Bankruptcy

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I. INTRODUCTION

During 1992, the United States Court of Appeals for the Eleventh Circuit decided fifteen cases in the area of bankruptcy law. The decisions covered a diverse array of sections of the Bankruptcy Code (the "Code"). In addition to cases with practical application within the Eleventh Circuit, several decisions have national significance. This Article is a survey of each bankruptcy decision by the Eleventh Circuit in 1992.

II. JURISDICTION

A. Jurisdiction of Related Proceeding upon Dismissal of the Bankruptcy Case

In Fidelity & Deposit Co. of Maryland v. Morris (In re Morris), the Eleventh Circuit held that the bankruptcy court did not abuse its discretion by retaining jurisdiction over an adversary proceeding after the underlying Chapter 11 case was dismissed. Jack W. Morris, the debtor, was a building contractor who built two housing projects for the Anniston Housing Authority (the "Authority"). The debtor defaulted on the projects, and his surety, Fidelity & Deposit Company of Maryland ("Fidelity"), funded completion of the projects in accordance with its bond. The debtor filed a petition for relief under Chapter 11 in 1985 and initi-
ated an adversary proceeding against the Authority to collect the unpaid retainage. The Chapter 11 case remained virtually dormant for three years, and in August 1989, the Chapter 11 case was dismissed.4

A hearing on dismissal of the adversary proceeding was held in September, 1989, after dismissal of the Chapter 11 case.6 Although the attorney for the Authority argued that a state court could more appropriately try the case, the attorney did not otherwise object to the bankruptcy court’s jurisdiction. The bankruptcy court conducted a trial the following month, which resulted in a judgment against the Authority in the amount of $107,465.08.8

The Authority appealed the judgment to the district court.7 The district court did not reach the merits of the appeal and held that the bankruptcy court lost subject matter jurisdiction over the adversary proceeding by failing to expressly preserve that jurisdiction in the order dismissing the bankruptcy case or, alternatively, that the bankruptcy court abused its discretion by retaining jurisdiction over the adversary proceeding after the debtor failed to pursue the Chapter 11 case in good faith.8

In reversing the district court, the Eleventh Circuit followed a two-step analysis of the jurisdictional issue.9 First, the Eleventh Circuit considered, as a matter of first impression in the circuit, whether dismissal of a bankruptcy case required dismissal of related proceedings.10 Dismissal of related proceedings normally follows dismissal of the bankruptcy case because federal jurisdiction over the related proceeding is originally premised on its nexus to the bankruptcy, but exceptions to the general rule exist.11 After surveying numerous decisions from other courts, the Eleventh Circuit stated that “nothing in the statute governing jurisdiction granted to the bankruptcy courts prohibits the continuance of federal jurisdiction over an adversary proceeding which arose in, or was related to,

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4. Id. at 1533.
5. Id.
6. Id.
7. Id. Fidelity also appealed from the denial of its motion to intervene in the adversary proceeding. Id.
8. Id.
9. Id. at 1533-35.
10. Id. at 1533-34. The Eleventh Circuit relied heavily upon the Third Circuit’s decision in In re Smith, 866 F.2d 576 (3d Cir. 1989), stating that: “The Third Circuit has previously examined a similar issue ... and concluded that the bankruptcy court properly retained jurisdiction of an adversary proceeding following the discharge of the debtor.” 950 F.2d at 1533. In his dissent, Judge Clark questioned the applicability of Smith, since the bankruptcy case in Smith concluded by the debtor’s discharge, rather than dismissal. 950 F.2d at 1537-38 (Clark, J., dissenting). See infra notes 21-25 and accompanying text.
11. 950 F.2d at 1534 (citing Smith, 866 F.2d at 580).
a bankruptcy case following dismissal of the underlying bankruptcy case.” The court concluded, therefore, that “the dismissal of an underlying bankruptcy case does not automatically strip a federal court of jurisdiction over an adversary proceeding which was related to the bankruptcy case at the time of its commencement.” The decision whether to retain jurisdiction should be left to the sound discretion of the trial court.

The second step in the Eleventh Circuit’s analysis was to determine whether the bankruptcy court abused its discretion by retaining jurisdiction in this instance. The factors to be considered in exercising such discretionary jurisdiction are: “(1) judicial economy; (2) fairness and convenience to the litigants; and (3) the degree of difficulty of the related legal issues involved.” The adversary proceeding was ready for trial at the time the bankruptcy court dismissed the Chapter 11 case, and the bankruptcy court based its retention of jurisdiction on judicial economy and fairness and convenience to the litigants. Under those circumstances, giving proper deference to the bankruptcy court, the Eleventh Circuit found that the bankruptcy court did not abuse its discretion by trying the adversary proceeding, even though the difficulty of the legal issues favored a trial in the state court. The Eleventh Circuit remanded the proceedings for the district court’s consideration of the merits of the appeal.

Judge Clark rendered a sharp dissenting opinion. Judge Clark asserted that the case authority relied upon by the majority was not applicable. Furthermore, he took issue with the key factual predicate that

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12. *Id.* (citations omitted).
13. *Id.* The district court analogized the adversary proceeding to a pendent claim in a civil suit and reasoned that the bankruptcy court lost jurisdiction over the adversary proceeding by failing to expressly state in its dismissal order that the adversary proceeding would be retained. *Id.* The Eleventh Circuit rejected this reasoning since the adversary proceeding and bankruptcy proceeding were two separate cases. *Id.*
14. *Id.*
15. *Id.*
16. *Id.* at 1535 (citing Smith, 866 F.2d at 580).
17. *Id.* This factual setting should be compared with Smith, where the trial of the adversary proceeding had already been completed at the time of the debtor’s discharge. *Id.*
18. The Eleventh Circuit quickly disposed of the district court’s finding that the bankruptcy court abused its discretion by retaining the adversary proceeding after the debtor’s failure to pursue the bankruptcy case in good faith, stating simply that “the decision of the bankruptcy court was entitled to deference.” *Id.*
19. *Id.* at 1535-36. “Although the Authority and Fidelity argue that the difficulty of the legal issues favors a trial in state court, we are not persuaded that this factor is so overwhelming that it outweighs the others.” *Id.* at 1535.
20. *Id.* at 1536.
21. *Id.* at 1536-40.
22. *Id.* at 1537.
the adversary proceeding was ready for trial when the bankruptcy case was dismissed. The net result, Judge Clark contended, was the creation of an exception which consumed the general rule that a bankruptcy court should not retain jurisdiction over adversary proceedings after the bankruptcy court dismisses the underlying bankruptcy case. This result would not have been “so egregious” to Judge Clark had the debtor been required to pay creditors from the proceeds of any final judgment.

Indeed, as pointed out by Judge Clark in his dissent, Morris broadly empowers a bankruptcy court or district court to retain jurisdiction over related proceedings after dismissal of the bankruptcy case itself. The key is that this exercise of subject matter jurisdiction is discretionary. From a practical standpoint, this power will most likely be asserted sparingly.

B. Claims Between Two Non-Debtor Entities

In United States v. Challenge Air International, Inc. (In re Challenge Air International, Inc.), the debtor, Challenge Air International, Inc. (“Challenge Air”), operated a commercial airline and had an agreement with American Express Travel Related Services Co. (“American Express”), to accept American Express cards for the purchase of its airline services. The agreement entitled American Express to withhold payments to Challenge Air as a reserve fund against chargebacks by cardholders. As of October 28, 1987, American Express owed Challenge Air approximately $162,000 from the reserve fund.

Meanwhile, Challenge Air failed to pay federal taxes for the first and second quarters of 1987. After the Internal Revenue Service (“IRS”) assessed the amounts due, the IRS filed tax liens against Challenge Air’s property. The IRS issued a notice of levy to American Express on October 28, 1987, seeking to collect taxes totaling $456,456.46. The levy attached to “‘all money or other obligations’” owed by American Express to Challenge Air. American Express did not honor the levy and refused to release the reserve fund to the IRS.

