

Contractual Rights Vanish Again in the "Bermuda" of Triangular Setoff

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The enforcement of triangular setoffs in bankruptcy, where affiliates set off their claims against the debtor, received another setback in a recent decision in the Lehman bankruptcy cases. See *In re Lehman Brothers Inc.*, No. 08-01420 (JMP) (SIPA), 2011 WL 4553015 (Bankr. S.D.N.Y. Oct. 4, 2011) Judge Peck's decision followed the Delaware Bankruptcy Court's seminal decision in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), which found that affiliated entities do not satisfy the mutuality requirement for triangular setoff under section 553(a) of the Bankruptcy Code.

In *Lehman*, UBS AG (UBS) terminated a swap agreement it had entered into with Lehman Brothers Inc. (Lehman) just prior to the entry of a liquidation order enforcing an automatic stay with respect to Lehman under the Securities Investor Protection Act (SIPA). Upon termination, UBS held approximately \$170 million in collateral posted to secure the parties' respective obligations. Upon termination and setoff under the swap agreement, \$76 million remained for the estate, as agreed by the SIPA Trustee. However, UBS relied on its contractual rights in the swap agreement to set off an additional \$23 million that Lehman owed to subsidiaries of UBS who were not party to the swap agreement. The SIPA Trustee objected to the additional setoff, claiming it was impermissible for failing to satisfy the mutuality requirement of section 553(a).

Subject to certain exceptions, section 553(a) allows a creditor to offset "mutual" prepetition debt that it owes the debtor against such creditor's prepetition claim against the debtor. UBS contended that the mutuality requirement was inapplicable where the triangular setoff right arose *contractually* (by the terms of the swap agreement) and not as the result of a common law right. Alternatively, UBS contended that the contractual right to triangular setoff actually satisfied the mutuality requirement, notwithstanding the fact that the affiliates were not parties to the swap agreement. *Lehman* rejected both arguments. Citing the *SemCrude* decision (among others), the court held that contractual language does not supersede or create an exception to the statutory mandate under section 553(a), which explicitly requires that any debts to be offset be mutual—between the *same* parties, standing in the *same* capacity.

UBS further argued that, even if its triangular setoff right was both subject to and contrary to the language of section 553(a), the right was nonetheless enforceable under the safe harbor provision of section 561 of the Bankruptcy Code. Although the *SemCrude* decision did not address this issue, the

Lehman court again rejected the argument, finding that section 561, which permits a swap creditor to enforce any contractual right notwithstanding the automatic stay, does not alter section 553 or vitiate the mutuality requirement.

Although the court acknowledged the validity and enforceability of triangular setoff provisions outside of bankruptcy, Judge Peck concluded that in bankruptcy, the mutuality requirement is designed to ensure that property is returned to the estate for equitable distribution—without preferential treatment of affiliates. The court left little room for exceptions to the mutuality requirement and looked to Congress to create an exception if it so desired. Given both the District of Delaware and the Southern District of New York have rejected contractual triangular setoff rights in bankruptcy, creditors in all jurisdictions would be wise to consider alternative structures, such as requiring a borrower to post collateral to secure the borrower's obligations to the creditor *and* its specific affiliates—in addition to a contractual right of setoff.

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