

California General Assignments: New Developments

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General assignments have been a part of California debtor-creditor law for over a century. This outline explores significant recent decisions affecting California general assignments. The impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Act”) on general assignments is also discussed.

I. THE NINTH CIRCUIT COURT OF APPEALS AND A CALIFORNIA APPELLATE COURT REACH OPPOSITE CONCLUSIONS AS TO WHETHER STATE PREFERENCE LAW IS PREEMPTED BY THE BANKRUPTCY CODE.

A. *SHERWOOD PARTNERS, INC. v. LYCOS, INC.*, 394 F.3d 1198 (9th Cir. 2005).

1. In *Sherwood*, the 9th Circuit held that California Code of Civil Procedure Section 1800(c), which since 1979 vested in an assignee the right to recover preferential transfers under provisions substantially the same as 11 U.S.C. §547, is preempted by federal bankruptcy law. Some have voiced concern that *Sherwood* may affect the continued vitality of general assignments as an alternative liquidation device to a bankruptcy liquidation under chapter 7. While *Sherwood* should change how assignors (and creditors) evaluate preference liability exposure, as discussed more fully below and in light of the *Haberbush* decision, it is not expected to materially alter the decision to liquidate pursuant to a general assignment as opposed to filing a bankruptcy petition.
2. *Sherwood* was wrongly decided and is not binding on the California State courts. As a result, California courts could - and in the case of the *Haberbush, infra*, did - reach a conclusion at odds with the holding in *Sherwood*.
 - a. **The U.S. Supreme Court has already held in several instances that state preference statutes similar to California Code of Civil Procedure Section 1800 are not pre-empted by Federal Bankruptcy Law.** *Stellwagen v. Clum*, 245 U.S. 605 (1918)(The Supreme Court upheld an Ohio preference statute against a claim that the state statute was preempted by the Bankruptcy Act of 1898); *Pobreslo v. Joseph M. Boyd Co.*, 287 U.S. 518 (1933)(The Supreme Court upheld a Wisconsin statute regulating general assignments which contained a preference provision); *Mayer v. Hellman*, 91 U.S. 496 (1875)(An Ohio statute providing for general assignments and avoidance of preferences was upheld).

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b. Decisions of lower federal courts (courts other than the U.S. Supreme Court) on federal questions are not binding on state courts. *Rohr Aircraft Corporation v. County of San Diego*, 51 Cal.2d 759, 764 (1959)(Decisions of the lower federal courts on federal questions are merely persuasive.); *Romano v. American Trans Air*, 48 Cal. App. 4th 1637, 1641 (1996) (The California District Court of Appeals declined to follow the 9th Circuit Court of Appeals ruling that state law claims were pre-empted by federal Airline Deregulation Act of 1978); *Debtor Reorganizers, Inc. v. State Board of Equalization*, 58 Cal. App.3d 691, 696 (1976)(Decisions of lower federal courts (including the circuit courts of appeal), even on federal questions, are not binding on the California state courts); *Walker v. Kiouisis* 93 Cal. App. 4th 1432, 1441 (2001) (Decisions of the lower federal courts on federal questions are persuasive but not binding on state courts).

B. *HABERBUSH v. CHARLES AND DOROTHY CUMMINS FAMILY LIMITED PARTNERSHIP*, 139 Cal. App. 4th 1630, 43 Cal. Rptr. 3d 814 (2nd Dist. 2006)

1. The *Haberbush* court rejected the reasoning of the majority in *Sherwood* and held that California Code of Civil Procedure Section (“CCP”) 1800 is not preempted by the Bankruptcy Code. In so holding the California Appellate Court reasoned as follows:
 - a. Congress intended to permit the co-existence of state laws governing voluntary assignments for the benefit of creditors.
 - b. The *Sherwood* majority reaches too far in suggesting that any state statute that implicates the federal bankruptcy law’s second major goal of equitable distribution is preempted. Because the common law right to make an assignment of property for the benefit of creditors is well established, it is illogical that state laws which provide a forum for the equitable distribution of that property should be preempted by federal bankruptcy law.
 - c. That California’s voluntary assignment system has a preference statute substantially identical to the Bankruptcy Code’s preference statute - making California general assignments more capable of effectuating the equality of distribution which is the aim of the federal bankruptcy law - does not necessarily interfere with bankruptcy’s goal of achieving equal distribution.
 - d. Federal regulation should not be deemed preemptive of state regulatory power absent persuasive reason- either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained. Voluntary assignments and the bankruptcy system have co-existed since the inception of bankruptcy law, and state laws regulating the rights

