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PERSPECTIVE

Federal v. State Claims in Bankruptcy

By Krsto Mijanovic

The recession has taken its toll on many California businesses, small and large. Many companies have come to a point where they are no longer viable and must close down. While bankruptcy is a stark reality for some, many troubled companies have the option of executing a general assignment for the benefit of creditors or ABC, which is a business liquidation device available to an insolvent debtor as an alternative to formal bankruptcy proceedings. An ABC is a contract in which a troubled entity aka the assignor transfers its assets to a third party aka the assignee in trust, who liquidates them and distributes the proceeds to the creditors. The goal of an ABC is to transfer the assets free of the unsecured debt incurred by the troubled business while minimizing negative publicity and potential liability for directors and management.

Section 1800 of the California Code of Civil Procedure makes the rights of creditors in an ABC similar to those in bankruptcy. Section 1800 gives California assignees, for the benefit of creditors, the power to recover purely innocent preference payments, such as legitimate payments made on legitimate debts, for redistribution. Because the property in the assignment estate is distributed in accordance with certain priorities under Code of Civil Procedure Section 1204, unsecured creditors are the last to be paid, if at all. Worse yet, an assignee's authority is similar to a bankruptcy trustee, including the power to unwind preferential payments that are made to creditors within 90 days of the assignment. For example, if a troubled company pays a creditor $250,000 on long overdue invoices for goods and services, the assignee may file a complaint under Section 1800 and require the creditor to give that money back if the payments were made within 90 days of the assignment. Under those kinds of scenarios, what is a creditor to do?

California's preference statute, or the Code of Civil Procedure 1800, mirrors section 547(c) of the Bankruptcy Code. It provides creditors with the several defenses, which include:

A contemporaneous exchange for new value given to the assignor - this exception basically protects cash on delivery transactions; transfers made in the ordinary course of business - this usually applies to short-term unsecured extensions of credit such as 45 days net or less; and new value exception, in which the creditor extends value such as shipping goods after it receives a preferential payment.

The application of these defenses is generally a question of fact and cannot be disposed on summary judgment. If a creditor is unable to establish any of these defenses, it will be required to return the preferential payments to the assignment estate.

Aside from defending a preference claim on its merits, a creditor may have a federal preemption defense. In 2005, the 9th U.S. Circuit Court of Appeals in [*Sherwood Partners Inc. v. Lycos Inc.],* 394 F.3d 1198, held that Section 1800 is unenforceable and is preempted by the Bankruptcy Code because Congress had "occupied the field" of bankruptcy law, invalidating state laws addressing bankruptcy issues except where the Bankruptcy Code makes specific provisions for them. A California Court of Appeal, however, has rejected the reasoning of the majority in [*Sherwood]* and held that Section 1800 is not preempted by the Bankruptcy Code. Given the split of authority, assignees will file their preference claims in state court, whereas creditors will be inclined to remove the state actions to federal court to take advantage of the [*Sherwood]* decision.

Because a Section 1800 preference claim involves a state claim, a creditor may remove the matter to federal court only on diversity jurisdiction grounds. Diversity jurisdiction exists where the matter in controversy exceeds the sum or value of $75,000 and is between citizens of different states. In cases where diversity jurisdiction exists, the assignee might consider commencing suit in the state court where the creditor-defendant resides. Or an assignee might name a guarantor who resides in California in order to eliminate diversity. A creditor who waits for the preference action to be filed runs the risk of allowing the assignee to destroy diversity jurisdiction, which will eliminate the creditor's best defense - preemption. This predicament begs the question: Can a creditor have the matter heard in federal court if the assignee has complete control over the existence of diversity jurisdiction?

Simply put, yes. The creditor must file a federal action for declaratory relief as soon as the creditor is notified of the assignee's demand for the return of preferential payments. While it may seem odd for a creditor to "make a federal case" out of a demand for payment, failing to do so will mean the creditor is sacrificing an opportunity to raise federal preemption as a complete defense to the Section 1800 preference claim.

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