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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

CRAM-DOWN OF THE UNSECURED CREDITOR: SECTION 1111(b)(2) RELIEF

"Cram-down" is an expression that any creditor would rather not hear in a chapter 11 case, but could be most disturbing when applied to the partially secured creditor. The concern is based on the fear that the debtor would merely "cash out" the secured claim by paying the current value of the collateral at a time when the market with respect to the collateral is temporarily depressed, thus leaving the undersecured creditor with a sizable unsecured deficiency.

Congress reduced this fear of partially secured creditors by including Section 1111(b)(2) in the Bankruptcy Code.[1] In essence, this section gives a class of partially secured creditors the right to elect to be treated as having fully secured claims for reorganization purposes. This election, which requires approval by more than half of the class members in number holding at least two thirds of the claims in amount, may not be made, however, if the actual collateral is of inconsequential value or the collateral is sold by the debtor in possession or the trustee or is sold pursuant to the reorganization plan.[2]

The effect of Section 1111(b)(2) is best understood when considered in connection with the requirements for confirmation governed by Section 1129. Most chapter 11 plans are confirmed pursuant to the acceptance method under Section 1129(a). However, in the event that any class of claims or interests impaired under the plan fails to accept it by the minimum percentage of votes,[3] the proponent of the plan may request confirmation by the alternative method under Section 1129(b), commonly called the "cram-down."

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[1] 11 U.S.C. § 1111(b)(2). See B. Weintraub & A. Resnick, *Bankruptcy Law Manual* ¶ 8.18 (1980).

[2] 11 U.S.C. §§ 1111(b)(1)(B)(i), 1111 (b)(1)(B)(ii).

[3] See *id.* § 1126.

The "Fair and Equitable" Standard

In addition to the other requirements for cram-down set forth in Section 1129(b), the plan must satisfy the "fair and equitable" standard with respect to the dissenting classes in order to qualify for confirmation.[4] A plan is fair and equitable with respect to a dissenting class of secured creditors if any one of three alternative conditions is satisfied.

The first way is (1) to provide that class members retain their security interests, whether the collateral is kept or is transferred by the debtor, to the extent of their allowed secured claims *and* (2) to give each secured creditor in the class deferred cash payments which aggregate to at least the amount of the allowed secured claim and which have a present value equal to the value of the collateral.[5]

This standard is complicated by the application of Section 1111 (b)(2) of the Code. The meaning of "allowed secured claim" as used in the preceding paragraph will depend on whether the secured class makes a Section 1111(b)(2) election to be treated as fully secured despite the fact that the collateral may be worth less than the amount of the claim. For example, assume that a creditor loaned $15 million to a debtor secured by real estate worth $18 million and the value of the real estate has dropped to $12 million by the date when the debtor filed a chapter 11 petition. If the creditor is alone in a class, makes a Section 1111(b)(2) election, and does not accept the plan, the plan will be fair and equitable with respect to the secured creditor if it provides that the mortgage lien will remain on the land to secure the entire $15 million debt, the face amount of deferred cash payments to be made are at least $15 million, and the present value of the present or deferred payments is at least $12 million. Because of the Section 1111(b)(2) election, the entire $15 million claim is deemed secured and must be paid in full eventually despite the $12 million value of the collateral.

It is easy to see that the Bankruptcy Code is designed to prevent the debtor from buying off the partially secured creditor by reducing the secured claim to the value of the collateral. In order to determine the present value of cash payments, the court must take into account the prevailing interest and discount rates. If the secured creditor does not elect under Section 1111(b)(2), such creditor will not be entitled to the full $15 million in cash payments because the total allowed secured claim will be only $12 million and the creditor would be treated as having an unsecured claim to the

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[4] *Id.* § 1129(b)(1).

[5] *Id.* § 1129(b)(2)(A)(i).

extent of $3 million.[6] Also, to the extent that the deferred cash payments exceed $12 million, such a nonelecting creditor will be unsecured in the event of a future default.[7]

A second way of complying with the fair and equitable standard with respect to a class of dissenting secured creditors is for the plan to provide for the realization of the "indubitable equivalent" of their secured claims.[8] Whether or not the secured creditor class makes a Section 1111(b)(2) election, abandoning the collateral to the creditors or giving them a lien on similar collateral may satisfy this standard. The electing class may not be deprived of the future appreciation of the collateral which is the purpose of permitting such an election. Present cash payments less than the allowed secured claim will not be the "indubitable equivalent" of the collateral. Again, if the class makes an election under Section 1111 (b)(2), the allowed secured claim must equal the full amount of the debt, not just the present value of the collateral. However, unsecured notes or equity securities of the reorganized debtor will not constitute the "indubitable equivalent" of the collateral.

The term "indubitable equivalent" derives from Judge Learned Hand's opinion in *In re Murel Holding Corp.*[9] That case involved a plan that provided that a mortgagee was compelled to forgo all amortization payments for ten years. Since the mortgagee had only a 10 percent margin of value above the loan balance and had to take its chances as to the ultimate value of the property at the end of the ten-year period, as no provision was made for amortization of principal, the mortgagee was not receiving "payment of the most indubitable equivalence" at the time of confirmation. It is conceivable that the court could have held that the "indubitable equivalence" might have been achieved by granting a lien on other property which was self-liquidating or, if it were not needed for the debtor's rehabilitation, by a scale of the property.

