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# Deciding on an Efficient Involuntary Bankruptcy Filing Petition Rule

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LLM Thesis

Advisor: Professor Theodore Eisenberg

**Deciding on an Efficient Involuntary  
Bankruptcy  
Filing Petition Rule**

Sergio A. Muro

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## **I. Introduction**

Bankruptcy Law deals with last recourse solutions to extreme financial and balance-sheet problems. Through ordinary course, businesses as well as individuals must decide how much they want to spend and when. They also must decide how to finance their expenditures, either by paying for them now or in some future time. If the decision to use credit is made, debtors expect future events to allow them to repay the debts that they have incurred.

In an ordinary situation, debtors pay their creditors at the contracted date and new deals will probably take place in the future as the debtors build a reputation of being trustworthy. Although every legal system expects that as many debtors as possible comply with their obligations, each one of them recognizes that in some circumstances debtors are not able to do it. Collections systems are employed then to satisfy creditors' expectations of getting paid in full. These systems usually provide for a first come first serve situation<sup>1</sup>, where creditors receive the benefits of their diligence in collecting their unpaid credits.

In those situations where the value of the Debtor's assets is not as large as the value of the outstanding debt owed to the creditors, as Professor Jackson has pointed it out, creditors find themselves with a Common Pool problem<sup>2</sup>. If every creditor proceeds to collect its credit through non-bankruptcy mechanisms, the assets of the

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<sup>1</sup>Thomas H. Jackson "The Logic and Limits of Bankruptcy Law", Harvard University Press , Cambridge, Mass., 1986, p. 12

<sup>2</sup> Id. at 16-17

debtor are going to be depleted just because of the many administrative expenses generated through these various proceedings. Therefore, bankruptcy law seeks to “permit the owner of assets to use those assets in a way that is most productive to [the creditors] *as a group* in the face of the incentives by individual owners to maximize their own positions”.<sup>3</sup> Consistently, almost every jurisdiction provides for a special set of bankruptcy mechanisms to deal with this problem whenever it arises.<sup>4</sup>

Once the decision to have a bankruptcy collection system is made, the issue to be addressed next should be how to provide for an adequate commencement of the proceeding. Both debtor and his creditors will have incentives to begin an insolvency case balanced with other reasons that will encourage them not to begin it. Consequently legal systems usually tend to concentrate on rules that will spur either group to bring the bankruptcy proceeding when it is adequate. As a result some countries have creditors bringing most of the proceedings (as is the case of the United Kingdom) and others have debtors as the prime figures.

This paper focuses on the creditor side of the equation and aims to provide for a normative stance on whether bankruptcy laws should promote liberal or restrictive standards for creditors to comply with in order to file an involuntary bankruptcy petition.

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<sup>3</sup> Id. at 5

<sup>4</sup> See World Bank's Global Insolvency Law Database <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/0,,contentMDK:20154417~menuPK:146240~pagePK:64065425~piPK:162156~theSitePK:215006,00.html>, in the document by Phillip R. Wood entitled “Insolvency Law and the Legal Framework”

Specifically, this paper will deal with the “unpaid due obligation” standard, which implies that a creditor can file an involuntary petition on the mere grounds of having an unpaid debt owed to the creditor. I will argue that a rule which restricts the ability of creditors to file an involuntary bankruptcy petition is inefficient. Section II and III will focus on the historical and theoretical background in order to see where the actual norms come from and what may they intend to accomplish. Section IV touches on the importance of getting a properly timed bankruptcy decision. Section V depicts the specifics of different national bankruptcy initiation rules and classifies them considering who they place the burden of initiating the proceeding on. Section VI and VII establish the logic that brings about the creditors and debtors’ decisions and how should the law tackle the problem in order to obtain the most efficient result. Section VIII sums up and provides some conclusive remarks.

## **II. Brief historical development of bankruptcy initiation law**

Modern bankruptcy law, both in common and civil law countries, matured from a uniform root. The “Law Merchant” was a distinct body of law developed by a network of medieval courts scattered across Europe.<sup>5</sup> These courts would exercise their jurisdiction in the locations where they resided over the dealings of merchants and commercial issues in general. The Law Merchant was based on the mercantile law of Italy, which itself resulted from Roman Law provisions, such as *Cessio Bonorum* (assignment of property for the benefit of creditors), *Distractio Bonorum* (forced

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<sup>5</sup> Ian F. Fletcher “The Law of Insolvency”, Sweet & Maxwell, London, 1996, p. 6

liquidation), *Remissio* and *Dilatio* (composition with creditors) and *Actio Pauliana* (action available to creditors defrauded by alienation).<sup>6</sup>

## II.I. England and Wales

By the year 1542 the first English Bankruptcy Act was enacted.<sup>7</sup> It dealt with absconding merchants- debtors and empowered any aggrieved party to procure seizure of the debtors' property, its sale and distribution to creditors according to the quantity of their debts.<sup>8</sup> Therefore the statute implied two tests: the debtor should be a trader and should flee from sight or withdraw into their abodes. The general vision of merchants at that moment was “viciously ugly picture of the cheat, the evil magician who manipulates intangible credit and property, who devours the store of others, and who literally and figuratively abscond”.<sup>9</sup>

In 1571 the Bankruptcy Act was reformed, making a profound division between traders and merchants (those who earned their livings buying and selling) and non-traders who could not be declared bankrupts. This distinction remained until 1861 when reform permitted bankruptcy proceedings to be available to non-traders. The Elizabethan statute was the first one to enumerate a list of acts of bankruptcy. The list consisted of, as professor Weisberg expresses it, “betaking oneself to sanctuary, making

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<sup>6</sup> Ian F. Fletcher “The Law of Insolvency”, Sweet & Maxwell, London, 1996, p. 6

<sup>7</sup> In the year 1350 a law was enacted to deal with fleeing Lombards, through which means the debtor escaped the creditor's common law remedies. As the debtor was an outlaw, his property would escheat to the state. See footnote 112 in Robert Weisberg “Commercial Morality, the Merchant Character, and the History of Voidable Preference”, 39 Stanford Law Review 3, 1986, p. 138

<sup>8</sup> Vanessa Finch “Corporate Insolvency Law. Perspectives and Principles”, Cambridge University Press, 2002, p. 8

an alienation in fraud of creditors, or voluntary procuring arrest to avoid execution on one's property all with the mental state of intending to defraud and hinder one's creditors".<sup>10</sup>

This catalogue of acts of bankruptcy was enlarged by the 1604 reform that made any fraudulent conveyance an act of bankruptcy and also took the primary steps toward constructive acts of bankruptcy.<sup>11</sup> Once again in 1623 the inventory of acts of bankruptcy was enlarged. On this occasion the aims followed by Parliament were to cover the debtor's procuring protections and inducing compositions that reduced debt or extended time.

As the initiation of the insolvency proceedings placed the creditors in a difficult situation, where their actions were usually taken extemporaneously, the English Parliament strengthened the creditors' position by granting that debtors who collaborated in recovering assets would retain 5 percent of the assets that were recuperated while those who did not cooperate would be hanged<sup>12</sup>. It is interesting to notice that debtors did not have the ability to file a voluntary petition under English Law until the enactment of an 1825 Statute<sup>13</sup>. Another important bill was enacted in 1856. The Joint Stock Companies Act introduced the distinction between the system of

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<sup>9</sup> Robert Weisberg "Commercial Morality, the Merchant Character, and the History of Voidable Preference", 39 Stanford Law Review 3, 1986, p. 13

<sup>10</sup> Robert Weisberg "Commercial Morality, the Merchant Character, and the History of Voidable Preference", 39 Stanford Law Review 3, 1986, p. 35

<sup>11</sup> The new law made an act of bankruptcy the mere fact of remaining in prison at least six months after being arrested due to an unpaid obligation. See Robert Weisberg "Commercial Morality, the Merchant Character, and the History of Voidable Preference", 39 Stanford Law Review 3, 1986, pp. 36-37

<sup>12</sup> See Douglas Baird "The Initiation Problem in Bankruptcy", 11 International Review of Law and Economics 223, 1991, p. 225



company winding up and bankruptcy of individuals, which has been maintained until present days<sup>14</sup>. The criteria of acts of bankruptcy remained as the cause that could trigger the insolvency proceeding.

The actual statute governing the subject is the 1986 Insolvency Act, with the late reforms provided by the Enterprise Act. Professor Finch, citing Carruthers and Halliday considers that various ideological undercurrents sought to champion reorganization, privatize bankruptcy administration, professionalise insolvency practice and discipline company directors, the result of a compromise of the contending parties in their quest to make their positions better off.<sup>15</sup>

## II.II. France

The historical evolution in France was marked by a period of great rigor towards the debtor following the enactment of the 1807 “Code de Commerce”. According to Professor Corinne Saint-Alary-Houin, it was probably Napoleon's personal influence what marked this strict and repressive style.<sup>16</sup> The debtor was usually criminally liable for his simple or fraudulent bankruptcy. Thus the statute followed two functions: to sanction and to eliminate the merchant from the commercial

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<sup>13</sup> See Randal C. Picker “Voluntary Petitions and the Creditors’ Bargain”, 61 University of Cincinnati Law Review 519, 1992, pp. 521-522

<sup>14</sup> Ian F. Fletcher “The Law of Insolvency”, Sweet & Maxwell, London, 1996, p. 519

<sup>15</sup> Vanessa Finch “Corporate Insolvency Law. Perspectives and Principles”, Cambridge University Press, 2002, p. 15, citing Carruthers and Halliday “Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States”, Clarendon Press, Oxford, 1998, p.148

<sup>16</sup> Corinne Saint-Alary-Houin “Droit des Entreprises en Difficulté [Enterprises in difficulty’s Law]”, Domat Droit Privé, Edition Montchrestien, 2001, p. 9

world.<sup>17</sup> The Code maintained the cessation of payments provision established by “L’Ordonnance de 1673” (also called “code Savary”) and expressed, in article 441, the facts that would entitle to place a debtor as a “faillite” (bankrupt).<sup>18</sup>

In 1838 a trend towards liberalization began. The 1838's amendment to the Code de Commerce considerably diminished the sanctions imposed on the bankrupts<sup>19</sup>. The law also dropped the definition of cessation of payments, leaving it to the courts to decide on its meaning<sup>20</sup>. In 1889, a new law was enacted that marked the initiation of the judicial liquidation (*liquidation judiciaire*), which was available if the merchant wasn't found dishonest or at fault.<sup>21</sup> Through this provision the debtor could even reorganize his affairs if he could agree new terms with his creditors.

A novel feature of French bankruptcy law was yet to come in the reform of 1967. Through this provision a preventive exceptional proceeding was established in order to aid enterprises in financial difficulties but not unremediably compromised where the disappearance would cause an important problem to the national or regional

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<sup>17</sup> Corinne Saint-Alary-Houin “Droit des Entreprises en Difficulté [Enterprises in difficulty’s Law]”, Domat Droit Privé, Edition Montchrestien, 2001, p. 10

<sup>18</sup> It referred to three kinds of acts: merchant absconding, closing of the merchants shops or the negative given to pay his commercial engagements. See Véronique Martineau- Bourgninaud “La Cessation des Paiements, Notion Fonctionnelle [The Cessation of Payments, Functional Notion]”, Rev. Trim. Dr. Com. 2002, p. 245

<sup>19</sup> French Law of may 28, 1838

<sup>20</sup> Until 1978 French courts considered that a cessation of payments would occur only when the debtor situation was “irréremdiablement compromise” (irremdiably compromised). In that year the Cour de Cassation changed the meaning to the actual “impossibilité de faire face à son passif exigible avec on actif disponible” (impossibility to meet the due debts with the disposable income). See Com. 14 févr. 1978, Bull. Civ.IV, n° 66, D. 1978 IR. 443. Another definition was given by Bonnecase in 1910 where he proposed that the cessation of payments had two elements: one formal, the halt of payments, and one purely juridical, the loosing of credit by the merchant. See Véronique Martineau- Bourgninaud “La Cessation des Paiements, Notion Fonctionnelle [The Cessation of Payments, Functional Notion]”, Rev. Trim. Dr. Com. 2002, p. 248

economy and that could be avoided with compatibles conditions to the interest of shareholders.<sup>22</sup> This amendment also permitted for the first time that non-merchants could be eligible for bankruptcy (“sujet passif”).<sup>23</sup>

In 1985 the present law was enacted and its principal objectives were to prevent the event when reorganization procedures won't succeed by intervening before this situation arrived. In so doing, the objective of the law is to consider the interest of everybody who has relation with the procedure.

### II.III. The United States

The United States recognized the importance of bankruptcy law very early in its independent life. It specifically addressed this issue in Article 1, section 8, cl. 4, where it empowered Congress to establish "uniform Laws in the subject of Bankruptcies throughout the United States". Notwithstanding the recognition of bankruptcy law as vital to national interests, more than a century passed before United States Congress could fashion a permanent bankruptcy statute acceptable to competing constituencies.<sup>24</sup>

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<sup>21</sup> Corinne Saint-Alary-Houin “Droit des Entreprises en Difficulté [Enterprises in difficulty’s Law]”, Domat Droit Privé, Edition Montchrestien, 2001, p. 11-12

<sup>22</sup> Corinne Saint-Alary-Houin “Droit des Entreprises en Difficulté [Enterprises in difficulty’s Law]”, Domat Droit Privé, Edition Montchrestien, 2001, p. 21. Citing Baudron “La suspension provisoire des poursuites et l'apurement collectif du passif selon l'ordonnance du 23 septembre 1967”, Préface Chr.Gavalda, Paris 1972, where it is stated "entreprises en situation financière difficile mais non irrémédiablement compromise dont la disparition serait de nature à causer un trouble grave à l'économie nationale ou régionale et qui pourrait être évitée dans des conditions compatibles avec l'intérêt des créanciers".

<sup>23</sup> See Yves Guyon “Droit des Affaires. Entreprises en difficultés, Redressement judiciaire- Faillite [Business Law. Enterprises in Difficulties, Judicial Reorganization- Liquidation]”, Edition Economica, 9e edition, pp. 107- 108

<sup>24</sup> Elisabeth Warren, Jay L. Westbrook "The Law of Debtors and Creditors", Aspen Law & Business, New York, 2001, pp. 161-162

Different short-lived laws were enacted in 1800, 1841 and 1867 (with a reform of this last one in 1874).

The first long-standing statute was the 1898 Bankruptcy Act that provided for a discharge provision to debtors and an ordered collection system for creditors.<sup>25</sup> The Bankruptcy Act was based on the English notion of acts of bankruptcy. Three or more creditors with aggregated unsecured claims of \$500 or more could petition the bankruptcy of the debtor. If the petition was contested, they were required to show that the debtor had committed an "act of bankruptcy" within four months prior to the filing of the petition.<sup>26</sup> A reform made in 1910 allowed for the first time corporate debtors to be eligible for voluntary and involuntary petitions<sup>27</sup>.

As a probable result of the Great Depression, in 1938 the Chandler Act reformed the Bankruptcy Act. As new features it brought the adoption of a business reorganization procedure and the creation of a wage-earner payout plan. Concerning the involuntary petition, the Chandler Act broadened the scope of the "appointment of a receiver for an insolvent debtor" as an act of bankruptcy, to include insolvency in the

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<sup>25</sup> Elisabeth Warren, Jay L. Westbrook "The Law of Debtors and Creditors", Aspen Law & Business, New York, 2001, p. 162.

<sup>26</sup> See Susan Block-Lieb "Why Creditors File So Few Involuntary Petitions And Why The Number Is Not Too Small", 57 Brook. L. Rev. 803, pp. 808-810. As Professor Block-Lieb expresses it the "acts of bankruptcy" were: a) fraudulent transfers under section 67 or 70 of the Act; b) preferential transfers under section 60a of the Act; c) the failure to vacate a judicial lien in a timely manner, within the later 30 days after the imposition of the lien or 5 days before the scheduled judicial sale, if the debtor was insolvent during this period [provision arising out of the 1926 amendment]; d) making a state law assignment for the benefit of creditors; e) the appointment under state law of a receiver of property when the debtor was insolvent or unable to pay its debts; and f) the admission in writing of an inability to pay debts and a willingness to be adjudicated bankrupt.

<sup>27</sup> See Randal C. Picker "Voluntary Petitions and the Creditors' Bargain", 61 University of Cincinnati Law Review 519, 1992, p. 522

sense of an inability to pay debts as they became due.<sup>28</sup> In 1952 another amendment was made to the substantive law of acts of bankruptcy, providing that any preferential transfers under section 60a implied an act of bankruptcy, eliminating the subjective requisite of intent<sup>29</sup>.

In 1978 the Bankruptcy Code was adopted. The present law was reformed in 1984 and 1994, but at its core, it remains the same enacted by the United States Congress in 1978, which basically aimed to update the preceding Bankruptcy Act.

#### II.IV. Argentina

The evolution of Argentine's Bankruptcy Law began with the enactment of the 1862 "Código de Comercio", which was drafted mainly taking into consideration Napoleon's 1807 "Code de Commerce" (even though the Spanish "Ordenanza de Bilbao" was applied since 1794 in the colony and could be considered the first statute to deal with bankruptcy issues<sup>30</sup>). Article 1521 of the Code would allow an individual creditor to file an involuntary bankruptcy petition.<sup>31</sup> The Statute also provided for creditors to take the main decisions, controlled by a "juez comisario"<sup>32</sup> (sheriff-judge). This stipulation would entitle creditors to continue with the debtors business, but leaving at their own risk, however, how the business would turn out.

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<sup>28</sup> See Note "'Acts of Bankruptcy' in Perspective", 67 Harvard Law Review 500, 1954, p. 502

<sup>29</sup> See Note "'Acts of Bankruptcy' in Perspective", 67 Harvard Law Review 500, 1954, pp. 502- 503

<sup>30</sup> Santiago C. Fassi and Marcelo Gebhardt "Concursos y Quiebras. Comentario Exegético de la Ley 24522. Jurisprudencia Anotada [Reorganizations and Liquidations. Exegetic Commentary of Law 24522. Cited Cases]" Editorial Astrea, 1997, p. 7

<sup>31</sup> See Héctor Cámara "El Concurso Preventivo y la Quiebra", Ediciones Depalma, Buenos Aires, 1982, vol. III, p. 1467

In 1889 the powers of the creditors were consolidated when the Commerce Code was revised. The reform would allow the creditors to take at their interest the assets and debts of the debtor if they didn't agree to the restructuring offer ('Concordato')<sup>33</sup>. The allowance of a creditor's involuntary filing (called "quiebra directa" or direct bankruptcy as opposed to the "quiebra indirecta" or indirect bankruptcy that aroused when the "Concurso Preventivo" or reorganization proceeding did not succeed<sup>34</sup>) persisted, as a possibility, unchanged.

At the beginning of the 1930's a reform movement arose, that would end in the "Ley Castillo".<sup>35</sup> This new provision would establish a dual system permitting independently the "Convocatoria de Acreedores" (a type of reorganization, only for corporations and merchants) and a "Quiebra" (liquidation proceeding). It also provided that the "Síndico" (a kind of trustee) would not be anymore the representative of the creditors, to adopt an equidistant position. This Statute would permit the opening of a bankruptcy case after the filing of the debtor, an unpaid "legitimate" creditor<sup>36</sup>, if the reorganization plan was not approved by the creditors or the court, or if the debtor didn't go to the creditors committee meeting or didn't propose a plan.

