

# Sales incentives and setoff: Using rebates to recover receivables

David H. Conaway outlines the key setoff concepts and how they are applied in Chapter 11 and Chapter 15



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**I**n assisting companies doing business with their customers and the supply chain, we have noted that companies increasingly propose to their customers incentives to purchase goods, often in the form of rebates and discounts.

There may be circumstances where setting off the obligation to pay such incentives owed to a customer against the customer's accounts receivable owed by the customer is necessary to avoid or reduce risk. The need for this "remedy" is exacerbated during periods of financial and market uncertainty.

Moreover, many global groups of companies do business through one or more affiliated legal entities, even though there is one corporate identity, requiring a "triangular" setoff with their customers.

Knowing the rules of setoff and how they are applied in Chapter 11 and Chapter 15 is essential.

## Important Chapter 11 and Chapter 15 decisions on setoff

In January 2020, the Delaware Federal District Court affirmed a Delaware Bankruptcy Court ruling that "triangular" setoffs are not enforceable in Chapter 11. The rulings arise in the *Orexigen Therapeutics, Inc.* Chapter 11 case, where McKesson Corporation, Inc.'s ("McKesson") motion to allow a triangular setoff was denied. McKesson has appealed to the Third Circuit Court of Appeals, which will likely affirm the lower court rulings.

In the Chapter 15 proceedings of *Awal Bank BSC*, the London-based administrator of the Bahrain bank sued the HSBC Bank USA, one of Awal Bank's largest creditors. The issue in dispute was HSBC's setoff of almost \$13 million of Awal Bank's money on deposit with HSBC against obligations owed to HSBC by Awal Bank, arising under a \$75 million overdraft facility provided by HSBC. This is an import issue for a foreign administrator involved in U.S. Chapter 15 proceedings because Chapter 15 does not expressly provide for setoff as a remedy available to foreign representatives. The *Awal Bank* case addressed this issue.

## Key setoff concepts

1. Setoff is a contractual or equitable right that allows entities that owe each other money to apply their mutual debts against the other, thereby avoiding the absurdity of making A pay B when B owes A (*Citizens Bank of Maryland v. Strumpf*, U.S. Supreme Court 1995).
2. Section 553 of the Bankruptcy Code does not create a federal law right of setoff; it merely recognizes a right of setoff that exists under a U.S. state law. There must be a contractual or U.S. state law setoff right in the first instance.
3. Section 553 allows a creditor to offset "mutual" debts owed by the creditor and the debtor. Also, the mutual debts owed by the creditor and the debtor must both arise pre-

petition, or both arise post-petition.

4. Section 553's mutuality requirement means that only obligations between the same legal entities may be setoff.

The "mutuality" requirement was the critical issue in the McKesson case. Orexigen was a biopharmaceutical company that manufactured Contrave, an obesity drug. Orexigen entered into a sales and distribution agreement with McKesson. Orexigen entered into a second contract with a McKesson subsidiary (the "Subsidiary") which managed Orexigen's loyalty script program. Customers could earn loyalty price discounts, which the Subsidiary paid. Orexigen was obligated to reimburse the Subsidiary for the discounts paid. When Orexigen filed Chapter 11, McKesson owed Orexigen about \$7 million for goods purchased, and Orexigen owed the Subsidiary about \$9 million for discounts paid.

McKesson filed a motion seeking court permission to exercise its setoff remedy, relying on the following provision in its contract:

*"Notwithstanding anything to the contrary in this Agreement, each of McKesson Corporation and its affiliates is hereby authorised to set-off, recoup and apply any amounts owed by it to Manufacturer's [the Debtor's] affiliates against any all [sic] amounts owed by Manufacturer or its affiliates to any of McKesson Corporation or its affiliates, without prior written notice[.]"*

As indicated above, the Delaware courts ruled against



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McKesson's attempt to setoff these amounts. In doing so, the Delaware Bankruptcy Court noted that "mutuality is strictly construed against the party seeking setoff" (*SemCrude, LLP*, DE Bankr.Ct. 2009), and that the triangular setoff contract provision was not enforceable.

With setoff, McKesson could have setoff the \$7 million it owed against the \$9 million accounts receivable, reducing its general unsecured claim to \$2 million. Without setoff, McKesson owed \$7 million to the debtor's estate, and its Subsidiary had a \$9 million general unsecured claim against Orexigen in Chapter 11.

