Clients&FriendsMemo

Bankruptcy Court for Southern District of New York Prohibits Triangular Setoff Provided for in Safe Harbored Contract

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On October 4, 2011, the United States Bankruptcy Court for the Southern District of New York ruled that a contractual right of a triangular (non-mutual) setoff was unenforceable in bankruptcy, even though the contract was safe harbored. *In re Lehman Brothers, Inc.*, No. 08-01420 (JMP), 2011 WL 4553015 (Bankr. S.D.N.Y. Oct. 4, 2011). In doing so, Judge Peck followed prior decisions by the Delaware bankruptcy and district courts in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010) and his own decision in *In re Lehman Brothers Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010) ("***Swedbank***").

Background

UBS AG ("**UBS**") held $23 million of Lehman Brothers Inc.'s excess collateral after the early termination of a swap agreement between UBS and Lehman Brothers Inc. ("**LBI**"). UBS refused to turn over the remaining collateral asserting its contractual right to set off these funds against the debt LBI owed to affiliates of UBS that were not parties to the swap agreement.

Triangular Setoff

Section 553(a) of the Bankruptcy Code provides, in relevant part, that

> [e]xcept as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.

The Bankruptcy Code does not define mutuality. The courts have held that debts are mutual only when they are "in the same right and between the same parties, standing in the same capacity."[1]

As an initial matter, the Court rejected UBS's argument that Section 553(a) did not apply to contractual setoff rights. The Court held that Section 553(a) governs any setoff rights, whether created at common law or by a contract. The Court noted that to be eligible for setoff under Section 553(a), (1) both debts must be pre-petition debts[2] and (2) such debts must be mutual.

UBS contended that the debts between the UBS affiliates and LBI should be viewed as mutual because the contract expressly allowed UBS to offset amounts owed to its affiliates. In rejecting UBS's argument, the Court ruled that mutuality could not be created "synthetically" by contract. In this case, the debts were not "in the same right and between the same parties, standing in the same capacity."[3] Therefore, the parties lacked mutuality necessary for setoff to be enforceable under section 553 of the Bankruptcy Code.

Safe Harbor

Following its own decision in *Swedbank*, the Court ruled that safe harbor provisions of Section 561 and 362(b) of the Bankruptcy Code did not preserve or protect a contractual right of cross-party setoff. In *Swedbank*, the non-debtor argued that the safe harbor provision of Section 560 of the Bankruptcy Code permitted a swap contract counterparty to exercise *any* contractual right notwithstanding the automatic stay. Therefore, the argument went, the reference to "any contractual right" in Section 560 should permit Swedbank to exercise a triangular right of setoff.

Here, UBS offered essentially the same argument with respect to Section 561 of the Bankruptcy Code which allows netting across multiple contracts. The Court explained that the Bankruptcy Code safe harbors permit the exercise of a contractual right of setoff in connection with derivatives contracts, notwithstanding the operation of any provision of Bankruptcy Code that could operate to stay, avoid or otherwise limit that right, "*but that right must exist in the first place.*"[4] The Court concluded that "[b]ecause there is no mutuality, UBS has no right of offset, and nothing in section

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1 *Lines v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 743 F.Supp. 176, 183 (S.D.N.Y. 1990); *see also MNC Commercial Corp. v. Joseph T. Ryerson & Son, Inc.*, 882 F.2d 615, 618 n.2 (2d Cir. 1989) ("under federal bankruptcy law, a subsidiary's debt may not be set off against the credit of a parent").

2 With respect to this element, Judge Peck previously held that mutuality was not present where a creditor attempted to set off post-petition funds deposited in a bank account against pre-petition indebtedness arising under a swap agreement. *Swedbank*, 433 B.R. 101.

3 *Lehman Brothers Inc.*, 2011 WL 4553015 at *4.

4 *Id.* at *7.

561 of the Bankruptcy Code can be read to preserve or protect a right that does not otherwise exist."[5]

Finally, the Court held that UBS violated the automatic stay by failing to seek relief while holding the LBI's collateral. The limited exception to the stay under Section 362(b)(17) of the Bankruptcy Code did not apply because the debts owed by LBI to UBS's affiliates did not arise under the swap agreement in question. Consequently, the Court ordered UBS to return the remaining collateral to the LBI's liquidating trustee.[6]

Conclusion

This decision may be viewed as a logical continuation of the judicial trend exemplified by previous decisions in *SemCrude* and *Swedbank* to strictly construe the mutuality requirement of Section 553. Taken together, these cases establish that triangular set off will not be enforceable in bankruptcy.[7]

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5 *Id.*

6 The Court awarded no damages and imposed no sanctions on UBS for violation of the stay noting that "the triangular setoff issue constitutes a good faith legal dispute." *Id.* at *8.

7 The decision has not been appealed as of the date of this Memo.