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Building Blocks

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Considerations for Creditors During the Gap Period in Involuntary Cases

Involuntary bankruptcies filed pursuant to § 303 of the Bankruptcy Code are somewhat distinct from voluntary bankruptcies filed under § 301. The most dramatic differences between the two types of bankruptcies are revealed during the “time period between the filing of the involuntary petition and the entry of the order for relief,” commonly referred to as the “gap period.”² Specifically, the differences between involuntary and voluntary bankruptcy filings can affect the priority of claims against the debtor. Thus, the differences are of particular importance to creditors doing business with debtors during the gap period.

Involuntary Bankruptcies

As its name suggests, the debtor does not file an involuntary bankruptcy; instead, creditors file an involuntary petition on behalf of the alleged debtor,³ utilizing their considerable power to *force* a business or individual into bankruptcy. Unlike voluntary bankruptcies, involuntary bankruptcies do not necessarily seek to realize a “fresh start” for the debtor.⁴ Involuntary bankruptcies “exist ... as an avenue of relief for the benefit of the overall creditor body.”⁵

Nevertheless, involuntary bankruptcies are not an avenue for individual creditors to “redress [their] special grievances, no matter how legitimate;” that redress is offered by state courts through state law remedies.⁶ An involuntary bankruptcy petition “help[s] to] ensure the orderly and fair distribution of an estate by giving creditors an alternative to watching nervously as assets are depleted, either

by the debtor or by rival creditors who beat them to the courthouse.”⁷

Given these concerns and the intended function of involuntary bankruptcies, the Bankruptcy Code restricts the availability of involuntary bankruptcies. Notably, involuntary bankruptcies may only be commenced under chapter 7 or 11⁸ and cannot be commenced against farmers, family farmers or nonprofit corporations.⁹

Procedurally, an involuntary bankruptcy can be filed by three or more creditors that hold “claims against [the alleged debtor] that [are] not contingent as to liability or amount” and that aggregate to at least \$18,600.¹⁰ Alternatively, if the alleged debtor has fewer than 12 creditors — excluding employees or insiders — *one* or more creditors that hold an aggregate of \$18,600 in claims may file the involuntary petition.¹¹

Once the involuntary petition has been filed, the alleged debtor — to the extent they choose not to consent to the bankruptcy — may file an answer to the petition.¹² Gap periods differ widely from case to case because of the varying amounts of time necessary to resolve these filings and subsequent related proceedings. The court may enter an order for relief after denying an alleged debtor’s motion to dismiss or if the alleged debtor consents to the proceeding; however, the court may only dismiss an involuntary petition after notice to all creditors and a hearing.¹³

The Bankruptcy Code further circumscribes the use, and potential abuse, of involuntary bankrupt-



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2 *In re Euro-American Lodging Corp.*, 357 B.R. 700, 726 n.20 (Bankr. S.D.N.Y. 2007).

3 Debtors are frequently referred to as “alleged debtors” during the gap period.

4 *Wilk Auslander LLP v. Murray (In re Murray)*, 900 F.3d 53, 59 (2d Cir. 2018).

5 *Id.* (emphasis added).

6 *Id.* (quotations omitted).

7 *Id.*

8 Chapters for liquidation and restructuring, respectively.

9 11 U.S.C. § 303(a).

10 11 U.S.C. § 303(b)(1); by notice dated Jan. 31, 2022, 87 F.R. 6625, effective April 1, 2022, the amount for claims was adjusted from “\$16,750” to “\$18,600.”

11 11 U.S.C. § 303(b)(2); 87 F.R. 6625.

12 11 U.S.C. § 303(d).

