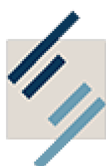
Declaring Personal Bankruptcy



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A declaration of personal bankruptcy doesn't carry the stigma it once did but it is, nonetheless, an admission that one is no longer able to pay one's debts or manage one's financial affairs. And that's an admission that more and more Canadians are having to make. According to statistics compiled by the Office of the Superintendent of Bankruptcy (OSB), just over 140,000 individual Canadians became insolvent in 2010.

While each individual story is different, there are some commonalities. Over the past decade or so, the amount of debt owed by the average Canadian family has increased significantly, both in absolute dollar figures and as a percentage of family income. Record low interest rates have combined with a sustained run-up in the value of residential real estate and an increase in the availability of all forms of credit to enable Canadians to accumulate unprecedented amounts of personal debt. As of the last quarter of 2010, the personal debt held by Canadian households was, on average, equal to 150% of their disposable income. Notably, while that percentage had risen from 108% to 150% in about 5 years, it had taken 15 years for it to increase from 93% (in 1990) to 108% (in 2005). As well, during the last quarter of 2010, the debt load of the average Canadian household reached the $100,000 mark.

Canadians have been able, in most cases, to handle such levels of debt because interest rates have remained low and real estate prices are at least stable. Many Canadians are, however, living more on less on the financial edge, and any one of a number of events—an increase in interest rates, an unanticipated drop in income, or even a new, unexpected financial obligation—is enough to tip them over that edge. And, of course, even where personal debt loads are not excessive, a prolonged illness or a job loss can create a more or less instant financial crisis. When any of those things happens, a declaration of personal bankruptcy can seem like the only available option.

Signs of financial trouble

Getting into financial trouble is something of a slippery slope. Almost all Canadians live with some degree of financial constraint, and most face some form of minor or major financial crisis (e.g., an unexpected large house or car repair bill, or a job layoff) at some point in their lives. It can be difficult to tell sometimes whether and when the usual financial pressures that most of us deal with on a regular basis have developed into something more serious. There are, however, objective signs which signal a need to re-evaluate one's financial situation and to consider that things may not be able to continue as they are. Those signs include:

- having to use credit to pay for non-discretionary purchases—e.g., buying groceries or making a property tax or rent payment with a credit card or from a line of credit, not for convenience, but out of necessity;
- having to repeatedly borrow to get to the next payday, or always going over the spending limit on credit cards;
- not being able to make more than the minimum required payment on credit cards or lines of credit, or using one source of credit to make a payment on another one;
- falling behind on debt repayment and then being subject to pressure from creditors or collection agencies.

Any one of these signs is a red flag of a developing problem with finances: where all of them are present, those problems have clearly materialized and it's time to consider one's alternatives.

Alternatives to personal bankruptcy

Individuals facing significant financial difficulties often view bankruptcy as their first or only option. In fact, there are a number of available options, and bankruptcy is the last one to consider.

The first thing to look at when considering options is just what's causing the financial problems. In some cases, that cause is a temporary one, whether it's a drop in income or higher than usual costs. For instance, a two-income family is temporarily living on one income during a maternity or paternity leave, or a family has a couple of children in university and

the family budget is strained by all the costs that entails. In such cases, it may be possible to re-work that family budget to cut back on discretionary spending in other areas (entertainment, vacations etc.) until things return to a more even keel. In other cases, the financial difficulties are caused by a single large ongoing expense—often a mortgage which is too big for the income which must pay it, or sometimes a couple of large car payments each month. In those cases, it may be possible to get some financial breathing room by, for instance, trading in the high-end vehicles for something more modest which comes with a much smaller monthly payment. The ultimate cutback—selling the family home and moving to a smaller place, with lower carrying costs—is a very difficult choice to have to make. But, if paying for that larger home is making a family house-poor to the extent of threatening its financial stability, lowering those housing costs (for most of us, housing costs are our single biggest expenditure each month) can relieve a lot of financial pressure.

