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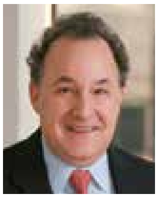
Triangular Setoff Rights Again Don't Pass Muster in Bankruptcy



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A trade creditor whose financially distressed customer has filed for bankruptcy is frequently looking for ways to maximize recovery on its claim. Setoff is one such risk mitigation tool that allows a creditor to net out its claim against its customer on a dollar-for-dollar basis to reduce the creditor's indebtedness to that customer.

Triangular setoff expands setoff rights by contract to permit affiliated entities to setoff the obligation of one of the affiliates to a debtor to reduce the debtor's indebtedness owing to another affiliate. Unfortunately for the creditor, triangular setoff rights are not necessarily enforceable in bankruptcy, despite being enforceable under state law.

In *In re Orexigen Therapeutics, Inc.*, the United States Bankruptcy Court for the District of Delaware recently refused to enforce a triangular setoff agreement among parent company McKesson Company ("McKesson"), McKesson's wholly owned subsidiary, McKesson Patient Relationship Solutions ("MPRS") and the Debtor, Orexigen Therapeutics, Inc. (the "Debtor"). The agreement permitted McKesson to setoff or net out its obligations to the Debtor against MPRS' claim against the Debtor. While the agreement permitting triangular setoff was enforceable under state law, the court refused to enforce McKesson's triangular setoff rights in the Debtor's bankruptcy case. The court relied on the absence of a mutuality of obligations that the Bankruptcy Code requires as a condition to a creditor's exercise of its setoff rights and rejected McKesson's attempt to contract around the mutuality requirement through its triangular setoff agreement.

Bankruptcy Requirements for Exercising Setoff Rights

Section 553(a) of the Bankruptcy Code preserves a creditor's setoff rights arising under state or other applicable non-bankruptcy law. A creditor's setoff rights are akin to a secured claim. Setoff rights enable a creditor to recover on its claim against a financially distressed customer, by reducing its claim against the debtor dollar for dollar by the amount the creditor owes the debtor. That avoids the absurd and unfair result of forcing a creditor to pay 100% of its indebtedness to a debtor and then permitting the debtor to avoid payment of the creditor's claim or paying only a fraction of the claim.

Triangular setoff rights are not necessarily enforceable in bankruptcy, despite being enforceable under state law.

However, Bankruptcy Code Section 553(a) contains certain prerequisites that a creditor must satisfy prior to enforcing its setoff rights. A creditor's setoff rights are conditioned on the creditor proving that: (i) the debtor's indebtedness to the creditor was incurred prior to the bankruptcy filing; (ii) the debtor's claim against the creditor also was incurred prior to the bankruptcy; and (iii) the debtor's claim against the creditor and the debt owed to the creditor were mutual. Aside from certain specialized "safe harbor" transactions, a creditor attempting to exercise its setoff rights against a debtor must also first obtain bankruptcy court approval for relief from the automatic stay that would otherwise bar the creditor from enforcing its setoff rights.

Triangular Setoff

Many businesses operate through a group of affiliated entities where several different legal entities conduct business with another company and the company's affiliates. Corporate law provides a long history of respecting the separate legal existence of each corporate entity and, absent extraordinary circumstances, bars the use of the assets of one affiliate to pay the liabilities of another affiliate. Thus, if one affiliated entity that owes a debt to a financially distressed company is not the same legal entity that is owed money by the same distressed company, then the debts are not mutual and the creditor cannot satisfy Section 553(a)'s mutuality requirement for exercising setoff rights.

Parties to contracts involving multiple affiliated entities have sought to create setoff rights by incorporating triangular setoff provisions in their agreements. These provisions, often referred to as "cross-affiliate" netting provisions, treat all affiliated entities of one party to the contract as a single entity, and all affiliated entities of the other contract party as a single entity in an attempt to create the necessary mutuality to allow for the enforcement of their setoff rights. The parties to such contracts agree to disregard the corporate separateness of their affiliates, and tally up and net out the debts and liabilities of all affiliates. Whichever party is the net creditor will have the right to seek payment from the other party of the amount due after application of the setoff. Through this legal construct, the parties agree that, for purposes of setoff, the debts of all affiliates of one party to the contract will be deemed to be mutual in nature to the debts of all affiliates of the other contract party.

