

NETTING/SETOFF UNDER THE BANKRUPTCY CODE

by Patricia Williams Prewitt

I. INTRODUCTION

What could be worse than a counterparty to a contract filing bankruptcy and owing you millions of dollars for pre-petition obligations? It is possible to hold an unsecured claim for millions of dollars and be required to cut a check to that same debtor for amounts owed to the debtor. Enforceable netting and setoff rights can alleviate, if not eliminate, the risk of being required to pay more than the excess or net of an obligation to a debtor in a bankruptcy case. It was to avoid this type of inequity that setoffs were allowed in bankruptcy courts. *In re DeLaurentis Entertainment Group, Inc.*, 963 F.2d 1269, 1277 (9th Cir. 1992). "The right of setoff ... allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the 'absurdity of making A pay B when B owes A.'" *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S.Ct. 286, 288, 133 L.Ed.2d 258 (1995) (quoting *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913)).

II. STATUTORY BACKGROUND

The Code does not create a right of setoff. Rather, it recognizes the right to setoff existing under non-bankruptcy state law. See, *In re Gullett*, 230 B.R. 321 (Bankr. S.D. Tex. 1999), *aff'd* 220 F.3d 585 (5th Cir. 2000). Setoff rights may be contractual or derived from state statute or common law. Since state laws vary, it is advisable to include express setoff language in contracts where mutual obligations are a possibility to ensure that setoff rights exist.

Under the Bankruptcy Code provisions, a right to setoff is an equitable right, and it is entirely within the discretion of the bankruptcy court to allow setoff rights for most contracts. See, e.g. *In re Beville, Bresler & Schulman Asset Mgmt. Corp.*, 896

F.2d 54, 59 (3d Cir. 1990); *Collier on Bankruptcy* § 553.02 at p. 553-11 (1997). A court may refuse to allow a setoff for virtually any reason, including an adverse effect that a setoff would have on a debtor's reorganization. See, e.g., *In re Nielson*, 90 B.R. 172, 175 (Bankr. W.D.N.C. 1988); *In re Blanton*, 105 B.R. 321, 337-338 (Bankr. E.D. Va. 1989).

In order to exercise ordinary state law setoff rights pursuant to general Code provisions, a party must generally prove three elements:

- A pre-petition debt owed by the creditor to the debtor;
- A pre-petition claim of the creditor against the debtor; and
- The debt and the claim must be mutual obligations. 11 U.S.C. § 553.

The requirement that debts and claims be mutual is strictly construed under the Code. *In re Beville, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 59 (3d Cir. 1990); *In re Virginia Block*, 16 B.R. 560, 562 (Bankr. Va. 1981). "Mutuality" requires that the debts be owed in the same capacity. There is mutuality if Party A owes Party B and Party B owes Party A. There is arguably no mutuality if Party A owes Party B and Party B's affiliate owes Party A. The purpose of the mutuality requirement is to prevent "triangular setoffs," a setoff among three or more affiliated entities. Some courts have created an exception to the general rule prohibiting triangular setoffs when the parties have entered into an express contractual agreement to allow setoff among affiliates. *Bloor v. Shapiro*, 32 B.R. 993, 1001-2 (Bankr. S.D.N.Y. 1983).

III. SETOFF VERSUS NETTING AND RECOUPMENT

Netting, setoff and recoupment are all risk reducing mechanisms in the event of a bankruptcy, which have some similarities but are dissimilar in other respects.

A. Netting

Netting and setoff are sometimes used interchangeably. Netting agreements normally contemplate a "settling" of accounts on a given day, such as the 15th of every month, for example. To provide maximum creditor protection, any netting agreement or setoff provision should also include express setoff rights that are not limited to a particular invoicing period or termination payment at the end of the contract. Setoff rights are broad and, if recognized, can offer great protection in the event of a bankruptcy proceeding, as discussed below. There is no requirement for setoff that the debt and the claim to be setoff arise from the same transaction setoff.

B. Recoupment

Recoupment is a common law doctrine that allows parties to setoff mutual obligations arising from the same transaction. See, e.g. *In re Kosadnar*, 157 F.3d 1011 (5th Cir. 1998). Recoupment, unlike setoff, does not require that both the claim and the debt have arisen on the same side of the bankruptcy petition timeline (i.e. either both post-petition or both pre-petition). See, e.g. *In re McMahon*, 129 F.3d 93 (2nd Cir. 1997). Recoupment is not subject to the automatic stay if a bankruptcy case is filed. *Id.* at 1016. The rationale that recoupment is not subject to the automatic stay is that a debtor has no rights or interest in funds against which recoupment is allowable. *Gullett*, supra at 327, citing *In re Holford*, 896 F.2d 176, 179 (5th Cir. 1990).

