INTERNATIONAL INSOLVENCY INSTITUTE

Tenth Annual International Insolvency Conference

Rome, Italy

DERIVATIVES AND COUNTERPARTY RISK: THE "INSTRUMENTS OF MASS FINANCIAL DESTRUCTION"

Setoff Issues in Derivative Transactions:
The Lehman Experience

By

Edwin E. Smith
Bingham McCutchen LLP
Boston

June 7-8, 2010

SETOFF ISSUES IN DERIVATIVE TRANSACTIONS: THE LEHMAN EXPERIENCE

Edwin E. Smith
Bingham McCutchen LLP[1]

May 15, 2010

The insolvency proceedings of Lehman Brothers Holdings Inc. ("LBHI") and its various subsidiaries have highlighted aspects of the law of the setoff that one would have thought were fairly well settled but on closer scrutiny raise either novel or unsettled issues. Many of the setoff issues being addressed today in the insolvency proceedings of LBHI and its subsidiaries arise out of derivative transactions. This paper will explore a number of those issues.

After a discussion of the background of the Lehman insolvency proceedings, this paper will explain various setoff and setoff related concepts and then will discuss some of the "hot issues" on setoffs relating to derivative transactions arising in the Lehman insolvency proceedings. While this paper is written primarily from the perspective of the U.S. insolvency proceedings of LBHI and its subsidiaries and issues arising under common law, the law of contract and the U.S. Bankruptcy Code, it is hoped that the paper will be instructive for those facing similar issues in other jurisdictions arising under other laws.

I. BACKGROUND

LBHI commenced a Chapter 11 bankruptcy case in the Bankruptcy Court for the Southern District of New York on September 15, 2008.[2] Lehman Brothers International (Europe) ("LBIE") entered into administration in England on the same day.[3] LBHI's U.S. broker-dealer subsidiary, Lehman Brothers, Inc. ("LBI"), became the subject of a liquidation proceeding under the U.S. Securities Investor Protection Act on September 19, 2008.[4] Various subsidiaries of LBHI also commenced insolvency proceedings at various times after September 15, 2008. Among those were two U.S. subsidiaries of LBHI, Lehman Brothers Special Financing, Inc.[5] ("LBSF") and Lehman Commercial Paper, Inc.[6] ("LCPI"). LBSF and LCPI

[1] The author wishes to thank Kate Lashley, an associate at Bingham McCutchen LLP, for her assistance in the preparation of this paper.

[2] Voluntary Petition, Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008) [Docket No. 1].

[3] See PricewaterhouseCoopers, Lehman Brothers International (Europe) In Administration: Joint Administrators' Progress Report for the Period 15 September 2008 to 14 March 2009 (2009), available at http://www.pwc.co.uk/pdf/LBIE_progress_report_140409.pdf.

[4] Securities Investor Protection Corp. v. Lehman Brothers Inc., No. 08-cv-08119 (S.D.N.Y. Sept. 19, 2008) (order commencing liquidation) [Docket No. 3], transferred to Bankruptcy Court, No. 08-01420.

[5] Voluntary Petition, Lehman Brothers Special Financing Inc., No. 08-13888 (Bankr. S.D.N.Y. Oct. 3, 2008) [Docket No. 1].

[6] Voluntary Petition, Lehman Commercial Paper Inc., No. 08-13900 (Bankr. S.D.N.Y. Oct. 5, 2008) [Docket No. 1].

commenced Chapter 11 cases on October 3, 2008 and October 5, 2008, respectively. The subsidiaries' Chapter 11 cases have been administratively consolidated with the Chapter 11 case of LBHI.

Before the commencement of their insolvency proceedings, LBI, LBIE, LBSF, LCPI and LBHI had engaged heavily in derivative transactions including securities contracts, repurchase agreements, swap agreements and commodity and forward contracts. LBHI often acted as a credit support party (a guarantor) for a number of these transactions entered into by its subsidiaries.

Under the contracts evidencing the derivative transactions for which LBHI acted as a credit support party, the non-debtor counterparty had the right to terminate the derivative transactions on account of the commencement by LBHI of its bankruptcy case. Even where LBHI did not act as credit support party, the non-debtor counterparty had the right to terminate its derivative transactions with LBI, LBIE, LBSF, LCPI or LBHI when LBI, LBIE, LBSF, LCPI or LBHI commenced an insolvency proceeding.

Most non-debtor counterparties exercised their termination rights and also took advantage of other exemptions afforded to them for derivative contracts under the insolvency laws. For example, under the U.S. Bankruptcy Code,

- a clause in the derivative contract permitting the non-debtor counterparty to terminate the derivative transaction on account of the debtor becoming subject to an insolvency proceeding was enforceable even though for transactions that were not derivative transactions the clause could not be enforceable[7];

- the non-debtor counterparty to a derivative contract was not barred by the automatic stay in the U.S. bankruptcy case from exercising a "contractual right" to terminate, accelerate or liquidate transactions under the derivative contract,[8] to net payments owing or owed between the parties[9] and to look to collateral in the possession or under the control of the non-debtor counterparty[10]; and

- the non-debtor counterparty to a derivative contract was insulated from preference and constructive fraudulent transfer challenges on payments and collateral received in connection with derivative transactions.[11]

The justification for these exemptions is based on a concern about systemic risk. Derivative contracts are so much a part of the capital markets that the bankruptcy of a participant may, absent exemptions from the Bankruptcy Code, "freeze" contracts with the debtor from

---

[7] 11 U.S.C. § § 362(b)(6)-(7), (17), (27); see also 11 U.S.C. § 555 (securities contracts); 11 U.S.C. § 556 (commodities and forward contracts); 11 U.S.C. § 559 (repurchase agreements); 11 U.S.C. § 560 (swap agreements); 11 U.S.C. § 561 (master netting agreements).

[8] Id.

[9] Id.

[10] Id.

