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U.S. BANKRUPTCY COURT

New Mexico

Notice of Electronic Filing

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Case Number: 02-01205-s
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Docket Text:
Memorandum and Order Granting Trustee's Motion For Partial Summary Judgment to Strike the Affirmative Defenses of Setoff and Recoupment Against Trustee (Related Doc # [69]) (mba)

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UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW MEXICO

In re:
FURR'S SUPERMARKETS, INC.,

Case No. 7-01-10779-SA
Chapter 7

Debtor.

YVETTE J. GONZALES, TRUSTEE,

Plaintiff,

v. Adversary No. 02-1205 S

ALBUQUERQUE TORTILLA COMPANY, INC.,
a New Mexico corporation, F & R FOODS, L.L.C.,
a New Mexico limited liability company, M.I. DISTRIBUTING,
an unincorporated entity, ROBERT MARTINEZ,
and M.I. DISTRIBUTING, INC., a Texas corporation,

Defendants.

MEMORANDUM AND ORDER GRANTING TRUSTEE'S MOTION FOR PARTIAL SUMMARY JUDGMENT TO STRIKE THE AFFIRMATIVE DEFENSES OF SETOFF AND RECOUPMENT AGAINST TRUSTEE

The Trustee's motion for summary judgment deals with a chapter 11 debtor in possession's postpetition overpayment for goods to a creditor vendor and double payments to two distributors of that creditor's products for shipment of those goods. As an affirmative defense to the Trustee's recovery of those postpetition payments, all three defendants argue, *inter alia*, the payments should be offset by the creditor's administrative reclamation claim. The Court finds that, regardless of whether the estate may be administratively insolvent, no offset is allowed. In addition, the Court also denies the distributor's affirmative defense of recoupment.

On February 8, 2001, Furr's Supermarkets, Inc. ("Furrs")

filed a chapter 11 case and commenced operating as a debtor in possession. On December 18, 2001, Furrs' bankruptcy case was converted to a chapter 7 case and Ms. Gonzales was appointed as the case trustee ("Trustee"). Prior to filing a Chapter 11 bankruptcy petition, Furrs purchased goods from Albuquerque Tortilla Company, Inc. ("ATC") for sale in its supermarkets. These sales were executed on an open account basis, in which ATC would ship goods to Furrs, which would then pay for those goods some time after receiving shipment. When ATC learned about the bankruptcy filing, it began to require Furrs to pay in advance for all goods purchased from ATC. Furrs also entered an agreement with ATC to install display racks and manufacture Furrs-brand packaging for tortilla and chili product. By the time the case was converted, Furrs had prepaid for more than the value of products it had received. On some occasions during the chapter 11 period, ATC product was shipped by F & R Foods, L.L.C. ("F & R") and M.I. Distributing ("M.I."), which also entered agreements with Furrs to install display racks. These racks were ultimately delivered to and used by Furrs. The shipments made by these distributors have allegedly been paid for by both Furrs and ATC, resulting in double payments. The Trustee filed a Complaint (doc 1), and then a First Amended Complaint (doc 32) which sought (1) from ATC, the recovery of postpetition overpayments of $320,000, (2) from F & R, the recovery of postpetition double payments of $41,668.38, and (3) from M.I., the recovery of postpetition double payments of

$146,346.73. ATC filed an Answer to Complaint and Counterclaim (doc 7) raising setoff as an affirmative defense to the Trustee's motion for recovery as well as a basis, *inter alia*, for a counterclaim to dismiss the Trustee's complaint. F & R filed a Response to the Trustee's complaint raising, *inter alia*, an affirmative defense of setoff and recoupment (doc 37). Finally, M.I. filed an answer to Trustee's complaint, but did not assert setoff or recoupment as an affirmative defense (doc 39).

The Trustee has now moved for partial summary judgment (doc 69) against all defendants on the issues of setoff and recoupment. All three defendants have responded, opposing the motion for partial summary judgment (docs 75, 76, 77, and 80), and the Trustee has replied (doc 83).

Having considered the pleadings, motions, affidavits and other evidentiary materials submitted by the parties, the Court will grant the Trustee's motion for partial summary judgment, thereby removing setoff and recoupment as affirmative defenses when this case is heard at trial.

ANALYSIS

Summary Judgment Standards

The Bankruptcy Code provides for summary judgment through Federal Rule of Bankruptcy Procedure 7056, which adopts Federal Rule of Civil Procedure 56. Pursuant to Rule 56(c), the court should grant summary judgment when after consideration of the record it determines that "there is no genuine issue as to any

material fact and that the moving party is entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c). "By its very terms, this standard provides that the mere existence of some alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no genuine issue of material fact." Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247-48 (1986).

