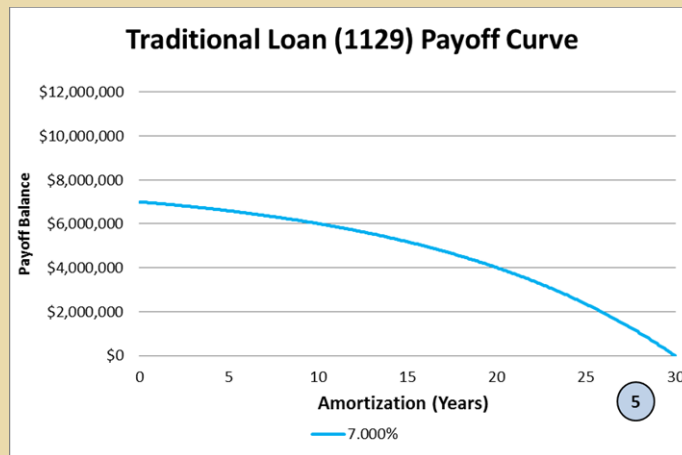
# Amortization of the Outstanding Balance Under 1129 and 1111(b)

- 506(a) bifurcates a secured claim into two 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.

# Payment/Payoff Calculations

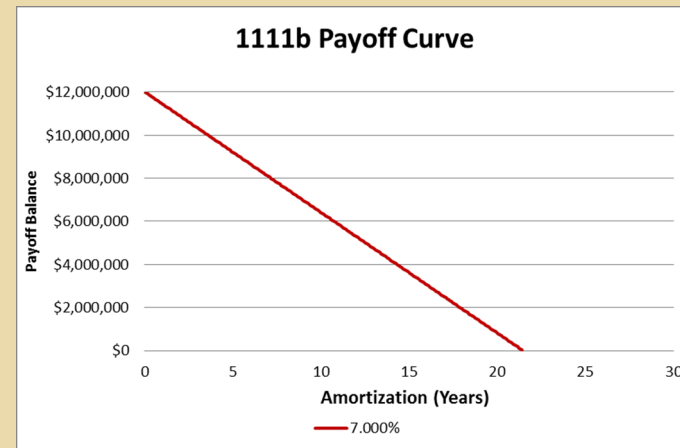
## 1129

- Balance – Value of Creditor’s Security Interest in its Collateral
- Payment – includes an interest payment
- Payoff – Prior Period balance less amount of principal paid