[11] 11 U.S.C. §§ 546(e)-(g), (j).

unwinding and produce a "daisy chain" effect of multiple defaults among market participants. The exemptions permit an orderly unwind of derivative contracts despite the bankruptcy of a participant in the chain.[12]

As derivative transactions were terminated, close out amounts were calculated, collateral was liquidated and proceeds of the liquidation were applied to the amounts owing in respect of the transactions. On some transactions, after giving effect to netting under a master agreement, the non-debtor counterparty was owed money by the debtor counterparty.[13] On other transactions, after giving effect to netting under a master agreement, the non-debtor counterparty owed money to the debtor counterparty.[14]

The non-debtor counterparty, of course, may have entered into separate transactions with the debtor, wholly apart from the derivative transactions subject to a particular master agreement. The non-debtor counterparty in these situations would hope to be able to reduce what it owes to the debtor counterparty on "out of the money" transactions by applying the amount that the debtor counterparty owes to the non-debtor counterparty on "in the money" transactions. It would want, in particular, to avoid being obligated to pay in full what it owes to the non-debtor counterparty on "out of the money" transactions while merely asserting an unsecured claim in the debtor counterparty's insolvency proceeding on "in the money" transactions and, given the likelihood that distributions would be less than 100% of the total amount of the creditor's claim that is allowed in the insolvency proceeding, ultimately receiving merely a fractional distribution of the total amount claimed.

II. SETOFF AND RELATED CONCEPTS

The extent to which the non-debtor counterparty is able to reduce what its owes to the debtor counterparty by applying the amount that the debtor counterparty owes to the non-debtor counterparty implicates the law of setoff and related concepts. This part of the paper will first describe the terminology for these concepts, including the concept of "netting", and then discuss common law setoff, contractual setoff and statutory setoff.

A. Terminology

At the outset it is important to distinguish among "recoupment", "setoff" and "netting".

Recoupment is a claim or defense arising out of a single transaction.[15] For example, if Seller sells goods to Buyer and the goods are not as warranted, Buyer may have a claim against

[12] See generally Franklin R. Edwards & Edward R. Morrison, Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 YALE J. ON REG. 91 (2005).

[13] When a counterparty is owed money on close out, it is often referred to as "in the money".

[14] When a counterparty owes money on close out, it is often referred to as "out of the money".

[15] See, e.g., In re Mortg. Lenders Network USA, Inc., 406 B.R. 213, 264 (Bankr. D. Del. 2009) ("Recoupment is a common law doctrine which 'permits a creditor that owes a debt to the debtor to reduce the amount of its debt by the amount of a debt owed by the debtor to the creditor' if the debts arise out of the same transaction." (quoting Anes v. Dehart, 195 F.3d 177, 182 (3d Cir.1999))); In re TOUSA, Inc., 422 B.R. 783, 871 (Bankr. S.D. Fla. 2009) ("Recoupment may be asserted only if 'the debtor's claim and the creditor's claim arose from the same transaction.'" (quoting In re Bill Heard Enters., Inc., 400 B.R. 813, 821 (Bankr. N.D. Ala. 2009))).

Seller for breach of warranty. If the goods are defective, Buyer may need to expend Buyer's own funds to remedy the defect. Buyer would then be able to reduce the purchase price that it owes to Seller by the amount expended by Buyer to remedy the defect. This is a classic case of recoupment: the assertion by Buyer of a claim or defense (breach of warranty) arising out of a single transaction (the sale of goods).[16]

In contrast, setoff is a claim or defense arising out of a separate transaction.[17] Let us assume in the previous example that Seller had been paid in full before Buyer had discovered the defect in the goods. Let us also assume that, by coincidence, Seller has loaned money to Buyer. Buyer might be able then to reduce the amount of the loan by the amount of Buyer's damages arising out of the sale of goods transaction. If Buyer did so, it would be exercising a right of setoff. That is because Buyer's obligation to Seller arises out of one transaction (Seller's loan to Buyer) but Buyer's claim or defense (breach of warranty), giving rise to the reduction of the amount owed by Buyer to Seller, arises out of a separate transaction (the sale of goods).[18]

Market players in derivative transactions often do not refer to such common law concepts as recoupment or setoff. Instead, they refer to "netting".[19] The term encompasses recoupment and setoff but may be broader. Netting may encompass, as well, setoff permitted by contract or statute. Accordingly, to appreciate what is meant by netting, it is important to understand the elements of common law setoff, contractual setoff and statutory setoff.

B. Common Law Setoff

Common law setoff is grounded in a policy of efficiency. If A owes money to B and B owes money to A, it is inefficient for A to pay B and B to pay A as separate transactions. It is far more efficient for each party to reduce what it owes to the other by the amount that the other owes to it, resulting in a single net amount being owed by one party to the other. For example, if A owes $100 to B and B owes $80 to A, it is far more efficient for A to pay to B $20 in a single

---

[16] Courts have also applied the doctrine of recoupment in other situations. See, e.g., In re Norsal, 147 B.R. 85 (Bankr. E.D.N.Y. 1992) (electric utility entitled to recoup debtor's pre-petition security deposit to reduce it claims against the debtor for electrical services); Rakozy v. Reiman Constr. (In re Clowards, Inc.), 42 B.R. 627 (Bankr. D. Idaho 1984), (damages claim for alleged breach of a construction contract applied to reduce the balance due under such contract); Waldschmidt v. CBS, Inc., 14 B.R. 309 (Bankr. M.D. Tenn. 1981) (record company entitled to recoup advances paid to a musician from post-petition record sales in lieu of filing a claim as an unsecured creditor).

[17] See Levine v. Telco Sys., Inc. (In re World Access, Inc.), 324 B.R. 662, 686 (Bankr. N.D. Ill. 2005) ("Recoupment is different from set-off because recoupment requires that the same transaction be involved in the debts. The rules of law regarding set-off apply as long as the same parties are involved, but the debts may have arisen from completely different transactions.").

[18] See Davidovich v. Welton, 901 F.2d 1533, 1537 (10th Cir. 1990) (discussing the concept of setoff); 5 COLLIER ON BANKRUPTCY ¶ 553.01 (Alan N. Resnick & Henry Sommer eds., 15th ed. rev.).

