Managing High Levels of Debt

Standard 13

The student will evaluate the consequences of bankruptcy.

Lesson Objectives

- Identify ways to deal with high levels of personal debt.
- Compare the costs and benefits of filing bankruptcy.
- Recognize the impact of filing bankruptcy.
- Explain the importance of reestablishing positive credit history.
- Demonstrate the steps to rebuilding positive credit history.

Personal Financial Literacy Vocabulary

Bankrupt: A person or company with insufficient assets to cover their debt.

Bankruptcy: A state of being legally released from the obligation to repay some or all debt in exchange for the forced loss of certain assets. A court's determination of personal bankruptcy remains in a consumer's credit record for 10 years.

Consumer credit counseling: Services offered by organizations that help consumers find a way to repay debts through careful budgeting and management of funds.

Creditor: A person or company to whom money is owed.

Debt consolidation loan: A single loan that replaces the debt owed by multiple loans, often with a lower monthly payment and a longer repayment period.

Financial counseling: Generally the same as consumer credit counseling.

Garnishment: A legal order concerning the attachment of property to satisfy a debt.

Home equity loan: A loan secured by a primary residence or second home at the amount where the fair market value exceeds the debt owed on the property.

Repossession: To take possession of property in which the owner is behind in payments.

Introduction

Monty and Caroline could not wait to graduate from high school and get married. They planned to go to college, if they could get student loans. Both worked part-time at a fast food place, and they were planning to work full-time once they got married.

In their premarital counseling class on debt, they each were shocked to learn how much the other person owed. Monty had a new truck. He borrowed money on his credit card for the down payment, tag, and title. He also booked their $5,000 honeymoon to Mexico on his credit card. Caroline drove an old car, but it was a "money pit," constantly requiring expensive repairs. Because money was tight, she charged those repairs on her credit card, along with her clothes, shoes, dinners with friends, and everything else she wanted or needed. Her charges totaled $8,000. Thank goodness her parents were paying for their wedding!

Is this a good way to start a marriage? What do you recommend Monty and Caroline do to get control over their debt?

Lesson

Have you ever gone shopping and realized you left your billfold at home when you get to the checkout stand, with no way to pay for your purchase? Now, imagine if you were in this position every day – having little or no money to pay your bills, make your rent payment, or buy food for your family. Unfortunately, there are numerous individuals and families who face that dilemma on a regular basis. Some are in that situation because they failed to manage their money or follow their spending plan; others face that problem for other reasons such as divorce, prolonged illness, or another situation that may be beyond their control.

If you have poor money management and a habit of overspending, you are setting up yourself to experience a high level of debt and a mountain of bills to pay. Getting behind in your payments creates more problems, and suddenly your debt is overwhelming.

Oftentimes, creditors will start taking legal steps against you to either take back the products you have purchased or to force you to make payments because they have a right to collect the money you owe them. If you get behind in your payments or stop making them, creditors may start calling you repeatedly, send threatening letters frequently, take you to court, take part of the wages from your paycheck as a garnishment, refuse to give you more credit, and even take back what you purchased from them in a repossession.

Failing to pay a creditor, for whatever reason, is not a good practice. If you find yourself in trouble, do not ignore them. While it may be annoying to get their letters or phone calls requesting payment, you are better off to respond, telling them you are having financial problems. If they see you are trying to be responsible, they may be more willing to help you.

At this point, your need to make some difficult choices. Perhaps you decide to stop spending in hopes you can start making your payments, or you decide to get a second job to earn additional income to pay the bills. But you also have some other possibilities to consider. While some of these options are better than others, each of them have costs without an "easy" way to escape. In addition, they tend to be rather complex solutions and can vary greatly, depending on the situation. Here are some of the choices you may consider when you cannot manage your debt:

1. Credit counseling or financial counseling. Credit counseling or other financial counseling services provide you with guidance on how to better budget your available funds. Oftentimes, they will help you come up with a plan to start paying off your debt. Most of the groups offering these services will also help you restructure your overall level of debt by working with your creditors to set up a new payment plan. However, you must be willing and able to follow the new plan or they will drop you from the program, putting you back where you started.

