Getting Out from Under

Bankruptcy Filings Tell the Story of This Recession and Its Impact

By GEORGE O'BRIEN

Michael B. Katz weight in below

Bankruptcy filings are on the rise locally and across the country — some experts predict 1.5 million people will file this calendar year — and the end seems nowhere in sight. Local bankruptcy specialists report brisk business, which is in many cases helping to offset losses in volume elsewhere. Meanwhile, the bankruptcy filers' stories are providing clear evidence of the many ways in which the economic downturn is impacting consumers and business owners.

Staff Photo

Mike Katz says more people than ever are willing to simply walk away from their homes.

Mike Katz was explaining the origins of the word bankruptcy.

It goes back to two Latin words, 'bancus' and 'ruptus,' he explained, noting that the former means a bench or table, while the latter means broken. In ancient times, many businesses were carried out on a bench. If that enterprise failed, or if it was deemed unsound, other merchants would break the bench as a way of conveying that the individual in question was definitely out of business.

Today, said Katz, a bankruptcy specialist with the Springfield-based firm Bacon Wilson, the term has come to connote bench repair much more than it does bench breaking, and in these difficult times, there is a great deal of bench-rebuilding work going on.

Indeed, bankruptcy filings have soared over the past several months, as the listings in the back of this magazine and the advertisements on TV and radio hyping firms that do such work would clearly indicate. The reasons for this surge in filings, involving individuals, local businesses such as the assisted-living community Reeds Landing, and large corporations such as Chrysler, are many, and they essentially tell the story of the current economic downturn, why it is so profound, and why it is some ways different from those that have come before.

"A lot of very honest people and good people find themselves in awful situations due to layoffs, divorce, illness, and other factors," said Katz. "I've seen very few of what you might call 'bad' people. About 99% of these people just find themselves victims of unfortunate circumstances, or they just weren't smart enough to understand the world of finance.

"Not everyone is a victim," he continued, "but sometimes people just aren't as smart as you wish they were. When credit was easy, some people bought homes when common sense should have told them not to."

Katz, who said that, historically, bankruptcy has been a last resort for individuals and businesses, believes it is still that for many who are now filing. But these individuals and business owners are reaching that stage more quickly than they might have in years or decades past.

"That's because there aren't many other things people can do," he explained, noting that, traditionally, those faced with the threat of bankruptcy would explore and often find ways to generate revenues or cut expenses to avoid that eventuality. "It's harder to go out and get another job, because there are fewer jobs, and people simply can't cut back enough to work their way out."

Ken Gogel, a partner with Springfield-based Gogel & Gogel, which specializes in bankruptcy work, said bankruptcy shouldn't always be considered a last resort, but he agrees that many people are finding themselves with fewer options. And, increasingly, many small-business owners are finding themselves in this position as they use credit cards to close gaps created by reduced cash flow.

"We're doing a lot of cases now where the debt is a mix of personal and business debt," he explained, "because these small-business owners are financing their personal and business expenses with credit cards. Usually, that strategy doesn't work very well, but people are trying to do whatever they can do to save their businesses any way they can."

Both attorneys said that, while they always look for alternatives to bankruptcy filing for their clients, sometimes this is the best course to take and, in their minds, almost always a better option than many of the debt-reduction programs being advertised on the radio and late-night television.

"I've never seen anyone actually come out of one of these programs successfully," said Gogel, referring specifically to plans where firms work with credit-card companies to pare a client's indebtedness. "Let's just say that consumers need to read the fine print."

In this issue, *BusinessWest* looks at the surge in bankruptcy filings, what's behind them, and when the spiraling numbers may begin to show some signs of improvement.

Chapter and Verse

Gogel said that, while his firm is busier than normal, the current surge in filings pales somewhat in comparison to the crush seen back in early 2005, just before bankruptcy-reform legislation was due to take effect.

"Looking back, I recall that we had about a year or a year and a half's worth of business compressed into about six months," he said. "We eventually had to stop taking cases."

Many individuals simply felt compelled to file at that time, he continued, adding that most were convinced that if they didn't, it would be more expensive and more difficult to file later. And while there was some truth to those opinions, Gogel nonetheless used the term "artificial" to describe the urgency attached to bankruptcy filings at that time, which reached record levels.

There's nothing artificial about what's been happening for the better part of the past year, said Gogel, noting that his firm, which he described as "always busy," because it handles bankruptcy work almost exclusively, is even more so those days.

"We're not as busy as we were in 2005, certainly," he said, "but there's definitely been heavier traffic to this office starting about a year ago."

Gogel's firm is one of many specializing in bankruptcy that are marketing themselves aggressively in the current climate. Gogel said his company's ads, including one featuring a couple talking about how hard it is to pay the bills after one of them was laid off, accurately reflect what he's seeing and hearing at his Mattoon Street office in Springfield on an almost-daily basis.

"Our marketing tracks what we're seeing," he explained. "We've seen so many couples come in under such extreme stress from their debts."

Both Gogel and Katz report a wide variety of bankruptcy activity coming to their door, including consumers, small-business owners, and the rare larger corporation filing for Chapter 11 (reorganization) protection.

"This is not a large market for Chapter 11s," said Katz, noting that he is handling one reorganization filing for a Connecticut-based manufacturer of screwdrivers. But overall, most activity is in Chapter 7s (liquidation) and chapter 13s (reorganization for consumers), both aimed at giving filers a fresh start.

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And there are plenty of both, with the stories involved serving to effectively hold up a mirror to the current economy and the difficult circumstances created by it.

As an example, Katz cited the case of a recent client, a manager for a large supermarket chain who was transferred to a store in Maine. The client and his wife had homes in Western Mass. and on the Cape and wound up unable to sell either, so he would up commuting a few hundred miles a day and racking up additional expenses in the process.

