

In re Awal Bank: Expanding Ability to Avoid Setoff in Chapter 15 Bankruptcy Cases

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Introduction

Foreign bankruptcy representatives seeking to avoid setoff of fund transfers pursuant to section 553 of the Bankruptcy Code may enjoy more flexible standards than ever before. In a recent decision by the United States Bankruptcy Court of the Southern District of New York, *In re Awal Bank*,¹ Judge Gropper allowed the foreign representative for Awal Bank to avoid a setoff by HSBC even though the bank had not filed a plenary chapter 7 or 11 bankruptcy proceeding within 90 days of the setoff, holding that Awal Bank's filing under Chapter 15 within the relevant 90 day look-back period was sufficient to avoid the setoff.² This memorandum explains how both HSBC and Awal Bank argued the main issues of first impression, how the bankruptcy court analyzed and decided these novel issues, and how the decision could potentially impact foreign bankruptcy proceedings in the future. Part I of this memorandum briefly describes setoff and when setoff may be disallowed. Part II explains the pertinent Bankruptcy Code provisions implicated in these situations. Part III discusses Awal and the main arguments of both parties regarding the issues, and Part IV discusses how the court came to

¹ 455 B.R. 473

² *Id.* at 484.

resolve them. Part V concludes by examining how the court’s decision could impact creditors and debtors in potential set-off situations.

I. Scenario Involving Potential Setoff and Avoidance Proceeding

Setoff is an equitable right of a creditor to deduct a debt it owes to the debtor from a claim it has against the debtor arising out of a separate transaction.³ A creditor seeking to setoff a debt must establish a claim and a right to do so under state or federal law;⁴ the Bankruptcy Code is not an independent source of law that authorizes setoff.⁵ Setoff is only available when the obligations between debtor and creditor are mutual (both obligations are held by the same parties in the same right and capacity) and both obligations arise either prepetition or postpetition.⁶

While bankruptcy courts technically lack a statutory predicate to disallow setoff for “equitable” reasons, most courts assume wide discretion to disallow setoff.⁷ Courts usually have disallowed otherwise valid setoff where the creditor committed an illegal or fraudulent act,⁸ where the setoff is contrary to public policy,⁹ and where the setoff would significantly harm or destroy the debtor’s ability to reorganize.¹⁰

II. Pertinent Bankruptcy Code Provisions

This section describes the two federal Bankruptcy Code provisions that address avoidance of a potential setoff: sections 553 and 1521.

Section 553 in Title 11 of the Bankruptcy Code describes the circumstances where a debtor party may commence an avoidance proceeding to recover from the creditor the amount of

³ *In re East 105 East Second Street Assocs.*, 207 B.R. 64, 68 (Bankr. S.D.N.Y. 1997).

⁴ *In re McMahon*, 129 F.3d 93 (2d Cir. 1997).

⁵ *In re Gordon Sel-Way, Inc.*, 239 B.R. 741, 750 (E.D. Mich. 1999).

⁶ *In re Davidovich*, 901 F.2d 1533, 1537 (10th Cir. 1990).

⁷ *See, e.g., In re Securities Group 1980*, 74 F.3d 1103, 1104 (11th Cir. 1996).

⁸ *In re Cascade Roads, Inc.*, 34 F.3d 756 (9th Cir. 1994).

⁹ *Id.*

¹⁰ *In re Lincoln*, 144 B.R. 498 (Bankr. D. Mont. B.R. 1992).

offset funds.¹¹ Section 553(b) states that a debtor may recoup offset funds where the amount owed on the date of the setoff is less than the amount owed on the later of either: 90 days before the petition filing, and; the first date during the 90 days immediately preceding the petition filing date on which there is an insufficiency.¹² Therefore, a debtor must initiate bankruptcy proceedings within 90 days of the purported setoff in order to later have the ability to potentially offset and recover these funds.

Section 1521 of the Bankruptcy Code specifically addresses possible relief that can be granted to foreign representatives upon chapter 15 recognition.¹³ Of particular relevance to Awal is subsection (a)(7), which posits that additional relief may be granted to a trustee, except for relief under sections 522, 544, 545, 547, 548, 550, and 724(a).¹⁴ It is noteworthy that section 553 is not expressly stated as a barred avenue of relief under subsection (a)(7).

III. Facts and Party Arguments of In Re Awal Bank

A. Facts of In Re Awal Bank

On May 19, 2008, Awal Bank and HSBC entered into a credit agreement providing for an uncommitted overdraft facility of approximately \$75,000,000.¹⁵ Later that month the credit agreement was terminated with approximately \$75,000,000 outstanding.¹⁶ One month later on June 26, 2009, HSBC served Awal Bank with a notice of default and demanded payment of \$75,071,671.31.¹⁷ On July 17, 2009, Royal Bank of Scotland electronically transferred \$12,996,220.98 to Awal Bank's deposit account at HSBC; the setoff at issue occurred upon this

¹¹ 11 U.S.C. § 553 (2006).

