Judge Schermer’s Top Ten Topics to Teach

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When you have co-taught a course with someone for twenty-eight years, you definitely get a feel for which subjects within that course excite your co-teacher. And so it is with Judge Barry Schermer and me. The two of us (along with either Lloyd Palans or Dave Going) have sat together at the front of the seminar room for almost three decades teaching a Chapter 11 Reorganization seminar to anywhere from sixteen to twenty second-year and third-year law students at Washington University School of Law.

Before we teach each class, the three co-teachers gather in my office to talk about the day’s coverage plan. Invariably, we have more material in our class notes than we will realistically have time to cover in the allotted ninety minutes of class time. Given that reality, we always need to decide in advance of class which topics for the day are “must teach” topics and which topics are expendable. During the course of those pre-class discussions, I can usually get a sense of the topics that Judge Schermer is truly “pumped up” about as well as the subjects for which he has only mild enthusiasm.

Make no mistake about it: Judge Schermer is a teacher who clearly gets excited about the topics that he teaches. When he teaches his basic Bankruptcy class each fall semester, he has been known to start yelling during class so loudly in his enthusiasm for a particular point that he will have to catch himself in mid-sentence and apologize to the class for the volume of his voice.¹ In the smaller seminar room that we use for the Chapter 11 Reorganization seminar, Judge Schermer does not need to speak nearly as loudly. Even still, I can tell during class when we are covering an issue about which Judge Schermer is particularly passionate.

After reviewing my class notes for the entire seminar, I had a difficult time narrowing down Judge Schermer’s favorite topics to just ten. In the interest of space, however, I know that I have to limit these topics to ten.

¹ Judge Schermer told me this himself, so I guess we can call this a “self-reported violation” by the Judge.
What follows is the “top ten” list that I ultimately assembled, with an introduction to each issue that is followed by an explanation of why I believe that Judge Schermer finds each issue to be so fascinating.

Before introducing the ten topics, I should note that we have been fortunate for the last twenty of the twenty-eight years we have taught this seminar to have an excellent Chapter 11 casebook to use for the course. *Business Reorganization in Bankruptcy* is now in its fourth edition. The four co-authors on this book bring an impressive array of bankruptcy, accounting and financial expertise to the faculty and students who use the book. The book is also problem-based, using a hypothetical foam manufacturer as the debtor. That same debtor then experiences all of the different phases of a Chapter 11 case. Many of the topics that appear below are based directly or indirectly on problems from that book.

**TOPIC ONE: THE SMALL-TOWN DEBTOR AND THE THREE DIFFERENT PROPOSALS TO BUY THE DEBTOR’S ASSETS**

We pose a fairly simple hypothetical to our students on the very first day of the seminar. Imagine that there is a small-town manufacturing company that files for Chapter 11 bankruptcy. In the course of the bankruptcy case it becomes clear that this company is not going to be reorganized in the traditional sense. Instead, there is going to be an auction for the assets of the Chapter 11 bankruptcy estate. At this auction, three bidders show up: 1) Bidder A proposes to give unsecured creditors a forty percent return on their claims in cash at confirmation and will continue to operate the company in the same small town with the same work force; 2) Bidder B will give unsecured creditors forty-five percent in cash at confirmation, and will continue to operate the business as a going-concern, but Bidder B will move the operations of this business across the country; and 3) Bidder C will give unsecured creditors a fifty percent return on their claims, also in cash at confirmation, but Bidder C will liquidate the business piecemeal and sell the assets separately to various other businesses.

The question that we pose to the class after introducing these facts is, if you are the judge in this case, which of these bids should you approve? We then allow the students to make their case for one bidder’s plan over another. Generally, we find that students will choose either Bidder A or Bidder C. Those students that argue for Bidder A will point out that Bidder A is the only bidder whose plans for the assets will preserve the jobs of the workers in that small town. The proponents of Bidder A will highlight that one of the main reasons that Congress created the Chapter 11 reorganization option for companies is to preserve jobs, and that Bidder A’s plan is the only one that would preserve the current jobs in the same location where the company now does business.3

After some discussion, Judge Schermer will give the students their first “reality check” about Chapter 11 bankruptcy. While it is certainly true that one of the benefits of Chapter 11 bankruptcy is the possibility of job preservation, ultimately Chapter 11 bankruptcies are about value maximization for the claimants in the case.4 This contrasts with consumer bankruptcies, where the primary focus is on the individual debtor’s opportunity for a “fresh start.”5 Corporations in Chapter 11 don’t need a “fresh start” because corporations are not people that have an existence separate from the assets of the bankruptcy estate.6

Closely related to the value-maximization idea of Chapter 11 is the notion that, in order to be a claimant in a Chapter 11 case, you need to have a legal right to payment that is owed to you by the debtor in bankruptcy. Current workers may indeed be claimants to the extent that

3. Cf. H.R. REP. No 95-595, at 220 (1977) (noting that the purpose of Chapter 11 reorganization is to allow a business to restructure its finances “so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.”).
4. See Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. CHI. L. REV. 97, 109 (1984) (stating that a firm seeking Chapter 11 bankruptcy protection “should be kept intact only if it has more value as a going concern than liquidated….”).
6. This explains why 11 U.S.C. § 727(a)(1) provides that there is no Chapter 7 discharge available for a debtor that is not an individual. Debtors that are not individuals (i.e., debtors that are corporations) do not need a bankruptcy discharge when they liquidate under Chapter 7. That is because a liquidating corporation ordinarily ceases to exist under state corporation law when it stops doing business. There is no “post-petition” existence for the corporate debtor that liquidates and thus no need for a discharge in a Chapter 7 liquidation case.
they have unpaid wages that they are still owed (or even future rights to payment under a collective bargaining agreement). However, as a general proposition, current workers cannot have a legally cognizable claim in bankruptcy merely because they hope to retain their job going forward.7

All of this is a precursor to saying that if Judge Schermer were in charge of this Chapter 11 case, he would approve the plan of Bidder C, even though Bidder C’s plan for the assets would end up being the most disruptive for this small town.8 We are quick to point out to students that even though Bidder C’s plan is the most disruptive one for this small town, Bidder C’s plan is not necessarily the one that is most disruptive to the economy as a whole: the assets of the company that will be sold by Bidder C will presumably be put to use by other companies. These other companies may not be located in this small town, but nevertheless they are companies that will create jobs in other locations and perhaps other sectors of the larger economy. The asset buyers at the post-bankruptcy auction conducted by Bidder C might well be local people, and indeed might be former managers of the now-defunct debtor. These former managers might buy certain pieces of the debtor’s assets in order to start new businesses in that same small town.

**TOPIC TWO: REFUSALS TO DEAL AND THE AUTOMATIC STAY**

As noted earlier, one of the features of the casebook that we use for the Chapter 11 seminar is that there is a single hypothetical debtor that the casebook authors use for most of their hypotheticals. This allows a continuity of background facts for the students as the casebook moves through each new topic in the natural progression of a Chapter 11 case. Because there are always three co-teachers sitting in the front of the seminar room, each of us also takes on a consistent identity or role as one

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8. See Barry S. Schermer, Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy – A Modern-Day Tale of Belling the Cat, 72 WASH. U. L.Q. 1049, 1050 (1994) (noting that “[a] bankruptcy court need only look at the money that a proposed sale will generate and make its decision based upon the potential return for creditors.”).
of the characters in the ongoing drama of the case. I am always the client, William Gruff, who is the CEO of the debtor, Foam Corporation, a California-based manufacturer of foam with various manufacturing plants on the east and west coasts. Judge Schermer is my lawyer, Ed Johnson, and our third co-teacher, either Lloyd Palans or Dave Going, generally plays the various creditors and trade suppliers that have claims against Foam.

The set-up facts for the refusal-to-deal scenario are that Foam has a crucial supplier, Chemco, that supplies a special flame-resistant chemical that Foam Corporation uses in manufacturing foam. When Foam Corporation filed its Chapter 11 petition, Chemco ceased accepting orders (even cash-on-delivery and pre-paid orders) from Foam. Chemco, according to its owner Peter Principle, follows a firm policy of cutting off business with any trade debtors who file for bankruptcy. The intent, Peter says, is to discourage its customers from filing bankruptcy and to encourage its customers to pay their trade obligations. William Gruff now fears that Foam has lost all of its bargaining leverage in price negotiations with its only other supplier of this special flame-resistant chemical. Chemco made a $10,000 delivery of chemicals to Foam a month before Foam filed Chapter 11, but Foam still has not paid for that shipment.

This hypothetical is a great jumping-off point to explore a number of different issues surrounding the automatic stay, especially when we change a key fact or two to raise a new issue. The baseline issue for the students is whether Chemco has the right to refuse to deal with Foam, even if Foam is willing to pay cash for new deliveries. We assume at first that Chemco’s refusal to deal with Foam is unconditional and is based on the principle of discouraging customer bankruptcies that is articulated above by Peter Principle. As Peter is quick to point out during this little improv skit, the United States is a free country and Chemco should be able to deal (or not deal) with whatever customer it chooses to. Simple enough, so far.

