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Clients&FriendsMemo

U.S. District Court Affirms Delaware Bankruptcy Court Decision in *SemCrude* Prohibiting Triangular Setoff

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The United States District Court for the District of Delaware recently affirmed a Bankruptcy Court decision that invalidated the use by creditors of so-called "triangular", or non-mutual, setoffs in which obligations are offset among not only the parties to a bilateral contract but also their affiliates. *In re SemCrude, L.P.*, 2010 U.S. Dist. LEXIS 42477 (D. Del. 2010).[1] The District Court's decision, like the Bankruptcy Court decision it affirmed, does not address whether the result would be different for derivatives and other financial contracts that fall under the safe harbor provisions of the Bankruptcy Code.[2] However, the recent *Swedbank* decision in the *Lehman Brothers* bankruptcy case[3] suggests that the safe harbor provisions do not override the mutuality requirement.

The District Court's decision in *SemCrude*, issued on April 30, 2010, affirmed last year's decision of the United States Bankruptcy Court for the District of Delaware in the chapter 11 cases of SemGroup, L.P., an energy industry services company, and its affiliates. Applying an abuse of discretion standard,[4] the District Court upheld the lower court's decision that Chevron USA, Inc. ("**Chevron**") could not set off its pre-petition obligations to SemCrude ("**SemCrude**") against

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[1] In *Chevron Products Co. v. SemCrude L.P.* (*In re SemCrude, L.P.)*, No. 09-288-JJF, 2010 WL 173710 (D. Del. Apr. 30, 2010), Chevron Products Company, a division of Chevron U.S.A., Inc. ("Chevron") appealed from the Jan. 9, 2009 Order of the Bankruptcy Court denying Chevron's motion seeking relief from the automatic stay and the March 19, 2009 Memorandum Order denying Chevron's motion for reconsideration of such order. The bankruptcy court decision is reported at *In re SemCrude, L.P.,* 399 B.R. 388 (Bankr. D. Del. 2009)(hereinafter, *"SemCrude I"*), and was reviewed in our January 16, 2009 Clients and Friends Memo entitled "Delaware Bankruptcy Court Decision in SemCrude Poses Setback to Triangular Setoff"; http://www.cadwalader.com/assets/client_friend/011609_Delaware_Bankruptcy_Court_Decision.pdf.

[2] *See, e.g.*, 11 U.S.C. §§ 362(b)(6)-(7), (b)(17) and (b)(27), 556, 560 and 561.

[3] *See In re Lehman Bros. Holdings Inc.*, Bankr. Case No. 08-13555 (JMP), 2010 WL 1783395 (Bankr. S.D.N.Y. May 5, 2010)(hereinafter, *"Swedbank"*), *appeal filed, Swedbank AB (publ.) v. Lehman Bros. Holding Inc.* (Bankr. S.D.N.Y. May 6, 2010) analyzed in our Clients & Friends Memo dated May 6, 2010 entitled "Lehman Bankruptcy Court Rules Safe Harbors Do Not Override Setoff Mutuality Requirement"; http://www.cadwalader.com/assets/client_friend/050610_LehmanBankCourt.pdf.

[4] This standard applies to a denial of relief from the automatic stay or of reconsideration. "An abuse of discretion exists when judicial action rests upon a clearly erroneous finding of fact, an errant conclusion of law or an improper application of law to fact.' " 2010 WL 173710 at *2 (*citing NLRB v. Frazier*, 966 F.2d 812, 815 (3d Cir. 1992))(further citations omitted).

amounts owed to Chevron by affiliated debtors SemFuel, L.P. ("**SemFuel**") and SemStream, L.P. ("**SemStream**"), and thereby effect a "triangular" setoff of the amounts owed between it and three affiliated debtors, notwithstanding that the parties had entered into pre-petition contracts that expressly contemplated multiparty setoff.[5]

The District Court also affirmed the Bankruptcy Court's decision that the mutuality required to setoff under section 553 of the Bankruptcy Code—"that is that debts are due to and from the same persons in the same capacity"[6]—could not be created by multiparty contracts, even those expressly contemplating a triangular setoff, citing the plain language of Section 553, case law, and "the primary goal of the Bankruptcy Code to ensure equal and fair treatment among similarly situated creditors."[7]

After the Bankruptcy Court's initial decision against it, Chevron filed a motion for reconsideration, asking the Bankruptcy Court to consider the argument that Chevron's contracts with SemCrude were derivatives (swaps, forwards, commodities agreements and/or master netting agreements) protected by various safe harbor provisions, not standardized fuel supply contracts.[8] The Bankruptcy Court denied that motion and, again finding no abuse of discretion, the District Court affirmed, noting that there had been no intervening change in controlling law or any new factual development to justify reconsideration, and that Chevron had not raised the safe harbor issue when it first had the chance (in fact, Chervon had expressly argued that safe harbor provisions were not at issue).[9] The District Court noted: "Reconsideration is not a proper vehicle to advance new legal theories or introduce already available evidence."[10]

The District Court's holding in *SemCrude* forms part of a judicial trend towards strict enforcement of the mutuality requirement of Section 553. Earlier this month, in *Swedbank*, the United States Bankruptcy Court for the Southern District of New York held that the safe harbor provisions of the Bankruptcy Code do not override the mutuality requirement for setoff.[11] *Swedbank* involved not a

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5 2010 WL 173710.

6 *See SemCrude I*, 399 B.R. at 393 (*citing Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir. 2002)) (further citations omitted).

7 *See* 2010 WL 173710 at *2.

8 *See* 2010 WL 173710; see also 399 B.R. at 398-99.

9 2010 WL 173710 at *3.

10 *Id.* (citations omitted). The District Court expressly noted that the Fourth Circuit's decision in *National Gas* was not controlling and, in any case, addressed only whether a commodity forward agreement constituted a "swap agreement" under 11 U.S.C. § 101(53B). *Id. (citing Hutson v. E.I. du Pont de Nemours & Co. (In re Nat'l Gas Distribs. LLC)*, 556 F.3d 247, 259-60 (4th Cir. 2009))(discussed in our newsletter article of June 2009 entitled "Fourth Circuit Examines Swap Agreements Subject to Bankruptcy Code Safe Harbors" http://www.cadwalader.com/assets/newsletter/RR_June_09_final.pdf).

11 *See* discussion, supra at 1 and n. 3.

multiparty setoff but a setoff of pre-petition claims against funds collected by the debtor post-petition,[12] but that ruling, taken together with the *SemCrude* decisions, suggests that multiparty setoffs are unlikely to survive bankruptcy challenges. Parties to financial contracts seeking multilateral netting should consider cross-collateralization under master netting agreements as a viable alternative to triangular setoff.

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Please contact the attorneys below if you have any questions about the decisions discussed in this memorandum:

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[12] *See Swedbank*, 2010 WL 1783395, at *3 ("[T]he following prerequisites must be satisfied to be eligible for setoff under section 553 of the Bankruptcy 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... Mutuality, in turn, exists, when "the debts and credits are in the same right and are between the same parties, standing in the same capacity")(further citations omitted).