Another Blow to Triangular Setoff in Bankruptcy:
"Synthetic Mutuality" No Substitute for the Real Thing

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Charles M. Oellermann
Mark G. Douglas

On October 4, 2011, Judge James M. Peck of the U.S. Bankruptcy Court for the Southern District of New York ruled in *In re Lehman Bros. Inc.*, 2011 WL 4553015 (Bankr. S.D.N.Y. Oct. 4, 2011), that a "triangular setoff" does not satisfy the Bankruptcy Code's mutuality requirement and that the Bankruptcy Code's safe-harbor provisions do not eliminate that requirement in connection with setoffs under financial contracts. The ruling, which involved a broker-dealer liquidation proceeding under the Securities Investor Protection Act, confirmed speculation that multiparty setoffs under financial contracts would be deemed impermissible (at least in Delaware and New York) in the wake of rulings recently handed down in the chapter 11 cases of SemCrude, L.P., and Lehman Bros. Holdings Inc. The debate on triangular setoff, however, is almost certain to continue.

Setoff Rights in Bankruptcy

Section 553 of the Bankruptcy Code provides, subject to certain exceptions, that the Bankruptcy Code "does not affect any 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." A creditor is precluded by the automatic stay from exercising its setoff rights without bankruptcy-court approval. The automatic stay, however, merely suspends the exercise of such a setoff pending an orderly examination of the respective rights of the debtor and the creditor by the court, which will generally permit the setoff if the requirements under applicable law are met, except under circumstances where it would be inequitable to do so.

As articulated by the U.S. Supreme Court in *Studley v. Boylston Nat. Bank*, 229 U.S. 523 (1913), setoff avoids the "absurdity of making A pay B when B owes A." Debts are considered mutual when they are due to and from the same persons or entities in the same capacity. An exception to this strict mutuality requirement may exist in cases involving "triangular setoff," the provenance of which is commonly traced (rightly or wrongly) to a 1964 ruling construing section 68(a) of the former Bankruptcy Act of 1898 by the Seventh Circuit Court of Appeals in *Inland Steel Co. v. Berger Steel Co. (In re Berger Steel Co.)*, 327 F.2d 401 (7th Cir. 1964). In this situation, A might have a relationship with B and C, where B and C are related parties. Triangular setoff occurs when A owes B, and A attempts to set off such amount against amounts C owes to A. The validity of triangular setoff in the bankruptcy context, as distinguished from under state contract or common law, is subject to debate, given the lack of mutuality involved.

SemCrude

In 2009, a Delaware bankruptcy court ruled in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), that triangular setoff is not permitted in bankruptcy due to the absence of mutuality. *SemCrude* involved contracts between Chevron USA Inc. ("Chevron") and three affiliated debtors providing for the purchase of crude oil, gasoline, butane, isobutene, and propane. The contracts contained or were governed by identical netting provisions that provided:

> In the event either party fails to make a timely payment of monies due and owing to the other party, or in the event either party fails to make timely delivery of product or crude oil due and owing to the other party, the other party may offset

> any deliveries or payments due under this or any other agreement between the parties and their affiliates.

The bankruptcy court ruled that, for the purpose of exercising a right of setoff under section 553 of the Bankruptcy Code, “mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff.” The court rejected the contention that parties can contract around section 553’s mutuality requirement. The court also rejected *Berger Steel* as authority for the proposition that nonmutual setoff provisions in a contract can be enforced against a debtor. In doing so, the court emphasized that none of the court rulings proffered in support of the practice actually upheld or enforced an agreement for a triangular setoff, but rather simply recognized the possibility of an exception for prepetition contracts contemplating triangular setoff in the course of denying setoff or finding mutuality.

A Delaware district court affirmed the bankruptcy court’s ruling in *In re SemCrude, L.P.*, 428 B.R. 590 (D. Del. 2010). However, as with the ruling below, the appellate decision does not address whether the result would be different for derivatives and other financial contracts that fall under the “safe-harbor” provisions of the Bankruptcy Code.

