The Housing Bubble and Consumer Bankruptcy (Parts III and IV)

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PART III. CHAPTER 13 (CONTINUED)

A. THE PRICE OF THE HOUSE[1]

Chapter 13 invites a debtor (*D*) to buy her house back from the bankruptcy estate in exchange for postpetition income. What is the price *D* must pay to buy the house along with the rest of the chapter 13 estate? There is a bipartite answer to this. First, *D* must pay the creditors at least what they would have received in a hypothetical chapter 7 liquidation.[2] This requirement goes under the name of "best interest of the creditors" test.

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[1] Part III picks up the narrative from Part II, which covered the fate of under-water mortgage lenders in chapter 13 cases, *See* David Gray Carlson, *The Housing Bubble and Consumer Bankruptcy (Parts I and II)*, 97 AM. BANKR. L.J. 395 (2023).

[2] 11 U.S.C. § 1325(a)(4). Unless otherwise noted all statutory references in the text of the article are to the United States Bankruptcy Code, 11 U.S.C. § 101, *et. seq.*

In making this purchase, *D* is granted some "scrip." *D* may offset the price owed for the house by the amount of any monetary exemption (*ME*) that D may claim. Judge Jeffrey Hughes put this colorfully (with respect to cars):

> Exempting property from the bankruptcy estate is in some ways like shopping at a warehouse outlet. For example, the debtor might want to purchase (*i.e.,* exempt) his car from the warehouse (*i.e.,* bankruptcy estate). If the trustee refuses to accept the exemption tendered and the court agrees, then the car stays in the warehouse. On the other hand, if the trustee accepts the tender, or if the trustee refuses but the court compels acceptance, then the debtor is allowed to drive the car home.[3]

Thus *ME* on the car is "funny money" which the chapter 13 trustee (T_{13}) is obliged to accept against the price of the car.

Once *ME* is applied and the amount of the home mortgage lien (*ML*) is accounted for, there may still be a surplus value in the house. *D* must pay sufficient future income such that the present value of the eventual payout equals the appraised amount of surplus.[4] That future payments must be reduced to present value follows from the appearance of the word "value" in § 1325(a)(4):

> the *value*, as of the effective date of the plan, *of property to be distributed under the plan* on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date.[5]

This is the first part of our bipartite answer as to the price *D* must pay for the house. The answer requires that we know the value of the house.

There is a second answer to the question of price. This second

[3] *In re* Brown, 375 B.R. 362, 371-72 (Bankr. D. Mich. 2007).

[4] *In re* Gillen, 568 B.R. 74, 79 (Bankr. C.D. Ill. 2017) ("The payment of interest is necessary to put the unsecured creditors in the same position they would have enjoyed in the hypothetical Chapter 7 liquidation").

[5] § 1325(a)(4) (emphasis added).

answer has nothing to do with the value of the house.[6] If *T* or any creditor objects to the plan, *D* must contribute all disposable income[7]--gross income minus expenses. The disposable income rule requires there to be a five-year plan for above-median debtors and a three-year plan if the debtor is below the state median for income.[8] The plan may be shorter if the creditors are paid in full in that shorter time.[9] For expositional convenience, we shall assume five years is the applicable commitment period.

Confirmation usually stands for the fact that *D* has "bought" the house on unsecured credit via the plan. Accordingly, *D* owns appreciation value, so long as that value is not cashed out by a sale. But if *D* sells, prior to the end of the five-year term, the sales proceeds should be (in part) considered disposable income. This means capital gain above a basis, which is set by the *ME*, plus capital improvements to the house, plus payments made under the plan to buy back debtor equity above *ML+ME*, plus payments made to reduce *ML*'s secured claim.

The realization of a capital gain does not mean the creditors automatically get it. The creditors are bound by the plan,[10] and the plan continues in force as written, so long as *D* makes the required plan payments. The plan stipulates the disposable income that *D* must pay, and so far the plan makes no reference to the fortuitous capital gain.

The unsecured creditors or *T* may move to modify the plan if *D* has received surplus disposable income over the stated plan amount.[11] We shall defer for a moment the calculation of the extent to which cash proceeds from the house constitute income. For the moment, we observe that not all the proceeds are income. From the proceeds there must be deducted a *basis*.

The concept of basis has not been worked out in the case law. But the existence of basis in determining income is implied. Consider this simple example. Suppose *D*'s house is valued at $100,000, where *ML* claims

[6] *In re* McGuire, Case No. 20-61183, 2022 Bankr. LEXIS 1778, at *15 (Bankr. N.D.N.Y. June 24, 2022) ("The two tests are not cumulative; rather, each test must be satisfied to achieve confirmation").

[7] § 1325(b)(1)(A).

[8] § 1325(b)(4)(A).

[9] § 1325(b)(4)(B). A below-median debtor must stay in the plan for three years but may request a longer term if needed to lower monthly payments. Black v. Leavitt (*In re* Black), 609 B.R. 518 (B.A.P. 9th Cir. 2019),

[10] § 1327(c).

[11] §§ 1127(e), 1329(a).

$80,000. *D*'s equity is $20,000. This *D* buys back from the chapter estate for a monetary exemption of $15,000 and future disposable income with a present value of $5,000. Suppose *D* is invited to live with her parents for free.[12] She sells the house for $20,000. The basic chapter 13 bargain is that *D* is not required to liquidate her prepetition property.[13] She is only required to pay disposable income. Therefore, she may keep the $20,000. It is not income. It is proceeds of property she is validly buying back (on credit) from the creditors. As long as *D* continues to make plan payments, she is not required to contribute former property of the chapter 13 estate to the creditors. Her duty is to pay disposable income from postpetition income.[14]

B. THE CREDITORS' RIGHT TO SURPLUS DISPOSABLE INCOME

The unsecured creditors can move to modify a chapter 13 plan to capture surplus disposable income above the amount stated in the plan.[15] This presupposes that the creditors find out about the house sale. How can they find this out?

D does have a duty to file an annual report about income,[16] but this

[12] Klein v. Anderson (*In re* Anderson), 613 B.R. 279 (B.A.P. 9th Cir. 2020) (D does not lose homestead by moving out postpetition).

[13] Willard v. Preuss (*In re* Willard), No. 21 Civ. 10220 (NSR), 2023 U.S. Dist. LEXIS 48994, at *7 (S.D.N.Y. Mar. 22, 2023); *See also* Hamilton v. Lanning, 560 U.S. 505, 508 (2010) ("Unlike debtors who file under Chapter 7 and must liquidate their nonexempt assets in order to pay creditors . . . , Chapter 13 debtors are permitted to keep their property, but they must agree to a court-approved plan under which they pay creditors out of their future income . . .").

[14] *In re* Marsh, 647 B.R. 725, 739 (Bankr. W.D. Mo. 2023).

[15] § 1329(a) ("At any time after confirmation of the plan but before completion of payments under such plan, the plan may be modified, upon request of the . . . trustee, or holder of an allowed secured claim, to--(1) increase the amount of payments on claim of a particular claim provided for by the plan . . . ").

[16] § 521(f) provides:

> At the request of the court, the United States trustee, or any party in interest in a case under chapter 7, 11, 13, a debtor who is an individual shall file with the court . . .
>
> (4) in a case under chapter 13--
>
> (A) on the date that is either 90 days after the end of such tax year or 1 year after the date of the commencement of the case, whichever is later, it a plan is not confirmed before such later date; and

reporting requirement may miss the house, where the sale is, say, a month after the report is submitted.

Some courts impose upon *D* additional reporting requirements. In *Standiferd v. United States (In re Standiferd)*,[17] a confirmation order imposed on *D* the obligation to "keep the trustee apprised of their postpetition financial condition."[18] Although the case did not involve the sale of a house, a sale would have to be reported, according to the terms of the confirmation order. In *Standiferd*, *D*'s chapter 13 case was dismissed for failing to obey a court order. In the converted chapter 7 case, failure to follow the disclosure order then became grounds to deny C a discharge.[19]

In *Cole v. Coastal Fed. Credit Union*,[20] the confirmation order provided *D* "shall not transfer any interest in real property without prior approval of the court."[21] The district court ruled that the court order was

> (B) annually after the plan is confirmed and until the case is closed, not later than the date that is 45 days before the anniversary of the confirmation of the plan;
>
> a statement, under penalty of perjury, of the income and expenditures of the debtor during the tax year of the debtor most recently concluded before such statement is filed under this paragraph, and of the monthly income of the debtor, that shows how income, expenditures, and monthly income are calculated.

See also § 521(g)(1):

> A statement referred to in subsection (f)(4) shall disclose—
> (A) the amount and sources of the income of the debtor;
> (B) the identity of any person responsible with the debtor for the support of any dependent of the debtor; and
> (C) the identity of any person who contributed, and the amount contributed, to the household in which the debtor resides.

[17] 641 F.3d 1209 (10th Cir. 2011).

[18] *Id.* at 1211.

[19] § 727(a)(6)(A) (no discharge if "the debtor has refused, in the case . . . to obey any lawful order of the court other than an order to respond to a material question or to testify").

[20] No. 5:20-CV-599-FL. 2022 U.S. Dist. LEXIS 39237 (E.D.N.C. February 9, 2022).

[21] This provision was inspired by that court's Local Bankruptcy Rule 4002-1(g)(4) ("After the filing of the petition and until the plan is completed, the debtor shall not dispose of any non-exempt property having a fair market value of more than $10,000 by sale or otherwise without prior approval of the trustee and an order of the court"). *See also In re* Fatsis, 396 B.R. 580, 582, 586 (Bankr. D. Mass. 2008), *aff'd*, 405 B.R. 1 (B.A.P. 1st Cir.

justified by Bankruptcy Code § 105(a), since the anti-alienation order aided *T* to recapture house proceeds pursuant to § 1329(a).

Is it legitimate for a court to supplement the Bankruptcy Code with court-made reporting requirements? Sections 1327(b) and (c) do seem to invite supplementing the plan with court orders involving vestment of assets in *D*[22] or the avoidance of creditor interests to property conveyed to *D*. This might be done over the opposition of *D*. After all, if *D* does not like these supplemental orders, *D* can use her right to convert the case to chapter 7 at will.[23] "To effectuate a conversion, a debtor need only file a notice with the bankruptcy court. No motion or court order is needed to render the conversion effective."[24] In the chapter 7 case, any property acquired by *D* after commencement of the case belongs to *D*, not to the chapter 7 trustee,[25] at least where *D* converts the case in good faith.[26] But § 1327(b) or (c) say nothing about adding reporting requirements. Reportage is not mentioned in § 1325(a) as a requirement for plan confirmation.

The Seventh Circuit, in *Petro v. Mishler*,[27] ruled that reporting requirements (and by implication anti-alienation orders) may not be added to a confirmation order. The court reasoned that the bankruptcy court was obliged to confirm a plan that complied with § 1325(a). Since § 1325(a) says nothing about extra reporting, a bankruptcy court could not add such requirements to the confirmation order.[28]

C. COURT APPROVAL OF SALE

2009) (confirmation order included an anti-vesting and anti-alienation provision).

[22] *In re* Kieta, 315 B.R. 192 (Bankr. D. Mass. 2004) (court unilaterally defers vesting and D does not appeal).

[23] § 1307(a) ("The debtor may convert a case under this chapter to a case under chapter 7 . . . at any time"). *Standiferd*, however, teaches that a *violation* of a disclosure requirement in a confirmation order is grounds to deny a discharge in the converted chapter 7 case. Standiferd v. United States (*In re* Standiferd), 641 F.3d 1209, 1215-16 (10th Cir. 2011).

[24] Harris v. Viegelahn, 575 U.S. 510, 514 (2015).

[25] § 348(f)(1).

[26] If *D* is in bad faith, postconfirmation property of the chapter 13 estate goes into the chapter 7 estate. § 348(f)(2).

[27] 276 F.3d 375 (7th Cir. 2002).

[28] *Id.* at 378 ("[[B]]y creating a finite list of affirmative requirements necessary for a plan's confirmation, we assume that Congress intended to exclude other requisites from being grated onto section 1325(a).").

Another way for creditors to find out about the impending sale and the accrual of disposable income is if *D* seeks court permission to sell the house. If *D* must have court permission to sell, *D* must notify the chapter 13 trustee in the motion pursuant to § 363(b). *T* is then in a position to counter-move to modify the plan and capture the income.[29]

But does *D* need court permission in order to sell? Prior to confirmation of the plan, *D* must clearly seek court approval to sell the house. According to Bankruptcy Code § 1303, *D* has the power to sell out of the ordinary course under § 363(b), but this requires court permission.

Once the plan is confirmed, however, *D* has bought the house. The house is no longer property of the estate.[30] According to § 1327(b): "Except as otherwise provided in the plan or order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor."[31] "Vest" is not a defined term. It is best interpreted as "transfer."[32] Thus, a plan *transfers* to *D* all of the estate's property (except the income that *D* gives back to the chapter 13 trustee). The bankruptcy estate has come to an end (except for the income actually paid to and in possession of T).[33] *D* no longer is licensee of the bankruptcy estate with regard to the house. *D* is the owner--a freeholder no longer in tutelage to the bankruptcy court. After confirmation, *D* can sell without court permission.[34] And if that is true, the creditors are hard pressed to find out about the impending sale.

Yet Bankruptcy Code § 1322(b)(9) invites the plan to delay vesting in the debtor.[35] Section 1327(b) provides that the chapter 13 estate mostly

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[29] Gamble v. Brown (*In re* Gamble), 168 F.3d 442 (11th Cir. 1999).

[30] Black v. U.S. Postal Serv. (*In re* Heath), 115 F.3d 521, 524 (7th Cir. 1997). ("[W]hile the filing of the petition for bankruptcy places all the property of the debtor in control of the bankruptcy court, the plan upon confirmation returns so much of that property to the debtor's control as is not necessary to the fulfillment of the plan . . ."); Sender v. Golden (*In re* Golden), 528 B.R. 803, 809 (Bankr. D. Colo. 2015) (but only proceeds existing at the time of conversion); *In re* Larzelere, 633 B.R. 677, 683 (Bankr. D.N.J. 2021).

[31] § 1327(b).

[32] *Golden*, 528 B.R. at 807; *In re* Van Stelle, 354 B.R. 157, 170 (Bankr. W.D. Mich. 2006); David Gray Carlson, *The Chapter 13 Estate and Its Discontents*, 17 AM. BANKR. INST. L. REV. 233, 242 (2009).

[33] *In re* Thompson, 142 B.R. 961, 964 (Bankr. D. Colo. 1992) ("property of the estate consists only of those funds actually paid to the Chapter 13 Trustee").

[34] *Golden,* 528 B.R. at 808.

[35] § 1322(b)(9). This provision states that a plan *may* provide for the vesting of property of the estate in *D*, implying that the plan may *prevent* such vesting.

vests in *D* after confirmation (income paid to *T* excepted). But it also says, "[e]xcept as otherwise provided in the plan or in the order confirming the plan . . . "[36] This suggests that a bankruptcy court may add a vesting delay to the confirmation order over the opposition of D.

Delay is sometimes invoked by *D*'s plan to extend the automatic stay past the time of confirmation.[37] Such a move guarantees that postpetition creditors may not reach debtor assets via postpetition money judgments. If § 1327(b) applied straight out, the automatic stay will have lapsed as to all property expelled from the automatic stay by means of § 1327(b).[38] But the cost of such a plan provision is that *D* must seek court permission to sell. That gives *T* the opportunity to recapture the capital gain in a modified plan.

Suppose *D* has sold without court permission, where permission is required because the house is still in the chapter 13 estate. A sale "out of trust" constitutes a reason to dismiss the case or convert to chapter 7.[39] We shall save for later what happens to the house proceeds in a converted chapter 7 case. For now, we note the dictum in *Brown v. Barclay (In re Brown)*,[40] that, in chapter 13, *T* could recover an unauthorized transfer.[41] The implication of *Brown* is the sale of the house is void. There is no "bona fide purchaser" rule in the Bankruptcy Code to protect a buyer from *D*. The buyer is most unwise to rely upon § 549(c), which constitutes a defense to § 549(a):

> the trustee may avoid a transfer of property of the estate-
>
> (1) that occurs after the commencement of the case;
>
> (2)(A) That is authorized under section 303(f)

[36] § 1327(b).

[37] *See, e.g.*, *In re* Frost, 744 F.3d 384 (5th Cir. 2014) , as described in Sender v. Golden (In re Golden), 528 B.R. 803, 813 (Bankr. D. Colo. 2015); *see also* Harris v. Viegelahn, 575 U.S. 510 (2015) (plan negated vestment, but the confirmation order negated the negation).

[38] *In re* Adams, Bankr. Case No. 19-14488ABA, 2022 Bankr. LEXIS 763 (Bankr. D.N.J. March 24, 2022).

[39] *In re* Brown, 953 F.3d 617 (9th Cir. 2020). Sale out of trust is not, however, one of the enumerated causes for conversion under § 1307(c). Section 1307(c) says that cause *includes* the enumerated items, so that infinite suitable causes are not enumerated.

[40] *Id.*

[41] *Id.* at 624 (chapter 13 trustee could recover wrongfully transferred property).

> or 542(c) . . . or
>
> (B) that is not authorized under this title or by the court.[42]

Section 549(a) is an *avoidance* section. It presumes that a person (other than *T*) actually has the power to make a transferee the owner free and clear of *T*. This occurs only rarely--under the circumstances described by § 303(f) and § 542(c). It may occur where *ML* has a senior foreclosure power by virtue of a prepetition mortgage.[43] Typically, sales without court approval are simply void. *T* may proceed to use, sell or lease the property (with court permission) as if the transfer never happened.

As a result, the defense of § 549(c) is *very* limited:

> (c) The trustee may not avoid under subsection (a) of this section a transfer of an interest in real property to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value unless a copy or notice of the petition was filed, where a transfer of an interest in such real property may be recorded to perfect such transfer, before such transfer is so perfected that a bona fide purchaser of such real property, against whom applicable law permits such transfer to be perfected, could not acquired an interest that is superior to such interest of such good faith purchaser . . . .

Where the sale is void, not voidable, the defense does not apply.[44] In chapter 13, if confirmation has not vested the house back to *D*, *D* has no power to convey the house free and clear of the chapter 13 estate.

[42] § 549(a).

[43] For example, suppose *D* conveys a recorded mortgage to *ML* for a contemporaneous loan and then files for bankruptcy. *T* has a junior judicial lien on *D*.s equity. § 544(a)(1), Under state law, *ML* can foreclose *T*. *T* must then avoid the otherwise valid transfer of *T*s property rights to the buyer. Confusingly, *ML* is in violation of the automatic stay. § 362(a)(4). By case law, courts are prepared to declare the foreclosure sale void, which renders § 549 avoidance superfluous. This contradiction is discussed in avid Gray Carlson, *Bankruptcy's Acephalous Moment: Postpetition Transfers Under the Bankruptcy Code*, 21 EMORY BANKR. DEV. J. 113, 128-31 (2004).

[44] *Id.* at 131-37.

As a result, anyone buying a house from a debtor in chapter 13 is well advised to insist the *D* get court permission to sell,[45] given the absolute chaos in the current understanding of the chapter 13 estate. B is wise to assume *D* has no power of sale. If *D* then accedes to this request, *T* can swoop in and countermove to modify the plan to capture a least some of the appreciation value.

Even if *D* need not move to sell the house (triggering a modification "counterclaim" by T), *D* typically pays *ML* when *D* receives proceeds from the buyer. If *D* is paying *ML* under the plan (as opposed to "outside the plan"),[46] *D* will have to modify the plan to prevent *T* from double-paying *ML*.[47] When *D* makes such a modification request, *T* will be in a position to counterclaim for the capital gain.[48]

D. TIME LIMITS ON MODIFICATION

If *D* has realized a profit from an actual sale, *D* has the duty to pay any capital gain to *T* for the benefit of the unsecured creditors. *T* must, however, move for plan modification.

May *D* flummox *T* by using some of the house proceeds to pay the plan amount early? Section 1329(a) requires *T* to request modification "before the completion of payment under the plan."[49] If, however, *D* has tendered and *T* has accepted early payment, the payments are completed even though the plan is not. Plausibly, it is too late for *T* to request modification, and *D* gets to keep appreciation value free and clear of the creditors. Some courts grant to *D* the right to prepay, thereby choking off *T*'s ability to capture appreciation.[50] Other courts think that *D* is not

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[45] These are called "comfort orders." *In re* Zavala, 366 B.R. 643, 648 n.4 (Bankr. W.D. Tex. 2007).

