Futures & Derivatives Law REPORT
The Journal on the Law of Investment & Risk Management Products
February 2012 ■ Volume 32 ■ Issue 2

Lehman Bankruptcy Court Denies Contractual Right to Triangular Setoff

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In the recent Lehman Brothers Inc. SIPA proceeding,[2] Judge James Peck of the Bankruptcy Court for the Southern District of New York denied UBS AG's assertion of a triangular setoff right in connection with amounts owed by Lehman Brothers Inc. to affiliates of UBS AG, despite the undisputed underlying contractual right of triangular setoff provided in the ISDA Master Agreement between the parties. In line with recent authority, the Bankruptcy Court held that there was no contractual exception to the strict mutuality requirement for setoff under the Bankruptcy Code and that the safe harbor provisions for swap agreements did not override the requirement to establish mutuality for setoff in a bankruptcy.

The *UBS* decision comes after and accords with the holdings of *In re SemCrude, L.P.*,[3] where the Delaware Bankruptcy Court also addressed triangular setoff. Triangular setoff is an agreement between two parties to setoff obligations owed by party X to party Y against obligations party Y owes to party X and affiliates of party X. In the alternative, the triangular setoff provision could also be formulated so that debt owing by party X to party Y is setoff against obligations party Y and its affiliates owes to party X.

Such a contractual agreement is a common provision in swap agreements. The *SemCrude* decision did not, however, address the relationship between the Bankruptcy Code's ("Code") "safe harbor" provisions to the question of triangular setoff. The safe harbor provisions create exceptions for swap agreements to otherwise applicable bankruptcy law. Building on the holding of the *SemCrude* decision, the UBS decision seems to close any door left open for triangular setoff by setting forth two important holdings: (1) section 553 of the Bankruptcy Code preserves parties' otherwise available setoff rights in bankruptcy but does not provide a contract exception to the statutory mutuality requirements defining such setoff right and (2) the safe harbor provisions of sections 560 and 561 of the Code do not create an independent right of nonmutual contractual setoff under the Code.

The *UBS* Case

On July 13, 2004, Lehman Brothers Inc ("Lehman") and UBS AG ("UBS") entered into a swap agreement ("Agreement") governed by a 1992 ISDA Master Agreement ("ISDA") and a credit support annex ("CSA") pursuant to which parties would post margin in respect of their obligations under the ISDA. Subsequently,

parties entered into numerous foreign exchange transactions under the ISDA. On September 16, 2008, UBS sent Lehman an early termination notice on the basis that an early termination had been triggered by Lehman's credit downgrade and by cross-defaults to other defaulting swap agreements between UBS and Lehman affiliates. Soon after, the United States District Court for the Southern District of New York entered an order (1) authorizing Lehman's trustee under the Securities Investor Protection Act of 1970 (the "SIPA Trustee") to take immediate possession of all property of Lehman and (2) providing notice that an automatic stay applied to any action to obtain possession or property of the Lehman estate and stayed and enjoined all entities from retaining or setting off or interfering with Lehman's assets and property. UBS subsequently provided a notice of calculation in respect of the terminated trades in which Lehman owed UBS an early termination amount. UBS claimed a right of setoff for the termination amount against the amount held by UBS as posted collateral in respect of Lehman's obligations. At the time, UBS held approximately $170 million of posted collateral in support of Lehman's obligations under the Agreement. After UBS setoff the early termination amount, and in reliance upon the contractual setoff right in the ISDA, UBS continued to hold $23 million of collateral to offset alleged amounts owed by Lehman to UBS' affiliates (UBS Securities LLC ("UBS Securities") and UBS Financial Services) against UBS' obligation to return the excess collateral under the CSA. While UBS Securities and UBS Financial Services were not parties to the Agreement, section 5(a) of the Schedule to the ISDA allowed for setoff of amounts owed to the affiliates of the nondefaulting party. The SIPA Trustee took the position that assertion of any third-party setoff right under section 5(a) violated the automatic stay and requested the immediate return of the excess $23 million of collateral. UBS objected and Lehman filed a motion to enforce the stay.

UBS asserted that section 5(a) of the Schedule created a contractual triangular setoff right (1) that did not violate the stay or turnover provisions of the Code and was not in contravention of the mutuality requirements of section 553 of the Code, and (2) even if it was at odds with section 553, such a contractual right of setoff was nevertheless protected by the safe harbor provisions of sections 560 and 561 of the Code.

