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The Law of
DEBTORS AND CREDITORS

*Sixth
Edition*



Wolters Kluwer
Law & Business

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**THE LAW OF DEBTORS
AND CREDITORS**
Text, Cases, and Problems

Sixth Edition

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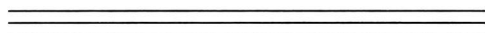
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*In Memory of My Parents,
Don and Pauline Herring*

— E.W.



*To Polly
Wonderful One Times One*

— J.L.W.

PREFACE

We should start the preface to the Sixth Edition of this casebook the same way we started the first five: Both of us love to teach. This book is a product of the delight we have found in introducing students to a part of the law that is as filled with human drama as it is with intellectual complexity and social importance.

This preface is a little like the owner's manual that comes with a new car, albeit in abbreviated form. It tells the people who will be using this book how it works and points out some special features available in this new model. Like all owner's manuals, the preface reflects our efforts to see that everyone uses this book to best advantage. It also reflects our fervent hope that people will have as much fun using it as we had writing it.

Our primary objective is to make debtor-creditor law lively, interesting, and intellectually challenging. Our method is to use ample explanatory text to permit readers to understand the law and legal system, coupled with realistic problems to test and expand that understanding. Our principal focus is bankruptcy law, although we also discuss a good deal of nonbankruptcy law, both state and federal.

The fundamental organizing principle of *The Law of Debtors and Creditors* is the division between consumer and business bankruptcy, rather than a doctrinal organization that lumps together legal principles regardless of the factual context in which they are used. Our experience in practice and our empirical research suggest that both social policy questions and the realities of the functioning bankruptcy system are quite different in consumer and business cases. We have also found that beginners find the material more accessible when consumer bankruptcy is presented first; it becomes possible to master basic principles and see how they interrelate in a somewhat more familiar setting before tackling the twists of bankruptcy law in a complex business reorganization. In turn, the consumer and business presentations are organized around the basic choice in each—liquidation or payout.

The Law of Debtors and Creditors is organized into four parts: Individual Debt Collection, Consumer Bankruptcy, Business Bankruptcy, and Functions and Boundaries of Bankruptcy Law. The first part covers the key points of debt collection outside bankruptcy, giving the view from 10,000 feet mainly as background for bankruptcy law. On the other hand, the substance of bankruptcy law in Parts II and III is covered in some detail.

The fourth part provides an overview of jurisdiction, both domestic and international, along with an introduction to the contemporary debate about the functions of bankruptcy. We do not have the luxury of devoting as much class time to each subject as we would like, so we have designed the book to permit a brief treatment of any of the subjects. Teachers can follow any of several “roadmaps” through the material, choosing the degree of emphasis to put on state law, consumer bankruptcy, or business bankruptcy.

While we have made every effort to ensure that the materials in the book are current and reflect the most pressing issues, the book is not a treatise designed to reveal every clever twist on a statutory provision. In making the difficult choices about how to use the space and time available, we have chosen not to include extensive citations to the majority rule, the minority rule, and the Virginia rule as recently amended. Instead, we devote our space to explaining difficult concepts and central provisions of the Code as clearly and accurately as we can. We leave the details to the hornbooks and the practitioner services.

New to the Sixth Edition

The Sixth Edition has some significant changes. The state law section has once again been condensed, a victim of riding on the same bus with the ever-expanding bankruptcy laws. The most important changes, however, are in the consumer bankruptcy materials, especially the areas affected by the 2005 Amendments. In the preceding edition, we worked hard to integrate the changes into Part II quickly, but there was no case law to guide the interpretation of a new text that is often, well, let’s say Delphic. We have substantially modified Part II in this edition to drop the practical problems that never developed (for example, from the notice-to-creditors provisions), to add the problems that developed in unforeseen ways (for example, calculation of payments due in Chapter 13 based on means test criteria), and to refine and update the rest. While the materials in Parts III and IV have changed less, we have added several new cases and problems throughout. Overall, there are enough new problems and new cases in most sections to refresh the interest of teachers who have used the book for years, but many of the old favorites remain. Discussion of some topics has been shortened (for example, details of state law debt collection) and some has been expanded (for example, the means test and related issues). In this edition, we have continued to expand our references to available empirical studies. Thanks to a growing number of academic studies, we are able to enrich the discussions at more and more turns. As before, we limit our citations of articles and books to those we think are especially accessible and helpful to students trying to understand difficult material.

