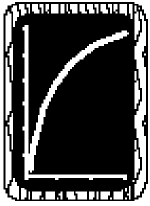
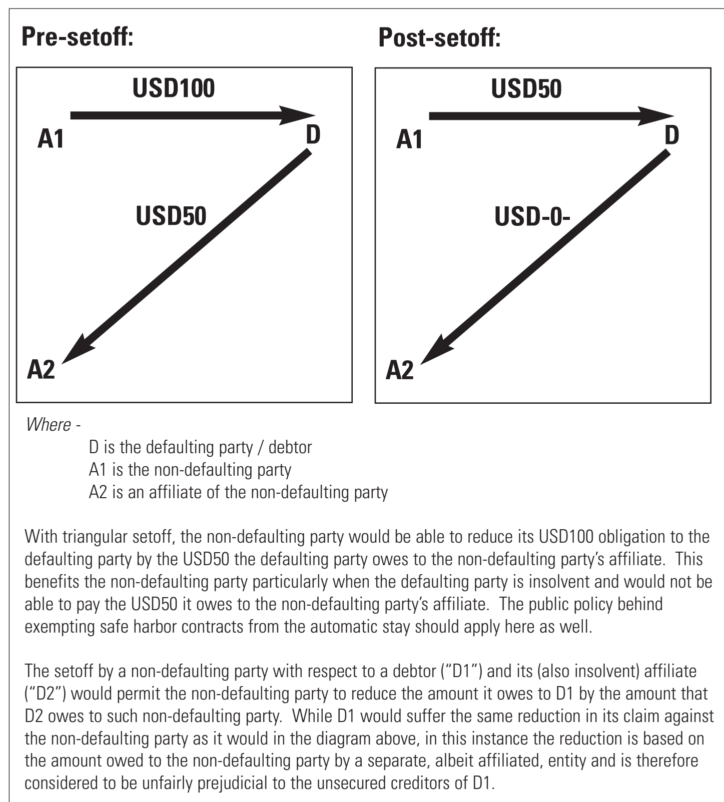


LEARNING CURVE®

Enforceability Of Triangular Setoff Rights In Safe Harbor Contracts — Still An Open Question? - Part 1

Almost every ISDA Master Agreement entered into between derivatives counterparties includes some type of setoff provision. The 1992 form of ISDA Master Agreement does not include a right of setoff, but a setoff provision was added to the Master Agreement Schedule with such regularity that a standard setoff provision was included as Section 6(f) of the ISDA 2002 Master Agreement form. The ISDA standard setoff provision requires mutuality, meaning that amounts are due to and from the same persons in the same capacity. The provision is frequently amended (at the behest of dealers doing business through multiple affiliates) to extend the right of setoff to affiliates of the non-defaulting party ("triangular setoff"), and the setoff provision found in many, if not most, 1992 ISDA Master Agreements provides for triangular setoff as well.

As the diagram below illustrates, triangular setoff permits one party, usually the non-defaulting party, to reduce any amount it owes to the defaulting party by any amount the defaulting party owes to an affiliate of the non-defaulting party.



Where -
D is the defaulting party / debtor
A1 is the non-defaulting party
A2 is an affiliate of the non-defaulting party

With triangular setoff, the non-defaulting party would be able to reduce its USD100 obligation to the defaulting party by the USD50 the defaulting party owes to the non-defaulting party's affiliate. This benefits the non-defaulting party particularly when the defaulting party is insolvent and would not be able to pay the USD50 it owes to the non-defaulting party's affiliate. The public policy behind exempting safe harbor contracts from the automatic stay should apply here as well.

The setoff by a non-defaulting party with respect to a debtor ("D1") and its (also insolvent) affiliate ("D2") would permit the non-defaulting party to reduce the amount it owes to D1 by the amount that D2 owes to such non-defaulting party. While D1 would suffer the same reduction in its claim against the non-defaulting party as it would in the diagram above, in this instance the reduction is based on the amount owed to the non-defaulting party by a separate, albeit affiliated, entity and is therefore considered to be unfairly prejudicial to the unsecured creditors of D1.

Dealer Need For Triangular Setoff

Many financial institutions trade derivatives through affiliates for regulatory capital and other reasons. Still, to the extent feasible, they want their counterparty exposure across such affiliates to be flat. In order to accomplish this, major dealers regularly enter into cross margining and netting agreements that permit them to transfer their counterparty's "in the money" amounts with respect to one affiliate's portfolio in order to meet deficits in the counterparty's portfolio with a different affiliate. The inclusion of triangular setoff rights in ISDA Master Agreements is consistent with the dealers' goal of viewing counterparty exposure on an enterprise-wide basis. The inability of one dealer affiliate to set off the obligations it owes to a debtor against amounts the debtor owes to another affiliate of that dealer would adversely affect the financial institution as a whole. Where the triangular setoff affects only the affiliates of the non-defaulting party, obviously there is no prejudice to the unsecured creditors of the defaulting party's affiliates.

The Recent Attack On Triangular Setoff

The question of whether a contractual triangular setoff provision is enforceable arises primarily in the bankruptcy context because setoff operates to reduce the assets of the bankruptcy estate available to satisfy claims of the debtor's creditors. Triangular setoff is currently under attack as the result of a recent decision in the *SemCrude*, L.P. chapter 11 cases pending in the U.S. Bankruptcy Court for the District of Delaware ("*SemCrude*").1 The *SemCrude* decision has had an unsettling impact on parties engaged in derivatives transactions because triangular setoff provisions are critical to the economic underpinnings of these agreements.

