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**Uncertainty in the Gap Period: The Dangers of Doing Business with an Alleged Debtor**

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**Introduction**

Section 303 of the Bankruptcy Code allows creditors to initiate an involuntary case against a debtor by filing a petition with the court.<sup>1</sup> Although the provisions applied to an involuntary case and a voluntary case are largely the same, one major difference surfaces in an involuntary case—the existence of what is commonly referred to as the “gap period.”<sup>2</sup> The gap period is the period between the filing of an involuntary petition and a Judge’s entry of an order for relief.<sup>3</sup>

Pursuant to § 303(f) of the Bankruptcy Code, the debtor may continue to operate during the gap period as if the involuntary case concerning its debt does not exist.<sup>4</sup> This continued operation is permissible because there has been no adjudication as to whether the entity satisfies the requirements to be a debtor under the Bankruptcy Code. Therefore, the debtor is commonly referred to as an “alleged debtor” until an order for relief is entered. Given the alleged debtor’s continued operation, the alleged debtor will likely incur debt. Creditors to whom that gap period

<sup>1</sup> See 11 U.S.C. § 303(a) (2012).

<sup>2</sup> See *In re Whistler Energy II, LLC*, 571 B.R. 199, 202 (Bankr. E.D. La. 2017).

<sup>3</sup> See *id.*

<sup>4</sup> See 11 U.S.C. § 303(f).

debt is owed may assert priority claims under § 502(f) of the Bankruptcy Code.<sup>5</sup> In order to assert such a claim, a creditor must show that the debt arose: (1) during the gap period, and (2) in the ordinary course of business.<sup>6</sup>

A creditor's right to a priority § 502(f) claim is frequently the subject of litigation. This memorandum will analyze a few of the hurdles a creditor must clear to ensure repayment.

Section I analyzes the strict requirement that gap period debt arises in the ordinary course of business. Next, Section II illustrates the dangers associated with violating the automatic stay.

Section III explains the trustee's power to avoid or recover post-petition transfers made within the gap period. Last, Section IV asserts that contracts remain effective after the filing of an involuntary petition and, in certain scenarios, have the ability to negate otherwise valid gap period claims.

### **I. A Gap Period Claim Is Not Appropriate When Debt Did Not Arise In The Ordinary Course Of Business**

Pursuant to § 502(f), a gap period claim is only allowed if the “claim aros[e] in the ordinary course of the debtor's business or financial affairs . . . .”<sup>7</sup> The definition of ordinary course is not defined in the Bankruptcy Code.<sup>8</sup> In evaluating what is deemed the ordinary course, courts apply both a subjective and an objective test. First, the courts look to the prior practices of the parties. Second, courts look to the standards of the relevant industry.<sup>9</sup> The reason prior engagements are considered in the courts' analysis is because they uncover the parties' standard behavior when “debtors are healthy,” when business is normal or ordinary.<sup>10</sup> If debt arises due to

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<sup>5</sup> See 11 U.S.C. § 502(f); see also 11 U.S.C. § 507(c) (listing gap period claims third in line for repayment, behind only domestic dispute claims and administrative claims).

<sup>6</sup> See 11 U.S.C. § 502(f) (describing the characteristics of a valid gap period claim).

<sup>7</sup> 11 U.S.C. § 502(f).

<sup>8</sup> See *In re Meredith Hoffman Partners*, 12 F.3d 1549 (10<sup>th</sup> Cir. 1993) (acknowledging that “[t]he Code does not define ‘ordinary business’”).

<sup>9</sup> See generally *In re Carled, Inc.*, 91 F.3d 811 (6<sup>th</sup> Cir. 1996).

<sup>10</sup> *In re Meredith Hoffman Partners*, 12 F.3d 1549, 1553 (10<sup>th</sup> Cir. 1993).

a normal practice that the parties engaged in prior to the looming bankruptcy proceeding—when the debtors were “healthy”—a court is likely to find that the debt arose in the ordinary course of business.<sup>11</sup>

Debt that results solely because of an impending bankruptcy proceeding fails the ordinary course test.<sup>12</sup> Courts will not allow a creditor to take advantage of the fact that § 507(f) of the code allocates gap period claims third priority status.<sup>13</sup> For example, courts will deny a claim if a creditor engages in a strategic, extraordinary transaction to attain a prioritized gap period claim.<sup>14</sup> In other words, courts will not deem debt as ordinary course debt if the claim was produced by an “obvious extra-ordinary transaction . . . designed to give” one creditor “an advantage over other creditors . . . .”<sup>15</sup>

