Chapter 1

Considering Bankruptcy

In This Chapter

- Understanding the history and tradition of bankruptcy
- Dispelling myths about bankruptcy
- Discovering what you can gain in bankruptcy
- Recognizing what you may lose in bankruptcy
- Knowing the consequences of not filing bankruptcy when you qualify

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Maybe you were socked with an unexpected and uninsured medical expense, and you didn't have the savings to cover the bills. Perhaps you lost your job, and you can no longer juggle your car and mortgage payments. Maybe you dipped into personal assets in a desperate (and futile) bid to salvage your business. Perchance your husband split and left you holding a big bag of joint debts. You likely bought into the easy-credit, instant-gratification, shop-till-you-drop mentality encouraged by lenders and retailers and found yourself mired in financial quicksand. In any case, things got out of hand and now you're up to your ears in debt.

Finance companies are warning that if you don't pay up, and soon, they're going to take your home and car. Credit-card firms are threatening to haul your butt into court. Debt collectors are pursuing you relentlessly. Your finances are a disaster. Your personal and professional relationships are strained. You're losing sleep, and you're becoming a perfect candidate for ulcers. Welcome to the club. Millions of Americans are in the same leaky boat.

Thankfully, you have a way — a perfectly legitimate way — to stop foreclosures and repossessions, put an end to lawsuits, protect your paycheck from garnishments, get those menacing debt collectors off your back, and regain control of your life: bankruptcy.

But bankruptcy is shrouded in myth and prejudice. You may have even felt a twinge of embarrassment buying this book.

If you're like many folks, the first step on the road to financial recovery is overcoming your feelings of inadequacy, shame, guilt, and fear of the unknown.

In this chapter, we encourage you to put myth and prejudice aside and look calmly at the advantages and disadvantages of bankruptcy. Then, and only then, can you make a rational decision about whether bankruptcy is the best choice for you and your loved ones. You have things to gain, and things to lose, in bankruptcy. This chapter gives you a glimpse of what's at stake with bankruptcy in kind of a broad way and serves as a gateway to the rest of the book.

Viewing Bankruptcy in a Historical Context

In the United States, the concept of bankruptcy is unique. Here, bankruptcy is viewed — legally and perceptually — as a means to an end, and not as "the end" of a debtor's financial life. America's Founding Fathers provided for bankruptcy right in the Constitution. A series of laws passed (and sometimes repealed) by Congress during the 1800s shaped the American view of bankruptcy as not only a remedy for creditors, but also as a way to give honest yet unfortunate debtors financial rebirth. The Bankruptcy Act of 1898 established that debtors had a basic right to financial relief without creditor consent or court permission. American bankruptcy laws have come to be recognized as far more compassionate and much less punitive to debtors than the laws of other countries.

Like much of American law, the country's bankruptcy statutes reflect the constant tension between the competing interests of debtors and creditors. Think of it as a perpetual tug of war, with each side striving mightily but never pulling their opponent all the way over the line. To this day, the balance of influence between creditors and debtors is in an ever-present state of flux. Sometimes debtors have the upper hand. Other times, creditors get the edge. At the moment, thanks to a new law that took effect in October 2005, creditors are holding the trump card.

The constant, however, is that Americans have always been (and remain) entitled to a fresh start. The obstacles that you must clear to obtain this fresh start are not constant; they're always changing.

Bankruptcy's roots

The word *bankruptcy* evolved from an Italian phrase *banca ratta* that means "broken bench or table." In medieval times, when a merchant failed to pay his debts, creditors would ceremoniously break the bench or table from which he conducted his business. The forgiveness of debts, on the other hand, has biblical roots.

Consider the Old Testament: "At the end of every seven years, you are to cancel the debts of those who owe you money. This is how it is done. Everyone who has lent money to his neighbor is to cancel the debt: he must not try to collect the money: the Lord himself has declared the debt canceled." (Deuteronomy 15: 1–2).

Debt forgiveness also is a prominent New Testament theme. In Matthew 18:21–27, Jesus relates the story of a servant who was indebted to his master. The master ordered the servant and his entire family into slavery but, upon reconsideration, he forgave the debt. Jesus used the parable to explain the virtue of debt forgiveness. (On the other hand, the apostle Paul admonishes debt in Romans 13:8, "Render therefore to all their dues . . . owe no man any thing." So maybe we can't afford to get too pious here.)