Challenge Air filed for relief under Chapter 11 on November 23, 1987. After the court appointed a Chapter 11 trustee, Challenge Air and the trustee filed an adversary proceeding against American Express and the
In the adversary proceeding, the IRS sought to hold American Express liable for the tax, interest, and penalties under section 6332(d) of the Internal Revenue Code for failure to honor the levy. The bankruptcy court granted turnover of the reserve fund to the bankruptcy estate and found that American Express had no liability to the IRS under 26 U.S.C. § 6332(d). The district court affirmed the bankruptcy court's decision.

On appeal to the Eleventh Circuit, the court of appeals affirmed the judgment for turnover to the bankruptcy estate. The Eleventh Circuit also upheld the bankruptcy court's jurisdiction to decide that American Express had no liability to the IRS under section 6332(d). The court stated that "[j]urisdiction of the bankruptcy court is limited to matters affecting the estate and the parties' conflicting claims to estate property." Since the IRS was attempting to penalize American Express for failing to honor the levy upon the reserve fund, which was ultimately held to be property of the estate subject to turnover, the bankruptcy court had jurisdiction to deny the relief the IRS sought against American Express under section 6332(d). The Eleventh Circuit was careful to point out that the bankruptcy court only determined whether American Express was liable under section 6332(d) from the date of the bankruptcy filing. The decision implies that the bankruptcy court would not have had jurisdiction to determine the liability of American Express under section 6332(d) for the period from the date of the levy to the date of the bankruptcy filing.

III. AUTOMATIC STAY

A. Domestic Relations Proceeding

In Carver v. Carver, the Eleventh Circuit delivered an important opinion on the frequent tension between the federal bankruptcy law and domestic relations under state law. In October 1988, Edward and Paulette...
Carver were granted a divorce. The court ordered the debtor, Edward Carver, to pay child support and to make mortgage payments on the former marital residence, which remained in the possession of his ex-wife. The debtor fell behind on mortgage payments, and the mortgage company initiated foreclosure proceedings. In February 1989, the debtor filed a Chapter 13 petition without listing his ex-wife as a creditor or otherwise giving her notice of the bankruptcy. The ex-wife proceeded to initiate a contempt action against the debtor in the Family Court of Akin County, South Carolina, on March 10, 1989. The attorney for the ex-wife learned of the debtor's bankruptcy filing from a third party on March 13, 1989. Nevertheless, the hearing on the contempt matter went forward in the family court on March 23, 1989.43

The debtor was present at the contempt hearing but was not represented by counsel. The family court found the debtor in contempt, sentencing him to six months in jail with the provision that the sentence would be suspended upon payment of all arrearages and charges due the mortgage holder. After the debtor spent seven and one-half days in jail, his current wife borrowed $8,792.48 from her father to make the payment necessary to secure the debtor's release from jail.44

Upon the debtor's release from jail, he filed an action in the bankruptcy court against the ex-wife and her attorneys for damages for their alleged willful violation of the automatic stay of section 362(a) of the Code.45 The bankruptcy court found a willful violation of the automatic stay and awarded the debtor $18,295.78 in damages.46 The district court upheld the finding of a willful stay violation but modified the damage amount.47

The initial question discussed by the Eleventh Circuit was whether the contempt action in Family Court was excepted from the automatic stay.48 Section 362(b)(2) of the Code49 excepts from the automatic stay "the collection of alimony, maintenance, or support from property that is not property of the estate."50 This section was of no help to the ex-wife and her attorneys, since the exception only applies to collection efforts directed at property that is not property of the estate, and in a Chapter 13 case, property of the estate includes earnings acquired by the debtor after the bankruptcy filing.51 "Under this statutory scheme, the exception in 11

43. Id. at 1574-75.
44. Id. at 1575.
45. Id. at 1575-76; 11 U.S.C. § 362(a) (1988).
46. 954 F.2d at 1576.
47. Id.
48. Id. at 1576-77.
50. 954 F.2d at 1576 (quoting 11 U.S.C. § 362(b)(2) (1988)).
51. Id. at 1577 (citing 11 U.S.C. § 1306(a) (1988)).
U.S.C. § 362(b)(2) has little or no practical effect in Chapter 13 situations. The contempt action in family court, therefore, was technically in violation of the automatic stay.

The Eleventh Circuit stated that the ex-wife should have moved for relief from the automatic stay under section 362(d) of the Code. Situations involving alimony, maintenance, or support constitute "cause" for lifting the automatic stay, and such relief should be liberally granted. Despite the fact that the ex-wife did not follow these recommended procedures, a further inquiry was necessary to determine whether sanctions were appropriate for the technical stay violation.

According to the Eleventh Circuit, a bankruptcy court must consider the well-grounded federal policy of abstention in domestic relations matters before exercising its jurisdiction. In diversity jurisdiction cases, federal courts traditionally abstain from deciding 'cases involving divorce and alimony, child custody, visitation rights, establishment of paternity, child support, and enforcement of separation or divorce decrees still subject to state court modification.' The reasons for this abstention policy include "the strong state interest in domestic relations matters, the competence of state courts in settling family disputes, the possibility of incompatible federal and state court decrees in cases of continuing judicial supervision by the state, and the problem of congested dockets in federal courts." The Eleventh Circuit stated that the same rationale applies to abstention by the bankruptcy courts.

The general abstention provision in bankruptcy proceedings is 28 U.S.C. § 1334(c)(1), which states: "Nothing in this section prevents a district court in the interest of justice, or in the interest of comity with State courts or respect for State law, from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11." This abstention provision may be invoked upon the request of a party or sua sponte by the court. Whether or not a party affirmatively moves for abstention, the Eleventh Circuit stated that bankruptcy and district courts should "tread very carefully" before imposing

52. Id.
53. Id.
55. 954 F.2d at 1578.
56. Id.
57. Id.
58. Id. (quoting Ingram v. Hayes, 866 F.2d 368, 369 (11th Cir. 1988)).
59. Id. (quoting Crouch v. Crouch, 566 F.2d 486, 487 (5th Cir. 1978)).
60. Id.
63. Id.
contempt sanctions in matters involving alimony, maintenance, or support.64

Under the facts of Carver, the Eleventh Circuit concluded that the bankruptcy court should have abstained from the contempt action against the ex-wife and her attorneys.65 The Eleventh Circuit stopped short of mandating abstention every time a domestic relations issue arises and stated that, in appropriate circumstances when the purposes of the automatic stay would be served, and the court would not be required to delve too deeply into family law, abstention might not be necessary.66

The court absolved the creditor in Carver of liability for a violation of the automatic stay. This decision should not be construed, however, to mean that the automatic stay can simply be ignored in all domestic relations matters. Instead, as suggested by the Eleventh Circuit, relief from the automatic stay for "cause" under section 362(d) of the Code should be sought by a party to the domestic relations dispute and freely granted by the bankruptcy court.

B. Administrative Freeze

In B.F. Goodrich Employees Federal Credit Union v. Patterson (In re Patterson),67 the Eleventh Circuit held that the freeze of a debtor's checking account was a violation of the automatic stay of section 362(a).68 The debtors, Fred C. Patterson and Mary L. Patterson, were members of the B.F. Goodrich Employees Federal Credit Union (the "Credit Union") where they maintained a savings account and a checking account. The accounts served as collateral for a loan taken out from the Credit Union. The debtors filed for relief under Chapter 13, and when the Credit Union received notice of the bankruptcy filing, it blocked all activity in the debtors' accounts.69

64. Id.
65. Id. at 1580. The purpose of the automatic stay was not served by the damage award, because other creditors were not harmed by the action in family court. Furthermore, the debtor was to blame for much of the situation, since he was repeatedly delinquent on his support obligations. Finally, the Eleventh Circuit concluded that the debtor was attempting to use bankruptcy as a tactical weapon in the domestic relations dispute with his ex-wife. Id.
66. Id.
67. 967 F.2d 505 (11th Cir. 1992).
68. Id. at 511; 11 U.S.C. § 362(a) (1988).
69. 967 F.2d at 507. The debtors were given notice that all services at the Credit Union had been suspended as a result of their bankruptcy filing. The Credit Union refused to cash the debtors' checks. At least six checks written by the debtors were returned, causing the debtors to incur returned check charges, and the debtors were prohibited from making deposits to cover the checks. Id. The Credit Union filed a proof of claim in the bankruptcy
The debtors filed an adversary proceeding against the Credit Union for turnover of the frozen funds and a second adversary proceeding to restrain the Credit Union from closing their accounts. After the bankruptcy court held a hearing, it enjoined the Credit Union from closing the debtors' accounts and awarded the debtors damages and attorney's fees for violating the automatic stay and wrongfully discriminating against the debtors under section 525 of the Code. The district court on appeal affirmed the order of the bankruptcy court. The Eleventh Circuit found that the Credit Union's freeze of the debtors' accounts violated at least three different subsections of the automatic stay of section 362(a). Specifically, the freeze was an improper exercise of control over property of the estate in violation of section 362(a)(3); an act to enforce a lien against property of the estate in violation of section 362(a)(4); and an act to recover a claim against the debtor that arose before the commencement of the bankruptcy case in violation of section 362(a)(6). These violations of the automatic stay made it unnecessary for the court to determine whether the freeze was a violation of section 362(a)(7), which stays setoff by a creditor.

