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The Case for Walking Away

Normally I'd say suck it up, cut spending and repay your debt. But not if you're going broke.

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In January, we're supposed to sit down and organize our personal finances. This year I'll risk my good-girl reputation with a subversive idea: go bankrupt in 2009. If you're reaching the end of your rope, don't try to hold on. Save what you can.

It's painful and humiliating even to consider bankruptcy, let alone join that crowd in the courthouse corridor, waiting for your name to be called. Normally I'd say suck it up, cut spending and repay your consumer debt. But that's not always possible, especially with an economic tsunami rolling over your home, job and health insurance.

Most families, honorable to the end, struggle longer than they should, says Katie Porter, a law professor at the University of Iowa. By the time they give in, they've lost assets they could have used to start over again. That defeats the point of bankruptcy—to stop the self-blame and hopelessness that goes with bad luck and bad bills, and give yourself a second chance.

The right time to go bankrupt is when you're financially stuck but still have assets to protect. You can use Chapter 7, the most popular type, only once in eight years, so draw upa "no kidding" plan for living on your income when you're finally clear. "If you're out of work, try not to go bankrupt until you have a new job and can see what's ahead of you," says Harvard Law School professor Elizabeth Warren.

It's a mistake to tap your retirement accounts to make minimum payments on monstrous bills. IRAs and 401(k)s are largely protected in bankruptcy, as is most of your child's 529 college-savings account. This money is your future. Leave it alone and use credit cards for your necessities. Card issuers know that some of their customers will fail. That's why they charge elephant fees.

Your health is your future, too. You're doing your family no favors by forgoing medical treatment because you can't pay. Bankruptcy eliminates medical as well as consumer debt.

Bankruptcy can even help you save your home, especially with home values down and so many mortgages underwater. You're allowed to keep a limited amount of home equity in most states. If the house is worth less than the mortgage plus your home-equity exemption, you can file for Chapter 7 bankruptcy, wipe out your consumer debts and still keep your home, provided that your mortgage payments are up to date, says Stephen Elias, a California bankruptcy attorney and coauthor of Nolo Press's do-it-yourself bankruptcy books. If your house is worth more, however, or you're behind on your payments, it will likely be sold.

When you're behind on the mortgage but have a new job with money coming in, choose a Chapter 13 workout. Your lawyer will negotiate a three- to five-year plan for paying your debts, including the mortgage arrears. Some people stay in the plan just long enough to get current on their mortgage and then resume their normal lives, Porter says. The next Congress may sweeten Chapter 13 by allowing a judge to reduce (or "cram down") your mortgage principal if the debt amounts to more than the house is worth. That would save a lot of homes.

Don't try to preserve your house if you're going broke. Stop making payments, stay there while foreclosure is underway, then move out and rent. If the mortgage is underwater, "you're already functionally renting because you have no equity," says Adam Levitin, a professor at Georgetown University Law Center. In theory, many states allow lenders to chase you for the sum still owed after the house is sold. But that's rare, Warren says. Lenders know that you probably can't pay.

Foreclosures stay on your record for seven years and bankruptcies for 10. If you re-establish good bill-paying habits, you may get decent credit even sooner. And you'll start fresh, which is what a new year ought to bring.

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