

Third Circuit Rejects Triangular Setoff: The Feeling Is Not Mutual

business
CREDIT

JULY 2021

THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS \$9.00



Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy & Restructuring Department, and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached at bnathan@lowenstein.com.

Michael Papandrea, Esq., is an associate in Lowenstein Sandler's Bankruptcy & Restructuring Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.

A trade creditor has many tools in its risk mitigation arsenal when its financially distressed customer files for bankruptcy. One such tool is a creditor's right to set off its claim against the customer to reduce any indebtedness the creditor owes the customer, dollar-for-dollar. This right of "setoff" is conditioned on the creditor and debtor owing mutual obligations to one another. However, creditors have sought to contract around and expand this "mutuality" requirement by negotiating "triangular" setoff agreements with their customers that permit a creditor to setoff a debt the creditor owes the customer against a debt the customer owes an *affiliate* of the creditor.

Unfortunately for trade creditors, several courts, including courts in Delaware and the Southern District of New York, have held that a triangular setoff cannot satisfy the mutuality requirement set forth in the Bankruptcy Code's setoff statute, section 553(a)—despite the enforceability of the triangular setoff under state law. The United States Court of Appeals for the Third Circuit (Third Circuit), in the Chapter 11 cases *In re Orexigen Therapeutics, Inc.*, has now joined this growing majority of courts. In *Orexigen Therapeutics*, the Third Circuit affirmed the lower courts' decisions to reject a creditor's exercise of triangular setoff rights (by crediting a debt the creditor owed the debtor against a debt the debtor owed to the creditor's affiliate), even though the parties' contract authorized the triangular setoff, because the creditor could not satisfy section 553(a)'s mutuality requirement.

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*.¹ Mutuality of debts requires that the claims subject to setoff are owed by the same parties acting in the same capacity.

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, the creditor cannot satisfy section 553(a)'s mutuality requirement for exercising setoff rights where one affiliated entity that owes a debt to the bankruptcy company is not the same legal entity that is owed money by the same bankruptcy company.

Parties to contracts involving multiple affiliated entities have sought to broaden their 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 their agreement, 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—including most recently the Delaware bankruptcy and district courts in *Orexigen Therapeutics*, as well as earlier decisions in Delaware (*SemCrude, L.P.*) and the Southern District of New York (*Lehman Bros.*)—have denied the enforceability of triangular setoff agreements in a bankruptcy case involving one or more of the parties to the agreement. The issue in these cases is whether a creditor that holds triangular setoff rights that are granted by contract and enforceable under state law can satisfy section 553(a)'s mutuality requirement. These courts refused to enforce a creditor's triangular setoff rights in bankruptcy cases because these cross-affiliate netting or triangular setoff agreements did not satisfy the mutuality requirement, *i.e.*, that the creditor and the debtor each owe a debt to the other.

The Facts of *Orexigen Therapeutics*

Orexigen Therapeutics, Inc. (Debtor), a biopharmaceutical company, filed a Chapter 11 bankruptcy case in the United States Bankruptcy Court for the District of Delaware. On the bankruptcy filing date, McKesson Company (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, McKesson Patient Relationship Solutions (MPRS), under a separate master services agreement.

The Debtor and McKesson had entered into the distribution agreement on June 9, 2016. Pursuant to the distribution agreement, McKesson agreed to purchase and distribute certain of the Debtor's products. The distribution agreement 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 agreement 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[.]”

The Debtor and MPRS entered into the master services agreement on July 15, 2016, pursuant to which MPRS had agreed to manage the Debtor's customer loyalty program. Under the master services agreement, MPRS agreed to pay for product price discounts and other services under the loyalty program to retail pharmacies and patients and the Debtor would, in turn, 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.

McKesson then filed a motion to assert its contractual triangular setoff rights on July 30, 2018. The Debtor and a group of note-holders objected 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.

Decisions and Appeals

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 noted that “courts have routinely held that triangular setoffs are impermissible in bankruptcy.” Specifically, the bankruptcy court relied on the Delaware bankruptcy court's 2009 decision in *In re SemCrude, L.P.* (which was also affirmed by the Delaware district court) that “the mutuality requirement [of] section 553 cannot be satisfied by a multi-party agreement contemplating a triangular setoff.” 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 arguments that the Bankruptcy Code's mutuality requirement merely identifies a state law right that is being preserved in bankruptcy, and the court should look to state law or general contract principles in determining whether a triangular setoff is appropriate. The bankruptcy court noted 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. In the instance of section 553(a), that means the court must enforce the statute'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.” This aligns with the fundamental bankruptcy policy of ensuring similarly-situated creditors receive an equal distribution from the debtor's estate.

