Phillips Lytle LLP

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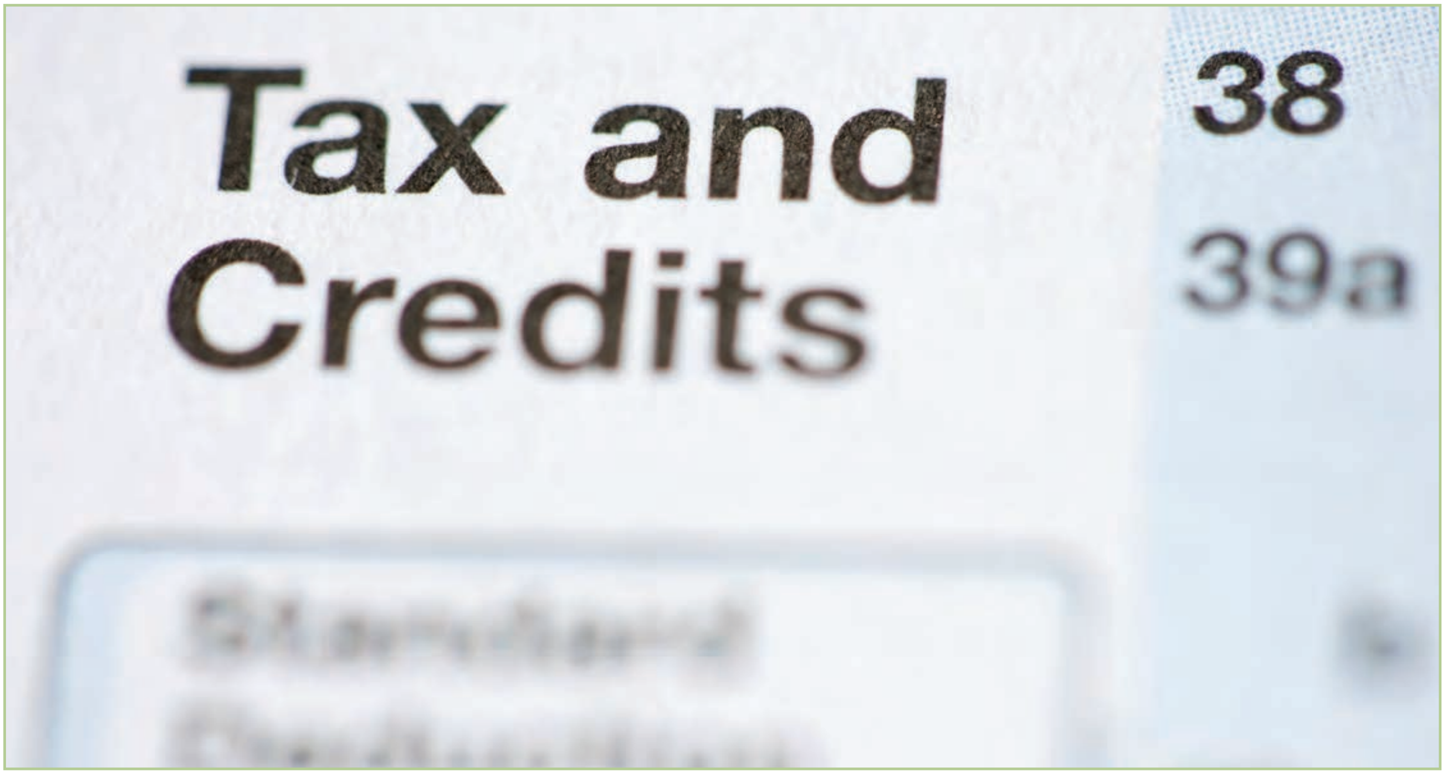

Lending Boost Possible From Tax Credit Bills

In recent months, Congress has introduced several bills to extend and/or expand various tax credit programs, including the Historic Rehabilitation Tax Credit, the New Markets Tax Credit and the renewable energy Investment Tax Credit. Lenders providing construction, bridge and permanent financing for real estate and energy development projects driven by these tax credits will be keeping a close eye on the second session of the 112th Congress.

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Can an Unauthorized UCC Termination Negate My Security Interest?

Recently, the Supreme Court of New York County addressed the question of whether the unauthorized filing of a UCC-3 termination would, as a matter of law, negate a secured party's security interest. The good news for secured lenders is that such unauthorized filings do not affect existing filings.