13 11 U.S.C. § 303(j).

cies. Creditors who file an involuntary petition face the risk of the court dismissing the petition *and* granting judgment against the petitioning creditors for the alleged debtor’s costs (including attorneys’ fees).¹⁴ Proximate and punitive damages may be imposed if a creditor filed the involuntary petition in bad faith.¹⁵

Business as Usual for the Alleged Debtor

During the gap period, an alleged debtor is, for the most part, allowed to continue with its business as though the involuntary petition had not been filed. The Code provides “except to the extent that the court orders otherwise, and until an order for relief in the case, any business of the debtor may continue to operate, and the debtor may continue to use, acquire, or dispose of property as if an involuntary case concerning the debtor had not been commenced.”¹⁶ Voluntary debtors are not offered such freedom. Alleged debtors are permitted to operate their business as usual during the gap period because “prior to the entry of an order for relief, the subject of an involuntary petition should not be adversely affected by the case.”¹⁷

An alleged debtor’s ability to proceed with business as usual during the gap period is not without limitations. If the bankruptcy is filed under chapter 7,¹⁸ during the gap period creditors have at their disposal an “even more extreme remedy [than the filing of an involuntary petition]—the appointment of an interim trustee.”¹⁹ Section 303(g) allows creditors to request that the court appoint an interim trustee “to take possession of the property of the estate and to operate any business of the debtor.”²⁰

An interim trustee is only appointed if the creditor can show it “is necessary to preserve the property of the estate or to prevent the loss of the estate.”²¹ Although this “extreme remedy” is available to creditors, this relief is rarely requested, and courts have stated that “a request for an interim trustee should be denied in ‘the absence of an exceptionally strong need for doing so’ or ‘where no facts are alleged showing a necessity for the appointment.’”²²

Stay in the Gap

While the alleged debtor is able to continue operating in the ordinary course during the gap period, creditors’ hands may be tied.²³ An alleged debtor immediately enjoys the protections afforded under § 362’s automatic stay²⁴ once an involuntary petition has been filed.²⁵ Unfortunately, creditors may not receive notice of an involuntary filing and may continue to conduct business as usual, despite being subject to the bankruptcy stay.

14 11 U.S.C. § 303(i).

15 *Id.*

16 11 U.S.C. § 303(f).

17 *Consolidated Partners Inv. Co. v. Lake*, 152 B.R. 485, 490 (Bankr. N.D. Ohio 1993).

18 Section 303(g) does not provide for the appointment of an interim trustee during a gap period in a chapter 11 involuntary bankruptcy. 11 U.S.C. § 303(g); *In re Beaucrest Realty Assocs.*, 4 B.R. 164, 165 (Bankr. E.D.N.Y. 1980).

19 *In re Diamondhead Casino Corp.*, 540 B.R. 499, 505 (Bankr. D. Del. 2015); 11 U.S.C. § 303(g).

20 11 U.S.C. § 303(g).

21 *Id.*

22 *In re Diamondhead Casino Corp.*, 540 B.R. at 505 (quotations omitted).

23 *In re Hunt*, 2018 Bankr. LEXIS 2164, at *4-5 (Bank. E.D. La. July 24, 2018).

24 The automatic stay offers the debtor a “breathing spell” and stays actions brought against the debtor. *Doran v. Courtright (In re Advanced Elecs. Inc.)*, 283 Fed. App’x 959, 965 (3d Cir. 2008).

25 11 U.S.C. § 362(a).

26 *In re Sweports Ltd.*, 476 B.R. 540, 545 (Bankr. N.D. Ill. 2012).

These concerns are particularly acute, because an alleged debtor also does not have the ability to stipulate or waive the application of the automatic stay during the gap period.²⁶ As one court explained, “[a]s vigorously as some debtors may fight involuntary petitions and seek dismissal, they nevertheless enjoy the protection of section 362(a) while they battle.”²⁷

Creditors who are aware that a business party is the subject of an involuntary bankruptcy petition should remain diligent during the gap period, because the automatic stay applies. The effect of the automatic stay may keep *creditors* from engaging in business as usual during the gap period.

Gap Claims

To alleviate the risks of doing business with an alleged debtor, § 502(f) provides creditors some protection for claims arising during the gap period.²⁸ Under § 502(f), “[i]n an involuntary case, a claim arising in the ordinary course of the debtor’s business or financial affairs [during the gap period] shall be determined as of the date such claim arises.”²⁹

If a gap claim arises “in the ordinary course” of the debtor’s business and it is otherwise allowed, the claim is treated as an unsecured claim with priority under § 507(a)(3) of the Bankruptcy Code.³⁰ While gap claims are “allowed or disallowed in the same manner as a pre-petition claim,” they are excluded from qualifying as an administrative expense under § 503(b) of the Bankruptcy Code.³¹

