

# A PREFERENCE FOR STATES? THE WOES OF PREEMPTING STATE PREFERENCE STATUTES

## INTRODUCTION

Financially distressed businesses, especially in California, are increasingly using assignments for the benefit of creditors (“ABCs”) to liquidate their assets as an alternative to filing a chapter 7 bankruptcy.<sup>1</sup> An ABC is a state collective action mechanism, akin to a chapter 7 liquidation, that permits a debtor to transfer its assets to its chosen fiduciary “for administration, liquidation, and equitable distribution among his creditors.”<sup>2</sup> For example, between the years 2000 and 2005, many California businesses initiated ABCs due to the collapse of the dot-com industry. Additionally, more business entities have been inclined to accept and promote general assignments as an alternative to bankruptcy in the past two decades.<sup>3</sup> This is because state assignments, as compared with bankruptcy, have been viewed as a superior exit strategy for businesses.<sup>4</sup> ABCs are more efficient,<sup>5</sup> less costly, and minimize negative publicity for management.<sup>6</sup>

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<sup>1</sup> See, e.g., Joe Lee & Thomas Parrish, Op-Ed, *Banks Gone Wild*, N.Y. TIMES, Jan. 13, 2007, at A15.

<sup>2</sup> *Freeman v. Marine Midland Bank-N.Y.*, 419 F. Supp. 440, 447 (E.D.N.Y. 1976) (quoting 28 N.Y. JUR. *Insolvency* § 7 at 569). While the common law tool of assignment is analogous to a chapter 7 Bankruptcy, “an [a]ssignment should only be considered if there are assets to liquidate.” Leslie R. Horowitz & John A. Lapinski, *Assignment for the Benefit of Creditors*, CLARK & TREVITHICK, Dec. 2002, [http://www.clarktv.com/PDF\\_R/assignmentforthebenefit.pdf](http://www.clarktv.com/PDF_R/assignmentforthebenefit.pdf).

<sup>3</sup> Geoffrey L. Berman, *Common Law Assignments for the Benefit of Creditors: The Reemergence of the Nonbankruptcy Alternative*, 21 CAL. BANKR. J. 357, 357 (1993); E-mail from Michael Joncich, CMA Business Credit Services, to Vivian Luo, Student, Emory University School of Law (Feb. 8, 2007, 12:36 EST) (on file with author) (“The number of general assignments accepted by CMA Business Credit Services has remained relatively constant during the last five years. Although there is no public source of statistical information to confirm, it is our impression that the total number of general assignments made to California assignees has increased, as more individuals and entities accept assignments and they promote assignments as an alternative to bankruptcy.”).

<sup>4</sup> David S. Kupetz, *Assignment for the Benefit of Creditors: Exit Vehicle of Choice for Many Dot-Com, Technology, and Other Troubled Enterprises*, 11 J. BANKR. L. PRAC. 71, 71 (Nov.-Dec. 2001); John W. Easterbrook, *Bankruptcy Petitions Versus Assignments for the Benefit of Creditors: A “Win” for Bankruptcy?*, 122 BANKING L.J. 415, 415-16 (May 2005).

<sup>5</sup> *Moskowitz v. Prentice (In re Wis. Builders Supply Co.)*, 239 F.2d 649, 656 (7th Cir. 1956).

<sup>6</sup> Kupetz, *supra* note 4, at 71; Easterbrook, *supra* note 4, at 416.

Despite their popularity, ABCs have weaknesses. One defect with common law ABCs is that assignees do not have the power to recover preferential transfers.<sup>7</sup> A preference is a transfer of property or an equitable interest in property by the debtor, typically to a favored or powerful creditor, for payment of prior debt.<sup>8</sup> “Usually, a preferential transfer is inequitable because that transfer takes away funds that would otherwise be shared by similarly situated creditors.”<sup>9</sup> Recognizing this defect, practitioners have long advocated legislation directed at protecting general creditors against preferences.<sup>10</sup> As a result, twenty-two states<sup>11</sup> have adopted statutes that permit the assignee to recover preferences.<sup>12</sup> California, a leader in the promotion of ABCs, has codified the preference recovery power in Section 1800 of the California Code of Civil Procedure.<sup>13</sup> However, California’s preference recovery statute has recently faced a constitutional preemption challenge. While all but one court that ruled on the issue upheld the state preference law, the potential invalidation of state preference recovery laws means that any business seeking to utilize an ABC must forgo any preference claims.

Recently, several courts considered whether the California preference statute, which gives a state assignee, but not creditors generally, the power to recover preferences, is preempted by the Bankruptcy Code. The Ninth Circuit

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<sup>7</sup> Richard H. Keatinge, *Assignment for the Benefit of Creditors at California Law—Legal and Practical Aspects*, 25 L.A. B. BULL. 99, 114 (1949).

<sup>8</sup> 11 U.S.C. § 547(b) (2000) (defining a preference, in part, as “any transfer of an interest of the debtor in property . . . to or for the benefit of a creditor . . . on account of antecedent debt” that enables the creditor to recover more than under a chapter 7 liquidation had the transfer not been made).

<sup>9</sup> Bethaney J. Vazzana, Comment, *Trustee Recovery of Indirect Benefits Under Section 547(b) of the Bankruptcy Code*, 6 BANKR. DEV. J. 403, 405 (1989).

<sup>10</sup> See E-mail from David S. Kupetz, Partner, Sulmeyer, Kupetz, Baumann & Rothman, to Vivian Luo, Student, Emory University School of Law (Feb. 8, 2007, 13:33 EST) (on file with author) (stating that while “there is no public record/filings with regard to CA ABCs[,] ABCs are done infrequently in the states (such as N.Y.) where there is a detailed assignment statute and a judicial process that makes the assignment much more like a chapter 7 bankruptcy”). Section 1800 was likely added “so that the preference issue would be eliminated as a potential reason why a bankruptcy might be better for creditors in general than an ABC. The statute was designed to be virtually identical to section 547.” *Id.*

<sup>11</sup> David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 556 (1994). The states that have enacted preference avoidance provisions are: (1) California; (2) Colorado; (3) Delaware; (4) Georgia; (5) Indiana; (6) Iowa; (7) Kentucky; (8) Maryland; (9) Missouri; (10) Montana; (11) New Hampshire; (12) New Jersey; (13) New York; (14) North Carolina; (15) Ohio; (16) Oklahoma; (17) Pennsylvania; (18) South Carolina; (19) South Dakota; (20) Tennessee; (21) Washington; and (22) Wisconsin. *Id.*

<sup>12</sup> E.g., CAL. CIV. PROC. CODE § 1800 (West 2007).

<sup>13</sup> *Id.*

Court of Appeals concluded that the statute had been preempted,<sup>14</sup> because the power to avoid preferences lies “within the heartland of bankruptcy administration.”<sup>15</sup> However, two divisions of the California Court of Appeals and a Wisconsin District Court took a non-preemptionist view of the issue.<sup>16</sup> The California Court of Appeals reasoned that the statute does not run afoul of “the essential goals and purposes” of the Bankruptcy Code because Congress recognizes the validity of state ABC laws.<sup>17</sup> Therefore, the California statute does not contravene any Congressional purpose, and upholding the statute would not interfere with the operation of federal law.<sup>18</sup> This Comment addresses whether the Bankruptcy Code, in granting a federal trustee the power to recover preferential transfers, preempts a state statute which grants a state assignee, but not an unsecured creditor, a similar power to avoid preferences.<sup>19</sup>

The decision to file for bankruptcy or to initiate ABC proceedings is predominantly a creditor concern. The decisions of the California Court of Appeals and the Ninth Circuit have substantial impact on creditors because a preemptionist resolution to the debate at hand would result in a tradeoff between recovering preferences in bankruptcy and lower expenses in ABCs. The preemptionist view also operates against the collective interests of creditors. By precluding any preference recovery actions by a state assignee, the Ninth Circuit effectively allowed creditors to keep their preferential payments. Even if the debtor later files for bankruptcy, there is a strong

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<sup>14</sup> *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1206 (9th Cir. 2005); Bruce S. Nathan, *Sherwood Partners Threatens Viability of State Law Preference*, 24 AM. BANKR. INST. J., May 2005, at 16, 16.

<sup>15</sup> *Sherwood Partners*, 394 F.3d at 1201.

<sup>16</sup> The Ninth Circuit analyzed the preemption issue in *Sherwood*. *Id.* at 1206. The California Court of Appeals ruled on the same issue in *Haberbush v. Charles & Dorothy Cummins Family Ltd. P'ship*, 43 Cal. Rptr. 3d 814, 817 (Cal. Ct. App. 2006). The District Court for the Eastern District of Wisconsin also agreed with the California view in *APP Liquidating Co. v. Packaging Credit Co. LLC*, No. 05-C-846, 2006 U.S. Dist. LEXIS 60195, at \*6–\*9 (E.D. Wis. Aug. 24, 2006).

<sup>17</sup> *Haberbush*, 43 Cal. Rptr. 3d at 817.

<sup>18</sup> *See id.* (quoting *Sherwood*, 394 F.3d at 1202). In *Sherwood*, the Ninth Circuit was concerned that the existence of a state preference avoidance mechanism would affect a debtor's decision to avail himself of federal law and would give creditors more incentive to turn toward involuntary bankruptcy proceedings. *Sherwood*, 394 F.3d at 1205.

<sup>19</sup> The Constitution of the United States grants Congress the power to establish “uniform Laws on the subject of Bankruptcies throughout the United States.” U.S. CONST. art. I, § 8, cl. 4. Because the federal government has been given this power, there have been “a host of unsuccessful objections based on constitutional grounds against the enactment of various [state insolvency] provisions.” CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 9 (Da Capo Press 1972) (1935). The latest addition to this series of challenges centers on an issue of federal preemption with regards to a trustee's preference avoidance power.

likelihood<sup>20</sup> that the preferential payment would fall outside the ninety-day preference recovery window granted by federal law.<sup>21</sup> Thus, in either bankruptcy or state law insolvency proceedings, the otherwise avoidable preference most likely remains with the preferred creditor, diminishing the amount available for distribution to the remaining creditors.

Some, including the Ninth Circuit, have suggested that this preemption challenge is primarily a debtor concern. Jurists and practitioners have recognized that, currently, if a debtor in California pursues the state law remedy, it risks invalidation of any preference recovery actions instituted by its assignee.<sup>22</sup> Alternatively, if the debtor files for bankruptcy, § 547 of the Bankruptcy Code ensures the trustee a preference avoidance power upon the filing of a bankruptcy petition.<sup>23</sup> The downside to bankruptcy is that filing and operating under federal law is more costly,<sup>24</sup> more drawn out, and enshrines the individual with a stigma than most are unwilling to tolerate.<sup>25</sup> To managers and directors of corporations hoping to maintain friendly relations with its creditors or who live in the public eye, state law may seem to offer less cumbersome proceedings. Even given these concerns, however, the effect on debtors is negligible.

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<sup>20</sup> In order for the bankruptcy trustee to recover the preference, the preference payment must be within the ninety-day pre-petition window, unless an insider is involved. 11 U.S.C. § 547 (2000). However, if a state assignee has already attempted to recover the preference, the action would have to have been concluded within ninety-days for the bankruptcy trustee to have any leeway for recovery. *Id.* This is highly unlikely due to the time frame for filings and responses. *See* Cal. Rules of Court, Rule 3.110 (“The complaint must be served on all named defendants and proofs of service on those defendants must be filed with the court within 60 days after the filing of the complaint. When the complaint is amended to add a defendant, the added defendant must be served and proof of service must be filed within 30 days after the filing of the amended complaint.” Additionally, “[t]he parties may stipulate without leave of court to one 15-day extension beyond the 30-day time period prescribed for the response after service of the initial complaint.”).

<sup>21</sup> 11 U.S.C. § 547(b)(4)(A); *see infra* note 268. An exception exists where the preference payment was made to an insider—an individual or entity that is personally related to the debtor, employs, or otherwise in control of the debtor. 11 U.S.C. § 101(31). In such cases, the trustee can avoid transfers that were made up to one-year before the petition date. 11 U.S.C. § 547(b)(4)(B).

<sup>22</sup> *See Sherwood*, 394 F.3d at 1206 n.1 (Nelson, J., dissenting).

<sup>23</sup> 11 U.S.C. § 547 (2000).

<sup>24</sup> *Statutory Regulation of Assignments for the Benefit of Creditors*, 47 YALE L. J. 944, 945 (1938) (noting that creditors may also fair better under state assignment laws than through bankruptcy).

<sup>25</sup> Mette H. Kurth & Theodore A. Cohen, *Bankruptcy Practitioners, Get Your Guns: Haberbusch and Sherwood Partners Set the Stage for a Showdown between the Code and State ABC Law*, 25 AM. BANKR. INST. J., Jul.-Aug. 2006, at 32, 32; STAFF OF H. COMM. ON THE JUDICIARY, 71ST CONG., ADMINISTRATION OF BANKRUPT ESTATES (Comm. Print 1931); *see also Sherwood*, 394 F.3d at 1208 (Nelson, J., dissenting); Lee & Parrish, *supra* note 1, at A15. It may also be the case that the stigma attached to bankruptcy has eroded over time and bankruptcy does not carry the same negative connotations in modern society. *See, e.g., Lee & Parrish, supra* note 1, at A15.