In any case, throughout history, creditors have not exactly displayed an attitude of Judeo-Christian charity toward debtors. Neither have governments.

The early Romans hacked up and divided the bodies of people who didn't pay their debts. In early England, people who were in over their heads financially were tossed in dungeons. The initial bankruptcy law, passed in 1542 during the reign of Henry VIII (the guy who kept beheading his wives), viewed debtors as quasi criminals but, for the first time, provided remedies other than imprisonment or mutilation.

Apparently, creditors finally realized that killing, maiming, or imprisoning debtors only ensured that they'd never get their money and that even if the debtor survived, he'd never be able to support himself and his family or become a productive member of society.

During the more enlightened reign of Queen Elizabeth I, a comprehensive bankruptcy law was passed (one that remained in effect for more than a century). The aim of the 1570 bankruptcy law was most certainly *not* to grant relief to debtors. Rather, it was designed to help creditors. It applied only to merchants (ordinary debtors still were imprisoned) and essentially laid out procedures by which a bankruptcy commissioner could seize the debtor's assets, sell them, and divide the proceeds among creditors. Debtors who did not cooperate had one of their ears lopped off.

The very idea of a bankruptcy law aiding debtors or forgiving debts remained a somewhat unimaginable concept until 1705, when Parliament enacted the first law that enabled a person to wipe out unpaid financial obligations. However, the terms were rather harsh: Consent of the creditor was required, and anyone who fraudulently sought bankruptcy relief faced the death penalty.

Before the United States won its independence, the various colonies handled bankruptcy their own respective ways, and little uniformity existed from colony to colony — except for the fact that settlers generally maintained the British tradition of jailing debtors (which extended to one of the British Empire's greatest literary stars, Charles Dickens.). In fact, Robert Morris, known as the "financier of the American revolution" and a signer of the Declaration of Independence, spent three years in debtors' prison (and six years in the United States Senate). Supreme Court Justice James Wilson fled Pennsylvania to avoid a similar fate.

Modern-day bankruptcy is rooted in the Bankruptcy Code of 1978, a federal law that was produced after more than ten years of careful study by judges and scholars. More recently, creditors and their lobbyists essentially rewrote what was a pretty well reasoned and fair law in their own image. The result was the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" — often known as the Bankruptcy Abuse Reform Fiasco, or BARF. It's not good for consumers. It's not good for the economy. It flies in the face of the risk-reward principles at the core of capitalism. And, in the long run, it's probably not all that good for the credit industry, which wrote it.

So how did a one-sided, ill-considered bucket of BARF happen to pass both houses of Congress as well as presidential scrutiny?

Some cynics think the eight-year lobbying campaign by the credit-card industry and the $100 million spent on campaign contributions may have had something to do with it. Some speculate that lawmakers, blinded by campaign contributions and sound-bite moralizing about personal responsibility (we are, by the way, all for personal responsibility — both for borrowers and *lenders*), simply didn't pay a whole lot of attention to the fine print in an incredibly complex amendment that's about the size of a metropolitan telephone book.

How these provisions will be implemented, applied and interpreted remains a mystery, and it will take years and years of cases and judicial opinions to sort it out. The simple fact of the matter is that neither we, your lawyer, nor even your local bankruptcy judge know for sure how or when the higher courts will decipher all this stuff and figure out how to apply it to circumstances never imagined by the people who wrote and voted for this bill.

Debunking Bankruptcy Myths

Bankruptcy is an economic decision, not a morality play, and you needn't be deceived into viewing it as anything else. The following sections look at some of the usual red herrings that are cast about by the credit industry.

People who go bankrupt are sleazy deadbeats

People file for bankruptcy because they're in debt. The more debt there is, the more bankruptcies there are. Well, duh! It really is that simple.

American bankruptcy

Our forefathers had radical ideas when it came to bankruptcy.

The founders of this country foresaw the possibility that honest people might suffer severe economic misfortune or make poor choices (Thomas Jefferson, certainly one of the most productive and accomplished individuals in the history of the world, was perpetually on the brink of bankruptcy during his later years), and had the wisdom to provide for bankruptcy in the U.S. Constitution.

