

Are State Preference Laws Preempted by the United States Bankruptcy Code? Not Necessarily!

*By: Bruce S. Nathan &
Scott Cargill*

Abstract

For decades, there has been scant legal discussion about the coexistence of the federal bankruptcy and state insolvency systems as independent options for a financially distressed debtor to liquidate its assets. Chapter 7 of the Bankruptcy Code provides a very developed framework for the liquidation of a debtor's assets, the priority rules governing the payment of creditors' claims, and a bankruptcy trustee's right to recover avoidable transfers, such as preferences. However, for most of this country's history, long before passage of the Bankruptcy Code nearly 30 years ago, the states have recognized the common law right of a debtor to make an assignment for the benefit of creditors (an "ABC"). States have varying laws that govern the operation of ABCs, including the right of an ABC fiduciary to recover preferential transfers.

*Until January 2005, the prevailing view was that, with limited exceptions, the state law ABC process and the Bankruptcy Code existed without conflict. That is why the decision of the United States Court of Appeals for the Ninth Circuit, in *Sherwood Partners Inc. v. Lycos Inc.*, caught many by surprise. The Ninth Circuit held that the Bankruptcy Code preempted the provisions of the California ABC law relating to preference claims. The implications of the *Sherwood Partners* decision are wide ranging, putting into question the long standing assumption about the coexistence of the preference provisions of ABC laws and the Bankruptcy Code. Further exploring these preemption issues, in June 2007, the United States District Court for the Western District of Wisconsin, in *Ready Fixtures Co. v. Stevens Cabinets*, denied the creditor's motion to dismiss a preference action under Wisconsin's ABC statute. The court declined to follow the Ninth Circuit's decision in *Sherwood Partners* and held that the Bankruptcy Code does not preempt the preference provisions of Wisconsin's ABC statute. These, and other conflicting opinions, have the potential for causing confusion in the area of ABC law and the defenses an ABC preference defendant can assert in different jurisdictions.*

Overview and Purpose of an ABC

An ABC is an alternative means of liquidating a financially troubled debtor, instead of a liquidation under chapter 7 of the Bankruptcy Code. An ABC is governed by state law, either by

common law or statute. ABCs, unlike chapter 7 cases, are not uniform nationwide. Each state has different ABC procedures. Some states, like California, have a modern ABC statute that has led to widespread use of ABCs, while other states, like New York, have an older, more antiquated, less used ABC statute.

As a general proposition, an ABC is a contract under which a debtor transfers all of its right, title and interest in, and custody and control of, its property to a third party assignee, to be held in trust. The debtor/assignor can be an individual, partnership, corporation, or limited liability company. An ABC is designed to be a quicker, less expensive, method of liquidation than a chapter 7 bankruptcy case. In an ABC, the debtor selects the assignee. The assignee is charged with liquidating the debtor's property and distributing the proceeds to the debtor's creditors according to priorities established under state law. Creditors usually must file a proof of claim to participate in an ABC and the assignee is responsible for reconciling and, if necessary, objecting to claims. A trustee under the Bankruptcy Code, unlike an assignee, is usually selected by the United States Trustee, an arm of the United States Department of Justice, except in rare cases, when creditors elect the trustee.

Understanding the Doctrine of Federal Preemption

Central to the differing outcomes of the *Sherwood Partners* and *Ready Fixtures* cases is an understanding of how the courts have interpreted and applied the federal preemption doctrine. According to the preemption doctrine, whenever state and federal law conflict, state law must give way to federal law. Preemption of state law by federal law is generally found to exist where the federal interest in a particular area is so dominant that it precludes enforcement of state laws on the same subject. By way of 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.

However, just because state and federal law may regulate the same activity does not necessarily mean the state law is preempted and invalid. Often state law can coexist with, and even supplement or extend, federal law without conflict. Indeed, the Bankruptcy Code itself includes numerous provisions where a creditor's state law rights are preserved under the federal bankruptcy law, such as state property exemptions from the bankruptcy estate and state fraudulent conveyance law. However, state law must yield to federal law where state law becomes an obstacle to carrying out the purposes and objectives that Congress had intended. The issue in both *Sherwood Partners* and *Ready Fixtures* ultimately turned upon whether a state's ABC procedures governing preference claims were an obstacle to carrying out the purposes and objectives that Congress had intended by enacting the Bankruptcy Code.

