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Third Circuit Holds Triangular Setoff Provisions Unenforceable in Bankruptcy

On March 19, the Third Circuit issued a precedential opinion in *In re Orexigen Therapeutics, Inc.*, addressing whether "triangular setoffs" are permissible under section 553 of the bankruptcy code. The opinion is unlikely to engender any significant controversy given that the Third Circuit followed the vast majority of courts to consider the issue, holding that triangular setoffs are simply not permitted under section 553. Nevertheless, the decision is notable because it touches on a matter of first impression for the Third Circuit – the meaning of "mutuality" in section 553 – and because the decision would seem to finally foreclose any argument that triangular setoffs could ever be permitted under section 553. Further, understanding the Third Circuit's decision and the underlying issue can potentially aid contracting parties in avoiding the multimillion-dollar pitfall that befell the appellant in Orexigen.

Section 553 of the Bankruptcy Code

Section 553 of the bankruptcy code provides that:

> Except 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 commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case[.]
>
> 11 U.S.C. § 553.

In other words, where a creditor has the right, under non-bankruptcy law, to offset any amounts owed to it by a debtor against amounts such creditor might otherwise owe to the debtor, the bankruptcy code does not affect such right. In most cases, an unsecured creditor holding a claim against a debtor in bankruptcy can expect to receive significantly less than the full value of its claim, frequently only pennies on the dollar. At the same time, a debtor or trustee of the bankruptcy estate can seek to recover the full amount of any receivables owed to the debtor. Section 553 provides that where a creditor otherwise might expect to receive only a small portion of its claim from the bankruptcy estate, such creditor may nonetheless utilize the full value of its claim by offsetting it against amounts it might owe to the debtor. In this way, a creditor who owes money to a bankruptcy debtor actually finds itself in a more advantageous position than a creditor who owes nothing to the debtor. As the Third Circuit noted in its opinion, the concept of setoff "is at odds with a fundamental policy of bankruptcy, equality among creditors, because it permits a creditor to obtain full satisfaction of a claim by extinguishing an equal amount of the creditor's obligation to the debtor, i.e., in effect, the creditor receives a preference." (quoting *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 57 (3d Cir. 1990)).

It is important to note that section 553 does not create any independent right to setoff. Instead, section 553 leaves in place pre-existing rights to setoff that would otherwise exist outside

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of bankruptcy. In doing so, however, it places limits on the bankruptcy code's recognition of non-bankruptcy setoff rights, balancing a party's expectation that setoff rights will be available against the inherent tension such rights create in relation to the bankruptcy code's fundamental policy of creditor equality. Thus, section 553 limits the availability of offsetting obligations by requiring a creditor to show, in addition to a pre-existing right to setoff, that the debts to be offset are, in fact, "mutual" as required by section 553. And this is where the issue of so-called "triangular setoffs" comes into play.

Triangular Setoffs

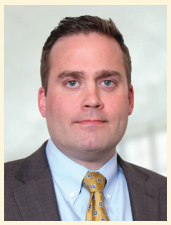
As the name suggests, a triangular setoff involves three parties. In the typical scenario, Party A owes money to party B, who owes money to Party C, who owes money to Party A. Outside of bankruptcy, the three parties might be able to offset these triangular obligations provided that there is some basis in law or contract to do so. The question in bankruptcy is whether such a setoff is permitted under section 553, which leaves in place a creditor's non-bankruptcy right to "offset a ***mutual*** debt owing by such creditor to the debtor." (emphasis added).

