NATIONAL ENDOWMENT FOR FINANCIAL EDUCATION

CONSIDERING FILING FOR BANKRUPTCY?
KNOW THE ALTERNATIVES FIRST
A Different Route to Resolve Debt May Be a Better Choice

ENGLEWOOD, COLORADO—For some Americans facing a seemingly insurmountable level of personal debt, declaring bankruptcy has become an increasingly popular option. In 2004, the number of non-business bankruptcies that were filed totaled 1,584,170, according to the Administrative Office of the U.S. Courts.[1] In 1994, only 800,000 bankruptcies were filed. That amounts to an increase of 98 percent over a ten-year period.

According to a recent article in the *Wall Street Journal*, the increased number of bankruptcies filed over the past decade may be due, in part, to a rise in the number of middle-aged Americans seeking relief from debt.[2] The article stated that while bankruptcy traditionally has been viewed as an option for younger, less-established individuals, it now also is seen as a way for older Americans to get out from under extreme debt, perhaps because of medical bills or a job loss.

"These statistics demonstrate that Americans of various ages and backgrounds often see no other way to resolve their debt problems than to file for bankruptcy," says William L. Anthes, Ph.D., president and CEO of the Colorado-based National Endowment for Financial Education® (NEFE®). NEFE is the only independent, nonprofit foundation wholly dedicated to helping Americans achieve financial well-being.

Bankruptcy may, in fact, be unavoidable for some. However, it carries financial consequences that can plague individuals for many years. Anthes says, "All Americans, but particularly older individuals who have less time to recover from financial mistakes, must understand the implications of filing for bankruptcy before doing so. People should be considering every other option available to them before taking such action."

Bankruptcy Basics

Bankruptcy is the legal process that relieves individuals of their debts so they may be granted a financial "fresh start." There are a number of different types of bankruptcies for which a debtor may file. However, the majority of personal bankruptcies are filed under Chapter 7. Bankruptcy laws vary by state, but, generally, if you file for Chapter 7 bankruptcy, a trustee will be appointed by the court to oversee your property. This individual will divide your property into exempt and non-exempt categories. Depending on your circumstances, assets such as your house, car or retirement savings may be considered exempt. All of your non-exempt property will be sold and the money used to pay off your unsecured debts, which are debts or loans, such as credit cards or medical bills, that do not have collateral attached to them.

After your property has been sold and the money distributed to your unsecured creditors, you will be released from most of your remaining unsecured debts. However, you are still responsible for paying some debts. Filing for Chapter 7 bankruptcy will remain on your credit record for up to 10 years.

Individuals also may file for Chapter 13 bankruptcy. If you choose to file under Chapter 13, you will propose a debt repayment plan to a bankruptcy court. If your repayment plan is approved, the court will appoint a trustee who will collect your payments and distribute them to your creditors. You will then have five years to pay off your debts. This type of bankruptcy is available only to individuals who have debt below a certain amount and whose income exceeds their living expenses. Filing for Chapter 13 bankruptcy will remain on your credit record for up to seven years.

Is Bankruptcy Right for You?

While filing for bankruptcy will clear your debts and allow you to begin anew financially, it is not without some negative consequences. Anthes says, "You likely will lose some of your personal property and you may have to pay court or lawyer fees. Also, your credit will be affected for years to come, making it difficult for you to obtain a reasonable rate for a future loan, credit card or mortgage."

In addition, not all unsecured debts will be dischargeable. For example, even if you file for personal bankruptcy, you still will have to pay off any student loans and outstanding income taxes. Before you decide to file, make sure you will be able to discharge the debts that concern you the most.

Finally, before you file for bankruptcy, you should consider what caused you to obtain an insurmountable level of personal debt. You may have incurred a large amount of medical expenses. Or, perhaps you lost your job and could no longer afford your lifestyle. Maybe you have a large amount of consumer debt on high-interest credit cards. Whatever the reason, you should consider how you will avoid this situation in the future so that if you must file, you will only need to do so once.

