What Is Bankruptcy & How Does It Work?

Bankruptcy is a legal life line for people drowning in debt. Consumers and businesses petition courts to release them from liability for their debts. In a majority of cases, the request is granted.

What Is Bankruptcy?

Bankruptcy is a court proceeding in which a judge and court trustee examine the assets and liabilities of individuals, partnerships and businesses whose debts have become so overwhelming they don't believe they can pay them.

The court decides whether to discharge the debts, meaning those who owe, are no longer legally required to pay them. The court also could dismiss the case if it believes the person or business has enough assets to pay their bills.

Bankruptcy laws were written to give people an opportunity to start over when their finances have collapsed. Whether the collapse is a product of bad decisions or bad luck, lawmakers could see that a second chance is a vital fallback in a capitalist economy.

The good news for anyone hesitant about this option is that nearly everyone who files for bankruptcy gets that second chance.

There were 544,463 bankruptcy filings in 2020. Chapter 7 was the most popular form with 381,217 filings (70%). Chapter 13 had 154,341 cases (28.3%) and Chapter 11 just 8,113 (1%).

Ed Flynn, of the American Bankruptcy Institute (ABI), found that 94.9% of Chapter 7 filings in his 2020 study were successfully discharged. Only 21,677 cases of the 442,145 cases completed in 2020 were dismissed.

Individuals who used Chapter 13 bankruptcy, known as "wage earner's bankruptcy," didn't have nearly as much success. In fact, of the 246,369 Chapter 13 cases completed in 2020, only 43.2% (106,476) were successfully discharged. The majority of cases – 139,893 – were dismissed and thus unsuccessful.

Who Declares Bankruptcy

Most individuals and business who file for bankruptcy have far more debts than money to cover them and don't see that changing anytime soon. In 2020, bankruptcy filers owed $86 billion and had assets of $56 billion. Most of those assets were real estate holdings, whose value is debatable.

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What is surprising is that individuals – not businesses – are the ones most often filing for bankruptcy. They owe money for a mortgage, credit card debt, auto loan or student loan – perhaps all four! – and don't have the income to pay for it.

There were 774,940 bankruptcy cases filed in 2019, and 97% of them (752,160) were filed by individuals. Only 22,780 bankruptcy cases were filed by businesses in 2019.

The other surprise is that most of the people filing bankruptcy were not particularly wealthy. The median income for those who filed Chapter 7, was just $31,284. Chapter 13 filers weren't much better with a median income of $41,532.

Part of understanding bankruptcy is knowing that, while it is a chance to start over, it definitely affects your credit and future ability to use money. It may prevent or delay foreclosure on a home and repossession of a car, and it can also stop wage garnishment and other legal action creditors use to collect debts.

However, in the end, there is a price to pay and you'll pay it for 7-10 years.

When Should I Declare Bankruptcy?

When asking yourself "Should I file for bankruptcy?" think hard about whether you could realistically pay off your debts in less than five years. If the answer is no, it might be time to declare bankruptcy.

The thinking behind this is that the bankruptcy code was set up to give people a second chance, not to punish them forever. If some combination of bad luck and bad choices has devastated you financially, and you don't see that changing in the next five years, bankruptcy is your way out.

Even if you don't qualify for bankruptcy, there is still hope for debt relief. Possible alternatives include a debt management program, a debt consolidation loan or debt settlement. Each one of those choices typically require 3-5 years to reach a resolution, and none of them guarantees all your debts will be settled when you finish.

The decision shouldn't come down to how long Chapter 7 bankruptcy takes – the process itself is only 4-6 months. The thing you have to remember is that bankruptcy carries significant long-term penalties. It is stuck on your credit report for 7-10 years, which can make getting loans in the future very difficult.

The flip side of that is there is a great mental and emotional lift when all your debts are eliminated, and you're given a fresh start.

Why Declare Bankruptcy?

The obvious answer for why you should declare bankruptcy is that you are drowning financially and no one – not banks, not online lenders, not family or friends – will throw you a lifeline.

The millions of people who lost their jobs or businesses because of the coronavirus, have some hope because of bankruptcy. They still had bills to pay, and in many cases, no way to handle them. That's what bankruptcy was meant to address. It's not a bailout. It was created to give people a chance to get back on their feet financially and restore their peace of mind.

