State Law Preference Actions: Still Alive after *Sherwood Partners v. Lycos*

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Last in Line

Serious doubt was cast on the ability of an assignee for the benefit of creditors to use underlying state law to prosecute avoidance actions by the Ninth Circuit Court of Appeals' decision in *Sherwood Partners v. Lycos Inc*.[1] In the decision's immediate aftermath, many wondered whether assignments and other nonbankruptcy proceedings were in jeopardy and few doubted that the era of state-conferred preference avoidance rights was over. However, as time has passed, the chorus of dissent has grown louder, turning the question of sustained viability onto *Sherwood Partners* itself.

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In *Sherwood Partners* a divided panel of the Ninth Circuit Court of Appeals invalidated California's preference law, which grants to assignees for the benefit of creditors the power to avoid preferential transfers to the assignor's creditors.[2] That law was preempted by the Code, according to the Ninth Circuit, for a variety of reasons. Foremost among these reasons were the Code's twin goals of "(1) giving the individual debtor a fresh start by giving him a discharge of most of his debts; and (2) equitably distributing a debtor's assets among competing creditors."[3]

The court correctly described the states' inability, because of preemption, to provide for a discharge of indebtedness. Without citation to authority, the court then expanded this precedent: "What goes for state discharge provisions also holds true for state statutes that implicate the federal bankruptcy law's other major goal, namely equitable distribution."[4] Continuing, the court stated: "Federal bankruptcy law seeks to avoid this scenario [of a 'mutually destructive feeding frenzy by creditors'] by 'creating a whole system under federal control designed to bring together and adjust all of the rights and duties of creditors and embarrassed debtors alike.'"[5] California's preference statute, the court determined, was inconsistent with this federal scheme and stood as an obstacle to a bankruptcy trustee's ability to carry out that scheme.

In support of its holding, the *Sherwood Partners* court reasoned that the Code provides a trustee no mechanism to enforce the California statute, which is available only to assignees and not to creditors and that the trustee could not recover funds once they had been collected from the preferred creditors and distributed by the assignee *pro rata*. The court also frowned on the manner in which the California statute altered the incentives for creditors to commence involuntary bankruptcy proceedings against the debtor once an assignment had been made. Of equal concern to the court was that the powerful device of preference avoidance was granted to the assignee who, unlike a bankruptcy trustee, is selected by the debtor, diminishing the impartiality that the Code intends for the protection of creditors.

Reaction to, and criticism of, the *Sherwood Partners* majority opinion was immediate, beginning with Judge Nelson's dissent. Of significant concern to Judge Nelson was the potentially broad reach of the decision's holding:

> [T]he reasoning by which the majority reaches this result would preempt any number of state laws governing voluntary assignments for the benefit of creditors because those laws have the affect of altering the incentives of various affected parties to initiate bankruptcy proceedings. Under the majority's reasoning, any state statutory scheme, including those governing voluntary assignments for the benefit of creditors, that "give[s] state assignees or trustees avoidance powers beyond those that may be exercised by individual creditors trench[es] too close upon the exercise of the federal bankruptcy power."[6]

The dissent concluded with the following:

> [W]hen the majority's reasoning is carried to its logical extension, it has the effect of punishing corporations threatened with insolvency from the less stigmatic, and less costly, voluntary assignment scheme into the world of federal bankruptcy. This should not have to be the case... That voluntary assignments are incorporated into bankruptcy law, and that they have existed alongside bankruptcy law since inception without causing interference with the goal of equitable distribution, supports my conclusion that state voluntary assignments and the laws that effectuate them, should not be preempted by bankruptcy law.[7]

Commentators were quick to weigh in on the *Sherwood Partners* decision and many of them shared, or at least acknowledged, Judge Nelson's concern that the decision's holding could be far-reaching.[8] One commentator, Alan Feld,

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1 394 F.3d 1198 (9th Cir. 2005), *cert. denied*, 546 U.S. 927 (2005).

2 California Code of Civil Procedure §1800.

3 *Sherwood Partners*, 394 F.3d at 1203.

4 *Id.*

5 *Id.* at 1204 *quoting In re Hoskins*, 102 F.3d 311, 316 (7th Cir. 1996), and *MSR Exploration Ltd. v. Meridian Oil Co.*, 74 F.3d 910, 914 (9th Cir. 1996).