and obligations of debtors or their assignees and creditors are often expressly incorporated in bankruptcy law. Congress has not indicated that voluntary assignments generally or preferential transfer avoidance laws specifically are to be preempted. California general assignments, therefore, to not stand as an obstacle to the accomplishment of the full purposes and objectives of the federal bankruptcy system.

II. IMPLICATIONS OF *SHERWOOD* AND *HABERBUSH*.

A. REMOVAL JURISDICTION

1. For defendants a key consideration will be whether federal subject matter jurisdiction exists so as to invoke the preemption holding of *Sherwood* in the United States District Court.
2. As a general matter a defendant may remove a case to the United States District Court in the district where the state court proceedings are pending, provided the case could have been filed originally in the federal court (i.e., based on federal question grounds (28 U.S.C. §1331) or diversity (28 U.S.C. §1332). 28 U.S.C. §1441; *See, Snow v. Ford Motor Co.*, 561 F.2d 787, 789 (9th Cir. 1977). Thus, there are two possible bases for removal jurisdiction, the first predicated on federal question and the second on diversity.
 - a. **There is no federal question jurisdiction.** Federal question jurisdiction is provided for in 28 U.S.C. §1331 which states in relevant part: “[t]he district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws or treaties of the United States.” The critical question is what constitutes “civil actions arising under.” In the case of a general assignment preference claims are predicated on a state statute - California preference statute, Cal. Code Civ. Proc. §1800. The assignee’s claim is wholly dependent on state law. Defendants may argue that under *Sherwood* federal law preempts the state statute and as a result a federal question is presented for the district court. That proposition, however, has been soundly rejected by the U.S. Supreme court.
 - i. The “well-pleaded complaint” rule has been adopted by the Supreme Court for determining which cases, where the complaint alleges state created causes of action, may be initiated or removed to the federal district court. “[W]hether a case is one arising under the Constitution or a law or treaty of the United States, in the sense of the jurisdictional statute, . . . must be determined from

what necessarily appears in the plaintiff's statement of his own claim in the bill or declaration, unaided by anything alleged in anticipation of avoidance of defenses which it is thought the defendant may interpose." *Taylor v. Anderson*, 234 U.S. 74, 75-76, 34 S.Ct. 724, 724, 58 L.Ed. 1218 (1914).

- ii. The Supreme Court has had occasion to fortify the "well-pleaded complaint" rule in a removal case, where the complaint asserted state created causes of action and the only issue was whether federal law pre-empted state law. *Franchise Tax Board of the State of California v. Construction Laborers Vacation Trust for Southern California*, 463 U.S. 1, 103 S.Ct. 2841, 77 L.Ed. 2d 420 (1983). In the *Franchise Tax Board* case the complaint stated two causes of action, the first alleging defendant failed to comply with three levies issued under Cal. Rev. & Tax Code §18817 and a second for declaratory relief under state law. Defendant asserted that the state statutes were pre-empted by ERISA and that there were no factual disputes. Defendant in turn removed the matter from the California Superior Court to the district court. In remanding the case and holding that the federal courts lacked jurisdiction the Court held as follows:

Even though state law creates appellant's [*Franchise Tax Board*] causes of action, its case might still "arise under" the laws of the United States if a well-pleaded complaint established that its right to relief under state law requires resolution of a substantial question of federal law in dispute between the parties. For appellant's first cause of action - to enforce its levy, under §18818 - a straightforward application of the well pleaded complaint rule precludes original federal court jurisdiction. California law establishes a set of conditions, without reference to federal law, under which a tax levy may be enforced; federal law becomes relevant only by way of a defense to an obligation created entirely by state law, and then only if appellant has made out a valid claim for relief under state law . . . The well pleaded complaint rule was framed to deal with precisely such a situation. As we discussed above, since 1887 it has been settled law that a case may not be

removed to federal court on the basis of a federal defense, **including the defense of preemption**, even if the defense is anticipated in plaintiff's complaint, and even if both parties admit that the defense is the only question at issue in the case.

