RED & BLACK

The Debtor/Creditor Relationship

by BARBARA E. KIRBY

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THE DEBTOR/CREDITOR RELATIONSHIP

by

Barbara E. Kirby, Esq.

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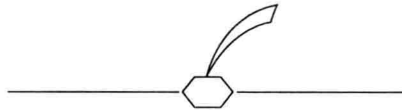

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"True ease in writing comes from art, not chance,
As those move easiest who have learned to dance." Alexander Pope

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Barbara Kirby

DEDICATION

This book is lovingly dedicated to three people whose constant support has been the foundation of my success as an attorney, an author, and a human being. I owe them a debt that I can never adequately repay:

Jane D. Kirby, my mother;
Sid Burall, my husband; and
Chuck Corrigan, my paralegal.

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PREFACE

An Overview of the Debtor/Creditor Relationship

Many view the areas of bankruptcy and the debtor-creditor relationship as specialized practices. Actually, these are areas of law that touch a variety of people on an individual basis. As Polonius advised Laertes, "Neither a borrower nor a lender be." (*Hamlet*, Act I, Scene iii) This is difficult advice to follow in the modern age. Upon reaching college age, the average person cannot avoid becoming a debtor. We all hope, someday, to become creditors. The debtor-creditor relationship will be an important one for every person who becomes an active participant in the free market economy.

There are numerous contexts in which knowledge of the debtor-creditor relationship ranges from useful to absolutely necessary. Most of an attorney's clients are participating in the mainstream of business and commerce. Many paralegals will seek employment in this mainstream. Knowledge of the various bodies of law that govern the debtor-creditor relationship creates a level of understanding of the ground rules under which clients operate, regardless of the type of legal problem presented. In addition, many jobs involving credit management, collection of accounts receivable, and bankruptcy coordination and management are available in corporations.

In the legal context, a basic understanding of debtor-creditor issues is essential in order to effectively assist clients. These clients may be consumers who, due to some catastrophic illness or disaster, are unable to pay their bills, or large corporations seeking counsel regarding customers who have not paid for goods or services. Even if you never counsel a client regarding payment or collection of money, the knowledge contained in this text will be useful in every area of legal practice. How can this be so? If you handle only plaintiff's personal injury cases, and you obtain a judgment for your client, it has absolutely no tangible value unless it can be converted to cash. In this book, you will learn which assets are protected from collection efforts of creditors, and the procedures you can use to get assets out of the hands of debtors, both before and after final judgment.

Often paralegals find lucrative jobs as law office managers or administrators. You may find that, as the only paralegal in a small office, day-to-day management chores may fall into your lap. Remember (and lawyers often do not) that the practice of law is also a business. Someone has to assure that accounts are paid and that any disputes that may exist regarding those accounts are resolved. This book will give you some of the tools needed to collect accounts in a manner that is sensitive to clients and customers, and also in compliance with state and federal laws that govern debt collection.

An additional incentive for study of the debtor-creditor relationship exists on a very personal level. As individual participants in a free-market economy, we are all at some point debtors, creditors, or both. It is important to know your rights as they relate to the extension of credit and the collection of payments, as well as potential remedies should it be necessary to proceed from an individual basis to collect a debt. There are numerous consumer protection statutes that apply to each of us as we utilize credit to purchase goods and services for our personal, family and household purposes.

Finally, although this is not intended to be a comprehensive text on bankruptcy law, you will find some basic information regarding the ability of debtors to obtain a "fresh start" through the different chapters of the Bankruptcy Code. The main purpose of this book is to give a basic understanding of the laws that apply to debtors and creditors, as a foundation to unraveling the intricacies of the bankruptcy process. Many texts concentrate solely on the bankruptcy process. Unfortunately, students often do not have the basic knowledge of the legal relationships that existed long before the bankruptcy proceeding was filed. It is much like skipping to calculus when you have not mastered basic mathematics. I hope this book lays a foundation that lessens the anxiety that may be encountered upon delving into a more substantive study of bankruptcy law and procedure.

Barbara Kirby

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Chapter One

KEY CONCEPTS

A Basic Vocabulary

A **debtor** is a person who owes a debt that is due or will become due. A **creditor** is a person who has a legal right to fulfillment of a debt or obligation. A **debt** is a specific sum of money owed or an obligation to pay, owed by one person to another. The term "person" in these definitions is meant in the strict legal sense, such that it includes not only individual beings, but also the business entities recognized as having a separate legal existence (corporations, limited partnerships, etc.).

