Postpetition Appreciation in Chapter 7: Who Gets It?

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Summary of the Issues

Main issue: In a chapter 7, do postpetition changes of value occur to the benefit (or detriment) of the estate or the debtor?

My answer: The estate.

Subissue 1: Does it matter if it is an increase or decrease in value?

My answer: No

Subissue 2: Does it matter if it is a case converted from chapter 13?

My answer: No

Subissue 3: Does it matter if the debtor is claiming an exemption?

My answer: Yes, this is a separate issue.

Explanation

"Value" vs. "Price." Often, lawyers and judges talk about "value" when they really mean "price." To illustrate the difference, suppose I have a widget-making machine that will produce 1,000 widgets that I can sell for a profit of $5 each and that after the machine produces 1,000 widgets, it will become inoperable. The machine has an inherent "value" of $5,000 (ignoring issues about the time value of money of the revenue stream). If both you and I are fully informed about all these facts, I would be a fool to sell it to you for anything less than $5,000, and you would be a fool to pay anything more than that. The "price" that will get paid in a sale is the same as the machine's "value."

The real world diverges greatly from this hypothetical widget-making machine. There will be many uncertainties about the useful life of the machine, the profit one can earn on each widget sold, and so forth. Also, we will have different estimates about the probabilities associated with these uncertainties. All these uncertainties and differences will mean that you and I will have different prices at which we are willing to exchange the machine. If you agree to buy the machine at a price of $5,000, it will be because your estimate of these uncertainties and differences are more optimistic than mine and vice versa if you do not. Moreover, there

will be a multitude of such estimates once we start introducing the possibility of other potential purchasers. Indeed, if I auction off the widget machine, the winning purchaser will be the party who was most optimistic about these estimates than all other people and therefore most likely to be wrong about the true value!

OK, but What Does That Have to Do with Anything? Thinking about a hypothetical market for widget machines helps us to understand that when we talk about "value" what we really mean are "prices." The values that bankruptcy courts ascribe to things are just prices that have been used in market exchanges. Omniscient gods can know "value." We mere mortals can only observe prices, which help inform but are ultimately fallible estimates of value. That insight will help us with the legal issues around changes of value in chapter 7.

To begin, let's consider a debtor who owns 100 shares of Alphabet stock which, as I write these words, are worth $11,836. (Alphabet is the parent of Google.) Certainly, few consumer debtors own common stock, and the bankruptcy issues usually involve a personal residence. Stock is a good place to start, however, because there is a ready market at which the stock can be bought and sold at a given price. And, like all corporations, Alphabet is basically a widget machine that will throw off an income stream. The stock price of $11,836 represents the consensus estimate of what 100 shares of that income stream is worth.

Now, We Can Begin to Answer the Basic Questions—When our hypothetical debtor files chapter 7, the 100 shares of Citigroup common stock become part of the bankruptcy estate. *See* Bankr. Code § 541(a). The stock itself is in the estate with all its attributes. The trustee now has a duty to reduce the stock to money. *See id.* § 704(a)(1). Whatever the trustee collects on the stock is proceeds of the stock and part of the bankruptcy estate, which the trustee then has a duty to distribute to creditors. *See id.* §§ 541(a)(6), 704(a)(1).[1] If the stock price has gone up to $16,000, that goes into the estate. If the stock price has gone down to $8,000, that goes into the estate.

The Answer Is the Same for a Converted Case—If this stock sale occurs in a case converted from chapter 13, the answer does not change. For the chapter 13 plan to have been confirmed, it would have needed to return to unsecured creditors as much they would have received in chapter 7. *See* Bankr. Code § 1325(a)(4). That amount would have included stock, assuming it was nonexempt. The chapter 13 "deal" is that the debtor makes the plan payments and receives a discharge at the end.

