or a trade creditor with a customer that has filed for bankruptcy protection, one of the key goals is to minimize the creditor’s exposure and maximize its recovery from the debtor’s bankruptcy estate. Often, the creditor’s claim against the debtor is based on credit decisions made in the weeks and months prior to the bankruptcy filing. The creditor’s recovery will be determined by the debtor’s assets available for distribution, the total amount of claims against the debtor, and the other claims that have priority in right of payment over the creditor’s claim in the hierarchy of the federal bankruptcy distribution scheme.

A significant state law right to help a trade creditor reduce its exposure on its claim against a financially distressed customer is the creditor’s ability to “setoff” or “net out” the creditor’s claim owed by the debtor against the creditor’s obligations to the debtor. Setoff rights often exist where the trade creditor and the debtor each operate different lines of business and sell goods or provide services to each other. For example, ABC Company may have a line of business that manufactures telephones and buys electronic components for the telephones from XYZ Company. At any given moment, ABC may have outstanding indebtedness to XYZ for electronic components that ABC purchased from XYZ on credit. ABC also has a different line of business that designs and manufactures computer chips used in electronics, and sells these computer chips to XYZ to produce XYZ’s electronic components. Accordingly, at any time, XYZ may owe money to ABC on account of XYZ’s purchases of ABC’s computer chips.

The question of whether XYZ can setoff the $700 it owes to ABC against the $1,000 that ABC owes to XYZ will have significant implications on XYZ’s prospects for recovery in ABC’s bankruptcy case.

A creditor’s setoff rights simply mean that if ABC owes XYZ $1,000 and XYZ also owes ABC $700, then XYZ can net out, or setoff, the amounts owed so that ABC only need pay XYZ the net amount of $300 owed. XYZ’s setoff rights are easily understandable and efficient—they eliminate ABC having to pay XYZ $1,000 and then requiring XYZ to immediately pay $700 back to ABC.

This otherwise straightforward principle becomes extremely important when viewed in the context of a bankruptcy filing. Let’s assume that ABC files for
bankruptcy and is only able to pay its unsecured creditors, including XYZ, 10% of the face amount of their claims. Notwithstanding the bankruptcy filing, XYZ is still indebted to ABC for the $700. The question of whether XYZ can setoff the $700 it owes to ABC against the $1,000 that ABC owes XYZ. After application of the setoff, XYZ will be left with a net claim of $300 against ABC that will be paid at 10 cents on the dollar, so XYZ will receive $30 at the conclusion of ABC’s bankruptcy case.

If XYZ can exercise its setoff rights, it will not have to write a $700 check to ABC. Instead, the $700 will be credited, or setoff, against the $1,000 that ABC owes XYZ. After application of the setoff, XYZ will receive only $100 on account of its claim against ABC because ABC’s unsecured creditors will receive only 10% of their claims.

By comparison, XYZ suffers additional losses if it cannot exercise setoff rights, which demonstrates their importance to XYZ. XYZ will have to pay ABC the $700 owed on account of the computer chips it purchased from ABC. While XYZ will still have its claim against ABC for the full $1,000, XYZ will receive only $100 on account of its claim against ABC because ABC’s unsecured creditors will receive only 10% of their claims.

Now let us take this hypothetical one step further. Suppose XYZ had sold goods to ABC, but purchased goods from ABC’s affiliate. Does XYZ have the same setoff rights to apply its claim against ABC in reduction of XYZ’s obligations to ABC’s affiliate? This is known as triangular setoff. The problem with XYZ enforcing its triangular setoff rights is that one of the prerequisites for setoff, a mutuality of obligations between the parties to the setoff, is lacking between XYZ and ABC’s affiliate because the claim XYZ is seeking to setoff against its obligation to ABC’s affiliate is against ABC. The United States Bankruptcy Court for the Southern District of New York, overseeing the liquidation of Lehman Brothers Inc. (LBI), rejected a creditor’s exercise of triangular setoff rights, despite a provision in the contract between the parties that permitted triangular setoff, because of the absence of mutuality of obligations.

Requirements for Exercising Setoff Rights

The Bankruptcy Code does not provide an independent setoff right, but instead preserves substantive rights of setoff that already exist under applicable federal or state law. A creditor is granted setoff rights because it would clearly be unfair to force the creditor to pay the full amount of its indebtedness to a financially distressed debtor when the creditor faces the real risk of a delayed payment of only a fraction of its offsetting claim against the debtor.

However, the Bankruptcy Code subjects a creditor’s setoff rights to several requirements. Generally, the prerequisites for setoff are: (i) the debtor’s indebtedness to the creditor must have been incurred prior to the bankruptcy filing; (ii) the debtor’s claim against the creditor must also have been incurred prior to the bankruptcy filing; and (iii) the debtor’s claim against the creditor and the debt owed to the creditor must be mutual. Aside from certain specialized “safe harbor” transactions discussed below, a creditor attempting to exercise its setoff rights against a debtor must first seek and obtain bankruptcy court approval. The bankruptcy court decides whether to permit the exercise of setoff rights. Setoff will ordinarily be permitted, unless it is prohibited or limited by Section 553 of the Bankruptcy Code.