The corporate debtor itself has little concern about the results of their insolvency proceedings when the end game is liquidation.<sup>26</sup> Corporate debtors receive no exemptions nor are they discharged from debt.<sup>27</sup> Oftentimes, once the company goes out of business, it goes out of existence. The managers of the company may have some opinion in the means of liquidation insofar as they have a vested interest. For example, principles may be concerned where they have personally guaranteed loans or have a desire to maintain good creditor relations in the hopes of building a new business. They may also opt for the least expensive process in the hopes of obtaining a share of any leftover proceeds after creditors have been paid.<sup>28</sup>

Any final resolution of the conflict between the Ninth Circuit and the California Court of Appeals will substantially affect creditors and will, at most, nominally impact debtors. If the Ninth Circuit's preemption view controls, creditors who receive a preferential transfer likely keep their preferential payments, and thus benefit at the expense of the other creditors. If the California Court of Appeals' anti-preemptionist view prevails, then the door remains open for states to grant an assignee more powers than are available to any general creditor. As the Ninth Circuit states, this may seem contrary to Congress's intent<sup>29</sup> in enacting a national bankruptcy law because the danger of inequitable distribution of the debtor's assets in state proceedings may dissuade certain parties from undergoing bankruptcy.<sup>30</sup> However, the Ninth

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<sup>26</sup> ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 396 (5th ed. 2006) ("[T]here is no advantage for the company in liquidation."). The common law tool of assignment is analogous to a chapter 7 Bankruptcy: "an [a]ssignment should only be considered if there are assets to liquidate." Horowitz & Lapinski, *supra* note 2, at 1.

<sup>27</sup> 11 U.S.C. § 727(a)(1); WARREN & WESTBROOK, *supra* note 25, at 396; *see also* S. Rep. No. 95-989, at 98 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5884 (noting that if the corporation reemerges from liquidation, it remains liable for its debts); H.R. REP. NO. 95-595, at 384 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6340 (same). However, a corporation that does reengage in business after a chapter 11 proceeding does get a discharge. 11 U.S.C. § 1141(d)(3).

<sup>28</sup> A fundamental principle of corporate law, recognized in bankruptcy, is that creditors of the entity must be paid in full before equity gets any of the proceeds. *See* 11 U.S.C. § 1129(b) (codifying the principle of absolute priority that all creditors must be paid before management or equity can recover against corporate assets, unless the creditor waives payment); *see also* 11 U.S.C. § 726 (noting that the trustee in a chapter 7 matter distributes first to creditors, then to the debtor if proceeds remain); *Everett v. Perez (In re Perez)*, 30 F.3d 1209, 1214 (9th Cir. 1994). One of the main goals of bankruptcy laws is to prevent inequitable distribution of assets to creditors. *Futoran v. Rush (In re Futoran)*, 76 F.3d 265, 267 (9th Cir. 1996).

<sup>29</sup> This statement assumes that Congress either intended to enact a uniform bankruptcy law or to reserve certain powers solely to the trustee. There is also a valid, strong argument that the bankruptcy laws exist to prevent inequitable distribution.

<sup>30</sup> *Sherwood*, 394 F.3d at 1205.

Circuit's argument is logically unsound, its conclusion stands contrary to the weight of authority, and creates undesirable public policy.

This Comment supports the decision of the California Court of Appeals to uphold California's ABC law granting a state assignee the ability to recover preferential transfers for four reasons: (1) there can be no conflict when no bankruptcy petition has been filed; (2) the weight of authority, including Supreme Court precedent and subsequent state and federal decisions, favors upholding the state law; (3) California's ABC provision does not interfere with the operation of the federal Bankruptcy Code but furthers the goals of insolvency legislation; and (4) statutes, such as section 1800, make good policy. Furthermore, this Comment addresses the possibility that both the Ninth Circuit and the California courts failed to address the core issue raised in *Sherwood* and *Haberbush*, the principal preemption and non-preemption cases. The question that should have been considered by the court is whether Congress has preempted the ability of the states to create fiduciary<sup>31</sup> duties to creditors.

Part I discusses relevant Bankruptcy Code provisions and bankruptcy alternatives in state law. It examines the development of federal preemption law and describes the operation and benefits of state ABC provisions. This section also provides a brief summary of the federal preemption doctrine and its scope in the bankruptcy context. Additionally, it summarizes and explains the operation of the California statute at issue—section 1800 of the California Code of Civil Procedure.

Part II presents a summary of the *Sherwood Partners* and *Haberbush* cases. This section steps through the Ninth Circuit's rationale, which lead to the conclusion that section 1800 is preempted, and the California Court of Appeals' reasoning for reaching the opposite conclusion.

Part III provides an analysis of the *Sherwood Partners* and *Haberbush* cases, considers their effect on bankruptcy, and weighs the merits of each court's ruling. This part looks at state preference laws and discusses similar

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<sup>31</sup> A bankruptcy "[t]rustee acts on behalf of *all creditors* and owes a fiduciary duty to them." Henson v. Lucas (*In re Henson*), No. 98-51326-ASW, 2006 WL 3861370, at \*7 (Bankr. N.D. Cal. April 21, 2006). Likewise, a state assignee owes creditors a fiduciary obligation. *See, e.g.,* Page v. Liberty Mut. Fire Ins. Co., 869 F. Supp. 596, 600 (N.D. Ill. 1994); *Sterling Consulting Corp. v. Credit Managers Ass'n of Cal.*, No. 05cv01573CBS, 2006 WL 3641009, at \*7 (D. Colo. Dec. 12, 2006) ("CMA is a nonprofit association of credit managers that operates as a third party fiduciary for the administration of assignments for the benefit of creditors . . .").

state assignment provisions that passed constitutional muster. The analysis also offers additional interpretations of the Ninth Circuit's rationale for invalidating California's ABC provision. In doing so, this Comment raises additional issues the courts may have overlooked and concludes that the arguments of the *Sherwood* court seem shortsighted at best. Finally, this section reviews the policy and purpose of bankruptcy and insolvency legislation and discusses the repercussions of permitting and denying states the ability to enact preference avoidance statutes.

## I. BACKGROUND BANKRUPTCIES—THE OLD AND THE NEW

The problem of preferential transfers has pervaded the bankruptcy jurisprudence of both English and American law.<sup>32</sup> A trustee's power to avoid preferences was, and remains, rooted in the notion of equity.<sup>33</sup> Today, preferences and fraudulent transfers are distinguished as separate ideas,<sup>34</sup> however "the emergence of preference law was closely tied to the concept of fraud."<sup>35</sup> The English jurist, Lord Coke, largely responsible for cultivating the meaning of preference law principles, condemned preferences in the name of equity.<sup>36</sup> A number of Parliamentary acts<sup>37</sup> also authorized and prescribed

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<sup>32</sup> EDWIN JAMES, *THE BANKRUPT LAW OF THE UNITED STATES* 153 (1867). Preference avoidance provisions were found even in

the first Bankrupt Act which was passed in the reign of James I . . . . [T]he English courts decided, that under the original Bankrupt Act of James I, all grants and conveyances were void as against the creditors of a bankrupt, which a Court of Equity would declare fraudulent, as well as all cases which either appear from the facts themselves to be, or from conclusion of law arising from these facts would be deemed to be, fraudulent as against third parties, however fair and binding they might be as between the parties themselves.

*Id.* at 153–54.

<sup>33</sup> *See id.* at 153 (explaining that a trustee is permitted to recover any transfers to creditors occurring four months pre-petition and any assignments made six months pre-petition so that the proceeds could be distributed generally among the creditors of the estate).

<sup>34</sup> Compare 11 U.S.C. § 547 (2000), with 11 U.S.C. § 548 (2000).

<sup>35</sup> John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 250 (1981).

<sup>36</sup> *Id.* at 251. Lord Coke applied these principles in a case involving a transfer of the bankrupt estate's assets after "the appointment of commissioners." *Id.* (citing *Smith v. Mills*, (1584) 76 Eng. Rep. 441 (K.B.)). There, he articulated the long-standing preference problem that has the bankruptcy laws seek to address: "[I]f, after the debtor becomes a bankrupt, he may prefer one (who peradventure hath least need), and defeat and defraud many other poor men of their true debts, it would be *unequal and unconscionable*, and a great defect in the law . . . ." *Mills*, 76 Eng. Rep. at 473 (emphasis added). Another situation with which the English legislature was concerned was the transfer of a debtor's property before an act of bankruptcy. McCoid, II, *supra* note 35, at 251. Lord Mansfield furthered bankruptcy's goal of equity in another case that went before the King's Bench: *Alderson v. Temple*, (1768) 96 Eng. Rep. 384 (K.B.). Lord Mansfield declared that:

mechanisms for the recovery of assets that were concealed or transferred to another party by the debtor after becoming a bankrupt.<sup>38</sup> This notion of equity is one of the driving forces behind modern bankruptcy and insolvency law.

The law provides various mechanisms to pay off the creditors of a business entity<sup>39</sup> that has fallen into financial hardship.<sup>40</sup> A business entity may resolve its debts in several ways under both state and federal law—reorganize the company or liquidate its assets.<sup>41</sup> This Comment will be concerned solely with the state and federal proceedings governing business liquidation.<sup>42</sup> In the

an act [not] in the ordinary course of business . . . defeats the equality intended by the law. So if the conveyance be not of all, but of great part, and the excepted part is merely colourable, it is also void. If the conveyance be for the benefit of all the creditors except one, or naming all the rest and omitting him . . . , it is void.

*Id.* at 385. However, he did not condemn all preferential transfers. *Id.* (“If one demands it first, or sues him, or threatens him, without fraud, the preference is good. But where it is manifestly to defeat the law, it is bad.”).

<sup>37</sup> *E.g.*, An Act against such Persons as do make Bankrupt, 1542-43, 34 & 35 Hen. 8, c. 4 (Eng.); An Act for the further Description of a Bankrupt, and Relief of Creditors against such as shall become Bankrupts, and for inflicting corporal Punishment upon the Bankrupts in some special Cases, 1623, 21 Jac., c. 19 (Eng.).

<sup>38</sup> *E.g.*, An Act against such Persons as do make Bankrupt (“[U]pon Complaint thereof made to the said Lords having Authority by this present Act, as is aforesaid, the same Lords shall have power and Authority by Virtue hereof to convent and call before them the said Recoverer or Recoverers, and after such Fraud, Deceit, Covin or Collusion, shall plainly appear, or be duly proved before the said Lords authorized, as is aforesaid, all the said Goods and Chattels, of the said Offender so recovered, shall be chargable, imployed, ordered and delivered toward the Payment of the true and due Debts of the said Creditor . . .”). These statutes and the decisions of the King’s Bench indicate that preference law in England was driven predominantly by the policy of equitable distribution. *See* McCoid, II, *supra* note 35, at 251 (“Lord Coke . . . went beyond the case to state the broader rule, which he based on the statutory language and on the principle of equal distribution . . .”).

<sup>39</sup> “A business corporation [or entity] is a legal device for carrying on a business enterprise for profit, a legal unit with a status or capacity of its own separate from the shareholders or members who own it.” JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS* 2–3 (2d ed. 2003). Business entities are traditionally thought of as corporations. *Id.* at 2. However, modern business entities have developed to include: “(1) the partnership, including the joint venture, (2) the limited partnership, (3) the limited liability company, (4) the joint stock company (sometimes referred to as a ‘joint stock association’), (5) the Massachusetts or business trust, and (6) in a few states, the ‘partnership association.’” *Id.*

<sup>40</sup> Some strategies the board of directors of a business might consider include: “(1) merging with or being acquired by a qualified candidate; (2) commencing a formal bankruptcy proceeding (chapter 11 reorganization or chapter 7 liquidation); (3) engaging in an out-of-court debt restructuring or workout; (4) shutting down their business and simply closing their doors (an informal death); (5) streamlining the company and focusing on a core business . . . ; or (6) making an assignment for the benefit of creditors.” Kupetz, *supra* note 4, at 71.

<sup>41</sup> *See generally* 11 U.S.C. §§ 704, 1106 (2000). In state law, corporate reorganization takes place under equity receiverships known as consent receiverships. Paula Whitney Best, Note, *Corporate Receiverships and Chapter 11 Reorganizations*, 10 CARDOZO L. REV. 285, 290 (1988).

<sup>42</sup> Reorganization generally takes place under chapter 11 of the Bankruptcy Code. *See* 11 U.S.C. §§ 1101–1174 (2000). The process of reorganization involves appointing a Debtor-In-Possession (“DIP”), stabilizing the business, recovering any preferential transfers and other property of the estate, assuming or

liquidation context, as soon as creditors suspect that their debtors are insolvent, they will move to collect on their debts. State and federal law provide two different options for distressed debtors facing this situation.

Under state law, debt collection becomes a race of the diligent—every unsecured creditor<sup>43</sup> attempts to compel payment from the debtor before other collectors exhaust its assets. To prevent this creditor feeding-frenzy, state-law generally provides two types of creditor collective action proceedings: (1) assignments for the benefit of creditors and (2) receiverships.<sup>44</sup> Congress, on the other hand, has implemented the Bankruptcy Code. The Bankruptcy Code, usually under chapter 7, provides debtors and creditors with orderly liquidation procedures carried out under judicial supervision.<sup>45</sup> The questions presented here involve the differences between, and the validity of, state ABC proceedings in light of the availability of chapter 7 bankruptcy case. In the following sections, these options will be discussed in turn.

#### A. *State Insolvency Law: The Original “Bankruptcy”*

State collective action proceedings, such as ABCs, serve as alternatives to bankruptcy<sup>46</sup> and provide creditors and debtors with a means to enforce their established financial relationships. In an ABC, the debtor-assignor executes a trust agreement, transferring all of its assets to an assignee.<sup>47</sup> The assignee,

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rejecting executory contracts, obtaining post-petition financing, negotiating a plan of reorganization with creditors, and obtaining confirmation of the plan. 11 U.S.C. §§ 301–366.

<sup>43</sup> The problem with preferential transfers only occurs with creditors that are not fully secured by their collateral. Section 547 of the Bankruptcy Code defines a preference, in part, as a transfer that would “[enable] such creditor to receive more than such creditor would receive if the case were a case under chapter 7.” 11 U.S.C. § 547(b)(5)(A). A transfer to repay a secured creditor would therefore not be a preference because that creditor would have been entitled to that payment, even in the event of liquidation.

<sup>44</sup> In a receivership, a court-appointed receiver takes legal control of the debtor’s property to preserve the assets pending liquidation. Allan Shine, *Receiverships Survive Pre-emption Attack*, 47 R.I. B. J. 11 (1999). The receiver acts as a fiduciary for the debtor and creditor. *Lewis v. Hankins*, 262 Cal. Rptr. 532, 535 (Cal. Ct. App. 1989). As such, the receiver works to “secure the rights of both parties to the underlying action.” *NationsBank of Ga. v. Conifer Asset Mgmt. Ltd.*, 928 P.2d 760, 764 (Colo. Ct. App. 1996).

