

Third Circuit Eschews Setoff Creativity in Favor of a Simple Mutuality Test

By **Wojciech F. Jung** and **John P. Schneider**

On March 19, 2021, the Court of Appeals for the Third Circuit issued its decision in *In re Orexigen Therapeutics, Inc.*, 2021 WL 1046485 (3rd Cir. Mar. 19, 2021), affirming lower courts' decisions rejecting "triangular setoff" agreements as a proper basis for the application of setoff rights under section 553 of the Bankruptcy Code.

Orexigen Therapeutics, Inc. entered into a distribution agreement (Distribution Agreement) with McKesson Corporation, Inc. (McKesson) through which McKesson distributed Orexigen's weight loss drug. As part of the Distribution Agreement, a setoff provision permitted McKesson and its affiliates to set off, recoup, and apply any amounts owed by it to Orexigen or its affiliates against any and all amounts owed by Orexigen or its affiliates to McKesson or its affiliates.

Subsequently, one of McKesson's subsidiaries, McKesson Patient Relationship Solutions (MPRS), entered into a services agreement (Services Agreement) with Orexigen, whereby MPRS would advance funds to pharmacies selling the weight loss drug, and Orexigen would later reimburse these payments. The Distribution Agreement and Services Agreement did not reference or incorporate one another, and McKesson and MPRS were distinct legal entities.

In March 2018, Orexigen commenced voluntary Chapter 11 bankruptcy proceedings in the District of Delaware. As of the petition date, Orexigen owed MPRS approximately \$9.1 million under the Services Agreement, and McKesson owed Orexigen approximately \$6.9 million under the Distribution Agreement. McKesson and MPRS argued that they held triangular setoff rights under the Distribution Agreement that were enforceable under applicable state law. That created sufficient mutuality under section 553(a) of the Bankruptcy Code, according to McKesson, to allow McKesson to apply its outstanding petition date indebtedness to Orexigen against Orexigen's petition date indebtedness to MPRS.

Beginning its analysis with the term "mutual" in section 553(a) of the Bankruptcy Code, the Third Circuit found dispositive the statutory text which states that "this title does not affect *any right of a creditor to offset a mutual debt*," and found that the text immediately following this language effectively limits any exercise of setoff rights to a debtor's claim against a creditor and a creditor's claim against the debtor. The court held that Congress intended for mutuality to mean only debts owing between two parties, specifically those owing from a creditor directly to the debtor and, in turn, owing from the debtor directly to that creditor. Section 553(a) setoff rights do not include within the concept of mutuality anything beyond a simple bilateral relationship. Therefore, the Court determined that triangular setoffs, by definition, are not mutual.

The Court also reasoned that allowing triangular setoff agreements to shoehorn multiparty debts into the provisions of section 553(a) would weaken the fundamental purpose of the Bankruptcy Code, which limits priority claims and aims to maximize all creditor payouts. Excluding non-mutual debts from the setoff privileges of section 553(a), according to the Third Circuit, also promotes predictability in credit transactions.

The Third Circuit's Orexigen decision is a reminder that triangular setoff provisions, no matter how creative, might not be enforceable against debtors in bankruptcy. As such, it is imperative for creditors to know their customer and understand the importance of corporate separateness and its impact on setoff rights. While a creditor's setoff agreement with its customer and affiliated entities may protect the creditor's triangular setoff rights in non-bankruptcy settings, these setoff rights will likely be lost in a bankruptcy setting even in the face of unambiguous contractual terms allowing triangular setoff.

As always, the Lowenstein Sandler Bankruptcy & Restructuring Department team stands ready to offer strategy and guidance on these and other related issues.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

WOJCIECH F. JUNG

Partner

T: 646.414.6862

wjung@lowenstein.com

JOHN P. SCHNEIDER

Associate

T: 646.414.6843

jschneider@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

This Alert has been prepared by Lowenstein Sandler LLP to provide information on recent legal developments of interest to our readers. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship. Lowenstein Sandler assumes no responsibility to update the Alert based upon events subsequent to the date of its publication, such as new legislation, regulations and judicial decisions. You should consult with counsel to determine applicable legal requirements in a specific fact situation. Attorney Advertising.