The 1111(b) Election: Advanced Mathematics and Strategies

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Presented By:

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TacticalFinancial Consulting

Today's Presenters

Richard M. Bendix, Jr., Esquire

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Chicago, Illinois

Richard Bendix is a business bankruptcy and creditors' rights attorney. He has played significant roles in two ground-breaking Chapter 11 bankruptcy cases - 203 North LaSalle Street and UNR Industries, Inc.

He has practiced law for over 35 years and is the Co-leader of Dykema's Bankruptcy and Restructuring Practice Group.

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Franklind Lea is routinely called upon to form expert opinions and testify in complex financial matters involving feasibility, interest rates, real estate and solvency related matters.

He over 25 years of professional experience and education in banking, investment management, financial analysis, commercial lending, debt structuring, real estate, and financial restructuring and workouts.

For additional information please contact Franklind Lea at 770-573-9366 or www.tacticalfinancialconsulting.com

Today's Presentation

1. • 1111(b) REVIEW
2. • MATHEMATICS
3. • CASE STUDY
4. • 1111(b) STRATEGY & WHAT IF'S
5. • AUDIENCE QUESTIONS AND ANSWERS

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- **1111(b) REVIEW**

§ 506(a): *Determination of Secured Status*

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.

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

§ 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, ...; and
- (II) *that each holder ...receive(s) ...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*.

- ***The Secured Creditor retains its liens until it receives cash payments from the Debtor of at least the present value of its collateral***

§ 1111(b)

(b) (1) (A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 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;

….

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

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

Payments to Electing Secured Creditor

If 1111(b) Election is made, payments to secured creditor must satisfy two requirements:

- Traditional repayment of the present value of the secured creditor's security interest under 1129 (i.e., principal and interest payments)
- Additionally, the payments must total AT LEAST the amount of the Allowed Claim

Each test requires a separate mathematical calculation

Timing of the Election

- Election must be made in writing unless made at Disclosure Statement Hearing (FRBP 3014)
- Before conclusion of the Disclosure Statement Hearing, or later date set by the Court
- Upon the Election, a secured creditor gives up it unsecured vote and retains its secured vote

Feasibility

- Debtor must be able:
  - to make Plan payments
  - to pay any unpaid balance of claim at end of Plan term (i.e., a secured creditor's balloon balance)

2

- **MATHEMATICS – the effect of changing repayment terms on the return to the Secured Creditor**

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!

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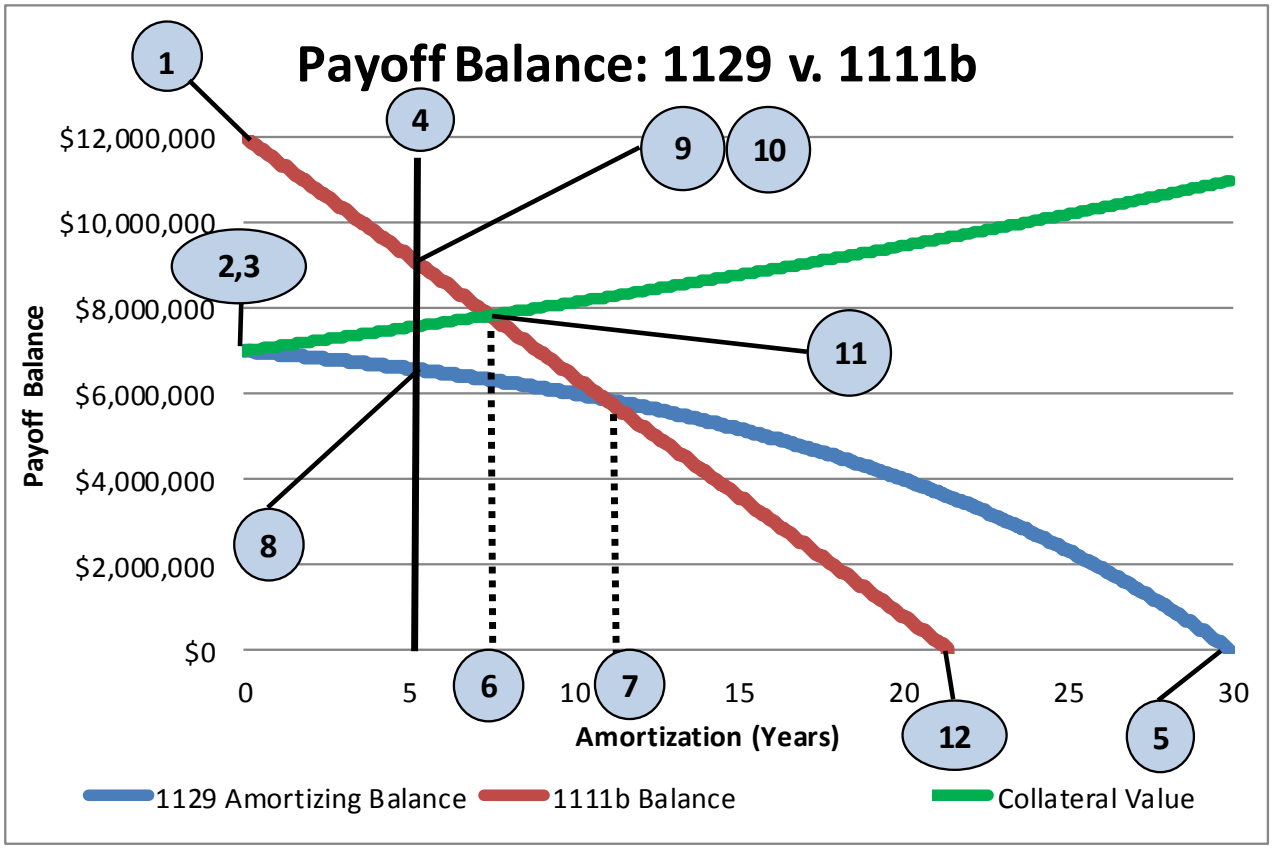
Elements of the 1111(b) Analysis

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



Traditional Loan Payments (i.e., 1129) are Calculated With a Formula Containing an Exponent

The Mathematics

$$\text{Payment} = \frac{P\,[\, i(1+i)^{n} \,]}{[\,(1+i)^{n} - 1\,]}$$

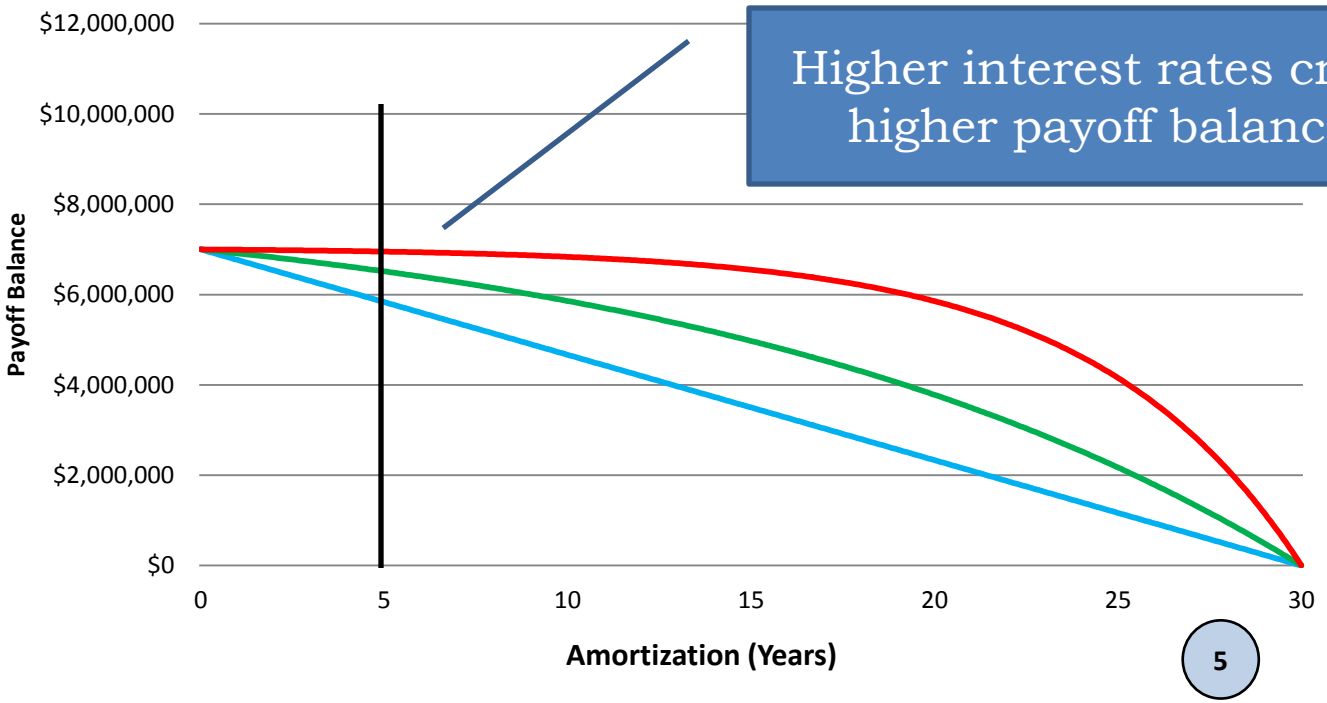
Where P equals the principal amount, i = interest rate per period, n = total number of periods

Why Does this Matter?

A portion of each payment goes to interest and the remainder goes to the outstanding balance, however because the formula is non-linear (see the "**n**" as the exponent) the amount of principal and interest in each payment varies.

This varied amount of principal makes the payoff balances vary too.

