BANKRUPTCY

CASES, PROBLEMS, AND MATERIALS

FOURTH EDITION

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PREFACE TO THE FOURTH EDITION

There have been two important developments in the world of bankruptcy since publication of the Revised Third Edition. The first is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which imposes a means test on individual debtors in bankruptcy and tinkers with the rules that govern small business debtors. The second development is not new bankruptcy law, but a significant change in bankruptcy practice. In recent years, the secured creditor has increasingly come to dominate the Chapter 11 reorganization process, usurping the traditional role of prebankruptcy management as the debtor in possession. These developments, along with some important recent cases, are the main subjects of the material added in this edition. Nevertheless, bankruptcy remains a domain with coherent principles that unite it. Focusing on these principles should prepare you for whatever you encounter, regardless when or in what form new bankruptcy legislation comes to us.

We owe others a debt of gratitude for help in the preparation of this book. For his tireless research efforts getting this edition into shape for publication, we thank Scott Pearsall. For their help on this or prior editions, we are grateful to Ronald Barliant, Bernie Black, Marcus Cole, Adrian Davis, David Epstein, Bev Farrell, Larry King, Jonathan Levy, Alan Littman, John Loatman, Leslie Keros, Florencia Marotta-Wurgler, Ed Morrison, Nick Patterson, Thomas Plank, Randy Picker, Tom Planck, Eric Posner, Robert Rasmussen, Larry Ribstein, George Royal, Damian Schaible, Alan Schwartz, Alan Resnick, Omer Tene, George Triantis, Steven Walt, Elizabeth Warren, and Jennifer Weidman. We are also grateful for research support from The Sarah Scaife Foundation, The Lynde and Harry Bradley Foundation, and a New York University School of Law summer research fellowship.

B.E.A.
D.G.B
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NOTE ON CITATIONS AND CONVENTIONS

Sections of the Bankruptcy Code are cited by section number only, both in our materials and in the opinions. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 is called "the 2005 Bankruptcy Act" or simply "the 2005 Act." Unless otherwise indicated, all citations to Article 9 of the Uniform Commercial Code (or "UCC") are to the revised Article 9, which took effect in most states in July 2001. The term "Bankruptcy Code" or "Code" refers to the current code as enacted in 1978 and as amended thereafter. (The law applicable before 1978 is called "the 1898 Act.") The numbering of some Bankruptcy Code sections or subdivisions has changed over time as a result of amendments. When older cases cite provisions that have not relevantly changed, we have indicated the citation to the current version of the Code in brackets. Generally, ellipses are used to indicate deletion of material within a paragraph, while deletion of material through the end of a paragraph or at the beginning, or more, is indicated by three asterisks. Citations and footnotes are omitted without indication. The original footnote numbering in cases is retained.

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Part One

DEBT AND THE NEED FOR BANKRUPTCY LAW

Extensions of credit help both debtor and creditor. Individuals depend on credit to finance their educations, buy their homes, and organize their lives. Business ventures need capital, and often it makes sense for an investor to make a loan rather than participate in the profits and losses as an equity holder. Loans to individuals and firms typically leave everyone better off. The creditors recover their principal with interest. The individual's life is improved, and the firm participates in a vibrant market economy.

The overwhelming majority of loans to individuals and firms are repaid in full. Social norms and other pressures lead many to repay their loans even in the absence of law. Nevertheless, a creditor's willingness to make loans depends in significant measure on that creditor's ability to call upon the state for help if a debtor does not pay what is owed.

Legal rules governing the collection of debts are in the background of every credit transaction. Much turns on how well crafted those rules are. If they are cumbersome and ineffective, creditors will be more reluctant to lend and debtors will find it harder and more expensive to borrow. On the other hand, if these rules allow creditors to behave in a way that is arbitrary and capricious, people as well as firms will be less likely to borrow. Potential creditors, like potential borrowers, will again be worse off.

Creditors have many remedies they can invoke individually. In addition to these tools that each creditor has at its disposal, our legal system also offers creditors as a group a debt collection remedy. This alternative avenue of debt collection comes into play when a bankruptcy petition is filed either by a group of creditors or by the debtor. The procedural and substantive rules of bankruptcy are the subject of this book.

Because bankruptcy law is only one of the two ways that our legal system adjudicates the rights of debtor and creditor, we must understand the other way to put bankruptcy law in its proper

perspective. It is to that subject that we turn in our first chapter. We begin with a simple case in which an unpaid supplier calls on nonbankruptcy rules to recover what it is owed. We then ask how a creditor changes its position under nonbankruptcy law when it takes collateral. With these background rules laid out, we turn in the next chapter to an overview of the Bankruptcy Code and the ways in which it tries to cure the deficiencies that exist under nonbankruptcy law.

As we shall see, nonbankruptcy rules suffer from two distinct problems. First, they are premised on individual creditors pursuing their own remedies. When a debtor has many creditors, the actions of each creditor often run counter to what is in the interest of creditors as a group. Bankruptcy law, in the first instance, responds to this collective action problem, a problem akin to the one that exists when individuals, pursuing their own interest, graze too many cattle in a common pasture. Solving this collective action problem gives the Bankruptcy Code much of its complexity.

