UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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In re: Chapter 7
Case No. 03-10096 (ALG)

FREESTAR TECHNOLOGIES, INC.

Debtor.

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MEMORANDUM OF DECISION

ALLAN L. GROPPER
UNITED STATES BANKRUPTCY JUDGE

FreeStar Technologies, Inc., the alleged debtor ("FreeStar"), has moved to dismiss an involuntary Chapter 7 petition filed against it by vFinance, Inc. ("vFinance"), David Stefansky, Richard Rosenblum, Marc Siegel, Boat Basin Investors LLC ("Boat Basin"), and Papell Holdings, Ltd. ("Papell" and with the others, collectively, the "Petitioning Creditors"). The motion is premised on FreeStar's assertion that the Petitioning Creditors hold debts that are the subject of a bona fide dispute under §303(b)(1) of the Bankruptcy Code and that it is paying its undisputed debts as they come due, within the meaning of §303(h)(1).

By agreement of the parties, the Court has taken up first the question whether the Petitioning Creditors include, as required by §303(b)(1), "three or more entities, each of which is either the holder of a claim against [the alleged debtor] that is not contingent as to liability or the subject of a bona fide dispute...if such claims aggregate at least $11,625 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims". The parties submitted extensive affidavits and over 100 exhibits; neither party requested an evidentiary hearing on this issue. While many of the facts are subject to wide disagreement, the facts essential to a determination of the instant motion are either admitted or, if they are contested, the dispute merely underscores the fact that the Petition is not advanced by entities, holding claims "not contingent as to liability or the subject of a bona fide dispute.…" Accordingly, the Petition will be dismissed.

BACKGROUND

The Alleged Debtor is a Nevada corporation headquartered in Santo Domingo, Dominican Republic, with offices in Dublin and Helsinki. It claims not to have an office in the United States; while the Petitioning Creditors cite documents filed with the Securities and Exchange Commission ("SEC") that reference a principal place of business in New York City, the matter appears to be of no moment. As a Nevada corporation, FreeStar can be a debtor under the Bankruptcy Code, 11. U.S.C. §109(a), and it has raised no issue as to whether venue is proper in New York.

The Petitioning Creditors include Boat Basin and Papell, which have been generally described by the parties as offshore investment companies that have transacted business with vFinance in the past; Messrs. Siegel, Stefansky and Rosenblum, who are described as the former President and current Senior Vice Presidents, respectively, of vFinance; and vFinance, a financial services company and broker-dealer located in New York City. The Petitioning Creditors made various loans and advances to FreeStar that were the subject of sophisticated and careful documentation. Each of the Petitioning Creditors asserts that it holds debt by way of "Promissory Notes" of FreeStar; the Petition sets forth the amount of the claimed debt exclusive of "interest and other charges."[1] Since the status of these loans determines whether the Petition was properly filed, it is necessary to review in detail the documentation regarding the issuance of the notes and subsequent developments.[2]

[1] The amounts claimed by each Petitioning Creditor are as follows: (i) vFinance $69,000; (ii) Stefansky $103,000; (iii) Rosenblum $$103,000; (iv) Siegel $40,000; (v) Boat Basin $135,000; and (vi) Papell $187,000.

[2] Certain of the following description adopts a portion of an opinion issued by District Judge Sweet in an action commenced in the District Court (S.D.N.Y. Index No. 03 Civ. 0493) by five of the six Petitioning Creditors against Paul Egan, the principal of FreeStar ("Egan"); First American Stock Transfer ("First American"), FreeStar's stock transfer agent; First American's principal, Phillip Young; Margaux Investment Management Group, S.A., an investment company hired by FreeStar; and ten John Does. The significance of this parallel action will become clear below.

March 2002 Convertible Notes

The Petitioning Creditors first advanced funds to FreeStar under a $270,000 financing agreement dated March 25, 2002. Notes were issued to Papell and Boat Basin in the amounts of $200,000 and $70,000, respectively, maturing in March 2003 and convertible into equity of FreeStar under certain circumstances. FreeStar received funds of $228,000, with the remaining $42,000 representing brokerage commissions and fees payable to vFinance and its counsel. Egan personally guaranteed the Notes and secured his guarantee with a pledge of 4,000,000 shares of FreeStar common stock.