The third alternative is to provide in the plan for the sale of the collateral free and clear of liens and for the security interest to attach to the sale proceeds. In addition, the security interest in the proceeds must be treated in accordance with either of the first two alternatives discussed above to meet the fair and equitable standard with respect to the dissenting class of secured creditors.[10]

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[6] See *id.* § 506(a).

[7] This illustration is based on a similar one contained in the *Congressional Record.* See 124 Cong. Rec. H11104 (daily ed. Sept. 28, 1978).

[8] 11 U.S.C. § 1129(b)(2)(A)(iii).

[9] 75 F.2d 941, 942 (2d Cir. 1935).

[10] 11 U.S.C. § 1129(b)(2)(A)(ii).

In re Griffiths

An illustration of the application of the cram-down provisions as applied to the partially secured creditor electing Section 1111(b)(2) may be found in the recent case of *In re Griffiths.*[11] The debtors were farmers who filed petitions under chapter 11 on August 4, 1982. A month later, Union State Bank (USB), which had a security interest in personal property including machinery, equipment, livestock, and stored grain, filed a Section 1111(b)(2) election and indicated an intention to reject the proposed plan which provided for the return of a *portion* of the collateral together with a lump-sum payment equal to the value of the remaining collateral in total satisfaction of USB's claim. Since the value of the collateral was less than the $570,670 debt owed to USB, the bank was undersecured.

The debtor's position in *Griffiths* was that the combination of the collateral to be returned to USB and payment in a lump sum of the value of the property to be retained by the debtors as being "beneficial to the rehabilitative efforts" is the "indubitable equivalent" of the creditor's allowed secured claim.[12] Thus, the debtors contended that the proposed plan was "fair and equitable" as applied to USB, which was in a class by itself, and the plan could be confirmed without their acceptance.

After analyzing Sections 1111(b)(2) and 1129(b)(2)(A), the bankruptcy court rejected the debtors' position and held that the plan did not offer USB the "indubitable equivalent" of its allowed secured claim. The court listed several reasons why the debtors could not return a portion of the collateral and pay the value of the remaining property as a means of effectuating a cram-down. First, said the court, the debtors owed USB $570,670, less the value of any property returned.

> The debtors must pay the indubitable equivalent of the remaining amount owed, and not simply the indubitable equivalent of the value of the remaining property. The indubitable equivalent of the *claim* must be realized. The post-election claim is something more than the value of the remaining property.[13]

In many cases a creditor would not elect under Section 1111(b)(2) because it would "be reluctant to give up the distribution to unsecured creditors under the plan in exchange for a lien for the full amount of their secured and unsecured claims."[14] The effect of the election, however, is to prevent a "cash-out" since without the

[11] 27 Bankr. 873 (D. Kan. 1983).

[12] *Id.* at 875.

[13] *Id.* at 876.

[14] *Id.* This language was quoted from 3 Norton, *Bankruptcy Law and Practice* § 57.02, at 14-15 (Supp. 1982).

election the debtors could offer a plan that would pay the secured creditor only the value of the collateral plus a pro rata share with respect to the unsecured deficiency. In *Griffiths*, the debtors were essentially proposing a cash-out for the bank for the value of the remaining collateral. "The Court cannot agree that a cash out payment is the indubitable equivalent of a post election claim that prevented a cash out."[15]

The court further observed that the first alternative way to satisfy the fair and equitable standard under Section 1129(b)(2)(A)(i)(II) requires that the proposed payments to the dissenting electing creditor pass two tests, i.e., (1) total payments must at least equal the total claim allowed, which would be $570,670 less the returned collateral and (2) the payments must have a present value equal to the value of the collateral. In *Griffiths*, the debtors did not propose to pay the total remaining allowed claim of the bank but only proposed to pay the value of the collateral. "Thus," observed the court, "under § 1129(b)(2)(A)(i)(II), the first requirement of cash payment cram down would not be satisfied. The Court does not believe § 1129(b)(2)(A)(iii) was intended as an alternative to the cash payment requirements of § 1129(b)(2)(A)(i)(II)."[16]

The debtors' argument that they could return *all* the collateral in satisfaction of the post-election secured claim was not contested by the bank. The debtors argued that "there is equitably no difference between returning collateral that could be sold by USB for $X, or just giving USB $X."[17] While the court found the argument to be "alluring," nonetheless, it still amounted to a cash-out and was not the indubitable equivalent of the electing creditor's claim. For the reasons stated above, the court in *Griffiths* held that the proposed plan could not be confirmed without USB's consent and the debtors were given fifteen days to modify the plan accordingly.

Conclusion

As illustrated in *Griffiths*, the congressional policy that fostered Section 1111(b)(2) was to prevent the undersecured creditor from being "cashed out" at the current market value of its collateral. By electing under Section 1111(b)(2), the claimant sacrifices the right to participate as an unsecured creditor to the extent of any deficiency if there is default under the plan, but gains protection against a cash-out for less than the amount of the entire debt owed. This represents a proper balancing of the interests of the debtor, who needs

[15] 27 Bankr. at 876.
[16] *Id.* at 877.
[17] *Id.*

continued possession and use of the collateral to enable it to be rehabilitated effectively, and the partially secured creditor who may be unfairly prejudiced by a cash-out equal to the temporarily depressed market value of the collateral.

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