Now suppose, however, that Chemco's refusal to deal with Foam while Foam is in Chapter 11 is conditional on whether or not Foam will pay for the $10,000 Chemco order that Foam received pre-petition. In other

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9. See SCARBERRY ET AL., supra note 2, at 130.
words, new facts emerge in which Peter Principle is not so principled after all. Peter admits that he is willing to continue supplying Chemco’s special flame-resistant chemicals post-petition if, but only if, Foam agrees to pay the outstanding pre-petition shipment bill that is due to Chemco. Could this conditional refusal to deal on the part of Chemco amount to a violation of the automatic stay as a veiled “act” to collect a pre-petition debt?¹⁰ And if so, does that mean that Chemco can be affirmatively compelled by the bankruptcy court to ship the chemicals to Foam or else risk being liable for damages for violating the stay?¹¹

At this point, students can start to appreciate the breadth of the automatic stay, particularly section 362(a)(6)’s language that prohibits “any act to collect” on the part of a pre-petition creditor. The automatic stay, which students may once have viewed exclusively as a defensive tool for the debtor, now can seem to the students more like a sword than a shield. This is especially true if the stay can be used successfully by the debtor to force a reluctant supplier to continue supplying goods to the debtor in bankruptcy.¹²

This hypothetical also leads the class into a discussion of the oft-litigated “critical vendor” motions debtors routinely make as part of a proposed first-day order in Chapter 11.¹³ We manage to raise the critical vendor issue by changing our original facts slightly. We create a modified scenario under which William Gruff, Foam’s CEO, affirmatively wants to pay his company’s outstanding pre-petition obligation to Chemco as a way to ensure Chemco’s continued cooperation in supplying more of these chemicals to Foam while Foam is in Chapter 11. In this new scenario, we ask our students whether Foam’s voluntary payment of Chemco’s pre-petition debt could amount to a violation of the automatic stay by Chemco for accepting such a payment. Even if that is a stay violation, we ask students how a party other than the debtor itself could have standing to

¹⁰ See 11 U.S.C. § 362(a)(6) (2012) (prohibiting “any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title”).


¹² See generally Daniel Keating, Offensive Uses of the Bankruptcy Stay, 45 VAND. L. REV. 71 (1992) (discussing various “offensive” uses of the automatic stay, including refusal-to-deal cases).

¹³ See, e.g., In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004) (surveying the critical-vendor case law and setting a higher standard for a vendor to qualify for critical-vendor status than many other courts have set).
assert a stay violation given that Foam, the debtor, is obviously fine with making that payment in order to receive continued post-petition chemical deliveries from Chemco.

We challenge the students to represent a competing creditor who is unhappy with this proposal by Foam to pay in a selective way certain pre-petition creditors like Chemco while refusing to pay other pre-petition creditors who are not deemed to be “critical vendors.” We ask the students whether any Bankruptcy Code provisions other than the automatic stay are violated when a debtor is allowed to pay pre-petition claims to selected suppliers. At that point, some student will suggest that the selective payments amount to an avoidable preference under section 547(b) of the Bankruptcy Code. That certainly sounds plausible, since those critical vendors are clearly being “preferred” relative to the suppliers that the debtor is deeming not to be “critical.”

However, once we direct the students to the language of section 547(b)(4), it becomes clear to them that Foam’s selective post-petition payments of pre-petition debts cannot qualify as avoidable preferences because the payments are not being made during the pre-petition 90-day or one-year window specified by the Bankruptcy Code for preferences. At this point, we typically have to nudge the students to consider applying a much less well-known Code section than section 547’s preference provision: section 549’s prohibition on certain post-petition transfers by the debtor. That section essentially says that the trustee in bankruptcy has the power to avoid any post-petition transfers by the debtor that are not otherwise authorized by the Bankruptcy Code.

Our final factual twist to the refusal-to-deal hypothetical is to tell the students to assume now that Chemco originally had made a long-term contract with Foam for a series of monthly deliveries of the special chemical. Under that long-term contract, payment is due within fifteen days following each delivery. We ask students to assume that Foam has failed to pay for the final pre-petition delivery under this contract and that

payment is currently overdue. Could Chemco now refuse to make the next scheduled delivery unless and until Foam first paid the outstanding pre-petition claim of Chemco? We remind the students that our earlier facts were exactly the same, except that each delivery was its own discrete contract. Yet, in that case, we had concluded that Chemco’s conditional refusal to deal might amount to a prohibited “act to collect” a pre-petition debt and thus amount to a violation of the automatic stay. Should the mere changing of the contractual form from a series of individual contracts to a single long-term contract with multiple deliveries be enough by itself to change the outcome on the stay-violation question?

Students often are surprised to learn that the answer is a resounding “yes.” All we need to do is point them to the clear language of section 365(b)(1)(A) concerning a debtor’s obligation to cure any pre-petition defaults as a prerequisite to exercising its right to assume the contract in bankruptcy.17 This seems at first a rather arbitrary outcome given that it all hinges on the happenstance of whether the debtor and the supplier decided at the front-end of their relationship to structure things as a long-term contract instead of a series of single-delivery contracts. At this point, some of the students (and at least one of the instructors) start to wonder whether the courts have been correct when finding stay violations in these refusal-to-deal scenarios that happen to involve a series of single-delivery contracts rather than a comprehensive executory contract covering all of the deliveries.

**TOPIC THREE: THE AGGRESSIVE AND DEMANDING POST-PETITION LENDER**

The students in our seminar are usually surprised to learn that a very common category of post-petition lender for the debtor-in-possession is the debtor’s major pre-petition lender. Students initially don’t understand why a lender who is already owed millions of dollars by the debtor would want to offer to give the debtor the proverbial “good money after bad.” The students soon appreciate that the lender is not being charitable. Instead, such a lender is simply trying to put the debtor in the best position

to repay the debtor’s outstanding pre-petition loan by giving the debtor a fighting chance to reorganize.

Our students also learn that oftentimes a debtor is desperate for any lender to come forward with post-petition financing and, as a result, the debtor may be inclined to accept very onerous terms for its post-petition loan. Sometimes other pre-petition creditors of the debtor are not as willing as the debtor is to have the debtor take on additional debt in the hopes of ultimately achieving a successful Chapter 11 reorganization plan. These other creditors may believe that they would be better off just getting what they can in the short term with a liquidation of the debtor, rather than risking a drawn-out reorganization process that might ultimately fail and leave them with nothing. After all, the “burn rate,” or administrative carrying cost, of most major Chapter 11 bankruptcies is quite significant.18

In our hypothetical that covers these issues, Foam owes its major lender, Kick Credit, $4.5 million in pre-petition loans that are secured by Foam's inventory and accounts receivable. At the time of Foam’s bankruptcy filing, Foam's inventory is estimated to be worth $1.5 million on a liquidation basis and $3 million on a retail basis. Its then-existing accounts receivable total $2.25 million, but it's not clear how much of these receivables will actually be paid on time and/or in full. Immediately after the case is filed, Foam desperately needs cash in short order, in large part because, for the time being at least, virtually all suppliers are demanding cash on delivery. New lenders have not emerged who want to take a chance on Foam.

Kick Credit, represented by bank officer Harry Hardline, offers to make a $1.5 million post-petition loan to Foam, but the offer comes with lots of conditions on the loan. Kick wants new liens on Foam’s currently unencumbered property to secure the new loan advances. Kick also wants “cross-collateralization” with this new loan, whereby any new post-petition collateral would also secure any unsecured pre-petition debt that Foam still owes to Kick.19 Finally, Kick demands from Foam a promise

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that no professionals will get paid until Kick is made whole on its post-petition loan obligations, as well as an acknowledgement from Foam that all of Kick’s pre-petition liens on Foam’s collateral are valid.

At this point, we divide the class into two sides. One side represents Foam’s CEO, William Gruff, who is so desperate to get this loan that he is willing to give in on virtually all of the terms proposed by Kick. The other side of the class represents the unsecured creditors’ committee, which wants to push back on a number of the terms Kick demands, especially the cross-collateralization clause that may ultimately diminish the returns of the unsecured creditors other than Kick.

Particularly for this issue, a recurring and important one in Chapter 11 cases, having both a bankruptcy judge and a bankruptcy lawyer sitting in the front of the room can give the students the unique benefit of multiple perspectives. Judge Schermer will describe these scenarios to the students as tantamount to a game of chicken that the post-petition lender is playing with the judge. Perhaps these onerous terms being proposed are truly the only terms under which this lender will lend to the debtor post-petition. Or, maybe this lender would actually be willing to make the same loan with terms that are a lot more favorable to the debtor, but the debtor is afraid to press the issue because the debtor fears that this lender might walk away, leaving no other willing and able post-petition lenders to take its place.

