

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for the Insolvency Professional

The §111(b) Election: A Decision-making Framework

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When a reorganization plan is filed, an undersecured creditor must decide whether it should elect plan treatment in accordance with 11 U.S.C. §1111(b) (the “§1111(b) election” or the “election”). The election provides an undersecured creditor with an alternative to certain proposed plan treatments. The §1111(b) election generally must be made by the conclusion of the disclosure statement hearing.² Accordingly, before that hearing, it is important to determine whether the §1111(b) election will either enhance the creditor’s recovery, or clarify and provide strategic advantages that will enable the creditor to defeat confirmation. This article illustrates an analytical framework for evaluating the election’s impact.

To understand the evaluation parameters, certain provisions of the Bankruptcy Code must be examined. Section 506(a) of the Bankruptcy Code provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest...is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property...and is an unsecured claim to the extent that the value of such creditor’s interest...is less than the amount of such allowed claim...(emphasis added).

Section 506(a) bifurcates the total allowed claim³ (AC) into two separate

claims (the “bifurcated claims”): a secured claim (the “allowed secured claim” or “ASC”) to the extent of the value of creditor’s interest (or “lien”)⁴ in its collateral, and an unsecured claim for the amount due and owing above such lien (the “allowed unsecured claim” or “AUC”). The allowed claim equals the sum of the bifurcated claims (i.e., the allowed claim equals the allowed secured claim plus the allowed unsecured claim, or $AC = ASC + AUC$). Generally, the allowed secured claim is equal to the lien.



Joel L. Tabas

An oversecured creditor has no allowed unsecured claim. For such a creditor, while the formula set forth in §506(a) still applies, the allowed unsecured claim is zero, and the allowed claim equals the allowed secured claim ($AC = ASC + AUC$, but since $AUC = 0$, $AC = ASC$). An oversecured creditor’s allowed secured claim is limited by and equal to the value of the allowed claim since the value of the collateral exceeds the value of the allowed claim. Accordingly, the oversecured creditor’s allowed claim also is equal to the value of its lien in the collateral ($AC = ASC = \text{lien}$). Therefore, no bifurcation occurs, and the oversecured creditor has no unsecured claim. The calculations are as follows:

$$\begin{aligned}AC &= ASC + AUC \\AUC &= 0 \\AC &= ASC + 0 \\AC &= ASC\end{aligned}$$

Since the allowed secured claim equals the lien, the lien is interchangeable with the ASC in the above calculations. The result is that for an oversecured creditor, the allowed claim, the allowed secured claim and the lien are equal.

Claim bifurcation occurs only when the creditor holds an undersecured claim. As with the case of an oversecured creditor, the allowed secured claim of an under-secured creditor is equal to the value of the creditor’s lien against the collateral ($ASC = \text{lien}$). The

⁴ The value of the secured creditor’s interest in the collateral is the same as the value of its lien for purposes of this discussion.

undersecured creditor’s allowed secured claim, however, is less than the allowed claim ($ASC < AC$). Such creditor’s allowed unsecured claim is calculated by taking the difference between the allowed claim and the allowed secured claim ($AUC = AC - ASC$). Section 506(a), in effect, specifies that an allowed secured claim is limited to the lesser of the lien (the ceiling for an undersecured creditor), or the amount of the allowed claim (the ceiling for an over-secured creditor). The calculations for the undersecured claimant are as follows:

$$\begin{aligned}AC &= ASC + AUC \\AUC &> 0 \\AC &> ASC\end{aligned}$$

The ASC still equals the lien as with the oversecured scenario. The allowed claim, however, is no longer equal to the ASC or the lien and exceeds both by the amount of the allowed unsecured claim.

Generally, bifurcated claims are classified separately in reorganization plans.⁵ The undersecured claimant is afforded a vote under each class.⁶ Even if an undersecured creditor is dissatisfied with the plan proponent’s treatment of its bifurcated claims, the plan may be confirmed and crammed down over such creditor’s objection if the plan satisfies certain provisions of the Bankruptcy Code. The relevant provisions include those governing (1) the treatment of secured claims,⁷ (2) the treatment of unsecured claims⁸ and (3) feasibility.⁹

Section 1129(b)(2)(A)(i) sets forth the guidelines for the treatment of secured claimants who object to a plan. That section provides:

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...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*

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² Bankruptcy Rule 3014.

³ 11 U.S.C. §502(a). Section 502(a) provides: “A claim or interest, proof of which is filed under §501 of this title is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.”

⁵ 11 U.S.C. §1122(a).

⁶ Bankruptcy Rule 3018(d).

⁷ 11 U.S.C. §1129(b)(2)(A).

⁸ 11 U.S.C. §1129(b)(2)(B).

⁹ 11 U.S.C. §1129(a)(11).

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... (emphasis added).

