Third Circuit Signals Possible Limitations On Setoff Rights

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Parties to corporate transactions often rely on contractual setoff rights to help ensure that they can be paid or at least limit the amounts lost if the counterparty fails to pay. While the Bankruptcy Code generally protects rights of setoff in a bankruptcy case, a recent decision from the Third Circuit highlights how contractual setoff rights might not work as planned and just when they are needed the most, i.e., when the counterparty files for bankruptcy.

The Third Circuit in *In re Orexigen Therapeutics, Inc.*, 990 F.3d 748 (3d Cir. Mar. 19, 2021) held that so-called "triangular setoff" arrangements are unenforceable under section 553 of the Bankruptcy Code. The triangular setoff arrangement in the *Orexigen* case arose because Company A had an agreement with Company B, and Company B had a separate agreement with Company A's subsidiary, Company C. Importantly, in this scenario, Company A, which wanted to exercise its setoff rights, owed money to Company B, but Company B did not owe any money to Company A. As a result, Company A wanted to setoff the money its subsidiary, Company C, owed to Company B.

While triangular setoff rights among affiliated parties created by contract may be enforceable under state law in the absence of a bankruptcy filing, the Third Circuit joins a growing number of courts that have concluded that triangular setoff rights are unenforceable in bankruptcy. Under state law, Company A had the right to setoff amounts its subsidiary owed Company B. But in a bankruptcy case, the Bankruptcy Code requires a "strict mutuality" of obligations as a prerequisite to setoff. In other words, the "mutuality" requirement under the Bankruptcy Code allows A to setoff money it owes to B *only* against money B owes to it. As in this case, the bankruptcy courts construe section 553 as overriding state law.

That being said, the *Orexigen* decision also highlights steps parties can take in advance to help ensure the availability of their contractual setoff rights in the event a counterparty files for bankruptcy.

Background

In 2016, McKesson Corporation, Inc. ("McKesson") and Orexigen Therapeutics, Inc. ("Orexigen") agreed to a pharmaceutical distribution deal for a weight management drug (the " Distribution Agreement"). The Distribution Agreement included a broad setoff provision whereby McKesson, as

the distributor of the drug, could reduce what it owed to Orexigen, the drug manufacturer, by any amount that Orexigen owed to McKesson or any McKesson subsidiary. Specifically, the setoff provision permitted "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."

Separately, McKesson Patient Relationship Solutions ("McKesson PRS"), a subsidiary of McKesson, entered into a Services Agreement with Orexigen. Under the Services Agreement, and as part of a customer loyalty program for Orexigen, McKesson PRS agreed to advance funds to pharmacies selling the weight management drug, with reimbursement arriving from Orexigen at a later date.

In March 2018, Orexigen filed its petition for chapter 11 relief in the District of Delaware. At the time of filing, Orexigen owed McKesson PRS approximately $9.1 million under the Services Agreement, and McKesson owed Orexigen approximately $6.9 million under the Distribution Agreement. McKesson sought to setoff those obligations pursuant to the setoff provision in the Distribution Agreement, which explicitly permitted McKesson to setoff amounts it owed to Orexigen against amounts Orexigen owed to a McKesson affiliate, such as McKesson PRS. This would have resulted in Orexigen owing McKesson PRS $2.2 million and McKesson owing nothing to Orexigen.

The Bankruptcy Court rejected McKesson's argument for a setoff, explaining that while the setoff provision in the Distribution Agreement constituted an "enforceable contractual right allowing a parent and its subsidiary corporation to effect a prepetition triangular setoff under state law, that relationship does not supply the strict mutuality required in bankruptcy." *In re Orexigen Therapeutics, Inc.*, 596 B.R. 9, 12 (Bankr. D. Del. 2018) (internal citations omitted). Indeed, relying on its own precedent in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), the Bankruptcy Court held that "contracts cannot turn nonmutual debts into debts subject to setoff under [section 553 of the Bankruptcy Code]." *Id.* at 18. McKesson appealed the mutuality decision to the District Court, which affirmed.

The Third Circuit's Decision

Like the Bankruptcy Court and the District Court, the Third Circuit focused on the effect of the term "mutual" explicitly provided for in section 553 of the Bankruptcy Code. Section 553 says that, "[e]xcept as otherwise provided . . . , this title does not affect any right of a creditor to offset a *mutual* debt owing by such creditor to the debtor . . . against a claim of such creditor against the debtor[.]" 11 U.S.C. § 553(a) (emphasis added). Considering the plain language of section 553, as well as *SemCrude* (and the cases cited therein), the Court easily determined that 553 requires direct mutuality between parties to effectuate a setoff in the bankruptcy context.

Next, the Third Circuit considered whether a contract could create an exception to the requirement for of direct mutuality under the Code. The Court answered with an unequivocal "no," holding that section 553 "imposes a distinct limitation strictly construed to prohibit enforcement of a setoff agreement involving three or more parties and indirect debt obligations." In so holding, the Third Circuit determined that mutuality is a distinct and limiting requirement of section 553 and reinforced 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." The Court relied on opinions from the Second, Third, Fifth and Seventh Circuits stating that multi-party agreements contemplating triangular setoff arrangements are definitionally not mutual. Thus, the Third Circuit rejected all argument that the setoff provision of the Distribution Agreement turned the debts between Orexigen, McKesson, and McKesson PRS from a triangular arrangement into mutual debt properly subject to setoff under the Code.

The Third Circuit did observe that if McKesson wanted the mutuality contemplated by section 553, it should have taken on the customer loyalty support program itself instead of having its subsidiary McKesson PRS handle it for Orexigen. Alternatively, McKesson PRS should have considered seeking a perfected security interest in the amounts owed by McKesson to Orexigen, thus obtaining priority to these amounts over Orexigen's other creditors.

Conclusion and Takeaways

With the *Orexigen* decision, the Third Circuit has now joined a growing number of courts that have prohibited triangular setoff arrangements in bankruptcy. And while *Orexigen* may not be persuasive authority in all jurisdictions, it is certainly an important decision that will likely influence future courts' consideration of triangular setoff arrangements.

Therefore, clients should begin to consider alternatives to triangular setoff arrangements.

The simplest and most direct option is to ensure that the same entity generates the accounts payable and the accounts receivable, which would provide the strict mutuality required for a setoff under the Code. In other words, have both contracts run through Company A (or Company C).

Alternatively, one may take up the Third Circuit's recommendation that Company C, to whom the money is owed, take a security interest in the accounts receivable owing by Company A to Company B. That may not be particularly practical. But had McKesson PRS (Company C) perfected a security interest in the amounts owed by McKesson (Company A) to Orexigen (Company B), McKesson PRS would have had the right to the funds owing by McKesson to Orexigen (or their value as part of a secured claim).

If you have any questions about how setoff rights might be applied in the future, please remember that the Bankruptcy team at Bailey Glasser stands ready to assist.

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Practice Areas

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