The case of *AEG Liquidation Trust vs. Toobro NY, LLC*, 32 Misc. 3d 1202(A), 2011 NY Slip Op 51156(U) (Sup. Ct. N.Y. Cty 2011) arose out of financing arrangements entered into between American Equities Group, Inc. ("AEG") and Ahava Dairy Products Corp. ("Ahava"). AEG and Ahava had entered into a factoring agreement dated November 6, 1996, whereby AEG agreed to purchase Ahava's accounts receivables (the "Factoring Agreement"). Pursuant to the Factoring Agreement, AEG was entitled to charge, with additional fees, Ahava's account for any of the purchased receivables that were not collected within 90 days of the invoice date.

To secure repayment of the obligations of Ahava to AEG, Ahava granted AEG a first priority security interest in all of its assets, and Lewis Country Dairy Corp. ("Lewis") guaranteed Ahava's obligations and secured such guarantee with a first priority security interest on all of its personal property. AEG perfected the security interest by properly filing UCC-1 financing statements on November 3, 1996.

On November 21, 2000, AEG commenced a Chapter 11 bankruptcy proceeding. As of December 31, 2000, AEG was owed over $8 million for charges to Ahava's account under the Factoring Agreement. On April 17, 2001, AEG commenced an adversary proceeding in the bankruptcy court, which was ultimately withdrawn to the U.S. District Court for the Southern District of New York. On February 27, 2002, UCC-3 termination statements were filed purporting to terminate AEG's security interest in the assets of Ahava and Lewis. The termination statements indicated that Ahava and Lewis were the parties who authorized the filing.

In 2005, Signature Bank ("Signature") became a secured creditor of Ahava and Lewis and accordingly filed UCC-1 financing statements to perfect its security interests. On July 28, 2006, upon discovering the unauthorized filing of the UCC-3 termination, AEG filed UCC-5 correction statements pursuant to UCC Section 9-518, in which AEG stated that the termination statements were unauthorized.

On February 7, 2008, Lewis and Ahava settled with AEG by agreeing to have a judgment entered against them in the amount of $3,500,000.00. On March 11, 2008, the New York Supreme Court entered judgment in favor of Signature in the amount of $9,338,103.90. On June 18, 2008, Signature sent a Notice of Secured Party Sale to a list of entities pursuant to UCC Section 9-613 indicating the planned sale of the assets of Ahava and Lewis to collect on Signature's judgment. As AEG was still in the midst of its bankruptcy proceeding, Signature required relief from the automatic stay imposed by Section 362 of the Bankruptcy Code to conduct the secured party sale.

On July 1, 2008, the Bankruptcy Court granted Signature relief from the automatic stay for the limited purpose of allowing Signature to conduct the secured party sale of assets with the proceeds of the sale to be held in escrow pending further adjudication of the priority of the competing liens of Signature and AEG. Upon completion of the secured party sale, AEG brought the instant action seeking a declaratory judgment that its lien remained senior to Signature's lien, notwithstanding the unauthorized termination statement. Ahava and Lewis filed a motion to dismiss the action, arguing, among other things, that the AEG lien had been terminated by the filing of the termination statement under Section 9-513(d) of the UCC. Section 9-513(d) provides that "[e]xcept as otherwise provided in section 9-510, upon the filing of a termination statement with the filing office, the financing statement to which the termination statement relates ceases to be effective."

The New York Supreme Court, however, ruled that the termination statement was not effective and that AEG continued to hold a validly perfected first priority lien under its original UCC statement. The Court based its ruling on the exception set out in Section 9-510(a), which provides that "[a] filed record is effective only to the extent that it was filed by a person that may file it under Section 9-509." Under Section 9-509, to be effective, the filing must be authorized by the secured party of record. If the secured party of record has failed to file or send a termination statement as required by Section 9-513(a), the secured party is required to file a termination if the financing statement no longer secures an obligation to the secured party.

In this case, the secured party, AEG, did not authorize the filing; and the financing statement indicated on its face that the filings were actually on behalf of the two debtors, Ahava and Lewis. Accordingly, the UCC-3 termination was simply an ineffective filing under Section 9-510, and AEG's status as a secured creditor was unimpaired and uninterrupted despite the unauthorized filing.