[19] See, e.g., Gabriella Rosenberg, Central Bank of Argentina, Maria Carmen del Urquiza, Argentine Securities and Exchange Commission & David Miller, Bank of America, N.A., Presentation, What is Netting? How Does Netting Work?, available at www.newyorkfed.org/fmlg/Millerspresentationonnetting.PPT (defining netting as "[a] method of reducing credit, settlement and other risks of financial contracts by aggregating . . . two or more obligations to achieve a reduced net obligation"). Note that there are various types of netting (e.g., multilateral netting, close-out netting and settlement netting) and the term "netting" alone is often used generically to apply to all forms. Philip R. Wood, Set-off and Netting, Derivatives, Clearing Systems, in 4 THE LAW AND PRACTICE OF INTERNATIONAL FINANCE SERIES 4 (2d ed. 2007).

transaction than for A to pay B $100 in one transaction and for B to pay A $80 in a separate transaction.[20]

Key, though, to the efficiency justification for setoff is that the obligations be mutual.[21] In other words, A needs to owe money to B and B needs to owe money to A so that payment in a single transaction makes sense. If A owes money B and B owes money to A's sister company, C, payment in a single transaction does not make sense. A would normally have to pay B in one transaction, and B would normally have to pay C in another transaction.[22]

The requirement of "mutuality" encompasses the notion that A and B need to be acting in the same capacity.[23] Let us say that A owes money to B and B owes money to A. But on the transaction in which B owes money to A, A was acting as trustee for C. Any payment that B makes to A would thus be for the benefit of C, not for A's own account. When A is acting in a different capacity, mutuality is lost. The situation is viewed no differently than if C, the beneficiary, were the payee rather than A.

Other requirements for common law setoff may exist as well, but the requirements may vary depending upon the jurisdiction. In some jurisdictions, only actual and liquidated amounts may be the subject of common law setoff.[24] In at least one jurisdiction in the United States common law setoff is not available if the collateral for the payment of the obligation to be setoff is adequate.[25]

---

[20] The United States Supreme Court has stated that "the right of setoff . . . allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'" Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 20, 116 S. Ct. 286, 289 (1995) (quoting Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528, 33 S.Ct. 806, 808, 57 L. Ed. 1313 (1913)).

[21] Section 553 of the U.S. Bankruptcy Code requires, inter alia, that a creditor's claim and debt be "mutual." The U.S. Bankruptcy Code, however, does not define this term and, thus, there exists a degree of confusion as to its meaning. See 5 COLLIER ON BANKRUPTCY ¶ 553.03[3].

[22] See Wood, supra note 19 at 93 (explaining that the doctrine of mutuality "requires that one person's claim shall not be used to pay another person's debt" and that, in general, there must only be two claimants, each the beneficial owner of the claim and each personally liable for the claim).

[23] In this context "capacity" refers to legal capacity (e.g., principal, agent, trustee, or beneficiary) so that, for example, under New York common law, A cannot set off amounts owed by A on its own account to B against amounts owed by B to A in A's separate capacity as a trustee for another person. Matter of Midland Ins. Co., 79 N.Y.2d 253 (1992); Scherling v. Hellman Elec. Corp. 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995). See generally 5 COLLIER ON BANKRUPTCY ¶ 553.03[3][c] (discussing the concept of capacity).

[24] See, e.g., Hoffman v. Gleason (In re Capital Nat'l Bank of Lansing), 107 F.2d 101, 103 (6th Cir. 1940) (articulating that setoff is limited to "liquidated debts or to those which are capable of liquidation only by computation"); but see 5 COLLIER ON BANKRUPTCY ¶ 553.03[1][f] (noting that, in general, the right to setoff is preserved under the U.S. Bankruptcy Code even in the case of unliquidated claims).

[25] Under Massachusetts law, for example, setoff is not available where the debt owed to a creditor is fully secured. See Sisk v. Saugus Bank & Trust Co. (In re Saugus Gen. Hosp., Inc.), 698 F.2d 42, 44-45 (1st Cir. 1983). The Massachusetts law rule seems to contrary to the general rule under which the right to setoff is available even when a claim is secured by some other form of collateral. 5 COLLIER ON BANKRUPTCY ¶ 553.03[1][g] (citing In re Progressive Wallpaper Corp., 240 F. 807, 810 (N.D.N.Y. 1917)).

Historically at common law, for setoff to be available, the amounts owed by each party should be in the same currency.[26] Perhaps this requirement was based on the notion that converting one currency into another for purposes of making a payment was a separate transaction for which setoff was inefficient. However, the more modern view, with national currencies being available in global foreign exchange markets at readily determinable conversion rates, is that common law setoff arising from obligations in different but freely convertible currencies should be available.[27]

Some cases have suggested that common law setoff is grounded more in equity than in efficiency.[28] The rationale is that it is inequitable for A to pay B when B owes money to A. This may be true. But the rationale has also led those courts to view the allowance of setoff as discretionary with the court, as with any other equitable claim.[29] The result has been that the standards on which the court could exercise discretion not to allow a setoff otherwise available at common law have been poorly defined. For example, one may wonder whether a court, applying a traditional equitable principles analysis, could disallow a common law setoff based the non-debtor party's "unclean hands", the non-debtor party having an adequate remedy at law or even other creditors of the debtor being disadvantaged by the setoff.[30] The argument that setoff is an equitable remedy subject to the discretion of the court would seem especially problematic in a U.S. bankruptcy case given that a right of setoff is treated by U.S. Bankruptcy Code as a secured claim.[31]

C. Contractual Setoff

[26] Setoff would arguably not be appropriate if a foreign currency were considered a commodity. Cf. In re Koreag, 961 F.2d 341, 355 (2nd Cir. 1992) (finding that an amount in a foreign currency is "goods" under Article 2 of the New York Uniform Commercial Code).