Factual Context of the *Sherwood Partners* and *Ready Fixtures* Cases

In the *Sherwood Partners* case, Thinklink Corporation had made an assignment for the benefit of creditors to Sherwood Partners in California. Sherwood sued Lycos in California state court to recover a \$1 million payment as a preference under California's ABC statute, Cal. Civ. Proc. Code §1800 (the "California Preference Statute"). Lycos removed the action to federal court on diversity grounds and moved to dismiss the complaint, arguing that the California Preference Statute was preempted by the preference provisions of the Bankruptcy Code, 11 U.S.C. §547.

The United States District Court denied Lycos' motion to dismiss Sherwood's complaint and eventually granted summary judgment in favor of Sherwood. Lycos appealed this decision to the Ninth Circuit Court of Appeals, which reversed the District Court.

The facts of *Ready Fixtures* are substantially similar to the *Sherwood Partners* case. Ready Fixtures Company made an assignment for the benefit of creditors under Wisconsin law. A receiver was appointed to administer Ready Fixtures' assets. The receiver commenced a lawsuit in Wisconsin state court, alleging that the defendant, Stevens Cabinets, had received payments totaling approximately \$80,000 from Ready Fixtures that were recoverable as preferences under Wisconsin's insolvency preference statute, Wisc. Stat §128.07 (the "Wisconsin Preference Statute"). Stevens Cabinets removed the case to federal district court based on diversity grounds and moved to dismiss the action because the Bankruptcy Code's preference provisions preempted the Wisconsin Preference Statute.

The Ninth Circuit's Holding In *Sherwood Partners* That the Bankruptcy Code Preempts the California Preference Statute

In *Sherwood Partners*, the Ninth Circuit considered whether the California Preference Statute should be preempted as inconsistent with the goals and purposes underlying the Bankruptcy Code. In a 2-1 opinion, the court found 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. The law has been long settled by the United States Supreme Court that the states could not grant debtors a discharge of their debts because a discharge is an integral part of federal bankruptcy law and exclusively reserved for Congress. Any state law that grants discharges of debts would interfere with nationally applicable federal laws (including the Bankruptcy Code) and the power granted to Congress in the United States Constitution to enact uniform laws on bankruptcy matters.

The central issue before the Ninth Circuit was whether the other principal purpose of the Bankruptcy Code, the equitable distribution of a debtor's assets among its creditors, could coexist with the California Preference Statute, or if the two laws conflicted in such a way as to preempt the California Preference Statute. The Ninth Circuit ruled that the Bankruptcy Code preempts state law, such as the California Preference Statute, that implicates the Bankruptcy Code's goal of equitable distribution, thereby warranting dismissal of the preference action against Lycos.

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 more lax state procedures and standards of California's ABC statute effectively circumvent this federally designed bankruptcy process. A bankruptcy trustee has the power to avoid and recover preferences for distribution to creditors. A debtor cannot select the bankruptcy trustee. Instead, the trustee is either appointed by the United States Trustee, an official of the United States Department of Justice, 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 the debtor's ability to handpick an assignee, such as Sherwood or any other assignee in a California ABC, and the concomitant lack

of supervision over the assignee's activities, and the risk of the assignee's potential self-dealing or conflict of interest.

The Ninth Circuit distinguished the United States Supreme Court's decision in *Stellwagen v. Clum*, which upheld a provision of Ohio's preference statute that granted a state trustee only those avoidance powers held by creditors, against a preemption challenge. California's ABC law, contrary to Ohio's preference statute, grants the assignee, rather than unsecured creditors, the sole power to set aside preferences. The *Sherwood Partners* court concluded that state statutes that grant assignees or other fiduciaries avoidance powers in addition to those held by individual unsecured creditors encroach upon the exercise of federal bankruptcy power.

The dissenting judge in *Sherwood Partners* stated that the Bankruptcy Code does not preempt the California Preference Statute. The dissent argued that the majority's reasoning was too broad and could potentially result in the preemption of many state laws governing ABCs if those laws alter the incentive for affected parties to initiate bankruptcy proceedings. The dissent reasoned that because both the California ABC and the Bankruptcy Code have virtually identical preference provisions, the California ABC helped effectuate the Bankruptcy Code's goal of equality of distributions among creditors. The dissent also noted that ABC laws have existed since the inception of federal bankruptcy law and have never been found to interfere with the bankruptcy law's goal of equitable distribution. Finally, the dissent argued that the result of the majority's opinion was to discourage corporations that were threatened with insolvency from utilizing the less stigmatic and less costly California ABC regime and push them into liquidation under the Bankruptcy Code.

