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Third Circuit Rules that Parties Cannot Contract Around the Mutuality Requirement for Setoff in Bankruptcy

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On March 19, in a matter of first impression, the Third Circuit Court of Appeals (Court) held that triangular setoff is not permissible in bankruptcy due to Bankruptcy Code Section 553(a)'s mutuality requirement, and that parties cannot evade that requirement by contracting around it. See *In re Orexigen Therapeutics, Inc.*, 990 F.3d 748 (3d Cir. 2021).

McKesson Corporation, Inc. (McKesson) and Orexigen Therapeutics, Inc. (Orexigen) were parties to a distribution agreement, where Orexigen would sell McKesson the drug Contrave, and McKesson would, in turn, sell the drug to pharmacies. The distribution agreement also had a provision (Setoff Provision) that stated McKesson could reduce any amounts it owed to Orexigen by any amount that Orexigen owed to McKesson or any of its subsidiaries. Separately, Orexigen and McKesson Patient Relationship Solutions (MPRS), a McKesson subsidiary, entered into a services agreement whereby MPRS would manage a customer loyalty program for Orexigen. The distribution agreement with McKesson and the services agreement with MPRS were wholly separate documents that did not reference, incorporate, or integrate each other.

On March 12, 2018, Orexigen filed for Chapter 11 bankruptcy. At that time, Orexigen owed MPRS \$9.1 million under the services agreement, and McKesson owed Orexigen \$6.9 million under the distribution agreement. McKesson asserted that it had rights of setoff under Section 553 of the Bankruptcy Code based on the Setoff Provision, and as a result of these setoff rights, McKesson owed Orexigen nothing, but Orexigen owed MPRS \$2.2 million. The Bankruptcy Court for the District of Delaware (Bankruptcy Court) disagreed, relying on its past ruling in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009). The Bankruptcy Court held that, although the Setoff Provision was an enforceable contractual right that allowed for a triangular setoff under state law, such a relationship did not provide "the strict mutuality required" for setoff under Section 553. The Bankruptcy Court ruled that a contract cannot turn nonmutual debts into mutual debts subject to setoff under the Bankruptcy Code. McKesson appealed the Bankruptcy Court's ruling, which the District Court for the District of Delaware affirmed.

On appeal to the Third Circuit Court of Appeals, the Court affirmed the lower courts' rulings, noting that this was a matter of first impression and that while other circuit courts have ruled on the meaning of "mutuality," they had not ruled on "whether a contract can create an exception to the requirement of direct mutuality."

The Court first held that the term "mutual" in Section 553 imposes a distinct limitation. McKesson argued that Section 553's mutuality requirement was defined by state law and that Section 553 imposed no independent mutuality limitation. McKesson submitted that Congress would have listed mutuality among the several

enumerated exceptions to setoff rights in Section 553 if it had intended that mutuality to serve as a distinct limitation. The Court disagreed, finding that McKesson's reading of the statute would render the term "mutual" in Section 553 superfluous. The Court further observed that Section 553's requirement that the debtor's claim against the creditor and the creditor's claim against the debtor both arise pre-petition is not specifically enumerated — yet, "[t]hat requirement is consistently viewed as a distinct limitation on the ability to assert a setoff right . . ." Thus, the Court reasoned, "there is no persuasive reason to treat the requirement of mutuality any differently."

The Court went on to find that mutuality under Section 553 excludes triangular setoffs, such as the one in the Setoff Provision. "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 did not intend to include as mutual "any contractual elaboration on that kind of simple, bilateral relationship."

However, McKesson further argued that the Setoff Provision changed the debts between Orexigen and MPRS and the debts between McKesson and Orexigen from a triangular debt arrangement into a mutual debt. Again, the Court disagreed, citing the *SemCrude* ruling. There, the Bankruptcy Court held that contractual arrangements could not transform a triangular set of obligations into bilateral mutuality. The Bankruptcy Court held that "mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff" and noted that Congress was highly precise in drafting Section 553, articulating exactly who must owe whom a debt to effect setoff rights. The *SemCrude* court also observed that "[o]ne of the primary goals — if not the primary goal — of the Code is to ensure 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." Triangular setoffs would undermine this goal.

The Court agreed with the *SemCrude* holding. The Court noted that "[i]f 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," or MPRS could have perfected a security interest in Orexigen's receivables due from McKesson, granting it a priority akin to setoff. From a policy perspective, the Court observed that, "McKesson's desired outcome, wherein contractual setoff agreements can shoehorn multiparty debts into § 553, would disincentivize public disclosure of prioritized claims, weakening a fundamental purpose of the Code." In contrast, the Court found, "a rule that excludes nonmutual debts from the setoff privilege of § 553 promotes predictability in credit transactions" and that "[a]n unambiguous rule regarding the scope of § 553 maximizes the payout for all parties by avoiding litigation expenses."

Finally, the Court rejected McKesson's argument that it held a direct claim against Orexigen through the Setoff Provision, observing that McKesson's interpretation of the term "claim" ignores the rest of the language of Section 553, and that "[i]f McKesson's definition of claim were to be inserted in this context, § 553 would state that 'this title does not affect any right of a creditor to offset a mutual debt . . . against [a setoff right] of such creditor.'" The Court quickly rejected this interpretation, noting that "[t]rying to offset a debt against a setoff right strikes us as nonsense."

The Court's holding in *Orexigen* is a reminder of the importance of considering bankruptcy implications when drafting contracts. The Court prioritized the policies reflected in Section 553 over the parties' agreement establish a contrary triangular setoff arrangement. Moreover, the Court went out of its way to highlight alternative business arrangements that can be made to achieve a similar result as a triangular setoff — e.g., taking a perfected security

interest or restructuring business arrangements to maintain a two-party relationship. Parties intending to draft a triangular setoff provision into their contracts should instead consider alternatives that comport with the Bankruptcy Code to avoid being deprived of otherwise agreed-upon rights should their counterparty file for bankruptcy.

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