Traditional Loan (1129) Payoff Curve

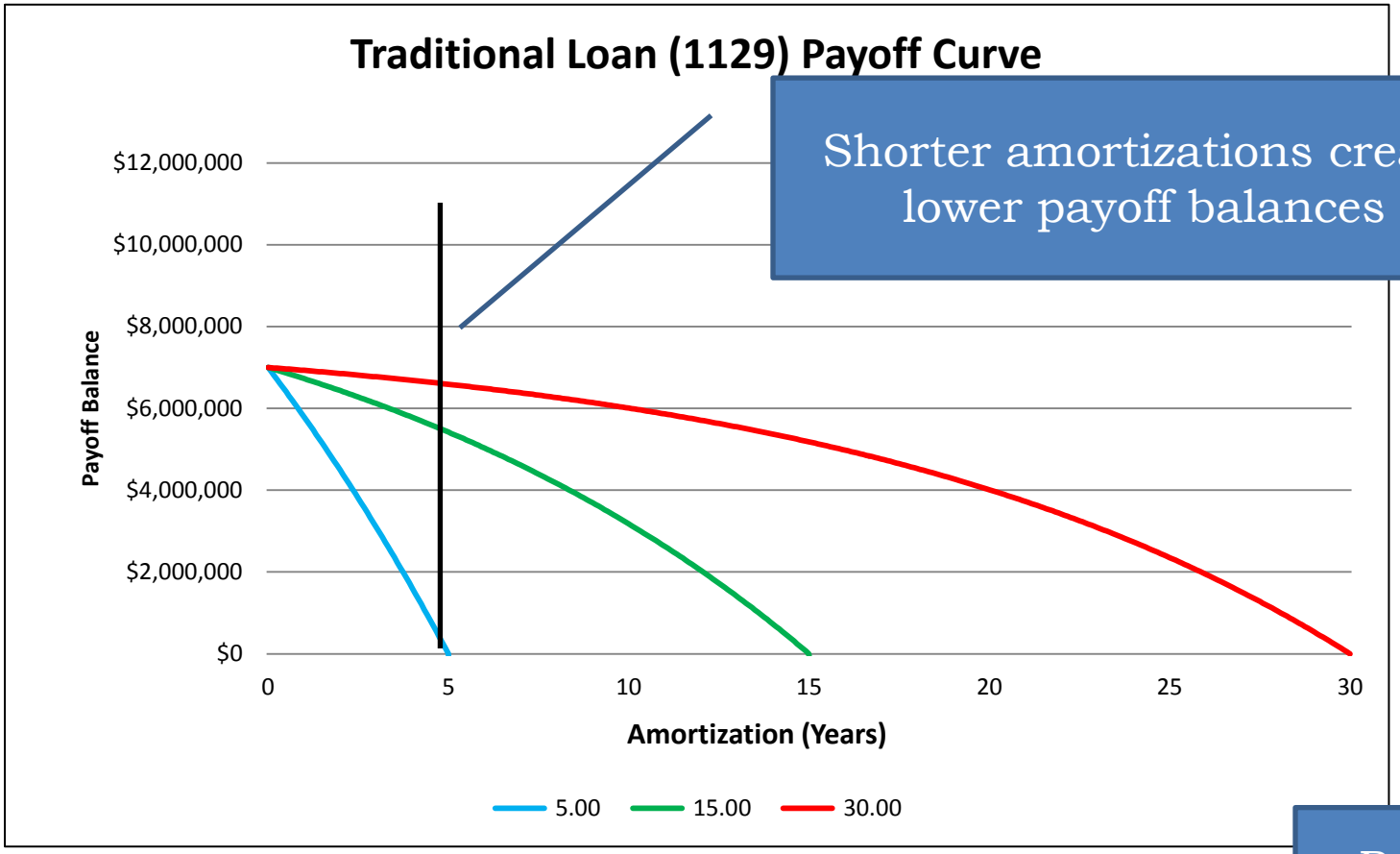


Higher interest rates create higher payoff balances

Calculated via the Prior Formula

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



Shorter amortizations create lower payoff balances

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

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

Please locate in your materials the exhibit labeled

*"**Amortization Schedule with Payoff Inflexion Point Highlighted**"*

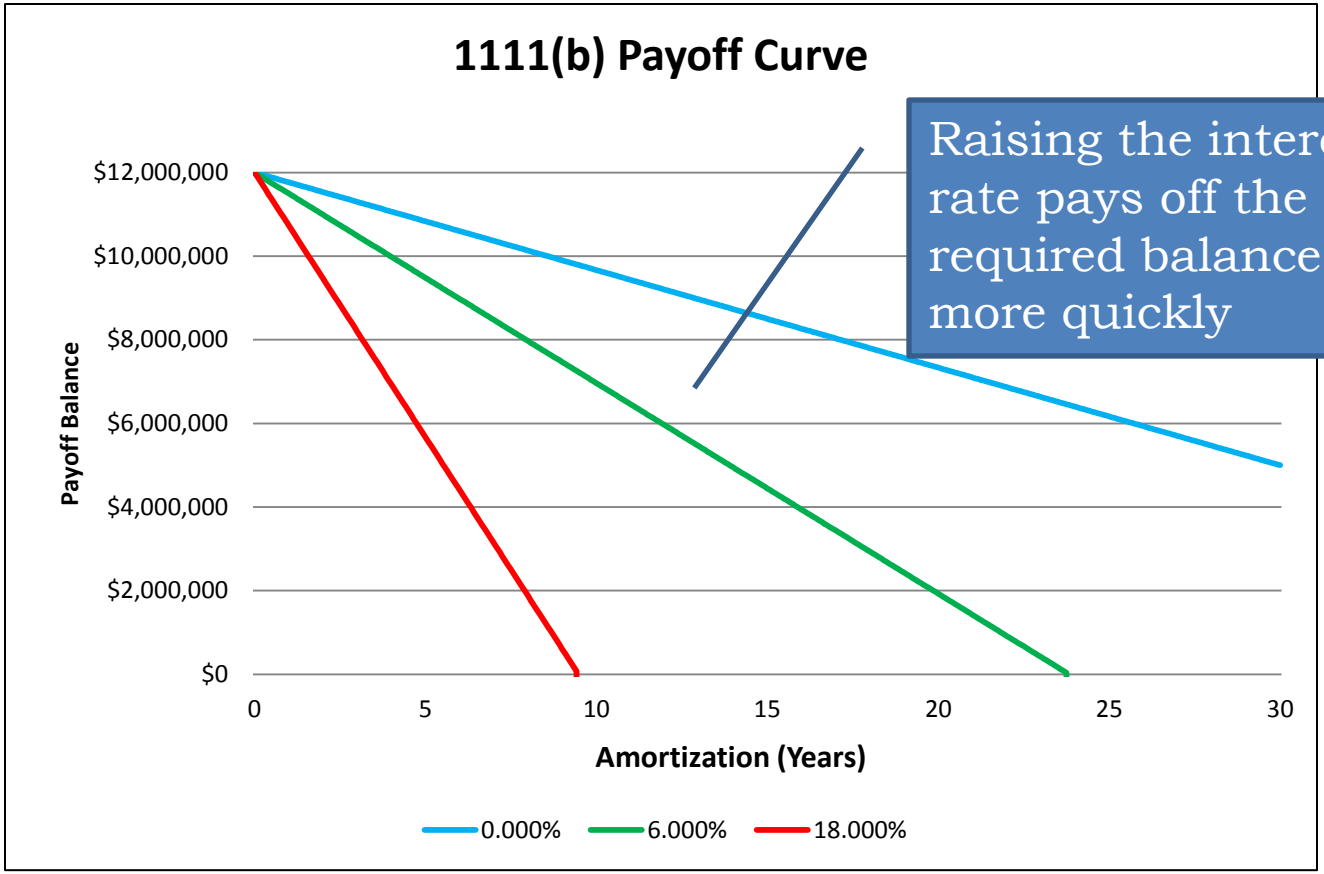
1111(b) raises the Secured Claim balance to equal the amount of the Allowed Claim. 1129 continues to require the payments total AT LEAST the amount of the (increased) Secured Claim

Amortization Schedule with Payoff Inflexion Point Highlighted

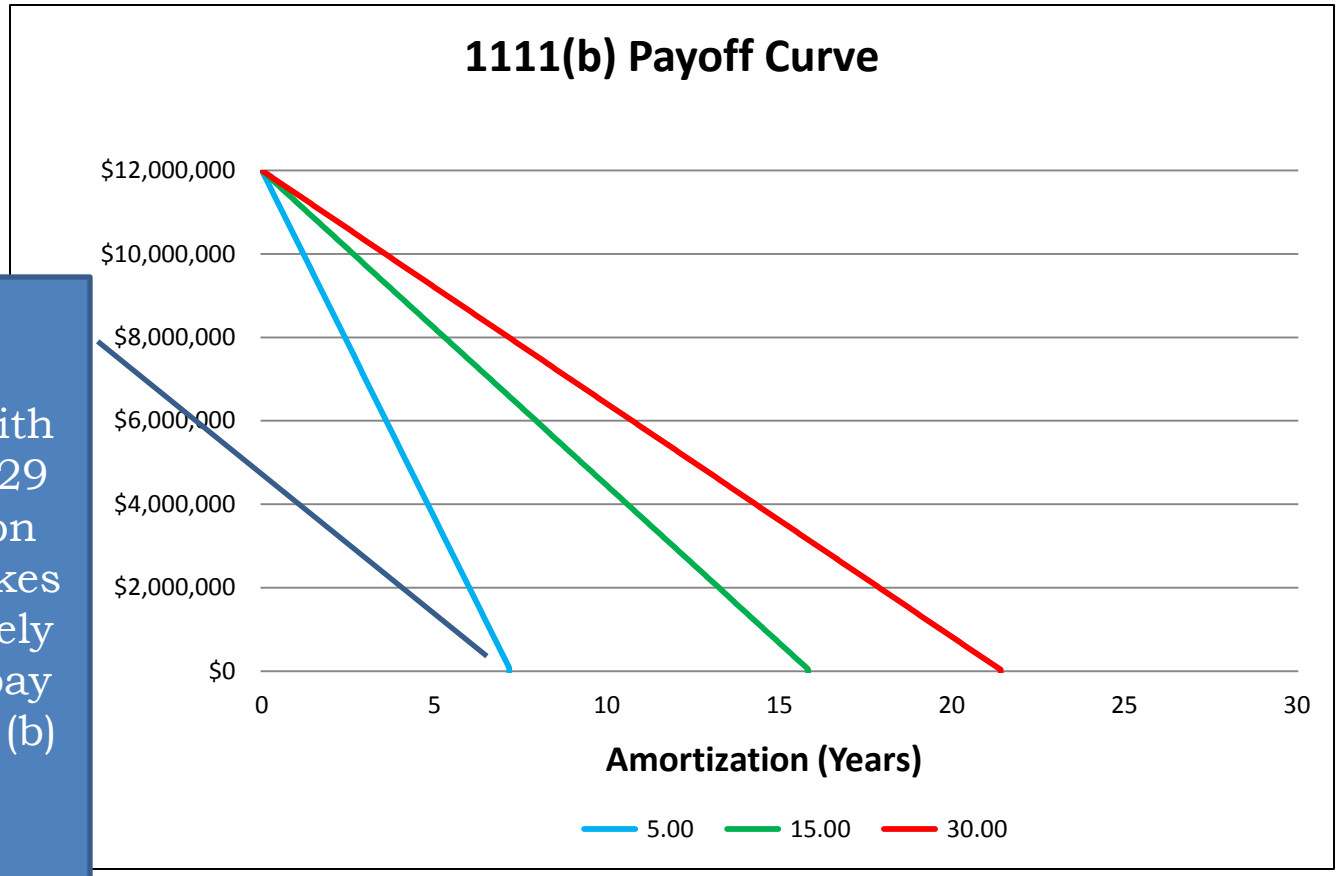
Allowed Claim	$12,000,000	Amortization (Years)	30
Appraised/Present Value	$7,000,000	Interest Rate	7.000%
Amortizing Balance	$7,000,000	No. of Payments Per Year	12
		Payment Amount	$46,571

Upper half of page

Month	Payment	Interest	Principal	1129 Amortizing Balance	1111b Balance
0				7,000,000	12,000,000
1	46,571	40,833	5,738	6,994,262	11,953,429
2	46,571	40,800	5,771	6,988,491	11,906,858
3	46,571	40,766	5,805	6,982,686	11,860,286
4	46,571	40,732	5,839	6,976,847	11,813,715
5	46,571	40,698	5,873	6,970,974	11,767,144
6	46,571	40,664	5,907	6,965,067	11,720,573
7	46,571	40,630	5,942	6,959,125	11,674,002
8	46,571	40,595	5,976	6,953,149	11,627,431
9	46,571	40,560	6,011	6,947,138	11,580,859
10	46,571	40,525	6,046	6,941,092	11,534,288
11	46,571	40,490	6,081	6,935,010	11,487,717
12	46,571	40,454	6,117	6,928,893	11,441,146



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)	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



Note that with a 5 year 1129 amortization period, it takes approximately 7 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

