BANKRUPTCY
IN A NUTSHELL®

TENTH EDITION

DAVID G. EPSTEIN
George E. Allen Chair Professor of Law
University of Richmond
Richmond, Virginia

CHAPTER II
AN OVERVIEW OF JUDICIAL COLLECTION LAW

A. WHAT CAN CREDITORS DO OUTSIDE OF BANKRUPTCY?

Creditors are generally happy to do nothing. More specifically, creditors are happy to do nothing so long as their debtors are paying them.

When debtors default in paying, creditors will first attempt through "persuasion" to get the debtor to pay "voluntarily." The creditor may even hire a collection agency or attorney to help persuade the debtor. If these nonjudicial collection efforts are unsuccessful, the creditor can resort to the debt collection remedies provided by either (i) creditors' judicial remedies or (ii) the creditor's contract to seize and sell the debtor's assets to satisfy the debt.

1. FORMS OF CREDITORS' JUDICIAL REMEDIES

Let's consider the law of creditors' judicial remedies first. At the broadest level, the law of creditors' judicial remedies involves only three questions: (1) when and how does a creditor gets a lien on property of the debtor, (2) how does a creditor with a lien enforce the lien so as to collect its debt and (3) what is the lien's priority in relation to third parties' rights to the property, including other creditors' liens and the claims of transferees. These

three issues are common to every kind of creditors' remedy.

Why the focus on "liens"? A creditor cannot seize and sell its debtor's property unless it has some property interest in the debtor's property, and the principal way to obtain such an interest is to obtain a "lien" on that property.

Say for example that *C* claims that *D* owes $1,000. *C* can't simply come over to *D*'s apartment and take *D*'s stuff. *C* needs to establish a legal right to be paid $1,000. *C* needs to establish a legal right to *D's* property. *C* needs to obtain a judgment and an execution lien.

This example illustrates the two most important general rules of the law of creditors' remedies: (1) generally a creditor is not able to obtain a lien in the debtor's property until the creditor reduces its claim to judgment[1] and (2) a creditor enforces this judgment through the appropriate postjudgment judicial process.

You should now be asking the questions why is action beyond a judgment necessary. The answer is that a judgment is no more than another form of debt.

A judgment does, however, differ from the original debt in that a judgment is the State's recognition of

[1] There is a very narrow exception to the general rule that a creditor cannot obtain a judicial lien until it has obtained a judgment. In a narrow group of situations, a creditor can obtain a prejudgment "attachment lien." Because of due process concerns, attachment liens do not often occur in practice (and will not occur on your exam.)

the legitimacy of the creditor's claim against the debtor. Along with this recognition a willingness by the state to use its coercive power to enforce this lien and otherwise collect the amount of the judgment forcibly from the debtor's property (both real and personal) if the judgment debtor does not pay "voluntarily."

a. Judgment Liens

But first the judgment creditor must obtain a lien. A judgment creditor can obtain a lien on the debtor's real property by "docketing" (i.e., recording) the judgment in the real property record system in the county in which the real property is located. Such a lien is called a "judgment lien."

A "judgment lien" is one form of a "judicial lien." A "judicial lien" is a lien obtained through litigation—through the creditor's use of the judicial process. A "judgment lien" is thus a judicial lien on the debtor's real property.

b. Execution Liens

A judicial lien on a debtor's personal property is called an "execution lien." Obtaining an execution lien on a debtor's personal property is a bit more complicated than obtaining a judgment lien on a debtor's real property.

A creditor with a judgment initiates the execution process by applying to the court that rendered the judgment (or sometimes a different court depending on where the debtor's property is located) for a *writ*

of execution, sometimes referred to as a writ of *Fieri Facias* ("FiFa" because lawyers like to use words that most people don't understand). The writ of execution is typically directed to the sheriff of the county where the property is located. The writ orders the sheriff to seize specified property of the debtor located within the county, sell it, and apply the proceeds in satisfaction of the judgment, after payment of the sheriff's costs. The process varies a bit from state to state,[2] but this is the general pattern.

With a judgment lien on real property or execution lien on personal property, an attorney for a judgment creditor can cause state officials to seize and sell a judgment debtor's property that is encumbered by the judicial lien.

c. Garnishment Liens

To reach a debtor's tangible property held by third persons, and to collect from third parties amounts owed the debtor, there is a special proceeding at law in the nature of an adversary suit against the person who holds the debtor's property or who owes the debtor money. This process is called *garnishment*.

Garnishment is in essence a special form of execution designed for reaching property of the debtor held by a third party The court orders the third party (called the garnishee) to turn over the property, or pay the judgment creditor the amount that the garnishee owed to the debtor.

[2] For example, in a few states a lien against personal property arises simply by a central filing of the judgment.

The most common example of garnishment is garnishment of bank accounts. When a creditor tries to collect its judgment against the debtor from funds in the debtor's bank account, it seeks to obtain property of the debtor held by a third person, in this case the bank. In this context, the proper terminology regarding what occurs when, for example, the IRS tries to seize a bank account of delinquent taxpayer, is that the IRS is garnishing the bank account and the bank is the "garnishee."