The party moving for summary judgment has the burden of establishing that summary judgment is appropriate. Wolf v. Prudential Ins. Co. of America, 50 F.3d 793, 793 (10th Cir. 1995). However, once the moving party has supported its motion, then it is incumbent upon the adverse party to show that there are material facts in dispute. Fed.R.Civ.P. 56(e). The adverse party may not rely solely on its pleadings but must "set forth specific facts showing that there is a genuine issue for trial." Id.

Setoff

Setoff is a procedure allowed by the Bankruptcy Code ("Code") whereby creditors keep payments that were made to them by the debtor. 11 U.S.C. § 553 (2006). "The right of setoff (also called 'offset') 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.'" Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995) (citing Studley v. Boylston Nat. Bank, 229 U.S. 523, 528 (1913)). Generally, four conditions must exist for setoff to be available: (1) the

creditor holds a claim against the debtor that arose prepetition, (2) the creditor owes a debt to the debtor that also arose prepetition, (3) the claim and debt are mutual, that is, between the same parties and of the same character, and (4) the claim and debt are each valid and enforceable. 5 Alan N. Resnick et al., Collier on Bankruptcy ¶ 553.01(2) (15th ed. rev. 2006) ("Collier"). Although there is no provision in the Code for setoff where the claim and payment arise postpetition, the 10th Circuit Court of Appeals has recognized the applicability of postpetition setoff in limited instances. Zions First Nat'l Bank, N.A. v. Christiansen Bros., Inc. (In re Davidson Lumber Sales, Inc.), 66 F.3d 1560 (10th Cir. 1995), cited in Gonzales v. Food Marketing Group (In re Furr's Supermarkets, Inc.), 320 B.R. 1 (Bankr.D.N.M. 2004).

In Gonzales, this Court provided a lengthy analysis of the relevant 10th Circuit decisions regarding setoff in the bankruptcy context. 320 B.R. at 10-14. It noted that the relevant test to determine whether debts arising postpetition can be setoff requires that the payment must have been used to benefit the estate's reorganization. Id. at 13. "Property acquired by the debtor post-bankruptcy must be used for the benefit of all unsecured creditors or for the debtor's benefit in reorganizing or for the debtor's fresh start." In re Davidson Lumber Sales, 66 F.3d at 1569 (citing USBI Co. v. Otha C. Jean & Assocs., Inc. (In re Otha C. Jean & Assocs.), 152 B.R. 219, 221 (Bankr.E.D.Tenn. 1993)).

The parties have spent considerable resources arguing whether the creditors' claims have the status of administrative expense claims. ATC contends that its agreement with Furrs is not an administrative expense because it is not an "actual or necessary" cost of preserving the estate, as required by 11 U.S.C. § 503(b)(1)(a).[1] It argues that the Court should merely regard its claim as essentially a contract claim against the Trustee which arose post-petition. However, if the Court were to determine that ATC's claim was not an administrative claim, it is likely that the claim would instead be treated as having a priority no higher than a prepetition non-priority unsecured claim. § 348(d).[2] As such it would not have the same "character" as Furrs' claims against it, and therefore setoff would by definition not be available to it.

Since the issue will have to be addressed sooner or later, the Court will address it now. ATC relies on a case from the 10th Circuit stating "[p]otential to benefit the estate does not satisfy [the statute]…the bankruptcy estate must benefit from the use of the creditor's property." Gen. Am. Transp. Corp. v. Martin (In re Mid Region Petroleum, Inc.), 1 F.3d 1130, 1133

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[1] ATC is concerned about having missed a deadline for filing administrative claims against the estate. ATC apparently also believes that having its claim not treated as an administrative claim would allow it to avoid being subjected to the offset analysis that the courts have applied in Davidson Lumber Sales and Gonzales.

[2] One thing seems quite clear at this stage of the case: no holders of prepetition non-priority unsecured claims will receive any payment whatever on account of those claims.

(10th Cir. 1993). ATC relies mistakenly on a correct statement of law taken out of context. In In re Mid Region Petroleum, Inc., the debtor had leased a set of railcars from plaintiff GATX prior to the filing of the petition. After the filing, the railcars were available to the trustee for a period of seven months but he never used them. Id. at 1131-32. The court refused administrative expense status for the rental charges since the railcars were clearly not being used for the benefit of the estate. Id. at 1134. In the current case, Furrs entered the agreement with ATC in pursuit of rehabilitating the company. This case is further distinguished by the fact that Furrs (a debtor-in-possession) actively ordered the products, as opposed to the trustee in In re Mid Region Petroleum, Inc., who, although he had not returned the railcars, had cancelled the lease and never used them. Although Furrs' reorganization attempt was ultimately unsuccessful, giving the payments administrative expense status falls in line with the underlying policy of interpreting Section 503(b)(1)(a) broadly. Collier ¶ 503.06(2). In this case, since the agreements were made to preserve the estate, they presumably would rightfully be considered administrative expenses. However, given that ATC has argued that its claim is not administrative, the Court will not decide the status of the claim at this stage, but will proceed with the analysis as if it were.