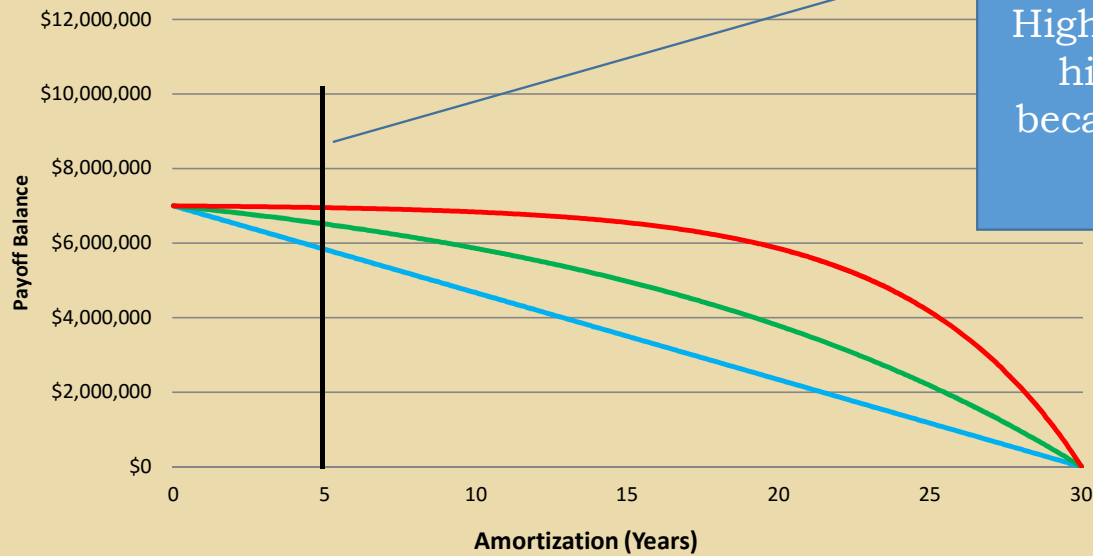


## 1111(b)

- 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



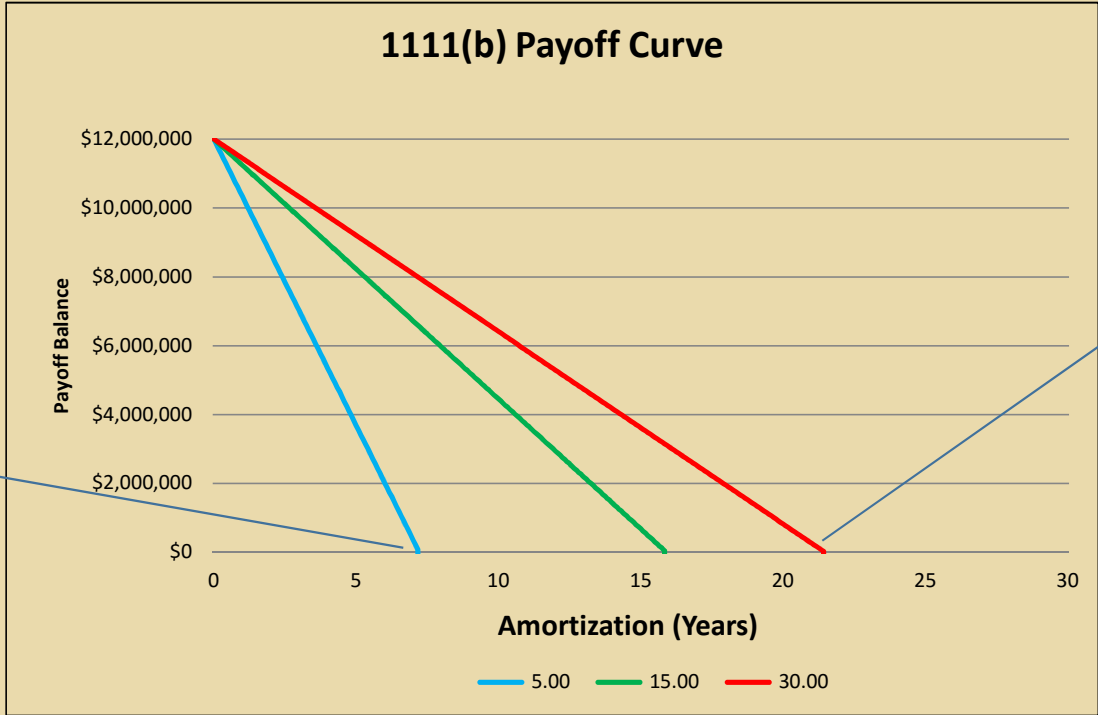
Higher interest rates create higher payoff balances because less payment goes toward principal

Interest Rates    0.000%    6.000%    18.000%

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

Payment amount is higher for higher interest rate

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

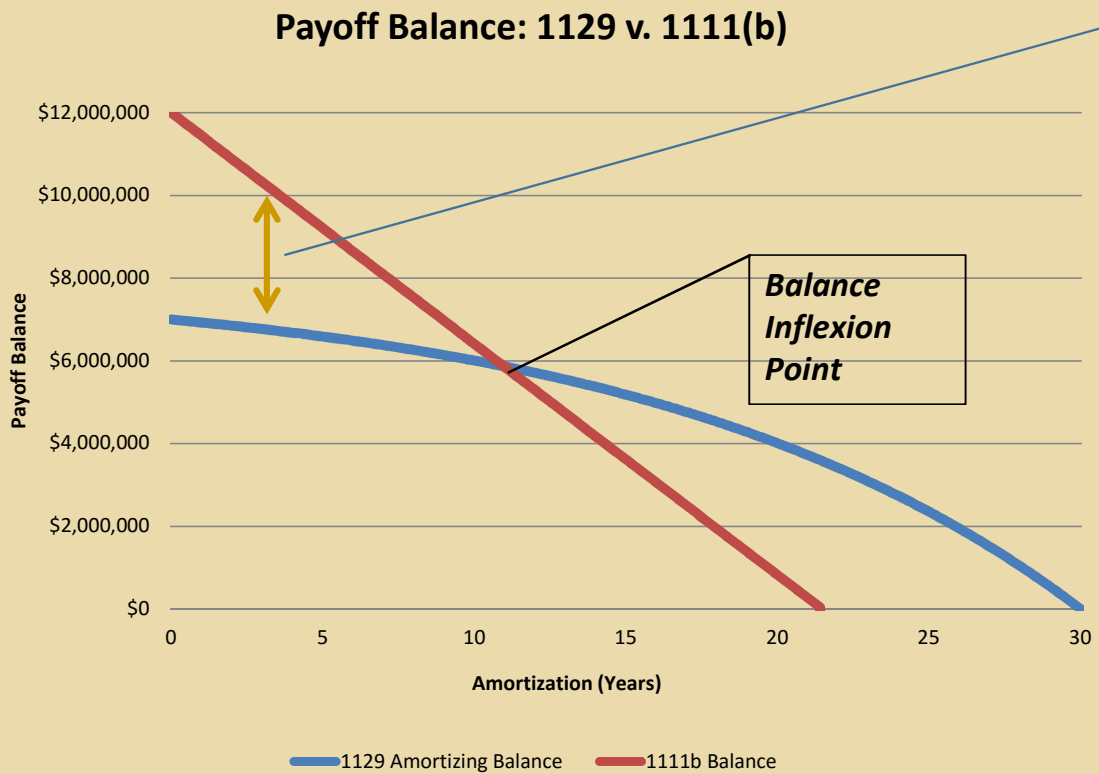


Note that with a 30 year amortization period, it takes less time (approximately 22 years) to pay off the 1111(b) balance

