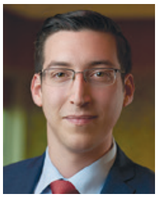
Delaware District Court Affirms Bankruptcy Court's Rejection of Triangular Setoff as Impermissible in Bankruptcy

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Trade creditors are constantly seeking to mitigate risk in the event that a financially distressed customer files for bankruptcy. One way a creditor can do so is by setting off its claim against the customer, dollar-for-dollar, against any indebtedness owed by the creditor to the customer.

State and bankruptcy law each condition a creditor's exercise of "setoff" rights upon the existence of mutual obligations owing between the creditor and debtor. Creditors have sought to satisfy this mutuality requirement by negotiating "triangular" setoff arrangements where their contracts permit affiliated entities to setoff the claims of one of the affiliates against indebtedness owed by another affiliate to the debtor.

However, triangular setoffs that are enforceable under state law are not necessarily enforceable where one or more of the contracting parties are involved in a bankruptcy case. For example, in *In re Orexigen Therapeutics, Inc.*, the United District Court for the District of Delaware recently affirmed the bankruptcy court's refusal to enforce a triangular setoff agreement among parent company, McKesson Company ("McKesson"), McKesson's wholly owned subsidiary, McKesson Specialty Arizona, Inc. d/b/a McKesson Patient Relationship Solutions ("MPRS"), and the Debtor, Orexigen Therapeutics, Inc. (the "Debtor"). Both the bankruptcy and district courts ruled that, notwithstanding the enforceability of the contractual right of triangular setoff under California law, the parties could not contract around the mutuality requirement contained in section 553(a) of the Bankruptcy Code. Their view, which is consistent with prior decisions in Delaware and other districts, is that the mutuality requirement set forth in section 553(a) of the Bankruptcy Code cannot be satisfied by crediting a debt owed by a debtor to one affiliate against a debt owed to the debtor by another affiliate, regardless of what is permissible under the parties' contract or applicable state law.

The Third Circuit Court of Appeals (the "Third Circuit") will now have the opportunity to weigh in on this issue, as McKesson and MPRS have appealed the *Orexigen Therapeutics* decision to the Third Circuit. Stay tuned!

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 obtain payment of its claim against a financially distressed customer by reducing the claim dollar-for-dollar by the amount the creditor owes the debtor. This avoids the unfair and patently absurd result of forcing a creditor to pay 100% of its indebtedness to a debtor and then permitting the debtor to pay only a fraction or no portion of the creditor's claim.

However, section 553(a) has certain prerequisites that a creditor must satisfy prior to enforcing its setoff rights. A creditor seeking setoff under section 553(a) must prove 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. Well settled corporate law respects the separate legal existence of each corporate entity and, absent an agreement or extraordinary circumstances, bars the use of the assets of one affiliate to pay the liabilities of another affiliate. Thus, a creditor cannot satisfy section 553(a)'s mutuality requirement for exercising setoff rights where the affiliated entity that owes a debt to the bankrupt company is not the same legal entity that is owed money by the same bankrupt company.

Parties to contracts involving multiple affiliated entities have sought to create broader setoff rights by including triangular setoff provisions in their agreements. These provisions—often referred to as "cross-affiliate" netting provisions—allow each party to the contract to treat itself and all of its affiliated entities as a single entity in an attempt to create the necessary mutuality to allow for the enforcement of their respective setoff rights. In other words, the parties to such contracts agree to disregard the corporate separateness of their affiliates so that they can combine and then 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 for the amount due after application of the triangular 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 federal courts have cast doubt on the enforceability of these agreements 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. The *Orexigen Therapeutics* case was no different, where the Delaware district court had affirmed the bankruptcy court's refusal to enforce a triangular setoff agreement among the Debtor, one of the Debtor's creditors and the creditor's parent that was indebted to the Debtor.

The Facts of *Orexigen Therapeutics*

The Debtor, a biopharmaceutical company that produced an obesity-combating drug called Contrave®, filed a Chapter 11 bankruptcy case in the United States Bankruptcy Court for the District of Delaware. As of the date of the bankruptcy filing, McKesson owed approximately $6.9 million to the Debtor under a "Distribution Agreement," and the Debtor owed approximately $9.1 million to McKesson's wholly-owned subsidiary, MPRS, under a separate "Master Services Agreement."