6 *Sherwood Partners*, 394 F.3d at 1206 (Nelson, J. dissenting) (*quoting id.* at 1205).

7 *Id.* at 1208.

took issue with the *Sherwood Partners* majority's understanding of the historical relationship between bankruptcy and assignments:

> In *Sherwood*, Judge Alex Kozinski...concluded that the Bankruptcy Code preempts the preference avoidance portion of California's assignment for the benefit of creditors statute. In reaching this conclusion, Judge Kozinski discussed and relied on three Depression-era cases decided by the U.S. Supreme Court, namely *Stellwagen v. Clum*, *International Shoe Co. v. Pinkus* and *Pobreslo v. Joseph M. Boyd Co.* Although these cases have been called "murky," they stand for the proposition that discharge is the limit of preemption, a unifying theory not previously offered. Because of this, preference statutes that supplement voluntary assignments generally survive preemption. Accordingly, *Sherwood* must be viewed as wrongly decided.[9]

In support of his conclusion, Feld undertakes a detailed examination of cases tracing back to the early years of the Bankruptcy Act of 1898. He also touches on, but does not fully develop, an important corollary to the historical view of preemption: The Code itself has long expressed an acceptance of nonbankruptcy alternatives and expressly permits deference to those alternatives under appropriate circumstances. As Feld notes, both Code §303(h)(2) (involuntary petitions) and §543(b)(1) (turnover of property) create exceptions for state proceedings that are at least 120 days old at the time the bankruptcy petition is filed, with the latter applying specifically to assignments.[10]

Abstention is another means of deference to ongoing nonbankruptcy proceedings. The 1978 revision to the Code codified abstention at §305 and is explained as appropriate where, for example:

> An arrangement is being worked out by creditors and the debtor out of court, there is no prejudice to the rights of creditors in that arrangement, and an involuntary case has been commenced by a few recalcitrant creditors to provide a basis for future threats to extract full payment. The less expensive out-of-court workout may better serve the interests in the case.[11]

Although pre-1978 law was silent on whether the bankruptcy court could refrain from exercising jurisdiction, as it can now under §305, it was generally understood that courts held the equitable power to dismiss an involuntary petition when it was in the parties' best interests to do so.[12] Moreover, whether under pre-1978 dismissal or post-1978 abstention, the considerations taken into account are largely the same.

In 1933, for example, the Tenth Circuit decided on *International Shoe Co. v. Smith-Cole Inc.*,[13] in which a receiver sold the debtor's assets and made a 25 percent distribution to creditors. One such creditor, citing its policy of accepting payments only through bankruptcy, refused the payment and commenced an involuntary bankruptcy against the company. The creditor argued that it had an absolute right to make the petition and that the court had no authority to consider the equities or balance the various parties' interests.

The court disagreed, describing the case as one devoid of substance. Declining to answer the question of whether the petitioning creditor's refusal of payment would render all other creditors "recipients of an illegal preference,"[14] the court was most concerned with the practical effect of allowing the bankruptcy to proceed:

> [T]he immediate result will be extended litigation in many states, with no object in view except the satisfaction of vindicating [the creditor]'s business policy. It is apparent that this slender estate would shortly be exhausted in such extensive litigation. The proceeds of the sale, instead of going to appellant and the other creditors, would go to officers of the bankruptcy court and their counsel. The long and short of the matter is that this proceeding is aimed at a dissipation, and not the conservation, of the estate of [debtor].[15]

Some 50 years later, the court in *In re Artists' Outlet Inc.*[16] cited to *International Shoe Co. v. Smith-Cole* in applying §305 and declining jurisdiction over a case in which, pursuant to an assignment for the benefit of creditors, the debtor's assets had already been liquidated when the involuntary petition was filed. Recognizing that its "first consideration is economy and efficiency of administration,"[17] the bankruptcy court determined that the expenses of the bankruptcy "would deplete the already minimal assets of the estate," thus prejudicing creditors and defeating the purpose of §305.[18]

The presence of a nonbankruptcy alternative remains an important consideration for courts considering abstention,[19] which makes a portion of the *Sherwood Partners* reasoning difficult to understand. Recall that court's concern that if an assignee "recovers a preferential transfer and distributes its proceeds to creditors, this will preclude a federal trustee from recovering the same sum" if a bankruptcy case is commenced.[20] What the *Sherwood Partners* court overlooks in its hypothetical, however, is that the main obstacle facing the bankruptcy trustee is a motion to abstain because, if assets have been distributed, then the assignment is nearly complete.[21] The same would be true where the assignee acted pursuant to a preference statute that

