

In Defense of the Blameless

Third Circuit Denies Creditor's Right to Setoff After Finding Involuntary Bankruptcy Was Commenced in Bad Faith

by Warren A. Usatine and Rebecca W. Hollander

It is axiomatic that bankruptcy courts are designed to provide equitable relief to those appearing before them in good faith. For example, it is well-established that bankruptcy courts afford “honest but unfortunate debtor[s]” petitioning for relief the opportunity “to start afresh[,] free from the obligations and responsibilities consequent upon business misfortunes.”¹ Similarly, creditors seeking to place debtors into involuntary proceedings must act in good faith in availing themselves of the bankruptcy system.²



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In *U.S. Bank, N.A. v. Rosenberg*, the United States Court of Appeals for the Third Circuit considered the intersection of the canonical bankruptcy principle of good faith and a creditor's equitable right, under Pennsylvania law, to offset a judgment in its favor against an adverse award. Specifically, the court considered a petitioning creditor's right to offset an award in its favor against a jury award imposed against it based on a finding that the creditor acted in bad faith in filing an involuntary petition.³ In an opinion citing the bankruptcy system's "strong roots in equity" and alluding to the broader goals of the bankruptcy process, the Third Circuit affirmed an opinion of the United States District Court for the Eastern District of Pennsylvania that prohibited a creditor from offsetting a district court judgment against a bankruptcy court award for sanctions.⁴

The Involuntary Bankruptcy Proceeding

The facts of the case, though voluminous and spanning two bankruptcy courts, two district courts, and two circuit courts of appeal, are relatively straightforward. Appellee Maury Rosenberg established and operated a series of entities under the name National Medical Imaging (NMI).⁵ NMI was a party to equipment leases with predecessors-in-interest to appellant U.S. Bank.⁶ In 2003, NMI defaulted on its obligations, causing U.S. Bank to sue NMI and Rosenberg.⁷ The parties settled and, among other things, agreed that Rosenberg would be personally responsible for NMI's debt.⁸ Twenty-one months later, NMI defaulted again.⁹ At the time of the second default, Rosenberg was liable to U.S. Bank for approximately \$5,000,000.¹⁰

In response to the second default, on Nov. 7, 2008, certain entities related to U.S. Bank (DVI entities) placed Rosen-

berg into an involuntary bankruptcy in the United States Bankruptcy Court for the Eastern District of Pennsylvania.¹¹ The case was then transferred to the United States Bankruptcy Court for the Southern District of Florida, the district in which Rosenberg lived.¹²

On Aug. 21, 2009, the Florida bankruptcy court dismissed the involuntary case as a bad faith filing.¹³ The court retained jurisdiction, however, to award Rosenberg "costs, reasonable attorneys' fees, compensatory damages, and punitive damages (if appropriate)"¹⁴ pursuant to 11 U.S.C. § 303(i), which provides bankruptcy courts with the ability to "grant judgment" 1) "against the petitioners and in favor of the debtor for—(A) costs; or (B) a reasonable attorney's fee," or 2) "against any petitioner that filed the petition in bad faith, for—(A) any damages proximately caused by such filing; or (B) punitive damages."¹⁵ Although Rosenberg initially filed a *Motion to Award Attorneys' Fees and Costs and for Compensatory, Consequential, Special and Punitive Damages for the Bad Faith Filing of the Involuntary Petition Against Maury Rosenberg* (the 303(i) motion),¹⁶ the Florida bankruptcy court entered an order directing Rosenberg to amend the 303(i) motion and file it as an adversary proceeding.¹⁷

Accordingly, on Dec. 27, 2010, Rosenberg commenced an adversary proceeding against U.S. Bank and the DVI entities under 11 U.S.C. § 303(i).¹⁸ After the reference was withdrawn and the adversary proceeding was litigated in the United States District Court for the Southern District of Florida, a jury awarded Rosenberg approximately \$1.1 million in compensatory damages and \$5 million in punitive damages.¹⁹ The Florida district court vacated the punitive damages award and reduced the remaining award to "\$360,000 in compensatory damages for emotional distress."²⁰ Rosenberg appealed to the United States Court of Appeals for the Eleventh Circuit, where

the jury verdict was reinstated.²¹ A copy of the court's decision was docketed with the Florida district court on Dec. 27, 2016.²² A \$6,120,000 final judgment (the 303(i) award) was entered in Rosenberg's favor and against U.S. Bank and the DVI entities.²³