## **II. Section 303(f) Does Not Absolve Creditors From Violations Of The Automatic Stay**

Pursuant to § 362 of the bankruptcy code, the filing of a petition, voluntary or involuntary, operates as a stay.<sup>16</sup> Although § 303 allows an “involuntary debtor [to] operate its business . . . the debtor may not waive the protections afforded to the property of the estate by the automatic stay.”<sup>17</sup> The debtor may not allow a creditor to take action against the estate’s property.<sup>18</sup>

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<sup>11</sup> See generally *In re Advanced Elecs., Inc.*, 107 B.R. 503 (Bankr. M.D. Pa. 1992) (holding that, after the filing of an involuntary petition, employees working to “resume normal business operations and relations” asserted a valid gap period claim); *In re CSVA, Inc.*, 140 B.R. 116 (Bankr. W.D.N.C. 1992) (holding that monthly rent payments, collected before and after the filing of an involuntary petition, arose in the ordinary course of business).

<sup>12</sup> See *In re Manufacturer’s Supply Co. Inc.*, 132 Bankr. 127, 129 (Bankr. N.C. Ohio 1991) (legal fees resulting solely because of bankruptcy filings are not debts arising in the ordinary course of debtor’s business).

<sup>13</sup> See 11 U.S.C. § 507(c).

<sup>14</sup> See *In re Monarch Capital Corp.*, 163 B.R. 899, 905 (Bankr. D. Mass. 1994) (“A claim arising from a strategic payment arrangement in lieu of a bankruptcy filing hardly arises in the ordinary course of a debtor’s business.”).

<sup>15</sup> See *In re Colonial Discount Corp.*, 807 F.2d 594, 600 (7<sup>th</sup> Cir. 1986).

<sup>16</sup> See 11 U.S.C. § 362(a); see also *In re Signature Apparel Grp.*, 577 B.R. 54, at 87 (“The automatic stay comes into effect instantly when an involuntary petition is filed.”).

<sup>17</sup> *In re Signature Apparel Grp.*, 577 B.R. at 87 (citing *In re E.D. Wilkins Grain Co.*, 235 B.R. 647, 650 (Bankr. E.D. Ca. 1999)).

<sup>18</sup> See *id.*

This scenario is demonstrated in *In re Omni Graphics, Inc.*<sup>19</sup> There, after the filing of an involuntary petition, a creditor sold off the debtor’s assets in an attempt to reclaim debt.<sup>20</sup> The Court held that the creditor’s “action in moving forward with the public sale . . . violated § 362(a)(3).”<sup>21</sup> More importantly, the Court alluded to the fact that, had the debtor initiated the sale with the intent to carry on its business operations instead of the creditor, § 303(f) would have applied and the Court would have likely rendered the sale acceptable.<sup>22</sup>

In summation, “[s]ection 303(f) of the Bankruptcy Code cannot be used to absolve a creditor from liability for violating the automatic stay where it takes action against property of the estate . . . .”<sup>23</sup> If a court deems that a creditor violated the automatic stay, among other punishments, it may: (1) void all transactions that violated the stay, (2) award costs and attorney’s fees for each violation, and, (3) where the violation is willful, award punitive damages.<sup>24</sup>

### **III. Any Payment By A Debtor To A Creditor During The Gap Period Is Avoidable Unless The Debtor Receives Value In Exchange**

A payment to a creditor during the gap period does not insulate a creditor from a trustee or debtor-in-possession’s strong arm powers. Under § 549 of the Bankruptcy Code, a trustee may “avoid a transfer of property of the estate” that occurs after the filing of a petition.<sup>25</sup> The avoidance powers under chapter 5 of the Bankruptcy Code apply equally to involuntary and voluntary cases.<sup>26</sup>

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<sup>19</sup> See generally 119 B.R. 641 (Bankr. E.D. Wis. 1990).

<sup>20</sup> See *id.*

<sup>21</sup> *Id.*

<sup>22</sup> See *id.* (“Here, the sale of the assets was conducted by the [creditor], not by the debtor, and in no manner enabled the debtor to carry on its business operations.”).