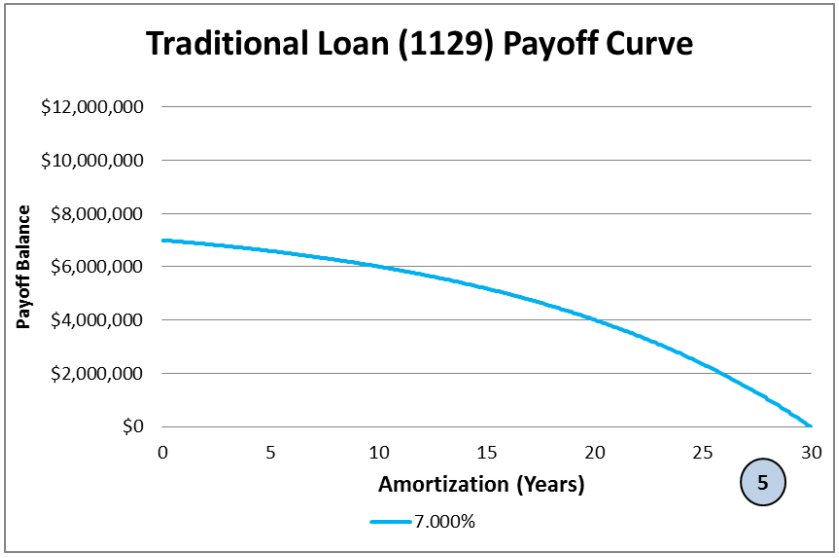
Payment/Payoff Calculations

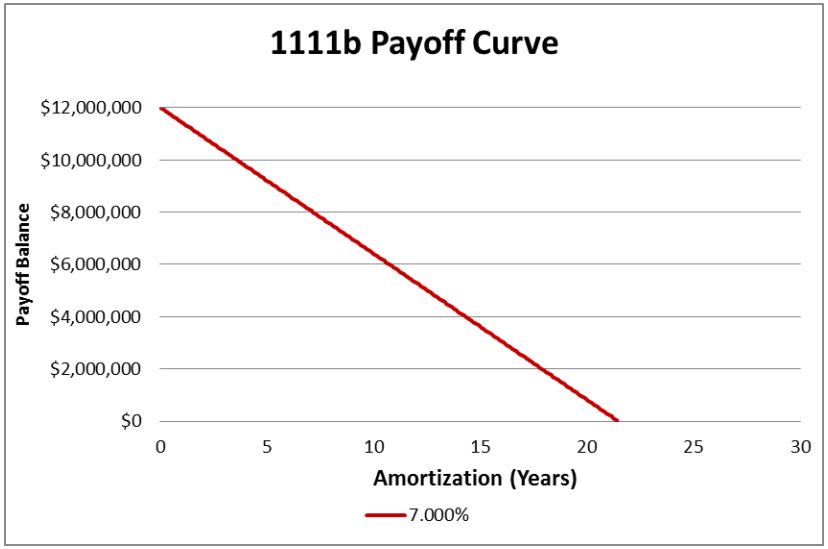
1129

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

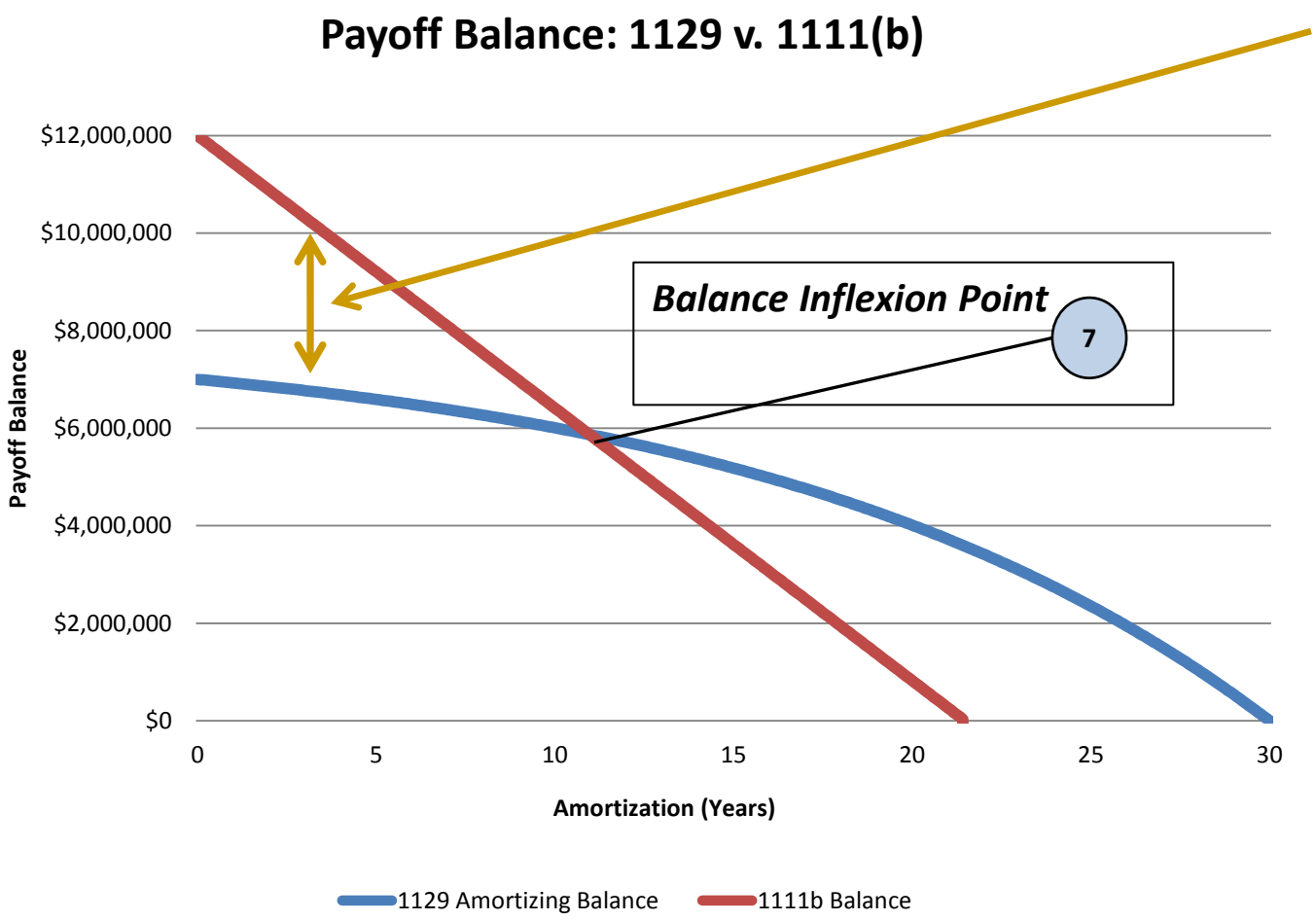
1111(b)

- 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





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 inflexion point, the difference between the two values that the red line and blue line represent is referred to as the "1111(b) Premium"

An 1111(b) Premium Increases the Rate of Return to Lender

Month	Payment	Interest	Principal	1129 Amortizing Balance	1111b Balance
0				7,000,000	12,000,000
1	46,571	40,833	5,738	6,994,262	11,953,429
2	46,571	40,800	5,771	6,988,491	11,906,858
3	46,571	40,766	5,805	6,982,686	11,860,286
4	46,571	40,732	5,839	6,976,847	11,813,715
5	46,571	40,698	5,873	6,970,974	11,767,144
6	46,571	40,664	5,907	6,965,067	11,720,573
7	46,571	40,630	5,942	6,959,125	11,674,002
8	46,571	40,595	5,976	6,953,149	11,627,431
9	46,571	40,560	6,011	6,947,138	11,580,859
10	46,571	40,525	6,046	6,941,092	11,534,288
11	46,571	40,490	6,081	6,935,010	11,487,717
12	46,571	40,454	6,117	6,928,893	11,441,146

Example: In month 12, the 1111(b) Premium is equal to $11,441,146 less $6,928,893; equaling $4,512,253

If the 1111(b) balance is higher than the 1129 balance at the end of the Plan term (i.e., the balloon date), then the Secured Creditor will receive additional consideration beyond the "normal" 1129 payments.

This additional payment boosts the absolute dollar return to the Secured Creditor and raises its rate of return.

Amortization Schedule with Payoff Inflexion Point Highlighted

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

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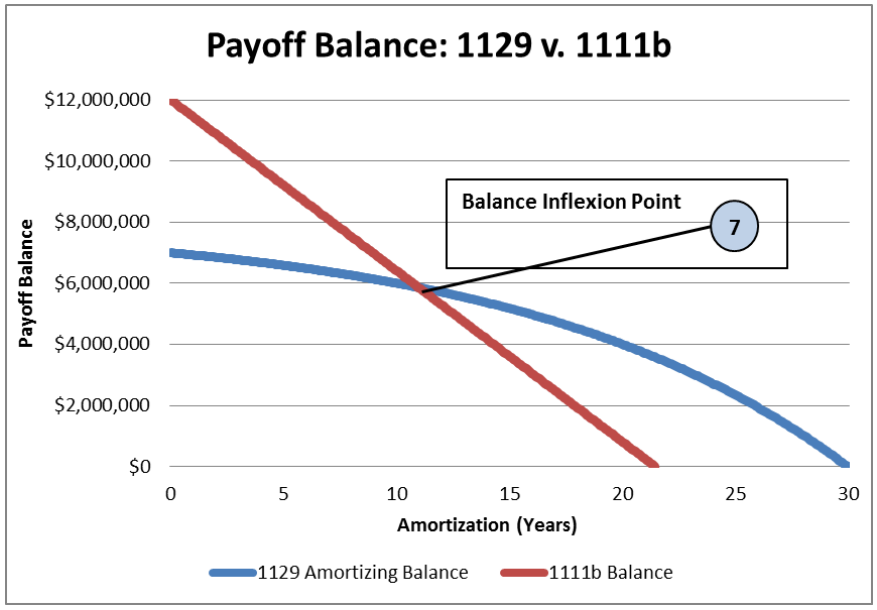
Month	Payment	Interest	Principal	1129 Amortizing Balance	1111b Balance
128	46,571	34,561	12,010	5,912,712	6,038,890
129	46,571	34,491	12,080	5,900,632	5,992,318
130	46,571	34,420	12,151	5,888,481	5,945,747
131	***46,571***	***34,349***	***12,222***	***5,876,259***	***5,899,176***
132	***46,571***	***34,278***	***12,293***	***5,863,966***	***5,852,605***
133	46,571	34,206	12,365	5,851,602	5,806,034
134	46,571	34,134	12,437	5,839,165	5,759,463
135	46,571	34,062	12,509	5,826,656	5,712,891

Present Value Discussion

Payoff Before Inflexion Point

- Payoff at a time before the Inflexion Point is based on the 1111(b) payoff curve
- Payoff at a time after the Inflexion Point is based on the 1129 payoff curve



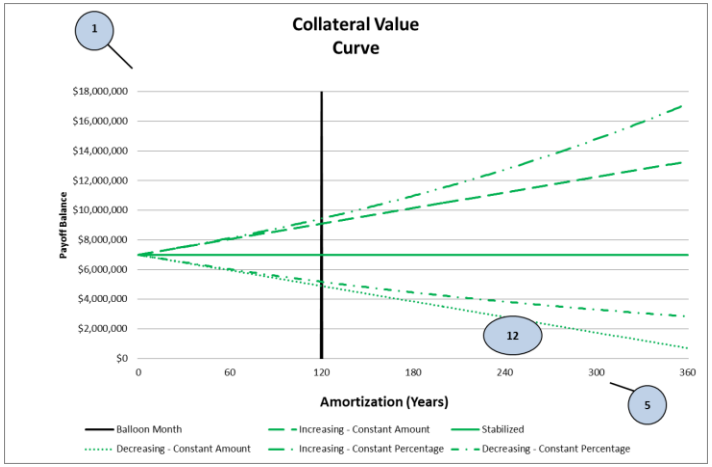
Payoff After Inflexion Point

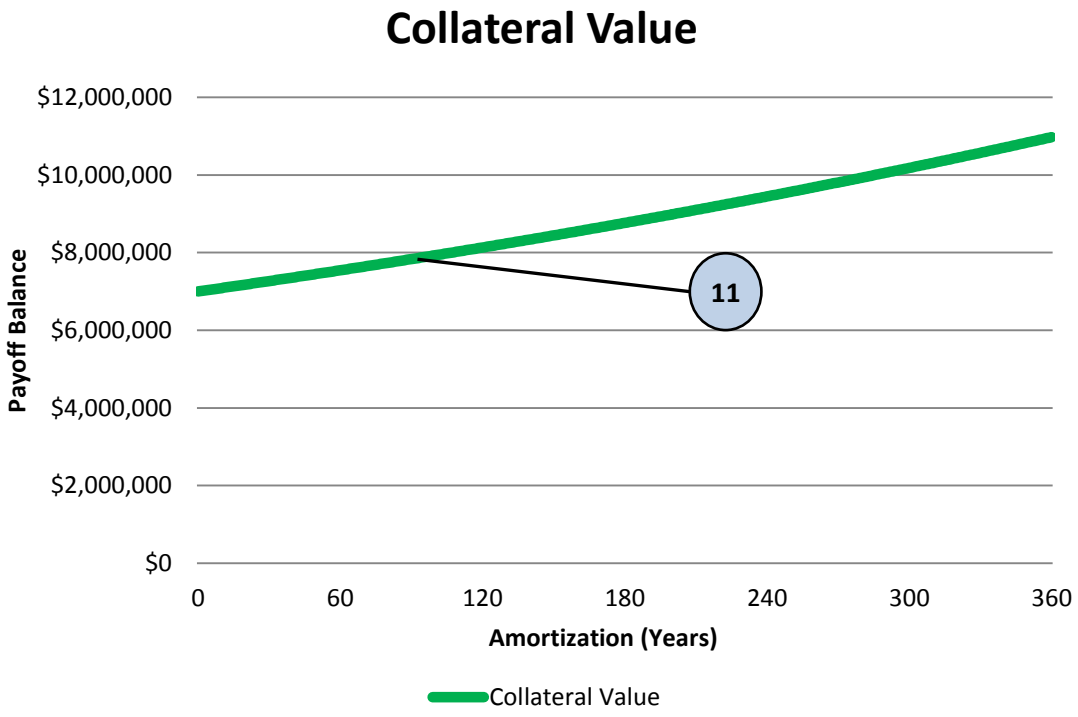
If the payoff were to occur after the Inflexion Point and the 1111(b) payoff amount was used instead of the 1129 payoff amount, the secured creditor will not receive the present value required by 1129.