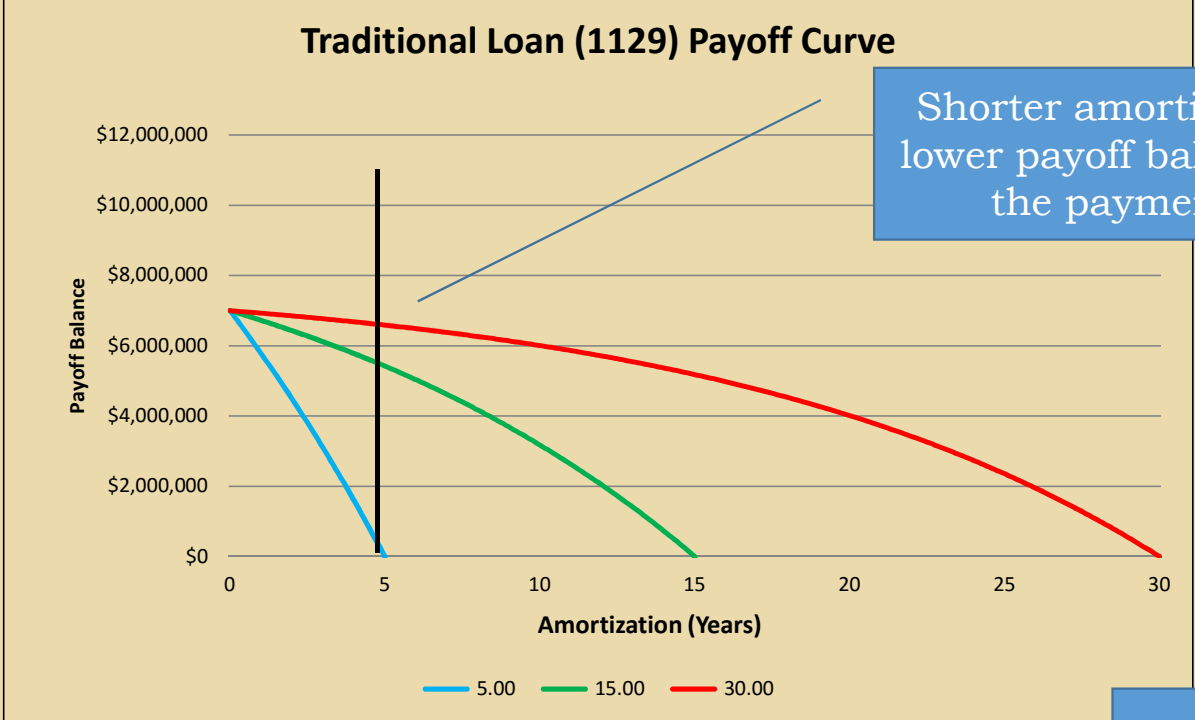
<b>Allowed Claim</b>	\$ 12,000,000	\$ 12,000,000	\$ 12,000,000
<b>Appraised/Present Value</b>	\$ 7,000,000	\$ 7,000,000	\$ 7,000,000
<b>Amortizing Balance</b>	\$ 7,000,000	\$ 7,000,000	\$ 7,000,000
<b>Amortization (Years)</b>	5	15	30
<b>Interest Rate</b>	7.000%	7.000%	7.000%
<b>No. of Payments Per Year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



