



Bankruptcy: When All Else Fails

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GLOSSARY

Bankruptcy: A legal process for declaring that a person is unable to pay his or her debts. The process may involve a court-supervised process of selling the bankrupt person's belongings to pay part of the debts owed to creditors.

Budget: An itemized summary of estimated income and expenses for a given period. A budget is a plan for managing income, spending, and saving during a given period of time.

Contract: An exchange, promise, or agreement between two parties that is enforceable by law. For example, a car buyer agrees to pay the amount financed at an agreed-upon interest rate for the length of the contract.

Credit report: A loan and bill payment history kept by a credit bureau and used by financial institutions and other potential creditors to determine the likelihood that a future debt will be repaid.

Credit score: A number based on information in a credit report, which indicates a person's credit risk.

Debtor: A person or organization that owes an amount of money.

Human capital: The knowledge and skills that people obtain through education, experience, and training.

"Bankruptcy is about financial death and financial rebirth. Bankruptcy is the great American story rewritten."¹

—Elizabeth Warren, U.S. Senator

Not overspending can help life go more smoothly. Still, many people find themselves in financial trouble. In fact, there were approximately 800,000 **bankruptcies** filed in 2017 (see the table for a breakdown of bankruptcy filings).² Hopefully you will never find yourself unable to pay your debts, but it is good to know there are options available should you need serious financial help.

Personal Finance Basics

First Things First—Earning Income

When it comes to money and being prepared, it is important to mention personal income. Earning income results from the skills you develop and apply to your work; this is what economists call **human capital**. Typically, the more skills you develop and the higher education level you attain, the higher income you will earn and the lower unemployment you will face.³ Of course, this also depends on what you study and the job market.

Budgets

Once you are earning income, developing a **budget** is a powerful tool you can use to help keep your finances in order. A budget is an itemized summary of estimated income and expenses for a given period, usually monthly. Budgeting can help you set goals, plan for major purchases, and make cutbacks in spending when necessary so that you can cover any unexpected expenses.

When Financial Problems Happen

Having a budget can help you establish good personal finance habits, such as saving part of your income and paying bills on time. Unfortunately, whether living within a budget or not, people can find themselves in difficult financial circumstances. There are many reasons for financial problems; sometimes the problems are temporary, minor setbacks, such as needing

Nonbusiness Bankruptcy Filings by Year					
Fiscal year	Total nonbusiness bankruptcies	Chapter 7 nonbusiness bankruptcies	Nonbusiness Chapter 7 filings as a percentage of total nonbusiness filings	Chapter 13 nonbusiness bankruptcies	Chapter 13 non-business filings as a percentage of total nonbusiness filings
2006	1,085,209	814,850	75.09%	269,699	24.85%
2007	775,344	467,248	60.26%	307,521	39.66%
2008	1,004,171	653,319	65.06%	350,015	34.86%
2009	1,344,095	949,002	70.61%	393,786	29.30%
2010	1,538,033	1,105,534	71.88%	430,583	28.00%
2011	1,417,326	1,001,813	70.68%	413,699	29.19%
2012	1,219,132	845,470	69.35%	372,132	30.52%
2013	1,072,807	730,592	68.10%	340,807	31.77%
2014	935,420	623,349	66.64%	310,914	33.24%
2015	835,197	533,572	63.89%	300,528	35.98%
2016	781,123	483,176	61.86%	296,824	38.00%
2017	767,721	472,135	61.50%	294,500	38.36%
Total	12,775,578	8,680,060	67.94%	4,081,008	31.94%

SOURCE: U.S. Courts. "Just the Facts: Consumer Bankruptcy Filings, 2006-2017." <http://www.uscourts.gov/news/2018/03/07/just-facts-consumer-bankruptcy-filings-2006-2017>, accessed March 12, 2018. Table F-2 for the 12-month periods ending September 30 for 2006-17.

a new laptop because of damage that cannot be repaired. Other times, people experience long-lasting, catastrophic financial situations, such as when they incur large medical bills from a traffic accident and cannot go back to work.