This ruling was contrary to the 2010 ruling of the United States District Court for the Southern District of New York on a similar issue in *Roswell Capital Partners LLC v. Alternative Constr. Techs.*, 08 Civ. 10647 (DLC), 2010 U.S. Dist. LEXIS 90695 (S.D.N.Y. Sept. 1, 2010). In *Roswell*, a UCC-1 financing statement in Florida was terminated without authorization, and a subsequent creditor who did not have notice that such termination was unauthorized believed it had a perfected first priority lien on the same collateral. The *Roswell* court, relying on multiple out-of-state cases concerning an earlier version of Article 9 of the UCC, reasoned that even if a termination statement was not authorized by the secured party, such unauthorized statement nevertheless extinguished any perfected security interest that party had in the collateral.

The *Roswell* court stated that the policy of the UCC places the burden of monitoring for a potentially erroneous UCC-3 filing on existing creditors who are aware of the true state of affairs as to their security interests rather than potential creditors who will not be in a position to know whether a termination was authorized or not. The *AEG* court, however, argues that the termination statement form promoted by the UCC does not support this policy analysis. The form financing statement provided under Article 9 of the UCC requires that the filer identify either the secured party authorizing the termination statement or, if the termination statement is unauthorized, the name of the debtor authorizing the termination. Therefore, the *AEG* court concluded the *Roswell* court's decision was incorrect.

These cases do raise an important issue regarding how a subsequent secured creditor can protect itself from a possible unauthorized UCC termination when entering into a secured transaction. From a practical perspective, lenders and others who routinely become secured parties in the ordinary course of their businesses should, when entering into secured transactions, and periodically during the life of the credit, require searches of the public records in which financing statements are filed. Simple searches of financing statements currently of record may be inadequate. Accordingly, termination statements may require further scrutiny or due diligence to confirm that they were authorized by the purported terminating secured party. This additional analysis requires additional efforts but could protect a secured creditor from a costly surprise.

Those with questions about UCC-3 terminations may contact any attorney on the Phillips Lytle Banking & Financial Services team. ■

E-Newsletter Sign-up

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I. HISTORIC REHABILITATION TAX CREDIT

The Historic Rehabilitation Tax Credit (HTC), which offers a one-for-one reduction of federal income tax liability for up to 20% of qualified rehabilitation expenses on certified historic structures, has been the subject of several bills seeking its expansion. On July 8, 2011, representatives Aaron Schock, R-Ill, and Earl Blumenauer, D-Ore., introduced the "Creating American Prosperity through Preservation Act of 2011" ("CAPP") (H.R. 2479). CAPP seeks to make the HTC more attractive to smaller-scale projects by, among other things, increasing the credit to 30% of qualified rehabilitation expenses spent on qualifying small projects.

In addition to CAPP, on October 12, 2011, Jim Webb, D-Va., and Mark Warner, D-Va., introduced the "Rehabilitation of Historic Schools Act of 2011" as a follow-up to the same bill the pair introduced in 2010 (S. 2970) and a similar bill introduced by Eric Cantor, R-Va., in 2009 (H.R. 4133). This bill is an attempt to attract private money to the cause. Lenders should note that both the CAPP and the Rehabilitation of Schools Act would significantly increase the pool of real estate projects qualifying for the HTC, thereby increasing potential opportunities in the construction lending market.

II. NEW MARKETS TAX CREDIT

The New Markets Tax Credit (NMTC) provides up to a 39% tax credit for private investors and financial institutions to invest in and finance real estate projects in low-income communities. The NMTC officially expired at the end of 2011, although several bills have been introduced that would retroactively extend it.

In May 2011, John D. Rockefeller, D-W.V., introduced the "New Markets Tax Credit Extension Act 2011" (S. 996), which seeks to extend the NMTC program through 2016 at a funding level of $5 billion a year. In July, James Gerlach, R-Penn., introduced similar legislation in the House (H.R. 2655). Most recently, Brian Higgins, D-N.Y., introduced a bill that would not only extend the program for five years but would also raise the annual funding level to $10 billion (H.R. 3224). Lenders, real estate developers and tax credit investors will be tracking the fate of the NMTC closely in the hope that it will be retroactively revived.

III. INVESTMENT TAX CREDIT

The Investment Tax Credit (ITC) currently provides investors with a 30% tax credit for qualifying investments in connection with the development of certain renewable energy projects, including wind projects with a capacity of less than 100 kilowatts. Presently, locally owned community wind projects with capacities of up to 20 megawatts are too big to qualify for the ITC and are too small to feasibly benefit from the production tax credit (PTC).

Al Franken, D-Minn., and Jon Tester, D-Mont., introduced the "Community Wind Act" (CWA) (S. 1741), which would allow wind projects aggregating at least 100 kilowatts but not more than 20 megawatts to receive the benefit of the ITC. For many regional lenders, the CWA could provide an avenue into an alternative energy finance market normally reserved for larger institutions.

