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Dance with the One that Brought You: Enforceability of Triangular Set-Off Provisions in Securities Contracts

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Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

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February 19, 2014 - Parties to financial contracts often include in those contracts triangular setoff provisions to reduce risk in case of default by allowing one party to offset the debt owed by another party against the obligations to a third party. Notwithstanding the customary nature of these setoff provisions, the mutuality requirement of Section 553 of the Bankruptcy Code prohibits parties from setting off non-mutual debts once bankruptcy proceedings have commenced. Until recently, however, whether the “safe harbor” provisions of the Bankruptcy Code exempt swap and repurchase agreements from the mutuality requirement of Section 553 remained unsettled. In November 2013, the bankruptcy court in the District of Delaware answered this question, holding that the “safe harbor” provisions do not provide an exception to the mutuality requirement for parties seeking to enforce prepetition triangular setoff agreements. *In re Am. Home Mortgage Holdings, Inc.*, 501 B.R. 44 (Bankr. D. Del. 2013).

Background

While it was an operating entity, American Home Mortgage Investment (“AHM”) entered into two financial contracts: a repurchase agreement with Barclays Bank and a swap agreement with Barclays Capital, an affiliate of Barclays Bank. The swap agreement contained a broad setoff provision that purported to authorize Barclays Bank to effectuate a “triangular setoff” of its obligations to AHM. Under the provision, Barclays Capital could set off monies owed to AHM under the swap agreement against funds owed to Barclays Bank under the repurchase agreement. AHM later filed for bankruptcy, and Barclays attempted to enforce its rights under the agreement by executing the setoff provision. AHM sued Barclays Bank and Barclays Capital seeking, among other things, a declaratory judgment that the triangular setoff was improper.

The Court’s Analysis

The question before the district court was whether the safe harbor provisions of Sections 559, 560 and 561 create an exception to the general mutuality requirement of Section 553 for prepetition triangular setoff agreements that are part of financial contracts otherwise covered by the safe harbor provisions. Section 553 of the Bankruptcy Code preserves prepetition contractual setoff rights in bankruptcy but imposes two key restrictions. First, both the amount owed by the debtor and the debtor's claim against the creditor must be prepetition. Second, the debtor's claim against the creditor and the debt owed the creditor must be mutual. Mutuality exists when the debts and credits are between the same parties, standing in the same capacity. Because triangular setoffs involve debts and credits that are not mutual, they are generally impermissible once a debtor has commenced bankruptcy proceedings.

Defendants argued that that the safe harbor provisions of Sections 559-561 trumped the mutuality requirement and exempted setoffs in swap and repurchase agreements. The court disagreed, however, relying primarily on two decisions from the United States Bankruptcy Court for the Southern District of New York in the Lehman Brothers proceedings. In the first—Lehman/Swedbank—Judge Peck had held that the safe-harbor provisions did not override the mutuality requirement even with respect to swap agreements. That case, however, involved an agreement to set off prepetition claims against funds collected postpetition—not a multi-party setoff. In the second—Lehman/UBS—Judge Peck addressed a more comparable factual scenario and held that the safe-harbor provisions do not exempt financial contracts from the mutuality requirement.

Consistent with these rulings, the Delaware court held that parties could not contract around the mutuality requirement of Section 553 even in the context of financial arrangements that otherwise might receive special treatment under the safe-harbor provisions of Sections 559-561.

Practical Implications

The AHM decision represents the latest in a series of decisions narrowing the availability of triangular setoffs in bankruptcy. As a result, parties to swap and repurchase agreements that contain triangular setoff provisions should not expect triangular setoff provisions to be enforceable under all circumstances. Parties seeking to redeem purported triangular setoff rights should seek relief from the automatic stay before setting off any obligations. In addition, parties in the drafting stages should take care in crafting triangular setoff provisions and seek alternative ways to reduce risk should bankruptcy occur.

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