The March Notes required FreeStar to file a registration statement within 60 days, presumably so the notes would be convertible into freely tradeable stock. Upon FreeStar's default in filing such a statement, the holders declared the Notes due and payable and proceeded to enforce Egan's guaranty and to foreclose on the 4,000,000 shares of FreeStar stock pledged in support of the guaranty. The holders' rights and obligations upon foreclosure were set forth in a carefully tailored Stock Pledge Agreement, dated March 25, 2002 and signed by the holders as secured parties, by Egan as Pledgor and by FreeStar. As applicable here, Egan as Pledgor represented and warranted "that there are no restrictions upon transfer and pledge of the Pledged Shares pursuant to the provisions of this Agreement except the restrictions imposed by Rule 144 under the Securities Act of 1933, and that such restrictions on resale shall not be applicable if an Event of Default occurs under the Notes, and the Secured Party exercises its remedies under the Guaranty and forecloses on the Pledged Shares." §5(A)(ii).

Section 10 of the Security Agreement further provided the following with respect to the secured parties' rights and remedies upon an Event of Default: each secured party could exercise the remedies provided for under the New York Uniform Commercial Code ("UCC"), "except

that the Secured Party waives any right to a deficiency pursuant to Section 9-608 thereof or otherwise" (§10(b)(i)); each secured party could retain all dividends, payments and other distributions on the stock (§10(b)(ii)); each secured party could cause any or all of the pledged shares to be transferred into its own name (§10(b)(iii)); and each secured party could exercise its right of sale of the collateral under the UCC (§10(b)(iv)). Importantly, the Security Agreement then provided the following with respect to the valuation of the collateral and the procedures that had to be followed in connection with the secured parties' exercise of their rights:

> Notwithstanding anything in this Agreement to the contrary, the Secured Party may only exercise the rights and remedies set forth in this Section 10 with respect to up to the aggregate number of shares of Common Stock into which the outstanding Notes are then convertible, and simultaneously with such exercise the amount owing by the Company under the Notes shall be reduced by an amount equal to the then applicable Conversion Price (as defined in the Note) multiplied by the number of Pledged Shares with respect to which the Secured Party has exercised its foregoing rights and remedies. For the purposes of any such sale, the Conversion Price set forth in any Notice of Conversion (as defined in the Note) issued in connection with the sale of the Collateral shall be controlling, regardless of the actual price received for the sale of the Collateral. There shall be no obligation on the part of the Secured Parties to sell the Collateral at one sale. The sale of Collateral may take place on as many occasions as Secured Parties deem fit in order to pay in full the Secured Obligations.

§10(c).

Pursuant to this provision, foreclosure on Egan's stock of FreeStar would in most respects mirror conversion. A secured party could foreclose only on the number of pledged shares into which its note could be converted and, simultaneously with the foreclosure, the amount of the note would be reduced by the then applicable Conversion Price (as defined in the Note) multiplied by the number of pledged shares foreclosed on. For purposes of the sale, the Conversion Price set forth in "any Notice of Conversion (as defined in the Note)" would control,

notwithstanding a different price received by the secured party in connection with the foreclosure sale. This provision at a minimum made the foreclosure on Egan's pledged shares the economic (if not the legal) equivalent of a conversion of the convertible notes (in that it set a ceiling on the number of shares that could be foreclosed and provided for an automatic reduction in the amount of the note, as if the note had been converted). It also fixed the proceeds from any foreclosure sale at an amount equivalent to the conversion price fixed in a Notice of Conversion under the Notes, and it provided that such Notice, "shall be controlling, regardless of the actual price received for the sale of the collateral." The apparent difference between foreclosure on Egan's shares and conversion is that the lenders would receive stock that was marketable in whole or in part.

Acting pursuant to these provisions, by notice dated May 29, 2002, Papell and Boat Basin notified FreeStar of their foreclosure rights and on June 7, 2002 the 4,000,000 shares were reissued in their names but with trading restrictions. After protest from the holders' counsel, who claimed in a letter dated June 10, 2002 that the shares had been registered, First American as FreeStar's transfer agent reissued the shares as unrestricted. Then, about a month later, the holders sent a notice of conversion which purportedly set the foreclosure price at $.06912 per share. This was done pursuant to §4(c)(i) of the notes, which permitted the conversion price to be set at 80% of the "Market Price", with Market Price defined as the lower of the average price of the stock on the OTC Bulletin Board during the 10 trading days prior to March 25, 2002 (the date of issuance of the notes) or the five trading days prior to the date of receipt by FreeStar of the notice of conversion. At the time it appears there was no dispute that the applicable "foreclosure price" was properly set at $0.06912 per share (based on the price during the 10 days

prior to March 25) and that the aggregate sum of $271,571.06 covered the debt almost precisely.[3] The holders also received unrestricted shares. Presumably based thereon, none of the March debt is included in the claims asserted in the Petition by the Petitioning Creditors. As further discussed below, FreeStar now claims that Papell and Boat basin "over-converted" the March Notes, resulting in an "overpayment" of $188,352 and $56,488, respectively, and that they should not have received unlettered stock. However, these assertions appear to have first been raised in connection with the current disputes among the parties.