The 1972 Bankruptcy Act ("Ley 19551") provided a systematized model that drew from the 1967 French reform to adopt the principle of the preservation of the

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<sup>32</sup> Miguel E. Rubín "Introducción", in "Instituciones de Derecho Concursal", Editorial Ad-Hoc S.R.L., Buenos Aires, 1992, p. 28

<sup>33</sup> Miguel E. Rubín "Introducción", in "Instituciones de Derecho Concursal", Editorial Ad-Hoc S.R.L., Buenos Aires, 1992, p. 29

<sup>34</sup> See Héctor Cámara "El Concurso Preventivo y la Quiebra", Ediciones Depalma, Buenos Aires, 1982, vol. III, p. 1468

<sup>35</sup> Argentine law number 11.719

enterprise and the prime intent to sell the business as a going concern rather than liquidate it. It states that the main bankruptcy proceedings will be opened once it has been proven that the debtor has become in cessation of payments<sup>37</sup> through one or more “hechos reveladores de insolvencia” (revealing facts of insolvency). Through the provision in article 84, any creditor, whatever the nature, amount and priority<sup>38</sup> of its credit can file an involuntary case proving the cessation of payments (through one of the “hechos reveladores” of article 86 or any other that the creditor can come up with).

In 1995, Argentina followed the American experience and instituted a new Bankruptcy Law<sup>39</sup>, which brought to place the debtor in possession provision and cram-down possibility. After the 2001 Argentine economic melt down, several modifications (most of them ad-hoc) have been entered into the 1995 statute. Currently a Congress Commission is studying a new reform to the Bankruptcy Law.

### **III. Contending Theories about Bankruptcy goals**

The common pool approach to bankruptcy law has not been isolated from criticism. In fact, many theorists believe that bankruptcy law should provide for different purposes than creditor wealth maximization (as Professor Jackson's bargaining

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<sup>36</sup> Under Article 2 of the “Ley Castillo” only commercial obligations, as opposed to civil obligations, were allowed the privilege of commencing a bankruptcy case

<sup>37</sup> Argentine Law turns into a “condition” of cessation of payments in order to declare bankruptcy. Due to the reform, it was no longer sufficient to prove any single act of the debtor to initiate a bankruptcy case. As a matter of fact, a situation of generalization and permanence of the debtor’s difficulties was required in order to allow the proceeding to start. On this subject, see Héctor Cámara “El Concurso Preventivo y la Quiebra”, Ediciones Depalma, Buenos Aires, 1982, vol. III, pp. 1570- 1627

<sup>38</sup> This stipulation has the exceptions of fully secured creditors, relatives or cessionaries of credit. See Argentine Law number 19551.

<sup>39</sup> See Argentine's Law "Ley de Concursos y Quiebras" number 24522

theory is routinely named). These distinct standpoints take a broader view of the rationale of bankruptcy law.

For example, Professor Donald B. Korobkin places special emphasis on two main principles: the inclusion of affected persons and rational planning. The first principle would seek that every party affected by financial distress would be eligible to press their demands<sup>40</sup>. The second principle would seek to promote the greatest part of the 'most important aims' and would involve formulating the most rational, long-term plan as a means of realizing the 'good' for the business enterprise. In complying with these objectives Professor Korobkin draws upon Rawls' theory of the good<sup>41</sup> and second principle of justice, the so-called difference principle<sup>42</sup>. Thus, a rational plan that would 'maximumly satisfy the aims', would mandate that persons in the worst-off positions in the context of financial distress should be protected over those occupying better-off positions<sup>43</sup>.

In another position we find Professor P. Shuchman<sup>44</sup>, who argues that the situation of the debtor, the moral worthiness of the debt and the size, situation and intent of the creditor should be taken into account in laying the foundations for bankruptcy law.<sup>45</sup> In this way, professor Shuchman would plead: "in the context of bankruptcy it is assumed that interpersonal comparisons of utility are significant and

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<sup>40</sup> Donald R. Korobkin "Contractarianism and the Normative Foundations of Bankruptcy Law", 71 Tex. L. Review 541, pp. 572-575

<sup>41</sup> John Rawls "A Theory of Justice", 1971, pp. 395-452

<sup>42</sup> John Rawls "A Theory of Justice", 1971, pp. 75-83

<sup>43</sup> Vanessa Finch "Corporate Insolvency Law", Cambridge University Press, 2002, p. 34

<sup>44</sup> P. Shuchman "An attempt to a 'Philosophy of Bankruptcy'", 21 UCLA L. Review 403, 1973

<sup>45</sup> Vanessa Finch "Corporate Insolvency Law. Perspectives and Principles", Cambridge University Press, 2002, p. 39



that social states can be ordered according to the sum of utilities of individuals; further that the choice of any given arrangement ordinarily ought to be some sort of aggregation of individual preferences".<sup>46</sup>

One additional competing theory involves what Professor Finch calls "The Multiple Value/ Eclectic Approach".<sup>47</sup> As the name suggests this view considers that insolvency law must support a wide range of values that can't be ordered neatly. Professor Warren described this way of thinking as a "dirty, complex, elastic, interconnected view" of bankruptcy law.<sup>48</sup> The argued virtue of this approach is that it is able to capture not only the economic dimension of bankruptcy but also "non-economic dimensions and the principle of fairness as a moral, political, personal and social value".<sup>49</sup>

Many political committees take this kind of view, where many social values and economic interests come into play at the moment of the drafting of their opinion. This was the case of the Cork Report<sup>50</sup>, where it stated that the role of insolvency law was in "reinforcing the demands of commercial morality and encouraging debt settlement, and also to stress deterrent and distributive ends in urging that insolvency law should seek

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<sup>46</sup> P. Shuchman "An attempt to a 'Philosophy of Bankruptcy'", 21 UCLA L. Review 403, 1973, p. 447

<sup>47</sup> Vanessa Finch "Corporate Insolvency Law. Perspectives and Principles", Cambridge University Press, 2002, p. 40

<sup>48</sup> Elizabeth Warren "Bankruptcy Policy", p. 811

<sup>49</sup> Donald R. Korobkin "Rehabilitating Values: A Jurisprudence of Bankruptcy", 91 Columbia L. Review 717, 1991, p. 781

<sup>50</sup> See Cork Report "Report of the Review Committee on Insolvency Law and Practice", Cmnd 8558, 1982, para. 198

to ascertain the causes of failure and consider whether conduct merited punishment"<sup>51</sup> and also the view of the National Bankruptcy Review Commission<sup>52</sup>.

As most people can recognize, the problem of delineating the goals and nature of bankruptcy law are extremely intricate. But some basic concepts are almost above questioning.<sup>53</sup> One of those unquestionable ideas, is the existence of a common pool problem that needs to be solved (at least under current financial structures, though some scholars as Professor Barry Adler<sup>54</sup> or Professor Lucian Bebchuk<sup>55</sup>, propose different scenarios under which this common pool problem may no longer exist). Whether the range of values is to be narrowed down to a wealth maximization scheme or broadened indefinitely as in an eclectic value-based approach, is an open question that will need much more empirical evidence and theoretical analysis than the one currently existing. Notwithstanding this last proposition, I share the view that bankruptcy law should deal with maximizing the value of the estate in a way that will allow the residual owners of the company to receive the maximum of it<sup>56</sup> and that is the position I use for the rest of the paper<sup>57</sup>.

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<sup>51</sup> See Vanessa Finch "Corporate Insolvency Law. Perspectives and Principles", Cambridge University Press, 2002, p. 41

<sup>52</sup> See Douglas Baird "Bankruptcy Uncontested Axioms", 108 Yale Law Journal 573, 1998, p. 576

<sup>53</sup> See Thomas H. Jackson "The Logic and Limits of Bankruptcy Law", Harvard University Press, Cambridge, Mass., 1986, pp. 20-27

<sup>54</sup> See Barry Adler "Financial and Political Theories of American Bankruptcy", 45 Stanford Law Review 311, 1993

<sup>55</sup> See Lucian Arye Bebchuk "A New Approach to Corporate Reorganizations", 101 Harvard Law Review 775, 1988

<sup>56</sup> This way of thinking would probably be categorized as a "proceduralist" under Professor Baird conceptualization of bankruptcy theories. See Douglas Baird "Bankruptcy Uncontested Axioms", 108 Yale Law Journal 573, 1998

<sup>57</sup> As it is generally described, this view would lead players to respect non-bankruptcy entitlements and therefore avoid strategic bankruptcy decision making potentially inefficient. It would also address non

#### **IV. The Timing of the Bankruptcy Filing Decision**

Whichever theory of bankruptcy law is the correct one, all of them would like to have as many assets to dispose from the bankruptcy estate in order to fulfill their objectives. Whether you want to pursue redistributive ends or allow the creditors get paid in full or any other objective, the more assets you have in the proceeding the better chance you can accomplish your aims.

As this last idea would induce the law-maker to provide for the beginning of the bankruptcy proceedings as soon as possible, she must take into account the consequences of doing so. In a capitalist economy, where prices are set at a market place through the free play of supply and demand in an imperfectly informed world, a bankruptcy proceeding can be a strong negative signal to the rest of the players in the market.

As a result, any time a bankruptcy petition is filed the market value of the enterprise could diminish, leaving the creditors with a worst chance of recovering in full due to the chance of tearing apart a sound business<sup>58</sup>. Of course this situation would carry some spill over effects to the community where the company interacts, possibly endangering, or even destroying, jobs (whether directly or indirectly connected to the company), supply chains, regional economies, etc., but these side effects will not necessarily be taken into account by the creditor or debtor at the moment of filing. So,

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bankruptcy issues in a general manner, avoiding non- equalitarian situations and providing the same incentives to every player

<sup>58</sup> See Yves Guyon “Droit des Affaires. Entreprises en difficultés, Redressement judiciaire- Faillite [Business Law. Enterprises in Difficulties, Judicial Reorganization- Liquidation]”, Edition Economica,

in such a state of affairs, bankruptcy law must adjust its provisions in order to account for the lack of internalization of the parties involved.

Evidently, law regimes have to decide how to handle this issue. From a normative standpoint, we may think of the available possibilities as a semi open set of involuntary petitions normative stipulations from which the legislators can choose. It could range from the most creditor friendly, as just requiring the creditor to file a petition as he does not obtain payment, to the worst for him, as asking him to get multiple creditors in order to file, requiring egregious mandatory bonding as a procedural prerequisite, high minimum credit amount, etc.

This issue asks for a solid method of determining to what extent each of those points of view should be followed. A minimum starting point can be found asking how creditors will get paid if the debtor does not honor his debts. As creditors will get paid out of the assets of the debtor (without considering exempt property in the case of individuals), it can be agreed upon a balance-sheet test to determine when should the bankruptcy proceeding be allowed to begin<sup>59</sup>.

As a consequence, it could be argued that in a world with perfect capital markets, perfect information<sup>60</sup> and no limitations to appropriately value businesses,

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9e edition, p. 131, where the author expresses that the bankruptcy case should not be brought prematurely because it is potentially cumbersome, traumatic for the enterprise and costly for the collective hole.

<sup>59</sup> The idea implies that as long as the debtor has equity in the property he will take care of the assets, because he will benefit from it. Of course, the debtor can shift risk to the creditors by investing in gambles even though he still has equity in his property, but even then at least in part he is financing the hazard enterprise and thus can be trusted on making business decisions (or at least take it as a proxy)

<sup>60</sup> This reasoning may be hyper- extended. As a matter of fact, this argument implies a world where there's no uncertainty, which may be impossible (unless the world is a deterministic place with no random events). How to address uncertainty is something scientists have not yet managed to figure out. See generally Theodore M. Porter "The Rise of Statistical Thinking 1820- 1900", Princeton University

the starting point question would be rather trivial. Creditors would know at all times how much the assets of the debtor are worth, under whichever valuation method they want to use as they have all the information, and therefore they would follow individual collection procedures until the time that the assets of the debtor are worth less than the total amount of the outstanding credit<sup>61</sup>.

Unfortunately, the world we live in does not follow those assumptions. Even if you think about creditors of publicly traded companies, where highly developed capital markets<sup>62</sup> may permit credit to flow in a smooth and easy way, creditors don't have the information required to know when to start a bankruptcy proceeding. By the same token, investors don't have enough information to precisely react to the incomplete news they receive, so as they value shares or bonds of a company, a default or bankruptcy petition announcement would likely trigger a steep downfall of the prices of those tradable papers. Hence, if the bankruptcy proceeding were started before it should, it would spur a number of undesirable consequences of the nature we mentioned earlier.

The timing issue has been addressed by many institutional projects and scholarly writings, all of whom tackle on this balancing issue. Both World Bank's

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Press, 1986, and Stephen Stigler "The History of Statistics: The Measurement of Uncertainty Before 1900", Belknap Press of Harvard University Press, 1986.

<sup>61</sup> Risk shifting methodologies may still be in place when the debt over equity ratio approximates 1, but technically the creditors as they decide what to do can account for it, given the information and expertise they possess.

<sup>62</sup> This may be very hard to find in a poorly developed economy, where centralism in decision making is usually both a public and private problem.

“Principles and guidelines for effective insolvency and creditor rights systems”<sup>63</sup> and UNCITRAL’s Working Group V (Insolvency)<sup>64</sup> express as a basic principle the enactment of timely and efficient proceedings that will enable to maximize the value of the estate. The International Monetary Fund Legal Department generally adheres to these guidelines and further recommends the establishment of a general cessation of payments standard to allow involuntary petitions to proceed, which implies some fuzzy test of the financial situation of the business<sup>65</sup>, to prevent a “grab race” of assets by individual creditors.<sup>66</sup>

American scholars<sup>67</sup> who have recently wrestled with this topic generally tend to focus on the incentives that the Bankruptcy Code generates in the debtor to file a voluntary petition, considering this the best way to handle the initiation problem. As a result of permitting the debtor to manage the company after it has entered into a reorganization process, commonly known as “debtor in possession”, it is claimed that the person who has the most information, and therefore who is most likely able to make

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<sup>63</sup> See World Bank’s Global Insolvency Law Database <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/0,,contentMDK:20154417~menuPK:146240~pagePK:64065425~piPK:162156~theSitePK:215006,00.html> , p. 26

<sup>64</sup> See United Nations Commission on International Trade Law’s “Draft Legislative Guide on Insolvency Law” at [http://www.uncitral.org/english/workinggroups/wg\\_il/wp-70-part1-e.pdf](http://www.uncitral.org/english/workinggroups/wg_il/wp-70-part1-e.pdf) , p. 13

<sup>65</sup> The definition of the cessation of payments may depend on many variables according to the specific legal system that applies it and there’s generally no more than vague guidelines for the judge to use. So the specific application of the standard depends greatly on open question.

<sup>66</sup> See Legal Department International Monetary Fund “Orderly and Effective Insolvency Procedures. Key Issues”, 1999, pp. 18- 25

<sup>67</sup> Among them we find Douglas Baird “The Initiation Problem in Bankruptcy”, 11 International Review of Law and Economics 223, 1991, Randal C. Picker “Voluntary Petitions and the Creditors’ Bargain”, 61 University of Cincinnati Law Review 519, 1992 and See Susan Block- Lieb “Fishing in Muddy Waters: Clarifying the Common Pool Analogy Applied to the Standard for Commencement of a Bankruptcy Case”, 42 American University Law Review 337, 1993

the accurate timing decision, will have incentives to file its own voluntary filing<sup>68</sup>. On these grounds a justification for the reorganization proceeding trigger is found: it would present “an appropriate inducement for the debtor to commence voluntary proceedings when it would otherwise not do so”<sup>69</sup>.

This approach is usually opposed to the one that endeavors imposing duties on managers in order to compel them to file at the proper moment<sup>70</sup>, normally conceived as a broad approach towards creditor protection, but specifically important in insolvency contexts. This approach has a couple of shortcomings. For example, it would be very difficult to impose an effective sanction for a failure to meet the duty to file and it would also be very difficult to decide ex- post what the proper time to file should have been. The dilemma over which one of this two approaches should legal systems emphasized has been pictured as offering “carrots or sticks” to the debtor<sup>71</sup>.

Frequently attached to those norms legal systems employ complimentary, not bankruptcy specific measures to protect the value of the business for its residual owners. They generally involve liability of third parties (as de facto directors or fraudulent conveyance provisions), shareholders (through shadow directors, equitable

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<sup>68</sup> See Douglas Baird “The Initiation Problem in Bankruptcy”, 11 *International Review of Law and Economics* 223, 1991, p. 230. Professor Baird expressed there that “Relying upon managers to file a bankruptcy petition makes sense because, at the time that the bankruptcy petition needs to be filed, the managers are likely to see a bankruptcy proceeding as the only way in which they can keep their jobs, at least for a time.”

<sup>69</sup> See Randal C. Picker “Voluntary Petitions and the Creditors’ Bargain”, 61 *University of Cincinnati Law Review* 519, 1992, p. 525

<sup>70</sup> See for example Germany’s *Aktiengesetz*, section 93, as well as *GmbH- Gesetz*, section 43

<sup>71</sup> See Elisabeth Warren, Jay L. Westbrook “The Law of Debtors and Creditors”, *Aspen Law & Business*, New York, 2001, p. 475

subordination or piercing the corporate veil doctrines) and auditors' liability (because of a failure to ensure that financial statements reflect accounting standards)<sup>72</sup>.

From another standpoint, fewer analyses concede a larger role to creditors considering them a relevant factor in order to opportunely commence a bankruptcy case. In this regard creditors face systems that are more or less stringent a propos their ability to file involuntary bankruptcy petitions. Whatever the special approach taken by the legal system, bankruptcy laws traditionally maintain that creditors' filings will help to bring recalcitrant, absconding or may be just overconfident debtors into bankruptcy.

Interestingly enough, as the legal system or a normative proposal decides where to place its focus in bringing the bankruptcy filing, the analysis of the complimentary roll of creditor filing is grossly neglected. This is probably due to the close to 1 subjective probability of the proponent of the norm towards his view as being the correct one. But as these probabilities diminish, the incentive to consider the other possibility increases, mostly when the different approaches can be complementary.

Coupled with these creditor or debtor oriented views are different standards for the commencement of the bankruptcy cases which scholars propose to follow. Besides the balance- sheet test many scholars and jurisdictions propose, as already mentioned, the cessation of payments standard to prove whether a debtor should be brought into bankruptcy, no matter who leads to the initiation of the case<sup>73</sup>. Professor Guyon

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<sup>72</sup> See generally Reiner Kraakman, et al. "The Anatomy of Corporate Law. A Comparative and Functional Approach", Oxford University Press Inc., New York, 2004, pp. 91- 95

<sup>73</sup> See André Jacquemont "Droit des Entreprises en Difficulté [Enterprises in difficulty's Law]", Éditions Litec, 2003, pp. 83- 84, where he considers this type of financial test as the least imperfect available to timely acknowledge the commencement of the bankruptcy case. Also see infra note 68



suggests that the proper test should be “l’existence des faits de nature à compromettre la continuité de la exploitation”<sup>74</sup> (the existence of facts that can compromise the continuation of the business or “going concern”) when it is up to the debtor to file a voluntary petition and to follow the cessation of payments in any other case.