Before contacting a credit or financial counseling service, you may want to check with the Better Business Bureau (http://welcome.bbb.org) to be sure they are a reputable company. Beware when using some of these services, especially if they are for profit, because they make promises they cannot keep, charge for their information, and create more bills for you to pay. Others, such as the Consumer Credit Counseling Service of Central Oklahoma, are non-profit organizations that provide some of their services for free or greatly reduced charges because their only purpose is to help you get out of debt and stay out of debt.

2. Debt consolidation. You may consider a debt consolidation loan that will put all of your debt into one payment, making it easier to manage. While it sounds like a great idea, it also has some costs. If you had problems managing your money and paying your bills before you combined them, you may have problems making your payments after consolidating them. In addition, you often pay a high rate of interest for debt consolidation loans that increase your overall debt and extend the time to pay off your debt.

3. Home equity loan. A home equity loan allows you to borrow money on your house to pay your bills, but you have to own a home in order to get a home equity loan. These loans are very similar to a debt consolidation loans except you are using your home as collateral. These loans have a high level of risk because the lender can take your home if you fail to make your payments.

4. Help from your creditors. Sometimes you can call the companies you owe and ask them to help you restructure your payments to help you get caught up on the amount you owe. However, they are not legally required to help you. Credit counseling services generally have contracts with creditors, which means they are more responsive to calls from credit counselors than calls from you. The level of help provided by creditors varies greatly, but may be worth trying. It is critically important to follow the plan and make all payments on time; otherwise, you will again owe the entire amount.

5. Personal bankruptcy. Bankruptcy is a legal process where you appear before a judge who determines if you can make reduced payments on your bills or if the court will dismiss your bills, meaning you no longer are required to pay them. Because bankruptcy is a court-ordered decision, it becomes part of your credit history for ten years. Most creditors will charge you higher interest rates after you file bankruptcy because you are a high risk borrower. And remember, those higher interest rates increase the cost of buying anything that requires a credit to purchase.

Bankruptcy is not new. It was first started in England in the mid 1500s and allowed the courts to punish people who failed to pay their bills by ordering they have an ear cut off or be put to death. Those laws were gradually modified over the years, eventually allowing the courts to dismiss a person's debt if they had no means to repay it. Today's bankruptcy laws are based on those old English laws, minus the physical punishment. While filing for personal bankruptcy has become more acceptable, it remains a drastic action that must be given serious deliberation before initiating the process.

What Does Bankruptcy Really Mean?

Basically, bankruptcy means you do not have sufficient income to pay your bills when they are due. As a result, the legal system allows you to request help to get out from under the burden of debt. Once you file bankruptcy, your creditors must stop trying to collect payments from you and wait for the bankruptcy judge to make a decision about what to do with your bills. The amount you pay will depend on what the bankruptcy court determines to be appropriate.

Bankruptcy filings are public record, like any other court case, and can take several months to resolve. Once you file, you are assigned to a bankruptcy trustee who manages your case. The trustee will meet with you and your creditors to resolve the problem. In addition, you are required to have an attorney to represent you at all bankruptcy hearings. When dealing with your attorney, the trustee, or your creditors, it is important to be honest with them about the problems you are having. Your honesty will help ensure the best outcome for you and your family.

Furthermore, making false statements or failing to accurately report all information during the bankruptcy process is a crime. If you decide to file bankruptcy, it is important to follow the rules or face serious charges. Should you decide to file for bankruptcy, be sure to take it seriously because it has long-term consequences for you and your finances.

REMINDER

Bankruptcy filings are public record, like any other court case, and can take several months to resolve.

Types of Personal Bankruptcy

Individuals can file two different types of bankruptcy: Chapter 7 and Chapter 13. Chapter 7 allows you to request that all of your debt be liquidated or dismissed while Chapter 13 reorganizes your debt with lower payments that fit within your ability to pay. Regardless of which type of bankruptcy you file, some debts – specifically taxes and federal student loans – are not part of the bankruptcy process. You owe them, regardless of your situation.

