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Consumer Bankruptcy and Race: Current Concerns and a Proposed Solution

Edward J. Janger

CONSUMER BANKRUPTCY AND RACE: CURRENT CONCERNS AND A PROPOSED SOLUTION

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I. INTRODUCTION

A series of studies have identified a persistent feature of our consumer bankruptcy system: a disproportionate number of African American debtors choose to file Chapter 13 bankruptcy instead of Chapter 7.[1] This would not be a problem if other attributes of African American debtors meant that Chapter 13 was actually the better choice. But for reasons I will discuss, it is not. In fact, Chapter 13 is typically more expensive, less certain, and provides less complete relief than the Chapter 7 alternative. Recent legislation, the Consumer Bankruptcy Reform Act of 2020, proposed by Senator Warren and Representative Nadler (and endorsed by President Biden as a candidate) would seek to remedy this problem

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1 AM. BANKR. INST., Final Rep. of the ABI Comm'n on Consumer Bankr., 159 (2019). Recommendation 4.01(a) states: "(a) The empirical evidence establishes that African American bankruptcy debtors are both disproportionately more likely to file chapter 13 cases than debtors of other races and disproportionately less likely to obtain a discharge." *Citing* Dov Cohen, Robert M. Lawless & Faith Shin, *Opposite of Correct: Inverted Insider Perceptions of Race and Bankruptcy*, 91 AM. BANKR. L.J. 623, 631, 633 (2017) (reporting a study where 55.0% of African American filers were in chapter 13 as compared to 26.3% for debtors from households where no debtor identified as African American); Jean Braucher, Dov Cohen & Robert M. Lawless, *Race, Attorney Influence, and Bankruptcy Chapter Choice*, 9 J. EMPIRICAL LEGAL STUD. 393, 398, 402 (2012) (reporting a study where 54.7% of African American filers were in chapter 13 compared to 26.7% for debtors from households where no debtor identified as African American) [hereinafter ABI Comm'n Rep.].

by creating a single consumer bankruptcy chapter for all individual debtors with debts under $7,500,000.[2]

In this article, I will review explain the practical differences between the Chapters and why one might rationally or irrationally choose one over the other. I will then review the empirical literature on race and chapter-choice and show how the current system does not serve African American debtors well. Finally, I will describe the recently proposed CBRA and how it seeks to remedy the racial inequities embedded in the current bankruptcy system.

II. THE STRUCTURE OF THE CONSUMER BANKRUPTCY SYSTEM

The basic architecture of the consumer bankruptcy system does not have any obvious features that should lead to racial disparities. However, peeling back the layers reveals both a problematic history and a problematic present.

An individual consumer debtor in financial distress has two basic options when considering bankruptcy: they can either pay their creditors back with their assets (liquidation),[3] or with their wages (a payment plan).[4] A debtor who chooses Chapter 7 must turn over all of their non-exempt assets and the trustee will sell them to satisfy the claims of creditors.[5] In return, they receive an immediate discharge, known as the "fresh start".[6] Crucially, the debtor's post-petition wages are not subject to claims of prepetition creditors.[7] A debtor who chooses Chapter 13 is allowed to

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[2] The Consumer Bankruptcy Reform Act of 2020, S. 4991, 116th Cong. (2019-2020).

[3] 11 U.S.C. § 701 *et seq.*

[4] 11 U.S.C. § 1301 *et seq.*

[5] The bankruptcy estate consists of "all of the debtors legal or equitable interest in property." 11 U.S.C § 541. The estate's interest in the property is subject to any liens or encumbrances, 11 U.S.C. § 506, and exemptions. 11 U.S.C. § 522. The trustee will abandon any property that is not of value to the estate, either because it is fully encumbered or exempt. 11 U.S.C. § 554. If the debtor has non-exempt equity in encumbered property, the trustee will sell encumbered property and distribute the proceeds first to the secured creditor then to the estate. 11 U.S.C. § 725. The remaining property will be distributed to the creditors in order of their priority, with the junior-most creditor receiving a pro-rata distribution. 11 U.S.C. § 726.

[6] 11 U.S.C. § 524 (discharge).

