

# The Eleventh Circuit Wallops Involuntary Bankruptcy Petitioners

Pursuant to section 303 of the United States Bankruptcy Code, 11 U.S.C. §§ 101-1532 (the "Code"), an involuntary petition can be filed against a debtor by three entities which hold claims which are matured, not contingent as to liability or disputed, and which total in the aggregate at least \$15,325. If there are fewer than twelve creditors, any single entity which holds a qualifying claim may file the petition. However, Code section 303(i) also provides that if an involuntary petition is dismissed other than on consent of all of the petitioners and the debtor, and the debtor does not waive the right to judgment, the debtor can recover from the petitioners' costs or attorneys' fees, and, in the case of a petition filed in bad faith, damages proximately caused by the filing and punitive damages.

## Rosenberg v. DVI Receivables XIV

*Rosenberg v. DVI Receivables XIV, LLC*, No. 13-14781, 2015 WL 845578 (11th Cir. February 27, 2015), dramatically instructs parties thinking about filing an involuntary petition to carefully comply with the Code or risk significant damages. In November 2000, as part of complex securitization transactions, certain limited partnerships affiliated with Rosenberg ("Lessees") entered into equipment leases with DVI Financial Services, Inc. ("DVI Financial") to finance the acquisition of medical equipment. The obligations under the leases were secured by, among other things, a limited guaranty from Rosenberg. As part of the securitization, DVI Financial transferred the leases and the related assets to the certain pass-through entities (the "DVI Entities"). The DVI Entities issued notes secured by the leases to noteholders which, in turn, made loans for the purpose of financing the acquisition of the leased equipment.

Subsequently, the DVI Entities assigned their rights and interests in the leases to U.S. Bank, N.A. ("USB") as Trustee. After DVI Financial filed for bankruptcy in August 2003, Lyon Financial Services, Inc. d/b/a U.S. Bank Portfolio Services ("Lyon"), a second-tier subsidiary of USB, assumed the servicing obligations for the leases. In December 2003, after a default, Lyon, as successor servicer, sued Rosenberg and the Lessees in Pennsylvania state court for the obligations due under the leases.

In 2005, the parties reached a settlement to restructure the obligations. Jane Fox,

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Lyon's Director of Operations, signed the settlement agreement on behalf of Lyon in its capacity as successor servicer and as agent for Trustee USB. As part of the settlement, Rosenberg executed another limited personal guaranty in favor of Lyon superseding all previous guaranties in the amount of \$7,661,945 ("2005 Guaranty"). Rosenberg also executed a confession of judgment.

In March 2008, Lyon declared a default as a result of the Lessees' failure to make certain requisite monthly payments; and in August 2008, requested judgment in the amount of \$4,724,866.16 against Rosenberg under his 2005 Guaranty. The Pennsylvania state court stayed execution of the judgment pending resolution of a dispute over the validity and amount of the debt owed by Rosenberg to Lyon.

On November 7, 2008, on behalf of the DVI Entities, Jane Fox, the Director of Operations for Lyon, filed an involuntary Chapter 7 petition against Rosenberg in the United States Bankruptcy Court for the Eastern District of Pennsylvania. Each of the DVI Entities asserted a claim of \$5,363,361.56 based upon the 2005 Guaranty. Fox signed for each of the DVI Entities, indicating she was signing in a representative capacity and listing the address for each DVI Entity as Lyon's address in Minnesota. Lyon filed the petition, but Lyon was not listed as a petitioner. The evidence subsequently showed that Fox was not an officer, director or employee of any of the DVI Entities, that no meeting of the DVI Entities was held to authorize the filing, and that the DVI Entities had no knowledge of the petition apart from Fox's knowledge. In fact, at the time of the petition, five of the DVI Entities were in bad standing and had been administratively dissolved by the Secretary of State of Delaware.