# The intersection of the 1129 and 1111(b) Payoff Curves is the “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”



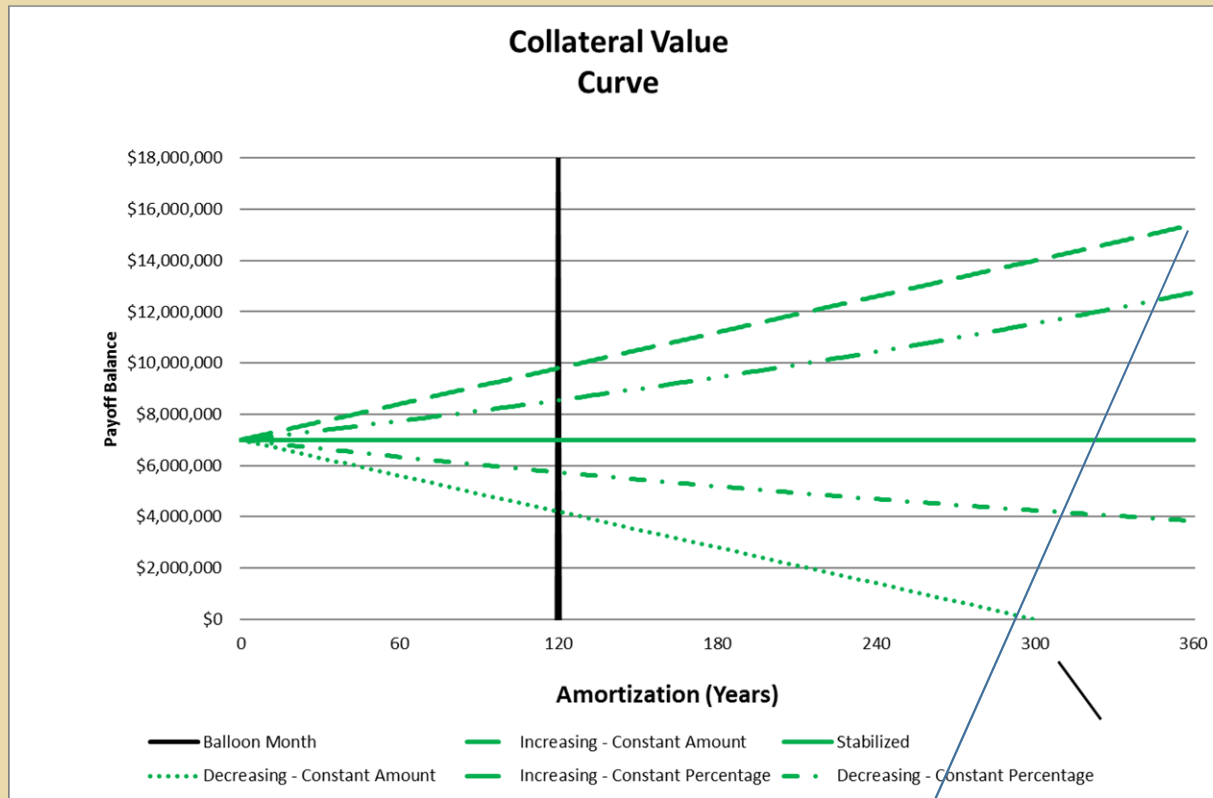
Shorter amortizations create lower payoff balances because the payment goes up

Payment amount is higher for shorter amortization

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

# Collateral Value

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

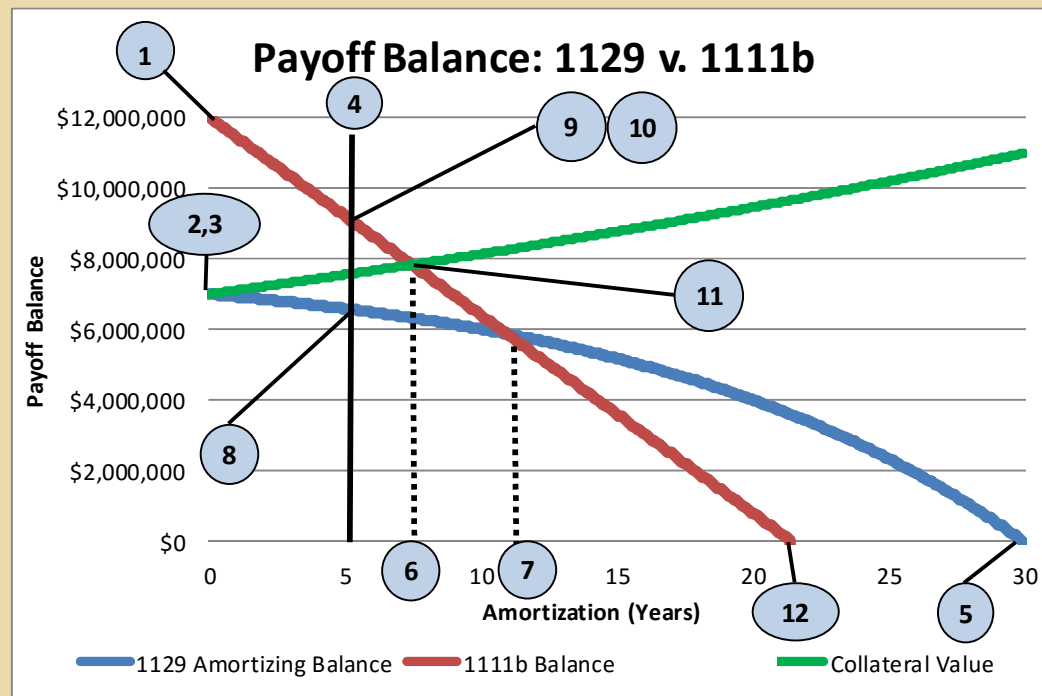


Collateral value often determines the feasibility of a Plan. Collateral values can behave in a myriad of ways often associated with the type of collateral and its economic life.