463 U.S. 1, 14, 103 S.Ct. 2841, 2849 [Emphasis added.].

b. **Existence of Diversity Jurisdiction Will Depend on Defendant's "Residence" and Whether Complete Diversity Exists.**

Diversity jurisdiction exists where the matter in controversy exceeds the sum or value of \$75,000, exclusive of costs, and is between – "(1) citizens of different states...." 28 U.S.C. §1332.

i. **Complete Diversity Is a Prerequisite.** Unless there is complete diversity (where none of the opposing parties are citizens of the same state) diversity jurisdiction would not exist. This has been a long established principal as articulated by Justice Marshall in *Strawbridge v. Curtiss*, 3 Cranch (7 U.S.) 267, 2 L.Ed. 435 (1806). As a result if an assignee commences a preference claim against an out of state entity for \$75,000 or more it may be that removal of that case from the California Superior Court to the United States District Court could be predicated on diversity jurisdiction. However, if the assignee, in addition to the creditor-defendant, also named a guarantor who resides in California then complete diversity may be lacking. If the guarantor is considered an indispensable party, within the meaning of Rule 19 of the Federal Rules of Civil Procedure ("FRCP"), the District Court would lack the discretion to dismiss the non-diverse party under FRCP Rule 21 in order to preserve diversity. See, *Newman-Green, Inc. v. Alfonzo-Larrain*, 490 U.S. 826, 832, 109 S.Ct. 2218, 2223, 104 L.Ed. 893 (1989); *Ross v. International Brotherhood of Electrical Workers*, 634 F. 453, 456 (9th Cir. 1980); *Beech Aircraft Corp., v. THC Financial Corp.*, 625 F.2d 273, 277 (9th Cir. 1980).

ii. In cases where diversity jurisdiction exists, the assignee might consider commencing suit in the state court where the creditor-defendant resides. That court may be compelled to follow California law, including the *Haberbush* decision.

B. HISTORICAL PERSPECTIVE ON CALIFORNIA PREFERENCE LAW.

1. There have always been significant differences in the net recovery of preferences under California Law (C.C.P. §1800(c) versus Bankruptcy Code Section 547. Even before *Sherwood* the net recovery on a portfolio of state preference claims is typically less than if the same portfolio were prosecuted in a bankruptcy case due to the following factors, among others:
 - a. Personal or substituted service required under California Law (Cal. Code Civ. Proc. §§413.10 et. seq.) as opposed to service by mail in a bankruptcy preference action. Fed. R. Bankr. Proc. 7004
 - b. Where the defendant/preference recipient is located outside the State of California there are significant issues of personal jurisdiction as opposed to preferences under 11 U.S.C. §547 where there is nationwide service of process. Fed. R. Bankr. Proc. 7004(d); But See, Ferriell, *The Perils of Nationwide Service of Process in a Bankruptcy Context*, 48 Washington & Lee L. Rev. 1199-1255 (Fall 1991).
 - c. Proper venue for preference actions under California Law is where the defendant resides. Cal. Code Civ. Proc. §395. By contrast, at least prior to the effective date of the 2005 Act, venue for preference actions under section 547 was generally in the “home” bankruptcy court (e.g. where the bankruptcy case is pending). 28 U.S.C. §1409. As a result assignees often times had to prosecute state preference claims in a number of different locations though out the state rather than a single “home court.” This results in greater costs incurred by an assignee as compared to prosecuting similar claims in bankruptcy.
 - d. Unlike the bankruptcy court, state judges were and are often unfamiliar with the state preference claims further complicating the prosecution of section 1800 preferences.

