The Section 1111(b) Election: A Primer

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INTRODUCTION

Section 1111(b) of the Bankruptcy Code was enacted to resolve two age old issues in the sphere of Chapter 11 cases; how can a secured creditor collect what it is owed by a debtor *from the debtor* when state law or the contract mandate that the debt is nonrecourse? And why should a debtor be permitted to simply pay the secured creditor the value of its collateral, perhaps over a short period of time, thereby stripping the lien and becoming the sole beneficiary of any future increase in its value?

As to the first issue, §1111(b) provides that the secured creditor shall share with other creditors even though the debt is nonrecourse.[1] This permits undersecured secured creditors to share in the plan with unsecured creditors whose claims are in fact recourse. As to the second issue, §1111(b) provides that the undersecured creditor may elect to retain its lien for the full amount owed, avoiding bifurcation under §506(a), and be paid in full in the plan (although not necessarily with interest).

The §1111(b) election has been used infrequently by undersecured creditors in the past; however, the issue has been considered more frequently in recent times, presumably because most secured creditors holding liens on property in bankruptcy today are undersecured. For that reason, practitioners are often surprised and unsure of how to approach the issue. This article will provide a very basic overview of the §1111(b) election, offer a few examples illustrating the effect of the election, and give the bankruptcy practitioner a basic understanding of how to structure a plan to respond to the issue at confirmation.

OVERVIEW OF CHAPTER 11 PLAN CONFIRMATION

A bankruptcy court will confirm a Chapter 11 plan of reorganization when all sixteen subsections of §1129(a) have been met. The four most important requirements are: (i) the creditors must be divided into classes;[2] (ii) each class must vote for the plan or be unimpaired;[3] (iii) the plan must pay creditors at least as much as they would receive in a Chapter 7 liquidation;[4] (iv) and the plan must be feasible.[5] In an individual Chapter 11 case, if an unsecured creditor objects, the plan must also provide for the payment of the "value" of the debtor's projected disposable income to her creditors for five years.[6]

When all the requirements of §1129(a) have been met except that some *class* has voted *against* the plan, or has not voted at all and is thereby deemed to have voted against confirmation, the plan may still be confirmed if the requirements of §1129(b) are met. These are known as the cram-down rules.

With respect to secured creditors, each almost always in a class by itself, the §1129(b) cram-down rules require that the creditor be paid the full amount of its *allowed secured claim*, either on the effective date of the plan[7] or, if paid over time, with reasonable interest for a reasonable amount of time.[8] The amount of its allowed secured claim is the value of its collateral[9] on the effective date of the plan. If the secured creditor's total claim is more than the value of its collateral—that is, the creditor is *undersecured*—the unsecured portion of the claim, or the deficiency, is paid with the unsecured class, even if it is nonrecourse. The unsecured class must be paid at least as much as it would receive in a Chapter 7 liquidation[10] and must be paid in full if the class votes against the plan and any class junior in priority to the unsecured creditors[11] is to receive anything under the plan or retain any interest in the debtor.[12] This is known as the absolute priority rule.[13] If these requirements are met, the plan is confirmed, the secured creditor's lien is reduced to the value of the collateral, and the deficiency claim is discharged.[14]

For example, assume that a secured creditor's total claim is $2 million, but the collateral is worth $1.6 million on the effective date. The plan proposes to pay the creditor $1.6 million, its allowed secured claim, with 6% interest amortized over 30 years and a balloon payment in seven years. The plan payments to that creditor then would be $9,592 per month. If that interest rate is reasonable, the payment is feasible, and the remaining fifteen requirements of §1129(a) are met, the plan would be confirmed as to that class even if that creditor has voted to reject the plan (provided at least one impaired class has voted for confirmation).[15] Once the plan is confirmed, subsequent increases to the value of the property inure to the benefit of the debtor since the lien is reduced to the amount of the allowed secured claim.[16]

The remaining $400,000 of this creditor's claim is treated with the unsecured class of creditors. The unsecured class often will receive a nominal amount unless the debtor has other assets. If that amount is at least as much as the liquidation value of the debtor's assets and the absolute priority rule has been met, the plan will be confirmed.