The Code does not define “ordinary course of business,” which is also used elsewhere in the Code.³² Courts, in considering whether claims arise in the ordinary course under § 502(f), have determined that landlords’ rent claims met such a requirement, but claims for accounting services did not.³³

Trustees’ Avoidance Powers

Bankruptcy trustees have the power to avoid various types of transactions.³⁴ These avoidance powers are only applicable in an involuntary bankruptcy after — and if — the court enters an order for relief and, if the case is brought under chapter 11, if a trustee is appointed. Nonetheless, if they are exercised, a trustee’s avoidance powers are not limited due to the fact that a bankruptcy was initiated through an involuntary petition.

Section 549(a)(2) specifically allows “a trustee to avoid a transfer of property of the estate that occurs during the so called ‘gap period’ ... if it was a payment on account of a pre-petition debt that was either authorized only under Section 303(f) or that was not authorized by the court.”³⁵ Explaining the interplay between §§ 303(f) and 549 of the Bankruptcy Code, one court noted that § 303(f) “generally allows an alleged debtor to use its property of the estate

27 *In re Howrey LLP*, 534 B.R. 373, 375 n.6 (Bankr. N.D. Cal. 2015).

28 *Id.* at 375.

29 11 U.S.C. § 502(f).

30 11 U.S.C. §§ 502(f), 507(3); *In re L. Scott Apparel*, 2019 Bankr. LEXIS 1303, at *207-08 (Bankr. C.D. Cal. Jan. 29, 2019).

31 11 U.S.C. § 503(b); *In re L. Scott Apparel*, 2019 Bankr. LEXIS 1303, at *208.

32 *See, e.g.*, 11 U.S.C. §§ 363(c)(1), 547(c)(2).

33 *In re Howrey LLP*, 534 B.R. at 375 (rent); *Healthtrio Inc. v. Scruggs*, 599 B.R. 119 (D. Colo. 2019) (accounting).

34 1 *Collier on Bankruptcy* ¶ 1.05[5] (16th 2022).

35 *In re Intelligent Surveillance Corp.*, 2021 Bankr. LEXIS 3376, at *11 (Bankr. N.D. Tex. 2021) (citing 11 U.S.C. § 549(a)(2)).

unfettered during the gap period (and therefore pay creditors) but, if an order for relief is ultimately entered, those payments on account of pre-petition debt will be avoidable pursuant to Section 549.³⁶

While § 549(a) allows a trustee to avoid transfers during the gap period, § 549(b) “protect[s the] contemporaneous exchanges for value to permit continued operation of the business during the ‘gap’ period” and “protects the recipients of transfers during the gap period ... to the extent that post-petition value is given for the transfer.”³⁷ Section 549(b) does not fully define what constitutes value — although it does specifically exclude “satisfaction or securing of a debt that arose prior to the commencement of the case.”³⁸

Further, “‘value’ under § 549(b) requires proof of services performed, not services promised, during the involuntary gap period.”³⁹ In *Poonja v. First National Bank (In re Mac-Go Corp.)*, the court allowed the trustee to avoid three payments made by the alleged debtor during the gap period because the creditor had not established whether the payments were for rent or to satisfy guaranty obligations, nor whether any value was derived by these gap payments.⁴⁰

Cautionary Tales

In *Fleet National Bank v. Gray (In re Bankvest Capital Corp.)*, the First Circuit Court of Appeals in the context of an involuntary bankruptcy recited “a cautionary tale about the dangers of ignoring the ‘automatic stay.’”⁴¹ In *Bankvest*, the committee of unsecured creditors and its trustee sought to avoid gap payments made to a fully secured creditor that held a perfected interest in all of the alleged debtor’s assets.⁴² The secured creditor had accepted more than \$2 million in assets or property as payment for pre-petition loan obligations during the gap period, despite its knowledge of the involuntary bankruptcy.⁴³ Important to the ultimate rulings of the courts, after the entry of the order for relief, the secured lender sold its own portfolio of loans to another entity, including the existing loans between the alleged debtor and the secured lender.⁴⁴