Sometimes the problem isn't ongoing costs, or diminished income, but pre-existing debt on which

payments have to be made each month. Frequently, that means credit card debt, and credit cards are among the most expensive sources of money around. Individuals who are carrying a lot of credit card debt have a couple of options. First, they can approach their creditors with a request to lower the interest charged, which is usually significantly higher than ordinary commercial rates of interest. A creditor who is faced with the choice of lowering an interest rate or seeing an account go into arrears may well view cutting the interest rate as the lesser of two evils. Where a reduction in interest rates on current debt can't be accomplished, it may be possible to take out a consolidation loan, which combines all outstanding debt into a single obligation. The interest rate charged on a consolidation loan obtained from a financial institution will virtually always be lower than credit card rates and, if the borrower has an asset, like a house, which can be pledged as security for that consolidation loan, the rate may be lower still. Of course, once the consolidation loan is obtained, it's critical to stop using the credit cards which were the source of the original problem.

Making a proposal

It can sometimes be the case that, even with paring expenses to the bone and/or reducing the interest rate payable on outstanding debts, an individual's debt load is still unmanageable. When that happens, the next option to consider is a proposal. Although the making of a proposal is still a formal procedure under bankruptcy law, it's not an actual bankruptcy.

There are two types of proposals available to individuals under our bankruptcy laws. A consumer proposal can be made by any individual whose debts, excluding his or her mortgage, are less than $250,000. Where non-mortgage debts exceed that amount, an individual can still make what is known as a Division 1 proposal. Whatever the form of proposal, the process is the same. In both cases, the individual works with an administrator (who might be a trustee in bankruptcy or a person appointed by the Superintendent of Bankruptcy) to develop a proposal to be put to his or her creditors. The proposal might extend the time period over which the full amount of the debts will be repaid, or it might involve having the creditors accept payment (usually over time) of some percentage of the amount which they are owed, rather than the full amount, or it might include both. Creditors then have 45 days to either accept or reject the proposal. And, while accepting a proposal might not be the first choice of creditors, a successful proposal at least means that they will eventually be paid at least some, or perhaps even all of the amount that they are owed. Either way, the outcome for creditors under a proposal is usually better than could be expected should the individual debtor declare bankruptcy.

There are advantages, as well, for the person making the proposal. First of all, making a proposal which is accepted by creditors means collection actions which those creditors have initiated against the individual will stop, which is usually a huge relief. Second, the individual does not have to give up ownership of any of his or her property or assets, as would be the case in a bankruptcy. A proposal, in essence, provides the debtor with the time and space to eventually pay off some or all of his or her debts with the minimum amount of disruption and without the need to make a formal declaration of bankruptcy.

Once the proposal is accepted, the debtor is responsible for making either lump sum or regular periodic payments to the trustee, who will forward those amounts to the individual's creditors, in the manner agreed to in the proposal. The debtor is also required to attend two financial counselling sessions.

It's critical that the debtor adhere to the payment terms and schedule outlined in the proposal. Once the payments agreed to in the proposal are made, the debtor has fulfilled all of his or her obligations to the creditors. However, where a payment schedule outlined in a proposal calls for monthly payments and the debtor misses three of those payments, or where the payment schedule is less frequent but the last payment made is more than three months late, the proposal is annulled. If that happens, the debtor is essentially back to square one.

Declaring bankruptcy

There are circumstances, like prolonged illness or long-term unemployment, which may make it impossible for a debtor to pay off even a portion of debts owed, no matter how long the time frame. In other circumstances, it may not be possible to come up with a proposal which is acceptable to creditors, or a proposal may have been accepted but not successfully carried out. In that case, the final available option is a declaration of bankruptcy.

In a proposal, the debtor uses assets and income to pay off outstanding debts; in a bankruptcy, the debtor effectively gives up all of his or her assets (with some exceptions) and those assets are sold and the proceeds used to satisfy claims of creditors, as far as they will go.

The process of declaring bankruptcy

Once the decision to declare personal bankruptcy has been taken, the first step is to meet with a licensed trustee in bankruptcy. A listing of persons or companies entitled to act as trustees in bankruptcy can be found by doing an online search, or by searching the Trustee Directory maintained by the OSB, which is available at www.ic.gc.ca/app/osb/tds/search.html?lang=eng.