[46] Gordon Bermant & Jean Braucher, *Making Post-Petition Mortgage Payments Inside Chapter 13 Plans: Facts, Law, Policy*, 80 AM. BANKR. L.J. 261 (2006).

[47] According to § 1329(a)(3), a plan may be modified to "alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan."

[48] *In re* Baker, 620 B.R. 655, 659 (Bankr. D. Colo. 2020).

[49] § 1329(a).

[50] Bayshore Nat'l Bank v. Smith (*In re* Smith), 252 B.R. 107 (E.D. Tex. 2000); *In re* Brumm, 344 B.R. 795, 797 (Bankr. N.D.W. Va. 2006); *In re* Forte, 341 B.R. 859 (Bankr. N.D. Ill. 2005). The *Brumm* court offered reasons why payment in advance was not a modification of the plan: (1) The substance of the plan that the "trustee and unsecured

privileged to prepay.[51] *D* must seek court approval because modification consists of "extend[[ing]] or reduc[[ing]] the time for such payments."[52] Where *D* must request the right to prepay, *T* is in a position to counterclaim for modification.

Suppose, however, that *D* sells in the waning months of the five-year plan. *T* finds out and moves to compel *D* to pay the gain to *T*. May the court order *D* to pay? Section 1329(c) provides a restriction. According to § 1329(c):

> A plan modified under this section may not provide for payments over a period that expires after the applicable commitment period under section 1325(b)(1)(B) after the time that the first payment under *the original confirmed plan* was due, unless the court, for cause, approves a longer period, but the court may not approve a period that expires after five years after such time.[53]

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creditors bargained for at confirmation is unchanged." (Query whether chapter 13 plans are "bargains," however. A court could confirm a qualifying plan over the unanimous opposition of the creditors.) (2) Not every minor, formal-not-substantive change is a modification; otherwise, the court would be awash in motions. (3) The trustee has no vested right to preserve an opportunity to move to modify in the future. (Motions to modify must be made "before the completion of payments under the plan." § 1329(a). (4) the unsecured creditors have no right to appreciation value of the debtor's post-confirmation property. (5) Borrowing funds is never income; selling assets is. (6) The debtor has a right to advantage herself by refinancing at a lower rate. (7) The amount of appreciation was not a substantial change in the debtor's financial situation. *Brumm,* 344 B.R. at 801.

[51] Berkley v. Burchard (*In re* Berkley), 613 B.R. 547, 552 (B.A.P. 9th Cir. 2020) ("[[U]]nless the debtor successfully modifies the plan to shorten its duration, the debtor is exposed to the possibility of continuing to commit his income and property even in excess of the original amount provided for under the plan."); Black v. Leavitt (*In re* Black), 609 B.R. 518 (B.A.P. 9th Cir. 2019); *In re* Niday, 498 B.R. 83, 88 (Bankr. W.D. Va. 2013); *see* Danielson v. Flores (*In re* Flores), 735 F.3d 855 (9th Cir. 2013) (en banc) (a zero payment plan must still have a mandatory three- or five-year duration to give teeth to T's right to modify).

[52] § 1329(a)(2).

[53] § 1329(c) (emphasis added). In Christensen v. Black (*In re* Black), 292 B.R. 693, 701-02 (B.A.P. 10th Cir. 2003), an appellate panel put a halt on a Utah practice whereby, if the modification order proclaimed that the first payment (and subsequent payments) were "deemed" to be made at a later date, the five year period would start to run at the later date. Said the diplomatic *Black* panel: "Perhaps the courts have simply overlooked the word

"The time limitation [[under § 1322(d)(1)]] was designed to avoid imposing a form of long-term involuntary servitude upon chapter 13 debtors."[54]

Let us consider the following scenario to test out the time limits. Suppose the fifth year expires on July 1[55] and *D* makes her last payment to *T*.[56] One month earlier, *D* had sold for a whopping profit. *T* discovers this fact and moves on June 20 to compel *D* to pay. In order to capture income from *D,* must the court sign the modification order on or before July 1?

There are two schools of thought on this issue. According to the first school,[57] moving to modify on June 20 does not lock in *T*'s entitlement to an eventual modification order. Section 1329(a) states: "At any time after confirmation of the plan but before completion of payments under the plan, the plan may be modified, upon *request* of . . . the trustee . . . "[58] This phrase suggests that *T* must *request* modification, and the plan is not actually modified until a bankruptcy court says so. Accordingly, on July 1, the plan is complete if *D* is current on the scheduled payments. *D* is entitled to a discharge and may keep the realized gain for himself, unless the court has signed the modification order on or prior to July 1.

Even if the court rules on, say, June 30, the court may not approve a modification that requires *D* to pay after July 1. Presumably, however, the court on June 30 could order, "Pay by midnight today." *D* may not be able to marshall the funds by then. Still, if *D* wants a discharge under § 1328(a), *D* will have to complete the payment.

In addition, at least one court has ruled that, where *D* has been cagey

'original'" in §1329(c). *Id.* at 699.

[54] *In re* Albert, 634 B.R. 380, 383-84 (Bankr. D. Colo. 2021).

[55] Courts are divided on when the five-year maximum period runs out, because *D* is required to make plan payments even before confirmation. § 1326(a)1) ("the debtor shall commence making payments not later than 30 days after the date of the filing of the plan or the order for relief, whichever is earlier . . . "). Some courts think that the five years starts to run on the first day a payment is made. Profit v. Savage (*in re* Profit), 283 B.R. 567, 575 (B.A.P. 9th Cir. 2002); *In re* Humes, 579 B.R. 557, 560-61 (Bankr. D. Colo.2018); Baxter v. Evans (*In re* Evans), 183 B.R. 331, 332-33 (Bankr. S.D. Ga. 1995). Others think it starts on confirmation day. West v. Costen, 827 F.2d 1376, 1378 (4th Cir. 1987).

[56] At this point, it is too late for *T* to move to modify. *In re* Stanke, 638 B.R. 571, 576 (Bankr. N.D. Tex. 2022).

[57] *In re* Profit, 283 B.R. 567, 570 (B.A.P. 9th Cir. 2002).

[58] § 1329(a) (emphasis added).

in failing to disclose the house sale, the deadlines in § 1329(a) are "equitably tolled."[59] Thus, where *D* had a duty to report (which is a question), a breach of duty suspends the time limits in § 1329(a) to give *T* a fair opportunity to move for modification.

The second school of thought won the day in *Meza v, Truman (In re Meza)*.[60] According to the Fifth Circuit, when *T* files her motion to modify on June 20, *T* has unilaterally modified the plan. On June 20, the plan becomes *D*'s obligation to pay in the capital gain. According to § 1329(b)(2), "The plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved."[61] This suggests that modification occurs if the court does nothing. The court may *cancel* the modification but need not approve it for it to be effective. If so, *D* is obligated to pay in the June 20 house proceeds in order to obtain the discharge. This was the implication in *Meza*. There, *D* realized some surplus disposable income. *T* moved to modify. *D* rushed a payment of the outstanding plan amount, claiming that this made *T*'s motion too late. The *Meza* court found that *T*'s motion was timely:

> Section 1329(a) provides that a plan may be modified "upon request" and "before the collection of payments;" but § 1329(b)(2) provides that the modified plan "*becomes the plan*" unless, after notice and a hearing, such modification is disapproved." (Emphasis added). Read together, both subsections show that, when a modification request is timely filed, the completion of the plan and eventual discharge of the debtor is stayed until the bankruptcy court is allowed to consider the modification on its merits A contrary result would encourage gamesmanship on behalf of debtors and prevent them from repaying creditors "to the extent of ⟦their⟧ capabilit⟦ie⟧s."[62]

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[59] *In re* Zavala, 366 B.R. 643, 651 (Bankr. W.D. Tex. 2007).

[60] 467 F.3d 874 (5th Cir. 2006).

[61] § 1329(b)(2).

[62] *Id.* at 880, citing *In re* Arnold, 869 F.2d 240, 242 (4th Cir. 1989). Does *Meza* speak to *D*'s ability to prepay *before* *T* moves to modify? Presumably not, since that would give *D* the opportunity for mischief, which was a key motive for the court's direct ruling that, once *T* has moved, prepayment does not choke off modification.

Thus, the modification "requested" by *T is* the plan when the request is made, and *D* is on the hook for the capital gain.[63] True, *D* had to pay after the five-year period. But the plan itself will not have required payments beyond the five-year term.

What if on July 2 *D* has not yet paid and *T* then moves to modify? The motion is timely under § 1329(a) because the motion was "before the completion of payments under such plan."[64] According to § 1329(c), *T* may not modify to provide for a payment after an applicable commitment period unless the court approves. Such a modification, proposed after the commitment period, is not self-executing, unlike the modification in *Meza*, since a court must approve the modification. But "the court may not approve a period that expires after five years after such time." A modification requested on July 2 of necessity says, "Pay now." But this extends the commitment period beyond five years and so the court may not approve it.[65]

Even so, an unpleasant surprise awaits *D*, if *D* thinks he has kept the house proceeds away from the creditors. *D* is two days late in paying the plan amount. Suppose *D* tenders late payment. *T*, having just found she has been flummoxed out of the house proceeds, refuses to accept payment and moves to dismiss the case for failure to make timely payments. The court can dismiss the case for lateness if it is willing to find a "material default by the debtor with respect to a term of a confirmed plan."[66] If the case is dismissed, *D* is without a discharge. The house proceeds can then be reached by creditors under state law. All was for naught.

At least in the Third Circuit, *D* is at the mercy of the court. If the court finds that the lateness was minor and not a serious breach, the court can refuse to dismiss and can also order *T* to accept the late payment, in

[63] Germeraad v. Powers, 826 F.3d 962, 968 (7th Cir. 2016) ("If we vacated the bankruptcy court's disallowance of the trustee's proposed modification, then by operation of § 1329(b)(2), the trustee's modified plan would 'become []the plan.' The modified plan would then 'provide' that the debtors must make increased payments . . . "); *see also In re* Baxter, 569 B.R. 153, 154 (Bankr. E.D. Mich. 2017) ("If a proposed plan modification is filed and served before a debtor completes her payments under the confirmed plan, but a timely objection to the modification is filed and not ruled on until after the completion of such payments, does the above phrase in § 1329(a) mean that the modification is untimely? The Court concludes that the answer to this question is "no.").

[64] § 1329(a).

[65] Derham-Burk v. Mrdutt (*In re* Mrdutt), 600 B.R. 72, 83 (B.A.P. 9th Cir. 2019).

[66] § 1307(c)(6).

which case *D* is entitled to a discharge under § 1328(a): "⟦A⟧s soon as practicable after completion by the debtor *under the plan* . . . the court shall grant the debtor a discharge of all debts provided for by the plan . . . "[67] Said the court in *Klaas v. Shivlin (In re Klaas)*,[68] "bankruptcy court retains discretion under the Bankruptcy Code to grant a reasonable grace period for debtors to cure an arrearage . . . "[69] But where *T* appears in court to accuse *D* of hiding a big capital gain, will a court use its discretion to permit a late cure? *D* is well advised to show up at *T*'s office on July 1 with a certified check, because lateness could be fatal.

The situation is worse in the Tenth Circuit, where a bankruptcy court has no discretion at all to authorize a late cure. Rather, *D* is absolutely disentitled to a discharge and so stands to lose the house proceeds. In *Kinney v. HSBC Bank USA, N.A. (In re Kinney)*,[70] the court seized upon the emphasized words from § 1328(a) and ruled that late payments are not "*under the plan*."[71] So *D* gets no discharge, even if the lateness is not material. When *D* is sitting on proceeds from the capital gain, *D* had better make the last plan payment on time.[72]

But even then *D* is not free from risk. According to § 1327(e):

> On request of a party in interest before one year after a discharge under this section is granted, and after a notice and a hearing, the court may revoke such discharge only if--
>
> (1) such discharge was obtained by the debtor through fraud; and
>
> (2) the requesting party did not know of such

[67] § 1328(a) (emphasis added). To this subsection is appended a long list of claims that cannot be discharged, such as debts incurred from fraud and student loans.

[68] 858 F.3d 820 (3d Cir. 2017).

[69] *Id.* at 827.

[70] 5 F.4th 1136 (10th Cir. 2021).

[71] *Id.* at 1139 (referring to § 1328(a) (emphasis added)).

[72] Covid came to the rescue in *In re* Albert, 634 B.R. 380 (Bankr. D. Colo. 2021). In 2020, Congress added new § 1329(d)(1) to the Bankruptcy Code, permitting *D* to request an extension of time to seven years if *D* "is experiencing or has experienced a material financial hardship due, directly of indirectly to the coronavirus disease 2019 (COVID-19) pandemic." The court in *Albert* extended the five-year period so that *D* could make the final payment. This section lapsed on March 27, 2022, however. COVID Extension Act, Pub, L, 117-5, 135 State. 249 (March 27, 2021).

> fraud until after such discharge was granted.[73]

Thus, if *T* finds out about the capital gain after discharge, and if failing to disclose the sale is a fraud (which is a question), *T* can have the discharge revoked. The case can be dismissed or converted, and *D* possibly loses the capital gain after all. The lesson here is that when *D* timely finishes paying under the plan, *D* should advertise the capital gain. If *T* and the creditors know of the capital gain before the discharge, these parties in interest cannot revoke the discharge. They knew too much too soon. Nor can they *oppose* the discharge. In chapter 7, fraud and failure to obey orders is grounds to deny a discharge.[74] But the chapter 13 rule is different; § 1328(a) says "the court shall grant the debtor a discharge" upon "completion by the debtor of all payments under the plan." Fraud discovered after the discharge is grounds to revoke the discharge, but fraud discovered before the discharge is not grounds to prevent the discharge. Strange but true! To quote Judge Elizabeth Brown: "Did Congress not realize that it was creating this wide window of opportunity for mischief?"[75] Obviously not. But Congress is the master, and the master must be obeyed.[76]

E. PROJECTED DISPOSABLE INCOME

Section 1325(b) requires that *projected* disposable income be paid pursuant to the chapter 13 plan:

> If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may

[73] § 1327(e).

[74] § 707(a).

[75] *In re* Frank, 638 B.R. 463, 468 (Bankr. D. Colo. 2022).

[76] The secret lesson of positivist jurisprudence turns out to be--"The master is an idiot." David Gray Carlson, *Hart avec Kant: On The Inseparability of Law and Morality*, 1 WASH. U. J. JURIS. 21, 86 (2009), quoting JEANNE LORRAINE SCHROEDER, THE FOUR LACANIAN DISCOURSES, OR TURNING LAW INSIDE-OUT 39 (2008); *see also* Renata Salecl, *Deference to the Great Other: The Discourse of Education*, in LACANIAN THEORY OF DISCOURSE: SUBJECT, STRUCTURE AND SOCIETY 163 (Mark Bracher ed. 1994) ("Law must be obeyed *because it is law* and not because there are good reasons to obey it").

> not approve the plan, unless, as of the effective date of the plan--
>
> . . .
>
> > (B) the plan provides that all of the debtor's *projected* disposable income to be received in the applicable commitment period . . . is due under the plan will be applied to make payments to unsecured creditors under the plan.[77]

Projected disposable income is a figure stated in the plan itself. Thus, § 1322(a)(1) requires that the plan "provide for the submission of all or such portion of *future* earnings or other *future* income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan."[78] If *D* has earned disposable income prior to confirmation, this *D* need not pay to *T* because *D*'s obligation is to pay *future* (post-confirmation) income not yet realized.

One is tempted to conclude that where, after a plan is confirmed, *D* sells a house and actually has the proceeds, this is not *projected* income. It is past income, which the plan does not require to be paid. The argument is that the plan does not actually require payment of *all* disposable income to *T*. It requires payment of some stated amount. Beyond that, *D* may keep the house proceeds, according to this misconception, because the plan does not require these proceeds to be paid.

Further continuing with this incorrect view, if *T* discovers that *D* has sold the house and has realized a capital gain, it is too late for *T* to modify the plan. The plan can only affect income going forward. The plan may not be modified to capture disposable income already realized.

In support of this view is § 1325(b)(2), a BAPCPA provision which, unfortunately for home owners, the Supreme Court has effectively deleted from the Bankruptcy Code. According to § 1325(b)(2): "For purposes of this subsection, the term "disposable income" means current monthly income received by the debtor ⟦less expenses⟧."[79] "Current monthly income" is defined in § 101(10A) as

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[77] § 1325(b) (emphasis added).
[78] § 1322(a)(1) (emphasis added).
[79] § 1325(b) (2).

> the average monthly income from all sources that the debtor receives . . . without regard to whether such income is taxable income, derived during the 6-month period ending on
>
> > (1) the last day of the calendar month immediately preceding the date of the commencement of the case if the debtor files the schedule of current income required by section 521(a)(1)(B)(ii) . . .[80]

Thus, disposable income is to be calculated using the historic record of earnings in the six month period *prior* to bankruptcy.[81] Since *D* has sold the house after the commencement of the chapter 13 case, the realized capital gain cannot be disposable income.

The Supreme Court, however, has ruled that this definition in § 1325(b)(2) contradicts the notion of *projected* disposable income in §1325(b)(1). In *Hamilton v. Lanning*,[82] *D* had received a one-time bonus in the six month look-back period prior to bankruptcy and therefore had high disposable income. But, looking forward, *D* had low *projected* disposable income. The Supreme Court ruled that the term "projected" canceled out the statutory definition of disposable income, which is based on actual prepetition history.[83]

Since disposable income requires that we look forward, not backward, it may seem as if a realized gain before a modification belongs to *D* alone. Once *D* gets his hands on the cash, the cash is not *projected* disposable income. This view should be rejected. If *D* sells the house and pockets the proceeds, the creditors may require *D* to cough up such part of the proceeds as constitutes the capital gain.

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[80] § 101(10A).

[81] "'Current monthly income,' in turn, is calculated by averaging the debtor's monthly income during what the parties refer to as the 6-month look-back period, which generally consists of the six full months preceding the filing of the bankruptcy petition." Hamilton v. Lanning, 560 U.S. 505, 510 (2010).

[82] *Id.*

[83] Justice Alito colorfully observes: "On the night of an election, experts do not 'project' the percentage of the votes that a candidate will receive by simply assuming that the candidate will get the same percentage as he or she won in the first few reporting precincts." *Id.* at 513-14.

In justification of this correct view, note that § 1329(b)(1) requires the modification to conform to certain designated provisions of chapter 13:

> Sections 1322(a), 1322(b), and 1323(c) of this title and the requirements of section 1325(a) of this title apply to any modification under subsection (a) of this section.[84]

Conspicuously absent is a reference to § 1325(b)(1)(B)--the place where chapter 13 refers to *projected* disposable income.[85] Therefore, *T* may move to modify to "increase . . . the amount of payments on claims . . . provided for by the plan . . . "[86] *T* may insist that yesterday's realized gain be paid to *T* for the benefit of the claims provided for in the plan.

In general, courts assume that excess disposable income *can*, after the fact, be captured upon motion of the trustee.[87] Where does this duty come from, if not from § 1325(b)? An alternative source for the duty is that a modification must meet "the requirements of section 1325(a)."[88] One of the requirements in § 1325(a) is that "the plan has been proposed in good faith."[89]

> Prior to 1984, good faith of the debtor was taken to mean "best efforts" to pay. And this in turn meant dedication of all disposable income, even beyond the minimum required by § 1325(a)(4)--the "best interest of the creditors" test. In 1984, however, § 1325(b)(1)(B) was enacted in order to codify the best efforts test of good faith. This implies that, where § 1325(b)(1) is applicable, good faith does *not* also mean the application of all disposable income. But where § 1325(b)(1) does *not* apply, good faith means what it meant before 1984--application of all disposable income to the plan. This is the principle that binds the debtor to surrender all surplus

[84] § 1329(a)(1).

[85] *In re* Sunahara, 326 B.R. 768, 781 (B.A.P. 9th Cir. 2005).