The Bankruptcy Code’s Safe-Harbor Provisions for Financial Contracts

Although one of the Bankruptcy Code’s primary policies is to provide for the equitable distribution of a debtor’s assets among its creditors, Congress recognized the potentially devastating consequences that might ensue if the bankruptcy or insolvency of one financial firm were allowed to spread to other market participants, thereby threatening the stability of entire markets. Beginning in 1982, lawmakers formulated a series of changes to the Bankruptcy Code to create certain safe harbors to protect rights of termination and setoff under “securities contracts," "commodities contracts," and "forward contracts." Those changes were subsequently refined and expanded to cover "swap agreements," "repurchase agreements," and "master netting agreements" as part of a series of legislative developments, including the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and the Financial Netting Improvements Act of 2006.

For example, section 561(a) of the Bankruptcy Code provides in relevant part that:

> [T]he exercise of any contractual right . . . to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more . . . swap agreements . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title.

In addition, section 362(b)(17) of the Bankruptcy Code provides a limited exception to the automatic stay for the exercise of setoffs of termination values, payment amounts, or other transfer obligations arising under or in connection with one or more swap agreements.

These safe-harbor provisions could be construed to suggest that where a triangular setoff is being exercised under a contract that is protected by the safe harbor, the mutuality requirement of section 553(a) would not apply. This issue was raised by Chevron before the bankruptcy court in *SemCrude*, but belatedly, such that it was never addressed by either the bankruptcy or district court.

Notwithstanding this argument, in *In re Lehman Bros. Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010) ("*Swedbank*"), Judge Peck held that the safe-harbor provisions of the Bankruptcy Code do not override the mutuality requirement for setoff, which, he wrote, is "baked into the very definition of setoff." According to Judge Peck, although the safe harbors permit the exercise of a contractual right of offset in connection with swap agreements, notwithstanding the operation of any provision of the Bankruptcy Code that could operate to stay, avoid, or otherwise limit that right, "that right must exist in the first place."

Swedbank was upheld on appeal by a New York district court early this year. *See In re Lehman Bros. Holdings Inc.*, 445 B.R. 130 (S.D.N.Y. 2011). That case, however, involved not a multiparty setoff, but a setoff of prepetition claims against funds collected by the debtor postpetition. Even so, many commentators speculated that, taken together, *Swedbank* and the rulings in *SemCrude* suggested that multiparty setoffs likely would not withstand challenge in bankruptcy.

The Latest Salvo

Judge Peck recently reprised his role as spoiler in this context in *In re Lehman Bros. Inc.*, 2011 WL 4553015 (Bankr. S.D.N.Y. Oct. 4, 2011). Lehman Brothers Inc. ("LBI") was the primary brokerage subsidiary of Lehman Brothers Holdings Inc. ("Lehman Holdings"). On September 19, 2008, four days after Lehman Holdings was forced to file the largest chapter 11 case in history, the Securities Investor Protection Corporation sought an order from a New York district court for a protective decree for LBI under the Securities Investor Protection Act of 1970 ("SIPA"), in the largest broker-dealer liquidation ever attempted. The district court issued the protective decree, appointed a trustee to oversee LBI's liquidation, and referred the case to the bankruptcy court.

A SIPA case proceeds in the bankruptcy court very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that to the extent consistent with SIPA's provisions, "a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11." Thus, the Bankruptcy Code's automatic-stay, setoff, and financial-contract provisions apply in a SIPA case.

LBI and global wealth management giant UBS AG ("UBS") had entered into a swap agreement in 2004. The swap agreement and related documents (the "Agreement") required the parties to post collateral to secure their respective obligations. The Agreement also provided as follows:

> [U]pon the designation of any Early Termination Date, in addition to and not in limitation of any other right or remedy . . . under applicable law the Non-defaulting Party or Non-affected Party (in either case, "X") may without prior notice to any person set off any sum or obligation (whether or not arising under this Agreement . . .) owed by the Defaulting Party or Affected Party (in either case, "Y") to X or any Affiliate of X against any sum or obligation (whether or not arising under this Agreement . . .) owed by X or any Affiliate of X to Y. . . .

Prior to the commencement of LBI's SIPA case, UBS delivered to LBI a notice of termination of the Agreement, designating September 16, 2008—the day after Lehman Holdings filed for chapter 11 protection—as the Early Termination Date and citing as cause for termination, among other things, a cross-default traceable to swap agreements between UBS and certain LBI affiliates.