After confirmation of the plan, the debtor will own its property worth $1.6 million with a lien on it of $1.6 million. Any remaining amount owed by the debtor will be discharged once the discharge is entered.

THE §1111(b) ELECTION

The §1111(b)(2) election applies to undersecured secured creditors, i.e., those whose collateral is worth less than the amount owed to the creditor and therefore whose "allowed secured claim" is less that the full amount of the debt. The election is one sentence:

> If such an election [under §1111(b)(1)(A)(i)] is made, then notwithstanding section 506 (a) of this title, such claim is a secured claim to the extent that such claim is allowed.[17]

Section 1111(b)(1) simply states that the secured claim is allowed "under section 502," even if it is a nonrecourse debt, unless the creditor makes the election under §1111(b)(2).[18] Section 1111(b)(1)(A)(i) simply states that a secured creditor may elect to be treated under §1111(b)(2) as fully secured, even if it is undersecured.

An undersecured creditor that makes the §1111(b)(2) election is entitled to have its entire claim treated in the plan as secured. The plan then must provide that the electing creditor will be paid the full amount of its claim—$2 million in the above example—and that it will retain its original lien until the full amount of the claim is paid. By making the election, the creditor no longer has an unsecured claim and thus is not part of the unsecured class.

But does the plan have to pay the full amount of the electing secured creditor's claim with reasonable interest for a reasonable amount of time pursuant to §1129(b)(2)(A)(i)(II)? If so, every undersecured creditor would make the election and §506(a) would be meaningless. The answer is no. The claim is still bifurcated into secured and unsecured pursuant to §506(a) for payment purposes.[19] The *secured portion* of the claim is still paid in full with reasonable interest for a reasonable amount of time. However, the total payments made to the electing creditor in the plan must equal the full amount of the claim.

In the above example, the debtor is paying the $1.6 million secured claim in monthly payments of $9,592 for 84 months and a balloon at the end of the 84 months of $1,443,822 for a total of $2,449,550.[20] The total payments are more than $2 million and therefore the election has been met, whether made or not. The electing creditor has given up the right to share with the unsecured class but retains its lien for $2 million until paid in full. By making the election the creditor has likely also given up its power to block confirmation by voting to reject the plan with the unsecured class. If the unsecured portion of the claim exceeds the total of the remaining unsecured claims, a vote to reject

3

will result in the rejection by that class[21] which usually results in the plan violating the absolute priority rule and denial of confirmation.

EXAMPLES

Example one:

Suppose a debtor owns real property with a fair market value on the effective date[22] of $1 million. Also suppose that the debtor owes the bank $2 million secured by the property. Without the election, the debtor must pay the bank $1 million with reasonable interest for a reasonable amount of time. The remaining $1 million is included with the unsecured creditors, whether the lien is recourse or not. The plan must pay the unsecured creditors at least as much as they would get in a liquidation and must not violate the absolute priority rule.[23] The debtor must also establish that it can actually make the payments, i.e., the plan is feasible.

If the bank in this example makes the §1111(b) election, the total payments made under the plan must equal $2 million. If the plan offers $1 million at 6% interest, amortized over 30 years with a balloon in ten, the total payments made under the plan equal only $1,400,016 and the plan fails. However, if the balloon payment is pushed out to 21 years, the total payments are $2,010,252, the plan succeeds, at least as to this issue.[24]

By making the election, the bank retains its lien of $2 million until paid in full but loses its right to vote with the unsecured class. If the bank's goal is to block confirmation, the §1111(b) election will hurt that goal. With a $1 million unsecured claim it would likely have significant voting power in the unsecured class and therefore be able to unilaterally block confirmation of the plan.[25] A "no" vote by the unsecured class usually leaves the plan violating the absolute priority rule since the owners of the debtor usually retain their ownership interest. The bank also loses its right to collect with the unsecured class which may or may not be meaningful.