The Pennsylvania Litigation

In the meantime, on Feb. 10, 2012, U.S. Bank sued Rosenberg for breach of contract in the Pennsylvania district court.²⁴ U.S. Bank alleged that "because NMI had defaulted under the modified leases, Rosenberg was personally liable" to NMI.²⁵ After a bench trial, on Sept. 3, 2015, the Pennsylvania district court awarded U.S. Bank approximately \$6,500,000 in damages, fees, and costs (the Pennsylvania award).²⁶

U.S. Bank then moved before the Pennsylvania district court for a mutual judgment satisfaction pursuant to Pennsylvania state law,²⁷ seeking to offset the 303(i) award against the Pennsylvania award.²⁸ Had U.S. Bank succeeded, it would have reset the balance of the judgments in its favor (Rosenberg would have owed U.S. Bank approximately \$380,000 and U.S. Bank would have owed Rosenberg nothing), but the Pennsylvania district court denied the setoff motion, finding: 1) there was a lack of mutuality in the judgments,²⁹ and 2) "the equitable principles embodied in § 303 of the United States Bankruptcy Code preclude setoff."³⁰

U.S. Bank appealed to the Third Circuit.³¹

At Cross Purposes: The Third Circuit Weighs In

The Third Circuit did not address the merits of the Pennsylvania district court's mutuality argument, instead opting to affirm based on the lower court's analysis of the equitable principles underlying the U.S. Bankruptcy Code and Section 303(i) thereof. The Third Circuit noted that setoff is "an equitable

right to be permitted solely within the sound discretion of the court” and weighed a creditor’s right to setoff against the “devastating consequences” an involuntary filing has on a putative debtor.³² The court noted that the “good faith filing requirement...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.”³³ The court also noted the deterrent and restorative effects of Section 303(i),³⁴ and that courts across the country have opined that Section 303(i)’s “equitable purpose would be frustrated if bad faith filers were allowed to offset a § 303(i) judgment.”³⁵

Finally, the Third Circuit looked at the merits of the case before it, noting that “a jury determined that U.S. Bank acted in bad faith when it filed the involuntary bankruptcy petition against Rosenberg,” and “concluded that Rosenberg was entitled not only to compensatory damages under § 303(i) but also to substantial punitive damages, which are only warranted when the evidence shows that a defendant acted ‘with intentional malice’ or that its conduct was ‘particularly egregious.’”³⁶ In light of the facts before it and the canonical bankruptcy principles at stake, the Third Circuit affirmed the Pennsylvania district court’s decision, finding the lower court did not abuse its discretion by denying U.S. Bank the right to setoff the Pennsylvania award against the 303(i) award.³⁷ The Third Circuit’s decision was not been appealed, and the time to do so has expired.

Conclusions

U.S. Bank, N.A. v. Rosenberg is an unabashed expression of support for the equitable principle that all parties petitioning the bankruptcy court for relief must come before the court in good faith. More particularly, the case serves as a cautionary tale to creditors. After 15

years of litigation in six courts, U.S. Bank and the DVI entities, having failed to demonstrate the good faith required of petitioning creditors, were burned thrice: They were ordered to pay the 303(i) award; barred from offsetting the Pennsylvania award against the 303(i) award; and left holding a judgment against a debtor who is, in all likelihood, judgment proof.³⁸

In the wake of *U.S. Bank, N.A. v. Rosenberg*, creditors within the Third Circuit would do well to keep the bankruptcy system’s equitable mandates top-of-mind and take care that their zealous collection efforts do not run afoul of their obligations to act in good faith when initiating involuntary bankruptcy proceedings. ⚡

Endnotes

1. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (citations omitted). See also *In re Standard Gas & Elec. Co.*, 30 F. Supp. 21, 23 (D. Del. 1939), *aff’d*, 119 F.2d 658 (3d Cir. 1941) (citations omitted) (discussing the history and purpose of the bankruptcy system); *In re Geo Specialty Chemicals Ltd.*, 577 B.R. 142, 191 (Bankr. D.N.J. 2017) (citations omitted) (applying the principles of *Local Loan v. Hunt* in the context of a corporate bankruptcy).
2. 11 U.S.C. § 303(i) (providing that “(i) [i]f the court dismisses a petition under this section other than on consent of all petitioners and the debtor, and if the debtor does not waive the right to judgment under this subsection, the court may grant judgment (1) against the petitioners and in favor of the debtor for—(A) costs; or (B) a reasonable attorney’s fee; or (2) against any petitioner that filed the petition in bad faith, for—(A) any damages proximately caused by such filing; or (B) punitive damages”); *In*

re Forever Green Athletic Fields, Inc., 804 F.3d 328, 330 (3d Cir. 2015) (finding that although the petitioning creditors had satisfied the criteria of 11 U.S.C. § 303, “bad faith provides an independent basis for dismissing an involuntary petition”).