Conversion means, for whatever reason, the debtor is not going to complete the chapter 13 "deal" and instead wants the chapter 7 "deal." Generally speaking, that "deal" means surrendering your nonexempt assets to the chapter 7 in exchange for a discharge. The stock is property of the chapter 7 estate. *See id.* § 348(f)(1). Just as in a nonconverted case, the

[1] An increase in a stock price is also not a "profit" under Bankr. Code § 541(a)(6) as that term refers to the concept of a "profit a pendre," a right to take something from land such as timber or minerals. *See* V. DiFrancesco & Sons v. West Chestnut Realty of Haverford, Inc. (*In re* West Chestnut Realty of Haverford), 173 B.R. 322 (Bankr. E.D. Pa. 1994). As law schools diminish the importance of doctrinal details in the first-year curriculum, this historical meaning may be lost, but I digress.

chapter 7 trustee sells the stock for whatever its current market price might be and distributes the proceeds to creditors.

Exemptions Are a Different Issue—Suppose the debtor claims a wild card exemption in the stock. An exemption removes the debtor's interest in property from the bankruptcy estate. *See Rousey v. Jacoway*, 544 U.S. 320, 325 (2005). If the debtor elects the federal exemptions and does not use a homestead exemption, the debtor can exempt the debtor's interest in "any property" up to $15,425 in value. *See* Bankr. Code § 522(d)(5). The Bankruptcy Code specifically directs that value is determined as of the petition date. *See id.* § 522(a)(2).

For our debtor with Alphabet stock, the debtor can thus remove from the bankruptcy estate as many shares as it wants up to the cap. If the market price of the stock is $11,836 on the petition date, the debtor can remove all 100 shares from the bankruptcy estate. If the market price increases, the debtor does not need to reallocate more of the wild card exemption just as a decline in the market price does not "free up" amounts from the wild card to put toward other assets.

The analysis is easy for the federal exemptions because section 522 has its own statutory definition of "value" that specifies it is determined as of the petition date. If a debtor is claiming state exemptions, the issue is less straight-forward because these statutes do not have a similar provision. For example, both the Illinois and Indiana statutes simply provide that certain property "is exempt." *See* 735 ILL. COMP. STAT. 5/12-1001; IND. CODE § 34-55-10-2(c).[2] There is no similar provision in these state statutes about the timing, and the Bankruptcy Code provision does not literally apply because it is a definition for section 522 of that statute. Still, interpreting the state statutes to speak to the time of the petition makes the most sense as no other date obviously presents itself for a different rule. Such an interpretation also would prevent an inconsistency between the state and federal exemption schemes and the strategic arbitrage that would otherwise might result.

Now, Let's Talk About Houses and Homestead Exemptions—The reason to start with publicly traded stock was to make the relevant principles easy to see. The litigation, however, has been about debtor's personal residences and the homestead exemption. If home prices keep rising, these cases will become more frequent. Homes do not have an exchange constantly setting prices by many market actors. Nonetheless, the principles are all the same.

Suppose our chapter 7 debtor owns a home in Illinois where the homestead exemption is $15,000. *See* 735 ILL. COMP. STAT. 5/12-901. Using Zillow or a similar service, the debtor's bankruptcy attorney determines a good-faith estimate is that the home would sell for $118,360 and lists that amount on Schedule A. The mortgage on the property is $105,000. The debtor's exemption means the debtor can remove up to $15,000 of the debtor's interest in the homestead. Unlike stock, the homestead cannot be divided up into smaller units. The debtor's claim of exemption is in the entire "thing" but limited in the amount of $15,000. Because the debtor's exemption and the secured claim together will mean the home will not produce a meaningful distribution for creditors, the trustee should not administer the asset.

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[2] Both Illinois and Indiana are opt-out states, and both have wildcard exemptions. Wisconsin is not an opt-out state.

Further suppose the trustee comes along and proves that the trustee can sell the house for $130,000. If the trustee does so two months into the case, perhaps the reason is that the market has gone up in two months or perhaps the reason is that the house was worth more than the $118,360 that the debtor listed on Schedule A. No matter what number got listed there, it was not a statement about the home's intrinsic "true" value, nor could it ever be so. Rather, it was just a guess about what price the house might have brought in an arm-length transaction. The principles developed in the stock example above still apply. The debtor's exemption was locked in as of the petition date. We just have a messy factual issue about what that means. Has the house appreciated or was it worth something different than what the debtor listed on the petition date?

