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Client Alert

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Third Circuit Rejects Triangular Setoff and Offers Practical Guidance

On March 19, 2021, the United States Court of Appeals for the Third Circuit affirmed lower court decisions that rejected a $7 million setoff attempt by McKesson Corporation ("McKesson") against chapter 11 debtor Orexigen Therapeutics, Inc. ("Orexigen") – a claim that arose from a McKesson subsidiary. In *In re Orexigen Therapeutics, Inc.*, – F.3d – No. 20-1136, 2021 WL 1046485 (3d Cir. Mar. 19, 2021), the Third Circuit upheld both corporate formality and a decade's worth of lower court authority rejecting triangular setoffs.

A. McKesson's Setoff Claim

McKesson as distributer and Orexigen as manufacturer were parties to a pharmaceutical distribution agreement containing a provision whereby McKesson could reduce amounts it owed to Orexigen by any amount that Orexigen owed to McKesson or any McKesson subsidiary. McKesson's subsidiary McKesson Patient Relationship Solutions ("MPRS") separately contracted to help Orexigen with a consumer discount program by advancing cash to pharmacies, with Orexigen then obligated to reimburse MPRS for those advances. As noted by the Third Circuit, "[t]he Distribution Agreement and Services Agreement did not reference, incorporate, or integrate one another, and the parties agree that McKesson and MPRS were distinct legal entities." However, the distribution agreement contained a "Setoff Provision" whereby "each of [McKesson] and its affiliates … [were permitted] 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."

When Orexigen filed for chapter 11 in March 2018, it owed MPRS approximately $9.1 million, and McKesson owed Orexigen approximately $6.9 million. McKesson sought to set off the debts and claims such that McKesson's debt would reduce to zero and MPRS's claim would reduce to approximately $2.2 million. Absent a successful setoff, McKesson – being a solvent entity – would be obligated to pay its $6.9 million debt to Orexigen in whole dollars while Orexigen – being an insolvent entity –

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would only be required to pay its obligation to MPRS in severely compromised dollars as a general unsecured claim, which in the Orexigen case was estimated to be approximately a two cent on the dollar recovery. The Delaware Bankruptcy Court and, on the first round of appeal, the Delaware District Court, each rejected McKesson's claim as an improper triangular setoff that violated the requirement of mutuality. McKesson appealed again to the Third Circuit.

B. Legal Analysis

Section 553(a) of the Bankruptcy Code provides (subject to inapplicable exceptions): "this title does not affect any right of a creditor to offset[1] a ***mutual*** debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case...." 11 U.S.C. § 553(a) (emphasis added).

When the Bankruptcy Court rejected McKesson's setoff argument, it followed its own decision in *In re SemCrude, L.P.*, 399 B.R. 388, 396 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010). *SemCrude* held that the Bankruptcy Code strictly construes setoff against the party seeking to assert it, requires both mutuality and an underlying nonbankruptcy right to setoff, and rejects triangular setoff even among affiliated entities:

> Setoff allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A. The Code section that governs setoff in bankruptcy, section 553, does not create a right of setoff, however. Rather, section 553 preserves for the creditor's benefit any setoff right that it may have under applicable nonbankruptcy law, and imposes additional restrictions on a creditor seeking setoff that must be met to impose a setoff against a debtor in bankruptcy.
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> In order to effect a setoff in bankruptcy, courts construing the Code have long held that the debts to be offset must be ***mutual***, prepetition debts … [D]ebts are considered "mutual" only when they are due to and from the same persons in the same capacity. Put another way, mutuality requires that each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally. Because of the mutuality requirement in section 553(a), courts have

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[1] The Bankruptcy Code uses the terms "setoff" and "offset" interchangeably.

> routinely held that triangular setoffs are impermissible in bankruptcy. ***Moreover, because each corporation is a separate entity from its sister corporations absent a piercing of the corporate veil, a subsidiary's debt may not be set off against the credit of a parent or other subsidiary, or vice versa, because no mutuality exists under the circumstances.***

SemCrude, 399 B.R. at 393 (emphasis added, internal marks and citations omitted).

McKesson asked the Third Circuit to reject *SemCrude* and "the unanimous line of authority from bankruptcy courts, beginning with *SemCrude*, that requires strict bilateral mutuality for § 553 to apply." McKesson argued that "both the general right to enforce a setoff and the requisite mutuality are defined by state law, with § 553 imposing no independent mutuality limitation. In other words, McKesson contends that the term 'mutual' is nothing more than a 'definitional scope provision that identifies the state-law right that is thereby preserved unaffected in bankruptcy[.]'" Adopting cannons of statutory construction and following *SemCrude*, the Third Circuit rejected this argument and held that the Bankruptcy Code's use of the term "mutual" is a limitation on what types of setoffs may be asserted.

Next, the Third Circuit adopted *SemCrude*'*s* holding that mutuality is 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." Although "that should end the matter," McKesson insisted "that its Setoff Provision in the Distribution Agreement turns the debts between Orexigen and MPRS and between McKesson and Orexigen from a triangular debt arrangement into a mutual debt." Again, the Third Circuit relied on *SemCrude* to reject McKesson's argument:

> The court gave that agreement careful consideration but rightly recognized that contractual arrangements cannot transform a triangular set of obligations into bilateral mutuality. The mutuality requirement set a limit, and [t]he effect of [mutuality's] narrow construction is that each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally. In the end, mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff.

(internal marks and citations omitted).

In short, the Third Circuit followed *SemCrude* and rejected anything but a strict interpretation of the Bankruptcy Code's setoff provisions and mutuality that recognizes corporate separateness.

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C. Practical Tips from Third Circuit

It is a credit to the Third Circuit that its opinion offers guidance as to what McKesson could have done or tried to do in order to preserve its setoff right or at least strengthen its position in bankruptcy:

> If McKesson wanted mutuality for the debts in question, it should have taken on the customer loyalty support that it instead had its subsidiary MPRS handle for Orexigen. Alternatively, if McKesson wanted MPRS to have a perfected security interest in Orexigen's account receivable due from McKesson, it should have taken steps to arrange that. By perfecting a security interest, MPRS may have obtained a priority right to the same amount McKesson now seeks via setoff, which would have had the added benefit of placing Orexigen's other creditors on advance notice of that priority claim.

These are excellent suggestions for structural planners to consider if there is a concern of potential future insolvency of the counterparty to an agreement. The first suggestion – keeping the contracts at a single entity so all the claims and debts would be mutual claims – is within a party's control. Preservation of mutuality to preserve a right of setoff, however, must be weighed against other potential rationales to keep contracts at different entities. The second suggestion – taking a perfected security interest in an account receivable – could leave a party in a superior position, but in many cases would not be feasible as this requires consent from the contract counterparty who may be reluctant to provide such consent and who may have already granted a more senior lien on the receivable to an existing lender.

D. Conclusion

Absent McKesson's appeal to the U.S. Supreme Court, the Third Circuit's decision in *Orexigen* settles and reinforces *SemCrude* and its progeny: setoff is strictly construed under the Bankruptcy Code, mutuality is required, corporate formality will be followed, and triangular setoffs cannot be mutual. As for planning, a business that divides its dealings with a single counterparty among several of its own affiliates may have excellent reasons for doing so, but its setoff claims will not be preserved.

Please contact the Olshan attorney with whom you regularly work or the attorney below if you would like to discuss further or have questions.

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