AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for Today's Busy Insolvency Professional

Bankruptcy Practitioners, Get Your Guns

Haberbush and *Sherwood Partners* Set the Stage for a Showdown between the Code and State ABC Law

Written by:
Mette H. Kurth
Sheppard, Mullin, Richter & Hampton LLP
Los Angeles
mkurth@sheppardmullin.com

Theodore A. Cohen
Sheppard, Mullin, Richter & Hampton LLP
Los Angeles
tcohen@sheppardmullin.com

Anything you can do,
I can do better.
I can do anything
Better than you![1]

In a judicial exchange reminiscent of the famous repartee between Annie Oakley and Frank Butler, the Ninth Circuit Court of Appeals last year in *Sherwood Partners*[2] ruled that the Bankruptcy Code preempts California's preference statute.[3] *Sherwood Partners* expressed concern that if an assignee may pursue preference actions in connection with an assignment for the benefit of creditors (ABC)—a procedurally streamlined and less-expensive alternative to a federal bankruptcy case—creditors may be content to forego important procedural protections afforded by the Code while a debtor avails itself of the more economical ABC.


Mette H. Kurth

In May 2006 the California Court of Appeals for the Second Appellate District responded, by its decision in *Haberbush*,[4] holding that the Code does *not* preempt the state preference statute.

About the Authors

Mette Kurth, a lawyer in Sheppard, Mullin, Richter & Hampton's Finance and Bankruptcy Group, represents strategic and financial buyers of distressed middle-market companies as well as companies in chapter 11. Ted Cohen, a lawyer in the Finance and Bankruptcy Group at Sheppard, Mullin, Richter & Hampton, LLP's Los Angeles office, represents strategic and financial buyers of distressed middle-market companies, banks, assignments for the benefit of creditors, workouts and refinancings.

The California appellate court, rejecting the notion that it might be bound by the Ninth Circuit decision,[5] stated that it could "discern 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 of a debtor's assets—'stands as an obstacle to the accomplishment...of the full purposes and objectives' of the federal bankruptcy system."[6] While these opinions raise interesting questions of federalism and comity, and the U.S. Supreme Court may ultimately be called on to reconcile the conflicting decisions, *Haberbush* appears to revive California's ABCs.

ABCs: A Long and Venerable Pedigree as Alternative


Theodore A. Cohen

An ABC is a nonjudicial alternative to a federal bankruptcy case whereby a debtor contractually assigns all of its assets to a third party for the benefit of its creditors. The assignee then has a fiduciary obligation to liquidate the debtor's assets, maximize their value, ascertain creditor's claims, and make a fair and equitable distribution to creditors of the liquidation proceeds. While ABCs are often associated with the wind-down of insolvent debtors, they also provide a swift and cost-effective means to facilitate a going-concern sale of a debtor's assets. Because ABCs are more efficient and less expensive than bankruptcies and provide some similar benefits, distressed companies in California—as well as their officers and directors, professionals, potential asset-purchasers and creditors—routinely opt for ABCs as an alternative to bankruptcy.[7]

Assignments trace their origins at least to the early Roman Empire, when the law provided for a debtor's property to be impounded and equitably

Feature

1 Berlin, Irving, "Anything You Can Do, I Can Do Better," from *Annie Get Your Gun.*

2 *Sherwood Partners Inc. v. Lycos Inc.*, 394 F.3d 1198 (9th Cir. 2005), *cert. denied,* 126 S.Ct. 397 (2005).

3 *See* California Code of Civil Procedure (CCP) §1800.

4 *Haberbush v. Charles and Dorothy Cummins Family Ltd. Partnership,* 139 Cal. App. 4th 1630 (2006).

5 *See Id.* at 1635, n.16.

6 *Id.* at 1640.

