



## Creditors' Rights and Bankruptcy

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### Chapter Objectives

1. Summarize the various remedies available to creditors, and indicate how and when creditors use these remedies to collect debts.
2. Differentiate between suretyship and guaranty arrangements.
3. Outline the typical steps in a bankruptcy proceeding.
4. Describe what property constitutes a debtor's estate in a bankruptcy proceeding and what property is exempt.
5. Compare and contrast the types of relief available under Chapter 7, Chapter 11, Chapter 12, and Chapter 13 of the Bankruptcy Code.

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### LAWS ASSISTING CREDITORS

- Both the **common law** and **statutory laws** other than **Article 9 of the UCC** create various rights and remedies for creditors.
- **Liens** - is an encumbrance on property to satisfy a debt or protect a claim for the payment of a debt.
- **Creditor's liens** include a mechanic's, artisan's, innkeeper's, and judicial liens.

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## Liens

- Creditors' liens include:

<b>Mechanic's lien</b> - A nonpossessory, filed lien on an owner's real estate for labor, services, or materials furnished to or made on the realty.
<b>Artisan's lien</b> - A possessory lien on an owner's personal property for labor performed or value added.
<b>Innkeeper's lien</b> - A possessory lien on a hotel guest's baggage for hotel charges that remain unpaid.
<b>Judicial liens</b> <b>Attachment</b> - A court-ordered seizure of property prior to a court's final determination of the creditors' rights to the property. Attachment is available only on the creditor's posting of a bond and in strict compliance with the applicable state statutes. <b>Writ of execution</b> - A court order directing the sheriff to seize (levy) and sell a debtor's nonexempt real or personal property to satisfy a court's judgement in the creditor's favor.

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International  
Perspective

## The Principle of Comity

- Under the **principle of comity**, a court in one country may *enforce a judgment* rendered by a court in another country.
- *What criteria should a U.S. court use to determine the fairness of a foreign court's writ of attachment?*

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## Garnishment

- A **collection remedy** that allows the creditor to **attach** a debtor's **money** (such as wages owed) and **property** that are *held by a third person* (such as the debtor's employer).

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## Creditors' Composition Agreement

- A **contract** between a *debtor and his or her creditors* by which the debtor's debts are **discharged** by payment of a sum less than the sum that is actually owed.

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## Mortgage Foreclosure

- **Mortgagee** - the *creditor* who takes a *security interest* in the debtor's property.
- **Mortgagor** - the *debtor* who gives the *creditor* a *security interest* in the debtor's property in return for a mortgage.
- On the **debtor's default**, the *entire mortgage debt is due and payable*, allowing the **creditor to foreclose** on the realty by *selling it to satisfy the debt*.

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## Suretyship and Guaranty

- Under an express contract, a **third person agrees** to be *primarily or secondarily liable* for the **debt owed** by the *principal debtor*.
- **Surety** - A person, such as a *cosigner on a note*, who agrees to be "*primarily*" responsible for the debt of another.
- **Guaranty** - A person who *agrees to satisfy the debt of another only after the principal debtor defaults*; a guarantor's liability is thus secondary.
- **Right of** ; Subrogation, Reimbursement, Co-surity, and Contribution.

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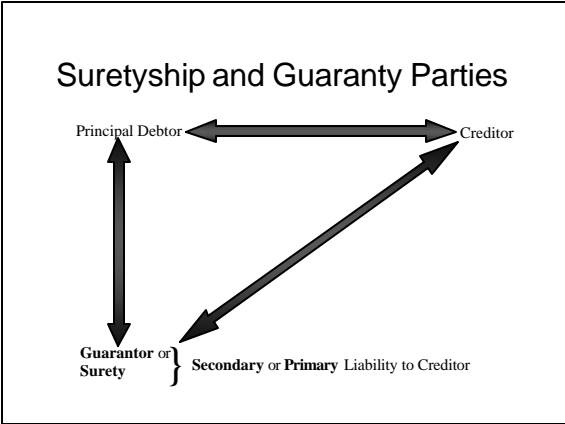
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### LAWS ASSISTING DEBTORS

- Numerous laws, including **consumer protection statutes**, assist debtors. Additionally, **state laws** exempt certain types of real and personal property from levy of execution or attachment.
  - Homestead Exemption** (real property) - Each state permits a debtor to *retain the family home*, either in its entirety or up to a specified dollar amount, free from the claims of unsecured creditors or trustees in bankruptcy. *Ensures that debtor retains some form of shelter.*
  - Personal property** - Personal property that is most often exempt from satisfaction of judgment debts includes the following:
    - Household furniture up to a specified dollar amount.
    - Clothing and certain personal possessions.
    - Transportation vehicles up to a specified dollar amount.
    - Certain classified animals, such as livestock or pets.
    - Equipment used in a business or trade up to a specified dollar amount.

