

OPTIONS FOR DEALING WITH DEBT AND THE STIGMA OF BANKRUPTCY

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It is difficult to turn on the television or listen to the radio without hearing an advertisement for some type of debt relief. So many of these advertisements are misleading and give false information. For example, there is no "secret government program that the credit card companies do not want you to know about." There are also no guarantees that any organization can absolutely reduce a consumer's debt so that the consumer pays pennies on every dollar owed.

Consumers are flocking to debt consolidation programs and other organizations because the advertisements sound good and it is not bankruptcy. There is a stigma about filing bankruptcy. Most people believe that anyone filing bankruptcy is a "loser" or is trying to avoid paying their debts, when nothing could be further from the truth. Most people are filing bankruptcy because they have fallen on hard times. They are not scamming the system. They are using a federal law designed for their particular circumstances so that they may alleviate certain debts and get a fresh start. In fact, most people filing bankruptcy are doing so because they have lost a job and have no income, or a family member became ill



and there was no medical insurance, or they went through a divorce. Additionally, given the state of the economy and the decrease in property values, consumers owe more for their real property than it is worth and, if they are in an adjustable rate mortgage, they simply can no longer afford their property. Moreover, they cannot sell their property unless they sell it for less than they owe on it and that presents additional problems.

Consumers and businesses are looking for any way to stay afloat in these rough economic times; unfortunately, many wait until their situation is dire and they have exhausted the property that would have been exempt and protected in a bankruptcy before they seek bankruptcy counseling. This article is designed to discuss the various debt relief options and when it is appropriate for a consumer or business in financial distress to seek advice regarding bankruptcy as an option.

BANKRUPTCY IS NOT DEAD

On October 17, 2005, the federal Bankruptcy Code was drastically changed and a myth was created that “bankruptcy is dead.” However, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) changes to the Bankruptcy Code only created more requirements for filing bankruptcy and made the system more complicated.

For example, individuals must now complete a credit-counseling class prior to filing a bankruptcy case and they must complete a financial management class after they have filed for bankruptcy. These classes may be completed via the Internet or by phone. In addition, the amount of income that individuals earn in the six months prior to filing bankruptcy determines what type of bankruptcy case they can file.

All individuals and businesses may file for bankruptcy relief; it just depends what type of bankruptcy case they qualify for under the new guidelines. Filing a Chapter 7 bankruptcy is more limited than before BAPCPA, but individuals may still file a Chapter 13 if they do not meet the requirements of a Chapter 7. Additionally, if an individual does not meet the debt limitations for a Chapter 13, that individual may file a Chapter 11 as a means to reorganize.

Bankruptcy is available to everyone in some form. The changes to the Bankruptcy Code increased

the amount of documentation relating to financial affairs that a debtor must provide to the debtor’s attorney and the bankruptcy trustee, but it did not eliminate the basic tenets of the previous bankruptcy code.

WHEN SHOULD SOMEONE SEEK BANKRUPTCY ADVICE?

Any individual or business that is in financial distress or might become financially distressed within the next year should seek the advice of bankruptcy counsel. Most bankruptcy consultations are free, so the potential debtor is not spending any money to obtain accurate information about the potential debtor’s individual circumstances. Consulting with a bankruptcy attorney does not obligate an individual to file a bankruptcy. In fact, there are many circumstances

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where bankruptcy might not be appropriate. Those in financial distress need to make educated decisions as to their financial future, which means they need to speak with a bankruptcy attorney about the specifics of their financial situation. Bankruptcy may not be appropriate at this time, but it may be appropriate in the future. Additionally, a bankruptcy attorney will be able to let the potential debtor know what debts to pay and what property is protected if a bankruptcy is imminent.

Too many times, individuals let the stigma of bankruptcy keep them from seeking advice from an attorney, and they exhaust otherwise protected assets in an attempt to pay their debt. Yet at the end of the day, and after exhausting their exempt assets, individuals have not made a dent in their overall debt. Essentially, they are in

the same situation as they were before, but now they have no assets.