¹² *Id.*

¹³ 11 U.S.C. § 1521 (2006).

¹⁴ *Id.*

¹⁵ 455 B.R. 73, 78.

¹⁶ *Id.*

¹⁷ *Id.*

transfer.¹⁸ However, this wire transfer was made in error because Awal Bank instructed Royal Bank of Scotland to transfer these surplus funds to Awal's account with the Bank of Bahrain and Kuwait, not HSBC.¹⁹ Awal Bank's foreign representative, Charles Russell LLP, applied for chapter 15 recognition on September 30, 2009, and after no objections were made, recognition was granted on October 27, 2009.²⁰ The subsequent Chapter 11 case, however, was not filed until October 21, 2010, almost one year after Chapter 15 recognition.²¹ Chapter 11 recognition was sought in order to provide for a statutory predicate for an action to avoid the HSBC setoff.²² Finally, on February 24, 2011, the foreign representative initiated an adversary proceeding against HSBC to avoid and recover the setoff.²³ Therefore, applying these facts specifically to section 553(b), if the court used the Chapter 11 filing date as the operative one to begin the look-back period, Awal would be unable to avoid the setoff since this date (October 21, 2010) was not within the acceptable 90 day range from the date of the setoff (July 17, 2009). However, if the court used the Chapter 15 filing date of September 30, 2009, Awal would be able to successfully avoid the setoff since this date was within 90 days of the July 17, 2009 setoff date.

B. Party Arguments

i. HSBC

HSBC moved to dismiss the adversary proceeding first based on the premise that it was untimely.²⁴ HSBC argued that the chapter 11 petition date was the only appropriate reference date for section 553(b)'s look-back period, and since the offset occurred 461 days before the

¹⁸ *Id.*

¹⁹ *Id.* at 79.

²⁰ *Id.* at 77.

²¹ *Id.*

²² *Id.*

²³ *Id.* at 78.

²⁴ *Id.* at 86.

chapter 11 petition date, the claim was untimely.²⁵ HSBC supported this contention by pointing to section 101 of the Bankruptcy Code, which defines “petition” as one “filed under section 301, 302, 303, or 304 of this title, as the case may be, commencing a case under this title.”²⁶

Therefore, HSBC claimed that a Chapter 15 petition did not qualify as a “petition” since it was not filed under any of the referenced sections of the Code.²⁷ HSBC also stated that the Chapter 15 date should not be used because Chapter 15 itself specifically precluded a foreign representative from avoiding a setoff under section 553 pursuant to a Chapter 15 proceeding alone.²⁸ Therefore, HSBC claimed that the foreign representative lacked standing to pursue an avoidance action because no case yet existed under chapter 7 or 11 of the Code.²⁹ HSBC looked to the legislative history and Congressional intent as well, stating that the U.S. delegation to the Model Law negotiations demanded that the Model Law not grant a foreign representative standing where there was no filed case under another chapter to supplement the Chapter 15 case.³⁰ HSBC argued that once the foreign representative filed the chapter 15 proceeding he had the right to immediately file a chapter 11 case and therefore create standing for an avoidance action; the foreign representative failed to do so, and he could not retroactively attempt to remedy this mistake with his flawed Chapter 15 argument.³¹

²⁵ *Id.*

²⁶ 11 U.S.C. § 101(42) (2006).

²⁷ *In re Awal Bank*, Memorandum in Supp. of Motion to Dismiss Adversary Proceeding, at 7.

²⁸ “[U]pon recognition of a foreign proceeding, the foreign representative has standing in a case concerning the debtor pending *under another chapter of this title* to initiate actions under sections 522, 544, 545, 547, 548, 550, 553, and 724(a).” 11 U.S.C. § 1523 (2006).

²⁹ *In re Awal Bank*, Memorandum in Supp. of Motion to Dismiss Adversary Proceeding, at 7-8.

³⁰ *Id.* at 8.