How Debts Arise

There are basically four ways that debts arise:

1. ***By contract***. Basic business law tells us that a contract exists with the presence of offer, acceptance, and consideration. Most debts, whether business or consumer, arise by this type of agreement. Automobile loans, promissory notes and equipment leases all are examples of debts that exist due to a contractual relationship. Another common way that debts arise through contract is by way of the revolving credit card. When someone initially receives a credit card, one may neglect to read the terms and conditions that arrive along with the card. Perhaps this document is hidden among numerous product advertisements, or smells too much like strong perfume to read in its entirety. What the reader would discover is that, each time you sign a credit card receipt, you are agreeing to be bound by the terms and conditions, and any changes and alterations to them, that the company may issue. The debts on a credit card thus arise by way of a contract.

An important fact to remember – a verbal contract is still a contract, provided that all three elements (offer, acceptance, consideration) exist. For example, if Bud offers to mow your lawn for twenty dollars, you accept this proposal, and Bud actually completes the job, a debt will

arise due to the verbal contract, with Bud as the creditor and you as the debtor.

2. ***By quasicontract***. There are those circumstances where all elements of a contract do not exist, but the equitable powers of the law may deem that a debt arises in order to avoid the unjust enrichment of one of the parties. For example, an attorney is at home in the middle of a day, perhaps toying with the idea of working from a "virtual office." A crew of painters arrive, and begin painting the house. The attorney knows that the neighbors were planning to have their house painted, and it appears that a mistake is being made. However, the attorney chooses to do nothing to stop the painters. When the project is completed and the painters demand payment, the attorney informs them that it was a mistake and that payment will not be forthcoming. This may be a circumstance where the painters wish to test the equitable theory of quasicontract. Because the attorney was aware that the services were being performed, a reasonable court might determine that unjust enrichment occurred. The court would determine a fair sum of money to compensate the painters.

A slight change in the scenario may change the outcome. Suppose that no one is at home. The painters begin their work on the wrong house, and the resident arrives home, aghast at the hideous shade the house has been painted. The resident meets the presentation of the bill by the painters with a refusal to bear the cost of their mistake, and demands a return of the house to its former pleasant tone. The court in this circumstance may not find that the resident was unjustly enriched, and may instead require the painters to take some action to remedy the situation.

A party attempting to enforce a debt through quasicontract will be seeking an equitable remedy. When litigants resort to theories in equity, no black and white outcomes can be predicted. As much as students may want to know exactly what would happen under both of the above scenarios, it is still only a guess as to how a "reasonably prudent judge" would rule.

3. ***By tort***. The law of torts is the area of law involving private wrongs (as opposed to the public wrongs addressed by criminal law)

other than breach of contract. Debts can arise due to the negligence or malfeasance of another, and the sum due from the tortfeasor debtor to the victim creditor may be determined by the court, by mediators, or even by agreement of the parties with the assistance of their insurance carriers. Some examples of torts from which debts may arise include medical and legal malpractice, personal injury, product liability, and defamation.

Consider the circumstances surrounding a minor automobile accident. Jane is driving down a neighborhood street when Chuck ignores a stop sign and runs into Jane's car. There is significant damage to Jane's car. Either by admission or through litigation, Chuck is determined to be at fault. A debt arises that Chuck owes to Jane in the amount determined necessary to compensate Jane for the damages to her car.

4. ***By statute.*** The final category under which debts arise is the mechanism by which various governmental entities become the creditor, and citizens under various statutory schemes are the debtors. Just as citizens receive goods and services from governments, there are also statutory schemes that fund the provision of these services. The classic example is the Internal Revenue Code, under which each U.S. citizen determines how much is owed in taxes on income. The statutes also give the government creditor the tools to pursue the citizen debtor for nonpayment. There are also certain penalties assessed in various statutory schemes (such as fines for violation of environmental codes, housing codes, etc.) that will also give rise to the existence of a debtor-creditor relationship between a government and its citizens.

Suppose that the Springfield Nuclear Power Plant is caught dumping toxic waste into the river. The federal statutes regulating discharge of waste into waterways provides a penalty to be assessed for violation of the statute and, after the proper administrative procedures are followed, the fine that is assessed against the power plant is a debt owed to the federal government, arising by way of statute.

Liquidated vs. Unliquidated Debts

A concept worth noting while dissecting the existence of debt is the distinction between a liquidated and an unliquidated debt. A **liquidated**

debt is one in which the amount of money due can be calculated as a sum certain. This calculation may come from the face of an agreement, such as a promissory note. For example, if a debtor stopped making payments on an automobile loan, it would not be long before the bank or financing institution contacted the debtor with the news that the note will soon be accelerated (a concept that will be explored more thoroughly later). It will be a simple matter to look at the loan documents, and follow the mathematical formula for determining precisely how much is owed on the defaulted loan, and it will be a sum certain. A liquidated debt does not require a written contract - it can also be the sum of outstanding unpaid invoices for goods received. The requirement is that some method or documentation exists from which the sum certain can be determined.