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2. 967 F.2d at 508.
3. Id. at 511.
4. Id.; 11 U.S.C. § 362(a)(3), (4), (6) (1988). These sections state as follows:
   (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title ... operates as a stay, applicable to all entities, of — ...
   (3) 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;
   (4) any act to create, perfect, or enforce any lien against property of the estate;
   (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title; ...
The Eleventh Circuit rejected the Credit Union's argument that the freeze was necessary to protect its right of setoff. Although the Code generally preserves a right of setoff under nonbankruptcy law through section 553(a), setoff under that section is expressly conditioned upon relief from the automatic stay. Thus, the Code contemplates a judicial determination before setoff is exercised, rather than the self-help remedy afforded by a freeze.

The Eleventh Circuit affirmed the award of damages and attorney's fees against the Credit Union for its violation of the automatic stay and its discrimination against the debtors in violation of section 525(b) of the Code. Yet, to give future guidance to creditors holding deposit accounts as collateral, the Eleventh Circuit offered a practical solution intended to balance the creditor's rights with the need for judicial approval of setoff.

The procedure suggested by the court is for the creditor to file an ex parte motion under sections 362(f) or 363(e) and accompany the mo-

77. 967 F.2d at 513. "Although we do not address here the issue of whether a freeze constitutes a setoff, per se, our opinion eviscerates the logic of those opinions which answer this question in the negative." Id.
78. Id. at 508-11. In fact, the Credit Union did not have a valid right of setoff under state law because the debt was not mature. Id. at 510. But that fact was not essential to the court's holding that the freeze was contrary to the Code. Id.
79. 11 U.S.C. § 553(a) (1988). This section provides, in relevant part:
   (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . .
   Id.
80. 967 F.2d at 509 (citing 11 U.S.C. § 553(a) (1988)).
81. Id. at 510.
82. Id. at 514.
83. Id. The Credit Union's action against the debtors was discriminatory, in violation of section 525(b), because the debtors' membership privileges were terminated solely as a result of their bankruptcy filing and not as a result of any loss they caused the Credit Union to suffer. Id.
84. Id. at 511.
85. 11 U.S.C. § 362(f) (1988). This section provides:
   (f) Upon request of a party in interest, the court with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.
   Id.
86. 11 U.S.C. § 363(e) (1988). This section provides:
   (e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall
tion with payment of the debtor’s funds into the registry of the bankruptcy court.  This procedure would not violate the automatic stay because it represents “an abdication of control by the creditor in favor of the bankruptcy court’s determination of the disposition of the funds.”

Although courts in other jurisdictions permit an administrative freeze on a debtor’s account, *Patterson* makes these cases inapposite within the Eleventh Circuit. A creditor faced with this situation who asserts control over the debtor’s account without following the recommended procedure of filing a motion and paying the funds into the registry of the bankruptcy court does so at its peril.

IV. OBTAINING CREDIT: CROSS-COLLATERALIZATION

The Eleventh Circuit decided in *Shapiro v. Saybrook Manufacturing Co. (Matter of Saybrook Manufacturing Co.)* that the use of cross-collateralization to obtain post-petition financing is impermissible under the Code. Cross-collateralization has been a controversial practice. By disallowing cross-collateralization, *Saybrook* puts an end to the controversy within the Eleventh Circuit.

The debtors, Saybrook Manufacturing Co. and related companies, filed petitions for relief under Chapter 11 on December 22, 1988. At the time of the bankruptcy filings, the debtors owed Manufacturers Hanover approximately $34 million. The value of the collateral securing the claim of Manufacturers Hanover was only $10 million, meaning that the creditor was undersecured by approximately $24 million. One day after the bankruptcy proceedings commenced, the debtors filed a motion for the use of cash collateral and for authorization to incur secured debt. The financing proposal submitted to the bankruptcy court was for Manufacturers Hanover to lend an additional $3 million to the debtors, in exchange for which Manufacturers Hanover would receive a security interest in all of the debtors’ property to secure *both* the pre-petition debt and the post-petition advance.

Two unsecured creditors, Seymour and Jeffrey Shapiro, objected to the financing arrangement. The bankruptcy court overruled the objections

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87. 967 F.2d at 511.
88.  *Id.* at 512.
89.  963 F.2d 1490 (11th Cir. 1992).
90.  *Id.* at 1496.
91.  *Id.* at 1493.
92.  *Id.* at 1491.
93.  *Id.* at 1492.
and entered an order approving the financing. The creditors appealed to the district court, but the district court dismissed their appeal on grounds of mootness. In order to reach the merits of the appeal, the Eleventh Circuit used its conclusion on the legality of cross-collateralization as the basis for its ruling on mootness.

The Eleventh Circuit described the type of cross-collateralization at issue in this case as Texlon-type cross-collateralization, defined as follows:

[1]n return for making new loans to a debtor in possession under Chapter XI, a financing institution obtains a security interest on all assets of the debtor, both those existing at the date of the order and those created in the course of the Chapter XI proceeding, not only for the new loans, the propriety of which is not contested, but [also] for existing indebtedness to it.

This type of cross-collateralization is distinguishable from the securing of post-petition debt with pre-petition collateral, which was not at issue in this appeal.

The Eleventh Circuit surveyed the cases on cross-collateralization and noted that, even though the practice has been approved by several bankruptcy courts, those courts were generally reluctant to do so. To obtain approval of cross-collateralization, the debtor and secured creditor had to meet a stringent four-part test. No other circuit court had directly approved the validity of Texlon-type cross-collateralization.

The Eleventh Circuit concluded that this type of cross-collateralization was illegal per se on two grounds. First, cross-collateralization is not authorized under section 364 of the Code. "By their express terms, sections 364(c) & (d) apply only to future—i.e., post-petition—extensions of credit. They do not authorize the granting of liens to secure pre-petition loans." Second, cross-collateralization cannot be approved under the bankruptcy court's inherent equitable power because it directly contra-

94. *Id.*
95. *Id.*
96. *Id.* at 1493. See *infra* notes 277-86 and accompanying text.
97. 963 F.2d at 1491-92 (quoting Otte v. Manufacturers Hanover Commercial Corp. *In re Texlon Corp.*, 596 F.2d 1092, 1094 (2d Cir. 1979)).
98. *Id.* at 1492.
99. *Id.* at 1493 (citations omitted).
100. *Id.*
101. *Id.* (citing *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983)).
102. *Id.* at 1494.
103. *Id.* at 1494-96.
105. 963 F.2d at 1495; 11 U.S.C. §§ 364(c)(1), (2), (3); 364(d)(1)(A), (B); 364(d)(2) (1988). These subsections provide:
venes the priority scheme of the Code. The Code calls for creditors within a given class to be treated equally, but cross-collateralization gives the lender a priority over all other unsecured claims. To create such priorities with a class of claims exceeds the equitable powers of the bankruptcy court. The Eleventh Circuit dismissed the contention that cross-collateralization furthers the objective of helping Chapter 11 debtors reorganize, stating that such an end does not justify the use of means so fundamentally at odds with the Code's rules of priority and distribution.

