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Assignee's Preference Avoidance Power

Ninth Circuit Rules That Bankruptcy Code Preempts It

By David S. Kupetz

Part One of a Two-Part Article

In *Sherwood Partners, Inc., Assignee for the Benefit of Creditors of International Thinklink Corporation v. Lycos, Inc.*, 394 F.3d 1198 (9th Cir. 2005), the Ninth Circuit Court of Appeals, by a divided court, recently held that a state statute authorizing an assignee for the benefit of creditors to void a preferential transfer is preempted by the federal Bankruptcy Code. The Ninth Circuit majority's theory was that because the right to void preferences was granted by state law to the assignee, but not to an individual creditor, the state statute "trenched too closely" on the federal bankruptcy power, which thus preempted the state law. The majority opinion was authored by Judge Alex Kozinski. The dissent was by Judge Dorothy W. Nelson. The Ninth Circuit denied a petition for rehearing and suggestion for rehearing *en banc*. Sherwood Partners, Inc. (Sherwood), has filed a Petition for Writ of Certiorari with the U.S. Supreme Court.

The majority opinion of the Ninth Circuit concluded that the United States Bankruptcy Code

Avoidance Power

continued from page 1

(Title 11 of the United States Code), enacted pursuant to the Bankruptcy Clause of the United States Constitution (U.S. Const. art. I, § 8, cl. 4), preempts California Code of Civil Procedure Section 1800 (C.C.P. 1800) Cal. Civ. Proc. Code § 1800 (C.C.P. § 1800) in pertinent part, provides that:

“The assignee of any general assignment for the benefit of creditors ... may recover any transfer of property of the assignor: 1) To or for the benefit of a creditor; 2) For or on account of an antecedent debt owed by the assignor before the transfer was made; 3) Made while the assignor was insolvent; 4) Made on or within 90 days before the date of the making of the assignment ... ; and 5) That enables the creditor to receive more than another creditor of the same class.”

In a voluntary assignment, “the debtor makes a voluntary transfer of all of its nonexempt assets to an assignee in trust for the purpose of liquidating the assets and distributing the proceeds to creditors on a *pro rata* basis.” See Tabb CJ: The Law of Bankruptcy § 1.5 (1997); see also *Credit Managers Association v. National Independent Business Alliance* (*CMA v. NIBA*), 162 Cal. App. 3d 1166, 1169, 209 Cal. Rptr. 119 (1984). General assignments have been recognized by state and federal courts as being tools to liquidate insolvent estates for the benefit of creditors without having to institute federal bankruptcy proceedings. See *Stellwagen v. Clum*, 245 U.S. 605, 617, 38 S. Ct. 215, 62 L. Ed. 507 (1918) (*Stellwagen*); see also *Pobreslo*

v. Joseph M. Boyd Co., 287 U.S. 518, 525-26, 52 S. Ct. 262, 77 L. Ed. 469 (1933) (*Pobreslo*); *Johnson v. Star*, 287 U.S. 527, 53 S. Ct. 265, 77 L. Ed. 473 (1933); *Mayer v. Hellman*, 91 U.S. 496, 502-03, 23 L. Ed. 377 (1875) (*Mayer v. Hellman*); *CMA v. NIBA*, 162 Cal. App. 3d at 1169; *Credit Managers Association v. National Independent Business Alliance* 162 Cal. App 3d 1166 (1984) (*Credit Managers Association*).

Absent an anti-preference statute, the assignee “stands in the place of the assignor,” and cannot recover preferential payments made by the debtor-assignor prior to the assignment, because at common law the debtor-assignor himself could not have sued to recover the transfers. See *Francisco v. Aguirre*, 94 Cal. 180, 183, 29 P. 495 (1892). The common-law assignee’s inability to recover pre-assignment preferences may, however, be remedied by a statute expressly enabling him to seek such recovery. See Philbin J: Assignments for the Benefit of Creditors § 98. 6 *Am. Jur.* 2d, 2000. The rationale for these “anti-preference” statutes is simple: the statutes seek to avoid “preferences given just before an insolvency or liquidation,” (Michael DC: The Past and Future of Kentucky’s Fraudulent Transfer and Preference Laws. 86 *KY. L.J.* 937, 942 (1997)), in order to “prevent unequal treatment of the insolvent’s creditors ... (Holliday BB: Insolvency § 68. 42 *Am. Jur.* 2d, 2004). The state statutes therefore “typically” provide that, “during a specified period of time before insolvency proceedings commence, any payment or transfer the debtor makes to one of his creditors in payment of a pre-existing debt may be avoided if statutory requirements or elements are met.” *Id.* Prior to the Ninth Circuit majority’s decision in *Sherwood Partners*, such statutes had never been held to be in conflict with federal bankruptcy law. See, eg, *Stellwagen*, *Pobreslo*, *Star*, 287 U.S. 527; *Maye v. Hellman* (*Hellman*), 91 U.S. 496 accord *CMA v. NIBA*.

