**CHAPTER 13 – CREDIT, SURETYSHIP, AND BANKRUPTCY**

**A. Chapter Introduction**

Chapter 13 introduces the subjects of credit, suretyship, and bankruptcy. Topics include different types of credit, such as unsecured and secured credit, suretyship, and the common chapters of the Bankruptcy Code.

After completion of this chapter, students should be able to:

* Distinguish between unsecured and secured debt.
* Describe the scope of Article 9 of the UCC.
* Define and distinguish between surety and guaranty contracts.
* Describe the procedure for filing for bankruptcy.
* Define fresh start and the discharge of unpaid debts.
* Describe a Chapter 7 liquidation bankruptcy.
* Identify voidable transfers in bankruptcy.
* Define secured and unsecured creditors’ rights in bankruptcy.
* Describe how a business is reorganized in Chapter 11 bankruptcy.
* Describe a Chapter 13 consumer debt adjustment bankruptcy.

B. Instructional Ideas

1. Explain the difference and significance between unsecured credit and secured credit. Ask the class for examples of unsecured and secured credit.

2. Discuss the factors that make someone creditworthy. If you have access to the Internet in class, you might want to access fico.com or other credit score-related web sites and show the class what lenders are concerned about when considering extending credit.

3. Explain the process of obtaining a mortgage, and who the parties to a mortgage are.

4. Explain the process of foreclosure. Pull your jurisdiction’s statute or rule of court on foreclosure, and show the class what must be done before a creditor can foreclose on the debtor’s property.

5. Explain what liens are. This can be a difficult thing for many to grasp, particularly with material person’s liens.

6. Discuss security interests in personal property and the concept of perfecting a security interest by the filing of a financing statement, as opposed to perfecting a security interest by possession of the collateral.

7. Explain the difference between a surety and a guaranty arrangement. Use similar fact-patterns involving third-party involvement in someone’s debt, and ask the class to determine whether the examples involve a surety or guaranty.

8. Explain the main features of a Chapter 7 bankruptcy proceeding. Ask the class if anyone has been involved in a Chapter 7 or knows someone who was. If so, ask the student to discuss his or her impressions of being in bankruptcy.

9. Explain how a Chapter 13 is different from a Chapter 7 bankruptcy. Ask the students for their thoughts on why someone might choose to file a Chapter 13 instead of a Chapter 7, and vice versa.

10. Gather information on Mike Tyson’s bankruptcy to discuss not only Chapter 11 bankruptcies, but the larger issue of whether it is too easy to file bankruptcy. You might want to discuss some of the key proposals that have been kicked around in Congress for years that would change present bankruptcy law. Some of those proposals would make it more difficult to file and refile bankruptcy.

**C. Video Recommendation(s)**

Insight Media has a four-volume video series entitled, “How Cases Move Through the Bankruptcy Courts.” The set-up for the series is a hypothetical department store filing bankruptcy. Included in the videos is a look at Chapters 7 and 11 bankruptcies.

If this class is taught in the fall semester, one might consider showing *It’s a Wonderful Life*. In addition to being beloved, the movie concerns debt collection between Potter and George Bailey.

**D. Chapter Outline**

**I. Types of Credit**

A. **Unsecured Credit**: Credit that does not require any security (collateral) to protect the payment of the loan.

**Recovery of unpaid loan**. If the debtor does not pay the loan, the creditor may bring a legal action and obtain a judgment against the debtor. The debtor is called judgment-proof if he or she has no money to pay the judgment.

B. **Secured Credit**: Credit that requires security (collateral) that secures the payment of the loan.

**Collateral**. The property that is pledged as security for the loan.

**II. Security Interests in Real Property**

A. **Mortgage**

1. **Mortgage**. The instrument that represents a security interest in real property.

2. **Mortgagor**. The owner-debtor who pledges his or her real property as security for a loan.

3. **Mortgagee**. The creditor who holds a security interest in the owner-debtor’s real property.

B. **Note and Deed of Trust**: Some states use a note and deed of trust as an alternative to a mortgage.

1. **Note**. The instrument that evidences the debt.