After the Constitutional Convention of 1787, the framers of the Constitution added a bankruptcy clause empowering Congress to pass uniform bankruptcy laws to prevent some states from establishing debtors' havens. In 1800 — 11 years after the ratification of the Constitution — Congress passed (by a single vote) a national bankruptcy law that enabled debtors to wipe out unpaid debts. But the provision was repealed three years later because of creditor complaints. Consequently, states began passing their own bankruptcy laws, a practice that was struck down by the U.S. Supreme Court.

By 1833, the federal government abolished debtors' prisons. Honest debtors would no longer be incarcerated. But bankruptcy was still viewed as a remedy for creditors, not debtors.

The tide began to shift when Congress, spurred by the powerful oratory of Daniel Webster, passed the Bankruptcy Act of 1841, a seminal event that established clearly that bankruptcy law was for debtors *and* for creditors. For the first time in history, the advocates for debtors had prevailed over the interests of creditors.

The victory, however, was short-lived. Only three years later, creditors succeeded in having the law withdrawn. A similar choreography occurred just after the Civil War: Congress passed the Bankruptcy Act of 1867, which again enabled debtors to wipe out their debts. Eleven years later, creditors got it repealed. The threshold problem was this: Debt elimination was viewed as a privilege, dependent on creditor consent or court permission, not a fundamental right.

In the late 1890s, a revolutionary and uniquely American idea emerged — namely, that bankruptcy relief needed to be available to an honest person without consent or permission from others. This concept, which has come to be known as the *unconditional discharge,* was carved into the Bankruptcy Act of 1898.

Regardless of the long history and legal tradition underlying the unconditional discharge, creditors never cease trying to turn the clock back to the days when your bankruptcy relief required their permission.

Whenever the political climate appears favorable, creditors predictably scamper to Congress, whine about their losses, and claim that the "crisis" of "out-of-control" bankruptcies threatens to undermine the whole of Western civilization.

And therein lies the roots of BARF!

(See Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States,* American Bankruptcy Institute Law Review, Vol. 3:5, 1995.)

The credit industry stereotypes folks who file bankruptcy as worthless deadbeats taking advantage of a loophole-ridden legal system to dump their moral obligations on the backs of the rest of us. This stereotype is false, discriminatory, and manifestly unfair. Sure, bankruptcies have increased dramatically along with consumer debt, although the number of bankruptcies per $100 million on consumer debt has remained remarkably constant. From the 1970s to the 1980s, filings virtually doubled. The pace continued to increase in the 1990s, with bankruptcy filings setting new records year after year, even with a seemingly robust economy and near full employment. In fact, by the mid-1990s, bankruptcy filings, on a per capita basis, were running some eight times ahead of those of the Great Depression. About 1 out of every 75 households in America have a member who has filed bankruptcy.

And who are these people filing for bankruptcy? Chances are they're your neighbors, regardless of what neighborhood you live in. Bankruptcy is an equal opportunity phenomenon that strikes every socioeconomic bracket.

The fastest growing group of bankruptcy filers are older Americans. More than half of those 65 and older are forced into bankruptcy by medical debts. Also, more families with children, single mothers, and single fathers are being driven into bankruptcy — the presence of children in a household triples the odds that the head of the household will end up in bankruptcy.

In any case, the image of the sleazy, deadbeat bankruptcy filer is a phantom and a scapegoat for irresponsible lending. The bankruptcy filer can be more accurately described as an ordinary, honest, hardworking, middle-class consumer who fell for aggressive and sophisticated credit marketing techniques, lost control, and unwittingly surrendered his financial soul to the devil that is debt.

Bankruptcy is the easy way out for folks who can pay their bills

Creditors have been making this claim since the 1800s, and it's as demonstrably wrong today as it was back then.

In recent years, the credit industry funded several *studies* — a handy euphemism for propaganda, the more accurate description — that supposedly support their argument that people are skipping to bankruptcy court to skip out of their obligations. Every one of these self-serving reports has been debunked by independent sources — every single one. Several of these studies were even discredited by two financial arms of Congress, the General Accounting Office and the Congressional Budget Office.