<sup>45</sup> It is possible for a debtor to liquidate its assets in a chapter 11 proceeding as well. See 11 U.S.C. § 1123(b). A confirmation plan can provide that assets will be sold over time, for example, one that converts all assets into a liquidating trust. See *id.* The principles of a chapter 7 liquidation generally also apply to a chapter 11 liquidation.

<sup>46</sup> *Credit Managers Ass’n v. Nat’l Indep. Bus. Alliance*, 209 Cal. Rptr. 119, 121 (Cal. Ct. App. 1984).

<sup>47</sup> *FDIC v. Juron*, 713 F. Supp. 1116, 1119 (N.D. Ill. 1989) (“An ABC ‘is a voluntary transfer by a debtor of his property to an assignee in a trust for the purposes of applying the property or proceeds thereof to the payment of his debts and returning the surplus, if any, to the debtor.’”) (quoting *Ill. Bell Tel. Co. v. Wolf Furniture House, Inc.*, 509 N.E.2d 1289, 1291–92 (Ill. App. Ct. 1987)).

often a lawyer, then takes title to the debtor's estate and manages and distributes it, at times under the court's supervision.<sup>48</sup>

Some parties favor ABC provisions, sometimes termed "out of court bankruptcies,"<sup>49</sup> over bankruptcy for their prompt and economical nature. Private assignments made for the collective benefit of creditors have long been recognized as a "cheap, expeditious, and convenient mode of arriving at the objects intended by [the Bankruptcy Law]."<sup>50</sup> In contemporary case law, ABCs remain the "more efficient [mechanism for the] collection, administration and distribution of the debtor's assets."<sup>51</sup> Furthermore, ABCs can maximize payoffs for creditors. The economic advantages and the absence of judicial oversight may, in some instances, help lenders mitigate loan loss.<sup>52</sup>

While ABCs take less time, require less court oversight, minimize deterioration of collateral, and generally translate to lower professional fees for administration of the assets, there are downsides to ABCs.<sup>53</sup> For example, a creditor can obtain judgment on a pending lawsuit because there is no automatic stay in ABC law.<sup>54</sup> Also, upon judgment, the creditor can file to discover the assignee's assets.<sup>55</sup> This is disadvantageous in several respects—payment to creditors generally can be delayed because the assignee can be forced to appear and testify at a hearing, and the creditor may be able to subordinate the assignee's lien right to the collateral if the ABC has not been perfected.<sup>56</sup> Additionally, with respect to the debtor-assignor, "unsatisfied creditors [may be able to] challenge the transaction later as a fraudulent

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<sup>48</sup> *Freeman v. Marine Midland Bank-N.Y.*, 419 F. Supp. 440, 447 (E.D.N.Y. 1976).

<sup>49</sup> Easterbrook, *supra* note 4, at 415–16.

<sup>50</sup> *Mayer v. Hellman*, 91 U.S. 496, 498 (1875).

<sup>51</sup> *In re Wis. Builders Supply Co.*, 239 F.2d 649, 656 (7th Cir. 1956).

<sup>52</sup> Easterbrook, *supra* note 4, at 415-16 ("The ABC alternative has become popular with many businesses and insolvency professionals in an expanding number of situations because of its speed, the ability of the insolvent party to select and perhaps influence the actions of the assignee who takes responsibility for the company's assets, and the ability to sell assets and administer the remains of the debtor company without judicial oversight. For some of these same reasons, and especially because of an assignee's ability to quickly sell a business, lenders also have recognized that the ABC can in some circumstances help mitigate losses from a problem loan."). *See also* Horowitz & Lapinski, *supra* note 2, at 1-2 ("Assignments lessen the time required to sell assets, increase the liquidation options, and keep the costs substantially lower, often resulting in a greater return for creditors.").

<sup>53</sup> Bruce C. Scalabrino, *Representing a Creditor in an Assignment for the Benefit of Creditors*, 92 ILL. B.J. 263, 263 (2004).

<sup>54</sup> *Id.* at 264.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

conveyance and try to force the buyer to pay more, or to unwind the deal.”<sup>57</sup> Consequently, debtors and creditors may neither prefer “a bankruptcy proceeding nor an ABC . . . in all situations by a lender. There may be significant benefits to each proceeding, depending upon the parties involved and the specific circumstances being dealt with. However, there is little question that the ABC has become an important and increasingly used option.”<sup>58</sup>

State ABC laws stem from the common law right of assignment.<sup>59</sup> This right “results from that absolute ownership which every man claims over that which is his own.”<sup>60</sup> Moreover, the fact that many states accept that

parties may make and enter into such contracts, bargains, and agreements as they may deem best for their interests, and neither the Legislature nor the courts have the power or right to restrict them in the exercise of that privilege, so long as their contracts are not immoral or tainted with positive illegality<sup>61</sup> further fortifies the “venerable common-law pedigree”<sup>62</sup> of ABC laws.

Today, most states have enacted a statutory scheme of assignment.<sup>63</sup> Assignment statutes “may be mandatory, replacing common law assignments entirely, or permissive, allowing common law assignments to continue,”<sup>64</sup> and many jurisdictions continue to recognize common law assignment.<sup>65</sup>

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<sup>57</sup> Richard G. Mason et al., *Troubled Internet Companies Bring New Opportunities to Strategic Buyers*, in COUNSELING CLIENTS IN THE NEW ECONOMY: OPPORTUNITIES FOR THE EMERGING AND ESTABLISHED COMPANY, at 721, 725 (PLI Corp. Law & Practice, Course Handbook Series No. B0-0100, 2001).

<sup>58</sup> Easterbrook, *supra* note 4, at 415–16.

<sup>59</sup> *Whithed v. J. Walter Thompson Co.*, 86 Ill. App. 76 (Ill. App. Ct. 1898) (“Such common law right to make an assignment for the benefit of creditors exists independently of the statute.” (internal quotation marks omitted)); M.L. Lieberman, Comment, *A Proposal for Strengthening the California Statute Concerning Assignments for the Benefit of Creditors*, 36 CAL. L. REV. 586, 586–87 (1948) (discussing the common law right of assignment).

<sup>60</sup> *Brashear v. West*, 32 U.S. 608, 614 (1833).

<sup>61</sup> *Damaskus v. McCarty-Johnson Heating & Eng’g Co.*, 295 P. 490, 491 (Colo. 1931); *see also Lucy v. Freeman*, 101 N.W. 167, 168 (Minn. 1904) (“[T]he right to make a common-law assignment for the benefit of creditors exists independent of statutes.”); *In re Bird*, 40 N.W. 827, 828 (Minn. 1888) (“The existence of a bankrupt act does not suspend the right to make a voluntary assignment for the benefit of creditors. That right is a common-law one, and exists independent of statute. True, if an insolvent debtor should make an assignment in conflict with the policy of a bankrupt act, it might be avoided by proceedings in involuntary bankruptcy, instituted by creditors, but only in that way. Except as against such proceedings, it would be as valid as if no such act existed.”).

<sup>62</sup> *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1205 n.8 (9th Cir. 2005).

<sup>63</sup> Kupetz, *supra* note 4, at 72.

<sup>64</sup> *Id.*

<sup>65</sup> WARREN & WESTBROOK, *supra* note 25, at 100.

Typically, “[s]tate assignment statutes . . . prohibit preferences to creditors and award priority to favored creditors.”<sup>66</sup> However, assignment does not discharge the debtor of any unpaid debt; the federal bankruptcy laws have preempted a state’s ability to discharge.<sup>67</sup>

### 1. *The ABCs of the California Code of Civil Procedure: Section 1800*

The modern California right to make a voluntary assignment for the benefit of creditors is governed by common law<sup>68</sup> and extended by various statutes, such as section 1800. The common law right is based on principles underlying the law of trusts.<sup>69</sup> ABCs, which have a long-standing common law heritage,<sup>70</sup> were absorbed into California state law through the California Civil Code.<sup>71</sup> California historically had two forms of ABCs—common law assignment and statutory assignment.<sup>72</sup> Statutory assignment was later repealed, leaving only common law ABCs.<sup>73</sup> Over time, the legislature, responding to certain defects in common law ABCs,<sup>74</sup> enacted supplementary statutes governing specific aspects of assignments.<sup>75</sup> The fiduciary in an ABC administers the assignor’s

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<sup>66</sup> Kupetz, *supra* note 4, at 72. “Favored creditors” here means creditors in a class that is granted priority.

<sup>67</sup> *Stellwagen v. Clum*, 245 U.S. 605, 615 (1918); *see also Scalabrino*, *supra* note 53, at 264.

<sup>68</sup> *Brainard v. Fitzgerald*, 44 P.2d 336 (Cal. 1935) (holding that the common law right of assignment is valid and trumps any subsequent attachment of the assets). *See also Credit Managers Ass’n v. Nat’l Indep. Bus. Alliance*, 209 Cal. Rptr. 119, 121 (Cal. Ct. App. 1984); Lieberman, *supra* note 59. In the past there were several means of making assignments in California—common law assignment and assignment under §§ 3448–3473 of the California Civil Code. CAL. CIV. CODE §§ 3448–3473 (West 1982) (§§ 3450–3473 repealed 1980); CAL. CIV. CODE § 22.2 (West 1982); *see Credit Managers Ass’n*, 209 Cal. Rptr. at 121. However, the statutory means of assignment, provided in §§ 3450–3452 of the California Civil Code, was repealed in 1980 because it was rarely used and “[c]ommon law assignments for the benefit of creditors are used to the exclusion of statutory assignments.” CAL. CIV. CODE § 3450–3452 (West 1997) (repealed 1980). *See* 1 BERNARD E. WITKIN, SUMMARY OF CALIFORNIA LAW, §§ 710, 729 (8th ed. 1973).

<sup>69</sup> Keatinge, *supra* note 7, at 100.

<sup>70</sup> *Whithed v. J. Walter Thompson Co.*, 86 Ill. App. 76 (Ill. App. Ct. 1898); *Brashear v. West*, 32 U.S. 608, 614 (1833).

<sup>71</sup> CAL. CIV. CODE § 22.2. The California Civil Code provides that “[t]he common law of England, so far as it is not repugnant to or inconsistent with the Constitution of the United States, or the Constitution or laws of this State, is the rule of decision in all the courts of this State.” *Id.*

<sup>72</sup> *Jarvis v. Webber*, 236 P. 138, 143 (Cal. 1925). Section 493.010 of the California Code of Civil Procedure defines a general ABC under California law. Under this provision, a debtor is permitted to assign “all the defendant’s assets that are transferable and not exempt from enforcement of a money judgment” for the benefit of all creditors to a state fiduciary. CAL. CIV. PROC. CODE § 493.010 (West 2000).

<sup>73</sup> CAL. CIV. CODE §§ 3448–3473 (repealed 1980).

<sup>74</sup> *See supra* text accompanying note 7.

<sup>75</sup> CAL. CIV. PROC. CODE § 493.010. Section 1800 of the California Code of Civil Procedure qualifies the rights embodied in § 493.010, which is California’s general assignment statute.

assets with the aid of some statutory tools in addition to the common law right.<sup>76</sup>

Section 1800 of the California Code of Civil Procedure is one such supplementary statute.<sup>77</sup> California's preference statute is not an anomaly. Fifteen other states have also enacted statutes permitting *only* the assignee to avoid preferences.<sup>78</sup> Section 1800 grants the fiduciary the power to recover "[preferential transfers] and exempt property in an assignment for the benefit of creditors."<sup>79</sup> This preference avoidance statute "mirrors its federal counterpart and uses virtually the same language."<sup>80</sup> Section 1800(c) also provides defenses for creditors similar to those of the Bankruptcy Code.<sup>81</sup> Thus, the state fiduciary is empowered, and also bound, by the same abilities and limitations for preference recovery as the federal fiduciary in its administration of the debtor's estate.<sup>82</sup> Section 1800 also serves the same ends as the Bankruptcy Code.<sup>83</sup> The California Court of Appeals has recognized that the preference power "discourag[es] [unsecured] creditors from racing to proceed against an insolvent debtor, and prevent[s] one creditor from obtaining greater payment than others of its class."<sup>84</sup>

Once the fiduciary has liquidated the debtor-assignor's assets, he must distribute them pro rata among creditors. The Bankruptcy Code provides a

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<sup>76</sup> See, e.g., *Brainard v. Fitzgerald*, 44 P.2d 336 (Cal. 1935).

<sup>77</sup> See CAL. CIV. PROC. CODE § 1800 (West 2000).

<sup>78</sup> See ARIZ. REV. STAT. ANN. § 44-1041 (2003); KY. REV. STAT. ANN. § 379.070 (LexisNexis 2002); MD. CODE ANN. COM. LAW § 15-101 (LexisNexis 2005); N.H. REV. STAT. ANN. § 568:27 (LexisNexis 2003); N.J. STAT. ANN. § 2A:19-3 (West 2000); N.M. STAT. ANN. §§ 56-9-1, -2 (LexisNexis 2007); N.Y. DEBT. & CRED. LAW § 15(6-a) (McKinney 2007); N.C. GEN. STAT. § 23-3 (2007); OHIO REV. CODE ANN. §§ 1313.56, 58 (LexisNexis 2006); 39 PA. CONS. STAT. ANN. §§ 71, 151 (West 2007); S.C. CODE ANN. § 27-25-20 (2007); S.D. CODIFIED LAWS § 54-9-13.2 (2007); TENN. CODE ANN. § 47-13-116 (2001); TEX. BUS. & COM. CODE ANN. § 23.09 (Vernon 2002); WIS. STAT. ANN. § 128.07 (West 2001).

<sup>79</sup> CAL. CIV. PROC. CODE § 1800.

<sup>80</sup> Easterbrook, *supra* note 4, at 417; compare CAL. CIV. PROC. CODE § 1800(b), with 11 U.S.C. § 547(b) (2000).