2. **Deed of trust**. The instrument that gives the creditor a security interest in the owner-debtor’s real property.

C. **Recording Statutes**: Permits copies of deeds and other documents concerning interests in real property (*e.g.*, mortgages, liens) to be filed in government offices where they become public record. Puts third parties on notice of recorded interests.

D. **Foreclosure**: Method whereby if a mortgagor defaults on the payment on a mortgage, the mortgagee can declare the entire debt due and proceed to acquire title to the property that is collateral for the loan.

E. **Deficiency Judgment**: If after foreclosure of the property, there is a deficiency owing, the mortgagee can sue the mortgagor to recover the amount of the deficiency.

F. **Antideficiency Statute**: Some states have enacted an antideficiency statute that prohibits a mortgagee from recovering a deficiency owed on a loan.

G. **Material Person’s Lien**: Lien that is given by law to contractors and laborers on real property on which they made improvements until the amount they are owed is paid.

**III. Security Interests in Personal Property**

A. **Article 9 of the UCC**: An article of the Uniform Commercial Code that governs secured transactions in personal property.

B. **Secured Transaction**: Transactions that are created when a creditor makes a loan to a debtor in exchange for the debtor’s pledge of personal property as security.

1. **Two-party secured transaction**. Where a seller sells goods to a buyer on credit and retains a security interest in the goods.

2. **Three-party secured transaction**. Where a seller sells goods to a buyer who has obtained financing from a third-party lender (*e.g.*, bank) who takes a security interest in the goods sold.

C. **Requirements for Creating a Security Interest**:

1. **Requirements**: a written security agreement.

D. **Perfection of a Security Interest**: Establishes the right of the secured creditor against other creditors who claim an interest in the collateral. The UCC provides the following methods of perfecting a security interest.

1. **Perfection by filing a financing statement**. The creditor files a financing statement with the appropriate government recording office. This statement puts the world on notice of the creditor’s security interest in the property. This method is the most common form of perfecting a security interest.

2. **Perfection by possession of collateral**. If the creditor has physical possession of the collateral, no financing statement has to be filed. This method is the least common form of perfecting a security interest.

**IV. Surety and Guaranty Arrangements**

A. **Surety and Guaranty Arrangements**: Occur when a creditor refuses to extend credit to a debtor without further security and a third person agrees to provide that security by agreeing to become liable on the debt.

B. **Surety Arrangement**: A third party—called the surety or codebtor—promises to be liable for another person’s debt. The surety is primarily liable for payment of the debt when it is due, along with the principal debtor. The creditor does not have to attempt to collect the debt from the principal debtor before demanding payment from the surety.

C. **Guaranty Arrangement**: A third party—called the guarantor—agrees to pay the debt of the principal debtor if the debtor defaults and does not pay the debt when it is due. The guarantor is secondarily liable and has to pay the debt only if the creditor has attempted unsuccessfully to collect the debt from the debtor.

**V. Federal Bankruptcy Law**

A. **Bankruptcy**:

1. **Bankruptcy Reform Act of 1978, as amended**. Federal statute that establishes the requirement and procedures for filing bankruptcy. Called the Bankruptcy Code.

2. **Bankruptcy courts**: Have exclusive jurisdiction to hear bankruptcy cases. A bankruptcy court is attached to each federal district court. Bankruptcy judges are appointed for 14-year terms.

B. **The “Fresh Start”**: The purpose of a bankruptcy is to discharge the debtor from burdensome debts.

**VI. Chapter 7 Liquidation Bankruptcy**

A. **Chapter 7 Bankruptcy**: The debtor’s nonexempt property is sold for cash, the cash is distributed to the creditors, and any unpaid debts are discharged. Also called liquidation bankruptcy.

B. **Bankruptcy Procedure**:

1. **Filing a petition**. The filing of a petition commences a bankruptcy case.

a. **Voluntary petition**. Filed by the debtor.

b. **Involuntary petition**. Filed by a creditor or creditors.

C. **Automatic Stay**: The filing of a bankruptcy petition stays (suspends) certain legal actions against the debtor or the debtor’s property.