Suppose instead that the trustee comes forward with a buyer willing to pay $300,000 in the same two-month time frame. Now, we should be quite dubious about the debtor's claim that the house would have sold for only about 40% of that amount just two months ago. Still, it is possible prices moved that much. What the court has in front of it is not a legal question about what the statute means—it means the same as it did when the asset in question was stock—but a fact question about the "value" of the home on the petition date. All it can do, however, is gather evidence on the prices the home would fetch on different dates.

Now, let's change the facts so it is two years later the trustee is claiming the house could be sold for $300,000. Such a delay would be common in a converted case. All the principles still apply. The debtor's rights were locked in as of the petition date. The value as of the petition date is still a factual issue. Only now, it is a very difficult fact question because it is much more likely market prices would move dramatically over two years as compared to two months.

Thus, the approach of *In re Jackson*, 317 B.R. 511 (Bankr. N.D. Ill. 2004), seems exactly right. In a case converted from chapter 13 to chapter 7, the trustee claimed the debtor's condominium was worth substantially more than the $37,000 the debtor had originally scheduled it in her chapter 13. The court allowed the chapter 7 trustee to hire professionals to value the condominium as of the petition date, but the court "would only approve a sale only if Jackson's scheduled value was inaccurate and there was actual equity available to creditors at the start of the chapter 13 case." *Id.* at 518.

In contrast, a new case out of Washington went the other way and thus is mistaken in this author's humble opinion. *See In re Castleman*, No. 2:21-cv-00829-JHC, 2022 WL 2392058 (W.D. Wash. July 1, 2022). The debtor had filed chapter 13 and scheduled their personal residence with a value of $500,000. On the petition date, the debtors' exemption and secured claim exceeded the value of the home. A little under two years later, the debtors converted to chapter 7, and the trustee claimed the home was now worth $700,000. The court relied on Ninth Circuit precedent, *Wilson v. Rigby*, 909 F.3d 306 (9th Cir. 2018), for the proposition that "post-petition appreciation in a debtor's home inures to the estate." *Castleman*, 2022 WL 2392058, at *3. Both cases, however, came out of Washington where the homestead exemption statute at the time exempted the "net value" (i.e., equity) in the home, and the *Wilson* court used that language to distinguish previous Ninth Circuit precedent involving the California homestead exemption which is simply a fixed amount. *See Wilson*, 909 F.3d at 310 (distinguishing *Alsberg v. Robertson (In re Alsberg)*, 68 F.3d 312 (9th Cir. 1995)). Indeed, since the

Wilson case, Washington has amended its state exemption statute to eliminate the "net value" language such that the *Wilson* case is no longer good law even for cases out of that state. *See* WASH. REV. CODE § 6.13.030.

Practice Pointers—There is no precedent from the Seventh Circuit on whether a consumer or the estate benefits from postpetition appreciation. If presented with the issue in the representation of a debtor, one practice pointer would be to make the sound and cogent arguments in this memorandum. If on the other side of the issue, argue the memorandum is the unhinged ramblings of an academic whose feet only know ivory-covered floors.

Perhaps of more help for consumer debtor lawyers is to strategically consider the schedules and how they interact with postpetition appreciation. In a world of rising real-estate value and within the limits of good faith estimates, higher home values on Schedule A will make it easier to assert a home has postpetition appreciation. Of course, one must be careful not to list values so high they exceed exemption levels in a chapter 7 or similarly create payment obligations because of the best interests rule in a chapter 13. And, again, the number on Schedule A must be a reasonable, good faith estimate of the asset's value.

