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The Third Circuit Definitively Rejects Triangular Setoff

On March 19, 2021, the United States Court of Appeals for the Third Circuit issued a unanimous decision¹ affirming that the mutuality requirement of section 553(a) of the Bankruptcy Code must be strictly construed and, therefore, that triangular setoffs are not permissible in bankruptcy. In reaching this conclusion, the Third Circuit found that the Bankruptcy and District Courts correctly concluded that there is no contractual exception to the mutuality requirement and that mutuality may not be satisfied under a third-party beneficiary theory.

Background

The debtor, Orexigen Therapeutics, Inc. (“Orexigen”) was a single-product pharmaceutical company that had separate contractual relationships with McKesson Corporation, Inc. (“McKesson”), and McKesson’s subsidiary, McKesson Patient Relationship Solutions (“MPRS”). Orexigen and McKesson were parties to a distribution agreement that included a “setoff provision,” which permitted “each of [McKesson] and its affiliates . . . to set-off, recoup and apply any amounts owed by it to [Orexigen and its] affiliates against any [and] all amounts owed by [Orexigen] or its affiliates to any of [McKesson] or its affiliates.” Separate from the distribution agreement with McKesson, Orexigen was party to a services agreement with MPRS. At the time of its chapter 11 bankruptcy filing in 2018, Orexigen owed MPRS approximately \$9 million under the services agreement and McKesson owed Orexigen approximately \$7 million under the distribution agreement. After Orexigen filed for protection under chapter 11 of the Bankruptcy Code, McKesson sought to set off the entire \$7 million it owed to the debtor against MPRS’s \$9 million claim against the debtor pursuant to the setoff provision in the distribution agreement.²

The Bankruptcy Court rejected McKesson’s attempted setoff on the grounds that while the setoff provision in the distribution agreement constituted an “enforceable contractual right allowing a parent and its subsidiary corporation to [e]ffect a prepetition triangular setoff under state law[.]” that relationship “does not supply the strict mutuality required in bankruptcy.” Rather, relying on its own prior decisions, including *In re SemCrude L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), the Bankruptcy Court held that section 553 is “strictly construed against the party seeking setoff” and that parties cannot by contract turn

¹ *In re Orexigen Therapeutics, Inc.*, No. 20-1136 (3d Cir. Mar. 19, 2021).

² Section 553 of the Bankruptcy Code provides in relevant part: “Except as otherwise provided in this section and in sections 362 and 363 of this title, 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.” (emphasis added).

nonmutual debts into mutual debts subject to setoff under the Bankruptcy Code. In so holding, the Bankruptcy Court rejected McKesson's argument that mutuality in section 553 "identifies the state-law right that is thereby preserved unaffected in bankruptcy" as well as the argument that MPRS's alleged status as a third-party beneficiary of the distribution agreement between the debtor and McKesson created mutuality to permit setoff under section 553.

The Third Circuit's Decision

Although the Bankruptcy Court and the subsequent District Court decision³ upholding the Bankruptcy Court's ruling relied on a unanimous line of authority from prior bankruptcy courts beginning with *SemCrude* in denying McKesson's request for setoff, the meaning of mutuality in section 553 was a matter of first impression for the Third Circuit. The Third Circuit first addressed McKesson's argument that both the general right to enforce a setoff and the mutuality required under section 553 are defined by state law, and that section 553 therefore does not impose an independent mutuality limitation. In rejecting this argument, the Third Circuit agreed with the *SemCrude* court that a compelling body of precedent, including from the Third Circuit itself, treats mutuality in section 553 as a limiting term rather than a redundancy, which would result from McKesson's proposed reading of the statute.

The Third Circuit next addressed whether section 553's mutuality requirement excludes triangular setoffs such as the arrangement contemplated under the distribution agreement. The Third Circuit again adopted the *SemCrude* court's conclusion 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. 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 observed that policies underlying the Bankruptcy Code disfavor a contractual exception to mutuality because triangular setoffs undermine the Bankruptcy Code's primary goal of ensuring that similarly situated creditors are "treated fairly and enjoy an equality of distribution from a debtor absent a compelling reason to depart from this principle."⁴ Finally, the Third Circuit noted that McKesson could have protected itself and achieved the result it desired by taking steps to have MPRS obtain a perfected security interest in Orexigen's account receivable due from McKesson or by entering into the services agreement with Orexigen directly as opposed to through its subsidiary, MPRS.

Conclusion

Although bankruptcy courts in Delaware (and elsewhere) have previously prohibited the enforcement of triangular setoff arrangements in bankruptcy, the *Orexigen* decision marks the first time that the Third

³ *In re Orexigen Therapeutics, Inc.*, 2020 WL 42824 (D. Del. Jan. 3, 2020).

⁴ The Third Circuit also rejected McKesson's alternative argument that it held a direct claim against Orexigen under the setoff provision of the distribution agreement (against which the \$7 million owed by McKesson to Orexigen could be set off).

Circuit Court of Appeals has addressed the issue and affirmatively agreed with the *SemCrude* line of cases. The unanimous decision definitively rejects triangular setoff arrangements, including—as the Third Circuit itself recognized—those that may otherwise be enforceable outside of bankruptcy.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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