Module 2: Debtor-Creditor Relationships

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Lesson 2-1: Bank Financing: Sureties & Guarantors

Lesson 2-1.1: Bank Financing: Sureties & Guarantors

In this lesson, we're going to talk about sureties and guarantors. These are people who agree to be liable for a debt in the event that the primary debtor refuses to pay or is unable to pay. So, we're going to learn about what sureties and guarantors are and some of their rights and liabilities. This lesson is the first in a module where we're going to be discussing debtor-creditor relationships. Now, there's a lot of ways for a business to raise money when it needs to expand or invest in capital, but in this module we care about instances in which a business borrows money, that's the essence of a debtor-creditor relationship, the borrowing of money. So, we're not going to be talking about selling stock or things like that, that's for another module. In this lesson, we're going to talk about sureties and guarantors.

Sureties & Guarantors

How do you convince a bank to lend you money?

Now, before we get into the definition of sureties and guarantors, let's take a step back and talk about, when you want to borrow money from a bank, what do you have to do to convince them to lend you money?

Well, there's really two big things that you can do if you don't have money yourself or you're not independently wealthy,

Sureties & Guarantors

How do you convince a bank to lend you money?

Pledge collateral

you can either gather up some collateral and pledge it as security for your loan,

that's not what we're going to talk about in this lesson, that's in a future lesson. The other thing you can do if you don't have the money yourself, you're not credit worthy,

Sureties & Guarantors

How do you convince a bank to lend you money?

- Pledge collateral
- Bring in a surety or guarantor

is you can bring in a surety or a guarantor. Now, a surety and a guarantor are

very, very similar concepts with one key difference. Both of these are people who agree to be liable for your debt if you don't pay.

Sureties & Guarantors

Surety = Primary liability

Guarantor = Secondary liability

Now, the big difference is that a surety has what we call primary liability, which means that

if you don't pay the debt or even if you haven't yet paid the debt, the surety is always liable. Meaning the lender, the bank usually, can choose whether to try and collect the debt from you, the original debtor, or from the surety, they're primarily liable.

Sureties & Guarantors

Surety = Primary liability

Guarantor = Secondary liability

Now, the difference is between a surety and a guarantor is that the guarantor is only secondarily liable.

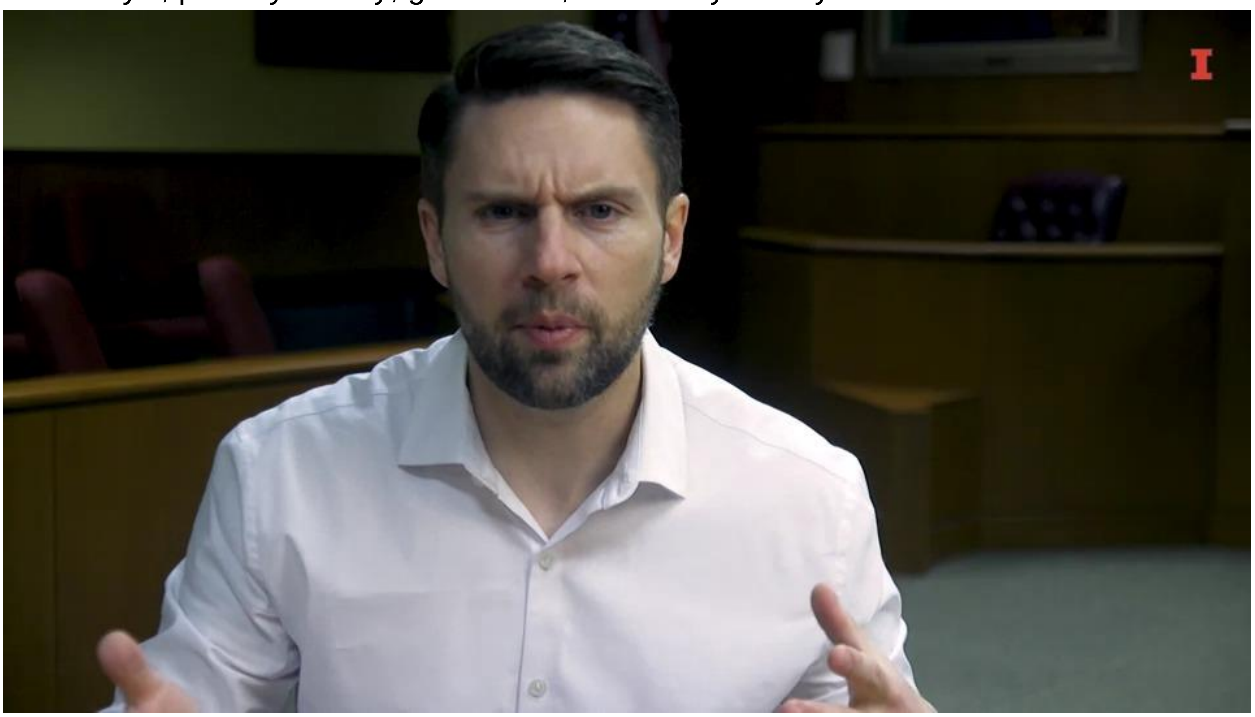
Secondary liability means that the bank, the lender, must first pursue the original debtor and only if the original debtor is unable to pay, then can the bank pursue the guarantor, that's how secondary liability works.

Sureties & Guarantors

Surety = Primary liability

Guarantor = Secondary liability

So surety's, primary liability, guarantors, secondary liability.



But for the remainder of this lesson, we'll use the terms interchangeably, I'll probably just say surety because their rights and their duties are very, very similar, the only real difference is primary versus secondary liability.

Sureties' & Guarantors' Rights

Right of reimbursement

Right of subrogation

Right of contribution

So, what rights do sureties and guarantors have? Well, there are three main rights that if you are a surety, you need to be aware of. First is called the right of reimbursement.

If you are a surety and you have to pay money, whether it's the principle of the loan or things like attorney's fees, court cost, other expenses, additional interest, that kind of stuff, sureties have the right of reimbursement, meaning the original primary debtor has the obligation to reimburse the surety for these expenses.

Sureties' & Guarantors' Rights

Right of reimbursement

Right of subrogation

Right of contribution

Next right the sureties and guarantors enjoy is called the right of subrogation.

Now, this right of subrogation means that if a surety or a guarantor is made to pay the original debt because the primary borrower was unable to do so or refused to, then the surety acquires all of the rights that the lender had with respect to the original borrower. So, if I'm a surety and I agree to be liable for someone else's debt, they don't pay and I am forced to pay instead, whatever rights the bank had with respect to that debt, I now have those rights, which means that I can go after the original borrower and try and recover, because really we want the original borrower to pay, and only if they're really, really unable to do we want to have to collect from the surety or the guarantor.

Sureties' & Guarantors' Rights

Right of reimbursement

Right of subrogation

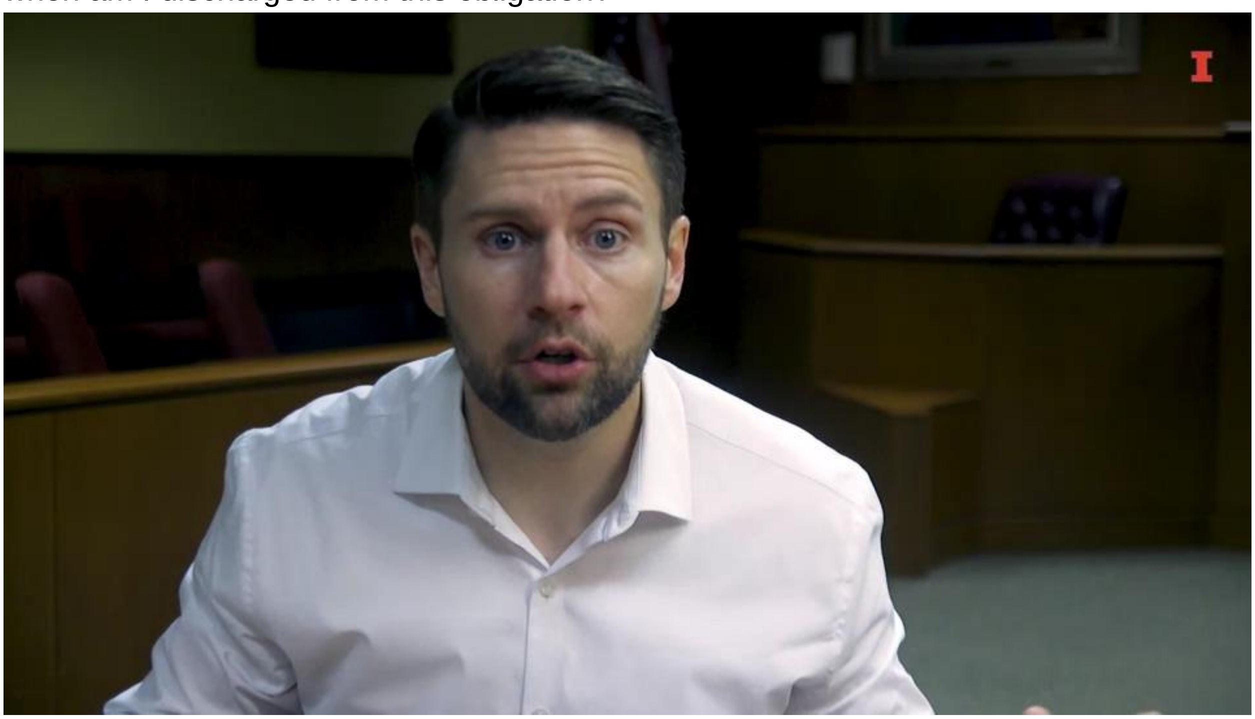
Right of contribution

Third right that sureties have is the right of contribution. Now, this only arises if you have more than one surety with respect to a transaction.

So, if you have multiple sureties or multiple guarantors and one of them is made to pay more than their fair share, the right of contribution gives them the power to collect from their core sureties so that everyone pays their fair share amount.

Discharge

Now, with respect to sureties and guarantors, from their perspective the big question is, when am I discharged from this obligation?



When can I be sure that I'm not on the hook for this money anymore?

Discharge

Payment in full

Now obviously, if the original debt is repaid in full, sureties are discharged. But aside from that,

really discharge most commonly comes when the debtor and the lender make a change in their relationship without the consent of the surety or the guarantor.

Discharge

Payment in full

Modification without consent

Now, this can come in usually one or two ways, they modify their agreement without consent,

so maybe they'll change the interest rate or change the payment or do something like that. If you don't get the consent of the surety, then that will actually serve to discharge a surety from liability.

Discharge

Payment in full

Modification without consent

Release of collateral without consent

And the second related way is if the lender agrees to release any collateral that had been pledged to secure the loan.

If they agree to release the collateral without the consent of the surety, then that will also discharge the surety. Now, we're going to talk a lot more about collateral in the future lesson and how secure lending works, but just know that if you have pledged some collateral to secure a loan and the lender releases that collateral, that's not fair to the surety because they were counting on that collateral being there to satisfy the obligations, so they don't have to. So, in that case, a surety or guarantor will be discharged from liability.

Lesson 2-1.2: Interview with Banker

All right, in this module that's coming up we're going to talk about financing and debt collection. We'll get into bankruptcy a little bit. So to kick things off, I'm here with Chip Jorstad from Busey Bank. Chip is the Regional President for Downstate Illinois, Busey Bank, and he is an expert on bank financing. So Chip loves the U of I as I do. He got his bachelors in finance here. He got an MBA from the College of Business. So I'm really, really thankful that Chip joined us today to talk a little bit about how bank financing works in the real world. because in these lessons, we're going to talk about the laws pertaining to financing, and guarantors, and sureties, and taking collateral for a loan, and that kind of stuff. But I thought it'd be helpful to have someone tell us, what does this really look like in the real world? So, Chip, thanks for being here, and maybe you can just start by telling us little bit about, your day-to-day life as a banker. And how you approach the process of providing funding for businesses.

Sure, thank you. In the commercial loan side of the bank, what we try to do is we meet with prospects and with customers. And we identify banking opportunities. And what that might consist of is someone that's starting a new business, that would maybe need a million dollars loan for equipment and maybe $500,000 for a line of credit. And what we would do is, we would walk through the process with them of what their business is and what they're trying to do. And that's really kind of the initial meeting that takes place so that we can get our arms around the story and what the customer is trying to accomplish. From there, we request a set of financial statements from the customer. So if it's an existing business, we would get three years of business tax returns or financial statements. If it's a new business, it would be more based on business plan, pro forma financial statements, and then also the personal financial statements of the business owner. Because when we underwrite a business, we look first at the cash flow of the business opportunity. But then as kind of a secondary repayment source, we look at what the person or people have behind that. So that's kind of where we start from.

Okay, so that brings up a good question. If a business is new and doesn't have that history of cash flows, or something like that, the bank isn't just going to give money for free most of the time. So when do you look at requiring like a co-signer or other sort of surety or guarantor on a loan?

Sure, so we always want to underwrite the business at first. So if it's a new business, we're going to work with the borrower or the prospect on what does that business look like. So if they're purchasing equipment, it might be to finance a piece of machinery that, lets just say, that piece is $500,000. We would maybe loan 75% of that. So, we would expect that the business would be able to put down 25% capital. Whether it's cash from the owner or it's from outside investors, and then we would maybe loan 75% of that. And where we go from that is then we take their pro forma cash flows or their business plan, which has a built-in set of assumptions which we go through in quite a bit of detail to make sure we understand who's their market? Who they're trying to sell to, what generates the revenue? What are some ancillary products that might button onto that piece of equipment? Not only initially, but over a five-year period. So, we can get comfortable that that loan will get paid back. We always look at the primary source of repayment, which is cash flow from the business operations. The secondary source of repayment which would be from a guarantor. And a lot of times the business is owned in an LLC, or a partnership, or an operating company, and then we would have a guarantor of the owner. And then the third source would be bringing in an outside guarantor, a consigner. Because the last thing the bank wants to do is repossess the collateral or take that back because as a bank, our job is to take in deposits and loan out money. And that's where the bank makes its money. It's not selling client's assets. We're not very good at operating businesses, so we try to stay out of that name. Just be a financial partner for the business owners.

And you say you're not a very good at operating businesses, but it sounds like you really do, really partner with the companies that you, I'm not going to say invest in, but you loan money to. I think a lot of times from a consumer perspective, we look at a bank as, they look at your credit score and if it's high enough, they'll give you some money. If not, they won't. But it sounds like you guys really do a lot of due diligence to investigate the companies that you work with, even brand new companies, to say does this seem like a viable business? Is this something that we feel like we can partner with for the long term, and invest in this company?

Exactly. So, a lot of people's perspective of a bank is to get a home mortgage loan, or a car loan, or something of that nature. Which is a little more transactional, there's certain ratios that everybody kind of knows or certain loan of values. And that's what your credit is really based off of, your credit score and your payment history. But on the commercial side, we do have to take a deeper dive, because it's not just the person that we're underwriting. Character or the quality of the person who's standing behind it is something we do factor in. But ultimately, we're financing the business, so we have to be a good partner whether it's somebody out in Research Park, who has a new idea, or whether it's an established business that makes widgets, for a lack of better words. We have to understand that whole scope, because in order for us to get the loan approved, it's a human element, it's not just a computer system that's scoring it.

Mm-hm, now you mentioned a couple of times that somebody might want to buy a big piece of equipment and it'll loan them a certain percentage of the value of that equipment to buy the equipment. Would you then usually take a security interest in equipment and take it as collateral? What types of collateral do you usually take? How does that process work if a company wants to pledge some asset as collateral for their loan?