All these other standards tend to be procedurally oriented, focusing on overcoming the difficulties that the players have in order to prove the substantial need for the bankruptcy proceeding so that the courts will open a case without focusing on the underlying theoretical grounds on which insolvency is required. Hence the imperative goal concerning the simplification of the burden of proof shouldn’t be confused with the logic that rest under bankruptcy theory.

It then follows that knowing “when” to start an insolvency petition has been widely discussed as it is a very important issue, when at stake are, directly or indirectly (through aggregated economic effects), the interest of shareholders, contract and non-contract creditors, workers, their dependents, competitors, suppliers, buyers, etceteras.<sup>75</sup> Different countries have approached this problem in different ways and with different results, due to the diverging tools provided and goals pursued by their law systems. This is the subject of the next section.

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<sup>74</sup> See Yves Guyon “Droit des Affaires. Entreprises en difficultés, Redressement judiciaire- Faillite [Business Law. Enterprises in Difficulties, Judicial Reorganization- Liquidation]”, Edition Economica, 9e edition, pp. 132- 133, where she considers it the best among “insolvabilité”, “surendettement” and “situation difficile” regarding the commencement of a reorganization proceeding.

<sup>75</sup> See Brad E. Godshall and Peter M. Giluhy “The Involuntary Bankruptcy Petition: The World’s Worst Debt Collection Device?”, 53 Bus. Law. 1315, 1998, pp. 1317-8, as they claim that “Courts have scrutinized involuntary petitions because they are considered to be an extreme remedy with serious

## V. Different methods of handling the same problem

Once lawmakers realized they were encountering a substantive problem, diverging solutions were thought to solve it. Every system recognizes that a debtor may find little incentives to file a bankruptcy petition under troublesome financial circumstances (absent any non-economic incentives or artificially created economic<sup>76</sup>). Therefore, they usually provide for a more or less stringent provision to allow creditors to petition the debtor bankruptcy (what's known as the involuntary petition<sup>77</sup>).

Two definitely distinct approaches have been taken by a number of countries to address this topic. On the one side, the “debtors’ choice” countries, like, though in varying degrees, the United States and France, creditors have to conform with tougher provisions that in some cases can even make them liable for damages if they don't strictly follow the imposed regulations. In other countries, the “creditors’ choice” countries, like Brazil, Germany, England and Wales, and Argentina, the bankruptcy petition can be filed after complying with very relaxed or liberal provisions.

### V.I. “Debtor's choice” countries

By “debtor's choice” countries I symbolize those legal systems where obstacles are imposed on the creditor who wants to file for bankruptcy<sup>78</sup>. Under this

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consequences for the alleged debtor including loss of credit status, business reputation, and public embarrassment”.

<sup>76</sup> An artificially created economic incentive may be the debtor in possession and a non economic one may be some moral personal requisite.

<sup>77</sup> United States Bankruptcy Code, section 303

<sup>78</sup> These jurisdictions usually coupled these provisions with incentives that are placed on the debtor in order to let him make the appropriate decision concerning the timing of the bankruptcy petition As it is the case of the United States Bankruptcy Code and the debtor in possession

conceptualization I believe, the United States and France, though with not so slightly distinct characteristics, are found.

#### V.I.I. United States

According to David Kennedy, James Bailey III and Spencer Clift III, “of the 1,436,964 bankruptcy cases filed in the calendar year of 1998, only 847 were involuntary filings”.<sup>79</sup> As this statistic shows, the American system, comprehending legal and non- legal areas, offers relatively many more stimuli available to the debtor than the ones available to the creditors.<sup>80</sup>

Section 303 of the Bankruptcy Code is the governing provision. After determining against which individuals an involuntary petition can be brought (persons, excluding farmers, family farmers or a corporation that is not a moneyed, business, or commercial corporation)<sup>81</sup>, section 303(b) sets the basic requirements for creditors to file a petition. In the case of a chapter 7 (liquidation) or chapter 11 (reorganization) filing, it has two general provisions to allow creditors to petition:

“1) By three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute, or an indenture trustee representing a such a holder, if such claims aggregate at least

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<sup>79</sup> See David S. Kennedy, James E. Bailey III and R. Spencer Clift III “The Involuntary Bankruptcy Process: A Study of the Relevant Statutory and Procedural Provisions and Related Matters”, 31 U. Memphis L. Review 1, 2000, p. 3. For a complete report of US bankruptcy filings see “The 2003 Bankruptcy Yearbook & Almanac”, edited by Christopher M. McHugh, New Generation Research, Inc., Boston, Ma, pp. 8-9 and <http://www.uscourts.gov/judicialfactsfigures/table5.01.pdf>

<sup>80</sup> See Susan Block- Lieb “Why Creditors File So Few Involuntary Petitions And Why The Number Is Not Too Small”, 57 Brooklyn Law Review 803, 1991, p. 836, where she says that there's a consistently small number of involuntary filings.

\$12,300 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;

2) if there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is avoidable under section 544,545,547,548,549, or 724 (a) of this title, by one or more of such holders that hold in the aggregate at least 12,300 of such claims;”<sup>82</sup>

Two other specific provisions concern partnerships<sup>83</sup> and international bankruptcies commenced outside of the United States.<sup>84</sup> As we can see, in order to allow a petition to be registered the usual requirement is for three creditors to join and have an aggregating outstanding debt of a considerable amount. It also can't be contingent or subject to a bona fide dispute. Further, if the creditors can overcome all these prerequisites they are subject to the challenge of the debtor. In such a case, it must be shown that the debtor is “generally not paying such debtor's debts as such debts become due”<sup>85</sup> or that “within 120 days before the date of the filing of the petition, a custodian... was appointed or took possession”.<sup>86</sup> The former standard implies that the creditors will have the burden of the proof to show that the debtor is not paying his debts as they become due.<sup>87</sup>

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<sup>81</sup> Title 11 U.S.C., section 303(a), all these words as defined in section 101, Title 11 U.S.C.

<sup>82</sup> Title 11 U.S.C., section 303(b) 1 and 2

<sup>83</sup> Title 11 U.S.C., section 303(b) 3

<sup>84</sup> Title 11 U.S.C., section 303(b) 4

<sup>85</sup> See Title 11 U.S.C., section 303(h) 1. The provision ends by stating “...unless such debts are the subject of a bona fide dispute”

<sup>86</sup> See Title 11 U.S.C., section 303(h) 2

<sup>87</sup> See “Collier on Bankruptcy. 15<sup>th</sup> Edition Revised”, Matthew Bender and Co., v. 2, 1996, section 303.14[1][e], p. 303-97, citing *In re Caucus Distribs., Inc.*, 106 B.R. 890, 914 (Bankr. E.D. Va. 1989).

The generally not paying test is different from the insolvency test that the Bankruptcy Code defines<sup>88</sup>, which provides for a balance-sheet test. It's closer to an "equity insolvency test", but there's a difference since this provision looks at whether the debtor is paying or not his debts and not if he can pay his debts.<sup>89</sup> The Bankruptcy Code doesn't define "generally not paying", but the Bankruptcy Commission's Report laid down a guideline for courts to follow: "It is intended that the court consider both the number and the amount [of debts] in determining whether the inability or failure is general".<sup>90</sup> This comprehensive standard is said to encompass many common factors, such as: the number of debts, the amount of delinquency, the materiality of nonpayment, the nature and conduct of the debtor's business, payments made by insiders both before and after the filing, the debtor's statement of a subjective desire to pay his debts, etceteras.<sup>91</sup> Therefore, the possibility to prove that the debtor is "generally not paying" exists and is broad as to the elements that may be employed. And probably because of this fact, the standard can be very difficult to conform to, due to the uncertainties of its broadness.

Besides, if the court dismisses a petition under section 303(i), the creditors may be liable for cost and a reasonable attorney's fee<sup>92</sup>. Or even worst, if the creditors are

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<sup>88</sup> See Title 11 U.S.C., section 101 (32) for the definition of insolvent.

<sup>89</sup> See "Collier on Bankruptcy. 15<sup>th</sup> Edition Revised", Matthew Bender and Co., v. 2, 1996, section 303.14[1], p. 303-90

<sup>90</sup> See Report of the Commission of the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1<sup>st</sup> Sess. Pt. II, 75, n.5 (1973), cited in "Collier on Bankruptcy. 15<sup>th</sup> Edition Revised", Matthew Bender and Co., v. 2, 1996, section 303.14[1], p. 303-91

<sup>91</sup> "Collier on Bankruptcy. 15<sup>th</sup> Edition Revised", Matthew Bender and Co., v. 2, 1996, section 303.14[1][b], pp. 303-93, 303-94 and 303-95

<sup>92</sup> See Title 11 U.S.C., section 303(i)1

considered petitioners in bad faith<sup>93</sup>, they will have to pay damages proximately caused by the filing or punitive damages.<sup>94</sup>

If all these requirements weren't enough to discourage creditors from filing, section 303 (e) comes into play to help. It allows the court the discretion necessary to require the creditors, after hearing and for cause, “to file a bond to indemnify the debtor for such amounts as the court may later allow under subsection (i) of this section”.<sup>95</sup> Also, the creditors who file will have to bear the costs of the filing fee, which will amount to 15 dollars in chapter 7 case and to 39 dollars in a chapter 11 case<sup>96</sup>.

The last element to consider is the power given to the courts under the "abstention" doctrine. As professor Block- Lieb points it out, United States Congress intended to encourage negotiation among the debtor and creditors<sup>97</sup>. Therefore, under section 305 of the Bankruptcy Code, a bankruptcy court can abstain from either a reorganization or liquidation case if the interests of the creditors and debtor would be better served by such dismissal.<sup>98</sup> The underlying goal of this provision is to permit “...the bankruptcy court system as both constitutional and capable of fulfilling the efficient resolution of bankruptcy cases.”<sup>99</sup>

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<sup>93</sup> There are several ways of determining bad faith. Some standards are subjective, some objectives and some are both objective and subjective, as the “combined” or “Rule 9011” test.

<sup>94</sup> See Title 11 U.S.C., section 303(i)2

<sup>95</sup> See Title 11 U.S.C., section 303 (e)

<sup>96</sup> See <http://www.uscourts.gov/fedcourtfes/03Nov1%20Bank%20Ct%20Fee%20Schedule.pdf>

<sup>97</sup> See Susan Block- Lieb “Why Creditors File So Few Involuntary Petitions And Why The Number Is Not Too Small”, 57 Brooklyn Law Review 803, 1991, pp. 833-834. For a deeper analysis of the abstention doctrine, also see professor Block- Lieb's “Permissive Bankruptcy Abstention”, 76 Washington University L. Q. 781, 1998

<sup>98</sup> See Title 11 U.S.C., section 305

<sup>99</sup> See Susan Block- Lieb's “Permissive Bankruptcy Abstention”, 76 Washington University L. Q. 781, 1998, p. 813

### V.I.II. France

France follows the long- standing principle of cessation of payments in order to allow a collective proceeding to arise (whether it is reorganization –“redressement”- or liquidation process-“liquidation judiciaire”-). To be in a cessation of payments situation means that the debtor is not able to meet his due obligations (“passif exigible”)<sup>100</sup> with his “actif disponible”<sup>101</sup> or disposable assets.<sup>102</sup>

This notion of cessation of payments, as Professor André Jacquemont puts it, needs to be distinguished from two separate concepts that are in its vicinity: isolated incident of nonpayment and insolvency.<sup>103</sup> The isolated nonpayment of an obligation is insufficient on itself to establish the debtor's cessation of payments.<sup>104</sup> Following this reasoning the demonstration of the cessation of payments must be done through a joint exam of the treasury situation.

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<sup>100</sup> For a definition of “passif exigible” see André Jacquemont “Procédures Collectives [Collectives Proceedings]”, Éditions Litec, 2000, pp. 35-36, expressing that “Le passif exigible s'entend de l'ensemble des dettes certaines, liquides et exigibles”. It is troublesome whether due obligations that were not presented for payment are to be taken into account for the “passif exigible”. The “Cour de Cassation” in Cass. com., 17 juin 1997: JCP E 1998, n° 1/2, p.28, takes the position that only debts asked for payment are part of the “passif exigible”. On this subject see André Jacquemont “Droit des Entreprises en Difficulté [Enterprises in difficulty's Law]”, Éditions Litec, 2003, p. 81. In the same way as in American law, debts subject to liquidation are not taken into account at the moment of considering whether the cessation of payments exists or not.

<sup>101</sup> For a definition of "actif disponible" see Corinne Saint-Alary-Houin “Droit des Entreprises en Difficulté [Enterprises in difficulty's Law]”, Domat Droit Privé, Edition Montchrestien, 2001, pp. 202-203, "L'actif disponible s'entend de l'actif immédiatement utilisable, mobilisable, c'est-à-dire de l'ensemble des sommes en caisse, des effets de commerce à vue, du solde créditeur des comptes bancaires"

<sup>102</sup> French Law number 85/98 of the 25<sup>th</sup> of January 1985

<sup>103</sup> André Jacquemont “Procédures Collectives [Collectives Proceedings]”, Éditions Litec, 2000, p. 35

<sup>104</sup> See André Jacquemont “Procédures Collectives [Collectives Proceedings]”, Éditions Litec, 2000, p. 35, citing “B. Rigaud c/Caisse Organic des Pyrénées”, Cass. Com. 25 Févr. 1997

The other concept from which the cessation of payments must be differentiated is insolvency. By insolvency Professor Jacquemont refers to a balance-sheet test<sup>105</sup>. In reference to this subject, according to French law, a debtor can be insolvent without being in cessation of payments (when the relatively large debts are not due and therefore his “actif disponible” suffices to cover the debts currently due). As well a debtor can be in cessation of payments without being insolvent (this could be the situation of the commonly named liquidity crises).

The burden of the proof concerning the existence of the cessation of payments is imposed on the person who petitions the opening of the collective proceeding. The petitioners can use any facts to try to prove the cessation of payments. As Professor Corinne Saint-Alary-Houin points it, generally the case will be one in which the existence of the cessation of payments will come out of number of *indiciae*.<sup>106</sup>

As a matter of normative principles, French law-makers decided that an involuntary proceeding couldn't be allowed “just in case”. In fact, proving a cessation of payments may be very difficult for a creditor with poor knowledge of debtor's financial and economic affairs. Perhaps, that is why it is said that, in practice, the existence of the cessation of payments is proved after a declaration of the debtor assuming his financial difficulties. In addition, French policy-makers decided that a

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<sup>105</sup> André Jacquemont “Procédures Collectives [Collectives Proceedings]”, Éditions Litec, 2000, p, 35

<sup>106</sup> Corinne Saint-Alary-Houin “Droit des Entreprises en Difficulté [Enterprises in difficulty's Law]”, Domat Droit Privé, Edition Montchrestien, 2001, p. 206



liquidation procedure should be allowed only if a reorganization is “manifestement impossible” (manifestly impossible) or the debtor ceased every business activity.<sup>107</sup>

## V.II. “Creditors' choice” countries

At the other side of the spectrum, some legal countries prefer to fully open the judicial gate for involuntary bankruptcy petitions to be received. “Creditor's choice” countries offer the possibility to creditors to file with minimal requirements, being the common denominator the requirement of an unpaid due obligation. Brazil, Germany, England and Wales, and Argentina, among others, follow this approach and I further examine those provisions.

### V.II.I. Brazil

Brazil is a clear cut “creditor's choice” country. Its Bankruptcy Act, "Lei de Falências", has come a long way since its enactment in 1945 leaving some provisions outdated. Among them we can find the lack of choice for an individual to be declared bankrupt (only allowed for merchants and companies) or the differentiation between Brazilian and foreign creditors.

Article 1 provides the basis for the commencement of an involuntary case: not paying a due, liquid obligation as it becomes due, unless the debtor has a relevant

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<sup>107</sup> See World Bank's Global Insolvency Law Database <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/GILDCOUNTRIES/GILDFRANCE/0,,contentMDK:20114336%7EmenuPK:262681%7EpagePK:157658%7EpiPK:157731%7EtheSitePK:262675.00.html> , in the document entitled “Insolvency Overview”

reason of right.<sup>108</sup> Consequently, the creditor has to prove that he possesses a due credit. This credit has to be written in a “título executivo” to comply with the requirements of the law.<sup>109</sup> The creditor can also prove his claim through the judicial verification of the existence of the debt in his or the debtor's accounting books.

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<sup>108</sup> See Title 1, Section 1, Article 1 of Brazilian “Lei de Falências [Bankruptcy Law]”, decree-law 7661, 1945. As it is expressed in the World Bank’s Global Insolvency Law Database <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/GILDCOUNTRIES/GILDBRAZIL/0,,contentMDK:20107752~menuPK:215548~pagePK:157658~piPK:157731~theSitePK:215080,00.html> , in the document entitled “Brazil - Insolvency Overview”: “Among the defenses available to the debtor for non-fulfillment of an obligation, the Bankruptcy Law mentions the existence of a relevant legal right for not making the payment. “Relevant legal right” is understood as any matter which legitimates the debtor's refusal to comply with his obligation to pay, some of which include situations where:

- (i) the instrument corresponding to the obligation is false (see Arts. 296-305 of the Penal Code [*Código Penal*]);
- (ii) statute of limitations has expired (see Arts. 161-179 of the Civil Code [*Código Civil*]);
- (iii) the obligation or its respective instrument is void;
- (iv) the debt has been paid, after the protest but before the bankruptcy petition;
- (v) a petition for preventive concordata is filed by the debtor before the debtor is summoned to bankruptcy court;
- (vi) the appropriate deposit is made with the court in a timely fashion;
- (vii) the debtor's commercial activities ceased more than two years ago, as evidenced by a valid document issued by the Registry of Commerce, which, however, shall not prevail over any evidence of activities being carried out after such registration has been made;
- (viii) any reason which extinguishes or suspends the fulfillment of the obligation, or which excludes the debtor from the bankruptcy proceeding.”

<sup>109</sup> As professor Tzirulnik comments in “Direito Falimentar [Insolvency Law]”, 4 ed., rev. E atual., São Paulo, Editora Revista dos Trivunais, 1997, p. 42, a “título executivo” in the commercial Brazilian language means every type of negotiable instrument. The Global Insolvency Law Database of the World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/GILDCOUNTRIES/GILDBRAZIL/0,,contentMDK:20107752~menuPK:215548~pagePK:157658~piPK:157731~theSitePK:215080,00.html> , in the document entitled “Brazil - Insolvency Overview”, consequently states that “When a creditor petitions for bankruptcy of a debtor based on an unpaid debt owed to the creditor by the debtor, to duly ground such a petition, it is essential to present not only a debt instrument representing a legal, certain and payable obligation, whose statute of limitations for bringing action has not expired, but also the respective protest instrument, showing that the corresponding cure period has expired. It is the

The “Lei de Falências”, in addition to the preceding standard, authorizes the declaration of bankruptcy under seven additional tests.<sup>110</sup> Among them we can find a proposition made by the debtor to his creditors to delay payments, making of ruinous or fraudulent payments, making of simulated transactions to hide assets from creditors or leaving the place of business without appointing somebody to represent or to manage the business.

In the case of article's 1 standard (not paying due obligations) being raised, the bankruptcy judge will summon the debtor to present his defense within the exiguous time frame of 24 hours. If the debtor pays the creditor or makes a judiciary deposit (“depósito elisivo”<sup>111</sup>) within the time provided for his defense, he will elude being declared bankrupt.<sup>112</sup> The debtor could also defend himself alleging, among other justifications, the existence of “relevant reasons of right” not to pay, as could be that the creditor holds a false title, prescription of the right in which the creditor bases his claim or having stopped exercising commercial activities two or more years ago.<sup>113</sup> In order to prove any of the available defenses the debtor can ask the bankruptcy court for a period of five days in which to present the evidence that can back up his case.