[86] § 1329(a)(1).

[87] *In re* Midgley, 2009 Bankr. LEXIS 22 (Bankr. D. Ore. 2009); *In re* Brown, 332 B.R. 562 (Bankr. N.D. Ill. 2005).

[88] § 1329(b)(1).

[89] § 1325(a)(3).

income in modifications.[90]

A related argument emphasizes that *D* owes *income* only. According to *McDonald v. Burgie (In re Burgie)*,[91] *income* means a stream of revenue.[92] It excludes lump sums. Therefore, *T* cannot capture any part of realized house proceeds, which usually come in the form of a lump sum payment.[93] Significantly, the court assumes the plan modifications are governed by § 1325(b), which, as we have seen, is not the case. This definition of income, it seems to me, wrongly echoes a chapter 13 eligbility requirement, which allows "[o]nly an individual with regular income . . . "[94] Regularity of income is the ticket for entering chapter 13, but "best efforts" to pay (but honoring the anti-liquidation bargain) is the hallmark for modifying chapter 13 plans.

Where *D* chooses for some reason to seek a modification, the bankruptcy court is in a position to hold *D* up in order to extract unpaid disposable income. In *In re Martin*,[95] the debtor wanted to change the time of payment by paying in one lump sum the amount due under the plan.[96] The court first required a statement of total disposable income received above and beyond what was paid to the trustee. In effect, the court conditioned approval of D's motion on the fulfillment of a duty to surrender disposable income not called for in the original plan. Of course, such a hold-up requires D to make a motion. Where D makes no motion to modify, there is no mechanism to trigger the fulfillment of such a duty.[97]

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[90] David Gray Carlson, *Modified Plans of Reorganization and the Basic Chapter 13 Bargain*, 83 AM. BANKR. L.J. 585, 616 (2009).

[91] 239 B.R. 406 (B.A.P. 9th Cir. 1999); *accord*, *In re* Smith, 514 B.R. 464 (Bankr. N.D. Tex. 2014) (chapter 12).

[92] *Id.* at 410 ("The test is whether the asset in question is an anticipated stream of payments").

[93] *Accord*, Black v. Leavitt (*In re* Black), 609 B.R. 518, 526-27 (B.A.P. 9th Cir. 2019). On this argument, if *D* wins the lottery in the post-confirmation period and takes payment as a lump sum, the unsecured creditors cannot claim any part of the largesse. But if *D* chooses periodic payments, as many lotteries offer, the creditors can get it. Carlson, *Bargain*, *supra* note 92, at 607-08.

[94] § 109(e).

[95] 232 B.R. 29 (Bankr. D. Mass. 1999).

[96] Not all courts think that a modification motion is necessary for the debtor's prepayment. *See supra* text accompanying notes 48-52.

[97] New § 521(f)(3) requires the debtor to file an annual report on disposable income. This report might then alert the unsecured creditors or the chapter 13 trustee to make a motion. *See supra* text accompanying notes 16-17.

The grounding of D's duty to pay surplus disposable income in the good faith requirement functions when D moves to modify. What if the unsecured creditors move to modify over D's opposition? D's good faith is a requirement for *confirmation*. If anything, as applied to a creditor's motion to modify, § 1325(a)(3) requires that the moving *creditor* be in good faith; *D's* bad faith can hardly be a reason to deny a *creditor's* motion to modify. How is it that, when the creditor makes the motion, D is obliged to give all disposable income? An answer has been inferred. After 1984, the chapter 13 trustee or any unsecured creditor has standing to modify. That creditors have standing to insist on increased payments must mean *something*.[98] So it follows that a valid purpose of modification by *T* is to increase payments by *D*. The basic chapter 13 bargain implies that creditors cannot force D to liquidate assets in chapter 13 proceedings. Ergo, by apagogic reasoning (*i.e.*, process of elimination), creditors must be able to force debtors to dedicate *all* disposable income to the plan--not just the disposable income seen from the perspective of confirmation day. Therefore, when there is surplus disposable income above plan amounts, the creditors are entitled to seek an increase of payments.[99]

Some trustees are nervous about unmooring the obligation to pay surplus disposable income from *D*'s good faith in proposing confirmation of a plan. They have on occasion not moved to modify but to compel *D* to modify.[100] When *D* modifies, *D* has a good faith duty and *D* is obligated to pay the surplus disposable income. But this compulsion of *D* to make the modification is not strictly necessary. *T* can move to modify because *D* generally has the duty to pay surplus post-confirmation disposable income.

[98] Germeraad v. Powers, 826 F.3d 962, 971 (7th Cir. 2016) ("[T]he legislative history relating to the 1984 amendments . . . supports the conclusion that plan modification is permitted when a change in the debtor's income makes increased payments affordable."); *In re* Self, 2009 Bankr. LEXIS 2880, at *15 (Bankr. D. Kan. September 11, 2009) ("There are few reasons that an unsecured creditor . . . would seek plan modification other than to request an increase in plan payments from disposable income.").

[99] *Germeraad*, 826 F.3d at 974 (7th Cir. 2016) ("Although it is true . . . that no provision of the Code expressly permits modification when a change in the debtor's financial circumstances makes an increase in payments affordable, it does not follow that modification for this reason is forbidden. Indeed, the Code does not contain *any* provision that expressly identifies the grounds on which a trustee or an unsecured creditor may modify a plan"),

[100] *In re* Kieta, 315 B.R. 192 (Bankr. D. Mass. 2004).

Many courts order *D* to pay house proceeds to *T* but do not expressly limit the payment to realized capital gain. Nevertheless, *D* should not have to forfeit all the proceeds of the house. *D* should be liable only for the capital gain. Why should *D* have to pay if *D* lost money on the transaction? Making *D* pay under those circumstances amounts to forcing *D* to liquidate capital to pay the creditors. The basic chapter 13 bargain is that *D* pays disposable income and gets to keep capital. Capital here means the bankruptcy estate as it existed on the effective date of the plan.

One appellate case clearly indicates that house proceeds are due and owing only if the proceeds constitute income. *Murphy v. O'Donnell (In re Murphy)*[101] is the consolidated appeal of two different debtors who looked to realize on tremendous appreciation value. D_1 sold his house and D_2 borrowed on it from *ML* in exchange for a mortgage.

Before we look at this case, we need a few more words on modifications under § 1329(a). Some courts have worried that, particularly where *T* failed to object to application of § 1325(a)(4) at the confirmation hearing, *T* could get a second chance by seeking a modification which would require a do-over of the § 1325(a)(4) test as of the day of modification.[102] The better answer is that the § 1325(a)(4) test is *never* recalculated in a modification. Section 1325(a)(4) requires a valuation on the effective date of the plan, not on the effective date of the modification. Rather than adhere to such a rule--no do-overs!--courts began to block modification requests by insisting that *T* show *D* had undergone a substantial and unanticipated change in post-confirmation financial condition. Otherwise, *res judicata* protected *D* from modification. The problem is that "substantial change of circumstance" is nowhere mentioned in the statute. Therefore, many courts hold that, at least when *D* sponsors the modification, *D* need not show

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[101] 474 F.3d 143 (4th Cir. 2007).

[102] An example of the distortion that do-overs can cause is *In re* Wright, Case No. 19-21544, 2022 Bankr. LEXIS 3520 (Bankr. D. Kan., Dec. 13, 2022), where *D* filed in chapter 13 and did not disclose ownership of a beneficial interest in a trust. A plan was confirmed. Failure to disclose was a fraud, which justifies revocation of the order of confirmation—if a party in interest moved to revoke within 180 days. § 1330(a). *T* later moved to modify the plan to capture the undisclosed asset for the unsecured creditors. *T* argued (and the court agreed) that a re-do of § 1325(a)(4) required *D* to pay more to the unsecured creditors, even though *D*'s disposable income had not increased. In fact, *T*'s sole remedy was revocation under § 1330(a), which was too late. The do-over permitted the court to write the time limit on revocation out of the Bankruptcy Code.

changed circumstances.[103]

The court in *In re Murphy*[104] assumed, however, that, when *T* moved to modify against D_1 to capture house proceeds, *T* had to show changed circumstances. Realization of "a substantial amount of readily available cash without any debt"[105] constituted a substantial improvement in financial condition. Furthermore, the appreciation value was unanticipated. In the two years since confirmation, housing prices had increased up to 13 percent a year. In two years, the parties should have anticipated up to a 25 percent increase in value. But D_1 had enjoyed a 51.6 percent increase--"an unanticipated change given the current market trends.[106] This is, however, poor financial economics. Value constitutes a weighted average of future outcomes. The fact that prices might increase by 51.6 percent is already included in the probability distribution that market value represents. Therefore, a valuation anticipates *any* future result. If we knew prices were going up 25 percent in two years, market price would be higher today. In any case, the statute nowhere mentions unanticipated change. Properly, this is no impediment to *T*'s right to modify. It suffices that D_1 has realized surplus disposable income.

In D_2's case, *T* could not modify:

> Thus, even when one considers that ⟦D_2's⟧ residence appreciated in value post-confirmation, at most, they simply received a large loan in place of a small one. By any stretch, a loan, regardless of size, is not income. The apparent increase in their balance sheet was offset by the amount of the loan, resting in virtually no change to their financial condition. . . . Under the doctrine of *res judicata*, there being no substantial change to ⟦D_2's⟧ financial condition, the cash-out refinancing cannot provide a basis for modifying ⟦D_2's⟧ plan pursuant to §§ 1329(a)(1) or (a)(2).[107]

[103] Whaley v. Guillen (*In re* Guillen), 972 F.3d 1221 (11th Cir. 2020); *In re* Meza, 467 F.3d 874, 877-78 (5th Cir. 2006); Barbosa v. Soloman, 235 F.3d 31, 28-41 (1st Cir. 2000); *In re* Witkowski, 16 F.3d 739, 742-46 (7th Cir. 1994).

[104] 474 F.3d 143 (4th Cir. 2007).

[105] *Id.* at 152.

[106] *Id.*

[107] *Id.* at 150.

Since borrowing is not income, *T* had no access to loan proceeds.

This leaves the matter in an unsatisfactory situation. If *D* takes cash by borrowing on equity, *T* has no complaint because loan proceeds are not income. If *D* sells, *T* gets the proceeds to the extent of the capital gain. Obviously, *D* has an incentive to dull husbandry by borrowing, in order to avoid realizing a capital gain.

Some courts think that house proceeds are *never* income, and *D* may keep appreciation value over opposition of the creditors. In *In re Baker*,[108] Judge Elizabeth Brown held that if *D* sells after confirmation day, *D* may keep all of the proceeds, including that part which constitutes a capital gain.[109] In the course of so ruling, Judge Brown makes compelling points about the nature of the chapter 13 estate. According to Judge Brown, the chapter 13 estate includes anything *D* has acquired before confirmation. Upon confirmation, the chapter 13 estate ends, because the estate is vested in *D* by virtue of § 1327(b). Therefore, proceeds received after confirmation are not property of the chapter 13 estate--which so far seems quite correct.

To reach this *entrepôt*, Judge Brown had to dispatch a bizarre theory of the chapter 13 estate--the so-called replenishment theory. This theory arises from a cogitation upon the conflict of § 1306(a) and § 1327(b). Under § 1306(a), the chapter 13 estate includes "all property of the kind specified in ⟦§ 541⟧ that the debtor acquires after the commencement of the case but before the case is closed, dismissed or converted . . . "[110] This contradicts § 1327(b), which holds that "⟦e⟧xcept as otherwise provided in the plan or order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor."[111] Since confirmation always occurs before closure and perhaps before dismissal or conversion, the two sections contradict each other. The solution is that § 1306(a) ceases to apply to property of the chapter 13 estate that exists on confirmation day. But it continues to apply to after-acquired property obtained after that. Thus, the chapter 13 estate is transferred to *D* but thereafter the chapter 13 estate is "replenished" when *D* after-acquires property.[112] This position is used to capture inheritances obtained after confirmation. Replenishment, however,

[108] *Id.*
[109] *Accord In re* Black, 609 B.R. 518 (B.A.P. 9th Cir. 2019).
[110] § 1306(a).
[111] § 1327(b).
[112] Barbosa v. Soloman, 235 F.3d 31, 37 (1st Cir. 2000).

is not necessary to achieve this result because inheritances are disposable income, and plan modification can capture surplus disposable income. Nevertheless, the replenishment courts think the issue to be whether the inheritance is property of the chapter 13 estate. If the inheritance is property of the chapter 13 estate, then it must supposedly be surrendered to *T*. But *D* is not obligated to convey property of the chapter 13 estate to *T*. *D* is obligated to pay disposable income (where *T* or a creditor has objected to confirmation).[113] Just labeling the inheritance "property of the estate" solves nothing.

Replenishment scoops up proceeds of a house liquidated after confirmation and so Judge Brown had to dispose of replenishment to reach the desired result.[114] According to Judge Brown, replenishment is defeated:

> ⟦I⟧f one interprets the vesting provision of § 1327(b) as permanently removing the home from the jurisdiction of the Court, or if one views the homestead proceeds as a "substitute" for the home ⟦*i.e.*, not after-acquired property⟧ rather than an entirely new property interest . . . [115]

Favoring "estate termination," Judge Brown set forth a vision from which one may infer a strong argument for her position:

> The estate termination view gives meaning to both statutes. Consider a debtor's home and his income. On the filing of his chapter 13 petition, both become property of the estate under § 1306(a) . . . On confirmation, his home and his income become property of the debtor once again, but despite this change in status, they continue to be protected by the automatic stay . . . until the case is closed, dismissed, or the debtor receives or is denied his discharge, whichever comes first.[116] The plan provides creditors with substitute rights in regard to their prepetition debts.

[113] § 1325(b)(1).
[114] *In re* Baker, 620 B.R. 655, 669 (Bankr. D. Colo. 2020) (replenishment "reads § 1306(a) too broadly and gives insufficient weight to § 1327(b).").
[115] *Id.* at 664; Black v. Leavitt (*In re* Black), 609 B.R. 518, 528 (B.A.P. 9th Cir. 2019).
[116] § 362(c)(2).

> Section 1306(a) still plays an important role in many respects, including bringing those assets under the umbrella of the automatic stay and in determining what assets must be considered in the [§ 1324(a)(4)] test analysis at confirmation. Section 1327(b), on the other hand, terminates the estate's rights to that property. The debtor is then free to spend his income and deal with the assets however he wishes, so long as he fulfills his plan obligations. Post-confirmation, he does not need to run into the bankruptcy court for approval to trade his car in for a new one or to obtain a home-equity line of credit to repair his plumbing. The plan is the only contract between the debtor and his prepetition creditors. They have no further rights in the debtor's property except those specifically preserved in the plan. Therefore, the bankruptcy court has no further authority over this property, except to rule on a motion for stay relief or a dismissal motion if the debtor defaults on his plan obligations.[117]

If proceeds of the home were to fall under § 1306(a) replenishment-style, then we must say that *T* holds a future interest in the home--a future interest that is retained while the balance of the home is conveyed by confirmation to *D*. But the home was conveyed *in its entirety*. *T* retained no part of the home and so the necessary future interest does not exist.

If such a future interest were to exist, absurd results would follow. Often wages are proceeds of a prepetition employment contract. When they are, the employment contract is conveyed to *D* by § 1327(b). But once *D* is compensated--say, by a wire transfer into her bank account--the bank account is proceeds of the employment contract. Under replenishment, *D* owns the right to compensation, but *T* owns the bank account which is debtor's after-acquired property. If *D* uses a debit card to buy a carton of milk, the replenishment theory says the milk belongs to *T*. Or alternatively, suppose *D* is a plumber who gets paid for repairs after every job. The very wages are after-acquired property and *T* owns them, thereby defeating the purpose of chapter 13. These absurd results strongly stand against the

[117] *Baker*, 620 B.R. at 667-68.

replenishment theory.[118]

But still, house proceeds might be disposable income, which *T* can, in part, recover through plan modification. Earlier, we tied *D*'s obligation to surrender surplus disposable income to *D*'s good faith duty to pay creditors as much as possible. This position Judge Brown rejected. In her view, the Bankruptcy Code gave the house to *D* and *D* could sell it and keep the proceeds. It is not bad faith to avail oneself of an advantage provided by the Bankruptcy Code, she thought.[119]

But Judge Brown ran into difficulty when, in passing, she referred to modification of chapter 13 plans.

> A modification request may alter the contract between the debtor and his prepetition creditors by requiring an increase in plan payment, but not because § 1306(a) causes his postpetition income to remain property of the estate. It is because Congress has expressly provided for the adjustment of the contract to reflect changes in the debtor's financial circumstances. It does so not by changing title to the property once again but only by increasing his payment obligation. In that sense, modification grants his unsecured creditors an *in personam*, not an *in rem* remedy.[120]

This passage concedes that, at the behest of creditors, the court must increase *D*'s monthly payments when the debtor's financial circumstances improve. It seems to me that this refers to an increase in disposable income. Sale of the house for a profit improves *D*'s financial circumstances. And so, to the extent of the capital gain, some of the house proceeds are disposable income recoverable by the creditors.

But this can be said in favor of Judge Brown's result. Even if it is true that *T* can modify if *D* realizes a capital gain, *D* could have avoided

[118] For a recent endorsement of replenishment in the context of appreciating house values, *See In re Marsh*, 647 B.R. 725 (Bankr. W.D. Mo. 2023). In *Marsh*, the court read Security Bank of Marshallton v. Neiman, 1 F.3d 687 (8th Cir. 1993), as precluding the estate termination theory of Judge Brown. *Neiman* is a surprising case that probably contradicts § 1327(b) (confirmation "vests all of the property of the estate in the debtor).

[119] *Marsh*, 647 B.R. at 671.

[120] *Id.* at 668.

realization by, instead of selling, *borrowing* against the increased equity. Since *D* gains money in exchange for a promise to pay it back, this can hardly be considered income. Thus, in *In re Trumbas*,[121] *D* sought permission to borrow against her home in order to raise funds to make all plan payments early. One of the unsecured creditors[122] moved to compel *D* to borrow more in order to pay the creditors more than the plan provided. Said the *Trumbas* court:

> I decline to construe the provision in such a manner that would lead to the absurd result that a chapter 13 debtor could be required by consecutive motions from unsecured claim holders to continuously modify the confirmed plan if the debtor owns an asset that appreciates after confirmation of each modified plan.[123]

If *D* can evade realization by switching from sale to borrowing, then why split hairs when *D* sells? Let *D* have the proceeds per Judge Brown's result, because this could have been achieved through house refinancing. Judge Brown's opinion can be understood as privileging substance over form.

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[121] 245 B.R. 764 (Bankr. D. Mass. 2000).

[122] Actually this was *ML* asserting its right to recover a deficit as an unsecured claim.

[123] *Id.* at 767, quoting KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY 6-132 (1996). The *Trumbas* court denied that *D* was obtaining a "windfall."

> [[The movant, an unsecured creditor,]] characterizes the appreciation of the Debtor's home as a "Windfall." The Court disagrees. An increase (or decrease) in the value of an asset is an intrinsic benefit (or risk) of ownership and absent further action by the owner, is not a "windfall," *i.e.*,unexpected income. The change in value standing along is simply an incident of ownership. It does not affect the Debtor's ability to pay based on her future earnings because the Debtor has not experienced any change in income. A number of courts . . . have considered post-confirmation sales of property which appreciated post-petition ad have concluded that the debtor must make the proceeds available to unsecured creditor. In this case, the fact that the Debtor has not realized proceeds from the appreciation of her home distinguishes her case from others and is outcome determinative.

Id. at 767 n.6.

F. UNREALIZED GAINS

Suppose *D*'s house has appreciated in value. If *D* were to sell, creditors, expecting to realize 5 percent of their claims, could achieve a 100 percent payout. May *T* move to modify the plan when no income is received?

Properly, the answer is no, but justifying this conclusion is subtle. According to § 1329(a), *T* is entitled to a modification to "increase . . . the amount of payments . . . " Nothing says expressly that these payments must come from disposable income. Furthermore, *T*'s modification must conform to § 1325(a).[124] According to § 1325(a)(4), it must be true that

> the value, *as of the effective date of the plan*, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date.[125]

If the italicized words mean value, as of the effective date of *modification*, *T* can insist that the valuation of plan payments must be done again. If so, *D* must cover the unrealized gain with plan payments if *D* is going to complete the plan and obtain a discharge.