8 *See, e.g.*, Nathan, Bruce S., "Sherwood Partners Threatens Viability of State Law Preference," 24 Am. Bankr. Inst. J. 4, 66 (May 2005) (decision could "virtually eliminate" assignee preference actions in states within the Ninth Circuit); Crabbe, Deborah A., "Preemption and the Bankruptcy Code: Lessons from Sherwood Partners," 24 Am. Bankr. Inst. J. 5, 63 (June 2005) (decision "casts a large shadow over" state alternatives to bankruptcy).

9 Feld, Alan J., *The Limits of Bankruptcy Code Preemption: Debt Discharge and Voidable Preference Reconsidered in Light of Sherwood Partners,* 28 Cardozo L. Rev. 1447, 1451-52 (2006) (footnotes and citations omitted).

10 *Id.* at 1457-58.

11 H.R. Rep. 95-595, 1978 U.S.C.C.A.N. 5963, 6281 (1977).

12 Shortly after the enactment of §305, but in a case to which the pre-1978 Act applied, the Seventh Circuit expressly held that this equitable power of dismissal existed. *In re Bailey's Beauticians Supply Co.*, 671 F.2d 1063 (7th Cir. 1982).

13 62 F.2d 972 (10th Cir. 1933).

14 *Id.* at 974.

15 *Id.*

16 25 B.R. 231 (Bankr. D. Mass. 1982).

17 *Id.* at 233 (citations omitted).

18 *Id.*

19 *See, e.g., In re Cincinnati Gear Co.*, 304 B.R. 784 (Bankr. S.D. Ohio 2003).

20 *Sherwood Partners*, 394 F.3d at 1204.

21 It should be noted that most states that have statutory support for assignments, also have a provision by which creditors are to be given notice of the assignment and a timeframe within which to file claims. In most instances, the notice period is greater than the 120-day period where a bankruptcy court has discretion to take jurisdiction of a case under §543. Therefore, if an assignee has already made a distribution to creditors, it is likely to be after the passage of the first 120 days from the making of the assignment, eliminating the court's ability to retain jurisdiction of the involuntary case.

Sherwood Partners would approve, *i.e.*, one in which creditors are also empowered to avoid preferential transfers. Indeed, except for the means by which assets come into the hands of the assignee, the *Sherwood Partners* hypothetical bears a striking resemblance to the 1933 decision in *International Shoe Co. v. Smith-Cole Inc.*

Sherwood Partners likewise does not explain why, as a matter of policy, an assignee's distribution *ought* to be undone when it is funded by preference recoveries; the court's concern is only that the undoing is not possible. The omission is an important one. After all, a central premise of the decision is that states may not lightly interfere with the bankruptcy's goal of orderly and equitable distribution, just as they may not provide for a discharge of indebtedness. Had the court discussed the policy implications of its hypothetical, it would have been forced to reckon with its own paradoxical reasoning: "To protect bankruptcy's distributional goals, the trustee must have the power to disrupt the distribution already made to creditors."

Correlatively, *Sherwood Partners* discounts, as the dissent points out, the possibility that the creditor body might prefer an assignment over a bankruptcy, not because someone else's ox is being gored,[22] but because the assignment would be a more efficient and less costly means of marshalling, liquidating and distributing a debtor's assets. In the wake of the "dot com" bust, for example, nonbankruptcy alternatives, especially general assignments, became a highly utilized and accepted choice.[23] Even assuming that creditors share the *Sherwood Partners* court's belief that the Code's safeguards make the bankruptcy trustee the better fiduciary for pursuing preference avoidance,[24] evidence suggests that those creditors are willingly trading those safeguards for the expediency and efficiency that assignments offer.

At a broader level, when the jurisprudence of abstention and dismissal is placed alongside the policy concerns articulated by the *Sherwood Partners* dissent and the longstanding "peaceable co-existence" of assignments and bankruptcy discussed by Feld and others, the *Sherwood Partners* decision becomes even harder to justify.