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protest, made according to commercial law provisions, that is official evidence that the obligation has not been paid upon maturity thereof”

<sup>110</sup> See Title 1, Section 1, Article 2 of Brazilian “Lei de Falências [Bankruptcy Law]”, decree- law 7661, 1945

<sup>111</sup> See Luiz Tzirulnik “Direito Falimentar [Insolvency Law]”, 4 ed., rev. E atual., São Paulo, Editora Revista dos Trivunais, 1997, p. 77

<sup>112</sup> See Title 1, Section 2, Article 11 of Brazilian “Lei de Falências [Bankruptcy Law]”, decree- law 7661, 1945

<sup>113</sup> On the available defenses provided by Brazilian Bankruptcy statute see Title 1, Section 1, Article 4 of Brazilian “Lei de Falências [Bankruptcy Law]”, decree- law 7661, 1945

A denied involuntary petition can bring unpleasant consequences for the claiming creditor. As Professor Tzirulnik expresses it, the debtor who is prejudiced by an involuntary petition made by creditor with malicious intent (“dolo”) is authorized under article 20 to bring a lawsuit against him for the damages that he suffered.<sup>114</sup>

Yet the debtor has another possibility. Once the bankruptcy has been declared he can ask the court to convert it to a reorganization proceeding known as “concordata suspensiva”. The juridical effect of the declaration of the “concordata suspensiva” is to suspend the bankruptcy proceeding and allow the debtor to try to arrange a deal with his creditors (he must attach a plan with the motion to convert the case into a “concordata suspensiva”).

Due to the view that the current “Lei de Falências” is outdated, a new project is seeking approval in Brazilian Congress.<sup>115</sup> It has as a main priority to allow for the recovery of viable enterprises. The project takes a multiple value approach, considering the interests of creditors, debtors, employees, etceteras. It takes into account the "social role" of the enterprise in its community.

Regarding the specific topic of the paper, the new project requires a minimum amount of credit to allow a creditor to file an involuntary petition. In the case of large and medium size businesses is 40 times the minimum wage and in the case of small ones is 20 minimum wages. It also directs that the “títulos executivos” must be due at

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<sup>114</sup> See Luiz Tzirulnik “Direito Falimentar [Insolvency Law]”, 4 ed., rev. E atual., São Paulo, Editora Revista dos Trivunais, 1997, p. 93

<sup>115</sup> The project has already been approved by the “Câmara dos Deputados” (House of Representatives) under PL number 205/95

least 90 prior to the filing of the petition. The enactment of this project would place Brazilian insolvency law half way between creditor and debtor's choice countries.

### V.II.II. Germany

The 1994 “Insolvenzordnung” came to existence after a long period of debate (the commission established to prepare the reform was set by the Federal Minister of Justice back in 1978).<sup>116</sup> As the models for many provisions came from American Law<sup>117</sup>, various parts resemble the United States Bankruptcy Code. The aims of the new statute as Manfred Balz expresses it are “...to establish a system that will provide market conformity of insolvency proceedings”.<sup>118</sup>

Although there are two basic legal grounds on which to open an involuntary Bankruptcy proceeding. The main condition for the commencement of insolvency proceedings in German law is the “Zahlungsunfähigkeit” or inability to pay<sup>119</sup>. The debtor is unable to pay, if he cannot meet his payments as they become due.<sup>120</sup> There are two requirements that German Law poses on the adjudicators at the time of deciding whether the test is met or not: the extension of time in breach of obligations and the relative amount of the unpaid debts. The first dimension of the standard looks into the

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<sup>116</sup> Hans-Georg Landfermann “The New German Insolvency Code”, in “Bankruptcy and Judicial Liquidation”, Counsel of Europe Publishing, 1996, p. 25

<sup>117</sup> Hans-Georg Landfermann “The New German Insolvency Code”, in “Bankruptcy and Judicial Liquidation”, Counsel of Europe Publishing, 1996, p. 26

<sup>118</sup> See Manfred Balz “Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law”, 23 Brooklyn J. Int'l L. 167, 1997, p. 171

<sup>119</sup> Ariel A Dasso, Ariel G. Dasso y Javier G. Dasso “Quiebras. Concurso Preventivo y Cramdown [Liquidations. Reorganizations and Cramdown]”, Editorial Ad-Hoc, 1997, p. 429

characteristics of the “inability to pay” concerning time. The debtor’s inability to meet his obligations for a limited period of time is called "Zahlungsstockung", and it has been interpreted as not conforming to the standard because it was just a temporary situation under the previous “Konkursordnung” of 1887 and “Vergleichsordnung” of 1935. Of course, this raises the issue of how long would a temporary situation last, and addressing this matter the government's explanation in the draft law of “inability to pay” says that “a person or company which has no liquidity for some time will only normally be able to bridge this time by a bank check; if the banks are no longer willing to extend credit to him, then in most cases it is in the interest of the creditors to open insolvency proceedings”<sup>121</sup>. Thus, the government believes that inability to pay should not be subject to a fixed or loose time frame.

The second characteristic to be met in order to comply with the inability to pay standard is that an essential part of the liabilities of the debtor cannot be fulfilled.<sup>122</sup> In the same way as in the previous characteristic of "inability to pay", government exposition refutes this theory and considers it to be sufficient that the debtor is unable to meet his due obligations and no other requirements should be installed.

The second legal ground that permits an involuntary petition is a balance- sheet test, only available when the debtor is a public or limited liability company. It is called "Überschuldung" or overindebtness. Section 19, Subsection 2 of the Insolvenzordnung

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<sup>120</sup> See Hans-Georg Landfermann “The New German Insolvency Code”, in “Bankruptcy and Judicial Liquidation”, Counsel of Europe Publishing, 1996, p. 34, citing section 17, subsection 2, sentence 1 of the Insolvency Statute

<sup>121</sup> See Hans-Georg Landfermann “The New German Insolvency Code”, in "Bankruptcy and Judicial Liquidation", Counsel of Europe Publishing, 1996, p. 34

provides that there is overindebtedness if the debtor's property no longer covers liabilities.<sup>123</sup> As the creditors' knowledge of the debtors' over indebtedness is unlikely, the system works borrowing from corporations law to oblige corporations' management to petition for the opening of an insolvency proceeding, not just in the case of overindebtedness, but in the case of ability to pay also. Criminal and Civil liabilities may be imposed over manager in breach of this duty.

### V.II.III. England and Wales

As a matter of dealing with the bankruptcy of companies (both registered and unregistered ones, within the meaning of the Insolvency Act and Companies Act) English law permit courts to wind up them.<sup>124</sup>

Section 122, subsection (1) of the Insolvency Act provides for seven grounds of support to bring an involuntary proceeding.<sup>125</sup> Many of those terms do not require

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<sup>122</sup> See Hans-Georg Landfermann "The New German Insolvency Code", in "Bankruptcy and Judicial Liquidation", Counsel of Europe Publishing, 1996, p. 34

<sup>123</sup> Ariel A Dasso, Ariel G. Dasso y Javier G. Dasso "Quiebras. Concurso Preventivo y Cramdown [Liquidations. Reorganizations and Cramdown]", Editorial Ad-Hoc, 1997, V. 2, pp. 429-430

<sup>124</sup> 1986 Insolvency Act, Chapter VI of Part IV and Part V

<sup>125</sup> As Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, p. 522, has put it, the seven grounds of section 122 (1) are:

- (a) the Company has by special resolution resolved that the company be wound up by the court;
- (b) being a public company which was registered as such on its original incorporation, the company has not been issued with a certificate under section 117 of the Companies Act 1985 (public company share capital requirements) and more than a year has expired since it was so registered;
- (c) the company is an old public company within the meaning of section 1 of the Companies Consolidation (Consequential Provisions) Act 1985;
- (d) the company does not commence its business within a year from its incorporation, or suspends its business for a whole year;
- (e) (except in the case of a private limited company limited by shares or by guarantee) the number of members is reduced below two;
- (f) the company is unable to pay its debts;
- (g) the court is of the opinion that it is just and equitable that the company should be wound up;

neither balance- sheet nor equity insolvency test to be checked by the courts in order to admit a winding up petition.<sup>126</sup>

As a matter of practice, the ground on which winding up petitions are generally based is section 122 (1)(f), when the company is "unable to pay its debts".<sup>127</sup> Section 123, subsections (1) and (2) furnish for different cash flows and a balance- sheet to know whether the "unable to pay its debt" standard has been met. Under section 123, subsection 1, five ways are set to comply with the standard. These are:

(a) if a creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding £750 then due has served on the company's registered office, a written demand requiring the company to pay the sum so due and the company has for three weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor; or

(b) if, in England and Wales, execution or other process is issued on a judgment, decree or order of any court in favor of a creditor of the company is returned unsatisfied in whole or in part; or

(c) if, in Scotland, the induciae of a charge for payment on an extract decree, or an extract registered bond, or an extract registered protest, have expired without payment being made; or

(d) if, in Northern Ireland, a certificate of unenforceability has been granted in respect of a judgment against the company; or

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<sup>126</sup> Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, p. 523

<sup>127</sup> Vanessa Finch "Corporate Insolvency Law. Perspectives and Principles", Cambridge University Press, 2002, p. 375



(e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.<sup>128</sup>

Section 123 subsection 2 focus on different grounds to bring an involuntary petition, namely, a balance-sheet test. Under this provision, a company would be reputed to be "unable to pay its debts" if it is demonstrated to the satisfaction of the court that the value of the company's assets is not sufficient to cover the total amount of the company's liabilities. For the purpose of aggregating liabilities under this subsection, both contingent and prospective liabilities should be added.<sup>129</sup>

It may be thought that even though there are many provisions to base the involuntary petition on, the grounds needed to comply with may not be simple. But the demonstration of the cash- flow test under section 123, subsection 1 (e) can be extremely simple for the creditor. Usually a creditor would utilize a debt that is due from the company against him, of what he obviously has complete knowledge. As Professor Ian Fletcher expresses it: "It has been consistently held by courts up to the level of the Court of Appeal that failure to pay even a single debt which is due and not disputed is of itself evidence of insolvency on which a winding up order can be made".<sup>130</sup> Moreover, in *Cornhill Insurance plc v. Improvements Services Ltd* [1986] 1 W.L.R. 114, the courts held that even if the debtor had enough assets to cover all the liabilities, the petition should be allowed.<sup>131</sup>

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<sup>128</sup> Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, pp. 523-524

<sup>129</sup> Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, p. 524

<sup>130</sup> See Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, p. 527. Especially see cite 37 on p. 527

<sup>131</sup> Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, p. 527

Evidently this rule gives the creditor a great amount of leverage against a debtor, who may not choose to be recalcitrant under the possibility of the winding up order being made. Nonetheless, if the company is capable of demonstrating that there are substantive grounds for disputing the debt claimed by the creditor, a court may consider that an abuse of process have occurred and impose damages on the creditor.

English Law tries to further extend the incentives to generate an on time winding up proceeding by imposing over the debtor's directors a series of duties and expose them to liabilities. Under common law, duties towards the creditors may arise and therefore the directors may be responsible for their actions towards the creditors. There are at least two important problems that arise out of this line of thought. First, it must be decided what kind of duty it is owed.<sup>132</sup> In second place it must be determined when does the duty arise.<sup>133</sup> In respect to liabilities, sections 213 and 214 of the Insolvency Act provide for fraudulent trading and wrongful trading respectively, as means of imposing responsibility on directors. The first section requires a showing of intent to defraud, which is a severe requirement that impedes many actions against directors due to the difficulty of the proof.<sup>134</sup> The second basis for civil liability was introduced by the 1986 Insolvency Act. Under this test, if the director (or shadow director<sup>135</sup>) knew or ought to have known that there was no reasonable prospect that the

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<sup>132</sup> See Vanessa Finch "Corporate Insolvency Law. Perspectives and Principles", Cambridge University Press, 2002, pp. 499-501. It must be chosen whether the duty is a fiduciary one directly or indirectly owed to the creditors or a duty of care.

<sup>133</sup> See Vanessa Finch "Corporate Insolvency Law. Perspectives and Principles", Cambridge University Press, 2002, pp. 504-510, where she discusses if the duty arises at the moment of bankruptcy, when bankruptcy is approaching or if it always exists.

<sup>134</sup> Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, p. 660

<sup>135</sup> See section 251, 1986 Insolvency Act

company would avoid liquidation, he may be declared liable if he continues trading and incurring liabilities.<sup>136</sup> Nevertheless, if the director can prove, under section 214, subsection 3, that once he acknowledged the insolvency situation he took every step with a view to minimizing potential loss to the companies creditors, he would impede the declaration of wrongful trading.<sup>137</sup> As a result of these unclear and contested dispositions, the law- created incentives toward directors' actions, preventing losses for creditors, are highly diluted.

#### V.II.IV. Argentina

The Argentine legal bankruptcy system possesses on its face many similarities with both French and Italian ones, from which Argentine law-makers drew many of its sections. Nonetheless when Argentine's model is set into practice, some commonalities become diffuse areas.

Argentine Insolvency Law only permits creditors the possibility to petition for a liquidation procedure.<sup>138</sup> Nevertheless, this doesn't limit the possibility of the debtor to obtain the opening of a reorganization procedure. If, once the liquidation procedure is opened, the debtor wants to transform the existent case into a reorganization - "Concurso Preventivo"- he may ask the court for it, after complying with the

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<sup>136</sup> Ian F. Fletcher "The Law of Insolvency", Sweet & Maxwell, London, 1996, p. 662

<sup>137</sup> Vanessa Finch "Corporate Insolvency Law. Perspectives and Principles", Cambridge University Press, 2002, p. 512

<sup>138</sup> See Title III, Chapter I, Section I, Article 77 of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522

requirements set by the reorganization voluntary petition.<sup>139</sup> The fees applicable to a filing creditor depend on the jurisdiction where it is filed but are relatively small<sup>140</sup>.

The law standard which, whoever who wants to petition for bankruptcy, as there is no distinction between voluntary and involuntary requirements for filing<sup>141</sup>, must furnish is the cessation of payments ("cesación de pagos"). As Professor Yadarola had put it, in accordance with French interpretation and in a way that Argentine commentators and courts usually follow, the cessation of payments implies a situation of the patrimony in which it shows itself unable to meet its regularly due obligations.<sup>142</sup> It has been said that, when evaluating this sort of cash- flow test, not mere financial difficulties must be taken into account by the adjudicator.<sup>143</sup>

When a creditor solicits the opening of liquidation proceeding, he must prove that the debtor is in cessation of payments through one or more of the tests provided by article 79 of the "Ley de Concursos y Quiebras". The enumeration provided in this article is open- ended. Therefore the courts are allowed to pay attention to other ways of

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<sup>139</sup> See Title III, Chapter I, Section IV, Articles 90 to 93 of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522. If an allowed debtor complied with all the requirements set under section IV, the court is obliged to make the conversion of the liquidation procedure into a reorganization one.

<sup>140</sup> For example, the involuntary fees in Santa Fe province are less than \$20 dollars. See Santa Fe Province Law number 3650, available at <http://santafelegal.com.ar/Archivos/LEY%203.650%20ley%20impositiva%20anual.htm>

<sup>141</sup> Even though there are some extra requirements for the debtor to comply with at the moment of filing a voluntary petition, if he doesn't accomplish to bring those prerequisites, the bankruptcy judge must open the case anyway. See Title III, Chapter I, Section II, Article 86 of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522

<sup>142</sup> See Yadarola "Algunos aspectos fundamentales de la nueva Ley de Quiebras [Some Fundamental Aspects of the New Liquidations' Law]", *Revista Crítica de Jurisprudencia*, 1934, No. 19, p. 433. Also see Yadarola "El concepto técnico- científico de la cesación de pagos [The Technical- Scientific Concept of Cessation of Payments]", *Jurisprudencia Argentina*, 68-69, secc. Doctrina.

<sup>143</sup> See Cámara Nacional en lo Comercial, Sala C, 21/05/1981, ED, 94-554, taking a strict approach to cessation of payments.

proving the cessation of payments, because what's important is to leave the appreciation for the courts to decide.<sup>144</sup>

The test through which the vast majority of involuntary cases are brought before the courts is the one that points at the non- payment of an obligation<sup>145</sup> (although from time to time, and in particular circumstances creditors utilize the rest of the standards). The unpaid obligation must be due ("exigible"), non- contingent ("no eventual") and undisputed ("no litigioso").<sup>146</sup> If the creditor has a special security interest in personal or real property, he must as well prove that his credit is undersecured in order to be permitted as a bankruptcy petitioner.<sup>147</sup> In practice, the combination of this provision with article 509 of Argentine Civil Code, gives as a result a potential proof of the cessation of payments any time that a post- dated obligation is contracted between a debtor and a creditor and the former doesn't meet it.<sup>148</sup>

Article 78 of the "Ley de Concursos y Quiebras" takes a strong position towards handing creditors the ability to file for involuntary bankruptcy. In its second paragraph provides that it is not necessary the plurality of creditors. Thus, a petitioning creditor

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<sup>144</sup> See Argeri "Consideraciones sobre el anteproyecto de Ley de Concursos Mercantiles [Thoughts about the Commercial Reorganizations' Law Project]", *Jurisprudencia Argentina*, doctrina 1970, p. 435

<sup>145</sup> See Title III, Chapter I, Section I, Article 79 (2) of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522, which points to the "mora en el cumplimiento de una obligación"

<sup>146</sup> Santiago C. Fassi and Marcelo Gebhardt "Concursos y Quiebras. Comentario Exegético de la Ley 24522. Jurisprudencia Anotada [Reorganizations and Liquidations. Exegetic Commentary of Law 24522. Cited Cases]", Editorial Astrea, 1997, p. 229. Also see Title III, Chapter I, Section I, Article 80 of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522

<sup>147</sup> See Title III, Chapter I, Section I, Article 80 of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522

<sup>148</sup> Santiago C. Fassi and Marcelo Gebhardt "Concursos y Quiebras. Comentario Exegético de la Ley 24522. Jurisprudencia Anotada [Reorganizations and Liquidations. Exegetic Commentary of Law 24522. Cited Cases]", Editorial Astrea, 1997, pp. 219-220

just needs to prove that the creditor is subject to the liquidation proceeding<sup>149</sup> and the situation of cessation of payments<sup>150</sup> (which can be demonstrated, as already expressed, by the inability to pay an obligation to the creditor<sup>151</sup>). That is why, in Argentina the involuntary proceedings are dominating the scene.<sup>152</sup> A mostly academic discussion (due to the very slim probability of occurring) is yet to be rendered in Argentina on whether the liquidation process can continue or not if there's only one creditor.<sup>153</sup>

Once the creditor has filed his petition, the debtor will be cited in order to express and prove what he considers of relevance to his position. Argentine lawmakers chose not to extend this period, so after hearing once again to the creditor, the bankruptcy judge must decide whether or not to admit the petition and thus, open the case.<sup>154</sup> In any case, the debtor is entitled to motion for a review of the decision opening the liquidation to the bankruptcy judge, based on substantial grounds (which are either

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<sup>149</sup> See Title I, Article 2 of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522

<sup>150</sup> Santiago C. Fassi and Marcelo Gebhardt "Concursos y Quiebras. Comentario Exegético de la Ley 24522. Jurisprudencia Anotada [Reorganizations and Liquidations. Exegetic Commentary of Law 24522. Cited Cases]", Editorial Astrea, 1997, p. 216, citing C1aCivCom La Plata, Sala I, 25/02/1971, *Jurisprudencia Argentina*, reseñas 1971-171, No. 184; Satta, "Instituciones de Derecho de Quiebra", p. 73, No. 24; C2aCivCom Tucumán, 07/08/1974, *La Ley*, 1975 A-830, No. 703

<sup>151</sup> On whether a credit is sufficiently proved, see Ariel A Dasso, Ariel G. Dasso y Javier G. Dasso "Quiebras. Concurso Preventivo y Cramdown [Liquidations. Reorganizations and Cramdown]", Editorial Ad-Hoc, 1997, V.1, pp. 354-355, citing "Lavandería Industrial S.A. s/pedido de Quiebra por Bianchi, Roberto", Cámara Comercial: B, Díaz Cordero - Piaggi - Butty, 22/11/1996, ficha No. 25736.

