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# When Should Your Client File Bankruptcy?

by Lyndsey D. Dilks, Esquire

**W**e, as attorneys, are accustomed to getting a bad rap based on the sole fact that we are lawyers. Who among us hasn't heard the joke: "What do you call 100 lawyers at the bottom of the sea?" I won't insult you with the punch line. But, you get my point. We are out there busting our humps, helping our fellow humans, and, yet, we are subject to such ridicule.

In my experience, the thought of filing bankruptcy gets the same bad rap. It is an opportunity provided under the federal laws of our great nation to prevent an individual or business from drowning in bills that cannot possibly be repaid. It encourages entrepreneurship. The forgiveness of debts is even mentioned in the Bible.<sup>1</sup> However, the average human does not rise in the morning and run to the mirror and declare, "Hey, good looking, it's a great day to file bank-

ruptcy!" It just doesn't happen. But, there are times when it should. And, you, as an advocate for your client, need to recognize those times. But, before you make a cursory decision about bankruptcy for your client, there are some things you need to know.

## **The Difference in Chapter 7 and Chapter 13 Bankruptcy Cases**

There are generally two options available under the Bankruptcy Code for individuals: Chapter 7 and Chapter 13. Chapter 7 bankruptcy is often the short-and-sweet version of bankruptcy. The first important thing to know about a Chapter 7 is the filer must pass the Means Test<sup>2</sup> in order to qualify. If they pass the Means Test, they can receive a discharge of their unsecured debts. The most common unsecured debts discharged in bankruptcy include credit cards, medical bills, old utility bills, deficiency balances on repossessed vehicles, and judgments obtained for these debts. Any debts on secured items the client wishes to walk away from can be surrendered in a Chapter 7 and the creditor cannot later attempt to collect on the deficiency balance. This is a good option for someone significantly upside down in a vehicle. Although Chapter 7 bankruptcy is referred to as "liquidation," the process rarely occurs in an average Chapter 7 case. So long as the filer's assets fall within the exemption limits, no liquidation will occur. Another thing to know about Chapter 7 is that the filer may retain and continue to pay for certain secured debt. The filer can discharge unsecured but continue to make regular mortgage payments and payments on a car note. Of course, there is more to know, but this is the simple explanation you can pass along to your client.

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Chapter 13 bankruptcy is referred to as “reorganization.” This chapter of bankruptcy is often used to help filers who have fallen behind on mortgage payments or car notes. While the Means Test does not determine whether a filer qualifies for Chapter 13, the test is used to determine if unsecured creditors will receive any payments on their claims. A Chapter 13 is very different from a Chapter 7 in that the filer must make regular monthly payments to the Chapter 13 Trustee for a period of no less than 36 months and no more than 60 months. These monthly payments are payroll deducted. Every Chapter 13 filer must have a regular source of income to qualify for this chapter of bankruptcy. A Chapter 13 case is filed with a plan of repayment indicating the amount each creditor or group of creditors shall be paid during the course of the bankruptcy. The Trustee follows this plan to make the payments indicated. So long as each payment is made as proposed in the plan, the filer will receive a discharge of all unsecured debts and any arrearage amounts on secured claims will be brought current. Because life goes on, even in bankruptcy, a filer may be permitted to incur new debt for the purchase of a home or vehicle.

Before you send your client on his merry way to see a bankruptcy attorney, there are a few general tidbits of information you should pass along. Please, help us dispel the myths surrounding bankruptcy! First, filing bankruptcy does not mean someone is going to come and take away all of their possessions. In fact, 11 U.S.C. 522 provides a list of exemptions available under the bankruptcy laws. A brief list of the exempt assets includes: equity in a home and vehicles, household goods and furnishings, jewelry and wedding rings, retirement accounts and 401(k) plans, life insurance policies, tools used in the business, and many other assets the client already owns or has an interest in. For an individual with a potential personal injury settlement the bankruptcy laws provide an exemption up to \$20,200<sup>3</sup>. More details on that

later. The point being, let the client know they do not “lose” anything just because they file bankruptcy. If they do have assets that exceed the exemption limits, their bankruptcy attorney will discuss the options with them.