Alternatives to Bankruptcy

Because filing for bankruptcy is not a fix-all for every situation, and it carries a number of negative consequences, you should take into account the following alternatives before deciding to file.

- *Establish a payment plan with your creditors.* Creditors probably want you to avoid declaring bankruptcy as much as you do. Call them and discuss your situation. Can you agree on a payment plan that will allow you to pay off your debts in a reasonable amount of time without feeling overburdened by interest charges? If so, you may want to take advantage of this option before filing for bankruptcy.

- *Sell your assets.* Take a household inventory and consider what you may be able to sell. Antiques, collectibles and jewelry all could provide you with enough extra income to pay off your debts. Anthes says, "While it may be difficult for you to part with valuable items, it probably is worthwhile if it can keep you from filing for bankruptcy."

- *Refinance your home.* If you plan to stay in your home for the foreseeable future, you may want to consider refinancing, which is the process of taking out a new loan on your home to pay off the old one. By doing this, you also may be able to lower your monthly house payment, lower your interest rate or cash out some of the equity in your home. All of these could provide you with money to pay your debts. You should, however, consider the drawbacks to this option, such as potentially expensive closing costs, and if it will be worthwhile to refinance based on the amount of time you plan to stay in your home. "Refinancing can be a powerful tool for tapping into the equity of your home," Anthes says. "If you can refinance with low fees and your home has appreciated quite a bit over the years, taking this action might save you from bankruptcy."

- *Consider a home-equity loan or reverse mortgage.* A home-equity loan occurs when you borrow money against the equity in your house. You then pay this money back in monthly installments. Taking out a home-equity loan can provide you with the cash you need to pay off your debts relatively quickly. Also, the interest rate for a home-equity loan may be lower than that of your other debts, especially credit cards. Finally, within limits, the interest that you pay is deductible from your income taxes as an itemized deduction. However, be aware that when you take out this type of loan, you are putting your house at risk. If you cannot make your monthly payments, you could lose your home.

  Additionally, reverse mortgages are available to individuals who are at least 62 years old or above and own their own home. As with a traditional home-equity loan, individuals who take out a reverse mortgage borrow money against their house. However, with a reverse mortgage you do not have to pay back the loan every month. The loan only must be repaid upon your death, or if you sell or permanently move out of your home. For this reason, a reverse mortgage may be preferable to a home-equity loan. Anthes says, "You cannot lose your house for failing to make monthly payments, because there are none." The downside to this option is that you will be losing equity in your home and increasing the amount of debt against it.

- *Consider using a credit counseling service.* These organizations offer debt counseling, money-management education and debt management for individuals in significant financial trouble. If you enroll in a credit counseling debt management program, the organization will work with your creditors to consolidate your loans. You typically will make one payment every month to the organization, which then will distribute the money to your creditors. Some creditors also may lower your finance charges when you enroll in a debt management program. However, if you are considering using this option as an alternative to bankruptcy, make sure you thoroughly investigate the organization before making a commitment. Not all programs are legitimate. Before you elect a firm, meet in person, check to make sure the organization is accredited with the National Foundation for Credit Counseling or the Association of Independent Consumer Credit Counseling Agencies and check the organization's history with the Better Business Bureau.

  Anthes says, "The benefit to using a legitimate debt management program is that your credit probably won't be as negatively affected as it would if you filed for bankruptcy. Also, most respectable firms will offer counseling in addition to debt management, so you can learn how to better manage your money in the future. The downside is that your creditors might not lower your finance charges, in which case you would not be relieved of any debt."

- *Borrow from or cash out your retirement fund.* Borrowing from your 401(k) or similar retirement fund essentially is borrowing from yourself, which may sound like a good idea—especially since you also will be paying interest back to yourself. Yet, because you lose the potential earning power of the money you borrow from your retirement plan for the period that you remove it, it is not as financially savvy as it may sound. Despite the downsides, this still may be a viable option. Investigate whether or not your plan allows borrowing, consider how much money you are allowed to borrow from your plan and what you will need to take out and ask a financial professional to help you calculate how much money you potentially could lose from your retirement plan. Weigh this information against the negative consequences associated with bankruptcy. "Financial professionals rarely recommend borrowing from your retirement plan," Anthes says, "However, doing so to avoid declaring bankruptcy is one instance where they may advise you otherwise."