Finally, the bankruptcy court rejected McKesson's argument that McKesson

proved 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. They argued that neither section 553(a) nor any other provision of the Bankruptcy Code adversely affects the enforceability of a creditor’s state law setoff rights in a debtor’s bankruptcy case. However, the district court affirmed the bankruptcy court’s holding that a triangular setoff provision otherwise enforceable under state law does not satisfy section 553(a)’s mutuality requirement. 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 in *Lehman Bros.*) that 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 and cannot be contracted away by a triangular setoff agreement.

McKesson then appealed to the Third Circuit. McKesson focused on whether the Bankruptcy Code (specifically, via section 553(a)’s mutuality requirement) imposes restrictions on a creditor’s ability to assert setoff rights the creditor otherwise has under applicable non-bankruptcy law (through an enforceable triangular setoff agreement), and whether a debtor and creditor could use a triangular setoff agreement to contract around the mutuality requirement. McKesson also argued that it met the mutuality requirement because its triangular setoff rights under the distribution agreement constituted a direct claim that McKesson held against the Debtor.

The Third Circuit’s Decision

The Third Circuit affirmed the district and bankruptcy court decisions, agreeing with *SemCrude* and the other courts that

have held that the mutuality requirement in section 553 limits a creditor’s ability to assert setoff rights. The Third Circuit rejected McKesson’s argument that section 553 simply preserves any state law setoff right that a party may have, including contractual triangular setoff rights, because such an interpretation of section 553 would render the word, *mutual*, completely redundant.

The Third Circuit also held that a debtor and creditor cannot avoid section 553(a)’s mutuality requirement for setoff by contracting around the requirement. The court relied on the *SemCrude* court’s conclusion that Congress had intended mutuality to encompass only debts owing between two parties—the debtor and the creditor. The court then concluded that mutuality cannot be supplied by a multiparty agreement providing for triangular setoff, particularly where triangular setoff would undermine one of the primary goals of the Bankruptcy Code to ensure that similarly situated creditors are treated fairly and equally.

The Third Circuit noted that McKesson and/or MPRS could have taken steps to protect their rights. McKesson could have satisfied the mutuality requirement by agreeing to be responsible for the customer loyalty support rather than have MPRS do so. Alternatively, McKesson could have sought to have MPRS obtain and perfect a security interest in the Debtor’s accounts receivable to McKesson, thereby giving MPRS a priority right in the same amount that McKesson sought via setoff (though any such security interest would have been subject to any prior perfected security interest in the Debtor’s accounts receivable). This would have the added benefit of satisfying another fundamental purpose of the Bankruptcy Code: ensuring the public disclosure and provision of notice to other creditors of priority claims against the Debtor.

Finally, the Third Circuit rejected McKesson’s argument that it had a direct claim against the Debtor that satisfied section 553(a)’s mutuality requirement for its triangular setoff. The court concluded McKesson had only setoff rights under the distribution agreement, and that the right to setoff is not, by itself, a *claim* against the Debtor.

Bottom line, the Third Circuit’s decision can be summarized in one simple sentence that the court used to close its opinion: “[McKesson] may enjoy privity of contract with [Orexigen], but it lacks the mutuality required by the plain language of [§] 553.”

Conclusion

The Third Circuit’s decision in *Orexigen Therapeutics* firmly establishes, as the emerging consensus view, that triangular setoff rights arising by contract are not enforceable in a customer’s bankruptcy case, even if those rights are enforceable under state law. Not only is the Third Circuit’s decision binding on the federal courts within the districts of Delaware, New Jersey, Pennsylvania, and the Virgin Islands, it is also consistent with prior court decisions in other jurisdictions, such as the Southern District of New York, that triangular setoffs are by definition not mutual and therefore unenforceable in a customer’s bankruptcy case.

Therefore, trade creditors should not rely too heavily on triangular setoff provisions when dealing with financially distressed customers since those provisions may not protect them if their customer files for bankruptcy protection. Trade creditors would be wise to consider alternative ways of protecting themselves. The simplest mechanism that the Third Circuit endorses is making sure the same entities are involved on the receivables and payables that gave rise to setoff rights. Trade creditors also might seek to obtain affiliate cross-corporate guarantees so that the same entities have a claim against and indebtedness to each other in order satisfy the mutuality requirement for setoff under section 553 of the Bankruptcy Code. ■

1 Section 553 expressly refers to mutual debts and claims. that arose prepetition. However, many courts have held that creditors may setoff mutual post-petition obligations as well.

**This is reprinted from Business Credit magazine, a publication of the National Association of Credit Management. This article may not be forwarded electronically or reproduced in any way without written permission from the Editor of Business Credit magazine.*