



## Another Bankruptcy Blow for Triangular Setoff

Setoff is a potent state law remedy available to trade creditors with a claim against, and an obligation owing to, the same financially distressed customer. Setoff enables a creditor to cancel out or apply its claim against its customer on a dollar-for-dollar basis in reduction of the creditor's indebtedness to the customer. Doing so eliminates the absurd and unfair result of making party A pay party B when party B owes party A. For example, suppose a trade creditor sold goods to a financially distressed customer and is owed \$200,000. At the same time, the customer provided services to the creditor and is also owed \$200,000. If the customer subsequently files for bankruptcy, the creditor, after obtaining relief from the automatic stay, can exercise its setoff rights by applying its claim against the customer to reduce, dollar for dollar, the creditor's obligation to that customer.

A creditor's setoff right is akin to a secured claim to the extent the creditor realizes a recovery of its claim by reducing it dollar for dollar by the amount of the creditor's indebtedness to the customer. In the absence of its setoff right and assuming the creditor cannot avail itself of any lien or rights against a third party, the creditor would be limited to asserting a far less potent general unsecured claim against the debtor.

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However, a different result occurs when the setoff is "triangular"—involving three or more distinct entities. A "triangular setoff" occurs when party A has entered into a contract or contracts with party B and party B's affiliate, party C, that allows party A to set off party A's claim against party B to reduce, dollar for dollar, party A's obligations to party C. While the broad triangular setoff rights among affiliated parties created by contract are enforceable under state law in a non-bankruptcy setting, triangular setoff rights are unenforceable in bankruptcy because they violate the Bankruptcy Code's



requirement of mutuality of obligations that is a prerequisite to setoff.

The United States Bankruptcy Court for the District of Delaware, in *In re American Home Mortgage Holdings* (AHMH), recently ruled that a triangular setoff is not enforceable in bankruptcy, despite the parties' contract that permits the setoff of a creditor's claim against one affiliated debtor to reduce that creditor's obligation to another affiliated debtor. There was no mutuality of obligations where a creditor was seeking to set off its claim against AHM Investment (one of the debtors) to reduce the indebtedness of the creditor's affiliate to AHM Investment. The court also ruled that the safe harbor provisions of the Bankruptcy Code, allowing contractual netting of obligations involving affiliated entities, and governing certain special qualified contracts such as swap and repurchase agreements and forward and commodities contracts, do not eliminate the Bankruptcy Code's mutuality requirement for setoff.

### Background

Prior to AHMH's and its affiliates' bankruptcy filings on August 6, 2007 (the petition date), AHM Investment entered into a swap agreement<sup>1</sup> with Barclays Capital, Inc. and a repurchase agreement<sup>2</sup> with Barclays Bank PLC, an affiliate of, but a distinct legal entity from, Barclays Capital. The swap agreement included a broad setoff provision, which, in the event of a default, allowed Barclays Capital to setoff Barclays Capital's obligations owed to AHM Investment under the swap agreement against AHM Investment's obligation to Barclays Bank owed under the repurchase agreement. The setoff provision stated in pertinent part:

*Right of Set-off.* In addition to any rights of set-off a party may have as a matter of law or otherwise, upon the occurrence of an Event of Default with respect to a party...(in each case, “Party X”), the other party (“Party Y”) will have the right (but not the obligation) without prior notice to Party A or any other person to set-off any obligation of Party X owing to Party Y or any of Party Y’s Affiliates, branches or offices (whether or not arising under this Agreement, whether or not matured, whether or not contingent...) against any obligation of Party Y or any of Party Y’s Affiliates, branches or offices owing to party X (whether or not arising under this Agreement, whether or not matured, whether or not contingent...).

An event of default occurred when AHM Investment filed for bankruptcy. Thereafter, relying on the setoff provision, Barclays Capital set off its indebtedness to AHM Investment under the swap agreement and reduced AHM Investment’s indebtedness to Barclays Bank under the repurchase agreement.