<sup>81</sup> Compare CAL. CIV. PROC. CODE § 1800(c)(1)–(5), with 11 U.S.C. § 547(c)(1)–(5) (providing similar provisions for the contemporaneous exchange, ordinary course of business, purchase money security interest, new value, and floating lien exceptions to the fiduciary's preferences avoidance power).

<sup>82</sup> That is, the assignee may recover any preference payment made (1) to or for the benefit of a creditor, (2) for or on account of antecedent debt, (3) made while the assignor was insolvent, (4) within ninety days before the date of the assignment or one year before the assignment if the creditor is an insider, and (5) that enables the creditor to receive more than any other creditor in the same class. CAL. CIV. PROC. CODE § 1800(b).

<sup>83</sup> *Blonder v. Cumberland Eng'g*, 84 Cal. Rptr. 2d 216, 221 (Cal. Ct. App. 1999).

<sup>84</sup> *Id.*

priority scheme for distribution of the proceeds to creditors.<sup>85</sup> A similar set of priorities exist under California law, though there is “no comprehensive . . . scheme for distributions from an assignment.”<sup>86</sup> Rather, separate statutes grant certain claims priority over general unsecured claims.<sup>87</sup> Because of these piecemeal priorities, it is unclear where they stand relative to each other.<sup>88</sup> However, as one practitioner observed:

distribution in California [ABCs] . . . is generally made in accordance with the following priorities: (1) obligations owing to the U.S.; (2) the costs and expenses of the Assignment, including the assignee’s fees, legal expenses and costs of administration; (3) priority wage and benefit claims; (4) state tax claims, including interest and penalties for sales and use taxes, income taxes and bank and corporate taxes; (5) security deposits up to \$900 for the lease or rental of property, or purchase of services not provided; (6) unpaid unemployment insurance contribution, including interest and penalties; (7) State of California, Department of Fish and Game, for all monies owing the State for the sale of licenses and license tags; and (8) general unsecured claims.<sup>89</sup>

Also, the priorities of creditors in an ABC case, unlike bankruptcy, may be modified by equity.<sup>90</sup>

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<sup>85</sup> See 11 U.S.C. §§ 364(c)(1), 502(f), 503(b), 507, 726(b). The general order of distribution amongst unsecured creditors is as follows: (1) the chapter 7 trustee is paid under 726(b); (2) Superpriority claims under 364(c)(1); (3) superpriority claims for creditors suffering from inadequate collateral where they were awarded adequate protection under 507(b); (4) domestic support obligations under 507(a); and (5) all other administrative expenses allowed under 507(a), 503(b), and 502(f). *Id.*

<sup>86</sup> Kupetz, *supra* note 4, at 80. The California Code of Civil Procedure provides that an “assignment does not itself create a preference of one creditor or class of creditors over any other creditor or class of creditors, but the assignment may recognize the existence of preferences to which creditors are otherwise entitled.” CAL. CIV. PROC. CODE § 493.010(c). Here, the term “preference” means “priority”.

<sup>87</sup> Kupetz, *supra* note 4, at 80.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* (internal citations and footnotes removed). Additionally,

[i]f there are insufficient funds to pay the unsecured claims in full, then these claims will be paid pro rata. If unsecured claims are paid in full, equity holders will receive distribution in accordance with their liquidation rights. No distribution to general unsecured creditors should take place until the assignee is satisfied that all priority claims have been paid in full.

*Id.*

<sup>90</sup> See, e.g., *Fansler v. Fansler*, 253 Cal. Rptr. 186, 188–89 (Cal. Ct. App. 1988).

### *B. Preferences in Bankruptcy: The Modern Federal Solution*

The Bankruptcy Code provides an alternative means of debt relief and collection. In bankruptcy, the most common way for a corporation to liquidate is by initiating a chapter 7 case.<sup>91</sup> In general, the debtor begins a chapter 7 liquidation by filing a bankruptcy petition. A trustee is then appointed,<sup>92</sup> and the corporation generally ceases to operate.<sup>93</sup> Next, the trustee sells the company's assets under the court's supervision. Finally, the trustee distributes the proceeds from the sale, first to lien holders, and then to general unsecured creditors in accordance with the priorities set forth in the Bankruptcy Code.<sup>94</sup>

In the course of administering the bankruptcy estate, the trustee has various bankruptcy powers at his disposal to recover property of the estate.<sup>95</sup> One such power resides in § 544. Generally known as the Strong-Arm Clause, § 544 gives the trustee the collective "rights and powers" of a hypothetical lien creditor under state law at the commencement of a case.<sup>96</sup> That is, the trustee may step into the shoes of (1) a judicial lien creditor,<sup>97</sup> (2) an execution creditor,<sup>98</sup> (3) a bona fide purchaser for value of real property,<sup>99</sup> or (4) any unsecured creditor,<sup>100</sup> to avoid any unperfected interests. The strong-arm power is entirely a derivative of state law and is similarly limited by state law.<sup>101</sup>

Another power bestowed on the trustee is the ability to recover preferential transfers made to creditors.<sup>102</sup> Specifically defined in § 547 of the Bankruptcy Code, a preference is a transfer of the debtor's interest in property, made to or

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<sup>91</sup> Scalabrino, *supra* note 53, at 263.

<sup>92</sup> 11 U.S.C. § 701 (2000) (establishing the procedure for appointment of a trustee).

<sup>93</sup> This does not necessarily have to happen; the corporation can continue to operate as a going concern.

<sup>94</sup> *Id.* §§ 507, 726.

<sup>95</sup> *See, e.g., id.* § 361 (preventing creditors from attacking the estate during bankruptcy); *id.* § 365 (granting the trustee the power to assume or reject contracts); *id.* § 544 (trustee assumes the rights and powers of hypothetical lien creditors under state law); *id.* § 547 (the trustee has the power to recover preferential transfers).

<sup>96</sup> *Id.* § 544(a).

<sup>97</sup> *Id.* § 544(a)(1). A judicial lien creditor is one "that extends credit to the debtor at . . . the commencement of the case, and obtains . . . a judicial lien on all property that a creditor on a simple contract could have obtained." *Id.*

<sup>98</sup> *Id.* § 544(a)(2). An execution creditor is one that extends credit to the debtor at . . . the commencement of the case, and obtains . . . an execution against the debtor that is returned unsatisfied." *Id.*

<sup>99</sup> *Id.* § 544(a)(3). Generally, the trustee gains more power under § 544(a)(3) because the bona fide purchaser has greater rights under state law than lien creditors.

<sup>100</sup> *Id.* § 544(b)(1).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* § 547.

for the benefit of a creditor, on account of antecedent debt, made while the debtor was insolvent, within the ninety days immediately preceding the bankruptcy petition date, and that would allow the creditor to receive more than he would under bankruptcy liquidation.<sup>103</sup> Under § 547, the trustee can “reach back” and pull any transfers made up to ninety days before the petition date back into the bankruptcy estate.<sup>104</sup> This preference avoidance power maximizes the funds available to pay creditors and furthers the Bankruptcy Code’s policy of equitable distribution of the debtor’s estate among creditors.

The development of preference law from its inception in England<sup>105</sup> to its modern form indicates some of the factors Congress considered in crafting the modern Bankruptcy Code. In each subsequent Act, Congress sought to better ensure the equal treatment of creditors and to balance the rights and obligations of debtors and creditors in a manner that maximizes repayment to creditors while giving debtors a measure of relief.<sup>106</sup> This history as well as the great weight of the modern courts firmly establishes that the Congressional goals underlying the Bankruptcy Code are (1) giving debtors a fresh start<sup>107</sup> and (2)

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<sup>103</sup> *Id.* § 547(b).

<sup>104</sup> *Id.* The ninety day period is extended for insiders. *Id.*

<sup>105</sup> The first federal bankruptcy law, passed in 1800, did not provide for the recovery of preferences. JAMES, *supra* note 32, at 3. This policy changed with the Act of 1841. In the new Act, Congress defined a preference, gave the trustee the power to avoid preferential transfers, and disallowed discharge for any debtor that granted an unauthorized preference. Bankruptcy Act of 1841, ch. 9, § 2, 5 Stat. 440, 442 (repealed 1843); McCoid, II, *supra* note 35, at 253. As bankruptcy jurisprudence expanded, the courts began to focus on whether a debtor intended to grant a preference. *Id.* at 254. The Bankruptcy Act of 1898 quelled the uncertainty among the courts as to the whether a debtor’s intent to grant a preference was a necessary condition for preference recovery; it was not. *Id.* at 256. However, the trustee had to demonstrate that the creditor knew, or should have known, that the bankrupt was insolvent at the time of the transfer. *Id.* at 258. Over time, the focus shifted from a debtor’s intent to the creditor’s knowledge. *Id.* (“Knowledge of preferential result . . . became key.”). Congress passed the Bankruptcy Reform Act in 1978, which comprehensively revised the bankruptcy law and enacted the Bankruptcy Code. Bruce D. Fisher, *The Bankruptcy Reform Act of 1994—Implications of Individuals Filing for Bankruptcy in Michigan*, 75 MICH. B. J. 662, 663 (1996). The Bankruptcy Reform Act also included a time limitation on the preference period as well as a presumption that the debtor is insolvent during the preference period. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, Part II, H.R. DOC. NO. 93-137, at 170 (1973); 11 U.S.C. §§ 547(b)(4), (f).

<sup>106</sup> See CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 7, 31–39 (1935) (stating that, in the late nineteenth century, bankruptcy power was centered on commerce and noting that this focus changed as Congress endeavored to rewrite the bankruptcy law in response to the “pressure from all debtor classes for a bill providing for actual, open, voluntary bankruptcy”).

<sup>107</sup> See 11 U.S.C. § 362. Mechanisms such as the automatic stay further the policy of a fresh start by giving debtors breathing room to plan their financial affairs.

providing for equitable distribution<sup>108</sup> of the bankruptcy estate among creditors.<sup>109</sup>

The first goal—the fresh start—lies at the heart of bankruptcy policy.<sup>110</sup> However, this policy only applies in cases of personal bankruptcy because corporate debtors do not receive discharge.<sup>111</sup> Individual debtors, on the other hand, are discharged of their debt in order to “motivate [them] to energetically seek [future] financially productive economic roles.”<sup>112</sup> The promise of financial viability not only gives the debtor an incentive to become productive, but the threat of being denied discharge encourages compliance with bankruptcy procedure.<sup>113</sup> As the issue of preference avoidance addressed in this Comment only implicates the latter goal of equitable distribution, the fresh start policy will not be discussed further.

The second major goal—equitable distribution—has historically been dedicated to the protection of creditors.<sup>114</sup> This policy, which ensures that all creditors are paid their fair pro-rata share of the bankruptcy estate as determined by the Bankruptcy Code’s priority scheme,<sup>115</sup> protects the creditors’ interests—“both from each other and from their debtors.”<sup>116</sup> This protection is especially important to smaller creditors who are most likely to suffer from the bankruptcy and be coerced by more powerful creditors.<sup>117</sup> Understanding that the Bankruptcy Code, as well as state law, is largely driven by equitable distribution is crucial to this preemption debate. “This emphasis on the protection of creditors is [of particular significance] in the context of [such proceedings because preferential recoveries] are intended primarily to

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<sup>108</sup> See *id.* §§ 507, 1129(b). The priority scheme and the requirements of plan confirmation represent several ways the Bankruptcy Code seeks to ensure equal treatment of creditors.

<sup>109</sup> *Sherwood Partners, Inc., v. Lycos, Inc.*, 394 F.3d 1198, 1203 (9th Cir. 2005).

<sup>110</sup> Paul B. Lewis, *Can't Pay For Your Debts, Mate? A Comparison of the Australian and American Personal Bankruptcy Systems*, 18 BANKR. DEV. J. 297, 297 (2002); Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1393 (1985).

<sup>111</sup> WARREN & WESTBROOK, *supra* note 26, at 396.

<sup>112</sup> Lewis, *supra* note 110, at 306.

<sup>113</sup> See generally *id.*

<sup>114</sup> Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 7 (1995).

<sup>115</sup> 11 U.S.C. § 507 (2000).

<sup>116</sup> *Leading Cases*, 120 HARV. L. REV. 125, 132 (2006). “In fact, equitable distribution to creditors was so large a bankruptcy consideration at the time of the Convention that one court of that era felt compelled to explain its refusal to jail a debtor for already-discharged debts in terms of fairness to creditors.” *Id.* (citing *Millar v. Hall*, 1 U.S. (1 Dall.) 229 (Pa. 1788)).

<sup>117</sup> *Id.* at 125.

benefit creditors.”<sup>118</sup> However, to analyze the issue of whether voluntary state assignments contravene the Congressional intent behind this goal, it is necessary to explore the scope of the constitutional preemption doctrine.

### *C. The Constitutional Preemption Doctrine*

The Supremacy Clause provides that the Constitution, the laws of the United States, and all treaties “shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.”<sup>119</sup> In determining whether federal law preempts state law, the Supreme Court has said that we ought to “start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.”<sup>120</sup> This assumption is derived from a basic tenet of federalism. States are granted full discretion to exercise their allocated governing authority unless state legislation violates the Commerce Clause.<sup>121</sup> “The intention of Congress to exclude states from exerting their police power must be clearly manifested.”<sup>122</sup>

The Supreme Court has identified two categories of federal preemption—express and implied preemption.<sup>123</sup> While express preemption is fairly straightforward,<sup>124</sup> implied preemption is more complicated because the issue turns on congressional intent.<sup>125</sup> Congressional intent is often murky and even where Congress has provided the courts with a measure of guidance, judges must inquire further to distill the scope of preemption.<sup>126</sup> There are, arguably, three types of implied preemption.<sup>127</sup> First, federal law controls in cases of

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<sup>118</sup> *Id.* at 133.

<sup>119</sup> U.S. CONST. art. VI, CL. 2.

<sup>120</sup> *City of Milwaukee v. Illinois*, 451 U.S. 304, 316 (1981) (quoting *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977)).