To learn more about these tax credit benefits, please contact any Phillips Lytle Banking & Financial Services attorney. ■

Spotlight

Victoria L. Grady, a partner with Phillips Lytle LLP, concentrates her practice in commercial law with an emphasis on lending transactional work and real estate. A member of the American, New York, Erie County and Monroe County Bar Associations, she received her J.D., *cum laude*, from Boston College Law School and her B.A., *magna cum laude*, from The American University. In 2007, she was honored by the *Rochester Business Journal* as a recipient of the "40 Under 40" award. Each year, the *Rochester Business Journal* honors forty Rochesterians under 40 years old for their professional success and noteworthy community involvement.

A partner at Phillips Lytle LLP, **Thomas R. Burns**' practice is principally in the area of banking and corporate law. He concentrates on commercial and real estate lending; mortgage-backed finance, including credit enhancements and bond purchases in subsidized and conventional markets; business formations; acquisitions; and related business matters. Mr. Burns earned his J.D. at the University of Notre Dame Law School and a B.B.A., *cum laude*, from Ohio University. He is listed in *The Best Lawyers in America*® and the *Upstate New York Super Lawyers*®.

Tom and Victoria have worked together over the past twelve years to develop a team with a unique expertise in advising financial institutions in connection with the construction and rehabilitation of affordable housing projects and in closing community development transactions across New York State and the country. They advise clients in the initial structuring of the particular transaction, whether it is contemplated to be a traditional construction loan, a bond purchase or a letter of credit issuance, alerting their clients to particular issues that may arise with respect to the project's anticipated use of federal and state Low Income Housing Tax Credits, New Markets Tax Credits, renewable energy Investment Tax Credits or Brownfields Tax Credits. In addition, their familiarity with the differing program requirements of various housing authorities, finance agencies and development corporations, together with their experience in negotiating with developers' and tax credit investors' counsel contribute to successful and efficient project closings for their clients.

Enforceability of Forbearance Agreements Against Claim of Economic Duress – No Good Deed Goes Unpunished

When borrowers find themselves unable to comply with the terms of financing arrangements, borrowers and creditors often find means of accommodation by entering into forbearance agreements. Forbearance agreements provide flexibility to borrowers by giving them time to improve their financial condition, find alternative financing or find supplemental credit support in lieu of the creditor realizing on its rights and remedies under the credit documents. In consideration of the forbearance, borrowers may be charged a fee, and certain terms of the financing arrangements, such as the interest rate, may be modified. Also, borrowers are usually asked to release the lender from any claims that the borrower may have against the lender through the date of the forbearance agreement so the lender does not find itself subject to a lawsuit after it tries to work with its customer.

Negotiating forbearance agreements is typically a contentious process, but it is a process that can lead to positive results for both creditor and borrower. It is a process, however, that is not free of risk.

In *Interpharm, Inc. v. Wells Fargo Bank, Nat'l Ass'n*, 655 F.3d 136 (2d Cir. 2011), Wells Fargo was faced with some of the pitfalls that can arise for a lender in connection with negotiating forbearance agreements.

Wells Fargo Bank National Association (Wells Fargo) and Interpharm, Inc. (Interpharm) entered into a credit and security agreement on February 9, 2006, wherein Wells Fargo provided Interpharm with a $22,500,000.00 line of credit secured by all assets with a borrowing base of 85 percent of eligible accounts and 50 percent of eligible receivables.

In the second half of 2007, Interpharm suffered a decline in revenue, triggering defaults under the credit agreement. Instead of exercising its rights and remedies, which included terminating the commitment to lend and accelerating the indebtedness, Wells Fargo entered into a forbearance agreement (October 2007 Forbearance Agreement) that amended the credit agreement, increased the credit line and increased the interest rate on the indebtedness. As is typical of forbearance agreements, Interpharm acknowledged that it was in default and that it was obligated to Wells Fargo for outstanding principal, interest, fees and expenses. In exchange, Wells Fargo agreed to forbear from exercising remedies for the existing default subject to Interpharm raising additional capital and compliance with certain other financial covenants, including that it have a positive pre-tax income and cash flow for both the month of November and the quarter ending December 31, 2007.

The October 2007 Forbearance Agreement contained a release in favor of Wells Fargo and a merger clause stating that the forbearance contained the entire agreement between the parties regarding the forbearance.

Subsequently, Interpharm was unable to comply with the financial covenants set forth in the October 2007 Forbearance Agreement, and in January 2008, Interpharm informed Wells Fargo that it would be in default under that agreement.