Judge Schermer will usually remind the students that judges in certain high-profile cases have called the lender’s bluff in situations like this and have refused to approve the proposed post-petition financing terms, particularly if it is early in the case. Judge Schermer likes to quote Judge Howard Buschman’s opinion in In re Ames Department Store, where Judge Buschman states that the terms proposed by the post-petition lender cannot be so one-sided as to “skew the Chapter 11 case.”

Lloyd Palans, who generally occupies the third seat at the front of the seminar room, can give the students a different perspective as someone who has represented post-petition lenders in a number of major Chapter 11 cases. Mr. Palans had a case in the early 1990s involving a drug store chain, Defender Drug Stores. Defender was in Chapter 11 and looking to

sell its remaining stores as a going-concern operation in a bankruptcy auction.\footnote{See In re Defender Drug Stores, Inc., 126 B.R. 76 (Bankr. D. Ariz. 1991).} The debtor needed more time to organize the auction, but Mr. Palans’ client, the post-petition lender, did not want to keep extending the terms of its post-petition loan. As a result, the lender was able to negotiate for a “contingent enhancement fee” representing ten percent of the proceeds of the ultimate auction sale as consideration for continuing to keep the post-petition line of credit open so that the stores could remain in business until the auction.

We note to the students that at least one academic commentator, in an article that appeared in the Business Lawyer, believed that Mr. Palans’ client was allowed by the bankruptcy court to go too far with its terms in the post-petition loan deal.\footnote{See David Gray Carlson, Post-petition Security Interests Under the Bankruptcy Code, 48 BUS. LAW 483 (1993).} I then read to the class how that author described what happened in Defender:

A coercive demand for a ten percent kickback from the proceeds of an auction was approved in In re Defender Drug Stores, Inc., where a post-petition loan was due and owing. The debtor begged the lender to extend the maturity a few months, because a profitable sale was in the offing. The lender agreed—provided the debtor obtained either a letter of credit for the benefit of the lender, or if the debtor would pay ten percent of the proceeds above and beyond the amount of the loan due and owing. The court agreed such a kickback was reasonable, though one wonders why the automatic stay did not prevent the lender from touching the collateral until the sale in question actually occurred.\footnote{Id. at 506-07 (citation omitted).}

Despite the impressions of criminality that the author’s use of the word “kickback” might suggest, Mr. Palans is always quick to point out to the class that the orders of the bankruptcy court in this matter were unanimously affirmed on appeal. Furthermore, each court considering this matter used the word “reasonable” in approving this post-petition financing that had terminated on its face before the contingent

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23. Id. at 506-07 (citation omitted).
enhancement fee was approved. Indeed, Mr. Palans likes to note, not even opposing counsel tried to describe the enhancement fee by use of the term “kickback.” The lesson here for the students is that, if you are the only viable option for the debtor as a post-petition lender, and the debtor truly believes that short-term financing will give it long-term value, you can insist on very favorable terms and probably even get the court to approve them.

**TOPIC FOUR: ELIGIBILITY TO SERVE ON THE CREDITORS’ COMMITTEE**

One of the joys of teaching the Chapter 11 seminar for over twenty-five years with the same co-teachers is getting to appreciate the special gifts of your co-teachers. In my case, one of the gifts of my co-teacher Lloyd Palans that I appreciate most is his acting ability. Much of the time during our seminar, we are essentially doing improvisational skits with each of us playing different roles in those skits for the students. As noted earlier, Judge Schermer and I tend to keep the same roles from class to class: he plays my lawyer, Ed Johnson, and I play the CEO of Foam, William Gruff. These are both simple roles that don’t require a lot of acting skills. Mr. Palans, on the other hand, is a jack-of-all-trades when it comes to the roles that he plays during the seminar skits.

Nowhere is Mr. Palans’ versatility as an actor more evident than when we cover the topic of eligibility to serve on the creditors’ committee. And that is why I include this topic in Judge Schermer’s “top ten topics to teach.” It is not necessarily that the topic itself is so fascinating, although it is reasonably interesting. Instead, what puts this topic on the list is the opportunity that it affords for Judge Schermer and me to see Mr. Palans’ acting skills in action by having him play multiple different characters over the space of about thirty minutes.

The setup for creditors’ committee eligibility is pretty straightforward. We ask the students to assume that an unsecured creditors’ committee is in the process of being formed in the Chapter 11 case of Foam. We let one half of the room represent the United States Trustee (in its role as selector

of the committee members) and we let the other half represent the debtor, Foam. We first review with the class the basic rules of creditor committee composition that are found in the Bankruptcy Code. Section 1102(b)(1) provides fairly minimal guidance on this issue when it says that the creditors’ committee “shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee...”

The word “ordinarily” opens the door to the possibility that even though a particular creditor is indeed one of the seven largest creditors, there may be something about the creditor that would make it unfit or inappropriate to serve on the committee. With that framing as our background, we then proceed to introduce to the students a series of potential members of the unsecured creditors’ committee, each of whom technically qualifies to serve since each is said to be one of the seven largest unsecured creditors. In each case, we ask whether the Trustee's side or the debtor's side would like to ask the potential committee member any questions, and whether anyone from either side has any objection to this particular creditor serving on the committee.

Our first potential committee member is Harry Hardline, a big trade creditor owed $100,000. Harry (played very angrily by Mr. Palans) explains that he has been ripped off by Foam, and Harry’s main goal in this bankruptcy (which he will freely admit) is to see Foam liquidate. Harry tells the students that he wants to see Foam liquidate for two reasons: first, because he has come to hate "Slick Willy," as he calls him; and second, because he honestly believes that Foam is worth more when liquidated piecemeal than as a going-concern business. The students then have to struggle with whether Harry should be allowed to serve on the creditors’ committee.

Judge Schermer has the students vote up or down on allowing Harry to serve, and then queries the students on the rationale for each side’s position. Those students saying that Harry should not be able to serve argue that Harry is not coming into this role with an open mind about the direction this case should take, and furthermore he seems to have a personal vendetta against the CEO of the debtor. Those students who

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argue that Harry should be able to serve on the committee point out that
the unsecured creditors’ committee needs a diversity of viewpoints
concerning the best way to maximize the return to the creditors. And just
because the debtor is in Chapter 11, these “yes” voters note, does not mean
that the maximum value of these assets can necessarily be realized through
a reorganization of the company rather than a liquidation.

The second potential committee member, Carl Collateral, made a pre-
petition loan of $6 million secured by one of Foam’s buildings. Depending
on which appraiser you believe, the building is worth anywhere from $5
million to $7 million. Carl wants to serve on the committee in case it turns
out that he is undersecured,26 but he does not want his decision to serve on
the committee to bind the court’s later valuation determination as to his
collateral.

When the students are asked whether the debtor’s side or the U.S.
Trustee’s side have any problem with Carl serving, some students will
sense that there might be a conflict of interest problem for Carl. However,
the students have a difficult time articulating exactly what that conflict of
interest is and how it differs from Harry Hardline’s predisposition to see
Foam liquidate. We will often have to flesh out the conflict of interest
point by noting that Carl’s problem here is that his primary interest is as a
secured creditor. As a secured creditor, he may have a strong preference
for a quick liquidation of the case so that his collateral does not dissipate
in the interim. That interest may be contrary to the best interests of the
unsecured creditors, whose return on their claims might benefit from a
slower, more deliberate effort by the debtor to reorganize.

Following Carl Collateral, we have Mr. Palans play Ken Chemical, the
owner of a chemical company. Ken explains to the class that he delivered
a $50,000 order of chemicals on credit a week before Foam’s Chapter 11
filing. Now Foam is insisting that the delivery of chemicals was
nonconforming and therefore Ken’s claim is not really for $50,000 but
instead is for zero. Ken disputes the contention that the chemicals weren’t
conforming and insists that he has a $50,000 claim and thus he should be
eligible to serve. Ken also shares with the class that, despite his

26. Section 506(a)(1) of the Bankruptcy Code provides that an undersecured creditor must
bifurcate its claim into two claims: a secured claim representing the value of the creditor’s collateral,
and an unsecured claim for the remainder. 11 U.S.C. § 506(a)(1).
disagreement about this shipment, he mainly wants to be on the committee to ensure that Foam survives as an ongoing business so that Ken’s company can continue to make money by supplying Foam with chemicals.