[7] 11 U.S.C. § 541(a)(6) (post-petition wages excluded from property of the estate).

keep their non-exempt assets but must redeem any equity in those assets by entering into a payment plan lasting three to five years.[8] Further, to discharge their unsecured debts they must commit substantially all of their disposable income to payments under the plan for the same period.[9]

To understand the differences between the chapters, it might make sense to consider a typical consumer debtor. For these purposes, we will assume that, like 90% of all debtors, their income is below the median for their state. Some debtors will be renters, but others may own a house. For simplicity, assume that the mortgage is either under water, or that any equity is within the applicable homestead exemption. Further, the debtor may own a car. Again, assume that any lien on the car exceeds its value, or that any equity is exempt.[10] The median income of consumer debtors in 2019 was $3,261 per month, and the average income of consumer debtors was $2,978 per month.[11] This would yield an annual income of approximately $36,000 per year, and the distribution appears to skew low. Median average monthly expenses were $2,836, or $34,032 per year.[12] In other words, most consumers in bankruptcy do not have a lot of income to spare.

This typical consumer debtor needs relief in three areas: (1) discharge of personal debts; (2) help with cost of shelter (mortgage or rent); and (3) help with cost of transportation (car loans). The current system provides different kinds of relief depending on which Chapter is used. I will address the treatment of each of these in Chapters 7 and 13, in reverse order.

First, for cars, Chapter 13 would appear on its face to provide greater assistance than Chapter 7, but as a practical matter, the reality may be the opposite. To illustrate, imagine that the debtor owns a car worth $5,000. The outstanding loan, secured by the car is $8,000. Because the car is worth less than the loan, the

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[8] 11 U.S.C. § 1322 (contents of a plan), § 1325 (confirmation of a plan).

[9] 11 U.S.C. § 1325(b).

[10] It should be noted that there are some high-income debtors who find their way into the system, who may also have significant non-exempt assets. These debtors, however, represents less than 10% of all filers and the problems that we identify here do not come into play. The median income of consumer debtors in 2019 was $3,261/month, and the average income of consumer debtors was $2978/month. *2019 Report of Statistics Required by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, USCOURTS.GOV (2019), https://www.uscourts.gov/statistics-reports/bapcpa-report-2019.

[11] *Id.*

[12] *Id.*

trustee will likely abandon it, leaving the debtor on their own to deal with the lender. While bankruptcy discharges all personal liability on the loan – and hence any deficiency – once the car is abandoned, the stay does not apply, and the lender will be free to repossess.[13] According to the Supreme Court, in *Dewsnup v. Timm,* the lien of $8,000 will ride through unimpaired.[14] Chapter 7 offers two statutory options, neither of which is particularly attractive: redemption[15] or reaffirmation[16] Redemption is the most attractive, in that the car can be redeemed from the lender by paying the value of the car – the "allowed secured claim"[17] rather than the amount of the debt. However, the money must be paid at the time of redemption, and it is unlikely that the debtor will have sufficient liquid funds to pay for the car all at once. Under reaffirmation, the debtor reaffirms the loan, promises to make up missed payments, and pays the full amount of the debt, regardless of the value of the loan.[18] Under the reaffirmation scenario, the monthly payments owed by the debtor are likely to go up, rather than down, because of the need to cure missed payments.

Chapter 13, by contrast, allows the debtor to "modify" the agreement with the car lender and keep the car, so long as they pay the value of the car (again, the allowed secured claim) over the life of the plan.[19] As a practical matter, the debtor would go into bankruptcy owing $8,000 on their car and would come out owing $5,000.

Unfortunately, the practical benefit of Chapter 13 over Chapter 7 may not be as great as it seems. First, if the car loan was taken out any time in the two and a half years preceding the filing, the modification of the loan cannot reduce the principal balance.[20] Therefore, to retain the car, it would still be necessary to pay the full $8,000. Second, a practice has emerged in Chapter 7 referred to as informal "ride through,"[21] under which the debtor files for

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[13] 11 U.S.C. § 524 (discharge); 11 U.S.C. § 554 (abandonment); 11 U.S.C. § 362(c)(1) (stay lifts upon abandonment).

[14] Dewsnup v. Timm, 502 U.S. 410, 417 (1992).

[15] 11 U.S.C. § 722

[16] 11 U.S.C. § 524

[17] 11 U.S.C. § 506

[18] 11 U.S.C. § 524(c).

[19] 11 U.S.C. § 1322.

[20] 11 U.S.C. § 1325(a).

[21] *Hardiman,* note 21 *supra,* 398 B.R. at 186.