Yeah, so in either a line of credit or a business loan for equipment, we would file a UCC filing. So the Uniform Commercial Code is something that's regulated through the legal system. It's a public database that shows who the debtors are that are filed on that. So if it's Chip's manufacturing company, Busey would put a filing on Chip's manufacturing company. And that would be out there for anybody to see that was looking to do business with Chip's manufacturing company. And that filing would be on inventory, accounts receivable and equipment, and everything that's kind of in between there. And so then if someone else was looking to work with Chip's equipment company, Chip's manufacturing, then they would able to look and see that Busey has a first priority interest in those assets. So anybody that would come in after that would be in a second, third, or fourth position. And as the lead bank or the first bank, we actually prohibit typically the customer from getting outside that without talking to the bank. Because we're making our loan decision on a set of parameters that have provided to us and that's usually what is the existing situation and what is the customer looking to do. If there's becomes a lot more variables or unknowns outside of that, that's when things can get a little upside down. So it's not, we're not doing it to be restrictive to the customer, we're just doing it to make sure that the deal we all signed up for and agreed to is what's being done.

I'm so glad you mentioned the UCC, because in the lessons that are going to be coming up in this module, we talk all about UCC Article IX, how it works to take a security interest in some form of collateral. Chip mentioned priority in the filing of financing statements and things like that, we're going to learn all about that in lessons that are coming up. And so that's one reason I wanted to have Chip here, just to kind of give us a little preview of what we're about to learn and help us understand how this stuff works in real life. Because we learn all these rules in a law class like this, but the reason we learn these rules isn't just to have the knowledge of the rules, it's to apply the rules. And so in real life if you own a business, if you get into banking, you're going to encounter UCC Article IX. You're going to deal with secure transactions. You're going to deal with cosigners, guarantors and sureties to loans, and things like that. So, Chip, thanks so much for joining me here today. I really appreciate your insight.

Thank you, appreciate it. And good luck to everybody.

Thanks.

Lesson 2-2: Bank Financing: Collection of Debts

Lesson 2-2.1: Bank Financing: Collection of Debts

In this lesson, we discuss bank financing, and how banks collect debts when those debts are not secured by collateral. So, what remedies are available to lenders when a borrower defaults on a loan? In this lesson, we're going to discuss how banks collect debts. Not just banks, but lenders in general, but most of the time it's banks.

Bank Financing: Collection of Debts

Creditor remedies when there's no collateral

So, we're focusing here on the collection of debts when there has been no collateral pledged to secure the debt.

A future lesson we're going to talk about secured lending and collateral and repossession of collateral. But here, we are only concerned with the collection of debts that are unsecured loans as we call them. Now, if you're a bank, and you lend money to a borrower without collateral, you just sit back and you hope that they're able to repay it. And if they're not, then you need to figure out what can I do as a lender to collect on this debt.

Bank Financing: Collection of Debts

Civil judgment

Now, there are several methods available to lenders to collect on unsecured debts. The first thing they always have to do most of the time is obtain what's called a civil judgment. So, they sue the debtor in court,

and they get a judgment. Basically, they just file lawsuits says, "Hey, debtor owes me money." The judge says, "Yes, I agree. Here's a judgment in your favor in the amount of how much you're owed plus interest and fees", and all that kind of stuff. So, once that lender has that judgment, the hope for the lender is that the debtor, seeing that there's a judgment rendered against him, her or it, will then just pay it. And sometimes that happens. In fact, a lot of the time that actually does happen. But when that doesn't happen, lenders have to look to other means to collect on their debts. The first mean that they have available to them

Bank Financing: Collection of Debts

Civil judgment

Lien (e.g., mechanics, judicial)

is called a Lien. Now, a lien is nothing more than

a lender's ability to latch on to something owned by the debtor. Whether that's a lien against your real property like a building or land or lien against personal property like a car or equipment or something like that. But if the debtor does not pay the judgment in cash when they're supposed to, the lender can then go back into the court and ask the court for a Judicial Lien, which is when a court orders the debtor to turn over some of its property to the lender in order to satisfy that judgment. So, a Judicial Lien could be for a valuable piece of equipment or any other personal asset that has value that can be used to satisfy the judgment.

Bank Financing: Collection of Debts

Civil judgment

Lien (e.g., mechanics, judicial)

Garnishment

In addition to a lien, which is a court order for the debtor to turn over its own property, lenders may also request what's called a Garnishment. Now, a garnishment is similar to a lien,

but instead of the court ordering the debtor to turn over its own property, a garnishment orders some third party to turn over property of the debtor that it's holding. Most often this comes in the form of a wage garnishment. You probably heard this term before. If you have a judgment against you, and you have a job, the lender can go to your employer with a wage garnishment order from the court ordering your employer to turn over some of your wages to the lender. That's one form of garnishment. Or really, any time a court orders a third party who holds property of a debtor to give that property to the lender, that's a form of garnishment.

Lesson 2-3: Debt Financing

Lesson 2-3.1: Debt Financing

In this lesson, we'll discuss debt financing, which is a mechanism that allows businesses to sell debt on an open market in order to finance their growth. We already mentioned that there are multiple avenues available to a business that's trying to raise money to expand.

Bank Financing: Collection of Debts

Civil judgment

Lien (e.g., mechanics, judicial)

Garnishment

The last couple of lessons, we talked about getting a bank loan. That's what most businesses do

especially when they're small and they need to raise some capital. But as the business gets bigger especially, more avenues become available for raising money.

Debt Financing vs. a Traditional Bank Loan

On another module, we'll talk about issuing equity securities, but one option available to companies that's a little bit above the level of a traditional bank loan is what we call debt financing. Now, a bank loan is a form of debt.

But when we say the word, debt financing, we're really talking about selling debt securities which are traded on an open market, which we usually call the bond market or something like that. So, when we say debt securities, you think of bonds, we're really talking about the same things. Instead of being a loan from an individual bank like you go down to the local branch of your bank and get a loan, a debt security or a bond is a loan from either an individual or institutional investors, usually multiple investors who buy bonds issued by a company, and it's a form of a loan but very different than a traditional bank loan.

Debt Financing vs. a Traditional Bank Loan

Debt securities

No ownership interest

So, a debt security is a form of security, which we'll talk about in another module how securities work, but debt securities carry with no ownership interest. So, whereas an equity security like a stock

or share of stock has ownership rights, you can vote, all that kind of thing, debt securities have no voting interest, no ownership interest, whatsoever.

Debt Financing vs. a Traditional Bank Loan

Debt securities

- No ownership interest
- Guaranteed rate of return

But what they do have is a guaranteed rate of return. So, whereas if you have an equity security

like a share of stock, you don't have a guaranteed rate of return but you get some votes, and you hope that you make some money. Debt Securities, you get no votes but you, at least have a guaranteed rate of returns. It's just like any other loan, there's an interest rate and periodic payments are made and then the principal is repaid after a certain period of time.

Types of Debt

- Debentures
- Secured bonds
- Convertible bonds
- Callable bonds

There are different types of debt that we speak of when we talk about debt financing, and these terms are a little bit flexible but for the most part, when we talk about something called a debenture. A debenture is an unsecured bond or an unsecured form of debt security,

meaning there is no collateral pledged by the corporation that the lenders can go, the lenders being the investors, can go and repossess in order to pay the principal if the borrower fails to do so.

Types of Debt

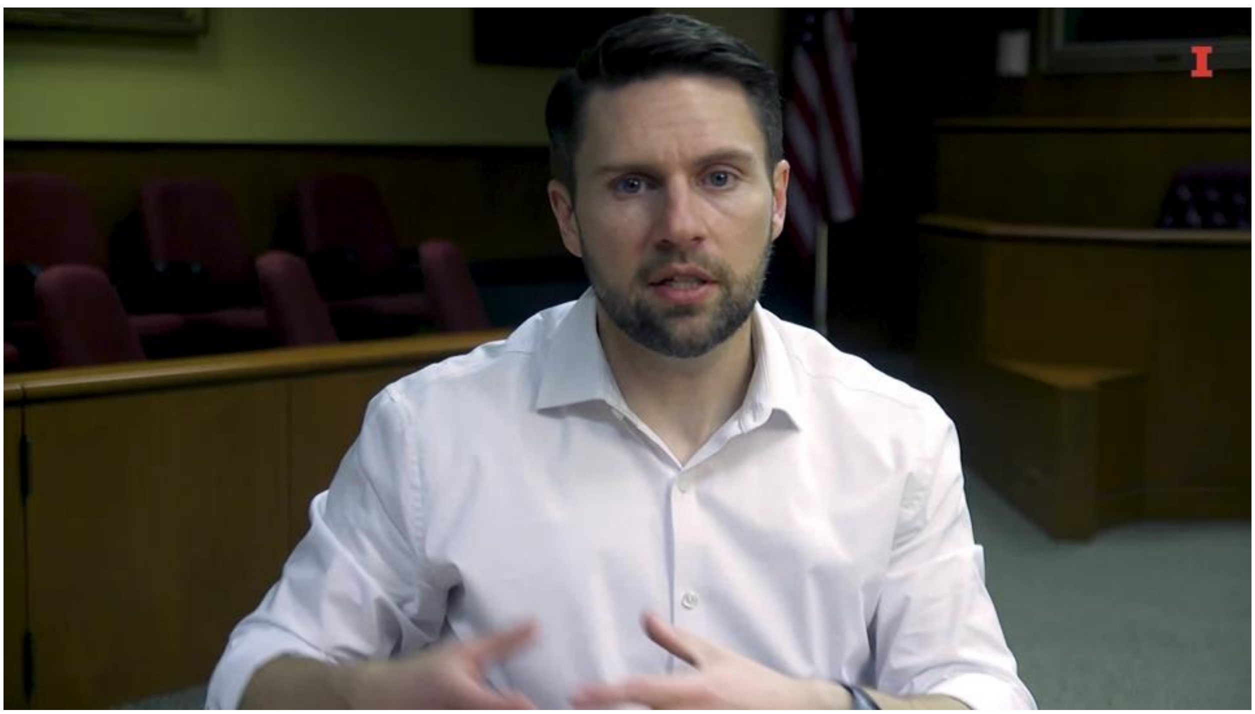
Debentures

Secured bonds

Convertible bonds

Callable bonds

On the flip side, there are secured bond. Secured bonds unsurprisingly, are secured by some collateral,



it could be equipment, inventory, land, anything. It's secured by some collateral so that if the company doesn't pay, the lenders have some means of recouping the principal.

Types of Debt

Debentures

Secured bonds

Convertible bonds

Callable bonds

Getting a little more exotic. Now convertible bonds are becoming much more popular especially among people like venture capitalists and angel investors.

Why? Because when a company is small, there's a lot of risk that it might not succeed, and having a bond is good because there's a guaranteed rate of return. We like that. But as it grows and especially when it goes public in an IPO, having a bond has a much smaller upside than having common stock. So, we want to convert that bond into common stock when it goes public or is bought by someone else, so that we can experience all the upside of the common stock. So, convertible bonds are becoming very popular.

Types of Debt

Debentures

Secured bonds

Convertible bonds

Callable bonds

And then, there's this thing called a callable bond.

Most of the time, a bond has a maturity date, and the company that issues the bond pays interest on regular intervals until the maturity date at which time it repays all of the principal amount of the bond or loan. A callable bond allows repayment prior to the maturity date, and these are used in some instances, although they're not terribly common.

Lesson 2-4: Secured Transactions: Foundations & Remedies

Lesson 2-4.1: Secured Transactions: Foundations & Remedies

In this lesson, we introduce the concept of secured transactions. Now, secured transaction is a loan that has some collateral attached to it in order to satisfy the debt if the borrower fails to do so. We're going to start this lesson by understanding the nature of secured transactions and then move on to future lessons to talk about some of the specifics of secured transactions. All right. Up till now, we've been talking about debt and debt financing and bank loans, primarily with respect to unsecured debt. There's no collateral. What can a bank or other lender do if you don't pay? Now we're going to start a multi-lesson series on secured transactions.

Secured Transactions: Foundations & Remedies

Secured vs. Unsecured Debt

Before we really get into it, we probably need to decide, what is secured debt? What is unsecured debt? What's the difference between them? We've alluded to it, we want to make sure we nail down this definition.

So, consider two examples. Example number 1, you have a credit card. A credit card is a form of a loan. Every time you swipe your credit card, your bank is lending you that money. At the end of the month, they send you a bill, and they expect you to pay it back. It's a loan. That's an unsecured loan because there is no collateral, no property of yours that you own attached to that loan for your credit card. They just hope that you can pay it back. That's why they run a credit check on you to see if you're worthy, meaning, do you have a history of repaying your loans? If so, then yes, we'll give you another unsecured loan. If you default on your credit card, the banks only option is to take you to court and hope you have the means to pay. Contrast that with a car loan. If you buy a car, and you take out a loan for your car, the bank isn't just going to give you the money and hope that you can pay it. The bank is going to give you the money, and hope that you can pay it, but also hold the title to your car until that loan is paid off.

Secured Transactions: Foundations & Remedies

Secured vs. Unsecured Debt

That's the difference between a secured debt and an unsecured debt.

The car loan is a secured debt, meaning, the car is collateral that secures the loan. In a credit card situation, there's no security. There's no collateral on unsecured debt. A secured debt is great from the perspective of the lender because they know they at least have something of value, even if it doesn't pay off the entire amount of the loan, it's better than nothing. So, usually, with secured debt, you'll get lower interest rates better terms, because there's less risk for the bank. So, in this lessons, we're introducing the concept of secured transactions, talking about some remedies that are available to creditors in secured transactions, and then we'll move on to some more specifics of secured transactions in future lessons.

Secured Transactions: Foundations & Remedies

Secured vs. Unsecured Debt

UCC Article 9 governs secured transactions

Now, with respect to personal property, everything except for land and buildings basically, secured transactions are governed by Article 9 of the Uniform Commercial Code. This is a big deal, secured transactions. If you ever go to law school, you learn tons about Article 9 of UCC, not super interesting, but it's really important.

Now, the big thing to know about Article 9, secured transactions,

is that you must have a security agreement. This is a document that's needed

in order to take a security interest and personal property. So, whatever the property is, equipment, inventory, anything, if you want to give or take a security interest in it under Article 9, you have to have a security agreement.

Now, what does a security agreement look like? It doesn't have to be long, but there are some essential elements that must be in a security agreement in order for it to be enforceable. First, you have to describe the collateral.

What property are you taking to secure this loan? Equipment, inventory, a car, whatever has to be described in the security agreement.

The debtor has to have rights to the collateral. Now, this seems obvious.

You can't pledge someone else's car as security for your loan. You can only pledge your car.

Third, the secured party must document in the agreement what value it's giving.

So, I'm loaning you $30,000 and taking your car that you're buying with it as security. The $30,000 is the value being given by the secured party.

Next, the security agreement must contain the terms of repayment. What's the interest rate? When are payments due?

What's the maturity date? All that kind of stuff has to be in there.

