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# Set-off and 'special accounts'

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*The* recent decision in *Bank of America, NA v. Lehman Brothers Holdings, Inc.* (In re Lehman Brothers Holdings Inc., et. al.), No. 08-13555, Adv. Pro. No. 08-01753, 2010 Bankr. LEXIS 3867 (Bankr. S.D.N.Y. Nov. 16, 2010) has shone a 10,000-watt spotlight onto the scope of common law set-off in New York.

Set-off permits one party to apply a debt owed to it by another party to satisfy all or part of a debt that the first party owes to that other party. Set-off is particularly critical to the party seeking to reduce the balance of a debt owed to another party where the other party is insolvent (and owes money to the person who has an obligation to the insolvent other party). In the global economy, set-off and netting are critical to risk management tools and reduce the transaction costs associated with mitigating risk. The right to set off has existed since Roman times (then known as "compensatio") and automatically exists between mutual obligors as a matter of common law.

The court relied heavily on a strained chain of reasoning dating back to 1864 involving a decision that did not directly consider set-off and which drew its reasoning from concepts of bailment. The court divided customer funds maintained with a financial institution into those held in either a "general" account or "special" account. The court started with the general premise that special accounts are not subject to set-off, whereas general accounts can be the subject of set-off.

In the **Bank of America NA** case, two significant financial institutions were each a debtor and a creditor of the other in transactions involving vast sums of money. Bank A, known here as BofA, arranged for Bank B, known here as Lehman Brothers, to deposit $500 million into a deposit account at Bank A; a deposit account is a debt of the depositary bank (Bank A) to its customer (Bank B). Bank B then granted Bank A a security interest in these deposited funds to secure certain specified debts (that is, intraday overdraft liabilities) of Bank B to Bank A. The security agreement did not exclude set-off. In fact, the security agreement preserved "all rights, powers and remedies given to [Bank A] by virtue of any statute or rule of law." No third-party rights or proprietary interests in the deposit account existed. **Lehman Brothers Holdings Inc.** subsequently declared bankruptcy. The court held that the deposited funds were held in a "special" account and thus not available for set-off by Bank A against the amounts that Bank B otherwise owed to Bank A (that is, net termination value debts under hedging arrangements). If set-off had applied, Bank A would have recovered $500 million. Instead, the bankruptcy estate of Bank B was entitled to the $500 million.

We are of the view that set-off is not a doctrine under New York common law that can be simplified by determining whether the account is "special" and hence not subject to set-off -- asking that question just obfuscates the analysis. Rather the proper question is whether a person other than the depositor has a proprietary interest in the account (for example, a beneficiary under a trust where the depositor is the trustee). The court's reliance on the overall commercial context (that is, the "setting matters here and highlights how inequitable it would be for [Bank A] to succeed in improving its position relative to other creditors on account of the circumstances enabling it to exert powerful leverage tied to [Bank B's] cash management practices") is, as a matter of law, incorrect. Anytime a creditor requires collateral from an obligor, the obligor is often faced with a difficult set of choices. Asymmetrical negotiating power is the hallmark of a demand for additional collateral by a creditor. This, however, is not a basis for denying well-established common law rights of set-off. The common law has not previously denied set-off for the supposed inequity identified by the court. Indeed, surely Lehman Brothers, prior to its demise, had a vast number of netting relationships in its favor.The court also relied on the parties' intent supposedly evidenced during negotiations to override the plain language of the security agreement. The fact that the parties did not discuss the issue of set-off and that, under the express terms of the security agreement, Bank A preserved "all rights, powers and remedies given to [Bank A] by virtue of any statute or rule of law" should, alone, have been a sufficient basis for reaching a different conclusion as to the preservation of the automatic right of set-off. The fact that the parties, at the time of negotiation of the security agreement, viewed the account as having the purpose of securing a particular Bank B obligation to Bank A is irrelevant. The parties to an agreement should not have to say everything that they are not doing. As a matter of law, the court should have concluded that the parties did not expressly waive the right of set-off under the security agreement, and hence the self-help remedy of set-off was available to Bank A.

We would argue that precedent and policy support a different and narrower conclusion: If funds deposited in an account are not the subject of a proprietary interest held by a third person, such accounts should properly be subject to set-off unless the parties have expressly waived the right of set-off as a matter of contract.

Set-off is a critical mechanic for the efficient allocation of capital by financial institutions, and this decision adds significant uncertainty where absolute clarity and razor-sharp rules of application are needed.

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