Bankruptcy isn't the cause of debt, but rather is the result. And it isn't the disease, but rather is the cure. Restricting access to bankruptcy court won't solve the problem of debt any more than closing the hospitals will cure a plague.

Bankruptcy threatens the ethical foundations of our society

Gee, you'd think that bankruptcy was the greatest threat to apple pie and motherhood since Elvis Presley and bell-bottom jeans!

Credit-card companies furiously push plastic on virtually anyone willing to take it. At present, more than one billion credit cards are in circulation — that's about a dozen for every household in America. Lenders mail out billions of credit-card solicitations every year. Low- and moderate-income households, high school students, and the mentally disabled — or, in their vernacular, "emerging markets" — are popular targets of lenders.

According to the Administrative Office of the United States Courts, consumers between the ages of 18 and 25 are one of the largest growing segments (next to senior citizens) of bankruptcy filers — students and other young people who lack the maturity and resources to handle debt.

Anyone with a brain can figure out that extending credit to folks with no income, no assets, and no track record is kind of dumb (not to mention morally questionable). But creditors are more than willing to ignore the dangers of tomorrow so that they can reap exorbitant interest rates today. They're counting on — literally banking on — your ignorance of the situation. They encourage robbing Peter to pay Paul by using credit-card advances to pay off credit-card bills. They convince many middle-class consumers to bleed all the equity out of their homes through aggressively marketed home-equity loans — with much of it going to finance consumable products (mall junk) rather than the homestead of the American Dream. That hundreds of solid, middle-class folks find themselves in bankruptcy court isn't surprising.

But why, in the face of increasing credit-card losses, does the credit industry continue dispensing credit with utterly reckless abandon? The answer is simple: Because it's profitable . . . extremely profitable. Since 1997, bankruptcy filings have increased 17 percent, while credit-card profits have soared 163 percent!

It's enough to make you BARF

A five-year study published in the medical policy journal *Health Affairs* in February 2005 found that between 1981 and 2001, medical-related bankruptcies increased by 2,200 percent — six times the increase in the number of all bankruptcies during the same period. And most of the medical filers were not the uninsured poor, but middle-class folks with health insurance. According to the study, it's not lack of insurance that wipes people out; it's copayments, deductibles, and uncovered services.

Honest folks pay a "tax" to support those who are bankrupt

That honest taxpayers are supporting people who are bankrupt is nothing short of an outright, bald-faced lie. The theory, trumpeted in press releases, is that hundreds of thousands of Americans routinely ignore their obligations, intentionally or recklessly drive up their debts, and then declare themselves insolvent, stiffing creditors, and ultimately, every God-fearing, bill-paying, hard-working, patriotic American.

Creditors note that they write off about $40 billion in debts annually, which works out to about $400 to $500 for every American household. Thus, the reasoning goes, if access to bankruptcy were restricted, the credit industry wouldn't suffer losses that it must pass along to consumers. So, they say, BARF is good for consumers.

They're not saying, take note, that they'll pass along any savings to their customers, and historically that has not been their practice. Besides, do you really believe that the credit industry paid politicians tens of millions of dollars to enact BARF in order to save you money? Not likely.

Understanding What You Can Gain Through Bankruptcy

If you have no way of paying your bills, you certainly need to consider bankruptcy. If you have an income but cannot repay your debts in full within three years while maintaining a reasonable standard of living, bankruptcy may be a wise option. (Chapter 2 can help you calculate your potential to pay your debts based on current income and expenses.)

Bankruptcy isn't the solution when your motive is anything other than reasonable relief from your debts. The U.S. Bankruptcy Code was established to assist *honest debtors*, not to provide a haven for chiselers and charlatans. If your aim is to jerk some creditor around, weasel out of debts you can easily pay, evade child support, or generally just stiff someone, bankruptcy is the wrong route. Bankruptcy should not be used for vengeance or as a stopgap measure. It should not be used as a ploy or a bargaining chip. You should not file bankruptcy unless you're serious about following through.

Bankruptcy can

- Halt almost every kind of lawsuit.
- Prevent garnishment of any wages you earn after filing.
- Stop most evictions if bankruptcy is filed before a state court enters a judgment for possession.
- Avert repossessions.
- Stop foreclosures.
- Prevent your driver's license from being yanked for unpaid fines or judgments. (The stay doesn't prevent revocation or suspension of your driver's license for failing to pay court-ordered support.)
- Bring IRS seizures to a skidding stop.

