

Bankruptcy and the Alternatives

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Congress saw the need to respond to the consumer credit society by modernizing and expanding bankruptcy laws through the Bankruptcy Reform Act of 1978, the first major change in the federal bankruptcy code since 1898.

Bankruptcy laws offer debtors a chance to make a fresh financial start and usually result in the creditors being paid approximately 50 to 60 cents for each dollar owed them. This amount, however, varies with each individual bankruptcy case.

The federal bankruptcy code is divided into chapters. Two of these chapters relate to the two options for discharging consumer debt. The most common option is straight bankruptcy (Chapter 7 of the code). This allows debtors (business or non-business petitioners) to turn over most of their assets for court liquidation in return for a discharge from most of their outstanding debt. About 70 percent of all bankruptcies are filed under Chapter 7. The percent of consumer bankruptcy filings as a percentage of total filings steadily increased, from 86 percent in 1980 to 91.7 percent in 1990 to 96.2 percent in 1997.

The second option (Chapter 13) enables debtors to seek court approval of a plan to repay their debts, usually within three years. During this period debtors are protected from further harassment by creditors, and are able to keep their assets.

Other forms of bankruptcy include Chapter 9, which applies to municipalities, and chapter 11, which applies primarily to business reorganizations. Chapter 12, added to the statute in 1986, is the newest operative section of the bankruptcy code. It makes available to family farmers the equivalent of a Chapter 13 repayment plan. Chapter 12 cases are classified as business bankruptcies.

Personal bankruptcies have risen sharply in recent years, even with an increase in both total employment and total personal income. In 1997 over 1.4 million bankruptcies were filed in the US involving 1,350,118 persons and 54,027 businesses. In North Dakota 1896 personal bankruptcies (Chapter 7 and 13) cases were filed in 1997, as compared to 873 in 1990 and 363 cases in 1980 (see Table 1).

Table 1. Business, Non-Business and Total Bankruptcy Filing

U.S. Total	Business	Non-Business	Total
1980	43,694	287,570	331,264
1990	64,853	718,107	782,960
1995	51,959	874,642	926,601
1997	54,027	1,350,118	1,404,145
North Dakota			
Total	Business	Non-Business	Total
1980	188	363	551
1990	209	873	1,082
1995	118	1,193	1,311
1997	155	1,806	1,961

Source: American Bankruptcy Institute

The increase in total bankruptcy filings for North Dakota was 29 percent from 1995 to 1996, and another 18 percent in 1997. Rapid growth in consumer debt is probably a key factor under-lying the increase in personal bankruptcies. Changing attitudes toward bankruptcy may be another factor that helps to account for the accelerated pace of bankruptcy filings. Less stigma is attached to bankruptcy, especially when defaults are due to socially acceptable causes such as death, illness, disability and long-term job loss. In addition, consumers are more aware of legal remedies to their financial problems. This is due in part to increased consumer awareness, but probably due more to increased advertising by lawyers (legally permissible since 1971).

Are You at Risk of Facing Bankruptcy?

The average debtor who files for bankruptcy owes 1.62 X his or her annual income in short term debt. If you think you might be in financial difficulty, the time to take action is before bankruptcy becomes an alternative. Some warning signals might be:

- creditors hounding you for payments
- threats of lawsuits
- loan balances are not decreasing
- borrowing to pay bills (for example, taking a cash advance on one credit card to pay the minimum on another)
- 20 percent of income going for installment (non-mortgage) debt

Before Considering Bankruptcy:

If you are feeling overwhelmed by debt, the first thing you will need to do is take stock of your financial situation. Does income match expense? If not, your first alternatives would be to increase income, decrease expense, or restructure debt. If this is not possible, consider selling assets. If your debt is largely due to credit, consider working with your creditors for extended payments, reduced charges or both.

Another option might be to contact a consumer credit counselor. Look in the phone book yellow pages under Credit & Debt Counseling to see what is available in your area. One statewide service is the Village Family Service Center (toll-free 1-800-450-4019) with counselors in Minot, Bismarck, Jamestown, Grand Forks, and Fargo. Other services may be available in your area.