<sup>23</sup> *In re Signature Apparel Grp.*, 577 B.R. at 87.

<sup>24</sup> *In re Omni Graphics, Inc.*, 119 B.R. at 644.

<sup>25</sup> 11 U.S.C. § 549(a); see also *In re Signature Apparel Grp.*, 577 B.R. at 86 (“[S]ection 549 is the exclusive remedy by which post-petition transfers of estate property may be avoided.”).

<sup>26</sup> See 11 U.S.C. § 549.

In regard to involuntary cases specifically, a trustee may avoid gap period transfers if the exchange or transaction does not confer value to the debtor.<sup>27</sup> Courts determine “the extent of value given . . . from the ‘giver’s’ perspective.”<sup>28</sup> For example, if an involuntary debtor made a payment during the gap period for rental space, that transaction is unavoidable because, although the debtor paid for the rental space, the debtor received value—the rental space—in exchange.<sup>29</sup> Conversely, if an involuntary debtor makes a payment to satisfy a debt, that payment is avoidable because the debtor is making a payment and receiving nothing in return.<sup>30</sup> More directly, § 549(b) specifically excludes the “satisfaction . . . of debt that arose before the commencement of the case” from the list of “value” transfers.<sup>31</sup>

#### **IV. Contractual Provisions Remain Effective Throughout the Gap Period and May Negate a Gap Period Claim’s Potential Value**

Contractual provisions remain effective throughout the gap period.<sup>32</sup> A party that neglects a contract due to the filing of an involuntary petition risks a potential breach.<sup>33</sup> Courts have held that to effectively terminate a contract “it must be terminated in accordance with its express terms.”<sup>34</sup> For example, in *In re Signature Apparel Grp.*, the relevant contract required that a party send notice to effect termination.<sup>35</sup> Instead, the defendant argued that the filing of the involuntary petition and the debtor’s subsequent behavior constituted repudiation or abandonment of the contract.<sup>36</sup> The Bankruptcy Court for the Southern District of New York disagreed and ruled that the defendant acted improperly during the gap period when the

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<sup>27</sup> See 11 U.S.C. § 549(b).

<sup>28</sup> *In re Oakwood Mkts.*, 203 F.3d 406, 410 (6<sup>th</sup> Cir. 2000).

<sup>29</sup> *See id.* at 410.

<sup>30</sup> *Id.* at 409.

<sup>31</sup> 11 U.S.C. § 549(b).

<sup>32</sup> *See generally In re Whistler Energy II, LLC*, 571 B.R. 199 (Bankr. E.D. La. 2017).

<sup>33</sup> *See In re Signature Apparel Grp.*, 577 B.R. 54, 111 (Bankr. S.D.N.Y. 2017) (concluding that defendant should have ensured that debtor’s rights under the contract were preserved during the gap period).

<sup>34</sup> *Id.*

<sup>35</sup> *See id.*

<sup>36</sup> *See id.*

defendant “treated [a] Signature Licensing Agreement as terminated . . . .”<sup>37</sup> An involuntary petition on its own will not terminate a contract.

In certain scenarios, contract provisions themselves may eliminate the right to a gap period claim. For example, in *In re Whistler Energy II, LLC* a force majeure clause prevented the accrual of a claim.<sup>38</sup> A force majeure clause is a clause that limits liability when an uncontrollable occurrence prohibits performance. In *Whistler*, a force majeure event, which resulted in a zero-dollar per day payment rate, persisted throughout the entire gap period.<sup>39</sup> This led the Court to determine that the creditor’s gap period claim was effectively null and void.<sup>40</sup> Here, it is important to note that the Court did not invalidate the gap period claim, but concluded that the claim lacked any value because the force majeure clause made the relevant payment required by the contract zero dollars.<sup>41</sup>

## **Conclusion**

There are many difficulties a creditor must traverse to ensure repayment of a gap period claim. Reclamation of a gap period claim is not as straightforward as it appears to be. Creditors should thoroughly analyze an involuntary debtor’s situation before deciding to engage in business with it.

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<sup>37</sup> *Id.* at 112.

<sup>38</sup> *See* 571 B.R. at 201.

<sup>39</sup> *See id.*

<sup>40</sup> *See In re Whistler Energy II, LLC*, 571 B.R at 206.

<sup>41</sup> *Id.*