In response, Wells Fargo, among other things, implemented the default rate of interest and excluded certain receivables from the pool of eligible accounts. By the end of January 2008, Interpharm's financial condition had worsened to the point where it could no longer pay its suppliers nor meet payroll. Interpharm advised Wells Fargo that without a working capital credit line it would have to liquidate the business. Wells Fargo agreed to advance additional funds subject to a short-term forbearance agreement pursuant to which Interpharm acknowledged that it was in default of the credit agreement and the October 2007 Forbearance Agreement, released its claims against Wells Fargo, and agreed to change the definition of eligible accounts to reflect the excluded receivables. Interpharm also retained a chief restructuring officer, as required.

Shortly after that, Wells Fargo and Interpharm entered into a new forbearance agreement for a longer term (February 2008 Forbearance Agreement), which amended the credit agreement and provided that Wells Fargo would continue to extend credit to Interpharm and refrain from exercising its rights and remedies for existing defaults under the credit documents through June 30, 2008. In turn, Interpharm again released any claims it may have had against Wells Fargo that arose prior to the date of the agreement and agreed to furnish additional collateral, pay certain fees and ultimately repay

Wells Fargo through either a refinancing with another lender or with the proceeds of an asset sale.

Early in March 2008, Wells Fargo adjusted the advance rate on eligible inventory from 50% to 39.6% as a consequence of a report from a field examiner with respect to the liquidation value of the inventory.

Interpharm claimed that this was a material breach of the February 2008 Forbearance Agreement and had the effect of reducing availability to a point where Interpharm would no longer be able to operate. Wells Fargo proposed a new forbearance agreement wherein Wells Fargo would agree to continue to forbear from exercising default remedies through June 30, 2008, and temporarily raise the advance rate on inventory to 49% while reserving the right to impose lesser rates as Wells Fargo may deem appropriate. In exchange, Interpharm acknowledged the defaults, paid certain fees, and released all claims arising prior to the date of the agreement.

Interpharm claimed that Wells Fargo's actions prevented Interpharm from refinancing and began to sell assets by entering into purchase agreements with potential buyers with closings scheduled in June 2008. Early in May, Interpharm told Wells Fargo that it wouldn't make it through closing unless Wells Fargo continued to forbear and lend at higher advance rates. Wells Fargo agreed to do so conditioned on the terms of a new forbearance agreement signed on May 12, 2008, (May 2008 Forbearance Agreement) wherein Interpharm again released Wells Fargo.

After completing the sale of all of its assets in June 2008, Interpharm repaid its obligations to Wells Fargo.

Subsequently, Interpharm wrote to Wells Fargo and unilaterally repudiated all of the forbearance agreements, including the release provisions, and in December 2008, filed an action against Wells Fargo alleging breach of contract, breach of the duty of good faith and fair dealing, tortuous interference with business expectations, unjust enrichment, and breach of fiduciary duty.

Wells Fargo moved for dismissal, citing the release provision in the May Forbearance Agreement. Interpharm's response was to oppose the motion on the basis that the releases it executed were the product of economic duress. Interpharm claimed that it entered into the forbearance agreements releasing all prior claims against Wells Fargo only because Wells Fargo threatened to continue to wrongfully restrict credit that would have been available to Interpharm had Wells Fargo complied in good faith with its contractual obligations, leaving Interpharm with no choice but to agree to the terms of the forbearance agreements.

The District Court found that Interpharm's allegations were insufficient as a matter of law to show economic duress.

The District Court listed the required elements of economic duress as (1) a wrongful threat by the lender and (2) overbearing of Interpharm's free will. The District Court found that as to the first element, there was insufficient evidence to support a claim of duress because when a lender is dealing with a borrower that continually defaults under the credit agreement, there is nothing wrongful in a lender exercising its rights and remedies as the borrower's creditworthiness deteriorates. The District Court summed up Interpharm's allegations as "the bank driving a hard bargain."

The Second Circuit Court agreed to review and focused on the validity of the release of Interpharm's claims against Wells Fargo. The Court noted that "Wells Fargo relies on the release provisions of the May 2008 Forbearance Agreement to support its motion for dismissal; Interpharm defends that motion on the ground that the agreement was procured by economic duress."

The Court stated that under New York law, a valid release constitutes a complete bar to an action on a claim which is the subject of the release; however, a release which is procured by economic duress may not be valid.