Contrast this concept with its opposite, the **unliquidated debt**. It is one in which the amount due cannot be calculated as a sum certain, but instead a trier of fact must be engaged or an agreement reached as to the total amount due. Debts that arise by tort are classic unliquidated debts. No written agreement or formula exists to tell how much a broken leg is worth, or how much the reputation of a libel victim has been damaged. You may be able to look at the damage estimate provided after an automobile accident, but numerous and different estimates of the same damage can easily be obtained.

You will often see documents that contain a combination of liquidated and unliquidated debt. A promissory note may contain precise language for calculation of the sums due in case of default, but the note may also contain a provision for "reasonable attorney's fees." If enforcement of this note is required through litigation, it may be possible to prove up the liquidated debt through documents and affidavits. However, a live witness will have to testify about what amount of attorney's fees are reasonable for similar cases in that jurisdiction.

Secured Transactions

This is the first time in this text that the concept of a security interest will be discussed. Rest assured, it will not be the last. What is the difference between secured and unsecured debt? A **security interest**, as

defined in the Uniform Commercial Code (UCC),[1] is "an interest in personal property or fixtures that secures payment or performance of an obligation." UCC Section 1-201(37). This interest is granted in the **security agreement**, signed by both the debtor and creditor. The property that is subject to the security interest is known as the **collateral**. State and federal laws recognize two basic types of creditors - secured and unsecured. The **secured creditor** is one who has an interest or security in collateral. For the secured creditor, there is the comfort of knowing that, if the debtor defaults, there is some property available to satisfy the debt.

The methods by which the secured creditor can obtain possession of its collateral are initially quicker and simpler than filing suit. For example, a bank that finances an automobile in which it retains a security interest can seek to repossess the car without judicial intervention, as long as there is no "breach of the peace." On the other hand, the unsecured creditor is forced to file a lawsuit, obtain a judgment against the debtor, and execute the judgment before there will even be an opportunity to satisfy its debt through seizure of personal property of the debtor.

If the debtor files bankruptcy, the differences become even more dramatic. For example, small businesses typically obtain their initial financing by borrowing money from a bank, which takes a security interest in virtually all of the property in which the debtor has an interest. If the business fails and files bankruptcy, this bank will have priority in its collateral. The unsecured creditors of this small business will have to take a place at the end of the line, awaiting distribution of the debtor's assets to the bank and any other secured creditors according to their priority. The unsecured creditors will then share pro rata in whatever pittance remains. The various laws regarding security interests will be discussed in greater detail in later chapters.

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[1] The Uniform Commercial Code is a set of uniform laws covering all of the phases that ordinarily arise in a commercial transaction, from start to finish. The UCC has been adopted, with some alternative language or provisions, in all fifty states, as the principal laws governing the sale of and payment for goods.

What is a Lien?

A **lien** is a charge on property that must be satisfied before the property or its proceeds are available for the satisfaction of the debts of general creditors. These charges on property take many forms and are found in a multitude of transactions. The lienholder does not have the right to take action against the property until an act of default occurs, but the lien does prevent the debtor from disposing of the property without first satisfying the interests of any lienholders.

There are three basic types of liens:

1. A **consensual lien**, as the name implies, is a lien that arises by the consent of the parties. It is granted by the debtor for the benefit of the creditor. Without a consensual lien in either real or personal property, the motivation is low for a bank, lending institution or financing organization to extend any significant amount of credit to a debtor. The classic example of a consensual lien is the security interest granted in personal property, such as the lien a bank or financing institution obtains when you borrow money to buy an automobile. In the automobile loan, the buyer signs a security agreement, in which the bank is granted a security interest in the automobile. Should the buyer fail to make the payments on time, the bank will have the right to obtain possession of its collateral – the car.

A lien on real property is generally created through a mortgage or a deed of trust, and will be governed by the code or statute of the state in which the real property is located. The typical deed of trust grants a lien on the described real property, outlines the rights, duties and obligations of the parties, names a trustee, and contains a power of sale clause. Through this power of sale, the trustee can conduct a nonjudicial foreclosure sale without resorting to the courts. As different collection methods are discussed later in this text, it will become apparent that this is a powerful tool for creditors. However, because this is not a book on real estate law, it will not dwell on the intricacies of drafting these documents or enforcing liens on real property.

2. A **statutory lien** is a creature of statute and, as such, is heavily procedural. The purpose of a statutory lien is to provide protection for

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