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Proper Valuation of Property and Exemptions in Consumer Cases

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One of the initial questions from most clients is, "Can I keep my house, car, etc.?" The answer to that question, like most legal questions, is, "It depends." Disclosing property and claiming it as exempt is probably one of the most important obligations of the lawyer preparing to file a consumer bankruptcy case.

Upon commencement of a bankruptcy case, nonexempt assets become property of the estate. Claiming the asset as exempt allows the debtor to either keep the asset itself or retain specific interests in the asset.[1] It is critical to properly claim exemptions, which ensures that the property exits the bankruptcy with the debtor because it gives the debtor sufficient assets to obtain a fresh start.[2]

How Much Disclosure Is Necessary?

In *Schwab v. Reilly*, the U.S. Supreme Court limited the items that a trustee must consider on Schedule C to the following: (1) the description of the asset, (2) the Bankruptcy Code provisions governing the claimed exemption and (3) the value of the claimed exemption.[3] While the Court excluded the column reflecting the debtor's assertion of the asset's market value, it noted that it is useful to a trustee to compare the value of the claimed exemption with the asset's estimated market value.[4]

Full and complete disclosure of all assets on the schedules is critical, yet the method of doing so carries great significance.[5] The disclosure must be sufficient to give interested parties notice of the exempt property and permit a challenge.[6] Although it is the trustee's duty to investigate the debtor's financial affairs, ambiguities in the schedules can generally be construed against the debtor.[7] In *Hyman v. Plotkin* and *Schwaber v. Reed*, the debtors entered the word "homestead" under "Description of Property," and in both cases, the Court found the entry to be ambiguous and held against the debtor.[8]

The *Schwab* Court attempted to provide guidelines on how to claim an in-kind exemption — for example, by listing the exempt value as "full market value" (FMV) or 100 percent of FMV.[9] Unfortunately, lower courts have generally not accepted either approach.[10] Therefore, it is important for the administration of the case for the debtor to specify the amount of exemption being applied to the asset. Claiming 100 percent of FMV creates ambiguity and fails to satisfy this obligation.

When the FMV is determined, 11 U.S.C. § 522(a)(2) defines "value" as the FMV on the date of the filing petition or, for property that later becomes property of the estate, the date such property became property of the estate. This is not the end of the matter because there is a split in the circuits. Generally, the nature and extent of the debtor's exemption is determined on the petition date. However, some courts have concluded that the appropriate date is the sale date by the chapter 7 trustee.[11]

The crux of these cases is how to address appreciation in an exempt asset at the time of sale. In *In re Gebhart*, the debtors exempted the full amount of the value of their primary residence on their schedules.[12] Although both debtors received discharges, their cases remained open by the chapter 7 trustees who sought to sell the properties due to an appreciation in values. Believing that the assets were exempt, the debtors continued to reside in their properties, pay mortgages and taxes, and even refinance a loan. However, the Ninth Circuit said that the appreciation was an asset of the estate, regardless of the trustees' failure to timely object to the exemptions.[13] Therefore, as the court explained, "[a] chapter 7 debtor will not be certain about the status of a homestead property until the case is closed (something that may not happen for several years after the bankruptcy filing) or the trustee abandons the property."[14]

How to Value, Exempt a Legal Claim

To determine the value of a legal claim, it is essential to consider and account for the poten-