**Relief from Stay**. A secured creditor may petition the court for a relief from stay in situations involving depreciating assets and the creditor is not adequately protected during the bankruptcy proceeding.

D. **Property of the Bankruptcy Estate**: The bankruptcy estate includes:

1. All the debtor’s legal and equitable interests in real, personal, tangible, and intangible property at the time the petition is filed.

2. Gifts, inheritances, life insurance proceeds, and property from divorce settlements that the debtor is entitled to receive within 180 days after the petition is filed.

E. **Exempt Property**: The Bankruptcy Code permits the debtor to retain certain property that does not become part of the bankruptcy estate. Exemptions are stipulated in federal and state law.

F. **Voidable Transfers**: The following transfers and preferences are voidable by the trustee:

1. **Preferential transfer to an insider within one year before bankruptcy**. The transferee must be an “insider” (*e.g.*, relative, business associate) and the creditor insolvent.

2. **Preferential liens within 90 days before bankruptcy**. Transfer must be for an antecedent debt. The creditor must receive more because of this lien than he or she would as an unsecured creditor in bankruptcy.

G. **Priority of Distribution**: Nonexempt property of the bankruptcy estate is distributed to the creditors in the following statutory priority:

1. **Secured creditors**. A secured creditor either obtains the collateral, or the collateral is sold and the secured creditor is paid. If the value of the collateral exceeds the secured interest, the excess becomes available to pay other creditors. If the value of the collateral is less than the secured interest, the secured creditor becomes an unsecured creditor to the difference.

2. **Unsecured creditors**. Unsecured creditors are paid in priority established by the Bankruptcy Code. Each class must be paid in full before any lower class is paid anything. If a class cannot be paid in full, the claims of that class are paid *pro rata* (proportionately).

H. **Discharge**: After the nonexempt property is distributed, the remaining unpaid claims of the debtor are discharged, and the debtor’s legal obligation to pay these unpaid debts is terminated. Discharge is available only to individuals.

I. **Discharge of Student Loans**: A student loan may be discharged after it is due only if nondischarge would cause an undue hardship on the debtor or his or her family.

**VII. Chapter 13 Consumer Debt Adjustment**

A. **Chapter 13 Consumer Debt Adjustment**: A rehabilitation form of bankruptcy that permits bankruptcy courts to supervise the debtor’s plan for the repayment of unpaid debts by installment. Called consumer debt adjustment or Chapter 13 bankruptcy.

B. **The Plan of Payment**: The debtor must file a plan of payment. The plan period cannot exceed three years unless the court approves a longer period (of up to five years). A plan may be modified if the debtor’s circumstances materially change. A permanent trustee will be appointed by the court. The debtor makes payments to the trustee, who is responsible for remitting payments to the creditors.

C. **Discharge**: The court will grant an order discharging the debtor from all unpaid debts covered by the plan only after all the payments required under the plan are completed.

**Hardship discharge**: The court can grant the debtor a hardship discharge even if the debtor does not complete the payments called for by the plan if (1) the failure to make the payments was caused by an unforeseeable circumstance, (2) the creditors have been paid as much as they would have been paid in a Chapter 7 liquidation proceeding, and (3) it is not practical to modify the plan.

**VIII. Chapter 11 Reorganization Bankruptcy**

A. **Chapter 11 Reorganization Bankruptcy**: Provides a method for reorganizing the debtor’s financial affairs under the supervision of the bankruptcy court.

B. **Plan of Reorganization**: Sets forth the debtor’s proposed new capital structure. The debtor has the exclusive right to file a plan within the first 120 days after the date of the order for relief.

C. **Executory Contracts**: The debtor-in-possession (or trustee) may assume or reject executory contracts. A special procedure has been established for rejecting union collective bargaining agreements.

D. **Confirmation of a Plan**: A plan of reorganization must be confirmed by the bankruptcy court before it becomes effective.

**E. Critical Legal Thinking Questions**

**1. What is the difference between secured credit and unsecured credit? As a creditor, which is preferable?**

 The difference is that collateral (the debtor’s property) is put at risk in order to obtain secured credit. As a creditor, being secured is preferable to being unsecured because of the extra protection and priority status provided.

