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THE SECTION 1111(B) ELECTION

from the Thomas Cooley Law School Bankruptcy Reorganization Workshop

By: Judge D. Gregg*

When you read the Bankruptcy Code, you will find that some sections are more complicated and confusing than others. See, e.g., §§ 365, 506, 724, and 1129. Subsection 1111(b) is a worthy inclusion in any such list. If and when you become involved in a chapter 11 case, you should always keep the possibility of a § 1111(b) election in mind.

Section 1111(b) is only applicable to chapter 11 cases. 11 U.S.C. § 103. The subsection gives undersecured creditors additional rights that do not exist under other chapters or, for that matter, outside of bankruptcy proceedings.

A holder of a claim on "recourse" secured debt may recover in rem, that is, by foreclosing upon and selling its collateral, and/or in personam, by obtaining a judgment and collecting from the obligor's other assets as well. In many, if not most, consumer and commercial transactions, the obligations are of a recourse nature.

However, with regard to a "nonrecourse" secured debt, collection of the obligation is limited to the property which serves as collateral for the debt. Absent special circumstances, such as fraud in the inducement, the person who signs the note is not personally liable for the debt. The creditor may only recover in rem. In a nonrecourse obligation, under state law, to retain the property the obligor must pay the full outstanding indebtedness; if not paid, the secured creditor recovers only the property. Therefore, outside bankruptcy, an undersecured, nonrecourse creditor is only partially paid; what may be characterized as the unsecured portion of the debt is not paid upon default, repossession, and eventual sale of the collateral.

In bankruptcy (except for chapter 11), the result is essentially the same. Any claim which is personally unenforceable against the debtor pursuant to agreement or under state law is disallowed. § 502(b)(1). Therefore, a nonrecourse undersecured creditor is limited to the recovery of the value of the property, § 506(a), and any unsecured deficiency is

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disallowed. In a chapter 7 liquidation case, the result under state law is achieved. Because the estate (and the debtor) has no equity in the property and there is no pending reorganization, relief from stay is granted, § 362(d)(2), and the secured creditor gets the property (albeit with some delay--see United Savings Association v Timbers of Inwood Forest Associates, Ltd., 484 US 365 [1988]).

Absent § 1111(b), the result under chapter 11 would not necessarily be the same as under state law. Assuming the debtor retains the property after reorganization, what would the nonrecourse unsecured creditor receive? When such a creditor is unimpaired, see § 1124(1), no problem exists. The debtor keeps the property, but the creditor retains unaltered in rem rights against the property postconfirmation. It is as though the bankruptcy case never occurred. Even assuming the debtor was in default on its obligation to the nonrecourse undersecured creditor, and a prepetition acceleration of all indebtedness had occurred, the result would be the same. To "unimpair" such creditor, obtain a deacceleration of the full indebtedness, and to reinstate the payment schedule, the debtor must (1) cure all defaults, whether prepetition or postpetition, (2) reinstate the maturity of the claim, and (3) compensate the holder of the claim for any damages incurred. § 1124(2).

However, what if the debtor desires to retain the property by "cashing out", by either a lump sum payment through refinancing, § 1124(3), or by directly paying the undersecured creditor periodic payments with present value (market rate interest)? It is in this type of an instance that problems may arise.

Absent agreement, the court must establish the value of the property to determine the principal amount to be paid to the undersecured creditor under any cash out or extended plan payments. § 506(a), FRBP 3012. Almost always, this requires expert testimony as to valuation an exact science (art?) at best. [For an excellent discussion of valuation of security interests, see James F. Queenan, Jr., "Standards for Valuation of Security Interests in Chapter 11", 92 Comm. L. J. 18 (1987)]. When this occurs, the secured creditor bears a risk that the property may be undervalued.

Another potential problem is that the collateral may appreciate postconfirmation. In some instances, market values of real estate are depressed, especially when a geographical area is over built and occupancy rates are low. However, as time passes, and more tenants are found, the collateral value may increase. Who ultimately benefits from such increased value, the debtor or the undersecured creditor?

Congress has addressed these types of questions in § 1111(b). It is submitted that the creditor's rights intent of this subsection is to maintain, as much as possible, the undersecured creditor's right and the debtor's remedies which exist under applicable nonbankruptcy law, while preserving a debtor's ability to restructure its financial affairs in chapter 11.