Late Payments

Financial trouble often has a way of catching people when they least expect it. Little things like birthday gifts and spending money for vacation can impact a person’s budget, but bigger issues like car repairs, medical expenses, and an inability to work can be very hard and sometimes impossible to navigate. Sometimes paying your bills late may not be your fault. For example, if you owned a business and were waiting for a client to pay for services you had provided, you could find yourself affected by that person’s slow payment. If you did not have adequate savings to cover your expenses while waiting for payment, you could fall behind on your own payments. Regardless of whether late payments are your fault, they can have negative consequences, including late fees added to the amount already owed. In addition, depending on how late the payments are, there can be negative effects on a person’s **credit score**. A person’s payment history and credit score are listed on a **credit**

report. A credit report lists all the credit activity a person has had and how well they have paid back the money owed.⁴ This is similar to the list of classes and grades found on a transcript. A credit score is a number based on information in a credit report, which indicates a person’s credit risk. A low credit score means it will be more difficult to obtain credit, just like a low grade point average on a transcript makes it more difficult to be accepted into technical college or a university.

There are different types of financial trouble, with credit card debt being the most common. If you find yourself unable to make one or two payments, it is best to contact the individual creditor or credit card company, try to explain the situation, and make arrangements with them to pay. This may increase your interest rate and may also affect your credit score. Ignoring or avoiding a creditor’s calls will not make the situation better, nor will the issue go away. Creditors are in business to make money, and your late payments affect their ability to pay their own creditors. When creditors do not receive payments on time, based on the **contract** you signed when you obtained the credit, they may use legal action to collect the money you owe.

Collections

If you have not been making payments and have not made arrangements with your creditors, they will likely turn your accounts over to a debt collection agency. A collection agency will contact you and attempt to get you to pay back the money. Debt collection agencies are highly regulated by the Federal Trade Commission to enforce ethical and legal collection practices.⁵ It is best to avoid paying any debt late if at all possible. Unfortunately, even with the best intentions, a good plan, and the use of a budget, people can still find themselves with debt so large that they can never pay their creditors back while maintaining a basic standard of living and avoiding hardship. When people have exhausted all of their usual options and are still unable to pay their debt, they have the option of legal protection in the form of bankruptcy. Of course, there are various reasons for bankruptcy, including medical expenses, loss of a job, excessive or unwise use of credit, separation or divorce, and unexpected expenses (e.g., natural disasters).

Filing a Bankruptcy Case

Bankruptcy can offer **debtors**—persons or organization that owe an amount of money—some protection from creditors under federal law while they review their situation and options. A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a “fresh start.” The Supreme Court made this point in a 1934 decision: “[I]t gives to the honest but unfortunate debtor... a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”⁶

A bankruptcy case is a federal civil case with specialized laws. It is where a bankruptcy judge determines how a debtor’s money and assets should be distributed among his or her creditors. The consequences and complexities of filing for bankruptcy are significant and require careful consideration and advice—usually from an experienced bankruptcy attorney. The minute a debtor files bankruptcy, an automatic stay goes into effect. The automatic stay is an injunction intended to stop all actions by creditors and debt collection agencies to collect debts. This does not always happen, however, as sometimes it takes an action by the debtor’s attorney or a lawsuit to stop some collection agencies. There are various types, or chapters, of bankruptcy; two common types that individuals file are Chapter 7 and Chapter 13.

A Chapter 7 bankruptcy case is a liquidation case. A trustee is appointed to take over a debtor’s property. Any property of value may be sold or turned into money to pay creditors. Some personal items and possibly real estate, depending on state laws where the debtor lives, can be retained by the debtor as exempt from collection. After any non-exempt assets have been distributed to creditors, any remaining debt, with some exceptions, is discharged and the debtor will never have to repay those debts. The discharge is a permanent court order prohibiting the creditors that the debtor named in the bankruptcy documents from taking any form of collection action on discharged debts. This includes legal action and communications such as telephone calls, letters, or any personal contact. The debts that cannot be discharged include nearly all taxes, student loans, child support, and alimony (payments to a former spouse); court fines and criminal restitution; and personal injury caused by driving drunk or driving under the influence of drugs.⁷

People filing for Chapter 13 can usually keep their property, but there are conditions. To be eligible for a Chapter 13 case, the debtor must have some kind of regular income. The bankruptcy court must approve a repayment plan and budget that can last for a period of up to 60 months. The repayment plan allows the debtor to pay a percentage of debts during the life of the plan. A trustee is appointed and will collect monthly payments from the debtor, pay creditors, and make sure the terms of the repayment plan are current. If all the payments are made under the plan, then some debts will have been paid in full, while the remainder of other debts, such as credit card debts, will be discharged.