V. Recovery of Assets of the Estate

A. Fraudulent Conveyances

The decision in Grissom v. Johnson (Matter of Grissom) amplifies that there is not a seventy-percent test or other mathematical formula for determining whether property sold through a lawful foreclosure brought a "reasonably equivalent value" for purposes of section 548(a). The fraud-

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt —

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
(3) secured by a junior lien on property of the estate that is subject to a lien.

(d)(1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if —

(A) the trustee is unable to obtain such credit otherwise; and
(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

11 U.S.C. §§ 364(c)(1), (2), (3); 364(d)(1)(A), (B); 364(d)(2).
106. 963 F.2d at 1495-96.
107. Id. at 1496 (citing 3 Collier on Bankruptcy § 507.02[2] (15th ed. 1992)).
108. Id.
109. Id. at 1495 (quoting In re FCX, Inc., 60 B.R. 405, 409 (E.D.N.C. 1986)).
110. Id. at 1496.
111. 955 F.2d 1440 (11th Cir. 1992).
112. 11 U.S.C. §§ 548(a)(2)(A); 548(a)(2)(B)(i), (ii), (iii) (1988). These sections provide:
(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one
ulent conveyance provision in the Code. In 1971, the debtor, Johnny Grissom, borrowed $18,000 from Citizens & Southern National Bank ("C&S") secured by his residence. After the loan was in default, C&S conducted a nonjudicial foreclosure sale of the residence on April 4, 1989. The property was sold to third-party bidders, Birnet and Leslie Johnson, for $14,059, the amount of the C&S debt. One day later, the debtor and his wife filed for relief under Chapter 13. The Grissoms filed a complaint in the bankruptcy court against C&S and the Johnsons to set aside the foreclosure sale.

The only issue in dispute before the bankruptcy court was whether the sale price of $14,059 was the "reasonably equivalent value" of the residence. The bankruptcy court found the value of the residence to be $26,000. Since $14,059 was less than seventy percent of $26,000, the bankruptcy court nullified the foreclosure sale in reliance upon Durrett v. Washington National Insurance Co. The district court affirmed, taking the seventy-percent test from Durrett as a given and finding that the evidence supported the valuation of the residence by the bankruptcy court.

In reversing the lower courts, the Eleventh Circuit reiterated its previous rejection of a purely mathematical approach to the avoidance of lawful foreclosures in Walker v. Littleton (In re Littleton). The court in Littleton adopted a test for determining reasonably equivalent value

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113. 955 F.2d at 1444.
114. Id. at 1443.
115. Id.
116. Id. at 1444.
117. 621 F.2d 201 (5th Cir. 1980). In dictum, the Fifth Circuit stated: "We have been unable to locate a decision of any district or appellate court . . . which has approved the transfer [of a debtor's property] for less than 70% of the market value of the property." Id. at 203. Thus evolved the so-called "Durrett 70% rule." 955 F.2d at 1444.
118. 955 F.2d at 1445.
119. 888 F.2d 90 (11th Cir. 1989).
"'based upon all the facts and circumstances of each case'" and established that the seventy-percent test was merely a guideline. Littleton validated a foreclosure sale at 63.49% of the property's value, but an important factor in Littleton was that the foreclosure also resulted in the termination of junior liens.

In Grissom the Eleventh Circuit went one step further by establishing a presumption that a legitimate foreclosure sale will bring a reasonably equivalent value, absent fraud, collusion, or other irregular or unlawful procedures. Thus, compliance with state foreclosure law will not conclusively deem a foreclosure sale to be immune from attack, nor will the failure of the foreclosure sale to bring a fixed percentage of value render the sale avoidable. Instead, a legitimate foreclosure sale carries a "presumption of reasonableness" requiring the trustee seeking to avoid the sale to "establish specific factors which undermine confidence in the reasonableness of the foreclosure sale price." All facts and circumstances must be considered. Relevant factors include the bargaining position of the parties to the foreclosure sale, the marketability of the property, the fact that foreclosure prices are notoriously below market, whether the foreclosing party obtained a fair appraisal prior to the sale, the extent to which the foreclosure sale was advertised, and the number of serious bidders at the sale.

The rationale for the court's decision is that it strikes the appropriate balance between preserving the rights of lenders and upholding the finality of foreclosure sales, on one hand, and protecting bankruptcy estates from depletion. To the extent Grissom makes it more difficult to set aside foreclosures, it is arguably beneficial to the lending community. However, another facet of the decision in Grissom may have more significant ramifications for foreclosing creditors.

The Eleventh Circuit stated in dictum that C&S could be held liable under section 550(a)(1) of the Code if the foreclosure sale would be

120. 955 F.2d at 1444 (quoting 888 F.2d at 93).
121. Id. at 1445 (citing 888 F.2d at 93).
122. Id. at 1445-46.
123. Id. at 1446.
124. Id. at 1447.
125. Id. at 1446.
126. Id. (citing 888 F.2d at 93).
127. Id.
128. Id. at 1446-47.
129. 11 U.S.C. § 550(a)(1) (1988). This section provides:
(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from —
finally set aside following remand of the case.\textsuperscript{130} This liability is only theoretical if the property is conveyed back to the estate upon avoidance of the transfer. But, if the Johnsons re-convey the property to bona fide purchasers for value from whom the residence cannot be recovered, C\&S could have exposure for $11,941, the difference between the $26,000 valuation and the foreclosure price of $14,059. Accordingly, lenders should be extremely careful when foreclosing on property whose market value significantly exceeds the secured debt. In addition to obtaining a fair appraisal beforehand, the lender might want to consider advertising the sale more widely than the minimal requirements under state foreclosure procedures.

B. Turnover

The primary issue before the court in \textit{United States v. Challenge Air International, Inc. (In re Challenge Air International, Inc.)},\textsuperscript{131} was whether the reserve fund held by American Express under a credit card merchant agreement with the debtor, a commercial airline, was property of the estate subject to turnover under section 542(a) of the \textit{Code}\textsuperscript{132} following a levy upon the reserve fund by the IRS.\textsuperscript{133} The bankruptcy court authorized turnover, and the district court affirmed.\textsuperscript{134}

On appeal to the Eleventh Circuit, the IRS argued that the interest it acquired in the reserve fund through its pre-petition levy prevailed over the right of turnover under section 542(a), but the Eleventh Circuit disagreed, finding that the Supreme Court's decision in \textit{United States v. Whiting Pools}\textsuperscript{135} was dispositive.\textsuperscript{136} In \textit{Whiting Pools} the Court held that property of the bankruptcy estate in a Chapter 11 reorganization included property of the debtor that was seized by a secured creditor prior

\textsuperscript{130} Id.
\textsuperscript{131} 955 F.2d at 1449 n.8.
\textsuperscript{132} 952 F.2d 384 (11th Cir. 1992). \textit{See supra} text accompanying notes 26-41.
\textsuperscript{133} 955 F.2d at 1449 n.8.