Chapter 7 - Straight Bankruptcy

By far the most common, Chapter 7 bankruptcy allows a debtor to completely erase most debts and might be appropriate for someone with irregular or declining income who is unable or unlikely to repay all debt within a five year time span.

When an individual petitions for straight bankruptcy under Chapter 7, a court-appointed trustee takes the petitioner's nonexempt property, sells it, and repays creditors with the sale's proceeds. The debtor is then discharged from remaining unpaid obligations. Federal law reasons that some property should be exempted to help debtors make a fresh start. North Dakota is one of several states that has chosen to set property exemptions that differ from federal law.

Table 2 summarizes North Dakota exemptions. Besides the absolute exemptions, debtors are allowed additional exemptions. Also, they may choose an alternative exemption in lieu of the additional personal property exclusion. The law, however, does not protect exempt property that is legally encumbered with unpaid debt. Creditors cannot access tax-deferred retirement accounts but may tap other personal savings and investments, which could affect retirement plans.

Table 2. Property and income exemptions available to North Dakota residents under North Dakota's Century Code.

Absolute Exemptions

- All family pictures.
- A church pew.
- Burial lots or plots.
- Family Bible and books, up to \$100.
- All clothing.
- One year's supply of food and fuel.
- A homestead up to \$80,000.
- Insurance benefits for absolute exemptions.
- Any debtor-resided trailer or mobile home.

Additional Exemptions

- Personal property or goods up to \$5,000 for a head of household or \$2,500 for a single person.
- Motor vehicle up to \$1,200.

Savings up to \$7,500 instead of homestead exemption.

Life insurance policies with cash value up to \$100,000 for a maximum total of \$200,000.

Instead of the personal property or good exemption the debtor may select the following:

Family books and musical instruments up to \$1,500.

Library and instruments of a professional person up to \$1,000.

All household furniture up to \$1,000.

Livestock and farm implements up to \$1,000.

Tools, implements and stock for trade or business up to \$1,000.

Debts such as alimony, child support, student loans, three years of back taxes, fines and penalties, and any debts resulting from drunken driving convictions cannot be discharged.

Filing a straight or Chapter 7 petition is relatively simple. A person files a petition, available from a lawyer, and pays a \$175 federal filing fee. The petition specifies the person's debts, assets and exemptions. In addition to the filing fee, the person should expect to pay a lawyer between \$350 and \$1000.

Chapter 13

The 1978 Federal Bankruptcy Code vastly expands the old "Wage Earner Plan." The current Chapter 13, sometimes called the debtor rehabilitation chapter, covers any person with regular income. The spouse of the person may file joint bankruptcy even if the spouse does not have regular income. In addition, sole proprietorships such as professional practices are now covered. Stockbrokers and commodity brokers are specifically excluded.

In a Chapter 13 proceeding, the court and creditors approve a repayment plan. The debtor is allowed to keep all property by planning to repay a portion of the debt in no more than three years. At the end of three to five years most unpaid debt except alimony, child support, school loans and long-term (mortgage) debt is discharged under Chapter 13.

The most recent bankruptcy law limits the amount owing on the date of filing under Chapter 13 to less than \$250,000 in unsecured debts and to less than \$750,000 in secured debts. A joint filing of a husband and wife is restricted to the same dollar figures. By limiting the debt amounts but expanding the coverage to include sole proprietors with mostly business-related debts, the law allows many smaller businesses to file a Chapter 13 and avoid a cumbersome reorganization plan under another chapter of the bankruptcy law.

A debtor must submit a debt repayment plan to the court for approval. The Village Family Service or other financial counselors may be able to help a debtor set up a debt repayment plan. The plan must include a list of creditors, debts, essential expenses, and income. Creditors have the right to object to the proposed plan, but the judge has the final decision.

The court schedules two meetings. At the preliminary meeting the debtor may be questioned about the debts, income, expenses and general financial situation. The confirmation hearing is the second meeting, where the bankruptcy judge presides. At this hearing the creditors may object, for example, to claims the debtor has made for essential expenses.

When the court approves the repayment plan, the debtor begins paying the predetermined amount to the court-appointed trustee. Included in the repayment plan are payments for the expenses resulting from the administrative and court costs for legal and trustee fees. Persons filing a Chapter 13 plan should expect to pay the filing fee (\$90) and about 10 percent of the charges for the legal and trustee fees. The debtor pays for the trustee responsibilities such as accounting for the debtor's property, examining proofs of claims, making reports, appearing at hearings and paying creditors.