The Court reviewed the elements of economic duress under New York law, which are (1) a threat, (2) which was unlawfully made, (3) that caused involuntary acceptance of contract terms, and (4) made under circumstances that permitted no alternative. The Court concluded that Interpharm did not act under economic duress. The Court stated that a demonstration of financial pressure or unequal bargaining does not alone establish economic duress.

The Court's decision was based on a number of factors including that Interpharm did not show that there was any wrongful threat. The Court described this as a critical flaw in Interpharm's pleading. Once Interpharm had defaulted on its obligations in late 2007 and again in early 2008, Wells Fargo had no obligation to continue providing credit. Wells Fargo was within its rights to terminate the line of credit and demand immediate repayment of the loans.

Because Wells Fargo had no obligation to forbear, threatening not to forbear was not wrongful.

The Court also described Interpharm's allegation of economic duress as conclusory, because in its pleadings Interpharm had asserted that it agreed to the forbearance agreements only because Wells Fargo threatened to take actions that it was not entitled to take under its contract. Specifically, Interpharm asserted that it agreed to the May 2008 Forbearance Agreement only because Wells Fargo threatened to continue to wrongfully restrict credit that would have been available to Interpharm had Wells Fargo complied in good faith with its contractual obligations. The Court found that these allegations were insufficient to support the assertion of wrongful threat when Interpharm was in default under the credit agreement and the earlier forbearance agreements, and the documentation gave Wells Fargo the right to terminate the line of credit.

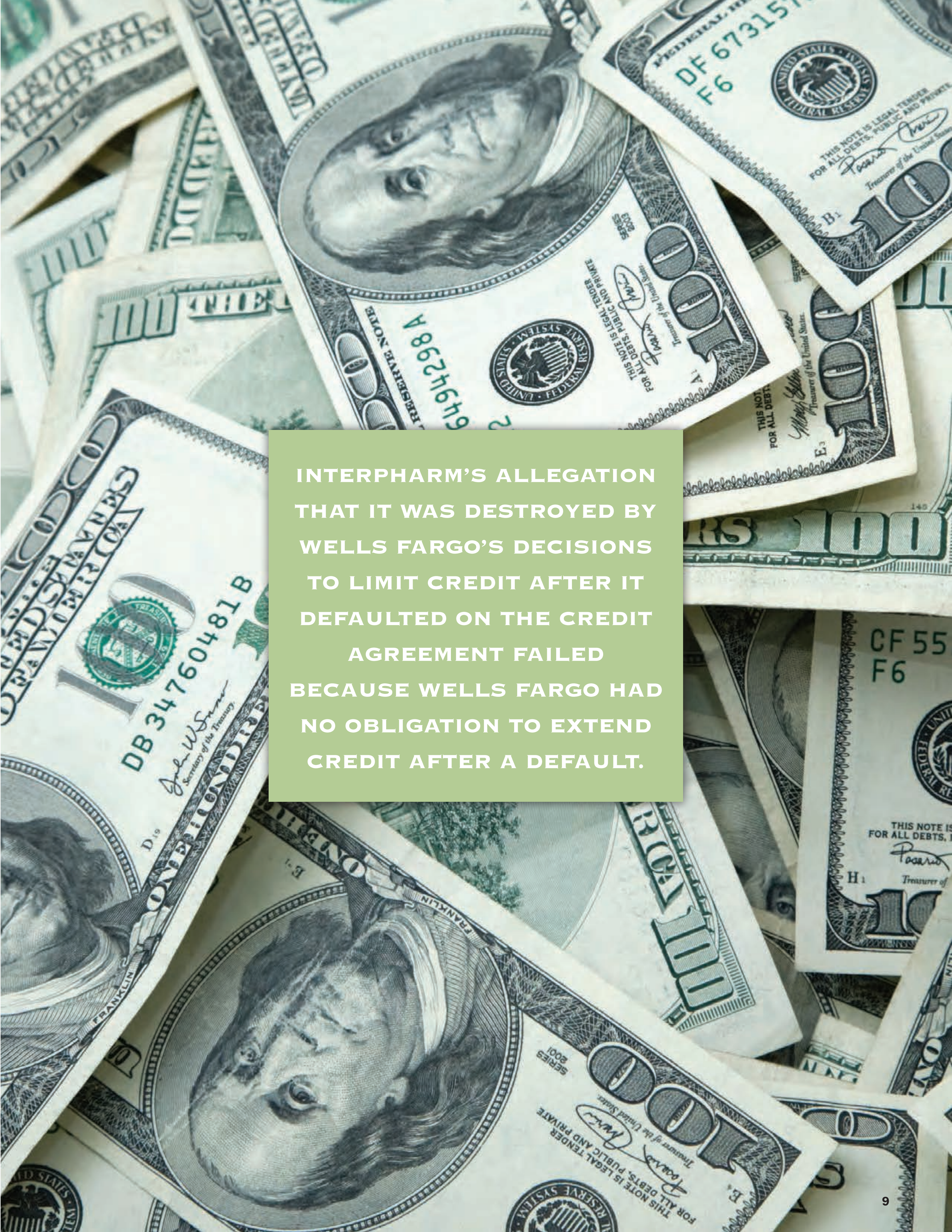
Interpharm also claimed that the decision to charge fees and increase interest rates, exclude certain accounts from the borrowing base, and modify the advance rate with respect to inventory were a violation of its obligations as a lender. The Court found that as a matter of law this cannot plausibly constitute a wrongful threat since Wells Fargo was not obliged to continue extending credit by the terms of the agreement.