The classic example of this situation is when individuals withdraw monies from their IRAs or ROTHs in an attempt to pay down credit-card debt. IRAs and ROTHs are protected under the Nevada state exemptions and a debtor is entitled to keep up to \$500,000 in retirement accounts. Once the money is removed from these accounts, the individual will have to pay penalties on the withdrawal, which adds to the individual's debt. Moreover, any penalties on the withdrawal that are owed to the Internal Revenue Service are nondischargeable in a bankruptcy. In addition, unless the amount pulled out of the retirement accounts will pay off the debt in full, the individual is still going to be required to make credit-card

payments. If the individual in this scenario had filed bankruptcy instead of exhausting their retirement accounts in an attempt to pay down credit card debts, the individual would not have a nondischargeable tax debt, would retain their retirement and have no legal obligation to pay any of the credit-card debts upon the discharge from bankruptcy. Generally, individuals do not seek the advice of bankruptcy counsel until after they have exhausted their exempt assets and still they have creditors calling and harassing them.

BANKRUPTCY AS AN ALTERNATIVE

Bankruptcy is a way to get a fresh start. It is governed by federal law that allows individuals or businesses to liquidate their assets or reorganize their financial affairs so that they get a clean financial slate. If a consumer needs to win the lottery in order to alleviate all of the consumer's debt, then likely bankruptcy is a viable option for that consumer.

Many individuals want to avoid bankruptcy, as they believe that it will harm their credit. However, the reality is that if bankruptcy is a viable option for the individual, the individual's credit is probably not that good already and it is likely to get worse as the individual is

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unable to pay bills and becomes further behind. Bankruptcy alleviates the legal obligation to pay most unsecured debt with the exception of student loans, spousal maintenance, child support and taxes, or alternatively allows the debtor to repay them based on the debtors' income through a plan.

Bankruptcy will be on an individual's credit report for 10 years after the date of the bankruptcy discharge. At the time of filing a bankruptcy, all negative credit reporting stops and an individual is in the circumstance of having a clean slate on which to re-establish their credit. Many creditors will extend credit to those who have been in bankruptcy as they view bankrupt debtors as a decent risk given the debtor may not re-file a Chapter 7 for eight years after discharge and may only file a Chapter 13 (which would allow for the creditor to be potentially re-paid some amount) in certain other circumstances. An individual that is discharged from bankruptcy has less debt than those who are struggling to pay their bills under high interest rates, late fees and over-limit fees.

DEBT CONSOLIDATION PROGRAMS

Consumers seeking to avoid bankruptcy often attempt debt consolidation through an agency. The concept sounds good and if the debt consolidation companies could guarantee that the consumer would be able to consolidate their debt to pennies on the dollar, then it would possibly be a viable alternative. However, no entity or person can guarantee that a creditor is going to reduce a debt or agree to alter the terms of repayment. Moreover, consumers can attempt to negotiate with creditors themselves and need not pay a third party to do so.

Typically, debt consolidation agencies are paid a percentage of either the amount they reduce the debt or a percentage of the total amount of the debt. The consumer makes a monthly payment to the debt consolidation agency that is used to pay the debt consolidator and also is intended to be distributed pro rata among the consumer's creditors. Sometimes debt consolidation agencies do not begin to contact the consumer's creditors until the consumer, via monthly payments to the debt consolidator, has paid the debt consolidator in full. This is devastating to the consumer as the consumer's creditors have no way to know that the consumer is in a debt consolidation program and all the

creditor knows is that they are not getting paid. Moreover, the consumer who thinks that the creditors are getting paid is oblivious to the fact that they are not. Consumers generally learn this truth when the creditors begin to sue for failure to pay. Additionally, the consumer's credit has been harmed as now there is negative credit history for the failure to make payments over a period of time. At this point, the consumer is left with no alternative but to file for bankruptcy and has lost the money that was paid to the debt consolidator.