Also of some help might be the recommendations of the ABI Commission on Consumer Bankruptcy, which have been attached as an appendix. (Full disclosure—I was the reporter for the commission.) The commission noted the postpetition appreciation issue becomes more acute the more time that passes after filing. The debtor can make a chapter 7 trustee "fish or cut bait" by filing a motion to abandon where the exemptions and the mortgage mean there will be no distribution for unsecured creditors. Unlike the commission, practitioners cannot wish away the $188 filing for a motion to abandon, but the cost could justify the protection if the debtor has a house that might appreciate. At the least, a motion to abandon should stop a trustee from keeping a case open on the speculation of value appreciation. The strategy will not work, of course, in a converted chapter 13 case where the passage.

Excerpt from the Final Report of the ABI Commission on Consumer Bankruptcy

Section 1.07, Postpetition Changes in Value

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> encumbered property"). For example, a trustee may be able to satisfy in full a blanket security interest on multiple units of property by selling only one unit. Similarly, a trustee may be able to obtain a higher price from an aggregate sale of assets than from selling the assets individually. In a case with other funds available for unsecured creditors, a trustee also may sell fully encumbered property to eliminate a deficiency, if the secured creditor agrees to waive any unsecured claim for a deficiency in the event the sale does not fully satisfy the security interest.[132]

The Commission notes that the examples cited in the *Handbook* — sale of one unit out of multiple units and aggregate sales of assets — are most relevant in commercial bankruptcies.

The Commission appreciates the past regulatory supervision of the USTP to help ensure that sales of overencumbered residential property occur only in appropriate situations, but cases like *Brown* indicate trustees often push the line, if not cross it altogether. The USTP should define the circumstances in which trustees can sell fully encumbered property and should prevent trustees from selling fully encumbered property outside these circumstances. Among the guidelines the U.S. Trustee develops should be a bar on sales of fully encumbered property that do not produce a distribution for unsecured creditors that exceeds the portion of the sales proceeds that pays the trustee's fee and expenses. Requiring that the distribution to unsecured creditors will exceed the trustee's portion of the sale proceeds provides a rule of thumb to help ensure that such sales only occur when there is consequential value for the estate.

§ 1.07 Postpetition Changes in Value

> (a) An individual debtor should be able to file a motion to compel abandonment without paying a filing fee.
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> (b) The Federal Rules of Bankruptcy Procedure should provide that if no interested party files an objection and request for hearing within fourteen days after a chapter 7 trustee files a no-asset report, any estate interest in property of the debtor scheduled under section 521(a)(1) will be deemed abandoned. The section 341(a) notice should set forth the effect of the chapter 7 trustee's filing of a no-asset report, the right to object and request a hearing within fourteen days, and the resulting abandonment if no objection and request for hearing is filed.

Background. Bankruptcy exemptions create a postpetition pool of assets that promote the debtor's postpetition economic well-being and further the debtor's fresh start. The debtor identifies exempt assets at the beginning of a case, but it takes time for a chapter 7 trustee to administer a bankruptcy estate. During administration, estate property will sometimes increase in value. When this happens, both the trustee and the debtor will want to claim the benefit of the appreciation.

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132 U.S. Dep't of Justice, Handbook for Chapter 7 Trustees, https://www.justice.gov/ust/handbook-chapter-7-trustees (last visited Jan. 12, 2018).

"Value" can be conceptualized as an inherent characteristic of an asset.[133] For a commercial asset, the value typically would be the discounted present value of the future cash flows the asset will bring to the firm. For a consumer asset, value would include what the owner would have to pay over the life of the asset for similar consumption of another asset — for example, the value of a particular house as compared to what the owner would pay for similar housing. Knowing the value of an asset requires practically omniscient knowledge about the world — e.g., what cash flows will come in the future, what alternatives a consumer will have over the life of the asset, the consumer's preferences over the life of the asset.

Human beings, of course, do not have omniscience about either the present or the future, so we use market prices to estimate value. As more information comes to light — for example, the evolving quality of the schools that are associated with a particular house or changes in the cost of borrowing — we update our estimates of value. "The observed transaction price associated with the transfer of an asset's ownership thus will represent a market consensus resulting from negotiation between various individuals."[134]

This analysis glosses over important variables—such as differing tastes, preferences for risk, and time horizons—that might lead real-world prices to diverge between buyers, but these complications do not diminish the underlying insight. There is no objective truth about the nature of "value" that will ineluctably lead to a principled outcome on whether the debtor or the trustee should benefit from postpetition appreciation. Talking about postpetition changes in "value" is just to say price estimates have moved over time as new information emerged. There is no theoretical reason why the debtor or the creditors should benefit from what is essentially just the passage of time.