III. RECENT CHANGES TO FEDERAL BANKRUPTCY LAW FAVOR GENERAL ASSIGNMENTS OVER BANKRUPTCY CASES

- A. **In the wake of *Haberbush* and the 2005 Act, preference recoveries in a general assignment under state law may result in a greater yield than a comparable portfolio of claims in a bankruptcy case.**
 1. **The standard for establishing the ordinary Course of business exception has been eased considerably under the 2005 Act.** As a result

recoveries on preference claims, pursuant to Bankruptcy Code Section 547, against vendors will be diminished.

- a. Prior Law. Under prior law preference defendants ("creditors") have had to prove three elements of 11 U.S.C. §547 (c) (2)² to except transfers from avoidance.
- b. The 2005 Act Change. Pursuant to Section 409 of the 2005 Act (new 11 U.S.C. §547(c)(2)), a creditor need only prove that the transfer was in payment of a debt incurred in the ordinary course of business and **either** (A) that the transfer was ordinary as between the debtor and the defendant, based on their historical dealings; **or** (B) the transfer was made according to "ordinary business terms" (construed to mean in accordance with the standards in the defendant's industry).
- c. Case Law **The change to 547(c)(2) will significantly reduce potential preference recoveries (at least as to claims against rank and file vendors), due to the relative ease of establishing "ordinary business terms" under current case law.** Judicial interpretation of the phrase "ordinary business terms," beginning with the now landmark case of In re Tolona Pizza Products, 3 F.3d 1029, 1033 (7th Cir. 1993) ("Tolona"), has made proving this element exceptionally easy. Tolona concluded that '*ordinary business terms*' refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection C.

The Tolona standard (dealings so idiosyncratic as to fall outside the broad range and therefore be deemed extraordinary), has been further "refined". The 3rd Circuit adopted Tolona but believed that Tolona was too restrictive. "Ordinary business terms" for an industry has become malleable as between the debtor and the creditor. It fuses the subjective and objective tests by adopting a rule that:

² 11 U.S.C. §547(c) permits a transferee of a preferential payment under 11 U.S.C. §547(b) to prevent avoidance by satisfying three requirements, as follows:
(c) The trustee may not avoid under this section a transfer -
(2) to the extent that such transfer was -
(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; **and**
(C) made according to ordinary business terms.

11 U.S.C. § 547 (c) (2)

The more cemented (as measured by its duration) the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm yet remain within the safe harbor of §547(c)(2). The 3rd Circuit approach, which adjusts the objective test based on the length of the parties relationship, has been referred to as the “sliding scale standard” or “sliding scale window”.

In re Molded Acoustical Products Inc., 18 F.3d 217, 225 (3rd Cir. 1994). Accord, Advo-System Inc. v. Maxway Corp., 37 F.3d 1044, 1050 (4th Cir. 1994)

Some decisions now suggest that the proper "interpretation" of "ordinary business terms" should be by reference to the industry debtor/creditor practices vis a vis troubled debtors only. In fact, Ganis Credit Corporation vs .Karl T. Anderson (In re Jan Weilert Rv, Inc.), 315 F.3d. 1192, 1198 (9th Cir., 2002) ("Weilert") contains dicta to the effect that *broad range* of terms encompasses the practices employed by those debtors and creditors, including terms that are ordinary for those under financial distress.

If the terms in question are ordinary for industry participants under financial distress, then that is ordinary for the industry.’’
315 F.3d 1197

If Weilert's dicta is followed by lower courts, all conduct that is "normal" for creditors concerned about the financial deterioration of their debtors may be insulated. There are a whole host of potentially non-idiosyncratic creditor behaviors that are "badges" under current law. If a creditors suspects that its ability to get paid is imperiled, wouldn't it then be normal to *apply pressure?*, *impose a more restrictive credit limit?*, *change terms? change manner of payment from check to wires?*, etc. Weilert's pronouncement, however, is only dicta.