Chapter 7 but continues making payments on the original loan.[22] In many, if not most cases, the lender will not take any actions to collect, so long as the payments continue. Indeed, in cases where principal modification is not permitted, "ride through" may be preferable to the Chapter 13 plan. In both cases, the debtor will have to pay $8,000 to keep the car, but in Chapter 7 any personal recourse (i.e., the deficiency) will be discharged, whereas in Chapter 13, the debtor does not receive a discharge until payments are completed under the plan.[23]

Second, with regard to the debtor's home, we will consider owners first and then renters. For homeowners, Chapter 13 does provide some limited assistance that is not available under Chapter 7. For the debtor who has non-exempt equity in their house and is facing foreclosure, Chapter 13 provides an automatic stay of foreclosure and the ability to reinstate and cure the mortgage arrearage over time.[24] This is not the scenario, however with which we are most concerned. Imagine instead a debtor who has a first mortgage that exceeds the value of the house, as well as a second mortgage that is completely under water. With regard to the first mortgage, no modification is permitted, other than reinstatement and cure.[25] However, with regard to the second mortgage, courts have held that the second mortgage is not "secured by an interest in the debtor's residence," and hence can be avoided.[26] None of this relief is available in Chapter 7. The Supreme Court recently held that an underwater second mortgage cannot be discharged in Chapter 7.[27] Therefore, other than discharging any deficiency claim, Chapter 7 does not provide significant relief to homeowners, but Chapter 13 provides the ability to reinstate and cure, and to "strip off" the lien of an underwater second mortgage.

For renters, neither Chapter 7, nor Chapter 13 provide much relief. Section 365 allows the debtor to assume their lease, but only if they can cure any defaults.[28] Again, as with a residential mortgage in Chapter 13, to avoid eviction, the monthly payments

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[22] *Coastal Fed. Credit Union v. Hardiman*, 398 B.R. 161, 166 (E.D.N.C. 2008); Amber J. Moren, *Debtor's Dilemma: The Economic Case for Ride-Through in the Bankruptcy Code*, 122 YALE L.J. 1594, 1616 (2013).

[23] *Id.* 188.

[24] 11 U.S.C. §§ 1322, 1325.

[25] 11 U.S.C. § 1322.

[26] 11 U.S.C. § 506.

[27] Bank of Am., N.A. v. Caulkett, 575 U.S. 790, 795 (2015).

[28] 11 U.S.C. § 365(b).

owed by renters in bankruptcy are likely to go up rather than down.

Third, for unsecured debt, Chapter 7 is the clear favorite for the typical consumer debtor. If we assume that the debtor has little disposable income and no non-exempt assets, then Chapter 7 provides virtually immediate relief. A no-asset Chapter 7 (which describes the vast majority of cases), where the debtor's income is below the state median, the immediate stay of debt collection, followed in relatively short order by a discharge, provides almost immediate relief.[29] Chapter 13 by contrast, is a much more uncertain and costly remedy. Even a debtor with no assets must submit substantially all disposable income to payments under a plan for three years.[30] The discharge is delayed until those payments are completed.[31] More importantly, the vast majority of Chapter 13 debtors do not complete the payments under their plans. Indeed, between 1994 and 2000, the completion rate was only about 33%.[32] In other words, for a typical, low income, low asset consumer debtor, Chapter 13 is a bad choice.

The question then arises: who would rationally choose Chapter 13? The answer is that there are some features in Chapter 13 that make it the rational choice for certain debtors. In particular, it provides the ability to modify a car loan, to reinstate and cure a home mortgage, and to "strip" an underwater second lien from the residence. None of these options are available in Chapter 7; all of them require the debtor to have assets to preserve, which is usually not the case. On its face, Chapter 13 is for a high-income, high asset debtor who wishes to preserve equity in their house, or high value car. Chapter 7 is for a low income, low asset debtor who has few, if any, non-exempt assets, and needs immediate relief. The choice is voluntary, except for the relatively few debtors whose income exceeds the state median.[33]

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[29] Dalié Jiménez, *The Distribution of Assets in Consumer Chapter 7 Bankruptcy Cases*, 83 AM. BANKR. L.J. 795, 819 (2009) (90% of consumer bankruptcy cases are no-asset cases with no distribution).

[30] 11 U.S.C. § 1322.

[31] 11 U.S.C. § 1328(a).

[32] Norberg & Nadja Schreiber Compo, *Rep. on an Empirical Study of District Variations, and the Roles of Judges, Trustees, and Debtors' Attorneys in Chapter 13 Bankruptcy Cases*, 81 AM. BANKR. L.J. 431, 432 (2007).

[33] 11 U.S.C. § 1322(b).

III. WHO USES CHAPTER 13 AND WHY?

Curiously, the history of Chapter 13 does not follow this pattern. The payment plan approach followed by Chapter 13 was originally developed in Birmingham, Alabama in the 1930s as an experiment by a local bankruptcy trustee. The logic was not about asset-based incentives, but instead based on the idea of finding an equitable arrangement between the debtor and the creditor, under which the debtor would pay as much as they could to the creditors pursuant to a repayment plan.[34] Indeed, the reality of the two-chapter system, for most filers, reflects dueling philosophies of consumer bankruptcy, one of which tries to get the debtor to pay as much as they can; the other of which focuses on providing needed debt relief as quickly and efficiently as possible. The result has been a system with two paths to rehabilitation, one (Chapter 7) more generous, faster, and cheaper than the other (Chapter 13).

