In Brief: Another Blow to Triangular Setoff in Bankruptcy

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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." 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 has sometimes been perceived to exist in cases involving "triangular setoff," the provenance of which is commonly traced (rightly or wrongly) to a 1964 ruling 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 commercial relationship with "B" and "C," where B and C are related parties. Triangular setoff occurs when A owes B, C owes A, and A attempts to set off the amount it owes to B against the amount that 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.

In *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), a Delaware bankruptcy court ruled that triangular setoff is not permitted in bankruptcy due to the absence of mutuality. According to

the court, "[M]utuality 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. It also rejected *Berger Steel* as authority for the proposition that nonmutual setoff provisions in a contract can be enforced against a debtor.

A Delaware district court affirmed the ruling in *In re SemCrude, L.P.*, 428 B.R. 590 (D. Del. 2010). However, neither decision addressed whether the result would be different for derivatives and other financial contracts that fall under the "safe harbor" provisions of the Bankruptcy Code (sections 559 through 561).

In *In re Lehman Bros. Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010) ("*Lehman/Swedbank*"), a New York bankruptcy court held that the safe-harbor provisions do not override the mutuality requirement for setoff, which, the court wrote, is "baked into the very definition of setoff." According to the court, 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 which could operate to stay, avoid, or otherwise limit that right, "that right must exist in the first place."

Lehman/Swedbank was upheld on appeal. *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.

In *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011) ("*Lehman/UBS*"), a New York bankruptcy court ruled that triangular setoff does not satisfy the Bankruptcy Code's mutuality requirement *and* that the 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 *SemCrude* and *Lehman/Swedbank*.

The latest salvo regarding triangular setoff in bankruptcy recently came from a Delaware bankruptcy court in *In re American Home Mortgage Holdings, Inc.*, No. 07-11047 (Bankr. D. Del. Nov. 8, 2013) ("*AHM*"). Prior to filing for bankruptcy, AHM Investment was a party to a swap agreement with Barclays Capital and a repurchase agreement with Barclays Bank. After the petition date, Barclays Capital set off monies owed to AHM Investment under the swap agreement against funds owed to Barclays Bank under the repurchase agreement. AHM Investment then sued Barclays Bank and Barclays Capital for breach of the swap agreement, turnover of property of the estate, violations of the automatic stay, and a declaratory judgment that the triangular setoff was improper.

Consistent with the rulings in *SemCrude*, *Lehman/Swedbank*, and *Lehman/UBS*, the court in *AHM* held that: (i) parties cannot contract around section 553's mutuality requirement; (ii) "the safe harbor provisions exceptions to the automatic stay embodied in sections 559–561 cannot be interpreted as implicitly removing the mutuality requirement for setoff"; and (iii) without moving for relief from the stay, the nondebtor counterparty to a swap or repurchase agreement cannot

exercise control over estate property by retaining funds in exercising alleged triangular-setoff rights.

Taken together, *SemCrude*, *Lehman/Swedbank*, *Lehman/UBS*, and *AHM* 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 alternatives to contractual triangular-setoff provisions, such as cross-collateralization under master netting agreements.