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### Bankruptcy Code - A Comparison

ISSUE	CHAPTER 7	CHAPTER 11	CHAPTERS 12 & 13
<b>PURPOSE</b>	<b>Liquidation.</b>	<b>Reorganization.</b>	<b>Adjustment.</b>
<b>WHO CAN PETITION</b>	Debtor (voluntary) or creditors (involuntary). Petition in bankruptcy.	Debtor (voluntary) or creditors (involuntary).	Debtor (voluntary) only.
<b>WHO CAN BE A DEBTOR</b>	Any "person" except railroads, insurance companies, banks, savings and loan institutions, investment companies licensed by the Small Business Administration, and credit unions. Farmers and charitable institutions cannot be involuntarily petitioned.	Any debtor eligible for Chapter 7 relief; railroads are also eligible.	<i>Chapter 12</i> -Any family farmer (one whose gross income is at least 50% farm dependent and whose debts are at least 80% farm related) or any partnership or closely held corporation at least 50% owned by a farm family, when total debt does not exceed \$1.5 million. <i>Chapter 13</i> -Any individual with regular income who owes fixed unsecured debts of less than \$269,250 or fixed secured debts of less than \$807,750.

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Continued...

ISSUE	CHAPTER 7	CHAPTER 11	CHAPTERS 12 & 13
<b>PROCEDURE LEADING TO DISCHARGE</b>	Nonexempt property is sold with proceeds to be distributed (in order) to priority groups. Dischargeable debts are terminated.	Plan is submitted; if it is approved and followed, debts are discharged.	Plan is submitted and must be approved if the debtor turns over disposable income for a three-year period; if the plan is followed, debts are discharged.
<b>ADVANTAGES</b>	On liquidation and distribution, <b>most debts are discharged</b> , and the debtor has an opportunity for a <b>fresh start</b> .  <b>On filing - Automatic Stay (suspension of)</b>  <b>Order of relief.</b>	Debtor <b>continues</b> in business. ( <b>DIP</b> ) Creditors can either accept the plan, or it can be "crammed down" on them. The plan allows for the <b>reorganization</b> and liquidation of debts over the plan period.	Debtor <b>continues</b> in business or possession of assets. If the plan is approved, most debts are discharged after a three-year period.

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Landmark  
in the Legal Environment

### The Bankruptcy Reform Act of 1978

- The **National Bankruptcy Act of 1898** allowed only for *liquidation* in bankruptcy proceedings
- Modern bankruptcy law is based on the **Bankruptcy Reform Act of 1978**, which repealed the 1898 act and represented a major overhaul of federal bankruptcy law to remedy previous abuses
- *The Code no longer refers to persons who file for bankruptcy as "bankrupts" but simply as "debtors." What does this change in terminology signify, if anything?*

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Inside  
the Legal Environment

### The Loan That Got Away

- Loans made "**pursuant to the terms of an employment contract**" that are used to *repay educational debts* are **not dischargeable** in bankruptcy
- *If a student, after graduating from college, took out a loan from a bank to pay off an educational debt, should that loan be dischargeable in bankruptcy? Why does this issue rarely come before the courts?*

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Ethical Perspective

### Employer Discrimination

- There is **no law prohibiting** *private employers* from **discriminating** against job applicants on the *basis of the applicants' prior bankruptcy status*.
- *Can an employer's discrimination against job applicants on the basis of their history of bankruptcy ever be justified?*

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### Case 14.6 In Re Johns-Manville Corp.

- Johns-Manville Corporation filed for protection under Chapter 11 asserting that the approximately sixteen thousand lawsuits pending and potential lawsuits of people who had been exposed to asbestos necessitated its filing.
- Manville's creditors contended that Manville was not insolvent, and that therefore the voluntary Chapter 11 petition should be dismissed. Court ruling: motion to dismiss petition was denied. *Key to reorganization process.*
- *In view of the fact that Manville was a solvent corporation, did it deserve the "fresh start" it achieved through Chapter 11 proceedings?*

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Ethical Perspective

### Chapter 11 Reorganizations

- According to some critics, the **main beneficiaries** of Chapter 11 corporate reorganizations are not the shareholder-owners of the corporations but *attorneys and current management*.
- *Should Chapter 11 be scrapped, as some critics recommend? Should it be amended to set time limits on reorganization proceedings?*

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## For Review

1. What is a prejudgment attachment? What is a writ of execution? How does a creditor use these remedies?
2. What is garnishment? When might a creditor undertake a garnishment proceeding?
3. In a bankruptcy proceeding, what constitutes the debtor's estate in property? What property is exempt from the estate under federal bankruptcy law?
4. What is the difference between an exception to discharge and an objection to discharge?
5. In a Chapter 11 reorganization, what is the role of the debtor in possession?

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