## **Dismissal of the Involuntary Petition**

The involuntary petition was subsequently transferred to the United States Bankruptcy Court for the Southern District of Florida, and in December 2008, Rosenberg filed a motion to dismiss the involuntary petition. In August 2009, the bankruptcy court dismissed the petition, finding that because the 2005 Guaranty ran to Lyon only, the DVI Entities were not eligible petitioners under the Code. Additionally, the court found that the DVI Entities were not real parties in interest but only pass-through entities created to facilitate the securitization transactions, and therefore lacked standing to file a petition. Finally, the court ruled that the DVI Entities were judicially estopped from prosecuting the involuntary case because Lyon had asserted in the state court case that the 2005 Guaranty ran to it, and inconsistently asserted in the bankruptcy case that the 2005 Guaranty ran to the DVI Entities. The bankruptcy court retained jurisdiction to award Rosenberg

fees and damages under Code section 303(i). The petitioners appealed the order of dismissal, which was affirmed by both the District Court and the Eleventh Circuit.

In December 2010, Rosenberg filed an adversary proceeding in the bankruptcy court seeking to recover attorneys' fees, costs and damages under Code section 303(i). In the proceeding, Rosenberg sought (1) attorneys' fees incurred to defend the involuntary petition and the appeals of the order of dismissal; (2) compensatory, consequential and punitive damages proximately caused by the bad faith filing of the petition; and (3) the payment of all costs and expenses to prosecute the adversary proceeding itself. Rosenberg demanded a jury trial, but because the parties did not consent to a jury trial before the bankruptcy court, the district court withdrew the reference with respect to the bad faith claim, which the court determined was analogous to a claim for malicious prosecution and therefore triable by a jury.

## **Adversary Proceeding for Fees**

The dispute regarding attorneys' fees remained before the bankruptcy court. In that action, Rosenberg sought (1) fees for the defense of the involuntary petition; (2) fees incurred to sustain the dismissal of the petition on appeal; (3) fees incurred in the adversary proceeding to recover the fees in the preceding categories ("fees on fees"); and (4) fees incurred to prosecute the bad faith claim. In a bench trial held in August 2012, the bankruptcy court held that it had the authority to award all four categories of the fees requested. In addition, it found that, although it was not a petitioner, Lyon, through Fox acting within the scope of her duties with Lyon, had exercised exclusive control over the DVI Entities and the DVI Entities and Lyon were so intertwined that Lyon was therefore liable under Code section 303(i). The bankruptcy court ultimately held the DVI Entities and Lyon jointly and severally liable for \$1,032,287.04 in fees and costs (without allocating the award among the categories), reserving jurisdiction to award additional fees and costs after completion of the jury trial in the district court.

## **Bad Faith Filing Trial**

In February 2013, the jury in the bad faith case awarded \$1,120,000 in compensatory damages for emotional distress, loss of reputation and loss of wages, and \$5,000,000 in punitive damages. The defendants filed an amended Federal Rule of Civil Procedure Rule 50(b) motion seeking to reduce the damages

as a matter of law. The district court found that the evidence supported bad faith but not punitive damages or damages for loss of reputation and/or wages, and reduced the judgment to \$360,000 for emotional distress.

The DVI Entities and Lyon appealed the bankruptcy court's attorneys' fees order. The district court affirmed and they further appealed to the Eleventh Circuit. On appeal, the DVI Entities and Lyon did not appeal the fees awarded for filing the bankruptcy petition or the fees incurred by Rosenberg to recover those fees. However, they did appeal the award of fees incurred in the appellate proceeding, any fees incurred in prosecuting the bad-faith claim and any fees to recover fees in those two categories.

## Fees Incurred During the Appeal

Regarding the award of appellate fees, the court found that Code section 303(i) has only two preconditions to an award of fees: (1) if the court dismisses the petition other than by consent; and (2) that the debtor does not waive the right to judgment. Both conditions were clearly met here. *Rosenberg*, 2015 WL 845578, at \*11. Affirming the award of fees at both the trial and appellate court levels, the court noted that nothing in Code section 303(i) limits the authority of the bankruptcy court to award only those fees incurred at the trial level.