There may be solutions to structure transactions to create mutuality, such as joint and several obligors or cross-corporate guarantees.

Or, for a material contract, why not use the same legal entities? Presumably there were business, accounting, or tax reasons to bifurcate the two McKesson contracts. However, McKesson could have been the counterparty to the loyalty script agreement and delegate its performance to the Subsidiary. In delegation of performance agreements, the original party normally remains obligated.

5. Section 506 of the Bankruptcy Code, "Determination of secured status," provides that the claim of a creditor that is subject to setoff under Section 553 is a **secured** claim to the extent of the amount subject to setoff.

For example, in the McKesson case, McKesson's \$9 million claim would have been a secured claim of \$7 million, and a general unsecured claim of \$2 million.

6. Section 553(b) provides that a debtor may recover a pre-bankruptcy setoff where the creditor improved its position with respect to any "insufficiency" between the mutual debts between the parties within the 90 days prior to the bankruptcy filing. "Insufficiency" is defined as

the "amount, if any, by which a claim against the debtor exceeds a mutual debt owed to the debtor by a holder of such claim." Because of the uncertainty created by this provision, creditors are well-advised to consider not exercising the setoff right during the 90-day period. Rather, wait until after the Chapter 11 filing and file a motion for relief from stay to exercise the setoff.

Though relief from the Section 363 automatic stay is required, courts will normally grant such relief if the requirements are met.

7. Outside of Chapter 11, triangular setoff provisions in contracts are generally enforceable under state law.
8. Recoupment. Creditors should take note of setoff's first cousin, recoupment. The key differences are that: (a) recoupment obligations can be pre-petition or post-petition obligations, (b) the obligations to be recouped must arise out of the same transaction (which is not required for setoff), and (c) exercise of recoupment does not require relief from stay.

### Setoff under Chapter 15

As indicated above, in the *Awal Bank* case, HSBC experienced a "self-help" setoff of \$13 million in an HSBC deposit account against obligations owed to HSBC.

On 30 July 2009, the Central Bank of Bahrain placed Awal Bank into administration in Bahrain. On 30 September 2009, the administrator for Awal Bank filed a Chapter 15 petition for recognition in the Southern District of New York. On 27 October 2009, the Bankruptcy Court entered an order recognising the administration in Bahrain.

On 24 February 2011, on behalf of Awal Bank, the administrator filed adversary proceedings against HSBC in order to recover the allegedly improper setoff under Section

553(b) of the Bankruptcy Code. HSBC filed a motion to dismiss the Awal Bank complaint, primarily because of its contention that Section 553(b) is not applicable in this case.

Specifically, Section 553(b) provides for the recovery of setoffs exercised within 90 days prior to the filing of a petition. The setoff was exercised within 90 days of the filing of the Chapter 15 petition. However, HSBC contends that the 90-day period should be calculated based upon Awal Bank's Chapter 11 proceedings (the history of the two proceedings is for another day), which was filed beyond 90 days of the exercise of the setoff.

In addressing HSBC's motion to dismiss, the Bankruptcy Court addressed the question of whether the Chapter 15 "tool-kit" of a foreign representative includes the ability to recover setoffs under Section 553(b). As most practitioners are aware, Section 1521(a)(7) of the Bankruptcy Code expressly excludes from a foreign representative's "tool-kit" avoidance powers for recoveries of transfers that constitute a preference (Section 547) or a fraudulent conveyance (Section 548). However, Section 1521(a)(7) does NOT expressly exclude Section 553(b).

The Bankruptcy Court ruled that the plain meaning of the statutory language must ordinarily govern when it does not lead to an absurd result. The Bankruptcy Court recognised a key distinction between Section 553(b), which provides for "recovery" of property, and Section 547 and 548, which provide for "avoidance" of transfers. Transfers avoided under Sections 547 and 548 are recovered under Section 550. The Bankruptcy Court concluded that applying Section 553(b) in Chapter 15 cases is a logical and appropriate result. Bottom line, the Bankruptcy Court agreed with Awal Bank, and denied HSBC's motion to dismiss. ■



**THERE MAY BE SOLUTIONS TO STRUCTURE TRANSACTIONS TO CREATE MUTUALITY, SUCH AS JOINT AND SEVERAL OBLIGORS OR CROSS-CORPORATE GUARANTEES**

