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Bankruptcy Court Rejects Triangular Setoff Rights in ISDA Agreement

By [Craig Enochs](#), [Kevin Page](#), and [Kelly Laukhuf](#)

On October 4, 2011, in the case of *In re Lehman Brothers Inc.*, the Bankruptcy Court in the Southern District of New York (the "Court") held that a cross-affiliate setoff provision contained in a swap agreement was not enforceable under the provisions of the U.S. Bankruptcy Code (the "Code").¹

On July 13, 2004, UBS AG ("UBS") and Lehman Brothers, Inc. ("LBI") entered into a 1992 ISDA Master Agreement, including a Schedule and Credit Support Annex forming a part thereof (collectively, the "ISDA Agreement"), for purposes of entering into foreign exchange transactions. Pursuant to the margining provisions of the Credit Support Annex, the parties exchanged collateral to secure payment obligations under the various transactions. Following the occurrence of certain events of default by LBI under the ISDA Agreement, UBS sent LBI a termination notice ("Termination Notice") designating September 16, 2008, as the ISDA Agreement's early termination date. After the date UBS sent its Termination Notice, the Court entered an order (i) authorizing LBI's trustee under the Securities Investor Protection Act ("SIPA Trustee") to take possession of LBI property, and (ii) notifying creditors that the automatic stay applied to all acts to obtain property from LBI's estate, and stayed all entities from directly or indirectly retaining or setting off any of LBI's assets (the "LBI Liquidation Order").²

Following the issuance of the LBI Liquidation Order, UBS exercised rights under the Credit Support Annex to set off approximately \$94 million that LBI owed UBS against \$170 million in collateral held by UBS as of the early termination date. After effecting such bilateral setoff, UBS still held approximately \$76 million of LBI's collateral (the "Remaining Collateral"). With respect to the Remaining Collateral, UBS sought to enforce triangular cross-affiliate setoff rights under the Schedule by offsetting amounts that LBI owed to two UBS affiliates under other agreements against the value of the Remaining Collateral held by UBS under the ISDA Agreement. Although the SIPA Trustee did not challenge the bilateral setoff effected by UBS under the Credit Support Annex, the Trustee did challenge UBS's right to setoff amounts allegedly due from LBI to UBS affiliates.³

In determining whether UBS' triangular setoff right was enforceable in bankruptcy, the Court first considered whether or not the parties created a valid and enforceable setoff provision under New York contract law. Relying on well-established New York law that parties are allowed to "create contractual setoff rights that differ from those provided by common law or statute," the Court held that without question "*outside the bankruptcy context*, section 5(a) [of the ISDA Agreement] is a valid and enforceable provision."⁴ However, the Court noted that this proposition does not extend to setoff under the Code.⁵ To be eligible for setoff under Section 533(a) of the Code,

"(1) the amount owed by the debtor must be a prepetition debt; (2) the debtor's claim against the creditor must also be prepetition; and (3) the debtor's claim against the creditor and the debt owed the creditor *must be mutual*."⁶ Although the Code itself does not expressly define mutuality, case law establishes that debts are mutual only when they are "in the same right and between the same parties, standing in the same capacity."⁷ The Court further clarified that "mutuality quite literally is tied to the identity of a particular creditor that owes an offsetting debt."⁸ In conclusion, the Court observed that:

"....mutuality is an essential, definitional element of the right to setoff that must be strictly observed. It is for Congress, not the bankruptcy court, to clearly delineate any exception to strict mutuality in the case of triangular setoff. Congress has not yet done so, and the Bankruptcy Code as presently written does not allow for it."⁹

Based on this case precedent and the Code's statutory requirements, the Court dismissed UBS's claim that the debts between LBI and UBS' affiliates were "mutual" under Section 553 of the Code and held that the triangular setoff provision in the ISDA Agreement was unenforceable.¹⁰

In light of this holding, market participants should exercise caution when making credit decisions that assume the enforceability of triangular setoff provisions in a bankruptcy proceeding.

If you have any questions regarding this e-Alert please contact **Craig Enochs** at 713.752.4315 or cenochs@jw.com, **Kevin Page** at 713.752.4227 or kpage@jw.com, **Kelly Laukhuf** at 214.953.5881 or klaukhuf@jw.com or **Bruce Ruzinsky** at 713.752.4204 or bruzinsky@jw.com.

¹ See *In re Lehman Brothers Inc.*, Memorandum Decision Enforcing the Automatic Stay and Compelling Payment by UBS AG, Case No. 08-01420 (Bankr. S.D.N.Y. October 4, 2011) (the "Opinion"). Note that the liquidation proceeding was brought under the Securities Investor Protection Act of 1970 ("SIPA"), 15 U.S.C. §§ 78aaa *et seq.* However, SIPA generally provides that any liquidation proceeding brought under SIPA is conducted as though such proceeding were being brought pursuant to the Code. See 15 U.S.C. § 78fff(b).

² Opinion at 3-4.

³ Opinion at 4-5.

⁴ Opinion at 6; see *Bank of N.Y. v. Meridien BIAO Bank Tanz. Ltd.*, NO. 95 Civ. 4856, 1997 U.S. Dist. LEXIS 1322, at *12 (S.D.N.Y. Feb. 10, 1997).

⁵ Opinion at 6.

⁶ Opinion at 7 (citing 11 U.S.C. § 553(a)); see *In re Lehman Brothers Holdings Inc.*, 433 B.R. 101, 107 (Bankr. S.D.N.Y. 2010) ("*Swedbank*") (emphasis added).

⁷ Opinion at 8; see *Lines v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 743 F. Supp. 176, 183 (S.D.N.Y. 1990).

⁸ Opinion at 10.

⁹ Opinion at 16.

¹⁰ Note that UBS alternatively argued that even if debts owed between LBI and UBS affiliates were not "mutual" under Section 553(a) of the Code, triangular setoff still should be enforced under the Code's "safe harbor" protections. See 11 U.S.C. §§ 560-61. The Court rejected UBS' argument, citing *Swedbank* which held that the mutuality requirement in Section 553 of the Code still applies when exercising setoff rights under the Code's "safe harbor" provisions. See *Swedbank*, 433 B.R. at 137.

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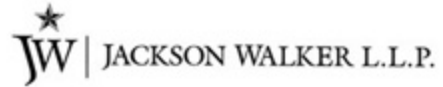
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