Cases decided since *Sherwood Partners* have amplified the discussion of its weaknesses. Not long after the *Sherwood Partners* decision was handed down, two California appellate courts were given the opportunity to evaluate the Ninth Circuit's reasoning and to determine whether its holding should be applied in the state courts.[25] In the first case, *Haberbush v. Charles and Dorothy Cummins Family Ltd. Partnership*,[26] the court summarized its many disagreements with *Sherwood Partners* by stating that, "*Sherwood Partners* reaches too far in suggesting that any state statute that 'implicate[s]' the federal bankruptcy law's second major goal of equitable distribution is preempted."[27] The *Haberbush* court opined that *Sherwood Partners* did not properly take account of the long history of assignments and their "peaceable co-existence" with the federal government's exclusive right to enact bankruptcy laws or of long-standing Supreme Court precedent upholding state enactments that, under *Sherwood Partners*, would be called into question.

Haberbush also questioned the Ninth Circuit's reliance on whether a state statute may alter the incentives in deciding whether to file a petition under the Bankruptcy Code. That reasoning, according to *Haberbush*, misses the point:

> The only pertinent question is whether the state statute's effect on those incentives somehow interferes with or is an obstacle to the Bankruptcy Code's objective of equitable distribution. In our view, the *Sherwood Partners* majority provides no cogent explanation of how the assignee's avoidance powers conflict with that objective.[28]

In the end, *Haberbush* rejected *Sherwood Partners* in *toto*, a conclusion that was soon echoed in *Credit Managers Association of California v Countrywide Home Loans*.[29] After making clear that *Sherwood Partners* is not binding authority on the California state courts,[30] the *Countrywide* court largely restated the reasoning of its sister court in *Haberbush* and likewise held that California's preference statute is not, in fact, preempted by the Code.

The rejection of *Sherwood Partners* has recently extended beyond California and the Ninth Circuit, with two federal district courts in Wisconsin weighing in on the preemption issue. The first of these cases is the unpublished decision in *APP Liquidating Co. v. Packaging Credit Co. LLC*,[31] in which the court found the *Sherwood Partners* reasoning to be "unpersuasive."[32]

APP Liquidators took issue with the *Sherwood Partners* court's conclusion that an assignee's power to avoid preferential transfers in state proceedings interferes with the bankruptcy's objective of protecting creditors by ensuring equitable distribution among them. The court observed that Wisconsin's assignment scheme, including its preference statute, serves the very same purpose. Accordingly, it is difficult "to see how a preference recovery scheme that assists in equitable distribution to creditors somehow interferes with the federal bankruptcy law's identical goal of equitable distribution."[33]

Drawing from the *Sherwood Partners* dissent, the *APP Liquidators* court also expressed its concern that the Ninth Circuit's reasoning could extend beyond a state preference statute, reaching generally the laws underlying assignments for the benefit of creditors:

> [T]he *Sherwood* dissent correctly posits that the reasons to strike down a preference provision are generaly equally applicable to voluntary assignment laws. The court in *Sherwood* explained that voluntary assignment laws, unlike preference provisions, do not create new rights for the assignee or receiver that do not already belong to the debtor or creditor. Yet the powers granted to an assignee in voluntary assignment laws are necissarily greater than any one creditor or debtor. A state assignee or receiver, even if there is no preference provision, exercises powers on behalf of all creditors, thus exercising powers greater than any one creditor could exercise. Accordingly, the court agrees with the *Sherwood*

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22 *See Sherwood Partners*, 394 F.3d at 1205.

23 *See* Mann, Ronald J., *An Empirical Investigation of Liquidation Choices of Failed High-Tech Firms,* 82 Wash. U.L.Q. 1375 (2004).

24 Interestingly enough, a 1995 survey on preferences conducted by the ABI suggests that creditors have less confidence in the bankruptcy regime as did the *Sherwood Partners* majority, insofar as preferences are concerned: "A widely-expressed criticism focused on the perceived coercive nature of many preference actions, with the preference defendant feeling pressured by economic and logistical concerns to settle claims of dubious validity. Based on these responses, one could fairly ask whether all of this preference litigation is 'worth the candle.'" Charles Jordan Tabb, Reporter, Preference Survey Report (ABI Bankruptcy Reform Study Project) (May 1997).

25 *Sherwood Partners* is not binding on state courts within the Ninth Circuit or on any federal courts in other circuits. The decision is binding precedent only on the lower federal courts within the Ninth Circuit.