The principle that the 1325(a)(4) test should be done over violates the basic chapter 13 bargain, whereby *D* gets to keep the chapter 13 estate and does not have to liquidate it, in exchange for which *D* pays disposable income into the plan. If *D* has to modify because of a decline in disposable income and if *D*'s house has gone up in value, *D* would have to liquidate assets (*i.e.*, the house!) to keep the plan going.[126] Chapter 13 stands for the promise that this will never be forced upon *D*, so long as *D* continues to pay disposable income into the plan.

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[124] § 1329(b)(1) ("the requirements of section 1325(a) . . . apply to any modification under subsection (a) . . . ").

[125] § 1325(a)(4) (emphasis added).

[126] *In re* Salpietro, 492 B.R. 630 (Bankr. E.D.N.Y. 2013) (denying *T*'s motion to modify where *D* did not liquidate the house).

In re Forbes[127] represents the proper (though minority)[128] view. In *Forbes*, D had received funds from a cause of action that arose after confirmation of the plan. He moved to modify the plan to terminate it upon a lump sum payment of all that was due in the future. Over objections, the bankruptcy court approved the modification. On appeal, a creditor objected that, given the receipt of funds, *D* could not meet the § 1325(a)(4) text as conducted as of the time of modification. The court ruled there could be no do-overs of the (a)(4) test. The court reasoned that there is only one plan per chapter 13 case. The plan may be modified, but it is still the same plan. The plan is a "unitary constant."[129]

> The Code thus contemplated change to a plan in bankruptcy in evolutionary terms, incorporating a new change into a preexisting basis--an original or previously modified plan . . . An individual who grows from infancy to adulthood alters significantly in the process and yet retains his or her identity throughout; so, too, does a plan retain its identity and constancy throughout its evolution and development in bankruptcy. Although it may change with time, it is, in essence, that which it always was--the plan.[130]

The unitary concept invoked in *Forbes* establishes that the "best interest of the creditors" test can be conducted but once in the life of a chapter 13 proceeding. Section 1325(a)(4) requires that the value that counts is value *as of the effective date of the plan*. Since there is only one plan, there is only one valuation, and it occurs as of the time of the plan's effective date. The effective date is *not* the date of the modification.[131] Accordingly, modification cannot be used to force liquidation of capital assets that were

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[127] 215 B.R. 183 (B.A.P. 8th Cir. 1997).

[128] *In re* Roberts, 514 B.R. 358, 364 (Bankr. E.D.N.Y. 2014) (declining to follow "minority view").

[129] *Forbes,* 215 B.R. at 188; *cf.* 3 LUNDIN, *supra* note 125, ¶ 255.1 ("the Code clearly substitutes the modified plan for its predecessor . . . ").

[130] *Forbes,* 215 B.R. at 188.

[131] *See In re* Gibson, 415 B.R. 735 (Bankr. D. Ariz. 2009); Sumski v. Sanchez (*In re* Sanchez), 270 B.R. 322 (Bankr. D.N.H. 2001); Massachusetts Housing Fin. Agency v. Evora, 255 B.R. 336, 341-42 (D. Mass. 2000); *In re* Sutton, 303 B.R. 510, 517 (Bankr. N.D. Ala. 2003); *In re* Statmore, 22 B.R. 37 (Bankr. D. Neb. 1982).

valued at the time of confirmation.[132]

Account, however, must be taken of the legislative history of the Bankruptcy Code as enacted in 1978.

> In applying the standards of proposed 11 U.S.C. § 1325(a)(4) to the confirmation of a modified plan, "the plan" as used in the section will be the plan as modified under this section, by virtue of the incorporation by reference into this section of proposed 11 U.S.C. § 1323(b) ⟦sic⟧. Thus, the application of the liquidation value test must be redetermined at the time of the confirmation of the modified plan.[133]

There is reason to view this legislative history as inaccurate. Section 1329(b), as eventually enacted, does not refer to § 1322(b).[134] Nevertheless, many courts believe that a modified plan is a new plan[135] calling for a new application of the "best interest of the creditors" test.[136]

One of these cases is *In re Barbosa*,[137] involving a rarity--a real estate investment property in chapter 13--not entitled to § 1322(b)(2) protection.

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[132] *In re* Burgie, 239 B.R. 406, 410 (B.A.P. 9th Cir. 1999) ("After confirmation of a chapter 13 plan, a debtor may volunteer to pay creditors from capital assets, and thereby relieve future income from the obligations under the plan . . . However, a chapter 13 debtor cannot be compelled to do so."); *See also In re* Baker, 620 B.R. 655 (Bankr. D. Colo. 2020).

[133] H.R. Rep. No. 595, 95th Cong., 1st Sess. 431 (1977).

[134] For analysis of this point, see Carlson, *Modified Plans, supra* note 92, at 603-04.

[135] *In re* Profit, 283 B.R. 567 (B.A.P. 9th Cir. 2002) ("A modified plan is essentially a new plan").

[136] *In re* Wilson, 555 B.R. 547 (W.D. La. 2016); *In re* Wetzel, 381 B.R. 247 (Bankr. E.D. Wis. 2008); *In re* Merritt, 344 B.R. 785 (Bankr. N.D. W.Va. 2006); *In re* Morgan, 299 B.R. 118 (Bankr. D. Md. 2003) (house); *In re* Jefferson, 299 B.R. 468 (Bankr. S.D. Ohio 2003); *In re* Nott, 269 B.R. 250 (Bankr. M.D. Fla. 2000); *In re* Barbosa, 236 B.R. 540, 552, (Bankr. D. Mass. 1999), *aff'd* 243 B.R. 562 (D. Mass. 2000), *aff'd sub nom.* Barbosa v. Soloman, 235 F.3d 31 (1st Cir. 2000). *In re* Martin, 232 B.R. 29, 38 (Bankr. D. Mass. 1999); *In re* Walker, 153 B.R. 565 (Bankr. D. Ore. 1993). In *In re* Profit, 269 B.R. 51 (Bankr. D. Nev. 2001), *rev'd on other grounds*, 283 B.R. 567 (B.A.P. 9th Cir. 2002), the court felt that its interpretation of §1325(a)(4) was compelled by § 1329(b)(2), which provides: "The plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved." This section, however, does not insist that the modified plan is a *new* plan and that all the criteria of confirmation must be done over. "Becoming" is an evolutionary concept that emphasizes continuity over replacement.

[137] *Barbosa*, 236 B.R. at 552.

Accordingly, *ML*'s claim in *Barbosa* could be and was bifurcated into secured and unsecured portions. The property was valued (by stipulation) at $64,000. Unsecured creditors were to get a 10 percent payout.[138] *D* moved for permission to sell,[139] though such permission was not required. The property had already vested with *D* and was no longer property of the chapter 13 estate. The bankruptcy court in *Barbosa* ordered the sale and ordered that the surplus after paying *ML* be held in escrow pending *T*'s motion to modify the plan.[140]

The bankruptcy court could not hide its contempt for *D* in seeking to keep appreciation value away from the creditors:

> [T]here is something unsavory about Chapter 13 Debtors "stripping down" a mortgage under § 506(a) and (d) and receiving the "super" discharge provided by § 1328(a) while walking away with substantial cash proceeds due to the appreciation in value of their Property, without amending their plan to satisfy the claims of their unsecured creditors, . . . Putting aside the various inconsistent Code sections, the problems created by the vesting language in § 1327(b) and the order of confirmation used in this case, and hairsplitting arguments about what constitutes property of the estate in chapter 13, the spectacle of the Debtors profiting while in bankruptcy is disconcerting and may be indicative of a bad faith manipulation of the Code.[141]

This intuition can be challenged. In a chapter 7 case, once *T* abandons the home because *ML+ME* exceeds appraised value, appreciation value belongs to *D*. Congress has expressed the policy that *D* should not pay a price for

[138] Oddly, it took more than two years for the chapter 13 plan in *Barbosa* to be confirmed. See § 1324(b) ("The hearing on confirmation of the plan may be held not earlier than 20 days and not later than 45 days after the date of the meeting of creditors under section 41(a), unless the court determines that it would be in the best interests of the creditors and the estate to hold such hearing at an earlier date and there is no objection to such earlier date.").

[139] FED. R. BANKR. P. 6004.

[140] Actually, *T* moved for an order compelling *D* to file an amended plan paying the unsecured creditors in full. *Barboza*, 236 B.R. at 544.

[141] *Barboza*, 236 B.R. at 551-52.

choosing chapter 13 over chapter 7.[142] Therefore, in chapter 13, it would follow that *D* deserves appreciation value, especially if *D* does not realize a capital gain through sale.

Nevertheless, the court intuited that under divine law *D* must lose, and so the task was to defeat *D* statutorily. The solution the court found was that *T* was entitled to a recalculation of the hypothetical liquidation test in § 1325(a)(4). For this to be true, it was necessary to find that house proceeds were indeed property of the bankruptcy estate and therefore subject to the 1325(a)(4) test. The replenishment theory of the chapter 13 estate filled the bill nicely. The court found that, whereas *D* owned the house free and clear of the bankruptcy estate by virtue of § 1327(b), *T* owned the proceeds by virtue of § 1306(a). Therefore, the proceeds had to be included in the do-over of the hypothetical liquidation test. The house had been *D*'s property but the proceeds of the house were *T*'s property.

This is both absurd and unnecessary. It is absurd because *D* owned the house, *D* had the right to sell the house, and *D* should own the proceeds. If the Bankruptcy Code says otherwise, it is absurd. It is unnecessary because the proceeds are income for *D*, to the extent of the realized gain.[143] This *T* was entitled to, without any reference to § 1325(a)(4) at all, or without theorizing what is in or out of the chapter 13 estate.[144] Indeed, we have linked the duty to pay surplus disposable income to § 1325(a)(3)--plans must be proposed in good faith. The bankruptcy court *also* found *D*'s proposed modification to be in bad faith, and so it was effectively ruling that withholding of proceeds was a withholding of disposable income. The § 1325(a)(4) do-over, then, can be considered unnecessary (and wrong) dictum.[145]

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[142] *In re* Nicols, 319 B.R. 854, 856-57 (Bankr. S.D. Ohio 2014); This occurs in the 1994 legislative history to § 258(f)(1)(A) . *See infra* text accompanying notes 134-38.

[143] As the bankruptcy court at one point acknowledged. *Barbosaa*, 236 B.R. at 550-51. *See* In re Murphy, 474 F.3d 143, 153 (4th Cir. 2007) (asserting that an estate theory is not necessary because house proceeds are income).

[144] The do-over was instituted as a way of recapturing income by *T* from *D* in *In re* Roberts, 514 B.R. 358 (Bankr. E.D.N.Y. 2014).

[145] Though the bankruptcy court in *In re Barbosa* was upheld on appeal, the § 1325(a)(4) do-over was ambiguously treated. The district court seemed to think that it sufficed to observe that proceeds of the house were property of the estate even though the house was not when it was sold. *See In re* Barbosa, 243 B.R. 562, 571 (D. Mass. 2000). This is clearly inadequate. In chapter 13, *D* has no obligation to pay property of the estate

If it is true that we are conducting the § 1325(a)(4) test again, then, in a case where the house has appreciated but there is no sale, *T* can move to modify and force *D* to liquidate property that *D* is buying through plan payments. This violates the chapter 13 bargain--D may keep estate assets in exchange for paying disposable income according to the plan.[146]

G. CALCULATING CAPITAL GAIN

If the unsecured creditors timely discover an impending sale of the house, they may move to modify the plan in order to compel *D* to fork over the proceeds. But not all proceeds are income. Only the capital gain is income, calculated in a way that guarantees to *D* the monetary exemption that applies to the house.

Capital gain does not mean what it means under the Internal Revenue Code. Rather, it refers to the gain above what *D* paid for the chapter 13 estate. Capital gain is an element of income, and income is anything that makes *D* wealthier in the post-confirmation period. Inheritance, for example, should be viewed as income because it makes *D* wealthier.[147]

To illustrate *D*'s capital gain, I borrow and slightly amend a hypothetical confected by Judge Brown in *Rodriguez v. Barrera (In re*

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into the plan. *D*'s obligation is to pay disposable income. *See In re* Berkley, 613 B.R. 547, 553-54 (B.A.P. 9th Cir. 2020). Under the district court's reasoning, if *D* lost money on the house (compared to a basis), *T* still gets the proceeds.

The court of appeals thought it sufficed to hold that *res judicata* did not bar the trustee from making a motion to modify and that what *D* was attempting was an outrage. Ergo *T* should prevail. It did not actually mention the § 1325(a)(4) do-over, other than to mention it as the bankruptcy court's theory, Still the court of appeals was not entirely wrong. *T* had the right to the proceeds to the extent the proceeds were a capital gain.

A recent new theory is presented in *In re* Taylor, 631 B.R. 346 (Bankr. D. Kan. 2021), involving a post-confirmation personal injury settlement. The case followed *Forbes* in requiring a § 1325(a)(4) do-over, but the test should be conducted as if the case were converted in good faith to chapter 7. *Id.* at 353-54. In such a case, the post-confirmation asset would not be property of the chapter 7 estate. So the settlement could not be recaptured in the do-over. This new idea still allows *T* to force *D* to liquidate the house in light of appreciation value.

[146] *In re* Baker, 620 B.R. 655 (Bankr. D. Colo. 2020).

[147] *But see In re* Roberts, 514 B.R. 358, 363 (Bankr. E.D.N.Y. 2014) (inheritance not income).

Barrera):[148]

> Consider this hypothetical: assume that a debtor's prepetition home had four bedrooms, two bathrooms, an old kitchen, a value of $300,000, with a mortgage lien against it of $250,000. Two years later, the debtor, who is a builder, has renovated the home himself, adding a fifth master bedroom suite, a third bathroom, and a new kitchen, all for a total cost of $50,000. His changes to the home have increased its value by $100,000, He has also reduced the principal balance of the mortgage loan by $25,000 and realized appreciation in value due solely to market conditions of $100,000. His home is now worth $500,000 due to this combination of factors and his equity interest is $275,000 instead of the ⟦confirmation⟧ date amount of $50,000.

We add one additional fact: *D* is entitled to a $75,000 monetary exemption. As a result, the dollars *D* must pay over time to the unsecured creditors is zero, because *D* can use $50,000 of the exemption to buy $50,000 worth of equity in the house. *D* therefore has $25,000 of unused exemption.

D's basis is

$25,000 Remaining Unused Monetary Exemption
$50,000 Capital Improvement
<u>$25,000</u> Mortgage Paydown
$100,000

D's net disposable income is $275,000-$100,00=$175,000. If the plan is indeed modified in advance of receiving the $275,000 sale price, *D* only owes $175,000. *D* retains $100,000 to recompense the expense of the improvement and the mortgage paydown and to fund the unused portion of the monetary exemption.

Repeating a point made earlier,[149] part of the basis must include the valuation of the house made for the purpose of the § 1325(a)(4) ("best

[148] 620 B.R. 645 (Bankr. D. Colo. 2020), *aff'd*, 22 F.4th 1217 (10th Cir. 2022).
[149] *See supra* text accompanying notes 11-14.

interest of the creditors") test. If the valuation was $10,000 above *ML+ME,* that $10,000 is part of the basis because this is what *D* is in the process of buying back from the chapter 13 estate by paying in post-confirmation income. *D* does not earn a profit until this investment of $10,000 has been recovered.

PART IV. CONVERTED CHAPTER 7 CASES

We are imagining that *D* has struck it rich in the real estate market after filing for chapter 13. In chapter 13, a sale prior to completion of the plan generates disposable income in the form of a capital gain. If *T* finds out about it in advance of realization, *T* can capture the gain. One strategy for *D* to avoid this capture is to convert the case to chapter 7. Conversion to chapter 7 is *D*'s right.[150] According to Bankruptcy Code § 1307(a), "[t]he debtor may convert a case under this chapter to a case under chapter 7 . . . at any time." According to Rule 1017(f)(3), conversion does not require *D* to make a motion to the court.

The data show that conversion from chapter 13 to chapter 7 is not the exception. It is the dominant fate of a chapter 13 proceeding--roughly two-thirds of chapter 13 jello molds dissolve into a chapter 7 puddle.[151] But it may also be the case that, given appreciation value in the house, chapter 7 is simply better for *D* than chapter 13, where the capital gain is surplus disposable income. The issue then becomes whether bailing out of chapter 13 to protect appreciation value is a bad faith conversion to chapter 7. If the conversion is bad faith, the creditors are more likely (but not certain) to recapture appreciation value. But whether converting to take financial advantage of chapter 7 is indeed bad faith--a manipulation of the Bankruptcy Code--divides the courts.

A. WHEN THE DEBTOR STILL POSSESSES THE HOUSE

In a converted case, where *D* converts in good faith or when *D* acts in bad faith and is involuntarily kicked into chapter 7 for some misbehavior

[150] Harris v. Viegelahn, 575 U.S. 510, 514 (2015).

[151] Sara S. Greene et al., *Cracking the Code: An Empirical Analysis of Consumer Bankruptcy Outcomes*, 101 MINN. L. REV. 1031, 1042 (2017); Scott F. Norberg & Andrew Velkey, *Debtor Discharge and Creditor Repayment in Chapter 13,* 39 CREIGHTON L. REV. 472, 476 (2006).

in chapter 13, the chapter 7 estate is defined by Bankruptcy Code § 348(f)(1)(A):

> Except as provided in paragraph (2), when a case under chapter 13 . . . is converted to a case under another chapter under this title—
>
> > (A) *property of the estate* in the converted case shall consist of *property of the estate*, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion . . . [152]

The chapter 7 estate is defined by what *D* originally had on bankruptcy day and still has on conversion day. This definition will cause migraines.[153] For now we start with a simple assumption that nevertheless generates a hard puzzle.

Suppose *D* still possesses the house she had on the day of the bankruptcy petition. Most courts think that the house is property of the chapter 7 estate. But there is a problem with this interpretation, linguistically speaking. In § 348(f)(1), the phrase "property of the estate" appears twice. The first usage refers to the converted chapter 7 case. We learn the content of the chapter 7 estate from what follows. "Property of the estate" is invoked a second time to describe this content. Does this second "property of the estate" mean, hypothetically, property that would have been chapter 7 property of estate if the chapter 13 case had been a chapter 7 case all along? If so, the house would have been property of the hypothetical chapter 7 estate (assuming that the hypothetical chapter 7 trustee hypothetically never abandoned the house as over-encumbered).[154] This thrusts the question of

[152] § 348(f)(1)(A) (emphasis added).

[153] This provision does not apply if an individual *D* in chapter 11 converts to chapter 13. *In re* Gorniak, 549 B.R. 721 (Bankr. W.D. Wis. 2016); *In re* Meier, 528 B.R. 162 (Bankr. N.D. Ill. 2015). This Article does not encompass individual chapter 11 cases. For details on individual chapter 11 cases, *See* Ann Lawton, *The Individual chapter 11 Debtor Pre- and Post-BAPCPA*. 89 AM. BANKR. L.J. 455 (2015).

[154] A slightly different interpretation is proffered by *In re* Cofer, 625 B.R. 194, 197 (Bankr. D. Idaho 2021). The second "property of the estate" means the actual chapter 13

estate content into the doubly subjunctive world of "would have beens"-- where anything can happen and nothing consistent with the laws of physics can be disproven!

Or, alternatively, does the second "property of the estate" refer to the *actual* chapter 13 case? Under this second reading, the house is, or at least for a while was, "property of the chapter 13 estate." Under § 1306(a), "property of the estate" includes at least what is specified in § 541(a). Thus, before a plan is confirmed, where *D* converts the case to chapter 7, the house (still in *D*'s possession) presumptively becomes property of the chapter 7 estate, per § 348(f)(1)(A).[155] But confirmation of the plan vests the house in *D*. The house is "property of the chapter 13 estate" no longer and so, upon conversion to chapter 7, the house does *not* become property of the chapter 7 estate. *D* owns the house outright.