The possibility of Ken Chemical serving on the committee raises two new issues for the students regarding creditors’ committee composition. The first is how the bankruptcy court should handle a disputed claim for purposes of deciding whether a particular creditor even qualifies as one of the seven largest creditors. That leads us into a nice discussion of the bankruptcy court’s power to estimate claims under section 502(c). The second issue is whether trade creditors like Ken have a disqualifying conflict of interest because of their desire to continue supplying the debtor in the future. We end up noting to the students that such a “conflict,” if it really qualifies as such, would probably be too common to be disqualifying. Trade creditors are frequently going to be represented on the committee and it is only natural that they would care about the possibility of future business with the debtor.

TOPIC FIVE: “EX POST FACTO DE FACTO IPSO FACTO” CLAUSES WITH EXECUTORY CONTRACTS

Executory contracts are a fun and complex topic to teach. That topic also becomes the set-up for probably our best pun of the semester, which I always have the privilege of delivering. Maybe that’s why Judge Schermer gets so much enjoyment out of teaching section 365 of the Bankruptcy Code.

There are many interesting aspects to section 365. The first is its great length, due to all of the successful lobbying efforts by special interests through the years to add new subsections that create special rules for certain industries. Yet despite its length, nowhere does section 365 actually define what is or is not an executory contract. Instead, for that definition we need to look to the case law, which for the most part has
adopted the *Vern Countryman* test for what constitutes an executory contract: Any contract in which a nontrivial performance remains for both sides of the contract.\(^{30}\)

A second interesting aspect to executory contracts in bankruptcy is how section 365 creates such a great deal for the debtor. A debtor in bankruptcy has the mostly unfettered right to assume or reject any executory contract that exists at the point of the bankruptcy filing.\(^ {31}\) Whether a debtor chooses assumption or rejection will depend in most cases on whether such assumption or rejection would be advantageous to the estate. If the debtor assumes an advantageous contract, the non-debtor party will end up paying real dollars for the cost of its continued performance and the estate will gain accordingly at the rate of 100 cents on the dollar. If the debtor rejects a disadvantageous contract, the debtor will have to pay damages to the non-debtor party to the contract, but only at the rate that is being paid to pre-petition general unsecured creditors, the proverbial “ten cents on the dollar.”\(^ {32}\) Therefore, the debtor is allowed to reap executory-contract gains at the rate of 100 cents on the dollar, but can pay executory-contract damages claims following a rejection at a rate of ten cents on the dollar. What a nice arrangement, indeed, for the debtor-in-possession and the estate!

The factual set-up for our big pun is a fairly straightforward equipment lease. We tell the class to assume that it is about two weeks following the Chapter 11 filing of Foam. William Gruff and Ed Johnson have agreed to meet with one of Foam’s major lessors, Snidely Whiplash of Imperial Insurance. The subject of the meeting is to discuss the status of a lease that Foam entered into with Snidely pre-petition involving three foam production machines owned by Imperial and leased to Foam. That lease is a three-year lease that was entered into one year ago. The lease calls for payments of $6,000 per month. Those same three machines could probably today command $8,000 per month if leased on the open market.

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32. See 11 U.S.C. § 502(g) (noting that claims for damages resulting from rejections of executory contracts under section 365 will be treated as pre-petition claims).
Foam, incidentally, missed the last two monthly payments on the lease prior to its bankruptcy.

Students can quickly appreciate that this is an executory contract Foam would wish to assume. Even if Foam itself has no more use for these particular machines, the students can see that this would be a situation where Foam would want to exercise the “third option” available under section 365. This third option would be to assume the executory contract and assign it to some third party in order for Foam to make a profit. Then we add a key fact to the hypothetical: Suppose that the three-year equipment lease has a clause saying that either side, upon one month's notice, can terminate the lease without cause with no further liability to the other side. Snidely is threatening to invoke that clause as a way to prevent any assumption of the lease by Foam.

The first issue that we pose to students regarding Snidely’s right to terminate this contract is the intersection between the automatic stay of section 362 and the right of a non-debtor party like Snidely to exercise a terminable-at-will clause that is contained in an executory contract such as this equipment lease. In other words, would termination of the lease by Snidely pursuant to this clause be a violation of the stay, since the termination is arguably an “act” to exercise control over property of the estate in violation of section 362(a)(3)?

Snidely, of course, would argue that the debtor’s rights to assume the contract in bankruptcy do not include the right to assume greater rights than exist under the contract outside of bankruptcy. Therefore, Snidely would say, even if the debtor assumed the contract, Snidely could simply exercise his right to terminate the contract immediately following the debtor’s assumption. William Gruff could counter Snidely’s argument by pointing to section 365(e)(1)’s prohibition of “ipso facto” clauses — i.e., the inability of non-debtor parties to enforce clauses in an executory contract that automatically terminate the contract if either side files for bankruptcy.

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34. See 11 U.S.C. § 362(a)(3) (prohibiting “any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate”).
As this exchange plays out in our class, Snidely says, “Wait a minute, this is not an ‘ipso facto’ clause because the provision that I am relying on to terminate this contract says nothing at all about bankruptcy. It simply says that either side, without the need to show cause, can terminate the contract at any time.” William’s response is the big setup for the pun, but there is a lot of important policy and substance behind the joke. William says,

The precise terms of the clause may not mention bankruptcy, but you decided only after Foam filed bankruptcy to use this open-ended clause to terminate the contract solely because Foam filed bankruptcy. So it’s true that the lack of any specific reference to bankruptcy means that this clause may not technically qualify as an ‘ipso facto’ clause. However, the way that you’re using the clause in this case essentially turns it into an ‘ex post facto de facto ipso facto’ clause, which should be just as unenforceable as a standard ‘ipso facto’ clause.

Puns aside, this is an interesting issue for a bankruptcy court to sort out. During my brief time in practice I represented a large bank that was essentially in the position of Snidely Whiplash in our seminar hypothetical above. The bank was providing merchant-bank credit-card services for a mail-order computer-hardware merchant that had filed for Chapter 11 bankruptcy after collecting millions of dollars in credit-card receipts from customers without shipping them their computers. We had a terminable-at-will clause in our merchant-bank agreement with this merchant; we exercised it as soon as the merchant filed for bankruptcy and we realized what had transpired. The merchant responded with a temporary restraining order that the bankruptcy judge granted. However, shortly after the judge required us to continue processing credit-card receipts for this merchant, the merchant’s case was converted from a Chapter 11 case to a Chapter 7 liquidation and we were off the hook anyway. I like to tell the students that even though the bank I worked for lost the short-term battle on that issue, we eventually won the war.
TOPIC SIX: THE PIPER AIRCRAFT CASE AND DEFINING A CLAIM FOR DISCHARGE PURPOSES

This topic may be Judge Schermer’s overall favorite topic to teach, and I am convinced that at least part of the reason is that one of the key cases on this issue was written by Judge Schermer’s friend, Judge Robert Mark of the U.S. Bankruptcy Court for the Southern District of Florida. That case, In re Piper Aircraft Corporation, involved an aircraft manufacturer that had filed for Chapter 11 bankruptcy. Professor David Epstein filed a proof of claim for $100 million in that case on behalf of unknown future claimants who he claimed would be injured or killed by post-confirmation accidents involving the more than 50,000 Piper-manufactured planes that were still flying. The amount of Professor Epstein’s claim on behalf of these future victims was based on statistical analysis of the likelihood of such accidents in light of the number of Piper-manufactured aircraft that would prove to have injury- or death-producing defects based on Piper’s negligent pre-petition manufacturing conduct.

Essentially, Professor Epstein argued that as long as one could show that a particular injury was caused by the debtor’s pre-petition conduct, the damages from such an injury should be cognizable as a claim in bankruptcy even if one has no idea exactly when the injury will take place or who the victim will be. As Judge Schermer likes to emphasize to our students, Professor Epstein in filing this massive proof of claim was purporting to represent every person in the entire world, since at the point that the proof of claim was filed literally anyone alive could potentially be affected by a future accident involving a defective Piper plane that was manufactured pre-petition.

Our Foam Corporation hypothetical involves similar facts as those in Piper. In our case, William Gruff explains to Ed Johnson that several victims were injured with serious burns before Foam’s bankruptcy filing based on a series of unrelated auto accidents. The victims’ common theory in each of their lawsuits against Foam was that the foam in their

37. Id. at 622.
38. Id. at 623.
39. See SCARBERRY, supra note 2, at 691.
respective car’s seat cushions, which was manufactured by Foam, caught fire too easily. The plaintiffs in these cases also said that the foam gave off a toxic gas as it burned, causing them to become disoriented and to have difficulty extricating themselves from the burning autos. The first part of our seminar class on claims consists of a discussion of how the bankruptcy court should handle these pre-petition lawsuits against Foam that were currently ongoing at the time of Foam’s bankruptcy filing.

