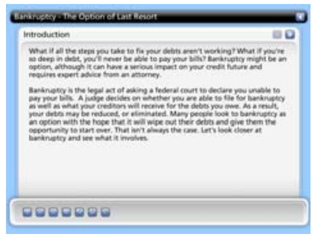
Bankruptcy - The Option of Last Resort

Introduction

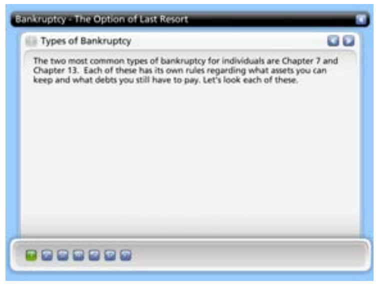


No Narration

What if all the steps you take to fix your debts aren't working? What if you're so deep in debt, you'll never be able to pay your bills? Bankruptcy might be an option, although it can have a serious impact on your credit future and requires expert advice from an attorney.

Bankruptcy is the legal act of asking a federal court to declare you unable to pay your bills. A judge decides on whether you are able to file for bankruptcy as well as what your creditors will receive for the debts you owe. As a result, your debts may be reduced, or eliminated. Many people look to bankruptcy as an option with the hope that it will wipe out their debts and give them the opportunity to start over. That isn't always the case. Let's look closer at bankruptcy and see what it involves.

Types of Bankruptcy



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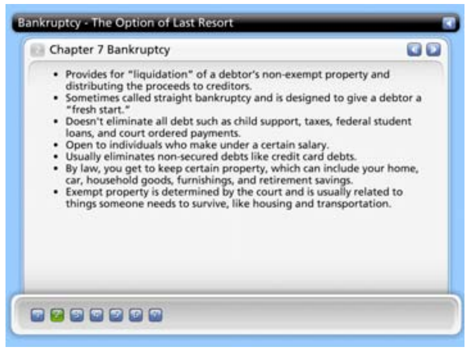
The two most common types of bankruptcy for individuals are Chapter 7 and Chapter 13. Each of these has its own rules regarding what assets you can keep and what debts you still have to pay. Let's look each of these.

Chapter 7 Bankruptcy



Step Text

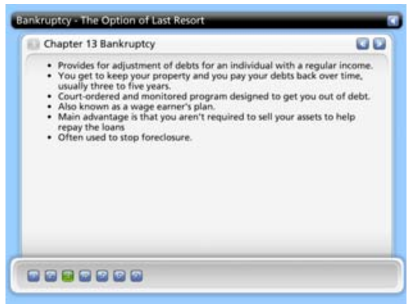
- Provides for “liquidation” of a debtor’s non-exempt property and distributing the proceeds to creditors.
- Sometimes called straight bankruptcy and is designed to give a debtor a “fresh start.”
- Doesn't eliminate all debt such as child support, taxes, federal student loans, and court ordered payments.
- Open to individuals who make under a certain salary.
- Usually eliminates non-secured debts like credit card debts.
- By law, you get to keep certain property, which can include your home, car, household goods, furnishings, and retirement savings.
- Exempt property is determined by the court and is usually related to things someone needs to survive, like housing and transportation.

Narration Script

Chapter 7 is the chapter of the U.S. Bankruptcy Code that provides for “liquidation” of a debtor’s non-exempt property and distributing the proceeds to creditors. In other words, the things you own, with a few exceptions, are sold and the money is distributed among your creditors in proportion to the amounts that you owe. Chapter 7 is sometimes called straight bankruptcy and is designed to give a debtor a “fresh start.” This type of bankruptcy doesn't eliminate all debt such as child support, taxes, federal student loans, and court ordered payments. Chapter 7 is only open to individuals who make under a certain salary.