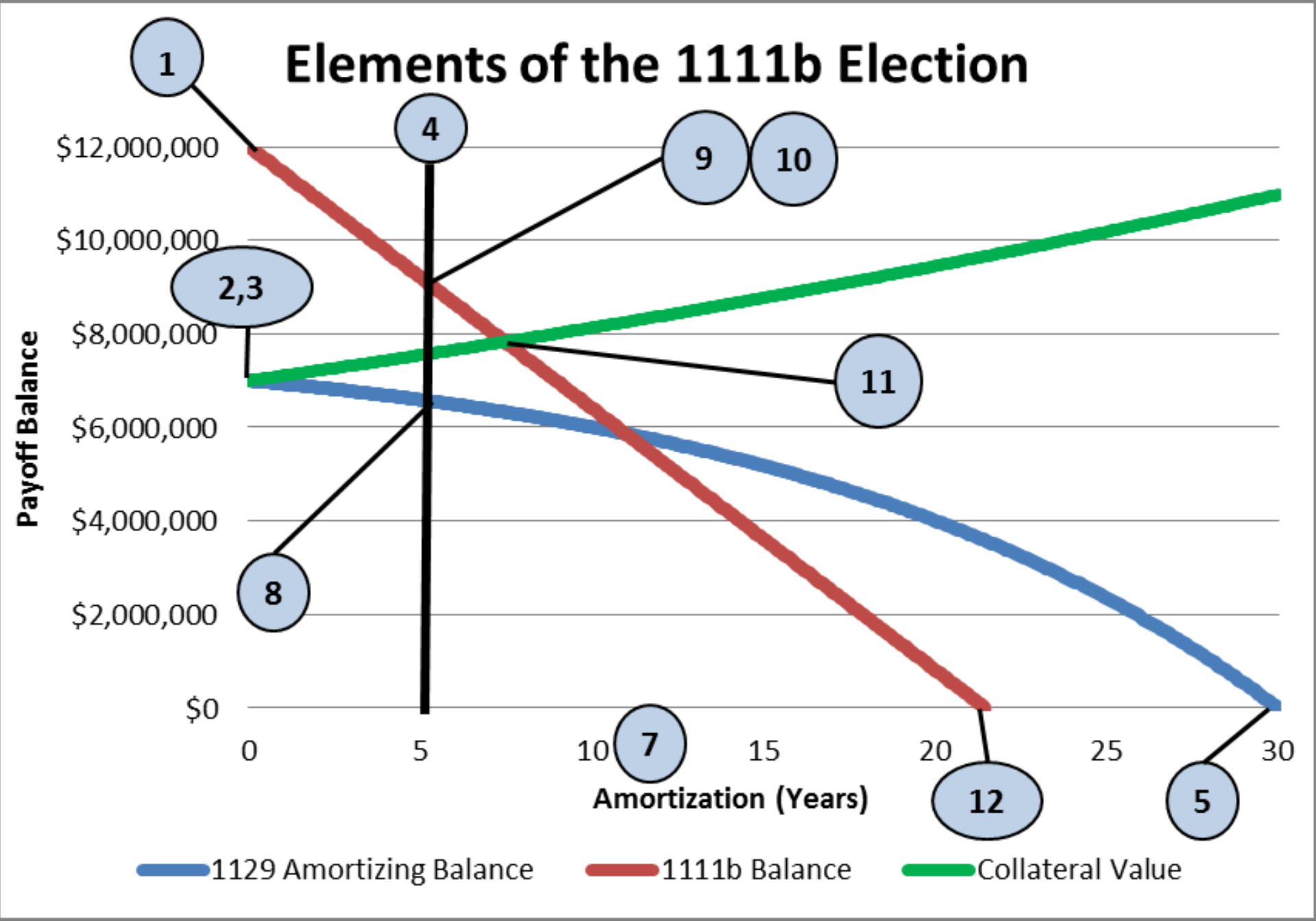
For example, if the payoff occurred in Year 15, a secured creditor would receive a present value of only $6,434,632 instead of the required $7,000,000.

Collateral

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







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- **CASE STUDY**

Case Study Overview

*Please locate in your materials the exhibit labeled "**Case Study**"*

- Class B Office Building
- Built 1970
- 75% leased
- Market Value $7,000,000
- Allowed Claim = $12,000,000
- Trade Debt = $100,000

Voting / Plan Claims Summary

DEBTOR'S PLAN		
	Does Not Make the §1111(b)(2) Election	**Makes the §1111(b)(2) Election**
Class 1 – Secured Claim		
Total Secured Claims	**1**	**1**
Total Secured Claim Balance	**$7,000,000**	**$12,000,000**
Class 2 – Secured Creditor's Deficiency Claim		
Total Unsecured Claims	**1**	**0**
Total Unsecured Balance	**$5,000,000**	**0**
Class 3 – Other Unsecured Claims		
Total Unsecured Claims	**5**	**5**
Total Unsecured Balance	**$500,000**	**$500,000**

Opinion of Proper Secured Claim Treatment

	Debtor's Perspective		Secured Creditor Perspective	
	Does Not Make the §1111(b)(2) Election	Makes the §1111(b)(2) Election	Does Not Make the §1111(b)(2) Election	Makes the §1111(b)(2) Election
Allowed Claim	$12 million	$12 million	$12 million	$12 million
Secured Claim	$7 million	$12 million	$7 million	$12 million
Deficiency Claim	$5,000,000	None	$5,000,000	None
Interest Rate	5.0%	5.0%	9.0%	9.0%
Amortization Period	30 Years	30 Years	20 Years	20 Years
Maturity	10 Years	10 Years	5 Years	5 Years

Feasibility

Ongoing Payments

- Measured by Debt Service Coverage Ratio*

* Additional tests such as sufficient cash balances would also apply but are not part of this presentation

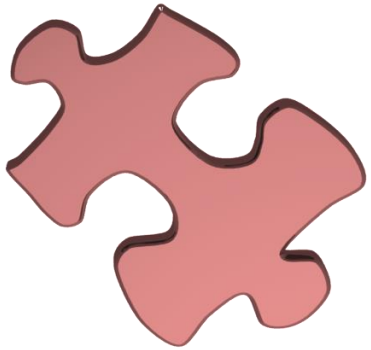
Payoff at End of Plan Term

- Measured by comparing collateral value at end of Plan term (balloon date) to the Payoff Balance
- Payoff Balance is the higher of the 1129 balance or the 1111(b) balance
- Collateral Value must be greater than Payoff Balance

Feasibility - Secured Claim Repayment

Two Independent Mathematical Requirements - Both Tests Must Be Passed

- Traditional Loan Payments / Present Value Test – "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 Test – " 1111(b)"
  - Total amount of ALL payments (principal and interest) must total AT LEAST amount of the Allowed Claim

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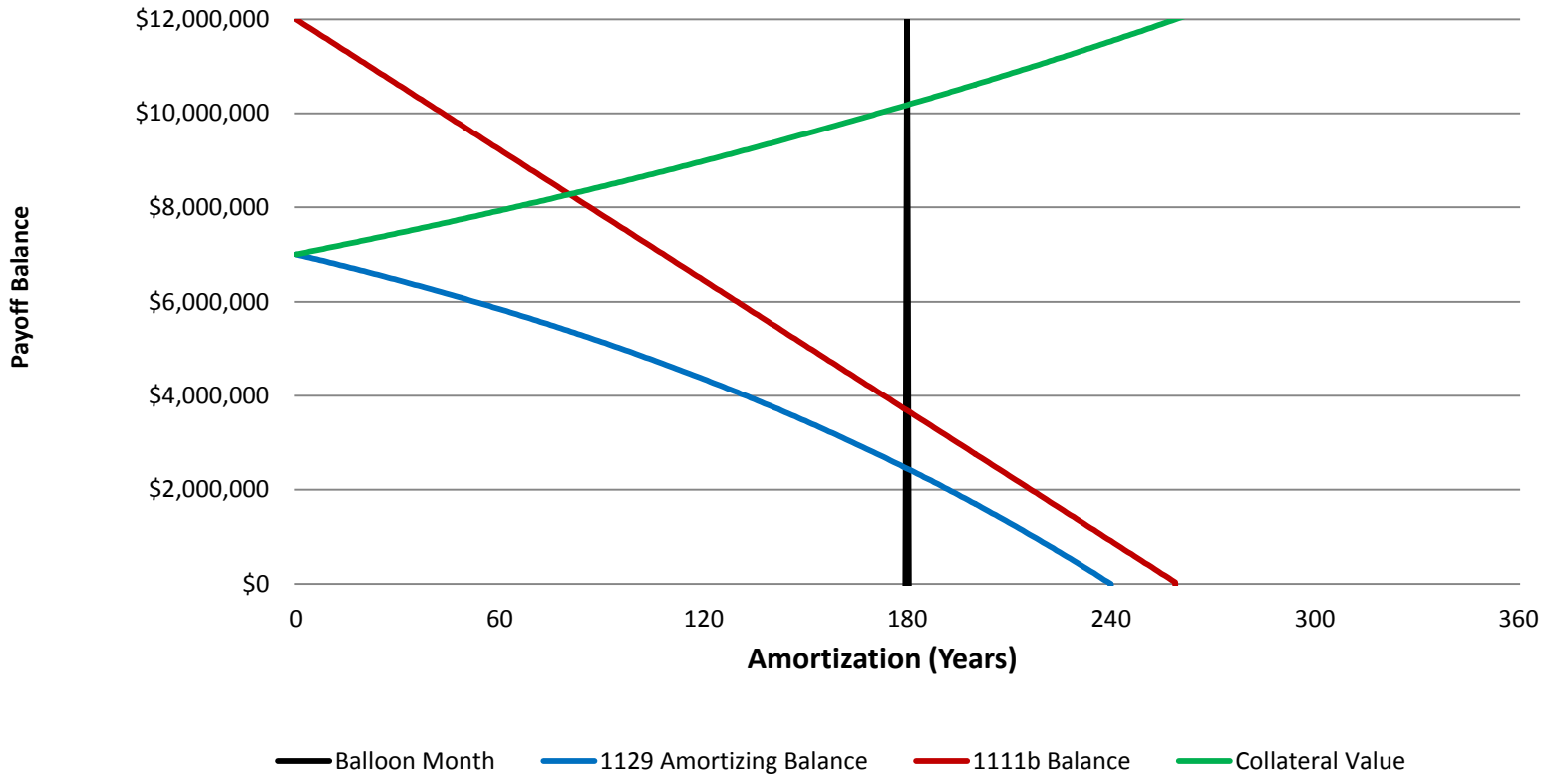
DEBTOR'S CASE PERSPECTIVE

Interest Rate = 5% / Amortization = 20 Years / Term(Balloon) = 180 Months / Monthly Payment = $46,197

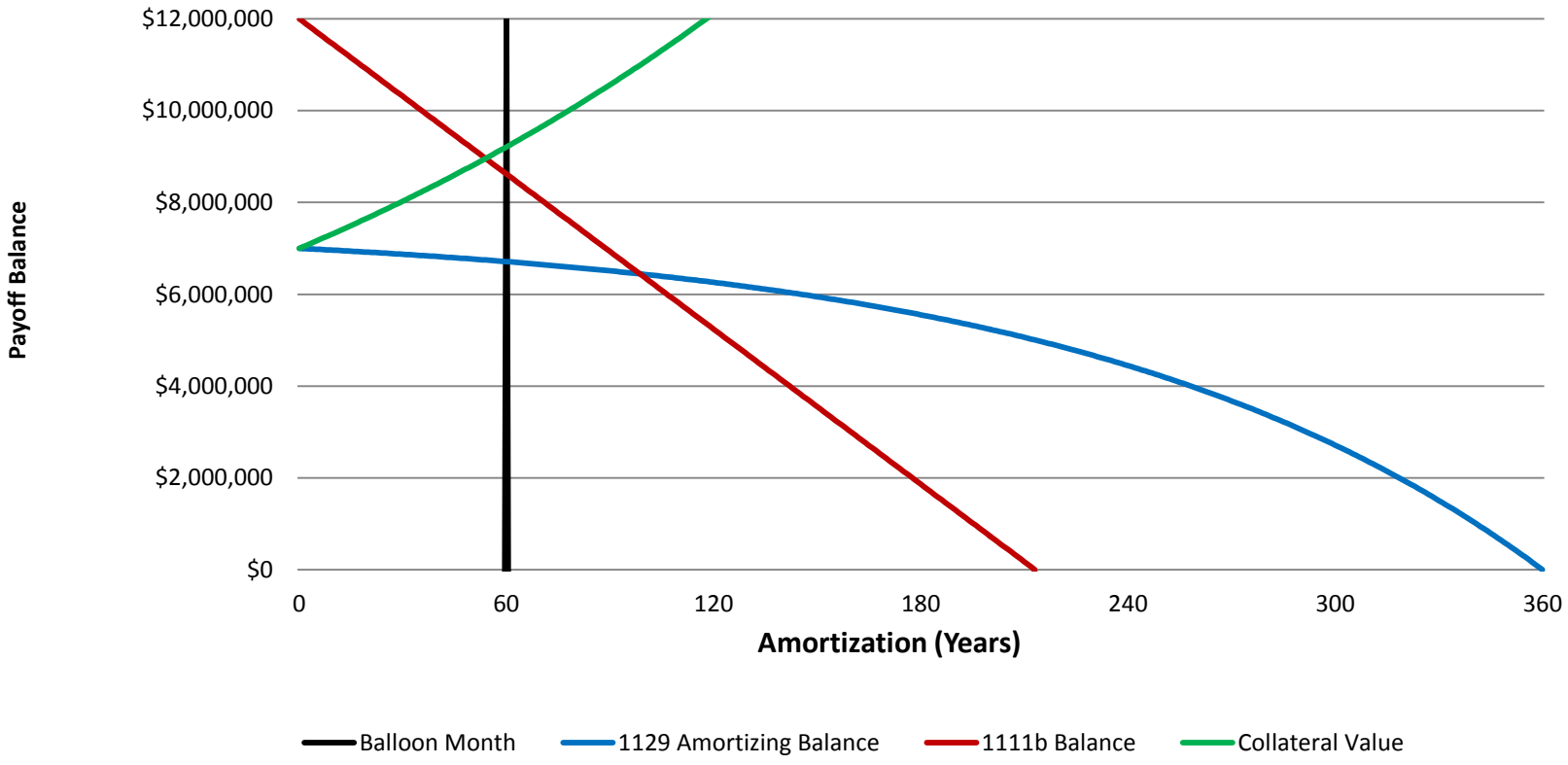
1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is increasing by 2.5% Per Year