Second, a client who is already dealing with the pain and emotional distress of an injury will be relieved to know that upon the filing of a bankruptcy case creditors can no longer have contact with the filer. Their mailbox will no longer be filled with threatening letters from debt collectors and they can answer the telephone without fear of being chastised for failure to make a payment on a bill. This perk to filing bankruptcy is very enticing to someone who has reached their emotional limit.

Third, if your client is having financial difficulties, you should encourage a consultation with a bankruptcy attorney so that the client can make an educated decision on how to deal with the financial problems. Face it, you practice personal injury work. You are a pro. You know the tricks-of-the-trade and the ins-and-outs. You don’t know bankruptcy. Don’t make the decision for your client. Most bankruptcy attorneys offer a free consultation. Send your client to meet with an attorney who can explain all the options.

## When Should your Client File Bankruptcy?

So, when does your client need to file bankruptcy? Here’s the short list:

- When They Have Nothing to Lose
- Before Divorce
- Lots of Medical Bills
- Credit Cards Out of Control
- Mortgage Problems & Foreclosure

### 1) Nothing to Lose

As personal injury attorneys, you likely represent several clients each year who have a modest settlement coming their way, but medical bills and liens will prevent them from seeing even a penny of the proceeds. In addition, the time they missed from work has caused them to fall behind on credit card repayments. Perhaps they even put some of their living expenses or

medical bills on credit cards during their recovery period. While they may have managed to keep the mortgage and car note current, it is difficult to see the light at the end of the tunnel. This is when you need to send your client to a bankruptcy attorney.

A couple or individual with modest assets and income, but a significant amount of credit card debt or medical bills, will likely qualify for a Chapter 7 bankruptcy. The bankruptcy case can be filed and at least \$20,200<sup>4</sup> can flow into your client’s pocket. Any unused portion of the “Wildcard” exemption could increase this amount.<sup>5</sup> This is money that otherwise would have gone to medical providers. Not to worry, you, as the personal injury attorney will also be paid.

However, be warned, no clear law exists in Arkansas regarding the dischargeability of Medicare, Medicaid and subrogation liens in bankruptcy. If a lien holder or potential lien holder asserts such debt is nondischargeable in bankruptcy, the argument of the made-whole doctrine could be applied<sup>6</sup>. As attorneys, we understand no 100% guarantees exist in any lawsuit. The important thing to remember is if your client stands to walk away from the settlement with empty pockets, there is nothing to lose by filing bankruptcy.

### 2) Before Divorce

It’s a well known fact that financial problems often lead to marital problems and ultimately to divorce. In these instances, the couple will disagree as to whom should pay which debt. The couple may successfully obtain a divorce and enter into a property settlement agreement, but one party ultimately files bankruptcy. This creates a hornet’s nest for the non-filing spouse. The bankruptcy spouse has discharged his debt obligations through the bankruptcy court, but a property settlement agreement may indicate he is responsible for those debts. The filing of one spouse will often push the other into also filing bankruptcy. Make the right suggestion before these problems arise. If you have a divorce client suffering from financial problems with the estranged spouse, send both of them to

a bankruptcy attorney prior to obtaining the divorce. One reason for doing this is to save money. A couple can file bankruptcy for the same cost as an individual. If the parties can remain amicable for the short period of time, usually 6 months, it takes to get through a Chapter 7 bankruptcy, they can discharge their debts and obtain their divorce without the overhanging debt problems. Your life will be made easier because you do not have to deal with the debts in the property settlement agreement.

### 3) Medical Bills

An individual who does not have medical insurance will quickly find themselves in a significant amount of debt after treatment for an injury. Unpaid medical providers will obtain judgments against the individual and collect on the judgments through garnishments of wages and bank accounts. A Chapter 13 or Chapter 7 bankruptcy filing will immediately stop a garnishment. Successfully completing either chapter will discharge all of the medical bills. Although you may decline to represent some of the calls you receive for personal injury claims, you should point every caller who has a significant amount of unpaid medical bills to a bankruptcy attorney.