However, the Lehman Brothers court, following other court decisions, cast doubt on the enforceability in bankruptcy of “cross affiliate” netting provisions, or other setoff agreements to allow triangular setoff, because they do not satisfy the mutuality requirement for setoff found in the Bankruptcy Code.

Triangular Setoff

As part of many business structures, it is highly unlikely that a company would operate different lines of business within a single entity. For a variety of reasons, including risk mitigation, taxation, finance and regulatory requirements, businesses normally operate through a host of related subsidiaries and affiliates. The coordinated operations of a group of affiliates may provide economic benefits to a business enterprise; however, it creates significant legal issues with respect to a creditor’s ability to exercise setoff rights. As noted above, one of the prerequisites for setoff is that the debtor’s claim against the creditor and the debt owed to the creditor must be mutual. If ABC and XYZ operate, like many businesses do, through a group of affiliated entities, it is unlikely that the ABC affiliate that bought electronic components from an XYZ affiliate is the same legal entity that also sold computer chips to that XYZ affiliate. Similarly, the XYZ affiliate that owes money to an ABC affiliate for the computer chips is probably not the same entity that is owed money by an ABC affiliate for the electronic components.

There is a long history in corporate law of respecting the separate legal existence of each corporate entity, absent extraordinary circumstances, and against using the assets of one entity to pay the liabilities of an affiliate. Thus, if the ABC entity that owes a debt to an XYZ entity is not the same legal entity that is owed money by the same XYZ affiliate, then the debts are not mutual and the requirements for exercising setoff rights have not been satisfied.

Parties to contracts involving multiple affiliates are concerned about losing their setoff rights upon a bankruptcy filing because a court may rule that there is a lack of mutuality of the debts owed. To address this concern, triangular setoff provisions are routinely drafted into many commercial contracts. In essence, these provisions provide that, for purposes of setoff rights, all affiliated entities of one party to the contract
will be treated as a single entity, and all affiliated entities of the other party to the contract will be treated as a single entity. This is often referred to as a “cross-affiliate” netting provision. The parties to such contracts agree that the corporate separateness of their affiliates will be disregarded, for setoff purposes, and the debts and liabilities of all affiliates will be tallied up and netted. Whichever party is the net creditor will have the right to seek payment from the other party for the net amount due after application of the setoff. Through this legal construct, the parties agree that the debts of all affiliates of one party to the contract will be deemed to be mutual in nature for setoff purposes to the debts of all affiliates of the other party to the contract.

However, the Lehman Brothers court, following other court decisions, cast doubt on the enforceability in bankruptcy of “cross affiliate” netting provisions, or other setoff agreements to allow triangular setoff, because they do not satisfy the mutuality requirement for setoff found in the Bankruptcy Code.

The Lehman Brothers Case

On September 19, 2008, Lehman Brothers was ordered to be liquidated pursuant to the provisions of the Securities Investor Protection Act of 1970 (SIPA), which provides for the liquidation of U.S. regulated broker-dealers. With certain exceptions, the liquidation of an entity under SIPA is governed by many provisions of the Bankruptcy Code. The administration of the LBI estate is being overseen by the U.S. Bankruptcy Court for the Southern District of New York.

Prior to the commencement of the SIPA proceeding, LBI and UBS AG (UBS) entered into a swap agreement, and related documents, under which the parties each agreed to post collateral to secure their respective obligations in relation to foreign exchange transactions. The agreement provided, in relevant part, that:

“upon 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 proceeding, UBS delivered to LBI a notice of termination of the agreement. UBS asserted two grounds for terminating the agreement: (i) a cross-default traceable to swap agreements between UBS and certain LBI affiliates; and (ii) the downgrading of LBI’s credit rating to a level below BBB-. The termination notice set September 16, 2008 as the early termination date under the agreement. As of this date, UBS was holding cash collateral in the amount of approximately $170 million to secure LBI’s obligations.

Following delivery of the termination notice, the court entered an order commencing the SIPA proceeding and authorizing the trustee appointed to oversee the liquidation of LBI’s estate to take immediate possession of LBI’s property. The order also 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 provided LBI a calculation notice of the amounts owing from LBI to UBS. In the calculation notice, UBS asserted a right of setoff under the agreement for certain amounts payable by LBI to UBS. The trustee did not challenge this asserted setoff right because of the mutuality of obligations between LBI and UBS. However, the calculation notice also asserted a setoff right under the agreement for amounts due from LBI to two affiliates of UBS (UBS Securities), which were not parties to the agreement. The trustee disputed the right of UBS to setoff its obligations to LBI with obligations that LBI owed to UBS Securities. After allowing for the undisputed setoff amounts, and UBS’s agreement to return some of the cash collateral in dispute to the trustee, approximately $21.3 million in cash collateral remained that UBS refused to return based upon its alleged setoff right.

