

SemCrude, Setoff, and the Collapsing Triangle: What Contract Parties Should Know

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Recently, the U.S. Bankruptcy Court for the District of Delaware held that a valid, prepetition contract cannot vitiate the strict mutuality requirement found in Section 553(a) of the Bankruptcy Code. The authors explain the court's decision and conclude that, after this ruling, contract parties should not rely on a negotiated cross-affiliate setoff — the triangle is no longer as sturdy as it may have once seemed.

On January 9, 2009, the Honorable Brendan L. Shannon of the U.S. Bankruptcy Court for the District of Delaware held in *SemCrude*¹ that a valid, prepetition contract cannot vitiate the strict mutuality requirement found in Section 553(a) of the Bankruptcy Code. In light of *SemCrude*, enterprises, such as energy trading and marketing companies, who rely on contractually based cross-affiliate or “triangular setoff” provisions as a means of setting off amounts owed among various entities should re-examine their agreements and reassess their counterparty bankruptcy risk. As *SemCrude* illustrates,² parties should also understand all of the legal remedies — including the potential applicability of the safe harbor provisions — that may be available to them under the Bankruptcy Code.

SETOFF AND TRIANGULAR SETOFF DEFINED

A setoff in bankruptcy, as defined by Section 553(a) of the Bankruptcy Code, involves the offset of mutual, valid, and enforceable prepetition debts between the same parties in the same capacities — i.e., a prepetition debt owing by a creditor (“Party A”) to a debtor (“Party B”) against a prepetition claim of Party A against Party B.³ The requisite elements of a Section 553 setoff are as follows:

- The creditor holds a claim against the debtor that arose before the commencement of the case;
- The creditor owes a debt to the debtor that also arose before the commencement of the case;
- The claim and debt are mutual; and
- The claim and debt are each valid and enforceable.⁴

Setoff, in effect, elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, prepetition claim against the creditor.⁵ Section 553 does not define “mutual.” The most common use of “mutual” includes the requirement that the prepetition claim and debt be owed among the “same parties” and that the parties be acting in the same “capacity.”⁶

By comparison, a triangular setoff typically involves the setoff of a debt owing from Party A to Party B against a debt of Party B owing to an affli-

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ate of Party A, rather than directly to Party A.⁷ In the energy trading marketplace, triangular setoff is used to manage risk among multiple affiliates trading under the same ultimate parent. Triangular setoff is considered to be a much more efficient means of managing credit exposure and maximizing the efficiency of collateral than limiting setoff to the obligations of the parties under each contract.⁸ The need for triangular setoff is even more acute when affiliates share the same guarantor of their obligations.⁹

SUMMARY OF JUDGE SHANNON'S DECISION

Despite the appeal and convenience of triangular setoff, the *SemCrude* decision should cause contract parties to re-evaluate the risk that triangular setoffs will not be enforceable against a debtor-in-possession. In *SemCrude*, the court denied the motion of Chevron Products Company (“Chevron”) for relief from the automatic stay in order to set off the balances owed by SemFuel, L.P. (“SemFuel”) and SemStream, L.P. (“SemStream”) to Chevron against the sum Chevron owed to SemCrude, L.P. (“SemCrude”). Specifically, Chevron owed SemCrude approximately \$1.4 million for the sale and purchase of crude oil, SemFuel owed Chevron approximately \$10.2 million for the delivery and purchase of gasoline, and SemStream owed Chevron approximately \$3.3 million for the delivery and purchase of butane.¹⁰ Each of the agreements among Chevron and the SemCrude parties contained identical netting provisions that provided in pertinent part:

[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.¹¹

SemCrude and at least seven other parties filed objections to Chevron’s motion. The primary focus of these objections was that the triangular setoff sought by Chevron was impermissible because the Bankruptcy Code does not permit parties to contract around the “mutuality” require-

ment set forth in Section 553 of the Bankruptcy Code. Chevron relied on a common law exception to the “mutuality” requirement, which recognized that parties could create mutuality through a contractual arrangement;¹² but upon a closer examination of the precedent cited by Chevron, Judge Shannon stated that in the court’s view none of the cited cases “actually upheld or enforced an agreement that allows for a triangular setoff; each and every one of the decisions have simply *recognized* such an exception in the course of denying the requested setoff or finding mutuality independent of the agreement.”¹³

In the absence of what the court viewed as controlling or persuasive authority concerning the validity of triangular setoffs, Judge Shannon addressed two related questions: (1) may debts owing among different parties be considered “mutual” when there are contractual netting provisions governing the parties’ business relationship; and (2) if not, is there a “contractual exception” to Section 553’s mutuality requirement?¹⁴

PARTIES CANNOT CONTRACT AROUND MUTUALITY

The court held that “non-mutual debts cannot be transformed into a ‘mutual debt’ under Section 553 simply because a multi-party agreement allows for setoff of non-mutual debts between the parties to the agreement.”¹⁵ For debts to be “mutual,” the debts must be “due to and from the same persons in the same capacity.”¹⁶ Therefore, Chevron did not have mutuality with SemCrude because even though Chevron owed SemCrude money, SemCrude did not have a debt due and owing to Chevron.

The court made an important distinction between a guaranty obligation, which creates a debt between guarantor and creditor, and a setoff agreement, which does not create indebtedness between parties and only provides that a party’s receivable may be reduced or eliminated. While there was a debt due from Chevron to SemCrude, as well as debts due from SemStream and SemFuel to Chevron, there was no reciprocal debt owing from SemCrude to Chevron. Even if Chevron had privity of contract with each of the debtors, it lacked the mutuality with SemCrude required by Section 553. As a result, Chevron could not enforce the contractual netting provisions to set off the monies it owed to SemCrude against

