Chapter 16

**Creditors’ Rights**

**and Bankruptcy**

Answers to Learning Objectives/

Learning Objectives Check Questions

at the Beginning and the End of the Chapter

**Note that your students can find the answers to the even-numbered *Learning Objectives Check* questions in Appendix E at the end of the text. We repeat these answers here as a convenience to you.**

**1A.** ***What is required to create a security interest?*** The three requirements that must be met to create an enforceable security interest are as follows.

**1.** Either the collateral must be in the possession of the secured party in ac­cordance with an agreement, or there must be a written or authenticated se­curity agreement that describes the collateral subject to the security interest and is signed or authenticated by the debtor.

**2.** The secured party must give to the debtor something of value.

**3.** The debtor must have “rights” in the collateral.

**2A.** ***How does a mechanic’s lien assist creditors?*** When a creditor follows the individual state’s procedure to create a mechanics lien, the debtor’s real estate becomes security for the debt. If the debtor continues not to pay the underlying debt, the creditor can foreclose on the debtor’s real property to collect the amount due.

**3A.** ***What are three ways for a debtor to avoid mortgage foreclosure?***A debtor can avoid mortgage foreclosure by means of forbearance, workout, and short sale. A forbearance is a postponement of part or all of the payments on a loan for a limited time. A workout agreement is a contract that describes the respective rights and responsibilities of the borrower and the lender as they try to resolve the default. A short sale is a sale of the property for less than the balance due on the mortgage loan.

**4A.** ***In a Chapter 7 bankruptcy, what happens if a court finds that there was “substantial abuse”? How is the means test used?*** If a court concludes there was substantial abuse, the court can dismiss a petition or convert it from a Chapter 7 to a Chapter 11 or 13 case. In the means test, the debtor’s average monthly income in recent months is compared with the median income in the geographic area in which the person lives. If the debtor’s income is below the median income, the debtor usually is allowed to file for Chapter 7 bankruptcy. If the debtor’s income is above the median income, then further calculations are necessary to determine if there is substantial abuse. The goal is to determine whether the person will have sufficient disposable income in the future to repay at least some of his or her unsecured debts.

**5A.** ***What constitutes a preference in bankruptcy law? When is a trustee able to avoid preferential transfers?*** A preference is a property transfer or a payment that favors (gives a preference to) one creditor over others. A trustee is allowed to recover payments made both voluntarily and involuntarily to one creditor in preference over another. To be recoverable, generally an insolvent debtor must have transferred property for a preexisting debt during the ninety days before the filing of the petition in bankruptcy. (If it is outside of the ninety day period, the trustee must prove that the debtor was insolvent at the time of the transfer.) Also, the transfer must be made in exchange for something other than current consideration to be avoidable as a preference.

Answer to Critical Thinking Question

**in the Feature**

**Linking Business Law to Corporate Management—Critical Thinking**

***Filing for bankruptcy under Chapter 11 may involve a time-consuming process. How might this affect the likeli­hood that a firm will be able to negotiate a workout agreement with its creditors?*** Negotiating workouts with creditors can avoid costly Chapter 11 pro­ceedings for debtors and creditors. More time to complete the proceedings may motivate a firm to consult with creditors in advance, and to have an acceptable Chapter 11 plan prepared before filing to expedite bankruptcy proceedings and save on costs.

Answers to Critical Thinking Questions

in the Cases

**Case 16.1—Critical Thinking— Ethical Consideration**

***Under the circumstances, is it ethical for GRB to enforce its security interest in the ring to recover the unpaid amount of the price? Discuss.*** Yes, under the circumstances, it is ethical for GRB to enforce its security interest in the ring to recover the unpaid amount of the price. Steven granted a valid security interest in the ring to Royal and the ring had not been fully paid for. With his consent, Royal assigned the security interest to GRB. Therefore, GRB had a valid and enforceable security interest in the ring. Presumably, the creditor has employees, investors, or others to whom it must account for its practices. It would be unethical for the company to forego collecting debts and risk failing to meet its obligations to its stakeholders.

