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Creditors Typically May Not Offset Section 303(i) Judgments Against Claims Against Debtors

By Stuart I. Gordon and Matthew V. Spero*

As a recent decision by the U.S. Court of Appeals for the Third Circuit confirms, bankruptcy courts generally do not permit an unsuccessful petitioning creditor to offset the amount of a bad faith judgment against its claims against the debtor.

Creditors that file an involuntary bankruptcy petition against a debtor under Chapter 7 or Chapter 11 of the U.S. Bankruptcy Code must satisfy several statutory requirements before obtaining relief.[1] When creditors fail to meet those requirements, or when their petition is otherwise dismissed as a bad faith filing, the debtor may be able to recover compensatory and punitive damages, as well as attorneys' fees and costs, from the petitioning creditors without the creditors being able to set off their claims.

A creditor that has filed an involuntary bankruptcy petition against a debtor, only to see its involuntary petition dismissed and a judgment entered against it in favor of the debtor, naturally might attempt to set off the amount of its claim against the debtor against the amount of the debtor's judgment against it. However, as the recent decision by the U.S. Court of Appeals for the Third Circuit in *U.S. Bank, N.A. v. Rosenberg*[2] makes clear, a creditor in this situation is unlikely to be successful in making the offset.

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[1] *See* 11 U.S.C. § 303. To file an involuntary case against a debtor who has 12 or more creditors, there must be three or more petitioning creditors; each petitioning creditor must hold a claim against the debtor that is not contingent as to liability or the subject of a bona fide dispute; and the claims must aggregate at least $15,775 more than the value of liens on the debtor's property. 11 U.S.C. § 303(b)(1).

[2] *U.S. Bank, N.A. v. Rosenberg*, 2018 U.S. App. LEXIS 21145 (3d Cir. July 10, 2018).

BACKGROUND

The *U.S. Bank* case arose in 2000, when Maury Rosenberg's medical imaging companies—National Medical Imaging and National Medical Imaging Holdings (together, "NMI")—entered into medical equipment leases with predecessors-in-interest to U.S. Bank, N.A., including Lyon Financial Services, Inc.

In 2003, Lyon claimed that NMI had defaulted and Lyon filed a lawsuit. By July 2004, Lyon had filed no fewer than 13 lawsuits against NMI and Rosenberg. These suits were settled in 2005 pursuant to an agreement that, among other things, modified the equipment leases. NMI continued to lease the medical equipment at a rate of $100,000 per month and Rosenberg executed a personal guaranty under which he agreed that he could be held liable for approximately $7,600,000 in the event of another default. This amount was to be reduced by about $127,000 every month that NMI made its payments. Therefore, after 60 consecutive months of payments, the personal guaranty would expire and Rosenberg would have no liability.

NMI, however, did not pay the amount due for the full 60-month period. Although NMI paid its rent for 21 months, reducing the guaranteed amount for which Rosenberg could be held liable to about $5,000,000, NMI failed to make its next monthly rental payment. After this default, further litigation ensued.

First, U.S. Bank sued Rosenberg for breach of his guaranty. Following a three day trial in June 2015, the U.S. District Court for the Eastern District of Pennsylvania found in favor of U.S. Bank and against Rosenberg personally. The district court entered judgment in favor of U.S. Bank and against Rosenberg for damages in the amount of $5,804,479.95. It also entered judgment in favor of U.S. Bank and against Rosenberg for attorneys' fees and costs in the amount of $701,595.46. The two judgments against Rosenberg became final and totaled $6,506,075.41 (excluding post-judgment interest).

Second, entities related to U.S. Bank filed a confession of judgment previously filed in a Pennsylvania state court as well as an involuntary bankruptcy petition in the U.S. Bankruptcy Court for the Eastern District of Pennsylvania against NMI and Rosenberg.

The confession of judgment eventually was stricken as to Rosenberg and, after the involuntary bankruptcy proceeding was transferred to the U.S. Bankruptcy Court for the Southern District of Florida, where Rosenberg lived, Rosenberg ultimately was successful in obtaining dismissal of the involuntary bankruptcy petition.