This is the position taken by Judge Jeffrey Hughes in *In re Brown*,[156] an intriguing opinion by a creative theoretician of the Bankruptcy Code. It has undeservedly received scant attention in subsequent case law. Judge Hughes suggests that the second "property of the estate" refers to the actual, historic chapter 13 case. Confirmation of the plan constitutes the transfer of the house from the chapter 13 estate to D personally. Since the house is *not* property of the chapter 13 estate, it cannot be property of the chapter 7 estate under § 348(f)(1). *D* therefore gets to keep the house (even if it is not exempt).

In *Brown*, D, a householder, commenced a chapter 13 case. A plan was confirmed. *D* later converted the case to chapter 7. In the chapter 13 proceeding, D claimed his house as exempt under Michigan's "bankruptcy only" exemption.[157] Neither T_{13} nor any creditor objection to this exemption was filed. Judge Hughes had, in a different case, ruled that

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estate as it existed on bankruptcy day, even if it not property of the chapter 13 estate at the time of the conversion. But since the chapter 13 estate on bankruptcy day precisely equals the hypothetical chapter 7 estate on bankruptcy day, this is a distinction that makes no difference. In *In re* John, 352 B.R. 895, 899-900 (Bankr. N.D. Fla. 2006), the court ruled that, once the case was converted, § 1327(b) no longer applies. That which was divested is revested. This seems to be a way of saying that one consults the hypothetical chapter 7 estate, not the historic chapter 13 estate.

[155] *In re* Vu, 245 B.R. 644 (B.A.P. 9th Cir. 2000) (pre-confirmation conversion from chapter 11 to chapter 7).

[156] 375 B.R. 362 (Bankr. D. Mich. 2007).

[157] MICH. COMP. LAWS § 600.5451(1).

"bankruptcy only" exemptions in state law were unconstitutional[158]--a view that the Sixth Circuit would later overrule.[159] In the chapter 7 case, T_7 wanted to object to the exemption as unconstitutional. *D* protested that T_7 was too late. The deadline for objecting to exemptions started to run at the conclusion of the first scheduled creditors' meeting in the chapter 13 case.[160] Thirty days passed and no one objected. So the exemption was final, unconstitutional though it may have been. According to the Supreme Court, a deadline is a deadline,[161] so the exemption was established as a matter of *res judicata*.

T_7 protested that he deserved a second chance to object to the exemption. The conversion to chapter 7 was a new "order for relief"[162] triggering a second creditors' meeting. The second creditors' meeting triggered a new thirty-day deadline for objecting, which T_7 did in fact meet. Judge Hughes agreed, after a fashion. If indeed the house entered into the chapter 7 estate on the date of conversion, T_7 would have a second bite at the apple of exemption.[163]

But, after lengthily justifying this conclusion, distracting the attention of his audience, Judge Hughes pulled a rabbit out of his hat. Yes, T_7 could object to exemption of the house if § 348(f)(1)(A) brings the house out of *D*'s ownership back into the chapter 7 estate. But § 348(f)(1) does no such thing. Section 348(f)(1)(A) is no avoidance provision, said Judge Hughes.[164]

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[158] *In re* Wallace, 347 B.R. 626 (Bankr. W.D. Mich. 2006).

[159] *In re* Schafer, 689 F.3d 601 (6th Cir. 2012); *See also* Lawrence Ponoroff, *Constitutional Limitations on State-Enacted Bankruptcy Exemption Legislation and the Long Overdue Case for Uniformity*, 88 AM. BANKR. L.J. 353 (2014).

[160] FED. R. BANKR. P. 4003(b)(1).

[161] Taylor v. Freeland & Kronz, 503 U.S. 638, 644 (1992) ("Deadlines may lead to unwelcome results, but they prompt parties to act and they produce finality.").

[162] § 348(a).

[163] Since *In re Brown*, 375 B.R. 362 (Bankr. D. Mich. 2007), Federal Rule of Bankruptcy Procedure 1019(2) was amended to confirm a chapter 7 trustee's second chance to object to exemptions. Sender v. Golden (*In re* Golden), 528 B.R. 803, 812 (Bankr. D. Colo. 2015).

[164] Judge Hughes pulls out the rabbit in an oblique fashion:

> As already discussed, the flaw that . . . I have both found in the minority's position regarding Rule 4003(b) is the failure to explain how property that has been removed from, for example, a Chapter 13 estate as an allowed exemption can then be returned to the bankruptcy estate

So *D* could not merely exempt the house. *D* owned the house outright and T_7 had no interest in it.[165]

This strikes me as startling but correct. Conversion "constitutes an order for relief."[166] So does a voluntary bankruptcy petition: "The commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter."[167] The difference between a

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> for further administration in the event the case is later converted to Chapter 7. Some minority view courts have relied upon Section 348(f)(1)(A) to respond to this criticism. For example, in *Campbell,* the panel stated that [[§ 348(f)(1) contains a revestment idea]].
>
> However, I do not agree with *Campbell* that Section 348(f) has meaning only if property previously removed from the bankruptcy estate by operation of Sections 1327(b) or 522(*l*) "springs back" to the bankruptcy estate upon conversion of the case to Chapter 7. *Campbell* is certainly correct that Section 348(f)(1)(A) has no meaning, or more accurately, no relevance, in situations where the subject property was previously removed from the estate by either of these sections. However, Section 348(f)(1)(A) would still be relevant in those instances where the debtor's plan provided that some or all of the bankruptcy estate's property that remained at the time of confirmation was to continue as property of the estate post-confirmation. 11 U.S.C. § 1327(b). Section 348(f)(1)(A) would also continue to be relevant in those many other instances where the Chapter 13 case is converted to Chapter 7 before confirmation since Section 1327(b) applies only when a Chapter 13 plan is actually confirmed. . . .
>
> Consequently, I do not interpret Section 348(f)(1)(A) as implicitly empowering Chapter 7 trustees in converted cases to recover property lawfully removed from the estate in the prior chapter proceeding. Rather, I interpret the reference in Section 348(f)(1)(A) to "property of the estate, as of the filing of the petition" as merely an acknowledgment that, upon conversion from Chapter 13 to Chapter 7, the bankruptcy estate is to be shed of whatever it had accumulated as post-petition assets under Section 1306 so as to resemble what the converted estate would have looked like had the case been in fact administered from the outset as a Chapter 7 proceeding.

In re Brown, 375 B.R. 362, 380-81 (Bankr. D. Mich. 2007), *citing* Campbell v. Stewart (*In re* Campbell), 313 B.R. 313 (B.A.P. 10th Cir.2004).

S *See* Sender v. Golden (*In re* Golden), 528 B.R. 803, 812 (Bankr. D. Colo. 2015). *Golden* is interpreted as saying the opposite in *In re* Cofer, 625 B.R. 194, 197-98 (Bankr. D. Ida. 2021).

166 § 348(a).

167 § 301.

conversion and a bankruptcy petition is that the voluntary petition commences the case.[168] An *involuntary* bankruptcy petition commences a case[169] and so creates an estate. But such an involuntary petition is no order for relief. The order for relief in an involuntary case is when a court finds that the debtor is not paying debts as they fall due.[170]

Commencement of a case has the effect of transferring D's property to *T*. According to Bankruptcy Code § 541(a): "The commencement of a case under section 301, 302, or 303 creates an estate." "Creating an estate" must be understood as a transfer from *D* to *T*. An order for relief, when separated from the bankruptcy petition, transfers nothing.

According to § 348(a), conversion

> constitutes an order for relief under the chapter to which the case is converted, but, except as provided in subsections (b) and (c) of this section, does not effect a change in the date of the filing of the petition, the commencement of the case, or the order for relief.

Thus, there is but one commencement and one moment of transfer from *D* to *T*. *D*'s property becomes *T*'s property when the case was commenced, not when the order for relief was entered. Conversion is not a second commencement.

The nature of the transfer from *D* to *T* is described by the strong arm power. Strong arm is the very organon of the Bankruptcy Code.[171] According to *T*'s hypothetical judicial lien, *D*'s property is involuntarily transferred from *D* to *T* (even though *D* has filed a voluntary bankruptcy petition).[172] With regard to real estate, *D* voluntarily transfers by purchase to *T* (even if the case is involuntary).[173] But these transfers occur "as of the

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[168] § 301(a) ("A voluntary case under a chapter case is commenced by the filing . . . of a petition . . . ").

[169] § 303(b).

[170] § 303(h). If not contested, the court must still order the relief. *Id.* Therefore the order for relief is *not* the petition.

[171] David Gray Carlson, *Bankruptcy's Organizing Principle*, 26 FLA. STATE UNIV. L. REV. 549 (1999).

[172] § 544(a)(1), (2).

[173] § 544(a)(3).

commencement of the case." Transfers do not occur upon order for relief, unless the order for relief is also a commencement.

Putting this together, it follows that a conversion from chapter 13 to chapter 7 is not a transfer. Rather, the meaning of § 348(f)(1) is to *shed* property of the chapter 13 estate (to the extent it still exists). It does not *avoid* transfers from the estate to D.[174]

But Judge Hughes and I nearly are lonely in asserting this view, correct though it is.[175] The vast majority of courts assume, usually without discussion, that the order for relief converting a case achieves a confiscation of property from *D*.[176] On this view, § 348(f)(1)(A) is an avoidance provision.

In any case, as we have seen,[177] it is very common for a chapter 13 to defer vesting of the bankruptcy estate in *D*. When § 1327(b) does not apply because of the plan or the confirmation order negates vesting, the post-confirmation house is still part of the chapter 13 estate. Accordingly, the house goes into the converted chapter 7 estate.

But is appreciation value thereby lost to *D*'s creditors? That ends up being a hard question,[178] thanks to a singular interpretation to the

[174] *In re* Brown, 375 B.R. 362, 381 (Bankr. D. Mich. 2007).

[175] This reasoning is followed in Sender v. Golden (*In re* Golden), 528 B.R. 803, 812 (Bankr. D. Colo. 2015). But *Golden* is not a case where the house still existed in *D*'s possession on conversion day. *D* had sold the house and dissipated the proceeds. I discuss this case in the next section. *See infra* text accompanying notes 249-5. Judge Hughes's interpretation was also asserted by dissenting Judge Richard C. Tallman in Castleman v. Burman (*In re* Castelman), 75 F.4th 1052 (9th Cir. 2023): "Here, the underlying property is ⟦*D*'s⟧ home, and their Chapter 13 plan was confirmed . . . When that occurred the home was no longer 'property of the estate' and therefore any appreciation in its value is not '⟦p⟧roceeds . . . of or from property of the estate.'" *Id.* at 1062 (citing § 541(a)(6)).

[176] *See, e.g., In re* Campbell, 313 B.R. 313, 321 (B.A.P. 10th Cir. 2004); *In re* Barrera, 620 B.R. 645, 648 (Bankr. D. Colo. 2020), *aff'd*, 22 F.3d 121 (10th Cir. 2022) ("With confirmation of the chapter 13 plan, unless the plan expressly states otherwise, all property of the estate vests in the debtor. Post-confirmation, it reverts to its pre-bankruptcy status as 'property of the estate.' Nevertheless, if the debtor retains possession or control over it at the time of conversion, it must be surrendered to the chapter 7 trustee.").

[177] *See supra* text accompanying notes 35-36.

[178] For general despair of a solution, see Lawrence Ponoroff, *Allocation of Property Appreciation: A Statutory Approach to the Judicial Dialectic*, 12 WM. & MARY BUS, L. REV. 721 (2022). Professor Ponoroff suggests amending § 348(f)(1) to force valuations on bankruptcy day, which awards appreciation value to *D*. *Id.* at 756-57.

Bankruptcy Code by the Supreme Court in *Schwab v. Reilly*.[179]

B. VALUATION OF THE HOUSE

One mysterious joker in the converted chapter 7 deck is § 522(a)(2), which defines value to mean

> fair market value as of the date of the filing of the petition or, with respect to property that becomes property of the estate after such day, the date such property becomes property of the estate.

This provision apparently says that we must take the value of the exempt property (here, the house) as it existed on bankruptcy day. Value may be high now. Value on bankruptcy day may have been low. Section 522(a)(2) means that we must *pretend* the value is low. This is the very provision which allows chapter 7 debtors to such appreciation value from *JC*, who had a prepetition judicial lien on the exempt home. Thanks to § 522(f)(2), *D*, not *JC*, owns appreciation value.[180] Can *D* pull off the same trick against T_7? T_7 is, after all, a hypothetical judicial lien creditor as of the date of case commencement.[181]

The meaning of § 522(a)(2) profoundly affects ownership of appreciation value. Suppose *D* files in chapter 7 when *ML* is under water. Suppose appreciation value smiles upon the house. The happy result is that *ML* is no longer under water, *D*'s exemption (worthless before) is now fully funded, and there is surplus beyond *ML+ME*. If valuations could occur upon the date of a later sale, *ML* gets the first increment of appreciation value, as guaranteed by *Dewsnup v. Timm*[182] (bifurcations are never final until the actual sale). Thereafter, *D* gets appreciation value to the extent of the exemption. *T* takes the surplus for the unsecured creditors.[183]

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[179] 560 U.S. 770 (2010).

[180] *See* Part I, *supra* note 1, at 411-18.

[181] § 544(a)(1).

[182] 502 U.S. 410 (1992).

[183] *In re* Castleman, 75 F.4th 1052 (9th Cir. 2023) (no mention of § 522(a)); *In re* Goetz, 647 B.R. 412 (Bankr. W.D. Mo. 2022), *aff'd*, 651 B.R. 292 (B.A.P. 8th Cir. 2023) (no mention of § 522(a)).

But § 522(a)(2) prohibits using value at the time of sale. Section 522(a)(2) insists that we must look back in time and consult value as of the bankruptcy petition. Accordingly, *D*, in the chapter 7 case, could move to force *T* to abandon the property, even though a surplus exists that *T* could otherwise realize. According to § 554(b):

> On request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is inconsequential value and benefit to the estate.

T_7 may protest that the house is no burden. Quite the opposite. There is valuable equity in it. But *D* responds that reference to present value is *verboten*. T_7 can only utter value as of bankruptcy day, when the property was under water. Even though the house is not under water, we must *pretend* it is. Therefore, the house must be abandoned. T_7 loses out on appreciation value[184] and *D* has considerably freshened his head start above and beyond *ME*. An enhanced fresh start is the punchline to § 522(f)(1) avoidance against *JC* with a judicial lien on the homestead. Now it appears that *T* (a hypothetical judicial lien creditor) gets the same treatment.

But, in a converted chapter 7 case, there is another possibility. If, upon conversion of a chapter 13 case, *D*'s house had departed the bankruptcy estate thanks to § 1327(b)—not an obvious conclusion—then the estate has *re-acquired the house* at the time of conversion. According to § 522(a)(2), value is "fair market value as of the date . . . such ⟦after-acquired⟧ property becomes property of the estate." Bankruptcy day value has now become irrelevant. What counts is the conversion day value, according to § 522(a)(2). Appreciation value now belongs to T_7. If the plan or confirmation order defers vesting in *D*. however, T_7's entitlement evaporates. We are back to bankruptcy-day valuation.

Yet a further paradox: Suppose the property in question is *D*'s summer beach house in the Hamptons—under water to *ML*. Since this pleasure dome is not *D*'s permanent residence, it is not exempt. Suppose *D* has filed for chapter 13 in a no-vest plan. In the years since the bankruptcy

[184] *In re* Hodges, 518 B.R. 445 (E.D. Tenn. 2014); *In re* Cofer, 625 B.R. 194, 202 (Bankr. D. Ida. 2021); *In re* Lynch, 363 B.R. 101 (B.A.P. 9th Cir. 2007); *In re* Jackson, 317 B.R. 511 (Bankr. N.D. Ill. 2004).

petition, appreciation value has visited the Hamptons, a neighborhood it is known to frequent. When the case is converted to chapter 7, there is no occasion to consult § 522(a)(2). The beach house is not exempt, and § 522(a)(2) does not govern. Therefore, appreciation value belongs to T_7. This is as it should be. As part of *D*'s fresh start he deserves appreciation value in connection with an exemption, and § 522(f)(1) implicitly supports such a view. But *D* does not deserve appreciation value in beach house, and so, it appears, the case is treated differently. Value of non-exempt property is current value. T_7, not *D*, gets the appreciation value in the beach house because § 522(a)(2) does not apply.

Topping off our frothy confusion is the fact that the Supreme Court, in one of its unintentionally legislative moments, has read § 522(a)(2) out of the Bankruptcy Code, insofar as that section governs D-T relations.[185] Prior to *Schwab v. Reilly*,[186] § 522(a)(2) served a purpose. Where *D* claimed a monetary exemption in the house, and where *T* objected, the court would value the house. If value (as of bankruptcy day) was less than *ML+ME*, the house was expelled from the bankruptcy estate. Subject to *ML*'s mortgage, *D* owned it in fee simple. In this view the exempt property was the house itself, and the house was permanently expelled from the bankruptcy estate in a chapter 7 case.

But *Schwab* establishes that the *house* is not expelled. Only the *monetary exemption* is expelled.[187] *T* retains a hypothetical judicial lien on the house. Thus, when appreciation value graces the house, *T* can reach it, if it exceeds *ML+ME*. As a result, insofar as *T* and *D* are concerned, valuation is a dead letter.

Still more wicked dreams disturb the curtained sleep. In 2005,

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[185] Justice Thomas denies this charge: § 522(a)(2) still serves a purpose. It commands *D* to assign a value to exempt property on Schedule C, which can guide *T* as to whether *T* should sell to gain the surplus or *T* should abandon. Schwab v. Reilly, 560 U.S. 770, 786-87 (2010).

[186] 560 U.S. 770 (2010).

[187] Justice Thomas emphasizes that *D*'s exemption was not the equipment itself, D's interest was in the monetary exemption. *Id.* at 783 ("As noted above, §§ 522(d)(5) and (6) define the "property claimed as exempt" as an "interest" in Reilly's business equipment, *not* as the equipment *per se*"). Ironically, this is the opposite of what the Supreme Court concluded in United States v. Whiting Pools, 462 U.S. 198 (1983), where "property" was not *D*'s interest in the thing but the thing-in itself. *See* Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L. REV. 193 (1998).

BAPCPA added § 348(f)(1)(B):

> Valuations of property and of allowed secured claims in the chapter 13 case shall apply only in a case converted to a case under chapter 11 or 12, but in a case converted to a case under chapter 7, with allowed secured claims but not in a case converted to a case under chapter 7 . . .

BAPCPA constituted an unsightly feeding frenzy by lobbyists at the expense of consumer debtors. As we have already seen, one of the greatest hyenas at the carcass was the car lending lobby. As a result, BAPCPA is laced with special interest exceptions to the Bankruptcy Code in favor of the car lender. The above quoted provision is one of them. It is designed to assure that a bifurcation of an automobile in a chapter 13 case is repealed in the converted chapter 7 case. For example, suppose, in chapter 13, *D* owns a car worth $20,000 but a secured lender (*SL*) has a security interest in the car and claims $25,000. Chapter 13 allows *D* to bifurcate *SL*[188] so that *SL* has a $20,000 secured claim and a $5,000 unsecured claim. Suppose the plan has paid $3,000 to *SL* on the secured claim and zero on the unsecured claim. *D* converts to chapter 7. At that time, the car is worth $19,000. In chapter 13, *SL*'s secured claim would be for $17,000 and *D* has an equity of $2,000. Thanks to § 348(f)(1)(B), the chapter 13 valuation of $20,000 is no longer operative. The present value is $19,000. Meanwhile, § 348(1)(C) completes the coup de grace:

> with respect to cases converted from chapter 13—
>
> > (i) the claim of any creditor holding security as of the date of the filing of the petition shall continue to be secured by that security unless the full amount of such claim determined under applicable nonbankruptcy law has been paid in full as of the date of conversion, notwithstanding any valuation or determination of the amount of an allowed secured claim made for the

[188] Unless the hanging paragraph of § 1325(a) applies. For details on this nightmare, see David Gray Carlson, *Cars and Homes in Chapter 13 Under the 2005 Bankruptcy Amendments*, 14 AM. BANKR. INST. L. REV. 301, 340-60 (2006).

> purposes of the case under chapter 13 . . .

In short, BAPCPA undoes the cram down of car loans in chapter 13 plans.

