Three Important Facts to Consider Before Filing Bankruptcy

Control Your Income. Get Out of Debt. Protect Your Future.

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Bankruptcy is a scary concept for most people. Many consumers tread water in financial trouble for years before they consider bankruptcy. It is not uncommon for someone to tread water for almost three years before they try and find help with finances. The tipping point may come from a job loss, illness, or unexpected emergency expense that pushes the consumer to feel that there is no other way out. There are two main chapters under the bankruptcy code available to help consumers. A Chapter 7 is a total liquidation of a consumer's debts, and a Chapter 13 is a "reorganization" of debts into a court approved payment plan to pay back the creditors. This ebook will look at the basics of bankruptcy, provide three facts that should be considered before filing, and discuss a potential alternative to bankruptcy that will also protect income, pay off debt, and has the added bonus of no bankruptcy on record.

I am a lawyer, so it may be odd that I recommend to many people that they should try financial coaching as an option before filing for Chapter 13 bankruptcy. It is also, in many cases, an unpopular opinion with both consumers and some lawyers. I'll get this out of the way upfront. Yes, I can take a bankruptcy matter, but I find there are many cases where it may do more harm than good. Many people cannot afford the bankruptcy filing fees and associated costs, so they either stop paying debts until they can save the money, or wait for a tax refund or bonus to file so they can afford it.

Bankruptcy Basics

When a consumer files for bankruptcy, all of the debts and all of the income are listed on various "schedules." The consumer's assets, meaning property, bank accounts, disposable monthly income, etc. becomes the "bankruptcy estate." This includes the consumer's income, because it is what the filer is promising the bankruptcy court he or she will use to repay the debts. A repayment plan is submitted to the court, and if approved, the estate (with the payment plan) will be managed by *a bankruptcy trustee*, who works for the court.

When most people think about filing bankruptcy, they are thinking about a Chapter 7. A Chapter 7 bankruptcy (meaning filed under Chapter 7 of the Bankruptcy Code) wipes out or "liquidates" almost all of the debtors unsecured debt, but there are exceptions, such as student loans. There are some rules regarding secured debt such as cars and mortgages, which can be "surrendered" or "affirmed".

Since 2008, the bankruptcy code requires the debtor "pass" a two-part means test for a chapter 7. In step one, this test looks at income and family size, not how much the debtor owes, to determine whether the debtor falls under the income thresholds for a chapter 7. In step two, the court will look at income, expenses and "disposable income" available to pay debts. If the consumer "passes" the means test, they are eligible to file a Chapter 7, and liquidate unsecured debt with specific exceptions.

What if the consumer “fails” the means test, meaning they do not qualify for a Chapter 7 liquidation of debts? Then the bankruptcy code they are eligible to file under is a- Chapter 13. A Chapter 13 is basically a court approved repayment plan to creditors. The bankruptcy filing creates an estate, and a bankruptcy trustee manages the repayment for three to five years until it is completed and the bankruptcy (estate) is discharged.

A chapter 13 bankruptcy can be a way to protect a home from foreclosure, or to address "non-dischargeable debt" such as tax debt or family support debts. For many people, however, a bankruptcy can be avoided with a plan developed without the court using a financial coaching option. There are three important facts about bankruptcy that are often not considered or really understood by consumers before filing. Often this is due to shame, dealing with financial issues over a long period, and fear of creditors taking action against them. But let's look at the three facts about bankruptcy every consumer should consider before filing.

Fact 1: The Debtor Loses Control Of His or Her Income in a Chapter 13 Bankruptcy

When someone files for Chapter 13 bankruptcy protection, and the payment plan is confirmed, they no longer get to control their income. Future income is an asset that goes into the estate, and is promised to pay debts. All debts are paid from this estate for the length of time that bankruptcy is in repayment. This also means that any income increase, such as a raise or bonus, at any time the estate still exists will belong to the trustee. The trustee may demand that more money be paid to the creditors, particularly if the increase exceeds 10% of the consumer’s current income. And you *cannot lie to the court*. Never a good idea. And most of the time the consumer must submit personal tax returns to the court annually anyway. This is for as long as the estate exists.