June-September 2002 Convertible Notes

On August 29, 2002 FreeStar entered into a second convertible note financing on substantially the same documentation. FreeStar issued six 8% convertible notes, each dated as of June 27, 2002, in the following amounts: (i) Papell $117,000; (ii) Boat Basin $65,000; (iii) vFinance $58,000; (iv) Rosenblum $60,000; (v) Stefansky $60,000; and (vi) Siegel $40,000.[4] FreeStar asserts that it received in return $100,000 in new funds, defeasance of $60,000 in loans that Rosenblum, Stefansky, Siegel and Boat Basin had advanced in June as short-term bridge loans pending completion of the documentation, and defeasance of another $50,000 short-term loan from Boat Basin, and that the balance of $190,000 was retained by the lenders (including vFinance) as brokerage commissions and fees.[5]

As with the March notes, Egan guaranteed FreeStar's obligations, and this time he pledged 14.4 million shares of FreeStar stock in support of the guaranty. Again, FreeStar committed to file a registration statement within 60 days, again it defaulted, and five of the six

[3] It seems to have been the intent of the transaction to link the debt to the stock price in this fashion. The holder would be protected by being able to set the sale price at 80% of the Market Price at the time the loan was made, providing for a potential return of principal and 20% interest, provided the trading price of the stock did not decline.
[4] These amounts are included as part or (in the case of Siegel) the entirety of the individual Petitioners' claims as set forth in the Involuntary Petition.
[5] Rosenblum, Stefansky, and Siegel also received 1,000,000 shares of FreeStar stock, apparently as a commission or fee for their June bridge loans of $60,000.

lenders proceeded against the Egan shares held as collateral pursuant to a Stock Pledge Agreement that in all material respects was the same as the March agreement.[6] On this occasion, they sent conversion notices to FreeStar promptly, on December 9, 2002.[7] On December 11, 2002, the lenders submitted to FreeStar's stock transfer agent Egan's stock certificate for 14.4 million shares, stock powers that had been signed by Egan, a copy of an opinion of Brian Faulkner, counsel to Egan and FreeStar, with respect to the ability to freely trade the Egan shares,[8] and a letter of their counsel demanding that all 14.4 million shares be transferred into her clients' names.[9] The transfer agent issued 14.4 million unrestricted shares to the Petitioning Creditors in the denominations requested in counsel's letter, on December 16, 2002. Even before they received the shares, the Petitioning Creditors had commenced selling them on the open market through a broker, Pond Equities ("Pond"), and between December 10, 2002 and December 30, 2002, they had sold 7,707,332 of the shares.

The December 2002 Convertible Notes

On December 20, 2002, the Petitioning Creditors (other than Siegel) made another loan to FreeStar, in the aggregate amount of $237,000.[10] It was documented in the same manner as the

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[6] vFinance did not foreclose on its collateral but, as discussed below, all 14.4 million shares posted as collateral have been foreclosed upon by the other lenders in the transaction. The Stock Pledge Agreement provides that the collateral is pledged to the "Secured Parties" generally "and to each of them to the extent of the Note held by each". Stock Pledge Agreement, §1. As further discussed below, it is assumed that the other lenders are holding the proceeds of the foreclosure for the rateable benefit of vFinance.

[7] The conversion notices indicated the parties were to receive shares in the following amounts: (i)Rosenblum 1,554,575; (ii) Stefansky 1,554,575; (iii) Siegel 1,036,000; (iv) Boat Basin 1,682,416; and (v) Papell 2,983,325. In the June-September Notes, the applicable date for calculating Market Price was ten days prior to June 27, 2002 or three trading days prior to date of receipt of the notice of conversion.

[8] Faulkner, in an opinion dated September 17, 2002, analyzed the number of FreeStar shares then outstanding and the average weekly trading volume for the past four weeks, and in light of SEC Rule 144, opined that Egan could sell 1,615,375 shares without restrictive legend.

[9] The lenders requested that the 14.4 million shares be issued to them in the following amounts: (i) Stefansky 2,526,336; (ii) Rosenblum 2,526,336; (iii) Siegel 1,684,080; (iv) Boat Basin 2,736,720; and (v) Papell 4,926,528.