The Orexigen Decision

In *Orexigen*, the debtor, Orexigen Therapeutics, Inc. (Orexigen) was party to a pharmaceutical distribution agreement with McKesson Corporation, Inc. (McKesson) pursuant to which McKesson, a distributor of Orexigen's products, could reduce any amounts it owed to Orexigen by any amount Orexigen owed McKesson or any of its subsidiaries. At the same time, one of McKesson's subsidiaries, McKesson Patient Relationship Solutions (MPRS) was party to a separate and unrelated agreement with Orexigen pursuant to which MPRS administered a customer loyalty program for Orexigen. At the time Orexigen filed for bankruptcy, McKesson owed Orexigen approximately $7 million. However, Orexigen owed MPRS approximately $9 million, and McKesson sought approval from the bankruptcy court to offset the $9 million owed to its subsidiary against the $7 million it owed to Orexigen, thereby reducing its obligation to $0 despite the fact that in the absence of a setoff, MPRS likely would receive only a small fraction of its $9 million claim.

The bankruptcy court, relying on its own prior decision in *In re SemCrude, L.P.* 399 B.R. 388 (Bankr. D. Del. 2009), held that the mutuality requirement under section 553 means what it says and that any debts to be offset must be mutual, i.e., must run directly by and between the offsetting creditor and the debtor. Triangular setoff rights that might otherwise exist outside of bankruptcy, therefore, are not preserved by section 553. The district court affirmed.

On appeal to the Third Circuit, McKesson argued that the word "mutual" in section 553 "is merely a non-limiting adjective meant to invoke an understanding of how state law setoff rights generally operate." The Third Circuit rejected this assertion and adopted the reasoning set forth in SemCrude, concluding that mutuality is a distinct statutory requirement under section 553. The Third Circuit noted that "McKesson's reading of the statute would render the term 'mutual' redundant, as the phrase 'any right . . .to offset' provides adequate definitional scope to §553." In other words, the word "mutual" either is superfluous or must be read to place a limit upon section 553's preservation of setoff rights.



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Takeaway

The *Orexigen* decision is not exactly groundbreaking despite establishing a new precedent in the Third Circuit. Instead, the decision follows a long line of cases holding that triangular setoffs simply are not permissible under section 553. The bottom line is that section 553's preservation of state law setoff rights is limited to "only debts owing between two parties, specifically those owing from a creditor directly to the debtor and, in turn, owing from the debtor directly to that creditor."

Is it possible for contracting parties to draft an agreement that deftly gets around the mutuality requirement of section 553? Likely, no. In rejecting an alternative argument by McKesson that including a setoff provision in the distribution agreement transformed the various obligations from a triangular debt arrangement into a mutual debt, the Third Circuit seems to have answered this question directly, noting that the court in *SemCrude* "rightly recognized that contractual arrangements cannot transform a triangular set of obligations into bilateral mutuality." There are, of course, many reasons to include triangular setoff provisions in a contract despite the potential pitfall of section 553. After all, for large corporate families conducting business through a number of affiliated entities, there are obvious business justifications for doing so. Further, in most cases, it is unlikely that the contract counterparty will find itself in bankruptcy. Nevertheless, it is important for parties to understand the potential exposure when conducting business with numerous affiliated entities.

The Third Circuit's decision offers some suggestions to parties looking to avoid the fate of McKesson. First, the court notes that "[i]f McKesson wanted mutuality for the debts in question, it should have taken on the customer loyalty support that it instead had its subsidiary MPRS handle for Orexigen." The suggestion ignores many practical realities of modern business practices.

Nevertheless, where the circumstances allow for it, contracting parties might structure their agreements so that separate obligations due and owing from various affiliated entities are joint and several such that all of the obligations run directly between each of the parties. Thus, if only one counterparty ends up in bankruptcy, section 553 will not prevent the exercise of a creditor's setoff rights. Second, the Third Circuit suggests that "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." Again, there are obvious practical problems with this suggestion, but it does offer a possible arrangement that might avoid the issue of triangular setoffs where appropriate. Finally, where practicalities render it unfeasible to avoid the potential impact of section 553, the simplest strategy is one where a party with contractual or other setoff rights consistently and promptly exercises such rights as soon as offsetting obligations accrue. In this way, one can minimize the exposure in the event of a bankruptcy filing.