### 4) Credit Cards

Oh, those credit cards, they are so tempting! They lure the unknowing into their web and treat them so, so

good! That is, until one payment is missed or sent late. When that happens, watch out! The interest rate will jump from 5% to 32% overnight, not to mention the late fees that will be added. If making the minimum payments created a hardship, this new exorbitant amount will send things right over the edge. Calling the credit card companies is a waste of time if a lump sum amount cannot be brought to the table. Debt consolidation companies are appealing, but there is no guarantee that the creditors will agree to participate and the phone calls, hate mail, and lawsuits will continue. Send this client to see a bankruptcy attorney.

While a client with significant income may not qualify for Chapter 7, the benefits of Chapter 13 can cure his financial headaches. In a Chapter 13, the Means Test is used to determine how much an individual can afford to repay to unsecured creditors. Taking into account the filer's necessary living expense and secured debt payments, the remaining monthly income of the filer is considered disposable income. The monthly disposable income is applied to the unsecured debt. Recall, a Chapter 13 bankruptcy may only last a maximum of 60 months. If disposable income is calculated to be \$500 a month, the filer will only pay \$500 per month for 60 months. The unsecured creditors are paid a pro rata distribution of this amount. From the time the bankruptcy case is filed, the unsecured creditors are no longer allowed to add

interest to the debt or to charge late fees or other expenses. This means the amount owed on the date of filing is the maximum amount the filer may repay on the debt. So long as the filer makes each of the payments for 60 months, any unpaid amounts are discharged. The creditors can never again attempt to collect on the remaining debt. Your client will also find satisfaction in knowing they have repaid some or all of their debt. Most filers want to pay their debts; they simply lack the income to do so.

### 5) Mortgages & Foreclosures

You have seen the headlines and heard the news reports, a great many people are struggling with their mortgage payments. In addition, it has been discovered that an increasing number of mortgage servicers have misapplied payments, especially when a homeowner has fallen behind at some point during the repayment process. When the mortgage payments are behind, either actually or because of misapplication, the lender will send the homeowner into foreclosure. A homeowner may defend a foreclosure action without filing bankruptcy. However, if the homeowner is experiencing any other financial problems, a bankruptcy filing can eliminate all of the financial burdens at once.

A Chapter 13 bankruptcy will allow the filer up to 60 months to bring the mortgage current. It is important to

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know, however, that the Bankruptcy Code does not alter the terms of the mortgage other than to allow a period of time to bring the arrears current. A homeowner who has bitten off more than he can chew, will not be able to keep a home with mortgage payments outside of his income level. In addition, while few other creditors are allowed attorney fees and expenses for the cost of dealing with the filer's bankruptcy, the mortgage creditor will be allowed to add these fees to its claim for payment.

### When Bankruptcy might not be the Right Option

While bankruptcy may appear to be a fix all for debt problems, certain debts are excepted from discharge.<sup>7</sup> Here is the short list:

- Taxes
- Child Support & Alimony
- Student Loans
- Debts arising from Really Bad Stuff

But, hold your horses, because there is always an exception to the exception. Don't be too quick to tell your client bankruptcy will not help him with his problems. I'll repay the favor by not telling them they don't have a valid personal injury claim.

### 1) Taxes

We all know the government is going to get its money. For the most part, this is true. Honestly, I pay my taxes each year so I am glad it cannot easily be discharged. Recent tax debt, generally that which was incurred in the three years before filing, cannot be wiped away through bankruptcy.<sup>8</sup> Tax debt incurred prior to those three years, and for which returns were filed by the client in a timely manner, might possibly be discharged. However, if the client has entered into a compromise and settlement with the IRS, there is a possibility the debt must be paid. Even if the tax debt must be paid, a bankruptcy case filing may prevent additional interest and penalties from being added. I'm providing you the basics. The point to take away is that some tax debt can be eliminated or reduced through bankruptcy.

### 2) Child Support & Alimony

Clients call it child support and alimony, among other distasteful descriptions, but the bankruptcy code uses the phrase "domestic support obligation."<sup>9</sup> A domestic support obligation may be more than simply child support or alimony. Do not indicate to your client that anything other than child support and alimony can be wiped away through bankruptcy. A debt owed to a spouse, former spouse, or child of a debtor that is incurred by the debtor in the course of a divorce or in connec-

tion with a divorce decree or property settlement agreement may not be dischargeable.<sup>10</sup> The important thing to pass along to your client is the likelihood that these debts must be paid. However, if your client has accrued arrearages on domestic support obligations, a Chapter 13 bankruptcy may afford him up to 60 months to bring those arrears current. Send your client to an expert before you give him bad advice.