Bankruptcy generally *won't* prevent

- Criminal prosecutions
- Proceedings against someone who cosigned your loan, unless you file a "Chapter 13" repayment plan and propose paying the loan in full (see Chapter 4)
- Contempt of court hearings
- Actions to collect back child support or alimony, unless you file Chapter 13 and propose to pay that obligation off during the life of your plan (see Chapter 17)
- Governmental regulatory proceedings

In recent years, some self-proclaimed "mortgage consultants" and "foreclosure service" outfits have made a business out of essentially tricking their clients into filing bankruptcy. These con artists exploit the bankruptcy laws to delay foreclosure, collect rents from the property during the delay, and then head for the hills. In the end, unsuspecting clients usually lose their homes and wind up with a bankruptcy on their records without realizing they'd even filed for bankruptcy. Bottom line: Discuss your options with an experienced bankruptcy attorney, not some fly-by-night flimflam operation. See Chapter 3 for tips on finding a good lawyer.

Stopping creditors in their tracks

The moment that you file a bankruptcy petition, a legal shield called the *automatic stay* kicks in, prohibiting creditors from contacting you, suing you, repossessing your property, or garnishing your wages.

After you file, a creditor can ask for permission to proceed with a repossession or foreclosure. But the creditor must obtain permission in advance, and the bankruptcy court judge may very well turn them down, if you propose a reasonable plan for paying that particular debt. (The following sections cover filing bankruptcy to eliminate some bills and pay others.)

Whenever a creditor is foolish enough to ignore the automatic stay, he'll have a federal judge on his back and may well get zapped with a fine and an order to pay your attorney fees.

Wiping out most of your debts

Bankruptcy wipes out or *discharges* most debts. Credit cards, medical bills, phone charges, loans, and judgments all are usually *dischargeable*. However, some obligations generally are not eliminated in bankruptcy, and these *nondischargeable* debts include

- Student loans (see Chapter 18)
- Alimony and child support (see Chapter 17)
- Damages for a personal injury you caused while driving illegally under the influence of drugs or alcohol (see Chapter 16)
- Debts from fraud (see Chapters 11 and 16)
- Financial obligations imposed as part of a criminal conviction (see Chapter 16)
- Taxes arising during the past three years (see Chapter 15)

Catching up on back mortgage and car payments

Sometimes, even dischargeable debts may continue to haunt you when they are tied to one of your essential possessions. For example, you can wipe out loans secured by your home or car, but the creditor can still foreclose on your house or repossess your vehicle if you don't pay.

In a Chapter 13 bankruptcy (one where you pay what you can toward your debts and the remainder is forgiven), you can propose a partial repayment plan to avoid foreclosure and make up back mortgage payments over a five-year span. You can prevent repossession of your car by catching up on back payments of the life of the plan. In some situations, you have to pay only what the vehicle is worth — rather than the whole loan balance (see Chapters 11 and 12).

Filing bankruptcy to pay some debts over time

Although some debts are not dischargeable, filing a Chapter 13 reorganization enables you to pay debts such as support obligations or back taxes over a five-year period and protects you from being hassled while you're paying down the balances. You can also gradually catch up on missed mortgage payments. In the meantime, most of your other debts are eliminated while you just pay for current expenses and keep current on future house and car payments.

Using bankruptcy to pay all your debts

Sometimes filing bankruptcy actually provides a way of paying all your debts rather than escaping them.

If the value of your property is sufficient to pay all your debts if only you had enough time to sell your assets, bankruptcy can be used to hold aggressive lenders at bay until your property is sold for the benefit of all your creditors — and possibly producing a surplus for you.

Here's how it works. Say, for example, that you own investment property worth $150,000, on which you have a mortgage of $100,000, and that you have other debts totaling $25,000.