Once a trustee is selected, a meeting is held with that trustee and the options available to the debtor are reviewed. If the decision is to declare personal bankruptcy, the trustee will assist in the completion of the required forms, which are then filed with the OSB. Once that's done, the debtor is officially bankrupt and his or her creditors must then deal directly with the trustee in bankruptcy. The trustee in bankruptcy is now also the owner of the debtor's assets (with some exceptions, as outlined below) and will sell those assets, holding the proceeds in trust for distribution to the creditors.

It's also the trustee's obligation to notify known creditors of the declaration of bankruptcy, and a meeting of those creditors may be held. If there is a creditors' meeting, the bankrupt must attend. It's also possible that the now bankrupt debtor will be examined, under oath, by a representative of the OSB. The purpose of that examination is to question the bankrupt about matters relating to the bankruptcy and to his or her financial affairs generally. Finally, the bankrupt must attend two counselling sessions, where he or she will receive information on personal financial management, the aim being to avoid a recurrence of the causes which precipitated the bankruptcy.

Debts not covered by a bankruptcy

It's a common misconception that a declaration of personal bankruptcy wipes out all existing debts, allowing the person to go forward with a completely clean slate. While it's true that most debts (including credit card debts) are eliminated by a bankruptcy, there are some exceptions to that rule, as follows.

The most important exception, for most bankrupts, is that accorded secured creditors. All personal debt falls into one of two categories—secured debt and unsecured debt. In the first type—secured debt—the lender "secures" the debt against an asset owned by the borrower, meaning that if the debt is not repaid as agreed, the lender has the right to seize and sell the underlying asset in order to be repaid. Although any asset can serve as security for money loaned (car loans being one example), the kind of secured debt most familiar to Canadians is, of course, a mortgage. Unsecured debt, by contrast, is money provided to a borrower on no more than the strength of the borrower's promise to repay—and the best example of that type of debt familiar to most Canadians is a credit card. On a personal bankruptcy, the debt owed to secured creditors is, generally, unaffected. A debtor whose has outstanding secured debt at the time he or she declares bankruptcy must inform the trustee in bankruptcy about it. If the debtor can afford to continue to make the monthly payments, arrangements to do can be made with the secured creditor. If those payments aren't made, the secured creditor has the right to seize and sell the asset which provided the security, in order to pay off the debt.

The following four types of unsecured debt are also not eliminated by a bankruptcy:

- alimony payments and child support;
- student loans, if bankruptcy is declared less than seven years after the bankrupt ceased to be a full or part time student;
- fines or penalties imposed by the Courts; and
- debts arising from fraud.

What assets can a bankrupt own?

Another common misconception is that a bankrupt will be left with nothing following a bankruptcy. While it's true that most assets must be turned over to the trustee in bankruptcy, so that the proceeds of sale of those assets can be distributed among creditors, the intent of our bankruptcy laws is not to leave the bankrupt destitute or unable to earn a living. It's not possible to provide a comprehensive list of assets which may be retained by person who declares bankruptcy in Canada, as that listing varies by province. However, in most provinces, a bankrupt is entitled to keep personal possessions (i.e., clothing, household furniture, appliances, etc.) up to a specified value, a vehicle whose value is not more than about $5,000, and any tools required to pursue the bankrupt's trade. In many cases, pension or registered retirement savings plan amounts are also protected in a bankruptcy. However, the rules in this area are complex and it is critical that advice be obtained from someone, usually the trustee, who is familiar with both the laws of the particular province and the bankrupt's individual situation.

A bankrupt can also, of course, generally retain assets which have been provided as security for a loan (e.g., a house), provided that that loan continues in good standing.

Who gets the income earned by a bankrupt?

Often, a person who has declared bankruptcy continues to hold down a job and earn income, and the question of who is entitled to that income comes up. The answer, in most cases, is the person who earned it. Anyone who has declared bankruptcy but has not yet been discharged from bankruptcy is entitled to keep any salary or wages earned up to a set limit, and that limit is determined by the person's living circumstances. Salary or wages which exceed the limit (known as "surplus income") is turned over to the trustee in bankruptcy and used to satisfy the claims of creditors.

