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Expert Analysis

Triangular Setoffs May Be Unenforceable in Bankruptcy

A recent bankruptcy decision in the District of Delaware presents serious implications for counterparties to derivative transactions in bankruptcy. Derivatives contracts, especially ones documented on the International Swaps and Derivative Association Inc. forms, often provide that setoff of debts and claims, or netting, is to occur between the counterparties and their affiliates, essentially treating an entity and its affiliates as one entity for setoff purposes.

In *In re SemCrude, L.P.*,[1] the Delaware bankruptcy court held that private agreements cannot confer mutuality on non-mutual debts to satisfy the "mutual debt" requirement in §553 of the Bankruptcy Code for setoff in bankruptcy. The court also held that no contractual exception to the mutuality requirement exists.[2] As a result, provisions in derivatives as well as other contracts that allow setoff between not only the principal parties, but also their affiliates, may not be enforceable in bankruptcy proceedings.

Setoff "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[3] Debts are considered mutual when "they are due to and from the same persons in the same capacity."[4] Section 553 of Bankruptcy Code governs setoff in bankruptcy. Section 553 does not create a new right of setoff in bankruptcy, but rather merely preserves the setoff rights a creditor has under applicable nonbankruptcy law.[5]

Courts interpreting §553 have made it clear that the Bankruptcy Code creates no independent right of setoff in bankruptcy; rather, it preserves the setoff rules under state law applicable to the contract.[6] Therefore, bankruptcy courts must look to state law to determine whether a setoff right exists.[7] In addition, although generally the application of setoff is subject to the automatic stay, the exercise of a setoff right with respect to certain derivative contracts is exempt from the stay.[8]

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New York law provides for both a statutory and a common law right of setoff. Section 151 of New York's Debtor and Creditor Law requires mutuality since it allows a debtor "to set off and apply against any indebtedness…of such creditor to such debtor, any amount owing from such debtor to such creditor."[9] There is also "no question that New York has long recognized a common law right of setoff."[10]

New York law recognizes that parties may modify setoff rights by agreement.[11] Two New York cases strongly suggest that a triangular setoff, i.e., an agreement to treat affiliated entities as one party for setoff purposes, is enforceable under New York law.[12] The U.S. Court of Appeals for the Second Circuit, in a related context, held that in addressing mutuality, New York law focuses on all of the facts and circumstances including the intent of the parties.[13] Other federal and state courts upheld triangular setoffs in cases of affiliated entities or persons where a written agreement provided for such setoff, including in the context of receiverships.[14]

The general rule is that triangular setoffs, "[where] A attempts to offset an obligation owed [to] B against B's debt to C," are not permitted under §553 because they fail the mutuality requirement.[15] Following this rule, "one subsidiary may not set off a debt owed to a bankrupt against a debt owing from the bankrupt to another subsidiary."[16] Numerous cases suggest, however, that an explicit agreement providing for triangular setoff among related entities could satisfy the mutuality requirement.

For example, in *In re Berger Steel Co.*,[17] the subsidiary corporation attempted to setoff its debts to a bankrupt third party against the debt owed by the bankrupt to the subsidiary's parent. The Seventh Circuit held that the setoff was not allowed absent an agreement.

Similarly, in *In re Hill Petroleum Co.*,[18] two entities under common control attempted to setoff debts to a bankrupt third party. The court noted that the exception to the general rule against triangular setoffs would apply in the situation if a formal agreement existed between the parties, but the court found that no such formal agreement existed.

In *Bloor v. Shapiro*, a New York bankruptcy court allowed a principal-guarantor to assert via setoff counterclaims on account of its subsidiary companies although the guarantor was not a party to the underlying agreement.[19]

'SemCrude'

In the recent *SemCrude* decision, the court held that a contractual triangular setoff between affiliated companies could not satisfy the mutuality requirement of §553 as a matter of Federal bankruptcy law.[20]

In *SemCrude*, the debtors were jointly administered direct and indirect subsidiaries that had energy contracts with a third party.[21] Each subsidiary had a separate contract with the third party, but the contracts contained identical netting provisions, providing that in the event any party fails to make a timely payment for, or delivery of goods, the other party may offset any deliveries or payments due under any agreement between the parties and their affiliates.

The parties agreed that all three debtors are affiliates of each other. The third party creditor was owed over $13 million by two of the debtor-subsidiaries, and was indebted to the third debtor-subsidiary by about $1.5 million. The creditor sought to offset its debt to the one debtor-subsidiary by the $13 million owed to it by the other two. The court held that the creditor could not effect such a setoff because §553 of the Bankruptcy Code prohibits triangular setoffs as a matter of law due to the lack of mutuality.