CREDITOR'S CASE PERSPECTIVE

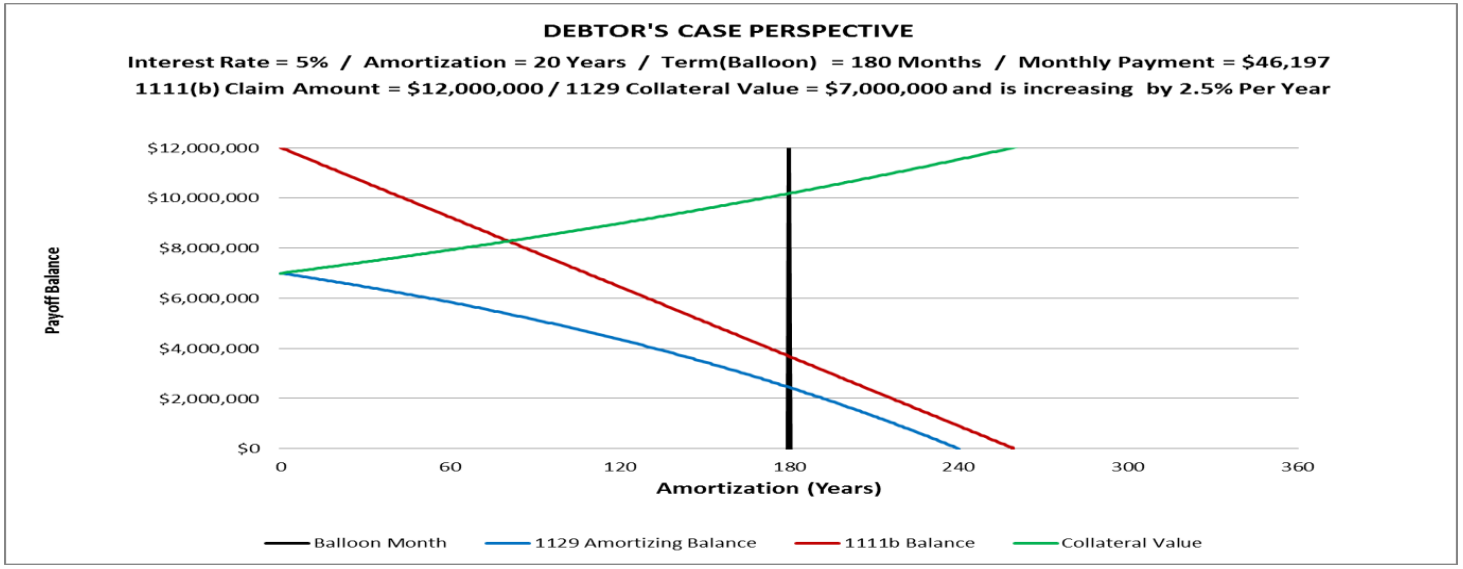
Interest Rate = 9% / Amortization = 30 Years / Term(Balloon) = 60 Months/ Monthly Payment = $56,324

1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is increasing by 5.5% Per Year

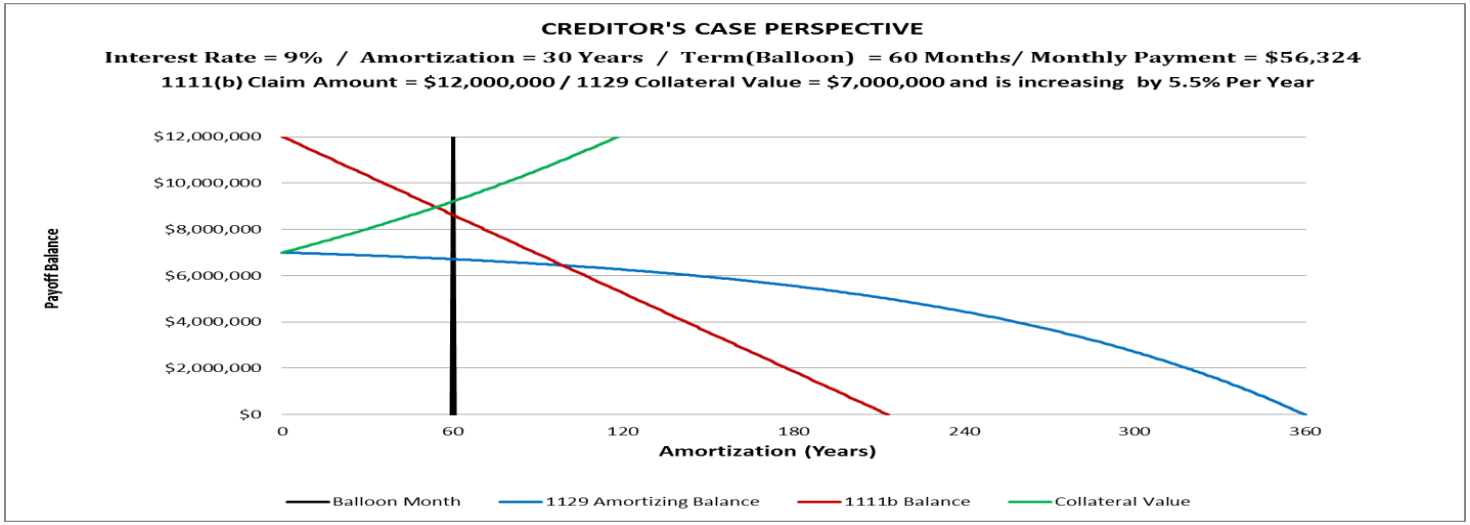


Comparison of Perspectives

Debtor Perspective



Creditor Perspective



Audience Question: Interest Rates

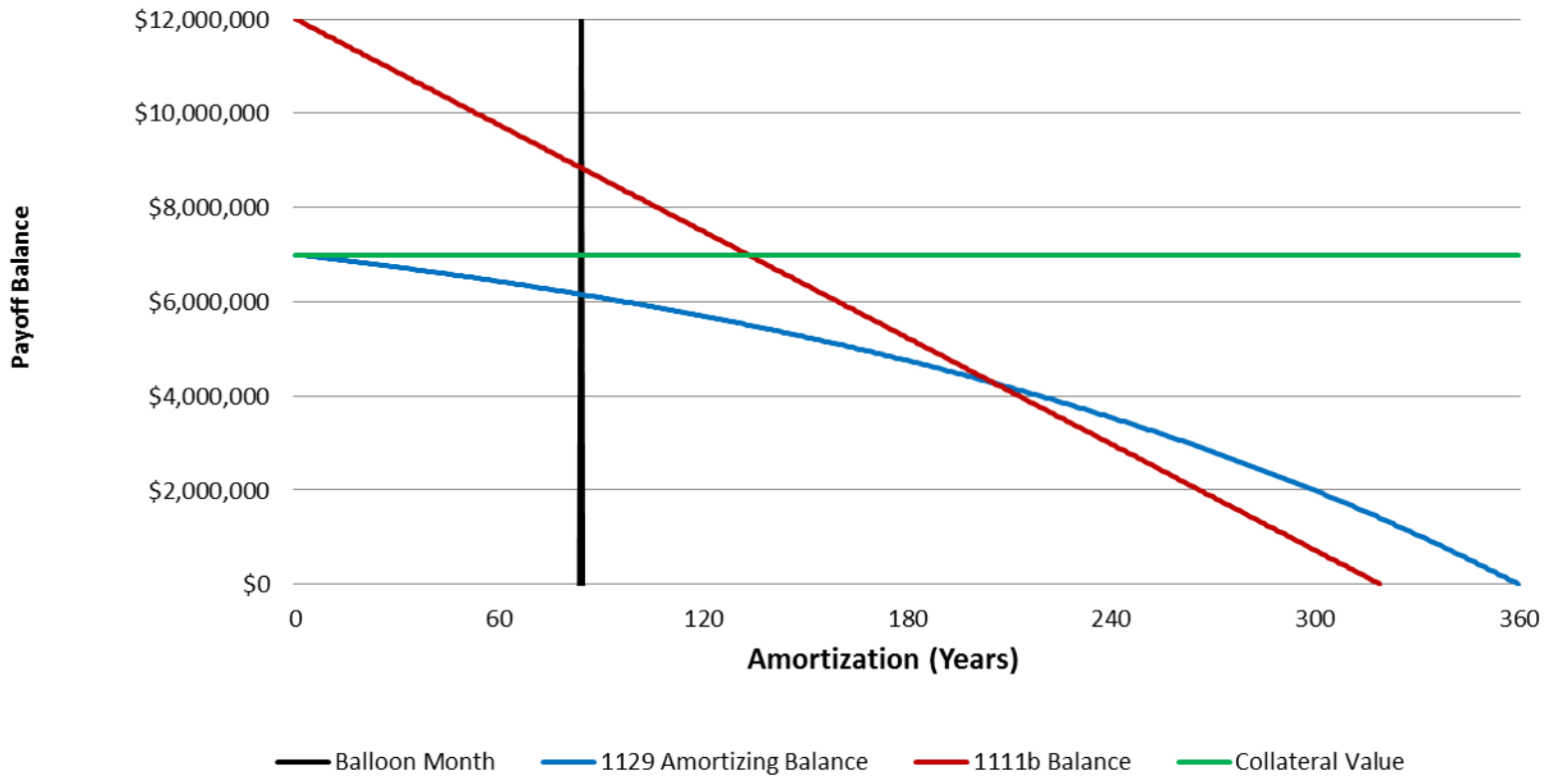
If the election is made and the loan matures in 7 years, what is the effect on the unpaid balance if the interest rate is increased from 5% to 9%?