UNDERLYING FACTS

International Thinklink Corporation (Thinklink) was a messaging

and communications company that offered its subscribers unified telephone and message services. Lycos owns and maintains a network of computer websites grouped under its brand (the Lycos Network), from which it makes a wide array of services and products available to Internet users. On Dec. 21, 1999, Thinklink and Lycos entered into an e-Commerce Agreement (the Original Agreement) pursuant to which the parties agreed to create a co-branded version of Thinklink’s Web site (the “Thinklink Site”) on the Lycos Network. Visitors to the Lycos Network could access the Thinklink Site and, if they wished, could subscribe and pay for Thinklink’s services. During the approximately 2-year term of the Original Agreement, Thinklink was to be the exclusive provider of message services on the Lycos Network. For its access to the Lycos Network, Thinklink agreed to pay integration fees totaling \$20 million over the 2 years of the Original Agreement, to pay a portion of its net sales revenue, and to share any advertising revenue. On or about July 14, 2000, Thinklink made the first payment due under the Original Agreement in the amount of \$3 million. However, no other payments were made. On or about Dec. 23, 2000, Thinklink and Lycos executed an Amended and Restated e-Commerce Agreement (Amended Agreement). On Dec. 26, 2000, Thinklink made a \$1 million payment to Lycos.

On Feb. 14, 2001, Thinklink made a general assignment for the benefit of its creditors to Sherwood, as assignee, in accordance with California law. There has been no case under the federal Bankruptcy Code commenced involving Thinklink, either voluntarily or, alternatively, involuntarily by Thinklink’s creditors.

SHERWOOD’S DISTRICT COURT ANTI-PREFERENCE LITIGATION

On May 16, 2001, Sherwood, in its capacity as assignee for the benefit of creditors of Thinklink, filed a complaint (the Complaint) commencing a lawsuit against Lycos, in the Superior

David S. Kupetz, a partner in SulmeyerKupetz, located in Los Angeles and Menlo Park, CA, specializes in business reorganization, bankruptcy and other insolvency matters. SulmeyerKupetz is counsel to Sherwood Partners, Inc., as assignee for the benefit of creditors of International ThinkLink Corporation, in the case discussed in this article. Mr. Kupetz can be reached at dkupetz@sulmeyerlaw.com.

continued on page 8

Avoidance Power

continued from page 7

Court of the State of California for the County of Los Angeles, pursuant to the anti-preference provisions of Cal. Civ. Proc. Code § 1800 (CCP 1800). The Complaint alleged that on the account of an antecedent debt, while Thinklink was insolvent and within 90 days of the assignment, Thinklink made a payment to Lycos in the sum of \$1 million that enabled Lycos to receive more than any other creditor of the same class. In its capacity as assignee for the benefit of Thinklink's creditors, Sherwood sought avoidance of the transfer to Lycos and recovery of \$1 million from Lycos pursuant to the provisions of Cal.

Civ. Proc. Code § 1800 (CCP 1800).

Lycos removed the action to the United States District Court for the Central District of California (the "District Court") on the ground of diversity jurisdiction pursuant to 28 U.S.C. § 1441 (28 U.S.C. § 1441). On July 23, 2001, Lycos moved to dismiss the Complaint and asserted that Cal. Civ. Proc. Code § 1800 (CPC § 1800) was preempted by the enactment of 11 U.S.C. § 101, *et seq.* (the Bankruptcy Code), and was therefore null and void. On Feb. 14, 2002, the District Court denied Lycos's motion to dismiss, holding that Cal. Civ. Proc. Code § 1800 was not preempted by the Bankruptcy Code because Cal. Civ. Proc. Code § 1800 does not intrude into a field occupied by the

Bankruptcy Code and that the state statute does not conflict with the Bankruptcy Code.

On Oct. 4, 2002, Sherwood filed a motion for summary judgment on its claim to recover the \$1,000,000 payment. Lycos filed an opposition. On Jan. 10, 2003, the District Court held that Lycos failed to establish any defense to the anti-preference action brought pursuant to Cal. Civ. Proc. Code § 1800 and that no genuine issue of material fact existed. Accordingly, the District Court entered judgment on Jan. 17, 2003, in favor of Sherwood, as assignee, for \$1 million plus prejudgment interest.

Next month, we discuss the Ninth Circuit's decision in depth.