Application of the doctrine of recoupment is sometimes narrowly construed, as was the case in *Kosadnar*. In that case, the court not only required that the payment owed to the debtor arise from the same contract or

transaction as the creditor's claim, but also that there must have been some type of overpayment made to the debtor before the debtor can exercise its recoupment rights. *Id.* At 1013. See also, *Gullett*, 230 B.R. 321, 327 (noting that the doctrine of recoupment should be narrowly construed).

IV. SPECIAL SETOFF RIGHTS AND RELATED REMEDIES APPLICABLE TO FORWARD AND COMMODITY CONTRACTS

In the event a counterparty to a contract becomes a debtor in a bankruptcy case, the automatic stay provisions of the Bankruptcy Code generally prohibit creditors from exercising their rights to terminate contracts, receive payments for pre-petition obligations, setoff mutual obligations or from exercising many other creditor rights without first lifting the automatic stay. In addition, a debtor in possession or trustee may generally recover certain payments or transfers made to a creditor pre-petition, including payments that were either netted or setoff, as a preference or fraudulent transfer. However, a number of special setoff rights, related remedies and protections exist under the Code to protect qualified oil and gas suppliers in the event of a bankruptcy by a counterparty to a contract.

A. Congressional Rationale

Congress has taken steps to exempt netting and setoff provisions for certain oil, gas and derivative contracts, among other specially protected types of contracts, from the effects of some of the more onerous provisions of the Bankruptcy Code. The purpose behind these special protections is explained in the legislative history to these safe harbor provisions:

The commodities and securities markets operate through a complex system of accounts and guarantees because of the structure of the clearing systems in these industries and the sometimes volatile nature [sic] the markets, certain protections are necessary to prevent the

insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market. See H.R. REP. NO. 97-420, Bankruptcy Act Amendments P.L. 97-420 (1982).

B. Safe Harbor Provisions

The Code contains what is often referred to as safe harbor provisions for eligible contracts, including "forward contracts" and "commodity contracts" that provide special protections for payments, liquidation, netting and setoff that occur pursuant to such contracts. These safe harbor protections allow parties to these protected contracts to terminate the contracts based upon a counterparty's bankruptcy, setoff mutual debts without first lifting the stay, and enjoy other preferential treatment not afforded most creditors in a bankruptcy case.

A party to a forward contract, commodity contract or swap agreement may immediately set off or net amounts owed to it in respect of a claim against the debtor for a "margin" or "settlement payment". 11 U.S.C. §§ 362(b)(6), (17). Section 362(b)(6) provides that the automatic stay will not apply to a setoff by a commodity broker or forward contract merchant, or party to a swap, of any mutual debt and claim under or in connection with any forward contract, including any setoff for a margin payment or settlement payment to settle a forward contract. 11 U.S.C. § 362(b)(6). A motion to lift the stay is not necessary to exercise a party's rights under these provisions, provided that, with regard to forward contracts, for example, the offset was (1) made pursuant to a forward contract, (2) both parties to the contract are forward contract merchants and (3) the offset qualifies as either a "margin" or "settlement payment" as defined in the Code.

1. What is a "Forward Contract"?

The initial pertinent inquiry of whether a contract is a "forward contract," as defined in the Code, has not been addressed extensively by the Courts. The Code defines a forward contract as:

"a contract (other than a commodity contract) for the purchase, sale or transfer of a commodity ... or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction deposit, loan, option, unallocated transaction or any combination thereof." 11 U.S.C. § 101(25).

The leading case on what constitutes a "forward contract," as well as a "settlement payment" under the Code was decided by a Texas bankruptcy court in the case of *In re Olympic*, 258 B.R. 161, 164 (Bankr. S.D. Tex. 2001), *aff'd*, 294 F.3d 737 (5th Cir. 2002), which was then affirmed by the Fifth Circuit. The bankruptcy court in *Olympic* found that the GISB natural gas sales contract in that case was a "forward contract" as defined in the Code. The bankruptcy court there stated that Congressional intent to broadly interpret the Code definition of "forward contract" should be followed and found that because the GISB contract involved in that case provided the ability to sell a commodity, gas, in the market on a forward basis and contained an express provision that it was a forward contract, the contract was a forward contract as defined in the Bankruptcy Code. The Fifth Circuit in *Olympic* explained that the commodities market, which includes natural gas contracts, is divided into only two categories; (1) on-exchange futures transactions and (2) off-exchange forward contracts, taking a sweeping approach to the types of contracts to be included within the definition of forward contracts. *Id.* at 740.

2. Who is a "Forward Contract Merchant"?

Both parties to a forward contract must be "forward contract merchants" to avail themselves of safeharbor setoff and related

protections. "Forward contract merchant" is defined in the Code as:

"a person whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity, as defined in Section 761(8) of this title, or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade." 11 U.S.C. § 101(26).

