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Lehman Brothers Court, Building on *SemCrude* and *Swedbank* Decisions, Denies Triangular Setoff by Swap Counterparty

The United States Bankruptcy Court for the Southern District of New York (the Court), has held that section 553(a) of the Bankruptcy Code prohibits a swap counterparty from setting off amounts owed to the debtor against amounts owed by the debtor to affiliates of the counterparty, notwithstanding the safe harbor provision in section 561 of the Bankruptcy Code and language in the ISDA Master Agreement permitting the swap counterparty to effect "triangular" setoffs. *In re Lehman Brothers Inc.*, Case No. 08-01420 (JMP)(SIPA) (Bankr. S.D.N.Y. October 4, 2011).

Section 553(a) of the Bankruptcy Code, which also applies in a proceeding under the Securities Investor Protection Act of 1970 (SIPA), preserves a creditor's pre-bankruptcy right to setoff "mutual debts." The term "mutual debts" is understood to mean debts between the same two parties in the same legal capacity. In the bankruptcy context, mutuality also requires that the debts to be setoff both arise prior to the filing of the bankruptcy petition.

UBS AG (UBS) was a party to an ISDA Master Agreement with Lehman Brothers, Inc. (LBI), which was placed into a SIPA proceeding on September 19, 2008. Based on certain defaults caused by the chapter 11 filings by LBI's affiliates earlier that week, UBS terminated the ISDA Master Agreement and designated September 16, 2008, as the Early Termination Date under the Master Agreement. UBS held approximately $170 million of collateral posted by LBI as of the Early Termination Date and ultimately setoff all but approximately $23 million of it against amounts owed by LBI to UBS by virtue of the termination of the transactions entered into under the Master Agreement.

UBS held the remaining $23 million of LBI collateral and claimed in the valuation statement delivered to LBI pursuant to the Master Agreement the right to setoff its obligation to return the excess collateral to LBI against obligations of LBI to two UBS affiliates. UBS asserted that it had the right to setoff such amounts in accordance with Section 5(a) of the Schedule to the Master Agreement. LBI disputed UBS's right to setoff the $23 million against obligations to other UBS affiliates arguing that the mutuality required by section 553(a) of the Bankruptcy Code was lacking as to UBS's affiliates, and that UBS could not contract around section 553(a) as it had in the Master Agreement. LBI's argument was consistent with a 2009 decision of the Delaware bankruptcy court in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010).

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On a plain reading of section 553(a), the Court rejected UBS's argument that the mutuality requirement applied only to common law setoff and not contractual setoff, holding that section 553(a) contained no such distinction.

The Court also rejected an argument not dealt with in *SemCrude*—whether the safe harbor permitting swap counterparties to terminate swap agreements and net obligations permits the setoff of prepetition obligations sought by UBS. The Court noted its prior decision in *In re Lehman Brothers Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), in which Swedbank, relying on the safe harbor provision in section 560 of the Bankruptcy Code, sought to setoff funds deposited by Lehman Brothers after the filing of its chapter 11 petition against obligations owed Swedbank under its terminated swap agreement. The Court held there that mutuality under section 553(a) prohibited the setoff of post-petition obligations against pre-petition obligations and that, although section 560 permitted Swedbank to setoff, no language in the safe harbor eliminated the pre-petition mutuality requirement of section 553(a).

UBS argued that section 561 of the Bankruptcy Code, a safe harbor dealing with the right to terminate and setoff under a master netting agreement and across financial contracts, permitted its triangular setoff of pre-petition obligations. Despite acknowledging that outside of bankruptcy the triangular setoff provision in Section 5(a) of the Schedule to the Master Agreement would be enforceable by UBS for the benefit of its affiliates, the Court held that the section 561 safe harbor only protected a contractual setoff right under a swap agreement "*where that right exists in the first place*. . . ." Because of section 553(a)'s mutuality requirement, UBS had no right of setoff once a SIPA proceeding was commenced against LBI.

Although the LBI-UBS ISDA Master Agreement was not a master netting agreement and the UBS affiliates were not parties to it, the rejection of UBS's safe harbor argument under section 561 of the Bankruptcy Code calls into question the effectiveness in bankruptcy of master netting agreements that purport to allow netting among counterparties and their affiliates and not merely among different types of financial contracts by a single counterparty.