First, § 1111(b)(1)(A) increases an undersecured nonrecourse creditor's rights. With certain statutory exceptions, the Code treats the nonrecourse obligation as a recourse obligation in chapter 11. As a simple example, if real property is worth $80,000 and the underlying debt is $100,000, the undersecured creditor would hold a secured claim for $80,000 and an unsecured claim for $20,000. This is different from state law (or bankruptcy cases in other chapters) because in those circumstances there would be no unsecured deficiency claim. One commentator suggests that this subsection was intended to protect nonrecourse creditors from the threat of cramdown and the "risk of unrealistically low valuations of collateral." 4 William L. Norton, Jr., Norton Bankruptcy Law & Practice 2d, § 89:2, at 894 (1993). As a by-product, a nonrecourse undersecured creditor has more negotiation leverage in chapter 11; not only may it vote its secured claim, it may also cast a vote regarding its unsecured deficiency claim. When the deficiency claim is relatively large, and may control the unsecured class's vote, debtors have counterattacked by seeking to separately classify the unsecured deficiency claim. That battle currently rages in many reported decisions.

Second, with respect to a possible future postconfirmation appreciation of collateral, the Code gives an undersecured creditor the opportunity for an election. The creditor may choose to be treated as a nonrecourse creditor and thereby waive its unsecured claim. § 1111(b)(1)(A)(i) and (b)(2). If the election under § 1111(b)(2) is timely made, FRBP 3014, the creditor is treated as fully secured, notwithstanding the secured-unsecured claim bifurcation under § 506(a).

(The second part of this article will be printed in a future edition of the newsletter. Judge Gregg and his new law clerk, Anne Lawton, former University of Michigan Business Law Professor are teaching a Bankruptcy Reorganization Workshop at Cooley Law School in Lansing this term on Wednesdays from 3:00 to 5:00 p.m.--Section members are welcome to attend to observe and/or participate.)

Suggested general readings:

4 William L. Norton, Jr., Norton Bankruptcy Law & Practice 2d, § 89:1 to 89:7 (1993).

5 Collier on Bankruptcy, paragraph 1111.02[1]-[6] (Lawrence P. King, ed., 15th ed. 1993).

RECENT BANKRUPTCY DECISIONS

The recent bankruptcy decisions for the Supreme Court and Sixth Circuit are summarized by John A. Potter; the Eastern District of Michigan cases are summarized by Jaye M. Bergamini; Western District of Michigan cases are summarized by Vicki S. Young, but due to her maternity leave, they were unavailable for this month before publication deadlines. They will be printed in next month's edition.

Abrams v. Federal Deposit Insurance Corp., 5 F3d 1013 (6th Cir. 1993). Plaintiff, Jack Abrams' mortgage payments to Peoples Bank were in arrears. The bank repossessed the property and then agreed that Abrams would deed the property to the bank and attempt to sell it at fair market value. Abrams agreed to be responsible for any deficiency remaining on the mortgage note after the property was sold. The bank then dismissed its state court foreclosure action. In October of 1981, the bank sold the property in exchange for $32,000.00 in cash and a second house. The consideration cited in the deed was $72,00.00, the outstanding sum due the bank on Abrams' mortgage note with the bank. In August of 1984, the bank sold the second house for $22,500.00, although it was valued at $40,000.00 on its books.

In December of 1987, the bank failed and was closed by Defendant, the FDIC. Plaintiff had $6,075.14 on deposit with the bank when it failed. The FDIC refused to give these funds to Abrams and instead applied the funds towards a $19,296.90 deficiency balance still allegedly owing on the mortgage note. Abrams then brought a conversion action against the FDIC. The district court granted the FDIC's motion for summary disposition. On appeal, the Court remanded for a determination of the amount of deficiency, if any, owed by Abrams to the bank. The district court, on remand, determined that Abrams' deficiency liability was determined when the property received by the bank was reduced to $22,500.00 in cash and not when it received the second house in the transaction. Abrams then appealed a second time.

