

April 23, 2009

## WEATHERING THE STORM Recent Decision Affects Setoff Under Netting Agreements

Companies that engage in multiple transactions with different entities of related groups often enter into contractual netting agreements that allow the setoff of obligations between entities within the groups. The effectiveness of these agreements has been called into question by a recent decision of a bankruptcy court in Delaware, which refused to allow a party to a contractual netting agreement to offset its obligations to the debtors against obligations of the debtors under the netting agreement. Parties to such netting agreements may have to reconsider how to structure such agreements and how to defend their effectiveness in court.

### The SemCrude Decision

In *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), Chevron had contracts for the sale or purchase of petroleum products with SemCrude, SemFuel and SemStream, all subsidiaries of SemGroup. Each of the contracts referred to certain Chevron standard terms and conditions, including netting provisions that authorized setoff between the parties *and their affiliates*. SemCrude, SemFuel and SemStream all filed Chapter 11 petitions. As of the petition date, Chevron owed SemCrude \$1.4 million, but SemFuel and SemStream owed Chevron a total of \$13.5 million.

Since exercising a setoff right is prohibited by the automatic stay of § 362 of the Bankruptcy Code, Chevron filed a motion to lift the automatic stay to allow it to set off its \$13.5 million SemFuel/SemStream claims against Chevron's \$1.4 million obligation to SemCrude pursuant to § 553 of the Bankruptcy Code. The court denied Chevron's motion, finding that the proposed "triangular setoff" was impermissible because of a lack of mutuality.

Section 553 recognizes any right of a creditor to offset a *mutual* debt owing by the creditor to a debtor against a claim of *such* creditor against the debtor. The court noted that debts are considered "mutual" only when they are due to and from the same persons, in the same capacity. Chevron argued that an exception existed to the mutuality requirement if a contract provides for triangular setoff and cited several cases that seemed to recognize such an exception. The court concluded that none of those cases actually allowed such a triangular setoff and that such an exception would be inconsistent with the express language of § 553, which only allows for the setoff of "mutual debts." The court distinguished the situation where one party guarantees another party's debts, thus creating a contractual obligation by the guarantor to pay another party's debt. By contrast, according to the court, a simple agreement to allow a setoff among affiliates does not create indebtedness from one party to another; instead such an agreement simply recognizes the parties' rights to offset obligations that already exist apart from the tripartite netting agreement. Consequently, because SemCrude did not guarantee the obligations of SemFuel and SemStream, SemCrude did not owe a debt to Chevron against which Chevron could offset its obligation to SemCrude. The Court concluded that Chevron did not have a "right to collect" against SemCrude under the tripartite setoff agreement and that mutuality did not exist.

The court went on to say that the agreement did not call for SemCrude to make a payment to Chevron and that § 553 only permits a right of a creditor to offset a mutual debt owing by *such* creditor to the debtor. Consequently, since no debt was owed by Chevron to SemFuel or SemStream, Chevron's claims against SemFuel and SemStream could not be set off against the debt of Chevron to SemCrude. Non mutual debts cannot be transformed into mutual debts by a multi party agreement that allows for triangular setoff of non mutual debts.

The court also determined that there was no exception to the mutual debt requirement and that parties could not contract around the provisions of the Bankruptcy Code.

### What Happened Next?

The SemCrude decision greatly troubled the energy industry since multi party netting agreements are commonly used and honored. Chevron was persuaded to file a motion to reconsider since it had failed to argue that the contracts in question were either forward contracts or swap agreements as defined in the Bankruptcy Code and subject to the "safe harbor" provisions of the Bankruptcy Code which Chevron argued permit the offset and netting of forward contracts and swap agreements without regard to the setoff provisions of § 553. The court denied the motion for rehearing holding that Chevron had not argued the safe harbor provisions at the prior hearing and that the court should not consider those arguments on a motion for rehearing. Thus, the issue of whether the contracts were protected by the safe harbor provisions was not addressed.

### Where Was The Court Wrong?

The court in SemCrude didn't recognize that by agreeing to the multi-party setoff and netting provisions of the contracts, each of the parties, in effect, agreed to a limited non-recourse guaranty of the obligations of its affiliates. This limited non-recourse obligation provided the requisite mutual obligation that the court ruled was necessary to permit setoff. Hopefully, in the future, courts will recognize the actual effect of such agreements and the parties will make the appropriate arguments regarding the applicability of the safe harbor provisions to these types of multi party offset and netting agreements.

To help avoid litigation over the existence of mutual obligations required for setoff, parties should consider including in their netting agreements express non-recourse guaranties of affiliates' obligations that would support setoff rights under § 553. Of course, the decision to include such non-recourse guaranties should be considered in the context of each party's overall legal and financial objectives.

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