<sup>152</sup> See Guillermo A. Moglia Claps and Julian B. McDonnell "Secured Credit and Insolvency Law in Argentina and the United States: Gaining Insight from a Comparative Perspective", 30 *Georgia J. Int'l & Comp. L.* 393, 2002, pp. 427-428

<sup>153</sup> See Argeri "Consideraciones sobre el anteproyecto de Ley de Concursos Mercantiles [Thoughts about the Commercial Reorganizations' Law Project]", *Jurisprudencia Argentina*, doctrina 1970, p. 435, who believes that the requirement of just one creditor is enough to open the proceeding but not to its prosecution. Also see Title III, Chapter I, Section II, Article 83 of Argentine's "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522

<sup>154</sup> See Title III, Chapter I, Section II, Articles 83 and 84 of Argentine's "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522. As a matter of choice Argentine Law decided

the non- existence of the cessation of payments or that the petition can't be brought against the debtor).<sup>155</sup>

Another interesting fact to be addressed concerns the possible liability of the petitioning creditor. Article 99 of Argentine Insolvency Law authorizes to impose damages on a petitioner who acted either fraudulently ("dolo") or under gross negligence ("culpa grave").<sup>156</sup> Any of the tests provided by article 99, must be asserted and proved by the debtor (the plaintiff in the new suit). But the creditor is not liable for the litigation costs he imposes on the debtor and the judiciary system.<sup>157</sup> This may seem very awkward, but it once again shows the interest of the law- makers in allowing the creditors to decide on when a bankruptcy proceeding should begin.

As regard of debtor's responsibility to creditors the focus must be shifted to Argentine's Companies Act ("Ley de Sociedades")<sup>158</sup> and to the regime of Public Companies ("Regimen de Transparencia de la Oferta Pública").<sup>159</sup> Article 59 of the

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on the extreme shortness of this proceeding stating that there's no trial on considering the issue of the opening of the liquidation proceeding or "antequiebra".

<sup>155</sup> See Santiago C. Fassi and Marcelo Gebhardt "Concursos y Quiebras. Comentario Exegético de la Ley 24522. Jurisprudencia Anotada [Reorganizations and Liquidations. Exegetic Commentary of Law 24522. Cited Cases]", Editorial Astrea, 1997, p. 523, citing C1a.CivCom Tucumán, 11/02/1981, *RepED*, 51-407

<sup>156</sup> See Title III, Chapter I, Section V, Article 99 of Argentine's "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522. On the concepts of "Culpa Grave" and "Dolo" see Atilio Aníbal Alterini, Oscar José Ameal and Roberto M. Lopez Cabana "Derecho de las Obligaciones Civiles y Comerciales [Civil and Commercial Obligation's Law]", Abeledo- Perrot, S.A.E. e I., 1998, pp. 183-199. Also see Rubén H. Compagnucci de Caso "Manual de Obligaciones [Obligation Manual]", Editorial Astrea, 1997, pp. 129-137

<sup>157</sup> See Santiago C. Fassi and Marcelo Gebhardt "Concursos y Quiebras. Comentario Exegético de la Ley 24522. Jurisprudencia Anotada [Reorganizations and Liquidations. Exegetic Commentary of Law 24522. Cited Cases]", Editorial Astrea, 1997, p. 239

<sup>158</sup> See Argentine's "Ley de Sociedades [Corporations Law]", number 19550

<sup>159</sup> See Argentine's Decree "Régimen de Oferta Pública de Acciones [Public Offer of Shares Regime]", number 677/2001

"Ley de Sociedades" requires that the administrators of a company must act with the "loyalty and diligence of a good businessman".<sup>160</sup>

The loyalty administrators must comply with while acting on behalf of the company means that they must perform their tasks with honesty and sincerity.<sup>161</sup> The test that the law imposes on the administrators concerning their diligence is that of a prototypical merchant, acting in his own behalf.<sup>162</sup> If a court finds that this standard has not been met, the representatives of the company may be find liable against the company itself or even third parties (in our case creditors).

Article 8 of the Argentine's "Régimen de Oferta Pública de Acciones" has a similar provision. After determining that directors and administrators (among others) must act conforming the duties of loyalty and diligence, it expresses they must always act in regard of the social interest of the company.<sup>163</sup>

Whether an administrator has violated or not his diligence duty is a very complex issue for courts to solve. Argentine doctrine and courts have developed an objective, minimum standard. It requires that the directors or administrator must have an enterprise plan ("plan de empresa"). If the plan is formalized, so that it can be

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<sup>160</sup> See Argentine's "Ley de Sociedades [Corporations Law]", number 19550, Article 59, which says "Los administradores y los representantes de la sociedad deben obrar con la lealtad y con la diligencia de un buen hombre de negocios" (The representatives and administrators of the company must act with the loyalty and the due diligence of a good business man).

<sup>161</sup> See Efraín Hugo Richard and Orlando Manuel Muiño "Derecho Societario. Sociedades Comerciales, Civil y Cooperativa [Corporations Law. Commercial, Civil and Cooperatives Corporations]", Editorial Astrea, 1997, p. 229. It is said there that an administrator must act postponing each of his personal interests that go against the social ones.

<sup>162</sup> See Carlos Gilberto Villegas "Derecho de las Sociedades Comerciales", Abeledo- Perrot S.A.E. e I., 1996, p. 197

<sup>163</sup> See Argentine's Decree "Régimen de Oferta Pública de Acciones [Public Offer of Shares Regime]", number 677/2001, article 8 (a) (1)



scrutinized and controlled, the chances of being held liable are very small.<sup>164</sup> This is a natural conclusion because if administrators are too contrived by the norms, their decision-making power gets affected and, consequently, the business outcome.

The courts have not always been consistent on deciding whether a unique creditor, offering as proof due debts being owed to him is sufficient to demonstrate that the debtor is in cessation of payments. Indeed some courts have decided against creditors in these situations because they weren't satisfied with the evidence presented by the debtor<sup>165</sup>. But many courts, arguably a great majority of them, after receiving the debtor's defense, are of the view that if the creditor hasn't been paid, the petition should be allowed and the bankruptcy case opened. This kind of opinion could be due to both the amplitude and generosity of the Argentine Insolvency Law and the great amount of judicial burden, which would impede judges from taking a closer look at every case.

## **VI. The underlying logic of the Involuntary Petition**

This section will deal basically with business entities<sup>166</sup>, as different from individuals. Even though the framework of analysis is, at its basis, the same in each

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<sup>164</sup> See Efraín Hugo Richard and Orlando Manuel Muiño "Derecho Societario. Sociedades Comerciales, Civil y Cooperativa [Corporations Law. Commercial, Civil and Cooperatives Corporations]", Editorial Astrea, 1997, pp. 232-233, citing Marzal "Empresa y Democracia Económica", p. 286

<sup>165</sup> See Cámara Nacional de Comercio, Sala D, "La Ley", 1979- C, pp. 131- 132, where the court has stated that "La simple exigibilidad de un crédito no importa, de suyo, la cesación de pagos del deudor, estado que supone para evidenciarse, por lo menos el reclamo del acreedor" (the simple claim of a debt doesn't imply in itself the debtor's cessation of payments, condition that needs at least to be shown by the claim of the creditor)

<sup>166</sup> The proxy here is to use business entities (recognized under the local organizational law) in order to benefit from the clear objective that they have, namely to pursue the long term interest of its owners. Which owners should be taken into account is a debated issue though. Many jurisdictions do not recognize the interests of residual owners as something the entity must aim at. See for example how

case, individual bankruptcy has particular intricacies that impede analysts to provide clear solutions just bearing in mind the business concerns. Individual bankruptcies deal with different policies, such as fresh start reasons,<sup>167</sup> personal exemptions regarding minimum living standards,<sup>168</sup> special priorities (such as child support or alimony)<sup>169</sup>, relative sophistication of the players of the market (almost certainly very one sided towards the creditors), etc. Each of these considerations requires special attention and therefore, they will be excluded from the scope of the remaining paper. Additionally, the more atomized and less significant amounts that are often the case involved in a personal bankruptcy would diminish the ability of making strong assumptions for developing the following thoughts.

So far we know that as a matter of fact creditors are allowed to file an involuntary petition to protect their interest in the debtor's property. Some legal systems make it tougher for a creditor to file, while others permit them a greater amount of liberty. But the basic question to be answered is what would the creditors do in the case that their legal system provide them the freedom to file whenever they have an unpaid due obligation. In other words, being the omission to honor an obligation the most

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English law tackles the issue in Eilis Ferran "Company Law and Corporate Finance", Oxford University Press, New York, pp. 124- 140, considering only the long term interests of the shareholders.

<sup>167</sup> This principle, although historically rejected by many jurisdictions until recent times, seeks to encounter a balance between the creditors' right to recover what's owed to them and individual debtor's need to be freed from a giant debt burden. If the debtor wasn't relieved from his debts, he could be guided into inefficient practices, such as shifting the risk of the projects he undertakes to creditors<sup>167</sup>. Besides, as Professor Jackson points out, there are inherent biases in the individuals' decision-making leading them to overconsume and undersave, which reinforce the need of a discharge provision. On the Fresh Start policy, see Thomas H. Jackson "The Logic and Limits of Bankruptcy Law", Harvard University Press, Cambridge, Mass., 1986, pp. 225-252

<sup>168</sup> See Elisabeth Warren, Jay L. Westbrook "The Law of Debtors and Creditors", Aspen Law & Business, New York, 2001, pp. 206-228

simple and unobjectable fact a creditor can establish to prove a debtor's abnormal conduct, what would the conduct of the creditor be if the law was as liberal as it could be (resembling non- existence)<sup>170</sup>. Starting from there, we may figure out what's wrong and hence, reasons why that liberty should be restricted.

This last question is important because if we can imagine perfect information and competition in the credit market (as pointed earlier), lenders will provide money as long as the company can afford it (the present value of the business is bigger than the aggregated amount of the debts)<sup>171</sup>. Therefore, the debtor will use the markets to supply him with the needed financial liquidity to face his due obligations and, naturally, the money faucet will be closed only when it won't make any more sense for the creditors to lend to the debtor.<sup>172</sup> Consequently, a "not paying an obligation as it becomes due" standard (unless the debt is subject to a bona fide dispute or contingent<sup>173</sup>) will assure,

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<sup>169</sup> See Title 11 U.S.C., section 507 (a) 7. Also see Title IV, Chapter I, Article 246 (3) of Argentine's "Ley de Concursos y Quiebras" number 24522

<sup>170</sup> This approach, though usually taken, is not universally accepted. See for example Elizabeth Warren "Bankruptcy Policymaking in an Imperfect World", Michigan Law Review 336, 1993, p. 379, where professor Warren states it in a very clear way "The basis for bankruptcy policy is so deeply rooted in market imperfections that any attempt to discuss such a policy in a perfect market is a Zen- like exercise, much like imagining one hand clapping"

<sup>171</sup> This statement assumes zero transaction costs. If the assumption is dropped the debt operation may actually turn out more expensive, but it does not change the basic framework of the analysis. It must be noted, though, that operational efficiency is a prerequisite of informational efficiency. On this topic, see Hendrik S. Houthakker and Peter J. Williamson "The Economics of Financial Capital Markets", Oxford University Press, Inc., New York, 1996, pp. 130- 131

<sup>172</sup> This time will obviously come when the balance- sheet test throws that the value of the assets is smaller or equal to amount of the aggregated debts.

<sup>173</sup> The exception is made because a due obligation subject to a bona fide dispute may not even be an obligation that the debtor owes. The same test applies to an obligation that is contingent, because it depends on an event that may or may not occur.

if no extra transaction incentives exist (what generically could be encapsulated into abusive situations), that the bankruptcy proceeding won't be started too early<sup>174</sup>.

As the world we live in does not possess the qualities depicted in the previous paragraph, many people consider that the bankruptcy triggering decision is a highly endogenous one<sup>175</sup>. The information asymmetry that exists in a debtor creditor relation can be of a very important magnitude. Even the information that creditors get a grasp on can be manipulated through different accounting techniques<sup>176</sup>. Expertise is most likely to exist with managers who run the business in an everyday basis and only rarely with other people. Uncertainty limits the precision in any valuation. Subjective probabilities many times do not add up to one even with rational actors. And the list can go on and on.

Anyway, creditors still have to figure out a way to act in response to a breach of the debtor promise. Anytime creditors do not receive the convened consideration, they face a three way choice<sup>177</sup> (if they do want to collect what it is owed to them):

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<sup>174</sup> The bankruptcy proceeding could still be started too late in the case of poor monitoring activities or unexpected and uninsured damaging events, or even insured events with the insurance company turning insolvent, and therefore, some other standard may be considered to handle this situation and complete the whole picture. These standards may involve information revealing requirements for corporations or, as early mentioned, “sticks” towards debtor’s management

<sup>175</sup> See for example Paul Povel “Optimal “Soft” or “Tough” Bankruptcy Procedures”, 15 J. L. Econ. & Org. 659, p. 659

<sup>176</sup> Many jurisdictions do not require business associations to follow a unified accounting system. Therefore, the accounting technique being used can help managers to value the company as they please the most. It must be noted that SEC rules require companies to follow GAAP (General Accepted Accounting Principles) which leaves many businesses not governed by Securities an Exchange Act provisions to just follow “fair valuing principles”. A similar situation is found in Europe where accounting system that follows IAS (International Accounting Standards) are not generally a mandatory requirement.

<sup>177</sup> This three way choice could be expanded if the creditor and debtor ex ante stipulate how to react in those situations. The added alternative does not fundamentally change the following conclusions. It only makes the decision process a little more complex for the players.

**A\_** Try to get a negotiated agreement of payment;

**B\_** Use the normal collective devices provided under the legal system that covers the credit transaction; or

**C\_** Use the last resort collective device: bankruptcy (through either of its possibilities, reorganization or liquidation)

Each of the preceding alternatives offers a creditor advantages and disadvantages. The first one permits the creditor to try to collect his unpaid credit without any judicial costs. Therefore, the creditor, if successful, can obtain what he was entitled to in a presumably cheap and unproblematic way<sup>178</sup>. This will even likely allow him to continue business relations with the debtor in the future, providing thus an extra incentive to manage the situation through this quiet and amicable way. The downside of this strategy arises out of the small pressure which poses on the debtor.

The second selection has its ups and downs itself. Once the creditor decides to use this option, he is likely to profit from his diligence. As the normal collection system provides for a first come first served ("first in time, first in right") situation, the diligence in going through the collection system will raise the chances that he has of getting paid. Naturally, if the creditor is secured, he has fewer incentives to rush to collect, but even in this situation uncertainty about the future gives him another incentive to seize collateral (as his collateral may be destroyed without being insured, or even the insurance company may turn to be insolvent). The down side will come in

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<sup>178</sup> The amount of money actually involved in the process and the very process complexity will vary with the specific situation, but if successful it probably comes at a cheaper expense than with the other

several ways. The creditor will have to pay for lawyers, foreclosure and may be judiciary costs<sup>179</sup>. Furthermore, the time when the creditor can effectively collect will be delayed. In addition, even the debtors' possible ruin (because of the foreclosure of an important business asset) can generate a worst prospect for the creditor's business.<sup>180</sup> It is important to notice at this point, that different legal system will provide its destinataries distinct remedies. Therefore, the parties' outcome, arising out of their court action, will diverge depending not just on the other party situation, but also on the tools provided to them as creditors.<sup>181</sup>

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possibilities at play. Of course whether the probability of it being successful is high will determine whether to use this alternative and so the price is dependent not just in the collection method used.

<sup>179</sup> The creditor is most likely to spend more money in collecting efforts under this option than on any of the other two (considering them as separate, though one of the options may follow the other because of the poor results obtained by it and hence the first option may turn out more expensive). On this regard, see, for example, according to a report done by the Department of Justice in 1996, the median length of a contract case in the nation's 75 Largest Counties is about 22.6 months. See <http://www.ojp.usdoj.gov/bjs/pub/pdf/ctv1c96.pdf>, page 7, table 8. Contrast these findings to the ones obtained by Robert M. Lawless, Stephen P. Ferris, Narayanan Jayaraman and Nil K. Makhija in "A Glimpse at Professional Fees and other Direct Costs in Small Firm Bankruptcies", U. Ill. L. Rev. 847, 1994, p. 875, where they state that "Our average chapter 7 case took 3.47 years, from filing to closing of the case file, while our average chapter 11 case lasted 3.29 years". For another account of these factors, see also Stephen P. Ferris and Robert M. Lawless "The Expenses of Financial Distress: The Direct Cost of Chapter 11", 61 U. Pitt. L. Rev. 629, 2000

<sup>180</sup> This situation could arise due to many circumstances as the termination of long term contracts that otherwise may have benefited the creditor. To address the issue of long- term contracts and relational contracts, see Charles J. Goetz and Robert E. Scott "Principles of Relational Contracts", 67 VA. L. Rev. 1089, 1981. Also see Ian R. Macneil "Contracts: Adjustment of Long- Term Economic Relations under Classical, Neoclassical and Relational Contract Law", 72 NW. U. L. Rev. 854, 1978. A specific consideration of the composition of assets of the debtor subject to attack is found in Professor Susan Block- Lieb article "Fishing in Muddy Waters: Clarifying the Common Pool Analogy Applied to the Standard for Commencement of a Bankruptcy Case", 42 American University Law Review 337, 1993, pp. 383- 384, where it is articulated that "Creditor's that force a sale of an insolvent business debtor's assets will face a pure consumption externality only if operations cease and assets are not replenished."

<sup>181</sup> A legal system maybe more useful than others to help collect business debt, as for example may be the case of one that allows general injunctions on assets disposing. This usefulness may come with a boost to the general efficiency of the system, but not necessarily. How socially efficient is a collecting system is an analysis that is out of the scope of this paper.