Consequences of Bankruptcy

Choosing to file bankruptcy should not be taken lightly. It is a serious decision with lasting consequences. For example, bankruptcy can remain on your credit report for up to 10 years, which will affect your ability to obtain credit and get a lower interest rate.⁸ Filing bankruptcy can also affect your ability to obtain employment or choose where to live. Employers, especially banks, financial service providers, certain IT companies, and government agencies that require security clearances often run credit checks on job applicants before making an offer of employment, and they’ll check their current employees’ credit as well. Banks and mortgage brokers always

obtain credit reports, which can affect the amount you are able to borrow, and this can affect the neighborhood in which you can afford to buy a home.

Conclusion

For most people, bankruptcy should be avoided. Reducing the possibility of bankruptcy starts with good financial preparation. Preparation includes developing your human capital to earn a higher income, establishing and living on your budget, saving money, and paying your bills on time. If disaster strikes, it is important to know that bankruptcy is an option, albeit a last resort. ■

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Notes

¹ Warren, Elizabeth. *Frontline* interview, September 20, 2004; <https://www.pbs.org/wgbh/pages/frontline/shows/credit/interviews/warren.html>, accessed March 1, 2018.

² U.S. Courts; <http://www.uscourts.gov/statistics/table/f/bankruptcy-filings/2017/12/31>, accessed March 5, 2018.

³ U.S. Department of Labor, Bureau of Labor Statistics, Employment Projections; https://www.bls.gov/emp/ep_chart_001.htm, accessed March 5, 2018.

⁴ Federal Trade Commission. "Credit and Your Consumer Rights." <https://www.consumer.ftc.gov/articles/pdf-0070-credit-and-your-consumer-rights>, accessed March 1, 2018.

⁵ Federal Trade Commission. "Debt Collection." <https://www.ftc.gov/news-events/media-resources/consumer-finance/debt-collection>, accessed March 1, 2018.

⁶ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

⁷ 11 U.S.C. §§ 523 and 727.

⁸ Federal Trade Commission (2018, see footnote 4).

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Name _____ Period _____

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After reading the article, select the best answer to each question.

1. A _____ is helpful in keeping your finances in order and preventing financial trouble.
 - a. budget
 - b. bankruptcy
 - c. credit report
 - d. background check

2. A person’s payment history can be found in a
 - a. budget.
 - b. contract.
 - c. credit score.
 - d. credit report.

3. In which of the following situations would the person likely consider filing for bankruptcy?
 - a. Several bills are due and the person is forced to make a payment plan to cover them.
 - b. This month’s budget is not balanced because of a major car repair.
 - c. A person is late on two to three credit card payments.
 - d. A person is months behind on paying bills with no possibility of ever paying all the debt back.

4. A **debtor** is
 - a. an exchange, promise, or agreement between two parties that is enforceable by law.
 - b. a person or an organization that owes an amount of money.
 - c. a person, financial institution, or other business that lends money.
 - d. a tool you can use to help keep your finances in order.

5. Bankruptcy cases are handled at the _____ level of court.
 - a. city
 - b. county
 - c. state
 - d. federal

6. Once a person’s debt has been discharged, only a small portion has to be paid back.
 - a. True
 - b. False

7. Which of the following statements is true?
 - a. Once an automatic stay is in place, creditors may start contacting debtors.
 - b. Bankruptcy protection gives creditors legal support to collect what is owed them.
 - c. All debt can be included in a bankruptcy case.
 - d. Once a debt is discharged, the debtor will never have to repay it.

8. Which of the following is a main difference between Chapter 7 and Chapter 13 bankruptcy cases?
 - a. Chapter 13 requires a regular income and allows the debtor to keep his or her property.
 - b. Chapter 13 is a liquidation case.
 - c. Chapter 7 is for businesses and Chapter 13 is for individuals.
 - d. Chapter 7 requires a regular income and allows the debtor to keep his or her property.

9. An increase in human capital usually leads to a higher income.
 - a. True
 - b. False

10. Which of the following statements is true?
 - a. The long-term consequences of bankruptcy are so minimal that filing a case is usually a good first option.
 - b. A trustee is assigned to all bankruptcy cases just to contact creditors and stop collection actions.
 - c. A bankruptcy can stay on a person's credit report for up to 10 years, affecting many aspects of life.
 - d. The main benefit of bankruptcy is that removing or reducing one's debt makes it easier to get credit.

11. Which of the following statements is true?
 - a. Banks and mortgage brokers never obtain credit reports for employees.
 - b. One possible consequence of bankruptcy is being unable to get certain jobs.
 - c. Government agencies that run security checks are less likely to order credit reports.
 - d. Banks cannot reject your loan application because of your credit report or credit score.

12. Filing for bankruptcy protection is a serious decision, and most people consult an experienced attorney.
 - a. True
 - b. False