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Two circuits limit creditors' setoff rights in bankruptcy cases

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"The right of setoff … allows entities to apply their mutual debts against each other to avoid the pointless exercise of 'making A pay B when B owes A.'" held the Seventh Circuit on Aug. 17, 2018. *Berg v. Social Security Administration*, 900 F.3d 864, 868 (7th Cir. 2018). But the Bankruptcy Code ("Code") limits "a creditor's right of setoff during the ninety-day period prior to the" date of bankruptcy, said the court. *Id*.

"In plain English — a commodity rarely found in the … Code — this means that a debtor … may recover from a creditor … an amount set off by the creditor in the ninety days preceding … bankruptcy … but only to the extent that the creditor improved its position during that ninety-day period." *Id*.

The Seventh Circuit followed the language of the Code to reach an unanticipated result.

The Third Circuit also recently denied a creditor's right of setoff "on equitable principles" in *U.S. Bank, N.A. v. Rosenberg*, 2018 WL 3640987,*2 (3d Cir. July 31, 2018). It reasoned that "[s]etoff is 'an equitable right to be permitted solely within the sound discretion of the court." *Id*., quoting *Foster v. Mut Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1095 (Pa. 1992). As shown below, the Third Circuit's decision was hardly equitable to the creditor bank.

The holdings of *Berg* and *U.S. Bank* are meaningless without reviewing their facts and the courts' reasoning. The Code's defined limit on setoff (*Berg*) and the judicially created equitable limit on setoff (*U.S. Bank*) are quite different in scope.

RELEVANCE

A creditor's right of setoff is a powerful state law remedy. The Code creates no "federal right of setoff," but, "with certain exceptions, whatever right of setoff otherwise exists is preserved in bankruptcy." *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995).

Code § 553(a) not only preserves a creditor's right of setoff, but Code § 506(a) also deems the creditor to have a secured claim for the amount subject to setoff.

A creditor with a setoff right thus gains preferential treatment in bankruptcy because it can be paid in full to the extent of that right, rather than being paid with a percentage bankruptcy dividend. *Studley v. Boylston Nat'l. Bank*, 229 U.S. 523, 528 (1913).

But the Code also limits the creditor's right of setoff and provides safeguards, some of which are summarized below. *See generally* Burton M. Freeman, "Setoff Under the New Bankruptcy Code: The Effect on Bankers," 97 Banking L.J. 484 (1980) ("Freeman").

(1) *Automatic Stay*. First, Code § 362(a)(7) stays a creditor from setting off "any debt owing to the debtor that arose" prior to bankruptcy "against any claim against the debtor." To set off, therefore, a creditor must seek relief from the automatic stay.

(2) *Property Subject to Setoff Protected*. The trustee or Chapter 11 debtor-in-possession ("DIP") cannot use property subject to a setoff (e.g., cash collateral "deposit accounts") without prior court authorization or lender consent. Code § 363(c)(2).

(3) *Turnover Power Subject to Setoff*. The Code's general turnover requirement in § 542 is also subject to a creditor's setoff right. *See In re C.W. Mining Co.*, 749 F.3d 895 (10th Cir. 2014) (refusing to upset post-bankruptcy setoff by secured creditor without court authorization).

(4) *Tax Overpayment Setoffs Not Stayed*. Code § 362(b)(6) exempts the Internal Revenue Service from the automatic stay when a debtor overpays its taxes. It may set off the debtor's refund against "an income tax liability."

(5) *No Improvement in Creditor's Positon*. As noted earlier, Code § 553(b) permits a trustee or DIP to recover from an offsetting creditor the amount by which it improved its position during the 90-day period prior to bankruptcy. Congress thus encouraged creditors not to set off, recognizing that a bank lender might pressure its debtor to increase its deposits after it learned of a likely bankruptcy filing. As shown in *Berg*, discussed below, a creditor's improvement in position may be innocent but still recoverable. Freeman, *supra*, at 498-504 ("The setoff netting test is absolute and purely arithmetical; there is no insolvency test or subjective element. … There is no rational explanation other than an intent to penalize the exercise of an admittedly valid and legal right.").

