

Coping with a Money Crunch: Dealing with Creditors

Mary N. Harrison and Vervil Mitchell. © 2005 University of Florida, Florida Cooperative Extension Service, Institute of Food and Agricultural Sciences. Reprinted with permission. All rights reserved.

Outstanding bills and no money to pay creditors can be very frightening. Unemployment, death, illness, divorce or an accident can cause a decreased income or make it impossible for you to pay all of your bills. It is important to face your creditors and to know how to deal with them.

What to Do First

When you don't have enough money to pay all your credit obligations, you must realize that some difficult financial decisions are necessary. It is important to realize that when income is reduced, changes in spending must be made. The sooner these changes are made the more likely financial problems can be lessened. The family should be a part of this decision-making process, since the cooperation from all family members is essential to carry out the plan.

Your past experiences with your creditors are important. If you have been good at paying bills when due, your creditors will be more cooperative than if you did not make regular payments.

Creditors are in the business of lending money or providing services. Creditors want your business and they encourage consumers who are having trouble paying to contact them early.

Contacting Your Creditors

Call on the credit manager, merchant, businessman, professional person or other creditor. Explain the exact facts (a reduction in family income due to unemployment, divorce, etc.) that make it impossible to keep up your complete payments. Discuss your future income prospects so your creditors can figure out some possible solutions to tide the situation over and avoid loss and inconvenience.

You may feel relieved after contacting creditors about the debt. But don't be so relieved that you agree to anything. If you have planned your spending you should be able to come up with a payment that is fair to your creditor and that you can afford. Remember, if your reduced income continues for longer than you anticipated, you may have to renegotiate your payment plans.

How to Decide Which Debts to Pay

You are obligated to pay all of your creditors. Not paying your debts will affect your credit record and may involve court action. Debt adjustments may help reduce the amount paid to creditors, or extend the time period for payments. Probably the fairest method of debt adjustment would be to pro-rate your available money to all creditors. In doing this, each creditor would be paid a fair share percentage of your regular monthly payment. This method doesn't always work since you must have the cooperation of all creditors. Each creditor may have a different procedure or policy to use when a debtor cannot meet all payments.

Another way to determine which creditor should be paid is to establish priorities. Ask yourself these questions:

- What will affect my family's health and security the most? Usually the house, utilities, food, and medical insurance take precedence. Transportation may be needed for a job, if so it must be protected. These creditors should be paid or contacted immediately to make provisions for small monthly payments. Expenses related to obtaining another job are also important.
- Is your debt due to secured or unsecured credit? Secured credit means the loan is made so the title of the property is conveyed to the lender as security in event of failure to pay. Home mortgages, car loans and sometimes furniture and large appliance loans are secured loans. If you are not positive, check the credit contract. Unsecured debts may have to take a lower priority since the only collateral is the signed guarantee of the borrower.
- How much equity do you have in the loan? Equity is the amount of principal paid on the debt. You may have loans on a television and a refrigerator. The refrigerator is essential, but if you have only two payments left to finish paying for the television, the TV payment may take precedence. Consider returning items purchased just before your income decreased. Voluntary repossession still requires you to pay the difference between the market value and the loan. It may appear on your credit record, but generally it has a more positive status when applying for credit in the future. Remember, any purchases made with a secured loan cannot legally be sold until the debt is paid in full. (For example, it is illegal to sell any item that can be repossessed before the loan is paid in full.) It can be returned to the seller which may, or may not, cancel the debt.
- What is the interest rate (APR) you are paying? Many credit card firms charge 18 percent or more annually. A loan with a lower rate of interest can reduce the amount of finance charges you are paying, but avoid increasing further credit obligations. It may be a good idea to destroy your credit cards and close accounts if you are having difficulty controlling the use of credit. Bank credit cards are more difficult to qualify for, so you may want to keep one for future use. It may be wise to put all credit cards in a safe place and not use them for a while.
- Is a consolidation loan a good idea? Personal finance companies want you to think so, but generally a consolidation loan charges higher interest, often 25 percent or more. A new loan also adds new credit costs. A single loan does

make payment easier, but this is a small benefit compared to the additional costs involved.

- What about your credit record? That is why it is important to contact all of your creditors immediately if you cannot pay bills. Remember to include professional people such as a dentist or physician. If you can manage to pay something on each debt, late payments may not be reported on your credit record.

Collection Practices

If you do not contact creditors and make no payments, creditors will turn the bill over to their collection department or they may hire a collection agency to try to get you to pay. Federal regulations limit these agencies in their collection of a bill. Collection agencies may only contact you between 8 a.m. and 9 p.m. They cannot discuss your financial situation with others (neighbors, employers), but they can contact others in order to locate you. You have the right to tell the collector in writing not to contact you and the collector must honor your written request.

What Will Happen If You Do Not Pay Your Bills?

