7-31-1995

IN RE: Flagstaff Realty

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 94-5650

IN RE: FLAGSTAFF REALTY ASSOCIATES
t/a F.R.A. LIMITED PARTNERSHIP
Debtor

MEGAFOODS STORES, INC.,

Appellant,

v.

FLAGSTAFF REALTY ASSOCIATES,
t/a F.R.A. LIMITED PARNERSHIP;
MAURICE L. MCALISTER;
J.E. ROBERT COMPANY, INC.;
KENNETH D. HINSVARK

On Appeal from the United States District Court
for the District of New Jersey
(D.C. No. 93-cv-1713)

Argued June 27, 1995

Before: MANSMANN, GREENBERG, SAROKIN, Circuit Judges

(Filed July 31, 1995)

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OPINION OF THE COURT

SAROKIN, Circuit Judge:

A landlord defaulted on its responsibility to make necessary repa demised premises, and the commercial tenant, as provided in the lease, cure by making the repairs. The lease permitted the tenant to offset the cost o improvements against future rents. The issue presented is whether the moni the tenant before bankruptcy can be recouped or otherwise credited against due thereafter, where the landlord, now debtor-in-possession, rejects the l conclude that they can, and thus reverse.

I.

In August 1991, tenant Megafoods Stores, Inc. became a lessee of property located in Flagstaff, Arizona. Under the lease, landlord Flagstaff Associates was obligated to maintain the parking area and exterior of the b repair. Property Lease at ¶¶ 9, 14. Tenant notified landlord of the need roof and parking lot and learned of landlord's "financial inability to perf obligations under the lease." App. at 136. As early as February 1992, ten

landlord that if it did not confirm that it would perform the repairs at it
tenant would repair the property and exercise its right of offset against t
Tenant performed the work and in July 1992 notified landlord of its intent
rent. In response, landlord declared that failure to pay rent constituted
the lease, and tenant subsequently agreed to remit the July rent and expres
willingness to cooperate with landlord in resolving this dispute either thr
reimbursement, offset against rent, or otherwise. Having failed to hear fr
tenant gave notice in mid-August 1992 that it would commence withholding re
paragraph 29 of the lease and again expressed its willingness to cooperate.
provides in pertinent part:

> [i]n the event the Landlord shall . . . fail to perform any oblig
> specified in this lease, then Tenant may . . . do all necessary w
> and make all necessary payments in connection therewith, and Land
> shall on demand pay Tenant forthwith the amount so paid by Tenant
> together with interest thereon at the rate of six per cent (6%) p
> annum, and Tenant may withhold any and all rental payments and ot
> payments thereafter due to Landlord and apply the same to the pay
> of such indebtedness.

App. at 95.

A little more than two weeks later, landlord filed a voluntary ba
petition under Chapter 11 of the Bankruptcy Code, and in October 1992, file
reject the lease. The specific bases for rejection were that the rent provi
lease was below market value and that tenant had asserted a claim for $477,
listed tenant's claim in its petition as a disputed prepetition unsecured c
priority. Tenant commenced a separate adversary proceeding seeking a decla
rights of the parties with respect to the rental payments and repair issue,
bankruptcy court decided to address this issue together with the motion to
bankruptcy court granted landlord's motion to reject and denied tenant's ap
offset its repair claims pursuant to the recoupment doctrine or, in the alt

U.S.C.A. § 365(h)(2) (West 1993). It also determined that tenant had exerc statutory prerogative to remain in possession of the property for the balan and therefore owed landlord, as debtor-in-possession, its prerejection amou U.S.C.A. § 365.

Tenant appealed, and the district court, exercising jurisdiction U.S.C.A. § 158(a) (West 1993), affirmed the bankruptcy court's ruling. Ten timely notice of appeal. We have jurisdiction over this appeal pursuant to 158(d) and 1291 (West 1993).

During the pendency of this appeal, the bankruptcy court confirme landlord's plan of reorganization. Tenant did not appeal the confirmation it seek a stay pending the resolution of this appeal.

