Davis Polk
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Insolvency and Restructuring Update

Lehman Bankruptcy Court Holds Contractual Right to Triangular Setoff Unenforceable In Bankruptcy and Not Protected by Safe Harbors

In a recent decision issued in the Lehman Brothers Inc. SIPA proceeding in the Southern District of New York, In re Lehman Brothers Inc., Case No. 08-01420 (JMP) (SIPA), slip op. (Bankr. S.D.N.Y. Oct. 4, 2011), Bankruptcy Judge James M. Peck held that a contractual right to effect a cross-affiliate setoff is unenforceable in bankruptcy. The court found that mutuality is a requirement for both common law and contractual setoff under Section 553 of the Bankruptcy Code, and that the contract did not create mutuality for purposes of Section 553. The court further held that the safe harbor provisions for swaps and other derivatives contracts in the Bankruptcy Code do not permit a party to exercise a contractual right to setoff where there is no mutuality.

While the ruling is consistent with the seminal case Chevron Products Co. v. SemCrude, L.P. (In re SemCrude, L.P.), 428 B.R. 590 (D. Del. 2010) and earlier decisions in the Lehman case that have stressed the requirement of strict "mutuality" for setoff in bankruptcy as well as a narrow reading of the safe harbors (such as Swedbank AB v. Lehman Brothers Holdings Inc. (In re Lehman Brothers Holdings Inc.), 445 B.R. 130 (S.D.N.Y. 2011)), this decision is significant in that it addresses the interplay between the safe harbors and the enforceability of cross-affiliate setoff or netting provisions.

Background

On July 13, 2004, UBS AG ("UBS") and Lehman Brothers Inc. ("LBI") entered into a 1992 ISDA Master Agreement (the "ISDA Master") governing foreign exchange swaps, together with a Credit Support Annex (the "CSA" and, together with the ISDA Master, the "Agreement"). Pursuant to the CSA, the parties posted collateral to secure their respective obligations under the ISDA Master.

UBS terminated the transactions under the ISDA Master on September 16, 2008 on the basis of, among other things, an event of default triggered by the Chapter 11 filings of certain of LBI's affiliates. At the time of termination, the transactions under the ISDA Master were net in-the-money to UBS, and LBI had posted collateral under the CSA to secure that exposure. The CSA did not purport to secure any other obligations of LBI to UBS or its affiliates.

On September 19, 2008, shortly after the termination notice was issued, LBI commenced liquidation proceedings under the Securities Investors Protection Act of 1970 ("SIPA"). As a result, all creditors were stayed from any act to obtain property of the estate, including retaining or setting off against any assets of LBI, subject to an exception for the exercise of contractual rights to liquidate, terminate or accelerate certain types of qualified financial contracts and offset termination values, payment amounts or other transfer obligations thereunder, and to foreclose on cash collateral.

After applying the collateral against the "Early Termination Amount" owed to it by LBI under the ISDA Master (which LBI did not dispute), UBS continued to retain $76 million in excess collateral. LBI argued that under the terms of the CSA, UBS was required to return the excess collateral to LBI. Even though UBS ultimately agreed to turn over $53 million of the $76 million to LBI, it resisted paying the $23 million balance on the grounds that LBI had outstanding obligations to certain affiliates of UBS, and that under

the terms of the Agreement it had a contractual right to effect a "cross-affiliate" or "triangular setoff" in respect of such amounts.[1]

Specifically, UBS asserted a right of cross-affiliate setoff on the basis of a provision in Part 5(a) of the Schedule to the ISDA Master[2] that permitted UBS to set off its obligations to LBI under the Agreement against amounts that LBI allegedly owed to two UBS affiliates (UBS Securities and UBS Financial Services) under separate agreements. UBS claimed that the amount LBI owed the UBS affiliates exceeded the $23 million in remaining collateral, and that UBS was entitled to set off such amount against its obligation under the CSA to return the remaining collateral to LBI.

Discussion

The Bankruptcy Court recognized that the contractual cross-affiliate setoff provision was valid and enforceable outside of the bankruptcy context, but held that cross-affiliate setoff was unenforceable in bankruptcy due to lack of mutuality. The court's reasoning is consistent with a number of its earlier decisions in the Lehman proceedings regarding the requirement of mutuality for setoff in bankruptcy, as well as its narrow interpretation of the safe harbors for derivatives transactions.