If you can sell the property, you can pay off the mortgage and other debts and still have something left over for yourself. But if the mortgageholder forecloses, neither you nor your creditors are likely to receive a cent. Although the property *is* put up for public auction in a foreclosure, bidders rarely show up, and the only bidder typically is the mortgageholder, which merely bids the amount that's owed on the mortgage. In other words, the mortgage company ends up owning the property without paying any cash. Filing bankruptcy interrupts the foreclosure so that the property can be sold for everyone's benefit. See Chapter 12 for more on how foreclosures work and how you can actually use the bankruptcy process to save your home.

Noncitizens of the U.S. of A.

You don't even have to be an American citizen to qualify for a fresh start. Neither citizenship nor even formal resident-alien status is required. As long as you have property or a business in the U.S., you're eligible for bankruptcy relief. But courts disagree on just what "property in the United States" constitutes, and some have rejected attempts by foreigners to create eligibility by simply obtaining a U. S. mailbox or establishing a nominal bank account. Others take a more liberal view.

For example, Ernestine didn't live, work, or do any business in the United States, but she had a few hundred bucks in a bank account. The court said Ernestine was eligible to file bankruptcy in the United States — expressing bewilderment as to why American credit-card companies would offer massive amounts of credit to a foreigner with no job and $522 to her name.

Knowing What You Can Lose in Bankruptcy

Although bankruptcy may be that miracle cure you sought for your financial woes, you may encounter some unpleasant side effects. The disadvantages of filing bankruptcy are

- **You can lose assets.** Depending on how much your home is worth and where you live, it is possible, but unlikely, that you'll lose it by filing bankruptcy. (If you're really worried about what will happen to your stuff, check out Part III, especially Chapter 10.) In most bankruptcies, debtors don't have to give up any of their belongings, but . . .
- **Bankruptcy is a matter of public record.** As more and more records are stored on computers and accessible on the Internet, searching that data becomes easier and easier for anyone who's interested. In other words, if your nosey neighbor wants to know whether you filed bankruptcy, how much you owe, and who you owe it to, the information may be just a few mouse clicks away,
- **Bankruptcy affects your credit rating.** Bankruptcy may have a negative effect on your credit rating, but that fact may well fall into the "So what?" category for you. Even with a bankruptcy on your record, your odds of obtaining credit are very good. With a little work and perseverance, you can reestablish credit almost immediately. Some credit-card companies actually target folks right after bankruptcy because they know that these people are free of all their existing debts and probably won't be eligible to file another bankruptcy any time soon. For a few years after bankruptcy, you may have to pay higher interest rates on

new credit, but this result will ease over time, even if your credit report still shows a bankruptcy. So, don't pay too much attention to the horror stories bill collectors tell you about the disastrous effect bankruptcy has your credit. (In Chapter 21, we walk you through rebuilding your credit after bankruptcy.)

- **Friends and relatives can be forced to give back money or property.** If you repaid loans to friends or relatives or gave them anything within the past year, they can be forced to repay a trustee the money they received, if you don't know what to watch out for. (We tell you what to watch out for in Chapter 19.) You can usually avoid these kinds of problems by carefully timing your bankruptcy filing.
- **Bankruptcy can strain relations with loved ones, especially parents who were raised in a different era.** (In Chapter 2, we give you some pointers on easing the strain.)
- **A stigma may still be attached to filing bankruptcy.** This drawback is especially true in small communities, but is much less likely to be a problem in cities, where newspapers rarely bother printing the names of nonbusiness bankruptcies.
- **Bankruptcy may cause more problems than it solves when you've transferred assets to keep them away from creditors.** (You can find out more about this problem in Chapter 19.)
- **You can suffer some discrimination.** Although governmental agencies and employers aren't supposed to discriminate against you for filing bankruptcy, they may still do so in a roundabout way. Prospective employers may also refuse to hire you (see Chapter 25 for more on employment discrimination).