Usually the court eliminates any non-secured debts like credit card debts. Keep in mind with Chapter 7, they take your possessions, sell them, and give the money to your creditors. Does that mean they take your house and car and leave you homeless and with no transportation? By law, you get to keep certain property, which can include your home, car, household goods, furnishings, and retirement savings. If you have a secured loan for a car or home, the collateral securing the debt will go back to the lender or be sold with the money going to help pay off that debt. You may be given a portion of the proceeds so that you can get a place to live and a less expensive car. Debt that is unsecured, such as credit card debt, is discharged, which means you don’t have to pay those debts. Exempt property is determined by the court and is usually related to things someone needs to survive, like housing and transportation.

Chapter 13 Bankruptcy



Step Text

- Provides for adjustment of debts for an individual with a regular income.
- You get to keep your property and you pay your debts back over time, usually three to five years.
- Court-ordered and monitored program designed to get you out of debt.
- Also known as a wage earner's plan.
- Main advantage is that you aren’t required to sell your assets to help repay the loans
- Often used to stop foreclosure.

Narration Script

Chapter 13 is the chapter of the U.S. Bankruptcy Code that provides for adjustment of debts for an individual with a regular income. With this option, you get to keep your property and you pay your debts back over time, usually three to five years. This is a court-ordered and monitored program designed to get you out of debt. This type of bankruptcy is sometimes called a wage earner's plan. The main advantage is that you aren’t required to sell your assets to help repay the loans. If you complete the plan successfully, any remaining unsecured debts are discharged. The Chapter 13 option is often used to stop foreclosure. To do this, you would have to keep making regular payments on your mortgage and you have to make separate “catch up” payments on overdue amounts according to your Chapter 13 plan. If you complete the repayment schedule successfully, your mortgage is considered up-to-date.

When do people file for bankruptcy?

Step Text

Most people file for bankruptcy voluntarily. There are times, however, when creditors for a person to file for bankruptcy involuntarily. Usually this happens when your creditors have tried repeatedly to get you to pay your debt, and you have ignored the problem or avoided them so they take matters into their own hands and have the court declare you bankrupt. Obviously, this is the worst case scenario!

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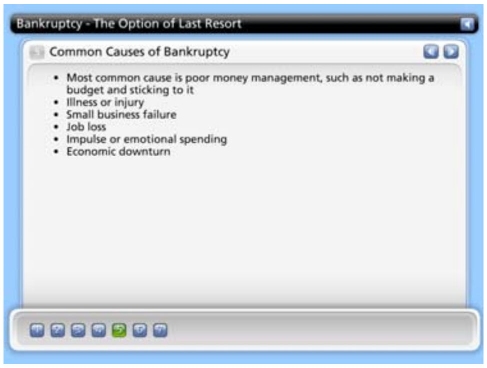
Common Causes of Bankruptcy



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- Most common cause is poor money management, such as not making a budget and sticking to it
- Illness or injury
- Small business failure
- Job loss
- Impulse or emotional spending
- Economic downturn

Narration Script

Like other credit problems, the most common cause of bankruptcy is poor money management, such as not making a budget and sticking to it, but there are other reasons that someone may become overwhelmed by his or her debt. Some of the other most common causes of bankruptcy are:

Illness or injury - If someone becomes sick or injured and can't work, that can be a major problem for paying bills, especially if he or she doesn't have disability insurance! Medical bills, in addition to not being able to work, can make debt really pile up.

Small business failure - As you learned in the economics modules, a person who owns a small business is liable for any debts that the business has. If the business fails, the owner still has to pay the business's debts as well as his or her own personal debts.

Job loss - When someone is laid off or fired, bills can pile up quickly as savings are depleted. By the time that person gets a new job, it may be impossible to catch up.

Impulse or emotional spending - People who practice "retail therapy" to make themselves feel better are in grave danger of getting into too much debt. Guilt over the purchases also contributes to the problem. You cannot solve debt problems with more debt! A person who falls into this category needs to get counseling for their credit problems but also for the reason he or she tries to use shopping for "therapy."

Economic downturn - When the economy is down, people have less money to spend. Unemployment rises. Businesses fail. An economic downturn can lead to people not having enough money to pay their bills. Credit gets harder to obtain. Lenders become much more selective in allowing credit. A slow economy hurts us all, but especially people who are already having trouble with debt.