A. 1129 amount goes up, 1111(b) amount goes up
B. 1129 amount goes down, 1111(b) amount goes down
C. 1129 amount goes down, 1111(b) amount goes up
D. 1129 amount goes up, 1111(b) amount goes down
E. Both stay the same
F. No idea, that's why I signed up for this presentation

DEBTOR'S CASE PERSPECTIVE

Interest Rate = 5% / Amortization = 30 Years / Term(Balloon) = 84 Months / Monthly Payment = $37,578

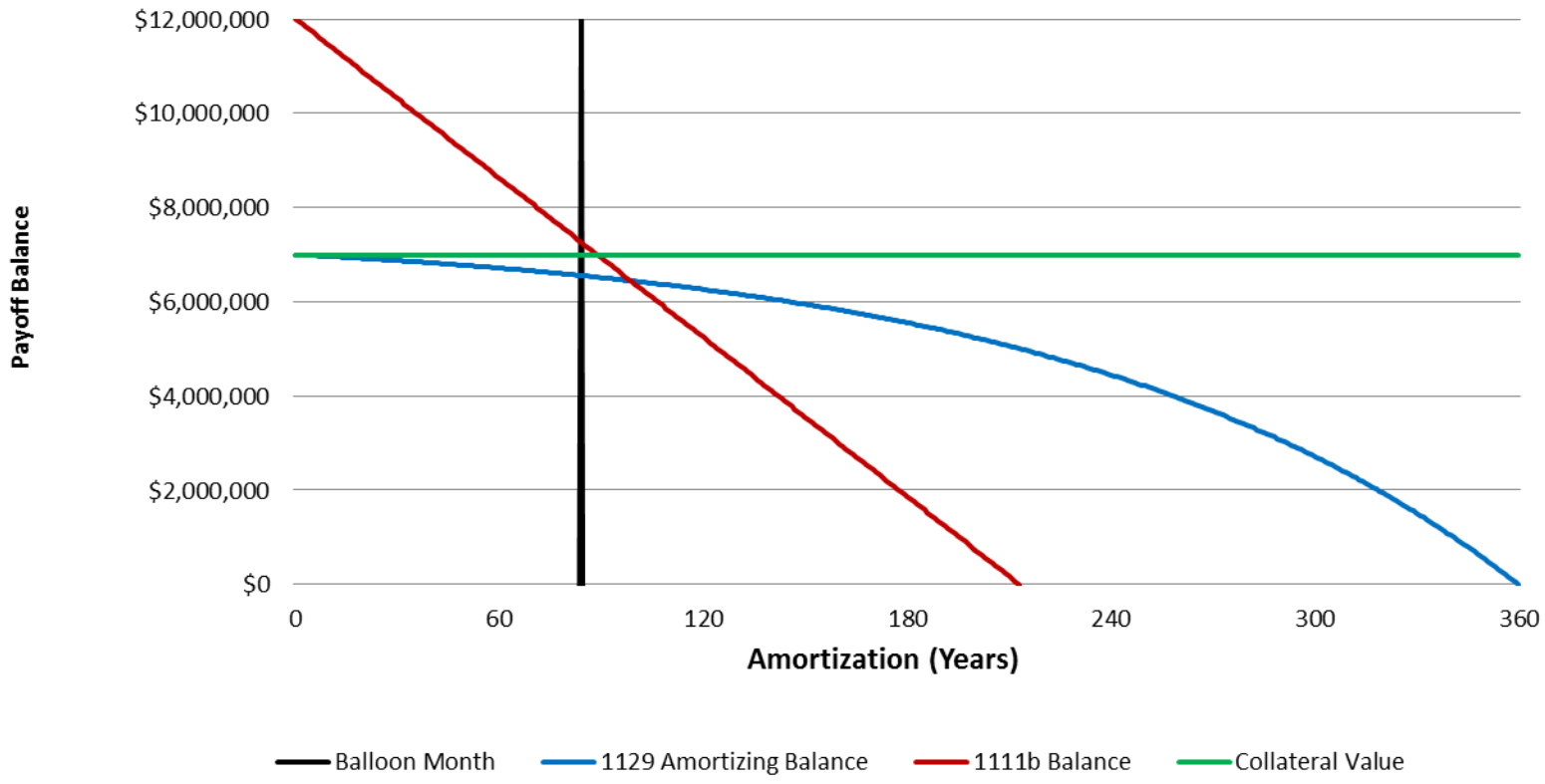
1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is stabilized at 0% Per Year



DEBTOR'S CASE PERSPECTIVE

Interest Rate = 9% / Amortization = 30 Years / Term(Balloon) = 84 Months / Monthly Payment = $56,324

1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is stabilized at 0% Per Year



Answer to Audience Question: Interest Rates

If the election is made and the loan matures in 7 years, what is the effect on the unpaid balance if the interest rate is increased from 5% to 9%?

The correct answer is D, the 1129 amount goes up, and 1111(b) amount goes down.

A higher interest rate both raises the payment and slows the traditional amortization effect as a greater portion of the payment must be contributed to interest. This results in a higher 1129 balance at maturity (a greater amount of principal remains outstanding) and a lower 1111b balance as the higher payments create a higher amount of aggregate payments toward the 1111b calculation.

This can be seen in the preceding graphs where the red line is lower and the blue line is higher on the balloon date.

Audience Question: Amortization

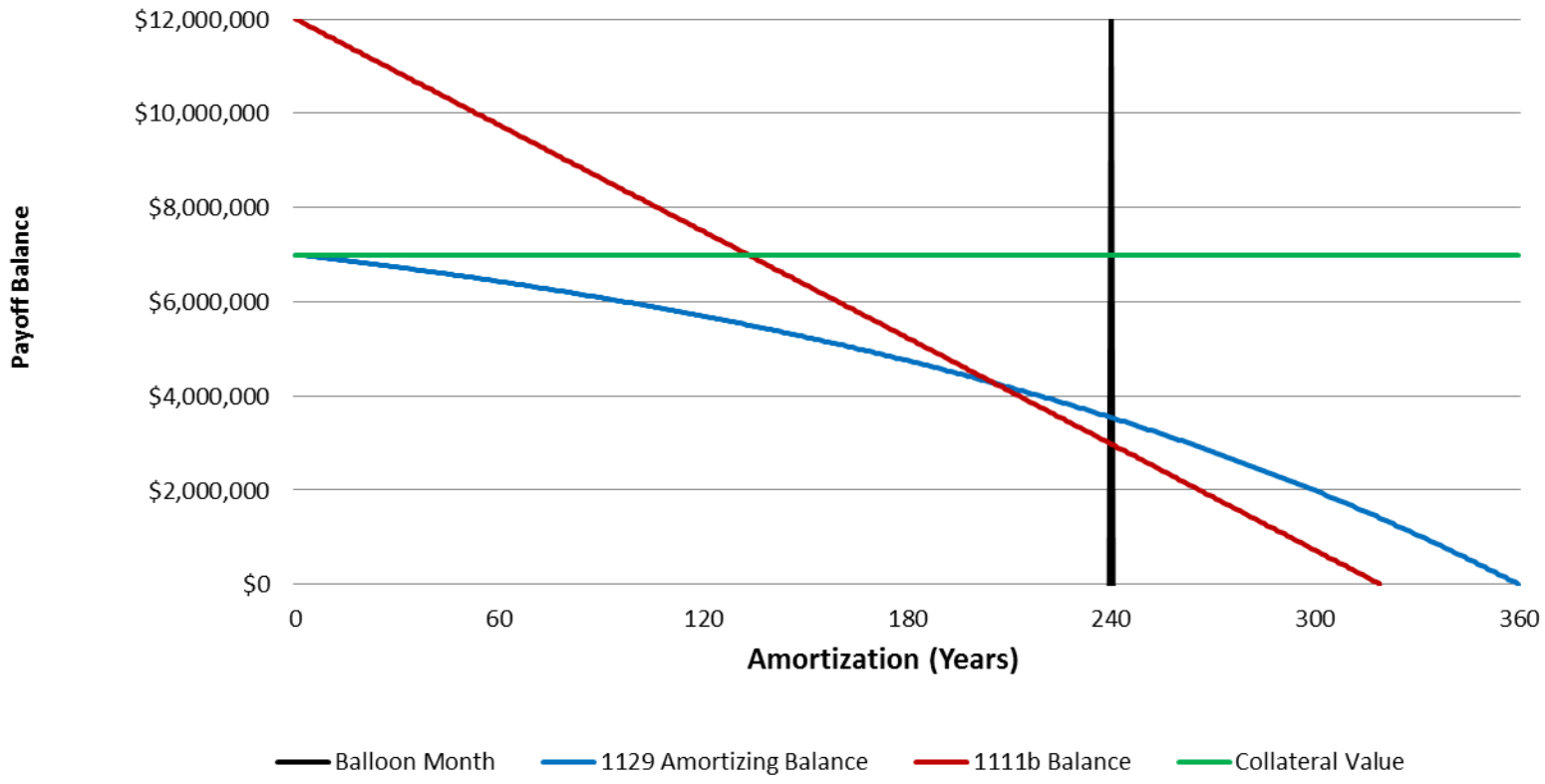
If the election is made, what is the effect on the payoff balance at the balloon date if the loan amortization is lengthened from 20 years to 30 years?

A. 1129 amount goes up, 1111(b) amount goes up
B. 1129 amount goes down, 1111(b) amount goes down
C. 1129 amount goes down, 1111(b) amount goes up
D. 1129 amount goes up, 1111(b) amount goes down
E. Both stay the same
F. No idea, that's why I signed up for this presentation

DEBTOR'S CASE PERSPECTIVE

Interest Rate = 5% / Amortization = 30 Years / Term(Balloon) = 240 Months / Monthly Payment = $37,578

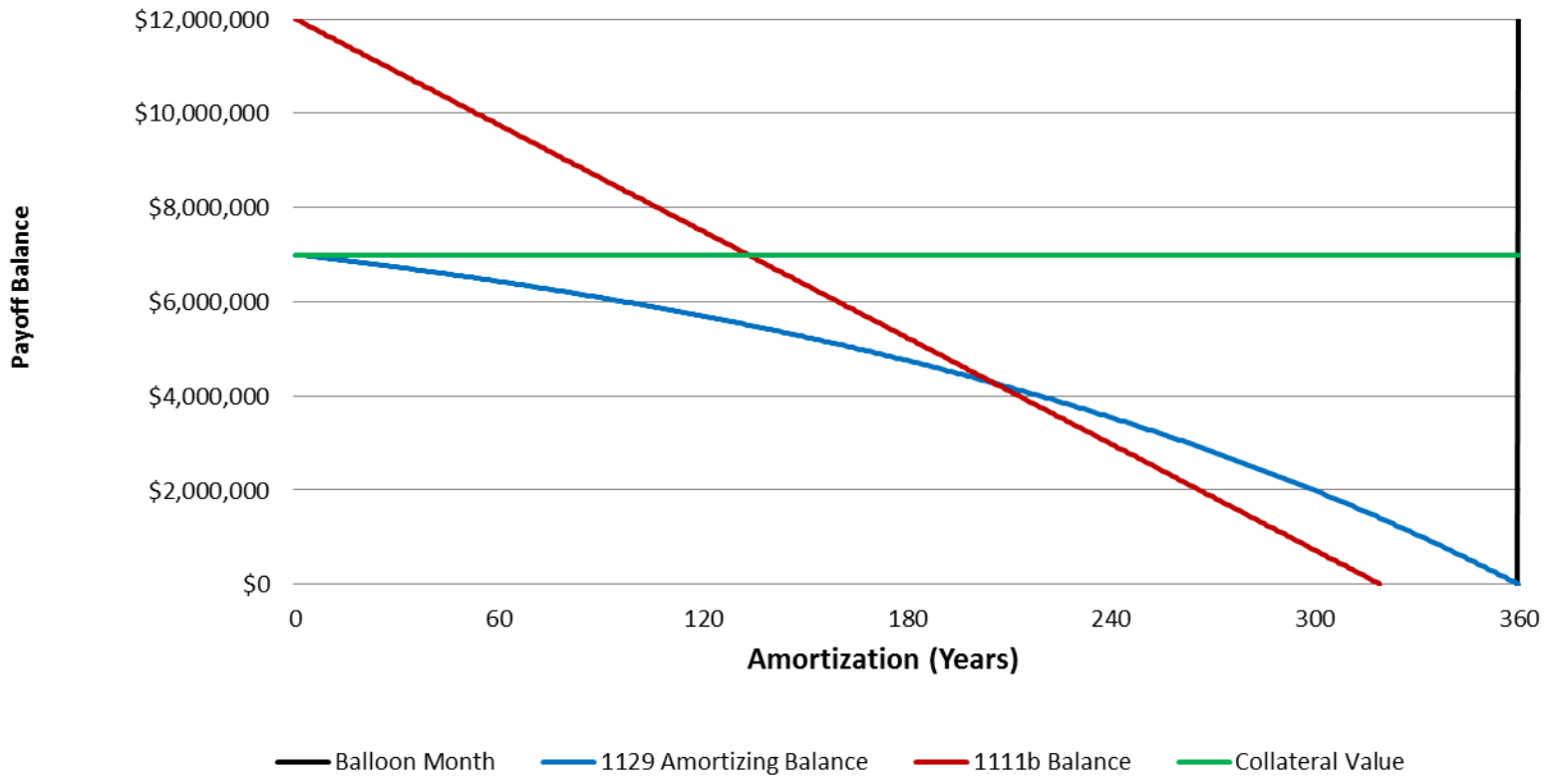
1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is stabilized at 0% Per Year



DEBTOR'S CASE PERSPECTIVE

Interest Rate = 5% / Amortization = 30 Years / Term(Balloon) = 360 Months / Monthly Payment = $37,578

1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is stabilized at 0% Per Year



Answer to Audience Question: Amortization

If the election is made, what is the effect on the payoff balance at the balloon date if the loan amortization is lengthened from 20 years to 30 years?

The correct answer is B, the 1129 amount goes down and the 1111(b) amount goes down,

This can be seen in the prior slide by observing the red and blue lines at lower levels at the 30 year mark than the 20 year mark.