Section 553(a) of the Bankruptcy Code provides that the Code does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor against a claim of such creditor against the debtor.[3] Although the Code does not define mutuality, "courts consistently find debts to be mutual only when they are 'in the same right and between the same parties, standing in the same capacity.'"[4]

UBS argued first that the mutuality requirement of Section 553 applies only to common law setoff rights and not to setoff rights created by contract. The court rejected this argument, noting that the text of Section 553 "by its plain wording applies whenever a creditor seeks to exercise *any* purported setoff right – including one created by contract – in a case under the Bankruptcy Code."[5]

Having concluded that the mutuality requirement of Section 553 applied to the contract at issue, the court next addressed UBS's argument that the debts should be considered mutual because the contractual provision permitting cross-affiliate setoff supplied the necessary mutuality "by collecting all affiliates under the same corporate umbrella and treating them as if they were a single counterparty."[6]

The court again rejected UBS's argument on the basis of the plain language of Section 553, which "expressly preserves the 'right of a creditor to offset a mutual debt owing by *such creditor* to the debtor . . .

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[1] Cross-affiliate setoff provisions are not unusual in derivatives transactions among complex financial institutions. For regulatory, tax and business reasons, financial institutions may book transactions in different products at different legal entities within the corporate group. The same may be true of the counterparty. In practice, however, parties often seek to manage their relationship on a global basis, without regard to legal entity.

[2] The relevant provision provides that "'upon the designation of any Early Termination Date, in addition to and not in limitation of any other right or remedy . . . under applicable law the Non-defaulting Party or Non-affected Party (in either case, "X") may without prior notice to any person set off any sum or obligation (whether or not arising under this Agreement . . .) owed by the Defaulting Party or Affected Party (in either case, "Y") to X or any Affiliate of X against any sum or obligation (whether or not arising under this Agreement . . .) owed by X or any Affiliate of X to Y . . . .'" *In re Lehman Brothers Inc.*, Case No. 08-01420 (JMP) (SIPA), slip op. at 5 (Bankr. S.D.N.Y. Oct. 4, 2011) (citing the Schedule to the ISDA Master).

[3] 11 U.S.C. § 553(a).

[4] *In re Lehman Brothers Inc.*, Case No. 08-01420 (JMP) (SIPA), slip op. at 8 (Bankr. S.D.N.Y. Oct. 4, 2011) (citing *Lines v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 743 F. Supp. 176, 183 (S.D.N.Y. 1990) (internal quotation marks and citations omitted)).

[5] *Id.* at 7.

[6] *Id.* at 9.

against a claim of *such creditor* against the debtor."[7] Such language, the court reasoned, is "conclusive" because it demonstrates that mutuality is "tied to the identity of a particular creditor that owes an offsetting debt."[8]

UBS also asserted that a line of cases endorsed a "contract exception" to mutuality—i.e., that mutuality was not required where parties had signed an express contractual provision permitting triangular setoff. The court examined the cases and found that none had actually upheld an agreement calling for triangular setoff, but rather had "'simply recognized such an exception in the course of denying the requested setoff or finding mutuality independent of the agreement.'"[9] Consequently, the "so-called contract exception" was actually "created by a game of 'whisper down the lane' from decision to decision."[10]

The court relied instead on *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010), which held that triangular setoff was prohibited under Section 553 as a matter of law due to a lack of mutuality, and that there was no exception to the mutuality requirement for rights of triangular setoff granted by contract. In that case, the bankrupt entities were SemGroup and its affiliates SemCrude, SemFuel, and SemStream. Chevron moved for relief from the automatic stay to effect a triangular setoff of the amounts it owed to SemCrude against the amounts owed to it by SemFuel and SemStream. The court denied the motion, holding that Section 553 prohibits a triangular setoff of debts against different debtor-obligors in bankruptcy as a matter of law due to lack of mutuality. Unlike *Semcrude*, the UBS case involved setoff across creditor affiliates against a single debtor, LBI. Nonetheless, the Bankruptcy Court found the reasoning of *Semcrude* persuasive.