<sup>121</sup> *Napier v. Atl. Coast Line R.R. Co.*, 272 U.S. 605, 610–11 (1926) (“It may be assumed, also, that there is no physical conflict between the devices required by the state and those specifically prescribed by Congress or the Interstate Commerce Commission, and that the interference with commerce resulting from the state legislation would be incidental only.”).

<sup>122</sup> *Id.* at 611. *See also Reid v. Colorado*, 187 U.S. 137, 148 (1902); *Savage v. Jones*, 225 U.S. 501, 533 (1912).

<sup>123</sup> *Gade v. Nat’l Solid Wastes Mgmt. Ass’n*, 505 U.S. 88, 98 (1992).

<sup>124</sup> Erwin Chemerinsky, *CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES* 376 (2d ed. 2002). Express preemption occurs where Congress has explicitly stated, in the statutory language, an intent to supersede state law. *Gade*, 505 U.S. at 98.

<sup>125</sup> *Gade*, 505 U.S. at 96.

<sup>126</sup> Chemerinsky, *supra* note 124, at 379.

<sup>127</sup> *Id.* at 378.

field preemption—where the congressional intent to preempt state law can be derived “from a scheme of federal regulation so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it.”<sup>128</sup> Second, conflict preemption arises where state law conflicts with federal law such that it would be physically impossible to comply with both regulations.<sup>129</sup> Third, laws that “stand[ ] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress” are also preempted.<sup>130</sup>

With respect to bankruptcy, the Court has determined that the preemption doctrine invalidates laws providing for debtor discharge<sup>131</sup> but does not extend to ABC statutes that give the assignee the rights of creditors generally.<sup>132</sup> The general principle is that “only state laws which conflict with the bankruptcy laws of Congress . . . are suspended; those which are in aid of the Bankruptcy Act can stand.”<sup>133</sup> The Bankruptcy Code preempts a state’s ability to discharge debt because a discharge provision would “have the effect of a bankruptcy discharge as to creditors in [all] States.”<sup>134</sup> Therefore, a state law that implicates the Bankruptcy Code’s goal of granting the debtor a fresh start is invalid.

The Supreme Court’s bankruptcy preemption jurisprudence further highlights the scope of preemption.<sup>135</sup> In *Boese v. King*, the issue before the Court was whether a New Jersey ABC statute was preempted.<sup>136</sup> The Court stated that, without doubt, the statute was “inoperative in so far as it provided for . . . discharge.”<sup>137</sup> However, assignments are valid, “for at least *the*

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<sup>128</sup> *Ctr. for Bio-Ethical Reform, Inc. v. City & County of Honolulu*, 455 F.3d 910, 917 (9th Cir. 2006); *Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm’n*, 461 U.S. 190, 204 (1983).

<sup>129</sup> *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963).

<sup>130</sup> *Id.* at 141. Some courts group obstacle preemption with conflict preemption. *See, e.g., Hines v. Davidowitz*, 312 U.S. 52, 67 (1941); *APP Liquidating Co. v. Packaging Credit Co.*, No. 05-C-846, 2006 U.S. Dist. LEXIS 60195, at \*3 (E.D. Wis. Aug. 24, 2006).

<sup>131</sup> *Boese v. King*, 108 U.S. 379, 385 (1883); *Stellwagen v. Clum*, 245 U.S. 605, 613 (1918); *Int’l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929); *Pobreslo v. Joseph M. Boyd Co.*, 287 U.S. 518, 524 (1933).

<sup>132</sup> *See, e.g., Boese*, 108 U.S. at 385 (finding that the Bankruptcy Act suspends all laws that provide for discharge, but that assignments that convey all the debtor’s assets to consenting creditors are permissible); *Johnson v. Star*, 287 U.S. 527, 528-30 (1933) (upholding the validity of ABCs).

<sup>133</sup> *Stellwagen*, 245 U.S. at 615.

<sup>134</sup> *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1203 (9th Cir. 2005) (quoting *Stellwagen*, 245 U.S. at 616).

<sup>135</sup> Alan J. Feld, Note, *The Limits of Bankruptcy Code Preemption: Debt Discharge and Voidable Preference Reconsidered in Light of Sherwood Partners*, 28 CARDOZO L. REV. 1447, 1451 (2006)

<sup>136</sup> *Boese*, 108 U.S. at 384.

<sup>137</sup> *Id.* at 385.

*purpose of securing an equal distribution of the estate among . . . creditors . . . in proportion to their several demands.*"<sup>138</sup> The existence of a discharge provision was also essential in *Stellwagen v. Clum*. There, the Court held that an Ohio statute, which grants general creditors the ability to avoid preferences and enables a court to appoint a receiver to take and administer the debtor's assets for the benefit of creditors, was not preempted because the statute did not attempt to discharge the debtor.<sup>139</sup>

The Court employed broader preemption language in *International Shoe v. Pinkus*, but also based its holding on the issue of discharge. *Pinkus*, involved an Arkansas statute governing receiverships that required a creditor to agree to discharge the debtor before it was eligible to receive any payment.<sup>140</sup> The Court found that provisions that provide for "discharge or that otherwise relate to the subject of bankruptcies are within the field entered by Congress when it passed the Bankruptcy Act, and [are] therefore . . . superseded."<sup>141</sup> However, throughout the opinion, the Court emphasizes the presence of the discharge provision and held that state law was preempted to the extent that it related to "the distribution of property and releases to be given."<sup>142</sup> Thus, the broader dicta is constricted by the facts and the Court's holding. Finally, in *Pobreslo v. Joseph M. Boyd Co.*, the Court reiterated the rule articulated in the previous cases and held that an assignment made without invoking any discharge law was valid.<sup>143</sup>

ABCs are not preempted, however, these cases involved statutes that gave the fiduciary the power to exercises the same rights as general creditors. The Court has not yet decided whether a state fiduciary may exercise rights not given to creditors generally.

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<sup>138</sup> *Id.* at 387 (emphasis added).

<sup>139</sup> *Stellwagen v. Crum*, 245 U.S. 605, 617–18 (1918).

<sup>140</sup> 278 U.S. 261, 263 (1929).

<sup>141</sup> *Id.* at 266.

<sup>142</sup> *Id.* at 264–68. This discharge rule conflicted with the federal law because it granted the debtor a discharge where the Bankruptcy Act would not, and was therefore invalid. *Id.* at 268.

<sup>143</sup> 287 U.S. 518, 525–26 (1933). The Court also declared that ABC provisions were severable from discharge provisions. *Id.* at 524.

## II. THE CENTRAL CASES: *SHERWOOD PARTNERS & HABERBUSH*

Four courts have considered whether the Code preempts state preference statutes.<sup>144</sup> In each case, a debtor made a voluntary general assignment for the benefit of creditors after defaulting on payments to its creditors.<sup>145</sup> The debtor-assignor did not petition for bankruptcy. The assignee later brought a preference avoidance suit under the state preference statute to recover payments made to the creditor.<sup>146</sup> On appeal, the creditor argued that the Code preempted the state preference statute and thus, the assignee did not have the power under state law to recover the preferences.<sup>147</sup> The assignee disagreed; it argued that states have the ability to exercise the preference avoidance power.

The Ninth Circuit<sup>148</sup> and the California Court of Appeals articulated the arguments for and against preemption in *Sherwood Partners* and *Haberbush* respectively.<sup>149</sup> Despite their divergent holdings, the two courts did agree on various aspects of the law. First, both courts maintained the correct preemption principle—the test for preemption is whether section 1800 conflicts with the Code. The Ninth Circuit articulated the standard as whether section 1800 is “tolerated by the Bankruptcy Code, or whether it gives assignee[s] powers that are within the heartland of bankruptcy administration.”<sup>150</sup> Similarly, the California Court of Appeals asserted that the proper gauge of preemption is “whether the state’s law ‘stands as an obstacle

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<sup>144</sup> *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198 (9th Cir. 2005); *Haberbush v. Charles & Dorothy Cummins Family Ltd. P’ship*, 43 Cal. Rptr. 3d 814 (Cal. Ct. App. 2006); *Credit Managers Ass’n of Cal. v. Countrywide Home Loans, Inc.*, 50 Cal. Rptr. 3d 259 (Cal. Ct. App. 2006); *APP Liquidating Co. v. Packaging Credit Co.*, No. 05-C-846, 2006 U.S. Dist. LEXIS 60195 (E.D. Wis. Aug. 24, 2006). The cases are factually similar, however, the subsequent discussion and analysis will focus solely on *Sherwood Partners, Inc.* and *Haberbush* – the leading cases on the issue of preemption of state preference statutes.

<sup>145</sup> *Sherwood*, 394 F.3d at 1200; *Haberbush*, 43 Cal. Rptr. 3d at 815; *Credit Managers*, 50 Cal. Rptr. 3d at 260; *APP Liquidating*, 2006 U.S. Dist. LEXIS 60195 at \*1.

<sup>146</sup> *Sherwood*, 394 F.3d at 1200; *Haberbush*, 43 Cal. Rptr. 3d at 815; *Credit Managers*, 50 Cal. Rptr. 3d at 264; *APP Liquidating*, 2006 U.S. Dist. LEXIS 60195 at \*7.

<sup>147</sup> *Sherwood*, 394 F.3d at 1200; *Haberbush*, 43 Cal. Rptr. 3d at 815; *Credit Managers*, 50 Cal. Rptr. 3d at 260; *APP Liquidating*, 2006 U.S. Dist. LEXIS 60195 at \*1.

<sup>148</sup> Petitioner alleged diversity jurisdiction and removed the action to federal court. *Sherwood*, 394 F.3d at 1200.

<sup>149</sup> The subsequent cases, *Credit Managers* and *APP Liquidating*, examined the merits of *Sherwood* and *Haberbush*, ultimately agreeing with the *Haberbush* decision. *Credit Managers*, 50 Cal. Rptr. 3d at 260; *APP Liquidating*, 2006 U.S. Dist. LEXIS 60195 at \*9.

<sup>150</sup> *Sherwood*, 394 F.3d at 1201.

to the accomplishment and execution of the full purposes and objectives of Congress.”<sup>151</sup> Both courts used conflict preemption.<sup>152</sup>

Second, there is no doubt that the goals of bankruptcy are (1) to grant a fresh start and (2) to facilitate equitable distribution.<sup>153</sup> Third, both courts also seem to agree that section 1800 does not affect the present rights of creditors.<sup>154</sup> Both *Sherwood* and *Haberbush* discuss the ability of the trustee to exercise the rights of creditors generally, but neither opinion takes the position that section 1800 would diminish the rights of general creditors.<sup>155</sup>

Finally, the validity of ABCs is not disputed.<sup>156</sup> The first point raised in *Haberbush* is that ABCs are a valid exercise of the state power because Congress contemplated the coexistence of state ABCs.<sup>157</sup> As the court states, this is clearly shown by the fact that the United States Supreme Court has upheld ABCs and the right of states to legislate in the realm of voluntary assignments.<sup>158</sup> Moreover, *Sherwood* does not expressly attack ABCs.<sup>159</sup> The majority did not question the validity of assignments and recognized the “venerable common-law pedigree” of ABCs.<sup>160</sup> The statement also acknowledged Supreme Court precedent and that Congress expressly incorporated ABCs into the Bankruptcy Code.<sup>161</sup>

The source of disagreement between the Ninth Circuit and the California Court of Appeals appears to lie in the analysis of whether section 1800 is inconsistent with the Code. The courts differ as to: (1) their interpretations of

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<sup>151</sup> *Haberbush v. Charles & Dorothy Cummins Family Ltd. P'ship*, 43 Cal. Rptr. 3d 814, 816 (Cal. Ct. App. 2006) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

<sup>152</sup> The Ninth Circuit and the California Court of Appeals seems to take the position that obstacle preemption is at least largely a part of conflict preemption. See *supra* note 130 and accompanying text.

<sup>153</sup> *Sherwood*, 394 F.3d at 1203; *Haberbush*, 43 Cal. Rptr. 3d at 818. *Sherwood* seems to focus more on the specifics of accomplishing these goals, emphasizing the need for federal “substantive standards and procedural protections.” *Sherwood*, 394 F.3d at 1204. See also *infra* text accompanying notes 183–89.

<sup>154</sup> *Sherwood*, 394 F.3d. at 1201, 1205; *Haberbush*, 43 Cal. Rptr. 3d at 818–19.

<sup>155</sup> *Sherwood*, 394 F.3d. at 1201, 1205; *Haberbush*, 43 Cal. Rptr. 3d at 818–19.

<sup>156</sup> *Haberbush*, 43 Cal. Rptr. 3d at 817–18; see also *Sherwood*, 394 F.3d at 1205. The Ninth Circuit recognized that the Bankruptcy Code explicitly incorporates ABCs and that voluntary assignments have a “venerable common law pedigree.” *Sherwood*, 394 F.3d at 1205 n.8. The *Haberbush* court made the same observation, stating, “it is undisputed that Congress intended, in general, to permit the coexistence of state laws governing voluntary [ABCs].” *Haberbush*, 43 Cal. Rptr. 3d at 817.

<sup>157</sup> *Haberbush*, 43 Cal. Rptr. 3d at 817.

<sup>158</sup> *Id.* (citing *Pobreslo v. Boyd Co.*, 287 U.S. 518, 526 (1933)); see also *supra* notes 131-32 and accompanying text.

<sup>159</sup> *Sherwood*, 394, F.3d at 1205 n.8.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

the presumptions underlying the preemption doctrine; (2) whether the assignee should be allowed to exercise more power than creditors generally; and (3) whether state preference statutes give creditors incentives to avoid federal courts. The following subsections will discuss how the two courts handled these issues.

