Navigating Triangular Setoff Through Safe Harbors

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Section 553(a) of the Bankruptcy Code preserves a creditor's prepetition right to setoff. Courts have strictly construed Section 553(a) to limit the preservation of setoff rights to claims and debts that arose prior to the commencement of the debtor's bankruptcy case. Courts have also strictly construed the mutuality requirement in Section 553(a) to require that debts be due to and from the same two parties in the same legal capacities. This construction has been routinely held to prevent what has been labeled as "triangular setoff" with respect to a debtor in bankruptcy.

Virtually all definitions of setoff provide for the netting of debts or claims and counterclaims between the same two parties acting in the same legal capacities. What is typically meant by the term "triangular setoff" is a contractual agreement where the debtor has agreed that a debt owed to the debtor by party A, can be applied to satisfy a debt owed by the debtor to party B. As one court observed, "outside of the bankruptcy context, … [such a triangular setoff provision] without a question is [] valid and enforceable … ." *In re Lehman Brothers Inc*., 458 B.R. 134, 139 (Bankr. S.D.N.Y. 2011) (*Lehman/UBS*).

The *SemCrude* Decision

In one of the seminal decisions analyzing triangular setoff in a bankruptcy context, *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), aff'd 428 B.R. 590 (D. Del. 2010), the bankruptcy court rejected a creditor's attempt at triangular setoff and refused to recognize a contractual exception to the mutuality requirement in Section 553(a), observing that the very need for an "exception" means mutuality is lacking. *SemCrude*, 399 B.R. at 396. The court analyzed and distinguished numerous cases from which parties inferred such a contractual exception to the mutuality requirement existed, noting that none of the cases cited actually enforced an agreement providing for triangular setoff. *Id.* at 394 n.4. The *SemCrude* court had no occasion to examine triangular setoff in the context of the "safe harbors" for securities contracts, commodity contracts and forward agreements, repurchase agreements, swap agreements, and master netting agreements contained in Sections 555, 556, 559, 560 and 561 of the Bankruptcy Code (Safe-Harbored Contracts).

Safe Harbors and Mutuality

The Bankruptcy Code's "safe harbors" provide that the rights of certain kinds of non-debtor counterparties (Protected Entities) to exercise any contractual right to terminate, liquidate or accelerate Safe-Harbored Contracts because of a condition of the kind specified in Section 365(e)(1) of the Bankruptcy Code and to offset or net out any termination values, payment amounts or other transfer obligations arising under or in connection with the termination, liquidation or acceleration of the contract cannot be "stayed or avoided or otherwise limited by operation of any provision of [the Bankruptcy Code] or by order of a court or administrative agency in any proceeding under [the Bankruptcy Code]." Whether a counterparty is a Protected Entity under the safe harbors varies with the nature of the counterparty and particular type of Safe-Harbored Contract.

The safe harbor provisions mentioned above are supplemented by stay exceptions in Sections 362(b)(6), (b)(7), (b)(17) and (b)(27) and avoidance exceptions in Sections 546(e), (f) and (g). Without the safe harbors, a counterparty would be

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prohibited from terminating or modifying any executory contract because of a provision in the contract that is conditioned on the insolvency or financial condition of the debtor, the commencement of a case under the Bankruptcy Code or the appointment of or taking possession by a trustee in a case under the Bankruptcy Code or a custodian before the commencement of a bankruptcy case. Likewise, in the absence of the safe harbors, the ability to setoff or net termination values, payments amounts or other transfer obligations would be stayed and there would be avoidance risk with respect to payments made by the debtor during the preference period, including the posting of additional collateral.

Since *SemCrude*, there have been three reported decisions dealing with the contours of mutuality and Section 553(a) in the context of certain of the safe harbors. The first, *In re Lehman Brothers Holdings, Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), aff'd 445 B.R. 130 (S.D.N.Y 2011) (*Lehman/Swedbank*), held that Swedbank AB could not setoff funds it received from the debtor after the commencement of its bankruptcy case, against the obligations of the debtor owed upon the termination of a pre-petition swap agreement that was a Safe-Harbored Contract. The bankruptcy court found that safe harbor provisions in Sections 560 and 561 of the Bankruptcy Code did not alter the "bedrock" principle of mutuality preserved in Section 553(a) and that Section 553(a) requires both the debt owed to the debtor and the claim of the creditor to have arisen prior to the commencement of the debtor's bankruptcy case. *Id.* at 112-113.

A subsequent decision by the same court had a more typical fact pattern arising out of the triangular setoff provision often found in International Swaps and Derivatives Association, Inc. (ISDA) master agreements. In *In re Lehman Brothers Holdings, Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011) (*Lehman/UBS*), UBS AG (UBS) sought to apply a collateral surplus remaining after termination of its swap agreement with the debtor to a debt owed by the debtor to UBS's affiliate. The court acknowledged that the provision in the schedule to the ISDA master agreement between UBS and the debtor providing for the setoff of any amount owed by UBS to the debtor against any amount owed to UBS's affiliates by the debtor was enforceable under New York law. Nevertheless, citing to *SemCrude* and its own decision in *Lehman/Swedbank*, the court held the provision to be unenforceable in light of the mutuality requirements of Section 553(a). *Id.* at 139-140. The court, consistent with its holding in *Lehman/Swedbank*, held that the safe harbor provisions of Sections 560 and 561 of the Bankruptcy Code did not eliminate the mutuality requirements of Section 553.