3. What are "Settlement Payments and Margin Payments"?

As set forth above, to take advantage of special safe harbor setoff provisions, the claims that are set off must be "settlement payments" or "margin payments." "Settlement payment" is defined in the Code as:

"for purposes of the forward contract provisions of this title, a preliminary settlement payment, a partial settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment or any other similar payment commonly used in the forward contracts trade." See 11 U.S.C. §§ 101(35); 741(8).

"Settlement payments" have been defined extremely broadly under a developing body of law, to include virtually any payment associated with a forward or commodity contract. See, e.g., *In re: David*, 193 B.R. 935, 940 (Bankr. C.D. Cal 1996); *Kaiser Steel Corporation v Charles Schwab Co., Inc.*, 913 F. 2d 846, 848 (10th Cir. 1990), *reh'g denied*, (Oct. 24, 1990). The Fifth Circuit in *Olympic, supra*, applied the Code definition of "settlement payment" to a payment for natural gas under a GISB. 294 F.3d at 742. The Fifth Circuit found that the term "settlement payment" should be interpreted very broadly and that it includes payments made in settlement of forward contract transactions. *Id.* See 11 U.S.C. §§ 101(35), 741(8).

4. Setoff of Margin Payments and Settlement Payments

Sections 362(b)(6) and 362(b)(14) of the Code appear to allow post-petition setoffs of claims for margin payment or settlement payment, which could have arisen either pre-petition or post-petition. No distinction is made in the Code as to whether "liquidation" or setoff of eligible safe harbor contracts allows pre-petition obligations to be setoff against post-petition obligation or whether normal setoff provisions, which require pre-petition claims to be setoff only against pre-petition debts, apply.

The Bankruptcy Code currently expressly recognizes cross product netting between "securities contracts," "forward contracts," and "commodity contracts." 11 U.S.C. § 362(b)(6). It is currently unclear as to whether "cross-netting" of contracts other than those listed, such as financial contracts (i.e. swaps) may be offset against physical delivery contracts).

Based upon the provisions set forth above, setoffs and payments made pursuant to standard gas sales contracts, such as GISB and NAESB contracts, should be protected payments in the event of a bankruptcy filing by a counterparty, provided that the contracts are forward contracts and the parties are forward contract merchants or another safe harbor exception is satisfied.

5. Termination of Forward Contracts: Exception to the "Ipso Facto" Clause

In some instances setoff rights may offer only limited protections, and a party may desire to end a contractual relationship with a bankrupt counterparty to avoid future losses. Related to the right to setoff claims afforded a forward contract merchant is a right to liquidate a contract upon a counterparty filing bankruptcy. The bankruptcy safe harbor provisions allow a non-defaulting party to a forward contract or commodity contract to terminate a contract based upon the counterparty's becoming a debtor in bankruptcy, in addition to netting out or setting off mutual obligations. Ordinarily, a contractual provision which states that a debtor's bankruptcy petition will be an event of default will be an unenforceable "ipso facto" clause pursuant

to 11 U.S.C. § 365 (e)(1). However, a qualifying non-debtor party to a forward contract or commodity contract may terminate and liquidate such a contract upon the commencement of the bankruptcy case, if the underlying agreement between the parties contains a contractual provision expressly allowing it to do so. Section 556 of the Code states:

“The contractual right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract, as defined in § 761(4), or forward contract because of a condition of the kind specified in § 365(e)(1) of this title and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title. As used in this section, the term “contractual right” includes:

“A right set forth in a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.”
11 U.S.C. § 556.

Section 556 of the Code allows a “forward contract merchant” to liquidate a forward contract without court approval, with the caveat that Section 556 of the Code does not allow self effectuating liquidation or termination of forward contracts or commodity contracts for all types of defaults. Only defaults based upon a counterparty becoming a debtor in a bankruptcy case are honored under this provision. Apart from exercising the bankruptcy default provisions, other types of defaults, such as failures to pay or perform will not authorize a party to terminate the contracts after a bankruptcy case has been filed without first seeking to lift the automatic stay or otherwise getting court approval. Accordingly, a netting

agreement or setoff provision should create the right to terminate the contracts at issue upon the counterparty filing bankruptcy so that section 556 may be utilized if the contracts are forward or commodity contracts.

6. Liquidation Does Not Constitute a Preference

Section 556 further provides that neither a margin payment nor a settlement payment, as those terms are defined under the Code, may be avoided pursuant to the avoidance, turnover, fraudulent conveyance or preference provisions of the Code, unless the debtor effectuated a transfer with actual intent to hinder, delay or defraud. See *a/so*, 11 U.S.C. § 548(d)(2)(B). “Variation payments,” an undefined term in the Code, along with maintenance margin payments made pursuant to a liquidation of a contract post-petition pursuant to section 556 are also exempt from the preference provisions. It is thus advisable to include stipulations in a netting agreement or contractual setoff provision that all payments and transfers effectuated thereunder constitute either a setoff pursuant to the safe harbor provisions of section 362 set forth above or a margin payment or variation payment pursuant to these provisions to buttress an argument that any post-petition payments are intended to be protected payments.

