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State Law Preferences Are Alive and Well

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Prior to the enactment of the Bankruptcy Code in the late 1970s, many struggling and insolvent companies relied on state insolvency proceedings to address their financial distress. For example, the states enacted statutes or recognize a common law right permitting a debtor to make an assignment for the benefit of creditors (frequently referred to as an ABC). The laws governing ABCs generally vary by state, including with respect to the recovery of avoidable transfers such as preference claims.

However, with the enactment of the Bankruptcy Code came the emergence of a federal statutory scheme that provides a comprehensive framework for bankruptcy cases—including priority rules for a debtor or bankruptcy trustee when making distributions to creditors and a debtor's or trustee's right to recover avoidable transfers such as prepetition preferences. Bankruptcy cases became the insolvency proceeding of choice for many distressed companies, but still coexisted with state insolvency proceedings like ABCs—generally without conflict.

That is until 2005, when the U.S. Court of Appeals for the Ninth Circuit, in *Sherwood Partners Inc. v. Lycos Inc.*, called into question the coexistence of the Bankruptcy Code and ABCs by holding that the Bankruptcy Code preempted California's ABC law regarding preference claims, Cal. Civ. Proc. Code § 1800 (California Preference Statute).[1] Following *Sherwood*, a number of other courts, including California's state appellate courts, rejected *Sherwood*'s holding and concluded that the Bankruptcy Code's preference statute and ABC preference law could coexist. That said, case law on the subject had been relatively scarce, so whether bankruptcy law preempts ABC preference law remained a very open issue.

However, that is beginning to change with the increased popularity of ABCs as an alternative to bankruptcy in recent years. In 2021, two different and very prominent federal district courts, the U.S. District Court for the District of Delaware (Delaware District Court) and the U.S. District Court for the Southern District of New York (Southern District of New York), joined the ranks of those courts that have rejected *Sherwood* in holding that ABC preference law (namely, California's) is not preempted by the Bankruptcy Code. These decisions are part of an emerging majority in favor of upholding the validity of ABC preference claims.

Background: What Is an ABC?

An ABC is a state law alternative to liquidation under Chapter 7 of the Bankruptcy Code. ABCs are, by and large, far quicker and less expensive than bankruptcy cases—which accounts for their increasing usage recently, particularly among smaller companies.

ABCs are governed by state law and therefore vary by state, unlike Chapter 7, which is uniform nationwide. An ABC is commenced by a contract between the debtor or assignor and a fiduciary, known as the assignee, where the debtor transfers all of its right, title and interest in, and custody and control of, its property to the assignee. The debtor/assignor can be an individual, partnership, corporation or limited liability company. The assignee takes control of the debtor's/assignor's assets to sell or otherwise liquidate them and distribute the proceeds to the debtor's creditors according to priority rules established under state law after reconciling claims filed by creditors in the ABC. Notably, in an ABC, the debtor selects the assignee. This contrasts with Chapter 7, where the Office of the U.S. Trustee (U.S. Trustee) typically appoints a Chapter 7 trustee who takes control of the debtor's estate and assets (or, in rare cases, creditors elect the trustee).

Background: What Is Federal Preemption?

Preemption is an affirmative defense that a defendant in an action bears the burden to prove. The doctrine of preemption essentially provides that the state law must give way to the federal law where state and federal

law irreconcilably conflict with one another. Congress may expressly legislate that certain federal law preempts a related state law. Or, alternatively, preemption can be implied.

There are generally two categories of implied preemption. First, there is *field preemption*, in which "the scheme of federal regulation is so pervasive as to make reasonable the inference that Congress left no room for the states to supplement it." Alternatively, there is *conflict preemption*, in which "compliance with both federal and state regulations is a physical impossibility" or the "state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." In sum, state law will generally be deemed preempted by federal law where the federal interest in a particular area is so dominant that it precludes enforcement of state laws on the same subject. For example, federal law exclusively governs patents, copyrights, currency, national defense and immigration. There are no state laws governing these subjects because they require uniform regulation by the federal government.

That said, state law can coexist with, and even supplement or extend, federal law without conflict. In fact, as some of the court decisions discussed below acknowledged, the federal Bankruptcy Code explicitly recognizes state law creditors' rights and preserves such rights, including with respect to state property exemptions from the bankruptcy estate and state fraudulent conveyance law. State law—such as state preference law—would be preempted only where it is an obstacle to carrying out the purposes of the Bankruptcy Code.

Ninth Circuit Holds Bankruptcy Code Preempts California Preference Statute

In *Sherwood Partners*, the Ninth Circuit ruled that the California Preference Statute is preempted by the Bankruptcy Code. The Ninth Circuit noted that Chapter 7 of the Bankruptcy Code was enacted to: (1) grant an individual debtor a discharge of most indebtedness to provide a fresh start for a debtor, and (2) equitably distribute a debtor's assets among competing creditors. Regarding the first goal, it has been settled by the U.S. Supreme Court that states cannot grant a discharge of debt because a discharge is an integral part of federal bankruptcy law and, therefore, exclusively reserved for Congress. According to the Ninth Circuit, the California Preference Statute is preempted because it implicates (and therefore interferes with) the second goal of equitable distribution of the debtor's assets among its creditors.