II.

We exercise plenary review over the legal issues presented in thi There are no disputes as to the material facts.

Section 365(h)(2) provides in pertinent part:

> [i]f such lessee . . . remains in possession as provided in paragraph this subsection, such lessee . . . may offset against the rent reserve such lease . . . any damages occurring after such date [of rejection] the nonperformance of any obligation of the debtor under such lease .

11 U.S.C.A. § 365(h)(2) (emphasis added). Therefore, our first inquiry is reserved under the lease.

The phrase, "rent reserved under such lease," plainly refers to t under the lease. See Consumer Product Safety Com. v. GTE Sylvania, Inc., 4 108 (1980)("plain meaning of legislation should be conclusive"); see also I House Partners, 97 B.R. 819, 823 (Bankr. E.D. Pa. 1989)("tenant is entitled under the same rental terms as are set forth in the lease")(citations omitt

Here, paragraph 29 of the lease plainly provides for a reduction when the tenant cures the landlord's default. In essence, the parties agre tenant advanced certain costs which were the obligation of landlord, the re reduced accordingly. The reduced rent is the "rent reserved," and it is th the tenant is required to pay.

"Rejection does not alter the substantive rights of the parties t and thus does not alter the continuing vitality of terms affecting the amou as paragraph 29. In re Chestnut Ridge Plaza Associates, L.P., 156 B.R. 477 W.D. Pa. 1993). The primary function of rejection is to "allow[] a debtor- escape the burden of providing continuing services to a tenant." In re Lee 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993)(citing cases), aff'd, 169 B.R. 507 (Rejection affects the lessor's duties to the tenant. See also In re Stable Associates, Inc., 41 B.R. 594, 597 (Bankr. S.D.N.Y. 1984)(rejection "reliev from covenants requiring future performance, such as the provision of utili maintenance and janitorial services by the debtor")(citation omitted); 2 Co Bankruptcy §365.09, at 356-58 (15th ed. 1995)(rejection "results merely in cancellation of covenants requiring performance in the future by the landlo Chestnut Ridge court emphasized that

> [t]he obligations under the lease and rights associated with tenant's leasehold interest do not just vanish because a debtor h rejected the lease. The leasehold interest remains intact and th lease remains operative between the parties.

156 B.R. at 485 (citations omitted). Thus, although the rejection of the l debtor-landlord relieves it of prospective obligations to perform under the not relieve it of its obligation to accept the agreed upon reduced rent pro the terms of the lease.

Although not the type of transaction traditionally recognized as security interest, this situation is analogous to the assignment of rents t loan. If the landlord had borrowed the money to make the repairs and assig to a lender, the landlord could not disavow the assignment after filing a b petition and insist that it receive the rent payments. See, e.g., In re Wh Office Partners Limited Partnership, 27 F.3d 1234, 1239-41 (7th Cir. 1994)(rents to secure mortgage is an interest in real property and hence a lien g security interest); Prudential Ins. Co. of America v. Boston Harbor Marina 616, 619 (D. Mass. 1993)(lien on rents gives rise to security interest in f payments); In re Buckley, 73 B.R. 746, 749 (D.S.D. 1987)(interest in rent g perfected security interest where lender obtains possession of property). Tavern Motor Inn, Inc., 80 B.R. 659, 660-62 (D. Vt. 1987)(landlord's assign to receive future rent gave lessee bank a security interest in real propert the debtor in this case, in effect, assigned to the tenant its own interest payments and thus permitted tenant to reimburse itself.

From yet another perspective, paragraph 29 can be interpreted as monies so advanced by the tenant as more akin to prepaid rent, rather than landlord or a debt the landlord owes the tenant. Certainly if a tenant pai in advance and the landlord filed for bankruptcy during the course of that tenant should not be required to pay the rent a second time for the remaini that year. Cf. In re M.W. Ettinger Transfer Co., 1988 WL 129334, *4 (Bankr 1988)(concluding it is "wholly unjust, improper and foolish" to require deb spent more than $300,000 in capital improvements in form of prepaid rent to to force tenant to sue separately for a prepaid rent claim). Thus, on stat we conclude that the "rent reserved" under the lease is the fixed rent less and customary cost of the improvements, to be apportioned towards tenant's obligation by the bankruptcy court on remand.

