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BANKRUPTCY LAW

The End of State Law Preference Actions?

Ninth Circuit decision could impact debtors' use of state court insolvency proceedings

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The United States Court of Appeals for the Ninth Circuit recently addressed whether state law preference actions are pre-empted by federal bankruptcy law. *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198 (9th Cir. 2005), cert. denied, 126 S.Ct. 397 (2005). The Ninth Circuit's decision limits the ability of an assignee in an assignment for the benefit of creditors proceeding to maximize creditor recoveries by precluding the assignee from recovering preferential transfers. The *Sherwood Partners* decision, if adopted by other circuits, could have a material impact on a debtor's decision to choose a state court insolvency proceeding as an alternative to a federal bankruptcy action.

In *Sherwood Partners*, Thinklink Corp. and Lycos, Inc., had an agreement governing the promotion of certain uni-

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fied messaging services on Web sites Lycos operated. The agreement provided for Lycos to promote Thinklink's messaging services exclusively for two years in exchange for certain payments. Thinklink defaulted on its payments under the agreement.

Lycos continued to promote Thinklink's messaging services, but the parties subsequently restructured the agreement to shorten the exclusive period, reduce the remaining payments required by the agreement, and provide stock to Lycos. Thinklink made the required \$1 million payment, but did not provide the stock to Lycos. Two months after the agreement was restructured and the payment to Lycos was made, Thinklink made a voluntary general assignment for the benefit of creditors to Sherwood Partners, Inc. as assignee.

An assignment for the benefit of creditors is a contract under which the assignor (the debtor) transfers all its right, title, interest in, and custody and control of its property to a third-party assignee in trust. The assignee's charge is to liquidate the property and distribute the proceeds to the assignor's creditors. The assignee is chosen by the assignor, usually without creditor input, and is not subject to the same levels of court supervision as a trustee in a federal bankruptcy proceeding. Troubled companies that opt to make assignments for the benefit of creditors do so as a

more economical and efficient alternative to bankruptcy liquidations.

In *Sherwood Partners*, the assignee closed Thinklink's business and began liquidating its assets. The assignee sued Lycos in the California state court under Cal. Code Civ. Proc. § 1800 (Section 1800) to recover the \$1 million payment. Section 1800 allows an assignee to avoid and recover for the benefit of all creditors certain preferential transfers made to other creditors pre-assignment. The elements of a Section 1800 claim are substantially similar to the elements of Section 547(b) of the Bankruptcy Code. The fiduciary specifically must prove the existence of: (1) a transfer to a creditor or for the creditor's benefit; (2) on account of an antecedent debt owed by the assignor; (3) made while the assignor was insolvent; (4) made on or within 90 days before the date of the assignment for benefit of creditors (or within one year, if the transfer was to or for the benefit of an insider); (5) enabling the creditor to receive more than other creditors of the same class. *Sherwood Partners*, 394 F.3d at 1200.

Lycos removed the action to the federal district court on diversity grounds and moved to dismiss. Lycos argued Section 1800, authorizing the avoidance and recovery of preferential transfers, was pre-empted by federal bankruptcy law that provides the same power to a bankruptcy trustee. The dis-

district court denied the motion and subsequently granted summary judgment in the assignee's favor. *Sherwood Partners*, 394 F.3d at 1200. On appeal, the Ninth Circuit remanded to the district court with instructions to dismiss the complaint. *Sherwood Partners*, 394 F.3d at 1206.