[10] Papell advanced $70,000, Boat Basin, $70,000; Rosenblum $43,000, vFinance, $11,000; and Stefansky, $43,000. These amounts, added to the principal amounts of the June-September Notes (see page 6, above), equal the amounts claimed by the Petitioning Creditors against FreeStar in the Petition.

March and June-September transactions. The Egan guarantee was secured by the shares that had already been foreclosed upon. In the words of an affidavit submitted by Stefansky on the instant motion:

> Although Petitioning Creditors were entitled to only 8.8 million shares to cover FreeStar's and Egan's defaults [on the June-September Notes], the transfer agent converted the entire 14.4 million shares into free trading stock and issued the entire amount proportionately to Petitioning Creditors .... Given FreeStar's pending request for yet another loan, the understanding was that Petitioning Creditors would hold the remaining approximate 5.6 million shares as collateral for a new credit advance to FreeStar in the amount of $237,000.00 which Plaintiffs, in fact, advanced on December 20, 2002.

Stefansky Affid. 2/12/03 at n. 10.[11] Counsel for the Petitioning Creditors agreed at the hearing on this matter that the amount advanced in December was based on the current market price and the number of shares already foreclosed on.

On the same day that the December loan was made, the first step was taken in a series that led directly to the filing of the Petition. FreeStar's counsel, Brian Faulkner, wrote to the transfer agent and noted that his legal opinion, required as part of the creditors' transfer documentation, had stated that only 1,615,375 shares could be freely traded during any three-month period. On behalf of FreeStar he demanded that any certificates in excess of this amount be issued only in restricted form. Thereafter, First American put a stop order on all the certificates that had been issued in connection with the foreclosure of the 14.4 million shares and, later, marked the freely tradeable shares as "cancelled" and substituted restricted or

[11] FreeStar apparently claims that the Petitioning Creditors over-converted the notes in the following amounts: (i) Boat Basin 1,682,416 shares for an excess of $98,000; (ii) Papell 2,988,325 shares for an over-conversion of approximately $318,000; (iii) Rosenblum 1,554,525 shares for an excess of $60,084; (iv) Siegel 1,036,000 shares for an excess of $68,712; and (v) Stefansky 1,554,575 shares for a $60,085 overage.

legended shares.[12] The Petitioning Creditors had already sold 7,707,332 shares of the stock through Pond and had deposited the unrestricted certificates with Pond. Pond was informed that those shares should be deemed restricted, and when the Petitioning Creditors were unable to make delivery of unrestricted shares, Pond started to buy shares of FreeStar to cover. At that time, the price of FreeStar shares had apparently risen from 10.5 cents per share to 19 cents per share, causing Petitioners significant potential losses. On January 7, 2003, the Petitioning Creditors submitted to First American an opinion of their counsel that all of the shares could be issued without a legend, but FreeStar and its transfer agent refused to remove the restrictive legends.

The Bankruptcy Petition and District Court Action

The Petitioning Creditors responded with the instant petition, filed on January 9, 2003. Two weeks later, on January 22, five of them filed a complaint in District Court against Egan, FreeStar's transfer agent, Phillip Young, Margaux Investment Management Group, S.A. and John Does 1-10. (S.D.N.Y. Index No. 03 Civ. 0493 (RWS).) The complaint (of which this Court has taken judicial notice) charges, among other things, that the plaintiffs are lawful owners of the 14.4 million shares of FreeStar stock, and it seeks both damages and injunctive relief. [13] On January 21, 2003 the plaintiffs moved for a preliminary injunction, claiming that they were irreparably damaged by being forced to cover their sales of 7,707,332 shares of FreeStar stock and that they had not only a probability of success on the merits – they had an "overwhelming likelihood of success on the merits." (Plaintiffs' Memorandum of Law in Support of Their

[12] The record contains the affidavit of Philip Young, principal of FreeStar's transfer agent, attaching the relevant certificates. They are stamped both "Canceled" and "Restricted," and it is impossible to tell which stamp was put on the certificate first. Young avers in the same affidavit, "As of today's date [February 3, 2003], Petitioners own collectively 19.4 million shares of Freestar stock."

[13] Among other allegations, it is asserted that the plaintiffs are "protected purchasers of the 14.4 million shares of FreeStar" within the meaning of UCC §8-401. (Complaint, ¶93).