Must also describe the secured party's rights. If the debtor fails to make payments like,

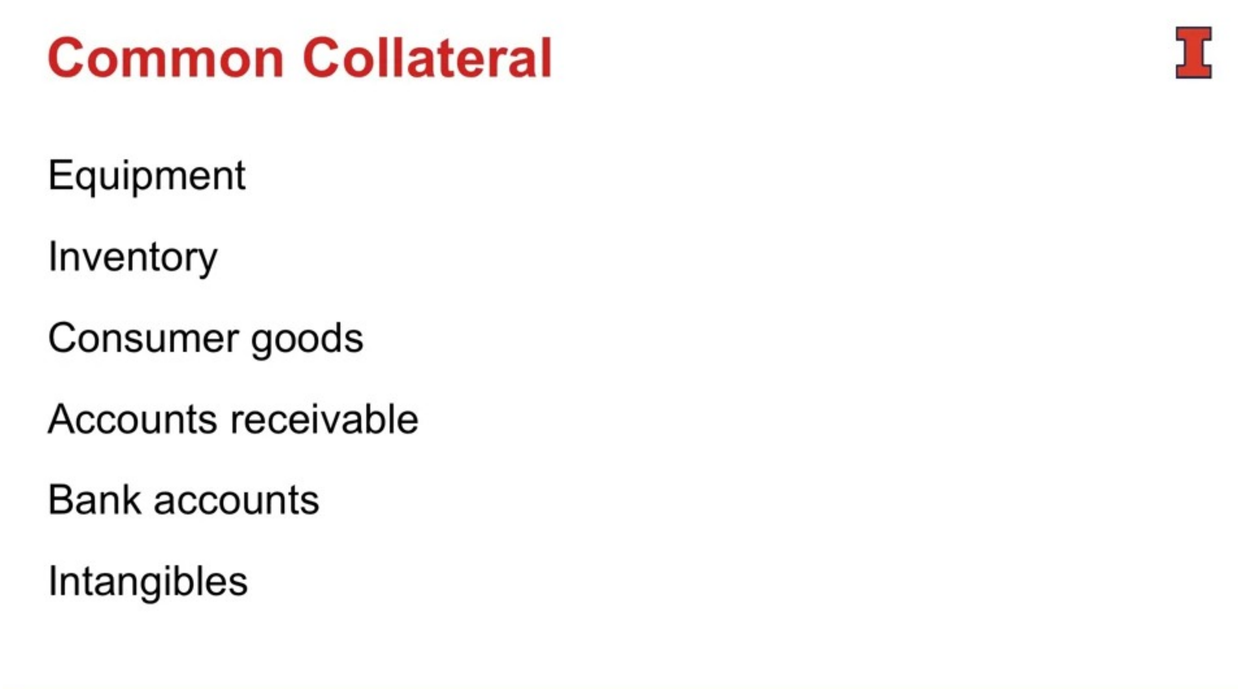
can I accelerate the due date? Can I charge excess interest? Are there fees and costs that I can charge? Those all have to be in the security agreement.

Then, finally a big one, has to be in writing signed by the debtor. Oral security agreements are unenforceable.

Now what kinds of things do people commonly pledge as collateral for security agreements? In a business context,

you get a lot of security agreements that pledge equipment.

Now, if you're a manufacturing facility, you've got big machines equipment, you may have earthmoving machines, whatever. If you're in construction, equipment is very often pledged as collateral.



Inventory, if you're a business that deals in retail or consumer goods,

you often have inventory. If you're a car dealership, you've got a bunch of cars sitting on your lot. That's your inventory, you can pledge that as collateral for a secured loan.

Common Collateral

Equipment

Inventory

Consumer goods

Accounts receivable

Bank accounts

Intangibles

Consumer goods are frequently collateral, accounts receivable. So maybe you have people that owe you money,

those are accounts receivable, and that is something you can pledge as collateral for a loan.

Common Collateral

Equipment

Inventory

Consumer goods

Accounts receivable

Bank accounts

Intangibles

Regular old bank accounts, deposit accounts. You can pledge those as collateral, and even intangible things like, I can pledge a patent or a trademark as collateral because they have value.

Now, what happens if the borrower in a secured transaction fails to repay the loan?

Secured Transactions: Foundations & Remedies

Remedy upon default: Repossess collateral

Lawsuit not required

Well, the answer is pretty easy. The lender just comes and takes the collateral. Usually, if they're able to do this without what we call, "disturbing the peace", they don't even have to go to court. You don't have to file a lawsuit, you just come and take it.

So, if you default on your car loan, and your car's parked on the street in front of your house, the lender can send a tow truck to the street in front of your house, hook up your car, tow it away, and that's it. It's easy. One great thing about secured transactions from a lender's perspective is that if you're able to, you can repossess the collateral without going to court. There used to be a TV show on where it showed people repossessing really big pieces of collateral, like airplanes and stuff like that. If you can do it without breaking and entering or disturbing the peace, then you can do it. No lawsuit required.

Lesson 2-5: Secured Transactions: Perfection & Priority

[Lesson 2-5.1: Secured Transactions: Perfection & Priority]

In this lesson, we continue our discussion of secure transactions by talking about three really important concepts: attachment, perfection, and priority. In the previous lesson, we introduced the concept of secure transactions, and defined what that means a little bit, and what remedies a lender might have. In this lesson, we're continuing to discuss secured transactions by

Three Key Concepts

Attachment

Perfection

Priority

focusing on three really important concepts: attachment, perfection, and priority. So, let's go through these one by one.

Attachment is what gives you rights in the collateral. Perfection as the lender, is what solidifies your place in line when it comes to who gets that collateral and then priority is the rules that we did use to determine how collateral is distributed. So, let's go through these in a little more detail.

Attachment

Attachment – When the security agreement becomes enforceable

First, attachment. Attachment is a term we can define by saying this is when the security agreement becomes enforceable against the debtor. What usually happens when the debtor signs the agreement, right?

So, if I'm borrowing money to purchase a car, the bank makes me sign a document that's a security agreement that says you know we'll lend you money, you agree to pledge this car as collateral and pay us back. When I sign that, the security interest attaches to my car, the collateral. Now, attachment is the first step in all secure transactions, and is very important. If the debtor never signs a written agreement, there's no attachment. And so the lender has no rights to the collateral. So, attachment must occur first. Next important concept is perfection. Once a security interest attaches to collateral, that's great. The lender has some rights in that collateral, but the lender's rights in that collateral aren't what we call perfected yet. The perfection is what's so crucial for secure transactions because that's what secures the lenders place in line when it comes to other lenders who might also have an interest in that same collateral.

Perfection

By filing

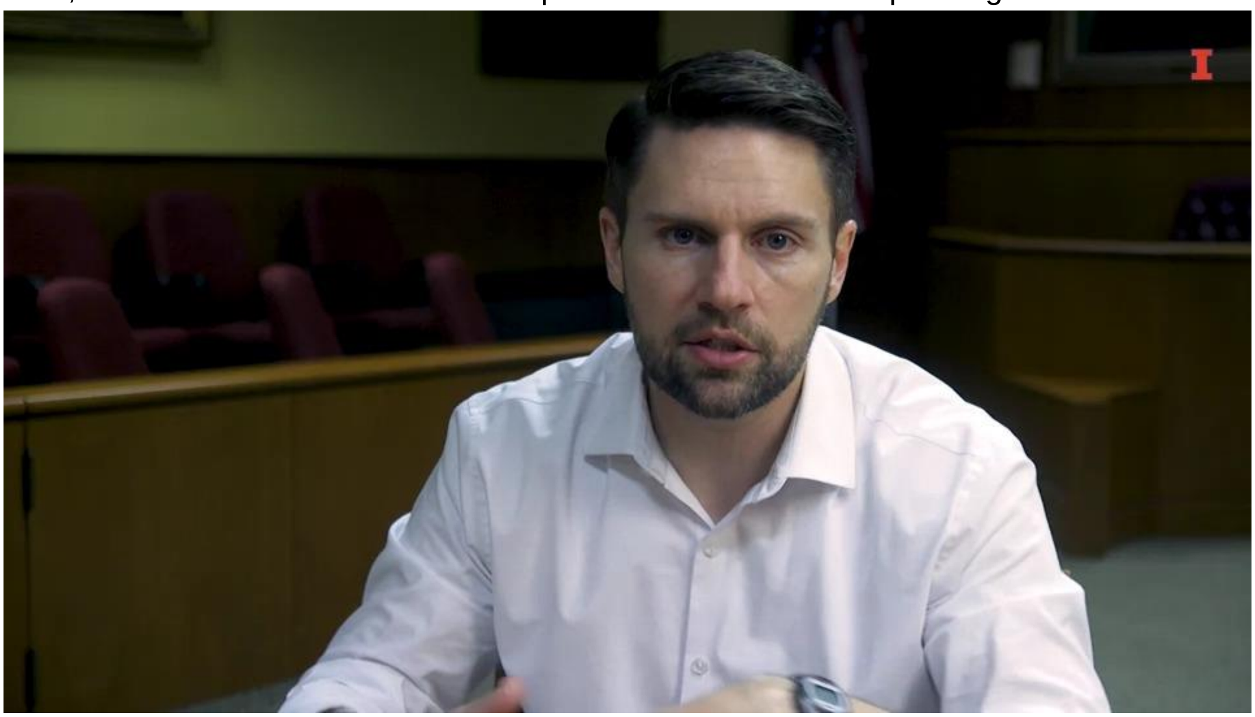
By possession

By possession of title

By control

By purchase money security interest

Now, there are numerous methods of perfection sometimes depending on



what type of collateral it is, or the nature of the transaction between the parties. But we'll go through the most common forms of perfection.

Perfection

By filing

By possession

By possession of title

By control

By purchase money security interest

The first is what's called perfection by filing. Now, this is by far the most common method of perfection. And it can be used for almost any form of collateral. Not all, but almost any.

And to perfect by filing, all you do is file this document called the UCC-1 with the state where the transaction took place. And the UCC-1 document basically says who's the debtor, who's the secured party, what's the collateral. And those are the main things. Just so the world is put on notice that, "Hey, this lender has an interest in this collateral." UCC-1s are public documents, you can search for them. So, a subsequent lender can search, and find out this other lender already has a security interest in this collateral. UCC-1s are good for five years, but then you can file a continuation statement to extend them for another five year period.

Perfection

By filing

By possession

By possession of title

By control

By purchase money security interest

Now, beyond perfection by filing, a lender can perfect its security interest by possession. Now, if you possess the collateral,

you actually have it in your possession. This is superior to perfection by filing for any filings that come later. So, for example, if I want to pledge a piece of equipment as collateral, and I actually give the equipment to my lender, that lender has a perfected security interest in that equipment, and also they beats any other lender that comes later and files a UCC-1 on that collateral because they actually have it in their possession. Now, perfection by possession isn't super common because most of the time if you're a debtor, and you have some collateral, you need it. Like the reason you have a UCC-1 you'd perfect by filing it so that you can continue using your property. If you have this collateral that you can just do without while the lender hangs on to it, maybe you should've sold it and use the proceeds for something else. So, perfection by possession isn't terribly common, especially in a business setting.

Perfection

By filing

By possession

By possession of title

By control

By purchase money security interest

But what is very common is perfection by possession of title. Now, under state laws depending on the state you're in, various forms of property can have their ownership evidenced by issuance of a title.

Motor vehicles this is the most common, right. How do you know who owns a motor vehicle? Well, there's a piece of paper called the title, and you look on it, and that shows you who owns that vehicle. For that type of property, whether it's a motor vehicle, certain forms of equipment, things like that, if it's property that's has title associated with it, the proper method of perfection is by possessing that title. So, when you take a loan to purchase a car, you might know the title of that car will actually be sent to your lender instead of you. Now, when you pay off the loan, they'll send you the title back.

Perfection

By filing

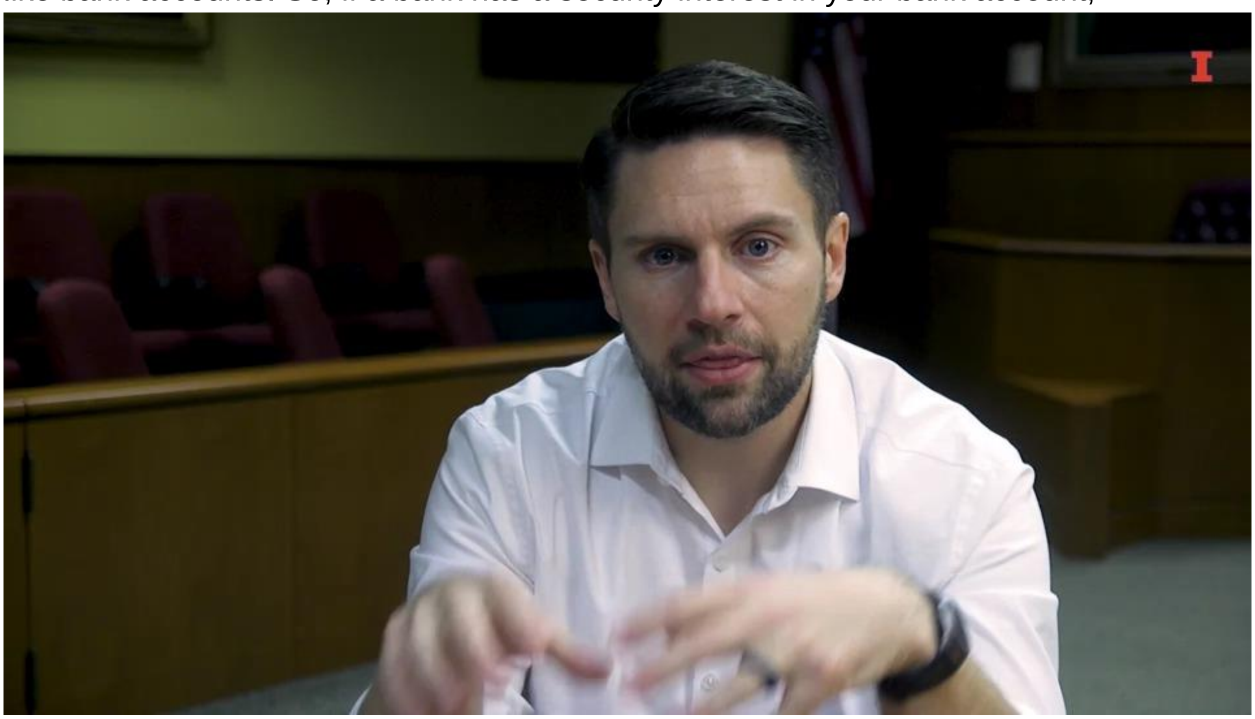
By possession

By possession of title

By control

By purchase money security interest

Next form of perfection is perfection by control. This is usually associated with things like bank accounts. So, if a bank has a security interest in your bank account,



they're going to want that account to be at their own institution so they can control it. If you default on your payments, they just lock down your bank account, prevent you from accessing it, and that's how they repossess it.

Perfection

By filing

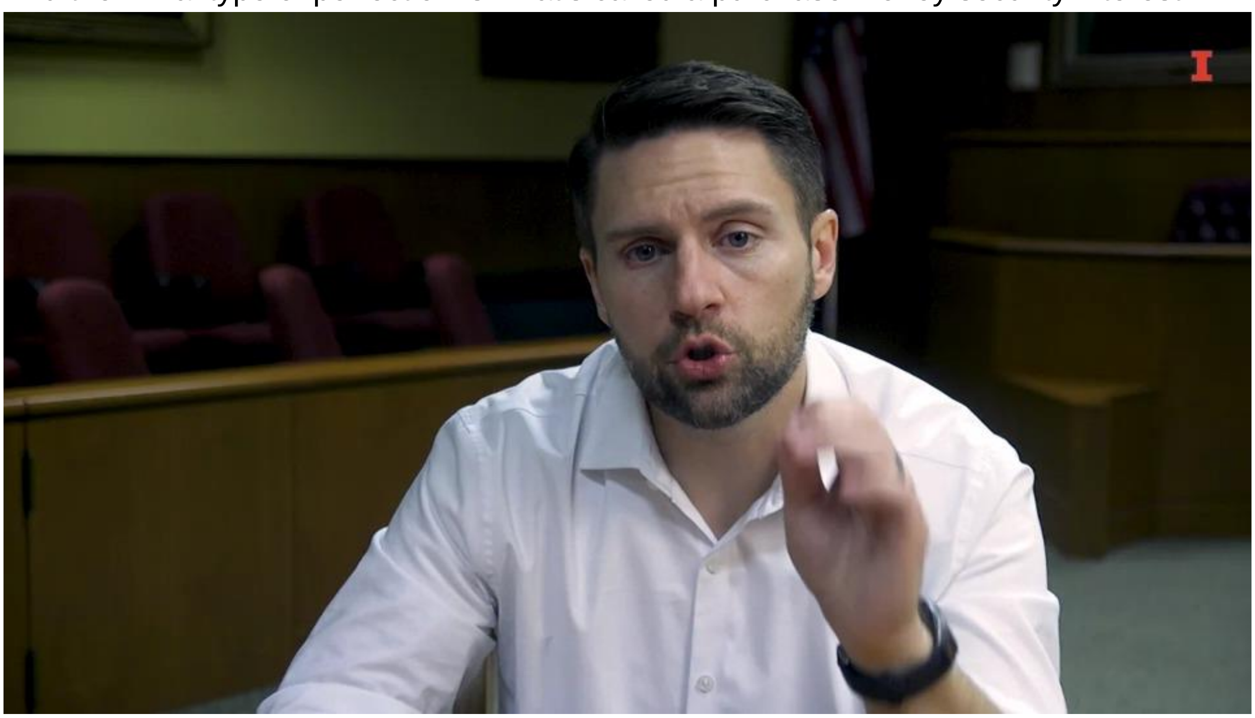
By possession

By possession of title

By control

By purchase money security interest

And then final type of perfection is what's called a purchase money security interest.