The trustee filed a motion with the bankruptcy court to compel UBS to turnover the remaining cash collateral to LBI. UBS objected to the motion and continued to withhold the collateral because UBS claimed it was entitled to setoff the cash against the debt owed by LBI to UBS Securities. Although UBS Securities was not a party to the agreement, UBS relied on the above-quoted provision of the agreement that permitted the cross-affiliate netting and setoff of claims.

In the alternative, UBS argued that even if the triangular setoff provision in the agreement did not establish the mutuality required under the Bankruptcy Code to allow for the exercise of setoff rights, the setoff should nonetheless be permitted because the agreement was protected by the Safe Harbor provisions of Bankruptcy Code. The Safe Harbor provisions generally permit the exercise of a contractual right of setoff in connection with certain transactions that Congress had concluded require special protection, such as swap agreements, repurchase agreements, forward contracts and commodity contracts, notwithstanding the operation of any other provision of the Bankruptcy Code that could stay, avoid or otherwise limit that setoff right.

In its October 2011 decision, the Lehman Brothers bankruptcy court held that generally parties can agree to whatever they choose in a contract, so long as it is not contrary to law or public policy. Parties can create contractual setoff rights that differ from those provided by common law or statute. The court further held that, outside of the bankruptcy context, the triangular setoff provision agreed to between UBS and LBI is valid and enforceable. However, the court went on to explain that Section 553 of the Bankruptcy Code preserves whatever right of setoff otherwise exists and provides additional limitations. Section 553(a) provides, in relevant part, that:
The court concluded that although the Bankruptcy Code does not define mutuality, other courts have held that debts are mutual only when they are “in the same right and between the same parties, standing in the same capacity.” Based upon the mutuality requirement in Section 553, the court rejected UBS’s argument that the triangular setoff provision in the agreement provided the mutuality required by the Bankruptcy Code. The court ruled that while the contractual provision may give rise to enforceable setoff rights outside of bankruptcy, the debts owed by LBI to UBS Securities and owed by UBS to LBI did not become “mutual” by virtue of the agreement and, under Section 553, UBS could not enforce its setoff right within the bankruptcy context.

In reaching its holding, the Lehman Brothers court relied on the 2009 decision by the U.S. Bankruptcy Court for the District of Delaware in In re SemCrude, L.P. The SemCrude court similarly found that a triangular setoff provision in a contract cannot create the mutuality of debts that is required for purposes of Section 553 and, accordingly, there is no so-called “contract exception” to Section 553’s mutuality requirement. The SemCrude court conducted an in-depth analysis of a line of court opinions that were cited to support the assertion that a contract exception to the mutuality requirement exists. However, the SemCrude court concluded that, upon a close inspection of the cited decisions, none of the cases actually held there was such an exception to the mutuality requirement. Instead, each opinion only recognized such an exception in the course of denying the requested setoff, or finding that the debts were mutual, independent of the contract between the parties. The decision of the SemCrude bankruptcy court was affirmed on appeal by the U.S. District Court for the District of Delaware.

The Lehman Brothers court also rejected UBS’s argument that the Safe Harbor provisions of the Bankruptcy Code permit the proposed triangular setoff, notwithstanding the lack of mutuality under Section 553. The court ruled that although the Safe Harbor provisions allow a party to a swap agreement to exercise a right of setoff, notwithstanding any other provisions of the Bankruptcy Code that could stay, avoid or otherwise limit that right, the setoff right must exist in the first instance. The court found no right of setoff because of an absence of the mutuality required by Section 553 and ruled that the Safe Harbor provisions cannot protect a right of setoff that does not exist. For these reasons, the court directed UBS to immediately return the remaining cash collateral to the trustee.

Conclusion
The decisions of the Lehman Brothers and SemCrude courts, that contractual triangular setoff provisions are not enforceable against debtors under the Bankruptcy Code, mean that two of the most popular venues for commercial bankruptcy filings—the Southern District of New York and the District of Delaware—have published opinions that threaten the ability of a creditor to exercise its setoff rights pursuant to the express terms of its contract. In light of these decisions, this may be an appropriate time for parties with contracts containing triangular setoff provisions to consider other avenues for protecting setoff and similar rights in the event a customer files for bankruptcy.

1. The SemCrude court did not consider what impact, if any, the Safe Harbor provisions had upon the rights of parties to triangular setoff agreements. Since arguments concerning the Safe Harbor provisions were first raised on a motion for reconsideration, the court declined to hear them on procedural grounds.

Bruce Nathan, Esq. is a partner in the New York City office of the law firm of Lowenstein Sandler PC. He is a member of NACM and is on the Board of Directors of the American Bankruptcy Institute and is a former co-chair of ABI’s Unsecured Trade Creditors Committee. He can be reached via email at bnathan@lowenstein.com.

Scott Cargill is Of Counsel to Lowenstein Sandler’s Roseland, New Jersey office. He is a member of NACM and ABI and can be reached at scargill@lowenstein.com.

*This is reprinted from Business Credit magazine, a publication of the National Association of Credit Management. This article may not be forwarded electronically or reproduced in any way without written permission from the Editor of Business Credit magazine.