While these triangular setoff agreements are enforceable under state law, several bankruptcy and United States district courts have cast doubt on their enforceability in a bankruptcy case involving one or more of the parties to the agreement. These courts have refused to enforce a creditor's "triangular setoff" rights in bankruptcy cases because these cross-affiliate netting or "triangular setoff" agreements do not satisfy Section 553(a)'s mutuality requirement for setoff. That is precisely what happened in the *Orexigen Therapeutics* case where the Delaware bankruptcy court had refused to enforce a triangular setoff sought by McKesson and MPRS.

The Facts of the Orexigen Therapeutics Case

The Debtor was a biopharmaceutical company that manufactured Contrave®, a drug that treats obesity. The debtor had entered into two agreements with McKesson and its wholly owned subsidiary MPRS.

On June 9, 2016, the Debtor entered into a Distribution Agreement with McKesson. McKesson had agreed to purchase and distribute Contrave® to various pharmacies in the United States. The Distribution Agreement, which was governed by California law, granted triangular setoff rights as follows.

> "Notwithstanding anything to the contrary in this Agreement, each of McKesson Corporation and its affiliates is hereby authorized to setoff, recoup and apply any amounts owed by it to … [the Debtor's] affiliates against … all … amounts owed by [the Debtor] or its affiliates to any of McKesson Corporation or its affiliates, without prior written notice[.]"

On July 15, 2016, the Debtor entered into a Master Services Agreement with MPRS. According to the Master Services Agreement, MPRS had agreed to manage the Debtor's LoyaltyScript® program. The LoyaltyScript® program allowed patients to receive price discounts on their purchases of Contrave® from pharmacies. MPRS agreed to pay the pharmacies and patients for the Contrave® price discounts and other services under the LoyaltyScript® program. The Debtor was then obligated to reimburse MPRS for all such payments.

On March 12, 2018, (the "Petition Date"), the Debtor filed its Chapter 11 case with the United States Bankruptcy Court in Delaware. On the Petition Date, McKesson owed $6,932,816.40 to the Debtor under the Distribution Agreement. The Debtor, in turn, owed approximately $9.1 million to MPRS under the Master Services Agreement.

Subsequent to the Petition Date, pursuant to a number of court-approved stipulations, McKesson paid the sum of $6,932,816.40 owed to the Debtor under the Distribution Agreement on the Petition Date, which the Debtor had agreed to segregate (the "Disputed Funds") subject to a preservation of McKesson's setoff rights with respect to MPRS' claim against the Debtor, and the Debtor's right to contest McKesson's setoff rights. McKesson and MPRS then moved in the bankruptcy court for an order permitting McKesson to invoke its triangular setoff rights to direct the Debtor's payment of the Disputed Funds to MPRS, toward payment of the Debtor's indebtedness of approximately $9.1 million to MPRS under the Master Services Agreement, as a credit against McKesson's indebtedness of $6,932,816.40 owed to the Debtor under the Distribution Agreement. McKesson and MPRS argued that McKesson was granted triangular setoff rights under the Distribution Agreement that were enforceable under California law. That created sufficient mutuality to allow McKesson to apply its outstanding indebtedness to the Debtor on the Petition Date against MPRS's claim against the Debtor also owing on the Petition Date.

The Debtor and a group of noteholders opposed McKesson's assertion of triangular setoff rights. They argued McKesson's indebtedness to the Debtor and the Debtor's indebtedness to MPRS were not mutual debts and McKesson, therefore, did not satisfy the strict mutuality requirement for a bankruptcy setoff arising under Section 553(a) of the Bankruptcy Code. The Debtor and the noteholders also argued that an agreement granting triangular setoff rights does not create the requisite mutuality for enforceable setoff rights in the Debtor's bankruptcy case because multiple affiliated entities on both sides of a transaction cannot contract around Section 553(a)'s mutuality requirement.