In the bankruptcy courtroom, the question of who benefits from postpetition appreciation is not a theoretical exercise but one with very practical consequences for debtors and creditors. Courts cannot throw up their hands at the conceptual impossibility of the task but must come up with a workable rule. For example, the Ninth Circuit has consistently ruled that postpetition appreciation accrues to the benefit of the bankruptcy estate and not the debtor.[135] But in one of these cases, the court indicated the result would be different if the debtor had exempted an asset in full.[136]

Although not the issue actually determined, the Supreme Court's decision in *Schwab v. Reilly* supports the idea that the debtor receives the benefit of appreciation in a fully exempted asset.[137] In *Schwab*, the debtor scheduled the value of exempt cooking equipment at the same amount that she had claimed

133 The discussion in the text draws on Robert M. Lawless & Stephen P. Ferris, *Economics & the Rhetoric of Valuation*, 5 J. Bankr. L. & Prac. 3 (1995); *see also* David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuation*, 41 Am. U. L. Rev. 63, 70 (1991) ("Value is a function of exchange. Since a bankruptcy judge will determine value without the benefit of an historical exchange, the judge is required to hypothesize one. The rules for this speculation have never been spelled out.").

134 Lawless & Ferris, *supra* note 133, at 12.

135 Wilson v. Rigby, 909 F.3d 306, 308-09 (9th Cir. 2018); Gebhart v. Gaughan (*In re* Gebhart), 621 F.3d 1206, 1211-12 (9th Cir. 2010); Alsberg v. Robertson (*In re* Alsberg), 68 F.3d 312, 314-15 (9th Cir. 1995); Hyman v. Plotkin (*In re* Hyman), 967 F.2d 1316, 1321 (9th Cir. 1992); Schwaber v. Reed (*In re* Reed), 940 F.2d 1317, 1323 (9th Cir. 1991); *In re* Vu (Vu v. Kendall), 245 B.R. 644, 647-48 (B.A.P. 9th Cir. 2000).

136 *See Reed*, 940 F.2d at 1323 ("No doubt Debtor's argument that appreciation enured to him would have merit if his entire interest in the residence had been set aside or abandoned to him; it was not.").

137 560 U.S. 770 (2010).

as exempt, although the actual market value of the property was more than the claimed exemption. Although the trustee did not object to the debtor's scheduled value, the Supreme Court held that the trustee was nonetheless entitled to the value of the property in excess of the amount listed in the debtor's schedules. However, in its discussion, the Court wrote that "[i]f an interested party fails to object within the time allowed, a claimed exemption will exclude the subject property from the estate even if the exemption's value exceeds what the Code permits."[138] Later, the Court indicated how an exemption of the "asset itself" might be claimed in practice and commented that if the debtor did so and the trustee did not object, "[T]he debtor will be entitled to exclude the *full value of the asset*."[139]

Recommendation. The Commission takes no position on whether the full or partial nature of a claim to an exemption determines who receives postpetition appreciation on the exempted asset. Apart from the doctrinal considerations, there are practical concerns about setting valuations as of the petition date — often called the "snapshot approach." Although valuations are easily asserted hypothetically, in the real world they are messy, fact-intensive affairs that courts must decide. In addition, real-world valuations must inevitably occur against the background of what later unfolded.

Rather than deal in abstractions, the Commission determined that the best approach would be directed at the practical reason disputes arise about who receives postpetition appreciation, and that reason is the inevitability that it takes time to administer a bankruptcy case. The longer a case lasts, the more likely it is that exempt assets will increase in value. Exempt assets also can decrease in value, but decreases in value only occur to the detriment of the debtor. Economists would refer to these concepts as the option value of the asset, an idea that captures the intuition that the longer the trustee can wait to see if the asset might increase in value, the more valuable the asset will be to the trustee.