Setoff under Section 553 of the Bankruptcy Code

Although the Code does not create an independent right of setoff, section 553(a) of the Code preserves certain setoff rights in a bankruptcy.[4] Section 553(a) provides, in relevant part, that

> **[e]xcept as otherwise provided in this section and in sections 362 and 363[5] 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…**

Citing the Court's recent *Swedbank*[6] decision, the Court stated that section 553 of the Code provides that contractual setoff rights are valid and enforceable, so long as (1) the amount owed by the debtor is a pre-petition debt (in other words, arose prior to the bankruptcy filing), (2) the debtor's claim against the creditor is pre-petition, and (3) the claims of the debtor and the creditor are held against each other in the same right or capacity (the "mutuality requirement").

Is a contractual right of triangular setoff protected under section 553(a)? The Court found that the contractual right of setoff by UBS for obligations owed by Lehman to its affiliates did not satisfy the mutuality requirement. The test for mutuality of debts requires that debts be in "the same right and between the same parties, standing in the same capacity."[7] The obligations of Lehman to UBS's affiliates did not offset a mutual debt owed to UBS itself, and could not be offset from the posted collateral UBS held. The Court emphasized that mutuality under section 553 is personal and tied to the identity of the contracting parties, and it was unwilling to disregard corporate formalities to treat affiliates as a single

counterparty despite the language in section 5(a) of the Schedule. Private contractual agreements as to the meaning of "setoff" could not override the mutuality requirement set forth in section 553(a) and would not be enforced in a bankruptcy to the extent that requirement was not met.

The Court did acknowledge, however, that contractual provisions providing for triangular setoff rights may be valid and enforceable under New York law outside of the context of bankruptcy and SIPA proceedings. When such triangular setoff right is at issue in a bankruptcy, however, the contractual right will be subject to the strict mutuality requirements of the Code.

Does a contract exception apply to section 553? UBS claimed that section 553(a) only governs common-law setoff rights, and any setoff agreed to contractually among the parties was not subject to the mutuality requirements under section 553(a). UBS argued that *SemCrude* had narrowly read the contract exception and had not credited the long line of authority allowing for such a contract exception. The Court, however, rejected UBS's claim that such a contract exception existed, finding the Delaware bankruptcy court's discussion in *SemCrude* persuasive and agreed with the Delaware Court's conclusion in *SemCrude* that the elusive "contract exception" cited by previous courts was based on string citations without any analysis. The Court scrubbed the case law and, after independent consideration, agreed with the *SemCrude* court that the seminal case at the head of the string citations, the *Berger Steel* decision[8], had been misquoted by numerous courts. The Court underscored the misuse of *Berger Steel* by previous courts, stating that it did not actually address the question of whether there is a contract exception to the mutuality requirement under the Code; *Berger Steel* merely pointed out that the law governing the cases cited as allowing triangular setoffs had been decided outside the bankruptcy context. The Court examined the case law following *Berger Steel* and found that in no instance did a bankruptcy court permit triangular setoff under the Code. In each instance, the ruling court had not found an enforceable agreement at law and had thus not reached the question of triangular setoff in a bankruptcy.

Do the safe harbor provisions of the Code trump section 553(a) mutuality requirements for setoff? UBS also argued that despite the mutuality requirements that may exist under section 553(e), the Code's safe harbor provisions for swap agreements would apply and act to preserve UBS's right to triangularly offset termination amounts due and owing under the affiliate swap agreements.

Sections 560 and 561 of the Code include safe harbor provisions for swap agreements. UBS referenced section 561, stating that the provision allows a swap counterparty to a derivative contract to exercise any contractual right notwithstanding the automatic stay.

Section 561 of the Code provides in relevant part:

> **[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 … (5) swap agreements …shall not be stayed, avoided, or otherwise limited by operation of any provision of this title [i.e., the Code] or by any order of a court or administrative agency in any proceeding under this title.**

The safe harbor provisions under the Code allow a creditor that is a swap counterparty to exercise its contractual rights to offset termination amounts in connection with termination, liquidation or acceleration of its swap agreement without having to seek relief from the automatic stay. The Court, however, did not agree with UBS's arguments that the safe harbor provisions protected the contractual right of setoff to the extent that the contract defined "setoff" (including the requirement of mutuality) other than as under the Code. The Court relied upon its prior decision in *Swedbank* where it had rejected essentially the same claim that the safe harbor provisions of sections 560 and 561 under the Code allowed a swap counterparty to exercise *any* contractual right notwithstanding the automatic stay and despite the undisputed lack of mutuality. The Court also referenced its analysis of the legislative history in *Swedbank*, finding it informa-

tive that the legislative history is silent and gives no sign of intent to apply the safe harbor provisions to exempt swap participants from the mutuality requirement of section 553(a). Absent any indication to the contrary, the Court found that in order to exercise a right of setoff under the safe harbor provisions, the right of setoff must first satisfy the requirements under section 553(a) of the Code.