1 *See* 11 U.S.C. § 541 (2006); *Schwab v. Reilly*, 130 S. Ct. 2652, 2663-64 (2010).
2 4 *Collier on Bankruptcy* ¶ 522.01 (Alan N. Resnick and Henry J. Sommer eds., 16th ed. 2010); *see Local Loan Co. v. Hunt*, 292 U.S. 234 (1934). H.R. Rep. No. 95-595, at 117 (1977), *reprinted in* U.S.C.C.A.N. 5963, 6078; *see Rousey v. Jacoway*, 544 U.S. 320, 322-25 (2005).
3 *Schwab*, 130 at 2663.
4 *Id.* at 2664.
5 *See In re Colvin*, 288 B.R. 477, 479-81 (Bankr. E.D. Mich. 2003) (citing cases).
6 *See* 11 U.S.C. § 704(a)(4) (2006); *see, e.g., Kuehn v. Cadle Co.*, No. 5:04-cv-432-Oc-10GRJ, 2007 WL 809656, at *4, 2007 U.S. Dist. LEXIS 18387 (M.D. Fla. March 15, 2007); *Preblich v. Battley*, 181 F.3d 1048, 1053 (9th Cir. 1999); *In re Wiford*, 105 B.R. 992 (Bankr. N.D. Okla. 1989); *In re Hill*, 95 B.R. 293 (Bankr. N.D.N.Y. 1988).
7 *See* 11 U.S.C. § 704(a)(4) (2006); *see, e.g., In re Hyman*, 967 F.2d 1316, 1319 n.6 (9th Cir. 1992); *In re Chappell*, 373 B.R. 73, 77 (B.A.P. 9th Cir. 2007), *aff'd*, 621 F.3d 1206 (9th Cir. 2010).
8 *See In re Hyman*, 967 F.2d 1316; *Schwaber v. Reed (In re Reed)*, 940 F.2d 1317 (9th Cir. 1991).
9 *See Schwab*, 130 S. Ct. at 2668.
10 *See In re Salazar*, 449 B.R. 890, 901 (2011); *Massey v. Pappalardo (In re Massey)*, 465 B.R. 720, 730 (2012); *In re Luckham*, 464 B.R. 67 76-77 (2012).
11 *Owen v. Owen*, 500 U.S. 305, 308 (1991); *In re Cunningham*, 513 F.3d at 325; *Polis v. Getaways Inc. (In re Polis)*, 217 F.3d 899, 902 (7th Cir. 2000); *In re Chiu*, 266 B.R. 743, 751 (B.A.P. 9th Cir. 2001); *In re Herman*, 120 B.R. 127, 130 (B.A.P. 9th Cir. 1990); *In re Gebhart*, 621 F.3d 1206 (9th Cir. 2010); *Hyman v. Plotkin*, 967 F.2d 1316 (9th Cir. 1992); *In re Alsberg*, 68 F.3d 312 (9th Cir. 1995).
12 *Gebhart*, 621 F.3d at 1208-09.
13 *Id.* at 1206, 1211.
14 *Id.* at 1206, 1212.

tial increase or diminution in value, and accurately adjust the FMV and exemption values accordingly. Hon. Richard Posner aptly cited the logic behind this method of claiming exemptions in *Polis v. Getaways Inc.*:[15]

> Often, property appreciates in a wholly unexpected fashion. A lottery ticket that turns out against all odds to be a winner is merely the clearest example … so it is with a legal claim. It might when it first accrued have seemed so "far out" that its [FMV] would be well within the limits of the exemption, and yet — such are the uncertainties of litigation — it might turn into a huge winner.…
>
> When there is uncertainty about whether some benefit, here an award of money in a class action suit, will actually be received, the *value* of the (uncertain) benefit is less than the *amount* of the benefit if it is received. A *claim* for $X is not worth $X. A 50 percent chance of obtaining a $1,000 judgment is not worth $1,000. As a first approximation, it is worth $500 (less if the owner of the chance is risk-averse, more if he is risk-preferring, but these are refinements unnecessary to consider in this case).[16]

In *Taylor v Freeland & Kronz*, the debtor listed "proceeds from lawsuit — *[Davis] v. TWA*" and "Claim for lost wages" with a value of "unknown."[17] Since the trustee did not object within the required 30 days by the conclusion of the § 341 hearing, the Supreme Court held that the property was exempt.[18] This resulted in the debtor recovering substantially more than she was entitled to exempt; however, this will not always be the case.[19] Thus, we do our clients a disservice if we fail to assess the value of assets and exemptions in Schedules B and C. When preparing schedules, an explanation of the determination of value is beneficial for several reasons: (1) it prevents courts and defense counsel from invoking judicial estoppel based on a low value; (2) it explains the basis for determination of market value; and (3) it prevents an objection to discharge based on improper valuation.

Two relevant cases provide examples of the importance of properly describing a claim or potential claim in a Schedule B. In *Cusano v. Klein*, the Ninth Circuit denied a post-discharge chapter 11 debtor his claim for pre-petition royalties and other damages that were accrued pre-petition.[20] The court stated that unpaid pre-petition royalties and other damages that accrued pre-petition are "subject to a separate scheduling requirement as accrued causes of action. Causes of action are separate assets, which must be formally listed."[21]

In *Tilley v. Anixter Inc.*, the court analogized the lack of specificity with which the debtor listed pre-existing claims to *Cusano* and reached the same result.[22] The debtor in *Tilley* listed claims pertaining to domestic-relations disputes with her former spouse, but failed to list a claim for intentional infliction of emotional distress.[23] The court determined that the debtor failed to make adequate disclosure.[24]

In *In re Cumba*, the court held that a chapter 13 debtor who listed the value of a claim as "unknown" must assign the estimate of the current value that she deems the claim is worth.[25] The debtor, citing *Ingram v. Thompson*, argued that there is no uniform procedure followed by courts to value a cause of action when the claim was a torts claim.[26] The court concluded that "the best guide for establishing the current value of a particular cause of action (legal claim) is to find out the monetary awards that the state courts have awarded to similar legal claims (causes of action) in the past."[27]

Adequate specificity in describing a claim requires avoiding the use of "unknown" as the description of the asset's value.[28] When "unknown" is used, a more detailed description of the claim should be provided, including whether the debtor is "a member of a class action claim against a defendant that has sought chapter 11 relief, the name of the lawsuit, defendant, contact information for class counsel, and the case number and jurisdiction of the defendant's bankruptcy."[29] The claim must have a numerical value in order to allow the debtor and trustee to allocate a value to the claimed exemptions.