Does § 348(f)(1)(B) also repeal § 522(a)(2) in converted cases? Properly, the answer is no. In chapter 13, when the house was valued in the exemption process, the court will have followed (or, perhaps, ignored) §522(a)(2). Whatever the chapter 13 court did is consigned to the memory hole. But it is still true that in the converted chapter 7 case, § 522(a)(2) applies (or not) and will have to be accounted for.[189]

Section 348(f)(1)(B) does slightly change the law pertaining to the house, however,[190] as illustrated by *Warren v. Peterson*.[191] In *Warren*, D in chapter 13 valued her home at $40,000, encumbered by *ML*'s claim of $36,000. *D* claimed a $7,500 exemption. Pursuant to the hypothetical liquidation test in § 1325(a)(4), *D* had to show sufficient income paid in to buy back $0 worth of debtor equity. Later, *D* converted to chapter 7. At the time, § 348(f)(1)(B) provided that "valuations of property and of allowed secured claims in the chapter 13 case shall apply in the converted case." T_7 then sought permission to sell the house to capture the appreciation value that had accrued above the $40,000. The district court in *Warren* held that the chapter 7 trustee was bound by the $40,000 value the chapter 13 court supposedly found.[192] Therefore, T_7 could not sell. By implication, T_7 had to

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[189] *In re* Cofer, 625 B.R. 194, 199 (Bankr. D. Ida. 2021); *In re* Hodges, 518 B.R. 445, 451 (E.D. Tenn. 2014). For a contrary view, see *In re* Adams, 641 B.R. 147 (Bankr. W.D. Mich. 2022).

[190] *See Cofer*, 625 B.R. at 202.

[191] 298 B.R. 322 (N.D. Ill. 2003).

[192] This premise may be questioned. According to the *Warren* court, compliance with 1325(a)(4)

> requires the bankruptcy court to rely on the scheduled values of the debtor's property in order to determine the amount unsecured creditors would be paid if the bankruptcy estate were liquidated under chapter 7 . . . Since the scheduled values are scrutinized by both the bankruptcy court and the creditors before a chapter 13 plan is confirmed, sufficient procedural protections exist to ensure that debtors are not deliberately undervaluing their property."

Id. at 325-26. But suppose *D*'s proposed disposable income over the life of the plan was $100,000. Then the court's § 1325(a)(4) finding is consistent with up to a $100,000 abandon, in which case the appreciation value would belong to *D*.

After § 348(f)(1)(B) was enacted in 2005, the chapter 13 valuation deserves no respect. But perhaps § 522(a) still governs the case. Yet because exempt property is at stake, courts are (perhaps) still bound by the rule of § 522(a)(2)--valuations are to be made as of bankruptcy day. But, then again, after *Schwab*, bankruptcy-day valuation falls by the wayside. At the time of conversion, the house goes back into the bankruptcy estate. The monetary exemption remains outside the bankruptcy estate. T_7 can therefore sell to capture the surplus.

Courts have reached this result but by incomplete reasoning. In *In re Goetz*,[193] D still owned her prebankruptcy house at the time her chapter 13 case converted to chapter 7. The house had been under water in chapter 13 but now had a surplus above ML+ME. D moved to force T7 to abandon claiming that appreciation value was after-acquired property that stayed outside the chapter 7 estate. Judge Brian T. Fenimore thought that appreciation value was the house itself, not an after-acquired accession

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value. All the court had to find is that income paid in covered the non-exempt equity in the house. *See In re* Lynch, 363 B.R. 101, 105 (B.A.P. 9th Cir. 2007) (making a similar point); *In re* Jackson, 317 B.R. 511 (Bankr. N.D. Ill. 2004) (same).

The *Warren* court was too quick in opining:

> Finally, treating orders confirming a bankruptcy plan as implicit valuations serves the interest of judicial economy. Establishing the valuation of property at an early stage in the proceedings ensure both stability and finality. Valuations need not be re-examined if the case converts from chapter 13 to chapter 7. Determining the present value of property, such as real estate, is already a complicated issue, and calculating the historic value of property is even more complicated. Holding that the confirmation of the chapter 13 plan constitutes an implicit valuation under section 348(f) simplifies this process by establishing valuations at the start of the bankruptcy proceeding. Were this court to reject implicit valuations, debtors would be required to request explicit judicial valuations of all their scheduled property before confirmation--injecting considerably more time and expense into the process--in order to rely on the protection {now repealed]} provided by section 348(f).

Warren, 298 B.R. at 326. In fact, no explicit valuations are required. All that need be consulted is whether a buyer is prepared to pay more than the *ML* claim and the monetary exemption. No valuation at all is required. B's willingness to pay is the only thing that need be consulted where valuation is not subject to the value definition in § 522(a)(2).

[193] 647 B.R. 412 (Bankr. W.D. Mo. 2022), *aff'd*, 651 B.R. 292 (B.A.P. 8th Cir. 2023).

glomming onto the house.[194] Therefore, T_7 could retain and sell the house. Section 522(a) was nowhere mentioned. So perhaps it is a dead letter *per Schwab*. Or perhaps § 522(a) applies, but the chapter 7 estate re-acquired the house on confirmation day, making valuation on confirmation day the appropriate benchmark. Which of these is true was not addressed by Judge Fenimore.

This result was defended because, if the case had started in chapter 7, T_7 would own the appreciation value.[195] But this overlooks the fact that, in the hypothetical land of what would have happened, T_7 would have abandoned the house, and D would capture appreciation value after all.

In *In re Goins*,[196] *D* in chapter 13 estimated his house as worth

[194] Provocatively, Judge Fenimore writes "equity is not a separate item of property; it exists only with reference to and as a characteristic of an underlying asset" *Goetz,* 647 B.R. at 416. We are actually interested in whether appreciation value is separate from equity (which is fee simple minus *ML*), not whether equity is separate from the house. Judge Fenimore makes this language shift in order to make it seem that the classic tax case of Crane v. Commissioner, 331 U.S. 1 (1947), applies. In *Crane*, D inherited underwater real property worth zero (to *D*). The land had been acquired for $262,000. The testator had granted a $255,000 purchase money mortgage to *ML*. The market value had fallen by the time of the inheritance, so that *D* obtained a valueless equity. But the building was deemed to depreciate over the years by $28,000. This could have been used to reduce *D*'s income (if she had any). *See* I. Jay Katz, *The Untold Story of Crane v. Commissioner Reveals an Inconvenient Tax Truth: Useless Depreciation Deductions Cause Global Basis Erosion to Bait a Hazardous Tax Trap for Unwitting Taxpayers*, 30 VA. TAX REV. 559 (2011) (arguing *D* has no income against which the depreciation could count as a deduction). *D* sold the building subject to the mortgage for $2,500, which she reported as a $2500 capital gain. The IRS claimed that she sold for $255,000+$2,500=$257,500 against a basis of $234,000, for a gain of $23,000. The Supreme Court ruled for the IRS. In so ruling, Chief Justice Vinson commented that "property," as that term was used in the Internal Revenue Code, meant "the physical thing which is a subject of ownership," whereas equity was "the value of a property above the total of the liens." *Id.* at 7. Equity was not a separate thing from property. Accordingly, D had sold for $2,500 (cash) plus ($255,000) (ML). The Supreme Court was anxious to establish that the IRS should recapture depreciation that in fact never historically accrued in the property.

Crane does not really fit consumer bankruptcies. In chapter 13, D's basis is defined as ME plus the surplus appraised value when the plan is confirmed minus cost of improvements and minus mortgage paydown. If D realizes a sale above this sum/difference, D realizes a capital gain which is disposable income in chapter 13. D is not required to "give back" depreciation.

[195] *Id.* at 417.

[196] 539 B.R. 510 (E.D. Va. 3015).

$98,000. *ML* claimed $103,000. Over the life of the chapter 13 plan, *D* paid down the mortgage by $27,000. *D* converted the case to chapter 7. At this time the mortgage debt was $76,000, appreciation value had made its golden appearance, thanks to the paydown. In chapter 7, T_7 proposed to sell the homestead for $147,000. No mention is made of *D*'s exemption, but in Virginia, the exemption amounts to $25,000 in value.[197] But *D* opposed T_7's sale and instead sought to force T_7 to abandon based on bankruptcy day values. The case nowhere cites § 522(a)(2), but *D*'s theory must have been that T_7 could only assert bankruptcy-day values.

By implication, the court agreed with this theory. But the court treated appreciation value as a property interest in the nature of "profit"[198] from property of the bankruptcy estate, within the meaning of § 541(a)(6).[199] One is tempted to observe that appreciation value is not something separate and apart from the house,[200] as is the case of cash proceeds. what is valuable is the house itself. Or so it would seem.[201]

If we concede that appreciation value is in the nature of proceeds or profit, it then becomes impossible to explain why this separate thing, which

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[197] VA. CODE TITLE 34, ch. 2 § 34-4.

[198] Perhaps the *Goins* court was confused by the term "profit" in § 541(a)(6). Appreciation value, crudely speaking, is the "profit" over basis that might be realized in case of a sale. But surely the term "profit" means a *profit à prendre* --"the right to acquire by severance or removal from another's land, something previously constituting part of the land." Hubscher & Son, Inc v. Storey, 578 N.W.2d 701, 703 (Mich. App. 1998). Where the profit refers to a right to remove gravel from the land of another, profit means the gravel not the appreciation value in land of another. Gravel is a form of proceeds of the land.

[199] In *Goins*, *T* generously offered to reimburse *D* for the paydown of *ML* during the chapter 13 case. Whether *T* was obligated to do this is discussed in the next section. *See infra* text accompanying notes 209-22.

[200] *In re* Goetz, 647 B.R. 412, 416 (Bankr. W.D. Mo. 2022), *aff'd*, 651 B.R. 292 (B.A.P. 8th Cir. 2023); *In re* Potter, 228 B.R. 422 (B.A.P. 8th Cir. 1999); *In re* Castleman, 631 B.R. 914 (W.D. Wash. 2022), *aff'd*, 75 F.4th 1052 (9th Cir. 2023); *In re* Adams, 641 B.R. 147 (Bankr. W.D. Mich. 2022); *In re* Larzelere, 633 B.R. 677, 683 (Bankr. D.N.J. 2021) ("Appreciation cannot be separated from the underlying real estate. One cannot separately pledge, mortgage, hypothecate or liquidate appreciation. One can only mortgage the entire asset: the real estate. Appreciation, itself, therefore, cannot be and is not a separate asset."); *In re* Black, 609 B.R. 518, 529-30 (B.A.P. 9th Cir. 2019) ("In normal speech, one would not say that, when a person's assets increase in value, that person 'acquires' an additional interest in the asset").

[201] Later, I will consider whether appreciation value is something separate and apart from the house after all if one considers some legislative history. *See infra* text accompanying notes 245-48.

D did not possess on bankruptcy day, comes into the chapter 7 estate via § 348(f)(1). The thing comes into the estate only if *D* possessed it on bankruptcy day. Thus the *Goins* court is in a contradiction. The appreciation value in the house (not yet sold) is proceeds for the purpose of § 541(a)(6), but appreciation value is the house itself--not something separate--for purposes of § 348(f)(1).

What happened to *D*'s $25,000 exemption? The court never mentions it. Has the exemption disappeared? It must be the case that, surreptitiously the *Goins* court applied the rule of § 522(a)(1) and valued the house as of bankruptcy day such that there was no value for the monetary exemption. *D* was frozen at this zero value.

But this overlooks the implication of *Schwab*. What gets expelled from the bankruptcy estate is the monetary exemption. This is a free-floating thing that is forever out of the bankruptcy estate. Indeed, the exemption has no meaning *until* *T* actually sells.[202] When *T* sells, *D* is entitled to be paid $25,000. Section 522(a)(2) is a rule about valuing the house. It is not a rule about valuing the monetary exemption, which is legislated by statute.

In re Castleman[203] is a case where the court more forthrightly dooms D's exemption. We may note, however, that *Castleman* is a Washington case, where the Ninth Circuit[204] permitted T_7 to strip down *D*'s exemption because of the peculiar wording of Washington's homestead provision--a provision that the Washington legislature angrily amended in response.[205] In *Castleman*, D valued a house at $500,000 in unencumbered form. It was subject to a mortgage of $375,000 and so debtor equity was $124,923. The Washington homestead is exempt in the amount of $125,000.[206] *D* claimed the house as exempt in chapter 13 and no one objected.

Later *D* converted to chapter 7. The house had risen in value to $700,000. T_7 proposed to sell the house free and clear of *ML*, as is appropriate under Bankruptcy Code 363(f)(3). *T*, however, wanted (apparently) to limit *D* to an exemption of $124,923, the value of the exemption on the day the house was exempted. But the exemption amount

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[202] Hyman v. Plotkin (*In re* Hyman), 967 F.2d 1316, 1321 (9th Cir. 1992). Until the sale, *D* gets to live in the house for free. *Id.* at 1321 n.11.

[203] 631 B.R. 914 (Bankr. W.D. Wash. 2021), *aff'd*, 75 F.4th 1052 (9th Cir. 2023).

[204] Wilson v. Rigby, 909 F.3d 306 (9th Cir. 2018).

[205] *See Part I, supra* note 1, at 410-11.

[206] WCW § 6.13.030.R.

was $125,000. T_7 claimed that the missing $1,000 was appreciation value that belonged to the chapter 7 estate.[207]

The *Castleman* court agreed with this view. T_7 could sell if the total price exceeded *ML*'s claim of $375,000 and *D*'s exemption is deemed frozen at $124,923. Thus, *D* was deprived of $77 of appreciation value--the amount that would have filled out *D*'s unrealized exemption--plus appreciation above *ML+ME*. We may dismiss *Castleman* as interpreting a Washington statute that has since been amended.

Goins and *Castleman* disagree on the relevance of § 522(a)(2). *Goins* assumed it did not apply, and T_7 therefore won appreciation value. *Castleman* assumed that § 522(a)(2) applied to limit *D*'s exemption, but that it did not apply to T_7. T_7 had his cake and ate it too. Thus, where *D* still possesses the house on bankruptcy day, the central mystery is whether § 522(a) awards appreciation value to *D*.

C. MORTGAGE PAYDOWNS

If a plan vests the house in *D*, so that the house leaves the bankruptcy estate, most courts believe that the house re-enters the chapter 7 estate when the case converts to chapter 7. Suppose, however, *D* has paid down some of *ML*'s claim, thereby creating equity in the property.

Some courts, agreeing with the *Goins* result, think that *D* has enriched the chapter 7 creditors by creating this equity, even though paid for by postpetition income.

One is tempted to think *D* should be *subrogated* to *ML*'s claim. For example, suppose on bankruptcy day the house is worth $100,000 and *ML* is $120,000. In the chapter 13, however, *D* has paid *ML* $30,000. By the time the case is converted, *ML* claims $90,000, and there is $10,000 in equity. Subrogation asks whether *D* intended to "pay" *ML*, thereby enriching *D*'s creditors, or whether *D* intended to "buy" *ML*'s position, preserving for *D* a lien of $30,000. A "buy" indicates a desire in *D* *not* to enrich the creditors. Subrogation awards *D* with a lien where *D* did not intend to enrich third parties. In subrogation. the creditors are neither

[207] Upon re-reading *Castleman* many times, I am not entirely sure whether the bankruptcy court wished to limit *D* to $124,923 (the bankruptcy-day surplus over ML) or to $125,000 (the statutory limit), in which case the appreciation value help to fund the full exemption. But presumably the court was simply following Wilson v. Rigby, 909 F.3d 306 (9th Cir. 2018).

helped nor harmed.[208]

In mortgage cases outside bankruptcy, however, courts deny *D* the right to subrogation when *D* pays a senior mortgagee.[209] When ML_1, ML_2, and ML_3 have mortgages in that order, and ML_3 sends funds to ML_1, ML_3 is usually thought not to intend the enrichment of ML_2. ML_3 is subrogated to ML_1 to the extent ML_3 advanced funds to ML_1. ML_3 has bought ML_1's senior mortgage, which can be asserted against ML_2. ML_2 is neither helped nor harmed by subrogation. But where the equity owner D pays ML_1, *D pays* but does not *buy* ML_1's mortgage, because *D* owes a duty to ML_2 and ML_3 to exonerate the land from ML_1's mortgage.[210] If that instinct is followed, subrogation should also be denied in converted chapter 7 cases. Still, it can be observed that *D* gave postpetition dollars to *ML*. The creditors had no right to these dollars. In state mortgage law, ML_2 and ML_3 do, in a sense, have a right to *D*'s dollars.

Congress, it seems, intended in 1994 that *D* be subrogated to *ML* against the creditors in a converted chapter 7 case. According to a House Report, § 348(f)(1) resolves

> a split in the case law about what property is in the bankruptcy estate when a debtor converts from chapter 13 to chapter 7. The problem arises because in chapter 13 . . . any property acquired after the petition becomes property of the estate, at least until confirmation of a plan. Some courts have held that if the case is converted, all of this after-acquired property becomes part of the estate in the converted chapter 7 case, even though the statutory provisions making it property of the estate do not apply to chapter 7. Other courts have held that the property of the estate in a converted case is the property the debtor had when the original chapter 13 petition was filed.
>
> These latter courts have noted that to hold otherwise would create a serious disincentive to chapter 13 filings. For example, a debtor who had $10,000 equity in a home at the

[208] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 7.6 cmt a. (Am. L. Inst. 1997).

[209] Jenkins v. Cont'l Ins. Co., 12 How. Pr. 66, 68 (N.Y. Common Pleas 1855).

[210] *In re* Adams, 641 B.R. 147 (Bankr. W.D. Mich. 2022).

> beginning of the case, in a State with a $10,000 homestead exemption, would have to be counseled concerning the risk that after he or she paid off a $10,000 second mortgage in the chapter 13 case, creating $10,000 in equity, there would be a risk that the home could be lost if the case were converted to chapter 7 (which can occur involuntarily). If all of the debtor's property at the time of conversion is property of the chapter 7 estate, the trustee would sell the home, to realize the $10,000 in ⟦non-exempt⟧ equity for the unsecured creditors and the debtor would lose the home.
>
> This amendment overrules the holding in cases such as *Matter of Lybrook*,⟦211⟧ and adopts the reasoning of *In re Bobroff*.⟦212⟧ However, it also gives the court discretion, in a case in which the debtor has abused the right to convert and converted in bad faith, to order that all property held at the time of conversion shall constitute property of the estate in the converted case. [213]

Notice that the second paragraph of the passage addresses the subrogation controversy. Subrogation follows because otherwise *D*, starting out, would face a serious disincentive to file in chapter 13.[214] Therefore, whether logical or not, Congress thought that *D* should be subrogated to *ML* for pre-conversion payments made to *ML*.[215]

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[211] 951 F.2d 136 (7th Cir. 1991).

[212] 766 F.2d 797 (3d Cir. 1985).

[213] H.R. Rep. No. 103-835, at 57 (1994).

[214] The legislative history to § 348(f) indicates that Congress did not want to discourage *D* from filing for chapter 13 in the first place. *In re* Pisculli, 426 B.R. 52 (Bankr. E.D.N.Y. 2010), *aff'd*, 408 Fed. Appx. 477 (2d Cir. 2011); *In re* Laflamme, 397 B.R. 194, 201 (Bankr. D.N.H. 2008); Wyss v. Fobber (*In re* Fobber), 256 B.R. 268, 278 (Bankr. E.D. Tenn. 2000). That is, if *D* faced a penalty in a converted chapter 7 case, *D* would hesitate to choose chapter 13 over chapter 7, especially since chapter 7 *is* the destination of a majority of chapter 13 cases. Therefore, a disincentive becomes a talking point for concluding that *D* owns appreciation value in a converted chapter 7 case. *In re* Niles, 342 B.R. 72, 76 (Bankr. D. Ariz. 2006).