For an effective fresh start, the debtor needs certainty that, at some point, an exempt asset and any appreciation in the asset are beyond the trustee's reach. The problem is a procedural one, not a problem of substantive valuations. The Commission thus turned to the need for a mechanism to force the trustee to act, instead of sitting by to see if an exempt asset will increase in value. The Bankruptcy Code already has such a mechanism: the power of the court under section 554(b) to compel an abandonment upon the motion of a party in interest. By moving to compel the trustee to abandon an asset, the debtor can force the trustee to decide sooner rather than later whether there is value in an asset claimed as exempt.

The Commission discussed how to make the existing abandonment mechanism more effective to deal with the problem of postpetition appreciation. Because most assets will not raise concerns about postpetition appreciation, an effective and balanced reform would give debtors a tool to use when needed but not burden trustees with the need to monitor all dockets and all assets at all times.

Therefore, the Commission first recommends that individual debtors should be able to file a motion to compel abandonment without paying a filing fee. The current filing fee for a motion to compel

138 *Id.* at 775-76.

139 *Id.* at 793 (emphasis added).

abandonment is $181.[140] This amount is over half of the $335 filing fee for filing a chapter 7 bankruptcy and can be a considerable sum in a consumer case, especially for matters where the dollar value of the asset in question is not very large. Removal of the filing fee for an appropriate motion to compel abandonment would thus remove a large impediment for many consumers when needed, but, because the consumer must take affirmative action and still pay their attorney if they have one, it would not unduly burden the trustee.

The Commission also recommends that the trustee's filing of a no-asset report be deemed an abandonment of any property the debtor scheduled under section 521(a)(1). (Thus, there would not be an abandonment of unscheduled property.) Any interested party would have 14 days to file an objection to abandonment and request a hearing. In addition, the notice for the section 341 meeting should put all parties on notice of the effect of the filing of the no-asset report.[141]

Eliminating the abandonment motion filing fee for individuals to file motions to compel abandonment and having the no-asset report serve as an abandonment are two reforms that work together to give debtors a tool to force a decision by the trustee whether to administer an asset. The Commission's recommendations may not solve the academic puzzle of postpetition value, but they provide a practical solution to make the issue less common in a consumer bankruptcy.

§ 1.08 Exemptions for Debtors Who Move States

(a) Section 522(b) of the Bankruptcy Code should provide that in the bankruptcy case of a debtor whose state of domicile changed during the 730 days preceding the bankruptcy filing —

(1) the exemption law of the debtor's current state of domicile applies, except that the amount of any homestead exemption in that law is capped by the amount of the homestead exemption in the debtor's applicable prior exemption law, and

(2) the applicable prior exemption law is that of the debtor's state of domicile for the greatest part of the 730 days preceding the filing of the bankruptcy case.

(b) If Congress does not amend the Bankruptcy Code consistent with the recommendation in subsection (a), courts should interpret the paragraph following section 522(b)(3)(C) to allow a debtor to elect the federal exemptions if the debtor is denied one or more exemptions otherwise available under the applicable state exemption law either because the debtor is not a resident of that state or because the exemptible property is not located in that state.

140 U.S. Courts, Bankruptcy Court Miscellaneous Fee Schedule, item 19 https://www.uscourts.gov/services-forms/fees/bankruptcy-court-miscellaneous-fee-schedule (last visited Jan. 9, 2019).

141 The Commission's proposal assumes that abandonment is irrevocable in the sense that the trustee could not attempt to revoke the abandonment later based on a higher sale price than anticipated. *See* Hardesty v. Haber (*In re* Haber), 2017 WL 1017731 (S.D. Ohio 2017) (trustee could not reopen case to capture a surplus on the sale of previously abandoned real estate), *aff'd,* Hardesty v. Haber (*In re* Haber), No. 17-3323 (6th Cir. Oct. 30, 2017).