# Elements of the 1111(b) Analysis

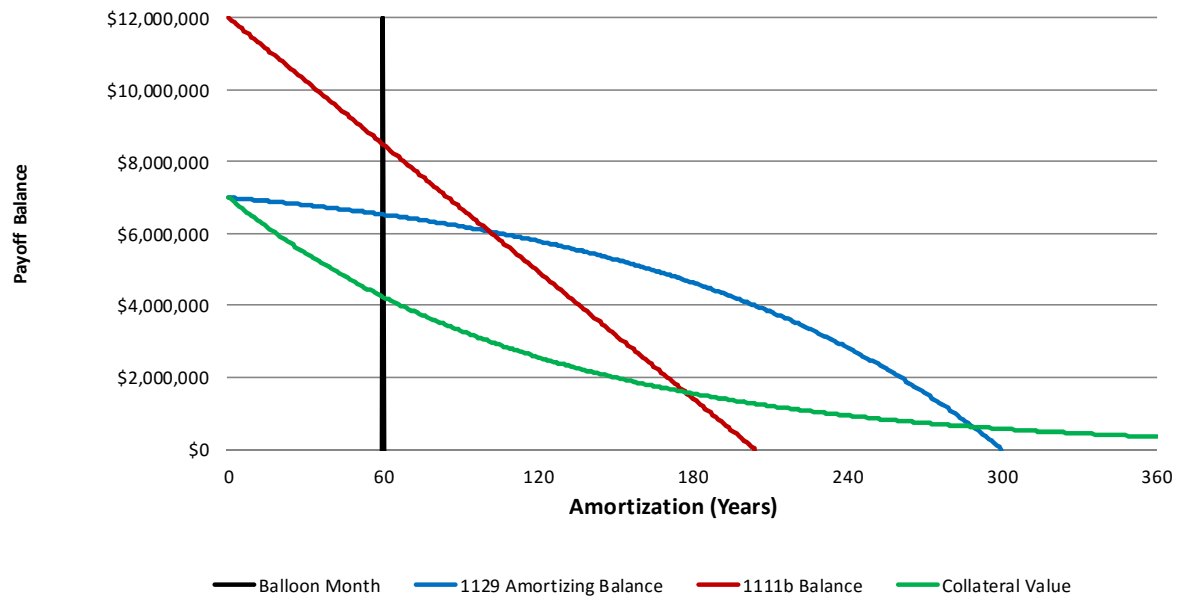
- 1 Allowed Claim
- 2 Appraised/Present Value
- 3 Amortizing Balance
- 4 Maturity Date (Month)
- 5 Amortization (Years)
- 6 Payoff Inflexion Point - Month
- 7 Balance Inflexion Point -
- 8 1129 Balance at Maturity
- 9 1111b Balance at Maturity
- 10 Payoff at Maturity
- 11 Collateral Value at Maturity
- 12 Payoff Month of 1111b



### 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



# Voting Strategy – Audience Question

## Plan Terms

- 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

# Creditor Claim(s)

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
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

# 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

# “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
<b>Total</b>	4	4	n/a	n/a	\$ 40	\$ 40	\$ 40
<b>TEST RESULTS</b>	<b>100% Pass</b>		<b>100% Pass</b>				

**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 allowed claims of such class held by creditors

# “Don’t 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*	1	-	\$ 110	\$ 50	\$ 60	\$ 60	\$ -
Other Unsecured Creditors	4	4	\$ 40	\$ -	\$ 40	\$ 40	\$ 40
<b>Total</b>	5	4	n/a	n/a	\$ 100	\$ 100	\$ 40
<b>TEST RESULTS</b>	<b>80% Pass</b>		<b>40% Fail</b>				

**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 allowed claims of such class held by creditors



# Recap on Voting Example

- In this example, the Secured Creditor could not have affirmatively “knocked out” the Plan by not 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.

# Retail Center

- Debtor filed a Chapter 11 bankruptcy for a 20,000 unanchored retail center
- The Secured Creditor has an allowed claim of *\$12,000,000*
- The Secured Creditor has a collateral interest valued at *\$1,300,000*
- The Value of the collateral is expected to remain *increase by 3% per year*
- The Center has an expected *remaining economic life of 30 years*

