No Safe Harbor Protection for Triangular Setoff Under Swap Agreement

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Does the Bankruptcy Code allow for triangular setoffs in swap and repurchase agreements after commencement of the debtor's bankruptcy case? In *Sass v. Barclays Bank (In re American Home Mortgage Holdings)*, Adv. Proc. No. 11-51851 (CSS) (Del. Bankr. Nov. 8, 2013), the court held that the Bankruptcy Code does not allow parties to set off non-mutual obligations, regardless of whether the agreements are subject to the safe harbor provisions of 11 U.S.C. §§ 559-661.

Section 553 of the Bankruptcy Code preserves any right of setoff that may exist under applicable non-bankruptcy law. However, to be eligible for setoff under Section 553, the amount owed by the debtor must be a prepetition debt; the debtor's claim against the creditor must be a prepetition claim; and the debtor's claim against the creditor and the debt owed the creditor must be mutual. As stated in *In re SemCrude*, 399 B.R. 388 (Del. Bankr. 2009), aff'd, 428 B.R. 590 (D.Del. 2010), "debts are considered 'mutual' only when they are due to and from the same persons in the same capacity."

Sections 559-561 of the Bankruptcy Code create a safe harbor for certain commodity and financial agreements, including repurchase or "repo" agreements and swap agreements. The safe harbor provisions were intended to minimize systemic risk to the securities and commodities markets that could be caused by a counterparty's bankruptcy filing. The provisions allow qualified parties to such contracts to enforce ipso facto clauses and contractual rights to liquidate, accelerate and set off obligations. Specifically, they provide that the rights of a repo or swap participant to cause the "liquidation, termination or acceleration" of a repo or swap agreement because of the bankruptcy or financial condition of the debtor, or to offset or net out any termination values or payment amounts, shall not be "stayed, avoided or otherwise limited" by operation of any provision of the Bankruptcy Code.

American Home Mortgage involved the interplay between Section 553 and Sections 559-561. AHM Investment entered into a repurchase agreement with Barclays Capital and a swap agreement with

Barclays Bank. The swap agreement contained a broad setoff provision that purported to authorize Barclays Bank to perform cross-obligation setoffs and cross-affiliate setoffs. The setoff provision allowed Barclays Bank to effectuate a triangular setoff of any obligations to AHM Investment under the swap agreement against any amounts AHM Investment owed to Barclays Capital under the repurchase agreement despite the fact that the debts were not mutual under the circumstances. The repurchase agreement and swap agreement were declared in default and terminated shortly before AHM Investment filed for bankruptcy. Subsequent to the petition date, Barclays Bank notified AHM Investment that it intended to set off amounts payable by Barclays Bank to AHM Investment under the swap agreement against AHM Investment's unsatisfied obligations to Barclays Capital under the repurchase agreement.

The trustee under the debtors' reorganization plan brought an adversary action against Barclays Bank and Barclays Capital for breach of the swap agreement, turnover of property of the estate, a declaratory judgment disallowing the triangular setoff taken by Barclays, and violations of the automatic stay by reason of the setoff. Barclays moved to dismiss the action, arguing that Sections 559-561 create a safe harbor for swap and repurchase agreements that exempts those types of agreements from the mutuality requirements of Section 553.

The court noted its approval of a prior decision by the bankruptcy and district courts in the Southern District of New York, which held that the plain language of the safe harbor provisions and their legislative history evidenced an intent to leave intact the mutuality requirements of Section 553. The court quoted the bankruptcy court in *In re Lehman Brothers Holdings*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), that the safe harbor provisions do not directly address the requirement of mutuality under Section 553 and permit the exercise of a contractual right of setoff in connection with swap agreements, notwithstanding the operation of any provision of the Bankruptcy Code that could operate to avoid or otherwise limit that right, provided the right exists in the first instance. The court reasoned that because there is no mutuality, there is no right of offset, and nothing in the safe harbor provisions can be read to preserve or protect a right that does not otherwise exist. The court in *American Home Mortgage*, like the *Lehman* court, refused to find an exception to the mutuality requirements of Section 553 for repurchase agreements, swap agreements and other safe harbor agreements.

The court found further support for insisting upon the mutuality requirement for setoffs under safe harbor agreements in the equitable distribution policies and principles of the Bankruptcy Code. "When a debtor is owed money and collects less due to offsets claimed by affiliates of its named contract-counterparty, the debtor's creditors are impacted by the reduction in amounts to be realized by the debtor's estate."

The court summed up its holding as follows: (1) parties cannot contract around the mutuality requirements for the exercise of the right to setoff in bankruptcy as required by Section 553; (2) the safe harbor provisions' exceptions to the automatic stay embodied in Sections 559-561 cannot be interpreted as implicitly removing the mutuality requirement for setoff; and (3) without moving for relief from stay, the nondebtor counterparty to swap and repurchase agreements cannot exercise control over property of the estate by retaining funds in exercise of its alleged triangular setoff rights.

Barclays has filed a motion for leave to appeal and a notice of appeal from the court's decision. It argues that a triangular setoff that was provided for under the terms of the swap agreement and is enforceable under applicable non-bankruptcy law is not prohibited by Section 553 by reason of the express language of the safe harbor provisions protecting the contractual rights of parties to swap agreements, master netting agreements and repurchase agreements. And it notes that the U.S. Court of Appeals for the Third Circuit has interpreted other financial contract safe harbors expansively based on their plain language.

At least until a Delaware district court has spoken, counterparties to swap agreements and other safe harbor contracts would be well advised to seek relief from the automatic stay before exercising any triangular setoff rights contained in their financial contracts.

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