The banking relationship provides a concrete example of how setoff works. Banks ordinarily require their borrowers to maintain a checking account with a "compensating balance." When the

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borrower maintains a checking account, the bank owes the customer the credit balance in its account. The customer also owes the bank the unpaid loan balance.

If, for example, the customer borrows $10,000 from the bank and maintains a checking account with a balance of $5,000, the bank owes the customer $5,000 on the account, while the customer owes the bank $10,000 on the loan.

If the customer defaults, the bank can set off the account balance ($5,000) against the amount of the loan ($10,000). After the bank sets off, the customer owes the bank $5,000.

Outside of bankruptcy, the bank does not have to seek judicial relief to set off and does not need its borrower's consent. Still, the bank must take some action (e.g., a book entry) to reduce its customer's account. *Citizens Bank, supra*, 116 S. Ct. at 286. Merely freezing the customer's account does not constitute setting off. *Id*.

THE SEVENTH CIRCUIT'S *BERG* DECISION: A CREDITOR'S INNOCENTLY IMPROVED POSITION

The Social Security Administration ("Agency") set off prior to bankruptcy the amount of a back-award ($20,307) that it owed to Berg, the debtor, against the amount that Berg owed the Agency due to an earlier Agency overpayment ($19,400). 900 F.3d at 665. Shortly thereafter, the Agency sent the debtor a check for $907, effectively recovering its earlier overpayment from her back-award. *Id*. at 866.

The debtor promptly filed a bankruptcy petition and sued the Agency to recover the amount of back-benefits set off by the Agency ($20,307). The bankruptcy court "found that the elements for setoff under the [Code] were present."

The Agency "had a pre-petition claim [$19,400] against [the debtor] for return of its earlier overpayment; [the Agency] owed a pre-petition debt [$20,307] to [the debtor] because of the award of back-benefits; the obligations were mutual; and both the claim and the debtor were valid and enforceable." *Id*., citing Code § 553(a) and *In re Doctors Hosp. of Hyde Park Inc.*, 337 F.3d 951, 955 (7th Cir. 2003) (setoff allowed when debts are mutual and "the general rule is that mutuality is satisfied when the offsetting obligations are held by the same parties in the same capacity … are valid and enforceable, and … both offsetting obligations arise either pre-petition or post-petition, even if they are raised at different times out of different transactions.").

The bankruptcy court nevertheless found that the Agency had improved its position during the 90-day pre-bankruptcy period before it set off.

The 90th day prior to the debtor's bankruptcy was May 9, 2014, when the debtor's approved back-benefit totaled only $17,385. On that day, the debtor owed the Agency $19,400, meaning that the Agency had a statutory "insufficiency" of $2,015.

Code § 553(b)(2) defines "insufficiency" to mean any amount "by which a claim against the debtor [Berg] exceeds any mutual debt owing to the debtor by [the Agency, as creditor]." 900 F.3d at 869.

When the Agency later set off on July 30, 2014, about a week before bankruptcy, the debtor still owed the Agency $19,400 for an overpayment she received, but the Agency now owed her $20,307 for back benefits.

That meant that there was no "insufficiency" on July 30, 2014, the date of setoff, "because the [Agency's] debt to the debtor was now larger than the amount that she owed the [Agency]), and the [Agency] had improved its position in the amount of $2,015 during the 90-day preference period." *Id*. at 866-67.

Thus, reasoned the bankruptcy court, the Agency "was entitled to keep $17,385," but the Agency had "to return $2,015 to [the debtor]." *Id*. 867.

> The Seventh Circuit followed the language of the Bankruptcy Code to reach an unanticipated result.

The Seventh Circuit affirmed, rejecting the debtor's argument "that she had no benefits from which to take an offset until" a date later than July 30, 2014. *Id*. at 869.

According to the court, under "the Social Security Act … a beneficiary has a right to payment of benefits as soon as the beneficiary survives to the end of the month that the beneficiary is eligible for benefits" — well before the setoff here. *Id*. at 870.