**2. Describe a mortgage and the parties to a mortgage. Describe a note and deed of trust and the parties to a note and deed of trust.**

 A mortgage is the arrangement where an owner of real property who borrows money from a creditor may use this interest as collateral for repayment of the loan. The owner-debtor is the mortgagor, and the creditor is the mortgagee. Some states provide for the use of a deed of trust and note instead of a mortgage. The note is the instrument that evidences the borrower’s debt; the deed of trust is the instrument that gives the creditor a security interest in the debtor’s property that is pledged as collateral.

**3. What is a recording statute? What protections does a recording statute provide?**

 A recording statute requires that the mortgage or deed of trust be recorded in the county recorder’s office of the county in which the real property is located. This record gives potential lenders or purchasers of real property the ability to determine whether there are any existing liens (mortgages) on the real property.

**4. Describe Article 9 of the Uniform Commercial Code. What is a secured transaction? What is a financing statement?**

 Article 9 of the UCC governs secured transactions in personal property. Article 9 has been adopted in one form or another by all states except Louisiana. Although there may be some variance between the states, most of the basics of Article 9 are the same. A secured transaction occurs when a creditor extends credit to a debtor and takes a security interest in some personal property of the debtor. A financing statement perfects the creditor’s security interest and is filed in the appropriate government office. It serves as constructive notice to the world that the creditor is claiming an interest in the debtor’s property.

**5. Describe the difference between a surety arrangement and a guaranty arrangement.**

 In a surety arrangement, the surety or codebtor is primarily liable on the debt. In a guaranty arrangement, the guarantor agrees to pay the debt of the principal debtor if the debtor defaults. This makes the guaranty secondarily liable.

**6. What does the bankruptcy doctrine of “fresh start” provide? What public policy is served by bankruptcy laws?**

 The primary purpose of federal bankruptcy law is to provide the debtor a fresh start by discharging the debtor from burdensome debts. The public policy served by bankruptcy laws is that giving debtors a fresh start, debtors can start over and lead productive financial lives. By placing creditors in classes of priority, creditors can have some fair method of collecting on the debts.

**7. Describe Chapter 7 liquidation bankruptcy. What is the property of the bankruptcy estate?**

 Chapter 7 is the most familiar form of bankruptcy where the debtor’s nonexempt property is sold for cash, the cash is distributed to the creditors, and any unpaid debts are discharged. The bankruptcy estate includes all the debtor’s legal and equitable interests in real, personal, tangible, and intangible property, wherever located, that exist when the petition is filed. The debtor’s separate and community property are included in the estate.

**8. Describe the concept of discharge. Is any party hurt by a bankruptcy discharge?**

 After the property is distributed to satisfy the allowed claims, the remaining unpaid claims are discharged, which means the debtor is no longer legally responsible for them. Only individuals may be granted a discharge. A debtor can be granted a discharge in a Chapter 7 proceeding only once every six years. Creditors are hurt by the debtor’s discharge because they will lose most, and sometimes all, of the credit they extended.

**9. Describe Chapter 13 consumer debt adjustment bankruptcy. When is discharge granted?**

 Chapter 13 is a rehabilitation form of bankruptcy for natural persons and permits the court to supervise the debtor’s plan for the payment of unpaid debts by installments. Chapter 13 is limited to individuals with regular income and unsecured and/or secured debt under the debt limits. Upon filing, the debtor submits a repayment plan to the court that runs from three to five years and calls for the debtor to make planned installment payments to the trustee within 30 days after the plan is filed. The court will grant an order discharging the debtor from all unpaid debts covered by the plan after all the payments required under the plan are completed.

**10. Describe Chapter 11 reorganization bankruptcy. What does a plan of reorganization do?**

 Chapter 11 provides a method for reorganizing the debtor’s financial affairs under the supervision of the bankruptcy court. Its goal is to reorganize the debtor with a new capital structure so that it will emerge from bankruptcy as a viable concern. Chapter 11 is available to individuals, partnerships, corporations, unincorporated associations and railroads. The majority of Chapter 11 petitions are filed by corporations. The debtor then submits a plan or reorganization with the bankruptcy court. After that, any party of interest may propose a plan. The plan sets forth the debtor’s proposed new capital structure, including designating the different classes of claims and interest. The reorganization plan must be confirmed by the court before it becomes effective. The purpose of Chapter 11 bankruptcy is to allow the business to shed debt, rid itself of bad contracts or obligations, reorganize its capital structure, and then continue as a going concern.

