What Is Bankruptcy?

Basic information on Chapter 7 and Chapter 13 bankruptcy.

Bankruptcy is a federal court process designed to help consumers and businesses eliminate their debts or repay them under the protection of the bankruptcy court. Bankruptcies can generally be described as "liquidations" or "reorganizations."

Chapter 7 bankruptcy is the liquidation variety: If you own property that isn't exempt under your state's laws, it may be taken and sold ("liquidated") to pay back some of your debt. Chapter 13 bankruptcy is the most common type of "reorganization" bankruptcy for consumers: You get to keep all of your property, but you must make monthly payments over three to five years to repay all or some of your debt.

Both kinds of bankruptcy have numerous rules -- and exceptions to those rules -- about what kinds of debts are covered, who can file, and what property you can and cannot keep.

Chapter 7 Bankruptcy

Chapter 7 bankruptcy can be filed by individuals (called a "consumer" Chapter 7 bankruptcy) or businesses (called a "business" Chapter 7 bankruptcy). A Chapter 7 bankruptcy typically lasts three to six months.

Property liquidation. In Chapter 7 bankruptcy, some of your property may be sold to pay down your debt. In return, most or all of your unsecured debts (that is, debts for which collateral has not been pledged) will be erased. You get to keep any property that is classified as exempt under the state or federal laws available to you (such as your clothes, car, and household furnishings). Many debtors who file for Chapter 7 bankruptcy are pleased to learn that all of their property is exempt.

Secured debt. If you owe money on a secured debt (for example, a car loan for which the car is pledged as a guarantee of payment), you have a choice of allowing the creditor to repossess the property; continuing your payments on the property under the contract (if the lender agrees); or paying the creditor a lump sum amount equal to the current replacement value of the property. Some types of secured debts can be eliminated in Chapter 7 bankruptcy.

Eligibility for Chapter 7. Not everyone can file for Chapter 7 bankruptcy. For example, if your disposable income is sufficient to fund a Chapter 13 repayment plan -- after subtracting certain allowed expenses and monthly payments for certain debts -- you won't be allowed to use Chapter 7 bankruptcy.

Bankruptcy doesn't work on some kinds of debts. Though bankruptcy can eliminate many kinds of debts, such as credit card debt, medical bills, and unsecured loans, there are many types of debts, including child support and spousal support obligations and most tax debts, that cannot be wiped out in bankruptcy.

Chapter 13 Bankruptcy

Chapter 13 bankruptcy is also known as "wage earner" bankruptcy because, in order to file for Chapter 13, you must have a reliable source of income that you can use to repay some portion of your debt.

Repayment. When you file for Chapter 13 bankruptcy, you must propose a repayment plan that details how you are going to pay back your debts over the next three to five years. The minimum amount you'll have to repay depends on how much you earn, how much you owe, and how much your unsecured creditors would have received if you'd filed for Chapter 7 bankruptcy.

Debt limits. Your debts must be within limits set by the federal government: Currently, you may not have more than $1,010, 650 in secured debt and $336,900 in unsecured debt

Secured debts. If you have secured debts, Chapter 13 gives you an option to make up missed payments to avoid repossession or foreclosure. You can include these past due amounts in your repayment plan and make them up over time.

Other Types of Reorganization Bankruptcy

In addition to Chapter 13 bankruptcy, there are two other types of reorganization bankruptcy: Chapter 11 and Chapter 12.

Chapter 11 bankruptcy. Chapter 11 is typically used by financially struggling businesses to reorganize their affairs. It is also available to individuals, but because Chapter 11 bankruptcy is expensive and time-consuming, it is generally used only by those whose debts exceed the Chapter 13 bankruptcy limits (rare) or who own substantial nonexempt assets (such as several pieces of real estate). If you are considering Chapter 11 bankruptcy, you'll need to talk to a lawyer.

Chapter 12 bankruptcy. Chapter 12 is almost identical to Chapter 13 bankruptcy. But to be eligible for Chapter 12 bankruptcy, at least 80% of your debts must arise from the operation of a family farm. Chapter 12 bankruptcy has higher debt ceilings to accommodate the large debts that may come with operating a farm, and it offers the debtor more power to eliminate certain types of liens.