The third and last option that the creditor bears consists directly on filing an involuntary proceeding right away.<sup>182</sup> Again, life is not bed of roses under this option either. As for the positive side, the creditor will avoid extra time trying to collect through the ordinary system (saving also the money which otherwise would have been spent in those other collecting efforts) and then facing a creditor that files for bankruptcy. As a negative outcome the creditor that faces a bankrupt debtor is likely to receive an important "haircut" on his credit (the previous choices also bear the haircut problem but presumably of a lower percentage of the total debt and probably the time value of money will be taken into account). Not only that the debtor assets usually are worth less than the aggregated amount of the debt, but also a liquidation realization of assets generally obtains a lower amount for those assets than at a normal sale<sup>183</sup> and previous transfers to the creditor may be voided due to the preference mechanism that Bankruptcy Law triggers<sup>184</sup>. In addition, the creditor may fear legal sanctions (as if the courts find that he is filing in bad faith), reputational issues if he is in the same market as other creditors- debtors who may fear contracting with him or even social sanctions in the community where he interacts (may for being seen as the triggering factor of the losses of jobs).

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<sup>182</sup> As ultimately the debtor will have the alternative to convert a case under one chapter into one of another chapter, I chose to gather the possibilities available to creditors in just one option. As the further comments will show this approach provides simplicity and conserves the accuracy of the statement.

<sup>183</sup> See Susan Block- Lieb "Why Creditors File So Few Involuntary Petitions And Why The Number Is Not Too Small", 57 Brook. L. Rev. 803, p. 844, where she expresses, citing William C. Whitford "A critique of the Consumer Credit Collection System", 1979 Wis. L. Rev. 1047, pp. 1060 and 1097, that "Repayment from the proceeds of a forced sale will be a less efficient and effective collection device than a method that relies on repayment out of liquid funds, because forced sales of assets generally result in a loss of value." Besides, any going concern value is endangered, as a liquidation decision may shut down the business.

This is a general picture of the possibilities open to creditors to select from. But, assuming that creditors are rational, they won't make a decision without taking into account what the debtor will do as a consequence of their actions. Thanks to the development of Decision Theory, we know that whenever an individual's outcome is subject to the action taken not only by him, but also by other individuals, each individual will foresee the others' actions and therefore, decide a course of action that will let him maximize his aims as a function of his and everybody's' else possible decisions.<sup>185</sup> Each player will try to maximize its outcome following dominance and expected utility principles.<sup>186</sup>

Consequently, a creditor will look at the debtor's choices under every possible course of action he can take. The debtor has, roughly speaking, three available alternatives to choose from, under each action taken by the creditor:

**I\_** He can agree with the creditor and pay what he owes;

**II\_** He can refinance his debt, usually through changing the priority of the creditor;

**III\_** He can file for a reorganization procedure; or

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<sup>184</sup> See for example U.S.C. Title 11, section 547

<sup>185</sup> See generally Michael D. Resnik "Choices. An Introduction to Decision Theory", University of Minnesota Press, Minneapolis, Minnesota and London, England, 2000, and more specifically see Douglas G. Baird, Robert H. Gertner and Randal C. Picker "Game Theory and the Law", Harvard University Press, Cambridge, Massachusetts, and London, England, 1994, pp. 6-8

<sup>186</sup> It must be noted that, even though rarely, these principles sometimes conflict with each other. The Newcomb paradox is a famous example of this situation. A discussion on this subject can be found in Robert Nozick, "Newcomb's Problem and Two principles of Choice," in *Essays in Honor of Carl G. Hempel*, ed. Nicholas Rescher, Synthese Library (Dordrecht, Holland: D. Reidel), p 115; and Lewis, D. (1981), "Causal Decision Theory", *Australasian Journal of Philosophy* 59, 5—30



#### IV\_ He can file for a liquidation procedure<sup>187</sup>

The debtor has a small advantage over creditors in that he already knows what the creditors did when he reacts. But this advantage is as said feeble, as the creditors who for example didn't file for an involuntary petition until the debtor's decision, may do it any moment afterwards, or even while he chooses what to do about his default. In the same way, any of other creditors may come into play and have the three possibilities open to them.

The first selection involves a debtor who wants and is able to pay<sup>188</sup>. He can choose this action under either of the creditors' options and his decision will depend upon his solvency, the nature of the creditor's obligation (if it is undisputed and not contingent), his future obligations, the timing of the filing regarding the ability to avoid or preserve pre- petition transfers, preserve or lose employees' limited priorities for wages, etc. Under the present option, I subsume the debtor who, without refinancing, delays his payment, because this would only modify the amount in present value that the creditor receives. Naturally, this part of the option is greatly moderated (under current black letter law) if the creditor filed an involuntary petition as the judicial clock begins to run.

The second choice acknowledges the feasibility of modifying the debtor's finance structure by contractual agreement. As the debtor has a prospect of future earnings (though may be neither creditor nor debtor know which probability to attach to

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<sup>187</sup> The possibility that the debtor doesn't take any of the numbered options, because he may decide to wait, is just subsumed under the preceding options as the result will be calculated considering a probable gap period and therefore discounting that into present value.

it), he may try to refinance his debt. This possibility may allow him the chance to extract future dividends or control earnings' for just keep the business running. As for the negative part he can offer one of three things in order to entice the creditor to refinance: better priority, higher interest rate or a mixture of both. Hence, the cost of keeping the business running will be augmented. In addition, his credit reputation may be diminished as the new deal would be evidence of a financial problem<sup>189</sup>.

The third alternative gives the debtor the chance to use a legal device that may give him time to protect his company from turbulent times and come out of the reorganization better fitted for market competition (this is the ambition of a reorganization process irrespective of whether the debtor remains in possession or not, and not withstanding the different incentives that the control of the company after bankruptcy generates on the debtor and/ or its manager). As a matter of fact, the bankruptcy reorganization provision is thought to allow viable companies to remain in business, when otherwise they would not. As Professors Baird and Rasmussen had expressed it, there are three characteristics that explain reorganizations:"1) It has substantial value as a going concern; 2) its investors cannot sort out the financial distress through ordinary bargaining and instead require Chapter 11's collective forum; and 3) the business cannot be readily sold in the market as a going concern."<sup>190</sup> The

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<sup>188</sup> Even though he may be in an actual balance sheet insolvency

<sup>189</sup> This argument assumes that many creditors do not have any previous knowledge of the financial situation of the debtor and that therefore they will consider him in worse shape due to the new information. If some creditors instead knew about the financial troubles, the fact that the debtor cut a deal may be either positive or negative for his reputation depending on the specifics of the deal that get to be known.

<sup>190</sup> See Douglas G. Baird and Robert K. Rasmussen "Chapter 11 at Twilight", 56 Stanford Law Review 673, 2003, pp. 673-674

debtor benefits from its "automatic stay" clause<sup>191</sup>, "strong arm" clause<sup>192</sup>, "cramdown" clause<sup>193</sup>, possible override of labor agreements, etc. On the negative side, depending on the legal system, a trustee or examiner will or may be appointed to scrutinize debtors' transactions and, therefore a stricter control will be set upon the operations of the "debtor in possession"<sup>194</sup>. Even worst, some system provide for the removal of managers and the appointment of an administrator to manage the company.<sup>195</sup> Also, if a secured creditor can show that he is not adequately protected or the encumbered asset is not essential to the reorganization, he may obtain the authorization of the court to lift the "automatic stay" provision and thus sell the encumbered assets<sup>196</sup>, which may trump some of the benefits looked for the debtor.

Whether the reorganization procedure makes sense or not, and if it should be maintained, has been the subject of strong consideration through legal scholarship publications recently.<sup>197</sup> But, whether it makes sense to have a reorganization proceeding (which Professors Baird and Rasmussen will support only in the case of

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<sup>191</sup> See Title 11 U.S.C., section 362. Also see Title II, Chapter II, Section II, Articles 19, 21, 23 and 24 of Argentine's "Ley de Concursos y Quiebras" number 24522

<sup>192</sup> See Title 11 U.S.C., section 544. Also see Title II, Chapter III, Section III, Article 36 of Argentine's "Ley de Concursos y Quiebras" number 24522

<sup>193</sup> See Title 11 U.S.C., section 1129

<sup>194</sup> As the Bankruptcy Code refers to the debtor under chapter 11

<sup>195</sup> As it is the case of the United Kingdom under the 1986 Insolvency Act as reformed by the 2002 Enterprise Act. This approach may be troublesome in jurisdictions where trustees are not experts in managing "turn around companies" or may be where they are lawyers with no or poor business training, leaving a greater risk that the company loses going concern value.

<sup>196</sup> See Title 11 U.S.C., section 362 (d)

<sup>197</sup> See Douglas G. Baird and Robert K. Rasmussen "The end of bankruptcy", 55 Stanford Law Review 751, 2002 and "Chapter 11 at Twilight", 56 Stanford Law Review 673, 2003. Also see Lynn M. LoPucki "The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's "The End of Bankruptcy", 56 Stanford Law Review 645, 2003

some small closely held companies<sup>198</sup>), the examination that debtor and creditors make in order to decide their course of actions will remain the same.<sup>199</sup>

The final option open to the debtor is arguably the least convenient to him. The only bright side of filing a voluntary bankruptcy petition, if any at all, is that a compromised and tired debtor may get some rest after filing for a liquidation proceeding. This is not a viable explanation, in a world where businesses are concerned in making money. The logic in this case, if the manager (or even owner- manager) is "tired" would be to appoint a new manager, sell or even wrap up the business. On the negative side, the shareholders are, almost every time, expliciting that they don't have any more interest in the company. In a way or another, the assets (or their value) of the company are going to end up in the creditors' hands. Furthermore, no control gains are going to be extracted as a trustee will be appointed in order to liquidate the assets and distribute them to whichever creditor corresponds.

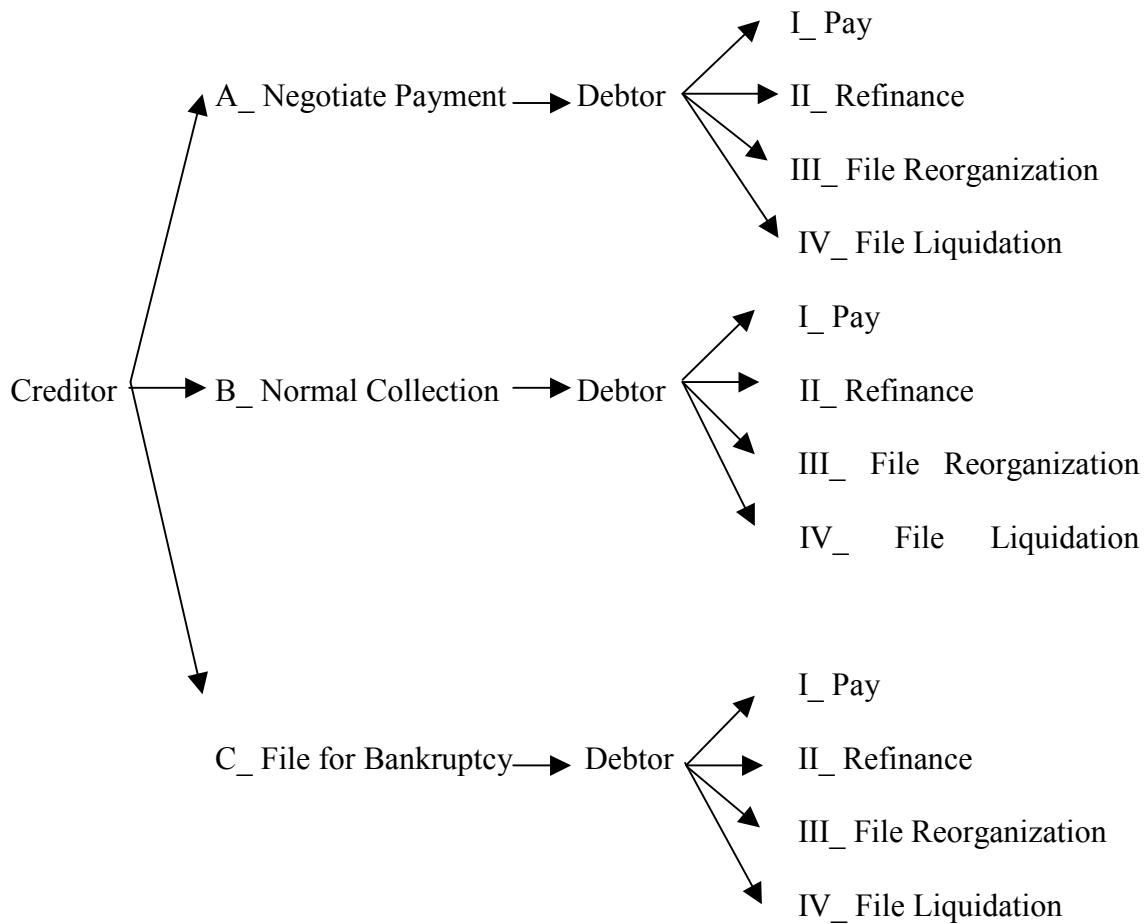
On the preceding accounts both the creditors and the debtor make their decisions<sup>200</sup>. Their decision tree structure would look like the following:

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<sup>198</sup> See Douglas G. Baird and Robert K. Rasmussen "The end of bankruptcy", 55 Stanford Law Review 751, 2002, pp. 788-789

<sup>199</sup> Of course the decision made in a situation with reorganization may differ from one made without this device, but still the analysis to produce is the same.

<sup>200</sup> In this analysis I have not tackled specific incentives (which may or may not generate inefficiencies) that both debtor and creditor may have arising of the specific distributions rules of bankruptcy law. Therefore any changes in the willingness of the players to opt for one of the preceding possibilities, such as the debtor avoiding bankruptcy because of the absolute priority rule, must be analyzed looking at that provision and hence it is out of the scope of this paper. See generally Michelle J. White "The Corporate Bankruptcy Decision", The Journal of Economic Perspectives, Vol. 3, N. 2, p. 129



Therefore, each creditor when considering what to do will look at the probabilities that any of those results may occur (given that any uncertainty situation can be treated by the players assigning subjective probabilities<sup>201</sup>). For example, a long-term supplier of a big corporation won't be interested in any hazardous gamble that may turnout in loosing a big- time purchaser. But anyway, the supplier will consider the probability that the debtor take any of the roman numbered decisions and then opt for

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<sup>201</sup> Even though this is not a trivial assumption, it is not unrealistic either. In everyday situations people account for uncertainties and decide based on proxies. A subjective probability in these cases really has this function.

the decision that will provide him the best outcome. To calculate this outcome, in a simple one time transaction, the creditors will assess the probability that the debtor opt for each alternative (considering the time period when each strategy will be taken), multiply by the amount that he would obtain and add up the results.<sup>202</sup>

Once the calculation is over and done with and the results figures are available, the creditor will choose the alternative that best fits his interests (namely, where he obtains most value in return taking into account any extra expenditure required). In the example of the supplier, he will also take into account the event of losing future sales, so valuing what he will receive under each possible outcome will be harder and hence require better financial analysis.

## **VII. Normative Analysis**

So far we realize that creditors will evaluate their chances considering the alternatives available to the debtor. We also know that the information scarcity that the creditors suffer from will make them have a margin of error in their decision making (though we do not know, and probably the creditors don't know either, how big that margin exactly will be), which will maximize the importance of their subjective probabilities. Finally, we concede that as long as there are market failures, individual incentives will most likely diverge from the efficient social optimum. But the problem to be addressed is whether these considerations make a difference in the policy that

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<sup>202</sup> This is a similar scheme as the one used by Robert Cooter and Thomas Ulen "Law and Economics", Harper Collins Publishers, 1988, chapter 10, pp. 484-492, where they refer to the settlement or trial option.

legal systems should adopt at the time of deciding whether to liberally allow involuntary petitions or to make it more difficult for creditors to file.

This section proposes that the most efficient regulation is the one which asks for no other prerequisites than having an unpaid, non contingent, not subject to liability, due credit in order to initiate an involuntary bankruptcy case. I will argue that the preceding rule's rationale is primarily based on the little incidence of early filings in the overall filing scheme and the reorganization protection overlapping with initiation safeguards.

#### VII.I. Early filing

As we previously pointed, creditors have scarce information about the debtor's balance- sheet situation. This could potentially drive them to file for bankruptcy either too early or too late in terms of the socially efficient investment recovery ratio. But interestingly enough, the vast majority of cases are those where the value of the assets is smaller than the aggregated value of debts<sup>203</sup>. Hence, we can infer that creditors may prefer in the majority of circumstances either negotiated methods or regular collection procedures, because of the incentives that they usually face.

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<sup>203</sup> For example see Theodore Eisenberg and Shoichi Tagashira "Should We Abolish Chapter 11? The Evidence from Japan", 23 Journal of Legal Studies 111, pp. 120-121 and appendix A table 1 at p. 156, showing that in their study of Japan reorganizations the average total amount of assets was equivalent to \$3.8 millions while the average total amount of debts was equivalent to \$7.1 millions. See also Nancy Ames et al., "An Evaluation of the U.S. Trustee Pilot program for Bankruptcy Administration: Findings and Recommendations", Consultants' study for the U.S. Department of Justice, Abt Associates, Cambridge, MA, 1983, pp. 47 and 96, where it is shown that a chapter 11 case has a ratio of debt to equity of 1.396 and a business chapter 7 ratio of 7.6

Professor Block- Lieb points to different reasons to why creditors prefer non-bankruptcy collection approaches to the bankruptcy one.<sup>204</sup> Among them we find the small gain for creditors arising of filing compared to what they could obtain through the other choices or even the fact that a creditor filing is going to carry the cost of the whole filing proceeding while the benefits can accrue to all the creditors. Besides, any gain that his filing produces is shared by all the creditors, what implies an important free riding problem on any interested party who do not file. These points lead us to wonder what the practical incidence of early bankruptcy petitions is and whether the worries of potential abuse situations may be overstated<sup>205</sup>.

As expressed before, in an ideal situation, the debtor will pay his creditors when the obligations are due. If he faces financial troubles, maybe because of poor financial planning that didn't allow him to get the money needed to pay the obligations as they became due or maybe because of both unpredicted and unexpected tort claims or for whatever other reasons, he can borrow against his business if it is a solid one<sup>206</sup>. Therefore, if a creditor files an involuntary bankruptcy petition because he is owed a debt non contingent as to liability and not the subject of a bona fide dispute, he will get paid immediately and, hence, the bankruptcy case could be dismissed and an action for damages may be brought against the creditor if he filed in bad faith.

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<sup>204</sup> See Susan Block- Lieb "Why Creditors File So Few Involuntary Petitions And Why The Number Is Not Too Small", 57 Brook. L. Rev. 803, pp. 844-851

<sup>205</sup> A typical worry involves the fear of "strike suits", which would involve a petitioning creditor filing for bankruptcy in order to extract a payment from the debtor because the debtor worries the damage to his reputation and the cost of credit. I will come back to this issue later on.

<sup>206</sup> Meaning that either it is solvent (under a non prospective valuation), it has positive cash flow or both. On the other hand, if the debtor is not solvent, it will serve a god purpose to allow the filing.



American courts generally arrive to a different result where the debtor pays the debt after the involuntary filing following *Bartmann v. Maverick*<sup>207</sup> as the one proposed above. In this case the Appellate Court for the Tenth Circuit found that paying a debt after the petition is filed is not in itself good enough ground to concede a dismissal of the case<sup>208</sup>. The result is understandable due to the path dependency of the bankruptcy statute. As the statute only provides for the debts to be unpaid when the petition is made, no further inquiry on this subject should be made. Plus, the reasoning continues, as the standard to be met tries to account for other players' stake, paying the filing creditor does not transform the case abstract.