No, under the circumstances, it is *not* ethical for GRB to enforce its security interest in the ring to recover the unpaid amount of the price. GRB may have a valid and enforceable security interest in the ring, but the value of the ring to Sheila may have been greater than its economic worth. Given Steven’s death before their promised marriage, the ring may have had considerable sentimental value. GRB might have been able to recapture its investment in the security interest by negotiating repayment terms with Steven’s estate.

**Case 16.2—Critical Thinking—Legal Consideration**

***If Chase cannot prove that it owned the note at the time of its complaint, what will happen next? Will Chase prevail? Why or why not?*** If Chase cannot prove that it owned the note as of May 11, 2009, the trial court will dismiss the complaint. Chase would then file another complaint. If it attaches the indorsed note, Chase will be entitled to enforce it at the time of the new com­plaint. Thus, Chase would have standing to foreclose and would probably receive judgment against McLean.

**Case 16.3—Critical Thinking—Economic Consideration**

***Why would a debtor risk the denial of a discharge to conceal assets? Discuss.*** A debtor might risk the denial of a discharge in a bankruptcy case to conceal assets so as to avoid their application to the payment of debt. Or a debtor might conceal an asset in order to, as in this case, use the asset as part of a post-petition “fresh start.” A bankruptcy discharge can have long-lasting repercussions on a debtor’s credit—it can affect the amount of funds available to do business, or to make personal purchases, and the conditions under which those funds are made available.

Answers to Questions in the Reviewing Feature

at the End of the Chapter

**1A.** ***Prior to filing***

Janet must receive credit counseling from an approved nonprofit agency. Under the BAPCPA, all debtors must receive credit counseling from an approved non­profit agency within the 180-day period preceding the date of filing a petition in bankruptcy. Therefore, before Janet can file her petition, she needs to attend ei­ther an individual or group briefing from an approved credit-counseling agency.

**2A.** ***Deadline to submit***

Janet has 45 days unless she is granted an extension of up to 45 additional days. If she misses the deadline, her case will be dismissed.

**3A.** ***Steps to “substantial abuse”***

To determine whether Janet’s petition is presumed to be “substantial abuse,” the court would calculate Janet’s average monthly income in recent months and compare it with the median income in the geographic area in which she lives.  If Janet’s yearly income is below the median income, then there is no presumption of abuse and she will be allowed to file for Chapter 7 bankruptcy. If Janet’s average monthly income is above the median, then the court will engage in further calculations to determine her future disposable income and whether she can afford to repay some of her unsecured debts.

**4A.** ***Ability to pay***

If a court found that Janet had an ability to pay a portion of her deceased hus­band’s medical bills, a court would convert her bankruptcy case to a Chapter 13, individual repayment plan.

Answer to Debate This Question in the Reviewing Feature

at the End of the Chapter

***Rather than being allowed to file Chapter 7 bankruptcy petitions, individuals and couples should always be forced to make an effort to pay off their debts through Chapter 13.*** Every time consumers deprive credi­tors of repayment by successfully obtaining Chapter 7 protection, the creditors’ costs rise.  Consequently, all business that extend credit must raise the interest rates they charge to all borrowers to cover these increased costs.  Therefore, al­lowing consumers to simply walk away from bone fide debts imposes extra bur­dens on all other borrowers.

Not all borrowers default on their debt repayments just because they bor­rowed “too” much.  Sometimes, unplanned events occur, such as illness, infirmity, and protracted unemployment.  It would not only be unfair, but unrealistic to think that everyone could repay even part of what was owned through use of a Chapter 13 plan.  No one wants Chapter 7 to be abused, but means testing at least partially takes care of the problem of abuse in filing Chapter 7 plans.

Answers to Issue Spotters

at the End of the Chapter

**1A.** ***Jorge contracts with Midwest Roofing to fix his roof. Jorge pays half of the contract price in advance. Midwest complete the job, but Jorge refuses to pay the rest of the price. What can Midwest do?*** Each of the parties can place a me­chanic’s lien on the debtor’s prop­erty. If the debtor does not pay what is owed, the prop­erty can be sold to satisfy the debt. The only requirements are that the lien be filed within a specific time from the time of the work, depending on the state statute, and notice of the foreclo­sure and sale must be given to the debtor in ad­vance.