Chapter 13 Benefits

During the repayment period the debtor's finances are under the protection and supervision of the court. This means that creditors must stop collection efforts. Any garnishment procedures or attachments against the debtor's wages begun before the Chapter 13 filing will be stopped by the court. Consigners are usually protected and delinquency and interest charges are normally stopped.

The debtor's responsibility in return for the court's protection is to carefully follow a spending plan and fulfill the repayment agreement. A payment should not be missed or additional debts incurred without consulting the trustee.

Completing a debt rehabilitation plan gives the debtor an opportunity for a fresh start with property intact and gives the satisfaction of having repaid all or a portion of the debts. Once Chapter 13 is completed, there is no time limit before another bankruptcy can be filed.

Chapter 12 - Farm Bankruptcy

Chapter 12 is designed to allow family farmers to remain in the business of farming while reorganizing and attempting to pay off their debts. Chapter 12 offers the family farmer several advantages over other bankruptcy reorganization chapters because it recognizes the seasonal nature of most agricultural income, the difficulty of predicting in advance annual farm income, and the increased credit needs of farmers. Chapter 12 was originally scheduled to be repealed on October 1, 1993, but the repeal date was extended to October 1, 1998. All cases commenced or pending under Chapter 12 by October 1, 1998 and all matters relating to such cases will proceed and be determined as if Chapter 12 has not been repealed.

Farmers Eligible to File for Chapter 12

Chapter 12 is only an option for farmers who receive at least half of their income from farming and have no more than \$1.5 million in debt. At least 80 percent of that debt must be related to the farming operations.

Mechanics of a Chapter 12 Bankruptcy

A Chapter 12 bankruptcy filing is similar to a Chapter 11 corporate reorganization bankruptcy or a Chapter 13 personal reorganization bankruptcy. After a farmer files for Chapter 12, a "stay" is imposed and all actions of creditors to collect debt from the debtor must cease.

After filing for bankruptcy, the farmer has 90 days to file a plan of reorganization with the bankruptcy court. The reorganization plan must reveal all the farmer's debt and detail how he or she plans to repay the debt over three to five years. If the plan meets all of the requirements of Chapter 12, the bankruptcy court must approve it at a hearing held within 45 days after it is filed. Creditors are given an opportunity to file objections to the plan but cannot veto it.

After filing for Chapter 12 the farmer almost always is allowed to continue operating the farm. An interested party can request that the farmer be removed from the farm, but a bankruptcy judge will only do so if the farmer is guilty of fraud, dishonesty, incompetence, or gross mismanagement of his or her affairs.

The reorganization plan is supervised by a court-appointed trustee. During the plan, the farmer makes periodic payments to the trustee who then pays creditors according to the terms of the plan. Should the farmer be removed for one of the above-mentioned reasons, the trustee steps in to manage the farm. At the end of the plan period, the court discharges any remaining debts, with certain limited exceptions, and the debtor is given a "fresh start."

Before Bankruptcy

Overextended or over indebted persons will need to list the amount owed, the essential family expenses, and their take-home or after-tax income to file under either Chapter 7 or Chapter 13 of the Federal Bankruptcy Code. This list should provide enough financial information to make a realistic decision on which type of bankruptcy, if any, should be filed.

As a guide for determining whether a Chapter 13 filing is appropriate, bankruptcy court asks whether essential expenses do not exceed more than 75 percent of take-home income and whether the remaining 25 percent will pay off all or most of the debts within three to five years. For example, if a family has a monthly net take-home pay of \$1,600, and \$1,200 in essential expenses, they cannot have more than \$400 in payments stretched over the next three years to pay off their debts to be considered for Chapter 13.