Another note, if the consumer owes family money, and pays some of it back in the months preceding a bankruptcy filing, the trustee, under what is known as a “claw back,” can demand the family member return the money so it can be added to the estate. This is because the court will presume that the money was paid back to a “preferred” creditor.

Only after discharge will the consumer regain control. While it is true a certain percentage of the debt can be discharged at discharge, most of the debt must be repaid. The general rule is that **at least as much** of the debt that would have been discharged if the consumer qualified for a chapter 7, and the court can order more based on disposable income and assets. And if there are non-dischargeable debts, such as student loans, if these weren't paid outside the estate (specific language required in the repayment plan) for the five years, they come back into repayment after the discharge of the estate.

Fact 2: The Majority of Chapter 13 Payment Plans FAIL

Consumers are already required to go through a credit counseling type personal finance class before filing any bankruptcy and again before it can be discharged. I can't speak to the effectiveness of these courses. But you can potentially see the limited change in money habits these courses have by looking at the average of Chapter 13 bankruptcies that successfully make if the full five years to discharge.

Only about one in three filed and approved payment plans makes it through to discharge. Yup. Only about 33%. Yikes. Another statistic? Approximately 8% of bankruptcies are from re-filers, which account for about 16% of annual filings. More than 1 in 20 filings are from consumers who already filed once before.

When a Chapter 13 fails, it is "dismissed" and not, "discharged." The bankruptcy stays on the credit and personal history, but the debt remains and the creditors can restart foreclosure, repossession, and any judgment proceedings, with the interest accrued tacked back on (minus payments made through the estate). This is because the protection of the bankruptcy court is withdrawn. When this happens, people are typically worse off than when their payment plan was approved by the court.

Fact #3: A Bankruptcy May Affect Future Opportunities Long After Discharge

A consumer may be asked about filing a bankruptcy long after it is removed from a credit report, and it may affect different opportunities. I find this to be a heartbreaking fact that many people do not really consider prior to filing. Many consumers are not warned that a bankruptcy can be asked about, legally, for the rest of their lives. Everyone is thinking about the credit report, the "ten years" hit in the "public records" section. But that is just one part.

Consumers are often asked on a job application, loan application, security clearance application, "Have you ever filed bankruptcy?" Which is not the same as, "Have you filed bankruptcy in the last ten years?" And the "have you ever" question must be answered YES. This can lead to loss of some future opportunities that were never even thought of before.

Jobs in law enforcement, for example, are difficult to obtain after filing. Not to lie, even getting a license to practice law can be a challenge because an applicant may not pass the Moral Fitness requirement. Military or government jobs requiring a clearance may be an issue. So, while there is protection against losing your job during a bankruptcy, and protection from discrimination at your current employer, no such protection exists if you try to change jobs later in private industry.

Financial Coaching as Another Option

There is another option that is a good one for many struggling people. Financial coaches are professionals who not only work on the mechanics of getting out of debt, but helping the consumer change his or her behavior towards managing money. When someone works with a coach, the repayment of debt comes not from fear of the court or trustee, but from a sincere desire to change from habits that can be personally harmful, to those habits that give peace of mind. The "not owing a monthly payment to anyone who charges a $39.00 fee if you are one second late with a payment" peace of mind.

Also, a coach can keep you accountable. How can you forget to budget if you meet with a coach each month for a while? What if something comes up and you have a question? There is a coach walking beside you for support. Coaching is not forever either, and many people don't even need three years of coaching, unlike a Chapter 13.

And that's it. My three biggest reasons for advising consumers to try coaching first, before filing a chapter 13 bankruptcy. If you or someone you know is in a financial situation where bankruptcy has been raised in conversation, you may want to have a chat with a financial coach, first. A financial coach can help create a plan to get out of debt, and in my experience, with changes and discipline, the "debt snowball" can be completed in an average of 18-30 months, which is a shorter time than the 36-60 month Chapter 13 repayment plan.

About the Author

Attorney Dawn K. Kennedy's Consumer Law practice focuses on helping families address their debts and financial crisis to achieve the peace of mind they desire. She excels in navigating the mass of federal regulations that guide debt collections, student loans, and other financial areas such as taxes and credit reports. She is also a financial coach with a mission to assist families with budgeting, getting out of debt, and setting up their long term financial future. She can be reached via her website www.dawnkennedylaw.com