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Delaware Bankruptcy Court Decision in SemCrude Poses Setback to Triangular Setoff

January 16, 2009 The United States Bankruptcy Court for the District of Delaware has ruled that a creditor cannot effect a "triangular" setoff of the amounts owed between it and three affiliated debtors, despite pre-petition contracts that expressly contemplated multiparty setoff. In re SemCrude, L.P., Case No. 08-11525 (BLS), 2009 WL 68873 (Bankr. D. Del. Jan. 9, 2009). The Court relied principally on the plain language of section 553(a) of the United States Bankruptcy Code, which limits setoff to mutual obligations between a debtor and a single nondebtor. The immediate upshot of this ruling is that Chevron USA, Inc. ("Chevron") was not permitted to setoff its prepetition obligation to debtor SemCrude L.P. ("SemCrude") against amounts owed to Chevron by affiliated debtors SemFuel, L.P. ("SemFuel") and SemStream, L.P. ("SemStream").

The decision, to the extent followed, would eliminate triangular or square setoff, at least where the contracts at issue are not subject to a Bankruptcy Code safe harbor provision, such as those that apply to swaps, repurchase agreements and other financial contracts.[1] While the decision involved a triangle involving multiple debtors, the court's rationale would appear equally applicable to a triangle with a single debtor and multiple affiliated nondebtors. However, the safe harbor provisions of the Code suggest that, where triangular or square setoff is being effected under a safe harbored contract, the mutuality requirement of section 553(a) is inapplicable. In addition, parties could avoid the set off problem by relying instead on cross-collateralization.

Background

In July 2008, energy industry services company SemGroup, L.P. and certain of its direct and indirect subsidiaries filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. At the time of the filing, Chevron had contracts for the sale or purchase of various fuels with three affiliated debtors, SemCrude, SemFuel and SemStream. These contracts were governed by various standardized agreements, each of which contained the following identical provision: " in the event either party fails to make a timely payment of monies due and owing to the other party, or in the event either party fails to make timely delivery of product or crude oil due and owing to the other

[1] See, e.g., 11 U.S.C. §§ 362(b)(6), (b)(7), (b)(17) and (b)(27).

party, the other party may offset any deliveries or payments due under this or any other Agreement between the parties and their affiliates." SemCrude, 2009 WL 68873, at *2.

As of the petition date, Chevron owed a balance of $1.4 million to SemCrude, while SemFuel owed Chevron $10.2 million and SemStream owed it $3.3 million. Id. Chevron claimed that, pursuant to the terms of the contracts, the amount it owed could be setoff, and it sought relief from the automatic stay of section 362(a) of the Bankruptcy Code to effect such setoff. The debtors, the creditor's committee, and a number of other creditors objected, citing the requirement of section 553 of the Bankruptcy Code that debts must be "mutual" in order to be setoff. Chevron responded that its prepetition contracts with the debtors either satisfied the mutuality requirement or that the Code allowed the parties to contract around the mutuality requirement by providing for setoffs across affiliates.

Mutuality Cannot Be Created Through a Private Agreement

In determining whether an agreement that contemplates triangular setoff can create mutuality under section 553, the court scrutinized the meaning of the term “mutual debt.” Finding that the nature of mutuality under section 553 was well settled, the court stated, "The authorities are...clear that debts are considered 'mutual' only when they are due to and from the same persons in the same capacity.'" SemCrude, 2009 WL 68873, at *3 (citing Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138, 149 (2d Cir. 2002)). It continued, “Put another way, mutuality requires that 'each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally.” Id. (citing In re Garden Ridge Corp., 338 B.R. 627, 633-34 (Bankr. D. Del. 2006)). In light of this definition, the court concluded that “mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff.” SemCrude, 2009 WL 68873, at *6.

Court Refuses to Recognize an Exception to the “Mutual Debt” Requirement

Less clear was whether an exception exists to the mutuality requirement that would allow for triangular setoffs under pre-petition contracts. Nearly a dozen cases decided over the last 30 years suggested that a contract providing for nonmutual setoff could be enforced. However, the court’s scrutiny of these cases led it to determine that "not one of these cases has actually upheld or enforced an agreement that allows for a triangular setoff; each and every one of these decisions have simply recognized such an exception in the course of denying the requested setoff or finding mutuality independent of the agreement. Moreover, these decisions cite only to other cases that recognize this purported exception in dicta, or, in some of the more recent cases, to a short reference in Collier on Bankruptcy, which also relies on this same handful of decisions for authority." SemCrude, 2009 WL 68873, at *4.

In particular, the cases supporting contractual nonmutual setoff seemed to rely on the decision of the Seventh Circuit Court of Appeals in Inland Steel Co. v. Berger Steel Co.(In re Berger Steel Co.), 327 F.2d 401 (7th Cir. 1964). Berger Steel was decided under the Bankruptcy Act of 1898 (the "Bankruptcy Act")(predecessor statute to the Bankruptcy Code), and was the first case to raise the possibility that an exception to the Bankruptcy Act's mutuality requirement (found in section 68) might exist in a contract contemplating triangular setoff.[2] In Berger Steel, a party attempted to effect a triangular setoff based upon an oral agreement between it and two other parties that allegedly created sufficient mutuality of amounts owing and owed to make a valid triangular setoff. The Berger Steel court found that no such agreement existed. The Berger Steel court noted that some previous cases cited by the party seeking to effectuate a triangular setoff allowed a triangular setoff to be taken pursuant to a valid contract. However, each of these cases was decided under state law or the common law of equitable receivership, not under the restrictive language of the Bankruptcy Act or Bankruptcy Code. Thus, the SemCrude court concluded that Berger Steel did not stand for the proposition that nonmutual setoff provisions in a contract can be enforced against a debtor. SemCrude, 2009 WL 68873, at *4-5.

Finding no actual precedent for enforcing nonmutual setoff, the Court focused on the plain language of the Code section 553(a). The section, in the court's view, clearly, and unambiguously, demands mutuality. SemCrude, 2009 WL 68873, at *8. Furthermore, the Court found that nonmutual setoff would be contrary "to the principle of equitable distribution that lies at the heart of the Code," because "one creditor or a handful of creditors could unfairly obtain payment from a debtor at the expense of the debtor's other creditors, thereby upsetting the priority scheme of the Code and reducing the amount available for distribution to all creditors." Id.

Conclusions and Recommendations

The SemCrude decision eliminates the possibility of triangular or square setoff, at least where the contracts at issue are not safe harbored. While, in this case, the nondebtor was trying to use multiple debtors, the result would not likely have been different if the nondebtor was trying to use obligations between it and its affiliates and a single debtor. While a policy argument could be made that nonmutual setoff involving multiple debtors is worse, because it mixes the assets and liabilities of estates, the court's analysis – in particular its reliance on the plain language of section 553(a) – suggests that the direction of the triangle does not matter.

SemCrude, however, did not involve safe harbored contracts. The 2005 and 2006 amendments to the safe harbor provisions, especially to the safe harbor portions of section 362, suggest that, in the

[2] Section 68 of the Bankruptcy Act provided that "[i]n all cases mutual debts and mutual credits between the estate of a bankrupt and the creditor shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

case of safe harbored contracts, section 553(a) does not apply and that the safe harbored contracts can be enforced as written. This question has not yet been decided by any court.

In addition, parties implementing master netting agreements may choose to rely on liens and pledges, in lieu of or in supplement to setoff rights. If security interests are properly created and perfected, the nondebtor does not need to rely on setoff, and the mutuality issue need not be addressed.

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