³¹ *Id.*

HSBC additionally argued that Awal's claims were barred by the discharge for value rule.³² This rule states that "[a] creditor of another or one having a lien on another's property[,] who has received from a third person any benefit in discharge of the debt or lien, is under *no duty to make restitution* therefore, although the discharge was given by *mistake* of the transferor as to his interest or duties, if the transferee made *no representation* and did *not have notice* of the transferor's mistake."³³ HSBC made clear that this rule applies to electronic funds transfers such as the one at issue in this case because the New York Court of Appeals stated that the discharge for value rule was consistent with and furthered the policy goal of finality in business transactions.³⁴ HSBC concluded that since the foreign representative's complaint made no suggestion that HSBC had any knowledge that Royal Bank of Scotland transferred the funds erroneously, HSBC had the right to consider the transfer of funds as a final and complete transaction, not subject to revocation.³⁵

ii. Awal

Awal Bank on the other hand argued that the chapter 15 filing date is the appropriate date to activate the look-back period for an avoidance action beginning within a related chapter 11 case,³⁶ and additionally that an avoidance proceeding under section 553(b) can be brought in a chapter 15 case without first instituting a plenary chapter 7 or 11 proceeding.³⁷ Awal claimed that HSBC's argument was based upon an outdated provision of the Bankruptcy Code and is

³² *Id.* at 10.

³³ *Banque Worms v. Bank of America Int'l*, 726 F. Supp. 940, 941 (S.D.N.Y. 1989) (emphasis added).

³⁴ *In re Awal Bank*, Memorandum in Supp. of Motion to Dismiss Adversary Proceeding, at 13, *citing Banque Worms v. BankAmerica Int'l*, 77 N.Y.2d 362, 372, 568 N.Y.S.2d 541, 547 (1991).

³⁵ *Id.*

³⁶ 455 B.R. 73, 86.

³⁷ *Id.* at 87.

refuted by the current, updated provision.³⁸ The current version of Bankruptcy Code Section 101(42) defines petition and includes “a petition filed under section...1504 of this title...commencing a case under this title.”³⁹ Awal said that HSBC relies an outdated version of Section 101(42), a version that included Section 304 of the Bankruptcy Code; this section has since been repealed.⁴⁰

Awal next contended that Section 553(b) expressly permits using the Chapter 15 petition date for purposes of initiating the look-back period.⁴¹ Awal argued that because the definition of “petition” includes a Chapter 15 petition for recognition, it is “almost self-evident” that Section 553(b) permits the recovery of offsets made within 90 days prior to filing the Chapter 15 petition for recognition.⁴² Awal first looked to Section 1521(a)(7), stating that the former explicitly permits one to seek “any additional relief that may be available to a trustee” except for a certain exceptions. Because Section 553 is not listed as one of the exceptions not available to a trustee, Awal contended that such relief is also available to a foreign representative upon the filing of a Chapter 15 petition for recognition.⁴³ Awal cited *United States v. Johnson*, where the court held that “[w]hen Congress provides exceptions in a statute, it does not follow that courts have the authority to create others.”⁴⁴ Awal then turned to Section 1523(a) and refuted HSBC’s argument that the section precludes Awal from bringing an action pursuant to Section 553 in connection with a Chapter 15 proceeding.⁴⁵ Awal stated that Section 1523(a) grants standing to a foreign representative to initiate certain avoidance actions, including Section 553 actions, in a Chapter

³⁸ *In re Awal Bank*, Memorandum in Opp. of Motion to Dismiss Adversary Proceeding, at 8.

³⁹ 11 U.S.C. § 101(42)

⁴⁰ *In re Awal Bank*, Memorandum in Opp. of Motion to Dismiss Adversary Proceeding, at 8.

⁴¹ *Id.* at 10.

⁴² *Id.* at 9.

⁴³ *Id.* at 10.

⁴⁴ *Id.* at 11.

⁴⁵ *Id.* at 12

11 proceeding, but it does not prohibit a foreign representative from bringing a 553 claim in a Chapter 15 proceeding.⁴⁶ Section 1521(a)(7) is the only provision of Chapter 15 that attempts to limit avoidance actions, but as previously stated does not list Section 553 as an exception to available relief.⁴⁷

Awal refuted HSBC's argument that the legislative history of Section 1523 prohibits Section 553 relief in chapter 15 proceedings. Awal stated that it was not necessary to resort to legislative history because Section 1523 lacks prohibitory language, and where statutory language is plain, it must be enforced according to its terms.⁴⁸ Regardless, Awal argued that this legislative history only indicates that section 1523's grant of standing is limited to avoidance actions in pending cases under another chapter, and does not try to limit actions that other provisions of the Bankruptcy Code allow.⁴⁹

Awal next contended that the purpose and structure of Chapter 15 requires that the Chapter 15 petition date be used as the reference date for the avoidance action.⁵⁰ Awal stated that other Chapter 15 provisions demonstrate that Chapter 15 is intended by Congress to be integrated with the rest of the Bankruptcy Code and cases commenced under other chapters of the Code.⁵¹ Awal argued that a foreign representative must first obtain Chapter 15 *recognition* before he can commence another case under another chapter (such as one under Chapter 7 or 11) of the Bankruptcy Code.⁵² Awal pointed out that the process of obtaining chapter 15 recognition can be

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 13.

⁵⁰ *Id.* at 15.