The holder of an allowed secured claim is entitled (1) to retain its lien up to the amount of the allowed secured claim under §1129(b)(2)(A)(i)(I), (2) to receive deferred cash payments which, when totaled, have a face value (the sum of the deferred cash payments shall be referred to as "deferred cash payments" or "DCP") greater than or equal to the allowed secured claim ($DCP \geq ASC$) and (3) to receive deferred cash payments that, when discounted to the present value,¹⁰ are at least equal to the creditor's lien¹¹ under §1129(b)(2)(A)(i)(II) ($NPV[DCP] \geq \text{lien}$).¹² So, under this section, a secured creditor must retain its lien and receive:

(1) $DCP \geq ASC$ (or the lien)
and

(2) $NPV[DCP] \geq ASC$ (or the lien)

For the secured creditor, this means that both the net present value of the deferred cash payments as well as the deferred cash payments must be at least equal to the allowed secured claim and, in turn, the lien. Remember, for an oversecured creditor, the allowed claim equals the allowed secured claim, and it also equals the lien. So, the $NPV[DCP]$ for the oversecured creditor must also be greater than or equal to the allowed claim. For the undersecured creditor, however, while the allowed secured claim still equals the lien, it does not equal, and in fact is less than, the allowed claim.

The undersecured creditor's allowed unsecured claim should be treated like other unsecured creditors. Section 1129(b)(2)(B) governs the treatment of allowed unsecured claims. That section provides:

With respect to a class of unsecured claims—

(i) the plan provides that each holder 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.

If an objecting, unsecured creditor class is not paid in full, junior claimants cannot receive or retain property on account of their prior interests in the debtor.¹³ If a junior class (such as equity) contributes new value, cramdown may be possible.¹⁴

The feasibility requirement must also be satisfied: The plan proponent must demonstrate that the reorganized debtor will be able to make all of the proposed, deferred cash payments and otherwise meet all of its obligations under the proposed plan.¹⁵

When the two parts of bifurcated claims are treated separately for purposes of plan confirmation, an undersecured creditor may receive two distinct payment streams. For example, under a reorganization plan, the proponent may offer payments over time in respect of both secured and unsecured claims while retaining control of the secured creditor's collateral.

In order to determine the total value at confirmation of the undersecured creditor's bifurcated claims (the "bifurcated claims recovery") under such a reorganization plan, the NPV of all proposed payments in respect of the allowed secured claim must be added to the NPV of all proposed payments in respect of the allowed unsecured claim. The bifurcated claims recovery represents the undersecured creditor's expected, total financial benefit under a proposed plan.

The undersecured creditor must determine whether the bifurcated claims recovery provides the maximum return. Unlike its oversecured counterpart, the undersecured creditor has the option of making the §1111(b) election. When deciding whether to make the §1111(b) election, the claimant must consider many factors including, but not limited to, the nature of the collateral, the debtor's financial profile and the potential treatments proposed for both unsecured and secured creditors under a reorganization plan. As with the bifurcated claims recovery, the claimant must also calculate the NPV of the payment stream that will be generated by the §1111(b) election (the "§1111(b) recovery").

Furthermore, employing the §1111(b) election may create an insurmountable barrier to plan confirmation, thereby resulting in conversion or dismissal, thus

enabling the undersecured creditor to recover its collateral. The election may also counteract the effects of a plan proponent's gerrymandering efforts (improperly classifying similar claims to manipulate voting results). In other cases, the election may yield deferred cash payments that, when reduced to their net present value not only exceed the value of the creditor's lien,¹⁶ but also exceed the value of the bifurcated claims recovery. To analyze the propriety of the election, therefore, the §1111(b) recovery must be compared to the bifurcated claims recovery.

Section 1111(b) provides, in pertinent part:

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

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

As discussed above, §506(a) bifurcates an undersecured creditor's allowed claim. Section 1111(b)(1)(A) provides that the undersecured creditor's combined bifurcated claims shall be considered an allowed claim under §502(a), even if the secured claimant did not have a contractual right of recourse against the debtor. Section 1111(b)(2) then provides that if the election is made, the undersecured claim is unbifurcated notwithstanding §506(a). The working definition of an undersecured creditor's allowed secured claim is altered. After the election is made, §1111(b) provides that for confirmation purposes, the allowed secured claim is no longer equal to the lien, but is now equal to the allowed claim (the "§1111(b) allowed secured claim" or the "§1111(b) ASC").