  If you are considering cashing out your retirement savings completely, discuss your situation with a professional. Anthes says, "You may be able to keep your retirement savings if you file for bankruptcy, so cashing out may not be the best option, especially if you are within a few years of your expected retirement date. You don't want to leave yourself with nothing for your later years." Finally, you should note that you typically cannot borrow from your IRA, as it is not permitted under current law. If you somehow are able to do this (generally the IRA custodian will alert you), all of your IRA balance may become immediately taxable.

- *Consider filing for Chapter 13 instead of Chapter 7*. If you have considered the above options and still feel bankruptcy would be the best choice for you, you may want to think about filing for Chapter 13 instead of Chapter 7. This type of bankruptcy typically is preferable because it will not remain on your credit record for as long as Chapter 7, and you can keep your non-exempt property. Also, Chapter 13 usually is a better choice if you are having a difficult time paying off your secured debt, such as your mortgage or car payment, because Chapter 7 does not discharge secured debt. By filing for Chapter 13, you will have the opportunity to establish a repayment plan that allows you to keep these items while you pay them off in full or in part.

- *Discuss your options with a professional.* As you consider these alternatives, discuss your money-management difficulties with a professional financial advisor. He or she will either be able to examine your situation and offer resolutions specifically designed to help you, or will refer you to an attorney who specializes in bankruptcy law.

Bankruptcy May Be Unavoidable

In some cases, filing for Chapter 7 bankruptcy is the only viable option left. "If you debt is insurmountable, and you will be crippled financially due to payments eating up your income for years to come, you may want to talk with a bankruptcy attorney about declaring bankruptcy," Anthes says. If you intend to file for Chapter 7, keep the following information in mind:

- When you file, the court will grant an "automatic stay," which prevents your creditors from taking further action against you outside of the bankruptcy proceedings until the case is closed. An automatic stay will prevent repossessions and foreclosures.

- To keep exempt property, such as your home or car, you must continue making payments after you file for bankruptcy if you still owe money on these items. If you aren't making payments, a creditor can ask that the court terminate the automatic stay before the case is closed. If this occurs, a creditor can repossess collateral for a loan. To keep this property, you must enter into a reaffirmation agreement with the creditor.

- A reaffirmation agreement is a voluntary agreement between a debtor and a creditor wherein the debtor agrees to pay off some of or the entire loan according to a set schedule. The creditor agrees not to foreclose on or repossess property as long as the debtor makes these payments. A reaffirmation must be filed with the bankruptcy court.

- If you are married, you may file bankruptcy together, or one spouse may file alone. If you file alone, your creditors may seek repayment for debts from your spouse if he or she personally is liable for the debt. Usually, you are personally liable if you incurred the debt. In addition, if you live in a community property state, all community property (that is, property acquired subsequent to your marriage) becomes part of the bankruptcy proceedings.

- If you are divorced and your ex-spouse files for bankruptcy, creditors can seek repayment from you if you are found to be personally liable for those debts incurred during the marriage.

- After your bankruptcy case has been filed, you may not file a petition to declare another Chapter 7 bankruptcy for six years.

Anthes says, "If you find that you must file for bankruptcy, make sure that you learn something from the situation. Begin anew, and make a commitment to be a savvy money manager in the future by keeping debt under control, saving for your retirement and building an emergency fund so that you never find yourself in dire financial straits again."

1www.uscourts.gov/Press_Releases/March04bk.pdf

2 Hwang, Suein. "New Group Swells Bankruptcy Court: The Middle-Aged. *Wall Street Journal* Aug. 6, 2004: A1, A5.