After discussing the issues with Ed involving the existing lawsuits, William notes to Ed that after Foam’s plan is confirmed, thousands of automobiles on the roads will have cushions made of foam that were sold before Foam’s Chapter 11 plan was confirmed. There will certainly be fiery accidents involving some of those autos, and some victims who are burned in these accidents will blame Foam and its defective pre-petition manufacturing of the foam in the cushions. William wants to know if there is any way that he can use the Chapter 11 process to protect the reorganized Foam from lawsuits that are filed post-petition by those persons.

We ask the students at this point whether Foam should even want such future claims to be allowed now in its Chapter 11 bankruptcy if some Professor Epstein-like character comes along purporting to represent all future victims who are injured by foam that was defectively manufactured pre-petition by Foam. The answer to this question is far from clear for the students. On one hand, if we do allow these claims now, then the claims will be discharged according to the language of section 1141(d)(1).40 That’s a good thing for Foam. On the other hand, allowing these claims to be filed now will lead to a massive addition to the total unsecured debt that Foam must contend with when it seeks to create a confirmable plan of reorganization. That will be a bad thing for Foam.

If these future claims are not allowed now, there is the benefit to Foam of not having to deal with that large liability in addition to all of the other pre-petition unsecured claims that must be dealt with in the confirmed plan. However, if these future claims are not allowed now, then the claims will not be discharged in this Chapter 11 bankruptcy. That means the reorganized Foam will need to continue dealing with lawsuits like this

even after Foam emerges from this Chapter 11 case. If there is enough
defective foam out there and enough fiery accidents that occur post-
petition, then the newly reorganized Foam might soon have to seek
bankruptcy protection again.

We then return to the *Piper* case and the three approaches that the court
in that case considers for defining when a claim arises in bankruptcy. The
analysis by Judge Mark of the three possible approaches reminds me a
little bit of the famous porridge in “Goldilocks and the Three Bears”: one
is too hot, one is too cold, and one is just right. The so-called “conduct”
test that is being espoused by Professor Epstein is just too broad in Judge
Mark’s opinion. Under that approach, any potential future damage that
stems from the debtor’s pre-petition conduct will give rise to a present
claim, even if we don’t know at the time of the debtor’s bankruptcy when
the injury will occur and who the victim will be.

On the other extreme is the so-called “accrual” test, which says that we
don’t have a claim that is cognizable in bankruptcy until the claimant has a
cause of action that has accrued under the relevant state-law doctrine. This
is the approach that was adopted by the Third Circuit in the case of *In
re Frenville*. However, the Third Circuit later reversed itself and rejected
the “accrual test” approach of *Frenville* in the case of *In re Grossman’s*.
Judge Mark in *Piper* deemed the accrual-test definition of a claim to be
too narrow, especially given the broad definition of claim that the Code
uses in section 101(5).

The “just right” way to define an allowable claim in bankruptcy,
according to Judge Mark, is the “pre-petition relationship” test. Under this
test, mere pre-petition conduct by the debtor that ultimately leads to injury
is not necessarily enough to give rise to an allowable claim. Instead, there
must be both pre-petition conduct by the debtor as well as some pre-

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42. *Id.* at 624.
43. 744 F.2d 332 (3d Cir. 1984).
44. 607 F.3d 114 (3d Cir. 2010).
46. See 11 U.S.C. § 101(5) (2012) (defining “claim” to include “right to payment, whether or not
such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured,
disputed, undisputed, legal, equitable, secured, or unsecured”).
petition relationship that the debtor has with the claimant.\textsuperscript{47} For example, if the debtor is a manufacturer of asbestos, claimants who can show that they worked for several years in a plant with the debtor’s asbestos could file a claim based on that pre-petition relationship with the debtor even if the claimants have not yet developed any symptoms of asbestosis.

The final piece of the claims coverage for this class is the due process element. That issue arises when we imagine claimants who would qualify under Judge Mark’s “pre-petition relationship” test but who simply do not realize that they are claimants in time to file a claim. For example, suppose these individuals worked for a company that had asbestos in its manufacturing plant, but they had no symptoms of asbestosis and were unaware that the asbestos manufacturer had filed for bankruptcy. Following the asbestos manufacturer’s bankruptcy, these hypothetical victims develop asbestosis and only then are able to trace their injury back to the asbestos manufacturer. Can the asbestos manufacturer successfully argue under the “pre-petition relationship” test that these victims are foreclosed from recovering now for their injuries because they indeed had claims in the Chapter 11 bankruptcy and these claims were discharged by the clear terms of section 1141(d)(1)?

The students are rarely surprised to learn that the answer here is a resounding “no.” No matter what the Bankruptcy Code says about claims and discharge, the U.S. Constitution says that nobody can have a property right taken away from them without due process of law.\textsuperscript{48} Due process would not be served in a case in which the victim had no reasonable way of knowing about and participating in the debtor asbestos-manufacturer’s bankruptcy case by filing a claim. That is one reason why “channeling trusts” have become so common in these cases in which the debtor’s pre-petition conduct leads to a series of delayed injuries that do not manifest themselves until long after the debtor has received its discharge.\textsuperscript{49}

\textsuperscript{47} Piper, 162 B.R. at 625-27.

\textsuperscript{48} See U.S. CONST. Amend. V (stating that no person shall “be deprived of life, liberty, or property without due process of law”).

\textsuperscript{49} See 11 U.S.C. § 524(g)-(h) (describing the requirements for channeling trusts for the benefit of future claimants that suffer injuries based on the debtor’s pre-petition conduct).
TOPIC SEVEN: RETIREE MEDICAL BENEFITS IN BANKRUPTCY

When we first offered the Chapter 11 seminar in the spring of 1990, Judge Schermer would definitely not have included retiree medical benefits in bankruptcy as one of his favorite topics to teach. Back then, I was one of the few people writing about the subject, which seemed at the time to be a fairly narrow and mostly unimportant topic despite Congress’ addition of section 1114 to the Bankruptcy Code in 1988. Indeed, it was something of a running joke between Judge Schermer and Lloyd Palans that anyone would or should care about retiree benefits in bankruptcy.

Fast forward a couple of decades, and suddenly retiree benefits in bankruptcy have become the driving force in a number of major bankruptcies, including one in Judge Schermer’s own district. Even though fewer and fewer companies these days will promise their employees retiree medical benefits, a fair number of legacy promises for such benefits still exist in heavily unionized industries such as auto, coal and steel. The tremendous increase in the cost of health care during the past few decades has only served to raise the stakes on the retiree benefit issue in those bankruptcy cases where the issue is present.

Our hypothetical in the seminar to introduce this topic to the students is a fairly straightforward one, but it opens the door to a number of the key issues in the area that students should know. We tell the students that shortly after Foam filed Chapter 11, it was looking for ways to cut its expenses. One idea that William Gruff had was to eliminate the insurance premiums that Foam paid on behalf of its 1,000 or so retirees. Healthcare costs had risen so dramatically in the last decade that it now cost Foam about $5,000 per retiree to give them the coverage that they were promised back when they were employees. William meets with Ed Johnson to discuss this "splendid idea" to save the company about $5 million per year. Unfortunately for William, Foam retiree Ralph Retiree (usually played by Mr. Palans) hears about the meeting and tries to take a stand for the position of the retirees.

The first issue that we raise with the students is to consider how the addition of section 1114 changed the landscape in bankruptcy with respect to retiree medical benefits. We challenge them to consider a world without section 1114, and ask them what the status of the retirees' claims for continued health insurance would be in such a world. What is perhaps surprising for the students to realize is that in the absence of section 1114, Foam probably could not have continued to pay retiree medical benefits post-petition even if it had wanted to do so.52

The retirees cannot claim that they have an executory contract with Foam because there is no remaining performance on the part of the retirees. Instead, the retirees’ claim for continued benefit payments by Foam is just that: a claim. More troubling still for the retirees in the pre-section 1114 world was that their claim to promised health benefits was nothing more than a pre-petition general unsecured claim. As a general proposition, a debtor cannot make post-petition payments at its discretion to selected pre-petition unsecured creditors without violating section 549's prohibition on certain post-petition transfers.53

The students then learn that, although section 1114 elevated the previous status of retiree medical benefits in bankruptcy, Congress did so in a strange and complicated way. Instead of assigning a particular priority in the bankruptcy pecking order to these claims by retirees, section 1114 requires the debtor-in-possession to continue to pay such benefits except to the extent that reducing those benefits is necessary to permit the reorganization of the debtor.54 Congress shamelessly borrowed essentially the very same standard for determining the permissibility of terminating or modifying retiree benefits as section 1113 of the Code uses for determining when a debtor-in-possession can reject a collective bargaining agreement in Chapter 11.55