Interpharm also claimed that certain demands under the forbearance agreements were unreasonable and inconsistent with the intentions of the parties when entering into the forbearance agreements. In other words, Interpharm claimed that there was some sort of side verbal agreements relating to the financing arrangements and Wells Fargo's obligations thereunder. The Court relied on the merger clause found in the May 2008 Forbearance Agreement to preclude Interpharm from maintaining that Wells Fargo had any legal obligation other than as set forth in the contract.

Interpharm's allegation that it was destroyed by Wells Fargo's decisions to limit credit after it defaulted on the credit agreement failed because Wells Fargo had no obligation to extend credit after a default. Interpharm agreed to a series of forbearance agreements imposing stricter requirements and costs on Interpharm. These demands by a creditor that is otherwise under no obligation to continue extending credit, do not constitute the wrongful threat required to establish economic duress under New York law, nor can a wrongful threat be based on Wells Fargo's exercise of discretion specifically conferred by the credit agreement.

The Court found that the releases granted by Interpharm in favor of Wells Fargo in the forbearance agreements were enforceable and that the District Court correctly dismissed the action based on those releases.

Phillips Lytle Banking & Financial Services attorneys are available to answer your questions about forbearance agreements or any other banking or financial matter. ■



INTERPHARM'S ALLEGATION THAT IT WAS DESTROYED BY WELLS FARGO'S DECISIONS TO LIMIT CREDIT AFTER IT DEFAULTED ON THE CREDIT AGREEMENT FAILED BECAUSE WELLS FARGO HAD NO OBLIGATION TO EXTEND CREDIT AFTER A DEFAULT.

Contractual Right of Triangular Setoff Cannot be Exercised in Bankruptcy

The doctrine of setoff generally "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A." Triangular setoff, in contrast, occurs where parties to a contract agree in advance to permit one party to setoff debt owed to a counterparty against debt owed to such party by an affiliate or related party of the counterparty. For example, the parties' contract may provide that, where B and C are affiliates or related parties, A is permitted to setoff debt owed by A to B against debt owed by C to A.

The Bankruptcy Code does not create an independent right to setoff. Section 553 of the Bankruptcy Code, however, preserves any existing state law right of the creditor to setoff prepetition "mutual debt" owed by the creditor to the debtor against a prepetition claim of the creditor against the debtor, subject to bankruptcy court approval through a motion for relief from the automatic stay. Prepetition debts are "mutual" within the meaning of Section 553 of the Bankruptcy Code when the debts are "due to and from the same persons in the same capacity."

Recent decisions in the Southern District of New York and the District of Delaware have concluded that, in general, the Bankruptcy Code prohibits parties from exercising a contractual right to triangular setoff in bankruptcy due to the lack of mutuality.

The United States Bankruptcy Court for the District of Delaware, in *In re SemCrude, L.P.,* 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd* 428 B.R. 590 (D. Del. 2010), concluded that the mutuality requirement of Section 553 of the Bankruptcy Code cannot be satisfied by the existence of a prepetition contract which contemplates triangular setoff.

In *SemCrude*, Chevron Products Company, a division of Chevron U.S.A., Inc., entered into prepetition contracts with SemCrude, L.P. and its affiliated debtors, SemFuel, L.P. and SemStream, L.P., which provided for the sale and purchase of energy products. The contracts each contained identical provisions contemplating triangular setoff, which stated that "in the event either party fails to make a timely payment of monies due and owing to the other party . . . the other party may offset any deliveries or payments due under this or any other Agreement between the parties and their affiliates."