Now, this is for consumer transactions only. If you're a consumer, and you buy goods on credit from the seller, that seller automatically has what we call

Perfection

By filing

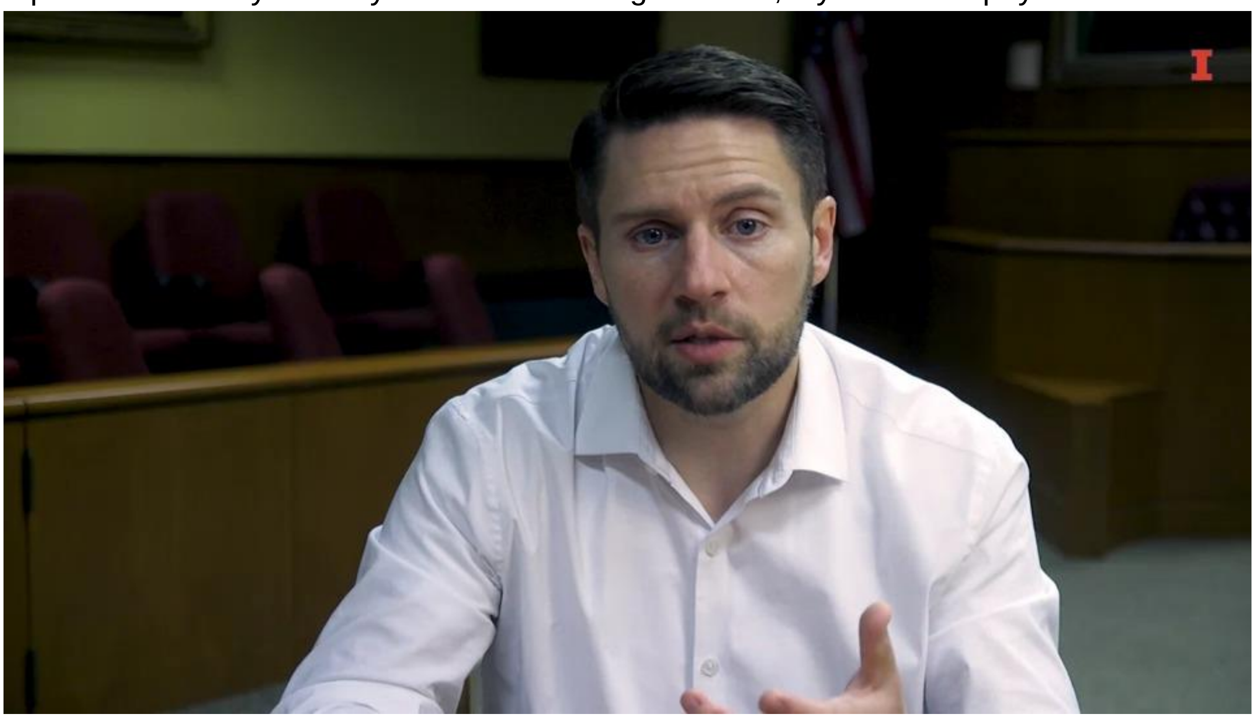
By possession

By possession of title

By control

By purchase money security interest

a purchase money security interest in those goods. So, if you don't repay



the credit that's been extended to you, the seller can come and take back the goods.

Three Key Concepts

Attachment

Perfection

Priority

Okay. That's perfection. So, attachment when the security interest becomes effective, perfection how you secure your place in line versus other creditors. And then the third key concept, priority.

How do we determine which creditors' claims get paid first? Who has the first rights to any collateral? There's three important rules to remember.

Priority of Claims: Three Rules

First: Secured creditors always have priority over unsecured

First rule. Secured creditors always have priority to collateral over unsecured creditors.

If I have a security interest in a piece of equipment, and an unsecured creditor has no security interest in that equipment, I get the equipment. The unsecured creditor doesn't.

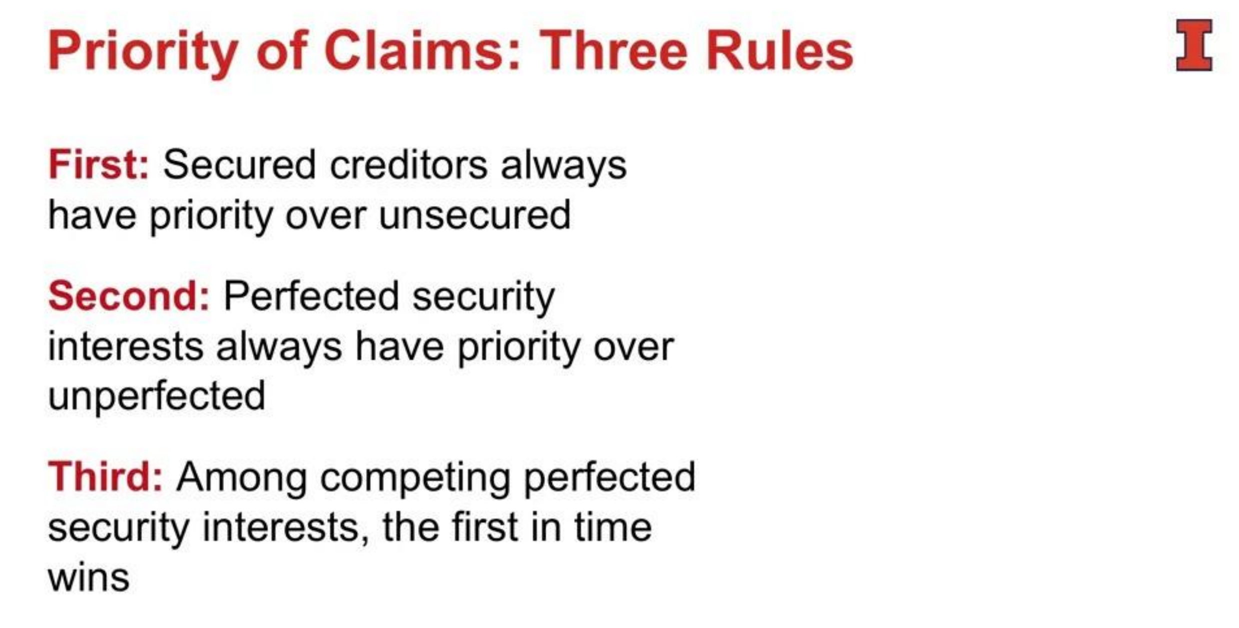
Priority of Claims: Three Rules

First: Secured creditors always have priority over unsecured

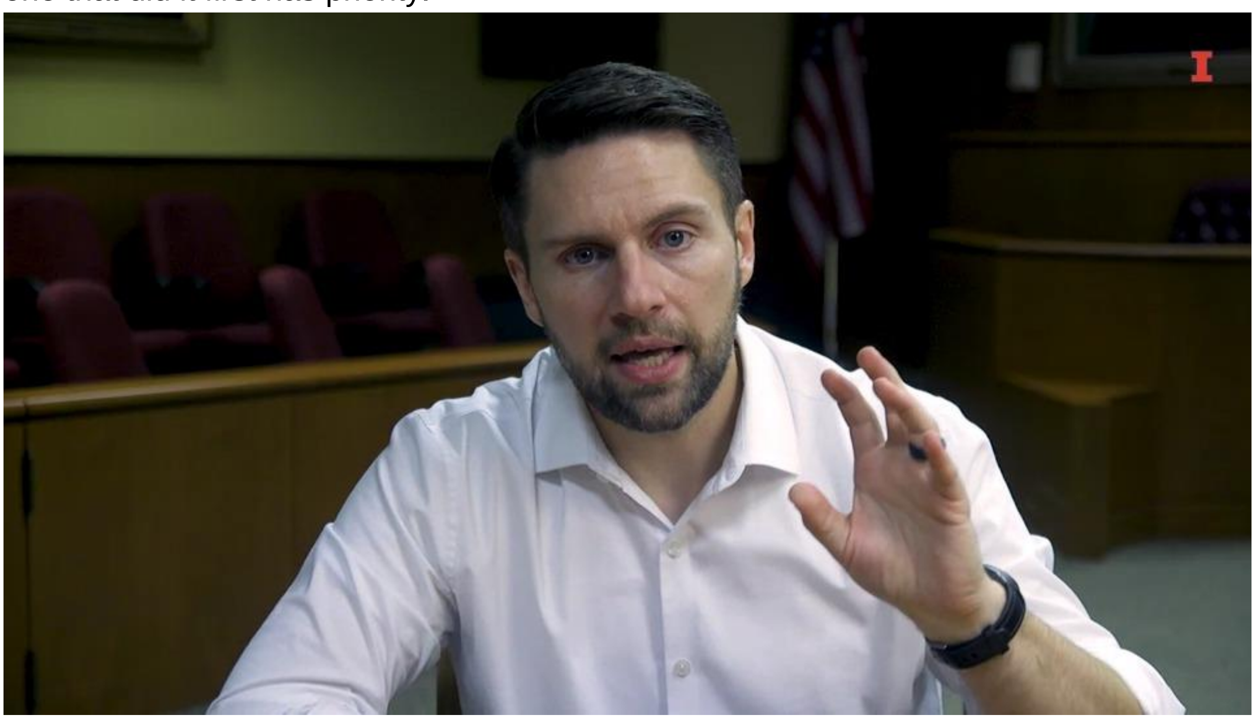
Second: Perfected security interests always have priority over unperfected

Second rule. A perfected security interest always has priority over an unperfected security interest.

So, the same debtor could sign two security agreements that are exactly identical giving two different lenders a security interest in the same collateral, but if one of those lenders perfects its security interest and the other one doesn't, then the perfected security interest gets the collateral in the event of a default.



And then the third rule. If both lenders have perfected their security interests, then the one that did it first has priority.



So, if I give bank A a security interest in my inventory, and bank B a security interest in my inventory, and bank A files it's UCC-1 on March 1st, and bank B files it's UCC-1 on April 1st, and I default on both loans, the bank A gets my inventory because they perfected their security interest first.

Lesson 2-6: Bankruptcy: Foundations & Procedure

Lesson 2-6.1: Bankruptcy: Foundations & Procedure

This is the first in our three-part series on bankruptcy. In this lesson, we'll talk about some of the key terms when we discuss bankruptcy, and the procedure that a bankruptcy case follows as it works its way through a bankruptcy court. You can't talk about debtor-creditor relationships without talking about bankruptcy, and talk about it we will. This is the first in a three-part series of lessons about bankruptcy.

Bankruptcy: Foundations & Procedure

Bankruptcy is awesome!

The first thing I want to say about bankruptcy is that it's awesome.

Now, if you've ever been through bankruptcy, or you know anyone who's been through bankruptcy, you might think, "It was definitely not awesome." But let me tell you what I mean. Conceptually, the fact that we have a bankruptcy system in this country that's enshrined in our Constitution is amazing, because it allows people to take risks. It gives them a fresh start if they fail. And the culture of innovation that has sprouted up so many amazing industries, and created so many new discoveries in our country is directly related to the fact that we have a system that allows people to fail and get a fresh start. Now, is it fun? Absolutely not. Is it challenging? Does it hurt a lot of people sometimes? Yes, but compared to the alternative. Suppose, all of your debts stayed with you forever until you paid them off, would we encourage people to take risks, and to innovate? No, absolutely not. And there are countries in this world where that is the case. So, bankruptcy is awesome, the fact that we have it shows tremendous foresight on the part of the framers of this country and the Constitution. Now, obviously it's not a lot of fun, but in this lesson we're going to talk about some of the key terms, and foundations of bankruptcy, and what a bankruptcy procedure looks like. In future lessons, we'll talk about some more specifics of the various forms of bankruptcy and some key concepts.

Bankruptcy: Foundations & Procedure

Bankruptcy is awesome!

Key concepts:

Bankruptcy code

So, what are the terms we need to know? First, the bankruptcy code.

As I mentioned, bankruptcy is enshrined in the Constitution and therefore, it is strictly a matter of federal law. The bankruptcy code is a set of federal statutes that govern bankruptcy and how it works.

Bankruptcy: Foundations & Procedure

Bankruptcy is awesome!

Key concepts:

- Bankruptcy code
- Bankruptcy courts

Bankruptcy courts are specialized courts that only handle matters of bankruptcy,

and you can think of them sort of if a federal courthouse is a building with multiple stories, and the trial courts, otherwise known as the district court, is on the first floor. And then, when you appeal from the trial court, you go up to the second floor, and that's the appellate court also known as a circuit court. And then if you appeal from the circuit court, you go to the Supreme Court that's in the penthouse. We can think of the bankruptcy court as being in the basement. So, the bankruptcy court is a level below the trial court. If you appeal something from the bankruptcy court, it usually goes to a trial court, and then can work its way up from there. So, bankruptcy court's, special forms of courts, created just to handle bankruptcy matters.

Bankruptcy: Foundations & Procedure

Bankruptcy is awesome!

Key concepts:

- Bankruptcy code
- Bankruptcy courts
- Bankruptcy estate

Now, the next concept is called the bankruptcy estate.

Now, this truly is a new concept that you may not have ever heard before. We've heard the word estate in other context, forget all that. The bankruptcy estate is this new entity that springs to life the minute you file your bankruptcy case in the bankruptcy court. And the estate is this thing that owns all of your stuff while you're going through bankruptcy. So, you file a bankruptcy case, and all of a sudden, you don't own your stuff anymore, your stuff is owned by the estate, and we'll see why that's important as we go along.

Bankruptcy: Foundations & Procedure

Bankruptcy is awesome!

Key concepts:

- Bankruptcy code
- Bankruptcy courts
- Bankruptcy estate
- Bankruptcy trustee

And then finally, there's this person called the bankruptcy trustee.

The bankruptcy trustees' job is to oversee and administer the estate. So, since you don't own your stuff anymore, somebody has to take care of it, and that person is what we call the trustee. Now, the way a bankruptcy case moves through the court varies a little bit depending on which type of bankruptcy chapter you're utilizing, but as a general rule we can say some things that apply to most bankruptcy cases.

Bankruptcy Procedure

Counseling

Now, for individuals, usually individual debtors, not business debtors but individual debtors, are required to complete some counseling both before and after they file their bankruptcy case

as counseling must be provided by an approved provider blah, blah, blah those kind of stuff, but is basically to help increase financial literacy so that we hopefully don't see this same individual back here again in bankruptcy court in a few years down the road.

Bankruptcy Procedure

Counseling

Petition

Now, after any pre-petition counseling has occurred, the real meat of a bankruptcy case starts with the filing of what we call a petition.