A. *Whether the Ninth Circuit’s Reasoning in Favor of Preemption Rises to the Level of Persuasiveness Necessary to Trigger the Preemption Doctrine*

First, the courts’ presentations of the cases and reasoning indicate that they disagreed as to the proper method of analysis. In *Sherwood*, the court seemed to implicitly presume that section 1800 was preempted and seemed to place the burden on the assignee to demonstrate persuasive reasons for upholding the statute.<sup>162</sup> However, the California Court of Appeals found this presumption erroneous.<sup>163</sup> A basic tenet of the federal preemption doctrine is that “federal regulation should not be deemed preemptive of state regulatory power absent ‘persuasive reasons—either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained.’”<sup>164</sup> Applying this standard, the California Court of Appeals charged that the proper standard is to assume no preemption absent persuasive reasons for preemption.<sup>165</sup> The Ninth Circuit’s reasons do not rise to the necessary level of persuasiveness.<sup>166</sup>

The Ninth Circuit declared that laws that implicate any of the goals of bankruptcy are preempted.<sup>167</sup> To reach this conclusion, the court begins with the accepted premise that state laws that implicate the goal of a fresh start by providing for discharge have been preempted.<sup>168</sup> The court then attempts to extend this rationale to the goal of equitable distribution.<sup>169</sup> Because laws that implicate the goal of a fresh start are preempted, laws that implicate the other goal of bankruptcy are also preempted.<sup>170</sup>

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<sup>162</sup> See, e.g., *id.* at 1201, 1205. A major part of the opinion consisted of the court rejecting the assignee’s arguments as insufficient to prevent preemption. *Id.* While *Sherwood* does not expressly contain a “burden” argument, the structure of the opinion is indicative of such a presumption. *Id.*

<sup>163</sup> *Haberbush*, 43 Cal. Rptr. 3d at 820.

<sup>164</sup> *Id.* (quoting *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963)).

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Sherwood*, 394 F.3d at 1203.

<sup>168</sup> *Id.*; see also *supra* note 134 and accompanying text.

<sup>169</sup> *Sherwood*, 394 F.3d at 1203.

<sup>170</sup> *Id.*

The California Court of Appeals does not find this reasoning persuasive. *Haberbush* takes the position that state laws must do more than merely implicate equitable distribution.<sup>171</sup> In support of this view, the court points to several cases where the Supreme Court has upheld ABC statutes in part because they implicate equitable distribution.<sup>172</sup> Also, the fact that a statute implicates a goal of federal law does not “justify the conclusion that the state law ‘stands as an obstacle’ to that goal.”<sup>173</sup> To the contrary, the *Haberbush* court determined that section 1800 necessitates a conclusion that there has been no federal preemption because ABCs have coexisted with federal bankruptcy law since the first bankruptcy act,<sup>174</sup> and Congress made no indication of any intent to preempt ABCs.<sup>175</sup>

*B. Whether Statutes Granting a Fiduciary Powers Beyond Those of General Creditors Are Inconsistent With Federal Law and Are Therefore Preempted*

The second disagreement focuses on the power section 1800 confers upon the assignee.<sup>176</sup> The fact that section 1800 grants the assignee more power than creditors generally is problematic for the Ninth Circuit for several reasons.<sup>177</sup> First, such statutes should be preempted because the preference avoidance power should only be exercised under a federal court’s supervision.<sup>178</sup> Preference avoidance should be an exclusive federal power because federal law provides superior standards and procedures to ensure impartiality on the part of the fiduciary and to protect creditors from fraud.<sup>179</sup> Particularly, a federal trustee is appointed by the court or elected by creditors, whereas an assignee is “hand-picked” by the debtor.<sup>180</sup> Federal law also

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<sup>171</sup> *Haberbush*, 43 Cal. Rptr. 3d at 818 (point 2 of the court’s analysis).

<sup>172</sup> *Id.* (citing *Pobreslo v. Joseph M. Boyd Co.*, 287 U.S. 518, 526 (1933), and *Stellwagen v. Clum*, 245 U.S. 605, 615 (1918)).

<sup>173</sup> *Id.*

<sup>174</sup> *Id.* at 820.

<sup>175</sup> *Id.* The opposite is true—Congress has explicitly incorporated ABCs into the Bankruptcy Code, suggesting an intent to preserve ABCs. *See id.*

<sup>176</sup> Compare *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1201 (9th Cir. 2005), with *Haberbush*, 43 Cal. Rptr. 3d at 818 (point 3 of the opinion).

<sup>177</sup> *Sherwood*, 394 F.3d at 1202.

<sup>178</sup> *Id.* at 1204. The Ninth Circuit cites no authority for this proposition.

<sup>179</sup> *See id.* The implication is that state law is not to be trusted because the potential for abuse under state law is greater than that under federal law. *See id.*

<sup>180</sup> *Id.*

protects creditors against any conflicts of interest or self-dealing on the part of the trustee.<sup>181</sup>

The court also rejected the assignee's argument that the Code "tolerat[es]" and "specifically incorporate[s]" state preference statutes.<sup>182</sup> In the event of bankruptcy, the federal trustee would be able to assume any powers enumerated under state law under § 544 of the Code.<sup>183</sup> Therefore, the assignee asserts that § 544(b) of the Code is a "[manifestation of] congressional intent not to preempt state statutes invalidating preferences" because the preprovision contemplates the concurrent use of state preference avoidance laws.<sup>184</sup> However, the court points out that § 544(b) only gives the trustee the powers available to general unsecured creditors under state law.<sup>185</sup> Section 1800, on the other hand, confers powers to the state assignee beyond those of individual unsecured creditors.<sup>186</sup> This means that § 544 would have to grant the trustee the powers of creditors' representatives in order to incorporate section 1800.<sup>187</sup> Section 544 makes no such grant.<sup>188</sup> Thus, the mere fact that certain state laws are integrated into the Code does not "save the California statute from preemption."<sup>189</sup>

In response, *Haberbush* underscores a point made in the *Sherwood* dissent—the majority's reasoning is flawed because assignees, by the nature of their position, have more power than individual creditors.<sup>190</sup> "The state assignee, regardless of the powers granted by section 1800, distributes a debtor's assets among creditors and otherwise exercises powers on behalf of all

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<sup>181</sup> *Id.*

<sup>182</sup> *Id.* at 1201.

<sup>183</sup> *Id.*; see also 11 U.S.C. § 544 (2000).

<sup>184</sup> *Sherwood*, 394 F.3d at 1201.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* at 1202. The court's textual interpretation of the Code suggests that Congress did not extend the Strong-Arm power to assignees because the term "creditors" does not include assignees in the context of § 544(b). *Id.* Custodian is defined in § 101(11)(A) to include "receivers, trustees and assignees" under a general ABC law. 11 U.S.C. § 101(11)(A). Furthermore, in several instances, custodians are defined as creditors; however, § 544(b) bears no mention of custodians and thus, the court concluded that assignee could not be read into the meaning of creditor under § 544(b). *Sherwood*, 394 F.3d at 1201. See also 11 U.S.C. §§ 101(10)(A), (11)(B)–(C), 544(b).

<sup>187</sup> *Sherwood*, 394 F.3d at 1202.

<sup>188</sup> *Id.* Section 101 of the Code categorizes assignees in an ABC as a custodian. 11 U.S.C. § 101(11)(B). As such, if Congress had intended to grant the trustee the powers of assignees through the Strong-Arm clause, it would have used the term "custodian" rather than "creditor." *Sherwood*, 394 F.3d at 1202.

<sup>189</sup> *Id.*

<sup>190</sup> *Haberbush v. Charles & Dorothy Cummins Family Ltd. P'ship*, 43 Cal. Rptr. 3d 814, 818–19 (Cal. Ct. App. 2006); *Sherwood*, 394 F.3d at 1206 (Nelson, J., dissenting).

creditors, thus exercising powers greater than any one creditor could exercise.”<sup>191</sup> Preempting all state laws that grant assignees more power than creditors generally would effectively invalidate all ABCs.<sup>192</sup> However, ABCs are not repugnant to the Code.<sup>193</sup> ABCs “protect creditors against each other” and assure that distribution is not affected or conditioned on other factors, such as discharge.<sup>194</sup> Far from obstructing the goals of bankruptcy, ABCs actually promote and facilitate equitable distribution.<sup>195</sup>

Second, *Sherwood* reasons that the statute should be preempted because allowing an assignee to recover preferences would preclude a trustee from recovering the same sum.<sup>196</sup> This leaves open the possibility that section 1800 will result in the inequitable distribution of the debtor’s property in the event the debtor petitions for bankruptcy after assigning its debt.<sup>197</sup> The trustee may not be able to identify or locate the creditors who received the payments.<sup>198</sup> Even if the trustee were successful in reaching the creditor, the creditor may have become insolvent himself.<sup>199</sup> Thus, any recovered funds would be distributed “by a state assignee subject to state procedures and substantive standards, rather than by the federal trustee subject to bankruptcy law’s substantive standards and procedural protections.”<sup>200</sup>

According to *Haberbush*, this rationale is unfounded.<sup>201</sup> The California Court of Appeals agrees that the trustee may not be able to recover the same preferences as the assignee. However, section 1800 contains the same provisions as the Code’s preference avoidance provision.<sup>202</sup> This means that the same preferences can be avoided under state law as well as under federal law.<sup>203</sup> Furthermore, because section § 1800 is identical to the Code, it ensures

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<sup>191</sup> *Sherwood*, 394 F.3d at 1206 n.1 (Nelson, J., dissenting).

<sup>192</sup> *Haberbush*, 43 Cal. Rptr. 3d at 819.

<sup>193</sup> *Id.*; see also *Pobreslo v. Joseph M. Boyd Co.*, 287 U.S. 518, 526 (1933); *Stellwagen v. Clum*, 245 U.S. 605, 615 (1918). The Ninth Circuit has conceded this point. *Sherwood*, 394 F.3d at 1205.

<sup>194</sup> See *Sherwood*, 394 F.3d at 1207 (Nelson, J., dissenting) (quoting *Pobreslo*, 287 U.S. at 526).

<sup>195</sup> *Id.* at 1207–08 (Nelson, J., dissenting).

<sup>196</sup> *Id.* at 1204.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> *Haberbush v. Charles & Dorothy Cummins Family Ltd. P’ship*, 43 Cal. Rptr. 3d 814, 819 (Cal. Ct. App. 2006).

<sup>202</sup> Compare 11 U.S.C. § 547 (2000), with CAL. CIV. PROC. CODE § 1800 (West 2007); see also *Haberbush*, 43 Cal. Rptr. 3d at 820.

<sup>203</sup> *Haberbush*, 43 Cal. Rptr. 3d at 820.

equal distribution of the insolvent party's assets to creditors.<sup>204</sup> The fact that California uses a similar statute to accomplish the same goal as the Code does not lead to the conclusion that section 1800 obstructs the goals of bankruptcy law.<sup>205</sup>

*C. Whether Allowing State Preference Statutes Will Affect the Incentives of Certain Creditors to Avail Themselves of Federal Bankruptcy Law*

The third reason for preemption, articulated in *Sherwood*, is that upholding section 1800 would “affect the incentives of various parties as to whether they wish to avail themselves of federal bankruptcy law.”<sup>206</sup> The assignee maintains that creditors always have the option of forcing a debtor into involuntary bankruptcy if they have met the requirements provided in § 303(b)(1) of the Code.<sup>207</sup> The court, however, does not think that involuntary bankruptcy is sufficient recourse for creditors.<sup>208</sup>

State preference laws may prevent creditors from bringing their cases to federal courts by dissuading certain creditors from filing an involuntary petition.<sup>209</sup> If the proceeds from the assignee's preference avoidances are being distributed to some creditors, the creditors benefiting from the state forum will not be likely to join in a petition for involuntary bankruptcy for fear of being paid less and subjected to greater restrictions under the Code.<sup>210</sup> There are particular circumstances under which federal law can be invoked and there is no reason to believe that Congress would “sharpen or blunt” the statutory incentives for initiating bankruptcy.<sup>211</sup>

The California Court of Appeals found that this analysis was a mere divergence from the issue at hand.<sup>212</sup> Any potential effect section 1800 may have on party incentives is insufficient grounds for preemption because all

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<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1205 (9th Cir. 2005).

<sup>207</sup> *Id.* In most cases, a minimum of three creditors is required to petition for an involuntary bankruptcy.

*Id.*

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

<sup>212</sup> *Haberbush v. Charles & Dorothy Cummins Family Ltd. P'ship*, 43 Cal. Rptr. 3d 814, 819 (Cal. Ct. App. 2006).

ABCs alter the incentives of parties.<sup>213</sup> It should then follow, that if section 1800 is preempted, all ABCs ought to be preempted.<sup>214</sup> That result does not stand.<sup>215</sup> Additionally, incentives to use federal law are irrelevant.<sup>216</sup> The only question at hand is whether section 1800's effect on the parties' incentives obstructs the goal of equitable distribution.<sup>217</sup> In this case, the Ninth Circuit did not offer any "cogent explanation of how the assignee's avoidance powers conflict with that objective."<sup>218</sup>

These differences in the application of the preemption doctrine ultimately have lead the courts to different conclusions. The following section will examine the impact of these decisions on insolvency systems, raise additional issues the courts did not consider, and conclude that *Haberbush* is the proper standard.

### III. ANALYSIS

The decisions of the Ninth Circuit Court of Appeals and the California Court of Appeals have left the validity of ABCs in a realm of uncertainty. Under state assignment law, if statutes like section 1800 are preempted, creditors may receive less than their fair share of the distribution because the assignee may not be able to recover preferences. On the other hand, a non-preferred creditor will have to run to a federal bankruptcy court if that creditor wants to recover the preference. Under federal law, any preference recovery action will likely be valid;<sup>219</sup> however, the parties must trade the more efficient and economical state proceedings for this assurance.<sup>220</sup>

This section will present four reasons why the California Court of Appeals decision is correct, and will raise points that both courts neglected to address. First, section 1800 should not be preempted because there can be no conflict between the state and federal law when no bankruptcy petition has been filed.

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<sup>213</sup> *Id.* at 818–19. The *Haberbush* court asserted that "this distinction . . . would cast doubt on the validity of all voluntary assignment statutes, not merely those allowing the assignee to avoid preferential transfers." *Id.* at 819.