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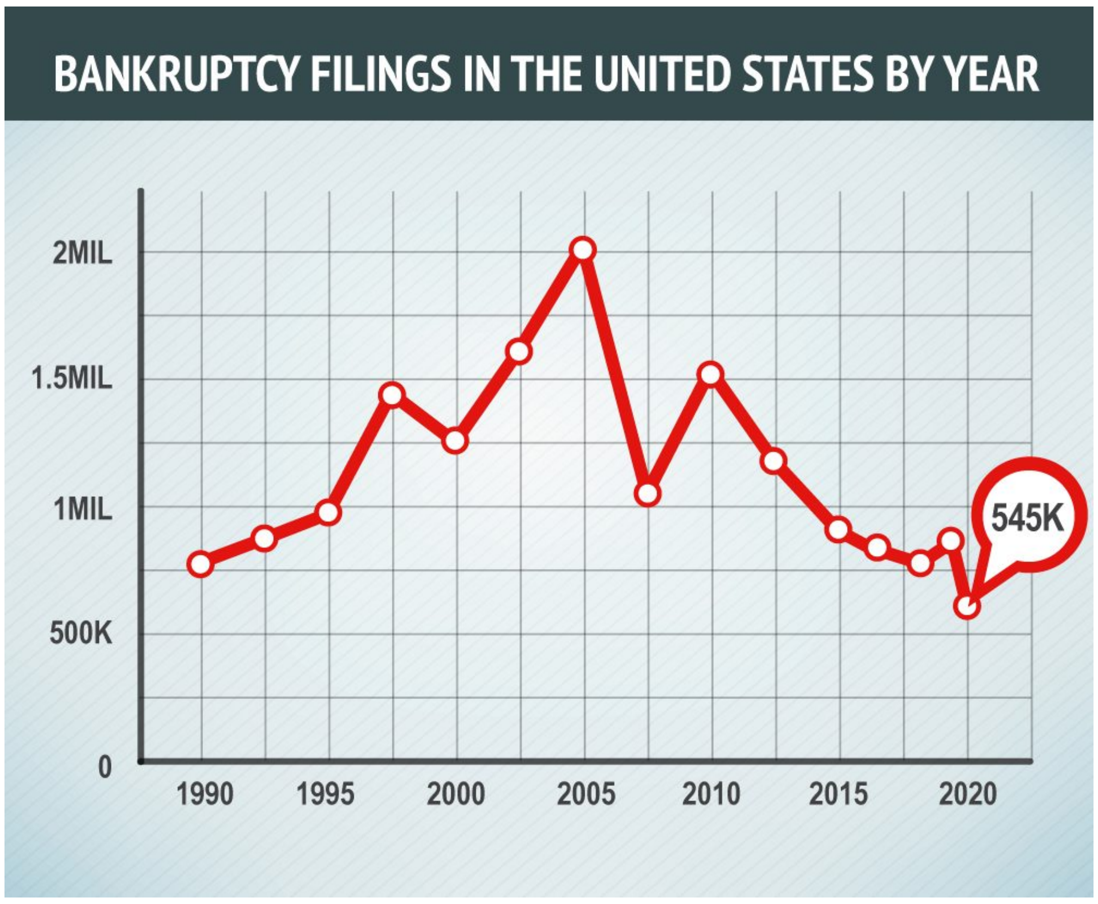
Bankruptcy in the United States



Like the economy, bankruptcy filings in the U.S. rise and fall. In fact, they are like dance partners; where one goes, the other usually follows.

Bankruptcy peaked with just more than two million filings in 2005. That is the same year the Bankruptcy Abuse Prevention and Consumer Protection Act was passed. That law was meant to stem the tide of consumers and businesses too eager to simply walk away from their debts.

The number of filings dropped 70% in 2006, but then the Great Recession brought the economy to its knees and bankruptcy filings spiked to 1.6 million in 2010. They retreated again as the economy improved, but the COVID-19 pandemic easily could reverse the trend in 2021. It seems inevitable that many individuals and small businesses will declare bankruptcy.

How to File for Bankruptcy

Filing for bankruptcy is a legal process that either reduces, restructures or eliminates your debts. Whether you get that opportunity is up to the bankruptcy court. You can file for bankruptcy on your own, or you can find a bankruptcy lawyer, which most experts regard as the prudent avenue to pursue.