California State Appellate Court Decisions Declining to Follow the Ninth Circuit's *Sherwood Partners* Holding

Since the issuance of the Ninth Circuit's *Sherwood* opinion in January 2005, the California state appellate courts issued at least two published opinions that reject the result reached in *Sherwood Partners* and rely upon the dissenting opinion in *Sherwood Partners* in holding that the Bankruptcy Code does not preempt the California Preference Statute. See *Harberbush v. Charles & Dorothy Cummins Family Ltd. P'ship* and *Credit Managers Ass'n. of California v. Countryside Home Loans Inc.* Although the Ninth Circuit Court of Appeals includes California within its jurisdiction, the two California state appellate courts determined that the Ninth Circuit's holding in *Sherwood* was not binding on them.

The court in *Haberbush* noted that Congress had intended state laws governing ABCs to coexist with the Bankruptcy Code. The court questioned the Ninth Circuit's holding that preempts any state statute implicating the Bankruptcy Code's goal of equitable distribution. The court held that the Ninth Circuit's *Sherwood* decision is contrary to the United States Supreme Court precedent that upheld state ABC and similar insolvency statutes from attack under the preemption doctrine, despite the fact that these statutes clearly implicated the bankruptcy law's goal of equitable distribution. See *Pobreslo v. Joseph M. Boyd Co.*, and *Stellwagen v. Clum*. The *Haberbush* court also did not share the Ninth Circuit's concerns about the additional powers conferred upon an assignee, that are not otherwise available to unsecured creditors of the debtor. State ABC law routinely grants an assignee more power than can be exercised by individual creditors. Finally, the *Haberbush* court noted that the California Preference Statute does not violate the Bankruptcy

Code's goal of equitable distribution because the California Preference Statute is virtually identical to the Bankruptcy Code's preference provisions.

***Ready Fixtures'* Holding That the Wisconsin Preference Statute is Not Preempted by the Bankruptcy Code**

The defendant in the *Ready Fixtures* case, Stevens Cabinets, primarily relied upon the Ninth Circuit's reasoning in *Sherwood Partners* for seeking dismissal of the Wisconsin state law preference action because the Bankruptcy Code preempts the Wisconsin Preference Statute. Stevens Cabinets argued that the Wisconsin Preference Statute conflicts with the Bankruptcy Code's goal of equitably distributing a debtor's assets among competing creditors because the Wisconsin Preference Statute grants greater power to a Wisconsin receiver to recover preferences than §547 of the Bankruptcy Code grants to a bankruptcy trustee. Stevens Cabinets provided the court with two examples of the receiver's more expansive preference recovery rights in the Wisconsin Preference Statute, than the preference powers granted to a bankruptcy trustee under §547 of the Bankruptcy Code, that undermines and, therefore, conflicts with the Bankruptcy Code. The Wisconsin Preference Statute has a four month preference period (providing for the recovery of preferential transfers made within four months of the filing of an ABC), in contrast to the more limited 90 day preference period provided in bankruptcy cases. The Wisconsin Preference Statute also does not provide any defenses to a state preference claim. By comparison, §547(c) of the Bankruptcy Code provides preference defendants with several defenses to preference claims, including payments made as contemporaneous exchanges for new value (§547(c)(1)) and payments made in the ordinary course of business (§547(c)(2)).

The United States District Court for the Western District of Wisconsin, in *Ready Fixtures*, rejected the Ninth Circuit's *Sherwood Partners* decision, and held that the Wisconsin Preference Statute is not preempted by the Bankruptcy Code because the Wisconsin Preference Statute does not interfere with either the goals or operation of federal bankruptcy law. The *Ready Fixtures* court 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.

The *Ready Fixtures* court also observed 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. The court found no difference between the parallel state and federal laws governing fraudulent transfers and the parallel state and federal laws that deal with the recovery of preferences.

The Wisconsin Preference Statute is one such parallel state preference law. Any differences between the Wisconsin Preference Statute and Bankruptcy Code do not prevent the equitable distribution of the debtor's assets that would otherwise warrant preemption of the Wisconsin Preference Statute.