<sup>214</sup> *Id.*

<sup>215</sup> *Id.* at 818. This is obviously wrong because the Supreme Court has held that ABCs are valid. *Id.*

<sup>216</sup> *Id.* at 819.

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> 11 U.S.C. § 547 (2000).

<sup>220</sup> See generally *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198 (9th Cir. 2005); *Haberbush*, 43 Cal. Rptr. 3d 814.

Second, under the Supreme Court's current preemption standard, the California preemption statute passes constitutional muster. Third, the Ninth Circuit's concern over equitable distribution is unfounded, or at best, too tenuous to be a practical impediment to the goals of the Bankruptcy Code. Finally, state preference provisions operate to further, not oppose, the purposes of bankruptcy.

*A. There Is No Conflict Between Section 1800 and the Bankruptcy Code Because the Bankruptcy Code Has Not Been Invoked*

Sherwood and Haberbush raise the question of whether the validity of the preferences actions was properly reached because neither case involved a bankruptcy petition.<sup>221</sup> A state law can conflict with the Bankruptcy Code only when the federal provisions are invoked.<sup>222</sup> The right to regulate voluntary assignments lies with the states.<sup>223</sup> Moreover, Congress has provided that bankruptcy proceedings should defer to a state's regulatory scheme<sup>224</sup> unless the debtor files a voluntary petition<sup>225</sup> or the requisite number of creditors file an involuntary petition.<sup>226</sup> The only exception to this general principle lies with discharge.<sup>227</sup> However, discharge is an act of bankruptcy, whereas assignments are not.<sup>228</sup> Thus, each state ought to be able to maintain its own form of creditor collective remedies, unless and until a bankruptcy case is filed, so long as it does not grant a discharge.

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<sup>221</sup> See generally *Sherwood*, 394 F.3d 198; *Haberbush*, 43 Cal. Rptr. 3d 814.

<sup>222</sup> See, e.g., Robert Lefkowitz, Note, *The Filing of a Bankruptcy Petition In Violation of 11 U.S.C. § 109(g): Does It Invoke the Automatic Stay?*, 26 CARDOZO L. REV. 297, 327 (noting that the automatic stay is invoked upon the filing of a bankruptcy petition).

<sup>223</sup> *Titlow v. MacPhail (In re Creech Bros. Lumber Co.)*, 240 F. 8, 15 (9th Cir. 1917) (noting that the power to make assignments lies in common-law).

<sup>224</sup> See, e.g., Patrick Collins, Note, *HMO Eligibility for Bankruptcy: The Case for Federal Definitions of 109(b)(2) Entities*, 2 AM. BANKR. INST. L. REV. 425, 437 (1994) (noting that bankruptcy is indeed a satisfactory alternative to state insolvency proceedings). However, it is submitted that in light of the policy of deference to state interests underlying the exclusionary provision, such a comparison is based on a questionable premise, namely that the goals of bankruptcy necessarily merit priority over those of state regulatory schemes. *Id.*

<sup>225</sup> 11 U.S.C. § 301 (2000).

<sup>226</sup> 11 U.S.C. § 303.

<sup>227</sup> *Int'l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929). The Court has ruled that the federal laws have preempted any state regulation of debtor discharge. *Id.*

<sup>228</sup> *In re Tarnowski*, 210 N.W. 836, 838 (Wis. 1926).

*B. Section 1800 Passes Constitutional Muster Because ABCs Are Valid Except to the Extent that State Law Seeks to Grant a Discharge*

The validity of state preference statutes necessarily begins with the Supreme Court's preemption standard.<sup>229</sup> Precedent seems to establish implied conflict or obstacle preemption as the appropriate analysis for questions regarding insolvency statutes that embody common law rights.<sup>230</sup> While Congress has the supreme power to establish bankruptcy laws,<sup>231</sup> the Ninth Circuit has held that preexisting common law rights shall be preserved unless there is a contradictory statutory purpose;<sup>232</sup> in those instances, Congress does not "write on a clean slate."<sup>233</sup> Such policy assures that "the federal-state balance will not be disturbed unintentionally by Congress or unnecessarily by the courts."<sup>234</sup> Thus, section 1800 must be permitted to stand unless the California law directly conflicts with or obstructs the Code, so that compliance with both is impossible.<sup>235</sup>

However, in *Sherwood*, the Ninth Circuit never discussed how section 1800 conflicted with the Code.<sup>236</sup> The court only concluded that state preference legislation is invalid because it "trench[es] too close upon the exercise of the federal bankruptcy power."<sup>237</sup> To support this proposition, the court attempted to analogize preference avoidance with discharge.<sup>238</sup> Since federal bankruptcy law supersedes state law in the realm of discharge,<sup>239</sup> the Ninth Circuit goes

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<sup>229</sup> Neither the Ninth Circuit nor the California Court of Appeals specifies the type of preemption raised in *Sherwood* and *Haberbush*—whether the statute presents a question of field preemption, preemption due to conflict, or preemption due to impairment of federal law.

<sup>230</sup> See, e.g., *Stellwagen v. Clum*, 245 U.S. 605, 615 (1918); *Pinkus*, 278 U.S. at 265 ("The general rule is that an intention wholly to exclude state action will not be implied unless, when fairly interpreted, an Act of Congress is plainly in conflict with state regulation of the same subject.").

<sup>231</sup> *Pinkus*, 278 U.S. at 265.

<sup>232</sup> *Silvers v. Sony Pictures Entm't, Inc.*, 402 F.3d 881, 902 (9th Cir. 2005) (Bea, J., dissenting) (citing *United States v. Texas*, 507 U.S. 529, 534 (1993). See also *Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 108 (1991) ("[W]here a common-law principle is well established . . . the courts may take it as given that Congress has legislated with an expectation that the principle will apply except when a statutory purpose to the contrary is evident." (internal citation marks omitted)); *Isbrandtsen Co. v. Johnson*, 343 U.S. 779, 783 (1952) (noting that statutes should be read "with a presumption favoring the retention of long-established and familiar principles, except when a statutory purpose to the contrary is evident").

<sup>233</sup> Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. *Cybergenics v. Chinery*, 330 F.3d 548, 569 (3d Cir. 2003).

<sup>234</sup> *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977).

<sup>235</sup> *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142–43 (1963).

<sup>236</sup> See *Sherwood Partners, Inc., v. Lycos, Inc.*, 394 F.3d 1198 (9th Cir. 2005).

<sup>237</sup> *Id.* at 1205.

<sup>238</sup> *Id.* at 1203.

<sup>239</sup> See *supra* note 131 and accompanying text.

one step further and assumes that state laws implicating the goal of equitable distribution are also preempted<sup>240</sup> The court's rationale begins with the Supreme Court's determination that state discharge laws are invalid.<sup>241</sup> Statutes providing for discharge are preempted because discharge implicates the goal of granting a fresh start. This is an essential goal of bankruptcy. It follows, according to *Sherwood*, that all laws that implicate any essential goal of bankruptcy are likewise invalid.<sup>242</sup> Therefore, section 1800 is preempted because it implicates the goal of equitable distribution and equitable distribution is an essential goal of bankruptcy. To reach this result, the court equated preference avoidance with discharge,<sup>243</sup> and fresh start with equitable distribution.

This reasoning is erroneous, and the California Court of Appeal was correct to criticize the Ninth Circuit for reaching too far.<sup>244</sup> First, preference law is readily distinguishable from discharge. The power to avoid preferences furthers bankruptcy's goal of equitable distribution and operates to the benefit of creditors generally.<sup>245</sup> On the other hand, discharge operates to the benefit of the debtor and permitting the states to enact discharge provisions may lead to abuse, such as forum shopping for the friendliest discharge law. Also, while the right of assignment existed at common law,<sup>246</sup> there is no similar common law right of discharge. These differences necessitate a uniform, national scheme for discharge; however, the same defects are not true of preference statutes.<sup>247</sup>

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<sup>240</sup> *Sherwood*, 394 F.3d at 1203.

<sup>241</sup> See *supra* note 134 and accompanying text.

<sup>242</sup> *Sherwood*, 394 F.3d at 1203.

<sup>243</sup> Note that the absurdity of this assumption is magnified by the fact that discharge is irrelevant to the corporate debtor. See *supra* text accompanying note 27.

<sup>244</sup> *Haberbush v. Charles & Dorothy Cummins Family Ltd. P'ship*, 43 Cal. Rptr. 3d 814, 818 (Cal. Ct. App. 2006) (arguing that the Ninth Circuit reached too far in stating that any law that implicates the goals of bankruptcy is preempted).

<sup>245</sup> See *Martin v. Enron Corp. (In re Enron Creditors Recovery Corp.)*, 376 B.R. 442, 459 (Bankr. S.D.N.Y. 2007) (stating that an exception to the avoidance power conflicts with bankruptcy's goal of equitable distribution).

<sup>246</sup> Keatinge, *supra* note 7, at 100 (noting that there are two types of ABC's in California—statutory ABCs as codified in the California Civil Code, and common law ABCs, based on the law of trusts).

<sup>247</sup> The Ninth Circuit asserted that state proceedings will affect the incentives of the parties to avail themselves of the bankruptcy law. *Sherwood*, 394 F.3d at 1205. However, corporate debtors will not be influenced so easily. WARREN & WESTBROOK, *supra* note 26, at 396. Moreover, the addition of a preference provision furthers the goal of equitable distribution.

Secondly, the California Court of Appeals' observation that all alternative proceedings would affect a party's incentives to use federal law<sup>248</sup> applies here as well. The Ninth Circuit claims that it does not question the validity of ABCs.<sup>249</sup> However, extending its rationale would render all state assignments and receiverships invalid because all voluntary assignments generally implicate the goal of equitable distribution.<sup>250</sup> The Code has clearly not preempted ABCs. ABCs operate as an alternative to bankruptcy for the purpose of "immediate conversion of the assigned property, or the disposal thereof, and the distribution of the proceeds ratably among the creditors."<sup>251</sup> One state court observed:

The discharge of the bankrupt from his debts constitutes the very essence of a bankruptcy law. While the administration of the estate of the bankrupt and the distribution of the proceeds thereof *pro rata* among his creditors is a usual, if not a necessary, incident of a bankruptcy law, the discharge of the debtor from his debts is no part of an assignment law. The winding up and a fair and equal distribution of the estate of insolvent debtors may arise in various ways, but *where such a proceeding does not result in the discharge of the insolvent debtor*, statutes regulating such a proceeding do not conflict in any manner with the bankruptcy law. . . .<sup>252</sup>

This simply means that state law cannot provide for discharge: it does not mean that states lack the authority to regulate collective proceedings.

Proponents of preemption could potentially derive support from several sources. First, the Court's language in *Pinkus* can be construed to be preemptive of ABCs.<sup>253</sup> *Pinkus* purports to invalidate statutes that relate to bankruptcy.<sup>254</sup> However, a survey of the Court's bankruptcy preemption cases decisively link preemption to discharge.<sup>255</sup> *Pinkus* is no exception. The facts

<sup>248</sup> See *supra* text accompanying notes 206–19.

<sup>249</sup> *Sherwood*, 394 F.3d at 1205 n.8.

<sup>250</sup> See *supra* note 2 and accompanying text.

<sup>251</sup> *Jarvis v. Webber*, 236 P. 138, 143 (Cal. 1925).

<sup>252</sup> *In re Tarnowski*, 210 N.W. 836, 838 (Wis. 1926) (second emphasis added) (“[T]here can be no doubt that legislation prescribing regulations for the administration of voluntary assignments constitutes one subject of legislation, while the discharge of bankrupts constitutes quite another. A voluntary assignment for the benefit of creditors is a personal right inherent in the ownership of property. Such a right existed at common law independent of statute. The statutes do not confer the right, but statutes in this country have been enacted for the purpose of regulating the administration of the estate for the benefit of creditors.”). See also *Pobreslo v. Joseph M. Boyd Co.*, 287 U.S. 518, 525–26 (1933).

<sup>253</sup> *Int'l Shoe Co. v. Pinkus*, 278 U.S. 261, 266 (1929).

<sup>254</sup> *Id.*

<sup>255</sup> *E.g., id.*

of *Pinkus* case are more telling than the dicta.<sup>256</sup> The question now becomes whether precedent resolves the current debate.

The second argument that would support the preemption view is that the Supreme Court has only upheld ABC statutes that grant the assignee the same powers as general unsecured creditors. Because section 1800 gives the assignee more powers, it is arguable that Supreme Court precedent does not apply.<sup>257</sup> This argument would also not hold. While it is true that the Court has only considered cases involving statutes that grant an assignee the same power as general creditors, the Court's intent is clear—statutes that promote equitable distribution are valid.<sup>258</sup> *Haberbush* correctly noted that no conflict leading to preemption arises from this distinction.<sup>259</sup> Thus, the Ninth Circuit's conclusion is overinclusive and ultimately fails to demonstrate any conflict between section 1800 and the Code.

*C. State Preference Statutes Do Not Contravene the Goal of Equitable Distribution Because § 543 Provides For the Turnover of Property From the Assignee to the Trustee*

The Ninth Circuit's main issue with section 1800 seems to be that it grants the assignee more power than creditors generally.<sup>260</sup> Specifically, the trustee cannot access the powers bestowed by section 1800 through the Strong-Arm clause because § 544 of the Code only grants the trustee the rights and powers of *creditors* under state law. However, the court did not explicitly specify why this is relevant to the question of preemption.

One explanation is that the court was concerned with a bankruptcy petition being filed amidst a state assignment. Bankruptcy is an alternative to ABCs. A bankruptcy petition during an ongoing assignment may cause concern over the preservation of the debtor's assets during the transition from state to federal proceedings. However, in observing that the trustee could not exercise

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<sup>256</sup> See *supra* text accompanying note 142.