Therefore, the §1111(b) allowed secured claim equals the allowed claim for purposes of §1129(b)(2)(A). However, the value of the creditor's lien remains unaltered.¹⁷ The only post-election difference between the

¹⁰ The "net present value" or "NPV" of a stream of payments is defined as the discounted value of that payment stream. It is calculated by adding all projected future cash receipts less all projected future cash disbursements and then applying an appropriate discount factor to such amounts, thereby reducing such cash flow to its net present value. When selecting discount rates, experts rely on various sources that indicate appropriate rates for investments with similar risk and return profiles. The NPV of the cash flows generated by a particular asset or business indicates the fair market value or current market value of such assets or business. It is only after reducing different assets' (in this instance, claim treatments are the assets under review) projected cash flows to NPV that such assets can be compared. The NPV of a set of deferred cash payments will be designated as either "NPV" or "NPV(DCP)."

¹¹ *Matter of James Wilson Associates*, 965 F.2d 160 (7th Cir. 1992).

¹² Alternatively, §1129(b)(2)(A)(iii) provides that the undersecured creditor is entitled to the "indubitable equivalent" of its claim. This section is mentioned only because it ostensibly provides an alternative to the test set forth in §1129(b)(2)(A)(i). This article will not discuss judicial interpretations of this alternative. Clearly, after the election is made, any such alternative treatment must be at least as beneficial to the electing creditor as that mandated by subsection (i), otherwise there would be no "indubitable equivalence."

¹³ *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).

¹⁴ *Bank of America National Trust and Savings Assn. v. 203 North LaSalle Street Partnership*, 119 S.Ct. 1411 (1999).

¹⁵ *In re Georgetown Ltd.*, 209 B.R. 763 (Bankr. M.D. Ga. 1997).

¹⁶ This excess over the collateral's value that is generated by application of §1111(b) shall be referred to as the "§1111(b) premium."

¹⁷ Because the oversecured creditor's allowed secured claim already equals the allowed claim (as well as the lien), the election is not applicable.

undersecured creditor and the oversecured creditor is that the former's lien is less than the value of its allowed secured claim, while the latter's lien equals the value of its allowed secured claim. This distinction is significant when §1129(b)(2)(A) is applied.

As with an oversecured scenario, the creditor holding the §1111(b) allowed secured claim is entitled to (1) vote and be treated in only one class and (2) plan treatment providing payments with both a present value greater than or equal to the lien value and with deferred cash payments greater than or equal to the allowed claim (which is always greater than the allowed secured claim by the amount of the allowed unsecured claim). When the §1111(b) allowed secured claim is used in the §1129(b)(2)(A) formula, the result is:

(1) $DCP \geq AC$ (or, the §1111(b) ASC which > the ASC)¹⁸

and

(2) $NPV[DCP] \geq ASC$ ¹⁹

Only the first part of the formula changes after the election. The DCP must now equal or exceed the larger allowed claim figure.²⁰ Before the election, the DCP only had to equal or exceed the allowed secured claim. The NPV test does not change after the election. Therefore, the only true measure of the economic difference between the two recoveries depends on the other elements of each recovery.

Under the bifurcated claims recovery, the claimant is entitled to a distribution on the unsecured portion of its claim (hereinafter the "bifurcated claims unsecured recovery element"). As previously mentioned, the §1111(b) formula yields the §1111(b) premium. Accordingly, to determine the best economic result, the NPV of the §1111(b) premium should be compared with the NPV of the bifurcated claims unsecured recovery element.

Hypothetical Case

A hypothetical case will be employed to demonstrate this decision-making framework. The analysis reveals the best recovery option. Collateral values and other factors can be varied to show the ramifications of the election under different assumptions.

The hypothetical secured claimant has a lien against real estate. The allowed claim is \$6.5 million. The debtor asserts that the claimant's lien on other assets lapsed before

the bankruptcy. The debtor claims that the going-concern value for the business is \$4.5 million and that the going-concern value of the enterprise will increase to \$5.15 million three years after confirmation. The typical loan-to-value ratio for loans on similar facilities is 75 percent. Such loans generally are amortized over 15 years and have three-year balloons. The prevailing interest rate for such loans is 11.5 percent. The debtor has used a discount rate of 11 percent²¹ to value its assets.

The plan provides for a 20 percent dividend to unsecured claimants to be paid on confirmation through new value contributions from the debtor's principals. The allowed secured claim is \$3.92 million (\$4.15 million in total real estate value minus \$230,000 in priority real estate tax liens). Unsecured claims (including the secured claimant's deficiency claim of \$2.58 million) total \$2.79 million. All available cash will be used for chapter 11 administrative claims.

The bifurcated claim recovery is \$4.436 million. This amount equals the value of the allowed secured claim (\$3.92 million) plus the bifurcated claim unsecured recovery element (\$516,000, which equals 20 percent of \$2.58 million).

The §1111(b) premium must now be derived. The monthly payment in respect of the allowed secured claim is \$45,793.04 (\$3.92 million amortized over 15 years at 11.5 percent). The face amount of the monthly payments over 36 months (*i.e.*, multiplied by 36) totals \$1,648,549.46. Under the §1111(b) allowed-claim test, the deferred cash payment must total \$6.5 million. Therefore, the required balloon payment at the end of three years is \$4,851,450.54.