7 *See* CCP §§493 and 1800; *see, also,* Crabbe, Deborah A., "Preemption and the Bankruptcy Code: Lessons from *Sherwood Partners Inc. v. Lycos Inc.,*" Am. Bankr. Inst. J. (June 2005).

distributed among creditors without discharge of the debtor's underlying obligations.[8] The right to make a voluntary assignment for the benefit of creditors later developed under common law, where it was conceived of as a personal right inherent in the ownership of property. While substantive rights under assignments depend upon contract, many states have adopted legislation to govern the execution and enforcement of the trusts by which a debtor's property may be conveyed. A long line of U.S. Supreme Court cases, dating back to at least 1877, recognizes that such voluntary assignments, and the state laws that regulate them, are not inconsistent with federal bankruptcy law.[9]

Sherwood Partners *Doubts the Viability of ABCs in the Ninth Circuit*

Although the Ninth Circuit in *Sherwood Partners* asserted that "we do not...question the validity of voluntary assignments for the benefit of creditors, which have a venerable common-law pedigree,"[10] the court found that one particular aspect of a voluntary assignment, California's preference statute, is preempted by Code §547. Most bankruptcy practitioners will be readily familiar with §547, the Code's preference statute. The California preference statute likewise grants an assignee the exclusive right to recover certain transfers of a debtor's property to ensure an equitable distribution of assets, and the elements required for such a preference action and the available defenses mirror those of §547 before its amendment by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).[11]

In finding that California's preference statute was preempted, the court reasoned that despite its substantive similarities to §547, one of the essential goals of federal bankruptcy law, equality of distribution of a debtor's assets among competing creditors, is undermined by the less-stringent procedural protections afforded to creditors in a nonjudicial assignment.[12] The court was not persuaded that a preference defendant could protect itself against these procedural infirmities by filing an involuntary bankruptcy petition, since the cooperation of at least two other creditors is typically required—creditors who likely stand to share in preference recoveries against the defendant, and who therefore have little incentive to protect their fellow creditor.[13] Distinguishing prior cases that had validated preference statutes in other states, the court concluded that state statutes giving assignees avoidance powers—at least to the extent they exceed powers that may be exercised by individual creditors—"trench too close upon the exercise of the federal bankruptcy power" and must yield to the regulation of Congress.[14]

Haberbush *Affirms Continued Validity of ABCs in California*

The California Court of Appeals' decision in *Haberbush* took a broader view, recognizing that preference statutes are an integral part of a larger, collective process designed to fairly and equitably marshal and distribute a debtor's assets. *Haberbush* expressly rejected the *Sherwood Partners* majority opinion, expressing concern that its reasoning casts doubt on the validity not only of state preference statutes but of all voluntary assignment statutes.

Adopting the reasoning of Judge Nelson's dissent in *Sherwood Partners,* the court in *Haberbush* discounted concerns that CCP §1800, in giving to an assignee powers beyond those available to individual creditors and more akin to those of a bankruptcy trustee, is inconsistent with the Code's essential goals. The court noted that voluntary assignments, by definition, give an assignee more power than is provided to an individual creditor. Tying a preemption analysis to whether an assignee's powers exceed those of an individual creditor therefore improperly threatens the validity of all voluntary assignment statutes in contravention of long-standing Supreme Court precedent upholding state assignment statutes.[15]

As for the possible alteration of incentives to commence a federal bankruptcy case—particularly in favor of a less-expensive and time-consuming alternative—the court concluded that the only pertinent question is whether the alteration of incentives somehow *interferes with* or is an obstacle to the Code's objective of equitable distribution. In the view of the California appellate court, the *Sherwood Partners* majority provided no cogent explanation of how the assignee's avoidance powers conflict with that objective, particularly inasmuch as California's preference statute is, by design, virtually identical to the Code's preference statute. If the same transfer can be avoided in both the state and federal systems, the court concluded that the state system cannot reasonably be said to interfere with the Code's goals.