Against this backdrop, a disturbing feature has been observed. "African American debtors are overrepresented among Chapter 13 filers."[35] This phenomenon has been persistent. 30 years ago, Professor Michelle White noted that the percentage of African Americans in a county increased the relative number of Chapter 13 filed in that county.[36] Since then, studies have consistently shown that African American debtors were twice as likely to find themselves in Chapter 13 as consumer debtors of other races,[37] and that in regression analyses, the differences remained even after controlling for legal, financial and demographic differences.[38]

The question remains: why? A study by Morrison and Uetwiller ties the phenomenon, at least in Chicago, to the dischargeability in Chapter 13 of government fines, and suggests that bankruptcy was being used by debtors to discharge large numbers of unpaid parking tickets – which could lead to license suspension or car seizure. Other studies find even more problematic

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[34] Timothy W. Dixon & David G. Epstein, *Where Did Chapter 13 Come from and Where Should It Go?,* 10 AM. BANKR. INST. L. REV. 741 (2002) [hereinafter Dixon & Epstein].

[35] ABI Comm'n Rep., *supra* note 1.

[36] Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis,* 63 IND. L.J. 1, 45, 47 (1987). *See also,* Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures,* 67 AM. BANKR. L.J. 501, 559-60 (1993) (In lawyer interviews, concern expressed that African Americans were being taken advantage of).

[37] Cohen and Lawless, *supra* note 2 at 631.

[38] *Id.* at 633.

explanations. Foohey, Lawless, Porter and Thorne identify the phenomenon of "no money down" Chapter 13 plans that tie the use of Chapter 13 to lawyers' desire to get paid. A problem faced by many debtors who seek to file Chapter 7 bankruptcy is that lawyers insist on an up-front retainer so that their unpaid bill will not be discharged in the bankruptcy once filed. This, in turn, produces the unusual phenomenon of debtors saving cash to pay in advance to file for bankruptcy. Chapter 13 provides an alternative. In Chapter 13, the attorney's fees can be paid as part of the repayment plan. Therefore, debtors who are unable to pay a retainer are forced to use Chapter 13 to pay their attorneys.[39]

The effects of this practice are stark. In 2017, Paul Kiel and Hannah Fresques studied bankruptcy filing patterns on a national level, including within two districts with high African American populations: Chicago and Memphis. First, they found that Chapter 13 filings were particularly prevalent (as compared to Chapter 7 filings) in the Southeast and Lower Midwest. In Memphis, they found that while Chapter 7 filing rates were similar between whites and blacks, the Chapter 13 filers were predominantly black. Similarly, while there were more filings in black neighborhoods, the black filers were much less likely to receive a discharge. Over 50% of filers received discharges in predominantly white neighborhoods, whereas only slightly more than a third received discharges in predominantly black neighborhoods.[40]

Second, Kiel and Fresques talked to attorneys and found a complicated story, in part moralistic and in part mercenary. Chapter 13, they were told, teaches debtors to live within their means, but also allows the attorneys to extend credit to their clients because of the ability to repay attorneys under Chapter 13. Moreover, the credit is not free. The fee for a Chapter 7 case usually

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[39] Pamela Foohey, Robert Lawless, Katherine Porter & Deborah Thorne, *"No Money Down" Bankruptcy*, 90 S. CAL. L. REV. 1055, 1072-74 (2017).

[40] Paul Kiel & Hannah Fresques, *Data Analysis: Bankruptcy and Race in America*, PROPUBLICA (2017), https://projects.propublica.org/graphics/bankruptcy-data-analysis. A shorter narrative describing the data analysis and including interviews with bankruptcy filers and bankruptcy attorneys was simultaneously published. *See* Paul Kiel & Hannah Fresques, *How the Bankruptcy System Is Failing Black Americans*, PROPUBLICA (2017), https://features.propublica.org/bankruptcy-inequality/bankruptcy-failing-black-americans-debt-chapter-13/ [hereafter, Kiel & Fresques, How the Bankruptcy System Is Failing]; ABI Comm'n Rep., *supra* note 1 at 163.

around $1,000, but a Chapter 13 cost $3,000 (though the collection rate on Chapter 13s was not 100%).[41]