Even if statutory grounds were not available, we hold that the do recoupment would provide relief to tenant. A claim subject to recoupment av bankruptcy channels and thus, in essence, is given priority over other cred Recoupment, which has its origins as an equitable rule of joinder, permits out of the same transaction to be adjudicated in one proceeding. Lee v. Sc F.2d 870, 875 (3d Cir. 1984); In re B & L Oil Company, 782 F.2d 155, 157 (1 This common law doctrine is not codified in the Bankruptcy Code, but has be through decisional law.

The "trustee of a bankruptcy estate 'takes the property subject t recoupment.'" In re Holford, 896 F.2d 176, 179 (5th Cir. 1990)(quoting In Consultants, Inc., 84 B.R. 419, 426 (Bankr. E.D. Va. 1988)); In re Universi Center, 973 F.2d 1065, 1080 (3d Cir. 1992). In recognition of the special recoupment, courts have permitted its application even in situations where not permit application of the related doctrine of setoff, 11 U.S.C.A. § 553 Thus, postpetition funds owing to the landlord may be recouped against prep owed by the landlord despite the usually inflexible automatic stay provisio 11 U.S.C.A. §362(a) (West 1993). See, e.g., In re Klingberg Schools, 68 B. (N.D. Ill. 1986), aff'd, 837 F.2d 763 (7th Cir. 1988).

However, recoupment is not available without limitation. As note contending claims must derive from the same transaction. Recoupment also c basis for asserting an independent claim against the estate. In re America Airlines, Inc., 60 B.R. 587, 590 (Bankr. N.D. Iowa 1986)(citation omitted).

This case satisfies the "same transaction" test. We have require debts must arise out of a single integrated transaction so that it would be for the debtor to enjoy the benefits of that transaction without also meeti obligations." University Medical Center, 973 F.2d at 1081. Both the claim

costs and the rent arise from the lease, and it would be inequitable for th
receive rent without compensating tenant for undertaking the repairs.

Although the usual posture of recoupment cases involves a defensi
of recoupment in response to a landlord or trustee filing suit to recover s
the estate, the creditor may take the "offensive" as in this case. See Pub
107 B.R. at 445-46 (landlord's argument that recoupment may be raised only
"misplaced"); B & L Oil, 782 F.2d at 156 (creditor brought suit for adjudic
right to recoupment). Although the creditor is the tenant here, this does
the essentially defensive nature of tenant's position. It is not seeking a
recovery of the repair costs, but rather an adjudication that it may deduct
costs from its post-rejection rent.

Thus, at the time of filing, tenant had a valid recoupment claim,
landlord had no interest in the future rental income to the extent of tenan

III.

Having concluded that the tenant has the right to reduce future r
the extent that it expended monies to make improvements which were the obli
debtor-landlord, we must next consider the impact of confirmation from whic
neither appealed nor sought a stay.

Section 1141 of the Bankruptcy Code states, in pertinent part and
exceptions not relevant herein:

> (a) . . . the provisions of a confirmed plan bind the landlord .
> and any creditor . . . whether or not the claim or interest of su
> creditor . . . is impaired under the plan and whether or not such
> creditor . . . has accepted the plan.
>
> *****
>
> (c) . . . except as otherwise provided in the plan or in the orde
> confirming the plan, after confirmation of a plan, the property d

> with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in th landlord.