Example two:

Suppose a debtor owns real property with a fair market value on the effective date of $14 million. Also suppose that the debtor owes the bank $20 million secured by the property. Without the election, the debtor must pay the bank $14 million with reasonable interest for a reasonable amount of time. The remaining $6 million is included with the unsecured creditors.

4

If the bank in this example makes the §1111(b) election, the total payments made under the plan must equal $20 million. If the plan offers $14 million at 6% interest, amortized over 30 years with a balloon in eight, the total payments equal $20,346,088, the plan succeeds at least as to that class. A balloon payment in fewer than eight years will make the entire payment stream total less than $20 million, and will therefore not pay the full allowed claim, violating §1129(a)(7)(B).

Again, the bank, by making the election, is giving up its power to block confirmation of any plan by voting with the unsecured class. It will, however, retain its lien in the full amount of $20 million until paid in full. If the property is sold or refinanced within the eight years, the creditor must be paid in full.

Example three:

Suppose a debtor owns real property with a fair market value on the effective date of $400,000 encumbered by a first lien of $600,000. Suppose the plan offers $400,000 at 6% interest, amortized over 30 years with a balloon payment in two years. Total payments to the bank equal $447,429 plus the amount received with the unsecured creditors. If the bank does not make the election, it will be entitled to vote its $200,000 unsecured claim, but that may not be enough to block confirmation, i.e. other unsecured creditors may out-vote it in that class. By making the §1111(b) election, the bank will force the debtor to extend the length of the payments to at least nine years so that total payments equal $600,000. It will retain its lien on the full amount until paid in full.

Example four:

Suppose a debtor owns equipment with a fair market value on the effective date of $40,000 on which there is a first lien of $60,000. If the plan pays $40,000 at 6% interest, amortized over five years with a balloon in two years, total payments to the bank will be only $43,979. Because it is unlikely that the court will permit plan payments to exceed the probable life of the equipment, the §1111(b) election will probably prevent confirmation. Suppose the equipment has five good years left; payment of $40,000 over five years will not exceed $60,000 in total payments unless the interest rate is at least 18%.

WHEN THE ELECTION MUST BE MADE

Under Federal Rule of Bankruptcy Procedure 3014, a creditor has until the "conclusion" of the hearing on the adequacy of the disclosure statement or "such later time as the court may fix" to make the election. If the court has permitted conditional approval of the disclosure statement and combined the final hearing on adequacy of the disclosure statement with the hearing on confirmation of the plan, the election must be made not later than the date ballots are due.[26]

The Rules give the creditor time to understand what the debtor's plan is going to provide before requiring the election to be made. For this reason, some courts require the debtor to set forth the consequences of creditors making the election in the disclosure statement and propose an alternative plan should the election be made.

WHEN THE ELECTION CANNOT BE MADE

The §1111(b) election cannot be made when the *value* of the secured creditor's lien in the debtor's property is "inconsequential."[27] Inconsequential means that the secured portion of the claim is a small part of the total claim.[28] There are few cases discussing inconsequential and the results reveal no simple rule of thumb.[29]

Assume the value of the property is $1 million, the first is owed $975,000 and the second is owed $300,000. The first cannot make the election because it is fully secured and must be paid in full. The secured portion of the claim of the second, $25,000, is 8% of its total claim. It is likely that this is inconsequential,[30] and an attempt to make the election should be rejected. This is fair since the election would require the debtor to pay $300,000 to the almost fully unsecured creditor, obviously to the detriment of the other unsecured creditors. The total paid to the creditor would be many times the amount of the allowed secured claim. The debtor will still have to pay the secured portion of the claim with reasonable interest but the unsecured portion will be treated with the unsecured creditor class.

CONCLUSION

"The real benefit of the election is that it protects the creditor against a quick sale of its collateral."[31] If the unsecured portion of the undersecured creditor's claim is minimal compared to the total claim, the §1111(b) election will rarely accomplish anything for the creditor. It will only prevent the debtor from essentially buying the

property from the creditor for its current value.   If the unsecured portion is large compared to the total amount of other unsecured claims, the election will take away the creditor's power to vote with the unsecured class and thereby usually block confirmation. But the election, unheard of and unused for many years, is currently being considered by secured creditors and therefore must be considered by debtor's counsel.

