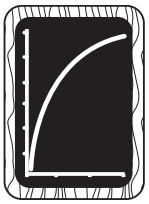

LEARNING CURVE®

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

In last week's issue, we explained what triangular set off accomplishes and why dealers need it, and presented the question of whether, after the *SemCrude* decision, a triangular setoff provision in a safe harbor contract is enforceable against a U.S. Bankruptcy Code debtor.

Section 362 And The Safe Harbor Provisions

Sections 362(b)(6), (7), (17) and (27) do not provide creditors with additional setoff rights but, rather, are timing sections that establish when creditors may exercise setoff rights. The Supreme Court considered this issue in *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995) (a case decided before the 2006 amendments to the Bankruptcy Code). As previously discussed, section 553 provides that its requirements apply only to the extent other provisions of the Bankruptcy Code, including section 362, do not. In *Strumpf*, the Supreme Court concluded this proviso "is most naturally read as recognizing [section 553's] restriction upon when an actual setoff may be effected – which is to say not during the automatic stay." Thus, a creditor's right to setoff is preserved by section 553(a) but section 362(a)(7) stays the exercise of that right. Sections 362(b)(6), (7), (17) and (27), like section 362(a)(7), speak to the timing of the exercise of a setoff right, but the right of setoff remains governed by section 553(a). Because section 553(a) relates to the substance of a creditor's setoff rights and includes the mutuality requirement, one can reasonably read *Strumpf* to mean that triangular setoff is not permissible even in a safe harbor context.

While *SemCrude* and *Strumpf* cannot be ignored, neither can the 2006 amendments to the Bankruptcy Code. Through these amendments, Congress removed the mutuality requirement formerly found in sections 362(b)(6), (7), (17) and (27). Although section 362(b) governs when a creditor may exercise a setoff right and not the right of setoff itself, it seems inconsistent with the amendments to construe section 362(b) to prevent a party to a derivatives contract that includes a triangular setoff right from exercising that right solely because the setoff does not meet the section 553 mutuality requirement. Notwithstanding *Strumpf* and *SemCrude*, the plain language of section 553(a) and the related case law holdings are that section 553 preserves (but does not create) "whatever rights of setoff exist under nonbankruptcy law." *See In re Ingersoll*, 90 B.R. 168, 171 (Bankr. W.D. N.C. 1987). Thus, if a derivatives contract grants the parties the right of triangular setoff, that right should be preserved by operation of the opening clause of section 553(a) — "except as otherwise provided in this section and in sections 362 . . ." — which refers to a section of the Bankruptcy Code from which the mutuality requirement was explicitly removed in 2006.

Unfortunately, there is no legislative history explaining the interplay between section 553 and the relevant provisions of section 362(b). However, the legislative history of the interaction between clauses (6), (7), (17) and (27) of section 362(b) and the other safe harbor provisions (specifically sections 560 and 561) is useful insofar as Congress indicated the "netting and offset rights in sections 560 and 561 [are] in addition to the protections afforded in sections 362(b)(6), (b)(7), (b)(17), and (b)(28) [sic] of the Bankruptcy Code."**6** Section 561(b)(1) provides that a party may exercise a contractual right to terminate, liquidate or accelerate "only to the extent that such party could exercise such a right under section 555, 556, 559 or 560 . . . ." Significantly, Congress excluded section 553 from the limiting language in section 561, thus strongly implying that section 553 (including its mutuality requirement) does not apply to safe harbored contracts.

Hedging Your Bets

While in a safe harbor context contractual setoff with respect to affiliates of the non-defaulting party should be enforceable against a Bankruptcy Code debtor, it remains to be seen whether and to what extent other courts will expand the *SemCrude* ruling to require mutuality. In the interim, derivatives counterparties might consider (i) assignment, and/or (ii) the creation of security interests and guarantees as ways to achieve mutuality.

Assignment

Courts generally agree that an assignment of rights can create mutuality for setoff purposes. *See*, *e.g.*, *In re U.S. Aeroteam, Inc.*, 327 B.R. 852 (Bankr. S.D. Ohio 2005);7 *In re Jones Truck Lines, Inc.*, 196 B.R. 123 (Bankr. W.D. Ark. 1996); *In re Assured Fastener Products Corp.*, 773 F.2d 105, 107 (7th Cir.1985)

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(determining that section 553 allowed setoff by assignment so long as the assignment occurred more than 90 days prior to the bankruptcy). When a party purchases a creditor's claim, the purchaser acquires all of the seller's rights as a creditor of the debtor and thereby satisfies the mutuality requirement. Assignments are, therefore, one way that parties can transform a non-mutual three party situation into one where mutuality exists.