11 U.S.C.A. § 1141(a,c) (West 1993). Landlord posits this as a per se bar assertion of its right to now reduce the rent where the plan listed tenant creditor without any special rights to offset against rental income. Debtor that the plan has been implemented such that the court can no longer provid relief to tenant without jeopardizing the success of the plan, which depend the unreduced rental flow. We reject these contentions for the following r

This is not a situation where a creditor has slept on its rights has been proposed, confirmed, and relied upon by others. Tenant's position and pursued from the outset. The equities are clearly with tenant. It mad improvements which were the obligation of landlord. It was entitled by agr deduct the cost of those improvements from the rent. To now prohibit it fr would create a windfall for the debtor. The approximately 15 partners have only $50,000 to the plan. Debtor and its other creditors proceeded to impl under the specter of potential reversal of the district court in favor of g tenant's recoupment claim and consequent reduction in rent. In fact, in it confirmation of the reorganization plan, tenant specifically noted the pend appeal. Objection to Confirmation of Proposed Third Amended Plan of Reorgan n.1.

We conclude that all parties proceeded to implement the plan with the district court's determination was subject to reversal upon appeal. Th challenging the plan or seeking a stay pending appeal was preferable, tenan do so does not render this appeal moot. Tenant otherwise diligently pursue gave landlord early indication of its intent to abate rent if landlord defa duties. See also In re Rooster, Inc., 127 B.R. 560 (Bankr. E.D. Pa. 1991)(

permitted to recoup despite failure to appeal from the confirmation order n
pending appeal); In re Maine, 32 B.R. 452, 453 (Bankr. W.D.N.Y. 1983)(credi
to recoup despite failure to object to confirmation of the plan nor appeal
confirmation order). Cf. In re De Laurentiis Entertainment Group Inc., 963
1271 (9th Cir.)(creditor had right to setoff although it did not object to
plan nor challenge confirmation order), cert. denied sub nom Carolco Televi
National Broadcasting Co., __ U.S. __, 113 S.Ct. 330 (1992); In re Ford, 35
(Bankr. N.D. Ga. 1983)(creditor permitted to setoff despite failure to obje
reorganization plan nor appealed the confirmation).

Thus, although we recognize the importance of maintaining the int
confirmed plans from later attack, these unique circumstances permit the pl
reopened and readjusted. We reach this conclusion, recognizing that the co
the lease has been at the instance of tenant and not the debtor-landlord.

Furthermore, permitting tenant to pay the rent reserved or to rec
rent payments will not necessarily upset the successful implementation of t
Landlord assumes that tenant would be able to withhold all rental payments
recovers the $325,000. Under such a scenario, the plan would indeed fail.
bankruptcy court has considerably more flexibility in fashioning an equitab
debtor acknowledges. On remand, we suggest that the district court return
the bankruptcy court for a determination of whether there is an amount of r
which would best balance ensuring the ultimate, if more gradual, success of
reorganization plan with reimbursing tenant for the repair costs. Tenant's
this court indicates that it has no immediate plans to vacate the premises,
considering tenant's other substantial improvements to the property, and so
monthly payments appears to be a viable option.

In sum, we conclude that confirmation and implementation of the r
plan does not prevent tenant from paying the "rent reserved" under the leas

asserting its right to recoupment. As we have held that tenant may pay red statutory and recoupment grounds, we need not reach tenant's other contenti issue.

IV.

We now clarify one remaining issue. The bankruptcy court conclud has elected to remain in possession of the lease "and any renewals or exten March 25, 1993 Order at ¶ E (emphasis added), and the district court affirm argues that the bankruptcy court erred in holding that it had elected to re possession for the remaining term of the lease and for all extension period therein. We agree with tenant that the language of §365(h)(1) is permissiv mandatory: the lessee "may remain in possession of the leasehold . . . for such term and for any renewal or extension of such term . . . ." 11 U.S.C. There is no statutory requirement that a tenant who elects to remain on the remain throughout all possible renewal periods nor that tenant must exercis as to renewal periods at the time it elects to remain in possession.

V.

For the foregoing reasons, we will reverse the district court and bankruptcy court for reconsideration of its order confirming the reorganiza for a determination of the amount of monthly rent.