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ALERTS

Finance, Insolvency & Restructuring Alert - Section 1111(b) Of The Bankruptcy Code: An Effective Weapon For Undersecured Creditors Opposing Confirmation Of Cramdown Chapter 11 Plans

January 22, 2014 | Atlanta | Chicago | Columbus | Delaware | Elkhart | Fort Wayne | Grand Rapids | Indianapolis | Los Angeles | Minneapolis | South Bend

Section 1111(b) of the United States Bankruptcy Code (the "Code") is one of its least understood provisions, primarily due to its somewhat opaque language. This Code subsection is divided into two distinct but related parts. The first part, section 1111(b)(1), provides that a nonrecourse secured claim in a Chapter 11 case will be treated "as if such holder had recourse against the debtor on account of such claim, whether or not such holder has such recourse" subject to two exceptions. This Code provision, adopted by Congress in 1978, reversed decisions under the prior Bankruptcy Act of 1898 holding that, in reorganization proceedings, the holder of an undersecured nonrecourse claim was not entitled to a claim against the debtor for any estimated deficiency claim. For example, if the nonrecourse claim totaled $11 million and the collateral's value was only $6 million, the creditor could receive no payment in the reorganization case on its deficiency claim of $5 million. A recent decision of the Seventh Circuit Court of Appeals , discussed below, held that this Code provision permits a creditor, a junior mortgagee, holding a nonrecourse claim secured by a lien in property of the debtor's bankruptcy estate, to an allowed deficiency claim notwithstanding the lack of collateral value.

The second part of this statutory provision, section 1111(b)(2), permits a holder of an undersecured claim to elect to have that claim treated as fully secured in a Chapter 11 plan that proposes retention of the collateral by the debtor after confirmation, provided that the lien has more than "inconsequential value." By making this election, the creditor may maximize his recovery in the event that the confirmed plan subsequently fails and the creditor forecloses on its collateral. In addition, the making of this election may render the debtor's plan to be not feasible and, therefore, incapable of confirmation.

A. The Brookfield Decision of the Seventh Circuit: The Plain Language of Section 1111(b)(1) Rules Notwithstanding a Valueless Lien

In *In re B.R. Brookfield Commons* No. 1 LLC, 2013 U.S. App. LEXIS 22385 (7th Cir. Nov. 4, 2013), the Seventh Circuit Court of Appeals addressed the issue of whether a nonrecourse claim secured by a junior mortgage on a Chapter 11 debtor's commercial real estate, a shopping center, would be allowed as an unsecured claim in the bankruptcy case when that lien had no value whatsoever – the value of the center was

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less than the amount of the claim secured by the first mortgage. The holder of the junior claim (which also held the senior claim) argued that the plain language of section 1111(b)(1) applied and that its nonrecourse deficiency claim was required to be treated as if it were a recourse claim against the debtor and, therefore, as an allowed claim in the Chapter 11 case. The debtor argued that, because state law would not allow this claim to trigger personal liability of the debtor, the claim should be disallowed. The Seventh Circuit rejected the debtor's argument, holding that the only perquisite for the application of section 1111(b)(1) is that the claim be secured by a lien on property of the estate even though that lien may have no value. Consequently, this deficiency claim was allowed in the Chapter 11 case as an unsecured deficiency claim for its full amount.

B. Electing Fully Secured Treatment Under Section 1111(b)(2): Maximizing Recovery and Blocking Plan Confirmation

It sometimes happens that an undersecured real estate lender is involved in a Chapter 11 case where the debtor proposes in its reorganization plan to retain the mortgaged real estate and pay the lender the value of its collateral over a period of years at a low cramdown interest rate. This scenario is relatively common in single asset real estate cases. For example, if the real estate is valued at $6 million and the mortgage debt is $11 million, the debtor's plan may treat the mortgagee as holding two claims – a secured claim for $6 million and an unsecured deficiency claim for $5 million. The plan may classify the creditor's unsecured claim in a class separately from other unsecured creditors and to pay that claim a small percentage of its total amount. The mortgagor's secured claim of $6 million would then be paid over a period of 10 to 15 years at a market rate of interest or, if no such market exists, at an interest rate determined in accordance with the United States Supreme Court's Till decision.

One strategy available to undersecured mortgagees in these circumstances is to invoke the provisions of section 1111(b)(2) of the Bankruptcy Code, which permits an undersecured creditor with a lien in property of the debtor's estate to elect to have its entire claim treated as a secured claim. This election, however, may not be made under the following circumstances. First, the election may not be made if the creditor's lien in the collateral is "of inconsequential value." Second, this election is not available to the creditor if (i) the creditor's claim is a recourse claim against the debtor (i.e., the debtor has personal liability for the claim); and (ii) the property will be sold pursuant under section 363 of the Bankruptcy Code or pursuant to the terms of the proposed Chapter 11 plan.

If the election is properly and timely made by the undersecured mortgagee, its entire $11 million claim will be treated as a secured claim but with one very important caveat – the creditor must receive under the confirmed plan a distribution equal to $11 million in total dollars but the "present value" of this distribution may not exceed the value of the creditor's lien, i.e., $6 million. Correspondingly, the creditor making this election will not be deemed to hold an unsecured claim for its estimated deficiency. The making of this election will normally require the debtor to tailor its Chapter 11 plan to provide distributions to the electing creditor that will satisfy this legal requirement. Any such plan must also satisfy the statutory confirmation requirement that the plan be "feasible" – that

confirmation of the plan will not likely be followed by “liquidation, or the need for further financial reorganization, of the debtor” unless the plan proposes this liquidation or reorganization.

Why would an undersecured creditor, such as a mortgagee of real property, decide to make this election? One important factor in evaluating this choice is the mortgagee’s expectation that the debtor’s long-term payment plan will eventually fail after confirmation and the mortgagee will eventually be permitted to foreclose on its lien in the collateral. If the mortgagee expects the property to increase in value after confirmation, then it may make economic sense in these circumstances to make the election and wait for the eventual collapse of the plan. At or after foreclosure, the creditor expects to realize a substantial return on its claim. Another reason to make this election is to constrict the debtor’s cash flow by requiring the debtor to make larger plan payments to the creditor – plan payments that the debtor’s cash flow projections may prove impossible to make. In this situation, the bankruptcy court may deny confirmation of the proposed plan because the plan is not feasible.

As noted above, making an election under section 1111(b)(2) of the Bankruptcy Code to have an undersecured claim treated as a fully secured claim in Chapter 11 cases is not often resorted to by creditors holding these claims. Sometimes, these creditors object to confirmation of reorganization plans based upon (i) the debtor’s aggressively low valuation of the collateral; (ii) the insufficiency of the plan cramdown rate assigned to the secured claim; and/or (iii) the separate classification of the creditor’s deficiency claim from other unsecured claims. On other occasions, undersecured creditors are satisfied with the treatment of their claims in proposed plans and decline to object to their confirmation or negotiate only minor alterations of that treatment. In evaluating whether to object to confirmation of a proposed Chapter 11 plan, undersecured creditors may want to seriously consider making a timely election under section 1111(b)(2), especially in circumstances where (i) the debtor’s plan is extremely skinny and likely to fail, and (ii) the collateral is expected to increase steadily in value over time.

To obtain more information, please contact the Barnes & Thornburg attorney with whom you work or the following attorney: Patrick E. Mears at (616) 742-3936 or pmears@btlaw.com. You can also visit us online at http://www.btlaw.com/financeinsolvencyandrestructuring/.