[27] See United States v. BCCI Holdings (Luxembourg), S.A., 941 F. Supp. 180, 183, 187 (D.D.C. 1996) (permitting American Express Bank to set off amounts arising from foreign currency obligations).

[28] See, e.g., In re Lehman Brothers Holdings Inc., 404 B.R. 752, 757 (Bankr. S.D.N.Y. 2009) ("Equity favors the right of setoff as a means to avoid multiplicity of lawsuits, inconvenience, injustice and inefficient use of judicial resources."); In re Genuity Inc., 323 B.R. 79, 82 (Bankr. S.D.N.Y. 2005) (noting that setoff is a "remedy rooted in equity"); Sisk, 698 F.2d at 45 ("[T]he right to set off debts owed to an insolvent party is derived not merely from principles of administrative convenience, but from principles of equity.").

[29] See In re Lehman Brothers Holdings Inc., 404 B.R. at 757 ("The decision to allow setoff is within the sound discretion of the bankruptcy court."); In re Enron Creditors Recovery Corp., 376 B.R. 442, 466 (Bankr. S.D.N.Y. 2007) ("In determining if setoff is proper, a court must examine equitable considerations in the context of the goals and objectives of the Bankruptcy Code."); Bohack Corp. v. Borden, Inc., 599 F.2d 1160, 1165 (2d Cir. 1979).

[30] See Warrington Mkt., Inc. v. Fleming Cos., No. Civ. A. 02-CV-719, 2003 WL 22594348, at *1 (E.D. Pa. Oct. 10, 2003) ("Setoff may be denied 'where the creditor has committed inequitable, illegal or fraudulent acts, or the application of setoff would violate public policy,' or where setoff would 'significantly affect a debtor's ability to reorganize.'" (quoting In re Nuclear Imaging Sys., Inc., 260 B.R. 724, 739, n.12 (Bankr. E.D. Pa. 2000))); In re Nuclear Imaging Sys., Inc., 260 B.R. at 739 (Bankr. E.D. Pa. 2000) (noting that courts have "disallowed an otherwise valid common law right to setoff in 'compelling circumstances'" (quoting In re Whimsy, Inc., 221 B.R. 69, 74 (S.D.N.Y. 1998))); but see 5 COLLIER ON BANKRUPTCY ¶ 553.02[3] (explaining that although setoff is an "equitable device subject to all of the discretions inherent in equity jurisprudence," the rights of setoff have increasingly become recognized by statute and the doctrine itself has "shed many of its equitable formalisms" and "acquired a more fixed set of governing principles").

[31] 11 U.S.C. § 506(a)(1). See 5 COLLIER ON BANKRUPTCY ¶ 553.06[4].

Common law setoff may be contrasted with contractual setoff.[32] Most master derivative contracts expressly provide for contractual setoff, whether in a master agreement or a master netting agreement.[33] And the parties may by contract expand as between them the circumstances in which setoff is permitted, even going beyond what common law setoff would normally allow. For example, A and B may agree in a bi-lateral contract that contingent or unliquidated amounts may be subject to contractual setoff, amounts owed in different and even non-convertible currencies may be setoff and setoff may be available even if collateral for the obligations to be setoff is otherwise adequate.

Contractual setoff may even arguably dispense with the requirement of mutuality, permitting A to set off against what A owes to B any amount that B owes to C or permitting A to setoff against what A owes B any amount that B owes to A when A is acting in a separate capacity.[34]

It is a mistake, though, for parties to a derivative transaction to rely exclusively on contractual setoff. Unless the derivative contact provides for a waiver of common law setoff, common law setoff should still be available to the parties if there is no contractual setoff clause or the contractual setoff clause is limited in scope.

---

[32] See 5 COLLIER ON BANKRUPTCY ¶ 553.03[3][b][ii].

[33] For example, the 2002 ISDA Master Agreement includes the following contractual setoff provision:

> Set-Off. Any Early Termination Amount payable to one party (the "Payee") by the other party (the "Payer"), in circumstances where there is a Defaulting Party or where there is one Affected Party in the case where either a Credit Event Upon Merger has occurred or any other Termination Event in respect of which all outstanding Transactions are Affected Transactions has occurred, will, at the option of the Non-defaulting Party or the Non-affected Party, as the case may be ("X") (and without prior notice to the Defaulting Party or the Affected Party, as the case may be), be reduced by its set-off against any other amounts ("Other Amounts") payable by the Payee to the Payer (whether or not arising under this Agreement, matured or contingent and irrespective of the currency, place of payment or place of booking of the obligation). To the extent that any Other Amounts are so set off, those Other Amounts will be discharged promptly and in all respects. X will give notice to the other party of any set-off effected under this Section 6(f).
>
> For this purpose, either the Early Termination Amount or the Other Amounts (or the relevant portion of such amounts) may be converted by X into the currency in which the other is denominated at the rate of exchange at which such party would be able, in good faith and using commercially reasonable procedures, to purchase the relevant amount of such currency.
>
> If an obligation is unascertained, X may in good faith estimate that obligation and set off in respect of the estimate, subject to the relevant party accounting to the other when the obligation is ascertained.
>
> Nothing in this Section 6(f) will be effective to create a charge or other security interest. This Section 6(f) will be without prejudice and in addition to any right of set-off, offset, combination of accounts, lien, right of retention or withholding or similar right or requirement to which any party is at any time otherwise entitled or subject (whether by operation of law, contract or otherwise).

Section 6(f), INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., ISDA MASTER AGREEMENT: MULTICURRENCY - CROSS-BORDER (2002).

[34] For the U.S. bankruptcy implications of such a "triangular setoff" clause see infra Part III.D.

D. Statutory Setoff

Sometimes setoff may be available by statute, wholly apart from set setoff arising under the common law or by contract. For example, English insolvency law provides for a mandatory setoff regardless of what the parties have contracted.[35] The U.S. Bankruptcy Code permits a non-debtor party to a real estate contract in certain circumstances to setoff damages if the contract is rejected by the debtor's bankruptcy trustee.[36]

III. HOT ISSUES

With this background and these concepts in mind, the balance of this paper will discuss some of the setoff issues arising in the insolvency proceedings of LBHI and its subsidiaries.