Bankruptcy costs include attorney fees and filing fees. If you file on your own, you will still be responsible for filing fees. If you can't afford to hire an attorney, you may have options for free legal services. If you need help finding an affordable bankruptcy lawyer or locating free legal services, check with the American Bar Association for resources and information.

Before you file, you must educate yourself on what happens when you file for bankruptcy. It's not simply a matter of telling a judge "I'm broke!" and throwing yourself at the mercy of the court. There is a process – a sometimes confusing, sometimes complicated process – that individuals and businesses must follow.

The steps are:

- **Compile financial records:** List your debts, assets, income and expenses. This gives you, anyone helping you, and eventually the court, a better understanding of your situation.

listed on the U.S. Courts website. Most credit counseling agencies offer this service online or over the phone, and you receive a certificate of completion once it's done that must be part of the paperwork you file. If you skip this step, your filing will be rejected.

- **File the petition:** If you haven't hired a bankruptcy lawyer yet, this might be the time to do it. Legal counsel is not a requirement for individuals filing for bankruptcy, but you are taking a serious risk if you represent yourself. Understanding federal and state bankruptcy laws, and knowing which ones apply to your case, is essential. Judges are not permitted to offer advice, and neither are court employees. There also are many forms to complete and some important differences between Chapter 7 and Chapter 13 that you should be aware of when making decisions. If you don't know or follow the proper procedures and rules in court, it could affect the outcome of your case. Without legal advice, you're also running a risk that the bankruptcy trustee can seize and sell your property.
- **Meet with creditors:** When your petition is accepted, your case is assigned to a bankruptcy trustee, who sets up a meeting with your creditors. You must attend, but the creditors do not have to. This is an opportunity for them to ask you or the court trustee questions about your case.

Types of Bankruptcy

There are several types of bankruptcy for which individuals, married couples or businesses can file. The two most common forms are Chapter 7 and Chapter 13.

Chapter 7 Bankruptcy

Chapter 7 bankruptcy is generally the best option for those with a low income and few assets. It is also the most popular form of bankruptcy, making up 63% of individual bankruptcy cases in 2019.

Chapter 7 bankruptcy is a chance to get a court judgment that releases you from responsibility for repaying unsecured debts. You also could be permitted to keep key assets that are considered "exempt" property. Non-exempt property will be sold to repay part of your debt.

By the end of a successful Chapter 7 filing, the majority (or all) of your debts will be discharged, meaning you will no longer have to repay them. Some debts that won't be discharged in bankruptcy include alimony, child support, some types of unpaid taxes and some types of student loans.

Property exemptions vary from state to state. Depending on your state, you may choose to follow either state law or federal law, which may allow you to keep more possessions.

Common examples of exempt property can include some equity in your home, a car, equipment you use at work, Social Security checks, pensions, veteran's benefits, welfare and retirement savings. These things can't be sold or used to repay debt. But because exempt property varies so widely from state to state, there is no general list of exempt property. If you are considering filing for bankruptcy, you should speak with legal counsel to determine if your property is exempt in your state.

Non-exempt property can include things like excess cash, bank accounts, stock investments, coin or stamp collections, a second car or second home, etc. Non-exempt items can be liquidated – sold by a court-appointed

Chapter 7 bankruptcy stays on your credit report for 10 years. While it will have an immediate impact on your credit score, the score could improve over time as you rebuild your finances.

Those who file for Chapter 7 bankruptcy will be subject to the U.S. Bankruptcy Court's Chapter 7 means test, which is used to weed out those who might be able to partially repay what they owe by restructuring their debt. The means test compares a debtor's income for the previous six months to the median income (50% higher, 50% lower) in their state. If your income is less than the median income, you qualify for Chapter 7.

If it's above the median, there is a second means test that may allow you to qualify for Chapter 7 filing. The second means test measures your income vs. essential expenses (rent/mortgage, food, clothing, medical expenses) to see how much disposable income you have. If your disposable income is low enough, you could qualify for Chapter 7.

However, if a person has enough money coming in to gradually pay down debts, the bankruptcy judge is unlikely to allow a Chapter 7 filing. The higher an applicant's income is relative to debt, the less likely a Chapter 7 filing will be approved.

Keep in mind that there are filing fees and lawyer fees that need to be paid to file bankruptcy. While some individuals may not qualify due to high income, others simply can't afford Chapter 7 bankruptcy due to the fees and expenses.