The Debtor and McKesson had entered into the Distribution Agreement on June 9, 2016, pursuant to which McKesson agreed to purchase and distribute Contrave®. Critically, the Distribution Agreement—which was governed by California law—permitted the parties to setoff debts owed by the Debtor and its affiliates against debts owed by McKesson and its affiliates. These triangular setoff rights were set forth in the contract as follows:

> "Notwithstanding anything to the contrary in this Agreement, each of McKesson Corporation and its affiliates is hereby authorized to set-off, 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[.]"

The Debtor and MPRS entered into the Master Services Agreement on July 15, 2016, pursuant to which MPRS agreed to manage the Debtor's loyalty program. Under the Master Services Agreement, MPRS would pay retail pharmacies and patients for product price discounts and other services under the loyalty program and, in turn, the Debtor would reimburse MPRS. The Master Services Agreement did not incorporate or relate to the Distribution Agreement; the two contracts were wholly distinct from one another.

During the Debtor's bankruptcy case, the bankruptcy court approved two stipulations pursuant to which McKesson had first paid its indebtedness of approximately $6.9 million to the Debtor, subject to the Debtor's agreement to segregate this sum. McKesson then moved for relief from the automatic stay to permit the setoff of the sum of $6.9 million (McKesson's indebtedness to the Debtor) to reduce the Debtor's indebtedness of approximately $9.1 million to McKesson's subsidiary, MPRS, all in accordance with the Distribution Agreement.

The Debtor and a group of noteholders each filed objections to the motion, arguing that the Bankruptcy Code's mutuality requirement for exercising setoff rights could not be abrogated or satisfied by the parties' contract. They argued that McKesson's indebtedness to the Debtor and the Debtor's indebtedness to MPRS were not mutual debts and, as such, McKesson could not satisfy the strict mutuality requirement set forth in section 553(a) of the Bankruptcy Code.

The Bankruptcy Court's Decision

The bankruptcy court denied McKesson's motion, holding that McKesson could not setoff the amount it owed and paid to the Debtor based on the amounts the Debtor owed to McKesson's subsidiary, MPRS. The bankruptcy court concluded that, despite the cross-affiliate netting provision in the Distribution Agreement, McKesson and the Debtor did not have a mutual debt that satisfied section 553(a) of the Bankruptcy Code. McKesson could not rely on the Debtor's approximately $9.1 million indebtedness owed to MPRS for purposes of satisfying the Bankruptcy Code's mutuality requirement. As the bankruptcy court noted, "mutuality [for purposes of section 553(a)] is strictly construed against the party seeking setoff," and "state and federal courts have found . . . that debts are 'mutual' only when they are due to and from the same persons in the same capacity." Regardless of the terms of the Distribution Agreement, McKesson and MPRS are not "the same persons in the same capacity."

The bankruptcy court relied on a 2009 decision by the Delaware bankruptcy court, *In re SemCrude, L.P.* (which was also affirmed by the Delaware district court), in noting that "courts have routinely held that triangular setoffs are impermissible in bankruptcy." As the *SemCrude* court held, "the mutuality requirement by section 553 cannot be satisfied by a multi-party agreement contemplating a triangular setoff." Thus, the bankruptcy court concluded that McKesson could not exercise a triangular setoff because McKesson and MPRS were legally distinct entities, and therefore there was no mutuality of debt as required by section 553(a) of the Bankruptcy Code.

The bankruptcy court rejected McKesson's argument that, pursuant to United States Supreme Court precedent, courts should not analyze state law-created interests differently simply because an interested party is in bankruptcy, unless some federal interest requires a different result. McKesson argued that the bankruptcy court's inquiry "must begin and end with state law"—that California law created a contractual right to triangular setoff that must be respected in bankruptcy, and the "federal interest" exception is inapplicable. The bankruptcy court disagreed, concluding that the cases McKesson relied upon were inapposite. The bankruptcy court noted that the primary case McKesson relied upon, a California Supreme Court decision involving reinsurance debts, ultimately defined mutuality consistently with the bankruptcy court's interpretation, that "such debts must exist between the same persons or entities in order to establish mutuality of identities," and could not be "distort[ed] . . . as legalizing a contractual exception to mutuality in bankruptcy."