Although a pre-petition cause of action is difficult to value prior to settlement or final judgment, counsel can include a description indicating the amount of damages prayed for in the complaint.[30] A tort claim without more is possibly worthless. After review by an attorney, the value increases. When a lawsuit is filed, the claim has more value because the filing fee was paid, a complaint was drafted, a defendant was identified, and an attorney may have begun discovery or attended an early case conference. Other considerations include the stage of the case, collectability, the identity of the defendant and the competency of its counsel.

For instance, the market value of a claim with a "face value" of $250,000 may have a current FMV of $25,000 because of (1) pre-discovery, (2) no admitted liability, (3) vagaries of litigation, (4) doubt as to liability, or (5) contributory or comparative negligence. However, per *Schwab*, you can then claim the entire asset exempt and determine an amount to show the allocation of the exemptions. Ultimately, the value on the filing date is the sale or settlement value of the claim. A claim against a hapless teenage driver has less value than a claim against a drunken employee returning from a holiday party in his work vehicle. Certainly, the latter claim has more potential collectability, and thus settlement value. The Seventh Circuit Court of Appeals applied the following rationale to valuing legal claims:

> Legal claims are assets whether or not they are assignable, especially when they are claims for money; as a first approximation, the value of Polis's claim is the judgment that she will obtain if she litigates and wins multiplied by the probability of that (to her) happy

15 *In re Polis*, 217 F.3d at 903.
16 *Id.*
17 *See Taylor v. Freeland & Kronz*, 503 U.S. 638, 640 (1992).
18 *Id.* at 638 and 643.
19 *Id.*
20 *See Cusano v. Klein*, 264 F.3d. 936, 942 (9th Cir. 2001).
21 *Id.* (citing *Vreugdenhill v. Navistar Int'l Transp. Corp.*, 950 F.2d 524, 525 (8th Cir. 1991)).
22 Task Force on Attorney Discipline Best Practices Working Group, Ad Hoc Committee on Bankruptcy Court Structure and Insolvency Processes, Working Paper: Best Practices for Debtors' Attorneys 90, *The Business Lawyer* (Vol. 64, November 2008).
23 *Id.*
24 *Id.*
25 *See In re Cumba*, No. 12-02396, 2014 WL 320050 at *6 (Bankr. D.P.R. Jan. 29, 2014).
26 *Id.* at *3.
27 *Id.* at *6.
28 Task Force on Attorney Discipline Best Practices Working Group, Ad Hoc Committee on Bankruptcy Court Structure and Insolvency Processes, Working Paper: Best Practices for Debtors' Attorneys 91, *The Business Lawyer* (Vol. 64, November 2008).
29 *Id.*
30 *See Wissman v. Pittsburgh Nat'l Bank*, 942 F.2d 867, 871 (4th Cir. 1991); Task Force on Attorney Discipline Best Practices Working Group, Ad Hoc Committee on Bankruptcy Court Structure and Insolvency Processes, Working Paper: Best Practices for Debtors' Attorneys 91, *The Business Lawyer* (Vol. 64, November 2008).

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> outcome. That is roughly how parties to money cases value them for purposes of determining whether to settle in advance of trial. They do so whether or not the claim is assignable; unassignable claims (tort claims, for example) command positive prices in the settlement "market."[31]

It is normal in the business world to "discount to present value." When an annuity or other asset will be paid at some future date, it should be discounted to consider the time value of the money. A promise to pay $10,000 in 10 years is worth substantially less than $10,000 today, especially if the payor is an ex-spouse. To determine what the present value of a future payment is, inflation, lost interest, opportunity costs and likelihood of payment must be factored into the equation. This is the value of the asset.[32]

In the business context, dissenters' rights, control and the like are ordinarily considered when valuing an asset and should be considered in listing a stock, partnership or limited liability company for an individual debtor. The individual factors are beyond the scope of this article but are worthy of consideration.

The ultimate goal is to have the asset leave the estate because it is exempt. If property is claimed as exempt and the exemption is not objected to, the property is withdrawn from the estate.[33] The effect is that it is abandoned and no longer available to the trustee to pay creditors. By ensuring that the property exits the bankruptcy with the debtor, the debtor may obtain a fresh start. abi

31 *In re Polis*, 217 F.3d at 903.

32 Task Force on Attorney Discipline Best Practices Working Group, Ad Hoc Committee on Bankruptcy Court Structure and Insolvency Processes, Working Paper: Best Practices for Debtors' Attorneys 104, *The Business Lawyer* (Vol. 64, November 2008).

33 *See Owen*, 500 U.S. at 308.