Individual debt collection remedies also rest on the premise that debtors have sufficient assets to repay what they owe. Problems arise when this premise proves faulty. Debtors often fail to pay their creditors because they do not have assets sufficient to meet their obligations. Legal rules cannot create assets where none exist. One cannot get blood from a stone. Moreover, debt collection rules premised on the existence of such assets have bad (although quite different) effects on both flesh-and-blood borrowers and on corporate debtors.

In the case of individuals, the nonbankruptcy rules of debt collection, if unchecked, can ruin the life of the debtor and the lives of others. Individuals burdened with debt they cannot pay may cease to be productive members of society. Bankruptcy law ensures that creditors can reach whatever assets they could reach outside of bankruptcy and—so long as the debtor has not abused the system—bankruptcy law then extinguishes these debts and allows individual debtors to get on with their lives. Bankruptcy's fresh start for individuals is an insurance policy. As we shall see, the contours of the fresh start (knowing, for example, what sorts of misbehavior constitute abuse) have proved elusive. This insurance policy is one for which everyone pays in the form of higher interest rates and less available credit. The more generous and more available the fresh start for they who receive it, the greater the costs borne by everyone else.

Even though limited liability corporations are radically different from flesh-and-blood individuals, the rules of individual debt collec-

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tion sometimes brings unnecessary costs and complications in these cases as well, although for different reasons. First there are firms that cannot pay their creditors because they have failed in the marketplace. For these firms, the ordinary rules of debt collection often do not offer a sensible way to shut them and at the same time parcel out assets in a single forum in a way that respects the rights of different investors.

The more important problem arises when a firm could survive as a going concern if the firm had a capital structure that was consistent with its current condition. Individual rules of debt collection prevent a firm from readjusting its capital structure when its creditors are diverse. Bankruptcy gives the investors a way to act collectively. It enables investors to rearrange their rights to the firm and yet still respects the priority the investors enjoy relative to one another under nonbankruptcy law.

I. INDIVIDUAL DEBT COLLECTION OUTSIDE OF BANKRUPTCY

Like legal rules generally, the rules governing debt collection have both a procedural and a substantive component. Procedurally, these rules tell creditors *how* to enforce their claims against their debtor when the debtor cannot or will not voluntarily pay what is owed. Unless a creditor has taken a security interest—that is, unless it has contracted for collateral to secure its loan—a creditor typically has to go to court. If the creditor prevails in the lawsuit and, to use the standard legal parlance, "reduces its claim to judgment," the creditor may then call on the state to seize the debtor's assets and sell them to repay the creditor. Enforcement of the judgment may involve foreclosing on real property, physically seizing personal property, or requiring some third party (such as an employer) to pay part of what it owes the debtor directly to the creditor. The procedures vary from one jurisdiction to another, but their basic contours are the same.

These procedural rules also demarcate the substantive rights of creditors and debtors. For example, a creditor can lay claim only to a percentage of a worker's wages, and a creditor cannot reach certain types of property (such as spendthrift trusts, clothes, or tools of trade). In the case of a general partnership, creditors can look to the assets of individual partners, but in the case of a corporation, creditors can usually reach only the assets of the corporation itself, not the assets of those who own shares of stock in the corporation.

To put individual creditor rights in perspective, one needs a basic understanding of the essential differences among general creditors, lien creditors, and secured creditors. The materials in this chapter provide an overview of the rights and remedies of these creditors.

In reading these materials, two principal questions should be kept in mind. First, what rights does a particular creditor have against a debtor or the debtor's property? This question is fundamentally a two-party issue and, as such, is governed principally by general rules of contract law. Second, what rights does a particular creditor have against other *creditors* (or other claimants) to the debtor's property? This second issue is generally referred to as the "priority" question. It focuses on how one creditor gains priority over another as to a particular asset of their common debtor. One of the most important questions in bankruptcy is the extent to which these nonbankruptcy priorities should be recognized inside of bankruptcy.

A. THE RIGHTS OF GENERAL CREDITORS

We start by examining the rights and remedies of a garden-variety creditor. The details of the debt collection process vary, but the basic steps are relatively constant across time and place. Although we shall examine a fairly simple transaction, most of the following discussion applies equally to larger and more complex arrangements. Involuntary creditors, such as tort victims, must follow much the same procedures. Perhaps surprisingly, they enjoy no priority over other kinds of creditors.

Supplier sells suits to local clothing stores, requiring its customers to pay within thirty days of delivery. Supplier discovers that one store, Retailer, has not paid for suits delivered more than sixty days before. Supplier sends Retailer another bill. When this tactic fails, Supplier turns to other nonjudicial remedies. Supplier refuses to ship any more suits. It can also plead with Retailer, or, if Supplier is careful, threaten a lawsuit. Supplier can also "discount" its claim (sell at something less than face amount) to a collection agency that will do the same things as Supplier, but perhaps more effectively. (In that case, of course, the inquiry of creditors' remedies simply shifts from Supplier to a third party.) Supplier might also put pressure on Retailer by reporting Retailer's name to a credit bureau.