My point here is not that the standard which determines whether to grant or not an order for relief should be changed.<sup>209</sup> As a matter of fact I believe quite the opposite. The difference rests on the quantity and quality of proofs that the petitioning creditor or any joining one has to offer, because to demonstrate that the debtor is generally not paying its debts as they become due turns more and more difficult as the filing creditors gets reimbursed and, conversely, the prospects of the judge granting the debtor a judgment for costs, reasonable attorneys' fees or even damages increases. Therefore, the difference in the application of the standard, now taking into consideration the payments made to the petitioning creditors, is explained by the new lighter requirements to be fulfilled by creditors in order to file. Otherwise the system may turn nonsensical.

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<sup>207</sup> See 853 F.2d 1540

<sup>208</sup> The court stated that "Post petition payment of a debt does not affect whether the debt is subject to a bona fide dispute"

Another important consideration, in order to make the system work smoothly, involves the bad faith provision that accompanies the involuntary filing right in order to prevent abusive situations. The bad faith standard when filing petition would have to be more narrowly defined than it is done by some American courts nowadays if the proposed standard for involuntary initiation is adopted. Even though there's no unified test which courts follow<sup>210</sup>, some of them would be too harsh on petitioning creditors as the creditor filing would be just using another possibility available to him once his credit is due. For example, the "improper use" test, which looks at whether the creditor conduct takes disproportionate advantage of other creditors<sup>211</sup>, cannot be understood to impose damages on the creditor who filed having a non contingent and not subject to a bona fides dispute claim while having been diligent in his collection effort, even though he did not use the "normal collection" (as used in section VI above) option, unless other facts show the existence of bad faith<sup>212</sup>. With these considerations in mind the prevailing test, namely the "Rule 9011" test, could still be employed<sup>213</sup>.

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<sup>209</sup> Which as previously shown, everyone considers to be the equity solvency test. See section VI above

<sup>210</sup> For the six different tests being used by American Courts and some examples of their application, see "Collier on Bankruptcy. 15<sup>th</sup> Edition Revised", Matthew Bender and Co., v. 2, 1996, section 303.06[1], pp. 303-45 – 303-47.

<sup>211</sup> See supra note at p. 303-46

<sup>212</sup> An example of other facts would involve cases where the creditor uses the bankruptcy procedure to acquire corporate control.

<sup>213</sup> For an enunciation of the "Rule 9011" test see the involuntary chapter 7 case *In re K.P. Enter.*, 135 B. R. 174 (Bankr. D. Me. 1992), where the court stated that the creditor had "made reasonable inquiry of relevant facts and pertinent law before initiating this involuntary bankruptcy case; whether the involuntary petition's allegations were well grounded in fact; whether the request for involuntary bankruptcy relief was warranted by existing law or by a good faith argument for extension, modification

## VII.II. Imperfect capital markets

The recognition of imperfect lending markets (which is one of the main reasons for having a reorganization proceeding) should not create a dilemma to law makers. A well- developed capitalist economy will provide for credit in the great majority of the circumstances. But if the company faces financial troubles, and the market doesn't provide it with credit to solve its problem (even because the potential creditor does not, wrongly, “buy” the debtor’s cash flow projections), it will probably be the healthiest thing to allow an unpaid creditor to file for bankruptcy. Under this situation, if the company has a fairly solid business plan, chances are that the debtor will manage to cut a deal with his creditors through reorganization proceeding, because this would be in the best interest of both debtor and creditors (as it enhances the value of the company). Moreover, the fastest the proceeding is started the fairer it will be to creditors who will share the burden with fewer hold outs (that in this case would be the previously paid creditors).

To illustrate the preceding idea we can picture a distributing business (DB). DB is going through financial difficulties and cannot pay to its trade creditors (due to having lost a couple of unexpected law suits where the courts reversed the previous opinions). DB has tried to refinance the company through the local bank, who has refused to do it because the financial officer of the bank figures that his firm has already a lot to loose if DB happens to go bust. Besides DB is feeling the pressure from its creditors who have threatened with all kinds of law suits, including bankruptcy

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or reversal of existing law; and whether the action was initiated for any improper purpose, such as

petitions. While this has been going on one of the gasoline providers (GP) has been trying to collect its credit with no positive results. GP feels his collecting efforts will get him nowhere and therefore files an involuntary bankruptcy petition.

As DB can't pay all his bills, and the prospect of joining creditors to the existing action or the initiation of new ones seems quite high, he will rather try to reorganize his business through chapter 11. Consequently DB figures that he will be able to show the soundness of his ROS (return on sales)<sup>214</sup> and therefore the expected utility of the reorganization is better than the liquidation one. Consequently, DB doesn't really necessitate the protection offered by the restrictions on more than one creditor in order to file.

The previous analysis is central to the idea I am defending. As the idea that abuses may arise from a liberal filing system is conceived, law makers seek to protect the debtor by requiring relatively stringent prerequisites for a creditor to file a petition. But the central point is whether the reorganization proceeding protections overlaps in its field of application with the necessity of more rigorous requirements to be fulfilled by a creditor to initiate a bankruptcy case.

For the two preceding reasons, little incidence of early filings and reorganization protection overlapping with initiation ones, a liberal involuntary petition

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harassment, delay or to increase costs".

<sup>214</sup> The return on sales is equal to the operating income divided by the sales. With it you then obtain the discounted cash flow. On this topic see generally Shannon P. Pratt, Robert F. Reilly, Robert P. Schweih's "Valuing a business : the analysis and appraisal of closely held companies", Irwin Professional Pub., Chicago, 1996

rule wouldn't create any damage to the company and in fact would make sense looking at the system as a whole.

VII.III. Enhanced creditor bargaining position?

The counterargument to allow single-creditor filing implies that it enables each creditor, in turn, to extract payment from a debtor who cannot pay all creditors. Therefore, as the creditors get a superior bargaining position, the potential for abuse is heightened. Under this line of reasoning, a debtor may end up preferring certain creditors, which traditional bankruptcy rules have sought to prevent. Beyond that, it means that the debtor may consume all of its property paying each threatening creditor (by way of demand for payment that generally precedes the bankruptcy filing), causing the business, without cash, to collapse.

The preceding proposition is interesting but necessarily assumes an insolvent but, at least to some extent, liquid debtor<sup>215</sup>, otherwise the threat would not be credible. To see why it may be useful to think about the different situations where the debtor may find himself in a matrix exposition.

	Liquid	Illiquid
Solvent	A	B
Insolvent	C	D

If the debtor finds himself in situation A, being solvent and liquid, he naturally won't have any trouble facing his credits and, obviously, this is of no importance to this paper<sup>216</sup>. If the debtor is solvent but illiquid, situation B, what should happen is that he will find people to finance him fairly easy. But, if he cannot get any financing, it follows from the opinion on the preceding subsection that reorganization is his best option<sup>217</sup>.

Under state D, if the debtor is insolvent and illiquid, the rule proposed in this work will be the best to trigger the bankruptcy proceeding in terms of timing and hence on preventing asset dilution (whatever the future of the business), because neither managers nor principals will have any incentives to file. Therefore the only situation that remains to be analyzed is the one the counterargument presupposes, namely state C, where the debtor is insolvent but, at least to some extent, liquid.

In a normal situation a debtor will foresee what the panorama of his business is. In such a case, if his forecast tells him that the value of the business is going to decline

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<sup>215</sup> At least he needs enough liquidity to pay the secured creditors who could repossess assets required to run the business plus some to pay filing creditors.

<sup>216</sup> This proposition is strongly dependent on a diligent dismissal of the involuntary petition (as stated in the Federal Rules of Bankruptcy Procedure and Official Bankruptcy Forms number 1013(a), which provides that "[t]he court shall determine the issues of a contested petition at the earliest practicable time and forthwith enter an order for relief, dismiss the petition, or enter other appropriate orders.") due to the factors mentioned in section VII.I.

<sup>217</sup> This proposition assumes that the debtor has a positive cash flow prospect. If the debtor is solvent but under financial difficulties and does not has a positive cash flow prospect it is going to be in his best interest to have an organized system to liquidate and pay off his debts, because it will be the way how he can get the more money and redeploy what he gets into better business opportunities. If bankruptcy is not the best fit for him, it would be possible to contract with his creditors to solve it outside of bankruptcy. In addition it should be noted that managers may have conflicting interests with its principals (in order to preserve their job or maintain a reputation) thus this outcome may not be triggered by their interested doing, but still would be the best possible scenario, so a creditor filing may help the overall efficiency by signaling to principals that something may be wrong and help them overcome managers self interested doing.

beyond the line where he does not have any more equity (and thus will turn into the paradigm of the counterargument), he will either try to sell his business now (profiting of the private information) or file for bankruptcy before this outcome results (just as a way of getting the maximum of liquidating his assets and apply them to better business opportunities<sup>218</sup>), as a rational debtor will easily realize that anything he recovers through the bankruptcy proceeding is better than zero (what he would get if he continues running the business as he does it now) and thus he would do that. As it is not feasible that a debtor acts against his own interest, this situation shouldn't present a problem<sup>219</sup>. The only concern to address in the case that a creditor files for bankruptcy is how much is he going to get if the debtor foresees a better value for his assets outside of bankruptcy<sup>220</sup> (what may be rare but indeed possible). On these (and other) grounds the mandatory characteristic of bankruptcy has been challenged, but this issue is outside the scope of this paper<sup>221</sup>.

The situation would be quite different if the debtor can't foresee his ruin (for whatever reason) and suddenly finds out that his business is insolvent but liquid (or in

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<sup>218</sup> There may be a case where the debtor considers that he will get the most out of the situation by receiving a high salary for the time he is able to keep running the business. This situation is actually good for the principle I am defending as it helps bring the bankruptcy proceeding sooner than later.

<sup>219</sup> Of course the debtor can change the way he does business and therefore use the reorganization proceeding to his advantage, but until he does or at least realize how to do it, the previous conclusions hold.

<sup>220</sup> This resembles what are usually called "Rubinstein Bargaining Games", honoring Ariel Rubinstein who studied them in the early 1980's. To read about this topic see Douglas G. Baird, Robert H. Gertner and Randal C. Picker "Game Theory and the Law", Harvard University Press, Cambridge, Massachusetts, and London, England, 1994, pp. 219- 224; Drew Fudenberg and Jean Tirole "Game Theory", The MIT Press, Cambridge, Massachusetts, 1992, pp. 74- 77 and 113- 117; and Robert Gibbons "Game Theory for Applied Economists", Princeton University Press, Princeton, New Jersey, 1992, pp. 55- 71

<sup>221</sup> See Robert K. Rasmussen "Debtor's Choice: A Menu Approach to Corporate Bankruptcy", 71 Tex. L. Rev. 51, 1992; Alan Schwartz "A Contract Theory Approach to Business Bankruptcy", 107 Yale L. J.

position to sell unencumbered assets and have thus some liquidity)<sup>222</sup>. Under this setting the question is whether the debtor has incentives to file for bankruptcy anyway. If the debtor has incentives to file for bankruptcy (may be due to a debtor in possession provision in the relevant statute and a future positive cash flow that will turn things around) the problem may be solved without the intervention of the involuntary filing rule. Many of the incentives to file arise out of debtor in possession provisions, some of the problems solved in the initiation area must be balanced with the inherent inefficiencies that the debtor in possession provokes<sup>223</sup>.

Conversely, if the debtor does not have incentives to file for bankruptcy and pays his creditors as they attempt to collect their outstanding credits, the question turns out to be more of bankruptcy preference and even fraudulent conveyance<sup>224</sup> than of proper commencement ones. Because, as I just pointed out, the debtor won't have incentives to file for bankruptcy in this scenario, it follows that he will keep disposing of the assets of the company may be until they disappear. Consequently, the harm to the creditors as a hole (due to non- equalitarian distribution) should be addressed under proper preference law to obtain a pro rata distribution of value among whoever has

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1807, 1998; Alan Schwartz "Bankruptcy Contracting Reviewed", 109 Yale L. J. 343, 1999; Steven L. Schwarcz "Rethinking Freedom of Contract: A Bankruptcy Paradigm", 77 Tex. L. Rev. 515, 1999

<sup>222</sup> Here we see that the incentives of the debtor or its managers consist on continuing as long as possible running the business in a way to extract out of it as much value as they can. It can also be thought of a debtor that never realizes the insolvency of his business as acting the same way, because if he thinks that the business is profitable he will keep running it

<sup>223</sup> See for example Richard M. Hynes "Optimal Bankruptcy in a Non- Optimal World", 44 B.C. L. Rev 1, 2002

<sup>224</sup> In other countries, as is the case of Argentina and England, the period of time to attack preference transactions is considerably longer than in the United States. In Argentina, can be as much as 2 years. See Argentine's Law "Ley de Concursos y Quiebras" number 24522, Title III, Chapter II, Section III, article 116. In England, the period can be as long as 6 months. See part VI, section 240 of 1986 England and Wales Insolvency Act



interest in the business or fraudulent conveyance law, if it is the case, or even absolute priority rule (in order to give the debtor incentives to file). But it must be remembered that making it difficult for creditors to file does not help anyhow to the solution of the problem<sup>225</sup> and even more worsen it. As making filing harder on the creditor will delay the decision (because he won't opt for the bankruptcy option because it is yet to expensive relative to the others and its payoffs), the system's global efficiency will be damaged.

It could be argued, though, argue that preference law is commingled in a provision that asks for more than a single creditor with "initiation law" and that it is not prohibited or nocuous to address two parts of the problem with just one phrasing. Therefore, urging more than one creditor to file would be an efficient way to preserve the assets of the company in order to dispose of them pro rata. The problem with this elucidation is that it doesn't take into account neither the incentives that a single creditor rule can have on bringing reorganizations nor the cost that it imposes to other companies.

First, anytime a debtor who finds himself in situation C, he does not have any incentives to file a voluntary petition. But he will want to continue managing the business (as it is the only way to extract money out of the business) and the easiest for the creditors to file, the hardest it will be for him to keep doing it. As a consequence, restrictions towards the creditors' ability to file are quite unhelpful, because with more or less pressure the debtor will attempt to keep his business running in order to extract

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<sup>225</sup> If you make it difficult for creditors to file, you will extend the period where the business operates and

all the only benefits he can, namely, those arising out of controlling the firm. And, as under these circumstances, the debtor won't be likely to find someone to lend him money (due to being insolvent), whether he uses his available liquidity in the short term to pay pressuring creditors under the rule proposed or in a longer period under the actual rule, the amount of assets that are being driven away from creditors is not going to diminish. As a matter of fact, if the debtor has more time, there's a positive probability of him turning his illiquid assets into liquid ones and that's why damage his creditors even more.

Second, we need to tackle the costs of limiting the bankruptcy filing. As the debtor will not file a voluntary petition and can't pay his creditors, if they are not allowed to file the debtor will be using them to finance the company. Plus, whenever there is a situation where a creditor can't bring an involuntary decision and in addition the creditor endures a natural information problem, the financing is obviously going to be coercive and most likely inefficient (otherwise the debtor would have obtained credit somewhere else). Therefore, to maintain a rule as the one actually existing will enhance the social costs of this particular case of insolvent situations.

So in order to choose whether to have a single creditor rule on the basis of preference law, the extra cost that will go into effect over creditors because they can't bring an involuntary bankruptcy case while being unpaid must be taken into account to balance the preference law benefits of such a provision. Although how much the costs are would be a matter of empirical evidence, it appears that a condition that is imposed

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hence the cost to the creditors increase due to the time value of money.

over all the companies in the market (whether or not insolvent) and that would consequently raise the cost of their capital would have more negative effects than one in which only an insolvency proceeding would be brought to distribute whatever assets are left for its creditors as a whole to grab (whatever the preference law benefits may end up to be, if they actually do exist, as the preceding paragraphs analysis tends to object).

It is also important to notice that many creditors are not going to be risk neutral. Usually, the smallest the business creditors, as self employed proprietorships, and the involuntary creditors will be risk averse. If they indeed are risk averse, they will assign a probability to succeed in the involuntary bankruptcy proceeding which is smaller than an objective one. Therefore, any rule that further deepens this problem should be readily avoided.

#### VII.IV. How does a creditor become “diligent”?

An interesting issue to analyze is how much time and effort must be employed by a creditor in order to be considered diligent. To allow a creditor who has an unpaid debt, which fits the rest of the requirements of the proposed norm, to file an involuntary petition right after the due date passed, may turn out to be too harsh on the debtor and misleading on other creditors. To picture the idea, a mere administrative mistake may trigger a judicial proceeding<sup>226</sup>, which besides its administrative and professional fees, brings along further uncertainty to the market place as unsound signals maybe sent to it mixed with sound ones.

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<sup>226</sup> If the creditor believes it is in his best interest to file the petition

The analysis that each player makes, however, remains the same no matter how restrictive the diligence constraint is. Therefore, as allowing a creditor to file an involuntary petition has some costs, they should be balanced against the benefits to the players and the system as a whole in order to judge its worthiness.

While England, as mentioned in section V.II.III, refers to an specific rule, namely a written demand requiring the company to pay the sum so due and the company has for three weeks thereafter neglected to pay, most jurisdictions leave the question open for courts to decide upon it<sup>227</sup>. Commonly these courts refer to loose standards and they analyze the specific facts of the case and their compliance with those standards.

#### VII. V. The diligence requirement as a rule

Following Professor Louis Kaplow's work<sup>228</sup>, I believe a rule should be preferred to the vague standards actually existing in most of the jurisdictions examined to tackle the involuntary bankruptcy petition. In this particular situation, a rule asking for a fixed period of time and a written demand would be cheaper to enforce and as cheap to enact. It would be as cheap to enact because the complex conditions (namely to require a non contingent and undisputed unpaid debt) have already been laid down

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<sup>227</sup> For Germany see Hans-Georg Landfermann "The New German Insolvency Code", in "Bankruptcy and Judicial Liquidation", Counsel of Europe Publishing, 1996, p. 34.

<sup>228</sup> See generally Louis Kaplow "Rules versus Standards: An Economic Analysis", 42 Duke L.J. 557, 1992, pp. 571- 596

by different expert commissions<sup>229</sup>. Consequently, no ex-ante, new definitions are required and ergo, no new costs should arise<sup>230</sup>.

Plus, the enforcement effort would be much cheaper due to the simplicity of the task asked from the courts in those jurisdictions where they are subject to fuzzy standards in order to decide (just checking the demand note and the amount of time in between the due date and the filing of the involuntary petition). In the United States, where the section 303(b) is already in place, the difference in overall lawyer costs may be close to neglectable, but still the costs regarding the creditor using the system are much cheaper. The information requirement is much smaller under the proposed option, and once it is achieved it, it would be difficult to think about requiring more information again. Furthermore, the cost for legal advice should be reduced as the time required to analyze the debtor's situation greatly diminishes and the creditor's one is likely to remain constant.

In addition, the specific circumstances that govern the initiation problem under the proposed rule tend to limit the under-inclusiveness problem. As the proposed rule requires just an unpaid due obligation, almost every person directly interested will have the possibility to file<sup>231</sup>.

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<sup>229</sup> See for example the 1973 "Commission's Bill". See also Eric A. Posner "The Political Economy of the Bankruptcy Reform Act of 1978", 96 Mich. L. Rev. 47, 1997, pp. 67-75, and See Frank R. Kennedy "The Origins and Growth of Bankruptcy and Reorganization Laws in the 20th Century: An Oral History Perspective", pp. 49-51.