You are allowed to file bankruptcy more than once as long as you file after the waiting period ends. Chapter 7 bankruptcy has a waiting period of 8 years starting from the day you first filed.

Chapter 13 Bankruptcy

Chapter 13 bankruptcies make up about 36% of non-business bankruptcy filings. A Chapter 13 bankruptcy involves repaying some of your debts in order to have the rest forgiven. This is an option for people who do not want to give up their property or do not qualify for Chapter 7 because their income is too high.

People can only file for bankruptcy under Chapter 13 if their debts do not exceed a certain amount. In 2020, an individual's unsecured debt could not exceed $394,725 and secured debts had to be less than $1.184 million. The specific cutoff is reevaluated periodically, so check with a lawyer or credit counselor for the most up-to-date figures.

Under Chapter 13, you must design a 3-to-5 year repayment plan for your creditors. Once you successfully complete the plan, the remaining debts are erased.

However, most people do not successfully finish their plans. When this happens, debtors may then choose to pursue a Chapter 7 bankruptcy. If they don't succeed, creditors can resume their attempts to collect the full balance owed.

Chapter 11 Bankruptcy

Chapter 11 is often referred to as "reorganization bankruptcy" because it gives businesses a chance to stay open while they restructure the debts and assets to pay back creditors.

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during bankruptcy proceedings, most of the decisions are made with permission from the courts.

There were just 6,808 Chapter 11 filings in 2019.

Consequences of Bankruptcy

The overriding principle of bankruptcy is that you get a second chance with your finances. Chapter 7 (known as liquidation), wipes away debt by selling non-exempt possessions that have some value. Chapter 13 (known as the wage earner's plan) gives you an opportunity to develop a 3-to-5 year plan to repay all your debt and keep what you have.

Both equal a fresh start, but many times without some of the property (real estate, cars, jewelry, etc.) that may have caused the financial problem in the first place.

Filing for bankruptcy impacts your credit score. Bankruptcy remains on your credit report for 7-10 years, depending upon which chapter of bankruptcy you file under. Chapter 7 (the most common) is on your credit report for 10 years, while a Chapter 13 filing (second most common) is there for seven years.

During this time, a bankruptcy discharge could prevent you from getting new lines of credit and may even cause problems when you apply for jobs. If some of your debts include loans that were co-signed by family or friends, they could be responsible for repaying at least some of the debt.

If you are considering bankruptcy, your credit report and credit score probably are damaged already. Your credit report may improve, especially if you consistently pay your bills after declaring bankruptcy.

Still, because of the long-term consequences of bankruptcy, some experts say you need at least $15,000 in debt for bankruptcy to be beneficial.

Where Bankruptcy Doesn't Help

Bankruptcy does not necessarily erase all financial responsibilities.

It does not discharge the following types of debts and obligations:

- Federal student loans (unless you meet very strict criteria)
- Court-ordered alimony and child support
- Debts that arise after bankruptcy is filed
- Some debts incurred in the six months before filing bankruptcy
- Some taxes
- Loans obtained fraudulently
- Debts from personal injury while driving intoxicated

It also does not protect those who co-signed your debts. Your co-signer agreed to pay your loan if you didn't, or couldn't pay. When you declare bankruptcy, your co-signer still may be legally obligated to pay all or part of your loan.

Other Options

Most people consider bankruptcy only after they pursue debt management, debt consolidation or debt settlement. If these options aren't possible, it may be worth it to look into low cost bankruptcy options.

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Debt settlement is a means of negotiating with your creditors to lower your balance. If successful, it directly reduces your debts.

However, if you are considering debt settlement instead of bankruptcy based on how it will impact your credit, it may not be your best move. In many cases, settling a debt is reflected on your credit report as a negative item in a similar way as bankruptcy. Before making a decision, it would be wise to speak with legal counsel to determine your best option.

To learn more about bankruptcy and other debt-relief options, seek advice from a nonprofit credit counselor or read the Federal Trade Commission's informational pages.

ABOUT THE AUTHOR

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Bill "No Pay" Fay has lived a meager financial existence his entire life. He started writing/bragging about it in 2012, helping birth Debt.org into existence as the site's original "Frugal Man." Prior to that, he spent more than 30 years covering the high finance world of college and professional sports for major publications, including the Associated Press, New York Times and Sports Illustrated. His interest in sports has waned some, but he is as passionate as ever about not reaching for his wallet. Bill can be reached at bfay@debt.org.

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