In this second appeal the Court held that the deficiency balance should be calculated when the bank sold Abrams' house and took the second house in trade. Accordingly, the bank's assessment of the fair market value of the second house at $40,000.00 should be used to determine Abram's deficiency liability.

United States of America v. Richard Moriarty, 8 F3d 329, (6th Cir. 1993). In December 1983, Clark International Security received a contract to supply barbed wire to the U.S. Government. In April of 1985 the government declared Clark in default and demanded the return of $1,091,105.08 of

progress payments. Clark then ceased production and became insolvent. In February 1986, Defendant, Richard J. Moriarty, an attorney with an Ohio firm, arranged for a settlement between Clark and Bataco Industries, resolving a law suit in Florida state court. Under the settlement, Clark sold certain equipment to Bataco for $411,500.00. Moriarty then used a portion of these proceeds to pay Clark's creditors. At all relevant times, Moriarty knew Clark was indebted to the United States, but he did not pay any of the proceeds to the United States.

In December 1991, the United States sued Moriarty and his law firm, alleging that under the 31 U.S.C. §3713(b), they were liable as representatives of Clark for $165,337.03 in improper payments they made to creditors other than the United States. Moriarty moved for summary disposition, contending that the United State' actions were barred by the applicable six year statute of limitations under 28 U.S.C. §2415. The district court granted Moriarty's motion, concluding that the statute of limitations began to run on the date the underlying claim against Clark accrued, in this case April 1985, not in February of 1986 when Moriarty made payments to the other creditors.

The Court of Appeals reversed the district court, concluding that the statute of limitations for a claim under 31 U.S.C. §3713(b) begins on the date the right of action accrues against debtor's representative. The United States cause of action under 31 U.S.C. §3713(b) against Moriarty is independent of the cause of action for breach of contract against Clark. Once the acts which trigger a representative's liability occur, then the United States' right of action accrues against the representative, and the United States then has six years from that time to file an action. Moreover, the statute of limitations applicable in this case provides that an action must be filed "within six years after the right of action accrues," without setting forth the relevant right of action. Consequently, the United States may avoid the bar of the statute of limitations by pursuing a cause of action against a representative of a debtor when the statute of limitations on the underlying claim against the debtor has expired.

In Re Brenner, File No. 89-19603 (ED Mich, Judge Graves, 11/3/93).

In a case in which he distinguished the Western District en banc decision of In re Zimmerman, (WD Mich 1993), Judge Graves allowed as a priority, the late filed claim of the IRS.

Debtor filed an apparent no asset case. The trustee recovered assets following litigation against relatives of the Debtor, and the standard notice of potential distribution was sent to all creditors. The IRS was served in the ordinary course, but filed its claim approximately 5 weeks after the bar date because of a handling problem within its office.

The trustee filed an objection to the claim, based upon the untimely filing. The trustee took the position that the claim of the IRS should be subordinated to all other timely filed claims, pursuant to 11 USC 726(a)(3).

Judge Graves relied on the case of In re: Century Boat Co., 986 F. 2d 154 (6th Cir. 1993), to determine that the late filing of the IRS claim did not bar it from being designated a priority under section 507(a)(7), and from being paid according to that status under section 726. Graves noted that the court in Century Boat held that "the language of 726 does not itself prohibit tardily filed priority claims. Subsection (a)(1) merely provides that the order of distribution of priority claims will be the order specified in section 507. This provision does not distinguish between tardily filed and timely filed priority claims with or without notice."

Graves applies the four part test of Century Boat to determine if the late claim of the IRS was allowable as a priority under 726. To have its claim allowed: (i) The creditor must file its proof of claim before the trustee makes any distribution from the estate; (ii) The creditor must file the proof of claim before the bankruptcy court closes the estate; (iii) the

creditor must not exhibit any indica of bad faith; and (iv) There must not be undue prejudice to the other creditors.

Finding that the IRS met all four elements, Graves allows its claim as a priority under section 507 and 726.

Graves specifically declined to follow the Western District en banc decision in Zimmerman, which he criticized for failing to discuss Century Boat.