Motion for Preliminary Injunction at p.5.) By decision dated February 10, 2003, the District Court found that FreeStar was a necessary party that had to be made a defendant in order for the Court to render any relief. *Boat Basin et al. v. First American Stock Transfer et al.*, 03 Civ. 493 (RWS), 2003 U.S. Dist. LEXIS 1838 at *1. Without determining the merits of the action, Judge Sweet nevertheless observed (*Id*. at *2) that the plaintiffs there (the Petitioning Creditors here) were "hoisted on their own petard" – their commencement of this bankruptcy case precluded them from joining FreeStar as a defendant, and this also prevented them from obtaining immediate injunctive relief in the District Court case.[14] The District Court stayed the action until FreeStar could be joined.

As will be seen below, the petard hoists even higher: the reasons the Petitioning Creditors propound in the District Court as those that provide them with an "overwhelming likelihood of success" are the very reasons why they fail to be holders of claims "not contingent as to liability or the subject of a bona fide dispute."

DISCUSSION

Under §303(b)(1) of the Bankruptcy Code, as initially adopted as part of the Bankruptcy Reform Act of 1978, an involuntary petition could be filed only by the holder of a claim "that is not contingent as to liability or an indenture trustee representing such a holder...."Although the statute was silent on whether a disputed claim could be considered a "claim" for purposes of §303(b)(1) or §303(h)(1) (requiring a finding that the debtor not be paying its debts as they come due), in *In re B.D. International Discount Corp.*, 701 F.2d 1071 (2d Cir. 1982), *cert. denied*, 464 U.S. 830 (1983), the Second Circuit held that "we have difficulty in believing that Congress intended that a debtor should be found to be generally not paying its debts as they become due

[14] FreeStar had been omitted as a party defendant, presumably because of the pendency of the automatic stay of this bankruptcy case.

under §303(h)(1) or that a claim qualifies under §303(b), when the claim is subject to serious dispute." 701 F.2d at 1076. The Court further held that in order to qualify as a petitioning creditor in an involuntary case, "a claimant need not make out a case warranting summary judgment...It is sufficient to establish...that there are good grounds for the claim and that no defenses have been asserted in substantiable form." *Id*. at 1077.

Two years after *B.D. International,* Congress amended §303 to provide that a claimant under §303(b)(1) had to hold a claim that was not "the subject of a bona fide dispute," as well as not contingent as to liability. It has been held that Congress in effect adopted the *B.D. International* formulation. *See In re Elsa Designs, Ltd.*, 155 B.R. 859, 864 (Bankr. S.D.N.Y. 1993); *In re Nargassans*, 103 B.R. 446, 449 (Bankr. S.D.N.Y. 1989). The legislative history itself is sparse, consisting of the statement of Sen. Baucus, proponent of the amendment, who stated that the Bankruptcy Code should not be used "as a club against debtors who have bona fide questions about their liability but who would rather pay up than suffer the stigma of involuntary proceedings." 130 Cong. Rec. S. 7618 (daily ed. June 19, 1984). The term "bona fide dispute" was not defined as part of the legislation, but many courts have used the following test: "if there is a genuine issue of material fact that bears upon the debtor's liability, or a meritorious contention as to the application of law to undisputed facts, then the petition must be dismissed...Under the standard, it must be determined whether there is an objective basis for either a substantial factual or legal dispute as to the validity of the debt." *Elsa Designs, Ltd.*, 155 B.R. at 863-64, citing *inter alia, In re Busick*, 831 F.2d 745, 747 (7th Cir. 1987), quoting *In re Lough*, 57 B.R. 993 (Bankr. E.D. Mich. 1986).

In the instant case it is the Petitioning Creditors who are, ironically, the most eloquent champions of the disputed nature of their debt, and therein lies their petard. In the District Court

action, five of the Petitioning Creditors assert that they are entitled to a preliminary injunction as they have an "overwhelming likelihood of success " in their position there that they appropriately foreclosed all of their debt into freely-tradable shares of Egan's stock. If they did so foreclose their stock, they are not holders of notes issued by the alleged debtor. If they did not, the issue is certainly "the subject of a bona fide dispute."[15]

It is no answer that FreeStar is contesting the District Court action.[16] It does not claim there that the Petitioning Creditors are still holders of debt of FreeStar or that they failed to foreclose on Egan's stock. It claims that the Petitioning Creditors foreclosed and got at least what they bargained for – Egan's stock and the right to sell a certain number of shares during a three-month period, as set forth in Faulkner's initial opinion. Whether the Petitioning Creditors are correct does not need to be determined by this Court, but by Petitioners' own account, the dispute is real and substantial.