**F. Cases for Discussion**

***In re Greenbelt Cooperative, Inc.***, 124 Bankr. 465 (1991), concerned the voidability of a lien placed on forklifts leased to Greenbelt Cooperative, a retail furniture business that did business under the trade name SCAN, a fact well known to consumers. A month after leasing the forklifts to Greenbelt, Raymond Leasing Corp., the lessor, filed a financing statement in the correct place, listing “Scan Furniture” as the debtor. Over a year later, Greenbelt filed for bankruptcy, and the bankruptcy trustee moved to avoid Raymond’s security interest in the equipment because the legal name of the debtor (Greenbelt) wasn’t listed on the financing statement. The bankruptcy court agreed with the trustee, concluding that a financing statement should list the legal name of the debtor or a name substantially similar to the legal name, so that it would not mislead a reasonably diligent creditor searching the financing records. A creditor should only be required to search under the legal name of a debtor obtain notice of a security interest or to be put on notice to inquire further. Therefore, the court voided Raymond’s lien on the equipment.

QUESTIONS

1. *Should creditors searching financing records be required to search for financing statements filed under the debtor’s trade names as well as its legal name?*

 This is an opinion question, focusing on the issue of how much time a creditor must spend investigating financing statements before extending credit. If Greenbelt is known as SCAN, filing the financing statement under that name might actually make sense, except the law prefers the debtor’s legal name.

2. *Did the bankruptcy trustee act ethically in avoiding the secured creditor’s security interest?*

 Considering that this equipment lease was a sale masquerading as a lease (buyout for $1.00), and considering the trustee’s job includes securing the bankruptcy estate and voiding whatever liens the trustee can, one could conclude that the trustee’s actions were ethical.

3. *Was the filing of the financing statement under the wrong name an error that could have easily been prevented?*

 It seems like it could have been easily prevented by using both names in the financing statement.

***In re Witwer***, 148 Bankr. 930 (1992), concerned the exemption of a retirement plan worth $1.8 million of an incorporated medical practice filing Chapter 7 bankruptcy. By the time Dr. Witwer filed bankruptcy for his medical practice, he had quite a retirement plan, which was exempt from the bankruptcy estate by California law. Several creditors filed objections to this, but the bankruptcy court held that regardless of the seemingly inequitable result, the statute on exemptions was clear. The entire retirement plan was exempt from being used for the creditors’ claims because it was a legitimate retirement plan.

QUESTIONS

1. *Do you think bankruptcy law was intended to reach the result in this case?*

 Well, as the court alluded, if this is an unfair result, it is because the debtor lobby did a better job in the California legislature than the creditor lobby.

2. *Was it ethical for the debtor to declare bankruptcy and wipe out his unsecured creditors while retaining $1.8 million in his retirement account?*

 Is it ethical that a debtor can use the bankruptcy laws to walk away, occasionally scot free, from his or her prior agreed obligations to creditors? If the law allows something to be done, then the ethics of doing that which is allowed becomes moot, doesn’t it? But, it makes for a good discussion.

3. *Should businesspeople establish and fund retirement programs?*

 Why shouldn’t they?

**13.1**

***S&D Petroleum Company, Inc. v. Tamsett***¸ 534 N.Y.S.2d 800 (N.Y.Sup.Ct.App. 1988), concerned the failure of Mr. Tamsett to file a financing statement for S&D, who loaned nearly $20,000 to C&H Trucking. The security interest was to be a 1984 Mack truck. Tamsett prepared a security agreement stating that the Mack truck also secured any debt, direct or indirect, that C&H would owe to S&D. C&H became insolvent, and the Mack truck was sold after the original debt was repaid. However, C&H incurred new debt to S&D before becoming insolvent.