More recently, the Delaware bankruptcy court was confronted by essentially the same fact pattern as the court in *Lehman/UBS*, and reached the same conclusion using the same rationale. *In re American Home Mtg. Holdings, Inc.* (*Sass v. Barclays Bank PLC*), 501 B. R. 44 (Bankr. D. Del. 2013). In that case, relying on the safe harbors, Barclays Capital, Inc. (Barclays) set off amounts owed to the debtor, AHM Investment, under a terminated swap agreement against amounts owed by AHM Investment to its affiliate, Barclays Bank PLC. In addition to its reliance on the mutuality analysis in the *SemCrude*, *Lehman/Swedbank* and *Lehman/UB*S decisions, the court cited to the policy argument in *SemCrude* that:

> By 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 the principle of equitable distribution that lies at the heart of the Code.

Id. at 59-60, citing *SemCrude*, 399 B.R. at 399.

Achieving the Effects of Triangular Setoff

The principle of equitable distribution has numerous exceptions in the Bankruptcy Code including statutory priorities for certain types of unsecured claims (*e.g.*, domestic support obligations, certain wage and pension claims, consumer deposit claims, certain tax claims) as well as the ability of secured creditors to obtain the value of their collateral. Indeed, each of the Bankruptcy Code's definitions of Safe-Harbored Contracts includes as a variety of such a Safe-Harbored Contract "any security agreement or arrangement, or other credit enhancement related to … [a Safe-Harbored Contract] … including any guarantee or reimbursement obligation … to a [Protected Entity].”

Collateral Workaround

For example, it is not uncommon for a client of a stockbroker or commodity broker to enter into Safe-Harbored Contracts and borrow funds for margin or collateral required to be posted for the Safe-Harbored Contracts from an affiliate of the broker secured by the client’s assets held by the broker. Accordingly, the affiliate’s security agreement should itself be considered a Safe-Harbored Contract protected from avoidance and the bankruptcy stay, so long as the affiliate is also a Protected Entity as to the particular type of Safe-Harbored Contract. To the extent the client becomes a debtor under the Bankruptcy Code and there are obligations owed to the lender-affiliate upon the termination by the broker of the Safe-Harbored Contracts and liquidation of the debtor’s assets (*i.e.*, assets that also serve as the affiliate’s collateral), any surplus that would otherwise constitute a debt of the broker to the debtor should be available to satisfy the debtor’s obligations to the affiliate.

While the effect appears similar, if not identical, to triangular setoff, because of the contractual security arrangement entered into by the debtor and the affiliate, the requisite mutuality exists between the affiliate and the debtor. Accordingly, under the plain language of the safe harbors, it should be possible for obligations owed to the debtor by one Protected Entity with respect to a Safe-Harbored Contract to be collateral under a security agreement or arrangement between the debtor and a second Protected Entity that relates to that Safe-Harbored Contract and therefore be available to satisfy the debtor’s obligations to the second Protected Entity.

In the above example, the affiliated margin lender is granted a lien on all of the debtor’s assets held by the Protected Entity-broker and any payment obligation from the broker to the debtor should constitute proceeds of the affiliate’s collateral. The debtor could grant a security interest in a subset of that collateral consisting of payables owed by the broker to the debtor (*e.g.*, accounts, payment intangibles), which would render the arrangement economically indistinguishable from a triangular setoff. While best practices suggest that such a security interest be perfected under the Uniform Commercial Code (UCC), to the extent the agreement between the debtor and a Protected Entity-lender is a security agreement or arrangement “related to” a Safe-Harbored Contract, that security arrangement itself should be a Safe-Harbored Contract and protected from avoidance or the stay even if the security interest is unperfected.

Such an arrangement might not be effective, however, with respect to payment obligations due to the debtor that arise after the commencement of the debtor’s bankruptcy case if such obligations are not proceeds of the Protected Entity’s prepetition collateral. Section 552 provides that property acquired by the estate or the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case unless such property constitutes proceeds of prepetition collateral. Absent a lien, the arrangement may be viewed as an impermissible attempt to setoff post-petition debts against prepetition claims. *See Lehman/Swedbank, supra*. Accordingly, whenever possible, the liens granted to affiliates should be as broad as possible, with the goal of rendering any such payment obligation as proceeds of the lender’s pre-petition collateral.

Guaranty Workaround

The foregoing workaround is not intended to create an exception to mutuality, which, based on current case law, does not exist, but is instead a mechanism to create mutual secured obligations between the debtor and each non-debtor affiliate. Another mechanism recognized as creating mutual obligations that would have the same effect as triangular setoff is affiliate cross-guarantees. There, the debtor’s shortfall to a counterparty would be guaranteed by an affiliate of that counterparty that is otherwise indebted to the debtor. *Compare In re England Motor Company*, 426 B.R. 178 (Bankr. N.D. Miss. 2010) and *Bloor v. Shapiro*, 32 B.R. 993 (S.D.N.Y. 1983) with *In re Ingersoll*, 90 B.R. 168 (Bankr. W.D.N.C. 1987).

To the extent the affiliate-guarantor owed a debt to the debtor, that debt could be offset against a contractual obligation of the debtor to reimburse the affiliate-guarantor to the extent the it pays its affiliate. The reimbursement obligation should create the requisite mutuality; mere subrogation may not. Moreover, there would appear to be no reason that the amount of the guarantee could not be capped at the amount of debt owed by the guarantor to the debtor. If the affiliate is providing a guarantee of a Safe-Harbored Contract, the guarantee itself would be a Safe-Harbored Contract so long as the guarantor is also a Protected Entity.

Conclusion

In each of the triangular setoff cases, the existence of the prepetition contractual arrangements makes clear the parties' intention and their agreement with respect to the economic outcome of triangular setoff. By taking care to structure the agreement in a manner to assure mutuality exists, it should be possible to achieve the economic result of triangular setoff without tripping over the requirement for mutuality in Section 553(a) of the Bankruptcy Code.