The Ninth Circuit noted that preference claims should be subject to the Bankruptcy Code's tougher standards and procedural court-supervised protections that are intended to ensure fair treatment of both debtors and creditors. The laxer state procedures and standards of California's ABC statute arguably circumvent the federally designed bankruptcy process. A bankruptcy trustee has the power to avoid and recover preferences for distribution to creditors. The trustee is not selected by the debtor, but rather is typically appointed by the U.S. Trustee or, on rare occasions, is elected by creditors, to ensure impartiality. In addition, the trustee is supervised by the U.S. Trustee and the bankruptcy court. This is in stark contrast to ABCs, where the debtor handpicks the assignee and, given the concomitant lack or lower degree of supervision over the assignee's activities, there is a risk of an assignee's potential self-dealing or conflict of interest.

The Ninth Circuit's decision that the Bankruptcy Code preempted the California Preference Statute was largely premised on the notion that the California Preference Statute gives ABC assignees *special avoidance powers* beyond those of individual creditors. The Ninth Circuit reasoned that a bankruptcy trustee's avoidance powers under section 544 of the Bankruptcy Code are limited to the powers held by unsecured creditors—such as the right of an individual creditor to avoid fraudulent conveyances under state law. That contrasts with the California Preference Statute under which only an ABC assignee, and not individual creditors, can prosecute a preference action and as such, the assignee is given new *special* avoidance powers "by virtue of his position."[2]

Notably, Ninth Circuit Judge Nelson issued a dissenting opinion thoroughly rejecting the majority holding in the *Sherwood* case. Judge Nelson explained that "state voluntary assignments, by definition, give the assignee more power than may be exercised by an individual creditor…[and b]ecause I believe that voluntary assignments for the benefit of creditors and related statutes are not preempted by federal bankruptcy law, I cannot join the majority opinion." Judge Nelson also expressed grave concern that the majority's opinion has the potential effect of "pushing" corporations facing insolvency towards the more expensive bankruptcy option and away from the less stigmatic and less costly ABC, despite the ability of both systems to "peaceably coexist."

The Trend Against the Ninth Circuit's Preemption Holding

On the heels of Judge Nelson's dissent, multiple courts have rejected the Ninth Circuit's holding in *Sherwood* and held that the California Preference Statute is not preempted by the Bankruptcy Code. In fact, even California state appellate courts have refused to follow the Ninth Circuit's Sherwood preemption ruling despite the fact that the Ninth Circuit includes the federal districts of California.

For example, in its 2006 decision in *Haberbush v. Charles & Dorothy Cummins Family Ltd. P'ship*, the California Court of Appeal held that *Sherwood* stretched preemption too far when the Ninth Circuit ruled that a state law merely "implicat[ing]" the goal of equitable distribution is preempted by the Bankruptcy Code. The *Haberbush* court noted that Congress had intended state laws governing ABCs to coexist with the Bankruptcy Code, and the U.S. Supreme Court had previously held—in 1933, in *Pobreslo v. Joseph M. Boyd Co.*, and in 1918, in *Stellwagen v. Clum*—that ABCs and other state insolvency statutes are not preempted, despite the fact that these statutes clearly implicated the bankruptcy law's goal of equitable distribution. The Haberbush court also flatly rejected the Ninth Circuit's concerns about "special avoidance powers" being granted to an assignee, concurring with dissenting Judge Nelson's view that ABCs necessarily give special powers to assignees and that the Bankruptcy Code's preference statute and the California Preference statute are "virtually identical." The court further observed that the California Preference Statute complements and does not contravene the Bankruptcy Code's goals.[3]

Thereafter, the Delaware Superior Court, in its 2008 decision in *Spector v. Melee Entertainment LLC*, agreed with and deferred to the rationale of California's state appellate courts in addressing whether the California Preference Statute is preempted by the Bankruptcy Code. The Delaware state court echoed the sentiments of Judge Nelson and *Haberbush* that "there is no persuasive reason to conclude that California's less stigmatic, and less costly, voluntary assignment scheme—which, like the federal bankruptcy system, serves to ensure equality of distribution ... stands as an obstacle to ... the full purposes and objectives of the [Bankruptcy Code]."

