



Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Sec. 1111(b) And Commercial Real Estate Cases

Law360, New York (September 21, 2009) -- A variety of sources predict a coming wave of commercial real estate problems. The prediction is that many of the acquisitions and refinancing of a few years ago are headed toward maturity in 2009 to 2011. Since many used funding vehicles that no longer exist, the conventional wisdom is that the defaults will soon begin. Just as summer follows spring, bankruptcies follow mortgage defaults.

The current economic conditions also come into play because today's values are nowhere near where they were in the two years preceding the 2008 liquidity crunch. As more properties find themselves in trouble, no one expects real property values to increase significantly in the near future.

Those who argue that "the recession is ending" as an indicator that values might not fall further ignore the fact that a recession ends when the economy's slide stops going further downhill. The ending does not mean that values have started improving.

Section 1111(b) was designed for times like these — significantly depressed property values and relatively high debt loads. The amount of debt was a reflection of the higher property values at the time of the financing — not its current value.

To understand how Sec. 1111(b) affects a secured creditor under a plan of reorganization, an overview of bankruptcy claims and plan confirmation is appropriate.

Secured creditors (those with liens on property) have a secured claim in a bankruptcy case. Depending on the value of their collateral, the claim is described as being either oversecured or undersecured.

For undersecured claims, the Bankruptcy Code actually recognizes two separate claims — a secured claim in an amount equal to the value of the collateral and an unsecured claim for the balance. The secured claim amount equals the amount of the debt when it is oversecured.

This is where Sec. 1111(b) first comes into play. It first provides that “nonrecourse” debt is treated the same as “recourse” debt when allowing claims. Without this provision, undersecured nonrecourse lenders would only have secured claims and would never receive an unsecured claim for the deficiency since a nonrecourse deficiency claim is an oxymoron under state law.

A plan, to be confirmed, must generally provide (among many other requirements) the secured creditor with payments that have a present value that is not less than the value of the collateral.

For an unsecured creditor, the present value of the payments must be not less than the creditor would receive in a Chapter 7 case. (As with secured claims, there are many other requirements and potential exceptions to these general rules and even tougher requirements if the creditors object to the plan.)

Sec. 1111(b) was added to protect secured creditors from having their nonrecourse debt “written down” to a fraction of its original amount as a result of market declines. It allows them a way to realize more from their collateral than the value provided by a depressed market.

Stated differently, it allows a nonrecourse lender to share in the property’s post-confirmation appreciation, rather than being trapped in a depressed market, by giving the lender the right to electing to treat its entire claim as a secured claim.

If a secured creditor makes the “1111(b) Election”, the plan calculus changes. First, making the election waives the creditor’s unsecured claim because the entire claim becomes a secured claim.

The plan is still required to provide the secured creditor with payments having a present value that is not less than the value of the collateral. However, a requirement is added under Sec. 1129(b)(2)(A)(II) — the sum of all of the payments may not be less than the total amount that is owed (that being the sum of the secured and unsecured claims).

Procedurally, an 1111(b) Election is made by either making the election in open court at the disclosure statement hearing or in writing before the disclosure statement has been approved. The court can extend the deadline if it chooses to do so.

There are a number of other issues that can arise — primarily in the loan documents themselves. In some instances, the loan might be part of a syndication that requires a majority of the lenders to consent to the Election or might make it solely the province of the Agent to decide.

In other situations, an intercreditor agreement among junior and senior lienholders might control whether the Election can be made. Before considering making an 1111(b) Election, a lender should carefully review all of the loan documents to see if the option is available.

When the creditor makes the 1111(b) Election, it necessarily waives a number of issues that could have been potent arguments to oppose the plan's confirmation. Those include challenging the classification of claims and possible unfair discrimination against its unsecured claims.

There is a significant amount of case law on whether deficiency claims can be placed in separate classes from general unsecured creditors and a general prohibition against "unfairly discriminating" against similarly situated claimants.

One of the more potent confirmation issues an electing undersecured creditor forgoes is the ability to raise the "Absolute Priority Rule" which provides that a plan cannot be confirmed over the rejection of an unsecured claim class that is not being paid in full if junior creditors (or equity owners) receive or retain anything of value under the plan unless the claims are paid in full.

The debate continues regarding whether there is a "new value exception" to the Absolute Priority Rule that would essentially allow existing equity to contribute "new value" in exchange for new equity ownership under the plan and if so, how it can be accomplished.

By making the 1111(b) Election, there is no longer an unsecured claim the lender can use to enforce the Absolute Priority Rule. Since relinquishing potentially strong arguments might discourage secured creditors from making the election, the logical question is what defenses or issues does the secured creditor receive in exchange for making the 1111(b) Election?

Quite simply, the secured creditor receives a potential blocking position without being required to proceed through a hotly contested confirmation hearing. If the election is made and the payments do not add up as required, the plan process stops.

Secured lenders cannot treat the 1111(b) Election as if it were a "fire and forget" magic bullet that prevents a plan from ever being confirmed. Some cases have described the election as applying to a currently pending plan.

It is not uncommon for a debtor to amend its plan after a disclosure statement has been approved or even withdraw one plan and replace it with another. If the 1111(b) Election would defeat the current plan, secured lenders should be prepared to deal with an amended plan since that might be a debtor's next step.

Understanding how the 1111(b) Election works and how it can be beneficial in the current economic climate will be essential to working through the wave of commercial real estate cases ahead.

--John D. Penn, Haynes and Boone LLP

John Penn is a partner with Haynes and Boone in the firm's Fort Worth, Texas, office.

The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.