Audience Question: Loan Term

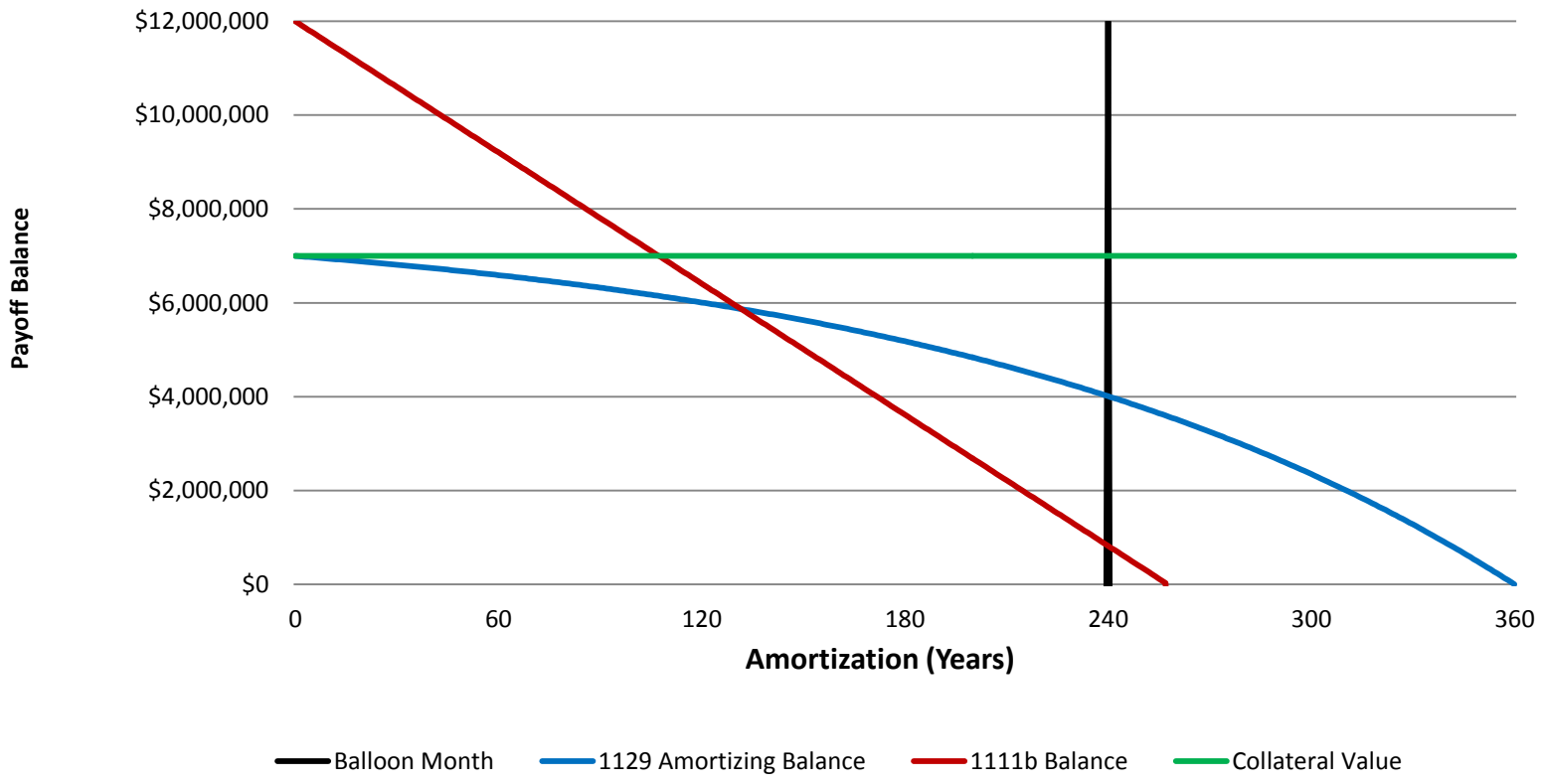
If the election is made, what is the effect on the payoff balance at the balloon date if the loan term is lengthened from 5 years to 10 years?

A. 1129 amount goes up, 1111(b) amount goes up
B. 1129 amount goes down, 1111(b) amount goes down
C. 1129 amount goes down, 1111(b) amount goes up
D. 1129 amount goes up, 1111(b) amount goes down
E. Both stay the same
F. No idea, that's why I signed up for this presentation

DYNAMIC CASE PERSPECTIVE

Interest Rate = 9% / Amortization = 30 Years / Term(Balloon) = 240 Months/ Monthly Payment = $56,324

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



Answer to Audience Question: Loan Term

If the election is made, what is the effect on the payoff balance at the balloon date if the loan term is lengthened from 5 years to 10 years?

The correct answer is B, the 1129 amount goes down and the 1111(b) amount goes down.

This can be seen in the prior slide by observing the red and blue lines at lower levels at the 30 year mark than the 20 year mark.

Audience Question: Feasibility

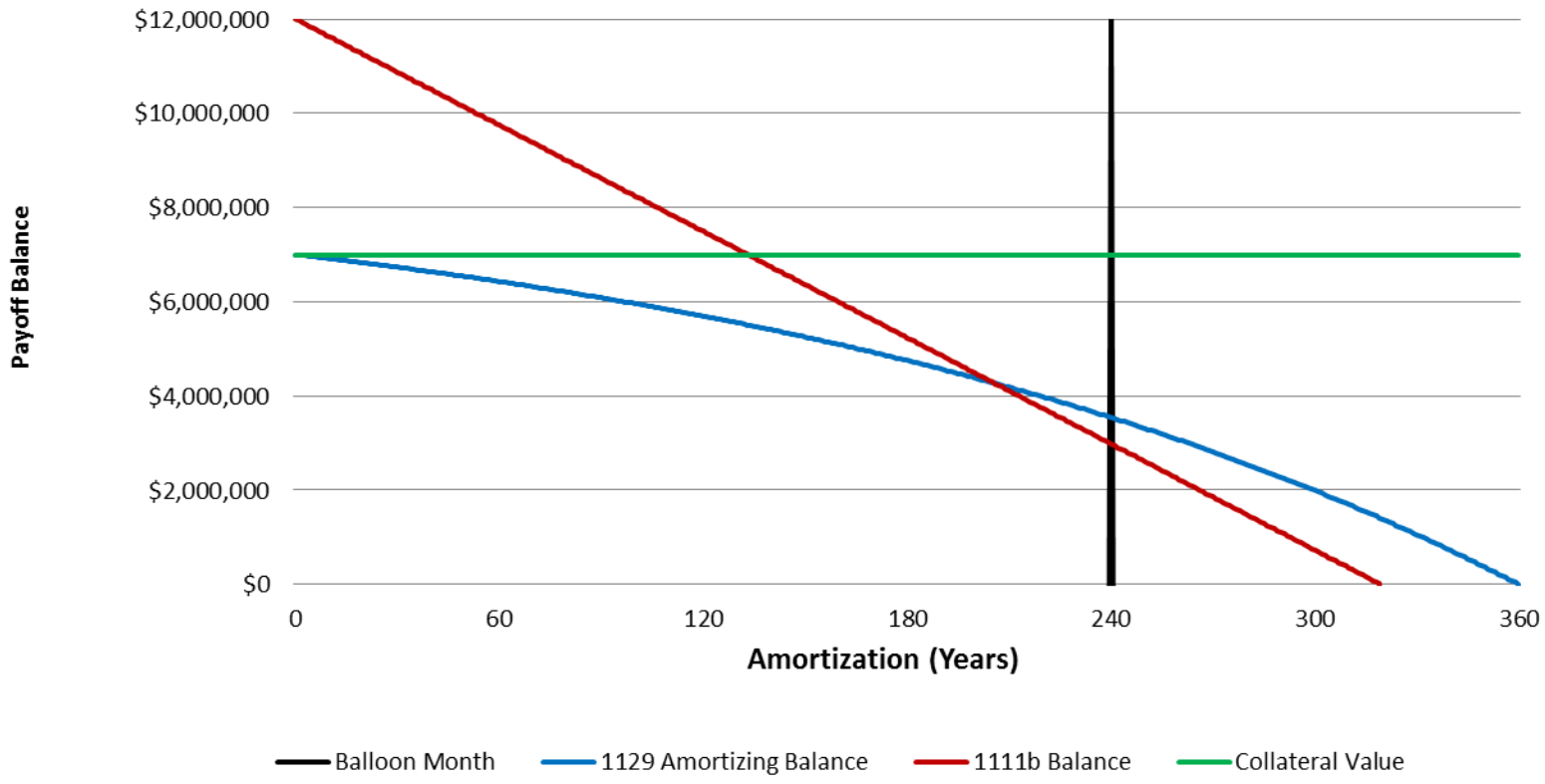
If the election is made, what is the effect on feasibility if the amortization is lengthened and the interest rate is reduced ?

A. Feasibility is easier
B. Feasibility is harder
C. Stays the same
D. None of the above
E. No idea, that's why I signed up for this presentation

DEBTOR'S CASE PERSPECTIVE

Interest Rate = 5% / Amortization = 30 Years / Term(Balloon) = 240 Months / Monthly Payment = $37,578

1111(b) Claim Amount = $12,000,000 / 1129 Collateral Value = $7,000,000 and is stabilized at 0% Per Year



Audience Question: Feasibility

If the election is made, what is the effect on feasibility if the amortization is lengthened and the interest rate is reduced ?

The correct answer is D or E.

The longer amortization slows the reduction in the both the 1111b and 1129 payoff amounts, however the lower interest rate slows the 1111b recovery and speeds the 1129 recovery. Without specifics and running the numbers the amount cannot be determined.

Feasibility Recap

Feasibility Tests			
	DSCR	**1129 Payoff**	**1111b Payoff**
Interest Rate (Increase)	**Harder**	**Harder**	**Harder**
Amortization (Longer)	**Easier**	**Harder**	**Harder**
Loan Term (Longer)	**No Effect**	**Easier**	**Easier**
Collateral Value (Increase)	**Harder**	**Harder**	**Harder**
Cash Flow (Increase)	**Easier**	**n/a**	**n/a**

For additional information please contact Franklind Lea at 770-573-9366 or www.tacticalfinancialconsulting.com

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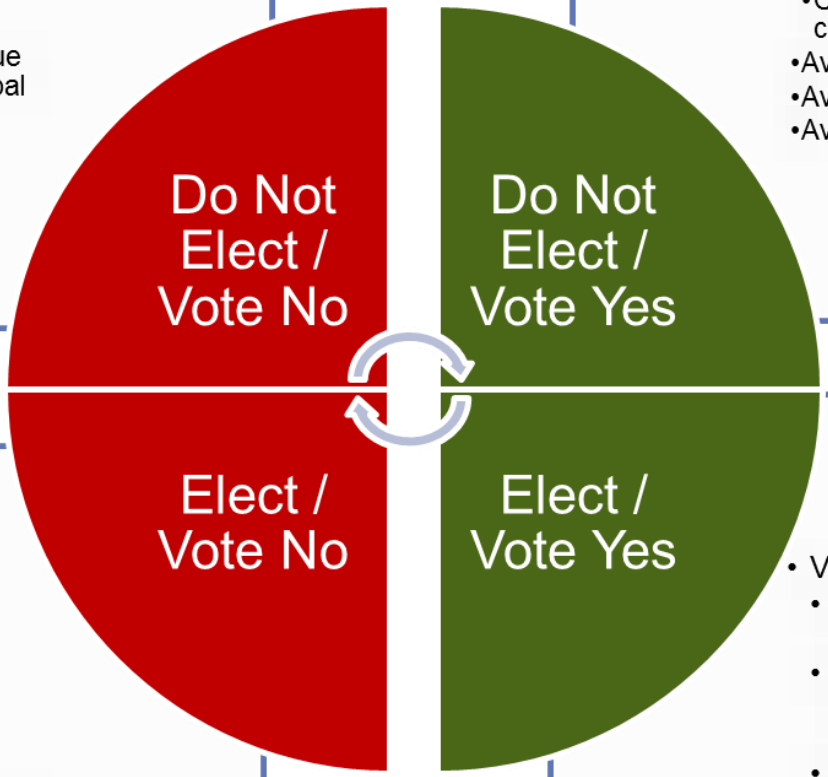
- **1111(b) STRATEGY**

GOAL: DO NOT SUPPORT PLAN

- Voting Challenge
  - Control of Unsecured Class
  - Control of Secured Class
- Feasibility Challenge
  - On-going Plan Payments
  - Residual Value challenge if value is decreasing faster than principal amortization

GOAL: SUPPORT PLAN

- Voting Challenge
  - Help Control the Secured Class
  - Help Control the Unsecured Class thru a larger vote
  - Create an impaired consenting class for confirmation
- Avoid a valuation fight
- Avoid a Feasibility fight
- Avoid/Compromise Litigation



- Voting Challenge
  - Control of Unsecured Class
  - Control of Secured Class
- Feasibility Challenge
  - On-going Plan Payments
  - Residual Value challenge if value is decreasing faster than principal amortization

- Voting
  - Help Control the Secured Class
  - Create an impaired consenting class for confirmation
  - Influence unsecured votes by leaving a larger return for remaining unsecured creditors (ex. could be part of compromise or settlement with Debtor
- Avoid Compromise Litigation

Case Strategies

WHAT CAN YOU CHANGE, NEGOTIATE OR LITIGATE ???

