



FEDERAL COURTS “JUST SAY NO” TO SETOFF BY CONTRACT

Federal Courts sitting in Delaware and New York cases have refused to permit contractual setoff in the absence of mutual debts. These decisions likely will lead other courts to question the enforceability of contractual setoff in future bankruptcy cases.

WHAT DO THESE TWO CASES MEAN FOR YOU?

- If you choose to rely on contractual netting arrangements, you run the risk of paying the amount owed to a customer’s bankrupt affiliate, while receiving only pennies on the dollar from the customer in its bankruptcy case.
- If you are responsible for the management and assessment of customer credit risk, you may no longer be able to rely on “master netting” or similar contract terms to provide for setoff among affiliates.
- If you use derivative contracts to manage certain types of risk, they may not be bankruptcy proof and fail to accomplish the intended outcome.

WHAT ARE THE ALTERNATIVES?

- *First*, instead of relying on contractual setoff rights under a “master netting” or similar agreement, you may negotiate for liens or cross-collateralization to create mutual debt obligations.
- *Second*, all of your sales to a customer could be made by a single member of your corporate family to that customer only, and not to any of its affiliates, thereby ensuring mutuality. This solution could be implemented through inter-company transfers undertaken by your corporate family, as seller, and by the customer’s corporate family, as buyer.
- *Third*, you may choose to operate through the use of assignments, guarantees, or the like to create mutual debt obligations.

None of these approaches is perfect. Your customer may be reluctant to grant liens, as doing so may (a) violate any number of covenants in the customer’s credit agreements, and (b) require more complex documentation and the filing of perfection devices, including UCC-1 filing statements, mortgages, or deeds of trust. Additionally, your customer may refuse to incur the cost of implementing and monitoring these arrangements.

CONCLUSION

Credit managers and others should seriously reconsider their reliance on contractual setoff to manage credit risk. Alternative legal structures are available, but some of these solutions may be difficult to implement and require the dedication of additional resources.

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