Features

We have structured *The Law of Debtors and Creditors* to be taught largely through its problems. The cases are primarily designed to show the

operation of the statute in a relatively simple context; the students can then attack the more complex analytic and policy issues by working through the problems. While some “leading” cases are included, our case selection depends much more on the teaching value of a case than on the prominence we would give it in a law review article.

We have divided the problems into three categories: statute readers and case extension problems, which help the students through key legal provisions; theoretical and policy problems, which require the students to think about the social and political implications of the law; and transactional problems, which reverse the litigation orientation of most problems to encourage students to think about planning transactions to help clients plan and structure their affairs. The problems also force a certain amount of review and integration. As students learn more about the legal process, problem-solving increasingly becomes a function of putting pieces together and selecting the right legal tool to achieve a certain result or to analyze a policy choice.

It is our intention to make every problem “real,” that is, realistic in operation and with a human face—the kind of problem a student might actually confront after graduation. The problems are designed to teach the commercial background of each subject area, as well as the legal rules. Many of the problems are practice oriented, while others put the student in the role of legislative aide, judicial clerk, or empirical researcher. In addition to practice and policy, problems raising ethical issues are woven throughout the materials, and a separate section near the end focuses on the special ethical issues raised in bankruptcy practice. These problems give a combination of perspectives. It is our intention to encourage students to appreciate issues beyond the mechanics of the statute, and we think that the complex realities reflected through a problem approach produce more interesting insights than do neoclassical ruminations.

The Megaproblem

Another important feature is the inclusion of a megaproblem, that is, a large problem involving one debtor—Barney Thornaby—and his closely-held corporation. Barney’s Problem is divided into sections and runs throughout the book. Each section reviews the material just covered and places it in a growing factual context to show how each of the doctrinal subjects relates to the others in the process of analyzing and solving Barney’s Problem. While the megaproblem can easily be omitted in favor of greater coverage, it has met with enthusiasm from teachers who have used it and from their students. The use of the megaproblem was quite unconventional in the first edition, but the approach is now appearing in a number of casebooks, reflecting its success in the classroom.

The Modern Role of Bankruptcy Law

These materials reflect our premises (or prejudices) about the modern role of bankruptcy law and bankruptcy lawyers, so we should declare those that are most important to us:

1. We believe that several factors have combined to make bankruptcy commonplace in contemporary America. One important factor has been the enormous growth in international trade competition and the creation of world markets. The consequence has been, and will continue to be, accelerating economic instability and change domestically, with one industrial or geographic sector booming while another is in sharp recession. Bankruptcy is a central part of the painful process through which both small families and big businesses adjust to the effects of rapidly changing world markets.
2. We believe that bankruptcy will be in the mainstream of commercial and business law and practice for the foreseeable future. It is therefore critical that it be understood by every lawyer and every policymaker concerned with the functioning of our economic system.
3. On a microeconomic level, we think that debtor-creditor law has been dominated too long by easy stereotypes and untested assumptions. Calvinistic sneers at deadbeats and populist disdain for money-changers reflect a distorted view of the complexities of financial relationships. Too often these emotional attachments serve as substitutes for detached analysis and careful research. One of the most important things we want to do for our students is to teach against their prejudices and, harder still, our own.

Charles Warren began his 1935 history of American bankruptcy law with the words "Bankruptcy is a gloomy and depressing subject." We reject that proposition. The economic pathology that leads to bankruptcy is indeed depressing, but bankruptcy itself is the process of healing and restoration. Bankruptcy is an integral part of a free market system that permits individuals and businesses to fail; a strong bankruptcy system undergirds a market-based economy. The bankruptcy lawyer and judge help individuals and businesses to pick up the pieces, right the wrongs, and begin anew when old approaches have failed. Bankruptcy is about the future. The bankruptcy scholar searches for a better treatment of economic wounds that is less painful and more permanent. It is good work, the work of the healer, and there is much of it to be done.

