ALERT MEMORANDUM

Third Circuit Holds 'Triangular Setoff' Unenforceable in Bankruptcy

March 25, 2021

On March 19, 2021, a panel of the U.S. Court of Appeals for the Third Circuit held that Section 553 of the U.S. Bankruptcy Code requires "strict bilateral mutuality." As a result, a creditor cannot set off an obligation it owes to a Bankruptcy Code debtor against an obligation that the debtor owes to the creditor's affiliate, regardless of contractual language providing for such a setoff. Accordingly, Section 553 protects only a creditor's ability to set off an obligation it owes to the debtor against an obligation the debtor owes to such creditor.

The Court's decision, *In re Orexigen Therapeutics, Inc.*, No. 20-1136, is the latest in a recent string of decisions rejecting the view that "triangular setoff" is enforceable in bankruptcy. The decision adopts the view that Section 553 contains an independent mutuality requirement, which demands that obligations to be set off must be owed by the same parties acting in the same capacity, and that parties cannot override this requirement through a contractual provision to the contrary.

However, the decision also indicates, albeit in dicta, that structures recently adopted by a number of market participants to achieve a similar economic effect to triangular setoff—such as joint and several liability arrangements and perfected security interests in receivables owed by or to affiliates—should be enforceable in bankruptcy. Accordingly, market participants may wish to consider these arrangements more closely.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Lisa M. Schweitzer
lschweitzer@cgsh.com

Sean A. O'Neal
soneal@cgsh.com

Luke A. Barefoot
lbarefoot@cgsh.com

Jane VanLare
jvanlare@cgsh.com

Sandra M. Rocks
srocks@cgsh.com

Penelope L. Christophorou
pchristophorou@cgsh.com

Kara A. Hailey
khailey@cgsh.com

Brandon M. Hammer
bhammer@cgsh.com

Background

In 2016, Orexigen Therapeutics, Inc. ("Orexigen") entered into a pharmaceutical distribution agreement with McKesson Corporation, Inc. ("McKesson"), pursuant to which Orexigen sold a weight management drug to McKesson. The distribution agreement included a broad setoff provision that permitted "each of McKesson and its affiliates . . . to set-off, recoup and apply any amounts owed by it to [Orexigen's] affiliates against any [and] all amounts owed by [Orexigen] or its affiliates to any of [McKesson] or its affiliates."[1] Orexigen also entered into a services agreement with a subsidiary of McKesson, McKesson Patient Relationship Solutions ("MPRS"), pursuant to which MPRS would advance funds to pharmacies on behalf of Orexigen, with Orexigen required to reimburse MPRS at a later date.

Orexigen sought bankruptcy protection in the District of Delaware on March 12, 2018. At that time, McKesson owed Orexigen approximately $9.1 million under the distribution agreement, and Orexigen owed MPRS approximately $6.9 million under the services agreement. McKesson sought to set off its $9.1 million obligation against the $6.9 million Orexigen owed to MPRS. It argued that such setoff was allowed under Section 553 of the Bankruptcy Code. That provision states, in relevant part, that with certain exceptions inapplicable in this case:

> 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 . . . .

The Bankruptcy Court, in *In re Orexigen Therapeutics, Inc.*, 596 B.R. 9 (Bankr. D. Del. 2018), rejected McKesson's attempt to effectuate a setoff on the basis that the obligations to be set off were not mutual. The court relied on its prior decision in *In re SemCrude*, 399 B.R. 388 (Bankr. D. Del. 2009), which held that Section 553 of the Bankruptcy Code has an independent mutuality requirement that parties cannot override through contract. In *In re Orexigen*, 2020 WL 42824 (D. Del. Jan. 3, 2020), the District Court for the District of Delaware affirmed the Bankruptcy Court's decision, with a brief opinion that emphasized the long line of cases on which the Bankruptcy Court had relied.

The Decision

The Third Circuit affirmed the District Court and Bankruptcy Court, relying heavily on the reasoning of *SemCrude* as well as the decision of a Bankruptcy Court for the Southern District of New York in *In re Lehman Bros. Inc.,* 458 B.R. 134, 141 (Bankr. S.D.N.Y. 2011).[2] In doing so, the Court rejected McKesson's argument that the term "mutual" in Section 553 is nothing more than a "definitional scope provision" that identifies the state-law right that Section 553 preserves. Rather, the Court held, mutuality in Section 553 is "a limiting term, not a redundancy." Accordingly, Section 553 only applies if the obligations at issue are mutual.

The Court further concluded that "Congress intended for mutuality to mean only debts owing between two parties, specifically those owing directly from a creditor to the debtor and, in turn, owing from the debtor directly to that creditor" and that "Congress did not intend to include within the concept of mutuality any contractual elaboration on that kind of simple, bilateral relationship." The Court therefore rejected McKesson's argument that the setoff provision at issue turns debts between Orexigen and MPRS and between McKesson and Orexigen into mutual obligations. Citing *SemCrude*, the Court stated:

[1] The setoff provision by its terms does not appear to apply to amounts owed to Orexigen itself. However, that does not appear to have been at issue in the case.

[2] The *Lehman* decision involved obligations arising under "swap agreements," to which the Bankruptcy Code extends special safe harbors for netting and other rights. *See* 11 U.S.C. § 560. The decision in this case did not involve agreements within the scope of the safe harbors, and the court did not address Section 560 or any other safe harbors.

> [C]ontractual arrangements cannot transform a triangular set of obligations into bilateral mutuality. The mutuality requirement set[s] a limit, and "the effect of mutuality's narrow construction is that each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally."[3]

However, in a footnote, the Court stated that this view of Section 553 is consistent with cases in which courts have found mutuality despite "one end of the mutual debts being joint and several," given that in those cases, the debts are still directly owing between the debtor and creditor. As an example, the court pointed to cases concerning a chargeback right that a bank has against all of its customers.[4]

Emphasizing that setoff rights effectively serve to prefer the offsetting creditor without notice to other creditors, the Court stated "if McKesson wanted MPRS to have a perfected security interest in Orexigen's account receivable due from McKesson, it should have taken steps to arrange that." Since McKesson did not take those steps and the obligations were not mutual, McKesson was not entitled to the protections of Section 553.

Implications

The Court's decision reinforces recent rulings of other courts that hold that triangular setoff provisions, though potentially enforceable under state law outside of bankruptcy, may not be enforceable if the counterparty or counterparties at issue become subject to bankruptcy proceedings, even where parties expressly contract for such protections. Accordingly, market participants may wish to consider the alternative arrangements mentioned by the Court, such as joint and several liability arrangements and perfected security interests in receivables, to achieve economically similar protections to triangular setoff. These structures have become more common in recent years and, though somewhat more complicated than a simple triangular setoff provision, may provide greater legal certainty.

…

CLEARY GOTTLIEB

[3] Internal quotation marks and alterations omitted.

[4] *See, e.g., In re United Sciences of Am., Inc.*, 893 F. 720, 723 (5th Cir. 1990).