First, the court analyzed whether private agreements can confer mutuality on non-mutual debts. The court used the definition of "mutual debts" adopted by the "overwhelming majority of courts," which is that the debts are due to and from the same persons in the same capacity. The court also pointed out that "[i]t is widely accepted

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that 'mutuality is strictly construed against the party seeking setoff.'"[22]

Applying the narrowly-construed definition of mutuality, the court concluded that mutuality could not be supplied by an agreement, because unlike a guarantee of debt, an agreement to setoff does not create an indebtedness.

The court emphasized that the individual debtor-subsidiaries had no obligation whatsoever to actually pay anything to the creditor on the basis of the setoff agreement. Therefore, the debtor to whom the third party owed money had no debt to repay the third-party. The only debt owed to the third party was that of the one debtor-subsidiary. The court stated that "[r]egardless of whatever contractual right to setoff these debts against each other might have under state law, the fact remains that [the creditor] only owes a debt to one debtor, [and that particular debtor] owes nothing to [the creditor]." Therefore, the court found no mutuality to exist.

Second, the court analyzed whether there is a contract exception to the mutuality requirement in bankruptcy. The court emphasized the rule of statutory interpretation that where the language of the statute is plain, courts must enforce the statute according to its terms. The court found nothing in the Bankruptcy Code suggesting the existence of a contractual exception to the mutual debt requirement. As a result, the court found it improper to enlarge the right of setoff beyond the text of the Bankruptcy Code.[23]

The *SemCrude* court did not ignore the long list of cases suggesting and in some instances enforcing triangular setoffs. Nevertheless, the court observed that none of the cases actually enforced triangular setoffs in bankruptcy, that each of the decisions simply recognized the contract exception in the course of denying setoff or finding mutuality on other grounds and that the courts recognizing the exception have done so in dicta.

The *SemCrude* court found support for its ruling in two principles: First, that allowing triangular setoffs would run counter to the weight of authority against enlarging the right of setoff.[24] Second, the *SemCrude* court held that the broader policies of the Bankruptcy Code requiring that similarly situated creditors be treated fairly, counsels against allowing parties to contract around the mutuality principle. Both principles appear contrary to the law at least in the Second Circuit, which held that setoff rights are entitled to a favored position even in bankruptcy and that compelling circumstances are required for a court to disregard state law setoff rights.[25]

A careful reading of the *SemCrude* opinion and some of the cases it cites to, reveals a potential split among the courts as to the interpretation of the term "mutual debts." Where the setoff right is governed by a state law like New York's, which contains a "mutuality" requirement, must the court apply the term as defined in state law or can it apply a federal law definition of the term? The *SemCrude* court held that setoff is appropriate when the creditor has a right of setoff under nonbankruptcy law and meets "the further Code-imposed requirements and limitations set forth in section 553,"[26] essentially establishing a federal law interpretation of the term independent of the one found in the applicable state law.

It appears, however, that the failure to apply state law could conflict with Supreme Court precedent holding that in the absence of a controlling federal law, property rights and interests in property are creatures of state law,[27] leading other courts to conclude that "the Bankruptcy Code [does not] contain a provision giving the federal courts broad power to develop federal common law."[28]

Bankruptcy courts must look to state law to determine whether a setoff right exists.

Conclusion

Parties to derivatives contracts should take great care to examine their positions and exposure on swaps, forwards and other derivative contracts (including master-netting agreements) in which their counter-parties are affiliated entities. The *SemCrude* opinion, while not binding on any other court, presents a clear and unambiguous authority that triangular setoffs are unenforceable in bankruptcy. If one assumes, as careful and thoughtful counter-parties should, that presently there is a significant risk that the triangular setoff provisions in their agreements are potentially unenforceable, risk exposure emanating from derivative positions could be significantly and materially greater (or smaller) than originally thought. Counter-parties should consider seeking advice of counsel as to various avenues to manage and reduce this newly found risk.

