UNIT 2

WHY ARE THERE SO MANY BANKRUPTCY CASES?

More than a million individuals and business entities file a petition for bankruptcy relief each year.¹

A legitimate question is why there are so many filings. An equally legitimate question is why there are so few.

The point of these two "questions" is that you should approach the investigation of bankruptcy with an open mind; to label the numbers above too many (or too few) means that you have already made some assumptions about bankruptcy relief. Before those assumptions harden, let us first explore the alternatives to bankruptcy.

A. WHAT CAN CREDITORS DO OUTSIDE OF BANKRUPTCY?

Creditors are generally happy to do nothing. More specifically, creditors are happy to do nothing so long as their debtors are paying them.

When debtors default in paying an obligation, creditors will first attempt through "persuasion" to get the debtor to pay "voluntarily." The creditor may even hire a collection agency or attorney to help persuade the debtor.² If these nonjudicial collection efforts are unsuccessful, the creditor can resort to the debt collection remedies provided by either (i) law of creditors' remedies or (ii) the creditor's contract with the debtor to seize and sell the debtor's assets to satisfy the debt.

Let's consider the law of creditors' remedies first. At the broadest level, the law of creditors' remedies involves only two issues: (1) when and how a creditor gets a lien on property of the debtor (or the property itself), and (2) the lien's priority in relation to third parties' rights to the

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¹. You can look up the official bankruptcy statistics online. See http://www.uscourts.gov/bankruptcystats/bankruptcystats.htm.

². When the debt is a consumer debt, these nonjudicial persuasion efforts are controlled by the federal Fair Debt Collection Practices Act and various state consumer protection statutes.
property, including other creditors’ liens and the claims of transferees. These two issues are common to every kind of creditors’ remedy.

Why the focus on “liens”? A creditor cannot seize and sell its debtor’s property unless it has some property interest in the debtor’s property, and the principal way to obtain such an interest is to obtain a “lien” on that property.

Say for example that Perris claims that Epstein owes her $1,000. Perris can’t simply come over to Epstein’s house and take his stuff. She needs to establish her legal right to be paid $1,000. She needs to establish her right to Epstein’s property. This example illustrates the most general rule of the law of creditors’ remedies: generally a creditor does not acquire or retain a lien or other property interest in the debtor’s property until the creditor reduces her claim to judgment and enforces this judgment through the appropriate postjudgment process, execution. 3

You should now be asking the questions: (1) why is action beyond a judgment necessary and (2) what is execution?

The answer to the first question that you should be asking is that a judgment is no more than another form of debt; it is a new form of the obligation that the debtor owes the creditor. A judgment does, however, differ from the original obligation in that a judgment is the State’s recognition of the legitimacy of the creditor’s claim against the debtor. Along with this recognition comes (1) a judgment lien, which attaches by force of law to the debtor’s real property once the judgment is appropriately recorded, and also (2) a willingness by the state to use its coercive power to enforce this lien and otherwise collect the amount of the judgment forcibly from the debtor’s property (both real and personal) if the judgment debtor does not pay “voluntarily.” This coercive power is brought to bear through the process of execution which is triggered simply by a judgment creditor requesting it.

Now, to answer the second question: what is execution? A creditor with a judgment initiates the execution process by applying to the court that issued the judgment for a writ of execution. The writ of execution is ordinarily issued from the court that rendered the judgment and is directed to a sheriff. The writ orders the sheriff to seize property of the debtor, sell it, and apply the proceeds in satisfaction of the judgment.

To reach tangible property of a debtor held by third persons, and to collect debts owed to the debtor, there is a special proceeding at law in the nature of an adversary suit against the person who holds the debtor’s property or owes the debtor money: garnishment. Garnishment is in essence a special form of execution—designed for reaching property of the debtor held by a third party.

3. There is a small exception to the rule that a creditor cannot seize property of the debtor except through postjudgment execution. In a narrow class of cases, property sufficient to satisfy a creditor’s claim can be impounded by judicial lien at the time suit is filed. The means is a provisional remedy known as prejudgment attachment or, when the property is held by a third person, prejudgment garnishment.
The most common example of garnishment is garnishment of bank accounts. When a creditor tries to collect its judgment against the debtor from funds in the debtor’s bank account, it seeks to obtain property of the debtor’s held by a third person. In this context, the proper terminology regarding what occurs when, for example, the IRS tries to seize a bank account of delinquent taxpayer, is that the IRS is garnishing the bank account.

Most lawyers do not like to do debt collection work; most creditors do not like to pay for this kind of legal work. Obtaining a judgment and getting a sheriff to seize and sell property of a debtor can be difficult, time consuming and expensive. And, most important, obtaining a judgment and getting a sheriff to seize and sell property of a debtor is often unsuccessful.

Why? One of the largest roadblocks to collection of debts through this legal process is that there is no guarantee that the debtor will have property that can be seized and sold, or that the property will be in the place that the creditor told the sheriff to go look.

Second, even if the debtor has property, that property may be encumbered by other creditors’ liens that have priority. These other liens may have been created because of (i) a prior judicial collection effort, or (ii) statute, or (iii) agreement.

Tax liens, mechanics’ liens and landlords’ liens are examples of statutory liens. These are liens that arise by operation of law—arise if the debtor fails to pay a debt protected by the statute.