The protective decree issued under SIPA for LBI on September 18, 2008, included a directive that the automatic stay precluded "any act to obtain possession of property of the estate or property from the estate" and stayed and enjoined all entities from directly or indirectly retaining or setting off or interfering with any assets or property owned by LBI. UBS subsequently delivered to LBI a valuation notice in which, among other things, it asserted a right to set off amounts allegedly due from LBI to UBS Securities and UBS Financial Services, two UBS affiliates, against the obligation of UBS under the Agreement to return certain excess collateral held by it to LBI. The SIPA trustee disputed the validity of any alleged setoff right under the Agreement and sought an order of the bankruptcy court enforcing the automatic stay and directing UBS to surrender approximately $23 million in excess collateral in its possession.

The Bankruptcy Court's Ruling

Judge Peck held in favor of the trustee, ruling that "[s]o-called triangular setoff that lacks mutuality . . . is not authorized under the Bankruptcy Code." The judge explained at the inception of his discussion that "[t]he question of central importance [in this case] . . . is whether the extension of the right of setoff [under the Agreement] to 'any Affiliate' is enforceable in bankruptcy."

UBS argued that: (i) because the setoff right in the Agreement, which is valid and enforceable under New York law, is one that was created by contract (and not a right at common law), the mutuality requirement in section 553 does not apply; and (ii) even if the court were to conclude otherwise, the setoff provision should be enforced because (a) triangular setoff does not violate the Bankruptcy Code (or SIPA) and (b) its contractual setoff right is protected by the safe-harbor provisions of the Bankruptcy Code.

Judge Peck rejected each of these arguments. He acknowledged that parties are entitled to agree to whatever they choose, so long as it is legal and not contrary to public policy. Even so, Judge Peck wrote, the attempt to override the independent status of the UBS affiliates in the Agreement

> disregards a consistent pattern of authority prescribing that, even where a setoff right exists under applicable law, the Bankruptcy Code imposes its own strict

> requirements—namely, that the debtor owes a pre-petition debt to the creditor, the creditor has a pre-petition claim against the debtor, and the debt and claim are mutual.

UBS's argument fails, Judge Peck concluded, because "the allegedly mutual debts flunk the test that they must be 'in the same right and between the same parties, standing in the same capacity.' "

Judge Peck gave short shrift to UBS's contention that *SemCrude* interpreted mutuality too narrowly and that it failed to credit the "numerous decisions" in which courts "did not enforce alleged contractual triangular setoffs because they found as a factual matter that there was no such contract." This argument, the judge wrote, "does not withstand careful examination," and the court in *SemCrude* correctly determined that triangular setoff was never permitted under the Bankruptcy Code. Courts that have predicated the legitimacy of triangular setoff on *Berger Steel*, Judge Peck explained, have done nothing more than engage in a misguided game of "whisper down the lane."

Given his ruling in *Swedbank* (by then affirmed by the district court), Judge Peck concluded that UBS's reliance on the safe-harbor protections of the Bankruptcy Code as authority for triangular setoff was misplaced. The safe harbors speak to rights that actually exist under other provisions of the Bankruptcy Code, he emphasized. Moreover, Judge Peck noted, in its affirmance in *Swedbank*, the district court found it "significant" that "there is no mention in the legislative history that the Safe Harbor Provisions were intended to eliminate the mutuality requirement." It is for Congress, not the bankruptcy court, "to clearly delineate any exception to strict mutuality in the case of triangular setoff," the judge concluded, and "Congress has not yet done so."

Outlook

Taken together, *Lehman Bros.*, *Swedbank*, and *SemCrude* mark a clear trend against the availability of triangular setoffs in bankruptcy. In the absence of further developments in the appellate courts or subsequent case law at the bankruptcy-court level, cross-affiliate setoff without mutuality would appear to be impermissible in the two most popular business bankruptcy jurisdictions in the U.S.—the Southern District of New York and the District of Delaware. As such, financial-contract participants seeking multilateral netting would be well advised to consider cross-collateralization under master netting agreements or other alternatives to contractual triangular-setoff provisions.

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