Girding Your Finances for Long-Term Unemployment

By Brett Arends

Updated Nov. 6, 2009 12:01 a.m. ET

The unemployment figures aren't as bad as they look. They're worse.

It isn't just that the headline jobless rate topped 10%. Go behind the figures and you'll find that 16.3% of the workforce, or one person in six, is either unemployed completely or working part-time. And the numbers of long-term unemployed are staggering: more than a third of unemployed Americans, 5.6 million people, have been out of a job for more than 27 weeks, according to the federal government. And the employment picture isn't expected to improve significantly until mid-2010.

If you are worried that your job is in peril, you are not completely powerless. You can protect what you've earned. This may be especially important for older workers, many of whom are having a tough journey back into the workforce. According to the Labor Department, those between 55 and 64 are twice as likely to drop out of the workforce, for whatever reason, as those age 25 to 45. What's more, this group is generally nearer retirement, and have less chance to rebuild their savings after a prolonged period of unemployment.

The first step toward shielding yourself is to protect your home. Many states, including Florida and Texas, offer homestead protection, which will shelter some or all of the value of your home from creditors (other than the mortgage company). Getting homestead protection may be as simple as filing a form at your local registry of deeds.

Less well known? If you are married, in about two dozen states, among them Massachusetts and Illinois, you can take advantage of a second type of protection: retitling your home as a "tenancy by the entirety." In layman's terms, this is a form of ownership that means your home is owned by the marriage rather than by the husband and the wife as individuals. As a result, unsecured creditors of either spouse will find it very hard to go after the home even if one spouse can't repay an outstanding debt. However, this does not offer protection against creditors owned money by both spouses, such as a credit card company where both spouses have their names on an account. And the level of protection varies from state to state.

Next, take steps to protect your savings. Most people know that money held in an individual retirement account (IRA) or a retirement plan such as a 401(k) or a qualified pension plan is protected from taxes until withdrawals are made. That money is also protected from creditors—so if you're able to make additional contributions to these accounts, this may be a good time to do so.

College savings held in 529 tax-sheltered account also enjoys protection from most creditors. Under federal rules, the money is protected once it's been in the account for two years (amounts up to $5,000 are protected after one year). Individual states may offer individual protection on top of that.

If you make a last-minute contribution to a 529, your money won't be fully protected for two years, so this is a wise move only if you're reasonably sure you can last two years without filing for bankruptcy, or if your state offers more protections.

The sooner you move to protect your assets, the safer they are likely to be. It makes sense to understand your options and take steps now, before you lose your job.

If you haven't already, cut way back on your spending. Everyone knows the drill by now. But if you are in deep crisis it may be worth looking at moving, which can bring huge savings, depending on where you live.

It's an obvious point, but worth repeating: You can live a lot longer on your savings in some parts of the country than in others. It costs less than half as much to live in Austin, Texas, or in Cincinnati, Ohio, as it does in Manhattan, according to the ACCRA Cost of Living Index.

Moving is not an option for everyone, but it's one you may need to consider. Slashing living costs is going to prove to be a key weapon in some people's financial arsenal.

Finally, take a hard look at your cash situation and your debts. But not necessarily in the way you think.

Most people know the basic rules of good financial housekeeping: Don't borrow money expensively on credit cards, pay your bills on time, build emergency cash reserves.

But these rules may not apply for many of the long-term unemployed, and in fact they may work in reverse.

Consider two workers, Bill and Ted, who earn the same salary, doing the same job at the same company. They hear rumors of big layoffs coming.

Bill does what he thinks he should: He cuts back retirement plan contributions, using the money instead to pay off his credit cards. He pays his bills on time to protect his credit score, and he builds up reserves in a cash account to live on should he end up unemployed.

At the same time, Ted keeps socking money into his IRA, his 401(k) and 529s for his children. The only bill he pays down is his mortgage because it's secured against his home. He opens up as many lines of credit while he still can, and he even pays bills with his credit cards, paying the lofty interest rates as the price of emergency liquidity.

Now imagine both men are laid off and remain out of work for a long time. Both end up filing for bankruptcy, which is what many American families are doing every day.

Surprisingly, Ted may end up substantially better off. In most cases the bankruptcy court will wipe out his card debt and he will still keep the money in his retirement accounts.

Bill, honorably, used his emergency money to pay off his creditors.

The only winners? His creditors.

"The debtor who loses his or her job and then seeks to file for bankruptcy is penalized if they are living off liquid savings," says Jay S. Fleischman, an attorney and co-founder of the Bankruptcy Law Network. "I see many debtors who have liquidated their protected 401k assets in order to live, and find themselves in a difficult situation."

In short, doing what we've long thought to be the right thing isn't always the right thing. It's not fair. But those are the rules, and in this economy everyone needs to understand them.

Write to Brett Arends at brett.arends@wsj.com