

Third Circuit Confirms Triangular Setoffs Are Unenforceable in Bankruptcy

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In a recent decision, the U.S. Court of Appeals for the Third Circuit ruled that contractual triangular setoff arrangements are unenforceable in bankruptcy.

The recent decision by the U.S. Court of Appeals for the Third Circuit in *In re Orexigen Therapeutics Inc.*¹ held that Section 553 of the Bankruptcy Code, which governs creditor setoffs, requires “strict bilateral mutuality.”

As a result, notwithstanding the parties’ contract, a creditor cannot set off an obligation it owes to a debtor in bankruptcy against an obligation that the debtor owes to the creditor’s affiliate (a so-called “triangular setoff”).

DEFINING BILATERAL AND TRIANGULAR SETOFFS

Setoff is a state law remedy available to a creditor with a claim against, and an obligation owing to, the same financially distressed counterparty. It enables a creditor to cancel out completely or apply its claim against the counterparty on a dollar-for-dollar basis in reduction of its obligation owing to the counterparty.

For example, suppose (a) a creditor sold goods to its counterparty and is owed \$1,000,000, and (b) at the same time, the counterparty provided services to the creditor and is also owed \$1,000,000. If the counterparty subsequently files for bankruptcy, the creditor, after obtaining relief from the automatic stay, can exercise its setoff rights under Section 553 of the Bankruptcy Code by applying its claim against the counterparty to reduce, dollar-for-dollar, the creditor’s obligations to such counterparty.

The foregoing illustrates bilateral setoff.

A “triangular setoff” is similar but involves an additional party—ordinarily an affiliate of one of the first two parties. It occurs when party 1 has entered into

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¹ *In re Orexigen Therapeutics Inc.*, 990 F.3d 748 (3d Cir. 2021).

one or more contracts with party 2 and party 2's affiliate, party 3, that allows party 1 to setoff party 1's claim against party 2 to reduce, dollar-for-dollar, party 1's obligations to party 3.

In other words, if party 1 and party 2 are parties to a contract, a triangular setoff arrangement would allow party 1 to reduce its outstanding liabilities to party 2 by setting off amounts owed to party 1 by party 3, who is an affiliate of party 2 but is not a party to the contract between party 1 and party 2.

In a bankruptcy case, setoff rights are governed by Section 553 of the Bankruptcy Code, which provides, in relevant part, that subject certain enumerated exceptions, the Bankruptcy Code “does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor. . . .”² In a recent decision, the Third Circuit held that contractual triangular setoff arrangements are unenforceable under Section 553 for failure to satisfy the “mutual debt” requirement.³

THE CASE

In 2016, Orexigen Therapeutics Inc. (“Orexigen”), entered into a pharmaceutical distribution agreement with McKesson Corp. Inc. (“McKesson”), pursuant to which Orexigen sold an anti-obesity drug to McKesson. The distribution agreement included broad setoff rights permitting “each of McKesson and its affiliates . . . to set-off, recoup and apply any amounts owed by it to [Orexigen’s] affiliates against any [and] all amounts owed by [Orexigen] or its affiliates to any of [McKesson] or its affiliates.”

Orexigen also entered into a services agreement with an entity that subsequently became a subsidiary of McKesson, McKesson Patient Relationship Solutions (“MPRS”), pursuant to which MPRS advanced funds to pharmacies utilized in Orexigen’s consumer discount program on behalf of Orexigen, and Orexigen was required to reimburse MPRS for such advances at a subsequent date.

Orexigen filed for bankruptcy in the U.S. Bankruptcy Court for the District of Delaware on March 12, 2018. As of the petition date, McKesson owed Orexigen approximately \$6.9 million under the distribution agreement, while Orexigen owed MPRS approximately \$9.1 million under the services agreement. McKesson sought to exercise its contractual right under the distribution agreement to set off its \$6.9 million obligation against the \$9.1 million Orexigen owed to MPRS.

² 11 U.S.C. § 553(a).

³ See *In re Orexigen Therapeutics Inc.*, 990 F.3d 748 (3d Cir. 2021).

THE BANKRUPTCY COURT AND DISTRICT COURT DECISIONS

The bankruptcy court rejected McKesson's attempt to enforce its setoff right on the basis that the obligations to be set off were not "mutual" within the meaning of Section 553.⁴ In reaching that conclusion, the court cited prior bankruptcy court precedent holding that Section 553 of the Bankruptcy Code imposes an independent mutuality requirement that parties cannot circumvent via contract.

The Bankruptcy Court's ruling was affirmed by the U.S. District Court for the District of Delaware on January 3, 2020.⁵

THE THIRD CIRCUIT'S DECISION

The Third Circuit affirmed the bankruptcy court and the district court, relying in large part on two prior bankruptcy court decisions: *In re SemCrude*⁶ and *In re Lehman Bros. Inc.*⁷ The court rejected McKesson's argument that the word "mutual," as used in Section 553, is merely a "definitional scope provision" that identifies the state law rights preserved by Section 553.

In the Third Circuit's view, the requirement for the debts to be "mutual" is instead "a limiting term, not a redundancy." It reasoned that "Congress intended for mutuality to mean only debts owing between two parties, specifically those owing from a creditor directly to the debtor and, in turn, owing from the debtor directly to that creditor" and that "Congress did not intend to include within the concept of mutuality any contractual elaboration on that kind of simple, bilateral relationship."

The Third Circuit also noted that different steps can be taken to achieve the same economic result as a triangular setoff arrangement. For example, the parties' pre-petition contracts with Orexigen could have provided MPRS with a security interest in Orexigen's accounts receivable. Once perfected, that would have given MPRS a priority right to the same amount that it sought via setoff and would not have run afoul of the Bankruptcy Code. (That approach, however, may have been cumbersome or impractical under the circumstances.)

⁴ See *In re Orexigen Therapeutics Inc.*, 596 B.R. 9 (Bankr. D. Del. 2018).

⁵ See *In re Orexigen* (D. Del. Jan. 3, 2020).

⁶ *In re SemCrude*, 399 B.R. 388 (Bankr. D. Del. 2009).

⁷ *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011).

CONCLUSION

The Third Circuit's decision reinforces prior lower court rulings holding that triangular setoffs are not enforceable in bankruptcy, even when the parties expressly contract for such rights and protections. As the Third Circuit observed, the bright-line rule that it adopted, which "excludes nonmutual debts from the setoff privilege of § 553" will "promote[] predictability in credit transactions."