Moreover, when the debtor had applied "for disability benefits in March 2014, she created an unliquidated, contingent claim against the [Agency] that related back to the … date that she became entitled to benefits … [, May 2013] … ." *Id*. at 871.

Because the Agency owed Berg $17,385, it had an "insufficiency" of $2,015 on May 9, 2014, but had "no insufficiency on July 30, 2014," when it set off. *Id*. The Agency "had improved its position in the amount of $2,015 during the 90-day preference period," enabling the debtor to recover that amount. *Id*.

As the Seventh Circuit explained, Code § 553 "does not bar setoffs entirely but simply prevents a creditor from improving its position during the 90-day pre-petition period. This limit on setoffs was imposed in order to allow the trustee to recover setoffs that improved the position of one creditor at the expense of all the others during the 90-day period prior to bankruptcy." *Id*., citing *In re Prescott*, 805 F.2d 719, 730 (7th Cir. 1986).

But the Agency's improvement in position was wholly innocent in *Berg* — no manipulation. The mere passage of time created increased benefits for the debtor and a statutory liability for the Agency.

THE THIRD CIRCUIT'S *U.S. BANK* DECISION: A PURPORTEDLY EQUITABLE LIMIT ON SETOFF

The Third Circuit barred a lender (U.S. Bank) with a $6.5-million judgment against a guarantor from setting off its judgment against the guarantor's $6.1-million Florida judgment against the lender. The guarantor had obtained its judgment based on the lender's bad faith filing of an involuntary bankruptcy petition under Code § 303.

According to the Third Circuit, the district court had not abused "its discretion in denying [the lender's] motion for mutual judgment satisfaction based on equitable principles." 2018 WL 3640987, at *2. Purportedly relying on applicable Pennsylvania law, the court reasoned that setoff is "an equitable right to be permitted solely within the sound discretion of the court." *Id*.

But the only Pennsylvania case cited by the Third Circuit for this broad proposition was *Foster v. Mutual Fine, Marine and Inland Ins Co.*, 531 Pa. 598, 617 (1992).

The court there, however, denied setoff in an in insurance company rehabilitation because a statute "expressly forbids a setoff of premium obligations," and because a reinsurer may not "offset obligations … that had not matured." *Id*. at 617, 621.

The Third Circuit was apparently troubled by the nature of the defendant-guarantor's judgment against the lender, stating that the "filing of an involuntary bankruptcy petition has devastating consequences for the putative debtor. … Several [lower] courts have concluded that [the Code's] equitable purpose would be frustrated if bad faith filers were allowed to offset a §303(i) judgment." *Id*.

It stressed the lender's "bad faith when it filed the involuntary bankruptcy petition against" the guarantor. *Id*. at *3. Because the lender had sustained a judgment not only for compensatory damages but for "substantial punitive damages," said the court, "equitable principles" barred the lender's remedy of setoff. *Id*.

The Florida district court decision awarding damages to the guarantor for the lender's improper involuntary bankruptcy filing is briefly mentioned in the Third Circuit's decision.

"Although the District Court vacated the [jury's] punitive damages award and reduced [its] compensatory damages award, the Eleventh Circuit reinstated the jury's verdict … ." 2018 WL 3640987, at *1.

But the Third Circuit failed to mention the Florida district court's findings after an eleven-day trial:

- "The [guarantor's] liability case [against the lender] was a close call";
- The guarantor's case relied heavily on "emotionally charged and at times inflammatory testimony";
- "The record is bereft of any maliciousness, intentional deception, or egregious conduct [by the lender] essential [to support] punitive damages.";
- "There is simply no pattern of bad acts"; and
- The guarantor "has a prolific history of using litigation as a tool to enhance his own bargaining position."

Rosenberg v. DVI Receivables, XIV, LLC, 2014 WL 4810348, *2, *7, *8. (S.D. Fla. Sept. 29, 2014).