### 3) Student Loans

Student loans are readily available to those seeking to further their education, as perhaps they should be. While these loans can provide an otherwise impossible opportunity to receive an education, a large number of recipients fail to complete their degree. Without the anticipated increased income that follows having earned the degree, a borrower is unable to make even low monthly payments toward the debt. Once the forbearance and deferment options run out, the borrower is put into default. A government backed education loan provider may setoff the amount owed from the borrowers tax refund. It is when this happens that the borrower begins looking for options.

For the most part, education loans cannot be wiped away like credit card debts under the bankruptcy code.<sup>11</sup> However, relief may be available through bankruptcy if the debt imposes an undue hardship on the debtor. The Eighth Circuit applies a totality of the circumstances approach to determine whether a debtor may discharge student loan obligations.<sup>12</sup> In making its determination regarding undue hardship, the Court will consider the debtor's past, present, and reasonably reliable future financial resources, the debtor's reasonable and necessary living expenses, and any other relevant facts and circumstances.<sup>13</sup> If the debtor's reasonable future financial resources will sufficiently cover payment of the student loan debt—while still allowing for a minimal standard of living—then the debt will not be discharged.<sup>14</sup>

### 4) Really Bad Stuff...

I bet Bernie Madoff wishes he

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could file bankruptcy. Unfortunately, he has more than one area of the bankruptcy code acting against him. A debt for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny will not be wiped away in bankruptcy.<sup>15</sup> Nor will a debt for willful and malicious injury by the debtor to another.<sup>16</sup> Criminal fines are also generally nondischargeable in bankruptcy.<sup>17</sup> This is not to say your client does not qualify for any bankruptcy relief, only that these types of debts will not be discharged.

Bankruptcy may still be a valid option for your client. In lieu of a wage garnishment to collect on the judgment rendered in the types of cases described above, your client may be allowed up to 60 months to repay the judgment. If the legal fees and expenses associated with paying the judgment have prevented your client from meet-

ing other obligations, a Chapter 7 or Chapter 13 bankruptcy discharge may help eliminate the rest of his financial problems.

I have provided you the quick and dirty on when your client should file bankruptcy. Certainly, these few words do not cover every situation. But, if ever your client indicates that financial trouble are looming, have him meet with a bankruptcy attorney to discuss his options. When bankruptcy is the right option for a client, it's as if you have handed him a big fat settlement check or the keys to the jail. They suddenly forget every lawyer joke they ever knew. Trust me. I'm a lawyer. •

#### Endnotes

1 Deuteronomy 15:1-2 provides: "At the end of every seven years you shall grant a release. And this is the manner of the release: every creditor shall release what he has lent to his neighbor, his brother, because the Lord's release has been proclaimed".

2 11 U.S.C. § 707; I am compelled to ensure you that although the Means Test has gathered a plethora of hype among the bankruptcy illiterate since its October 2005 debut, the Test often will not prevent the average family from qualifying for the debt relief afforded in a Chapter 7 Bankruptcy case.

3 11 U.S.C. § 522(d)(11)(D)

4 11 U.S.C. § 522(d)(11)(D)

5 11 U.S.C. § 522(d)(5)

6 For a discussion of the applicability of the made whole doctrine in a bankruptcy case, see Chapter 7 Trustee's Brief filed in *In re Fred White*, Western District of Ark. Case number 1:05-bk-79706.

7 11 U.S.C. § 523

8 11 U.S.C. § 523(a)(1) and (7)

9 11 U.S.C. § 523(a)(5)

10 11 U.S.C. § 523(a)(15)

11 11 U.S.C. § 523(a)(8)

12 *Educational Credit Mgmt. Corp. v. Jesperson*, 571 F.3d 775, 779 (C.A.8 (Minn.), 2009)

13 *Id.*

14 *Id.*

15 11 U.S.C. § 523(a)(4)

16 11 U.S.C. § 523(a)(6)

17 11 U.S.C. § 523(a)(7)

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