The bankruptcy petition creates the bankruptcy estate, starts a new matter in bankruptcy courts, and the petition is a very long document. It basically sets out all the relevant information about the debtor, all their debts, who are the creditors, what's their contact information, how much they're owed, what's the debtor's income, assets, liabilities, all that kind of stuff. It's a very long document, and that's what starts a bankruptcy case in bankruptcy court.

Bankruptcy Procedure

Counseling

Petition

Automatic stay

Now, I mentioned that the petition creates the bankruptcy estate, and it also triggers one other thing that's pretty cool if you're the debtor, and that's what's called the automatic stay.

The moment you file your bankruptcy petition, the automatic stay goes into effect, and what that says is that, "Any creditors who are currently engaged in any efforts to try to collect money from you have to stop," The automatic stay immediately stops all collections efforts, whether they're in court, from collections agencies, anything. Once the automatic stay is in effect, it all has to stop. Why? Because before bankruptcy, the only way for your creditors to get money from you was by suing you or other collections efforts, but now we have bankruptcy. And there's a nice, orderly way that creditors can interact with you, to try and get paid. So, forget all that other stuff. Let's just do it in bankruptcy, that's why we have the automatic stay.

Bankruptcy Procedure

Counseling

Petition

Automatic stay

Meeting of creditors & proof of claims

So, then after the petition is filed, were eventually going to have to have a meeting of the creditors and they'll have to sometimes file what we call proof of claims.

So, the creditors will have to say, "Yes. This is how much I'm owed, here's a proof that I'm owed this much." The creditors get together depending on the chapter of bankruptcy we're talking about for various purposes.

Bankruptcy Procedure

Marshaling of assets

And then, eventually, if we're in a liquidation type of bankruptcy, the trustee will gather up all of the assets of the debtor, it's called marshaling the assets, and then sell them, this is called liquidation.

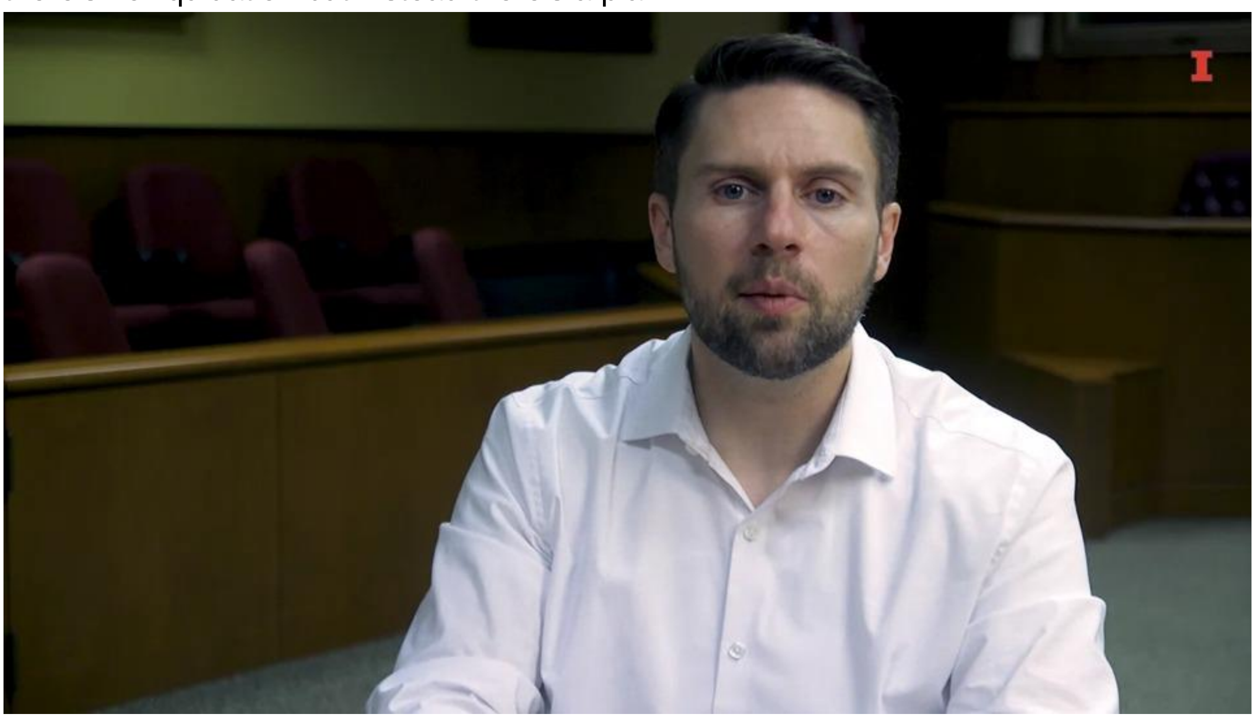
And then, pay the proceeds out to all the creditors. That's in a liquidation bankruptcy. In other types of bankruptcies like a Chapter 11, Chapter 13, which we'll talk about in a future lesson,

Bankruptcy Procedure

Marshaling of assets

Liquidation or plan approval

there's no liquidation but instead there's a plan.



The debtor and creditors sometimes come up with a plan of repayment or reorganization. The bankruptcy court will approve a plan. Once the liquidation has happened, or the plan has been approved and complied with,

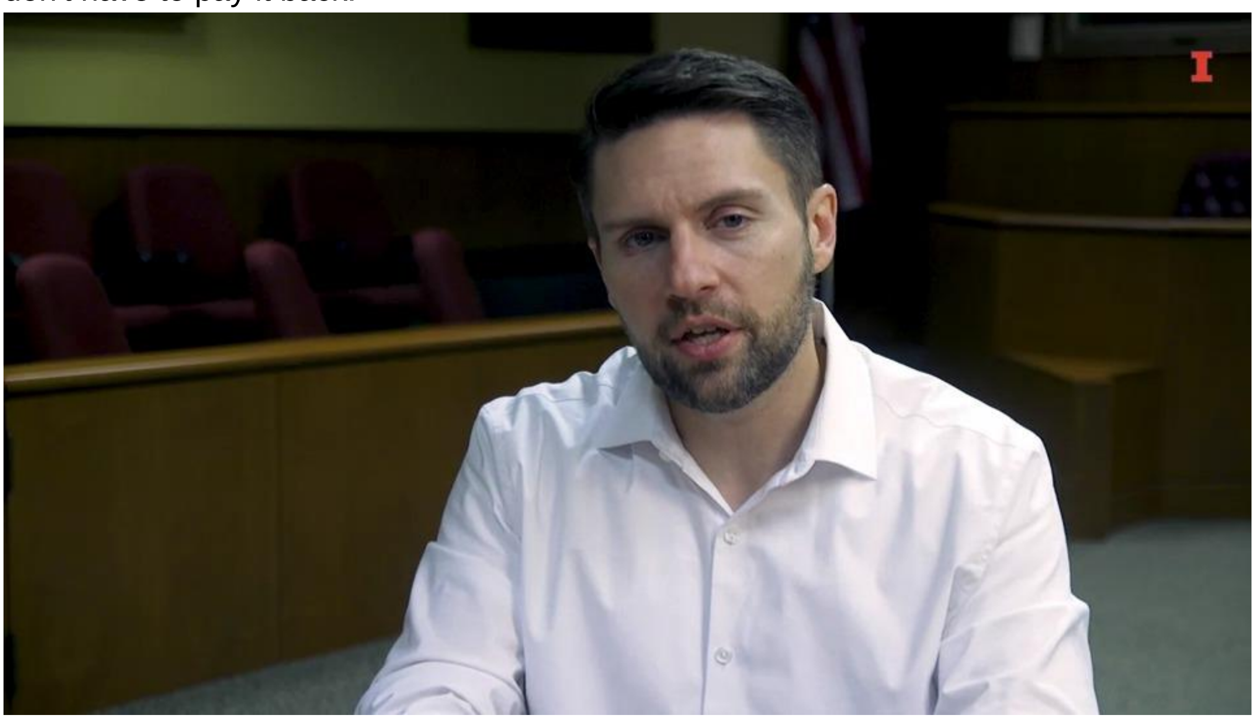
Bankruptcy Procedure

Marshaling of assets

Liquidation or plan approval

Discharge and reaffirmation

then the debtor can be discharged from their debts. This is the great thing about bankruptcy. You can receive discharge from debts meaning, I owe this much, and I don't have to pay it back.



Now, discharge of debts is a great thing but unfortunately, some debts cannot be discharged in bankruptcy. And the one that really bums me out and might bum you out too is the fact that

Most Common Non-dischargeable Debts

Student loans

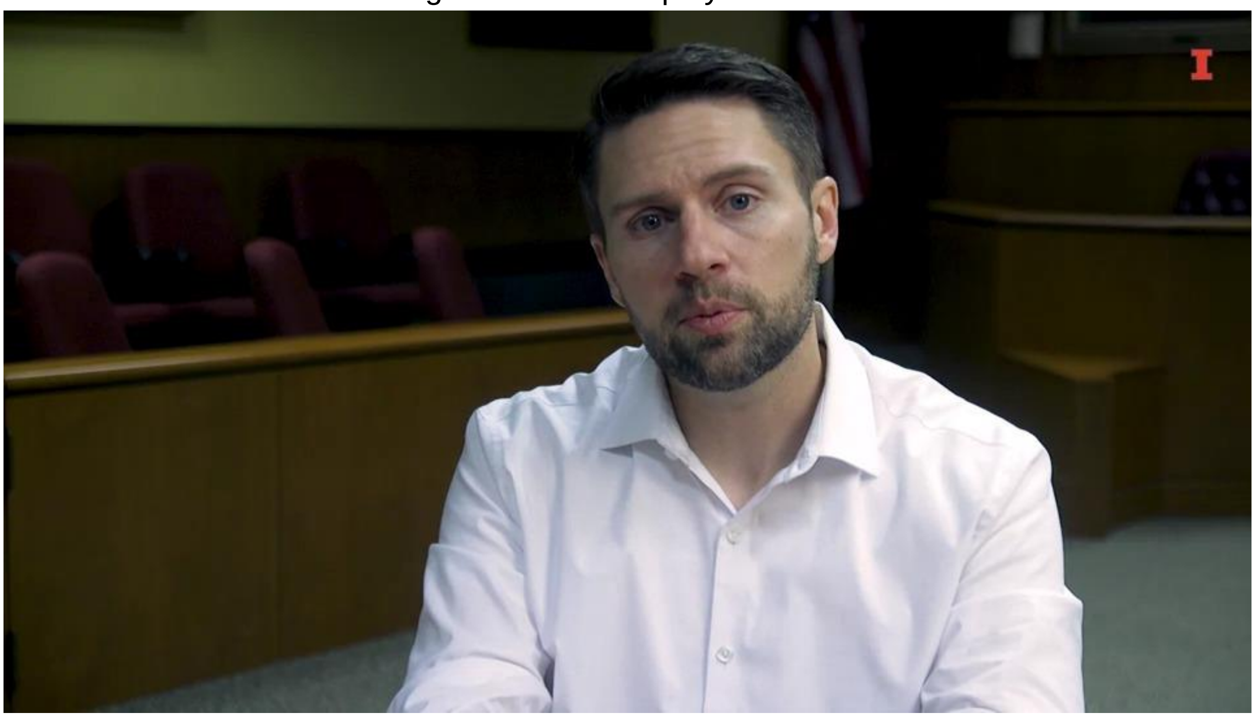
Unscheduled debts

Money owed to the government

Child support, spousal support, etc.

Willful/malicious injury, fraud, or theft

student loans are non-dischargeable in bankruptcy.



So, you can go through bankruptcy, come out the other side, and still have to pay your student loans back, unless you can prove some extreme hardship, which is very hard to do.

Most Common Non-dischargeable Debts

Student loans

Unscheduled debts

Money owed to the government

Child support, spousal support, etc.

Willful/malicious injury, fraud, or theft

So student loans are non-dischargeable, unscheduled debts also non-dischargeable. If you don't put a debt in the petition,

the court basically says, "We didn't know about it, so we can't discharge it." So, you have to schedule all of your debts in a petition.

Most Common Non-dischargeable Debts

Student loans

Unscheduled debts

Money owed to the government

Child support, spousal support, etc.

Willful/malicious injury, fraud, or theft

Almost all money owed to the government like taxes fees, that kind of thing is non-dischargeable, you got to pay your taxes. Domestic support obligations, child support, spousal support, alimony, those unpaid amounts for those sorts of things are usually non-dischargeable. And also, interestingly, money owed for willful, or malicious injury, fraud or theft is not dischargeable, but it wasn't always this way. And we'll see why in the next lesson.

Now, once you receive your discharge or you're about to receive your discharge, debtors actually have the option in some instances to

what we call reaffirm certain debts. So, you might have a debt that you could have discharged

but you don't want it discharged, you would like to pay it. Maybe it's because the debt is secured by some collateral and you want to keep that collateral. So, you agree to reaffirm that debt if the lender agrees so that you can keep the collateral and continue making payments on that debt.

Lesson 2-7: Bankruptcy: Exempt Property & Fraudulent Transfers

Lesson 2-7.1: Bankruptcy: Exempt Property & Fraudulent Transfers

In this, the second of our three part series on bankruptcy, we discuss exempt property and fraudulent transfers, two very important concepts in the realm of bankruptcy. [SOUND] [MUSIC] [SOUND] In the previous lesson, we laid some foundations for our discussion of bankruptcy. We talked about like, what is a bankruptcy estate, what's a bankruptcy trustee. Some of the key concepts to understand how bankruptcy works. Now, in the next lesson, we're going to discuss the differences between the different types of bankruptcy filings, chapter 7, chapter 11, chapter 13, you've probably heard at least 1 of those before. But here in this lesson, we're going to focus on two, two and a half real important concepts.

Exempt Property: Federal v. State Rules

Those are the concepts of exempt property and fraudulent transfers. So let's start with exempt property.

In the previous lesson, I said that when you file your bankruptcy petition that bankruptcy estate is created and it owns all of your stuff. And that's not entirely true. What's actually true is it owns most of your stuff or some of your stuff because the bankruptcy code actually includes this concept of exempt property and it sets forth a certain amount of property that you can keep for yourself that doesn't go into the bankruptcy estate.

Exempt Property: Federal v. State Rules

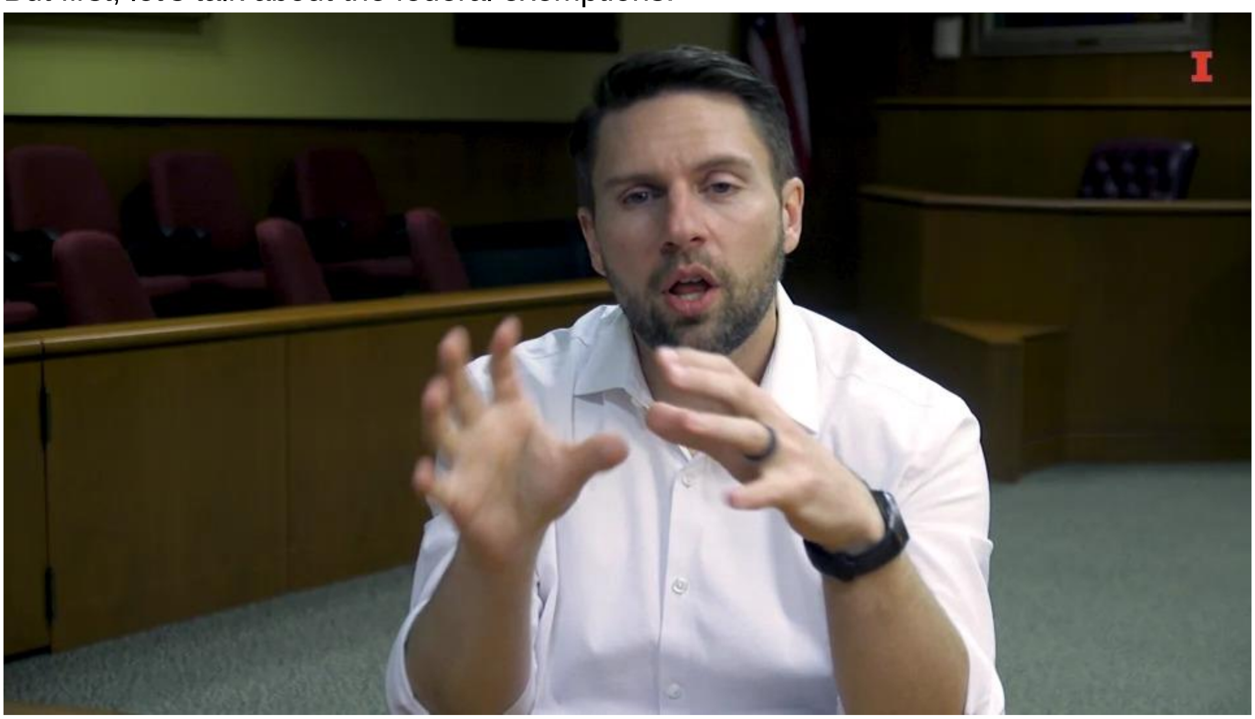
And this is actually the one area where state law comes into play in a bankruptcy setting.