Chevron sought bankruptcy court permission to effect setoff of certain prepetition amounts owed by SemCrude to Chevron against prepetition amounts owed by Chevron to SemFuel and SemSteam, as contemplated by the parties' agreements.

The bankruptcy court denied Chevron's request, holding that Section 553 of the Bankruptcy Code "prohibits a triangular setoff of debts against one or more debtors in bankruptcy as a matter of law due to lack of mutuality." The court reasoned that triangular setoff is impermissible because the mutuality requirement of Section 553 of the Bankruptcy Code is not satisfied where the debts to be setoff are owed by more than two parties.

The bankruptcy court rejected Chevron's contention that a so-called contract exception to Section 553's mutuality requirement exists. Chevron argued that, pursuant to the so-called contract exception, "a valid, pre-petition contract . . . either satisfies the mutuality requirement or allows the parties to contract around the mutuality requirement found in Section 553(a) if the contract provides that one or more parties to the agreement can elect to setoff any debt it owes to one of the other parties against an amount owed to it by a different party to the agreement."

The bankruptcy court disagreed, noting that, although a number of decisions have made reference to the so-called contract exception, no court has ever actually enforced a prepetition agreement which permits triangular setoff. Relying on the established meaning of "mutual debt," the bankruptcy court concluded that "non-mutual debts cannot be transformed into a 'mutual debt' under Section 553

simply because a multi-party agreement allows for setoff of non-mutual debts between the parties to the agreement."

The recent decision of the bankruptcy court for the Southern District of New York in *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011), confirmed that the holding of the *SemCrude* court, rejecting the use of triangular setoff in bankruptcy, would also apply in the Southern District of New York.

The *Lehman Brothers* decision involved a proceeding under the Securities Investor Protection Act of 1970 ("SIPA"), which takes place in the bankruptcy court utilizing fundamentally the same procedures as a Chapter 7 bankruptcy case. Lehman Brothers, Inc. ("LBI"), the debtor, and UBS AG ("UBS") entered into a swap agreement, which permitted triangular setoff. After the commencement of the Lehman Brothers bankruptcy case, UBS sought to setoff certain obligations of LBI owed to two affiliates of UBS against the obligations of UBS to LBI under the swap agreement.

The *Lehman Brothers* court concluded that Section 553 of the Bankruptcy Code prohibited UBS from exercising its contractual right of triangular setoff based upon the same reasoning employed by the *SemCrude* court. The court explained that, outside of bankruptcy and SIPA proceedings, "parties are free to agree to pretty much anything." When the parties to the contract "are solvent, the contract affects only the parties themselves and the interests of others are in no way implicated."

In the bankruptcy context, however, triangular setoff affects the rights of other entities who are not a party to the underlying contract. "When a debtor party to such a contract is 'in the money' and collects less due to offsets claimed by affiliates of its named counterparty, the creditors necessarily are adversely impacted by the reduction in the amounts to be realized by the estate." For this reason, the *Lehman Brothers* court observed, the mutuality requirement of Section 553 of the Bankrutpcy Code "must be strictly observed."

Neither the *SemCrude* decision nor the *Lehman Brothers* decision affect the validity and enforceability of contractual provisions permitting triangular setoff outside of bankruptcy. The decisions will, however, bring an end to triangular setoff in the bankruptcy cases filed in the District of Delaware and the Southern District of New York—the venue of the vast majority of large, complex Chapter 11 bankruptcy cases. In the absence of a contrary decision by the appellate courts in Delaware or New York or an amendment to the Bankruptcy Code, creditors will need to locate alternatives to triangular setoff in multi-party transactions.

If you would like additional information regarding triangular setoffs, contact any Phillips Lytle Bankruptcy & Creditors' Rights attorney. ■

Today more than ever, financial institutions are the driving force of the economy. And for those institutions to lend wisely, realize on their loans, and enforce their remedies, they need the help of experienced attorneys who understand the intricacies of both law and finance.

As a premier banking and commercial law firm, Phillips Lytle's Banking & Financial Services attorneys enjoy an excellent reputation built on decades of successful representation of major commercial, savings, and foreign banks; trust companies; finance companies; credit unions; and various other types of financial institutions. Phillips Lytle has been practicing law in New York for more than 175 years. We have built a substantial practice to meet the financing needs of our FORTUNE 500, midsized, and closely held business clients and are experienced in structuring, negotiating, and closing complex transactions on behalf of borrowers and lenders.

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