Finally, UBS argued that even if the court were to find that the asserted right to triangular setoff is both subject to and contrary to the language of Section 553, such a right nonetheless exists under the "safe-harbor" provisions of Section 561 of the Bankruptcy Code, applicable to swaps and certain other qualified financial contracts, which provides that "'[t]he exercise of any contractual right . . . to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more . . . swap agreements . . . shall not be stayed, avoided, or otherwise limited'" by any provision under the Bankruptcy Code or by any order of a court in any proceeding under the Code.[11]

In response to this argument, the court held that the safe harbor provisions protect the exercise of contractual rights to offset only where that right exists in the first place. Because there was no mutuality, the court held that UBS had no right of offset, and nothing in the Bankruptcy Code "can be read to preserve or protect a right that does not otherwise exist."[12] In reaching this conclusion, the court relied on *In re Lehman Brothers Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), *aff'd*, 445 B.R. 130 (S.D.N.Y. 2011) ("*Swedbank*"), which held that a safe harbor provision did not permit Swedbank to exercise a contractual right to setoff where there was no mutuality. In *Swedbank*, the lack of mutuality derived from timing – the creditor sought to offset post-petition funds deposited in a bank account against pre-petition indebtedness arising under a swap agreement – rather than from the identity of the parties, but the same principle applied.

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[7] *Id.* at 10 (citing 11 U.S.C. § 553(a) (emphasis added)).

[8] *Id.* at 10.

[9] *Id.* at 11 (citing *In re SemCrude, L.P.*, 399 B.R. 388, 394 (Bankr. D. Del. 2009)).

[10] *Id.* at 12.

[11] *Id.* at 13 (citing 11 U.S.C. § 561). The court did not address the interplay between the safe harbor provisions of the Bankruptcy Code and the safe harbor provisions under SIPA.

[12] *Id.* at 14.

Although the court noted that the triangular setoff issue constitutes a good faith legal dispute, by retaining the collateral, the court found, UBS had "exercis[ed] control over property of the estate in violation of the [automatic stay]."[13] The court therefore directed UBS to return the collateral to the SIPA Trustee immediately.

The court concluded with a policy rationale for "strictly observ[ing]" mutuality.[14] When a debtor "collects less due to offsets claimed by affiliates of its named counterparty, the creditors necessarily are impacted by the reduction in the amounts to be realized by the estate."[15] Disregarding corporate formalities and treating a subsidiary just like a parent for purposes of setoff rights "is to ignore the separate nature of these entities to the obvious detriment of other creditors."[16]

Future Implications

Although contractual cross-affiliate setoff and netting provisions are valid under New York law outside of bankruptcy, parties considering arrangements that rely on cross-affiliate setoff or netting as a credit risk mitigant should be aware of the risks of these arrangements in the event their counterparty enters bankruptcy, and may want to explore alternative credit risk mitigation techniques such as cross-collateralization and the pledge of contract rights.

In this regard, it is worth noting that the obligation UBS sought to set off was not an obligation to pay the net termination value of the transactions under the ISDA Master, but an obligation to return excess collateral. Had the obligations of LBI to the UBS affiliates been secured by a perfected lien on the collateral, the affiliates would have enjoyed secured creditor status and the collateral would not have been "excess." In this respect, the facts of the UBS case bear some similarity to those in the Bankruptcy Court's recent decision in *Bank of America, N.A. v. Lehman Brothers Holdings Inc. (In re Lehman Brothers Holdings Inc.)*, 439 B.R. 811 (Bankr. S.D.N.Y. 2010), although that case did not involve cross-affiliate or contractual setoff. In his decision in that case, Judge Peck held that a bank deposit with Bank of America that was expressly pledged as collateral for a specified obligation could not be set off by Bank of America against other obligations. Although the court's reasoning in the instant case could similarly have focused on the fact that the lien secured only the obligations of LBI under the ISDA Master, the court did not pursue this approach. Rather, the broad language and reasoning of the court's decision seems to implicate other types of cross-affiliate setoff or netting arrangements, including those that involve pure contractual termination payment obligations.

- See a copy of *In re Lehman Brothers Inc.*, Case No. 08-01420 (JMP) (SIPA), slip op. (Bankr. S.D.N.Y. Oct. 4, 2011)

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[13] *Id.* at 15.

[14] *Id.* at 16.

[15] *Id.*

[16] *Id.*

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