Plaintiff, Steven D. Sass, the plan trustee, appointed pursuant to AHM Investment’s and the other affiliated debtors’ confirmed plan of liquidation, filed suit against Barclays Capital and Barclays Bank (collectively, the defendants). The trustee sought a declaratory judgment that the triangular setoff was not allowed under the Bankruptcy Code or the swap agreement and a recovery of the sums improperly setoff. In response, the defendants filed a motion to dismiss the trustee’s lawsuit. The defendants argued, in part, that the triangular setoff was allowed under the “safe harbor” provisions included in Bankruptcy Code Sections 559-561<sup>3</sup> and the unambiguous terms of the swap agreement.<sup>4</sup>

#### The AHMH Court’s Analysis

The AHMH court held that the triangular setoff at issue in the case was not enforceable because the mutuality requirement, contained in Section 553 of the Bankruptcy Code, was not satisfied.<sup>5</sup> The AHMH court noted that Section 553 does not create an independent right of setoff, but, instead, preserves and governs any right of setoff allowed under non-bankruptcy law. Section 553 applies whenever a creditor seeks to exercise any setoff right, including a right of setoff arising under a contract, like the swap agreement, with the triangular setoff provision in AHMH.

Critical to the AHMH court’s holding is Section 553’s requirement that claims subject to setoff must be mutual. In order for claims to be mutual, they must be “due to and from the same persons in the same capacity.” In other words, “each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally.” Moreover, in the context of a group of affiliated companies, unless the corporate veil can somehow be pierced, a subsidiary’s debt cannot be setoff “against the credit of a parent or other subsidiary, or vice versa, because no mutuality exists...” The court also observed that there is no “contractual exception” to Section 553’s mutuality require-

ment when a bankruptcy is filed. In other words, mutuality cannot be created through a multi-party agreement allowing for triangular setoff.

The court next addressed the defendants’ argument that the safe harbor provisions allowing contractual netting of obligations involving affiliated entities somehow modify or eliminate Section 553’s mutuality requirement. The legislative history for the safe harbor provisions provides the following three reasons for their enactment:

- (i) to allow a non-debtor swap participant or the trustee to terminate a swap agreement so that a swap agreement could only continue after the bankruptcy is filed only by mutual consent of the non-debtor swap participant and the trustee;
- (ii) to permit immediate termination in order to minimize exposure to market volatility; and
- (iii) to address the need for swap participants to be able to close out existing transactions without fear that (a) closing out swaps would violate the stay, (b) a debtor would opportunistically reject unfavorable swaps and assume favorable ones; or (c) the transactions would be challenged as voidable preferences.

The swap agreement included a broad setoff provision, which, in the event of a default, allowed Barclays Capital to setoff Barclays Capital’s obligations owed to AHM Investment under the swap agreement against AHM Investment’s obligation to Barclays Bank owed under the repurchase agreement.

The AHMH court relied on three decisions from the Lehman Brothers Holdings Inc. bankruptcy cases, pending in the United States Bankruptcy Court for the Southern District of New York, that addressed the interaction between the safe harbor provisions and a creditor’s setoff rights. A decision by the bankruptcy court addressed whether Swedbank, a Swedish financial institution, could setoff its pre-petition claims against a Lehman entity against amounts owing to that same Lehman entity arising out of post-petition deposits with Swedbank (*Lehman/Swedbank*). This case dealt with another limit that Section 553 imposes on a creditor’s setoff rights; that a creditor’s and debtor’s claims against each other subject to setoff must both be pre-petition claims. While different from the setoff the defendants had attempted in AHMH (the setoff of prepetition amounts owing by affiliated entities), the AHMH court agreed with the *Lehman/Swedbank* bankruptcy court’s ruling that Congress did not intend the safe harbor provisions to nullify Section 553’s requirements,<sup>6</sup> whether mutuality in AHMH or the claims subject to setoff both being pre-petition in *Lehman/Swedbank*.

The United States District Court for the Southern District of New York affirmed the *Lehman/Swedbank* bankruptcy court's holding that the triangular setoff provision in the pre-petition swap agreement that authorized the setoff of amounts owed to affiliates of a counterparty is not enforceable in bankruptcy because mutuality, which is absent in a triangular setoff, is a prerequisite for the enforceability of setoff rights in bankruptcy. The court also noted that the legislative history for the safe harbor provisions did not address, and, therefore, could not be construed to eliminate, Section 553's mutuality requirement.