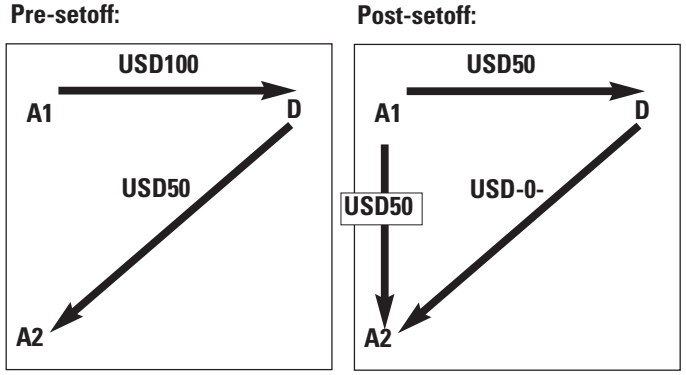
In drafting section 553, Congress understood that creditors might seek to create agreements in order to establish setoff rights that otherwise they would not have.**8** To prevent "trafficking" in claims for this purpose, Congress enacted section 553(a)(2) which generally precludes a creditor from effecting a setoff in bankruptcy if the claim was transferred to the creditor by an entity other than the debtor (i) after the bankruptcy petition was filed or (ii) within 90 days of the filing of the petition and while the debtor was insolvent. 11 U.S.C. §§ 553(a)(2).

However, different policy considerations play out in the case of safe harbor contracts. Section 553(a)(2)(B)(ii) includes exceptions to the general rule above, including with respect to safe harbor contracts. Section 561(a) provides that the offsetting termination values, payment amounts or other obligations in connection with safe harbor contracts "shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ." This means that a bankruptcy court will enforce a creditor's setoff with respect to two safe harbor contracts based on an assignment that enables the creditor to satisfy the mutuality requirement, even if the assignment is effected within 90 days before the commencement of a bankruptcy proceeding, while the debtor is insolvent and for the sole purpose of creating mutuality.

Creation Of Security Interests And Guarantees

Mutuality also can be established through the creation of security interests in favor of affiliated entities. When a bank's trading relationship with its counterparty extends across various bank affiliates, the bank can establish mutuality by requiring the counterparty to grant to each bank affiliate a security interest in the amounts that each of the other affiliates owes to the counterparty.

Courts are divided on whether mutuality can be established where affiliates of one party each guarantees the obligations to the counterparty of each other such affiliate. *Compare Bloor v. Shapiro*, 32 B.R. 993 (S.D.N.Y. 1983) (holding that where a guarantor assumed a third party's obligations to the debtor, the liability became a debt owed by the debtor to the guarantor and thus subject to setoff) *with In re Ingersoll*, 90 B.R. 168, 171 72 (Bankr. W.D. N.C. 1987) (despite the presence of a guarantee, debts between different parties in different capacities held not subject to setoff). *SemCrude* did not foreclose the possibility that guarantees may be used to create mutuality under section 553(a), but the creation of contingent liabilities through a cross guarantee arrangement may make this option unattractive or not feasible for many counterparties.



Where -

D is the defaulting party / debtor
A1 is the non-defaulting party
A2 is an affiliate of the non-defaulting party
D has granted A2 a security interest in the USD100 A1 owes to D

To protect against the possibility that a bankruptcy court would not enforce triangular setoff even in a safe harbor context, the master agreement between A1 and D could provide that D grants to A1 a security interest in any amount A2 owes to D, and, similarly, the master agreement between A2 and D could provide that D grants to A2 a security interest in any amount A1 owes to D. In the Pre-setoff diagram above, A2 would have a security interest in the USD100 owed to D by A1, which, for purposes of establishing mutuality of obligation, constitutes a claim owed by A2 to D contingent upon D paying the USD50 it owes to A2. Mutuality thus established, A2 could setoff its USD50 receivable from D against D's USD100 receivable from A1. As reflected in the Post-setoff diagram, A1 would pay to A2 USD50 of the USD100 A1 owes to D (thereby extinguishing D's USD50 obligation to A2) and USD50 to D.

Conclusion

The story of triangular setoff and the Bankruptcy Court's ruling in *SemCrude* is far from over. On March 26, Chevron appealed the Bankruptcy Court's ruling to the Untied States District Court for the District of Delaware. The appeal is currently pending.

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6) *See* H.R. Rep. No. 109-31, 109th Cong. 1st Sess. 131 (2005). Sections 362(b)(6), (7), (17) and (27) of the Bankruptcy Code reinforce the protections afforded under the Bankruptcy Code's safe harbor provisions.

7) In the *U.S. Aeroteam* case, U.S. Aeroteam ("USAT"), a manufacturer of parts for the aerospace and automotive industries, was having difficulty paying its own suppliers for the components of parts it had agreed to deliver to one of its largest customers. The customer agreed to pay the supplier the amount USAT owed to the supplier in exchange for an assignment to the customer of the supplier's right to receive payment from USAT. The court found that the assignment of the supplier's right of payment to the customer created dual obligations of payments between the customer and USAT, one stemming from an assignment, and the other stemming from unpaid goods, thereby establishing the requisite "mutuality" for setoff.

8) *See In re Davicter Enterprises, Inc.*, 248 B.R. 794 797 (Bankr. S.D.III. 2000).