A. Same Capacity

One issue that has arisen relates to the component of the requirement of "mutuality" for common law setoff that the parties be acting in the same capacity.[37] A number of large money center banks had in effect programs for customers to loan out customer securities or to enter into repurchase transactions for the benefit of customers. Under such a program, the bank entered into the loan or repurchase transaction with a subsidiary of LBHI, but the bank did so as agent for a customer whose name may or may not have disclosed to the debtor.

Upon termination and close out of the transaction, the debtor may have been owed money. The situation was likely to occur in a securities loan transaction for which the debtor had posted cash collateral with the agent bank. Given the sharp decline in the prices of equity securities following the commencement of LBHI's bankruptcy case, the cash collateral posted created a significant margin surplus over the value of the loan securities. When the loaned securities were not returned, the bank was able to buy in the securities for the account of the customer, leaving a surplus owing to the debtor.

But the bank also had its claims against the debtor arising in transactions in which the bank was acting for it own account rather than as agent for customers. The question arises as to whether the bank may setoff against those claims the amounts that are owed back to the debtor under the transactions for which the bank acting as agent for customers.

---

[35] Specifically, England's Insolvency Act of 1986 provides:

> [W]here before the commencement of the bankruptcy there have been mutual credits, mutual debts or other mutual dealings between the bankrupt and any creditor . . . , [a]n account shall be taken of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other.

Insolvency Act, 1986, c. 45, Part IX, c. IV, § 323 (Eng.).

[36] See 11 U.S.C. §§ 365(h)(1)(B), (h)(2)(B) and (i)(2)(A).

[37] See supra note 23 and accompanying text.

At first glance, it would seem that setoff should not be available given that the bank was acting in the capacity as agent in the transactions while its claims against the debtor are in the bank's individual capacity.

However, for transactions governed by New York law, as would be typical for a large portion of the derivatives in the Lehman bankruptcy cases, there is a countervailing argument arising under Article 9 of New York's Uniform Commercial Code. The argument is that the bank was, for purposes of Article 9, the "secured party" with respect to the cash collateral posted. This is because, as set forth in the definition of "secured party" in Article 9 of New York's Uniform Commercial Code, the bank was an "agent…in whose favor a security interest is created or provided for…."[38] It is the secured party, not persons for which the secured party acts as agent, who has the statutory obligation under Article 9 to "account to and pay a debtor for any surplus".[39] If the obligation to pay over the surplus is a personal obligation of the bank, it would seem that the bank should be able to setoff that obligation against its own personal claims against the debtor.

B. Setoff of Pre-Commencement Claim against Post-Commencement Obligation

Normally under the U.S. Bankruptcy Code a creditor with a pre-petition claim against a debtor may not set off against the pre-petition claim an amount that the creditor owes to the debtor post-petition. This is because section 553 of the U.S. Bankruptcy Code states, as a general rule, that the U.S. Bankruptcy Code does not affect the right of a creditor to setoff "a mutual debt owing by such creditor to the debtor that arose *before* the commencement of the case."[40] Section 553 suggests that the U.S. Bankruptcy Code does affect a creditor's setoff right if the debts are mutual but nevertheless one debt arose before the commencement of the case while the other debt arose after the commencement of the case. And courts have so held. [41]

However, a question does arise if the mutual debts arose, one pre-petition and the other post-petition, under different derivative contracts. If the creditor would have under non-bankruptcy law a "contractual right" to net, for example, a pre-petition claim arising under a derivative contract against a post-petition liability arising under another derivative contract, the creditor might well argue that the contractual right may be exercised notwithstanding the provisions of section 553 requiring that both the claim and the liability arise pre-petition. The argument would be based on those derivative exemptions that permit netting notwithstanding other provisions of the U.S. Bankruptcy Code, presumably including section 553.[42]

---

[38] N.Y. U.C.C. LAW § 9-102(a)(72)(E) (McKinney 2002).

[39] N.Y. U.C.C. LAW § 9-615(d)(1) (McKinney 2002).

[40] 11 U.S.C. § 553(a) (emphasis added).

[41] See, e.g., Cooper-Jarrett, Inc. v. Cent. Transp., Inc., 726 F.2d 93, 96 (3d Cir. 1984) (affirming district court's decision that there was no right of setoff under section 553 where the debt owed to the debtor came into existence after the filing of the bankruptcy petition).

[42] 11 U.S.C. § 560, 561. Section 560 provides, in relevant part:

> The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of

This issue was recently litigated in the Lehman bankruptcy cases.[43] Swedbank AB was owed money by LBHI under a closed out swap agreement and under a guaranty of a close out swap agreement. LBHI deposited funds with the bank post-petition, and the bank asserted a "contractual right" under sections 560 and 561 of the U.S. Bankruptcy Code to setoff the post-petition deposit against the pre-petition swap claims. Referring to the creditor's argument as "without precedent and unsupported by a fair reading of the textual language", the Bankruptcy Court rejected the argument and refused to permit the setoff.[44] The decision has been appealed.[45]

C. Common Law Triangular Setoff

Transactions with corporate groups occur all of the time. For example, A may enter into a transaction with B and a separate transaction with B's sister company, C. On a business level A may regard B and C as single counterparty since B and C are part of the same corporate family. Accordingly, when the transactions are terminated and A owes B and C owes A, A's immediate reaction might be to setoff what C owes A against what A owes B.

But the setoff should not be done so fast. Since A, B and C are separate legal entities, it is hard to see how the requirement of mutuality for common law setoff is met. If C is in an insolvency proceeding, A may be furious that it needs to pay money to B while receiving only a fractional distribution in C's insolvency proceeding on A's claims against C, but A would not appear to be entitled to exercise a common law setoff right because of the lack of mutuality with C.