Implications

No triangular setoff? Ever? The *UBS* decision unequivocally shuts the door in the Southern District for parties attempting to give effect to contractual rights of triangular setoff in a bankruptcy (in particular, when such rights derive from swap agreements). In light of the *SemCrude* decision in Delaware, the *UBS and SemCrude* decisions, together, have arguably closed the door for triangular setoff in a bankruptcy in the two most important bankruptcy jurisdictions in the US (although the *SemCrude* court did not address the safe harbor provisions). The decisions in *UBS* and *SemCrude* do not, however, affect insolvencies and liquidations that are not subject to the Code. The Code governs bankruptcies for corporations (including non-bank financial institutions such as Lehman and, in most instances, bank holding companies and non-bank affiliates of a bank). FDIC-insured US banks and federally insured US branches of non-US banks, however, are not subject to the Code, but rather are subject to the receivership regime of the Federal Deposit Insurance Act ("FDIA"). Uninsured banks are subject to the liquidation regime set forth under the National Bank Act, if chartered under federal law, or the state law liquidation statutes under the law of the state which chartered it. Query, however, if we will see the same reasoning applied to the FDIA insolvency regime of federally insured banks and the relevant laws of uninsured banks.

Beyond swap agreements. Interestingly, *SemCrude* involved a single creditor seeking to effect a triangular setoff against the debtor's affiliates for amounts the creditor owed to the debtor, while the *UBS* Case involved a creditor seeking to effect a triangular setoff for amounts owed to the creditor's affiliates against a single debtor. Judge Peck did not find compelling neither the fact that the parties to the triangular setoff were distinct nor the fact that the triangular setoff provision was provided in a swap agreement (*UBS*) rather than in a service contract (*SemCrude*). Judge Peck does not limit his holding to particular facts or circumstances relevant to the derivatives market. The holding is broad and would seem to include any contractual provision of triangular setoff. Unlike the *SemCrude* court, however, Judge Peck has the opportunity to clarify the relationship between the safe harbor provisions governing swap agreements and the preservation of setoff rights under section 553: any rights of setoff exercised under the safe harbor provisions are subject to the setoff requirements set forth in section 553 of the Code. While Delaware has not yet addressed triangular setoff under the safe harbors or with respect to creditor affiliate setoff versus debtor affiliate setoff, given the strong view against triangular setoff expressed in *SemCrude*, the Delaware Court would likely not deviate from the Southern District of New York Bankruptcy Court's position in *UBS*.

Guarantors? The *UBS* decision does not answer the question of whether the same rule should apply to guarantors who are the third party in the triangular setoff provision. Would the guarantee of the obligations under the guarantee contractual arrangement satisfy the mutuality requirements of the Code? Courts are divided on this issue.[9] However, parties should note that Judge Peck underscored the personal identity of the mutual debt in *UBS* in stating that "section 553 expressly preserves the 'right of a creditor to offset a mutual debt owing by *such creditor* against the debtor' … The clarity of this language is conclusive – mutuality quite literally is tied to the identity of a particular creditor that owes an offsetting debt. The right is *personal*, and there simply is no ability to get around this language."[10] Query whether the guarantor would need to assume *all* of the rights and obligations of the contract underlying the debt in question in order to satisfy mutuality. A guarantor's obligations to satisfy the debt may not suffice to "get around" the Code. Instead, parties who want to ensure affiliate setoff rights would fare better by entering into swap agree-

ments on a joint and several basis with the counterparties to its swap agreements.

NOTES

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2 *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D. N.Y. 2011) (the "*UBS* decision").

3 *In re SemCrude, L.P.,* 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010) (the "*SemCrude* decision").

4 *See* 399 B.R. at 393, citing *In re Lehman Brothers Holdings Inc.*, 433 B.R. 101, 107 (Bankr. S.D. N.Y. 2010) (the "*Swedbank* decision") and *Citizens Bank of Maryland. v. Strumpf*, 516 U.S. 16, 18, 116 S. Ct. 286, 133 L. Ed. 2d 258 (1995).

5 Section 362 of the Code provides that the filing of a petition for bankruptcy has the effect of imposing an automatic stay on certain actions against the debtor or its property, including exercising control of such property. Section 363 covers the use, sale or lease by the trustee of property of the estate.

6 *See In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D. N.Y. 2011).

7 458 B.R. at 140 (quoting *Lines v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 743 F. Supp. 176, 183 (S.D. N.Y. 1990) (internal quotation marks omitted)).

8 *In re Berger Steel Co.*, 327 F.2d 401 (7th Cir. 1964) (the "*Berger Steel* decision").

9 *See SemCrude*, 399 BR. at 397, n.7. Courts are divided on the issue of whether a guarantor-beneficiary relationship can satisfy mutuality requirements under the Code.

10 *In re Lehman Brothers Inc.* 458 B.R. at 141.