The choice between chapters, and the differences in rules regarding compensation tell a dystopian story. Indeed, Kiel and Fresques point out that in other districts, such as the Eastern District of New York (Brooklyn) where Judges are less receptive to "no-money down" Chapter 13 cases, the prevalence of Chapter 13s over 7s disappears.[42]

IV. THE CONSUMER BANKRUPTCY REFORM ACT OF 2020: A POSSIBLE SOLUTION

This past December, Senator Warren and Representative Nadler introduced the Consumer Bankruptcy Reform Act of 2020 (the Act), which proposes a wholesale redesign of the consumer bankruptcy system.[43] That statute the Act would replace both Chapters 7 and 13 with a new Chapter 10. Instead of choosing between two chapters with varying treatments, all individual debtors with debts below $7,500,000 would file a Chapter 10 petition.[44] Differences in treatment would be driven by differences among debtors, rather than by chapter choice. The Act has several features that would go a long way toward ameliorating the inequities described above. To illustrate, I will discuss the questions asked above concerning unsecured debt, houses and cars, and explore how each would be addressed under the Act.

First, a debtor who needed to keep their car could create a repayment plan, under which they would pay the lender the value of the car over a three-year (or if necessary up to a 5-year) period. While car loans taken out within 90 days of filing would be excluded from this remedy, many more debtors could obtain relief from onerous car payments through this plan.[45]

Second, a debtor whose home mortgage was under water could propose a repayment plan to satisfy their mortgage by paying the secured lender the value of the home over time. Unlike the

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[41] *Id.*

[42] *Id.*

[43] The Consumer Bankruptcy Reform Act of 2020, S. 4991, 116th Cong. (2019-2020).

[44] The Consumer Bankruptcy Reform Act of 2020, S. 4991, 116th Cong. § 109(d) (2019-2020).

[45] The Consumer Bankruptcy Reform Act of 2020, S. 4991, 116th Cong. § 1026 (2019-2020).

car, however, the payments could be amortized over a longer period. The distinction between Chapter 7 and 13 would be eliminated, as would the distinction between first and second liens. Further, the Act would eliminate the "no modification" rule contained in current Chapter 13, thus allowing debtors to get meaningful relief on their mortgages.

Third, the CBRA provides meaningful relief to renters who have fallen behind on their rent; it allows debtors who file for bankruptcy to assume their leases while forgiving up to six months of rental arrearage. This reduces the distinction between debtors who rent and debtors who own their homes.[46]

Finally, with regard to unsecured debt, the Act would give most debtors quick and certain relief. Debtors whose income is less than 135% of the state median for households of similar size and who have no non-exempt assets would receive an immediate discharge (except to the extent that they had entered into repayment plans for their house our car, as described above). As noted above, this describes the vast majority of consumer cases, regardless of race. For the relatively few high-income debtors who need bankruptcy, the Act creates a minimum payment obligation ("MPO") which is calculated on a statutorily determined sliding scale.[47] As income increases, the minimum payment increases. For high-asset debtors, non-exempt assets may only be regained if the debtor's equity is redeemed from the creditors over time in a repayment plan.[48] It is anticipated that the MPO will be applicable to relatively few debtors, and it is hard to imagine how race would enter into decisions about which assets to keep or dispose of.[49]

Perhaps most importantly, the Act eliminates the discrepancy in business models between the two chapters. As introduced in 2020, no provision is made for paying attorneys as part of the repayment plan.[50] This eliminates the phenomenon of "no money down" bankruptcy. It is possible that this will be changed when the bill is reintroduced in the new Congress. Either way, so long as the treatment is consistent, it eliminates the lawyers' incentive to steer clients into Chapter 13 as part of their business model.

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[46] The Consumer Bankruptcy Reform Act of 2020, S. 4991, 116th Cong. § 1026 (2019-2020).

[47] *Id.* at § 104(a).

[48] *Id.* at § 1022.

[49] The Consumer Bankruptcy Reform Act of 2020, S. 4991, 116th Cong. § 1025 (2019-2020).

[50] *Id.*

Further, because of the immediate discharge, even debtors who finance their cases will receive a discharge of any debts not contained in a repayment plan more quickly and at a far lower cost.

V. CONCLUSION

In sum, the current structure of the consumer bankruptcy system has substantial disparate impact on debtors based on race. The sources of that disparate impact are diverse. They include social mores about debt repayment, judicial views about debt relief, implicit bias, and consumer bankruptcy attorneys' business model. The proposed Consumer Bankruptcy Reform Act provides a comprehensive reshaping of that system that will allow debtors and their attorneys to focus on the relief that the debtor needs: discharging debt; keeping their cars; and keeping their homes.