A would not have better luck if B and C were debtors in U.S. bankruptcy cases. Section 553 of the U.S. Bankruptcy Code validates common law setoff rights but only if the debts are "mutual".[46] A common law setoff among A, B and C, often referred to as a "triangular setoff"[47], would almost by definition not involve mutual debts.[48]

> any provision of this title or by order of a court or administrative agency in any proceeding under this title.

11 U.S.C. § 560. Section 561 includes substantially similar language that applies in connection with the exercise of such contractual right under a master netting agreement or across contracts. 11 U.S.C. § 561.

[43] See In re Lehman Brothers Holdings Inc., No. 08-13555, 2010 WL 1783395 (Bankr. S.D.N.Y. May 5, 2010) (memorandum decision granting debtors' motion pursuant to sections 105(a) and 362 of the bankruptcy code for an order enforcing the automatic stay against and compelling payment of post-petition funds by Swedbank AB) (hereinafter "Swedbank").

[44] The decision also implicated the question of whether Sections 560 and 561 go so far as to permit a contractual right of setoff when one of the debts arises from a derivative transaction but the other does not. This issue is discussed in Part III.F below.

[45] See Notice of Appeal, In re Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. May 6, 2010) [Docket No. 8831].

[46] 11 U.S.C § 553(a). See In re Lehman Brothers Holdings Inc., 404 B.R. 752, 757 (Bankr. S.D.N.Y. 2009) (outlining the prerequisites of setoff under section 553 of the U.S. Bankruptcy Code).

[47] In re Garden Ridge Corp., 338 B.R. 627, 634 (Bankr. D. Del. 2006).

[48] See, e.g., In re HAL, Inc., 196 B.R. 159, 163 (B.A.P. 9th Cir. 1996) ("The general rule . . . holds that triangular setoffs among related parties do not meet the mutuality requirement.").

It is even doubtful that A would be saved if B and C were substantively consolidated in their bankruptcy cases. One might think that, if B and C were treated as a single entity under principles of substantive consolidation, mutuality would be established. But courts that have faced the issue have determined that substantive consolidation is intended to facilitate asset distributions from the combined debtors but not to bestow on a creditor a substantive right or claim that it did not have before substantive consolidation.[49]

D. Contractual Triangular Setoff

While the requirement for mutuality for common law setoff would not appear to be met for a triangular setoff at common law, nevertheless one may question whether the mutuality requirement is in fact met if the triangular set off is contractual.[50] For example, in their master derivative contact, A and B could agree that on the close out of the transactions covered by the master agreement A could reduce whatever amount it owes to B by whatever amount B's sister company, C, owes to A. Such a contractual triangular setoff clause is often referred to in the derivatives market as a "cross-affiliate netting" clause.

The argument for why a contractual triangular setoff clause meets the mutuality requirement is a straightforward one. If the clause is enforceable as a matter of non-insolvency law, then A has a claim or defense to payment of whatever amount it owes to B. That claim or defense, based on the contractual triangular setoff clause, permits A to reduce the amount that it owes to B by the amount that B owes to C. If B were to sue A for the full amount owed, A could assert that claim or defense to reduce the amount that it owes to B. A's ability to raise that claim or defense suggests that the debts between A and B are in fact mutual.[51]

Indeed, there would be little question of the existence of mutuality if B had guarantied C's debt to A limited only to the amount that A owes B. In that case mutuality would be clear: A could reduce what it owed to B by the amount that B owed to A under B's guaranty of C's debt. One could even interpret a contractual triangular setoff clause as being nothing more than a guaranty by B of C's debt to A limited to the amount that A owed B.

---

[49] In re Garden Ridge Corp., 338 B.R. at 640-41.

[50] Courts have suggested that a contract providing for non-mutual setoff could be enforced. See, e.g., U.S. Aeroteam, Inc. v. Delphi Auto. Sys., LLC (In re U.S. Aeroteam, Inc.), 327 B.R. 852 (Bankr. S.D. Ohio 2005); U.S. Bank v. Custom Coals Laurel (In re Custom Coals Laurel), 258 B.R. 597 (Bankr. W.D. Pa. 2001); Wooten v. Vicksburg Ref., Inc. (In re Hill Petroleum Co.), 95 B.R. 404 (Bankr. W.D. La. 1988); Inland Steel Co. v. Berger Steel Co., Inc. (In re Berger Steel Co.), 327 F.2d 401 (7th Cir. 1964). However, as noted in In re SemCrude, L.P. (discussed below):

> [N]ot 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.

399 B.R. 388, 394 (Bankr. D. Del. 2009).

[51] Cf. Bromfield v. Trinidad Nat'l Inv. Co., 36 F.2d 646, 649 (10th Cir. 1929) (a three-cornered agreement supplied the requisite "privity" to support a triangular setoff).

However, the case law in the United States, such as it is, is to the contrary. In SemCrude,[52] decided in early 2009 by the Bankruptcy Court for the District of Delaware and recently affirmed by the United States District Court, A and B were sister companies that did business with C.[53] When C filed for bankruptcy, A and B moved for relief from the automatic stay in C's bankruptcy case to effect a contractual triangular setoff clause[54] so that A could reduce what it owed to C by the amount that C owed to B.[55] The court denied the requests, citing section 553 of the Bankruptcy Code. The court found that section 553 required the debts to be mutual and that a triangular setoff, even a contractual one, does not involve mutual debts.[56]

One may question whether SemCrude was correctly decided[57]. But whether it was correctly decided or not, it may arguably have no relevance under the U.S. Bankruptcy Code to the exercise of a contractual triangular setoff right under a derivatives transaction. This is because under the U.S. Bankruptcy Code a non-debtor counterparty is entitled to exercise a "contractual right" to net amounts owing under derivative contracts following termination of the derivative transactions.[58] The exercise of that right is free of the automatic stay in the debtor's bankruptcy case and may not be limited by any other provision of the Bankruptcy Code, presumably including section 553.[59]

The SemCrude court had the opportunity to address whether a contractual triangular setoff clause in a derivative transaction is enforceable, but declined to do so. That issue was raised by the non-debtor parties only on a motion for reconsideration after the court had rendered its decision.[60] However, the Bankruptcy Court denied this motion, again declining the opportunity to rule on this matter.[61] And the United States District Court affirmed the denial of the motion for reconsideration as a proper exercise of the Bankruptcy Court's discretion.[62]

---

[52] In re SemCrude, L.P., 399 B.R. 388 (Bankr. D. Del. 2009), aff'd, No. 08-11525, 2010 WL 1737103 (D. Del. Apr. 30, 2010).

[53] Id. at 390-91.

[54] Specifically, the contractual triangular setoff clause provided: "'[I]n 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 party, the other party may offset any deliveries or payments due under this or any other Agreement between the parties and their affiliates.'" Id. at 391.

[55] As of the bankruptcy petition date, Chevron owed approximately US$1.4 million to SemCrude and was owed approximately US$10.2 million and US$3.3 million by SemFuel and SemStream, respectively. Id. at 392.

[56] See id. at 397 (concluding that "mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff").

[57] See, for example, Martin J. Bienenstock et al., Are Triangular Setoff Agreements Enforceable in Bankruptcy?, 83 AM. BANKR. L.J. 325 (2009), for an argument that SemCrude was wrongly decided.

[58] 11 U.S.C. § 362(b)(6)-(7), (17).

[59] 11 U.S.C. § 555 (securities contracts); 11 U.S.C. § 556 (commodities and forward contracts); 11 U.S.C. § 559 (repurchase agreements); 11 U.S.C. § 560 (swap agreements); 11 U.S.C. § 561 (master netting agreements).

[60] Chevron Products Company's Motion for Reconsideration of this Court's Opinion Dated January 9, 2009 Regarding Contractual Netting, In re SemCrude, L.P., No. 08-11525 (Bankr. D. Del. Jan. 20, 2009) [Docket No. 2853]. Chevron argued that the transactions were forward contracts.

[61] In re SemCrude, L.P., No. 08-11525 (Bankr. D. Del. Mar. 20, 2009) (memorandum order) [Docket No. 3465].

[62] In re SemCrude, L.P., No. 08-11525, 2010 WL 1737103, at *3 (D. Del. Apr. 30, 2010).

The argument that the mutuality requirement of section 553 does not apply to contractual triangular setoff rights under derivative contracts has some support in the legislative history of the U.S. Bankruptcy Code in view of the amendments to the U.S. Bankruptcy Code effected by the Financial Netting Improvement Act of 2006 ("FNIA").[63] Prior to those amendments becoming effective, the exceptions to the automatic stay for netting under derivative contracts was limited to the setoff or netting of a "mutual debt and claim". The FNIA amendments, however, replaced that phrase to permit the exercise of "any contractual right" to setoff or net.[64] If under non-bankruptcy law a contractual triangular setoff right is enforceable, so the argument goes, the FNIA amendments make it clear that the automatic stay does not prevent the enforcement of the contractual right.

The Swedbank court, though, discounted the argument. The court, reviewing the legislative history of the FNIA amendments, found that the amendments were intended to effect "technical" changes but not to expand dramatically the rights of derivative creditors.[65]

E. Setoff Following Assignment

In the absence of common law or contractual setoff being available at the outset, some non-debtor counterparties have thought about taking actions to create a right of setoff. A particular technique would be for the non-debtor counterparty who owes money to the debtor to acquire a claim against the debtor the purpose of effecting a setoff.[66] The technique would be especially attractive if the claim could be acquired from an affiliate of the non-debtor counterparty or at a discount from an unaffiliated creditor of the debtor.

In many situations a setoff arising by acquisition of a claim would not be allowed in a U.S. bankruptcy case. Section 553 of the U.S. Bankruptcy Code strikes down a set off arising by acquisition of a claim if the claim is acquired after commencement of the debtor's bankruptcy case or within the 90-day period before the commencement of the debtor's bankruptcy case while the debtor was insolvent.[67] Section 553 also strikes down a setoff arising from a debt incurred by a creditor within the 90-day period before the commencement of the debtor's

---

[63] Pub. L. No. 109-390, 120 Stat. 2692 (2006).

[64] See id. at § 5(a)(2) (replacing the phrase "mutual debt and claim" in sections 362(b)(6), (b)(17), and (b)(27) with "any contractual right").

[65] The court stated that "[t]he legislative history of FNIA reveals that Congress intended merely to make 'technical changes to the netting and financial provisions' of the Bankruptcy Code to 'update the language to reflect current market and regulatory practices.' . . . These technical amendments cannot be read as authority for so fundamental a change in creditor rights." Swedbank, supra note 43, at *8. Arguably the court could have ruled more narrowly that, whether or not the FNIA amendments removed the mutuality requirement from section 553 for derivative transactions, the amendments did not affect the requirement of section 553 that the mutual debt and claim must each arise pre-petition for setoff under non-bankruptcy law to be preserved.

[66] This result could be accomplished through an assignment of rights. Under principles of contract law, when party A pays B's debt to C and obtains a valid assignment of C's rights against B, party A may "step into the shoes" of C and assert all rights C had against B. U.S. Aeroteam, Inc. v. Delphi Auto. Sys., LLC (In re U.S. Aeroteam, Inc.), 327 B.R. 852, 864 (Bankr. S.D. Ohio 2005). Courts are generally in agreement that a valid assignment can create mutuality for setoff purposes. Id. at 865 (citing In re New Haven Foundry, Inc., 285 B.R. 646, 648 (Bankr. E.D. Mich. 2002); Schechter v. ACME Screw Co., Inc. (In re Assured Fastener Products Corp.), 773 F.2d 105, 107 (7th Cir.1985)).

[67] 11 U.S.C. § 553(a)(2).

bankruptcy case while the debtor was insolvent if the debt were incurred for the purpose of effecting the setoff.[68]

However, the amendments to the U.S. Bankruptcy Code, effected by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,[69] include provisions that appear to protect a setoff arising from the acquisition of a claim under a derivative contract, or the incurrence of a debt under a derivative contract, within the 90-day period before the commencement of the debtor's bankruptcy case.[70]

In the Lehman insolvency cases, the amendments left open the possibility that, if A owed money to a Lehman debtor under a derivative contract and B was owed money by the same Lehman debtor under a different derivative contract, A could acquire B's claim against the Lehman debtor for purposes effecting a setoff so long as the acquisition was accomplished before the commencement of the Lehman debtor's bankruptcy case. This opportunity arose because the commencement of LBHI's bankruptcy case constituted a default that permitted termination of a derivative contact by the non-debtor counterparty facing a subsidiary of LBHI. Between the time of termination on account of LBHI's bankruptcy and the commencement of the subsidiary's bankruptcy case A and B could terminate their derivative contracts, and A, who owed money to the subsidiary on close out, could acquire the claim that B had against the subsidiary on close out.

Despite the literal language of the amendments that would seem to shelter setoffs effected by acquisition of claims in these circumstances, one could argue that the amendments were not intended to go so far. Bear in mind the original justification for the derivative contract exemptions as based on a concern about systemic risk. That concern may support permitting claims to be acquired and debts to be incurred by a non-debtor counterparty under *open* derivative contracts within the 90-period before the commencement of the debtor counterparty's bankruptcy case. But one could question whether there is any systemic risk concern for claims arising under derivative contacts once the contracts have been terminated and close out claims are outstanding.

If permitting setoff for closed out derivative claims acquired within the 90-day period before the commencement of the debtor's bankruptcy case cannot be justified out of concern for systemic risk, then there would seem to be no policy justification supporting permitting the setoff. Indeed, permitting the setoff would seem to undermine one of the normal goals of the U.S. Bankruptcy Code to provide in a collective proceeding equal treatment of all creditors similarly situated. A could purchase B's claim at a discount that results in a greater recovery by both A and B but at the expense of a lesser recovery by other creditors of the debtor counterparty. In fact, permitting the setoff in these circumstances would suggest the possibility of an entire market for buying and selling closed out derivative claims at the expense of other similarly situated creditors of the debtor.

---

[68] 11 U.S.C. § 553(a)(3).

[69] Pub. L. 109-8, 119 Stat. 23 (2005).

[70] See id. at § 907(n); see generally Rhett Campbell, Financial Markets Contracts and BAPCA, 79 AM. BANKR. L.J. 697 (2005).

Another argument that the amendments to the U.S. Bankruptcy Code, effected by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, literally protect eve of bankruptcy claims acquisitions to effect setoffs on closed out derivative claims is that the setoff of an eve of bankruptcy acquired claim is merely an exercise by the non-debtor counterparty of a "contractual right" to net under a derivative contract that cannot be limited by other provisions of the Bankruptcy Code including presumably section 553. But, if that were true, as the Swedbank court suggested,[71] it would not have been necessary to add to section 553 specific exemptions for derivative contracts.

F. Setoff of Derivative and Unrelated Non-derivative Transactions

As mentioned, a non-debtor derivative counterparty is not barred by the automatic stay in a U.S. bankruptcy case from exercising a "contractual right" to terminate, accelerate or liquidate transactions under the derivative contract or to net payments owing or owed between the parties under derivative contracts.[72] The question arises, though, as to whether the "contractual right" to net free from the automatic stay is applicable only to amounts owed and owing under derivative contracts themselves or whether an amount owed or owing arising under a derivative contact may be netted against an amount owing or owed arising under a transaction that is not a derivative contract.[73]

Consider the following example. A entered into a swap with Debtor. A also made a loan of $10 million to Debtor. When Debtor commences a bankruptcy case, A terminates the swap and owes Debtor $3 million. May A setoff against the $10 million owed by Debtor to A the $3 million that A owes to Debtor on close out of the swap?[74]

The literal language of the Bankruptcy Code might suggest so.[75] But, once again, if the justification for the exemption from the automatic stay is based on mitigating systemic risk, one

[71] Swedbank, supra note 43, at 5.

[72] See supra note 7-10 and accompanying text.

[73] In addition to the issue being raised in Swedbank, the issue has been raised during the Lehman bankruptcy proceedings in a setoff adversary proceeding currently pending. Bank of America, N.A. v. Lehman Brothers Holdings Inc., No. 08-01753 (Bankr. S.D.N.Y. filed Nov. 26, 2008). In that adversary proceeding, Bank of America seeks a declaratory judgment affirming that it was proper for it to setoff approximately $509 million held in certain conventional deposit accounts against close out claims by Bank of America arising from terminated derivatives transactions. Id. The Swedbank court did not reach the issue. See Swedbank, supra note 43, at *3 n.12.

[74] Assume that A's setoff right would constitute a "contractual right".

[75] Specifically, the U.S. Bankruptcy Code provides that the filing of a Chapter 11 petition does not stay

> . . . the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements.

11 U.S.C. § 362(b)(17). That the section should not be limited to the setoff of claims owing under swap agreements against amounts owed under other swap agreements has some support in the legislative history of the section. The 2006 FNIA amendments deleted language providing that a swap participant could set

may question how permitting a setoff of a derivative close out obligation against a non-derivative obligation implicates any concern about systemic risk.

IV. CONCLUSION

The Lehman insolvency proceedings have proven to be a fertile ground for raising novel or unsettled setoff and setoff related issues. A number of the issues raised may be settled, leaving resolution for another insolvency proceeding. Others may be subject to resolution over time through adjudication. In the meantime, parties entering into derivative transactions and anticipating or bargaining for setoff or setoff related rights will need to keep these issues in mind and make their credit decisions and plan their transactions accordingly.

---

off "against any payment . . . cash, securities, or other property held . . . to margin guarantee, secure, or settle any swap agreement." Pub. L. No. 109-390, § 5(a)(2)(A), 120 Stat. 2692 (2006) (emphasis added).