In order to satisfy the NPV test, the net present value of the deferred cash payments must equal or exceed \$3.92 million. Using the debtor's discount rate, the net present value of these payments is (1) \$1,398,742.67 (NPV of 36 monthly payments of \$45,793.04 discounted at 11 percent), plus (2) \$3,547,338.82 (NPV of \$4,851,450.54 balloon payment discounted at 11 percent). The net present value of the payments totals \$4,946,081.49, and the debtor's plan meets the §1111(b) NPV

test—the net present value exceeds \$3.92 million.

The §1111(b) premium in this hypothetical equals \$1,026,081.49 (\$4,946,081.49 - \$3.92 million). The §1111(b) premium is substantially greater than the bifurcated claim unsecured recovery element (\$516,000), and hence provides the superior recovery.

This analysis also demonstrates that this plan is not feasible. First, the §1111(b) recovery (\$4,946,086.49) exceeds the present value of the entire enterprise (\$4.5 million). It further demonstrates that the new value infusion is not warranted. After the election, the principals would have to contribute even more money than originally anticipated, since there is no more value that can be extracted from the enterprise. That additional contribution would be far in excess of any reasonable assessment of the "equity" based on the debtor's enterprise valuation.

Second, the required balloon payment at the end of three years (\$4,851,450.54) far exceeds the value that could be obtained upon refinancing (.75 x \$5.15 million, or \$3,862,500, could be raised). The collateral would have to be worth at least \$6,468,600.72 (\$4,851,450.54 / .75) in three years to finance such a balloon payment. The debtor would have to increase its estimate of the expected future enterprise value by more than 25 percent. Such a dramatic increase would be difficult to justify.

The debtor could propose a payment stream that might satisfy both the §1111(b) allowed claim test and the NPV test. For instance, the debtor could propose to fully amortize the secured claim over 15 years (the entire useful life of the enterprise) at a 100 percent loan-to-value ratio and argue that the interest rate should still be 11.5 percent and that the discount rate should be 11 percent. As that proposal deviates from generally accepted lending practices, however, it is not reasonable to expect that the entire enterprise risk would be imposed upon the secured claimant while, at the same time, maintaining the secured claimant's rate of return at a level corresponding to that of a standard secured obligation. Obviously, the interest rate provided would have to be increased, which would inflate the monthly plan payments. In addition, the discount rate would have to be adjusted to reflect the increased risk associated with the over-leveraged financial profile. The corrected rates would have the effect of either increasing the monthly payments beyond the debtor's ability to pay, or reducing the net present value of the payment stream such that the NPV test is not satisfied.

¹⁸ This first threshold under §1111(b) shall be referred to as the "§1111(b) allowed claim test."

¹⁹ This second threshold, which remains unaltered by the election, shall be referred to as the "NPV test."

²⁰ A debtor may, of course, propose any payment stream in order to satisfy its financial obligations to a particular creditor. The proposal, however, must be feasible. For instance, if the monthly payments required to meet the §1111(b) formula are far greater than the amount of cash historically available from the debtor's operations, such a fact could provide grounds to challenge feasibility. Likewise, if the debtor stretches out payments only to satisfy the §1111(b) formula, such machinations by a debtor may appear disingenuous.

²¹ This hypothetical is derived from an actual case wherein the expert actually suggested the rates and values employed herein. Such rates were intended to favor the debtor's position at confirmation. These rates are employed here to demonstrate that even under such extreme and unsupportable assumptions, the analytical framework suggested herein can be employed to ferret out the logical shortcomings of a debtor's proposal. If lenders require such rates and loan-to-value ratios, it stands to reason that a higher rate should apply if the debtor proposes a plan that incorporates a higher loan-to-value ratio, because both the enterprise and the corresponding repayment proposal are riskier. Likewise, the discount rate for an enterprise with a less than optimal (*e.g.*, a higher loan-to-value ratio) capital structure should be higher than discount rates employed when evaluating an enterprise that is optimally capitalized. Levy, H. and Sarnat, M., *Capital Investments and Financial Decisions*, pp. 406-13 (2d. Ed. 1982).

Conclusions

Generating and comparing the §1111(b) premium and the bifurcated claim unsecured recovery element enables a secured creditor to evaluate which recovery stream will yield the greatest economic benefit. It also reveals shortcomings in the debtor's valuation and feasibility analyses. This framework can be used to analyze variations in amortization and payout assumptions, thereby enabling the secured creditor to make the most appropriate decision regarding §1111(b) under any set of variables. Accordingly, this analysis dispels the common view that the §1111(b) election should be utilized only to capture potential appreciation in collateral. ■

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