1. *In re SemCrude, L.P.*, 2009 WL 68873, at *7 (Bankr. D. Del. Jan. 9, 2009).
2. *SemCrude*, at 9.
3. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995).
4. *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir. 2003).
5. *In re Bennet Funding Group*, 146 F.3d 136, 139 (2d Cir. 1998) (Section 553 "does not create a right of setoff, but rather preserves whatever right exists under applicable non-bankruptcy law.").
6. *Strumpf*, 516 U.S. at 18 ("Although no federal right of setoff is created by the Bankruptcy Code, 11 U.S.C. §553(a) provides that, with certain exceptions, whatever right of setoff otherwise exists is preserved in bankruptcy."); *In re Sentinel Prod. Corp. Inc.*, 192 B.R. 41, 45 (N.D.N.Y. 1996) (§553 "preserves for the creditor's benefit any setoff right that it may have under applicable nonbankruptcy law").
7. See *In re Tarbuck*, 318 B.R. 78, 81 (Bankr. W. D. Pa. 2004).
8. Section 362(b)(6) (commodity contracts, forward contracts and securities contracts); 362(b)(7) (repurchase agreements); 362(b)(17) (swaps).
9. See N.Y. DEBT & CRED. LAW §151; *Beecher v. Peter A. Vogt Mfg. Co.*, 227 N.Y. 468, 473 (1920); *In re Sentinel Prods. Corp.*, 192 B.R. 41, 45 (N.D.N.Y. 1996).
10. *Bennet Funding*, 146 F.3d at 139.
11. *Edwards v. Sterling Nat'l Bank & Trust Co.*, 5 F. Supp. 925, 928 (S.D.N.Y. 1934); *Samuel v. Public Nat'l Bank & Trust Co.*, 270 N.Y.S. 112 (1932).
12. *MNC Commercial Corp. v. Joseph T. Ryerson & Son Inc.*, 882 F.2d 615, 619 (2d Cir. 1989); *Bank Leumi Trust Co. of N.Y. v. Collins Sales Serv. Inc.*, 47 N.Y.2d 888 (1st Dep't 1978). In both cases the courts denied the attempted triangular setoff because the agreement authorizing it was entered subsequent to the grant of a security interest. The courts distinguished the cases from *Commerce Bank, N.A. v. Chrysler Realty Corp.*, 244 F.3d 777 (10th Cir. 2001), where the court enforced a triangular setoff agreement, by holding that a perfected security interest prevails over a subsequent unperfected interest, i.e., setoff right.
13. *Bennet Funding*, 146 F.3d at 140.
14. *Commerce Bank*, 244 F.3d 777; *Piedmont Print Works v. Receivers of People's State Bank of S.C.*, 68 F.2d 110, 111 (4th Cir. 1934); *Fisher v. State Bank of Annawan*, 163 Ill.2d 177 (1994); *Black & Decker Mfg. Co. v. Union Trust Co.*, 53 Ohio App. 356 (1936); *Poultry Grower's Inc. v. Westark Prod Credit Ass'n*, 246 Ark. 995 (1969).
15. See 5 Collier on Bankruptcy §553.03 (Lexis 2008).
16. *Depositors Trust Co. of Augusta v. Frati Enters. Inc.*, 590 F.2d 377, 379 (1st Cir. 1979); *In re Vehm Engineering Corp.*, 521 F.2d 186, 190-91 (9th Cir. 1975) (same).
17. 327 F.2d 401, 404-06 (7th Cir. 1964),
18. 95 B.R. 404, 411 (Bankr. W.D. La. 1988).
19. 32 B.R. 993, 1002 (S.D.N.Y. 1983).
20. In fact, the *SemCrude* decision does not identify the applicable state law nor analyzes the issue under state law.
21. *SemCrude*, 2009 WL 68873, at *1.
22. *SemCrude*, at 6 (citing *In re Bennett Funding Group Inc.*, 212 B.R. 206, 212 (2d Cir. BAP 1997), aff'd, 146 F. 3d 136 (2d Cir. 1998).
23. *SemCrude*, at 8 (citing *In re NWFX Inc.*, 864 F.2d 593, 595-96 (8th Cir. 1989); *Boston and Maine Corp. v. Chicago Pac. Corp.*, 785 F.2d 562, 564-66 (7th Cir. 1986)).
24. *SemCrude*, at 8 citing *In re NWFX Inc.*, 864 F.2d 593, 595-96 (8th Cir. 1989).
25. *Bennet Funding*, 146 F.3d at 139 ("This [c]ircuit…made clear the favored position of setoff and that that position extends to bankruptcy…. Cases under the prior Bankruptcy Act required 'compelling circumstances' to disregard state sanctioned setoff rights," (citing *Bohack Corp. v. Borden Inc.*, 599 F.2d 1160, 1165 (2d Cir. 1979) and noting that while the case was decided under the old Act, "section 553 is fully in accord with the prior Second Circuit jurisprudence.")).
26. *SemCrude*, at 3 (citations omitted).
27. *Butner v. United States*, 440 U.S. 48, 55 (1979); *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992); *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 329 (1993). Property and property rights are intended to be extremely broad. *United States v. Whiting Pools Inc.*, 462 U.S. 198, 204-05 (1983).
28. See, e.g., *In re Papercraft*, 211 B.R. 813, 822 (Bankr. W.D. Pa. 1997), aff'd on other grounds, 160 F.3d 982 (3d Cir. 1998).

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