Favorable setoff and liquidation rights under the safe harbor exceptions would be of no value if a debtor or trustee in a bankruptcy case could later avoid such actions under any of the trustee’s avoiding powers. One of the most important protections afforded a forward contract, commodity contract, or party to a swap is that payments on these types of contracts are generally deemed to be “for value” under specific provisions of the Code. See, 11 U.S.C. §§ 548 (d)(2)(B), 546(e). Accordingly, there is excellent risk reduction available in offsetting or netting amounts under eligible forward contracts when a counterparty’s financial health is taking a turn for the worse (but be advised that entering into a netting agreement or setoff agreement during the preference and fraudulent transfer periods might in and of

itself constitute a preference). 11 U.S.C. § 548(d)(2)(B) provides:

a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency that receives a margin payment as defined in section 101, 741 or 761 or settlement payment, as defined in section 101 or 741 of this title **takes for value to the extent of such payment** (emphasis added).

The legislative history of the forward contract provisions relating to settlement payments specifically states:

Section 204 of the bill amends § 548(d)(2)(B) of the Bankruptcy Code to broaden the types of margin payments and settlement payments the acceptance of which by a forward contract merchant is deemed to be taking for value to the extent of such payment, to include margin payments and settlement payments as defined under section 201 of the bill (emphasis added). Similarly to section 104 of the bill, this provision exempts these types of customary setoff payments in the forward contract trade from scrutiny as to whether they are actually fair value for the amount used.

[T]his provision is not intended to preempt the statute of frauds or any other provision of law, **except** for the provisions of the Bankruptcy Code (emphasis added). H.R. REP. NO. 101-484, pp. 228-29 (1990).

This provision illustrates Congressional intent to afford safe harbor eligible contract payments (including settlement payments) the broadest protection possible.

V. DRAFTING NETTING AGREEMENTS

There are a number of practical drafting issues to keep in mind when drafting netting agreements or setoff provisions in contracts that are set forth below.

- 1) It is helpful to include affirmations in a netting agreement or setoff provision that the transactions governed thereby are "forward contracts" and/or "commodity contracts." The court in *Olympic*, supra, cited such a provision as a factor. However, this designation does not necessarily require a bankruptcy court to consider all contracts thereunder as forward contracts. Expressly state the intent of the parties that the agreement is to be protected by relevant safe harbor provisions of Bankruptcy Code, and cite those provisions and that they are applicable.
- 2) The identity of the parties whose obligations shall be offset must be determined and specifically identified. A decision must be made as to whether to include affiliates of a counter-party or whether such inclusion may only increase exposure based upon the risk that setoff may not be allowed if there is no mutuality and a contractual triangular setoff is not allowed.
- 3) Covered transactions subject to setoff must be clearly identified. Consider whether you want all transactions, existing and all future transactions, to be included, or whether you want to carve out financial and/or other types of transactions, based upon the ambiguity in the Code as to whether cross-netting of different types of contracts, such as financial and physical delivery contracts, for example, will be allowed.
- 4) An early termination provision is key to invoking bankruptcy safe harbor protections and to preclude waiting for notice/cure period to run when a bankruptcy proceeding is pending or filed. The provision may be self-effectuating upon the counter-party becoming a debtor in bankruptcy or may contain an option to terminate upon a bankruptcy case being filed. There does not appear to be any published opinions regarding the time period within which a party must make an election to terminate under section

556. It certainly appears possible to waive this right if it is not exercised promptly.

- 5) Include a stipulation in physical delivery contracts that neither party is a utility for purposes of 11 U.S.C. § 366 and that the counterparty has alternative sources of supply available to attempt to avoid potential conflicts with safeharbor protections and first day motions filed in bankruptcy cases, which may improperly attempt to limit these rights by characterizing a supplier as a utility that cannot discontinue service.
- 6) Ensure there are no conflicting provisions with related contracts; a netting agreement or setoff provision should expressly state that in the event of any conflicting provisions, it will govern.
- 7) Include a broad contractual setoff provision that allows setoff of all obligations arising from any and all transactions and final net settlement amount (making certain that you have not limited yourself with definitions of these terms).
- 8) Include a choice of law provision, keeping in mind that these provisions may not always be enforceable. Do not agree to choice of law in current political hotbed states.

It is necessary to keep in mind that these are general guidelines and that the law in this area is rapidly evolving.

Patricia Williams Prewitt is a Senior Counsel with the firm of Locke Liddell & Sapp LLP in Houston and can be reached at (713) 226-1200 or pprewitt@lockeliddell.com.