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[1] "A nonrecourse creditor is one who can 'look only to its collateral for satisfaction of its debt and does not have any right to seek payment of any deficiency from a debtor's other assets.' A recourse creditor 'has the right to seek payment of a deficiency in the value of its collateral from the debtor's other assets.'" *First Federal Bank of California v. Weinstein (In re Weinstein)*, 227 B.R. 284 (9th Cir B.A.P. 1998) (quoting *680 Fifth Ave. Assocs.*, 29 F.3d 95 (2nd Cir. 1994)).

§1111(b)(1)(A) provides: "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 . . . ."

[2] §1123(a).

[3] §1129(a)(8). Unimpaired means the creditor will be paid under the plan according to the then-existing terms between the parties.

[4] §1129(a)(7).

[5] §1129(a)(11).

[6] §1129(a)(15) In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan -
    (A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
    (B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer.

[7] Typically, the effective date of the plan is within thirty days of the plan confirmation hearing.

[8] In order to meet the requirement of fair and equitable treatment of dissenting classes, §1129(b)(2) requires:

> (A) With respect to a class of secured claims, the plan provides—
> (i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another 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.

The appropriate interest rate is, of course, the subject of much discussion among bankruptcy pundits. The reader is admonished to read carefully Judge Ted Alberts opinion in *In re North Valley Mall, LLC.,* Case No. 8:09-bk-19346-TA, -- B.R. -- (Bankr. C.D. Cal. 2010) (Alberts, J.). He states:

> [T]he plan cannot impose uncompensated risk upon the bank by paying too low an interest rate under the plan. Of course, determining a sufficient rate of interest in any individual case depends on quantifying risk, which in turn depends on issues such as collateral value, credit history, term of the loan and the market rates of interest generally…. All risks must be identified and compensated to a reasonable degree; what the law seeks is that elusive equilibrium between the value of the funds invested in the plan through interest vs. the value to the creditor of being able to retrieve its capital for reinvestment elsewhere, or stated differently, the non-consenting creditor must receive a value under the plan not less than the value of its right to immediately foreclose upon its collateral… Although there are many 'formula' cases, the Court believes the approach that is best utilized in a commercial real estate case like ours is the 'blended rate' approach in *Pacific First Bank v. Boulders on the River, Inc. (In re Boulders on the River, Inc.),* 164 B.R. 99, 105 (9th Cir B.A.P. 1994). . . . [T]he Court finds that an interest rate of 8.5% per annum, fixed for seven years, will provide the 'present value' of the bank's secured claim within the meaning of §1129(b)(2)(A)(II).

[9] §1129(b) (2)(A) (i)(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

[10] §1129(a)(7) With respect to each impaired class of claims or interests—
(A) each holder of a claim or interest of such class—
> (i) has accepted the plan; or
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date;

[11] Often the "holder of any claim or interest that is junior to the claims of the unsecured class" is the debtor or insiders of the debtor who intend to retain their interest in the debtor. BAPCPA appears to have modified the absolute priority rule for individual debtors. See § 1129(b)(2)(B)(ii): "* * * in a case in which the debtor is an individual, the debtor may retain property included in the estate under section

1115, subject to the requirements of subsection (a)(14) of this section." In re Shat, 424 B.R. 854 (Bkrtcy D. Nev. Feb. 2010, Markell J.)(absolute priority rule no longer applies to individual debtors); In re Gbadebo, 431 B.R. 222 (Bkrtcy N.D. Cal. April 2010, Tchaikovsky J.)(absolute priority rule continues to apply to individual debtors)

[12] §1129(b)(2) (B)With respect to a class of unsecured claims—
(i)the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
(ii)the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.

[13] There is another exception to the absolute priority rule known as the "new value exception." That judicially created exception is beyond the scope of this article. See Bank of America National Trust and Savings v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1999)

[14] These rules do not apply when the collateral is the debtor's residence since the debtor is not allowed to modify the secured debt over the objection of the creditor. §1123(b)(5) In an individual case, the discharge is not entered until "completion of all payments under the plan." §1141(d)(5)(A).