The Ninth Circuit began its analysis by examining whether Congress intended for federal bankruptcy law to pre-empt state law insolvency proceedings. *Sherwood Partners*, 394 F.3d 1200-01. The court determined "there can be no doubt that federal bankruptcy law is 'pervasive' and involves a federal interest 'so dominant' as to 'preclude enforcement of state laws on the same subject'— much like many other areas of congressional power listed in Article I, Section 8 of the Constitution." *Sherwood Partners*, 394 F.3d 1201. The court also recognized, however, that federal bankruptcy law and state insolvency proceedings coexist peaceably, with federal law often expressly incorporating state laws regulating the rights and obligations of debtors. *Sherwood Partners*, 394 F.3d 1201. The Ninth Circuit accordingly framed the issue as whether Section 1800 was "merely another creditor rights provision of the kind that is tolerated by the Bankruptcy Code, or whether it gives the state assignee powers that are within the heartland of bankruptcy administration." *Id.*

The Ninth Circuit concluded that Section 1800 impermissibly duplicates a bankruptcy trustee's ability to avoid preferential transfers pursuant to 11 U.S.C. § 547 and intrudes upon a major goal of federal bankruptcy law: the equitable distribution of the debtor's assets among creditors. *Sherwood Partners*, 394 F.3d at 1204-05. The Ninth Circuit determined that by providing special powers to an assignee that are unavailable to a debtor's gener-

al unsecured creditors, Section 1800 conflicts with federal bankruptcy law. *Sherwood Partners*, 394 F.3d at 1202.

In reaching that conclusion, the court examined 11 U.S.C. § 544(b), which allows a bankruptcy trustee to assert the same rights as an unsecured creditor under "applicable law" to avoid certain transfers of debtor property. *Sherwood Partners*, 394 F.3d at 1202-03. The court noted the Bankruptcy Code's definition of "creditor" did not include or encompass an assignee and therefore would not empower a bankruptcy trustee to exercise the rights of an assignee under state law. Rather, the court noted that assignees are included within the Bankruptcy Code's definition of "custodians" and "instead of being by their nature creditors, stand in a certain fiduciary relation to creditors." *Sherwood Partners*, 394 F.3d at 1202. Consequently, the court found that a right, power or privilege conferred upon an assignee under state law, but not available to general unsecured creditors, is pre-empted by federal law, even where the right otherwise is consistent with federal law. *Id.*

In view of the *Sherwood Partners* decision, an assignee in the Ninth Circuit can no longer accomplish what a trustee in bankruptcy can achieve, i.e., the avoidance and recovery of preferential transfers for the benefit of all unsecured creditors. The unavailability to the debtor's estate of preference recoveries in Ninth Circuit states undoubtedly will factor into the decision of a distressed entity as to the forum in which to conduct its liquidation. Many corporations choosing between a bankruptcy proceeding and a state court alternative may choose the latter because of the ability to insulate certain transfers to creditors from avoidance and recovery by an assignee as preferences. Conversely, creditors of insolvent corporations in those jurisdictions may

more often elect to file an involuntary bankruptcy to replace an assignee with a bankruptcy trustee armed with the power to avoid preferential transfers for the benefit of all unsecured creditors.

If the *Sherwood Partners* rationale is adopted by courts in the Third Circuit, the use of state court insolvency and receivership proceedings as an alternative to federal bankruptcy proceedings similarly will be affected. New Jersey, for example, has two specific statutes that provide for the ability of entities to avoid and recover preferential transfers. New Jersey's assignment statute, N.J.S.A. 2A:19-1 et seq., gives an assignee the ability to avoid and recover preferential transfers from creditors. Similarly, N.J.S.A. 14A:14-1, et seq., commonly referred to as the Receivership Act, gives a court-appointed receiver the power, among other things, to avoid and recover preferential transfers from creditors of an insolvent corporation.

Both statutes fail to provide to creditors in general the right to avoid and recover preferential transfers, reserving that power solely for the assignee or receiver. In addition, both statutes provide for a four-month look-back period to examine transfers of debtor property, which is inconsistent with the 90-day period provided by federal bankruptcy law. Those statutes therefore are vulnerable to a pre-emption argument under the reasoning of *Sherwood Partners*.

The United States Supreme Court declined to review the *Sherwood Partners* decision. Accordingly, it remains uncertain how jurisdictions outside the Ninth Circuit will confront this important issue. It is certain, however, that defendants in state law preference actions throughout the country will seek to capitalize on the *Sherwood Partners* decision to avoid liability. ■