Potential Mathematical Variables

Claims

1. Allowed Claim
2. Secured Claim

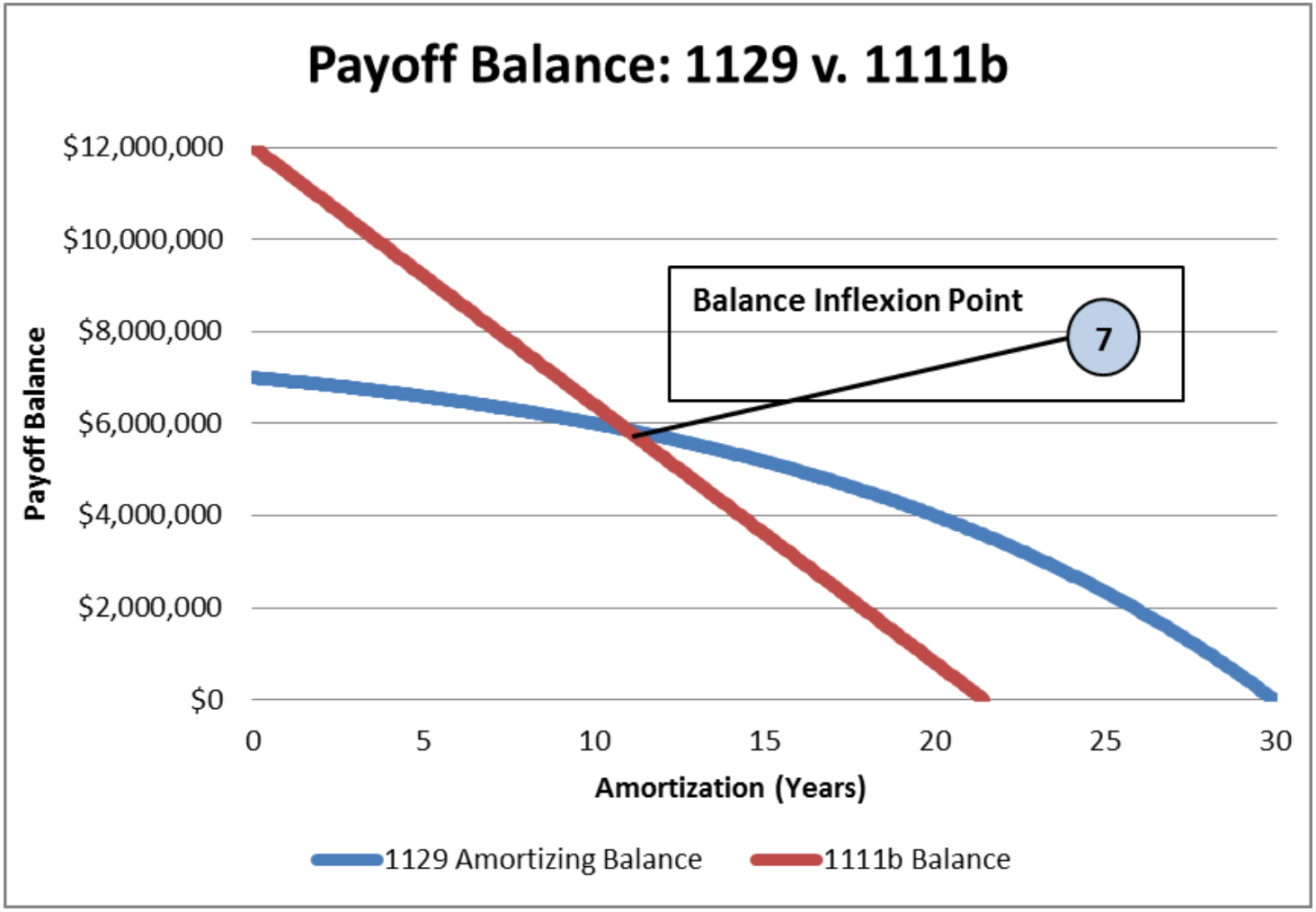
Collateral

3. Collateral Value

Repayment Terms

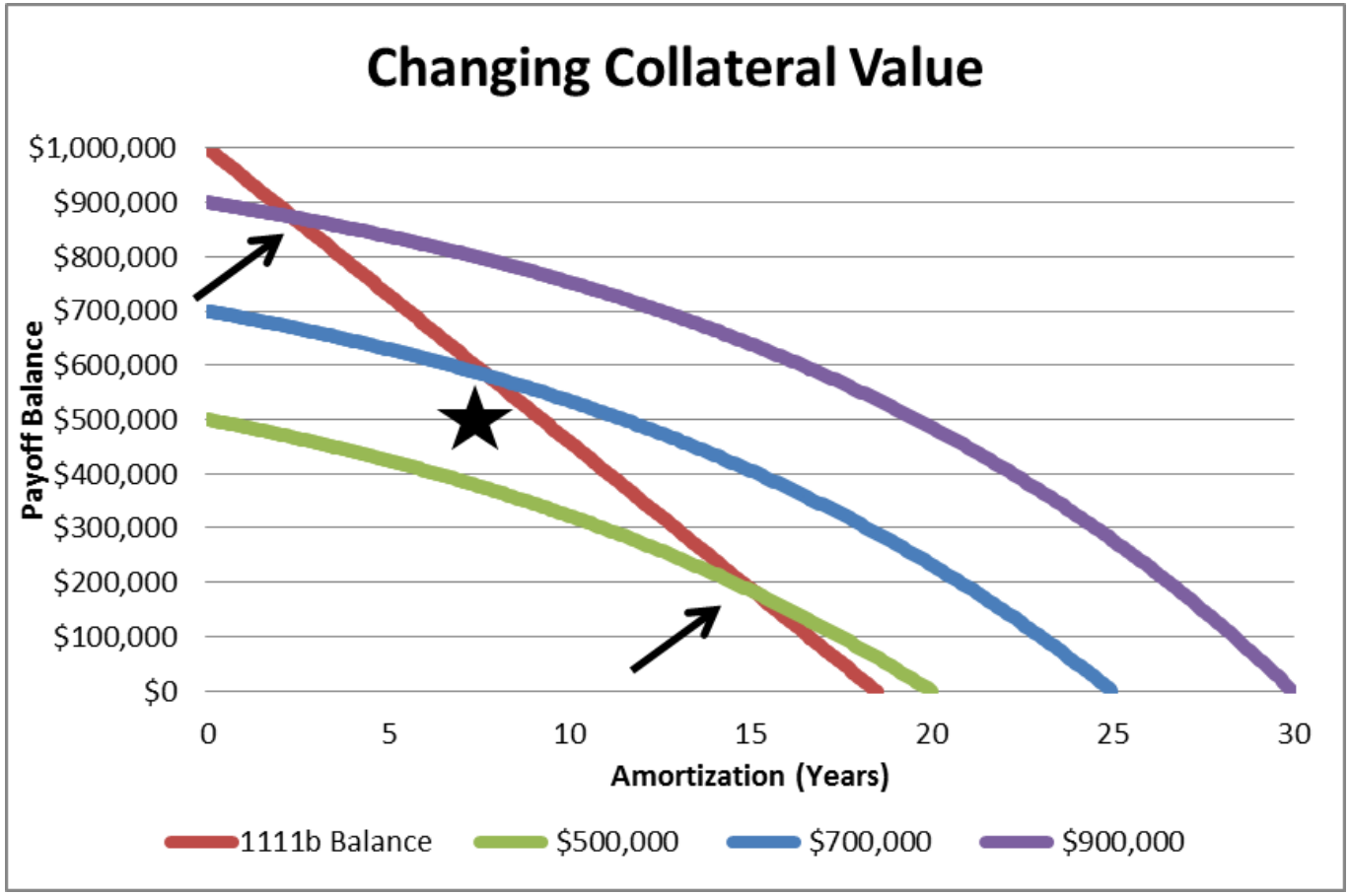
4. Interest Rate
5. Amortization
6. Term
7. Payment Frequency

Move the Inflexion Points!



Change Starting Collateral Value

Negotiate or Stipulate to more favorable starting Collateral Value



Raising the Collateral Value makes the inflexion point occur sooner; lowering it pushes the inflexion point further into the future

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- AUDIENCE WHAT IF'S & QUESTIONS AND ANSWERS

DYNAMIC CASE PERSPECTIVE

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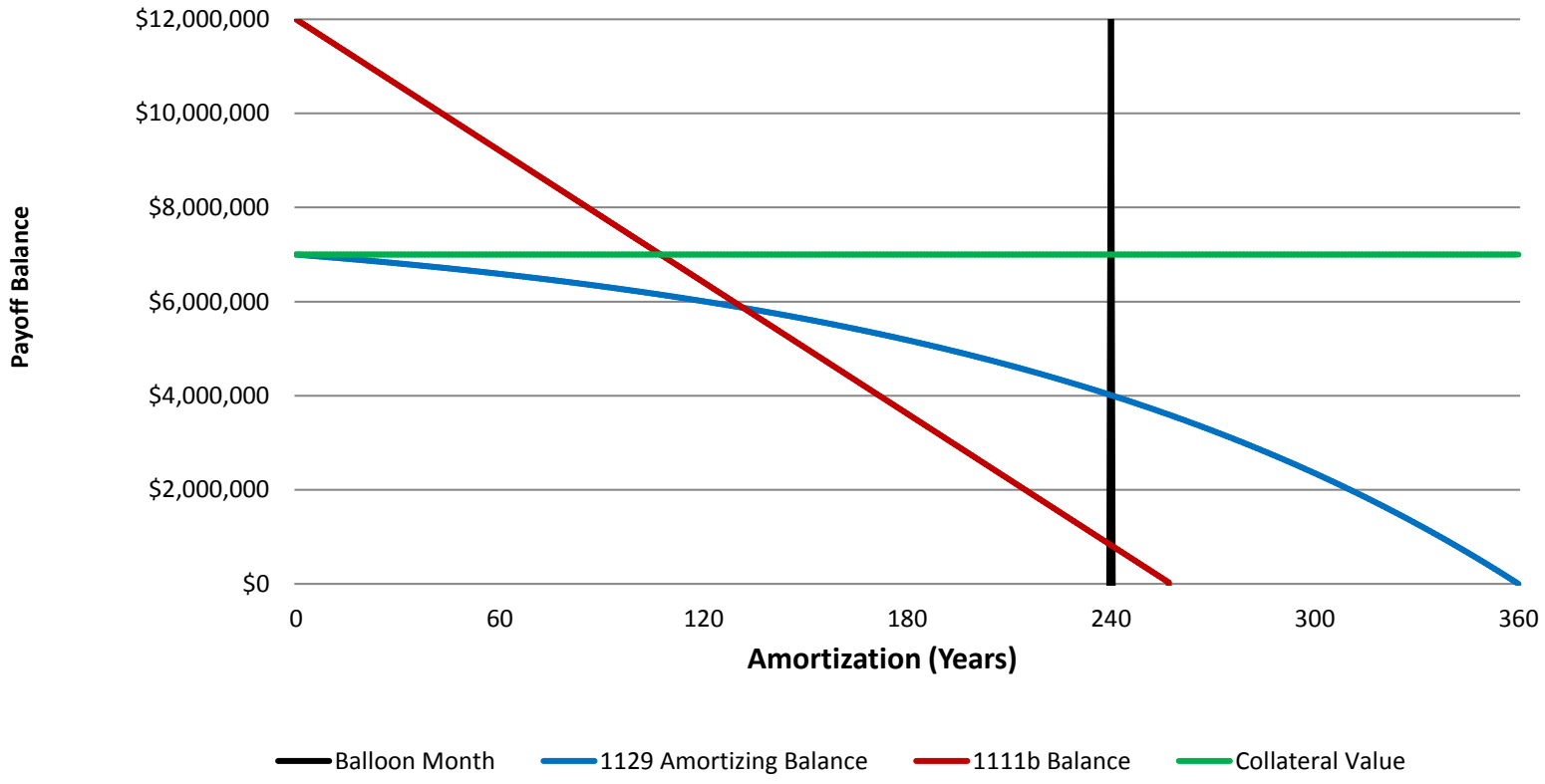

THANK YOU FOR ATTENDING!

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DYKEMA

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