52. See Retiree Benefits In Bankruptcy: Oversight Hearing on H.R. 5238 Before the Subcomm. On Monopolies & Commercial Law of the H. Comm. On the Judiciary, 99th Cong. 52 (1986) (statement of Herbert P. Minkel, Jr., and Prof. Lawrence P. King) (stating that “[t]he most difficult thing for managers of a debtor corporation to rationalize and accept is the fact that [retiree benefit] claims arising prior to the filing of the bankruptcy petition are pre-petition claims and may not be paid without an order of the court”).
Congress’ drafting shortcut raises two key issues that students come to appreciate during our seminar. The first problem with that drafting shortcut by Congress that students come to appreciate during our seminar is that section 1113 covers a true executory contract, whereas section 1114 covers a mere claim by retirees. With section 1113, the union workers still have something valuable in the future to give to the debtor: their ongoing labor for the benefit of the company. The retirees, on the other hand, have already given to the company all of the value that they were contractually obligated to give in exchange for the company’s promise to provide retiree benefits in the future. Therefore, the borrowing of the “necessary to permit a reorganization” language from section 1113 to section 1114 is a rough fit at best. The second problem that students can quickly see with section 1114’s priority for retiree benefits is that the priority is only effective in a Chapter 11 case. If the company in Chapter 11 that owes the retiree benefits ends up converting its case to a Chapter 7 liquidation, then any special rights that retirees have under section 1114 relative to other pre-petition unsecured creditors suddenly disappear.56

There are a couple of other wrinkles surrounding section 1114 that we explore with students before we run out of time for that day. First, we ask the students to suppose that the health plan document creating the retiree benefits had specifically reserved Foam’s right to alter or terminate the program at any time. We then have the students consider whether that right to alter or terminate the retiree benefit plan still exists for Foam once it files for Chapter 11, or whether instead section 1114 takes that right away following the Chapter 11 filing. The cases are actually split on this question,57 but we are mostly interested in hearing the students’ arguments one way or the other on the issue.

Occasionally, a student will ask why Foam is not prohibited from exercising a “terminable at will” clause regarding retiree benefits during bankruptcy under the theory that such a termination by Foam would amount to an “ex post facto de facto ipso facto” clause as described earlier

56. While the provisions of Chapters 1, 3, and 5 of the Bankruptcy Code apply to both Chapter 7 and Chapter 11 cases, the provisions of Chapter 11 only apply to cases under Chapter 11. Cf. 11 U.S.C. § 105(a).
in this article. The answer to that question is simple but elusive. The “ipso facto” prohibition itself that forms the basis for the “ex post facto de facto ipso facto” theory comes from section 365(e). Section 365, however, only applies to executory contracts. Retiree medical benefit agreements as applied to existing retirees are generally not executory contracts, but simply claims by retirees against the company in Chapter 11. Thus, no “ipso facto” theories could apply here.

Finally, we push the students to consider how seriously we should take the language of section 1114(e)(1) that debtors-in-possession “shall timely pay and shall not modify any retiree benefits.” We ask them to suppose that the only cash Foam has is encumbered by validly perfected secured creditors. Does section 1114 require that Foam nevertheless must use that cash to continue paying retiree medical benefits? At least one court has held that it does not. In other words, the special status given to retiree medical benefits does not supersede an otherwise valid security interest. As a different bankruptcy court facing section 1114’s “shall timely pay” mandate put it so aptly, “short of printing money, there is no way to see that all claims are paid in full.”

TOPIC EIGHT: CLAIMS CLASSIFICATION AND GERRYMANDERING

One of the things that Judge Schermer appreciates about covering the Code’s rules for classification of claims is that the relevant provision, section 1122, is so short and simple. Most of the action here is contained in just one sentence, section 1122(a), which says that “[e]xcept as

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58. 11 U.S.C. § 365(e). Section 365(e) prohibits the operation of contractual clauses that allow a non-debtor party to terminate an executory contract solely on the basis that the debtor filed for bankruptcy. Such clauses are called “ipso facto” clauses. However, sometimes a non-debtor party will try to terminate an executory contract with the debtor that files bankruptcy in the absence of such a specific bankruptcy clause in the contract, but clearly for reasons related to the debtor’s filing bankruptcy. These attempts by a non-debtor party to terminate its contract with the debtor can also be prohibited by the bankruptcy court as an “ex post facto de facto ipso facto” clause. However, in the case of retiree benefits, neither pure “ipso facto” clauses nor the “ex post facto de facto” kind of “ipso facto” clauses will be at issue. That is because the retiree benefits contract is no longer an executory contract at all by the time that the debtor seeks to terminate the retiree benefits. At that point, the retirees have given all of their consideration to the debtor, and so we lack the unperformed obligations on both sides that a true executory contract requires.


provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class. The reference to subsection (b) incorporates the exception for “convenience classes,” whereby a debtor can designate a special class of even dissimilar claims that are less than a certain dollar figure. Those claims can then be paid in full so that the estate can be spared the time and expense of having to provide those de minimus claimants with all of the information that potential voters on a plan would otherwise need to get.

Even though the Code’s rules around classification are so simple — essentially paraphrased as “you can’t place dissimilar claims in the same class” — there is a challenge in teaching the classification material to students who have not yet covered the rules for voting on a plan in Chapter 11. Without some background on the voting rules, students would not be able to address the fundamental question of why a debtor would want to place dissimilar claims in the same class. This requires us to give students a broad outline of the voting rules, but especially a discussion of the difference between a consensual plan, where all impaired classes vote in favor of the plan, and a cramdown plan, where only a single impaired class is required to vote yes in order for the debtor to get the plan approved as long as certain other requirements are met.

This background is usually enough for students to see that a debtor might wish to place a small claimant who is likely to vote no into a larger class of claimants that are likely to vote yes, even if the smaller claimant is probably dissimilar to the claims in the larger class. That way, the debtor might be able to preserve the consensual route to plan confirmation and avoid the need for cramdown. This is particularly true if the debtor believes that the small claimant, although dissimilar to other claimants and

63. The consensual route to plan confirmation under section 1129(a) includes the requirement that all impaired classes of claims or interests have voted to accept the plan, 11 U.S.C. § 1129(a)(8). However, acceptance of a plan by a particular class requires that two-thirds in dollar amount and a bare majority in number of claimants vote to accept the plan (as measured against those claimants that actually vote), 11 U.S.C. § 1126(c). Therefore, the smaller, dissimilar claim that is placed in the larger class might get outvoted by other creditors in that class, which would still allow the debtor to meet the requirements for a consensual plan.
probably entitled to its own separate class, is likely to be the only claimant who is going to vote no on the debtor’s plan.

Students will often note that the benefit of brevity, demonstrated in section 1122’s classification rules, comes at a cost of clarity. In particular, section 1122 gives no guidance to litigants on the issue of whether the Code’s classification scheme allows a debtor to place similar claims in different classes. The Code is completely silent on that issue, which then leaves it to courts to decide.

Before we challenge the students with the question of what they would do on that issue if they were the judge, we pose a different issue to them — one which is essentially the flipside of the one that we posed to them earlier in the class. This time, instead of asking why a debtor would want to place dissimilar claims in the same class, we ask why a debtor would want to place admittedly similar claims in different classes. The answer to that question also relates to voting and the two routes to plan confirmation, but now the answer is the opposite of the answer to the first question that students considered.

As explained earlier, a debtor might wish to place dissimilar claims in the same class as a way to preserve the consensual route to plan confirmation. However, in this case, a debtor might wish to place similar claims in different classes as a way to preserve the cramdown route to confirmation. By placing a friendly (but similar) claimant into a separate class, a debtor can ensure that it will achieve the one impaired class voting yes that it will need for a cramdown confirmation. Both scenarios that were just described could be called an attempt by the debtor to “gerrymander” the voting process through questionable classification approaches. Yet students come to appreciate from the cases included in the casebook that this second scenario — the one that section 1122 does not even cover — is the one that is much more likely to arise in practice.

This second kind of gerrymandering often arises in a single-asset Chapter 11 case where there is a major secured lender that is

64. Section 1129(b)’s requirements for a cramdown confirmation do not include section 1129(a)(8)’s requirement that all impaired classes of claims and interests must vote to accept the plan. However, even a cramdown plan confirmation under section 1129(b) includes the requirement in section 1129(a)(10) that at least one impaired class of claims has accepted the plan. See 11 U.S.C. §§ 1129(a)(10), 1129(b)(1).

undersecured, along with a few friendly unsecured trade creditors. The trade creditors might be friendly because they wish to have continued business with the debtor if the debtor can emerge from the Chapter 11 case with a confirmed reorganization plan. The size of the trade creditors’ claims will often pale in comparison to the size of the secured creditor’s unsecured claim. However, both the trade claims and the big bank’s unsecured claim share the exact same priority and for that reason arguably should be placed by the debtor in the same class — as long as a court believes that the Code drafters intended for similar claims to be placed in the same class despite section 1122’s silence on that issue.