ATC refers to a two-prong approach taken by the 10th Circuit in Davidson: "[I]f the right to set-off will not

substantially interfere with the debtor's reorganization effort and has been obtained in good faith, equitable considerations favor lifting the automatic stay to allow set-off." Davidson, 66 F.3d at 1569 (citing Row Steel, Inc. v. Asphalt & Sealers Equip. Mfg. (In re Row Steel, Inc.), 33 B.R. 20, 22 (Bankr.E.D.N.C. 1983)). There being no indication that setoff is being pursued in this case in bad faith, the relevant issue is whether setoff substantially interferes with the debtor's reorganization.

The requirement to permit setoff of postpetition debt is not met in this case. Without applying setoff, the creditors' claims would be subject to the standard administrative process of allowing and paying claims according to their statutory priority. 11 U.S.C. 503; 11 U.S.C. 507; In re Airlift Int'l, Inc., 761 F.2d 1503, 1509 (11th Cir. 1985); In re Dakota Indus., Inc., 31 B.R. 23, 25-26 (Bankr.S.D. 1983). There is some question whether the estate is administratively solvent. If the estate is in fact insolvent, postpetition debt setoff would have the effect of paying these creditors more than other administrative claimants who are similarly situated. On the other hand, if the estate is administratively solvent *and* setoff is not applied, all three creditors might be paid on their administrative claims through the usual claim-payment process. As this Court noted in Gonzales, the orderly way to address this problem is to have the creditors return the overpayments/double payments to the estate and then receive back their share of the

distribution. Although the parties do discuss the issue of whether the creditors have missed their chance to file a chapter 11 administrative expense claim, that issue is not before the Court.[3] In any event, it does not make sense to permit ATC to set off the amount of its administrative claim on the grounds that the claim might be found to have been filed too late and therefore not paid. If ATC's administrative claim is not allowed, then it would have been particularly inappropriate to have rewarded ATC's dilatory or otherwise culpable behavior by treating ATC more generously than the administrative claimants who have acted diligently and within the rules. If it turns out that the claim is allowed, including on the basis of excusable neglect, see § 503(a)(1); Pioneer Investment Services Co. v. Brunswick Associates Limited Partnership, 507 U.S. 380 (1993) ("excusable neglect" standard for permitting late filed claims), then ATC will have suffered no harm. Therefore resolution of that issue, including the issue of whether ATC's claims against the estate are administrative claims, would be appropriate in a separate proceeding to determine if late administrative claims can be filed in this case.

Recoupment

"[A] creditor properly invoking the recoupment doctrine can receive preferred treatment even though setoff would not be permitted. A stated justification for this is that when the

[3] Or, if it is, it needs an evidentiary hearing to be resolved.

creditor's claim arises from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on setoff in bankruptcy would be inequitable." Ashland Petroleum Co. v. Appel (In re B & L Oil Co.), 782 F.2d 155, 157 (10th Cir. 1986). This effectively allows a creditor to net out a postpetition payment from a debtor against a prepetition debt. This Court has emphasized, while reviewing applicable 10th Circuit decisions, that the two transactions (the incurring of debt and the repayment) must be "so closely related that the one claim was 'essentially a defense' to the other claim." Gonzales, 320 B.R. at 8 (citing B & L Oil Co., 782 F.2d at 157). "It is not enough merely that the claims arise out of the same contract; something more is required." Id. at 9.

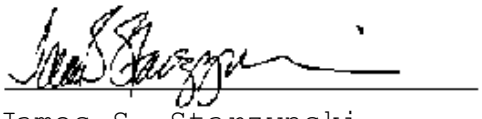
Without getting into a lengthy discussion of the finer points of the doctrine of recoupment, it is clear that the situation F & R is in, or the other defendants for that matter, does not fit this defense. There is no evidence that F & R ever did *any* business with Furrs prior to the filing—a requirement of recoupment.

Conclusion and Order

Given that the facts of this case do not support the application of setoff and recoupment, and recognizing the requirement of redistributing assets of the estate in an orderly way, the Trustee's motion for partial summary judgment should be

granted, and neither should be used as a defense when this case proceeds to trial.

IT IS THEREFORE ORDERED that the affirmative defenses of setoff and recoupment are stricken and may not be asserted as defenses at trial. Whether any party has an administrative claim shall be determined in a later proceeding should any party request such a determination.



James S. Starzynski
United States Bankruptcy Judge

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