[15] §1129(a)(8)(A).

[16] §506(d).

[17] §1111(b)(2).

[18] §1111(b)(1)(A) provides:
> 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; or (ii) such holder does not have such recourse and such property is sold under section 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.

[19] "[B]ecause of the Code's artful language, an electing creditor's allowed secured claim is not treated the same as a fully secured claim. Rather, the §1111(b)(2) election can be understood as giving rise to an 'election claim' equal to the total claim but allotted special treatment for purposes of the plan confirmation process." *First Federal Bank of California v. Weinstein (In re Weinstein)*, 227 B.R. 284 (9th Cir B.A.P. 1998).

[20] Establishing the ability to come up with the balloon payment is problematic in many courtrooms. In this example, the balloon payment, seven years later, is still some 90% of the value of the property at confirmation. Arguing that property values will increase in the coming seven years will not be enough absent some evidence of the truth of that argument.

[21] §1126(c).

[22] Valuation is as of the confirmation date, see §1129(b)(2)(A)(II).

[23] Again, it is unresolved at this time whether the absolute priority rule applies in individual cases.

[24] The issue for the debtor then is feasibility; it is a little more difficult to establish the ability to make payments for 21 years than for ten. On the other hand, the balloon after ten years is much higher that the balloon after 21 years.

[25] The unsecured class is considered to have accepted the plan if more than one-half of the ballots accept the plan and more than two-thirds of the dollars that vote have accepted the plan. §1126(b)(c).

[26] Fed. R. Bankr. P. 3014 provides:

> An election of application of § 1111(b)(2) of the Code by a class of secured creditors in a chapter 9 or 11 case may be made at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix. If the disclosure statement is conditionally approved pursuant to Rule 3017.1, and a final hearing on the disclosure statement is not held, the election of application of §1111(b)(2) may be made not later than the date fixed pursuant to Rule 3017.1(a)(2) or another date the court may fix. The election shall be in writing and signed unless made at the hearing on the disclosure statement. The election, if made by the majorities required by §1111(b)(1)(A)(i), shall be binding on all members of the class with respect to the plan.

[27] § 1111(b)(1)(B)(i)

[28] In re Wandler, 77 B.R. 728 (Bankr. D. N.D. 1987)(secured portion of the claim is 4% of total claim and is therefore inconsequential for 1111(b) election purposes).

The Wandler Court stated:
The Debtors, within a reasonable life of a plan, could not make payments to Liberty National totaling approximately $390,000.00 with a present value of $15,000.00. Payment in consequence of such a proportionally small value of collateral could simply not be amortized in such a manner. If larger payments were made other unsecured creditors would be discriminated against in consequence of Liberty's windfall, as Liberty would be receiving more than the present value of its claim. This court believes that when a claim cannot be paid in full, either amortized annually or in a lump sum payment at the end of a specified period of time (i.e. thirty to forty years), without exceeding the present value of the collateral, the creditor's claim is probably of inconsequential value and an 1111(b) election should not be allowed.

[29] In re Tuma, 916 F.2d 488 (9th Cir. 1990)(stock in closely held corporate Chapter 11 debtor was more than inconsequential value); In re Century Glove, Inc., 74 B.R. 958 (Bankr. D. Del. 1987)(surrender of a portion of the collateral to make remaining portion inconsequential rejected); In re Rosage, 82 B.R. 389 (Bankr. W.D. Pa. 1987)(property was "nuisance and legal harassment action" which had no value and therefore lien was

inconsequential); In re Baxley, 72 B.R. 195 (Bankr. D. S.C. 1986)(where lien is 8% of total claim, interest is not inconsequential). See also In re Rideout, 75 B.R. 104 (Bankr. N.D. Ohio 1987).

[30] At least in the opinion of the authors.

[31] *First Federal Bank of California v. Weinstein (In re Weinstein)*, 227 B.R. 284 (9th Cir B.A.P. 1998).