Chapter 7

The purpose of Chapter 7 is to totally release you from all debt included in your bankruptcy petition. Chapter 7, sometimes called Straight Bankruptcy, allows the bankruptcy trustee to collect any or all of your assets, convert them to cash by selling them, and then use the money to pay your creditors. The laws protect your right to retain certain assets called "exempt property". Being "exempt" means they are excluded from the bankruptcy process and cannot be taken by the trustee. The list of exempt property varies from state to state, but generally includes your home and other basics needed to live. Any remaining property is non-exempt and can be seized by the bankruptcy trustee. Most people approved to file Chapter 7 have few, if any, nonexempt items. If you are approved for Chapter 7 bankruptcy, you cannot file again for eight years from the date you started the first process, regardless of your debt level or financial situation.

Chapter 7 bankruptcy is only available if you meet certain income requirements, so not everyone is eligible to have their bills dismissed. In addition, the process includes mandatory credit counseling to help reduce the potential of getting into financial trouble in the future.

Chapter 13

Chapter 13 bankruptcy is a little different. Commonly called Debt Adjustment, it allows the trustee to work with you, your attorney, and your creditors to generate a repayment plan for your bills and for you to keep all of your personal possessions. You generally have about three to five years to make reduced payments on your debt. During this time, you creditors cannot contact you or take any actions against you as long as you are keeping your commitment to pay your bills. With Chapter 13, you rarely pay the entire amount owed when you filed bankruptcy, but you will repay a substantial part of what you owed at reduced interest rates. The amount you pay will depend upon the settlement reached with your creditors during the bankruptcy process. Once you have completed your payment plan, you are debt free and able to start over rebuilding your credit history.

Chapter 13 is available if you do not meet the income requirements for Chapter 7 and if you have sufficient income to make the restructured payments. All debt payments are made directly to the bankruptcy court, who then distributes the payments to your creditors. Like Chapter 7, there are serious consequences if you fail to make your required payments, and you are mandated to complete special debt counseling classes.

Bankruptcy is not a substitute for good money management skills. It should only be considered as a last resort for managing your debt. You should seriously consider other possible options, such as financial counseling, before taking this step. Bankruptcy may be necessary to help you start over, but understanding how and why you got into debt are important steps to preventing additional problems in the future. While you may not be able to control or prevent everything that happens, you can decrease the potential for filing bankruptcy by making good choices. These include establishing and following a budget, making a monthly commitment to savings, and spending less than you earn.

Top 10 Reasons for Filing Bankruptcy

1. Medical Expenses
2. Reduced Income
3. Job Loss
4. Credit Debt
5. Divorce
6. Unexpected Expenses
7. Student Loans
8. Utility Payments
9. Foreclosure
10. Poor Budgeting or Overspending

Life After Bankruptcy

Bankruptcy has both costs and benefits. It provides immediate relief from creditors who are calling you asking for payments, and it reduces the stress of trying to manage everything by yourself. Bankruptcy also allows you the opportunity to start fresh with little or no debt.

However, the decision to file has substantial costs. Because bankruptcy remains on your credit file for ten years, it lowers your credit score which results in limited credit opportunities and much higher interest rates. In addition, it may prevent you from buying a home or getting certain types of jobs. In general, potential lenders, employers, and others may not feel comfortable with your level of personal responsibility.

Filing for bankruptcy also has some immediate costs because you are required to pay a filing fee to the court and hire an attorney to represent you. On top of that, you will need to take off from work to meet with attorneys, attend counseling sessions, and appear in court. Those requirements add additional costs to your decision to file bankruptcy.

Societal Costs

Bankruptcy also has a cost to society. Tax dollars spent on bankruptcy courts and the people who work there cannot be spent on other public goods and services. In addition, creditors must employ people to represent them in court — adding to their cost of doing business. And, because there are no "free rides," someone has to pay those costs. Creditors simply pass those costs on to other customers, meaning everyone pays higher interest rates to offset the cost when someone cannot pay.

Repairing Your Credit

You may have seen the ads on television, received them in your email, or heard them on the radio: "Come see us to erase everything negative in your credit file and improve your credit score." Beware! Most of these advertisements are scams. Most are making promises they cannot keep. Spending money to have your credit repaired is money wasted. In reality, there is very little a company can do to improve your credit rating for you. The best way to improve your credit score is to establish a budget and start paying your bills on time. If you continue that practice, your score will gradually increase as you rebuild a positive credit history over a period of time.