ISSUE: *Does S&D have a security interest in the Mack truck? Is Tamsett liable to S&D?*

No, S&D has no security interest in the Mack truck Yes, Tamsett is liable to S&D because his legal malpractice was the proximate cause of plaintiff’s damages.

**13.2**

***In re Tabala***, 11 B.R. 405 (Bk.S.D.N.Y. 1981), concerned Tabala’s conveyance of the house he and his wife owned to his three daughters, ages 9, 19, and 20, for no money, about two-and-a-half years before filing a Chapter 7 bankruptcy. Four years earlier, Tabala and his wife purchased a Carvel ice cream business for $70,000 with a loan from a bank, and Carvel extended trade credit to the Tabalas. By the time of the conveyance, the Tabalas owed more than $100,000 to creditors. The bankruptcy trustee moved to set aside the Tabalas’ conveyance as a fraudulent transfer.

ISSUE: *Who wins?*

The trustee wins. The court concluded that the Tabalas’ transfer of their home to their daughters without consideration and while they were indebted was presumptively made while they were insolvent, and therefore a fraudulent transfer, regardless of actual intent.

**13.3**

***In re Jet Florida System, Inc.***, 105 B.R. 137 (Bk.S.D.Fla. 1989), concerned Air Florida’s Chapter 11 bankruptcy filing. Within 90 days of filing Air Florida paid more than $13,000 to COPA in payment of an antecedent debt, which enabled COPA to receive more than it would have received if Air Florida were liquidated under Chapter 7.

ISSUE: *Is the payment to COPA an avoidable preferential transfer?*

Yes. The payment was made within 90 days of the filing, and while Air Florida was insolvent, resulting in COPA receiving more than it would have under the Chapter 7.

**13.4**

***Forsyth County Memorial Hospital Authority, Inc v. Sales***, 346 S.E.2d 212 (N.C.App. 1986), concerned whether the sister of a patient in the Forsyth hospital was obligated to pay the bill when the patient didn’t. Ms. Sales signed the admission form for her sister Ms. Lynch, the patient, and the form stated that the undersigned was obligated to pay the charges incurred.

ISSUE: *Is Sales liable? Did Sales act ethically in denying liability? Did she have a choice when she signed the contract?*

Sales is liable as a guarantor because she signed the hospital admission agreement, which bound her as a guarantor. Whether Sales acted ethically is an opinion question, and less important than whether she had a choice when she signed the contract. The court, however, said nothing about the admission form being an adhesion contract.

**G. Case for Briefing**

**1. Case Name**

*Dewsnup v. Timm*, 116 L.Ed.2d 903 (1992)

**2. Key Facts**

A. In 1979, the Dewsnups borrowed $119,000 from the Timms, accompanied by a deed of trust granting a lien on two parcels of Utah farmland owned by the Dewsnups.

B. The Dewsnups defaulted the following year, and two years later the Timms issued a notice of default.

C. Before the Timms could have the properties sold at a foreclosure sale, the Dewsnups filed a Chapter 7 bankruptcy.

D. The bankruptcy court determined the value of the properties to be less than the value of the loan.

E. Because of this, the Dewsnups attempted to use sections 506(a) and 506(d) to reduce, or “strip down,” the lien to the value of the properties securing the lien.

**3. Issue**

 May a Chapter 7 debtor use § 506 of the Bankruptcy Code to reduce the value of a secured claim to the present value of the collateral, when the collateral is worth less by the time of the bankruptcy proceeding than it was when the property was collateralized?

**4. Holding**

 The U.S. Supreme Court held that the creditor’s lien stays with the property until the foreclosure and can’t be reduced because the property’s value has shrunk below the value of the loan.

**5. Court’s Reasoning**

A. If the Dewsnups’ argument was to win here, the practical effect would be to freeze the creditor’s secured interest at the judicially determined valuation. As such, the creditor would lose the benefit of any increase in the value of the property by the time of the foreclosure sale.

B. The Court reasoned that the creditor’s lien stays with the real property until the foreclosure.

C. If this were not so, unsecured creditors would be in a better position than secured creditors.