[215] *In re* Hodges, 518 B.R. 445 (E.D. Tenn. 2014); *In re* Lynch, 363 B.R. 101 (B.A.P. 9th Cir. 2007); *see also In re* Nichols, 319 B.R. 854, 856-57 (Bankr. S.D. Ohio 2004) ("We find that there is ambiguity in whether the definition of 'property of the estate' includes equity. Section 541(a)(6) clearly excludes earnings for debtor's services after commencement of the case and in normal situations where a debtor purchases new assets

Other courts find this legislative history contradicts the plain meaning of § 348(f)(1). In *In re Peter*,[216] involving the paydown of a car loan, the court observed:

> ⟦T⟧he Supreme Court has consistently admonished that where a statute's text is plain, the court is to apply it as written, unless its application would lead to absurd results. ⟦¶⟧ Pursuant to § 348(f)(1)(A), upon conversion, property of the Chapter 7 estate consists of "*property of the estate*" as of the filing of the petition that remains in the possession of or is under the control of the debtor on the date of conversion." (emphasis added) There is no dispute that the Honda was "property of the estate" (as defined by § 541(a)(1)), as of the filing of the ⟦chapter 13⟧ petition. The statute does not limit the subsequent Chapter 7 estate to "equity in" "property of the estate" as of the filing of the (chapter 13) petition. That policy choice appears to have been dealt with by § 348(f)(1)(B).[217] Application of the statute as written will not lead to the level of "absurdity" that would allow this court to ignore the plain wording of the statute.[218]

There is nothing, however, plain about the word "property." The *Peters* court thought it plain that "property" meant the car, not *D*'s interest in the car, in spite of evidence that Congress favored a subrogation solution. Should we not consult what Congress meant by the word "property"?

The *Peters* court concludes: "The court notes, however, that the debtor may be able to assert a claim (having administrative priority) based on the payments that he made for the benefit of the estate."[219] According to

with those earnings, it would not be argued that those new assets were property of the estate. However. If those earnings are used to 'purchase' equity in existing assets, it is not clear from a straightforward reading of § 541 or § 348 whether that new equity is property of the estate. The legislative history to § 348 clearly indicates that it is not.").

[216] 309 B.R. 792 (Bankr. D. Or. 2004).

[217] This is the provision that repeals chapter 13 valuations in converted chapter 7 cases.

[218] *Peter*, 309 B.R. at 794-95.

[219] *Id.* at 795. The court cites to *In re* Prospero, 107 B.R. 732 (Bankr. C.D. Cal. 1989). In *Prospero*, a chapter 7 case, *D* made postpetition payments to *ML* and to property taxes. *T* moved to close the case with the proviso that *T*'s hypothetical judicial lien would

Bankruptcy Code § 503(b), "there shall be allowed administrative expenses . . . including (1)(A) the actual, necessary costs and expenses of preserving the estate . . . " Since *D*'s postpetition payments did indeed preserve (or actually enhance) the value of property of the estate, § 503(b) implies that *T* will have to give back to *D* the mortgage payments before non-priority creditors enjoy the fruits of the paydown value.

To summarize, the legislative history states outright that when appreciation value stems from the chapter 13 paydown of a mortgage, *T* must reimburse *D* for the paydown. In other words, *D* is subrogated to the rights of *ML*.

D. MORTGAGES OUT OF THE MONEY

We have seen that where ML_1 sucks up all of a house's value and ML_2 is out of the money, *D* in chapter 13 can treat ML_2 as an unsecured creditor. Suppose *D* so treats ML_2 in a confirmed plan, but before the plan is completed, the case is converted to chapter 7. Does ML_2's mortgage lien come back to life? Some courts have thought so,[220] but there are two reasons to think otherwise. First, § 1327(c) provides:

> Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim *or interest* of any creditor provided for by the plan."[221]

As Judge Markell recognized,[222] ML_2 is not a secured creditor under § 506(a)(1), but ML_2 nevertheless has a mortgage lien, which is an "interest" in *D*'s house. Section 1327(c) makes clear that this "interest" is destroyed by confirmation of the plan. Nothing in § 348 revives it.

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continue to encumber the house even after closure. In an *ex parte* hearing, the court granted *T* this relief. When *T* had the case reopened in order to sell the home, *D* protested the sale, claiming *D* had a right to expect that the underwater house be abandoned. The *Prospero* court, however, seems quite hostile to the proposition that *D*'s postpetition payments might be administrative expenses, but doesn't actually rule it out. It is not clear why the *Peters* court cites *Prospero*.

[220] Branigan v. Davis (*In re* Davis), 716 F.3d 331, 338 (4th Cir. 2013); *In re* Okosisi, 451 B.R. 90, 100 (Bankr. D. Nev. 2011).

[221] § 1327(c) (emphasis added).

[222] *In re* Okosisi, 451 B.R. at 100.

Second, § 348(f)(1)(B) provides

> Valuations of property and of allowed secured claims in the chapter 13 case shall . . . not ⟦apply⟧ in a case converted to a case under chapter 7 . . .

This provision undoes chapter 13 bifurcations in converted chapter 7 cases, but our premise is that ML_2 is not a secured creditor. Valuation did indeed occur, and ML_2 was deemed on unsecured creditor on the basis of it, but de-bifurcation under § 348(f)(1)(B) undoes valuations of *allowed secured claims*, which *ex hypothesi* ML_2 does not have. Of course, if we *Dewsnupify*[223] § 348(f)(1)(B), lazerus-like ML_2 lives again. But our refusal to *Dewsnupify* ML_2 in chapter 13 is why ML_2 lost her lien. It would be odd to change that horse in the middle of the converted chapter 7 stream.

Does ML_2 fare better if the case is dismissed? Dismissals are governed by § 349. Subsection (b)(1) provides for reinstatements of fraudulent transfers, voidable preferences and the like. And subparagraph (1)(C) reinstates "any lien voided under section 506(d) . . . " We have already concluded, however, that it was not § 506(d) that stilletoed ML_2's lien. It was the combined daggers of § 1325(a) and § 1327(a) and (c) that did Caesar in. Therefore, ML_2 remains in its grave sleeping well after chapter 13's fitful fever.

E. HOUSE PROCEEDS

> It is astonishing that, more than 42 years after the enactment of the Bankruptcy Reform Act of 1978, there are five judicial interpretations of what constitutes post-confirmation property of a Chapter 13 estate.[224]

So far, we have considered cases in which, at the time of conversion, *D* still possesses the house she had when she filed in chapter 13. Suppose she has sold the house at a considerable profit. Chapter 13 says the proceeds

[223] "*Dewsnup*" became a verb after the publication of Margaret Howard, *Dewsnupping the Bankruptcy Code,* 1 J. BANKR. L. & PRAC. 513 (1992).

[224] *In re* Klein, 2022 WL 3902822, Case No. 17-19106-JGR, at *1 (Bankr. D. Colo. 2022).

are in part disposable income, which the chapter 13 trustee can capture, to the extent of the capital gain. Can *D* keep the gain away from the chapter 13 trustee if she exercises her right to convert the case to chapter 7?

We have seen that, in converted chapter 7 cases, § 348(f)(1)(A) sheds property of the chapter 13 estate if the property possessed by *D* was not also possessed by *D* on bankruptcy day. If *D* possesses the house on bankruptcy day and also on confirmation day, most courts think that the house is in the chapter 7 estate.[225] But what if *D* sold the house prior to conversion? In that case, *D* possesses proceeds, but these proceeds did not exist on bankruptcy day. Therefore the proceeds are not in the chapter 7 estate.

A recent Tenth Circuit panel has strongly asserted that proceeds and the house are *not* the same thing. In *Rodriguez v. Barrera (In re Barrera)*,[226] *D* had sold the house and pocketed $140,000 in profit. Thereafter *D* converted to chapter 7. T_7 sought a turnover order to recover these proceeds. T_7 lost for a simple reason. *D* did not possess the house on conversion day. *D* possessed proceeds of the house. These proceeds *D* did not possess on bankruptcy day. Proceeds are after-acquired property and therefore § 348(f)(1) excludes the proceeds from the bankruptcy estate.

Barrera was an appeal from an interesting opinion by Judge Elizabeth Brown, who tread a very different path of primrose analysis. It is worth our time to give Judge Brown our full attention, in order to see how the Tenth Circuit's much simpler approach stacks up. Under both approaches, appreciation value was awarded to *D*.

As to the simple approach that the Tenth Circuit eventually would take, Judge Brown found it was not an option:

> A strict reading of ⟦§ 348(f)(1)⟧ might suggest that the debtors in this case have no obligation to turn over to the Trustee any of the sale proceeds regardless of the home's prepetition value. The home was a prepetition asset but on the date of conversion the Debtors no longer had possession of nor control over it because they had sold it. However, this Court has not found any reported decision that has arrived

[225] *See supra* text accompanying notes 153-57.
[226] 22 F.4th 1217 (10th Cir. 2022).

> at that conclusion.[227] Instead, courts have treated the proceeds from a pre-conversion sale of property as property of the estate "as of the petition date" under § 348(f)(1)(A). Some have reached this conclusion by reasoning that § 541(a)(6) includes in the definition of property of the estate "[p]roceeds" . . . Neither party disputes that this subsection would require the Debtors to turn over any non-exempt funds attributable to the prepetition value of the home. And since both now agree that the home was only worth $386,606 on the filing date and that the greater amount realized at sale was attributable to a postpetition increase in value, the only dispute left is whether a postpetition increase in value of a prepetition asset constitutes a postpetition asset excluded from the chapter 7 estate by § 348(f)(1)(A).[228]

Thus, Judge Brown failed to institute a "strict" reading of § 348(f)(1)--something that the Tenth Circuit would do. Accordingly, Judge Brown conducted her analysis as if the house had never been sold. She also assumed that the house, if still in *D*'s possession, leaves the bankruptcy estate upon confirmation but re-enters it upon conversion to chapter 7.[229] She never addresses the point that, under § 522(a)(2), bankruptcy day is not the day of valuation. Rather, conversion day is the day of reckoning, because that is when the house was acquired by the chapter 7 estate. Application of § 522(a)(2) presumptively contradicts the result she reached and it is striking that Judge Brown mentions it only once. Indeed, her opinion could fully apply to real property that is not exempt property at all.

According to Judge Brown the house is not "the physical thing, the bricks and mortar of a home."[230] Rather, property in the house is a bundle of sticks, as it were. Some of the sticks belong to *D*, and some belong to T_7. The appreciation value is a separate thing from the house as it existed on

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[227] Judge Brown overlooked Sender v. Golden (*In re* Golden), 528 B.R. 803 (Bankr. D. Colo. 2015), discussed *infra* text accompanying notes 249-50.

[228] *In re* Barrera, 620 B.R. 645, 648-49 (Bankr. D. Colo. 2020), *aff'd*, 22 F.3d 121 (10th Cir. 2022).

[229] *Id.* at 648 ("Nevertheless, if the debtor retains possession or control over [the house] at the time of conversion, it must be surrendered to the chapter 7 trustee").

[230] *Id.* at 649.

bankruptcy day. We earlier questioned such a view. "Proceeds" might be a thing different from the house, but the *value* of the house is a prediction of what a buyer would pay for the house. Value *is* the house, as much as the bricks and mortar are.

Judge Brown knew full well that value is the house itself, but she made a compelling case that Congress, in 1994, intended the opposite: the house and its value are *different* things. Absurd it may be, but it is what Congress intended!

Unlike many a judge who experience § 348(f)(1) as having a plain meaning, Judge Brown found § 348(f)(1) to be a masterpiece of confusion:

> When Congress refers to "property . . . as of the date of the filing of the petition," does it mean the property interest *as it existed* on that date? In other words, when the term "property'" is modified by the qualifying language that ties it to the petition date, is that a reference to the property with the attributes it had on that date?[231]

So, is property the *thing* or is property the debtor's *interest in the thing*? As we have seen, the Supreme Court has given two different answers. The most recent answer is in *Schwab v. Reilly*,[232] which holds that property is not the thing--it is the debtor's interest in the thing. Two houses, both alike in dignity, occupy the Verona of converted chapter 7 cases.

Judge Brown chose the sophisticated view: property is a bundle of sticks.

Judge Brown found that T_7 is entitled to the home "*as it existed* on the petition date."[233] This occurs in other parts of the Bankruptcy Code. She gave some examples. Unsecured creditors have their claims frozen on bankruptcy day and are not allowed postpetition interest.[234] Secured creditors with after-acquired property rights are cut off from liens on postpetition after-acquired property, when they are not proceeds of prepetition property.[235] One example she gave has to be qualified. According to Judge Brown, valuation of exempt property is frozen by §

[231] *Barrera,* 620 B.R. at 650.
[232] 560 U.S. 770 (2010).
[233] *Barrera,* 620 B.R. at 651.
[234] Unless there is a surplus in the chapter 7 estate. *See* § 726(a)(6).
[235] § 552(a).

522(a)(2) at bankruptcy-day values. This remains true insofar as *D* seeks avoidance of *JC*'s lien on the homestead. It is no longer true as between T_7 and *D*, thanks to the legislative innovation in *Schwab v. Reilly*.[236] Be that as it may, Judge Brown concluded "it is not illogical to assume that Congress intended to freeze the estate's rights in the debtor's prepetition asset at their prepetition values."[237]

Section 348(f)(1)(A) therefore "has a latent ambiguity despite its superficial clarity"[238] Thus, Judge Brown, as many other judges have done,[239] examined the three-paragraph 1994 legislative history of § 348(f)(1) quoted earlier. According the second paragraph of that history:

> These latter courts have noted that to hold otherwise would create a serious disincentive to chapter 13 filings. For example, a debtor who had $10,000 equity in a home at the beginning of the case, in a State with a $10,000 homestead exemption, would have to be counseled concerning the risk that after he or she paid off a $10,000 second mortgage in the chapter 13 case, creating $10,000 in equity, there would be a risk that the home could be lost if the case were converted to chapter 7 (which can occur involuntarily). If all of the debtor's property at the time of conversion is property of the chapter 7 estate, the trustee would sell the home, to realize the $10,000 in ⟦non-exempt⟧ equity for the unsecured creditors and the debtor would lose the home.[240]

This second paragraph addresses a case in which *D* owned a home on bankruptcy day, *D* still owned the home on conversion day, and *D* created equity by paying *ML* $10,000 via the chapter 13 plan. Congress thought that § 348(f)(1) preserves for *D* the equity created by paying down *ML*'s mortgage. Therefore, Congress must have viewed the house as subdivided between T_7 and *D*. Judge Brown found that this legislative history

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[236] 560 U.S. 770 (2010).

[237] *Barrera*, 620 B.R. at 652.

[238] *Id.*

[239] *In re* Niles, 342 B.R. 72, 76 (Bankr. D. Ariz. 2006); *In re* Nichols, 319 B.R. 854 (Bankr. S.D. Ohio 2004).

[240] H.R. Rep. No. 103-835, at 57 (1994).

contradicted the premise that "property" is the house-in-itself.[241]

The legislative history speaks of equity-creation through paydown of *ML*. Does this extend to pure appreciation value in the absence of a paydown or capital improvement? Said Judge Brown:

> [T]his Court cannot see any language in § 348(f)(1)(A) or elsewhere in the Bankruptcy Code to support such a distinction. Moreover, the broader concept that the legislative history points toward is Congress's intent to leave a debtor who attempts a repayment plan no worse off than he would have been had he filed a chapter 7 case at the outset. If a debtor filed a chapter 7 case, and his trustee did not sell his home [and if the home was abandoned because value was less than [*ML+ME*]], then [*D*] would enjoy the future increase in value realized by a change in market conditions in the year following his chapter 7 filing.[242]

From the legislative history Judge Brown drew the conclusion that Congress wanted debtors to have postpetition appreciation value in all cases. According to the legislative history, the 1994 amendment was designed to remove all penalties on *D* for initially having chosen chapter 13 over chapter 7. Thus, Congress intended to separate the house from its value. T_7 could have value as of bankruptcy day (usually zero, when that value is below *ML+ME*). *D* could have the rest.

In effect, under Judge Brown's approach, appreciation value becomes exempt property in the converted chapter 7 case. Since by definition T_7 can never realize a surplus over *ML+ME*, T_7 must abandon the house.

This analysis, however, is superseded. The Tenth Circuit favored *D* on the simple ground that *D* had sold the house and held only proceeds. Since these are after-acquired property, T_7 could not touch them.[243]

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[241] *See also Niles,* 342 B.R. at 76 ("While admittedly an increase in value to real property is not the same as after-acquired property as that term is traditionally defined under bankruptcy law, it is similar in nature and justifies the same result.").

[242] *Barrera*, 620 B.R. at 653. Judge Brown agrees with Judge Albert E. Radcliffe in *In re* Peters, 309 B.R. 792, 795 (Bankr. D. Or. 2004) that whatever the rule is for paydowns is also the rule for pure appreciation value. *Peters*, however, awarded paydown value to the chapter 7 trustee, not to *D*.

[243] *Barrera,* 22 F.4th at 1222-23.

But we now arrive at the following absurdity. If *D* had never sold the house, *D* potentially surrenders value to the chapter 7 trustee. But if *D* troubles to realize the gain before converting, *D* walks away with the whole gain. The result seems rather arbitrary if the Tenth Circuit is correct and Judge Brown is wrong. Perhaps they are both right.

A slightly different approach was taken in *Sender v. Golden (In re Golden)*.[244] In *Golden*, *D* filed for chapter 13 bankruptcy. A confirmed plan vested *D*'s house back to *D*, so that the house was out of the bankruptcy estate. *D* then sold the house. After *ML* was paid, *D* netted $33,000. *D* gave these funds to his wife. *D* then converted the case to chapter 7. There T_7 alleged that the proceeds were property of the bankruptcy estate and that W had received a postpetition transfer voidable under § 549(a). T_7's complaint, however, was dismissed. The proceeds of the house were proceeds of *D*'s private property, not proceeds of the bankruptcy estate. Therefore, § 348(f)(1) did not capture these proceeds for the chapter 7 trustee. Thus, *Golden* denies that the price received was proceeds of estate property. *Barrera* concedes that the proceeds *are* proceeds of estate property, but § 348(f)(1) says T_7 cannot have them because *D* did not possess the proceeds on bankruptcy day.

F. Bad Faith Conversions

Section 348(f)(1)(A) defines the property of the converted chapter 7 estate as that which *D* possessed on bankruptcy day and still possesses on conversion day. A different rule applies if *D* converts a case from chapter 13 to chapter 7 in bad faith. According to § 348(f)(2):

> If the debtor converts a case under chapter 13 . . . to a case under another chapter . . . in bad faith, the property of the estate in the converted case shall consist of the property of the estate as of the date of conversion.

Notice that § 348(f)(2) applies only when *D* exercises her right to convert a chapter 13 case to chapter 7. It does not apply when, because *D* has misbehaved somehow, T_{13} moves to convert the chapter 13 case. This

[244] 528 B.R. 803 (Bankr. D. Colo. 2015).

means that subsection (f)(1)(A) will apply in bad faith cases--when the creditors initiate the conversion. Section 348(f)(1) applies only if *D* initiates the chapter 7 conversion.[245]

Does the choice of § 348(f)(2) make any difference in the case of appreciation value? The answer is no, where *D* still possesses the house on conversion day. The usual view is that the house is in the chapter 7 estate whether we choose (f)(1)(A) or (f)(2), and courts will have to figure out the meaning of § 522(a)(2) either way.

Where *D* holds house proceeds, however, we face a formidable decision tree. The choice of § 348(f)(2) makes a difference if *Barrera* is the law in (1)(A) cases. Since, under (f)(2), that which *D* possesses on conversion day goes into the chapter 7 estate, the (f)(2) choice enriches *D*'s creditors, where *D* still possesses house proceeds *and* either (1) conversion precedes confirmation or, (2) if at the moment of conversion, the proceeds are property of the chapter 13 estate. The proceeds are property of the chapter 13 estate if the egregious replenishment theory reigns or if the plan negates house-vesting in *D*. But, with a vesting plan, some courts reject replenishment, in which case the proceeds are not part of the chapter 13 estate and therefore not part of the converted chapter 7 estate. If the house proceeds are not part of the bankruptcy estate, application of § 348(f)(2) is of no avail.

But still, when § 348(f)(2) applies, *D* must possess the proceeds. If *D* has dissipated the proceeds, *D* does not possess them on conversion day and so the proceeds are not part of the chapter 7 estate. Thus, § 348(f)(2) is a disappointment to the creditors.

D rightfully disposes of the proceeds if the house vested in *D* upon confirmation and the replenishment theory is rejected. *D* also rightfully disposes of the proceeds if replenishment holds and *D* has spent the proceeds on ordinary living expenses.[246] *D*, however, wrongfully disposes of proceeds if the house has not vested in *D*[247] or if the house is vested and the replenishment theory holds sway. Where *D* has wrongly dissipated the proceeds, the chapter 7 estate may be enhanced where § 349(f)(2) governs.