I had mentioned in the previous lesson that bankruptcy is a creation of federal law. And that's true, except for this one little area of exempt property, because there are federal exemptions and there are also state exemptions. Each state has the ability to create own exemptions and those things will be property that you can keep

Exempt Property: Federal v. State Rules

Common federal exemptions

that doesn't go in to the bankruptcy of state. Now, this can be somewhat controversial, and we're going to see why in a few minutes through reference to a very famous case. But first, let's talk about the federal exemptions.



The actual amount of federal exemptions are adjusted pretty frequently based on consumer price index and some things like that. But under federal law, every debtor is entitled

Exempt Property: Federal v. State Rules

Common federal exemptions

Homestead: $23,675

to a homestead exemption, which at this moment is $23,675.

So up to $23,675 of equity in your primary residence, you can keep. Now, for valuing a house, that's not very much, right? You don't get a lot of house for $23,675 no matter where you live. But it's at least some equity in your house that you can keep. So you're probably going to have to sell your house, but you can keep that amount.

Exempt Property: Federal v. State Rules

Common federal exemptions

Homestead: $23,675

Motor vehicle: $3,775

You can keep up to $3,775 in equity in a motor vehicle.

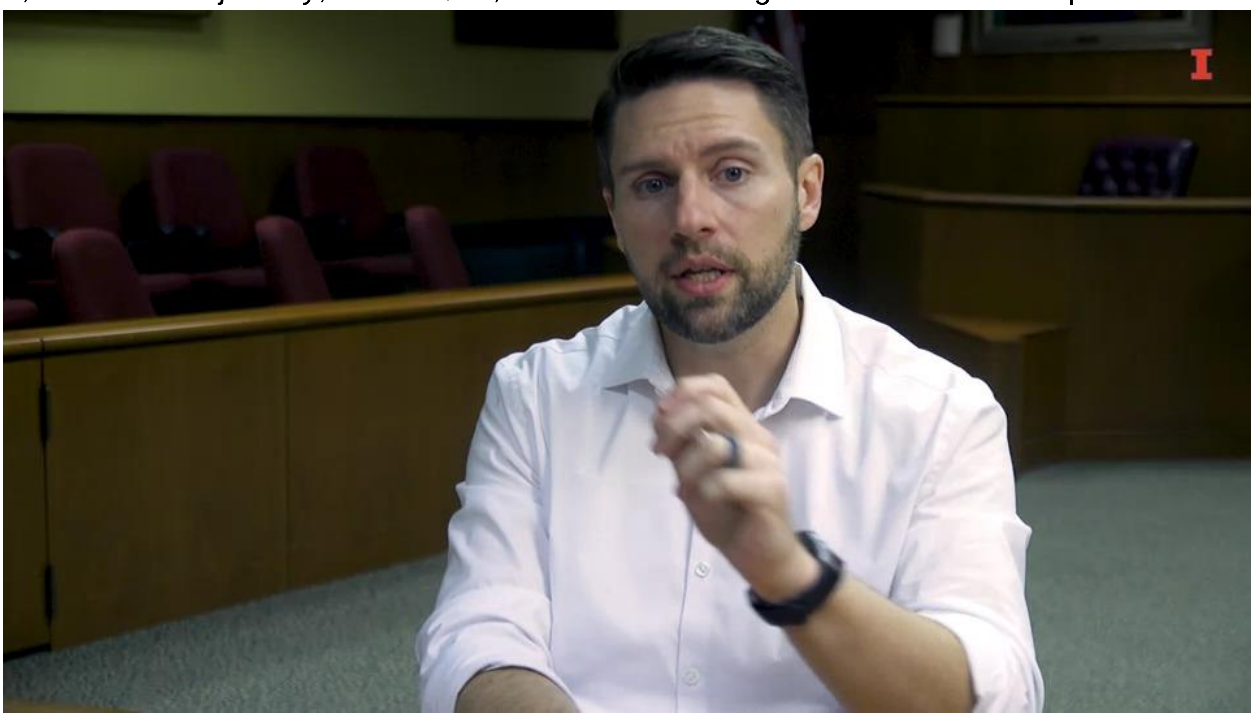
Again, can you buy a nice car for $3,775? No, but you can buy a car.

Exempt Property: Federal v. State Rules

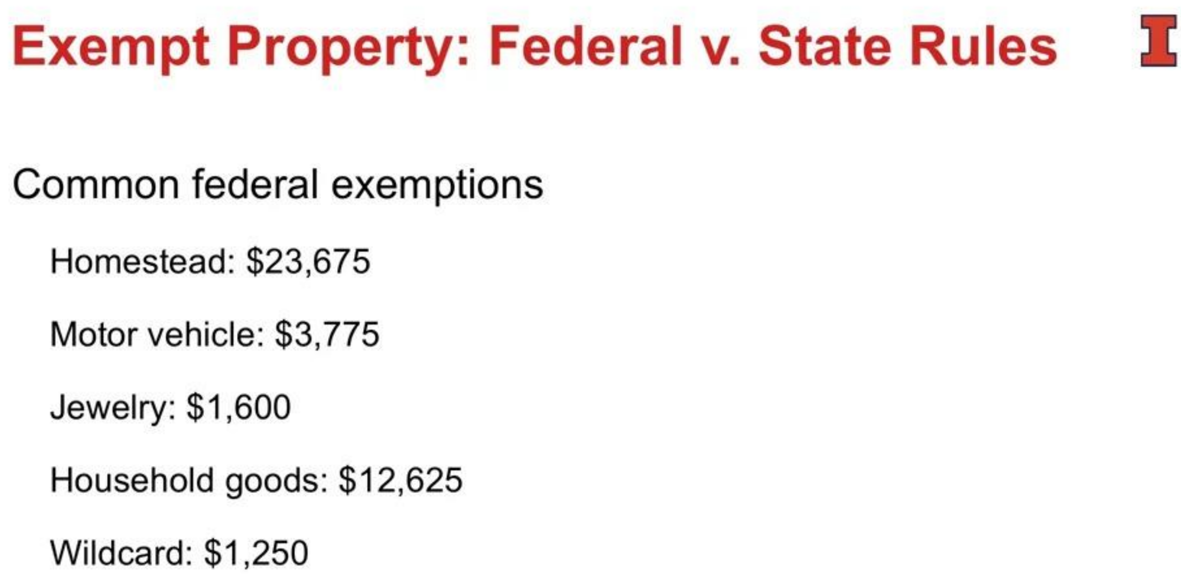
Common federal exemptions

- Homestead: $23,675
- Motor vehicle: $3,775
- Jewelry: $1,600
- Household goods: $12,625

6,000 bucks in jewelry, almost $13,000 in household goods but there's a cap on the limit



of exemption for any 1 individual household good.



And then there's a wild card exemption of $1,250 that you can apply to anything. There's some other federal exemptions but

those are just like examples of some of the things that the federal law allows you to keep yourself that doesn't go into the bankruptcy of estate. Now, states are allowed to create their own exemptions or even expand the federal exemptions, and many states have. In fact, there's a very famous case where the state exemptions in the state of Florida, became quite controversial.

Exempt Property & Fraudulent Transfers

State exemptions and the case of OJ Simpson

Now, if you're all like me, you remember the trial of the century. Not this century, the last century. And that was the case of OJ Simpson, who was on trial

for murdering his ex-wife and her friend. In the criminal trial, OJ Simpson was found not guilty. But he was sued civilly by their families, the victim's families, and he was found liable. Now, the difference between civil and criminal courts and standard burden's of proof, way outside the scope of this lesson, just know that he was found liable for their wrongful death in civil court, in order to pay $33 million in judgement, that's a lot of money. Now, OJ Simpson had a lot of really smart layers and they knew that the state of Florida had an unlimited homestead exemption at that time. Which meant that if OJ Simpson moved to Florida, took all of his money and bought the biggest, most expensive house he could afford and then went through bankruptcy, he could keep the house. He could then, after the bankruptcy was over, sell the house and have all the money.

Exempt Property & Fraudulent Transfers

State exemptions and the case of OJ Simpson

That seems a little controversial, right? And in fact, it was so controversial,

that it inspired Congress, when it was revising the bankruptcy code in 2005, to change the rules such that any debts that arose from willful or malicious behavior like murder, are now non-dischargeable. So OJ Simpson today would not be able to go through bankruptcy and have his civil judgement for $33 million discharged in bankruptcy. The 2005 changes also allowed courts to get at homesteads that were purchased for the sole purpose of avoiding creditors. So no longer are those forms of homesteads exempt. So we have OJ Simpson to thank for those changes.

Fraudulent Transfers

Okay, next important concept for today's lesson, fraudulent transfers. Let me start by giving you an example.

You know you're about to go bankrupt. And you have some stuff you'd really like to hang on to, you don't want to have to sell it in the bankruptcy proceedings. So you come up with a great idea. You say, I'm just going to take my stuff, transfer ownership of it to my spouse, or my boyfriend, or girlfriend, or a good friend, or a parent or anybody, and then I'm going to go through bankruptcy, have all my debts discharged, and then once that's done, they'll give my stuff back and I'll have it. I'm a genius, right? Wrong, the bankruptcy court anticipates that you're going to be conniving like this, and this is why we have the rules about fraudulent transfers.

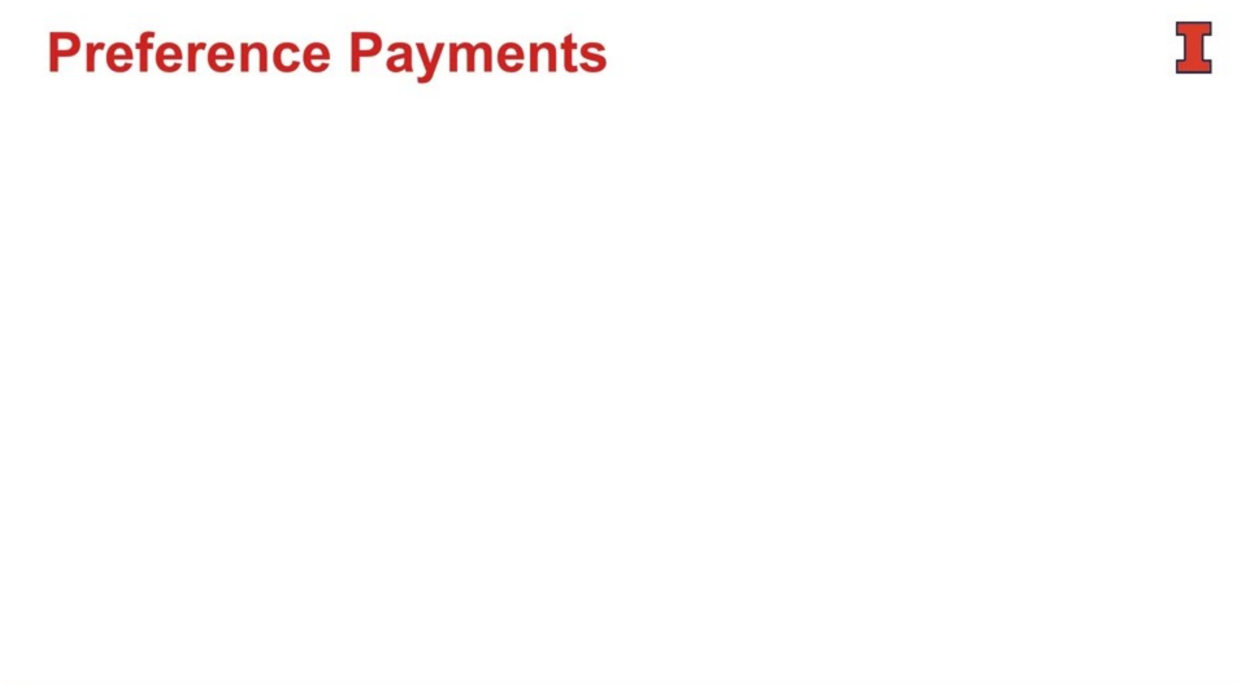
Fraudulent Transfers

Within 2 years prior to filing petition, and either:

- Debtor received less than fair value, or
- Transfer occurred with intent to harm creditors

So what the rules about fraudulent transfers say is that, for any transfer of assets that you give to somebody else within the two years prior to filing your bankruptcy petition, that's a pretty long time, it's pretty unlikely you're going to have two years of foresight to plan out your scheme. So within two years of filing your petition, if you transfer assets to someone and you either receive less than their fair value, or it can be demonstrated that you transferred those assets with the specific intent to harm your creditors, then those transfers can be undone. And the bankruptcy court can actually go and retrieve those assets that you transfer to someone else.

So in contrast to a fraudulent transfer which is a transfer of an asset to a friend, family member of something like that, a preference payment is actually a payment made to a creditor including creditors in bankruptcy.



The payment made prior to the filing of your bankruptcy petition that gives that creditor an unequal footing with the other creditors by receiving more payment than it would have received in bankruptcy. So let's take an example.

Say I owe money to ten banks and I'm about to go bankrupt, but one of those banks comes to me and says, okay, look, before you file your bankruptcy petition, pay us 50% of what we're owed and then after bankruptcy we'll be more willing to work with you. So I pay that bank 50% of what it's owed then go through bankruptcy and everybody else gets pennies on the dollar instead of 50 cents on the dollar, that's a preference payment

Preference Payments

To unrelated creditors within 90 days prior to petition

To insider creditors within 1 year prior to petition

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if it was made within 90 days prior to the petition. For unrelated creditors, payments made within 90 days prior to the filing of the petition are preference payments and actually can be clawed back from the creditors who received those payments because we want all creditors to share in the burden of bankruptcy equally. Now, if the creditor's an insider to your company,

like a stockholder of your company, loaned money to the company, and you made a preference payment to that stockholder, they're an insider. They're an owner also. We don't just look back 90 days, we look back a whole year. Any payments made to creditors who are insiders can be undone for a period of one year prior to petition so that all creditors are placed on an even footing.

Lesson 2-8: Types of Bankruptcy

[Lesson 2-8.1: Types of Bankruptcy]

This is the final lesson in our three part series on bankruptcy, we discussed the differences between the three main types of bankruptcy, chapter 7, chapter 11 and chapter 13. Way back in our first lesson on bankruptcy, we defined the bankruptcy code which is a set of federal statutes that deal with bankruptcy, bankruptcy procedures, all the rules about bankruptcy. Now, the bankruptcy code is divided into chapters.