<sup>230</sup> This statement of course does not imply that enacting costs will be trivial. As different interest groups will be trying to bring water to their own mill, the lobbying efforts may get the reform proposal to be longly delayed as we usually see happening with bankruptcy law reforms.

<sup>231</sup> Many people with indirect claims to the company due to the damage that they may experience due to the company's insolvency cannot be dealt with so easily. As law makers try to establish an equilibrium between the possible recovery and the potential harm to the business of those very claims, they are not

The over-inclusiveness problem is difficult to establish. To consider the possibility of over-inclusiveness directs to first point out, again, that as a principle based on the lack of information, to file for bankruptcy, when all other requirements are met, is just another possibility open for the creditor to choose from to facilitate the collection of their credits. Now, when other objectives are in mind, an abusive situation can arise (although it is always up to the debtor to avoid any trouble, just by paying to whoever has a debt that fulfils the requirements) and that is the topic of the next subsection.

#### VII.VI. Should any creditor be allowed to file?

It is pretty clear that not every creditor should be allowed to file. As many legal systems already recognize it, holders of disputed or contingent claims are out of the picture. The substantial reason behind this statement relies on the uncertainty of their rights contrasted to the harshness of the bankruptcy remedies. Also secured creditors shouldn't be permitted to file, as the collateral of their credit covers their interest (unless undersecured, because normal collection devices would adequately protect their interests)<sup>232</sup>.

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allowed nowadays in most jurisdictions, and in the ones that are allowed those petitions are very rarely seen. At the heart of the problem is the great difficulty that the courts have to establish what the value of the business is, due to the lack of firm specific knowledge, the lack of information, uncertainty about the future, etc.

<sup>232</sup> Some systems further prohibit creditors with close family ties to the debtor to file for involuntary filings which will impact, for the purpose of this paper, the case of any debtor that owns a business without being a separate business entity. See for example Argentine's Law "Ley de Concursos y Quiebras" number 24522, Title III, Chapter I, Section I, article 81. This paternalistic provision is very difficult to sustain in a complex business world. Furthermore, it is not clear if it violates the "family

A somewhat difficult problem to solve would concern the threshold amount that the due credit should surmount in order to qualify as an admissible claim. The problem here consists in assessing the possible negative effect of a very small claim held by an insolvent creditor filing an involuntary petition against a solvent company (whichever the aims of the creditor may be). Although a marginal problem, the financial image of a corporation may be shaken just because the market perceives a bad signal in the company's finance. Consequentially, the next time the corporation borrows money the interest rate may be higher (even after paying right away the amount required by the creditor, and an order of relief never been given by the court).

But the latter problem should not be exaggerated. A borrowing company would present its cash flow, both present and expected to the possible lender (along with other requested information), who after analyzing it, won't pay attention to a very marginal operation, mostly when after filing the involuntary bankruptcy petition the debt is fully paid and the petition is duly dismissed.<sup>233</sup> Thereupon, law drafters should not use the amount limit, as it doesn't really protect companies and undermines the rights of the creditor.<sup>234</sup> The only reason that appears to be solid in order to limit the minimal credit

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creditors' property rights. In any case, the economic effects as to the estate of this provision are rather small.

<sup>233</sup> A related issue concerns a bad faith creditor who takes his claim to the bankruptcy court. Even if the amount that the creditor claims is not small, the result would likely be the same, because a lender is presented with a lot of information at the moment of lending and he will be able to recognize the abnormal situation. Plus we shouldn't forget the importance of the power of abstention that the court could exercise in such a situation to minimize the effects of any situation where the financial and balance sheet situation is so clearly solvent that bankruptcy has no meaningful role to play.

<sup>234</sup> This last statement should not be read to mean that creditors of small amounts are unprotected or anything alike in a system that forbids them to file for involuntary petition if they don't get to the threshold, as for example is the case of England and Wales or the United States. It just points at the relatively worst position that they are compared to creditors of bigger amounts.

amount required to file concerns the administration of justice. If it were the case that “small claimers” win consistently only very few involuntary filings petitions, maybe the costs of the proceedings wouldn’t be justified by a “small claimer” given that the probability of the petition being dismissed is close enough to 1. While, in any case, this should be the subject of an empirical demonstration, raising initiation fees or distributing otherwise the cost of the proceeding would under most circumstances make more sense.

A last remark must be made concerning unpaid creditors. In almost every company nowadays, a different option may be available to creditors. Sophisticated lenders will probably also try to contract around some possible problems and sign a clause that allows them to get different degrees of control under different default options.<sup>235</sup> Through this type of ex ante planning creditors can better allocate control rights of a distressed corporation.

This contracted alternative will provide the sophisticated creditors with great leverage to control managers of the company. But, does this change the general picture? In the event that new managers are brought through new control rights, the corporation will remain the same. The amount of debt and equity won't change just because of that situation and the incentives of creditors remain the same. The rest of the creditors will still have the same incentives to bring or not to bring the involuntary proceeding and the creditors in control would not gamble with the assets of the company because they

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<sup>235</sup> To read about this kind of arrangements see Barry E. Adler "A Theory of Corporate Insolvency", 72 N.Y.U. Law Review 343, 1997. Also see Alan Schwartz "A contract Theory Approach to Business Bankruptcy", 107 Yale Law Journal 1807, 1998



have their own stake at play. Therefore, this alternative doesn't modify the general picture described in the preceding pages for creditors.<sup>236</sup>

Furthermore, many of the contracts which I am referring to use cascade default covenants, so that if the debtor defaults on any debt, he defaults on the debt under the contract also. In such a case, to allow a “small claimer” the possibility to file would further enhance the possibility of obtaining a proper financial structure and a more efficient commencement date, as the pressure over the debtor increases.

#### VII.VI. Potential abuse

Abusive situations arise out the very nature of the human spirit. Therefore, they are present in every field of life. In the case under study, abuse fears have been fundamental in the way the law was drafted and interpreted. For that reason, abusive behavior is punished by legal sanctions, as for example rule 303(i)2. But this is not the only sanction an abuser faces. Reputational damages, if the creditor is in the same market with many other competitors and customer, social sanctions (although probably to a lesser extent and only if the community is small enough) and trust, as proposed by Blair and Stout<sup>237</sup>, greatly counters the incentives that creditors may have to take an improper advantage of the legal system. Hence, the amount of abusive situations leans towards a small number.

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<sup>236</sup> Even the creditors that may get control through this alternative have the same structure to think about their situation. The difference in their case will be that in the case of a contracted default that allows them to get control, the probability of the debtor doing one thing or the other would be of 100%.

As mentioned above, a problem may arise out of having a long gap period until the order dismissing the involuntary petition is issued. There are two aspects of the quandary that must be distinguished: the automatic stay and involuntary gap period creditors. As in the United States the automatic stay is triggered by the involuntary filing and not by the order of relief<sup>238</sup> other creditors may find themselves in an awkward position, not being able to sue the debtor and the debtor himself will be prejudiced because he may not accede to credit, or has to pay higher interest or give security interest that raise the cost of the transactions. The second problem is based upon the uncertainty that gap creditors have at the time of contracting with a debtor subject to an involuntary petition. The creditors will not know what the situation of the debtor is and therefore will require a more onerous transaction in order to deal with the debtor.

The automatic stay is triggered at the time the involuntary petition is filed with the intention of preventing a common pool problem. As a side effect, both creditors and debtor suffer from the provision nuisances, as a consequence of limiting the debtor's ability to manage his business. The previous situation could be improved moderately easily though, just by limiting the automatic stay effects in this period, from the initial petition to the order of relief, in order to involve only materially adjudicating property to the creditors. Under such a provision, the damage to creditors would be greatly

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<sup>237</sup> See Margaret M. Blair & Lynn A. Stout "Symposium: Norms & Corporate Law: Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law", 149 U. Pa. L. Rev. 1735, 2001, pp. 1750- 1751.

<sup>238</sup> See Title 11 U.S.C., section 362 (a)

diminished, while permitting the continuation of any court actions that are not in an adjudicating phase.

A possible setback to this solution could be argued to appear when a debtor joins a creditor (which may simply be its subsidiary) to just stop a creditor from collecting his credit while being solvent (otherwise the creditor would most likely join the petition). While this hypothetical situation will be more probable to happen under the proposed rule (as involuntary petitions would be filed more easily), I suppose that it will not be usual. Whether the setback example arises or not, the debtor wouldn't have much trouble finding two more creditors or, maybe even subsidiaries, to impede the creditor collection efforts under the rule actually existing<sup>239</sup>. Therefore, the change proposed wouldn't represent a noticeable shrink in deterrence of this type of abusive behavior.

The other component of the gap period problem arises from the so called gap creditors<sup>240</sup>. Bankruptcy statutes offer them a special priority, as for example is depicted by section 507(a)(2)<sup>241</sup>. As previously noticed, it is conceivable that the cost of credit in this period is going to be higher for the debtor due to the uncertainty generated in the creditors mind (over the debtor's solvency) due to the filing of the involuntary petition. Moreover, the argument would proceed by stating that this increase would, marginally,

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<sup>239</sup> This is arguably an unavoidable nuisance for having the automatic stay triggered by the involuntary petition. So the trade off here consists on the protecting the distributive justice among creditors and protecting individual creditor for abuse by the debtor and its confederates. Whether the choice adopted by the Bankruptcy Code is the efficient one or not is beyond the scope of this paper.

<sup>240</sup> This problem is not encountered in every legal system. For example Argentine Law provides that the judge declares the initiation of the bankruptcy proceeding after a hearing which the debtor a chance to defend itself. See Title III, Chapter I, Section II, Articles 82- 84 of Argentine's Law "Ley de Concursos y Quiebras [Reorganizations and Liquidations' Law]" number 24522

drive into bankruptcy businesses otherwise not necessitating the protection. But this is a pretty vague statement. The marginal increase in the cost of credit shouldn't be so big that only because of the filing the company requires to reorganize. Plus the new price needs only be paid to gap creditors, so the overall cost of financing should be relatively small if there's a finance planning involved. If, anyway, the increase is large and drives the company into bankruptcy chances are that the creditor was pretty uninformed in his previous dealings with the business and now is asking for a more reasonable rate of interest. Thus, maybe the company already needed to be reorganized. Furthermore, the cost that such a rule may impose on debtors is not likely to outweigh the cost of involuntary financing made by the creditors. In addition, the gap period is supposed to be relatively short. In this respect, Bankruptcy Rule 1013(a) provides that "[t]he court shall determine the issues of a contested petition at the earliest practicable time and forthwith enter an order for relief, dismiss the petition, or enter other appropriate orders." Hence, I suspect that the length of the period in cases where a dismissal of the proceeding should follow is relatively small. Anyway, it is always up to the debtor to eliminate the possibility of the involuntary petition arising under the rule proposed in this note. Because, as noticed earlier, the only way to file is by having a claim that is "not contingent as to liability or the subject of a bona fide dispute", the debtor has the incentives to avoid the involuntary filing<sup>242</sup>.

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<sup>241</sup> See Title 11 U.S.C., section 507(a)(2).

<sup>242</sup> Although not impossible, it would be quiet rare that a person who can not pay his creditors at the due time, can immediately after the filing find it easier to pay.

Naturally, the position defended in the present note assumes that there is an efficient reorganization proceeding in place. But if the reorganization is not efficient the reasoning shouldn't change. As a matter of fact, the problems should not be mixed or mistaken. The purpose of this paper is to tackle the involuntary initiation problem and if the existing reorganization is inefficient then the solution is to amend the reorganization and not turn upside down what logically follows in order to have an efficient involuntary initiation provision. Only if it can be demonstrated, for whatever reason, that an efficient reorganization in the form of a chapter 11 proceeding cannot be achieved or that the arguments in favor of a reorganization proceeding are fundamentally flawed should the position taken by this paper be revised to adapt to the new facts.

Another interesting issue arises out of the possible existence of strike suits. Strike suits are brought by actors who know, or at least suspect, how prejudiced a business (or its managers) maybe due to the suit and further knows that, consequently, the managers will be obliged to settle the dispute. As many scholars<sup>243</sup> and some courts<sup>244</sup> (as recognized under some of the bad faith standards) consider that the bankruptcy petition should not be a collecting mechanism, an involuntary bankruptcy petition may threaten the debtor and hence be used only to force him to pay his debt.

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<sup>243</sup> See, for example, Charles Jordan Tabb "The Law of Bankruptcy", The Foundation Press, Inc., 1997, where at page 96 enunciates "The goal is to make it easy for creditors to commence a bankruptcy case when needed, but to prevent creditors from improperly using the threat of involuntary bankruptcy as leverage against the debtor to obtain unwarranted advantages"

<sup>244</sup> See *In re Salmon*, 128 B.R. 313 (Bankr. M.D. Fla. 1991)

Two points must be established to clarify the concern. First, and most importantly, as a creditor needs to have a non contingent and not subject to liability due credit in order to be allowed to file an involuntary petition, only those creditors who already have clearly determined their rights are allowed to file. Therefore, the bankruptcy court cannot be, at least before the order of relief is issued, a proper forum to solve the existence or not of rights. And second, under the rule I propose, filing is a possibility available to creditors as any other one. Hence, no actual abusive threat concerning his unpaid credit can be made as one of the very objectives of the proposed rule is to have creditors using this option in order to obtain payment. A different outcome may arise out of a creditor filing, getting paid and further arguing that the debtor is insolvent if his objective was just to harm the debtor business. But this possibility is reduced by the bad faith provision that deters creditors from taking unfair advantage of the system, by imposing damages.

#### VII.VIII. One creditor scenario

Another interesting question involves a situation where the debtor only has one creditor. The logic following from the "common pool" conception of bankruptcy would ban a unique creditor from starting a bankruptcy proceeding whatever the amount he is owed, basically because the problem that is gives reason to the very existence of a bankruptcy proceeding is not present.

The "common pool" dilemma arises out of various creditors and debtors whose actions generate a negative externality on other creditors. Therefore, a bankruptcy case

with just one creditor cannot develop a "common pool" problem.<sup>245</sup> Besides, it will probably be the case that a unique creditor may get greater reward of his collection actions outside of bankruptcy. For example, a receiver or trustee may be appointed to take charge of the property of the debtor for a smaller amount of money than the one spent through a bankruptcy proceeding.

But the whole concept behind the common pool formulation involves arriving to an efficient solution (that is maximizing the value of the estate) in paying the creditors when other solutions would be less satisfactory. Under this proposition, it may well be the best option to allow the filing of bankruptcy petitions in a single creditor case because it may be the most cost efficient option for both the debtor and the creditor. Unless it can be shown that a mandatory rule impeding the commencement of the case in single creditor situations is cost efficient (because the litigation costs saved are more valuable than what can be saved through the former possibility), I believe that law-drafters should permit the initiation under these circumstances because it shares the logic of Bankruptcy Law and it would leave it to the interested parties to make the decision they consider the best.<sup>246</sup>

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<sup>245</sup> See Susan Block-Lieb "Fishing in Muddy Waters: Clarifying the Common Pool Analogy Applied to the Standard for Commencement of a Bankruptcy Case", 42 American University Law Review 337, 1993, pp. 410-412

<sup>246</sup> This result is consistent with some Bankruptcy Courts resolutions. Specifically, see David S. Kennedy, James E. Bailey III and R. Spencer Clift III "The Involuntary Bankruptcy Process: A Study of the Relevant Statutory and Procedural Provisions and Related Matters", 31 U. Memphis L. Review 1, 2000, pp. 29-37, where besides citing *In re Cordova* 34 B.R. 70( Bankr. D.N.M. 1983), *In re 7H Land & Cattle Co.* 6 B.R. 29 (Bankr. D. Nev. 1980) and *In re Concrete Pumping Servs.*, 943 F. 2d at 630, concludes that courts reject the per se restricting involuntary petitions in two parties disputes when: a) the creditor has no other adequate remedy under applicable non- bankruptcy law; b) the debtor has engaged in fraud, trick, or scam; or c) one creditor holds one particularly large outstanding debt.

An important point to underline is that a one creditor only situation is indeed quite rare in everyday commercial activity. Therefore, if there are any negative effects arising out of permitting the involuntary proceeding would be very marginal. Furthermore, one of the biggest cost in these case is the enactment and interpretation of the whole proceeding, and as the general liquidation or reorganization law existing could be used, those costs would be minimal, if they exist at all<sup>247</sup>.

The possibility of abuse may still be there when the debtor files his own bankruptcy petition while it is more efficient to have, say, a state trustee involved or even after his appointment. In this setting we can observe some of the benefits of the doctrine of abstention stated in the United States Bankruptcy Code. If it can be demonstrated that the interests of the creditor and debtor would be better served by a dismissal of the case, then courts can take the action and avoid any threats made by the debtor to better his bargaining position.

#### VII.IX. Is a single creditor rule contrary to bankruptcy objectives?

A different issue concerns the logic of a single- creditor rule for bankruptcy involuntary initiation and the fact that the bankruptcy proceeding is usually thought as a collective mechanism. As a result, the question to be addressed is whether a single- creditor initiation is consistent with the collective aim of the process.

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<sup>247</sup> It may be the case that special provision needs to be reinterpreted because of the special case and hence some cost may arise out of it.



Once again I want to highlight that the praised collective nature of bankruptcy has a very fundamental logic: maximize the value of the estate which due to the common pool idea can't be left to the interested creditors' individual actions to deal with<sup>248</sup>. I believe, therefore, that the answer should be clear here: the single- creditor rule doesn't tackle the collectivity fact but it is merely a way to get the case started in a way that is as proper (efficient) as possible.

Consequently, any line of reasoning that stated that there could be a case where there's only one creditor commencing and thus the bankruptcy case shouldn't start has no ground, provided it is the creditor who is the one whose stake is at play and he decides to initiate the process (thus he will have the right incentives, which include the possible sanctions for fraudulent initiations to choose what is better for himself).

### **VIII. Conclusions**

The involuntary bankruptcy petition is not a magical solution to the adequate commencement of the bankruptcy case problem that by itself will erase the initiation problem from the face of bankruptcy theory. As a matter of fact, the persons in possession of the best information available (i.e. managers of the business) are only indirectly comprehended under this rule.

Law-makers then face the challenge of reducing the problem. While in the United States the focus has been set on the incentives of the managers to bring the case in the proper time (which considering the relative power of the debtor is extremely

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<sup>248</sup> Unless they can recreate an enforceable mechanism that deals with the problem

logic), the role of creditors shouldn't be neglected (even though the incentives of the majority of the creditors will likely refrain them from filing until the last moment). If the creditors are to be allowed to contribute by starting some proceedings, the stricter the rules that are imposed on them the smaller the contribution that they will be able to produce in favor of maximizing the value of the estate.

A rule imposing minimum requirements on creditors is what logically follows. Besides those creditors having contingent and disputed claims, other creditors should be allowed to file for bankruptcy regardless of the total amount of creditors or the amount of the claim. This proposition does not affect the necessity of imposing a diligence requirement on the creditor's collection efforts and therefore the focus of the proceeding does not change into a collection device. Consistently, costs and damages should still be supported by the petitioning creditor if his plead is dismissed.

As a result not only will creditors help by bringing involuntary cases to the courts (because they will also indirectly have a more credible threat to exercise over the debtor to make him bring the case at an even relatively more efficient time) but avoid involuntary financing the debtor, and hence bring its cost down.