\textsuperscript{134} \textit{Id.}
\textsuperscript{135} 462 U.S. 198 (1983).
\textsuperscript{136} 952 F.2d at 386.
to the bankruptcy filing.\textsuperscript{137} The IRS was given no special immunity from the reach of the bankruptcy turnover provision.\textsuperscript{138} Although the IRS was entitled to adequate protection of its interest in the seized property, it could not withhold the property from the debtor's efforts to reorganize.\textsuperscript{139}

The IRS attempted to distinguish \textit{Whiting Pools} on the grounds that it involved the seizure of tangible personal property, whereas the case at hand involved a levy upon cash equivalent property; however, this did not persuade the Eleventh Circuit.\textsuperscript{140} The Supreme Court did not evidence any intent to limit its decision in \textit{Whiting Pools} by the type of property involved.\textsuperscript{141} Moreover, the enforcement provisions of the Internal Revenue Code\textsuperscript{142} "do not transfer ownership of the property to the IRS." \textsuperscript{143} Case law makes clear that an administrative levy by the IRS is merely a "provisional remedy" that does not involve a determination of the government's rights in the seized property relative to other claimants.\textsuperscript{144} For those reasons, the Eleventh Circuit concluded that the fund was subject to turnover in spite of the levy by the IRS.\textsuperscript{145}

\textbf{VI. Executory Contracts and Leases}

The question presented in \textit{Citizens & Southern National Bank v. Thomas B. Hamilton Co. (In re Thomas B. Hamilton Co.)}\textsuperscript{146} was whether a credit card agreement between a merchant and a merchant bank constituted a contract to extend "financial accommodations" within the meaning of sections 365(c)(2)\textsuperscript{147} and 365(e)(2)(B)\textsuperscript{148} such that the credit card

\begin{itemize}
  \item \textsuperscript{137} \textit{Id.} (citing 462 U.S. at 209).
  \item \textsuperscript{138} \textit{Id.}
  \item \textsuperscript{139} \textit{Id.} (quoting 462 U.S. at 212).
  \item \textsuperscript{140} \textit{Id.} at 387.
  \item \textsuperscript{141} \textit{Id.} at 386-87.
  \item \textsuperscript{143} 952 F.2d at 387 (quoting 462 U.S. at 210).
  \item \textsuperscript{144} \textit{Id.} (quoting United States v. National Bank of Commerce, 472 U.S. 713, 721 (1985)).
  \item \textsuperscript{145} \textit{Id.}
  \item \textsuperscript{146} 969 F.2d 1013 (11th Cir. 1992).
  \item \textsuperscript{147} 11 U.S.C. § 365(c)(2) (1988). This section provides:
    \begin{itemize}
      \item (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if — . . .
      \item (2) such contract is a contract to make a loan, or extend other \textit{debt financing or financial accommodations}, to or for the benefit of the debtor, or to issue a security of the debtor; . . .
    \end{itemize}
  \item \textit{Id.} (emphasis added).
  \item \textsuperscript{148} 11 U.S.C. § 365(e)(2)(B) (1988). This section provides:
    \begin{itemize}
      \item (e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not
agreement could not be assumed by the merchant in a Chapter 11 case.\textsuperscript{149}

The debtor, Thomas B. Hamilton Co., was a merchant engaged in the business of retail sales of sterling silver products. The majority of the debtor’s business consisted of credit card sales received through telephone and mail orders. The debtor had a Card Program Member Agreement through Citizens & Southern National Bank (“C&S”) which permitted the debtor to accept its customers’ MasterCard and Visa charge cards in retail sales transactions.\textsuperscript{150} The Card Program Member Agreement was typical of arrangements between merchants and financial institutions dealing in credit card transactions.\textsuperscript{151}

The debtor and C&S functioned under the terms of the Card Program Member Agreement for more than nine years. After the debtor filed a Chapter 11 petition in June 1989, C&S requested that the debtor submit a new application for a credit card merchant agreement. In reviewing the new application, C&S determined that the debtor's unstable financial condition increased its own financial risks, and in October 1989, C&S rejected the debtor’s new application. C&S then moved for relief from the automatic stay to terminate the existing agreement.\textsuperscript{152} Following an evidentiary hearing, the bankruptcy court concluded that the agreement did not fall within the ambit of sections 365(c)(2) and 365(e)(2)(B) and, therefore, could be assumed by the debtor.\textsuperscript{153} The bankruptcy court denied the motion by C&S to terminate the agreement, and the district court affirmed the decision of the bankruptcy court.\textsuperscript{154}
The Eleventh Circuit began its analysis with the observation that the Code does not define the term "financial accommodations." Therefore, the Eleventh Circuit looked at the legislative history to section 365, the leading treatise on bankruptcy law, and case law, all of which narrowly construe the term. The cases distinguish contracts for which the extension of credit is a primary purpose from those in which the extension of credit is merely incidental, with only the former constituting contracts to extend "financial accommodations" within the meaning of sections 365(c)(2) and 365(e)(2)(B). The types of contracts routinely held to fall within these provisions include "loan commitments, guaranty and surety contracts, and other contracts the principal purpose of which is to extend financing to or guaranty the financial obligations of the debtor."

Applying this analytical framework to the facts, the Eleventh Circuit concluded that the purpose of the Card Program Member Agreement between the debtor and C&S was not to provide financing. The specific terms of the agreement "do not evidence any intent on the part of C&S to extend credit to [the debtor]." The potential liability to C&S for chargebacks was only incidental to the overall relationship between the debtor and C&S. Thus, the court held that the Card Program Member Agreement did not constitute a contract for "financial accommodations" within the meaning of sections 365(c)(2) and 365(e)(2)(B).

The Eleventh Circuit buttressed its conclusion with the policy consideration of furthering the financial rehabilitation of retail merchants. Unless credit card merchant agreements are deemed to be assumable, rehabilitation would be virtually impossible for a merchant dependent upon credit card sales. The court added that its conclusion did not impose an unreasonable burden on merchant banks, because assumption of the credit card merchant agreement was subject to approval of the bankruptcy court under section 365(a), with assumption being conditioned on

155. Id.
156. Id. (citations omitted).
157. Id. (quoting 2 COLLIER ON BANKRUPTCY ¶ 365.05[1] (15th ed. 1992)).
158. Id. at 1018-19 n.7 (citations omitted).
159. Id.
160. Id. at 1018-19.
161. Id.
162. Id. at 1020.
163. Id.
164. Id.
165. Id.
166. Id.
167. Id.
168. Id. at 1021; 11 U.S.C. § 365(a) (1988). This section provides: "(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section,
under the curing of defaults as required by section 365(b).\textsuperscript{169} Under certain circumstances not present in the instant case, the court stated that assumption of such an agreement may be denied if continued performance would put an unreasonable risk on the merchant bank.\textsuperscript{170}

VII. CLAIMS AGAINST THE ESTATE

A. Administrative Expense

The question presented in \textit{Alabama Surface Mining Commission v. N.P. Mining Co. (In re N.P. Mining Co.)}\textsuperscript{171} was whether penalties incurred post-petition for environmental violations by a strip mining company were entitled to administrative expense priority.\textsuperscript{172}

The debtor, N.P. Mining Co., was engaged in the business of strip mining coal. The Alabama Surface Mining Commission (the "Commission") is the state agency responsible for administering and enforcing the Alabama Surface Mining Control and Reclamation Act.\textsuperscript{173} In order to insure reclamation of land that has been strip mined, the regulatory scheme in Alabama requires that each licensed operator purchase reclamation bonds. In this instance, the debtor's insurer honored the bond by paying the state of Alabama more than $2 million for compensatory damages to the land mined by the debtor. Therefore, the fines by the Commission in question were solely punitive with no connection to the actual cost of restoring the environment.\textsuperscript{174}

The debtor filed its Chapter 11 petition on February 6, 1987. After a time, the debtor became unable to mine coal of a sufficient quality to

\textsuperscript{169} 969 F.2d at 1021; 11 U.S.C. § 365(b) (1988). This section provides, in relevant part: (b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee —

\begin{itemize}
  \item[(A)] cures, or provides adequate assurance that the trustee will promptly cure, such default;
  \item[(B)] compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
  \item[(C)] provides adequate assurance of future performance under such contract or lease.
\end{itemize}

\textsuperscript{171} 963 F.2d 1449 (11th Cir. 1992).

\textsuperscript{172} Id. at 1451-52.

\textsuperscript{173} \textsc{ALa. Code} §§ 9-16-70, \textit{et seq.} (1975).