Three Main Types of Bankruptcy

Chapter 7

Chapter 11

Chapter 13

You've probably heard the term chapter 7 bankruptcy, or chapter 11 bankruptcy, or chapter 13 bankruptcy.

Those just refer to chapters within the bankruptcy code that define certain methods by which a debtor can go through bankruptcy. So, in this lesson we're going to talk about the three most common forms of bankruptcy, the chapter 7 bankruptcy, the chapter 11, and the chapter 13.

Chapter 7

Key Concept: **Liquidation**

So, let's start with chapter 7. This is what we call straight liquidation or just a regular bankruptcy, this is the original form of bankruptcies, the chapter 7. The key concept here is that in a chapter 7 bankruptcy, all of the debtors non-exempt assets are liquidated and then the proceeds distributed to the creditors and discharge occurs.

It's easy, that's the great thing about chapter 7 is it's easy. There's no plans, there's no long term commitments, you just sell everything, distribute it, and everybody goes on their way. Now, not everyone can qualify to file for chapter 7. Businesses almost always can, but individuals have to go through one or two tests before they're able to file for chapter 7 bankruptcy.

Chapter 7

Key Concept: **Liquidation**

Individuals (not businesses) must qualify

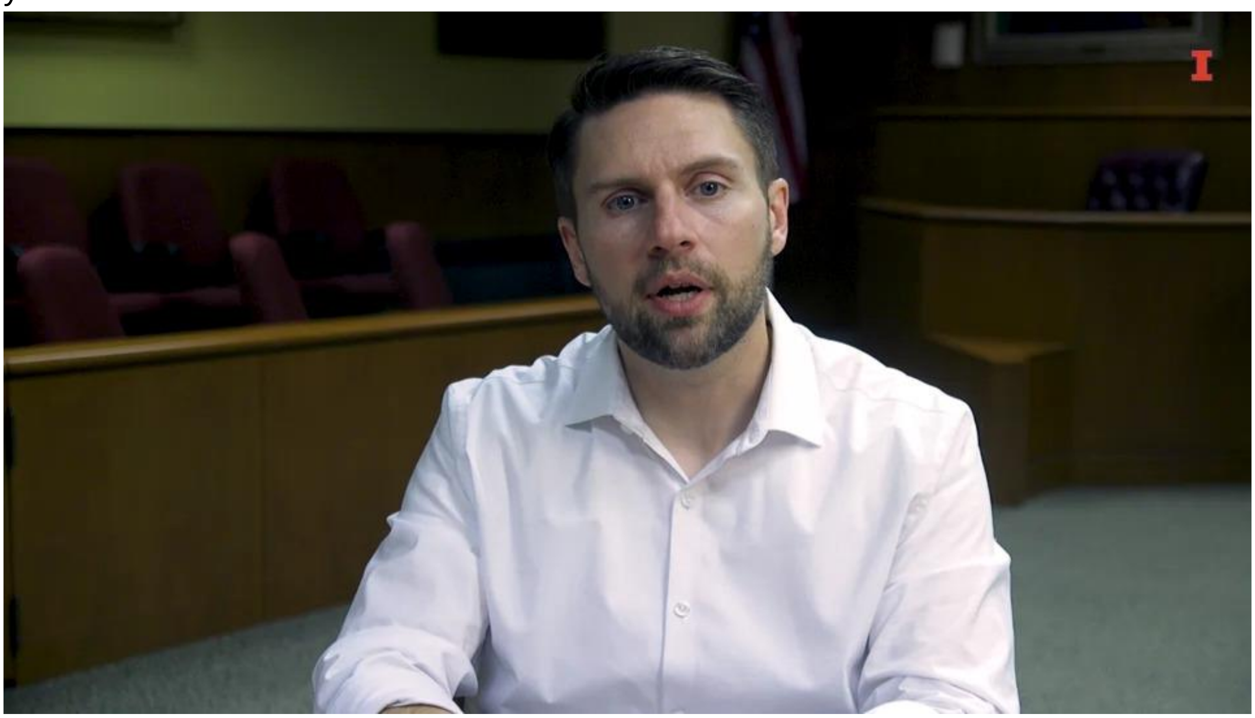
- Median income test

Now, the first thing that individuals must do is pass them what we call the median income test. Now, under the median income test

we look at the median income in your state. If your income is higher than the median income in your states then you are not automatically allowed to file chapter 7 bankruptcy. If your income is lower than the median income in your state, then you get to go through chapter 7 bankruptcy and you don't have to pass any other tests. But for those individuals whose income is higher than the median income in their state, they then have to move on to what we call the means test and this is a very complicated algorithm that tries to calculate whether your income is enough to support you and your family and also repay your debts. You plug in all the numbers and you run the math, and if the algorithm says, "No, your income is not enough to pay your debts and support you", then "Congratulations, you are allowed to go into chapter 7 bankruptcy." So, if you're not allowed to go into chapter 7 bankruptcy, you can still probably go into chapter 13 or chapter 11, but we'll get to those in a few slides.

Chapter 7: Distribution of Proceeds

Now, when you have a chapter 7 bankruptcy, we already mentioned that the key concept is liquidation. You gather up all your non-exempt assets, the trustee does all this, the trustee gathers up your assets, sells them and then distributes the proceeds to your creditors.



But this distribution process doesn't just happen haphazardly. There is actually a statutory order for the way in which the proceeds are distributed.

Chapter 7: Distribution of Proceeds

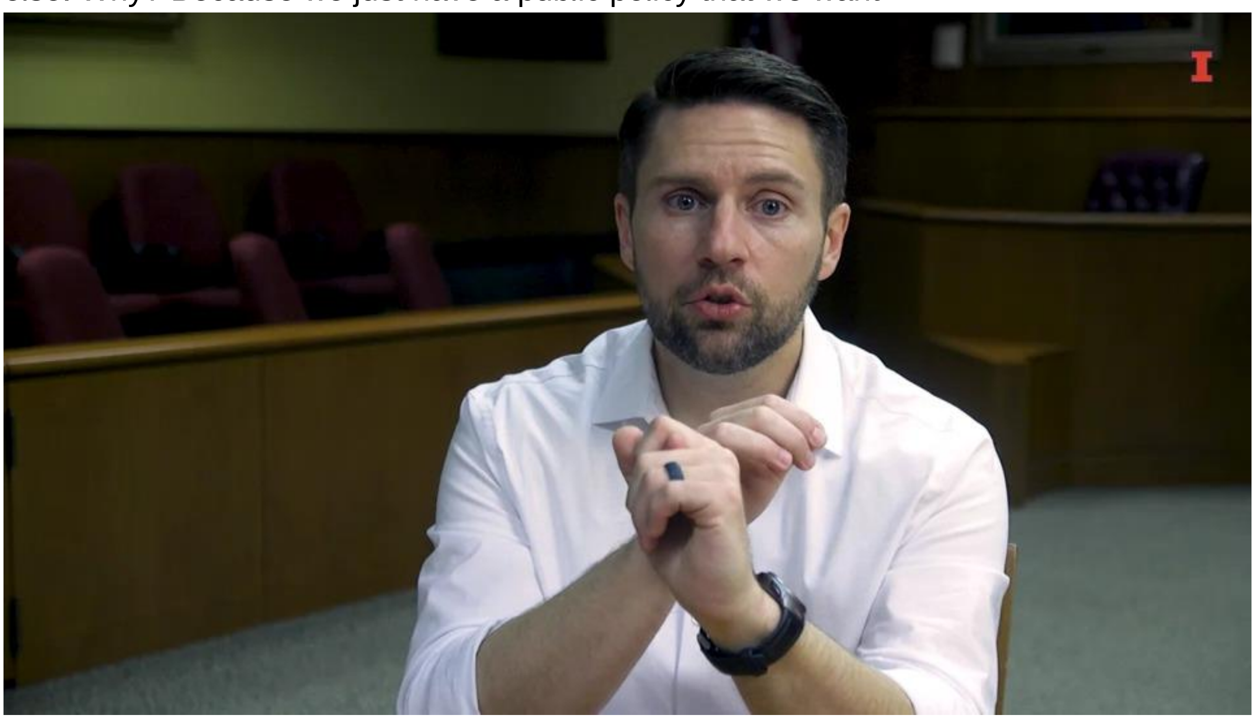
Domestic support

Bankruptcy costs

Employee obligations

Claims for undelivered goods/services

Here's the order. First, all of your domestic support obligations get paid before anything else. Why? Because we just have a public policy that we want



mostly children to be taken care of. If you owe child support or spousal support even, that gets prioritized first just as a matter of public policy.

Chapter 7: Distribution of Proceeds

Domestic support

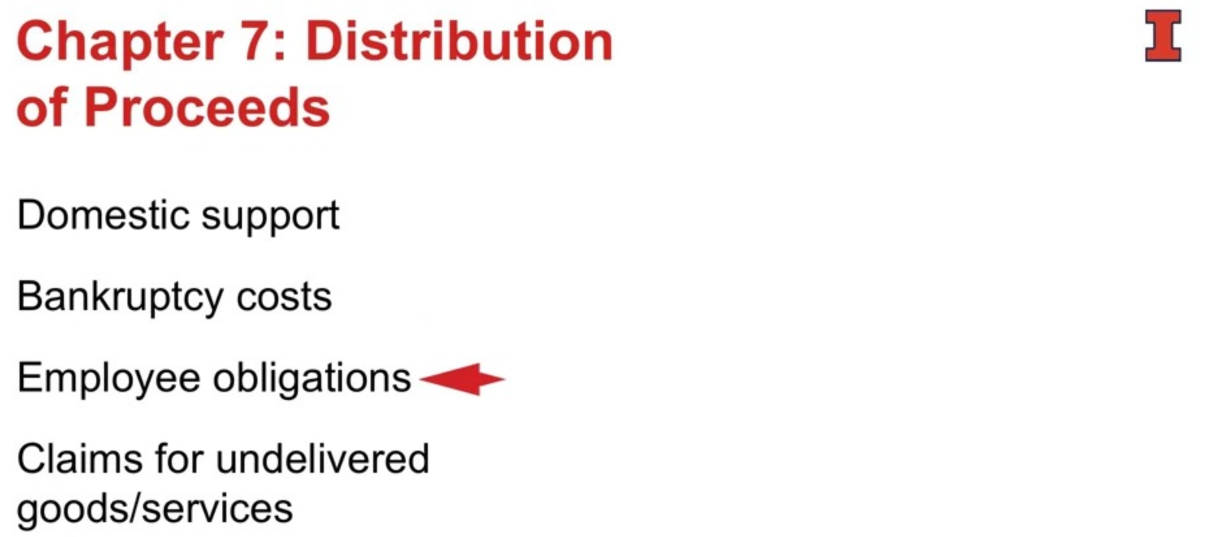
Bankruptcy costs

Employee obligations

Claims for undelivered goods/services

Then after that bankruptcy costs. Why? Because the lawyer's got to get paid.

I'm not objecting to that at all. In fact, since lawyers drafted this, I'm surprised that bankruptcy costs didn't go in front of the children. It's actually a testament to somebody out there who put the children before the lawyers, but then the lawyers come next, the bankruptcy costs get paid after that.



After the bankruptcy costs, employee obligations.

So, if you're a business or a business owner and you owe unpaid wages, unpaid commission checks, that sort of thing, those get paid next.

Chapter 7: Distribution of Proceeds

Domestic support

Bankruptcy costs

Employee obligations

Claims for undelivered goods/services

Then your business any claims for undelivered goods or services from your customers.

Chapter 7: Distribution of Proceeds

Taxes

Others

General unsecured claims

Equity owners

Taxes come after that,

Chapter 7: Distribution of Proceeds

Taxes

Others

General unsecured claims

Equity owners

then there's a whole bunch of other things that are less common that come after that can kind of do that.

Chapter 7: Distribution of Proceeds

Taxes

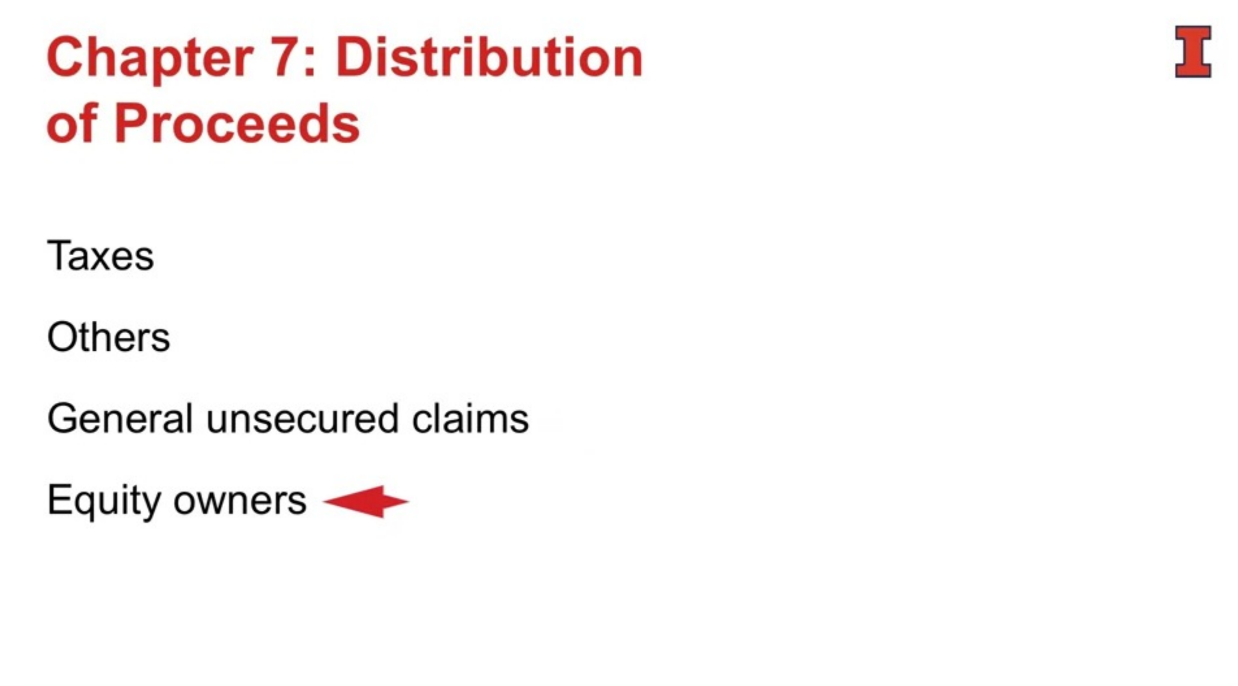
Others

General unsecured claims

Equity owners

But then at the very end, you have general unsecured claims.

