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Alert Memo

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LEHMAN BANKRUPTCY COURT HOLDS THAT CONTRACTUAL CROSS-AFFILIATE SETOFF RIGHTS ARE UNENFORCEABLE IN BANKRUPTCY

On October 4, 2011, the U.S. Bankruptcy Court for the Southern District of New York held in the SIPA proceeding of Lehman Brothers Inc. ("LBI") that "a contractual right of setoff [in a swap agreement] that permits netting by multiple affiliated members of the same corporate family outside of bankruptcy may no longer be enforced after commencement of a [bankruptcy proceeding]." This decision is consistent with—but also broader than—the decision of the U.S. District Court for the District of Delaware in *SemCrude*,[1] which addressed cross-affiliate setoff but not the effect of safe harbor provisions, and the decision of the U.S. District Court for the Southern District of New York in *Swedbank*,[2] which addressed pre- and post-petition claims between the same entities and the effect of safe harbor provisions in that context. Unless overruled on appeal, the LBI court's holding, when taken together with the decisions in *SemCrude* and *Swedbank*, would appear to provide a comprehensive determination that mutuality is required for setoff rights to be enforceable after commencement of a bankruptcy proceeding, even in the context of "safe harbored" contractual agreements. These decisions do not, however, affect the analysis of structured solutions—such as pledges of receivables—to achieve the goal of cross-affiliate setoff.

Background

On July 13, 2004, UBS and LBI entered into a swap agreement, comprised of a 1992 ISDA Master Agreement, a schedule (the "Schedule") and a credit support annex (the "Credit Support Annex") (collectively, the "Agreement"). Pursuant to the terms of the Credit Support Annex, the parties agreed to post collateral (the "Collateral") to secure their respective obligations. Upon LBI's bankruptcy, UBS delivered LBI a notice of termination, at which time UBS held approximately $170 million of Collateral. In a notice of calculation, UBS claimed a set off right pursuant to the Credit Support Annex of amounts payable by

[1] *Chevron Products Co. v. SemCrude, L.P.*, 428 B.R. 590 (D. Del. 2010).

[2] *Swedbank v. Lehman Brothers Holding Inc.*, 445 B.R. 130 (S.D.N.Y 2011). For an extensive discussion of this decision, please see our alert memorandum of January 31, 2011 entitled "U.S. District Court Affirms the Lehman Bankruptcy Court's *Swedbank* Decision Regarding the Scope of the Safe Harbor Provisions of Sections 560 and 561 of the Bankruptcy Code".

LBI to UBS—a right that was not disputed. After this undisputed right to setoff, there remained approximately $76 million in Collateral (the "Remaining Collateral"). In the notice of calculation, UBS also asserted the right to set off amounts allegedly due from LBI to UBS Securities and UBS Financial Services (the "UBS Affiliates") against the obligation of UBS to return the Remaining Collateral to LBI. The SIPA trustee disputed the validity of any alleged setoff right with respect to the UBS Affiliates. UBS agreed to turn over a portion of the Remaining Collateral, but resisted paying the $23 million balance. Thereafter, the SIPA trustee filed a motion to enforce the automatic stay and stays imposed under the LBI liquidation order against UBS and to recover the $23 million balance held by UBS. UBS opposed the motion and filed a cross-motion for an order enforcing the parties' agreement.

The Decision

The Court concluded that the contractual right of UBS to set off amounts it owed against amounts owed to its affiliates lacked mutuality and held that such a right of setoff (typically referred to as "triangular setoff") is unenforceable after commencement of a case governed by the Bankruptcy Code (the "Code").

The triangular setoff provision in the Agreement at the center of the dispute provides, in relevant part, that:

> upon the designation of any Early Termination Date,…the Non-defaulting Party or Nonaffected Party (in either case, "X") may…set off any sum or obligation (whether or not arising under this Agreement…) owed by the Defaulting Party or Affected Party (in either case, "Y") to X or any Affiliate of X against any sum or obligation (whether or not arising under this Agreement…) owed by X or any Affiliate of X to Y….

UBS asserted that the right of setoff in the Agreement was created by contract (not common law) and that therefore the mutuality requirement in section 553(a) did not apply. As an alternative, UBS asserted that even if section 553(a)'s mutuality requirement applied, the contractual setoff provision was protected by the Code's safe harbor provisions. The Court rejected these arguments.

To advance its first argument, UBS reasoned that section 553 of the Code "is derived from, and preserves, common-law setoff rights." The Court quoted the language of the Code to find that section 553 is not limited to common law setoff but rather to *any* purported setoff right, regardless of its origin:

Section 553(a) of the Code provides, in relevant part, that:

> [e]xcept as otherwise provided in this section and in sections 362 and 363 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….[emphasis supplied by the Court]

The Court quoted from the *Swedbank* decision in stating that in order to be eligible for setoff under section 553 "(1) the amount owed by the debtor must be a prepetition debt; (2) the debtor's claim against the creditor must also be prepetition; and (3) the debtor's claim against the creditor and the debt owed the creditor must be mutual."

The Court noted that the Code does not define mutuality, but that courts have consistently held that debts are mutual only when they are "in the same right and between the same parties, standing in the same capacity." UBS contended that the debts owed by LBI to UBS Securities should be viewed as mutual with UBS's obligation to LBI because of the express provision in the Agreement allowing UBS to offset amounts owed to its affiliates, all of which were treated under the Agreement as if they were a single counterparty. The Court rejected UBS's attempt to "override the independent status of UBS Securities." UBS also argued that the triangular setoff rights should be held valid and enforceable because parties have freedom to contract under New York law, and the parties intended for these rights to be enforceable, even in bankruptcy. Although recognizing freedom of contract, the Court rejected this reasoning and stated that "[t]he clarity of [section 553(a)] 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."

The Court similarly disagreed with UBS's second argument that the triangular setoff right is protected by the Code's safe harbor treatment of swap agreements. UBS based its argument on section 561 of the Code, contending that mutuality was not a required element under that statutory provision. Section 561 of the Code provides, in relevant part, that:

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

The Court followed its own decision in *Swedbank* that "the safe harbors permit the exercise of a contractual right of offset in connection with swap agreements, notwithstanding the operation of any provision of the Code that could operate to stay, avoid or otherwise limit that right, *but that right must exist in the first place*", and without mutuality UBS had no right of offset and "nothing in section 561 can be read to preserve or protect a right that does not otherwise exist". It also referred to the District Court's finding in *Swedbank* that "'there is no mention in the legislative history that the Safe Harbor Provisions were intended to eliminate the mutuality requirement.'" Retaining the Remaining Collateral was therefore in

violation of the stays in effect, and UBS was ordered to return the property to the SIPA trustee.

* * *

If you have any questions about this case or the Lehman bankruptcy more generally, please contact any of your regular bankruptcy, restructuring or structured finance contacts, or any of our partners and counsel listed under "Bankruptcy and Restructuring" or "Derivatives" in the "Practices" section of our website at http://www.clearygottlieb.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299