The Bankruptcy Court's Decision

The bankruptcy court denied McKesson's triangular setoff and barred McKesson from crediting the amount it owed and paid the Debtor and compelling the Debtor to pay the Disputed Funds to MPRS to reduce MPRS' claim against the

Affiliated entities seeking to obtain setoff rights should consider obtaining affiliate guarantees where the debtor's indebtedness to one affiliate would be guaranteed by another affiliate that, in turn, is indebted to the Debtor.

Debtor. The court held that McKesson did not satisfy Section 553(a)'s strict mutuality requirement for setoff in bankruptcy. Section 553(a) only permits a creditor in a bankruptcy case to offset a "mutual debt" that is due to and from the same persons in the same capacity.

The bankruptcy court concluded that McKesson and the Debtor did not have a mutual debt that satisfied Section 553(a) of the Bankruptcy Code. On the Petition Date, McKesson owed the Debtor $6,932,816.40, while the Debtor owed McKesson's subsidiary, MPRS, approximately $9.1 million. As such, the court noted that the debts subject to setoff were not mutual because they were not due to and from the same persons.

The bankruptcy court relied on a 2009 decision by the Delaware bankruptcy court in *In re SemCrude, L.P.* that was affirmed by the United States district court in Delaware in 2010. Both the bankruptcy and district court in *SemCrude* held that a triangular setoff provision in a contract cannot create a mutuality of debts that is required to satisfy Section 553(a) because there is no multi-party "contract exception" to Section 553's strict mutuality requirement.

The bankruptcy court also rejected McKesson's argument that California law, which governs the Distribution Agreement, granted McKesson the requisite mutuality of debts to allow a setoff of its obligation to the Debtor against MPRS's indebtedness to the Debtor. Section 553(a) unambiguously requires that a "mutual debt" must be owing by the creditor to the debtor prior to the commencement of the bankruptcy case which can only be applied against that creditor's pre-petition claim against the debtor. There is no multi-party contractual exception to Section 553's mutuality requirement that would allow a creditor to exercise triangular setoff rights.

The bankruptcy court also found that McKesson could not exercise a triangular setoff because McKesson and MPRS were legally distinct entities. As such, there was no mutuality of debt required by Bankruptcy Code Section 553(a).

The court also concluded that Section 553(a)'s mutuality requirement is consistent with the fundamental bankruptcy policy of insuring that similarly situated creditors are treated the same in bankruptcy. The court refused to grant McKesson a greater distribution, based on McKesson's triangular setoff rights, than other creditors of the Debtor with the same priority status would have received. Any contrary holding that would have allowed McKesson to contract around Section 553(a)'s mutuality requirement risked diluting the Debtor's bankruptcy estate to the detriment of all other creditors.

Section 553(a) only permits a creditor in a bankruptcy case to offset a "mutual debt" that is due to and from the same persons in the same capacity.

The court also rejected McKesson's argument that the third-party beneficiary doctrine arising under contract law provided McKesson with the requisite mutuality to allow its triangular setoff. McKesson had argued that MPRS was a third-party beneficiary of the Distribution Agreement that created a mutuality of debts because MPRS was a counterparty with the Debtor on both the Distribution Agreement and Master Services Agreement. The court rejected McKesson's third-party beneficiary argument as an improper attempt at circumventing Section 553(a)'s mutuality requirement.

Conclusion

This is not the end of the story. McKesson and MPRS have appealed the *Orexigen Therapeutics* court's denial of McKesson's enforcement of its triangular setoff rights.

Nevertheless, the *Orexigen Therapeutics* decision is a reminder that triangular setoff provisions might not be enforceable against debtors in bankruptcy, despite their enforceability under state law. Entities dealing with a financially distressed customer should consider other ways of protecting their setoff rights in light of the *Orexigen Therapeutics* holding, and the court holdings in the District of Delaware and Southern District of New York, that have denied the enforceability of triangular setoff agreements where one of the parties filed bankruptcy. Affiliated entities seeking to obtain setoff rights should consider obtaining affiliate guarantees where the debtor's indebtedness to one affiliate would be guaranteed by another affiliate that, in turn, is indebted to the Debtor. These affiliate cross-guarantees could create the requisite mutuality to allow setoff where one or more of the parties is a debtor in a bankruptcy case.