

**Supreme Court Refuses to Hear Appeal From Ruling that  
California Preference Lawsuit is Preempted by U.S. Bankruptcy Code**

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On October 3, 2005, the U.S. Supreme Court refused to hear an appeal from the Ninth Circuit Court of Appeal's decision in *Sherwood Partners v. Lycos, Inc.* The Ninth Circuit had ruled that California's preference statute -- contained in California's assignment for the benefit of creditors ("ABC") law -- is preempted by the United States Bankruptcy Code. The Supreme Court's decision means an end to preference actions under California's ABC law and under other similar state law preference statutes .

An ABC is a type of state law liquidation proceeding that has some similarity to a liquidation case under Chapter 7 of the Bankruptcy Code. California has a modern and widely used ABC statute, including a preference provision that is similar to Section 547 of the Bankruptcy Code. The California ABC law enables an "Assignee" for the benefit of creditors, who is akin to a Chapter 7 bankruptcy trustee, to recover preferential transfers.

Thinklink Corporation had made an assignment for the benefit of creditors to Sherwood Partners in California. Sherwood sued Lycos to recover a \$1 million payment as a preference under the California's preference statute. Lycos moved to dismiss, arguing that the preference provisions of California's ABC law were preempted by the Bankruptcy Code. The United States District Court denied Lycos' motion to dismiss and eventually granted summary judgment to Sherwood. Lycos appealed this decision to the Ninth Circuit Court of Appeals, which reversed the District Court in a January 2005 opinion.

The Ninth Circuit ruled that the Bankruptcy Code preempts Sherwood's exercise of preference avoidance powers under California's ABC law as inconsistent with the federal bankruptcy system. Preference claims should be subject to the federal bankruptcy law's tougher standards and procedural court-supervised protections that are intended to ensure fair treatment of both debtors and creditors. The more lax state procedures and standards of California's ABC statute effectively circumvents this federally designed bankruptcy process. A bankruptcy trustee has the power to avoid and recover preferences for distribution to creditors. The trustee is not handpicked by the debtor, as was Sherwood, or any other assignee in a California ABC. Instead, the trustee is appointed by the United States Trustee, an official of the United States Department of Justice, or elected by creditors, to ensure impartiality. In addition, the trustee is supervised by the U.S. Trustee and the bankruptcy court, in contrast to the lack of supervision over the assignee's activities in a California ABC.

The U.S. Supreme Court's decision not to review the Ninth Circuit's ruling will encourage parties defending ABC preference claims in California, and in other states with preference statutes similar to California's, to make similar preemption arguments that will defeat state law preference claims in these states.