

## UPDATE ON SETOFFS IN BANKRUPTCY

In a previous article on pre-bankruptcy planning we suggested that one important mechanism that sellers of goods worried about a customer's ability to pay could employ is to obtain an agreement from the buyer that would allow the seller to setoff amounts owed to and from the seller against not only the buyer but any affiliate of the buyer.<sup>1</sup> As we noted in the prior article, it is not unusual for sellers of goods to have multiple and complicated relationships with customers and suppliers in which seller and its subsidiaries both sell goods to and buy goods from another entity and its affiliates. Section 553 of the Bankruptcy Code requires that debts to be setoff in a bankruptcy case must be mutual, which means that the setoff must be between the same legal entities, so that any post-bankruptcy setoff will have to take legal entities into account. For example, if one of Seller's wholly owned subsidiaries, X, sells goods to Buyer, and one of Buyer's subsidiaries sells goods to another of Seller's subsidiaries, Y, and Buyer and its subsidiary are in Chapter 11, unless there is an exception to the mutuality requirement of Section 553, Y cannot setoff the amount it owes to the subsidiary for the goods it purchased from that subsidiary against the amount that Buyer owes to X.

Although commentators and cases have suggested that parties could agree by contract to non-mutual setoffs among affiliates, thereby avoiding the mutuality restriction of Section 553, a recent decision by the U.S. Bankruptcy Court for the District of Delaware calls that strategy into question. On January 9, 2009, that court issued a ruling in *In Re SemCrude, L.P., et al.*, Case No. 08-11525 (Dkt. Instr. 2754) that denied Chevron the right to enforce a pre-bankruptcy contract it had with debtor and debtor's affiliates (that are separate legal entities that filed separate bankruptcy cases) that would have permitted Chevron to setoff amounts Chevron owed to SemCrude against amounts owed to Chevron by SemCrude affiliates. The judge in the *SemCrude* case reviewed all of the prior decisions he could find on contractual exceptions to the mutuality provision of Section 553, and surveyed the discussion of the issue among the commentators, and concluded that the cases and commentators either did not support the idea of a contractual exception to mutuality or were wrongly decided. The court in *SemCrude* held that the plain language of Section 553 requires that the debts a creditor seeks to setoff be mutual and that no basis exists in law or logic to permit a contract-based exception to the mutuality requirement to be engrafted into the statute.

The decision in *SemCrude* is one decision by one Bankruptcy Court, but the Delaware Bankruptcy Court is closely watched by bankruptcy courts, practitioners, and academics because so many large bankruptcy cases are filed there. Moreover, the court's decision in *SemCrude* is thorough and strongly written, and it is likely that other courts will seriously

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<sup>1</sup> That previous article is posted on the Robison, Curphey & O'Connell website, with the following link: <http://www.rcolaw.com/documents/PrebankruptcyPlanning.pdf>.

consider following its reasoning even though it has no precedential authority outside Delaware.<sup>2</sup> Although Chevron may appeal the decision, for the foreseeable future the ruling in *SemCrude* will cast doubt on the enforceability of any contractual arrangement that would permit a creditor to engage in non-mutual setoffs in a bankruptcy case.

That is not to say that sellers seeking greater protection for their right to payment from a financially suspect buyer should not obtain such agreements whenever possible. The mutuality requirement of Section 553 applies only in a bankruptcy case, and not all financially troubled buyers will file for bankruptcy protection. There is no restriction on non-mutual affiliate setoffs outside of bankruptcy.

Given this new threat to the enforceability in bankruptcy courts of contractual provisions for non-mutual setoff, what steps should careful and concerned sellers take to increase their setoff potential?<sup>3</sup> We believe that sellers should focus on recoupment, assignment, and guaranty, some or all of which may apply to particular circumstances.

### **Recoupment**

Recoupment is a legal theory that permits the netting of obligations arising out of a single transaction. It is not considered a setoff and Section 553 does not apply. The key, however, is that the cross-obligations must arise from the same transaction or set of transactions. For example, if a seller of component parts enters into a master agreement with an original equipment manufacturer and that agreement covers all sales of parts to the OEM and all of its subsidiaries and affiliates by the seller and all of its subsidiaries and affiliates, such a master agreement should be deemed a single transaction even though it covers multiple entities for both buyer and seller. As a single transaction, such an agreement would give the seller the ability to net out, or recoup, amounts the OEM or any of its affiliates owe the seller or any of its affiliates against amounts owed by the seller or its affiliates.

### **Assignment**

Cases have held that an assignment of a debt or a right to collect a debt can create mutuality where none previously existed. In the context of a seller worried about a shaky buyer and its affiliates, if for example the seller sells only to the parent but buys from a subsidiary of the parent, the seller could insist that the sales contract with the parent provide that if the parent defaults in its payment obligations for the goods it purchases from the seller, those obligations will automatically be deemed to be assigned to the subsidiary, where the obligations could be setoff against seller's debt to the subsidiary.

The problem with this approach is that Section 553 also provides that a creditor cannot setoff a debt acquired within 90 days prior to the filing of the bankruptcy case. In the example above, if the parent is in default on its payment obligations to seller it may be on the brink of bankruptcy, and if it files within 90 days after the assignment of the debt to the subsidiary,

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<sup>2</sup> Even within the Delaware Bankruptcy Court, the decision by one judge is not binding on the other judges if they disagree with the reasoning. Nevertheless, it is likely that courts everywhere will find this decision persuasive.

<sup>3</sup> The methods discussed here are in addition to the other, non-setoff issues addressed in the initial article.

Section 553 probably would prohibit a setoff. This limitation does not mean that seller should not try to obtain such an agreement from its buyer if the circumstances are appropriate, but it may limit the practical value of this approach.

## Guaranty

Finally, sellers should insist on cross guaranties from the buyer and all of its affiliates. While such guaranties may have intrinsic value (as explained in the prior article), they also may create mutuality that would support a setoff in bankruptcy. Take again the example in which the seller sells only to the parent but buys from a subsidiary of the parent. If the seller obtains guaranties of payment from not only the parent but also the parent's affiliates, which guarantee the parent's payment of its obligations to seller, in the event of a default by the parent buyer the guaranty given by the subsidiary from which seller buys goods creates a direct obligation from that subsidiary to the seller, against which seller could setoff its payment obligations to that subsidiary.

## Conclusion

The decision of the Delaware Bankruptcy Court in *SemCrude* will be used by debtors and creditors committees to object to contractually based, non-mutual setoffs in bankruptcy cases. Sellers should still obtain such contractual setoff rights whenever possible since such rights will continue to be enforceable outside of the bankruptcy context. In addition, sellers should consider whether their circumstances are appropriate to employ other tools, such as recoupment, assignment, or cross-guaranties to supplement potential setoff rights. The commercial law specialists at Robison, Curphey & O'Connell would be happy to assist any client in evaluating the use of such strategies.

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