On January 9, the *SemCrude* Court denied a motion filed by Chevron Products Company for relief from the automatic stay to permit the setoff of debts owed by it to various affiliated debtors under prepetition agreements for the sale and purchase of crude oil, natural gas and other commodities. Even though these contracts were forward contracts ordinarily subject to the safe harbor provisions of the U.S. Bankruptcy Code (the "Bankruptcy Code"), Chevron's original motion surprisingly did not raise that point.2 The Bankruptcy Court held that section 553 of the Bankruptcy Code, which deals with the right of setoff, requires mutuality of obligations and therefore prohibits triangular setoffs. While the attempted setoff in

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SemCrude involved affiliates of the debtor, the Court did not base its decision on that factor, so the decision calls into question the enforceability of a setoff even among affiliates of the non-defaulting party. In fact, the Bankruptcy Code does not create a right of setoff, but, instead, preserves for a creditor's benefit any such right it may have under applicable non-bankruptcy law, subject to certain restrictions.3

The Bankruptcy Court's ruling in *SemCrude* was based solely on its interpretation of section 553 of the Bankruptcy Code without giving consideration to the fact that the contracts at issue may have been entitled to the benefits of sections 555, 556, 559, 560 and 561 of the Bankruptcy Code (the so-called "safe harbor" provisions). It did not help matters that Chevron's original motion in the Bankruptcy Court failed to assert that the contracts at issue are subject to the safe harbor provisions.

The Bankruptcy Code's safe harbor provisions provide that there is no stay of a "contractual right" to liquidate, terminate, or accelerate securities, forward, commodities, repurchase, swap and master netting agreements based on any condition listed in section 365(e)(1) of the Bankruptcy Code. The conditions listed in section 365(e)(1) include, among other things, a debtor's insolvency, the commencement of a bankruptcy proceeding or the appointment of a bankruptcy trustee. The term "contractual right" as used in the Bankruptcy Code's safe harbor provisions includes any right "by reason of normal business practice." Broadly speaking, the safe harbor provisions are "intended to minimize the displacement caused in the commodities and securities markets in the event of a bankruptcy affecting these industries." *See* 135 Cong. Rec. S1414, 1416 (daily ed. Feb. 9, 1989) (quoting 128 Cong. Reg. H261 (daily ed. Feb. 9, 1982).

Where safe harbor contracts are concerned, the relationship between sections 553 and 362 of the Bankruptcy Code may mean the difference between enforceable and unenforceable triangular setoff rights. Section 362 provides for an automatic stay of creditor actions against a debtor and its property upon the filing of a bankruptcy petition, subject to certain exceptions. Significantly, section Section 362(b)(17) excepts from the automatic stay the exercise by a swap participant or financial participant of a contractual right to "offset or net out any termination value, payment amount, or other transfer obligation" arising under one or more of such contracts, and section 362(b)(27) creates a similar exception to the automatic stay permitting "offsets" and "netting" under master netting agreements.4 These sections expressly permit the exercise of contractual setoff rights and, since 2006, have not included the mutuality requirement set forth in section 553.

A closer inspection of sections 553(a) and 362(b) reveals an inconsistency and supports the conclusion that triangular setoff is permitted where safe harbored contracts are involved.

Section 553

Section 553 permits the setoff of mutual, prepetition debts. The long line of cases interpreting section 553 hold that debts are "mutual" only when they are "due to and from the same persons in the same capacity." *See*, *e.g.*, *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir.2002). Section 553, while expressly requiring mutuality, also expressly states that its requirements apply only to the extent that the relevant provisions of other Bankruptcy Code sections, including section 362, do not. However, according to the view expressed by the *SemCrude* Court, parties cannot bypass the mutuality requirement merely by entering into an express contractual arrangement that allows for netting of obligations among various parties. Of the various Bankruptcy Code provisions that deal with safe harbor contracts, it is significant that section 553 is the only section to include a mutuality requirement.

Prior to 2006, sections 553 and 362 each required debts to be "mutual." Congress' 2006 amendments to the Bankruptcy Code removed the "mutual debt" requirement from sections 362(b)(6), (7), (17) and (27).5 While the legislative history does not address this change and no court has been called upon to interpret this revision, one may reasonably interpret this modification to indicate congressional intent to remove derivatives contracts entirely from the ambit of section 553. However reasonable that interpretation may be, it is as yet unsupported by the case law.

In Part II of this Learning Curve, which will appear in next week's issue, we conclude that a contractual setoff provision with respect to affiliates of the non-defaulting party should be enforceable against a Bankruptcy Code debtor based on the interplay among Sections 553, 362 and the safe harbor provisions, and we discuss ways to create mutuality just in case future court decisions expand the SemCrude ruling to cover safe harbor contracts.

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1) *In re SemCrude*, 399 B.R. 388 (Bankr. D. Del. 2009).

2) Chevron moved for reconsideration of the Bankruptcy Court's decision, but the Court denied this motion on March 20, 2009, holding that the applicability of the safe harbor provisions was not raised in Chevron's original motion. Chevron has since appealed to the District Court.

3) *See* 11 U.S.C. § 553(a). *See also*, *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995) ("Although no federal right of setoff is created by the Bankruptcy Code, 11 U.S.C. § 553(a) provides that, with certain exceptions, whatever right of setoff otherwise exists is preserved in bankruptcy.").

4) The same benefits are provided with respect to commodity contracts, forward contracts and securities contracts under section 362(b)(6) and to repurchase agreements under section 362(b)(7).

5) These provisions were also amended at that time to substitute the term "offset" for the term "setoff." Even though the term "offset" may be used to include both setoff and recoupment, based on our analysis of the relevant Bankruptcy Code sections, we do not believe that these substitutions were made with any substantive congressional intent. Neither term is defined in the Bankruptcy Code.