Like so many of Judge Schermer’s favorite topics to teach, this one has no clear answer in case law.66 Even without clear answers, though, this topic teaches students a few important lessons about bankruptcy law. First, it shows them that even though the Bankruptcy Code is so long and detailed, the courts still have a key role to play in crafting and shaping bankruptcy law. Second, this topic reminds students that even an apparently straightforward provision of the Code, such as section 1122, may have a lot of complexity buried beneath the surface. And finally, this topic shows students the important interconnectedness of different parts of the Code, even when those connections are not obvious: in this case, the connection between the Code’s rules on classification under section 1122 and the Code’s rules on plan voting under section 1129.

**TOPIC NINE: THE SECTION 1111(b) ELECTION**

Section 1111(b) is one of the most complex provisions of the Bankruptcy Code, so it is probably a good thing that this topic comes later in the semester after the students have had a chance to get more comfortable with the Code. Judge Schermer enjoys this topic partly for the challenge of helping students master a difficult issue, and partly because the genesis of section 1111(b) was Congress’ distrust of a

66. *Compare*, e.g., *In re Route 37 Bus. Park Assocs.*, 987 F.2d 154 (3d Cir. 1993) (disapproving debtor’s plan to separately classify unsecured trade claims from the secured creditor’s unsecured deficiency claim), with *In re United States Truck Co.*, 800 F.2d 581 (6th Cir. 1986) (permitting separate classification of unsecured claims that were at the same priority level).
bankruptcy judge’s valuation of a secured creditor’s collateral in a famous Chapter 11 case.

You cannot truly understand how section 1111(b) works until you first appreciate the case that led Congress to enact that section. The case was *In re Pine Gate Assocs. Ltd.*,67 and we give the students a simplified version of the facts of *Pine Gate* that is sufficient for them to see the problem that Congress needed to address. In our simplified facts, Debtor owes Mortgage Bank $7 million pursuant to a loan that is secured by a piece of real property owned by Debtor. Debtor files Chapter 11 and Mortgage Bank opposes Debtor’s plan of reorganization. However, there is a class of impaired trade creditors that favors Debtor’s plan, so Debtor attempts a cramdown plan. Debtor’s plan proposes that Debtor retain the real estate, which means the bankruptcy court has to value the collateral for purposes of determining Mortgage Bank’s rights as a secured claim holder in the cramdown plan.68

The bankruptcy court values the collateral at $5 million for purposes of Mortgage Bank’s treatment in the plan, which means that Mortgage Bank gets a $5 million secured claim in the plan and a $2 million unsecured claim.69 Unsecured creditors are scheduled to be paid ten percent in cash at confirmation according to the plan’s terms. Mortgage Bank believes that its collateral is worth at least $8 million, so Mortgage Bank is quite disappointed with the bankruptcy court’s valuation. What is even more upsetting to Mortgage Bank is that six months following confirmation of the plan, Debtor ends up selling Mortgage Bank’s real estate collateral to a third party for $8 million. As we note to the class at this point in the story, Debtor is the party that gets to keep the “profit” from this post-confirmation sale and Mortgage Bank receives only the $5 million amount of its secured claim from those sale proceeds, less any payments that it has received up to that point on the secured claim.

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67. 12 Collier Bankr. Cases (MB) 607 (Bankr. N.D. Ga. Mar. 4, 1977) (allowing the debtor to reduce the secured creditor’s claim in the bankruptcy reorganization case to the value assigned by the judge, thereby prompting Congress to add § 1111(b) to the new Bankruptcy Code two years later as a way to protect similarly situated secured creditors in future bankruptcy reorganization cases).

68. See 11 U.S.C. § 1129(b)(2)(A)(i)(II) (providing that secured creditors in a cramdown confirmation are entitled to receive the present value of the amount of their secured claim over the life of the Chapter 11 plan).

69. See 11 U.S.C. § 506(a)(I) (providing that undersecured creditors must bifurcate their claim into a secured claim up to the value of their collateral and an unsecured claim for the deficiency amount).
The question that we then pose to the class is how does section 1111(b) help Mortgage Bank to protect itself in this situation? The answer, although not completely obvious from the language of the statute itself, is that Mortgage Bank can “elect” under section 1111(b) to be treated as a fully secured creditor for its $7 million claim for purposes of Debtor’s Chapter 11 plan. That way, the bank does not need to worry about the bankruptcy court’s valuation of the collateral because the bank’s claim will be treated as fully secured in the debtor’s plan.

At this point in the discussion, we pause to share two observations and to pose one question to the class. The first observation is to grant fairness to bankruptcy judges. When we talk about the faulty valuation made by the bankruptcy judge in Pine Gate or in other cases like Pine Gate, we note one important caveat: while it is possible the bankruptcy judge got it wrong with its $5 million valuation of the collateral in our hypothetical, it is also possible that the bankruptcy judge was actually right at the time he or she valued the real estate. Under this alternative possibility, what actually happened in that case was that the real estate market took a sudden and unexpected turn for the better shortly after the debtor’s confirmation. However, whichever explanation is accurate concerning the problematic valuation of the collateral, the secured creditor in such a situation can protect itself in either case by making the section 1111(b) election.

Our second observation about section 1111(b) is that the section 1111(b) election will allow the secured creditor to have a “fully secured” claim in one sense, but not in another sense. Making the section 1111(b) election means that if the secured creditor’s collateral is later sold by the debtor, the secured creditor will reap the full benefits of that sale, unlike in Pine Gate itself or in our variation of that case. However, outside of the section 1111(b) context, a creditor’s secured claim in a Chapter 11 plan is normally entitled to a full present-value treatment in the debtor’s plan. That means in the non-section 1111(b) context that a secured claimant must be paid both principal and market-interest over the life of the Chapter

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70. The way that section 1111(b)(2) puts it is, “If such an election is made [under section 1111(b)(1)], then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.” 11 U.S.C. § 1111(b)(2).
11 plan for the full amount of its secured claim. If you are a section 1111(b) “electing secured creditor,” by contrast, you are not necessarily entitled to present-value treatment of your secured claim in the debtor’s plan. Instead, you must be paid over the life of the plan just the nominal amount of your elected secured claim, and only present-value treatment for whatever portion of your elected secured claim represents the court’s valuation of your collateral.

Returning to the simple facts of our Pine Gate hypothetical, recall that Mortgage Bank was owed $7 million but the judge valued Mortgage Bank’s collateral at just $5 million. If Mortgage Bank in our hypothetical made the section 1111(b) election to be treated as a fully secured creditor for $7 million, this means that Mortgage Bank must be paid a stream of payments totaling at least $7 million over the life of the plan, and that stream of payments must have a present value of at least $5 million. More importantly, however, making the section 1111(b) election to be treated as a fully secured creditor means that if the collateral is sold during the life of the plan for $8 million, as in our hypothetical, Mortgage Bank will collect $7 million, less any payments made up to that point on the secured claim. That is a much better outcome for Mortgage Bank than the $5 million that Mortgage Bank would get upon Debtor’s $8 million post-confirmation sale of the real estate in the absence of the section 1111(b) election.

The question that we pose to students at this point is simple enough on the surface, but complex when we push them to dig deeper. Our question is, why would any secured creditor not make the section 1111(b) election to be treated as a fully secured creditor? Or, put another way, what are the costs and benefits for the secured creditor of making the section 1111(b) election? At this point, at least one benefit of making the election is obvious to students: it ensures that if the collateral is sold or otherwise disposed of during the life of the confirmed Chapter 11 plan, the secured creditor will capture any post-confirmation appreciation of its collateral. We then suggest to the students (if they don’t raise these benefits

72. The confusing way that section 1129(b)(2)(A)(i)(II) captures this concept is “that each holder of a claim of such class [i.e., a secured claim] receive on account of such claim deferred cash payments totaling at least the allowed amount 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.” 11 U.S.C. § 1129(b)(2)(A)(i)(II).
themselves) a couple of additional benefits to a secured creditor of making the section 1111(b) election that may not be as obvious to them. First, the election may force a larger total payout to the secured creditor over the life of the plan. Second, the section 1111(b) election may even block confirmation of the debtor’s proposed plan if the debtor is unable to afford the higher payments required by the “fully secured” treatment of its claim that section 1111(b) allows the undersecured creditor to elect. A debtor can always respond by extending the timetable of its proposed plan so that it can reduce the size of the annual payments, but such a lengthy proposed plan period by a debtor could lead to a denial of confirmation based on a lack of feasibility under section 1129(a)(11).

The cost to a secured creditor with a section 1111(b) election is usually much more difficult for students to discern. In order to tease that out, we encourage the students to consider what special benefits there are of being an unsecured creditor in a Chapter 11 plan. There are at least three. First, there is the unsecured creditor’s dividend in the plan, which may in certain cases be reasonably generous, even though the norm is for a much smaller payout to unsecured claimants in a Chapter 11 plan. The second benefit to unsecured status is the right to vote on the plan as an unsecured creditor, which in some cases might prove to be the difference between the debtor’s plan being confirmed and not being confirmed. If you are a secured creditor who is hoping for a conversion of the case and a liquidation of the estate, the benefit of your voting power as an unsecured creditor could be significant. Finally, as an unsecured creditor you have the right to assert your rights under section 1129(b)’s absolute priority rule, which in certain cases might be enough to block the debtor’s plan of reorganization.