Thereafter, in the Florida bankruptcy court, Rosenberg filed an adversary

proceeding under Bankruptcy Code Section 303(i) against U.S. Bank and six co-defendants (the "DVI entities") to recover costs, attorneys' fees, and damages for the bad faith filing of the involuntary bankruptcy petition. The bankruptcy court awarded Rosenberg fees and costs after a bench trial, and transferred the claim for damages to the district court for a jury trial. The jury awarded Rosenberg $1.1 million in compensatory damages and $5 million in punitive damages against U.S. Bank and the DVI entities.

The district court initially overturned the punitive damages award in its entirety and limited compensatory damages to $360,000, but the U.S. Court of Appeals for the Eleventh Circuit held that U.S. Bank's post-trial motion was untimely and reinstated the jury's verdict. Following the Eleventh Circuit's directive, the jury's verdict was reinstated, and a final judgment was entered in favor of Rosenberg and against U.S. Bank and the DVI entities in the amount of $6,120,000.

U.S. Bank filed a motion in the Pennsylvania district court for mutual judgment satisfaction, to set off the two judgments; if the judgments were set off, Rosenberg would owe a net judgment to U.S. Bank of approximately $380,000. U.S. Bank noted that Rosenberg claimed to be judgment proof and as a result would likely not pay the $6.5 million he owed, so it alleged that enforcing the $6.12 million judgment against it would be unfair.

THE DISTRICT COURT'S DECISION

The district court denied U.S. Bank's motion.[3]

In its decision, the district court explained that setoff is an equitable doctrine that "allows entities that owe each other money to apply their mutual debts against each other," thereby avoiding "the absurdity of making A pay B when B owes A." The district court observed that the Bankruptcy Code did not create a federal right to setoff, but that Bankruptcy Code Section 553(a) preserves whatever right to setoff may exist under applicable non-bankruptcy law. The district court noted that, in this case, Pennsylvania law was the applicable non-bankruptcy law and that Pennsylvania has long recognized a common law right to setoff.

The district court then pointed out that, to perfect a right to setoff, the party asserting setoff rights must prove that the debts between the creditor and the debtor were "mutual"—that is, that the debts were "in the same right and between the same parties, standing in the same capacity." The district court

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[3] *U.S. Bank, N.A. v. Rosenberg*, 581 B.R. 424 (E.D. Pa. 2018).

added that setoff most commonly was applied in bankruptcy cases "to adjust the mutual rights and obligations of the parties to reflect the balance between them," and that courts do not allow setoff where doing so would "offend the general principles of equity."

With those principles in mind, the district court ruled that setoff was impermissible because the opposing judgments were "not mutual." The district court reasoned that it previously had entered two judgments in favor of U.S. Bank and against Rosenberg totaling $6,506,075.41, and that the Eleventh Circuit Court of Appeals had reinstated a jury verdict of approximately $6,120,000 in favor of Rosenberg and against U.S. Bank and the DVI entities after the jury had concluded that they had acted in bad faith by filing an involuntary bankruptcy petition against Rosenberg.

The district court explained that the judgments were not mutual because they were not held "solely" by Rosenberg and U.S. Bank. Instead, the district court pointed out, the DVI entities also were jointly and severally liable for the Florida judgment, and they were not parties to the judgment the district court had entered against Rosenberg. The district court also held that even if it overlooked the presence of the DVI entities, the judgments were not currently held by the same parties, as Rosenberg had assigned the Florida judgment to a trust created for the benefit of his son before judgment had been imposed against him. The district court also noted that Rosenberg claimed that there were several attorney charging liens recorded in Florida that pre-dated the entry of judgments against him and that limited any right U.S. Bank had to setoff because an earlier-filed charging lien had priority over a setoff claim founded on a later judgment.

Therefore, the district court concluded that U.S. Bank as the moving party had not proven that the opposing judgments were mutual and it denied U.S. Bank's motion on that ground.

The district court also ruled that even if U.S. Bank could show mutuality, the "equitable principles" embodied in Bankruptcy Code Section 303 precluded setoff. It reasoned that the Florida jury had concluded that U.S. Bank and related entities had acted in bad faith by pursuing an involuntary bankruptcy filing against Rosenberg, and that the Florida court had entered a judgment pursuant to Bankruptcy Code Section 303(i) against U.S. Bank for approximately $6,120,000. This award, the district court said, was entered in part to discourage abuse associated with the bad faith filing of involuntary bankruptcy petitions. The Florida judgment thus concerned "important equitable principles of bankruptcy law that should not be overlooked," and the district court said that it would not offset the two judgments where such concerns were present.