26 139 Cal. App. 4th 1630 (Cal. App. 2d Dist. 2006).

27 *Id.* at 1637 *quoting Sherwood Partners*, 394 F.3d at 1203.

28 *Haberbush*, 139 Cal. App. 4th at 1639.

29 144 Cal. App. 4th 590 (Cal. App. 4th Dist. 2006).

30 *Id.* at 598.

31 2006 U.S. Dist. LEXIS 60195 (E.D. Wis. Aug. 24, 2006).

32 *Id.* at *6.

33 *Id.* at *7.

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> dissent that the arguments to invalidate a preference provision are equally applicable to voluntary assignment laws, generally.[34]

Such a result would be in conflict with the Supreme Court cases that long ago upheld state assignment schemes that "generally act in harmony with the purpose of the federal Bankruptcy Code to equitably distribute assets to competing creditors."[35] The court added: "Preference provisions and voluntary assignment laws merely effectuate that purpose and are perfectly legitimate."[36]

The second Wisconsin case, *Ready Fixtures Co. v. Stevens Cabinets*,[37] flatly rejected the soundness of *Sherwood Partners*, stating that its problems are "manifold."[38] Among these problems was the Ninth Circuit's error in equating the bankruptcy goals of a fresh start for debtors and equitable distribution to creditors: "Although Congress surely intended that bankruptcy provide a fair means of distributing assets, the focus of the Code is on debtors, not creditors."[39] Relying on Supreme Court authority, the *Ready Fixtures* court points out that bankruptcy's "principal purpose" is "not to guarantee that creditors receive particular distributions of assets," but to afford a fresh start to the honest, but unfortunate, debtor.[40]

The *Ready Fixtures* court adds that *Sherwood Partners* could actually lead to a contravention of the very goals that case relied on in holding that California's preference statute was preempted by the Code:

> Wisconsin insolvency proceedings provide debtors with an efficient, inexpensive way to liquidate their remaining assets equitably among their creditors. Within that system, [Wisconsin's preference statute] provides receivers with a means of insuring that no one creditor gets more than his fair share of a debtor's estate. Although Wisconsin law gives receivers slightly more power to recover preferential transfers than the Bankruptcy Code gives trustees,[41] those differences do not prevent the "equitable distribution" of the debtor's assets in a manner that would justify rendering the state procedure inoperable. To find that the state statute is preempted would force insolvent debtors always to file for bankruptcy, even when simpler, less expensive state proceedings are available to them. That result is ahistorical and, if anything, *undermines* the Bankruptcy Code's focus on protecting (rather than exploiting) the debtor.[42]

The same can be said of creditors as well, for it is they who ultimately bear the additional costs that a bankruptcy may entail.

It remains too early to tell whether there is a decided trend away from the *Sherwood Partners* holding.[43] However, the post-*Sherwood Partners* cases and commentary have certainly lessened the decision's initial impact and eased fears that state-granted preference avoidance powers—and, possibly, assignments and other nonbankruptcy proceedings—were threatened with extinction. ■

34 *Id.* at *7-8 (citations and quotations omitted).
35 *Id.* at *8 *citing Pobreslo v. Boyd*, 287 U.S. 518, 526 (1933).
36 *Id.* at *8.
37 488 F. Supp. 2d 787 (W.D. Wis. 2007).
38 *Id.* at 790.
39 *Id.* at 791.
40 *Id. citing Marrama v. Citizens Bank of Massachusetts*, ____ U.S. ____, 127 S. Ct. 1105, 1107 (2007).
41 Wisconsin's preference statute allows avoidance of transfers made up to four months before the date that an assignment or a petition for the appointment of a receiver is made. *Id.* at 789.
42 *Ready Fixtures*, 488 F. Supp. 2d at 791.
43 There is a third decision out of Wisconsin reaching the same result as *APP Liquidators* and *Ready Fixtures. BDI Liquidating Co. v. Quest Graphic LLC*, 2007 U.S. Dist. LEXIS 63902 (E.D. Wis. Aug. 29, 2007). However, that decision, which is very short, merely agrees with the reasoning and adopts the holdings of the prior two Wisconsin cases. It does not discuss *Sherwood Partners.*

6 For more on the work of the Fee Study, *see* Bowles and Lubben, Fee Study.