**TOPIC TEN: NEGATIVE AMORTIZATION**

Negative amortization is a nice follow-up to our discussion about the section 1111(b) election, and it is a favorite of Judge Schermer’s at least

73. See 11 U.S.C. § 1126(a) (2012) (providing that “[t]he holder of a claim or interest allowed under section 502 of this title may accept or reject a plan”).
74. See 11 U.S.C. § 1129(b)(2)(B) (2012) (providing that unless unsecured creditors in a cramdown confirmation receive full payment on their claims, then no junior class may receive any value under the plan).
partly because he and his then-law clerk, Keith Bartz, co-authored an article on the subject early in Judge Schermer’s tenure on the bench. This is typically not an easy issue for students to grasp because most students do not even have much of a sense for what amortization is, much less “negative amortization.” And even those rare students who might know what “negative amortization” means are typically not able to explain how that concept fits within Chapter 11’s plan confirmation rules, especially cramdown plans.

We begin by explaining to students that any secured claim that is to be paid over the life of a Chapter 11 plan with interest must be amortized — a shorthand way of saying that we need a payment schedule in which the total stream of payments representing both principal and interest is equal to the present value of the principal amount owed by the debtor on the secured claim. This presumes that we have a rate of interest to work with that is set by the bankruptcy judge. Students generally can relate to the idea that a consumer’s secured debt in a standard home mortgage will typically be amortized in a way that provides for equal monthly payments over a set period of months. In a Chapter 11 scenario, however, a debtor that is proposing a plan will often want to defer its payments as much as possible. What this means for the secured creditor is that the repayment schedule in the debtor’s proposed Chapter 11 plan may not resemble the equal monthly payments that are typical in a home mortgage-payment schedule.

We pose a fairly simple hypothetical for students in the context of a section 1111(b) election in order to illustrate the negative-amortization point more concretely. Secured Creditor has a $5 million total claim and a security interest in Debtor’s collateral, which the bankruptcy judge values at $3 million. Secured Creditor makes the 1111(b) election with respect to its $5 million claim to be treated as a fully secured creditor. The court sets a market rate of interest at six percent for Secured Creditor’s present-value rights in the plan with respect to the $3 million collateral value assigned by the court. We remind students that this section 1111(b) election by Secured Creditor means that Debtor must pay Secured Creditor over the life of the plan the present value of $3 million (because that is the court’s

valuation of the collateral) and total payments over the life of the plan of at least $5 million (the value of Secured Creditor’s secured claim in light of the section 1111(b) election).76

Debtor’s five-year plan proposes to pay Secured Creditor $100,000 per year for the first four years of the plan, followed by a balloon payment in year five of $6 million, with Secured Creditor retaining its lien on the collateral throughout the life of the plan. Debtor argues that the plan complies with its requirements both under section 1111(b) and under section 1129(b)’s cramdown provisions. The plan provides for a present value of more than $3 million, thanks to the balloon payment of $6 million in year five, and taking into account the court’s six percent rate of interest. The plan also provides for a nominal stream of payments of more than $5 million, thanks again to the $6 million balloon payment at the end of the plan.

Given this seeming compliance with the requirements of sections 1111(b) and 1129(b), why might Secured Creditor have a problem with this plan? This is where the more business-minded students in the seminar can see the problem of negative amortization. Suppose that Debtor does not complete the five-year plan, or suppose that Debtor is not in a position to pay $6 million when year five comes around—where does that leave Secured Creditor? What makes this plan truly a “negative amortization” plan is that the annual payments of $100,000 do not even cover the annual six percent interest on the $3 million collateral value. The annual payments would need to be at least $180,000 in order to do that.77

Secured Creditor’s only protection here if this plan falls apart following confirmation is the continued strength of its collateral value, since Secured Creditor will be looking to realize the value of that collateral if Debtor defaults on its plan obligations. Secured Creditor may not be fully comfortable with such an arrangement, especially since this plan essentially allocates the risk of declining collateral value to Secured Creditor and gives Debtor the benefit of a lot of time to keep using Debtor’s collateral.

76. See supra text accompanying note 70.
77. That is because six percent of $3 million equals $180,000.
Then we challenge our students to come up with a Code-based argument for Secured Creditor to use if it wishes to argue against this negative-amortization plan. We usually have to help our students here a bit with some hints, but eventually they come up with two possible theories that Secured Creditor could use to object to this plan. The first is the language of section 1129(b)(1), which creates additional requirements for a debtor’s plan to be confirmed when the plan is a cramdown plan rather than a consensual plan. One of those requirements is that the proposed cramdown plan must be “fair and equitable” to the creditors whose claims are being treated in the plan. Students can argue that a plan like the one we have proposed, that does not even pay enough each year to Secured Creditor to cover Secured Creditor’s annual interest, is a plan that is not “fair and equitable” to Secured Creditor.

A second possible legal challenge that might be available to Secured Creditor will depend on additional facts that we would need to know about the nature of Secured Creditor’s collateral in this hypothetical. In order to raise that new issue for students, we ask them to assume that the $3 million collateral is depreciating at a rate of five percent each year. Based on that new fact, students have an additional argument for Secured Creditor that relies on an arguable violation of the spirit, if not the letter, of section 362(d)(1). That section says that a court may grant a secured creditor a lift of the automatic stay if the debtor fails to give the secured creditor “adequate protection” of the creditor’s interest in its collateral.78 In this negative amortization scenario, the Debtor’s proposed payments do not even keep pace with the depreciation rate of the collateral during the life of the plan.79 Therefore, if Debtor’s plan here fell apart a couple of

78. 11 U.S.C. § 362(d)(1). The reason that I say here that the alleged violation of section 362(d)(1) may only be a violation in spirit rather than a violation of the letter of the law is that except in Chapter 11 cases involving individual debtors, once the plan is confirmed, then the automatic stay of section 362 terminates. See 11 U.S.C. § 362(c)(2)(C) (providing that the automatic stay terminates once there is a discharge in a Chapter 11 case) and 11 U.S.C. § 1141(d)(1)(A) (providing that confirmation of a Chapter 11 plan discharges the debtor from liability on any pre-petition debts). Thus, a secured creditor would not need to seek “lift of stay” once the Chapter 11 plan has been confirmed. Instead, the post-discharge injunction of section 524(a) would prevent the secured creditor from enforcing its pre-petition rights against its collateral. However, there is no “lift of stay” equivalent to section 362(d)(1) that can be found in section 524’s post-discharge injunction.

79. That is because a five percent rate of depreciation on collateral worth $3 million means a depreciation rate of $150,000, which is greater than the $100,000 per year that Debtor is proposing to pay under this plan to Secured Creditor.
years following confirmation, Secured Creditor’s interest in its collateral will not have been adequately protected because the collateral will have depreciated faster than any payments received by Secured Creditor at that point.

The bottom line that we leave with the students, and it is the same one that Judge Schermer gave in his article on this subject, is that negative amortization does not necessarily violate the “fair and equitable” rule in every cramdown situation.80 We note to the students that they need to look especially at the collateral value and its predicted rate of depreciation over the life of the plan. If the secured creditor is oversecured and the collateral value is expected to be stable, then even a negatively amortized cramdown plan should be confirmable. However, if the creditor is undersecured and the collateral is expected to depreciate at a rate that exceeds the value of payments being made by the debtor, then the negatively amortized plan will likely be deemed not “fair and equitable” under section 1129(b) and therefore not confirmable by the court.

CONCLUSION

It is difficult for most adjunct professors who have full-time “day jobs” to fit in one class per week during one semester each year. Judge Schermer, on the other hand, has managed to teach for over twenty-five years, and most of that time he has taught both semesters each year. Furthermore, in the fall semester, he typically teaches three times each week, usually at 7:30 in the morning. The only way that someone could keep up that teaching schedule for such a long time is if he truly loved the subject that he was teaching. I have seen that enthusiasm first-hand as Judge Schermer’s co-teacher in the Chapter 11 seminar for almost three decades. Probably the most challenging part of writing this article was narrowing down Judge Schermer’s favorite Chapter 11 topics to just ten. Also, this article does not even touch on the many consumer bankruptcy issues that Judge Schermer loves to teach in the basic Bankruptcy class. I have no doubt that the consumer “top ten topics” could be their own

80. See Schermer & Bartz, supra note 75.
separate article. That article, however, will have to wait for another day—perhaps on the occasion of Judge Schermer’s 50th year on the bench?