**2A. *After graduating from college, Tina works briefly as a salesperson before filing for bankruptcy. As part of her petition, Tina reveals her only debts are student loans, taxes accruing within the last year, and a claim against her based on her misuse of funds during her employment. Are these debts dischargeable in bankruptcy? Explain.*** No. Besides the claims listed in this problem, the debts that cannot be discharged in bankruptcy include amounts borrowed to pay back taxes, goods obtained by fraud, debts that were not listed in the petition, domestic support obligations, certain cash ad­vances, and others.

Answers to Questions and Case Problems

**at the End of the Chapter**

**Business Scenarios and Case Problems**

**16–1A . *Voluntary versus involuntary bank­ruptcy***

**1.** Any person, including a rancher or farmer, can voluntarily petition himself or herself into bankruptcy. The person has only to be a debtor. This in­cludes partnerships and corporations that are liable on a claim held by a creditor, as well as individuals. The debtor does not have to be insolvent to file a petition. Under the Code, a debtor is presumed to be insolvent when his or her debts exceed the fair market value of nonexempt assets. Thus, even though Burke owns a $500,000 ranch and has debts of only $70,000, she can voluntarily petition herself into bankruptcy.

**2.** Neither Oman nor Sneed—nor any combination of Burke’s credi­tors—can involuntarily petition Burke into bankruptcy. The Code provides that involuntary bankruptcy proceedings cannot be commenced against a farmer. The definition of a *farmer* includes a person who receives 50 percent of her or his gross income from farming operations, such as tilling the soil, ranching, or the produc­tion or raising of crops or livestock. Because Burke obviously fits the definition of a farmer, no creditor can force her into bankruptcy.

**16-2A. *Distribution of property***

The Bankruptcy Code establishes a payment priority of claims from the debtor’s estate. Each class of debt in this priority list must be fully paid before the next class in priority is entitled to any of the proceeds. If insufficient funds remain to pay an entire class, the proceeds are distributed on a *pro rata* basis to each cred­itor within that class. The order of priority for claims listed in this problem is as follows:

**1.** $ 500—Administrative bankruptcy costs (Dietrich).

**2.** $ 2,000—Claims for back wages (Elmer), limited to $2,000 per claimant, provided the wages were earned within ninety days of the petition.

**3.** $ 1,000—Taxes and penalties due and owing (Rock County).

**4.** $10,000—General creditors:

Carlton $ 2,500

Elmer $ 2,500 (balance of wages owed)

United Bank $ 5,000

$10,000

Because the amount remaining is only $1,500, these creditors share on a *pro rata* basis. For example, for United Bank it is:

5,000

––––––– x $1,500 = $750

10,000

**16–3A. Business Case Problem with Sample Answer—*Automatic stay***

Gholston can recover damages because EZ Auto willfully violated the automatic stay. EZ Auto repossessed the car even though it received notice of the automatic stay from the bankruptcy court. Moreover, EZ Auto retained the car even after it was reminded of the stay by Gholston’s attorney. Thus, EZ Auto knew about the automatic stay and violated it intentionally. Because Gholston suffered direct damages as a result, she can recover from EZ Auto.

**16–4A. *Guaranty***

No, Martinez’s argument that the bank could not enforce his guaranty while other funds were available to satisfy K&V's debt—for example, that the debt might be paid out of the proceeds of a sale of corporate assets—is not an effective defense to the guaranty in the *Community* case. The guaranty contract terms determine the extent and time of the guarantor’s liability. Thus, a defense such as Martinez asserted might be defeated by the language of the guaranty—for example, it might state or indicate that payment is “unconditionally guaranteed” or that the creditor “is not required to seek payment of the principal’s debt from any other source to enforce the guaranty.”