## **Debtor's Position**

Interest Rate: 5.0%

Term: 15 years

Amortization: 30 years

Monthly Payment: \$37,578

## **Creditor's Position**

Interest Rate: 9.0

Term: 5 years

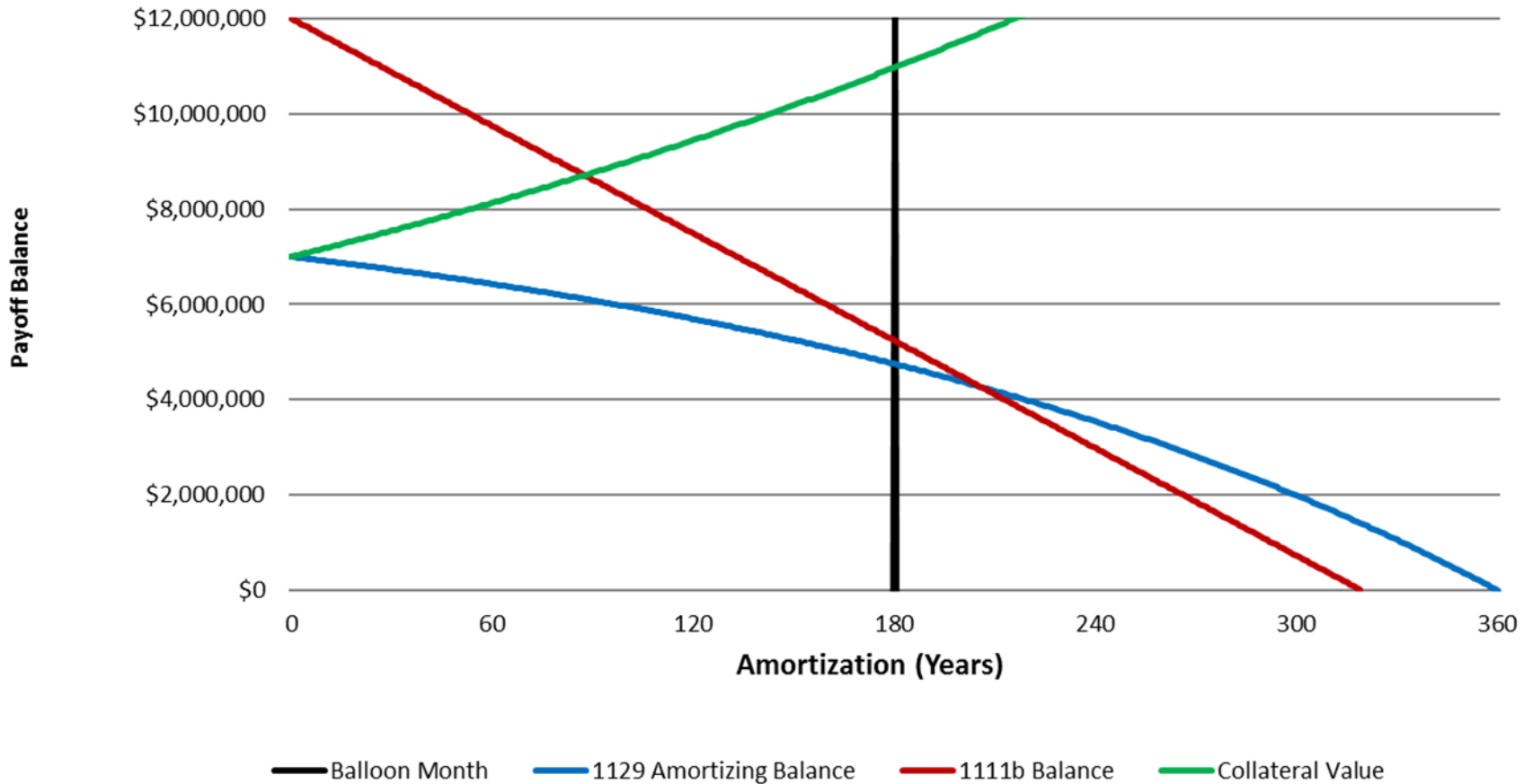
Amortization: 20 years

Monthly Payment: \$62,981

### DEBTOR'S CASE PERSPECTIVE

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

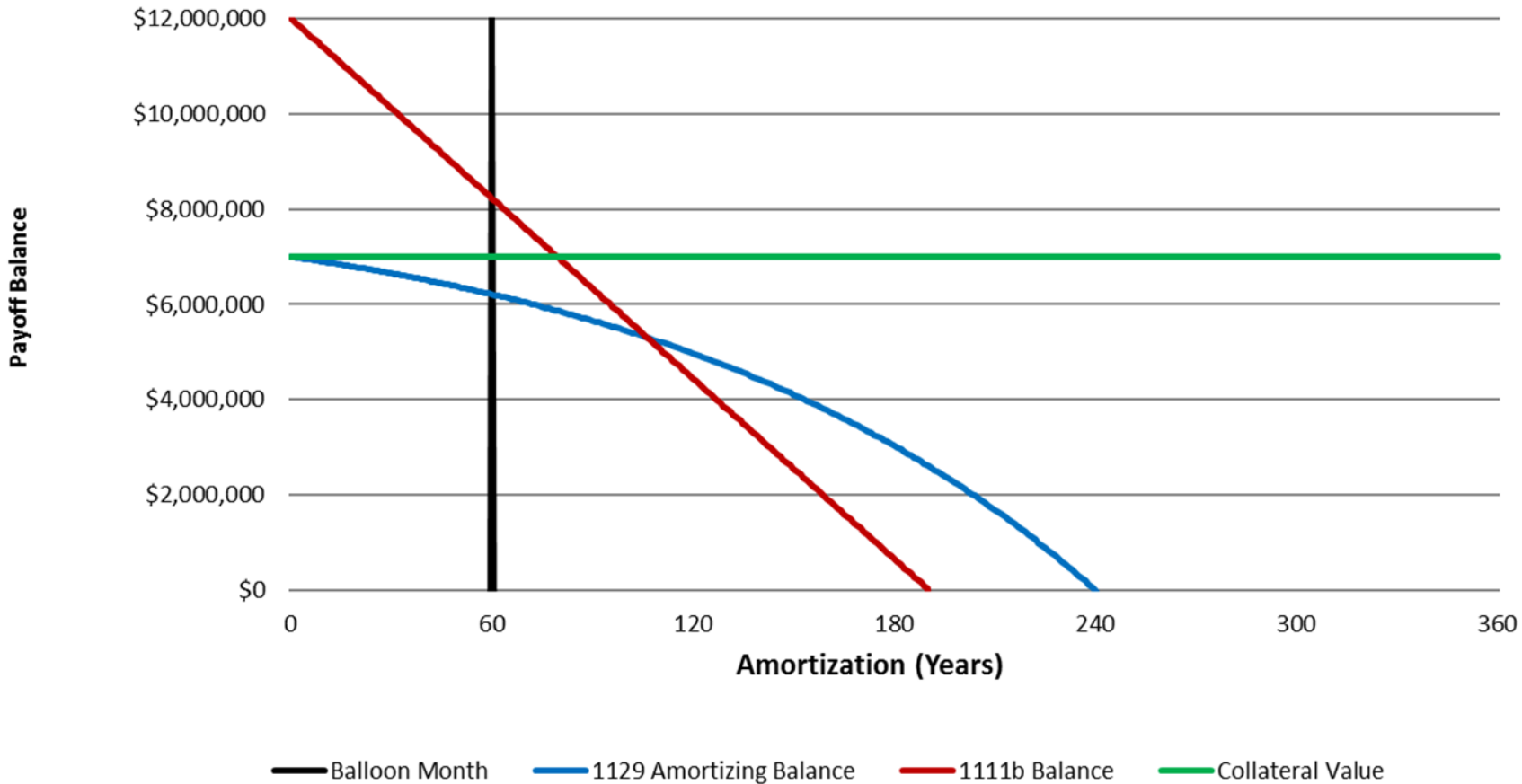
1111(b) Claim Amount = \$12,000,000 / 1129 Collateral Value = \$7,000,000 and is stabilized at 3% Per Year