Alternatives to consider before filing bankruptcy include:

- Until your debts have been paid off, cut up and return all of your credit cards, or at least freeze them in a bag or tray in your freezer. Promise yourself to leave them there until you are "debt free."
- Develop a spending plan to keep saving, spending and debt reduction on track.
- Increase the number of your withholding exemptions if you have been getting tax refunds (see your employer's payroll office).
- Use any cash value of your life insurance to pay toward your debts.
- Convert your cash value insurance to term insurance.
- Shop for lower cost auto insurance and get it from the same company as your homeowners' insurance for a discount on your premiums.
- Sell personal items such as boats, cycles, guns or other hobby or recreational equipment.
- Involve every household member in a "treasure hunt" of unused items to be sold in classified ads or in a garage sale.
- Find a temporary second job or turn a personal hobby into an income producing hobby.
- Make sure that money raised in these ways be used immediately for debt repayment before it is spent.
- Speak to the credit managers of the places where you have payment problems. Explain why you cannot make your scheduled payments right now, and ask for a reduced payment for a while.
- Get a clear agreement on any reduced amount you will pay each month and exactly when it will be due. Faithfully keep this new agreement.
- Ask the managers to report your new, smaller payment to the credit bureau as "on time." Otherwise the credit bureau may record these payments as delinquent because you are paying less than in your original credit agreement.
- Auto loans permit creditors to repossess your car any time you are in default on your payments. No advance notice is required. If your car is repossessed, you may have to pay the entire balance on the loan as well as towing and storage costs to get it back.
- Try to solve the problem with your creditors as soon as you realize you can't meet your payments. For example, it may be better to sell the car and pay off your debt to avoid the costs of repossession and a negative entry on your credit report.

After Bankruptcy

Bankruptcy is not a painless or easy escape from debts. Bankruptcy should be thought of as a last resort. The process is generally traumatic. The bankrupt person must explain to the judge what happened, describe his or her assets, and explain his or her inability to pay. In addition, certain controls are applied to people who have filed for bankruptcy:

1. They are not able to declare Chapter 7 bankruptcy again for six years.
2. Their records of Chapter 7 bankruptcy are kept in credit bureau files for 10 years (credit bureaus must distinguish between the chapter filed in their reports). Chapter 13 remains on record seven years after discharge.
3. They are not allowed new credit while Chapter 13 is in effect.
4. They can qualify for new credit after filing under Chapter 7, but usually only by paying higher interest rates than those paid by people who do not have a bankruptcy record.

Whether filing personal bankruptcy under Chapter 7 or Chapter 13, a person needs to secure the services of a lawyer.

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Use worksheet 1 to list your income and essential expenses, not your debts. Under insurance, list only the amounts that aren't deducted from your paycheck. There are two columns for your dollar amounts. In Column A list the amount you receive or spend per period (weekly, biweekly, or monthly). Column B is the annual amount. Multiple the value in Column A by 52 for weekly, 26 for biweekly or 12 for monthly to complete the annual amount in Column B.

WORKSHEET 1 - Income and Essential Expenses

COLUMN A
(per period:
Weekly, Biweekly,
or Monthly)

COLUMN B
(Annual amount)

1. INCOME OR WAGES AFTER TAX	_____	_____

II. ESSENTIAL EXPENSES	_____	_____
Food/groceries at home	_____	_____
Meals out	_____	_____
Housing/rent or mortgage	_____	_____
Home energy (electricity, gas, heating fuel)	_____	_____
Other household maintenance (phone, water, etc.)	_____	_____
Clothing	_____	_____
Transportation (gas & oil)	_____	_____
Other transportation	_____	_____
Insurance -		
Life	_____	_____
Auto (car/truck)	_____	_____
Health and/or disability	_____	_____
Renter or homeowner	_____	_____
Other Expenses	_____	_____

TOTAL ESSENTIAL EXPENSES	_____	_____

Use Worksheet 2 to subtract your essential expenses from your after-tax income (step 1) and to determine what percent of your after-tax income is needed for essential expenses and what percent can be used to pay off debts (step 2).

WORKSHEET 2 - What's left over?

	COLUMN A (per period: Weekly, Biweekly, or Monthly)	COLUMN B (Annual amount)

Step 1		
I. After-tax income	_____	_____
II. Subtract total essential expenses	_____	_____
III. Amount left to pay debts and for savings	_____	_____

Step 2		
Amount left (III)	_____	_____
Divided by after tax income (I)	_____	_____
Percent to pay off debts	_____	_____

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