ISDA MASTER AGREEMENTS

AND THE ENFORCEABILITY OF SET-OFF CLAUSES UNDER NY LAW

Introduction

A recent case heard before the United States Bankruptcy Court Southern District of New York has returned to the question of whether an agreement to set off amounts owed by a debtor to affiliates of a creditor against amounts held by the creditor ("triangular set off") is enforceable in the context of bankruptcy. The case is relevant to practitioners as the clause in question resembles the standard set-off provisions found in the User's Guides to the 1992 and 2002 ISDA Master Agreements and widely used in the market.

Background

The facts of *In re: Lehman Brothers Inc*[1] are that UBS AG ("UBS") and Lehman Brothers Inc ("LBI") entered into a number of foreign exchange transactions governed by a 1992 ISDA Master Agreement dated 13 July 2004 and a New York law governed Credit Support Annex. On 16 September 2008 UBS terminated the ISDA Master Agreement due to the occurrence of a cross-default on the part of LBI and because of a downgrade of LBI's credit rating. On termination, UBS was holding approximately USD 170 million of collateral belonging to LBI.

In calculating its "Early Termination Amount", UBS claimed a personal right of set-off pursuant to paragraph 8(a)(iii) of the CSA[2]. After effecting this set-off, UBS continued to hold approximately USD 76 million in collateral belonging to LBI. Subsequently, by virtue of a set-off clause included within the ISDA Schedule, UBS then claimed the right to set-off further amounts owed by LBI to two UBS affiliates (UBS Securities and UBS Financial Services). After affecting this set-off, UBS claimed that no collateral remained to be returned to LBI. LBI's trustee under the Securities Investor Protection Act of 1970 ("SIPA") disputed UBS' right to effect the subsequent set-off. UBS agreed to return a proportion of the collateral to LBI, but approximately USD 23 million remained in dispute.

The Set-off Clause

The relevant parts of the set-off clause at the centre of the dispute stated that:

[1] Case No. 08-01420 (JMP)(SIPA)

[2] Paragraph 8(a)(iii) states that "If at any time…an Early Termination Date has occurred or been designated…then, unless the Pledgor has paid in full all of its Obligations that are then due, the Secured Party may exercise one or more of the following rights or remedies…the right to Set-off any amounts payable by the Pledgor with respect to any Obligations against any Posted Collateral or the Cash equivalent of any Posted Collateral held by the Secured Party (or any obligation of the Secured Party to Transfer that Posted Collateral)"

"…upon the designation of any Early Termination Date, in addition to and not in limitation of any other right or remedy…under applicable law the Non-defaulting Party or Non-affected Party (in either case, "X") may without prior notice to any person set off any sum or obligation (whether or not arising under this Agreement…) owed by the Defaulting Party or Affected Party (in either case, "Y") to X **or any Affiliate of X** against any sum or obligation (whether or not arising under this Agreement…) owed by X **or any Affiliate of X** to Y…"

The Decision

The central question for the court was whether the extension of a right of set-off to "any Affiliate" was enforceable in a bankruptcy situation. The court held that, outside of a bankruptcy context, parties are generally free to agree whatever they choose, provided that it is not contrary to law or public policy. Such arrangements can include triangular set-off provisions as, outside of bankruptcy, this will ordinarily impact only the net obligations of the parties in question. However, the court made equally clear that this proposition is no longer true "once the parties to that contract are subjected to the constraints of the Bankruptcy Code" due to the fact that netting of a debtor's claim in this way will, by definition, reduce the amount available to other creditors.

The court held that the purported set-off right claimed by UBS was subject to section 553(a) of the Bankruptcy Code, which states that:

"…this title does not affect any right of a creditor to offset 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**…"

Applying the findings in *Swedbank*[3], the court confirmed that to be eligible for set-off under Section 553:

(1) The amount owed by the debtor must a prepetition debt, and
(2) The debtor's claim against the creditor must also be prepetition, and
(3) The claims must be mutual.

To be mutual, debts must be "…in the same right and between the same parties, standing in the same capacity…"[4] On the basis that they failed the mutuality test, the court in *Swedbank* had already held that pre-petition and post-petition debts could not be subject to set-off in a bankruptcy situation. On the same basis, the court now held that UBS' claim failed. The only way to properly reconcile references to "such creditor" in section 553 was to conclude that the concept of "mutuality" is a personal right which applies only between the debtor and the creditor in question.

[3] In re Lehman Brothers Holdings Inc., 433 B.R. 101,107 (Bankr. S.D.N.Y. 2010)
[4] Lines v. Bank of Am. Nat'l Trust & Sav. Ass'n, 743 F Supp. 176, 183 (S.D.N.Y. 1990)

The court held further that Section 561 of the Bankruptcy Code[5] (the 'safe harbor' provisions) did not assist UBS as, citing the conclusions of *Semcrude*[6], it only operates to protect rights which actually exist in the first place (which, due to lack of mutuality, did not apply in UBS' case).

Conclusion

The Bankruptcy Court has provided clear and consistent guidance as to the limited effectiveness of set-off clauses within a bankruptcy situation. Practitioners are now on notice that the fundamental prerequisite of any set-off is mutuality. As the court concluded in the instant case, this concept "quite literally is tied to the identity of a particular creditor that owes an offsetting debt. The right is personal, and there simply is no ability to get around this language."

October 2011

Michael Beaton		**Sean MacGloin**	
Email:	michael.beaton@doc-risk.com	Email:	sean.macgloin@doc-risk.com
Tel:	+44 (0) 20 3195 8070	Tel:	+44 (0) 20 3195 8057
Mob:	+44 (0) 7500 887 899	Mob:	+44 (0) 7826 937 852

[5] Section 561 states that "…[t]he exercise of any contractual right … to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more…swap agreements…shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title."

[6] In re SemCrude, L.P., 399 B.R. 388 (Bankr. D. Del. 2009)