The Eleventh Circuit never addressed the merits of the jury verdict or the district court's findings regarding the record. It merely vacated the district court's order granting the lender's motion to set aside the jury's verdict, holding that it was untimely under the Federal Rules of Bankruptcy Procedure although it was timely under the Federal Rules of Civil Procedure. *Rosenberg v. DVI Receivables XIV LLC*, 818 F.3d 1283, 1293 (11th Cir. 2016) (because post-trial motion was "not timely filed, we need to (and, indeed cannot address … merits"; "… district court … must apply [shorter] filing deadline … in … Federal Bankruptcy Rules … . ").

> As the Seventh Circuit explained, Code § 553 "does not bar setoffs entirely but simply prevents a creditor from improving its position during the 90-day pre-petition period."

The Third Circuit in *U.S. Bank* relied on lower court decisions to support its decision. *In re Macke Int'l Trade Inc.*, 370 B.R. 236, 255 (B.A.P.) (9th Cir. 2007); *In re Diloreto*, 442 B.R. 373, 376 (E.D. Pa. 2010); *In re K.P. Enter.*, 135 B.R. 174 (Bankr. D. Me. 1992) and *In re Forever Green Athletic Field Inc.*, 2017 WL 1753104, at *7 (Bankr. E.D. Pa. May 4, 2017).

But the cited cases, neither persuasive nor controlling, do not apply Pennsylvania law that may permit setoff of a judgment for a debt against a tort judgment based on the creditor's attempt to collect a valid debt. *See Porreca v. Marks*, 23 Pa.D. 276, 277 (Ct. Com. Pl. 1913) (unpaid jeweler had customer arrested for larceny; customer obtained judgment for malicious prosecution; setoff still granted; customer awarded damages for jeweler-creditor's error; "no reason why [customer] should not pay for article he purchased."; and to deny setoff would be "inequitable and unjust.").

A hard look at the facts in *U.S. Bank* — something the district court failed to do[1] — shows why the decision is troubling. The lender had a final $6-million judgment against the guarantor for his admitted default. He had yet to pay a cent on that judgment. Nor did he deny the absurdity of making "A pay B when B owes A." *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913).

It was also unfair to deny setoff to the bank when the defendant guarantor apparently had no intention of paying the bank what it owed.

The Third Circuit's *per se* rule barring setoff of a judgment for damages under Code § 303(a) may also be inconsistent with applicable Pennsylvania law. *See*, e.g., *Koken v. Legion Ins. Co.*, 900 Pa. D. 418, 426 (Pa. Comm. Ct. 2006) (setoff permitted when one party to contractual relationship committed a tort).

Such a rule here imposed a double loss on the lender and gave the defendant-guarantor a windfall. The lender held a valid final judgment that would likely go unpaid without a setoff, in view of the guarantor's asserted insolvency. *Rosenberg*, *supra*, 2014 WL 4810348, at *7.

The Third Circuit failed to explain why the defendant-guarantor's judgment against the lender was not itself a sufficient deterrent against a purportedly improper involuntary bankruptcy filing.

Nothing in the Code should have superseded the bank's state-law remedies here, particularly when Code § 553(a) preserves pre-bankruptcy state-law setoff rights subject only to specific narrow statutory exceptions that did not apply here.

The Third Circuit should not have relied on vague "equitable powers" to add a remedy not authorized by the Code. *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 987 (2017) (reversing Third Circuit, held that courts cannot, for equitable reasons, permit priority-skipping distributions not authorized by Code); *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the … Code"); *Kham & Nate's Shoes No. 2 Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1361 (7th Cir. 1990) (Bankruptcy courts "no longer have equitable powers to modify contracts to achieve fair distributions. [They] enforce entitlements created under state law.").

In *U.S. Bank*, fairness and equity mandated the lender's ability to set off its judgment against the guarantor's judgment. *See Loughran v. Loughran*, 292 U.S. 216, 229 (1934) ("Equity does not demand that its suitors have led blameless lives.") (Brandeis, J.).

NOTES

[1] The Third Circuit applied an "abuse of discretion" standard in *U.S. Bank*: "We will not disturb the District Court's exercise of discretion unless no reasonable person would adopt the district court's view." 2018 WL 3640987, at *2, quoting *Stecyk v. Bell Helicopter Textron Inc.,* 295 F.3d 408, 412 (3d Cir. 2001).

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