\textsuperscript{174} 963 F.2d at 1450.
fulfill its primary contract, but the contract was maintained by brokering coal from another company at a profit. A Chapter 11 trustee was appointed on June 15, 1988. By that point, the debtor’s mining operations had ceased completely, and the case was ultimately converted to a liquidation under Chapter 7. The Chapter 7 bankruptcy estate had assets of approximately $400,000 to $500,000.¹⁷⁶

During the pendency of the case, the Commission assessed penalties of $2,349,000 for which the Commission sought allowance as an administrative expense priority under section 503(b) of the Code.¹⁷⁸ The Commission assessed a portion of the penalties post-petition for the failure to abate pre-petition violations, which the Eleventh Circuit summarily excluded from priority treatment.¹⁷⁷ At stake, however, were $102,850 in penalties incurred while post-petition mining operations were ongoing, and $1,949,400 in fines incurred after mining operations were terminated.¹⁷⁸

First, the Commission argued that the penalties for post-petition violations qualified as administrative expenses under the rationale of the Supreme Court’s decision in Reading Co. v. Brown,¹⁷⁹ in which tort claims against a bankruptcy estate for compensatory damages were payable as administrative expenses despite the absence of any benefit to the estate.¹⁸⁰ The Eleventh Circuit distinguished Reading, since that decision to allow compensatory damages as administrative expenses was predicated on “‘fairness to all persons having claims against an insolvent.’ ”¹⁸¹ Reading did not open the door for all liabilities incurred by a bankruptcy estate to be treated as administrative expenses without a showing of benefit to the estate.¹⁸² Fairness would not be served by allowing all of the Commission’s penalties to be paid on an administrative priority basis, because the penalties did not represent compensation for damage or injury.¹⁸³

Second, the Commission argued that administrative expense status for the penalties would further the Code’s policy in favor of environmental

175. Id. at 1450-51.
176. Id. at 1450; 11 U.S.C. § 503(b) (1988). This section provides, in relevant part: “(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including — (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case; ...” 11 U.S.C. § 503(b).
177. 963 F.2d at 1459.
178. Id. at 1451.
180. 963 F.2d at 1453.
181. Id. at 1456 (quoting 391 U.S. at 477).
182. Id. at 1455.
183. Id.
This contention was also unpersuasive to the Eleventh Circuit, because the environmental violations by the debtor did not pose a threat to public health or safety, and the fines were not calculated to pay for environmental cleanup. Therefore, the policy in favor of environmental protection did not justify giving these penalties an administrative expense priority.

Finally, the Commission argued that the penalties should be deemed administrative expenses under 28 U.S.C. § 959(b), which requires a trustee to "manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor would be bound to do if in possession thereof." The Eleventh Circuit sustained this argument, holding that "punitive civil penalties assessed as a consequence of the operation of a bankruptcy estate's business are 'actual, necessary costs and expenses of preserving the estate' under section 503(b)(1)(A)." The court concluded, however, that the business was not being operated within the meaning of 28 U.S.C. § 959(b) when coal was merely being brokered. Accordingly, the administrative expense liability for fines was limited to those penalties assessed for mining violations during the operation of a mine by the debtor in possession of the trustee.

B. Tax Penalties

In United States v. Sanford (In re Sanford), the Eleventh Circuit held that certain tax penalties must be waived or imposed in their entirety and could not otherwise be adjusted by the bankruptcy court under its equitable powers. The debtor, Arthur Carol Sanford, was an elderly man who was forced into bankruptcy involuntarily in 1989. As of the date of the bankruptcy filing, the debtor had not filed income tax returns for the 1983 through 1988 tax years. The Internal Revenue Service ("IRS") filed a claim for unpaid taxes in the amount of $417,853.26 along with penalties in the aggregate amount of $125,573.89 under 26 U.S.C.

184. Id. at 1453.
185. Id. at 1458.
186. Id.
188. 963 F.2d at 1458.
189. Id. at 1459 (quoting 28 U.S.C. § 959(b) (1988)).
190. Id. at 1460.
191. Id. at 1461.
192. 979 F.2d 1511 (11th Cir. 1992).
193. Id. at 1513.
§ 6651(a)(1) for failure to file tax returns, 194 26 U.S.C. § 6651(a)(2) for failure to timely pay taxes, 195 and 26 U.S.C. § 6654(a) for underpayment of estimated tax. 196

Although the debtor did not dispute the tax liability or the accuracy of the penalty computations, he requested the bankruptcy court to “reduce or eliminate” the penalties based upon his “good cause” for failing to file returns or pay taxes for the applicable years. 197 The bankruptcy court reduced the penalties by approximately two-thirds to $36,796.18. The IRS appealed to the district court, contending that the penalties had to be either allowed or disallowed in total. The district court affirmed, holding that the bankruptcy court had the equitable power to partially disallow the tax penalties. 198

The Eleventh Circuit reversed the lower courts and remanded the case for further findings on whether the debtor had proven facts demonstrating that he was eligible for a waiver of the tax penalties. 199 Under section 502(b)(1) of the Code, 200 a claim may be disallowed if it “is unenforceable against the debtor and property of the debtor under any agreement or applicable law . . . .” 201 The court observed that, outside bankruptcy, enforceability of the tax penalties would be governed by sections 6651(a)(1), 6651(a)(2), and 6654 of the Internal Revenue Code. 202 Therefore, the bankruptcy court was required to determine the allowance or disallowance of the penalties under those provisions of the Internal Revenue Code. 203

Because the Internal Revenue Code does not allow for partial waiver of penalties under sections 6651(a)(1) or 6651(a)(2), “the bankruptcy court may not use its equitable powers to reduce the amount of the penalties by

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197. 979 F.2d at 1512. The debtor was eighty-six years old. When he retired from his business in 1980, he left his financial affairs to his then-wife, thirty-nine years his junior, and her accountant. The debtor developed serious health problems in 1983, and his wife filed for divorce in May 1984. Id. at 1511-12.
198. Id. at 1512-13.
199. Id. at 1515.
202. Id. at 1513.
203. Id. Sections 6651(a)(1) and 6651(a)(2) of the Internal Revenue Code allow a taxpayer to escape penalties if the failure to file returns or to timely pay taxes was “due to reasonable cause and not to willful neglect.” Id. (quoting 26 U.S.C. § 6651(a)(1), (2) (1988)). Under 26 U.S.C. § 6654(e)(3)(A) (1988), the penalties for underpayment of the estimated tax may be waived “to the extent the Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience.” 979 F.2d at 1514 (quoting 26 U.S.C. § 6654(e)(3)(A) (1988)).
Similarly, under the facts of this case, the penalty under section 6654(a) of the Internal Revenue Code had to be waived or imposed in full. Since the bankruptcy court cannot exercise its equitable power in contravention of section 502 or any other section of the Code, the bankruptcy code did not have the power to equitably reduce the penalties outside the purview of the statutory waiver provisions in the Internal Revenue Code.

C. Tax Returns by a Liquidating Trustee

The Eleventh Circuit decided in Smith v. United States (In re Holywell Corp.) that a liquidating trustee was not required to file federal income tax returns or pay federal income taxes. The Supreme Court subsequently reversed that decision in Holywell v. Smith.

The question before the court in Tambay Trustee v. Pizza Pronto, Inc. (In re Pizza Pronto, Inc.) was whether an accountant retained by a Chapter 7 trustee to prepare federal income tax returns for the bankruptcy estate was entitled to compensation for services rendered. The lower courts had denied the accountant’s application for compensation under the holding of the Eleventh Circuit’s opinion in Holywell that tax returns for the bankruptcy estate were unnecessary. Since the reversal of Holywell by the Supreme Court undercut the basis for denying the accountant’s compensation, the Eleventh Circuit determined that the accountant was properly engaged by the Chapter 7 trustee to prepare tax returns and remanded the case for further proceedings on the application for compensation.

VIII. Property of the Estate

Property of the bankruptcy estate is broadly defined in section 541(a) of the Code. Section 541(c)(1)(B) of the Code expands the reach of

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204. 979 F.2d at 1513.
205. Id. at 1514. Although the waiver provision in 26 U.S.C. § 6654(e)(3)(A) is flexible, allowing waiver “to the extent” the penalties would be inequitable, under these facts, if there was cause to justify part of the underpayment, the entire underpayment would be justifiable. Id.
206. 979 F.2d at 1513-14.
207. 911 F.2d 1539 (11th Cir. 1990), rev’d, 112 S. Ct. 1021 (1992).
209. 970 F.2d 783 (11th Cir. 1992).
210. Id. at 784.
211. Id.
212. Id.
214. 11 U.S.C. § 541(c)(1)(B) (1988). This section provides:

Government Securities Corporation ("GSC"), a securities broker, became the subject of a liquidation proceeding in district court under the Securities Investor Protection Act. The district court granted the application for liquidation, appointed a trustee, and referred the case to the bankruptcy court for administration. One of the assets claimed by the trustee was a fidelity bond issued by National Union Insurance Company of Pittsburgh ("National-Union"), against which the trustee filed a proof of loss for employee dishonesty. National Union refused coverage under a provision in the fidelity bond which purported to terminate or cancel the bond "'upon the taking over of [GSC] by a receiver or other liquidator.'"