This is like if you're a bank who has issued a credit card to a debtor, that's just a general unsecured claim. You come down very low in the process which is why these folks usually get pennies on the dollar if anything. Then finally, if there's any money left over after paying all the creditors and you're a business

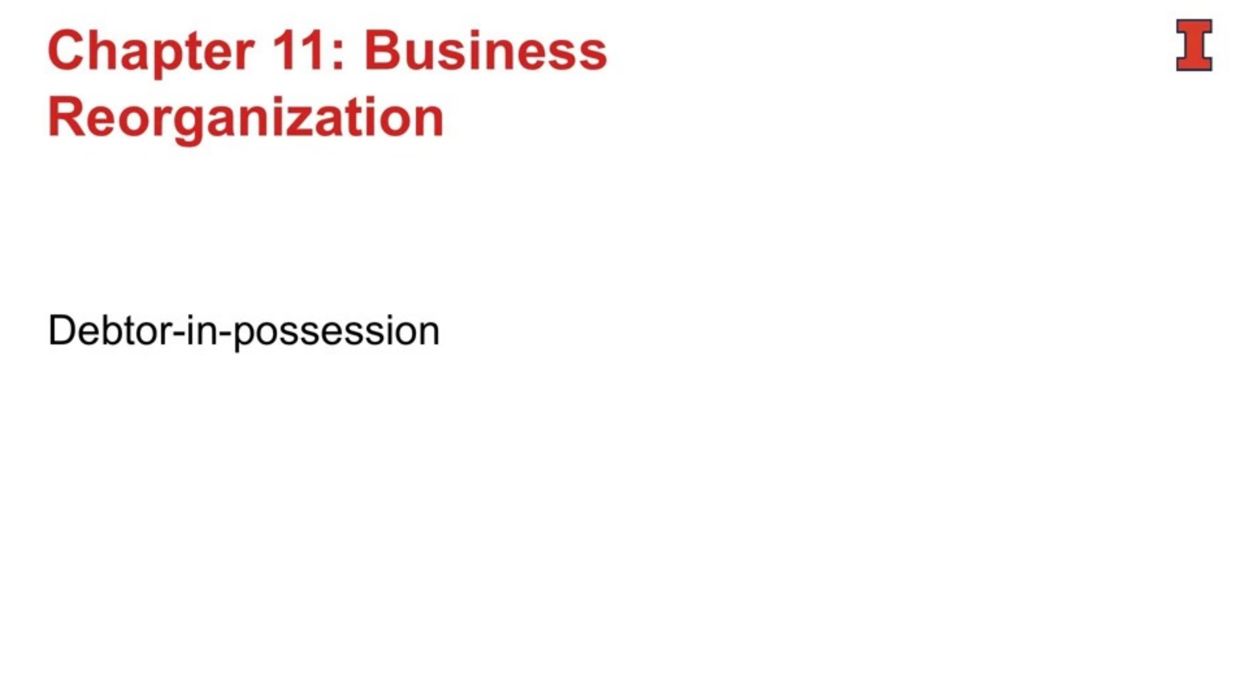


then the rest gets distributed to the owners of the business and if you're an individual then the individual gets to keep it.

Now, it's pretty uncommon to get down that low, domestic support often sucks up a huge chunk, bankruptcy costs soak up a huge chunk and there's no pro rata distribution among the levels. If domestic support obligations take up all of the proceeds, then everybody else just gets nothing.

Let's move on to chapter 11 bankruptcies. This is usually referred to as a business reorganization type of bankruptcy.

Individuals actually can use chapter 11, but usually at here you are really rich and it's pretty uncommon, so it's almost exclusively businesses. A few key concepts about chapter 11. This is truly a reorganization of your debts and the goal is for the business to go through bankruptcy and come out the other side and still be an operating business but in a much better position to succeed. In order to do that the debtor can't give up its assets to the trustee while the bankruptcy is pending, that would be bad for business. So, in chapter 11 usually



we apply this concept called the debtor-in-possession or DIP. Instead of the trustee taking over all the debtors assets, the debtor acts like it's own trustee for the most part and retains it's assets

so that it can continue operating it's business during the pendency of the bankruptcy.

Chapter 11: Business Reorganization

Debtor-in-possession

Creditors committee

Another unique concept of chapter 11 is that the creditors form a committee, because usually this happens

with a business, oftentimes a big business, oftentimes a business with many, many creditors. So they form a committee, they send representatives, and the entire process is basically a negotiation between the committee of creditors and the debtor with the encouragement of the court and the threat that, "Hey creditors, if you don't play ball, we're just going to shift this over to a chapter 11 and liquidate everything and then you're really going to be unhappy about it. So, the chapter 11 bankruptcy court is really there just to provide an incentive for both parties to try and find a negotiated compromise,

Chapter 11: The Plan

because the end result of a chapter 11 bankruptcy is called the chapter 11 plan.

Now, the plan can be a really, really hefty document and it sets forth all of the changes in the debtor's financial structure as a result of bankruptcy. So, maybe some loans will have their interest rates reduced, and some payment terms might be extended, or some loans might be partially forgiven or whatever your financial changes are all set forth in the plan which has to be approved by the court. Now, the court will approve a plan

Chapter 11: The Plan

Best interests of creditors

usually if it's in the best interest of the creditors.

What does it mean to be in the best interest of the creditors? Basically, it means that they will get more under the plan than they would have gotten in a chapter 7 liquidation. So, as long as that's true, it's in the best interests of the creditors.

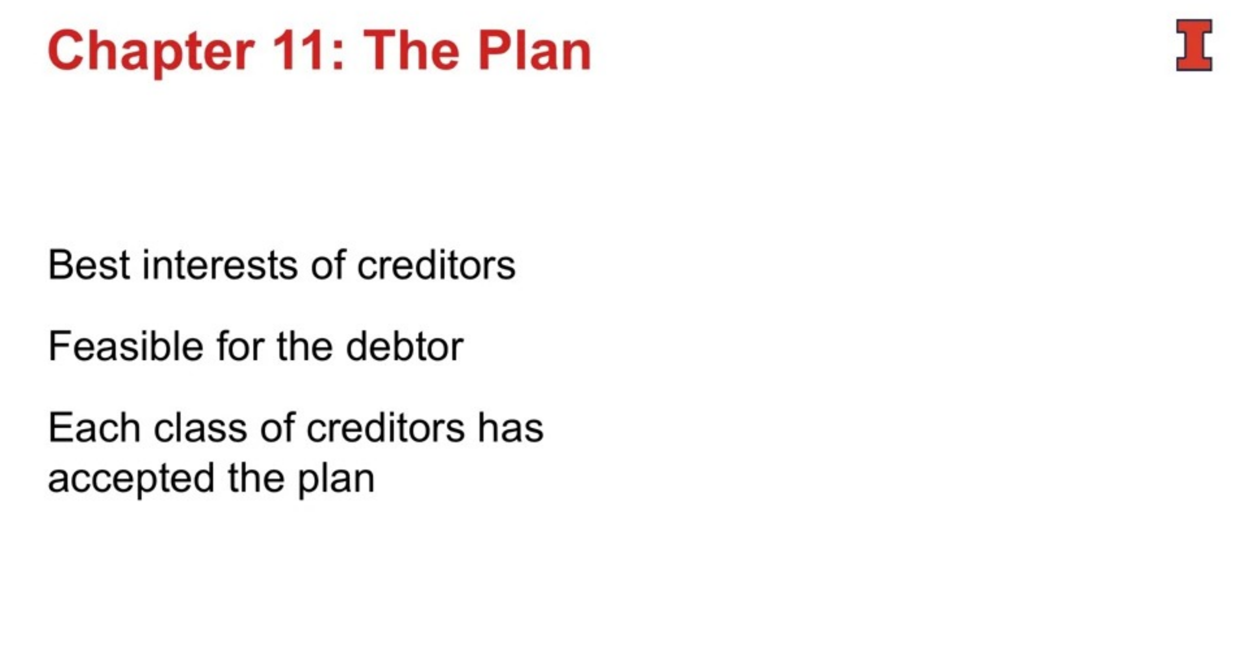
Chapter 11: The Plan

Best interests of creditors

Feasible for the debtor

Next, it has to be feasible for the debtor.

You can't be a company that has revenues of $10 million a year and promised to pay $100 million a year in your chapter 11 plan, that's not feasible.

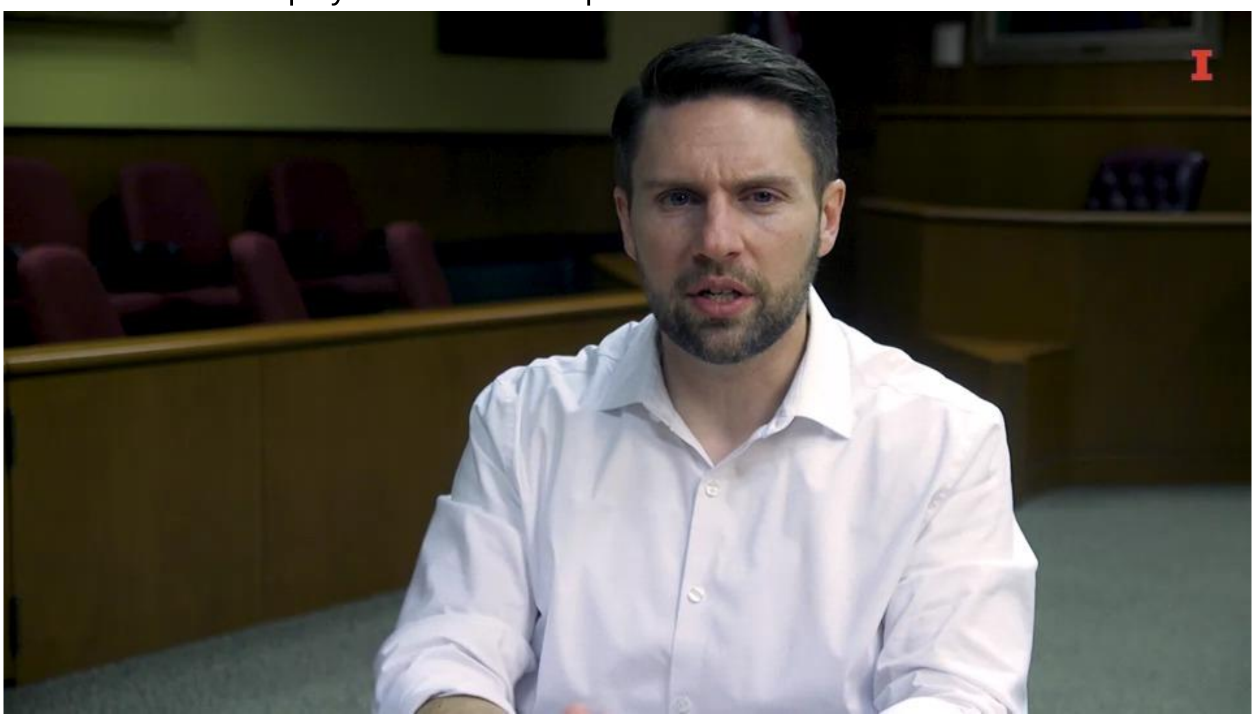


Finally, each class of creditors has to have accepted the plan.

So, a classes of creditors can be secured creditors, unsecured creditors. There are various classes of creditors, but they all have to by majority vote of the class accept the plan. If that's true, then the court will usually approve the bankruptcy plan, the chapter 11 case will be discharged and the company will go forth with it's new financial structure.

Chapter 13: Qualifications

Final form of bankruptcy is called the chapter 13. This is sometimes called like



the individual reorganization, because it's very similar to a chapter 11 and that there's a plan, but chapter 13 is only for individuals.

Chapter 13: Qualifications

Individuals with a regular income

Now, you have to meet a couple of qualifications in order to file for chapter 13 bankruptcy if you're an individual. First one is you have to have a regular income.

If you don't have a job you can't file chapter 13, you have to file chapter 7.

Chapter 13: Qualifications

Individuals with a regular income

Cap on amount of debt

Next, you actually cannot have debts that exceed a certain amount in order to file chapter 13 bankruptcy.

The amounts are about $400,000 in unsecured debt and a little over a million dollars in secured debt. If your debts are more than that, you actually can't file chapter 13, you have to go through chapter 7 instead, as an individual.

Chapter 13: The Plan

Now, the chapter 13 plan, it's not the same as a chapter 11 plan

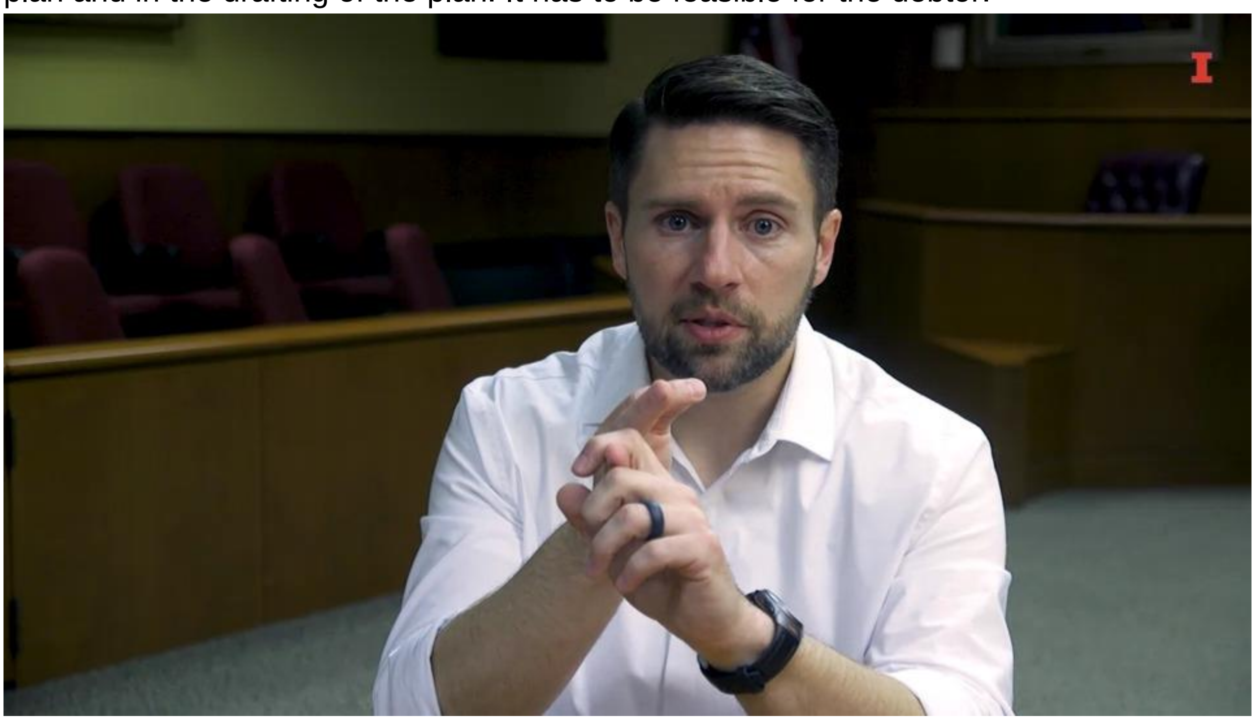
because there's not really the collaborative effort between the debtor and the creditors, the chapter 13 plan is more of the debtor saying, "This is what I proposed to pay to my creditors" and then the bankruptcy court saying, "Yeah, that sounds good" and the creditors are sort of have to go along with it.

Chapter 13: The Plan

Proposed in good faith

Feasible for the debtor

Now, in order for a chapter 13 plan to be confirmed by the court, it has to be proposed in good faith by the debtor meaning they have to be honest in their presentation of the plan and in the drafting of the plan. It has to be feasible for the debtor.



Again, they can't promise to pay more than they actually make.

Chapter 13: The Plan

Proposed in good faith

Feasible for the debtor

Best interests of creditors

3-5 years

It has to be in the best interest of the creditors. Same definition as before, they have to get more than they would get in chapter 7. The chapter 13 plan usually has a period of about 3-5 years. So, what happens is

the debtor promises to make payments usually to the trustee over a period of 3-5 years. The trustee then takes those payments and allocates them to the creditors using some formula, usually on a pro rata basis. But then once the five years is up, even though the debtor hasn't paid back all of his or her debts, the remaining amount of the debts will be discharged and the case will be closed. So, this takes a long time, but the great thing about chapter 13 is that the debtor gets to keep their stuff. So, if you have a job and you want to keep your stuff, chapter 13, yeah, it takes a while, and you got to make more payments than you would under chapter 7, but you don't have to sell grandma's earrings or something like that, family heirlooms, you get to them, you get to keep your stuff. So, that's the good thing about chapter 13.