The bankruptcy court determined that the secured lender violated the automatic stay by accepting and applying payments made during the gap period to an existing pre-petition loan.⁴⁵ The court held that the gap payments could be avoided and that the secured creditor was obligated to repay the amount of the gap-period payments, plus interest. In addition, the bankruptcy court found that the secured lender had sold any right to a § 502(h)⁴⁶ claim to the purchaser of its portfolio of loans.⁴⁷

Conversely, the district court found that the secured lender had retained its interest to a § 502(h) claim under the lan-

guage of the portfolio sale agreement.⁴⁸ The district court recognized that the accepted gap-period payments were “technically” void because they were applied in violation of the automatic stay, but determined that it would be “futile” for the secured lender to return payments to the debtor because the secured debtor would be entitled to a § 502(h) claim in the same amount as the money it returned.⁴⁹

Ultimately, although based on a slightly different interpretation of the portfolio sale agreement, the First Circuit in *Bankvest* upheld the district court’s ruling and found that the secured creditor had retained its § 502(h) claim.⁵⁰ The First Circuit explained that the secured creditor did violate the automatic stay, but that the secured creditor would have been entitled to a full recovery of the gap payments if they were avoided, so “[t]he fact that [the secured creditor] would be entitled to receive exactly what it would be forced to return through avoidance renders avoidance pointless.”⁵¹

In *In re Signature Apparel Group*, the bankruptcy court found that the licensor to an exclusive license agreement and other third parties violated the automatic stay during the gap period, even though the debtor licensee did not object to the licensor and third parties treating the license agreement as terminated.⁵² The court noted that there was no abandonment of the license agreement that could be “blessed” by § 303(f) where the debtor took no steps to abandon or terminate the license and then, “without seeking leave of the Court,” acted as though the agreement had been terminated.⁵³

Conclusion

Given these potential pitfalls during the gap period, creditors should be advised to stay cautious when parties begin to slow pay. If creditors ask questions and do their research, they may be able to stay informed of whether parties they do business with are the subject of an involuntary petition, putting themselves in the best position to mind the involuntary gap and its attendant risks.

If a client plans to pursue important transactions during the gap period, they should consider seeking court approval, especially if the transaction would result in the payment of obligations that arose before the involuntary filing. To the extent that a client has received payment during the gap period from an alleged debtor, they should be informed that such a transaction may later be avoidable by a trustee. Finally, should a subsequent trustee demand the return of payments, §§ 502(f), 502(h) and 549(b) may provide some level of protection. **abi**

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36 *Id.*

37 11 U.S.C. § 549(b); *In re Fort Dodge Creamery Co.*, 121 B.R. 831, 835 (Bankr. N.D. Iowa 1990); *Sullivan v. Kickel (In re Kickel)*, 357 B.R. 490, 496-97 (Bankr. N.D. Ill. 2006).

38 *In re Fort Dodge Creamery Co.*, 121 B.R. at 835.

39 *In re Sanchez-Casis*, 99 B.R. 115, 117 (Bankr. S.D. Fla. 1989) (“The obvious legislative purpose of § 549(b) is to give credit to a transferee to the extent that the bankrupt estate has received equivalent value for the transfer and, therefore, has not been depleted.”).

40 2014 Bankr. LEXIS 4641, at *12-16 (Bankr. N.D. Cal. Nov. 5, 2014).

41 375 F.3d 51, 55-56 (1st Cir. 2004).

42 *Id.*

43 *Id.*

44 *Id.*

45 *Bankvest Capital Corp. v. Fleet Boston (In re Bankvest Capital Corp.)*, 276 B.R. 12, 26-27 (Bankr. D. Mass. 2002).

46 Allowing creditors to file claims for amounts returned to the estate. 11 U.S.C. § 502(h).

47 *Bankvest*, 276 B.R. at 31.

48 *Fleet Nat'l Bank v. Gray (In re Bankvest Capital Corp.)*, 2003 U.S. Dist. LEXIS 4876, at *22-24 (D. Mass. March 28, 2003).

49 *Id.*

50 *Bankvest*, 375 F.3d at 65.

51 *Id.* at 55, n.1, 69.

52 577 B.R. 54, 67-68, 86-87 (Bankr. S.D.N.Y. 2017).

53 *Id.* at 86-87, 112.