Considering Alternatives to Bankruptcy

Bankruptcy isn't for everyone, and sometimes better solutions are available. We explain them in Chapter 7. If it appears that the negatives outweigh the positives, another route may be your best choice. Depending on your situation, the best alternative may be

- Selling assets to pay debts in full
- Negotiating with creditors to reduce your debts to a manageable level
- Restructuring your home mortgage
- Taking out a home-equity loan
- Doing nothing at all if you have nothing, expect to acquire nothing, and don't care about your present or future credit rating

In any event, you need to weigh your decision on a simple, rational scale. Ask yourself whether the benefits outweigh the drawbacks. Many people, ravaged by guilt and shame, think they need to fully exhaust every alternative before considering bankruptcy, including

- Making payments that never reduce the principal balance owed
- Taking out second mortgages to pay credit-card debts
- Borrowing against pensions
- Withdrawing funds from retirement accounts
- Obtaining loans from friends and relatives
- Taking second jobs

You must think seriously about the strain your financial distress places on your health, marriage, and family. Granted, bankruptcy is a very serious step that you shouldn't take lightly, but that doesn't mean you have to wait until you've lost everything. Think of it in these terms: If you have some blocked arteries, it just may be smarter to have bypass surgery *before* you have a heart attack. The same is true of bankruptcy. Think of bankruptcy as preventative medicine.

Introducing the Different Types of Personal Bankruptcy

Consumer bankruptcies are covered mainly under two parts of the U.S. Bankruptcy Code:

- ***Chapter 7 liquidation,*** which enables you to eliminate most of your debts but may require you to forfeit some of your assets for distribution to creditors.
- ***Chapter 13 reorganization,*** which enables you to pay off all or a portion of your debts during a three- to five-year time span but doesn't require you to forfeit any of your belongings or assets to pay *unsecured debts* (those that are not secured by property, such as your car or another valuable asset). See Chapter 11 for more on the difference between secured and unsecured debts.

Likewise, other special kinds of bankruptcy exist. *Chapter 11 bankruptcy* is available to individuals but primarily is used for large business reorganizations. *Chapter 12 bankruptcy,* which is similar to Chapter 13 bankruptcy, addresses the unique problems faced by family farmers and family fishermen. As a practical matter, almost all consumer cases are covered under Chapter 7 or Chapter 13 of the code.

Liquidations (Chapter 7)

CHAPTER 7
7

Chapter 7, commonly referred to as *straight bankruptcy,* is often what people mean or think of when they use or hear the term generically.

In its simplest form, Chapter 7 wipes out most of your debts and, in return, you may have to surrender some of your property. Chapter 7 doesn't include a repayment plan. Your debts are simply eliminated forever. If you buy a lottery ticket the day after filing and hit the jackpot, yippee! for you and tough beans for your creditors. You obviously can voluntarily pay back your creditors if you suddenly strike it rich, but, legally, you don't owe a dime after your debt is discharged. Most property you receive after filing Chapter 7 doesn't become part of your bankruptcy, but there are a few exceptions. Income tax refunds for prebankruptcy tax years go to pay your debts as well as divorce property awards, inheritances, and life insurance that you become entitled to receive within 180 days of bankruptcy. See Chapter 10 on what assets are at risk.

Theoretically, a debtor's assets can be seized and sold for the benefit of creditors. All nonexempt assets owned on the petition date are fair game. They can be sold, with the proceeds distributed to your creditors. But in practice, 96 percent of consumer bankruptcies are *no-asset cases,* meaning that no property is taken away from the debtor because it's all exempt or worth so little that it's not worth the trouble.

In order to qualify for Chapter 7, if you earn more than the median income for your state, you'll have to pass a new *Means Test* (see Chapter 5) where you show that you don't have enough income to pay a significant portion of your debts. Although the test is ungodly complicated, when all is said and done, just about everyone can pass. The toughest part is just assembling the information you have to provide. You can find helpful worksheets in Chapter 2.

Consumer reorganizations (Chapter 13)

CHAPTER 13
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Chapter 13 involves a repayment plan in which you pay all or part of your debts during a three- to five-year period. In a Chapter 13, you propose a debt repayment plan that requires court approval and thereafter keeps creditors at bay as long as you keep making payments. This plan can be a great relief, when you're able to establish and live within the confines of a budget.

A budget plan that demands frugality to the point of misery is doomed to fail ("Frugality is misery in disguise," observed Pubilius Syrus some 2,000 years ago). One that is reasonable has a good chance of succeeding. The operative word, however, is *reasonable*. See Chapters 2 and 22 for more on creating and living within a budget.