Even if there were no dispute pending in another court, FreeStar argues that the Petitioning Creditors cannot simply rescind the steps they have already taken in connection with the foreclosure on Egan's stock and restore themselves to the status of holders of FreeStar's promissory notes. The Stock Pledge Agreement requires that the notes be reduced "by an amount equal to the then applicable Conversion Price (as defined in the Note) multiplied by the number of Pledged Shares with respect to which the Secured Party has exercised its foregoing rights and remedies…." There appears to be no question that five of the six Petitioning Creditors exercised their rights and remedies under the Stock Pledge Agreement with respect to a number

[15] It should be noted that the statute uses the term, "the subject of a bona fide dispute," not the more vague term, "subject to a bona fide dispute." The existence of a separate ongoing lawsuit or other dispute will often satisfy the test that a separate material dispute actually exist and that the dispute not be one created in response to the involuntary petition. *See, e.g., Efron v. Gutierrez*, 226 B.R. 305 (D.P.R. 1998).

[16] Although not a party, FreeStar appeared in court and opposed the motion for a preliminary injunction.

of shares that would, when multiplied by the applicable Conversion Price, cover the face amount of all of their promissory notes, as well as the notes of their co-investor, vFinance. The Petitioning Creditors have not attempted to rescind that transaction, nor have they offered to surrender Egan's stock as part of the District Court proceeding.[17] On the contrary, the Petitioning Creditors have sought a mandatory injunction to enforce the transaction. Thus, although no determination need be made on the present record, FreeStar has demonstrated, "in substantiable form," *B.D. International Discount Corp.*, 701 F.2d at 1077, that the Petitioning Creditors may no longer hold any debt.[18]

FreeStar also argues that the Petitioning Creditors sent conversion notices in connection with their foreclosure on Egan's shares, that a notice of conversion is irrevocable under the terms of the Promissory Notes, and that the Petitioners thereby effectively converted their debt into stock. FreeStar appears to be on weaker ground in this position. Not all of the Petitioning Creditors sent conversion notices, the notices did not cover all 14.4 million shares, and although the notices were not conditioned on receipt of unrestricted shares, the intent of the transaction was that the conversion notices would set the price at which Egan's shares would be deemed foreclosed. But the fact that FreeStar may be on weaker ground in connection with this argument does not mean that there is no bona fide dispute. As noted above, from all appearances, foreclosure on Egan's shares was intended to be the economic and legal equivalent of conversion of the debt. The Petitioning Creditors intended to obtain unrestricted shares by

[17] In order to rescind, a party must offer to restore the other party to its original position by returning consideration received in connection with the transaction to be undone. *See Sokolow, et al. v. Lacher*, 299 A.D.2d 64, 747 N.Y.S.2d 441, 447 (1st Dep't 2002); RESTATEMENT (SECOND) CONTRACTS §283 cmt. c, illus. 3 (1981).

[18] This would include vFinance, even though vFinance did not take all of the explicit steps to foreclose taken by the other Petitioning Creditors and did not join in the District Court action. As discussed above, vFinance has been the beneficiary of the steps taken by the others, and they have assumed control of all of the collateral for the benefit of vFinance as well as for their own benefit. vFinance has not offered to return its share of collateral, and the dispute with FreeStar goes to the entirety of the claims asserted by all of the Petitioning Creditors.

way of foreclosure on Egan's shares, but it is not at all clear that they are entitled to restore themselves to the status of debtholders even if they can demonstrate that FreeStar failed to give them that to which they were contractually entitled.

In their papers in this Court, the Petitioning Creditors contend that they advanced funds to FreeStar, attempted to foreclose on Egan's stock, but have obtained absolutely nothing. Their conclusion is that the original debt must still be outstanding as if nothing had happened. But even on their terms, they are not empty-handed. They have a lawsuit in which they contend they have an overwhelming likelihood of success on the merits to get what they assert they bargained for. They have foreclosed on Egan's shares, and if the shares are not freely tradeable, FreeStar claims that is what the Petitioners are entitled to. In any event, there certainly is a bona fide dispute.[19]

The Petitioning Creditors rely on *LaRoche v. Amoskeag Bank (In re LaRoche)*, 969 F.2d 1299 (1st Cir. 1992), for the proposition that a creditor can, in good faith, file an involuntary

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[19] Egan represented in the Stock Pledge Agreement that "there are no restrictions upon transfer and pledge of the Pledged Shares pursuant to the provisions of this Agreement except the restrictions imposed by Rule 144 under the Securities Act of 1933, and that such restrictions on resale shall not be applicable if an Event of Default occurs under the Notes, and the Secured Party exercises its remedies under the Guaranty and forecloses on the Pledged Shares." He may have breached this representation, but that does not make FreeStar liable therefore. FreeStar also gave irrevocable instructions to its transfer agent as follows:

> This letter shall serve as our irrevocable authorization and direction to you to record the transfer of the Pledged Shares to the Holders of the Notes upon their respective exercise of rights as a Secured Party under the Stock Pledge Agreements, from time to time, upon surrender to you of (i) one or more of the stock certificates evidencing the Pledged Shares, and (ii) stock transfer powers properly executed by the registered owner of such Pledged Shares, in the form attached hereto as Exhibit B relating to the certificate or certificates so surrendered for transfer, (iii) the opinion of counsel to the Company or the Holders in the form attached as Exhibit C hereto, indicating that upon disposition of such shares, the new certificate issued as a consequence of the disposition and evidencing the transferred shares will be free of restrictive legend, pursuant to the provisions of Rule 144 under the Securities Act of 1933, as amended.

(See Young Affidavit Exhibit 3).

The Petitioning Creditors claim that FreeStar violated these instructions in that they did not obtain unrestricted shares. But the instructions speak of the opinion of counsel to the Company, in the form attached as Exhibit C, which opinion stated only that a limited number of shares could be traded in any three-month period. Judge Sweet commented in his opinion that the Petitioning Creditors have never explained how shares that were restricted when owned by Egan could become freely tradeable when owned by Petitioners. *See Boat Basin*, 2003 U.S. Dist. LEXIS at *11, fn. 1.)

petition after it has taken steps to foreclose on collateral securing the subject debt. There, the Court held that a Bank's action in placing stock held as collateral in its own name, while expressly reserving its other rights and remedies against the obligor, did not constitute a proposal to accept and retain the collateral in full satisfaction of the indebtedness under the Uniform Commercial Code and did not result in "full payment" of the debt. 969 F.2d at 1302-03. The Court noted that the pledge agreement gave the Bank authorization to transfer the stock into its own name and that this is a common remedy, giving the secured creditor the right to vote the shares and receive dividends. The Court further found that there had been no "explicit act of foreclosure," much less a satisfaction of the debt, and that the debtor, LaRoche, remained the beneficial owner of the shares. *Id*. at 1304.

The situation at bar is different in several crucial respects. Here, there has been an "explicit act of foreclosure," and one that arguably resulted in elimination of the debt as such and transformation of the Petitioning Creditors' interest in FreeStar into an equity interest. Moreover, even if the Petitioning Creditors here had only transferred Egan's stock into their names, without taking any further steps toward foreclosure, the result would have divested them of their status as creditors. Unlike the stock pledge provisions in the *LaRoche* case, the carefully wrought Stock Pledge Agreement in the instant matter provided that upon a transfer of Egan's stock into the names of the Petitioning Creditors, the creditors were obligated to assign their notes to Egan. Stock Pledge Agreement §10(d). FreeStar asserts, in fact, that the Petitioning Creditors were required to assign their notes to Egan when his stock was placed in their names by the transfer agent, and that this is another reason why the Petitioning Creditors no longer hold debt and could not properly file the Petition herein. It is not at all clear that the assignment requirement was intended to apply when stock was transferred into the names of creditors after a foreclosure, as

opposed to prior to foreclosure (as in *LaRoche*). But, again, this is a point of contention, and another reason why the claims asserted by the Petitioning Creditors are the subject of a bona fide dispute.

A creditor is not prevented from exercising its right under the Bankruptcy Code to file an involuntary petition by the existence of collateral, or, as in *LaRoche*, after it has taken certain limited steps to protect its interest in the collateral. [20] Moreover, the existence of a guarantee does not prevent a creditor from filing an involuntary petition against the principal obligor. *See In re Sjostedt*, 57 B.R. 117 (Bankr. M.D. Fla. 1986). But the Petitioning Creditors have cited no authority that suggests that an involuntary petition can be filed by creditors who have arguably completed a foreclosure on collateral pledged by a guarantor of their debt and, as part of the transaction, surrendered their debt. The Court need not determine at this point whether the Petitioning Creditors did in fact surrender their debt, but it does find that there is a bona fide dispute on the issue. Moreover, the Petitioning Creditors have cited no authority that holds that they can pursue litigation that would assuredly result in the conversion of their debt to equity while at the same time petition the obligor into bankruptcy.