First, you will probably receive a letter asking you to meet your payments. Next, you may receive telephone calls about the matter. Many unpaid bills are turned over to an independent collection agency. The Fair Debt Collection Practices Act protects you from mistreatment by debt collectors (businesses handling their own collections are not covered by the Act). While it does not cancel a debt that you owe, the Act does give you certain rights. Within five days after you are first contacted, the debt collector must send you written notice telling you the amount of money you owe, to whom and what to do if you feel you do not owe the money. If you send a letter within 30 days stating you do not owe the amount, a debt collector cannot make further collection efforts until you are sent verification of the debt in writing by the collector. A written description of the agreement creating the debt or the specifics of the debts may be obtained verbally from the original credit grantor to meet the requirement of the law. If a collector cannot verify a debt they cannot try to collect it.

In addition, the Fair Debt Collection Practices Act makes it a federal offense for debt collectors to use abusive language, threaten violence, contact you at inconvenient times or places, misrepresent themselves to you (for example, pretend to be an attorney, lawyer, or policemen), use unfair means to collect debts, contact anyone else concerning the debt, except in an attempt to locate you, and collect more than is legally owed or apply payment to a debt in dispute.

You can stop collectors from communicating with you by notifying them in writing that all contacts are to cease. If the collector chooses to go to court, suits to force payments must be brought either in the judicial district where you live or in one where the contract was signed.

Lenders have a variety of legal recourses, many of which are written into the sales contract you signed. The following are the main recourses used:

Acceleration. A widely used creditor's remedy is an acceleration clause in a credit contract in which your entire debt, including future installments, is payable if you default on any payments of principal or interest. Acceleration is especially useful to creditors by having courts force you to pay by seizing your property or selling your property to pay the debts.

Security interest and repossession. A clause used frequently in merchandise installment contracts involves security interest. It gives a creditor the right, in the case of your default on a loan, to take possession of specified collateral (property offered to support the loan as stated in the credit agreement). Even after the creditor seizes your collateral property, if its sale brings less than the amount you owe, you are still responsible for paying the balance owed.

How To Get Out Of Financial Trouble

Generally, there are five routes you can take to get out of financial trouble. The one you choose depends on how much trouble you are in and your creditor's willingness to wait for repayment.

Talk To Your Creditors

No matter what other actions you choose to take, you should speak to and be honest with your creditors. Do not tell them you are going to pay them if you cannot.

Make an inventory of your assets available for conversion into cash to meet payments, and set up a priority schedule of debts indicating the order in which you will repay debts. Use your car less, buy cheaper foods, do not purchase new clothes, cancel any trips or vacations, cut down on beverages, cigarettes, and entertainment, and do not purchase anything on credit. It may even be possible to return goods bought on credit. Utility bills, taxes, and rent or mortgage interest should receive top payment priority. Other debts may be postponed if the creditor agrees. As a last resort, you may be able to borrow on the mortgage of your house or the market value of your car.

There may be ways to increase income to meet payment demands. You may be able to work overtime, find extra part-time work, or possibly find a better paying job. If your spouse is not working, an additional full- or part-time job in the family would be beneficial, particularly if there are no children in the household or if children are in school or do not need much supervision. Older children may be able to earn money through part-time jobs.

Once you know what you can and are willing to pay, speak to your creditors about making smaller payments and extending the loan over a longer period of time. Most will make adjustments if you show a willingness to pay. Be sure to have this new agreement in written form, then stick to this agreement.

Credit Counseling Services

If you follow a debt emergency program such as described above for two or three months you may find yourself in better financial shape. If not, outside help may be necessary.

Credit counseling agencies help people who are in financial trouble budget their

money. These agencies analyze budget situations and then draw up a more effective money management plan. At times, this analysis and reorganization is enough. At other times, the counseling service will contact your creditors and try to arrange for your bills to be paid off in smaller installments over a longer period of time. If this is possible, you usually give the counseling service an established amount of each paycheck and in turn, the agency distributes this amount to creditors. Repayment plans arranged by credit counselors last an average of 21 months and can run as long as four years.

With the Internet, there is a growing number of credit counseling services funded by various organizations. Some even counsel over the Internet, others by phone and some by personal contact. Organizations such as the Consumer Credit Counseling Service have a long history of reliable service and offer the choices of phone or office visit assistance. Many counseling centers are financed through creditors and there is no charge to you or it is nominal. Some church and voluntary community groups, banks and savings and loan associations also offer financial counseling. If you belong to a credit union, you may find it offers such financial advice. You may also contact a local Better Business Bureau, Chamber of Commerce, Cooperative Extension Service, or the National Foundation for Consumer Credit for names of credit counseling services in your area.

Before going to the counseling service, be sure you know who sponsors the program: what, if any charges will be made; and how the program operates. Do not confuse credit counseling services available at little or no charge with fee agencies in the business of debt pooling or debt adjusting. Such agencies often charge high fees to pay bills without the benefit of counseling.