The trustee commenced an adversary proceeding against National Union, arguing that the bond remained enforceable, notwithstanding the appointment of a trustee to liquidate GSC, by virtue of section 541(c)(1)(B) of the Code. The trustee contended that this Code section was applicable to a liquidation under the Securities Investor Protection Act through 15 U.S.C. § 78fff(b), which provides: "'To the extent consistent with the provisions of [the Securities Investor Protection Act], a [Securities Investor Protection Act] liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I, and II of chapter 7 of [the Bank-

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law —

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

Id. 215. 972 F.2d 328 (11th Cir. 1992).
217. 972 F.2d at 329.
218. Id.
219. Id.
220. Id.
ruptcy Code.' The bankruptcy court ruled in favor of the trustee, and the district court affirmed.

The Eleventh Circuit upheld the conclusion of the lower courts that section 541(c)(1)(B) of the Code was applicable to a liquidation proceeding under the Securities Investor Protection Act, relying upon the plain language of 15 U.S.C. § 78fff(b) and the intent of the Securities Investor Protection Act to maximize the recovery of assets to distribute to the customers of brokerage firms in financial distress. Thus, the forfeiture clause in National Union’s fidelity bond was unenforceable to bar any recovery by the trustee.

IX. Exemptions

A. Homestead Exemption

In Owen v. Owen (In re Owen), the Eleventh Circuit decided, on remand from the Supreme Court, that a debtor could not avoid a judicial lien under section 522(f)(1) of the Code based on its interpretation of the judicial lien and the homestead exemption under Florida law. Helen Owen obtained a judgment against her former husband, Dwight Owen, for $160,000 in 1975. The judgment was recorded in Sarasota County, Florida, in July 1986, even though Dwight Owen did not own any real property in Sarasota County at that time. However, in 1984, Dwight Owen purchased a condominium in Sarasota County. One year later, Florida amended its homestead law to qualify the condominium for a homestead exemption. Dwight Owen filed a Chapter 7 petition in 1986.

221. Id. (quoting 15 U.S.C. § 78fff(b) (1988)).
222. 972 F.2d at 329-30.
223. Id.
224. Id. at 331.
225. Id. at 330.
226. 961 F.2d 170 (11th Cir. 1992).
227. The Supreme Court granted certiorari, Owen v. Owen, 495 U.S. 929 (1990), to review the Eleventh Circuit’s decision in In re Owen, 877 F.2d 44 (11th Cir. 1989). 961 F.2d at 171. The case was remanded, Owen v. Owen, 111 S. Ct. 1833 (1991), for the circuit court to consider whether the judgment lien attached to an interest of the debtor in property, and if so, whether extension of the Florida homestead exemption resulted in a taking of a property interest. 961 F.2d at 172.
228. 11 U.S.C. § 522(f)(1) (1988). This section provides:

(f) Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is —

(1) a judicial lien; . . .

Id.
229. 961 F.2d at 173.
and sought to avoid the judgment lien of his ex-wife under section 522(f)(1). The bankruptcy court, district court and Eleventh Circuit all declined to avoid the lien.

Under Florida law, the judgment lien of Helen Owen immediately attached to the condominium in Sarasota County when it was acquired by Dwight Owen in 1984. "Therefore, there was never a fixing of a lien on an interest of the debtor, as the debtor had no property interest prior to the fixing of the lien." As the Supreme Court held in *Farrey v. Sanderfoot*, "unless the debtor had the property interest to which the lien attached at some point before the lien attached to that interest, he or she cannot avoid the fixing of the lien under the terms of section 522(f)(1)." Accordingly, the Eleventh Circuit reaffirmed its conclusion that the judgment lien could not be avoided.

B. Annuity Contract

The case of *LeCroy v. McCollam (In re McCollam)* addresses another exemption issue under Florida law. The question presented was whether an annuity contract established in settlement of a tort claim in lieu of a lump sum payment was within the scope of the Florida exemption statute, which, on its face, appears to exempt all annuity contracts from creditor claims. Rather than attempting to answer this question of

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230. *Id.* at 171-72.
231. *Id.*
232. *Id.* (citing B.A. Lott, Inc. v. Padgett, 154 Fla. 304, 14 So. 2d 667 (1943)). "A judgment lien is a general lien which attaches to any property currently owned by the judgment debtor. It springs to life the minute the debtor acquires property to which it attaches." *Id.* at 172 (quoting Allison on the Ocean, Inc. v. Paul's Carpet, 479 So. 2d 188, 190-91 (Fla. Dist. Ct. App. 1985)).
233. *Id.* at 172 (emphasis added).
235. 961 F.2d at 172 (quoting 111 S. Ct. at 1829.)
236. *Id.* at 173.
237. 955 F.2d 678 (11th Cir. 1992).
238. FLA. STAT. § 222.14 (1989). This section provides: The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract, unless the insurance policy or annuity contract was effected for the benefit of such creditor.
239. 955 F.2d at 678.
state law, the Eleventh Circuit certified the issue to the Supreme Court of Florida.\(^\text{240}\)

The debtor, Paula L. McCollam, entered into a settlement with Travelers Insurance Company ("Travelers") arising from the wrongful death of her father. In relevant part, the settlement provided that the debtor was entitled to receive monthly payments of $1,320, subject to a three percent annual increase, and to receive five periodic lump sum payments between the years 1988 and 2006 ranging from $25,000 to $250,000.\(^\text{241}\)

Two years after entering into the settlement, the debtor had an automobile accident that subjected her to a tort claim. Upon the filing of a Chapter 7 bankruptcy petition, the debtor argued that the proceeds of the settlement with Travelers were exempt. The creditor asserting the claim from the automobile accident objected to the debtor's schedule of exemptions.\(^\text{242}\) The bankruptcy court and district court both concluded that the contract with Travelers fell within the broad language of the annuity exemption in the Florida statute.\(^\text{243}\)

The objecting creditor argued on appeal to the Eleventh Circuit that the contract with Travelers was merely a structured stream of payments in settlement of a debt, not a true annuity.\(^\text{244}\) According to the Eleventh Circuit, courts in other jurisdictions have held that statutes similar to the Florida statute in question do not exempt annuity contracts established in settlement of debts.\(^\text{245}\) In the absence of a Florida court decision on point, the Eleventh Circuit opted to let the Supreme Court of Florida interpret the annuity exemption statute under these facts.\(^\text{246}\)

C. Avoidance of Nonpossessory, Nonpurchase-Money Security Interest

In\ Snap-On Tools, Inc. v. Freeman (In re Freeman),\(^\text{247}\) the debtor, James Freeman, was an auto mechanic. Some time before June 1987, the debtor began purchasing tools from a Snap-On dealer under a revolving account. The debtor purchased additional tools in February 1988. At that time, the dealer assigned its interest in the revolving account to Snap-On, and Snap-On financed the purchase under an extended credit agreement.