Conclusion

Practicing good money management reduces the potential for dealing with high levels of debt. However, life events can disrupt your plans and create serious debt problems that need immediate attention. Dealing with high levels of debt is stressful and can have a negative impact on you and your family. Knowing your options will help you find the best way to handle debt problems when you owe more than you can pay. Only time, effort, and commitment to paying your bills on time will make a difference in your credit score once you have experienced credit problems.

FINAL NOTE: What did you recommend for Monty and Caroline before reading this lesson? Did reading this lesson you change your mind?

If you said they need financial counseling, then you are correct. Managing debt is very stressful and is frequently a source of marital problems, suicide, and health-related issues. Young people like you, Monty, and Caroline are among the fastest growing segment of the population filing bankruptcy because of a lack of money management skills. Taking classes like this one, getting financial counseling, setting a budget, and changing some basic behaviors will help prevent you and this couple from being another bankruptcy statistic.

Name: ______________________________ Class Period: _____________________________

Managing High Levels of Debt Review 13.1

Answer the following questions and give the completed lesson to your teacher to review.

1. Which one of the following is considered a good option to bankruptcy?
    a. Stop payment on all bills.
    b. Hire a credit repair service.
    c. Get consumer credit counseling.
    d. Get additional credit to pay off your bills.

2. When you file bankruptcy,
    a. you seek legal protection from your creditors.
    b. your credit score increases because you have no debt.
    c. you are no longer responsible for paying any of your creditors.
    d. you have the right to determine which bills you will repay and which ones you will not repay.

3. Bankruptcy stays on your credit file for
    a. 10 years.
    b. 5 years.
    c. 7 years.
    d. 4 years.

4. Which of the following statements is <u>TRUE</u>?
    a. Only poor people file bankruptcy.
    b. People who file bankruptcy can never get credit again.
    c. People who file bankruptcy are deadbeats who do not want to pay their bills.
    d. People who file bankruptcy pay higher interest because they are a higher risk to lenders.

Name: ______________________________ Class Period: _____________________________

You Be the Judge Activity 13.1

Use the following information to determine whether or not the person should file for personal bankruptcy.

Sanya and Jay have been married for 20 years. Life was good until Jay was diagnosed with a serious illness that required him to quit working. Even though they both had good jobs, they had little or no savings because they spent all of their extra money traveling, making frequent trips to Europe and Hawaii. Shortly before Jay got sick, they bought two new cars, a new house and new furniture. This is the last month his company will pay his health insurance, and he has no disability benefits after six months. The medical bills are growing, and their income is almost half of what it used to be. What should they do?

File bankruptcy Get credit/financial counseling Get a debt consolidation loan

Elaborate on why they should choose this option:

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Steve is a single dad with three children. His wife was unhappy with their marriage and filed for divorce about a year ago. She moved out of state to get a new job and start a new life. With three kids and limited income, Steve's bills are mounting, and he continues getting further behind with his monthly payments. The bill collectors are calling and he is not sure what to do. What would you recommend to him?

File bankruptcy Get credit/financial counseling Get a debt consolidation loan

Why do you recommend this option to Steve?

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Heather enjoys spending money. She lives in a nice apartment, drives a sporty car, and wears fashionable clothes. She was so busy with her friends and having a good time that she forgot to pay her personal income taxes last year. But it really does not worry her; she knows she will take care of it someday. Heather thought she was a good money manager because she had several credit cards and always made the minimum payments on time each month. But with student loan payments, car payments, and all of those credit card bills, it is becoming harder each month to pay her bills. And now, the government wants its money. She had a friend who filed bankruptcy last year and thought she might do the same so she can erase her debt and start over. What would you recommend to her?

File bankruptcy　　Get credit/financial counseling　　Get a debt consolidation loan

Why do you think this is the best option for Heather?

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List costs and benefits of filing for bankruptcy:

Costs of filing for bankruptcy:	Benefits of filing for bankruptcy: