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Alert

Swaps Update: 'Triangular Setoff' Held Unenforceable in Bankruptcy Cases

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Setoff provisions are commonly found in a variety of trading related agreements between hedge funds and their dealer counterparties. Last November, Judge Christopher Sontchi of the United States Bankruptcy Court for the District of Delaware held that "triangular setoff" is not enforceable in the context of a bankruptcy case.[1] "Triangular setoff" is a contractual right of setoff that permits one party ("Party One") to net and set off contractual claims of Party One and its affiliated entities against another party ("Party Two"). The setoff provision allows Party One to offset amounts it would otherwise owe Party Two against amounts owed by Party Two to Party One or to Party One's affiliates under their various agreements.[2]

In the case, American Home Mortgage Investment Corp. ("AHM") and Barclays Capital entered into a repurchase agreement dated February 2006.[3] Separately, in March 2006, AHM entered into an ISDA Master Agreement with Barclays Bank,[4] which contained a broad setoff provision that authorized Barclays Bank to set off any amounts owed to it or any of its affiliates, which included Barclays Capital.[5]

In August 2007, Barclays Bank asserted that AHM was in default under the ISDA Master Agreement, and notified AHM of its intent to exercise its setoff rights. The following day, Barclays Capital asserted that AHM was in default and terminated the repurchase agreement. When Barclays Bank terminated the ISDA Master Agreement, there was a "surplus" because the amounts owed to AHM exceeded the

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[1] *Sass v. Barclays Bank PLC (In re American Home Mortgage, Holdings, Inc.)*, No. 11-51851 (CSS) (Bankr. D. Del. Nov. 8, 2013).

[2] In the context of a fund structure, generally funds do not have affiliated entities and therefore this right generally only benefits the dealer counterparty. In addition, setoff rights are characterized as the "right, but not the obligation" of Party One, therefore providing an incentive of Party One to select to exercise a setoff right only when it would benefit Party One and its affiliates.

[3] The repurchase agreement provided for, among other things, AHM (as seller) to transfer to Barclays Capital (as buyer) various securities and other assets ("Purchased Securities") in exchange for the transfer of funds from Barclays Capital, with a simultaneous agreement by Barclays Capital to transfer to AHM such Purchased Securities as of a date certain or on demand in exchange for the transfer of funds from AHM (the "Repurchase Price"). Barclays Capital and AHM, for the most part, agreed on the Repurchase Price, but not the value of the Purchased Securities.

[4] In connection with underwriting a securitization, Barclays Bank entered into interest rate cap options with AHM, which were governed by the ISDA Master Agreement (Multi-Currency-Cross Border), the Schedule to the Master Agreement, the ISDA Credit Support Index, and certain related Confirmations, and other related transactional documents. The ISDA Master Agreement with Barclays Bank provided, among other things, margin protection in the form of cash collateral or securities to be delivered to the counterparty upon demand and under certain circumstances.

[5] We note that the introduction to the opinion incorrectly states that AHM was "a party to a Swap Agreement with Barclays Capital and a Repurchase Agreement with Barclays Bank."

amounts owed to Barclays Bank.[6] When Barclays Capital terminated the repurchase agreement there was a "shortfall" because the amounts owed to AHM were less than the amounts owed to Barclays Capital. When AHM filed for relief under Chapter 11 of the Bankruptcy Code, Barclays Capital calculated its deficiency claim and applied the surplus to the shortfall (i.e., the surplus payable to AHM by Barclays Bank was eliminated based on the shortfall under AHM's repurchase agreement with Barclays Capital).

The court held that the contractual right of setoff that permits netting by multiple affiliates of the contract counterparty outside of bankruptcy may not be enforced after the commencement of a bankruptcy case. In addition, neither the terms of the ISDA Master Agreement nor the safe harbor provisions of the Bankruptcy Code can, either explicitly or implicitly, override the obligation of "mutuality"[7] to effectuate a setoff. The court also concluded that the equitable distribution policy in the Bankruptcy Code's priority scheme would be undermined if creditor-affiliates could contract around it.

The court's finding is consistent with an earlier decision of the United States Bankruptcy Court Southern District of New York, where Judge James Peck held that "once the parties to that contract are subjected to the constraints of the Bankruptcy Code," triangular setoff provisions are not enforceable because netting of a debtor's claim in this way will reduce the amount available to other creditors.[8]

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the following attorneys: Craig Stein or Lawrence V. Gelber.

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[6] The surplus arose because the value of the collateral held by Barclays Bank under the ISDA Master Agreement exceeded the amounts AHM owed to Barclays Bank.

[7] The Bankruptcy Code does not create an independent right of setoff. Rather, it preserves any right of setoff that may exist under applicable non-bankruptcy law. Section 553 of the Bankruptcy Code, however, provides that a creditor may only set off "a mutual debt" owed by the creditor to the debtor against a claim "of such creditor "against the debtor. Although the Bankruptcy Code does not define "mutual debt," a majority of courts have held debts are mutual only "if they are due to and from the same persons in the same capacity." *See, e.g., In re SemCrude, L.P.*, 399 B.R. 388, 396 (Del. Bankr. 2009) aff'd, 428 B.R. 590 (D. Del. 2010) ("*Semcrude*") (citations omitted in original). Because parties cannot contract around this statutory requirement, the court then considered whether the safe harbor provisions of the Bankruptcy Code would apply.

[8] *In re Lehman Brothers Inc.*, 458 B.R. 134, 139 (2011). *See also, SemCrude*, 399 B.R. at 393-94 (upholding mutuality requirement and denying triangular setoff).