Every Chapter 13 plan must pass two tests:

- The *best-interest test,* which mandates that unsecured creditors be paid at least as much as they would receive if you filed a Chapter 7 instead of a Chapter 13.
- The *best-efforts test,* which requires that you pay all your disposable income (the amount left over after paying reasonable living expenses) to the trustee for at least the first 36 months of your plan. If your monthly income is more than the median for your state, allowable expenses will be based on *Internal Revenue Collection Financial Standards,* and the plan must run for five years. Otherwise, the amount of your payment will be based on your actual expenses, so long as they are reasonable.

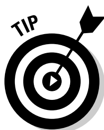
When you're done, you're done. Most creditors have gotten all they're going to get. Life goes on. See Chapter 4 to see what type of bankruptcy is best for you.

Weighing the Consequences of Not Filing Bankruptcy

In the same way that filing bankruptcy can have negative consequences, *not* filing can also have negative consequences. If you're eligible for bankruptcy, but opt against filing, creditors have a number of options they can pursue, depending on whether a particular debt is secured by your property.

Claims secured by your car

If your car secures a debt, the creditor can repossess the vehicle and sell it to cover the loan. The proceeds of a repossession sale usually aren't enough to pay the debt, so you'll lose the car and still have to pay the balance that you owe on it — the worst of both worlds.



Although the law requires a creditor to sell a car in a "commercially reasonable" manner, that doesn't necessarily mean that the creditor will receive nearly as much as you can by selling it yourself. Before allowing repossession, you may want to try selling the vehicle. Your chances of getting more money for the car are greater than the finance company's. See Chapter 11 for more on how bankruptcy can affect your car. If you and your lawyer agree that it's best to get rid of the car because you just can't afford it, you can voluntarily surrender it to the lender rather than wait for them to repossess it. Despite what people may tell you, your credit report will not look that much better, but at least you'll avoid the hassle of finding your car gone when you come out of the supermarket, or the embarrassment of a tow truck showing up at your house.

Claims secured by your home

Mortgage companies can't simply boot you out of your home and onto your derrière if you miss a few payments. They must first go through a foreclosure procedure to extinguish your ownership rights. Although not all foreclosures involve court proceedings, all do take time — at least three months in most cases and frequently much longer. You can continue to live on the property until the foreclosure is completed. Chapter 12 has more on the workings of foreclosures.

Student loans

Government agencies can *garnish* (siphon off) up to 10 percent of your disposable income without going to court. A garnishment is almost like a withholding tax — the money is gone from your paycheck before you ever see it. You also need to be aware that Congress canceled state statutes of limitations on student loans. In other words, you can't just wait it out. You must deal with student loans. They won't disappear on their own. See Chapter 18 for more on student loans.

Support obligations

Although debtors' prisons are officially a thing of the past, a divorce court can still send you to jail for neglecting your support obligations, and some states have programs to revoke professional licenses — such as licenses for practical nurses or accountants or cosmetologists — of people who haven't kept up with their support. Chapter 17 covers support obligations.

Fines and restitution

If you've been ordered to pay a fine or make restitution in connection with a criminal proceeding and don't pay, accommodations at the local jail may await you. Don't tempt the judge, because some of them don't need much tempting to have you hauled off in handcuffs. See Chapter 16 for more on fines.

Taxes

The IRS has truly scary powers to seize your bank account, pension, real property, or even the shirt off your back. State taxing authorities also have similar special powers. In addition, your town or city, student loan creditors, or your ex-spouse or kids may be able to grab your tax refund whenever you owe alimony or support. Chapters 9 and 15 cover taxes.

Lawsuits

Creditors with other types of claims can't do much without first suing you and obtaining a judgment. To do this, they must serve you with legal documents and give you a chance to dispute the debt in court. If you don't respond, a default judgment can be entered against you. That means the ruling goes against you even though you never presented your case.

Using the Statute of Limitations

Most debts — student loans being the most notable exception — eventually evaporate simply through the passage of time. In most cases, the *statute of limitations* (the time period within which an action must be commenced) is six years or less. But whenever a judgment has been entered against you, it can be as long as 20 years.

Sometimes the statute of limitations (usually ten years) can make federal taxes disappear. See Chapter 9.

The trick is figuring out when the statute of limitations clock begins ticking. Sometimes, just making partial payments or acknowledging a debt can start the time running all over again. And you sure don't want that to happen.