The amount of income which may be retained by an undischarged bankrupt is set by the OSB and depends on the number of people in the bankrupt's household, the amount of the bankrupt's income, and whether there is anyone else (like a spouse) in the household who is also earning income. Where the bankrupt is the only income-earner in the household, the calculation is a simple one. The amount determined by the OSB as necessary to support the number of people in the bankrupt's household is subtracted from the bankrupt's monthly income and any excess becomes surplus income, which must be turned over the trustee in bankruptcy.

For example, the OSB income standard for a bankrupt who is a single person with no dependents living with him or her is $2,089 monthly. Therefore, a bankrupt person in that situation can earn and keep up to $2,089 each month. Of course, the income standard increases with the number of people in the bankrupt's household.

Where another person living in the bankrupt's household is also earning an income, the calculation of surplus income becomes much more complex, and the trustee in bankruptcy will be able to help with that calculation.

Effect of bankruptcy on a spouse and family

When someone is considering declaring bankruptcy, one of the concerns is often the effect that such a declaration will have on the finances of others, especially those of a spouse—for instance, that a spouse's credit rating will go down as a result of the other spouse's bankruptcy. There is, however, no such thing under Canadian law as a family or joint bankruptcy—each individual is responsible for only his or her own debts and not those of a spouse.

When an individual, including a spouse, is affected by another person's bankruptcy, it is generally because their financial affairs are intertwined, not specifically because of the spousal or other family relationship. For instance, a spouse may own assets jointly with the bankrupt, in which case the bankrupt's share of the jointly owned assets may have to be sold to become part of the bankrupt's estate. In other cases, a spouse may have co-signed for a loan with the bankrupt or have acted as guarantor for a debt taken on by the bankrupt. In such cases, while the spouse will become liable for the debt when the

bankrupt defaults, the liability arises from the co-signing or the guarantee, not from the individual's family or spousal relationship with the bankrupt. The same result would occur if the co-signer or guarantor was not married to or related to the bankrupt.

Discharge from bankruptcy

Once the bankrupt's assets have been aggregated and sold by the trustee and distributed among the bankrupt's creditors, the bankrupt can be discharged from bankruptcy. For someone who is declaring bankruptcy for the first time, who has fulfilled all of the obligations imposed on him or her (i.e., attended any required examinations or meeting of creditors and any financial counseling sessions, as required) and who is not required to pay a portion of surplus income, an absolute discharge happens 9 months after the declaration of bankruptcy. Where there is an obligation to pay surplus income to the trustee, that discharge is delayed until 21 months after declaring bankruptcy. Those timelines are extended for anyone declaring bankruptcy for a second time.

In some cases, a discharge from bankruptcy is granted, but is made conditional, meaning that there are further obligations which the bankrupt must fulfill prior to obtaining an absolute discharge from bankruptcy.

Effect of discharge from bankruptcy

Once an absolute discharge has been obtained, the bankrupt is, essentially, free to go forward with a clean slate. He or she will, of course, still be subject to any debts which were not part of the bankruptcy, including secured debts, alimony and maintenance, some student loans, any fines or penalties imposed by a court, and any debts arising from fraud, but the now discharged bankrupt has no further obligations with respect to debts that were part of the bankruptcy.

An individual who is considering making a consumer proposal or declaring bankruptcy is often concerned that the fact of that proposal or that bankruptcy will remain on their credit record, making it difficult or impossible for them to obtain any kind of loan in the future. It is true that the fact that an individual has declared bankruptcy (or that he or she made a consumer proposal) will form part of the individual's credit record for a period of time, and will have a decidedly negative effect on his or her credit rating. As a practical matter, however, the credit rating and history of any individual whose financial situation is such that the making of a proposal or a declaration of bankruptcy is under consideration is already likely quite poor. Making and carrying out a successful proposal or declaring bankruptcy and eventually being discharged represents a chance to make a fresh start, and eventually to build a good credit history and a better credit rating.

Conclusion

With very rare exceptions, nobody plans to or wants to become insolvent or declare bankruptcy. For most, it's the option taken when all other options have been tried and have failed, and it's difficult for anyone to admit that they simply can no longer pay their debts or manage their financial affairs. Once the admission is made, however, the reality is that a declaration of personal bankruptcy, and eventual discharge from that bankruptcy, represents an opportunity to make a fresh start, armed with a better understanding of past mistakes and, hopefully, the tools needed to avoid them in the future.