### 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



# 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**

Collateral Value: \$600,000

Interest Rate: 6.0%

Term: 10 years

Amortization: 15 years

Monthly Payment: \$5,063

## **Creditor's Position**

Collateral Value: \$900,000

Interest Rate: 12.0%

Term: 5 years

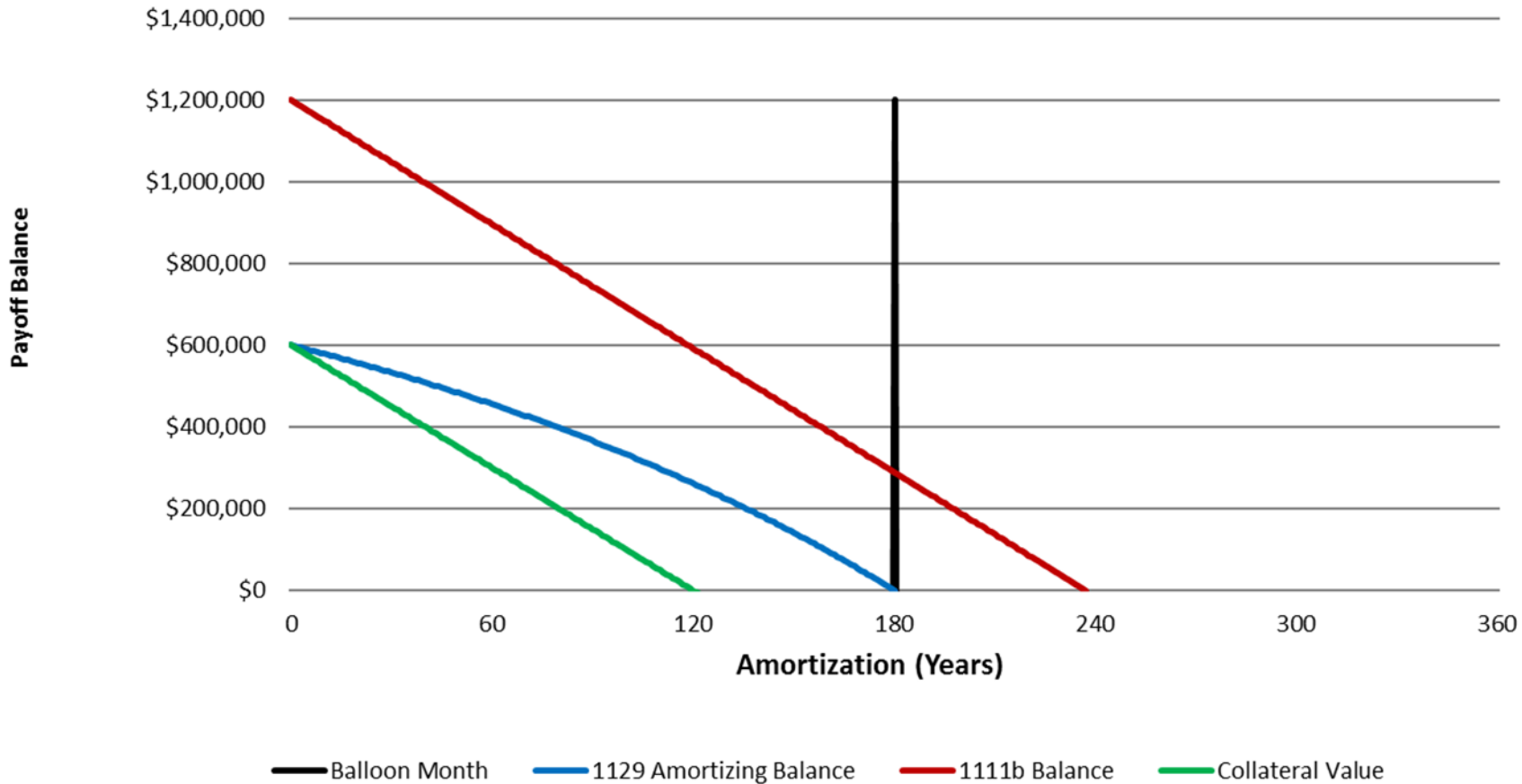
Amortization: 8 years

Monthly Payment: \$14,628

### DEBTOR'S CASE PERSPECTIVE

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

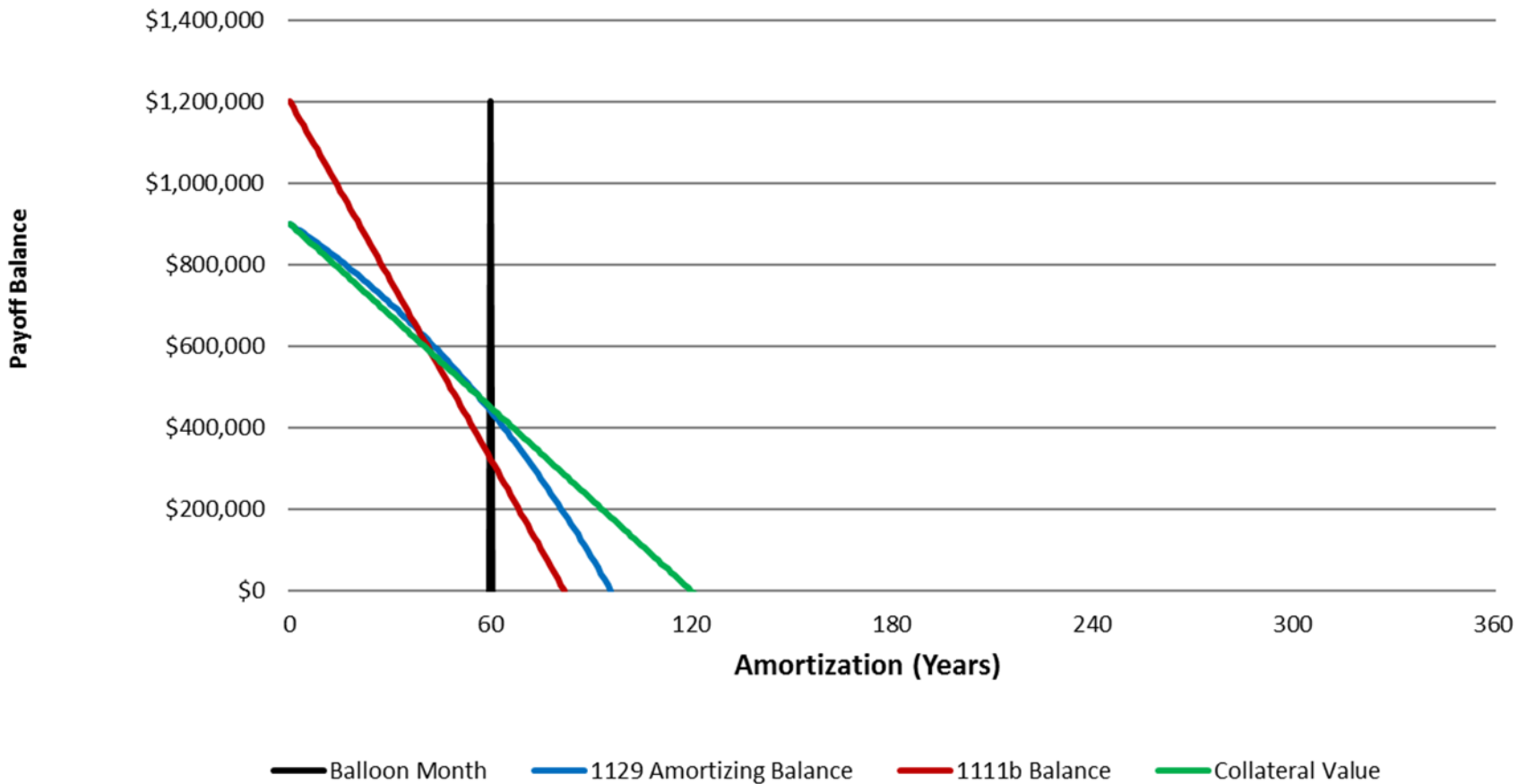
1111(b) Claim Amount = \$1,200,000 / 1129 Collateral Value = \$0,600,000 and is decreasing at 10% Per Year



### 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



# Strategy Recap



## 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?

## 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?

## 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?

## 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?

# 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

# Potential Secured Creditor Strategies

## **Willing Lender**

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

## **Unwilling Lender**

- Block Class via voting
- Block the Plan through Feasibility Challenge
  - Payments Too High
  - High Ending Balance