These remedies are not trivial. Without new inventory, Retailer will lose customers. Supplier's actions may also destroy Retailer's ability to get credit in the future. But these steps do not always lead to payment. Retailer, for example, may claim that Supplier has delivered defective goods or is otherwise in breach of its obligations. More likely, Retailer lacks the money needed to pay Supplier and its other creditors in full. Retailer may play for time by repaying only the creditors it needs to stay in business.

If these alternatives fail (or if Supplier simply chooses not to use them), Supplier must turn to the judicial process. As an unsecured creditor, Supplier is not permitted, without the actual consent of Retailer (or its agent), to take back the suits from Retailer's store or, indeed, to take any other property of Retailer (such as shirts or overcoats of roughly equivalent value). Self-help remedies are not available to unsecured creditors. (Secured creditors have some ability to engage in self-help. We examine these later in this chapter.)

At this point, obtaining the right to reach Retailer's assets is not Supplier's only worry. Supplier also wants to be sure that its right enjoys priority over those of Retailer's other creditors. Priority against other creditors matters whenever a debtor lacks sufficient assets to pay everyone in full. Outside of bankruptcy, obtaining payment is the best way to ensure priority. Supplier, however, can also use the legal process to establish its priority against other unpaid creditors.

At the early stages of its lawsuit, before Supplier has proven its case, Supplier may be able to take advantage of a "prejudgment" or provisional remedy. These take different forms. Supplier, for example, might be able to have a notice filed in the real estate records or in the records in which security interests in personal property are filed. Alternatively, it might be able to have the sheriff seize (or "attach") some of Retailer's physical assets. These provisional remedies ensure that assets will be available to Supplier if it prevails in the litigation. Once these steps are taken, they establish Supplier's priority over Retailer's other creditors.

Prejudgment remedies, however, are not freely available, and a series of Supreme Court cases in the early 1970s placed significant limits on the ability of an unsecured creditor to reach property of its debtor without first providing some sort of notice and holding a hearing before a judicial officer. See North Georgia Finishing, Inc. v. Di-Chem, Inc., 419 U.S. 601 (1975); Mitchell v. W.T. Grant Co., 416 U.S. 600 (1974); Fuentes v. Shevin, 407 U.S. 67 (1972). Supplier is most likely able to use prejudgment remedies if there is some danger that the debtor will abscond with the assets or might otherwise dissipate them over the course of the litigation. To use a prejudgment remedy, Supplier also may have to post a bond to cover any damages Retailer might suffer if Supplier's action later proves unsuccessful.

If no prejudgment remedies are available, Supplier must win its lawsuit both to establish its priority over other creditors and to obtain Retailer's property. If Supplier wins, the court will issue a "judgment." Even if Retailer does not appear, Supplier can still vindicate its claim and receive a "default judgment," which is as effective as any other judgment so long as Supplier follows the proper procedures. Debtors most commonly fail to contest actions brought against them in consumer finance transactions.

Judgments normally resemble the following:

> It is ordered and adjudged that Plaintiff recover $500 from Defendant and that Plaintiff have execution therefor.

The judgment is then "docketed," which means it is recorded on a "judgment roll." What happens next turns on the kind of property that Retailer owns. The most basic distinction is between land (real property) and other kinds (personal property). There is also an intermediate category called "fixtures." Fixtures are goods such as large pieces of machinery that are bolted to the factory floor. They are so much a part of the building that they are treated as real property, even though they once were personal property and might be again. The transfer of ownership of real property requires more formalities than the transfer of ownership of personal property. To buy land and have rights against the world, one usually must record one's interest in the public records. By contrast, one typically obtains title to personal property simply by taking physical possession of it. (When the property is in possession of a third party, notification to the third party substitutes for physical possession.) These different rules governing the transfer of ownership in turn affect the way in which a creditor reaches these assets after reducing its claim to judgment.

In most states, a judgment alone establishes a lien (called, not surprisingly, a "judgment lien") on a debtor's real property, including fixtures. In many states, the docketing must be in the county where the property is located. Hence, in these jurisdictions, a judgment rendered in one county must be docketed in all other counties in which the debtor has real property in order for the judgment to cover that property. Once a judgment has been entered, however, docketing is a ministerial act (at least within the jurisdiction of the court issuing the judgment).

A judgment lien does not usually give the creditor a right to immediate possession of the debtor's real property. Often, a judgment lien merely encumbers the property in the creditor's favor—it establishes the creditor's place in line and fixes rights against third parties (including buyers and competing creditors). What the lien gives Supplier is a *right* to go after the property and priority over all those who acquire later liens or who acquire the property after the lien arises. The moment at which Supplier becomes a lien creditor matters tremendously for bankruptcy as well.

Let us now consider how Supplier reaches Retailer's personal property, such as the suits Supplier sold to Retailer, other items of Retailer's inventory, or the equipment in the store. In virtually every jurisdiction, to reach personal property, Supplier would have to do more than simply ensure that its judgment was entered on the docket roll. The docketing of the judgment only gives Supplier the right to obtain

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