Similarly, in 2007, the U.S. District Court for the Western District of Wisconsin, in *Ready Fixtures Co. v. Stevens Cabinets*, rejected the Ninth Circuit's holding in *Sherwood*. The *Ready Fixtures* court held that Wisconsin's preference statute is not preempted by the Bankruptcy Code because the Wisconsin statute does not interfere with either the goals or operation of federal bankruptcy law. The *Ready Fixtures* court also noted that the Ninth Circuit was mistaken in placing the goal of equitable distribution on a par with the goal of a bankruptcy discharge. Congress intended federal bankruptcy law to grant a "fresh start" to debtors through a bankruptcy discharge. While Congress also intended that federal bankruptcy law provide a fair method of distributing a debtor's assets, it did not guarantee the creditors' receipt of any particular distributions of assets. Finally, the court concluded that federal bankruptcy law has acknowledged the existence of parallel avoidance powers granted under state and federal bankruptcy law. For example, there are duplicate state and bankruptcy remedies for avoiding and recovering fraudulent transfers, and bankruptcy trustees could assert both remedies. Wisconsin's preference statute duplicates bankruptcy preference law and does not prevent the equitable distribution of the debtor's assets that would otherwise justify the court's invocation of preemption to dismiss the preference action.

The Delaware District Court and Southern District of New York Reject Sherwood

In 2021, two of the more prominent federal district courts in the country—the Delaware District Court and Southern District of New York—issued opinions rejecting *Sherwood*, further solidifying an emerging majority view that the Bankruptcy Code does not preempt state preference law.

The Southern District of New York, in *Insolvency Services Group, Inc. v. Samsung Electronics America, Inc.*, held that the Bankruptcy Code does not preempt the California Preference Statute. The court noted that the California Preference Statute is "virtually identical" to the Bankruptcy Code's preference avoidance provisions and the Bankruptcy Code expressly makes state law avoidance claims available to a trustee in bankruptcy cases. Therefore, the two schemes "work in tandem" and the California Preference Statute does not conflict with the Bankruptcy Code.

Similarly, in *Insolvency Services Group, Inc. v. Comcast Cable Communications, LLC*, the Delaware District Court rejected the Ninth Circuit's *Sherwood* ruling and held that the Bankruptcy Code does not preempt the California Preference Statute because the California Preference Statute does not create an "unavoidable conflict" with the Bankruptcy Code. The Delaware District Court reached its decision after analyzing the aforementioned decisions and heavily relying on Judge Nelson's dissent in *Sherwood*. Like prior courts, the Delaware District Court noted that the U.S. Supreme Court had previously upheld ABC laws and reasoned that *Sherwood* ran afoul of this Supreme Court precedent because its rationale would lead to the preemption of *any* law governing ABCs. The court emphasized that voluntary ABCs, including their preference laws, "can work together with federal bankruptcy law to protect creditors and ensure equality of distribution" and the California Preference Statute "complements, rather than hinders, bankruptcy's goal of ensuring equitable distribution."

Conclusion

Now that the U.S. District Courts in Delaware and the Southern District of New York have weighed in, it is becoming increasingly clear that preference claims asserted in ABCs are not preempted by the Bankruptcy Code. It will be very interesting to see if this trend continues because ABCs have become an increasingly popular alternative to bankruptcy. Unless bound by Ninth Circuit precedent,[4] courts that address this issue in the future are more likely to fall in line with the emerging majority view that state law preference claims are not preempted by the Bankruptcy Code. Nonetheless, creditors that are sued or threatened with liability under state preference law should raise federal preemption as a defense to the preference claim as part of their preference defense toolkit since the law remains unsettled.

1 California's preference law, set forth in California Code of Civil Procedure §1800, states as follows:

> [T]he assignee of any general assignment for the benefit of creditors . . . may recover any transfer of property of the assignor that is all of the following:
>
> (1) To or for the benefit of a creditor.
>
> (2) For or on account of an antecedent debt owed by the assignor before the transfer was made.
>
> (3) Made while the assignor was insolvent.
>
> (4) Made on or within 90 days before the date of the making of the assignment . . .
>
> (5) Enables the creditor to receive more than another creditor of the same class.

2 The Ninth Circuit distinguished the U.S. Supreme Court's 1918 decision in *Stellwagen v. Clum*, where the Supreme Court upheld a statute that allowed a state trustee to recover preferential transfers, but the avoidance power granted by the statute "was one that could have been exercised by any creditor."

3 The California Court of Appeal also rejected Sherwood's holding in its 2006 decision in *Credit Managers Ass'n. of California v. Countrywide Home Loans Inc.* on essentially the same reasoning as it did in Haberbush.

4 Federal courts in California have held that the Bankruptcy Code preempts state preference law, largely (if not entirely) because these courts are bound to follow Ninth Circuit precedent in Sherwood. See, e.g., *Windmill Health Products, LLC v. Sensa Products* (2015 decision, U.S. District Court, Northern District of California); I*nsolvency Services Group, Inc. v. Federal Express Corporation* (2014 decision, U.S. District Court, Central District of California); *Development Specialists, Inc. v. Shedrain Corporation* (2012 decision, U.S. District Court, Central District of California).