⁵¹ *Id.*

⁵² *Id.* at 16.

lengthy,⁵³ and therefore if the date of the subsequently filed chapter 7 or 11 petition were used as the operative reference date, this unavoidable lapse in time between Chapter 15 filing and recognition would inappropriately run out the 90 day look-back period pursuant to Section 553(b).⁵⁴ For even if the foreign representative filed the Chapter 11 petition immediately after Chapter 15 *recognition*, such Chapter 11 petition would probably have been filed well over 90 days after the relevant setoff, and therefore 553(b) action would be unavailable.⁵⁵

Awal next contended that using the Chapter 15 petition date was consistent with other rules applying to multiple petition dates.⁵⁶ Where a case is converted from one chapter of title 11 to another, the conversion does not effect a change in the date of the filing of the petition, commencement of the case, or order for relief.⁵⁷ This is referred to as the “first filed rule”, and Awal argued that its purpose is to maximize the look-back period for avoidance actions.⁵⁸ In addition, Awal pointed out that where concurrent cases are consolidated, the first-filed petition date is again used as a reference date for avoidance actions in order to maximize the look-back period.⁵⁹ Awal asserted that using the Chapter 15 petition date as the reference date for a Section 553(b) action would promote this goal as well.⁶⁰ Given that a foreign representative cannot commence a chapter 11 case until there is chapter 15 recognition, which can be a lengthy process, Awal argued that using anything but the chapter 15 petition date would lead to transfer

⁵³ *Id.* at 17.

⁵⁴ *Id.*

⁵⁵ *Id.* at 18.

⁵⁶ *Id.* at 22.

⁵⁷ 11 U.S.C. § 348(a).

⁵⁸ *In re Awal Bank*, Memorandum in Opp. of Motion to Dismiss Adversary Proceeding, at 23.

⁵⁹ *Id.*

⁶⁰ *Id.*

recipients potentially dodging a meritorious avoidance action that is initiated only after chapter 15 recognition and chapter 11 commencement.⁶¹

Finally, Awal refuted HSBC's contention that the discharge for value rule applies in this situation, arguing that this rule doesn't apply where the complaint alleges that the recipient was on notice of the mistake prior to setoff.⁶² Awal contended that the discharge for value rule is an affirmative defense that HSBC could not properly invoke at the motion to dismiss stage.⁶³ Awal also stated that contrary to HSBC's assertions, the complaint set forth sufficient allegations that HSBC was or should have been aware of the mistaken transfer.⁶⁴ In turn, Awal stated that since HSBC had actual or constructive notice of the mistake, the discharge for value rule was unavailable. The plain terms of the discharge for value rule state that actual or constructive notice of the mistake prevents application of the defense.⁶⁵

IV. Court Rationale

Judge Gropper found Awal's arguments to be more persuasive, concluding first that an avoidance action could be brought in a Chapter 15 case without first instituting a plenary chapter 7 or 11 case, and second that the Chapter 15 petition date was the relevant reference date for the avoidance action. The court determined that the definition of "petition" in 11 U.S.C. § 101(42) expressly includes a chapter 15 petition.⁶⁶ The court cited Awal's argument regarding the conversion of cases, saying that while the filing a new plenary petition is not a conversion since the original chapter 15 case remains open, the principle of preserving the look-back filing date is

⁶¹ *Id.* at 24.

⁶² *Id.* at 26.

⁶³ *Id.* at 27.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ 455 B.R. 73, 88.

“also respected where multiple proceedings regarding the same debtor have been filed.”⁶⁷ The court stated that shortening the look-back period, which would result from using anything but the chapter 15 petition date as the reference date, would lead to two undesirable consequences: (1) it would encourage potential targets of an avoidance action to attempt to run out the look-back period before a plenary petition could be filed by intentionally delaying the chapter 15 recognition process,⁶⁸ and (2) it would limit a foreign representative’s right to undergo a detailed and complete discovery period since each day investigating a potential cause of action would be “another day of the look-back period slipping away.”⁶⁹

V. Conclusion

In re Awal Bank addresses two issues of first impression: (1) whether a section 553(b) avoidance action may be brought in a chapter 15 case without first instituting a plenary chapter 7 or 11 petition, and (2) whether the chapter 15 filing date can be used as the relevant reference date in a section 553(b) action brought in a subsequently filed chapter 11 case. The decision may prove significant because it removes the potential barrier of having first to institute a chapter 7 or chapter 11 case in order to bring a section 553(b) action. As a result, foreign representatives may more easily bring section 553(b) setoff in United States courts. In addition, the court’s emphasis on preserving a longer look-back period is positive news for debtors, as this trend would result in the harmonization of debtor payments while reducing certainty for creditors. The increased uncertainty works to the benefit of debtors because it increases the risk that creditors will not be paid in full (or at all) by debtors.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*