<sup>257</sup> See *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1204 n.6 (9th Cir. 2005). However, the court also did not identify a sufficient source of conflict between section 1800 and the Bankruptcy Code. Also, the Ninth Circuit, in a footnote, conceded that if section 1800 made the preference power available to general creditors, it would not conflict with federal law. *Id.* The California Court of Appeals, also in a footnote, stated that it failed to see the importance of this distinction. *Haberbush v. Charles & Dorothy Cummins Family Ltd. P'ship*, 43 Cal. Rptr. 3d 814, 819 n.22 (Cal. Ct. App. 2006). A trustee is not deprived of the avoidance power—§ 547 expressly gives the trustee the ability to avoid preferences. *Id.*

<sup>258</sup> *Pobreslo*, 287 U.S. at 526; *Boese v. King*, 108 U.S. 379, 387 (1883).

<sup>259</sup> *Haberbush*, 43 Cal. Rptr. 3d at 819 n.22.

<sup>260</sup> See, e.g., *Sherwood*, 394 F.3d at 1201–02, 1205.

section 1800 through the Strong-Arm clause, the Ninth Circuit failed to fully consider other provisions of the Code, such as § 543.<sup>261</sup> Instead, the court's reasoning seems to gloss over § 543, basing its rationale on § 544. While doing so lends more support to the Ninth Circuit's conclusion, the court should have considered § 543 in analyzing the scope of the assignee's powers.

Timing is essential in determining whether and how the debtor's assets are distributed. There are three situations that can arise depending on when bankruptcy is filed relative to the assignment. A petition may be filed (1) more than 120 days after an ABC was initiated or after the assignee has recovered and distributed any preference; (2) after the assignee has recovered any preferences, but before he has distributed the proceeds to the general creditors; or (3) while the assignee is in preference recovery litigation. The court's concern about the repercussions of a bankruptcy filing appears to be tied with the federal trustee's ability to recover preferences.<sup>262</sup> However, the Code accounts for state law collective proceedings in each instance. The following subsections will discuss each case in turn.

*1. If Bankruptcy is Filed More Than 120 Days After Assignment or After the Assignee Has Distributed Any Recovered Preferences, Equitable Distribution Will Likely Have Been Accomplished Through the Assignment*

The simplest case is where the proceeds have been distributed to creditors or the assignment was made more than 120 days prepetition because where bankruptcy comes after the completion or significantly after the initiation of an assignment, the goal of equitable distribution is met. First, when the assignee has made all distributions, the assignment is essentially complete. As noted above, it is difficult to conceive of a conflict between state and federal law before the Code is invoked.<sup>263</sup> Likewise, it would be difficult for state law to obstruct the federal law when state law is no longer in effect.<sup>264</sup> Second, if an assignee has been in place for more than 120 days, the Code provides that the state assignment *must* be permitted and the assignee need not turn over any property of the debtor to the bankruptcy trustee unless a bankruptcy proceeding

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<sup>261</sup> The Ninth Circuit did note that § 543 indicates that Congress contemplated state ABCs and excused some assignees from turnover. *Id.* at 1201.

<sup>262</sup> After the Ninth Circuit disposed of the assignee's argument that the trustee has access to state powers under § 544, it puts forth that "[a] creditor who disgorged the transfer cannot disgorge it twice." *Id.* at 1204.

<sup>263</sup> See generally Lefkowitz, *supra* note 222.

<sup>264</sup> See *supra* note 220 and accompanying text.

is “necessary to prevent fraud or injustice.”<sup>265</sup> In either instance, the assignee would be able to recover the same preferences as the trustee because section 1800 is identical to § 547 of the Code.

2. *The Bankruptcy Code Provides for Turnover If Bankruptcy Is Filed after the Assignee Has Recovered Any Preferences and Before Distribution to Creditors*

The Code provides the bankruptcy court with two alternatives where the petition is filed after the assignee has recovered any preferences but before distribution—have the trustee take over or allow the assignment to continue. As in the first situation, here either case also ensures equal treatment of creditors.

Section 543(a) prevents the assignee from distributing the debtor’s property once the assignee knows bankruptcy has been filed.<sup>266</sup> The assignee must “deliver to the trustee any property of the debtor held by or transferred to [the assignee], or proceeds, product, offspring, rents, or profits of such property” in the assignee’s possession.<sup>267</sup> Alternatively, the court may exercise one of § 543’s exceptions to turnover. Under subsection (d)(1), the court may permit the assignee to complete the assignment “if the debtor is not insolvent,” and “if the interests of creditors and . . . equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property.”<sup>268</sup>

3. *If Bankruptcy is Filed While the Trustee is in the Middle of Preference Recovery Litigation, the Preference Claim or the Proceeds Thereof Should Be Turned Over to the Trustee Under § 543*

A murkier situation arises if the debtor or creditors successfully petition for bankruptcy while the assignee is litigating to recover a preference. However, there is little reason to fear any loss of the debtor’s property or any disruption of equitable distribution because there are strong indications that § 543 also covers an assignee’s preference claim.

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<sup>265</sup> 11 U.S.C. § 543(d)(2) (2000).

<sup>266</sup> *Id.* § 543(a).

<sup>267</sup> *Id.*

<sup>268</sup> *Id.* § 543(d)(1).

The concern that a “creditor who disgorged the transfer cannot disgorge it twice” is the most apparent in this case.<sup>269</sup> It is important to note that a transfer will only be a preference in bankruptcy if the transfer is made within 90 days.<sup>270</sup> If the transfer was made within the preference window, the assignee has an obligation to turn over any property of the debtor to the trustee under § 543.<sup>271</sup> Assuming that there is a preference, the question becomes whether the claim the assignee brought against the preferred creditors falls within the scope of § 543. A plain reading of the statute would suggest that the meaning of “property of the debtor” under § 543 does not encompass legal claims.<sup>272</sup> However, when placed in the context of the goals and objectives of the bankruptcy law, § 543 should be read more expansively.

The scope of § 543 depends on whether a legal claim may constitute “property of the debtor” or the “proceeds, product, offspring, rents, or profits of such property.”<sup>273</sup> Authority and legislation suggests that a more expansive reading of § 543 is appropriate in this circumstance. For example, one U.S. Circuit Court affirmed a bankruptcy court’s determination that a lawsuit constitutes property of the estate because the subject of the lawsuit was “[sufficiently rooted in Debtor’s] pre-bankruptcy past.”<sup>274</sup> Case law also establishes that a claimant has the right to assign its claims in contract.<sup>275</sup> Moreover, state legislatures have the authority to designate the assignee’s suits against preferred creditors as property of the debtor.<sup>276</sup> The Supreme Court has determined that “[p]roperty interests . . . are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law.”<sup>277</sup>

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<sup>269</sup> *Sherwood*, 394 F.3d at 1204.

<sup>270</sup> 11 U.S.C. § 547(b)(4).

<sup>271</sup> *Id.* § 543(a).

<sup>272</sup> *Id.*

<sup>273</sup> *Id.* § 543(b)(1).

<sup>274</sup> *O’Dowd v. Trueger (In re O’Dowd)*, 233 F.3d 197, 201 n.6 (3d Cir. 2000); *but see, e.g., Bd. of Regents v. Roth*, 408 U.S. 564 (1972) (holding that there is no constitutional deprivation of property where the Plaintiff was not rehired for a job at the expiration of the contractual period of one year).

<sup>275</sup> *Cf. Schlauch v. Hartford Accident & Indem. Co.*, 194 Cal. Rptr. 658, 661 (Cal. Ct. App. 1983) (noting that although an insured can assign the contractual element of a bad faith claim, the personal tort elements of such a claim are not assignable).

<sup>276</sup> *See Roth*, 408 U.S. at 577.

<sup>277</sup> *Id.*

*D. Section 305 Grants Bankruptcy Courts Discretion to Permit a State Law Insolvency Proceeding to Commence Notwithstanding an Involuntary Bankruptcy Petition*

In addition to the turnover provision, § 305 of the Bankruptcy Code, also known as abstention, contemplates the coexistence of state insolvency law with the Bankruptcy Code as well.<sup>278</sup> Abstention allows a bankruptcy court, upon motion,<sup>279</sup> to decline jurisdiction over a case.<sup>280</sup> Section 305 provides in pertinent part: “The court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if the interests of creditors and the debtor would be better served by such dismissal or suspension.”<sup>281</sup> The advantages of state ABCs would certainly better serve the interests of creditors in many cases.<sup>282</sup>

*E. Non-Preemption Furthers the Goals of Bankruptcy and Insolvency Legislation*

Section 1800 makes good policy because it furthers the goals of the Bankruptcy Code and creates universally beneficial policy. As the California Court of Appeals reasoned, ABCs, like bankruptcy, serve the general interests of creditors. The Ninth Circuit even used the fact that section 1800 implicates the bankruptcy goal of equitable distribution as a premise for its conclusion. Also, in deciding a prior question of preemption, the Supreme Court upheld a state ABC statute that implicated equitable distribution but that did not provide for discharge.<sup>283</sup> The Court proclaimed, not only was the statute not preempted, but it operated “quite in harmony with the purposes of the federal [bankruptcy law].”<sup>284</sup> Statutes regulating voluntary assignments “serve to protect creditors against each other and go to assure equality of distribution.”<sup>285</sup>

Furthermore, the Bankruptcy Code includes provisions where Congress contemplated the use of, and even defers to, state proceedings to carry out the objectives of bankruptcy. Section 543 provides for the turnover of property of

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<sup>278</sup> See 11 U.S.C. § 305 (2000).

<sup>279</sup> Such motions are generally made by the debtor and joined by the assignee. GEOFFREY L. BERMAN, GENERAL ASSIGNMENTS FOR THE BENEFIT OF CREDITORS: THE ABCS OF ABCS 42 (2d ed. 2007).

<sup>280</sup> *Id.*

<sup>281</sup> 11 U.S.C. § 305.

<sup>282</sup> See *supra* note 5 and accompanying text.

<sup>283</sup> *Pobreslo v. Joseph M. Boyd Co.*, 287 U.S. 518, 526 (1933).

<sup>284</sup> *Id.*

<sup>285</sup> *Id.*

the debtor from the custodian to the federal trustee in the event bankruptcy is filed during a state proceeding.<sup>286</sup> The statute also specifies several instances where turnover is excused. One instance occurs where the custodian is an assignee for the benefit of creditors and took possession of the debtor's property more than 120 days before the bankruptcy petition was filed.<sup>287</sup> The Bankruptcy Code's explicit incorporation and deference to state ABCs supports that such state assignments further the ends of the federal law.

In California's case, section 1800 not only serves the same ends as the Bankruptcy Code, the trustee may be harmed in its absence.<sup>288</sup> Without section 1800, the assignee may not be able to distribute property of the debtor equitably. One of the defects of the California's common law assignment was the lack of means for the assignee to recover preferential transfers. This means that "in sizable cases the remaining non-preferred creditors [would] be forced to file a bankruptcy petition in order that the trustee in bankruptcy may void such transfers or liens."<sup>289</sup> Section 1800 corrects this flaw in common law assignment. Moreover, section 1800 contains the same provisions as its federal counterpart, allowing the assignee to reach all the transactions a trustee would be able to avoid in bankruptcy, and preventing certain creditors to take more than they would otherwise get from the debtor.

Granting an assignee the power to avoid preferences ultimately furthers bankruptcy's goal of equitable distribution by preventing favored or more powerful creditors from diminishing the assets available to creditors generally.

## CONCLUSION

As common law ABCs in California have become more widely used in the past years, the legislatures have been more apt to pass supplementary legislation to ensure fair and equitable proceedings for creditors and debtors. Section 1800 is one such supplement.

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<sup>286</sup> 11 U.S.C. § 543.

<sup>287</sup> *Id.* § 543(d)(2). After 120 days, the bankruptcy court must permit the assignee to continue the assignment. *Id.*

<sup>288</sup> See Nahum L. Gordon, *The Security Interest in Inventory Under Article 9 of the Uniform Commercial Code and the Preference Problem*, 62 COLUM. L. REV. 49, 60 (1962) ("The hypothetical state insolvency . . . [which] invalidates interests taken for antecedent value that are otherwise beyond the reach of a trustee in bankruptcy . . . will probably be sustained on the ground that it is in aid of a bankruptcy trustee . . .").

<sup>289</sup> Keatinge, *supra* note 7, at 115.

The strongest argument in favor of preemption is the need for a uniform bankruptcy law. The California preference statute may have drawn a preemption challenge for no other reason than that it makes an ABC proceeding, on its face, look like a type of state bankruptcy. “[T]here is a need for preemption in bankruptcy law based on uniformity and finality concerns.”<sup>290</sup> For example, “the threat later state litigation to redress activities in bankruptcy would undercut the uniformity and finality of bankruptcy proceedings.”<sup>291</sup> However, ABCs are not, and do not purport to be, bankruptcies.

There is also no conflict between ABCs and the goals of Congress. Not only are general creditors helped by section 1800, they are harmed by the preemption view. Preemption would obstruct equitable distribution because without some type of deterrent, certain creditors could compel and keep preferences, diminishing the estate for other creditors generally. ABCs have long been recognized as a valid exercise of the state regulatory power and preference avoidance statutes aid ABCs in furthering goals of bankruptcy by giving general creditors an added layer of protection.

The basic premise of the federal avoidance power under the Bankruptcy Code is that the trustee should have the same avoidance rights that would be available to creditors in non-bankruptcy law.<sup>292</sup> The simplest way to eliminate any potential future preemption challenges is to mollify the Ninth Circuit’s concerns about the California statute by extending the state preference avoidance power to unsecured creditors. However, this would be a needless precaution because there is no rational basis for finding federal preemption with respect to section 1800.

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<sup>290</sup> FDIC v. Barton, No. Civ.A. 94-3294, 1998 WL 169696, at \*3 (E.D. La. April 8, 1998).

<sup>291</sup> *Id.*

<sup>292</sup> Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198, 1204 n.6 (9th Cir. 2005); *see also* 11 U.S.C. § 544.

In sum, future courts considering this issue should adhere to the non-preemptionist view because state preference avoidance statutes cannot conflict with federal law when there is no bankruptcy, they are constitutional because they facilitate equitable distribution, they do not interfere with any bankruptcy proceedings that may arise, and they are necessary to ensure equitable distribution. The Ninth Circuit simply got it wrong in *Sherwood*.

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