3. ___ Fed. Appx. ___, Case No. 18-1249, 2018 WL 3640987 (3d Cir. July 31, 2018).
4. *Id.* at *2 (citing *Forever Green*, 804 F.3d at 334).
5. *Id.* at *1.
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*; *In re Rosenberg*, United States Bankruptcy Court for the Eastern District of Pennsylvania Case No. 08-17346, Docket No. 1 (Nov. 7, 2008).
12. *Id.*
13. *In re Rosenberg*, United States Bankruptcy Court for the Southern District of Florida Case No. 09-13196, Docket No. 96 (Aug. 21, 2009).
14. *Id.*
15. 11 U.S.C. § 303(i).
16. *In re Rosenberg*, United States Bankruptcy Court for the Southern District of Florida Case No. 09-13196, Docket No. 101 (Oct. 29, 2009).
17. *Id.*, Docket No. 126 (Jan. 27, 2010).
18. *Rosenberg v. DVI Receivables, XIV, LLC*, United States Bankruptcy Court for the Southern District of Florida Adv. Pro. No. 10-03812, Docket No. 1 (Dec. 27, 2010).
19. *U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987 at *1.
20. *In re Rosenberg*, 724 Fed. Appx. 882, 883 (11th Cir. 2018).
21. *U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987 at *1.
22. *Rosenberg v. DVI Receivables, XIV, LLC*, United States Bankruptcy Court for the Southern District of

- Florida Adv. Pro. No. 10-03812, Docket No. 706 (Dec. 27, 2016).
23. *U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987 at *1.
 24. *U.S. Bank, N.A. v. Rosenberg*, United States District Court for the Eastern District of Pennsylvania Case No. 12-00723, Docket No. 1 (Feb. 10, 2012).
 25. *U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987 at *1.
 26. *Id.*; *U.S. Bank, N.A. v. Rosenberg*, United States District Court for the Eastern District of Pennsylvania Case No. 12-00723, Docket No. 211 (Sept. 3, 2015).
 27. *U.S. Bank, Nat'l Ass'n v. Rosenberg*, 581 B.R. 424, 428 (E.D. Pa. 2018) ("There is [] no question that Pennsylvania has long recognized a common law right to setoff.") (*citing Shenango Sys. Sols., Inc. v. Micro-Sys., Inc.*, 887 A.2d 772, 774 (Pa. Super. Ct. 2005); *Pierce to Use of Snipes v. Kaseman*, 326 Pa. 280, 192 A. 105 (1937)). The Pennsylvania district court noted that although title 11 of the United States Code (the bankruptcy code) does not create a federal right to setoff obligations, 11 U.S.C. § 553(a) "preserves whatever right to setoff that may exist under applicable non-bankruptcy law." *Id.* (citations omitted). Specifically, 11 U.S.C. § 553(a) provides that, subject to certain exceptions, the bankruptcy code "does not affect any [state law] right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case." *Id.*
 28. *U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987 at *2.
 29. Among other things, the Pennsylvania district court noted: 1) the judgments were not held solely by Rosenberg and U.S. Bank (the parties to the Pennsylvania district court action) because the 303(i) award was against the DVI entities as well, and 2) the judgments were no longer "held by the same parties, as Rosenberg assigned the [303(i) Award] to a trust created for the benefit of his son before [the Pennsylvania District Court]'s imposition of the judgment against him, and U.S. Bank has not pointed to any authority suggesting that [that] assignment does not immunize a judgment from a later-claimed setoff." *U.S. Bank, Nat'l Ass'n v. Rosenberg*, 581 B.R. at 429.
 30. *Id.* at 430.
 31. *See generally, U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987.
 32. *Id.* at *2.
 33. *Id.* (*citing Forever Green*, 804 F.3d at 334; *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 119 (3d Cir. 2004)).
 34. *Id.* ("As the District Court correctly noted, § 303(i) plays a key role in deterring bad faith filing and remedying the negative effects of improperly-filed petitions.").
 35. *Id.* (citations omitted).
 36. *Id.* at *3 (*citing Rosenberg v. DVI Receivables, XIV, LLC*, Case No. 12-22275, 2014 WL 4810348, at *6 (S.D. Fla. Sept. 29, 2014), *rev'd on other grounds*, 818 F.3d 1283).
 37. *See generally U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987.
 38. Recall that Rosenberg transferred his 303(i) award to a trust created for the benefit of his son, such that it is no longer his asset. *See n.29, supra.*