No court has yet considered the impact of BAPCPA, which amended §547 such that the federal and state preference statutes are no longer identical. The California legislature originally enacted CCP §1800, which took effect simultaneously with the Bankruptcy Reform Act of 1978, with the intention that the state statute would mirror §547.[16] Under both CCP §1800 and pre-BAPCPA §547, a transfer is insulated from recovery under the so-called "ordinary course of business" defense if the defendant can establish three elements: (1) the transfer was in payment of a debt incurred in the ordinary course of business; (2) the transfer itself was made in the ordinary course of business; *and* (3) the transfer was made according to ordinary business terms. But BAPCPA amended §547(c)(2) so that a defendant need establish only the first and *either* the second *or* the third elements of the ordinary-course defense. BAPCPA also established minimum dollar thresholds for preference actions and requires that certain small actions must be brought in the defendant's home district. If a difference between the state and federal statutes now exists where there was no difference before, is CCP §1800 now preempted in its entirety?[17] CCP §1800 might be defended on the grounds that states

8 *See Pobreslo v. Boyd,* 287 U.S. 518, 519 (1933) (*citing* Radin, Max, *Handbook of Roman Law,* p. 314 (1927)).

9 *See, e.g., id.; Stellwagen v. Clum,* 245 U.S. 605 (1918); *Burlingham v. Crouse,* 228 U.S. 459, 473 (1913); *Hanover National Bank v. Moyses,* 186 U.S. 181, 192 (1902); *Neal v. Clark,* 95 U.S. 704, 709 (1877).

10 *Sherwood Partners,* 394 F.3d at 1205, n.8.

11 *See* Nathan, Bruce S., "*Sherwood Partners* Threatens Viability of State Law Preference," Am. Bankr. Inst. J. (May 2005) (discussing Code §547 as it existed pre-BAPCPA, and CCP §1800).

12 *Id.* at 1204-05.

13 *Id.* at 1205.

14 *Id.* at 1206.

15 *Haberbush,* 139 Cal. App. 4th at 1635-40 (*citing Sherwood Partners,* 294 F.3d at 1205; *Pobreslo,* 287 U.S. at 526; *Stellwagen,* 345 U.S. at 615).

16 *Angeles Electric Company v. Superior Court,* 27 Cal. App. 4th 426, 430-431 (1994).

17 *Silkwood v. Kerr-McGee Corp.,* 464 U.S. 238, 248 (1984) (state law preempted to extent it actually conflicts with federal law).

may provide greater protection to individual rights than federal law affords,[18] but does CCP §1800 provide greater protections to individual rights because it affords the creditor body greater opportunities for recovery than are now available under the federal preference statute? Or does it provide fewer protections because, from the perspective of the individual preference defendant, it will receive relatively fewer procedural protections under the state preference statute?

Preemption: Who Gets the Last Word?

Haberbush and *Sherwood Partners* illustrate the uncertainty surrounding the doctrine of federal preemption and the power of the states to make laws "implicating" particular aspects of the federal bankruptcy law, such as its equitable distribution scheme. Whether the Code preempts CCP §1800 raises a federal question, and one might wonder how the California appellate court in *Haberbush* could disregard the decision of the Ninth Circuit Court of Appeals in *Sherwood Partners*. Citing to several prior California cases, the *Haberbush* court concluded that "decisions of the lower federal courts on federal questions are persuasive but not binding on state courts."[19] While at least one decision by the U.S. Supreme Court lends credibility to this position,[20] the Ninth Circuit has expressed "serious doubts as to the wisdom of this view."[21] The conflict between *Sherwood Partners* and *Haberbush* on the substantive question of preemption, as well as the question of comity that has been raised, may ultimately be resolved by the U.S. Supreme Court.[22] Meanwhile, whether an assignee may bring a preference action under CCP §1800 will be influenced by the venue in which the litigation is pending, and as discussed below, this will create opportunities for forum shopping and legal maneuvering for bankruptcy practitioners dealing with insolvent California companies.

This split in authority should be taken into account by professionals who are representing distressed companies within the Ninth Circuit considering whether to execute an ABC or commence a federal bankruptcy case, potential buyers or others dealing with these companies, and those pursuing or defending preference actions in the Ninth Circuit.