"This is a good, hardworking person who just got caught in these traps," Katz explained. "They rented the house on the Cape, then moved out here, thinking they would be able to sell that house. But they got a note from the bank saying that house was in a high-loss mitigation area, meaning that they were essentially calling the mortgage even though the couple hadn't missed a payment — banks can do that. Therefore, they're facing a potential foreclosure on that house.

"From his Chapter 7, he can now eliminate the deficiency amount from that foreclosure on the Cape," said Katz, referring to the difference between what a property is worth and what is owed the bank, "and eliminate his credit-card debts and start fresh again."

Each story is different, said Katz, but there are many common denominators, including the inability on the part of many filers to find ways around bankruptcy, as they might have in different times and different circumstances.

Elaborating, Katz, who has handled bankruptcy work through three recessions, said there are some similarities between this one and those that came before it. But in some ways, the current crunch is different. Specifically, he said, fewer people have the means, or the inclination, to fight.

"People are walking away from their homes to a degree that we've never seen before," he told *BusinessWest*. "Before, people would do whatever it took not to lose their home; they'd stop making car payments, they'd stop paying their credit cards, they would cash in their 401(k)s … that's because people believed in the sanctity of their residence. They always believed that their house was an appreciating asset as opposed to a depreciating asset."

Recent events have changed all that, he said, adding that the sharp fall in home prices, as well as the attraction of home-equity loans and the proliferation of no-money-down mortgages, have left many people, including more senior citizens than in the past, with little or no equity in their homes, and little hope of gaining any soon.

"It used to be that when people in their 60s came in, and they'd owned that house for 25 or 30 years, there was virtually no mortgage," he said. "Now, 90% of the time, even with people in their 70s and 80s, there's a mortgage close to what the house is worth because they've refinanced the house; people in their 70s have a 20-year term left on their mortgage."

Dollars and Sense

Gogel said he's handled a number of consumer filings in recent months, but, by his count, more than half the people coming to his door are business owners who are falling into the same traps as consumers as they battle to stay afloat through the downturn.

"People are trying to maintain their small businesses, but they can't do it with their current cash flows, so they're using credit cards," he explained, noting that he's seeing some cumulative balances of $100,000 or more on a fairly regular basis. "People are trying to save their businesses in the hope that things will pick up, but they're not picking up."

Gogel said that, while bankruptcy is generally considered a lagging indicator because it often takes considerable time to dig the hole that one is eventually unable to get out of, he could see early signs of trouble with the economy through the business owners coming to his office.

"It started with the construction trades, like it did in the early '90s," he explained, referring to the last large-scale downturn, one many businesses didn't survive. "And it's spread to many other sectors.

"Any business depending on consumers for cash flow is being hurt," he explained. "That's because consumers will cut back on just about everything. They're eating out less, they're spending less on entertainment, they're not buying as much. Virtually every business is feeling the impact."

But the recession has had another, rather intriguing impact on bankruptcy filings, said Gogel, noting that declines in salaries among consumers either collecting employment or faced to take lower-paying jobs, and in revenues among small business owners, have made more of both constituencies eligible for Chapter 7 than would have been possible a year or two ago.

"You're seeing a lot of small business owners qualify for Chapter 7 simply because they're not making any money," he explained.

Thus, while in some cases it is more expensive and difficult to file for bankruptcy — the desired outcome of the 2005 reform legislation — for some there is some consolation in a liquidation filing rather than a restructuring (Chapter 13). The converse is that creditors are far less likely to be paid what they are owed in a 7 than in a 13.

However, said Gogel, the default rate on Chapter 13s is climbing to rates much higher than normal, again because of those traps that people are falling into.

"I've had several clients in Chapter 13 who will call and say one spouse has been laid off," he said, "and that's really the end of their ability to finance their Chapter 13, and as a result those plans have to be converted [to a 7]. We've had several instances just this month where that's occurred."

Summing up the current landscape, Katz and Gogel said that a number of factors, from mounting debts to soaring mortgage payments; from plummeting home equity to sharp declines in consumer confidence and spending, conspired to put many consumers and business owners in vulnerable financial situations. And when the full force of the recession hit, there was simply no wiggle room.

Some have tried to crawl out through the various debt-reduction programs on the market, but most have seen their efforts fail and/or turn into expensive tax traps, said Gogel.

"As the economy has soured, there has been so much spent on attracting consumers with debt problems into these various programs," he told *BusinessWest*. "Very often, I see people in my office who have participated in these programs, and they've been unable to complete them. I find that the promises that are made to consumers, when they actually read the contract, are not as far-reaching as the promises that are made in the marketing."

And there are tax issues that come with most programs, he continued, noting that, if $10,000 in debt is discharged, that amount is then listed as income, on which the individual is taxed. "And I'd rather owe $10,000 to the credit-card companies than $3,000 to the IRS."

Looking ahead, what's not known is when the economy will start to improve and when any recorded improvement will bring reductions in the number of bankruptcy filings.

"I think we're still going to continue to see a significant number of layoffs," said Gogel. "And I don't know how badly the layoffs that are to be expected — in the auto industry, for example, if General Motors files for bankruptcy — will affect this region. But I don't expect the unemployment rate to fall in the next quarter, meaning we're still probably right in the middle of this."

Bankruptcy Benchmarks

Katz has one very unscientific, qualitative measure for the level of bankruptcy work he's handling — the volume of tissues he's going through.

"I'm up to about a box a day," he said. "These are very difficult times for people; there's nothing fun at all about filing for bankruptcy."

It's not like it was centuries ago, when the bench was literally broken into pieces, he explained, but bankruptcy still connotes that someone or some company is out of business.

The hope is that, with the bench-repair work going on, it won't be for long. ■

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