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Reinterpreting Section 553's Mutuality Requirement

Law360, New York (January 21, 2009) -- The decision in *In re SemCrude LP, et al.*, prohibiting parties from contracting around Bankruptcy Code section 553's mutuality requirement may disrupt customary business practices, including those widely used in the energy, natural gas and crude oil markets, because it rules that contracting for cross affiliate netting does not "create" the mutuality required for setoff.

On Jan. 9, 2009, the U.S. Bankruptcy Court for the District of Delaware (Judge Brendon L. Shannon presiding) in the *In re SemCrude LP, et al.* (debtors) bankruptcy cases held that, as a matter of law, triangular setoffs were impermissible under section 553 of the U.S. Bankruptcy Code (Bankruptcy Code) regardless of a prepetition contractual agreement allowing such a setoff.

Background

The debtors and their related companies provide goods and services to the energy industry, primarily to independent producers and refiners of petroleum products.

SemCrude LP (SemCrude), for example, gathers, transports, stores, blends, markets and distributes crude oil. SemFuel LP (SemFuel) focuses on the transportation and distribution of refined petroleum products such as gasoline and kerosene. SemStream LP's (SemStream) product lines involve distribution of propane and natural gas products.

Chevron USA Inc. (Chevron) entered into separate prepetition contracts with SemCrude, SemFuel and SemStream for the purchase of crude oil; gasoline; and/or butane, isobutene and propane, respectively.

Chevron's purchases were governed by three sets of terms and conditions, which were cross-referenced in the contracts with the other debtor counterparties. The terms and conditions contained identical provisions that:

"in 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."

The term "affiliate" was defined as "a corporation controlling, controlled by or under common control with either party." Chevron and the debtors agreed that SemCrude, SemFuel and SemStream were affiliates as used in the relevant agreements.

As of July 22, 2008, the date of the commencement of the debtors' Chapter 11 cases, under the various agreements with SemCrude, SemFuel and SemStream, Chevron approximately owed SemCrude \$1.4 million, and was owed \$10.2 million by SemFuel and \$3.3 million by SemStream.

On Aug. 21, 2008, Chevron filed a motion seeking authority to set off the amounts it owed to SemCrude against the amounts it was owed by SemFuel and SemStream.

The debtors, the Official Committee of Unsecured Creditors and several individual creditors objected to the motion arguing that the parties to the dispute were not permitted to contract around the provisions of section 553 of the Bankruptcy Code and that, even if they could, the provisions in the relevant contracts did not permit setoff.

On Oct. 8, 2008, by agreement of the parties, the court held a hearing solely on the legal arguments and to put off an evidentiary hearing, if necessary, to a future date. The court determined that further factual development was unnecessary and that a decision could be reached on the terms of the agreements and applicable law.

The Decision

The court first examined section 553 of the Bankruptcy Code, which addresses setoff rights in bankruptcy. Section 553 provides, in relevant part, that: "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 the commencement of the case against a claim of such creditor against the debtor that arose before the commencement of the case[.]"

The court observed that section 553 "preserves for the creditor's benefit any setoff right that it may have under applicable non-bankruptcy law, and imposes additional restrictions on a creditor seeking setoff that must be met to impose a setoff against a debtor in bankruptcy."

Accordingly, the court held that for a party to be permitted a right of setoff it must have the right under applicable non-bankruptcy law and satisfy the additional requirements of section 553.

The additional requirements under section 553 are well-established and require that the obligations be mutual, prepetition debts. Debts are mutual when “they are due to and from the same persons in the same capacity.” Such a requirement prohibits so-called triangular setoffs where A tries to setoff a debt it owes to B against a debt C owes to A.

The court then turned to Chevron’s argument that there exists ample case law providing for an exception to section 553’s mutuality requirement where the parties expressly agree that the contract parties shall have a right of setoff between parties to other agreements, the “contract exception.”

The court acknowledged that there were nearly a dozen cases decided in the last three decades that observed that a contract exception existed, but that in each such case setoff was not permitted.

The court noted that such cases largely cite each other and to a 1964 Seventh Circuit Court of Appeals decision, which raised the possibility that a contract exception could exist.

Because none of the decisions actually permitted setoff, the court concluded that there was no controlling or persuasive case law on the issue of the contract exception and, accordingly, turned its focus to two questions:

“[M]ay debts owing among different parties be considered ‘mutual,’ when there are contractual netting provisions governing all parties’ business relationship?”

“If the answer to the first question is ‘no,’ then the second question is whether a ‘contractual exception’ exists to section 553’s mutuality requirement.”

The court found that past decisions have unanimously required mutuality of debts and have strictly construed mutuality against the party seeking setoff.

Based on a narrow reading of the mutuality requirement, the court concluded that mutuality “cannot be supplied by a multi-party agreement contemplating triangular setoff” because “an agreement to set off funds does not create indebtedness from one party to another.”

In this case, despite the privity of contract between SemCrude and Chevron, there was no contractual requirement that SemCrude pay anything to Chevron. Instead, SemCrude merely saw its receivable from Chevron reduced or eliminated.

Similarly, Chevron did not have the right to collect anything from SemCrude because the setoff provision did not require SemCrude to make a payment. Accordingly, the setoff provisions under the relevant agreements did not create the mutuality required by section 553.

Next, the court held that under a plain reading of section 553, there is no basis for contract exception to the section 553's mutuality requirement. Absent a clear indication in the Bankruptcy Code that such an exception exists, the court deemed "it improper to recognize one."

In fact, the court reasoned that such a reading would be demonstrably at odds with "the great weight of authority holding that there is no reason for enlarging the right of setoff beyond that allowed in the Code[.]" and the purpose of section 553 and the broad policies behind the Bankruptcy Code "ensure that similarly situated creditors are treated fairly and enjoy an equality of distribution from a debtor absent a compelling reason to depart from this principle."

Conclusion

The court's decision raises significant concerns as it would strip the ability of parties in bankruptcy to receive the benefit of prepetition contractual netting or setoff provisions across multiple agreements between multiple parties.

The court's decision held that such agreements do not satisfy the mutuality requirement for setoff and are not valid as a "contract exception" to the mutuality requirement under section 553 of the Bankruptcy Code.

Consequently, this decision may be viewed as announcing a ruling for the SemCrude cases that triangular setoffs are impermissible even where there is an express right to do so in a prepetition contract.

The wider appeal of the decision remains unclear but could be significant because of the interpretation of section 553, and the court's ability to distinguish and eliminate what had become widely utilized means for addressing the mutuality requirement.

On Jan. 19, 2009, Chevron filed a motion for reconsideration on the basis that the contracts at issue are "forward contracts" and/or "swap agreements." Accordingly, Chevron argues that the court's setoff analysis under section 553 is "inapplicable and inapposite." The court has not ruled on the motion for reconsideration as of the date of publication of this article.

Because of the significance of this decision in and outside of the SemCrude cases, it may be appealed if the decision stands after the disposition of the motion for redetermination, in which case the ultimate impact of the ruling may not be known for some time.

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