\(^{240}\) Id.
\(^{241}\) Id. at 679.
\(^{242}\) Id.
\(^{243}\) Id. at 680.
\(^{244}\) Id.
\(^{245}\) Id. at 678.
\(^{246}\) Id. at 681.
\(^{247}\) 956 F.2d 252 (11th Cir. 1992).
The security under the extended credit agreement included tools from the revolving account.248

The debtor thereafter continued to buy tools on the dealer's revolving account. Second and third financing agreements were entered into between the debtor and Snap-On in July and November, 1988, respectively. The list of tools included in a UCC-1 financing statement filed by Snap-On in November 1988, included an air ratchet and an impact wrench purchased prior to the first extended credit agreement.249

The debtor filed a Chapter 13 petition in February 1989, which was later converted to a case under Chapter 7.250 The debtor filed a motion to avoid Snap-On's lien on the tools under section 522(f)(2) of the Code.251 Under that section, the debtor may avoid a lien that: (1) impairs an exemption to which the debtor is entitled, (2) is a nonpossessory, nonpurchase-money security interest, and (3) applies to certain types of personal property, including tools of the trade.252 Alabama law allows a debtor to exempt personal property, including tools of the trade, worth up to $3,000.253 Both the bankruptcy court and the district court concluded that Snap-On did not have a purchase-money security interest in the tools, making avoidance of the lien possible.254

The issues before the Eleventh Circuit were whether the consolidations by Snap-On destroyed the purchase-money character of its security interest, and whether Snap-On's agreement with the debtor contained an adequate method of allocating payments to preserve the purchase-money character of the security interest.255 The court stated that, if an item of

248. Id. at 253.
249. Id.
250. Id.
251. Id. at 254; 11 U.S.C. § 522(f)(2) (1988). This section provides:
   (f) Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is — . . .
   (2) a nonpossessory, nonpurchase-money security interest in any—
   (A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
   (B) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
   (C) professionally prescribed health aids for the debtor or a dependent of the debtor.
11 U.S.C. § 522(f) (2)(A), (B), (C).
253. Id.; Ala. Code §§ 6-10-6, 6-10-126 (1975).
254. 956 F.2d at 254.
255. Id.
collateral secures an antecedent debt, the creditor does not have a purchase-money security interest in the collateral. The fact that the tools purchased by the debtor under the dealer’s revolving account purported to secure the debt to Snap-On militated against the finding of a purchase-money security interest.

The dispositive factor, however, was that the “first-in, first-out” method in the financing agreements for allocating payments to Snap-On was inadequate to determine which tools had been paid for and which remained as collateral to secure Snap-On’s indebtedness. As the Eleventh Circuit previously held, “unless the lender contractually provides some method for determining the extent to which each item of collateral secures its purchase money, it effectively gives up its purchase money status.” After the loans were consolidated, this determination could not be made. Accordingly, the decision of the lower courts were affirmed, and Snap-On’s lien was avoided.

X. APPEALS: MOOTNESS

The case of First Union Real Estate Equity & Mortgage Investments v. Club Associates (In re Club Associates) addresses the doctrine of mootness in the context of the appeal of an order confirming a Chapter 11 plan of reorganization. The debtor, Club Associates, owned and operated an apartment complex. The principal secured claim was a $22 million wrap-around note payable to First Union Real Estate, Equity and Mortgage Investments (“First Union”). On September 18, 1989, more than two and one-half years after its Chapter 11 filing, the debtor obtained confirmation of its plan of reorganization. The plan allowed the debtor to continue its ownership and operation of the apartment complex by restructuring the wrap-around note. Under the plan, the debtor was required to: (1) raise at least $487,500 from its limited partners or new investors through a supplemental securities offering by the effective date of the plan; (2) pay all administrative expense claims by the effective date of the plan; (3) pay trade creditors eighty percent of their claims within thirty days after confirmation; and (4) fulfill certain other contractual re-

256. Id. at 255 (citing In re Fickey, 23 B.R. 586, 588 (Bankr. E.D.Tenn. 1982)).
257. Id.
258. Id.
259. Id. (quoting SouthTrust Bank of Ala. v. Borg-Warner Acceptance Corp., 760 F.2d 1240, 1243 (11th Cir. 1985)).
260. Id.
261. Id.
262. 956 F.2d 1065 (11th Cir. 1992).
263. Id. at 1066.
264. Id. at 1066-67.
sponsibilities, including assumption of a ground lease, repayment of tenant security deposits, assumption of a management agreement, restructuring of another note, and assumption or rejection of a satellite master license. In the event the debtor failed to raise the required $487,500 within the specified time, the plan contained a self-destruct mechanism which would have permitted First Union to foreclose on the apartment complex without opposition.266

First Union filed a timely notice of appeal from the confirmation order on October 18, 1989. On November 30, 1989, after the debtor filed a certificate that it had raised the requisite capital, First Union moved for a stay pending appeal in the bankruptcy court. In the meantime, First Union filed its second motion for relief from the automatic stay in the bankruptcy case, which the bankruptcy court denied on December 15, 1989. First Union filed a timely appeal from that order, and both appeals by First Union were consolidated. On April 4, 1990, the bankruptcy court denied First Union's motion for a stay pending appeal. Then, on April 26, 1990, First Union filed a motion in the district court for a stay pending appeal. The debtor filed a counter motion in the district court to dismiss both of First Union's appeals for mootness and reasons of equity.268 The district court granted the debtor's motion and dismissed the appeals, and First Union appealed to the Eleventh Circuit.267

The Eleventh Circuit confined its analysis to the issue of mootness.268 Generally, mootness involves "a determination by an appellate court that it cannot grant effective judicial relief."269 In a confirmation setting, the mootness doctrine focuses on "whether the reorganization plan has been so substantially consummated that effective relief is no longer available."270 The Eleventh Circuit described the test for mootness as a balancing of "the equitable considerations of finality and good faith reliance on a judgment and the competing interests that underlie the right of a party to seek review of a bankruptcy court order adversely affecting him."271

In applying this test, substantial consummation of a plan, by itself, is not dispositive.272 Rather, the appellate court must make a more thorough

265. Id. at 1067-68.
266. Id. at 1067.
267. Id.
268. Id. at 1068 n.9.
269. Id. at 1069.
270. Id. (quoting Miami Ctr. Ltd. Partnership v. Bank of N.Y., 820 F.2d 376, 379 (11th Cir. 1987)).
271. Id. (citing In re Information Dialogues, Inc., 662 F.2d 475, 477 (8th Cir. 1981)).
272. Id.
evaluation of whether judicial relief remains available. Among the relevant factors are the following:

Has a stay pending appeal been obtained? If not, then why not? Has the plan been substantially consummated? If so, what kind of transactions have been consummated? What type of relief does the appellant seek on appeal? What effect would granting relief have on the interests of third parties not before the court? And, would relief affect the re-emergence of the debtor as a revitalized entity?

After considering these factors, the Eleventh Circuit concluded that the investors who committed new funds to the debtor could not be protected if the confirmation order was reversed on appeal. For that reason, the appellate court was not able to render effective judicial relief, and the Eleventh Circuit affirmed the dismissal of First Union’s appeals on the grounds of mootness.

The mootness issue also arose in Shapiro v. Saybrook Manufacturing Co. (Matter of Saybrook Manufacturing Co.), but in a different manner. The bankruptcy court had approved Texlon-type cross-collateralization as part of a post-petition financing arrangement. When the objecting unsecured creditors appealed to the district court, the district court dismissed the appeal on the grounds of mootness because the objectors were unsuccessful in their attempts to obtain a stay pending appeal. The section of the Code at issue was section 364(e), which generally gives finality to financing orders, notwithstanding the pendency of an appeal, unless a stay pending appeal is obtained. "The purpose of this provision is to encourage the extension of credit to debtors in bank-

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273. Id. at 1069 n.11.
274. Id.
275. Id. at 1070.
276. Id. at 1071.
277. 963 F.2d 1490 (11th Cir. 1992).
278. Id. at 1492-93.
279. Id. at 1491-92.
280. Id. at 1492.
281. 11 U.S.C. § 364(e) (1988). This section provides:

(e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

Id.
282. 963 F.2d at 1492-93.
ruptcy by eliminating the risk that any lien securing the loan will be modified on appeal. 283

The Eleventh Circuit deferred consideration of the mootness issue under section 364(e) until it reached the central issue on appeal—whether section 364 authorized the type of cross-collateralization approved by the bankruptcy court. 284 The court answered that question in the negative, concluding that cross-collateralization was not permissible. 285 Having made that determination, the court further concluded that section 364(e) was not applicable, hence the appeal was not moot. 286 Saybrook makes clear that a creditor extending post-petition financing outside the provisions of section 364 may not receive the protection normally afforded by section 364(e) if the financing arrangement is set aside on appeal.

283. Id. at 1492.
284. Id. at 1493.
285. Id. at 1493-96. See supra notes 89-110 and accompanying text.
286. 963 F.2d at 1496.