# Creditors' Rights

Commercial transactions class
Lecture 4.02

## Introduction

### Setting

- Creditors generally collect the debts that are owed to them
- Sometimes, however, a debtor cannot or will not pay
- The law provides means to protect the creditor’s right to payment
- Creditors have rights against third parties who provide payment assurances on behalf of the debtor

### Objective

- Today we examine the rights and remedies of creditors. After this lecture, you should be able to answer the following questions:

1. What is a lien?
2. What are two types of statutory liens?
3. What is a judicial lien?
4. What is foreclosure of a mortgage?
5. What is the difference between suretyship and guarantyship?
6. What protections does the law give to debtors?

## A creditor may seek out multiple ways to guarantee repayment of a loan

### Personal guaranties

- A creditor may agree to allow a debtor to substitute a personal guaranty instead of collateral to assure that a loan will be paid back if the debtor defaults on payment
- Creditors may wish to make the debtors more accountable by securing a business loan with both a security interest in certain collateral and a personal guaranty
- Personal guaranties may also occur in a commercial lease context

## Rights against third parties

### A creditor may also permit a debtor to secure a loan by asking a third party to back up the promises made by the debtor regarding repayment of the loan

- When a party agrees to be primarily liable (e.g., creditor doesn’t have to go after the debtor first) to pay the loan, it is known as a surety
- When a party agrees to be liable only if the debtor actually defaults, it is known as a guarantor

### Surety/guarantor agreements are a form of contract

- Sureties/guarantors are entitled to assert defenses that would relieve them of payment liability.

- The surety/guarantor not only can have defense against the creditor directly, they can assert any defenses the debtor has on the underlying contract.
- Under the statute of frauds, surety/guarantor agreements must be in writing

## Liens

### A lien is an interest in property

- A lien is a claim against a debtor's property
- A lien gives the holder of the lien the right to possession of some of the debtor's property if the debtor fails to perform its obligation (e.g., fails to pay back a loan).
- There are several types of liens

### Judicial Liens

- A judicial lien is one that arises from a judicial proceeding, most commonly a lawsuit filed by a creditor.
- A judicial lien protects the winning party in a lawsuit
- A judgment by a court is judicial recognition that the creditor is owed a certain sum of money by the debtor.

### Statutory Liens

- A statutory lien is a lien on a debtor's property authorized by a state statute or, less often, state common law.

### Mechanic's Lien

- The most common statutory liens are statutes that provide contractors and subcontractors who work on real estate an interest in the labor and materials used to improve the property

### Artisan's lien

- State statutes also offer parties that provide service and materials to repair equipment with a statutory lien of the repaired real/personal property
  - (e.g., a mechanic could get a lien on a car if a customer did not pay for the repairs)

### Consensual Liens

- A consensual lien is created when the owner of property grants a lien to a creditor.
- A consensual lien attached to personal property is called a security interest and is governed by Article 9

### Mortgages are a form of consensual lien

- A consensual lien attached to real estate that is being used to collateralize a loan allows a creditor to take an interest in the collateral
- A mortgage is a written document that specifies the parties and the real estate and is filed with a state and/or local government agency, thereby becoming a public record that gives notice to other parties that there is a lien of the property

- The creditor is the mortgagee; the borrower is the mortgagor

### Fraudulent Liens

- Many states statutes include penalties (actual and punitive damages) for creditors that file fraudulent liens.
- Fraudulent liens include a creditor filing a lien
  - for an amount that exceeds what the property owner actually owes or
  - for work that was not actually performed on the property.

## Collecting unsecured debts

### Obtaining and Enforcing a Judgment

- The process for collecting an unsecured debt begins with the plaintiff creditor filing a complaint to start the judicial process.
- Obtaining the judgment is the first step.
- A "judgment proof" defendant is one that is without any assets or one whose assets are statutorily outside the reach of the creditor.

### Garnishment

- A judgment creditor has obtained a judgment against the debtor and is now entitled to enforce the judgment
- Without any collateral, the creditor can look for other assets, such as cash, which can be reached through the process of garnishment
- A garnishment document directs a third party to pay the judgment creditor rather than the debtor
- Some states allow garnishment of wages

### Levy

- A levy is a court order that authorizes the sheriff to take possession of the defendant's (debtor's) personal property on behalf of the judgment creditor in order to preserve the property from being transferred or sold by the debtor
- If the property is real estate, the sheriff (or in some states the judgment creditor) files notice with the county recorder of deeds.
- Many states exempt real estate (up to a certain dollar value) used by the debtor as a primary residence from levy

### Discovery

- To collect the judgment, a judgment creditor is entitled to conduct discovery
- Discovery involves having the debtor testify under oath to discover
  - (1) what assets the debtor owns and
  - (2) the location of the assets

### Sale of Property

- At a sheriff's sale the sheriff can sell the levied property

- If the auction does not produce enough revenue to pay off the debt, the creditor continues to search (or wait) for assets and must levy any real property as they become known to the judgment creditor
- If the auction produces more money than is required to pay the judgment, the surplus goes to the debtor

### State Exemption Laws

- State statutes on garnishment and levy provide certain exemptions that place assets (related to the safety and well-being of the debtor) outside the reach of an unsecured judgment creditor
- The most common full exemption is the debtor’s primary residence
- State statutes provide partial exemptions (up to a certain dollar value) for items such as cars, furniture, clothing, and designated retirement funds

## Conclusion

### What did we learn today?

- A creditor may seek out multiple ways to guarantee repayment of a loan
- A lien is an interest in property
- There are legal means to collect unsecured debts