Further, the bankruptcy court observed that Congress recognized a federal interest in enacting section 553(a), and where the statute's language is plain, the court's sole function is to enforce the language according to its plain terms. The bankruptcy court noted that there is no "multi-party contractual exception" to the Bankruptcy Code's mutuality requirement. Section 553(a)'s unambiguous requirement that a "mutual debt" must be "owing by such creditor to the debtor . . . against a claim of such creditor against the debtor" aligns with the fundamental bankruptcy policy of ensuring similarly situated creditors receive an equal distribution from the debtor's estate. Allowing parties to contract around section 553(a)'s mutuality requirement would permit a creditor to receive a greater distribution than other similarly situated creditors.

Finally, McKesson argued that it had the requisite mutuality to allow its triangular setoff pursuant to the "third-party beneficiary" doctrine—*i.e.*, that MPRS's status as a third-party beneficiary of the Distribution Agreement created the requisite mutuality for effectuating setoff pursuant to section 553(a). The court rejected this argument as an improper attempt to circumvent the Bankruptcy Code.

McKesson and MPRS appealed the bankruptcy court's decision to the United States District Court for the District of Delaware. McKesson and MPRS argued that neither section 553(a) nor any other provision of the Bankruptcy Code adversely affect the enforceability of a creditor's state law setoff rights in a debtor's bankruptcy case. Pursuant to the Distribution Agreement, McKesson and MPRS were permitted to be treated as a single counterparty to enable them to setoff MPRS's claim against the Debtor to reduce McKesson's indebtedness to the Debtor, all of which arose out of a fully integrated product distribution and customer loyalty program. Therefore, the appellants argued the Distribution Agreement created sufficient mutuality of obligations to result in enforceable triangular setoff rights under both California and bankruptcy law.

The Debtor argued that the bankruptcy court had correctly ruled that McKesson's indebtedness to the Debtor and the Debtor's indebtedness to MPRS were not mutual debts under section 553(a) because section 553(a) conditions mutual obligations as owing between the same persons in the same capacity. This is the consensus view of prior court precedent that rejects the enforceability of triangular setoff rights in bankruptcy cases.

The District Court's Decision

The district court affirmed the bankruptcy court's holding prohibiting triangular setoff based on the lack of a contractual exception to section 553(a)'s mutuality requirement for the exercise of setoff rights in bankruptcy cases. The district court relied on "the large number of court decisions" (including *SemCrude* and courts in other jurisdictions, including the Southern District of New York) that have upheld the bankruptcy court's interpretation of section 553(a)'s mutuality requirement. These courts, like the *Orexigen Therapeutics* court, held that debts are mutual only where they are due to and from the same persons in the same capacity. That would permit a creditor to offset its indebtedness to a debtor against that same creditor's (and not an affiliate's) claim against the debtor.

The district court held that the bankruptcy court "thoroughly analyzed the law governing mutuality under [section] 553(a) and . . .

correctly concluded that neither a contract nor California law supplied McKesson the mutuality required by [section] 553(a)." The district court found the bankruptcy court's decision to be consistent with general bankruptcy principles concerning the strict construction of mutuality and the primary goal of the Bankruptcy Code to ensure equal treatment among similarly situated creditors.

Conclusion

The *Orexigen Therapeutics* decision, as supported by prior rulings in Delaware (*e.g., SemCrude*) and other districts, reaffirms the consensus view that triangular setoff provisions that are enforceable under state law are not necessarily enforceable against a debtor in bankruptcy. The Third Circuit will now have the opportunity to weigh in on this consensus view because McKesson and MPRS have appealed the *Orexigen Therapeutics* decision. That said, even if the Third Circuit ultimately reverses the *Orexigen Therapeutics* decision, the Third Circuit's opinion will only be binding on the federal courts in the districts of Delaware, New Jersey, Pennsylvania and the Virgin Islands.

Therefore, trade creditors seeking to mitigate the risk of dealing with financially distressed customers should not rely on triangular setoff provisions to protect them in the event a customer files for bankruptcy protection. One alternative is to obtain affiliate cross-corporate guarantees under which a debtor's indebtedness to one affiliate would be guaranteed by another affiliate that is indebted to the Debtor. That way, the affiliate-guarantor may be able to establish the requisite mutuality to allow setoff under section 553 of the Bankruptcy Code.