While statutory liens are important, consensual liens are the most common liens. Most debt deals which are large enough to involve lawyers also involve consensual liens.

We are going to spend a lot of time in this course talking about consensual liens—property rights that creditors obtain by contract. For now, you need to understand that (1) by contract, a creditor can obtain rights in addition to the rights available to a creditor under creditors’ remedies law, (2) these rights, i.e., consensual liens, have the effect of limiting the rights of other creditors under creditors’ remedies law, and (3) these consensual liens are property rights and so enjoy the constitutional protection afforded to property rights.

Federal bankruptcy law does not govern the creation of these consensual liens. Instead, state law controls here, and state law tends to categorize the types of consensual liens by the type of property involved. The two basic types of property in this regard are real property (that is, dirt and things built on and attached to the dirt) and personal property (that is, things that are not real property).

There are various devices for creating consensual liens on real property—the mortgage, the deed of trust, and the land-sale contract. The differences in these devices largely concern the procedures for (a) applying
the collateral in satisfaction of the secured obligation, and (b) safeguarding the debtor's rights and interests.

When the creditor and debtor create a consensual lien on personal property or fixtures, the governing law is Uniform Commercial Code Article 9, the subject of another course in law school sometimes called "Secured Transactions" or "Commercial Law." Article 9 provides for only one kind of consensual lien on personal property, the Article 9 security interest.

"Security interest" is Article 9's term for a consensual lien on personal property. Other Article 9 terms that are you will encounter in this course are "secured party" and "collateral." A "secured party" is a creditor with a security interest. The property subject to the secured party's security interest is the "collateral."

**Problem 2–1: What Can a Creditor's Attorney Do Without Bankruptcy?**

Your firm's client, C, has a $1,000,000 judgment against Nick's Chicks, Inc. (N), a chicken farm operating adjacent to C's property. What can you do to collect this judgment if N's assets include:

(i) chicken houses,  
(ii) 25,000 chickens,  
(iii) equipment,  
(iv) accounts receivable, and  
(v) various bank accounts in S Bank.

And, N's other creditors include:

(i) S Bank,  
(ii) IRS,  
(iii) trade creditors, and  
(iv) employees who are to be paid $70,000 in wages, benefits, etc. at the end of the week.

**Problem 2–2: How Much Can the Creditor's Attorney "Bill?"**

How much should your firm charge C for collecting the $1,000,000 judgment? How much should your firm charge if C's judgment is only a $100,000 judgment? How much should you charge if, at the end of the day, you collect nothing for C despite good faith and reasonable attempts to do so?

**B. WHAT CAN A DEBTOR DO OUTSIDE OF BANKRUPTCY?**

There is not much a debtor can do outside of bankruptcy to fix its debt problems. At least not much that a debtor can do without the help and support of its creditors.
Recall that when a debtor does not pay a debt despite the requests (and then demands) of a creditor, the creditor can go to court and sue on the debt. Such a suit usually results in a default judgment; that is, in most cases the debtor will not defend or show up, and the creditor will get everything it asked for in its complaint “by default.”

Remember, that a creditor with a judgment can then obtain an “execution lien” from the court that issued the judgment. And, with an execution lien, the creditor can get the sheriff to “levy on,” or take physical possession of, the debtor’s property. The sheriff will then sell the property at an execution sale, the terms of which will be set by state statute.

A debtor can try to work out some sort of debt repayment agreement with its creditors. Professors who teach first year contracts courses call these agreements “compositions” and “extensions.” Real lawyers call these agreements “workout agreements.”

Whatever you call these agreements, they are “agreements” and only bind the creditors who agree. If even one creditor refuses to participate in the workout agreement, that dissenting creditor, can in essence, “blow up” any deal by suing on its debt and using the execution process to seize and sell assets of the debtor that are essential to the debtor’s performing its workout obligations to the assenting creditors.

Assume, for example, that Perris Printing Company has reached an agreement with nine out of ten of its largest creditors to pay 90% of its debts over three years at a new, higher interest rate. The tenth, non-assenting creditor is not bound by that agreement. And, that creditor can sue on its debt, obtain a judgment and a writ of execution and seize and sell the equipment essential to Perris Printing’s continued business operations.

**Problem 2–3: What Can a Debtor’s Attorney Do Without Bankruptcy?**

Same facts as Problem 2–1 except that you represent Nick’s Chicks, Inc. What can you do for Nick’s Chicks outside of bankruptcy?

If the debtor is an individual, state and federal laws exempt certain property of the debtor from the collection efforts of certain creditors. At most, these exemption statutes enable a debtor to keep some of his or her property from some of his or her creditors. Exemption statutes do not enable a person with debt problems to “fix” the problems.

State exemption laws vary significantly from state to state. In most states, the amount of property that a debtor can designate as exempt is very limited. And, in all states, creditors with a mortgage or security interest in property that is designated as exempt can still seize and sell that property. If, for example, First Bank has a mortgage on Epstein’s
house and Epstein defaults, First Bank can seize and sell Epstein’s house even if Epstein has designated the house as his exempt homestead.

C. BUT WHY BANKRUPTCY?

Again, more than one million bankruptcy petitions are filed each year. More than 99% of these petitions are filed by debtors, less than 1% are filed by creditors against debtors.

Why? “Inquiring minds want to know.” These guys must know something we don’t. But not for long.