In reaching this conclusion, the court ruled contrary to the only other circuit court to address the issue. In *Higgins v. Vortex Fishing Systems, Inc.*, 379 F.3d 701, 708-709 (9th Cir. 2004), the court held that Code section 303(i)(1) specifically grants discretion to award fees at only the trial level and should not be construed to grant similar authority to award fees at the appellate level. This was a discrepancy in the statute that only Congress can rectify. Instead, appellate attorneys' fees are only allowable if the debtor shows the appeal was frivolous under Federal Rule of Appellate Procedure 38. *Id.* at 709. Squarely disagreeing with *Higgins*, the *Rosenberg* court said that Rule 38 is not the exclusive vehicle for awarding fees under Code section 303(i) (1). Nothing in that section limits the award of attorneys' fees if the two conditions in the section are met, the court held that fees are allowable if the debtor successfully defends an involuntary bankruptcy petition whether they are incurred at the trial or appellate level. *Rosenberg*, 2015 WL 845578, at \*12.

## Fees for Prosecuting the Bad Faith Claim

The court noted that issue of recovery of attorneys' fees for prosecuting a bad faith claim under Code section 303(i)(2) was one of first impression in the circuit. The court noted that reading Code sections 303(i)(1) and (2) in isolation might suggest that attorneys' fees are allowable if the petition is dismissed under subsection (1) and that damages are only allowable if there is a showing of bad faith under subsection (2). However, when the subsections are read together as a whole, the court concluded that attorneys' fees should be allowed for all phases of a Code section 303 action.*Id.* In reaching its conclusion, the court relied on *Glannon v. Carpenter (In re Glannon)*, 245 B.R. 882 (D. Kan. 2000), where the court found that the damages were proximately caused and punitive damages are additional recoveries if the court finds the petition was filed in bad faith. The Kansas court said that, reading Code section 303(i) as a whole, attorneys' fees are allowable without drawing a distinction between the offensive or defensive phases of a Code section 303 action.*Id.* at 894.

While adopting the reasoning in *Glannon*, the Eleventh Circuit went on to say under Code section 303(i), only "reasonable" attorneys' fees may be awarded. *Rosenberg*, 2015 WL 845578, at \*13. This can only be determined after the case is concluded. The bankruptcy court awarded fees for the bad faith claim in 2012, and by 2013, Rosenberg had incurred additional fees prompting him to file a motion to supplement the fee award to approximately \$2.1 million. The appellate court found that the 2012 fee award was premature and vacated that portion of the award relating to the prosecution of the bad faith claim only, and remanded the case to district court to remand to the bankruptcy court to determine the allowable fees related to the bad faith damage claim.*Id.*

## Liability of Lyon as a Petitioner

Finally, Lyon argued that it was not a petitioning creditor, and therefore could not be held liable under Code section 303. The court said that the issue was not whether Lyon was liable under an agency or third party theory, but whether Lyon should be found liable as an actual petitioning creditor.*Id.* at \*14. All of the evidence suggested that Lyon was the de facto petitioning creditor. The 2005 settlement agreement was executed by Lyon and the 2005 Guaranty that Rosenberg executed in connection with the settlement ran only to Lyon and not the DVI Entities. Lyon successfully obtained a judgment on the 2005 Guaranty in state court covering the same debts that the DVI Entities asserted in the



involuntary petition. Lyon, through Fox, signed the petition on behalf of the DVI Entities, which were merely pass-through entities created for the securitization transaction, and five of which had been administratively dissolved by the Secretary of State of Delaware. The bankruptcy court did not err, said the court, in finding that Lyon and the DVI Entities were intertwined and that Lyon, through Fox, signed the involuntary petition, albeit in the name of the DVI Entities.*Id.*

## Conclusion

This case stands as a stark warning to creditors considering using an involuntary bankruptcy petition as a collection strategy. Code section 303(i) provides for sanctions in the event a petition is dismissed, including attorneys' fees relating to defense of the petition, and compensatory, punitive damages and fees if the petition is found to have been filed in bad faith. In certain circumstances, such as the ones presented here, these sanctions can be many millions of dollars. It is essential that these risks be taken into account as various creditor strategies are considered to avoid what could be a very expensive surprise.

If you have any questions on the topics discussed in this e-alert, please contact your Reinhart attorney or any member of Reinhart's [Business Reorganization team](#).

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