The *Ready Fixtures* court concluded its opinion by noting that the United States Supreme Court, in *Pobreslo v. Joseph M. Boyd Co.*, upheld the Wisconsin ABC law as not preempted by the federal bankruptcy law in effect at the time. The Supreme Court emphasized that the Wisconsin ABC law did not provide for a discharge of debt that would have warranted preemption, but rather assured equality of distributions to creditors.

Although not cited in the *Ready Fixtures* opinion, another federal district court in the Eastern District of Wisconsin, in an unreported August 2006 decision in *APP Liquidating Co. v. Packaging Credit Co.*, also refused to follow the Ninth Circuit's holding in the *Sherwood Partners* case. The *APP Liquidating* court held that, because the Wisconsin Preference Statute assists in providing an equitable distribution to creditors, the statute does not interfere with the Bankruptcy Code's identical goal of equitable distribution. Accordingly, the *APP Liquidating* court found that the Bankruptcy Code did not preempt the Wisconsin Preference Statute and denied the defendant's motion to dismiss the receiver's lawsuit seeking to recover an alleged preferential transfer.

Subsequent to the *Ready Fixtures* opinion, in August 2007, the federal district court in the Eastern District of Wisconsin, in *BDI Liquidating Co., Inc. v. Quest Graphic, LLC*, again denied a defendant's motion to dismiss a complaint seeking recovery of a preference under the Wisconsin Preference Statute. Without discussion, the court held that the Bankruptcy Code did not preempt the Wisconsin Preference Statute, relying upon the opinions in *Ready Fixtures* and *APP Liquidating*.

Conclusion

Both the Ninth Circuit, in *Sherwood Partners*, and United States District Court for the Western District of Wisconsin, in *Ready Fixtures*, agreed that any state ABC law that attempts to provide a debtor a discharge is preempted by the Bankruptcy Code as an obstacle to Congress' objectives to establish uniform bankruptcy laws. However, the courts disagree on the weight to be given to the Bankruptcy Code's goal of "equitable distribution" of a debtor's assets among competing creditors.

The Ninth Circuit, in *Sherwood Partners*, held that the Congressional goal of equitable distribution was of the same or similar importance as the goal of providing a fresh start to a debtor by granting a discharge. Accordingly, the *Sherwood Partners* court ruled that any procedure (such as the California Preference Statute) that materially alters the goal of equitable distribution is preempted by the Bankruptcy Code and, therefore, impermissible.

By comparison, the United States District Court for the Western District of Wisconsin, in *Ready Fixtures*, rejected the Ninth Circuit's holding that, for federal preemption purposes, the goal of equitable distribution should be considered "on par" with Congress' goal of providing debtors with a fresh start through a bankruptcy discharge. Therefore, the *Ready Fixtures* court was much less concerned with whether or not the Wisconsin Preference Statute altered the rights of preference defendants, when compared to the rights they have under the Bankruptcy Code. The court observed that a receiver's more expansive preference avoidance powers under the Wisconsin Preference Statute, compared to a chapter 7 trustee's right to recover preferences

under the Bankruptcy Code, did not materially hinder the goal of equitable distribution for purposes of a preemption analysis.¹

The bottom line is that the Ninth Circuit's holding in *Sherwood Partners* may not be the end of the line for state law preference actions, as some had predicted. The import of the *Sherwood Partners* decision is far from certain in light of the refusal of the California state appellate courts, and other courts in the federal system outside the Ninth Circuit, such as the *Ready Fixtures* court and other federal courts in Wisconsin, to follow the Ninth Circuit's holding. The law is currently in such a state of flux, in light of these recent conflicting decisions, that creditors who are sued under a state preference law should consider the numerous federal preemption arguments they may be able to raise to defeat preference exposure, in addition to the preference defenses available under state law.

Bruce Nathan is a partner with Lowenstein Sandler PC's New York City office. Mr. Nathan can be reached via e-mail at bnathan@lowenstein.com. Scott Cargill is counsel in Lowenstein Sandler's Roseland, New Jersey office. Mr. Cargill can be reached via e-mail at scargill@lowenstein.com.

¹ Although not specifically discussed, the *Ready Fixtures* court presumably also would not have considered the additional concerns raised by the *Sherwood* court (e.g. the process for selection of the trustees and potential conflicts of interest arising out of a debtor's selection of an assignee in an ABC) as having materially hindered the goal of equitable distribution that may have otherwise warranted preemption of the Wisconsin Preference Statute.