If *D* wrongfully disposes of the proceeds, then the chapter 13 estate

[245] *See* Adams v. Bostick (*In re* Bostick), 400 B.R. 348, 360 (Bankr. D. Conn. 2009).

[246] Rupp v. Pearson, 551 B.R. 625 (D. Utah 2015); Bogdanov c. Laflamme (*In re* Laflamme), 397 B.R. 194, 201 (Bankr. D.N.H. 2008).

[247] *But see Bostick*, 400 B.R. at 360 (Bankr. D. Conn. 2009), discussed *infra* text accompanying notes 257-59.

owns a cause of action against *D* for "converting"[248] property of the chapter 13 estate.[249] Alternatively, the court might be tempted to find *D* liable to *T* under § 549(a) (postpetition transfers). But § 549(a) requires *D* to be a transferee. Here *D* was a transferor. Nevertheless, by transferring, *D* converted to his own use property of the chapter 13 estate and so had to account for it under § 542(a). Oddly, *D* "possesses" this cause of action, as *D* has the exclusive right to possess the bankruptcy estate in general. Possession here stands for the right to exclude others,[250] not manucaption of some physical object. The cause of action therefore passes to the chapter 7 estate if bad faith *D* converts the case to chapter 7. *D* "possessed" this cause of action on the day of conversion. But if bad faith *D* did not initiate conversion to chapter 7, we are under § 348(f)(1)(A). *D* possesses the cause of action on conversion day but, since we are dealing with a postpetition cause of action, *D* obviously could not have possessed this type of property on bankruptcy day.

Adams v. Bostick (In re Bostick),[251] is a case where *D* wrongfully disposed of the chapter 13 estate and suffered no consequences. *D* filed in chapter 13 and thereafter won the lottery. A plan was never confirmed, so that the lottery proceeds were property of the chapter 13 estate. *D* dissipated the funds on gifts, investments and a vacation. T_{13} moved to convert the case to chapter 7. Because the T_{13} initiated the conversion, § 348(f)(1)(A) governed the case. Since *D* did not possess the dissipated funds on bankruptcy day, the funds (dissipated or not) did not belong to T_7. In chapter 7, however, T_7 sued to deny *D* a discharge under § 727(a)(2)(B) for dissipating property of the chapter 7 estate. But none of the funds dissipated was chapter 7 estate property. Therefore, *D* committed no foul against the

[248] In this discussion, I am obliged to refer to converting assets and converting a chapter 13 case. Hereafter, I will refer to converting assets as "expropriation."

[249] In Moser v. Mullican (*In re* Mullican), 417 B.R. 389 (Bankr. E.D. Tex. 2008), *aff'd*, 417 B.R. 408 (E.D. Tex. 2009), the court thought *D*'s conversion of property of the estate constituted a violation of the automatic stay. The court did not specify *which* part of § 362(a) was violated. Presumably *D* violated § 362(a)(3), which prohibits "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate . . . " The problem is that *D* was entitled to possess and control property of the chapter 13 estate by § 1303. It is hard to imagine that obtaining possession of the estate (granted to *D* under § 1303) should be a violation of § 362(a)(3).

[250] Rakas v. Illinois, 439 U.S. 128, 144 n.12 (1978).

[251] 400 B.R. 348 (Bankr. D. Conn. 2009).

chapter 7 estate. This result turns on the choice of § 348(f)(1)(A). If we are under (f)(2), then *D* "possessed" the chapter 13 right to sue herself for dissipating chapter 13 estate property.[252] This cause of action passes into the chapter 7 estate, where T_7 may sue bad faith *D*. But it is still the case that *D* did not convert chapter 7 property. *D* converted *chapter 13* property. According to *Bostick*, § 727(a)(2)(B) covers only expropriations of the chapter 7 estate after case-conversion.

Applying *Bostick* to house proceeds, even if proceeds *would* have gone into the chapter 7 estate (contrary to *Barrera*), *D* never feels the consequences of having dissipated those proceeds because the proceeds are not property of the chapter 7 estate.

Other cases, however, hold that *D* can be denied a chapter 7 discharge if *D* dissipated property of the chapter 13 estate.[253]

What is a bad faith conversion? Section 348(f)(2) gets discussed in the case law, but mainly it is used to figure out what § 348(f)(1)(A) means.[254] There are only a few cases of bad faith conversion. Basically, misbehavior in chapter 13 (unrelated to conversion) means *D*'s conversion is in bad faith.[255] Courts do not require the bad faith to be in connection with the decision to convert.[256]

What if *D* strategically converts in order to keep house proceeds away from her creditors? If *D* had started in chapter 7, T_7 would have abandoned the house, and proceeds would have belonged to *D*, not to *T*. How can it be in bad faith to be in chapter 7 (where *D* has a right to be) when *D*'s behavior there is perfectly in accord with the Bankruptcy Code?[257] Nevertheless, some authorities point to bad faith. In *In re Lien*,[258] *D* received a postpetition inheritance. Now preserving for *D* the

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[252] *In re* Standiferd, Adversary N. 07-1076, 2008 Bankr. LEXIS 4024, at *17 (Bankr. D.N.M. December 17, 2008), *aff'd* 641 F.3d 1209 (10th Cir. 2011).

[253] *Id.* at *6-*9 (*D* lost discharge in converted chapter 7 case because *D* failed to follow reporting requirements in the chapter 13 confirmation order).

[254] Harris v. Viegelahn, 575 U.S. 510, 518 (2015) ("Section 348(f)(2)'s exception for bad-faith conversions is instructive.").

[255] Lentz v. Myers (*In re* Myers), 486 B.R. 365 (Bankr. D. Miss. 2013) (failure to disclose assets during the chapter 13 case); *In re* Siegfried, 219 B.R. 581 (Bankr. D. Colo. 1998) (pattern of dissembling, lack of disclosure and procedural gymnastics).

[256] *In re* Gibson, Case No. 01-17173, 2008 Bankr. LEXIS 212 (Bankr. S.D. Ohio Jan. 17, 2008).

[257] *Id.* at *5.

[258] 527 B.R. 1 (Bankr. D. Minn. 2015).

postpetition inheritance was the very motive of Congress in enacting § 348(f)(1)(2). Yet the *Lien* court found *D* was in bad faith for withholding this surplus disposable income from the creditors in chapter 13.[259] Applied to house proceeds, this authority says that *D* has a duty to stay in chapter 13 so that the creditors may capture the capital gain. Converting to chapter 7 because there is surplus disposable income in chapter 13 is bad faith.

Section 348(f)(1)(A) still applies in bad faith cases, where *D* does not initiate the conversion. This implies that *D* escapes the consequences of dissipating house proceeds. There is a growing case law, however, giving T_7 remedies against *D* where *D* dissipates property of the chapter 13 estate without court permission. Here we remember that, after confirmation of a vesting plan, it is not exactly clear that the proceeds *are* part of the chapter 13 estate.

In *Bogdanov v. Laflamme (In re Laflamme)*,[260] *D* earned a brokerage fee before filing a chapter 13 petition but was paid after bankruptcy day. The cash was property of the chapter 13 estate. *D* spent these funds on ordinary living expenses. No plan was confirmed, and *D* converted to chapter 7. In chapter 7, T_7 sought turnover of the proceeds, which was impossible, since they were dissipated. What T_7 really wanted was a money judgment as part of an equitable accounting. Bankruptcy Code § 542(a) requires an entity (such as D) to "account for such property or the value of such property . . . "

The solution suggested by § 348(f)(1)(A) is that proceeds on case-conversion day did not exist on bankruptcy day. Therefore, *D* owned all these commissions and the chapter 7 trustee did not. But the *Laflamme* court disagreed. Section 348(f)(1)(A) was designed to reserve for *D* after-acquired property that *D* originally acquired after bankruptcy day. The section did not intend, supposedly, to cover proceeds of prepetition property. Since § 348(f)(1)(A) is all about avoiding disincentives from choosing chapter 13 in

[259] *Id.* at 10 ("If the inheritance-related property is not brought into the chapter 7 estate the Debtors will receive a windfall by virtue of their conversion to chapter 7. This Court finds that the main reason for the Debtors' conversion from chapter 13 to chapter 7 was to avoid paying the chapter 13 trustee the non-exempt inheritance . . .") (footnote omitted). *Accord*, Moser v. Mullican (*In re* Mullican), 417 B.R. 389 (Bankr. E.D. Tax. 2008), *aff'd*, 417 B.R. 408 (E.D. Tex. 2009); *but see In re* Castillo, 508 B.R. 1 (Bankr. W.D. Tex. 2014) (converting to protect inheritance not bad faith, giving extenuated circumstances).

[260] 397 B.R. 194 (Bankr. D.N.H. 2008).

the first place, here there was no disincentive. In a hypothetical chapter 7 case, the proceeds of the brokerage commission would have been property of the chapter 7 estate. It would not penalize *D* to give those proceeds to T_7.[261] In short, the court felt free to ignore the literal command of § 348(f)(1)(A), when the proceeds related back to property *D* had possessed at commencement. *D* was thus guilty of expropriating property of the chapter 7 estate (during the time the case was in chapter 13).

The court, however, excused *D* from spending chapter 13 estate property on ordinary living expenses:

> The Bankruptcy Code, however, does not contain any explicit provision that governs what a debtor can do with chapter 13 property while the debtor is waiting to have a proposed plan confirmed. Presumably a debtor must be able to use earnings to pay ordinary and necessary living expenses in that interim gap period.[262]

The case was remanded for further findings on whether *D*'s expenditures were ordinary or a "shenanigan."[263] It is, by the way, eloquent testimony to the slapdash drafting of chapter 13 that it nowhere expressly invites *D* to use her postpetition income on ordinary living expenses.[264]

The rule in *Laflamme* is that *D* is liable in chapter 7 if *D* has dissipated chapter 13 assets out of the ordinary course of everyday living. The force of this case is much limited because no plan was confirmed. If a regular vesting plan was confirmed, then the chapter 13 estate would have been transferred to *D*. *D* would then be entitled to dissipate proceeds in any way she chose, because they are *D*'s own property, not property of the chapter 13 estate.

In *Wyss v. Fobber (In re Fobber)*,[265] *D* filed for chapter 13 and sold

[261] *Id.* at 202-03.

[262] *Id.* at 205; *accord, In re* Pisculli, 426 B.R. 52, 66 (Bankr. E.D.N.Y. 2010), *aff'd*, 408 Fed. Appx. 477 (2d Cir. 2011).

[263] 397 B.R. at 204 (citing 4 KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY, § 316.1 (3d ed. & Supp. 2004)).

[264] Carlson, *Chapter 13 Estate*, *supra* note 32, at 256 ("There is no good theory, other than common sense, that explains why, prior to confirmation, debtors need not seek permission to use property of the estate for ordinary living purposes").

[265] 256 B.R. 268 (Bankr. E.D. Tenn. 2000).

a tractor before confirmation of a chapter 13 plan. Unlike *Laflamme*, which involved the authorized use of estate cash for ordinary living expenses, sale of the tractor out of the ordinary course was clearly a violation of § 363(b), which requires court permission. D had done a wrongful act. Such proceeds could not be used for ordinary purposes because their generation was extraordinary.[266]

In the converted chapter 7 case, *D* obtained a discharge. T_7 later found out about the tractor and sued *D* to revoke the chapter 7 discharge, because "the debtor acquired property of the estate, and knowingly and fraudulently failed to report the acquisition of or entitlement to such property . . . " The court indicated that, if proven that *D* fraudulently failed to report receipt of tractor proceeds, *D*'s discharge could be revoked.[267] This case, however, proves nothing about cases where a vesting plan is confirmed.

In *Fobber*, the court refused to be bound by § 348(f)(1)(A) because it is absurd:

> Literal application, however, of § 348(f)(1) to the facts of the present case would lead to an absurdity. The debtors' argument is that even if the trustee's allegations are true, that the debtors knowingly and fraudulently disposed of the proceeds from the sale of the ⟦truck⟧, the trustee has no standing to object because neither the proceeds nor the ⟦truck⟧ would constitute property of the estate under § 348(f)(1) as neither was in the debtors' possession when the case converted from chapter 13 to 7. If this is a correct statement of the law, then § 348(f) gives debtors *carte blanche* to commit fraud. A chapter 7 debtor who decides

[266] The court rejected the idea that there is a special rule for cases that start in chapter 7, convert to chapter 13, and convert back to chapter 7. The legislative history approvingly cited Bobroff v. Continental Bank (*In re* Borboff). 766 F.2d 797 (3d Cir. 1985), which was also a 7-to-13-to-7 case. "Based on the precise language of § 348(f) in the reference to *Bobroff* in the statute's legislative history, it would appear that § 348(f)(1) is not limited to cases commenced as chapter 13, but applies *whenever* a case is converted from chapter 13 to another chapter, regardless of the case's original status." 256 B.R. at 276.

[267] *T*'s complaint was deficient for leaving out "knowingly and fraudulently," but *T* was given leave to correct the complaint. *Id.* at 279.

> that he does not want to surrender to the trustee an asset which is property of the estate can convert to chapter 13 long enough to dispose of the asset, and then reconvert to chapter 7 and obtain a discharge with impunity. In other words, the very act which generally would form the basis for the denial or revocation of discharge, *i.e.*, disposition of property of the estate, would insulate the debtor from liability.[268]

The court cited the legislative history which described § 348(f)(1)(A) as removing a disincentive on *D* to prefer chapter 13 to chapter 7. Since the truck proceeds would have been part of a case that began and stayed in chapter 7, *D* was not being punished for choosing to convert to chapter 13. Accordingly, the court felt entitled to ignore § 348(f)(1)(A).[269]

The court in *Brown v. Barclay (In re Brown)*[270] felt uncomfortable in simply ignoring § 348(f)(1)(a) or (2). In *Brown*, *D* inherited money. Thereafter, *D* filed in chapter 13 but no plan was ever confirmed. *D* then conveyed the inherited funds to his brothers. T_{13} found out about it and had the case converted to chapter 7. In chapter 7, T_7 sought to recover the funds from the brothers. The brothers pointed out that *D* had conveyed the funds prior to conversion. Since § 348(f)(1)(A) applied, the chapter 7 estate had, they said, no claim to the funds because *D* did not possess them on conversion day.

The bankruptcy court favored T_7 on alternative theories. First, because *D* had been in bad faith, the funds came into the chapter 7 estate, theresult demanded by § 348(f)(2). This makes no sense. *D* did not initiate the conversion and so the section does not apply. Second, *D* possessed a cause of action (as fiduciary of the creditors) to retrieve the funds wrongfully transferred out, and so § 348(f)(1)(A) brought the cause of action into the chapter 7 estate. *D* was indeed a fiduciary for the creditors with the right to dissipate the inheritance for ordinary living expenses but not otherwise. Fiduciaries who wrongly convey trust assets out of trust can change their minds and rescind their wrongful transfers on behalf of the cestui que trust.[271] So *D* possessed the cause of action. But this does not compute. The

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[268] Wyss v. Fobber (*In re* Fobber), 256 B.R. 268, 276 (Bankr. E.D. Tenn. 2000).

[269] Id. at 279. For a similar refusal to abide by § 348(f)(1)(a)'s literal command, see *In re* Pisculli, 426 B.R. 52 (Bankr. E.D.N.Y. 2010), *aff'd*, 408 Fed. Appx. 477 (2d Cir. 2011).

[270] 953 F.3d 617 (9th Cir. 2020).

[271] Stevenson v. J.C. Bradford & Co. (*In re* Cannon), 277 F.3d 838, 851 (6th Cir.

cause of action did not exist on bankruptcy day. And so under § 348(f)(1)(A), the chapter 7 trustee doesn't get this cause of action.

The BAP upheld the bankruptcy court. But it disagreed that *D* "possessed" a cause of action. The majority thought that a cause of action is not "property" until *D* wins. Since *D* had not yet prevailed by the time of conversion, *D* had no property. Therefore, the chapter 7 estate had no property.[272] Nevertheless, T_7 still prevailed. The BAP majority stated that, because *D* had exceeded the *Laflamme* rule, the transfers were nonevents. *D* therefore possessed the funds now held by the brothers, and these funds went into the chapter 7 estate under § 348(f)(1)(A). In short, though § 348(f)(1)(A) requires debtor possession on conversion day, because of *D*s wrongful act, the court could *pretend* that *D* still possessed the transferred funds.

Concurring, BAP Judge Gary Allan Spraker, not surprisingly, was dissatisfied with the above theories. Instead, he reasoned that when *D* wrongfully transferred estate property and that a cause of action under § 549(a) came into existence, and *this* was property of the chapter 13 estate. True, but it is still the case that, under § 348(f)(1)(A), this cause of action must be possessed by *D* on conversion day. Judge Spraker could not explain how this cause of action constituted "property of the estate, as of the date of filing of the petition." It is after all a cause of action for a *postpetition* transfer.

The Ninth Circuit sustained the lower courts. But it too was dissatisfied with the theorizing of the lower courts. Instead, the Ninth Circuit cut through the Gordian knot. The Ninth Circuit reasoned that applying § 348(f)(1)(A) to wrongfully transferred property was bad policy. Therefore, in the name of *good* policy, the court could *pretend D* had possession when in fact the brothers had possession. The solution was to announce that *D* had "constructive possession." Constructive possession is

2002).

[272] Brown v. Barclay (*In re* Brown), BAP No. SC-17-1068-AkuS, at *14 (B.A.P. 9th Cir. May 21, 2018). This is a disastrous theory. It suggests that when *D* has an unliquidated tort claim and files for bankruptcy, the tort claim is not property of the bankruptcy estate, because tort claims are not property. This violates countless cases that hold the cause of action *is* part of the bankruptcy estate. *E.g.*, Slater v. United States Steel Corp., 871 F.3d 1174 (11th Cir. 2017) (en banc) (*D* had a duty to list prepetition causes of action amongst his assets).

used in drug and money laundering cases. Why not use it here? "Constructive" means "it's a lie, but we choose to pretend it is true."[273] Besides,

> [t]he brothers may, for example, have intended to give the money back to the debtor Jason after the bankruptcy was over. We therefore hold that those funds remained within his constructive possession or control, and hence should be considered property of the converted estate under § 348(f)(1)(A).[274]

In short, in order to reach the result it wanted, the Ninth Circuit simply made stuff up. This was no doubt justified under principles of (and perhaps is the essence of) divine law but is not well grounded in the language of the Bankruptcy Code.

CONCLUSION

Appreciation value is a blessing. It windfalleth from heaven on the place beneath. The beneficiaries of this quality of mercy vary drastically from chapter 7 to chapter 13. In chapter 7, the underwater mortgage lender is the first beneficiary, thanks to the Supreme Court's ruling in *Dewsnup v. Timm*, [275] which prohibits lien stripping in chapter 7 cases. In *Bank of America, N.A. v. Caulkett*,[276] barred "strips-off" when a junior mortgage lender was entirely out of the money, all value being claimed by a senior lender. Oddly, a debtor can strip down judicial liens on exempt homes.[277] Mortgage liens benefit from appreciation value, but judgment liens do not.

In chapter 13, debtors can oust from the waterfall junior mortgage lenders that are entirely out of the money--a practice expressly prohibited in chapter 7 cases by *Caulkett*. Chapter 13 debtors can capture appreciation value from many lien creditors, but if a debtor tries to realize a capital gain during the chapter 13 case, the unsecured creditors can recapture this capital

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273 *See* Robert Stevens, *When and Why Does Unjust Enrichment Justify the Recognition of Proprietary Rights?*, 92 B.U. L. REV. 919, 936 (2012).

274 *Brown,* 953 F.3d at 624.

275 502 U.S. 410 (1992).

276 575 U.S. 790 (2015).

277 § 522(f)(1).

gain (if they find out about it).

Chapter 13 debtors wishing to sell may try to convert the case to chapter 7. Here there is a real possibility that a debtor can take appreciation value away from the unsecured creditors, but the law is especially obscure. There is evidence that courts ignore what the Bankruptcy Code actually says and instead do what natural law requires.