Commonwealth of Kentucky v Claiborne Kinnard, 1 F3d 1240, (6th Cir. 1993). Defendant Claiborne Kinnard's corporation, Perpetual Corporation, was in the funeral home and cemetery business. As part of this business, Perpetual sold funerals and grave sites in advance of death or "pre-need". Kentucky statutes require all moneys received for such services to be placed in a trust at a financial institution until the need for the services arises. The Kentucky Consumer Protection Division investigated Perpetual and discovered that several of its pre-need trust fund accounts were underfunded by approximately $455,000.00. Perpetual and Mr. Kinnard filed bankruptcy. The State of Kentucky brought an adversary proceeding in the personal bankruptcy of Mr. Kinnard and his wife seeking to have the trust fund deficiency declared a personal debt of Mr. Kinnard. Kentucky also sought to have it declared nondischargeable under 11 U.S.C. §523(a)(4).

The bankruptcy court held that the debts were dischargeable and the district court agreed. The Court of Appeals affirmed the lower court decision.

The Court of Appeals stated that to establish a non-dischargeability under 11 U.S.C. §523(a)(4), it must be shown that (1) an express trust governed the property at issue; (2) defendant acted in a fiduciary capacity; (3) defendant violated his fiduciary duty by committing a defalcation. The Court found that there was an express trust that did not arise out of the wrongdoing of the corporation.

The Court then sought to determine whether Perpetual and Kinnard were one and the same and whether personal liability as to Kinnard arose from a violation of fiduciary duties to which he was subject under a pre-existing express trust.

The Kentucky statute imposed personal liability on officers, directors and shareholders who knew of a corporate failure to comply with any trust provisions and who failed to take prompt and reasonable corrective action. The Court held that this was insufficient to satisfy the requirements of §523(a)(4), distinguishing the statute from other statutes which impose fiduciary duties on insurance agents (MCLA 500.1207(1), e.g.). Moreover, Kinnard's breach of any fiduciary duty that he owed to Perpetual as an officer was not a breach of duty as to a third-party creditor. The debt was discharged.

EDITOR'S NOTEBOOK

This marks my first issue as the new editor of the Bankruptcy Newsletter. Getting this issue out has been a learning experience, and if any of you are dissatisfied with the product or with the timing, please be patient. I hope that things will improve in the next few months as I get more comfortable with the job.

In reviewing past issues in anticipation of taking over as editor, I am amazed to see that the newsletter has now been published for more than five years. To a large extent, this has been due to the yeoman's efforts of the past editors -- Pat Mears, Larry Ver Merris, and Tom Sarb. I will strive to maintain the excellent quality that has always characterized this publication.

The Newsletter is always looking for articles to be published in future issues. The remunerations are great -- your name in print and an invitation to the annual summer seminar -- and the editor is just a delight to work with, so please consider submitting an article. If anyone has an interest in submitting an article, or wishes

to have something else included in the Newsletter, I can be contacted at my office address below:

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Lastly, I would like to thank Tom Sarb for all of the help that he has provided in the past few months in transferring the editorship to me.

On the legal front, the Supreme Court has accepted certiorari on In re Bonner Mall Partnership, 2 F3d 899 (9th Cir. 1993) to decide the issue of whether the "new value" exception to the absolute priority rule survived the enactment of the Bankruptcy Code.

Legal Definitions -- Ex Parte: a gathering of people at 2 a.m. after the police have arrived.

STEERING COMMITTEE MINUTES

A meeting of the Steering Committee of the Bankruptcy Section of the Federal Bar Association of the Western District of Michigan was held on January 21, 1994 at the Peninsular Club in Grand Rapids. Present were Brett Rodgers, Dan Casamatta, Denise Twinney, Bob Wright, Peter Teholiz, Tom Sarb, Gordon Toering (for Tim Hillegonds), Doug Lutz (for Pat Mears) and Tom Clinton.

1. Brown Bag Lunch. Bob Wright indicated that the Brown Bag Luncheon held on January 14 had been well attended and showed a modest profit.

2. Federal Bar Association. Bob Wright reported that the executive committee of the Federal Bar Association for the Western District of Michigan had offered a seat to the chairperson of the steering committee. Pat Mears will begin attending upcoming meetings. Brett Rodgers suggested that the Newsletter be expanded to include items of interest to other sections of the FBA. After much discussion, it was decided that the bankruptcy newsletter be kept in its present form, although we could offer to coordinate mailings for the other sections. Brett also indicated that the new treasurer of the FBA had some questions about the costs for the telephone line for the fax machine in the attorney lounge, as well as some reimbursement costs for the Newsletter. Brett will explain these costs to him.