Consolidation Loans

A consolidation loan is a single loan which can pay off all your debts. The payments on the new loan are smaller than the total of your other monthly payments because the loan stretches your payments over a longer period of time. This also means you pay more interest. Yet, a consolidation loan makes it easier to keep track of your debt since you only have one payment per month.

The danger of a consolidation loan is that you may forget how much you owe overall. You might be tempted to take on new credit obligations because your existing payments seem so small. Lowered monthly payments do not mean you have more money to spend, they just ease the pressure. Thus, a consolidation loan can only work effectively if you give up additional credit purchases and get spending in line with income.

An officer at your bank, savings and loan association, or credit union can help you determine if a consolidation loan is best for you. If you decide on such a loan, shop around for the best terms available.

When Everything Fails

If you have tried everything possible to resolve your financial problems and nothing works, bankruptcy may be the solution. Filing is not easy and there are consequences. Recent legislation has revised the bankruptcy laws (2005).

The Wage Earner Plan

If your debts are too extensive to be resolved by one of the above mentioned solutions, the Wage Earner Plan, as Chapter 13 of the U.S. Bankruptcy Act is called, may be the answer. The plan allows you to pay off obligations from future earnings while under the protection of the bankruptcy court. Once your petition for the plan is filed, you are protected from lawsuits, garnishment proceedings, wage assignments, repossession of secured goods, and other legal actions that could be taken by creditors.

Your debts are paid off according to a plan set up by you in cooperation with your lawyer; you should check with your county or local bar association for a lawyer who is familiar with Chapter 13. Also, find out if you are eligible for free legal advice from the Legal Aid Service in your area. While it is not always practical, it is possible to file a plan by yourself. Your creditors can object to the plan before it is accepted by the court, particularly if they believe fraud or misleading information is involved. Yet, once the court agrees to the plan, your creditors will probably be issued a restraining order so they will not harass you in any way as long as you continue with the plan.

Basically, the Wage Earner Plan consists of paying a fixed amount of money each payday to a court appointed trustee who then distributes it to your creditors. The plan is generally considered feasible if your total essential living expenses do not exceed 75% of your take home pay. If the remaining amount can pay off all your debts within three years, the court will normally approve the plan, provided a majority of creditors also accept it. Since creditors are much more likely to be paid under this plan as opposed to its alternative, bankruptcy, they usually agree to the program. Some plans propose to pay back 100% of your debt, but most pay less. The exact percentage depends on your income and the amount you owe.

Fees for the plan include court costs, lawyers' fees, and trustee fees and costs. These fees may be paid in installments along with your other debts. Once you file for the plan, you cannot file for bankruptcy until after 6 years or until you repay 70% of your debt. The effect of the Wage Earner Plan on a person's credit rating is unclear. Although the Wage Earner Plan is usually included in a credit report, it is up to the credit grantor to decide whether or not to extend credit. The actual effect of a person's credit rating is hard to predict. In some cases it could enhance a credit rating since there is no chance of bankruptcy for the next six-year period. However, this positive effect assumes that the borrower has a current source of income and is able to pay off former debts while taking on new credit. Other creditors may choose not to extend credit. This information remains in your credit report for 10 years.

Bankruptcy

Under the recent legislation the court will determine if you can file under Chapter 13, The Wage Earner Plan or Chapter 7. Under Chapter 13 you will be required to repay some of your debts. Chapter 7 discharges most of your debts. All participants under both plans must participate in a credit counseling program and a financial management class.

Chapter 13: The Wage Earner Plan

If your debts are too extensive to be resolved by one of the above mentioned solutions, the Wage Earner Plan, as Chapter 13 of the U.S. Bankruptcy Act may be the answer.

The plan allows you to pay off obligations from future earnings while under the protection of the bankruptcy court. Once your petition for the plan is filed, you are protected from lawsuits, garnishment proceedings, wage assignments, repossession of secured goods, and other legal actions that could be taken by creditors. Your debts are paid according to a plan set up by you in cooperation with your lawyer. Basically, the Wage Earner Plan consists of paying a fixed amount of money each payday to a court appointed trustee who then distributes it to your creditors.

Chapter 7

Filing for bankruptcy, should not be thought of as an easy way out, but as a last resort. Bankruptcy involves filing a petition in court to have yourself legally declared unable to meet your debt obligations. Once you are judged bankrupt, all your assets and possessions, except those exempted by federal or state law are turned over to a court trustee to be sold at public auction. The proceeds are then distributed to your creditors. Under some circumstances, you may still be held responsible for secured loans. Debts that cannot be discharged include taxes, alimony or child support, and money or property obtained by fraud. In Florida, your home is exempt, however, if there is a mortgage you must continue paying the mortgage or the house will be repossessed. A mode of transportation is also exempt. Also the bankruptcy will be noted in your credit report for 10 years making it extremely difficult for you to receive any form of credit during these years.