Implications for Insolvent Companies and Potential Acquirers

Before *Sherwood Partners* was decided, preference recoveries were not a significant factor in California to be evaluated in deciding whether an ABC or a federal bankruptcy case was the better chouce for a borrower because the preference statutes were identical. Today, however, one should consider the impact of *Haberbush* and *Sherwood Partners*. Commencing a federal bankruptcy case may be the only way to be certain that preference actions may be pursued, and in some circumstances, this could be a determinative factor in favor of a bankruptcy case. However, preserving preferences may be a minor consideration where a preference analysis indicates that these actions are unlikely to enhance creditor recoveries, either because there are few potential preferences or because the preferences at issue involve small amounts that are not cost-effective to pursue. An asset purchaser that intends to do future business with the debtor's former vendors might be concerned that ongoing preference litigation will generate unwanted disruption and costs, and it might condition the purchase on the debtor's agreement not to pursue preferences. Alternatively, it might be desirable to effect a sale of the debtor's business using an ABC, leaving the assignee or creditors with the responsibility of evaluating and preserving preferences, perhaps even through a subsequent chapter 7 filing.

Implications for Preference Litigants

An assignee seeking to pursue preference recoveries under CCP §1800 will find a significant advantage in bringing the preference actions in a California court because California trial courts, even those outside of the Second Appellate District, will be required to follow *Haberbush*.[23] But in many cases, the assignee under CCP §1800, or the preference defendant itself, will be incorporated in states other than California, creating the prospect of diversity jurisdiction. Defendants facing preference litigation in a California court may consider whether diversity of citizenship exists and whether the amount in controversy is such that they have a basis to remove the preference action to a district court in the Ninth Circuit, where *Sherwood Partners* will be binding precedent. The additional litigation costs likely to be associated with these tactics, and the risk that preference actions may be removed to a federal district court, should be factored into any preference analysis that is undertaken.

Conclusion

For those involved with financially distressed companies, the cost-benefit analysis that must be undertaken when evaluating different vehicles for selling the company as a going-concern or liquidating its assets has become more complex. *Haberbush* lends authority for the proposition that California's preference statute is *not* preempted by the Code, and in so holding, the California appellate court has endorsed the state's ABC procedure as a "less-stigmatic, and less-costly, voluntary assignment scheme" that, like the federal bankruptcy system, serves to ensure equality of distribution of a debtor's assets. ■

Reprinted with permission from the ABI Journal, Vol. XXV, No. 6, July/August 2006.

18 *Oregon v. Hass,* 420 U.S. 714, 719 (1975) (states may provide greater protection to individual rights than federal law affords); *accord, Dibella v. Hopkins,* 403 F.3d 102, 111 (2nd Cir. 2005), *cert. denied,* 126 S.Ct. 428 (2005).

19 *Haberbush,* 139 Cal. App. 4th at 1635, n.16; *accord, Walker v. Kiousis,* 93 Cal. App. 4th 1432, 1441 (2001) (*citing Raven v. Deukmejian,* 52 Cal. 3d 336, 352 (1990); *Tully v. World Savings & Loan Assn.,* 56 Cal. App. 4th 654, 663 (1997)).

20 *See Arizonans for Official English v. Arizona,* 520 U.S. 43, 66 n.21 (1997) (*stare decisis* effect of a U.S. district court's ruling is distinctly limited because it is not binding on Arizona state courts).

21 *Yniguez v. Arizona,* 939 F.2d 727, 736 (9th Cir. 1991).

22 The U.S. Supreme Court previously denied a petition for *writ of certiorari* in the *Sherwood Partners* case. But the U.S. Supreme Court could now consider the conflict between the California and Ninth Circuit appellate courts should the defendants in *Haberbush* elect to appeal that decision to the California Supreme Court, and ultimately, to the U.S. Supreme Court under 28 U.S.C. §1257 (final judgments rendered by the highest court of a state in which a decision could be had may be reviewed by the Supreme Court where the validity of a statute of any state is drawn into question on the ground of its being repugnant to the Constitution or laws of the United States).

23 *Gwartz v. Superior Court,* 71 Cal. App. 4th 480, 481 (1999); *Auto Equity Sales v. Superior Court,* 57 Cal. 2d 450, 455 (1962).