*Warren & Westbrook
Professors of Law*

Cambridge, Massachusetts
Austin, Texas
October 2008

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This section is the most fun to write because as we write it we know we are finished. It is also fun to write because it causes us to reflect on how much this book has been the product of wonderful students, helpful colleagues, supportive spouses, tolerant friends, and patient children. For all the help and support, we are grateful.

Some people have given extraordinary help and they deserve a special thanks. For the Sixth Edition we particularly thank Laura Bartell, Evelyn Biery, Jon Eddy, Melissa Jacoby, Kenneth Kettering, Jason Kilborn, Stephen Kropp, Robert Lawless, Adam Levitin, Keith Lundin, Nathalie Martin, Gary Neustadter, Rafael Pardo, Katherine Porter, John Pottow, Marie Reilly, William Rochelle, Mark Scarberry, Steve Ware, William Woodward, and Timothy Zinneck for their comments, suggestions, corrections, and advice. The Sixth Edition is built on the hard labor from the preceding five editions, and we gratefully acknowledge help on those editions from Dick McQueen, Ray Nimmer, and Paul Razor, who taught from early versions of the text and pointed out a frightening number of errors. We owe a special debt to Alan Axelrod who taught one of us bankruptcy law, and then read and commented on early outlines and sample chapters. Barry Cass has been a special friend, teaching our classes—and us—a great deal about the tax implications in business bankruptcy. Teresa Sullivan, our sociologist coauthor on empirical research projects, has helped us develop a view of bankruptcy that looks beyond legal doctrine to difficult social and policy implementation issues. Our colleague Doug Laycock has given the best kind of support—always willing to argue a point, challenge a premise, and enjoy a new insight.

Douglas Whaley and Lynn LoPucki have been both tough and generous in their comments from the first wrinkled photocopies of cases to the completion of this Sixth Edition. We are grateful to them both.

We have been blessed with intelligent, dedicated research assistants. For the Sixth Edition we had the able help of Erin Murdock and David Park of the University of Texas Law School. On earlier editions we also had great help—from the University of Texas, Karen Cheyney, Brian Farney, Jonathan Hammer, Bruce James, Catherine Nicholson, and Kimberly Winick—and from Harvard University, Bruce Gottlieb, Dirk Suringa, Derrick Talerico, and Anthony Tu. The students in our classes have remained unfailingly cheerful—even enthusiastic—about helping us with the book, and many of the successful problems and comments in the following pages

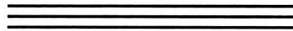
stem from interesting discussions with them. One former student who is now a valued colleague, Ronald Mann, provided a particularly helpful critique early on.

Our editor, Matthew Seccombe, has been nothing short of miraculous. Not everyone could dive into a book as full of complex statutory references and technically exacting problems as this one, but Matt has done so on multiple editions of this book, pulling it off with grace and wit. He has brought a level of professionalism to his editing work that leaves us with deepest respect for a fellow professional. We have had excellent technical support from Dee Wellborn. We have also shared in the blessings of the Tarlton Law Library and its talented staff.

Finally, thanks to our friends and families who patiently listened to alternative versions of how to teach section 1111(b) elections and the merits of learning voidable preferences in a business rather than a consumer context. Polly Westbrook actually read the book and still smiled. Bruce Mann gave more loving support than anyone could reasonably ask. We are richly blessed.

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SPECIAL NOTICE

The problems in this book are filled with debtors, creditors, lawyers, trustees, and others who are the products of our imaginations. Any resemblance to any real person, solvent or insolvent, is purely coincidental.

We have edited cases and articles for the sake of smoother reading. Citations and footnotes have been deleted without indication. Footnotes that were not eliminated retain their original numbers; asterisks indicate editors' footnotes.

The Bankruptcy Code is referred to as "the Code," and citations to it are by section number only. "The Act" refers to the Bankruptcy Act of 1898.

Citations to various federal consumer law acts may be to the USCA or the original public law number; references are to the public law sections only because this conforms to popular usage.

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