The Impact of Bankruptcy

Step Text

- Bankruptcy stays on your credit record for up to ten years
- Fewer options for creditors and higher interest rates for loans
- Some insurance companies will charge you higher rates
- Can make it harder to get a job.

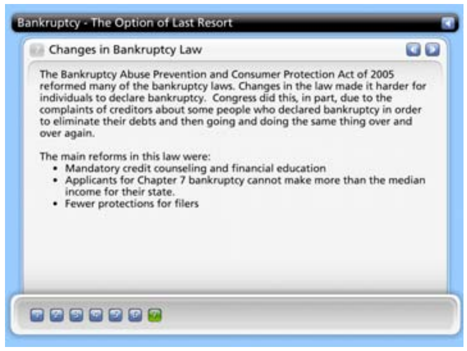
Narration Script

So, why is bankruptcy such a big deal? It gets you out of debt, right? Yes and no! It does eliminate some of your debts but the effects really hurt your credit for a long time. While most negative items on your credit report are removed after seven years, a bankruptcy stays on your record for up to ten years, visible to anyone who has access to your report.

When you apply for credit, you'll find a much smaller pool of creditors willing to risk their money, and those that do will charge a much higher interest rate. Some insurance companies will charge you higher rates. Don't forget that many employers screen their applicants using their credit report, so you might find it harder to get a job.

Bankruptcy can make everything much more expensive and limit the number of options you have in life. It should always be your last resort for solving credit problems.

Changes in Bankruptcy Law



Step Text

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 reformed many of the bankruptcy laws. Changes in the law made it harder for individuals to declare bankruptcy. Congress did this, in part, due to the complaints of creditors about some people who declared bankruptcy in order to eliminate their debts and then going and doing the same thing over and over again.

The main reforms in this law were:

- Mandatory credit counseling and financial education
- Applicants for Chapter 7 bankruptcy cannot make more than the median income for their state.
- Fewer protections for filers

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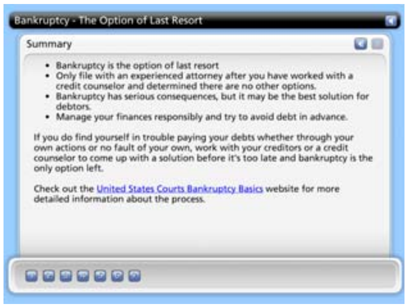
The main reforms in this law were:
Mandatory credit counseling and financial education - Before filing for bankruptcy, most applicants must undergo credit counseling in a government-approved program. At the end of the bankruptcy proceeding before any debts can be discharged, debtors must also participate in a financial management education program.

Changes to filing under Chapter 7 and Chapter 13 - Applicants wishing to file Chapter 7 bankruptcy are now required to have an income that is less than the median (average) income for their state. If the applicant makes more than the median, he or she must file under Chapter 13.

Fewer protections for filers - Filing for bankruptcy no longer delays or stops eviction actions, driver's license suspensions, legal actions for child support, or divorce proceedings. In fact, people that are owed unpaid child support and alimony take priority over any other creditors.

Summary



Step Text

- Bankruptcy is the option of last resort
- Only file with an experienced attorney after you have worked with a credit counselor and determined there are no other options.
- Bankruptcy has serious consequences, but it may be the best solution for debtors.
- Manage your finances responsibly and try to avoid debt in advance.

If you do find yourself in trouble paying your debts whether through your own actions or no fault of your own, work with your creditors or a credit counselor to come up with a solution before it's too late and bankruptcy is the only option left.

Check out the United States Courts Bankruptcy Basics website for more detailed information about the process.

Narration Script

Filing for bankruptcy is the option of last resort and only should be pursued with an experienced attorney after you have worked with a credit counselor and determined there are no other options. Bankruptcy has serious consequences, but it may be the best solution for debtors.

The obvious lesson is that it pays to manage your finances responsibly and try to avoid debt in advance. If you do find yourself in trouble paying your debts whether through your own actions or no fault of your own, work with your creditors or a credit counselor to come up with a solution before it's too late and bankruptcy is the only option left.