THE MONEY MARATHON: WHEN IS BANKRUPTCY OK? FEBRUARY 2010

The “bank” in bankruptcy is not considered a positive for bankers or former bankers like me. It represents at some level a financial failure in which there are many losers (creditors having their debt eliminated and debtors who have their credit score destroyed) and no real winners. Not surprisingly, with the severe recession and record unemployment, there have been a record number of bankruptcies.

I have consulted people who have become burdened and overwhelmed with debt, and they want to know what they should do in their particular circumstances. Following is a summary of my approach to this decision.

The first point I want people to understand is that from my standpoint there is no condemnation of being in their situation. I don’t want them to feel guilt or despair. Every one of us has made mistakes in our past. Unfortunately, we cannot change the past. However, we can affect the present and the future. Therefore, the most important question is where do we go from here?

Many people in this situation are torn between an ethical and moral dilemma of wanting to pay the debts they have incurred and a need to seek relief from being overwhelmed with mountains of debt. My position is that this is a decision that should not be taken lightly.

On the one hand, there is the ethical and moral obligation to pay your debts. Additionally, bankruptcy will destroy a person’s credit rating for at least several years. Consequently, if a person can reasonably pay his debts, he should. On the other hand, in many cases the debt burden is so great that it is unreasonable to think that debts can be paid in a realistic period of time. Rather than fighting a losing battle, continuing to ruin a person’s life, it may make sense to get a fresh start, and bankruptcy maybe necessary.

According to Liz Pulliam Weston, a writer for MSN, *When Bankruptcy is Best*, 12-08-08, her rule of thumb is as follows, if “despite your best efforts it would take more than five years to pay off your credit card bills and medical bills or you would need to use assets that would normally be protected in bankruptcy-like retirement accounts (up to $1,000,000) and home equity, then you should at least consult with a bankruptcy attorney about your options.” I agree with this five-year rule. If a person can reasonably pay off debt in a five year period, he should do it. If not, he is a candidate for at least discussion with a financial consultant or an attorney. I discussed this five year rule with a local attorney who handles bankruptcies, and his advice was that five years can be too long for some older people who don’t have as much time to rebuild their future as a younger person would. This is a good modification of the rule.

Here are some things a person should know about bankruptcy. A bankruptcy filing which is done by an attorney will stop foreclosure, garnishment of wages and collection calls at least temporarily. Also, bankruptcy filings cost money, so a person needs to have enough funds to file. My estimate for the cost of a typical personal bankruptcy is approximately $2000 which may vary based on the person’s particular circumstances. (It should be noted that sometimes it is possible for a debtor to negotiate a settlement for an unsecured debt or a medical bill. As an example, if a person is a candidate for bankruptcy, a hospital may rather have a lump sum cash settlement that is less than the full amount owed if there is significant risk they will lose the full amount in bankruptcy. Of course, a person needs to have a source for a lump sum settlement offer.)

There are two types of personal bankruptcy. In Chapter 13 Bankruptcy, the court helps come up with a plan to pay as much of the debt as the debtor can afford within a three to five year period. After this period of time, the remainder of the unsecured debt is eliminated. (Remember that secured debt, like a home loan or car loan, can’t be eliminated with losing a person’s home or car.)

In Chapter 7 Bankruptcy, credit card, medical bills and other unsecured debts are eliminated totally. (Recent taxes and school loans can’t be eliminated in bankruptcy.) The property securing a person’s secured loans can be sold to erase that debt. However, bankruptcy law allows a person to keep some equity in a home (up to $15,000) and a car (up to $3000) if he can keep making payments on the secured debt. In Chapter 7, there is a “means” test that applies if a person is over the median income for his area. If the “means” test determines a person can pay back some of their debt he will be moved into Chapter 13.

If bankruptcy is the best answer for a person or couple, the next decision is to change the behavior that caused this bankruptcy. This might mean living within a person’s means, not spending what a person doesn’t have, cutting up credit cards, making a budget, and acquiring adequate insurance. The past is over and guilt and despair about the past is not the answer. The answer after a new start is to decide to change a person’s behavior for a better financial future. Everyone has made mistakes, but I especially admire people who can recognize the mistakes and take action to change for the better.

(Remember every investor’s situation is unique; and it is important to review your specific situation with a financial professional.)

Ed Douglas is a Certified Financial Planner/Consultant, Chairman Emeritus of Citizens Bancshares and author of two books, “Making a Million With Only $2000-Every Young Person Can Do It” and his new book “The Money Marathon: 7 Simple Steps to Financial Freedom” available at www.eddouglas.com . Ed may be contacted at ed@eddouglas.com or 660-646-2066.