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Priming Setoff Rights

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In an effort to subordinate the unsecured creditor's setoff rights,¹ debtor in possession (DIP) lenders often seek to prime setoff rights in orders approving DIP financing (DIP orders). While in appropriate circumstances § 364(d) of the Code authorizes the priming of existing liens, a right of setoff, unlike a lien, is not directly affected by § 364(d) despite contrary arguments from secured creditors. However, bankruptcy courts have not taken a uniform stance on the ability to prime setoff rights.

Statutory Background



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Several Code sections are implicated when a DIP lender attempts to prime a creditor's setoff right, including §§ 364(d), 553(a) and 506(a). Section 364(d) permits a DIP lender to prime existing liens as follows:

The Court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—

- (A) the trustee is unable to obtain such credit otherwise; and
- (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or

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equal lien is proposed to be granted.²

In turn, § 553(a) preserves a creditor's common law right to setoff under the following terms:³

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.⁴

By its terms, then, § 553 may be affected by only two Code sections. Section 362

recognition of and in conjunction with the setoff right preserved in § 553, § 506(a) provides that a setoff right be treated as a secured claim as follows:



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An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is

a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject

Problems in the Code

governs the automatic stay, and as such, "operates as a stay, applicable to all entities—of the setoff of any debt owing to the debtor that arose before the commencement of the case under this title."⁵ Section 363 governs the use, sale or lease of estate property, granting the debtor or trustee the right to do so even if the property is subject to the right of setoff.⁶ Finally, in

to setoff is less than the amount of such allowed claim.⁷

Analysis

Notwithstanding the express language of § 553 prohibiting the Bankruptcy Code (other than §§ 362 and 363) from affecting setoff rights, DIP orders occasionally include express language subordinating setoff rights pursuant to § 364(d),⁸ or authorizing a general priming lien pursuant to

² 11 U.S.C. § 364(d)(1).

³ A right of setoff is preserved if the following conditions are met: (1) the creditor holds a claim against the debtor that arose before the commencement of the case; (2) the creditor owes a debt to the debtor that arose before the commencement of the case; (3) the claim and debt are mutual; and (4) the claim and debt are each valid and enforceable. 11 U.S.C. § 553(a); *In re Garden Ridge Corp.*, 338 B.R. 627, 633 (Bankr. D. Del. 2006) (internal citations omitted).

⁴ 11 U.S.C. § 553(a).

⁵ 11 U.S.C. § 362(a)(7).

⁶ The distinction between §§ 362's and 363's effect on § 553 is summarized by Judge **Mary F. Walrath**: "Section 362 does not eliminate setoff rights; it merely imposes a stay on enforcing them. Section 363, on the other hand, does eliminate setoff rights *vis-à-vis* the buyer by permitting a sale free of such interests." *In re Trans World Airlines Inc.*, 275 B.R. 712, 718 (Bankr. D. Del. 2002).

⁷ 11 U.S.C. § 506(a)(1).

⁸ See, e.g., Final DIP Order at ¶ 13, *In re River Oaks Holdings Inc.*, et al., No. 08-11264 (Bankr. D. Del. Aug. 13, 2008) (order granting rights senior to any right of holder of claim, including, without limitation, any mortgagee, governmental authority or landlord, to set off or to recoup such claim); see also Interim DIP Order at ¶ 13, *St. Mary's Hospital*, No. 09-15619 (Bankr. D. N.J. Mar. 12, 2009) ("any right of setoff...will be subordinate to the liens and interests of the" DIP lender); Final DIP Order at ¶ 17, *Verasun Energy Corporation*, et al., No. 08-12606 (Bankr. D. Del. Dec. 4, 2008) ("Post-petition Liens...shall be senior to and prime the Pre-petition Liens and any Liens, setoff rights.").

¹ 11 U.S.C. § 506(a)(1).

§ 364(d) “upon all tangible and intangible property of the Debtors’ estates that are encumbered” and often include additional protective language that the priming liens are senior to all other liens, security interests or claims.⁹ Even where the DIP order’s priming language does not expressly seek to prime or subordinate rights of setoff, DIP lenders often argue that a DIP order’s § 364(d) priming lien has primed a creditor’s setoff rights.¹⁰

DIP lenders seeking to prime setoff rights point to the broad equitable powers of a bankruptcy court pursuant to § 105 and the adequate-assurance requirement of § 364(d) for support in favor of priming setoff rights. As long as adequate assurance is provided to creditors with primed setoff rights, DIP lenders may argue that the right of setoff is not “affected” and a creditor has no basis for disrupting the debtor’s efforts for an orderly reorganization or liquidation.¹¹

On the other hand, the absence of any Bankruptcy Code authority to prime setoffs has been highlighted by some bankruptcy courts. An example, in pertinent part, from a hearing at which the DIP lender was seeking to prime certain government setoff rights pursuant to § 364(d) follows:

Lender: What position we are taking is that we want the benefit of relief under 364 and particularly that the lenders’ rights will be senior to the government’s rights [to setoff] in that regard.

[The Court]: Where do you get a right under 364 for that purpose?

Lender: ...[W]e would take the position that under 364 we have the right to prime potential lien rights and other rights that there may be in the debtors’ property. And this is a right that is in that regard.