In this problem, Timothy Martinez, owner of Koenig & Vits, Inc. (K&V), guaranteed the firm’s debt to Community Bank & Trust. WhenK&V defaulted, the bank sought payment of the debt from Martinez. Martinez made the argument stated above. But the guaranty expressly stated that the bank was not required to seek payment of the debt from any other source before enforcing the guaranty. This language is sufficient to support the rejection of Martinez’s argument.

In the actual case on which this problem is based, in the bank’s suit in a Wisconsin state court against Martinez to recover the amount of the debt, the court ruled in the bank’s favor. A state intermediate appellate court affirmed. “The terms of the guaranty compel us to reject all permutations of this argument. \*  \*  \* It is no defense to the guaranty that other funds may be available [now or] in the future to be applied to the bank's debt.”

**16–5A. *Discharge***

No, Michael is not entitled to a discharge of the debt to Dianne of half of the amount in the investment accounts or the unpaid alimony and child support. The debt qualifies as an exception to discharge. As far as a debtor is concerned, the primary purpose of a liquidation proceeding is to obtain a fresh start through a discharge of debts. But certain debts are not dischargeable in bankruptcy. Claims that are not dischargeable in bankruptcy include domestic-support obligations and property settlements provided for in a divorce decree and claims based on willful or malicious conduct by the debtor toward another.

In this problem, on Michael and Dianne’s divorce, a court ordered Michael to pay alimony and child support and to tender half of the couple’s $184,000 in their investment accounts to Dianne. Michael did not comply with this order, but withdrew half of the investment funds and spent them on himself. Meanwhile, the court repeatedly held him in contempt for failing to pay Dianne alimony, child support, and half of the investment funds. These items are nondischargeable because they are domestic-support obligations and part of the property settlement provided for in the parties’ divorce decree. The unpaid investment funds also constitute a claim based on Michael’s willful and malicious conduct towards Dianne. Michael deliberately defied multiple contempt orders to leave Dianne uncompensated, thereby certain to inflict harm on her.

In the actual case on which this problem is based, the court concluded that Michael's conduct was willful and malicious and that therefore the debt to Dianne listed in the petition’s schedule was nondischargeable. On Michael’s appeal, the U.S. Court of Appeals for the Fifth Circuit affirmed.

**16–6A. *Liens***

Among the liens discussed in this chapter, a mechanic’s lien would likely be most effective to Jirak in its attempt to collect the unpaid cost of its work for the Balks. A creditor can place a mechanic’s lien on the real property of a debtor who has contracted for improvements to the property and has not paid the price. When a creditor obtains a mechanic’s lien, the debtor’s real estate becomes security for the debt. If the debtor does not pay, the creditor can foreclose on the property and sell it to collect the amount due.

In this problem, the Balks contracted with Jirak for the remodel of their farmhouse. Due to the Balks’ changes to the project during the course of the work, the costs exceeded the amount of Jirak’s original estimate.AlthoughJirak regularly advised the Balks about the increasing costs and provided an itemized breakdown at their request, they refused to pay the price. Jirak can make most effective use of a mechanic’s lien to collect the unpaid amount.

In the actual case on which this problem is based, Jirak filed a suit in an Iowa state court against the Balks to foreclose on their property by way of a mechanic’s lien and collect the unpaid amount. The court entered a judgment in Jirak’s favor and enforced the lien. A state intermediate appellate court affirmed the judgment.

**16–7A. *Discharge under Chapter 13***

No, Thomas’s mortgage and lien debts are not dischargeable in a Chapter 13 bankruptcy case. Domestic-support obligations, such as child support and alimony, are excepted from the automatic stay provision and from discharge under most, if not all, circumstances on a bankruptcy petition, including one filed under Chapter 13. And claims for domestic-support obligations have the highest priority among unsecured claims, so these debts must be paid first.