3. Pro Bono Program. Tom Clinton gave a presentation regarding the Grand Rapids pro bono program. After some discussion, it was decided that in the Committee not attempt to establish a duplicate system merely for bankruptcy problems. Tom will coordinate getting the names and addresses of the various Legal Aid associations throughout the district and provide those to the judges for their use.

The Steering Committee urges that practioners enroll with their local Legal Aid associations to provide referral services for bankruptcy problems.

4. FRCP 26. Tom Sarb brought up the fact that the District Court for the Western District had chosen to opt out of the new "mandatory disclosure" provisions under revised FRCP 26. After a discussion on the subject, Bob Wright was appointed to write a letter to the Bankruptcy Court asking the Judges to consider opting out also.

5. Advertising and Presentations. A discussion was held regarding whether outside entities, such as banks, appraisers and the like, should be allowed to address the Committee regarding their services in the bankruptcy field. The Committee felt that its meetings were to conduct business and should be kept free of such presentations. Similarly, the Committee reaffirmed its original decision to keep the Newsletter free from advertising.

6. February Meeting. The next meeting of the Steering Committee is tenatively scheduled for Friday, February 18, 1994, at noon at the Peninsular Club in Grand Rapids.

1993 BANKRUPTCY FRAUD TASK FORCE CASE STATUS REPORT

Case Name	Criminal Case Number	Indicted	Plea/ Trial	Sentence
Brake, Sandra & Judson	1:92-CR-139	11/5/92	Guilty Plea	5/10/93 - Ct 1 - 10 mos CAG, 2 yrs Sup Rel., No Fine/Rest. $50 SA; Ct 2&3 dismissed
Hammond, Thomas	1:92-CR-153	11/19/92	Guilty Plea	6/28/93 - Sentence 12 mos CAG; $94,000 Rest.; $3000 Fine; $50 SA; 2 yr Sup Rel
Marshall, Steven	1:92-CR-59	Info	Guilty Plea	3 yrs probation; $1000 fine $60,000 Rest.
Meyers, Gary	1:93-CR-103	Info	Guilty Plea	27 mos CAG; 3 yrs sup. rel $385,389.84 Rest.
Parks, Lewis	1:93-CR-122	7/28/93	Jury Trial Guilty Verdict all 3 Cts	24 mos CAG; 2 yrs sup rel; $5,000 Fine
Spiegel, Conrad	1:93-CR-115	7/15/93	Guilty Plea	18 mos CAG; 3 yrs sup rel; $15,000 Fine; $18,466 Rest. payable 1-22-94; Pay costs of ct appt counsel
Swierenga, Marcia and Paul	1:93-CR-130	10/22/92	Guilty Plea	Marcia Swierenga- 12 mos CAG; 3 yrs sup rel; Rest $74,000; Paul Swierenga 27 mos CAG; 3 yrs sup rel; Rest $116,111

Updated 1/21/94

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the period from January 1, 1993, through December 31, 1993. These filings are compared to those made during the same period one year ago and two years ago.

Bankruptcy Chapter	1/1/93 - 12/31/93	Percent Increase (Decrease) over 1992	1/1/92 - 12/31/92	Percent Increase (Decrease) over 1991	1/1/91 -- 12/31/91
Chapter 7	4543	(14.0%)	5281	5.1%	5027
Chapter 11	121	(4.7%)	127	(1.7%)	153
Chapter 12	34	41.7%	24	0%	24
Chapter 13	1457	(12.4%)	1582	(6.3%)	1699
	6155	(12.2%)	7014	1.6%	6903

1993 marks the first year that there has been a decrease in the total number of filings since the newsletter has begun reporting statistics in 1988. The total number of filings (6155) is the least amount since 1990 (5888). Interestingly, Chapter 13 filings have decreased each year since 1990 (from 1717 to 1457), as have Chapter 11 filings (from 154 in 1990 to 121 in 1993).

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