[The Court]: “If Title 11 can’t affect any right of a creditor

to setoff but for 362 and 363, I think you have no argument at all. And to the extent that you’ve advanced this argument in many courts, I think you’ve made a mistake and the courts, if they’ve granted it, have made a mistake. There’s no impact on setoff rights by virtue of the [B]ankruptcy [C]ode if 553 is complied with except with respect to automatic stay and certain aspects of 363 which are totally irrelevant here... You know, this is old Roman law setoff.”¹²

The Third Circuit has distinguished a setoff from a lien. Section 364(d) authorizes a debtor to obtain credit or incur debt secured by a senior or equal lien on property of the estate that is subject to a *lien*. A setoff is not a lien. A setoff and a lien “connote independent concepts, governed by distinct legal principles.”¹³ The *Folger* court determined that “[s]etoff... refer[s] to situations where both plaintiff and defendant have independent causes of action maintainable against each other in separate actions which can be mutually deducted whenever either one brings a suit against the other while ‘lien’ is a charge or encumbrance upon property to secure the payment or performance of a debt, duty, or other obligation. [A lien] is distinct from the obligations which it secures... while the same is not true of a right of setoff.”¹⁴

This distinction between a setoff and a lien is supported by Code § 506, which treats setoff rights as secured claims, thereby elevating the holder’s interest in the proceeds of the holder’s claim to a property right. While the exercise of creditors’ setoff rights pursuant to § 553 (assuming that the creditor has a valid right of setoff) results in a notional secured claim, this does not transform the right of setoff into a lien. The distinction made by § 506 between determining the value of a secured claim for a “setoff” (*i.e.*, a secured claim to the extent of the amount subject to setoff) and the value of a secured claim for a “lien” (*i.e.*, value of such creditor’s interest in the estate’s interest in such property) is consistent with the conclusion reached by the *Folger* court that each “[setoff and lien] connote independent concepts,

governed by distinct legal principles.”¹⁵ While a DIP lender’s priming lien may create a competing interest in the same property that is subject to a creditor’s setoff rights, a DIP lender’s attempt to utilize § 364(d) to prime a right of setoff is arguably both contrary to the express language of § 553 and beyond the authority granted by § 364(d) to prime *liens*.¹⁶

Conclusion

Until bankruptcy courts take a uniform and formal position on the conflict between a DIP lender’s priming rights and a creditor’s right of setoff, DIP lenders will likely continue to try to prime setoff rights and creditors with setoff rights will likely object—in an effort to either remove express setoff priming language from a DIP order or obtain adequate assurance. If Congress wants to allow lenders to prime setoff rights, the Bankruptcy Code should be amended to clearly permit such priming. ■

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⁹ Final DIP Order at 10, *In re Sea Launch Company LLC*, et al., No. 09-12153 (Bankr. D. Del. Dec. 3, 2009); see also Final DIP Order at 18, *In re Ultimate Escapes Holdings LLC*, et al., No. 10-12915 (Bankr. D. Del. Oct. 8, 2010); Final DIP Order at 19-20, *Consolidated Horticulture Group LLC*, et al., No. 10-13308 (Bankr. D. Del. Dec. 17, 2010).

¹⁰ See, e.g., Response of [DIP Lender] to Motion of [Creditor] for Relief from the Automatic Stay to Exercise Setoff Rights, *In re Sea Launch Company LLC*, et al., No. 09-12153 (Bankr. D. Del. Feb. 25, 2010) (DIP lender objection that bank’s setoff rights have been primed in response to bank’s stay relief request to exercise setoff rights); Joinder of [DIP Lender] to Debtors’ Objection to Motion of [Creditor] to Modify Automatic Stay to Permit Setoff, *In re Semcrude LP*, et al., No. 08-11525 (Bankr. D. Del. Mar. 6, 2009) (DIP lender objection that DIP lender has particular interest in preventing improper elevation of setoff rights of unsecured creditors in response to creditor’s stay relief request to exercise setoff rights).

¹¹ See, e.g., Interim DIP Order at ¶ 18, *In re Delphi Corp.*, et al., No. 05-44481 (Bankr. S.D.N.Y. Oct. 12, 2005) (language at ¶ 18 subordinating setoff rights to three groups of creditors) to the Final DIP Order, *In re Delphi Corp.*, et al., No. 05-44481 (Bankr. S.D.N.Y. Oct. 25, 2005) (language at ¶ 18 authorizing exercise of certain setoff rights and providing adequate protection for other setoff rights).

¹² Transcript of Hearing, *In re St. Mary’s Hospital*, No. 09-15619 (Bankr. D. N.J. Mar. 31, 2009).

¹³ *Folger Adam Sec. Inc. v. DeMatteis/MacGregor JV*, 209 F.3d 252, 259 (3d Cir. 2000) (citing *Marley v. United States*, 381 F.2d 738, 743 (Ct. Cl. 1967)). The *Folger* court extended its analysis, distinguishing a setoff from a lien to also include as separate from a setoff mortgages, security interests, encumbrances and liabilities that possess characteristics similar to a lien. *Id.*

¹⁴ *Folger*, 209 F.3d at 259-60 (citing *Marley*, 381 F.2d at 743).

¹⁵ *Folger*, 209 F.3d at 259 (citing *Marley*, 381 F.2d at 743).

¹⁶ The priority of a right of setoff in conflict with a security interest is resolved by applicable state law and not the Bankruptcy Code. For instance, in certain limited circumstances, priority between a setoff right and a competing security interest may be resolved by Article 9 of the Uniform Commercial Code as set forth in 9-109(d)(10).