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The *AHMH* court also relied upon a third Lehman decision involving UBS (*Lehman/UBS*). This court addressed the identical issue raised in *AHMH*, the propriety in bankruptcy of the triangular setoff of pre-petition obligations among affiliates that was allowed under the parties' contracts. The trustee argued against the triangular setoff that occurred in the case and sought recovery of the sums improperly set off. The *Lehman/UBS* court held, in part, that: (a) triangular setoff is not enforceable in bankruptcy because it does not satisfy Section 553's mutuality requirement; (b) there is no contract exception to Section 553's mutuality requirement; and (c) the safe harbor provisions, that allow for the netting of obligations among affiliated entities, cannot be interpreted to implicitly do away with the mutuality requirement as there is nothing in the safe harbor provisions that justifies allowing triangular setoff rights that do not satisfy the mutuality requirement.<sup>7</sup>

Finally, the *AHMH* court observed that the mutuality requirement precluding triangular setoff is also supported by one of the Bankruptcy Code's primary goals, ensuring that that similarly situated creditors are treated fairly and enjoy an equality of distribution from a debtor. The court stated:

[b]y allowing parties to contract around the mutuality requirement of Section 553, one creditor or a handful of creditors could unfairly obtain payment from a debtor at the expense of the debtor's other creditors, thereby upsetting the priority scheme of the Code and reducing the amount available for distribution to all creditors.... Such a result is clearly contrary both to the text of the Code and to the principle of equitable distribution that lies at the heart of the Code.

Accordingly, the *AHMH* court held that: (i) parties cannot contract around the mutuality requirement for setoff contained in Bankruptcy Code Section 553; (ii) the safe harbor provisions, that allow for the netting of obligations among affiliated entities under multiple qualified agreements, such as the swap agreement and repurchase agreement, cannot be interpreted as eliminating the mutuality requirement for setoff; and, as a result (iii) the non-debtor counterparties to the swap and repurchase agreements had no enforceable triangular setoff rights with respect to affiliate obligations.

### Conclusion

While the *AHMH* court's decision involved complicated financial contracts governed by the safe harbor provisions, it is equally applicable to trade creditors' agreements that permit triangular setoff of obligations owing by and to affiliated entities. There is no right of setoff in these circumstances because there are no mutual obligations, as required by Section 553 of the Bankruptcy Code, where the claim of an affiliated debtor is offset against an obligation owing to another affiliated debtor. Creditors cannot contract around the mutuality requirement for setoff by entering into triangular setoff agreements that allow the creditor to set off a claim against one affiliated entity against an obligation owing to another affiliated entity.

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The bottom line truism is just as applicable here: trade creditors doing business with financially distressed affiliated entities should know their customer. While a creditor's setoff agreement with its customer and affiliated entities may protect the creditor's triangular setoff rights in a non-bankruptcy setting, these setoff rights will likely be lost—even in the face of unambiguous contractual terms allowing triangular setoff—when the creditor's financially distressed customer and affiliated entities file for bankruptcy. Creditors may avoid the risk of losing their triangular setoff rights by obtaining the guaranty of each affiliate with whom they are dealing. ▀

1. A swap is a financial contract to exchange benefits of two underlying financial contracts during a fixed period over the duration of the swap. Swaps can be of various types such as currency, interest rate, commodity, equity, etc. Trade creditors would most likely be involved with a swap involving a commodity.

2. A repurchase agreement is an agreement for the sale of securities together with an agreement for the seller to buy back the securities at a later date.

3. The pertinent safe harbor provision is Section 561 of the Bankruptcy Code. Section 561 states in relevant part: “[t]he exercise of any contractual right...to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more...(5) swap agreements...shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title.”

4. As the *AHMH* court held that triangular setoff was not allowable under the Bankruptcy Code, the court did not reach the independent issue of whether triangular setoff was allowed under the swap agreement.

5. Subject to certain exceptions not applicable here, Section 553 states:

Except as otherwise provided in this section and in sections 362 and 363 of this title, this title 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... (emphasis added).

6. Quoting from the *Lehman/Swedbank* decision, the *AHMH* court observed: “Plainly, then, the 2005 amendments to Section 553 with respect to Sections 560 and 561 are narrow and leave intact the mutuality requirement of Section 553(a). Such an interpretation dovetails with common sense. If Congress had intended to eliminate the mutuality requirement of Section 553(a), it would have done so directly and with clarity.”

7. The *AHMH* court also agreed with the decision of the United States Bankruptcy Court for the District of Delaware, in *SemCrude*, that there is no contractual exception to Section 553’s mutuality requirement. In *SemCrude*, a trade creditor unsuccessfully sought to set off a debt owed to the debtor against a balance due to the creditor from an affiliated debtor.

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