Here, when Clark and Thomas divorced, the decree gave Clark custody of their children, required Clark to pay their first mortgage, required Thomas and Clark to make equal payments on a second mortgage, and provided that Clark would receive all proceeds on the sale of the home. Thomas failed to make any payments, and Clark sold the home. She then learned that Auto Now had a lien on the home because Thomas had not made payments on his car. Clark used all the sale proceeds to pay off the lien and the mortgages. When Thomas filed a petition for a Chapter 13 bankruptcy, Clark filed a proof of claim to collect on the mortgage and lien debts. These debts could be construed as non-dischargeable domestic-support obligations. At the time of the divorce, the parties and the court most likely intended the mortgage debt to serve as a support obligation and in fact the debt actually provided support.

In the actual case on which this problem is based, Thomas filed a petition for a Chapter 13 bankruptcy in a federal bankruptcy court. Clark filed a proof of claim for the mortgage and lien debts. Over Thomas’s objection, the court ruled that the debts were non-dischargeable domestic-support obligations. The U.S. Court of Appeals for the Sixth Circuit affirmed this ruling.

**16–8A . A Question of Ethics—*Guaranty contracts***

**1.** Both at trial and on appeal, the triers of fact were not convinced of Li’s ar­guments. Li held out Zhang as her manager and as a person authorized to bind the ten­ant to the lease.

**2.** The reviewing court did agree with Li that there was no proof that she signed the guarantee agreement. In other words, her allegation that, because there was no evidence that she signed the guarantee agreement, the agreement was unenforceable against her because of the Statute of Frauds. A guarantee is similar to a suretyship and is a contract in which a party, sometimes referred to as a secondary obligor, “contracts to fulfill an obligation upon the default of the principle obligor.” Because there was no evidence that Li signed in a personal ca­pacity as a guarantor to the lease, the appellate court did not hold her liable. She had claimed that the personal guarantee had been signed by someone else. The plaintiff /lessor did not present any evidence to prove otherwise.

**Critical Thinking and Writing Assignments**

**16–9A . Business Law Writing**

**1.** A creditor can place a mechanic’s lien on real property when a person contracts for labor, services, or material to be furnished for the purpose of mak­ing improvements on the property but does not immediately pay for the im­provements.

**2.** With an artisan’s lien, a creditor can recover payment from a debtor for labor and materials furnished in the repair of personal property. The lien­holder must have possession of the property and have agreed to pro­vide the ser­vices on a cash, not a credit, basis. The lien terminates once pos­session is sur­ren­dered—unless the surrender is temporary, in which case there must be an agree­ment that the property will be returned to the lien­holder. If a third party obtains rights in the property while it is out of the pos­session of the lien­holder, the lien is lost. The only way that a lienholder can protect a lien and surrender possession at the same time is to record notice of the lien.

**3.** Attachment is a court-ordered seizure and taking into custody of property for a past-due debt before the securing of a judgment (either at the time of or immediately after the commencement of a lawsuit and before the entry of a final judgment). To use attachment as a remedy, the creditor must have an en­forceable right to payment and must follow certain procedures.

**16–10A. Business Law Critical Thinking Group Assignment**

**1.** Debtors who seek Chapter 13 relief commit to a three-to five-year period of repayment, after which their remaining debts are discharged. Unlike Chapter 7 debtors, who are entitled to a discharge of debt as soon as their estate is liquidated and distributed, Chapter 13 debtors are not entitled to a discharge of debts unless and until they com­plete payments to creditors under the repayment plan.

**2.** Student loans are excepted from discharge unless the debtor can show “undue hardship.”

**3.** A fundamental goal of bank­ruptcy is to protect the debtor by giving him or her a fresh start free from debt. It could be argued that a debtor who is burdened by student loans will not emerge from bankruptcy with a “fresh start” if the debt is not discharged. According to the facts in the question, Coleman is less than one year into a five-year plan. She would not nor­mally be entitled to a discharge of any of her debts until she completed the plan and of course would not be entitled to discharge her student loans unless she could show “un­due hardship.” Here, the hardship to Coleman arguably consists of the commitment of five years of disposable income to payments without any guarantee that the student loans will be discharged at the end of the period. This suggests that the court might at least agree to a discharge of the student loan debt on the completion of the plan.