If debt consolidation is an avenue that a consumer wishes to explore, the consumer needs to read the contract with the debt consolidator carefully to determine what exactly the debt consolidator will do, when the debt consolidator will do it and how much, total, the debt consolidator will charge. If the consumer's creditors are not going to continue to get regular monthly payments through the process of debt consolidation, it is not advisable to pursue it.

SHORT SALES AND FORECLOSURE

Property owners in financial distress attempt to sell their properties to alleviate debt. However, given the decrease in overall property values, most property owners are unable to sell their properties for the amount that is owed on the property. In certain circumstances, the mortgage holder will allow the property owner to sell the property for less than what is owed on it, which is called a "short sale." However, when the property is not the debtor's primary residence, the property owner will be issued a 1099 for miscellaneous income for the forgiveness of the debt. At that point, the property owner will have to pay taxes on the amount of debt that the bank forgave. For example, if a property owner owes \$200,000 on a nonresidential property and the bank allows the property to be sold for \$150,000, then the property owner will have \$50,000 that is considered income by the Internal Revenue Service and the property owner will have to pay taxes on that amount.

In the case of short sales or foreclosures of a debtor's principal residence, the U.S. Congress passed the Mortgage Forgiveness Debt Relief Act of 2007. This act remains in effect until December 31, 2009 and excludes any forgiveness of debt on a debtor's primary residence from being taxable.



Additionally, if a property owner's sole financial difficulty is paying for the real property, foreclosure may be the appropriate option. The mortgage holder may foreclose on the property and that, potentially, would alleviate the debtor's obligation to pay. However, foreclosure is not the optimal alternative when the property owner has more than one mortgage on the property, as unless the most junior lien holder forecloses, the property owner will remain personally liable for the amount owed on any junior mortgages. Thus, the property owner will be sued on the second or third mortgage for payment. In addition, if the real property is sold for less than the amount owed to the lien holder selling the property, the lien holder may sue for a deficiency judgment within six months from the date of the sale.¹ If the property owner has no additional financial problems other than the inability to pay for a certain parcel of real property and there is only one mortgage on the property, it may be advisable to let the property be foreclosed and wait to see if there is a lawsuit for a deficiency. If there is, then bankruptcy may become a more viable option.

No one plans to file bankruptcy, but the option is available when it is necessary. There is no shame in

using the federal laws designed to assist individuals in these circumstances that make bankruptcy appropriate. Individuals should not shy away from getting accurate information about their circumstances and the viability of bankruptcy and other debt management options. The key is to be educated about all the options available so that an individual or business may make an educated decision about the most effective and optimal way to deal with the individual's or business' debt. **NL**

1. NRS 40.455

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TYPES OF BANKRUPTCY

CHAPTER 7 - LIQUIDATION

Chapter 7 bankruptcy is available to individuals as well as businesses. Under the bankruptcy code a "person," for the purposes of filing bankruptcy, is defined as an individual, partnership and/or corporation. A Chapter 7 bankruptcy requires the collection of the individual's non-exempt property for sale or liquidation and the cash proceeds from its sale is paid on a pro rata basis to creditors with claims against the estate. The reality is that most people filing for bankruptcy have no non-exempt property to sell.

As a result, Chapter 7 bankruptcy generally eliminates all of an individual's unsecured debt and unsecured creditors generally receive no payment. Secured creditors continue to be paid in full if the individual wishes to keep the secured property. If the individual does not want to keep the secured property, the individual may return the secured property/collateral (for example, a vehicle or house). Once the secured property is returned, the secured creditor may take no further action against the individual for collection. The return of the property is considered full and final payment no matter how much is owed and no matter how much the property is worth.



CHAPTER 13 - REORGANIZATION

Chapter 13 bankruptcies are designed to restructure the debts of an individual. In a Chapter 13 bankruptcy case, individuals file a plan to repay some or all of their debt over a period of time (usually 60 months). The amount that must be paid to creditors is determined by the individual's specific income and expenses. When individuals file a Chapter 13 case, they will begin to make one monthly payment to the Chapter 13 trustee as determined by their plan and their income. The trustee will distribute the payment to the creditors. Once all of the plan payments are made, the individual will be granted a discharge.