In addition to bank accounts, a judgment creditor might also seek to garnish the debtor's wages by bringing a garnishment action against the debtor's employer or the cash surrender value of an insurance policy by garnishing the insurer.

2. CREDITORS' JUDICIAL REMEDIES SHORTCOMINGS

If you understood what you just read (and more especially if you did not understand what you just read), then you will understand why

- Most lawyers do not like to do debt collection work.
- Most creditors do not like to pay for this kind of legal work.
- Most law professors do not like to teach judicial collection law.

Happily, judicial collection law has become less important in practice and less important in law school. There are three reasons for this change:

(1) The most important reason for the diminished role of judicial collection law in practice and in law school is the increased role of bankruptcy in practice and in the classroom. Businesses and individuals are more willing to file for bankruptcy. And, as we will see, the filing of a bankruptcy petition not only bars a creditor from continuing its efforts to collect its debt using judicial collection remedies but also can require a creditor who has successfully collected its debt using judicial collection remedies to return what it has collected.

(2) Obtaining a judgment and getting a sheriff to seize and sell property of a debtor can be difficult, time consuming and expensive.

(3) Obtaining a judgment and getting a sheriff to seize and sell property of a debtor is often unsuccessful as a way of collecting a debt. There is no guarantee that the judgment debtor will have property that can be seized and sold, or that the property will be in the place that the judgment creditor told the sheriff to go look.

And, even if the judgment debtor has property, that property may be encumbered by other creditors' liens that have priority. These other liens may have been created because of (i) a prior judicial collection effort, or (ii) statute, or (iii) agreement.

3. STATUTORY LIENS AND LIENS CREATED BY AGREEMENT

Tax liens, mechanics' liens and landlords' liens are examples of statutory liens. These are liens that arise by operation of law-arise if the debtor fails to pay a debt protected by the statute.

While statutory liens are important, consensual liens are the most common liens. Most debt deals which are large enough to involve lawyers also involve consensual liens.

A big part of bankruptcy practice and a big part of law school bankruptcy courses deals with consensual liens and so a big part of this book deals with consensual liens, For now, you need to understand that: (1) by contract, a creditor can obtain property rights in addition to the rights available to a creditor under generally available state creditors' remedies law; (2) these rights, i.e., these consensual liens, have the effect of limiting the rights of other creditors under creditors' remedies law; and (3) these consensual liens are property rights and so enjoy the constitutional protection afforded to property rights (you know, due process, no takings, and all that Fifth Amendment stuff on your Con Law test). In essence, a creditor with a consensual lien (or any lien for that matter) really has two claims: (1) an *in personam* (or contract) claim against the debtor based on the promise or obligation to pay, and (2) an *in rem* (or property) claim against the collateral.

State law controls the creation and effect of consensual liens. State law tends to categorize the

types of consensual liens by the type of property involved. The two basic types of property in this regard are real property (that is, dirt and things built on and attached to the dirt) and personal property (that is, things that are not dirt or attached to dirt, both tangible (goods) and intangible (like accounts receivable)).

There are various devices for creating consensual liens on real property; i.e., the mortgage, the deed of trust, and the installment land-sale contract. When properly recorded in the local real estate records, these instruments establish the lender's *priority* in the property over other parties, such as other creditors and purchasers, that might claim an interest in the land.

When the creditor and debtor create a consensual lien on personal property or fixtures, the governing law is Uniform Commercial Code, Article 9. All 50 states have adopted Article 9 (yes, *even* Louisiana). Article 9 provides for only one kind of consensual lien on personal property, the "Article 9 security interest."

"Security interest" is Article 9's term for a consensual lien on personal property. Other Article 9 terms that you will encounter in this book are "secured party" and "perfection." A "secured party" under Article 9 is a creditor with a security interest. Perfection refers to action taken by the secured party to establish the priority of its security interest over other parties with an interest in the same property, including creditors with judgment liens. Perfection is usually, but not always, accomplished by filing

what's known as a UCC financing statement in the appropriate state government office.

B. WHAT CAN A DEBTOR DO OUTSIDE OF BANKRUPTCY?

There is not much that debtor can do outside of bankruptcy to fix its debt problems. At least not much that a debtor can do without the help and support of its creditors.

1. EXEMPT PROPERTY

If the debtor is an individual (that is, a flesh and blood human), state and some nonbankruptcy federal laws exempt certain property of the debtor from the collection efforts by judgment creditors. At most, these exemption statutes enable a debtor to protect some of their property, or at least part of the value of their property, from execution by their creditors.

State exemption laws vary significantly from state to state. In most states, the amount of property that a debtor can designate as exempt, and retain free from execution, is very limited—enough to assure only a subsistence level of living for the debtor and her dependents. And, in all states, creditors with a mortgage or other lien on property that is designated as exempt are not covered by exemption law; they are themselves "exempt" from it, and therefore can still seize and sell that property free from the exemption law claim. If, for example, Bank has a mortgage on *D*'s house and *D* defaults, First Bank can seize and sell *D*'s house even if *D* has designated the house as *D*'s exempt homestead.