An involuntary petition is much more than just another, alternative debt collection device available to a dissatisfied creditor. *In re Nordbrock*, 772 F.2d 397, 400 (8th Cir. 1985); *In re SBA Factors of Miami, Inc.*, 13 B.R. 99, 101 (Bankr. S.D. Fla. 1981); *In re Cates*, 62 B.R. 179, 181 (Bankr. S.D.Tex.1986); *In re Hope Communications, Inc.*, 59 B.R. 939, 943 (Bankr. W.D.La. 1986). An involuntary petition commences a collective proceeding whose existence is intended to benefit all creditors, that may have many adverse ramifications to an operating company,

[20] Section 303(b)(1) states explicitly that a secured creditor may join in a petition if the claims of the Petitioning Creditors "aggregate at least $11,625 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims."

including an adverse affect on its stock price, and that is not lightly undone.[21] The Petitioning Creditors cannot file a company into bankruptcy while simultaneously asserting in another court that they have an "overwhelming likelihood of success" on their claim that they are in fact stockholders. Section 303(b)(1) requires the existence of three creditors whose debt is not "the subject of a bona fide dispute" precisely so that a litigant in another contested proceeding involving the debtor cannot lightly make the dispute the subject of a full-fledged bankruptcy case, "given the severity of an involuntary bankruptcy as a remedy." 2 COLLIER ON BANKRUPTCY ¶303.02[2][b][i] (15th ed. 1999). Usually, it is the debtor that raises the issue and contends that it is not liable on the alleged debt. Under the unusual circumstances present here, it is the Petitioning Creditors themselves who are the most eloquent proponents of the disputed nature of their claims. In any event, there is a bona fide dispute as to whether the Petitioning Creditors are really shareholders and not creditors at all, and this Petition must accordingly be dismissed.[22]

In light of the foregoing disposition, it is not necessary to determine whether FreeStar's alleged counterclaims against the Petitioning Creditors are sufficient to raise a bona fide dispute that would negate the debt that arose under its promissory notes. As indicated above, FreeStar argues in support of its motion to dismiss this case that it has claims against the Petitioning

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[21] FreeStar asserts that in this case, the filing was intended to depress its stock price and make it cheaper for Pond to buy in stock and cover the Petitioning Creditors' default in delivery of marketable stock after the foreclosure. The Court makes no finding that the Petitioning Creditors had this intent, but the fact that an involuntary petition may have such an effect on stock price is another reason why one should not be filed lightly.

[22] Under the prior Bankruptcy Act, it was held that a creditor could not be a petitioner in an involuntary case if it participated in the act of bankruptcy on which the petition was predicated (for example, if it procured or consented to the appointment of a State court receiver). In *Matter of De Gelleke Co., Inc.*, 411 F. Supp. 1320 (E.D. Wisc. 1996), the Court noted that "The underlying rationale for the rule has been variously expressed as estoppel, election of remedies and *volenti non fit injuria*," and that its premise is that the alleged bankrupt "enjoys some concomitant right to be free from parallel proceedings begun by the same creditor where one proceeding is dependent on the other." 411 F. Supp. at 1323 (footnotes omitted). Here, the parallel proceedings are inconsistent, rather than dependent, but it would be equally unfair for these Petitioning Creditors to be able to put FreeStar into bankruptcy while at the same time asserting in another court that they are shareholders. The requirement that a debt not be subject of a bona fide dispute insures that an alleged debtor not be whipsawed in this fashion. *In re Braten*, 86 B.R. 340, 343 (Bankr. S.D.N.Y. 1988).

Creditors that they were overpaid in connection with their foreclosure on Egan's stock, that the fees and costs they charged in connection with their loans were unconscionable and illegal, and that Siegel failed to perform under a consulting contract with FreeStar. The existence of a possible counterclaim, especially a counterclaim that is not already "the subject of a bona fide dispute," does not necessarily mean that a claim is insufficient to form the basis of an involuntary petition under §303(b)(1). *See In re Audio Visual Workshop, Inc.*, 211 B.R. 154, 158 (Bankr. S.D.N.Y. 1997); *see also In re Onyx Telecommunications, Ltd.*, 60 B.R. 492, 497-98 (Bankr. S.D.N.Y. 1985). The strength of the counterclaim, the circumstances under which it was first asserted and whether it would eliminate the whole or only part of the debt are all relevant in determining whether an involuntary petitioner's claim is "the subject of a bona fide dispute." *See Efron v. Gutierrez*, 226 B.R. at 314. The Court makes no finding as to whether FreeStar's alleged counterclaims are of sufficient weight, in and of themselves, to invalidate this Petition.

Counsel for FreeStar is directed to settle an order on three days' notice dismissing the involuntary petition.

Dated: New York, New York
February 26, 2003

/s/ Allan L. Gropper
UNITED STATES BANKRUPTCY JUDGE