Accordingly, the district court concluded that U.S. Bank had not met its burden of demonstrating that setoff was warranted as a matter of equity.

U.S. Bank appealed to the Third Circuit. Finding that the district court had not abused its discretion in denying U.S. Bank's motion, the Third Circuit affirmed.

THE THIRD CIRCUIT'S DECISION

In its decision, the Third Circuit explicitly declined to rule on U.S. Bank's contention that the district court's conclusion on the issue of mutuality was erroneous. The Third Circuit instead focused on, and adopted, the district court's alternative basis for its denial of the motion: that "equitable principles" embodied Bankruptcy Code Section 303 precluded setoff.

The Third Circuit observed that setoff was "an equitable right to be permitted solely within the sound discretion of the court." It added that the filing of an involuntary bankruptcy petition "has devastating consequences for the putative debtor" and that the Bankruptcy Code's good faith filing requirement, with "strong roots in equity," seeks to prevent the improper filing of involuntary petitions and "ensures that the Bankruptcy Code's careful balancing of interests is not undermined by petitioners whose aims are antithetical to the basic purposes of bankruptcy." Section 303(i), the Third Circuit added, plays a "key role" in deterring bad faith filing and remedying the negative effects of improperly-filed petitions.

The Third Circuit reasoned that a jury had determined that U.S. Bank had acted in bad faith when it filed the involuntary bankruptcy petition against Rosenberg and concluded that Rosenberg was entitled not only to compensatory damages but also to substantial punitive damages—warranted only when the evidence showed that a defendant had acted "with intentional malice" or that its conduct had been "particularly egregious."

The Third Circuit concluded that in light of U.S. Bank's conduct and the equitable principles embodied in Section 303(i), it could not find that the district court had abused its discretion by denying U.S. Bank the equitable remedy of setoff.

CONCLUSION

Other courts have reached the same conclusion reached by the district court and Third Circuit in the *U.S. Bank* case and have determined that Section 303(i)'s equitable purpose would be frustrated if bad faith filers were allowed to offset a Section 303(i) judgment. For example, the Ninth Circuit Bankruptcy

Appellate Panel, in *In re Macke International Trade, Inc.*,[4] pointed out that the "consensus" of courts was that a setoff in these circumstances was "impermissible." As another example, in 2017, a decade after *Macke* was decided, a Pennsylvania bankruptcy court adopted its reasoning to deny setoff of a Section 303(i) award.[5]

Another bankruptcy court decision explained that the allowance of a setoff right would "severely weaken" the purpose of Section 303(i),[6] while still another bankruptcy court decision denied setoff of a Section 303(i) award after concluding that setoff would "blunt" the policies underlying Section 303(i).[7]

Perhaps the most referenced opinion on this issue, decided more than 30 years ago, most clearly explained why setoff generally is not permitted in these circumstances; the bankruptcy court in *In re Schiliro*[8] declared that an award pursuant to Section 303(i) "should not and cannot be permitted to be set off against the unsuccessful petitioning creditor's claims against the [d]ebtor." It concluded:

> If the petitioning creditor could suffer no other recourse except a reduction in his probably-uncollectible judgment as a penalty for requiring a debtor to defend an unjustified case, and Congress has specifically stated should result in such a penalty, the disincentive built into the system to discourage such actions would evaporate. The rule sought by [the petitioning creditor] would surely be a boon to creditors who seek to wear down to submission small debtors such as the [d]ebtor here.

Given the general rule discussed in this article, creditors should carefully weigh both the benefits and the potential drawbacks before filing an involuntary bankruptcy petition against a debtor.

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[4] *In re Macke International Trade, Inc.*, 370 B.R. 236 (B.A.P. 9th Cir. 2007).

[5] *In re Forever Green Athletic Fields, Inc.*, 2017 Bankr. LEXIS 1240 (Bankr. E.D. Pa. May 3, 2017).

[6] *In re Diloreto*, 442 B.R. 373 (E.D. Pa. 2010).

[7] *In re K.P. Enterprise*, 135 B.R. 174 (Bankr. D. Me. 1992).

[8] *In re Schiliro*, 72 B.R. 147, 149 (Bankr. E.D. Pa. 1987). *See also* 2 Collier on Bankruptcy ¶ 303.33[8] (16th ed. 2018) ("[S]etoff would undermine the goals of section 303(i)").