- d. Unlike the 2005 Act, California preference law retains the ordinary course of business exception in substantially the same form as federal bankruptcy law prior to the effective date of the 2005 Act. As a result preference recoveries could be greater in a general assignment than in a comparable bankruptcy case.

2. **The 2005 Act creates a new \$5,000 “safe harbor” for preference defendants in business cases.** Section 409 of the 2005 Act added a new safe harbor for defendants in business cases. A trustee (or debtor in possession) may not avoid a transfer “if in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is **less than \$5,000**.” New 11

U.S.C. §547(c)(9). Curiously, this change was added as a defense/exception and **not** as part of plaintiff's *prima facie* case (eg. that the transfers must exceed \$5,000 to be actionable).

a. No such exception exists under California law.

3. **Changes to venue requirements further complicate prosecution of preference claims in bankruptcy cases.** Section 410 of the 2005 Act amends 28 U.S.C. §1409 (b) and shifts venue to the district court for the district where a non-insider defendant resides if a Trustee, or debtor in possession, seeks to recover a money judgment of less than \$10,000. For most debtors or trustees it will be unappealing to chase \$5,000-\$10,000 claims (gross transfers). Estate expenses would now include the transaction costs of local counsel. As a result the 2005 Act essentially creates a de-facto jurisdictional limit of \$10,000 as to transferees located outside the home court's judicial district.
4. The 2005 Act made other changes to the preference law. However, on a day to day basis those changes will have less direct impact on the choice of a liquidation vehicle (bankruptcy vs. general assignment under state law).

B. **OTHER 2005 ACT AMENDMENTS WHICH MAKE CALIFORNIA GENERAL ASSIGNMENTS MORE ADVANTAGEOUS FOR UNSECURED CREDITORS AS COMPARED TO A BANKRUPTCY CASE.**

The 2005 Act changed a number of provisions of the Bankruptcy Code which will adversely affect the net recovery to unsecured creditors in a bankruptcy liquidation as opposed to unsecured creditors recoveries in a general assignment. Some of those changes include the following:

1. **Expanded Wage and Benefit Priority Under Bankruptcy Law.** The 2005 Act expands the wage and benefit priorities to \$10,000 per employee and lengthens the time of accrual from 90 to 180 days before the petition date. 11 U.S.C. §507(a)(4) & (5). State wage and priority benefits are still \$4,300 per employee and the time for accrual remains at 90 days before the date of the general assignment is made. Cal. Code Civ. Proc. §1204(a)(1).
2. **Expanded Reclamation Rights Under Federal Law.** The rights of reclaiming creditors have been expanded under the 2005 Act. First, the period for making a reclamation demand has been increased from 10 to 45 days after receipt of the goods by the debtor. 11 U.S.C. §546(c). If the 45 day period expires after the petition date then the demand must be made not later than 20 days after the commencement of the bankruptcy case. *Id.* Even if the reclaiming creditor fails to make a proper reclamation demand the creditor will be entitled to an administrative expense (the highest level

of priority) for goods received by the debtor within 20 days before the bankruptcy case is commenced. 11 U.S.C. §503(b)(9). By contrast, in a general assignment, there is no administrative expense for goods shipped to the assignor prior to the date the general assignment is made. As to reclamation rights, they are limited to 10 days after buyer's receipt of the goods. Cal. Com. Code §2702.

3. **The 2005 Act's Addition Of a Consumer Privacy Ombudsman Could Delay and Increase the Costs of s Sale of the Debtor's Assets.** If certain conditions are met the 2005 Act requires that a consumer privacy ombudsman must be appointed at the expense of the bankruptcy estate and its creditors and the appointment process could also delay the sale. See, 11 U.S.C. §§363(b)(1) and 332. No such ombudsman exists in the case of an assignment as a matter of California law.

IV OTHER NEW CASE LAW DEVELOPMENTS AFFECTING GENERAL ASSIGNMENTS

- A. A California District Court of Appeals declined to hold that conspiracy liability or an independent fiduciary duty of an assignee's counsel to creditors of the estate arose where the gravamen was essentially that the assignee's attorneys charged unnecessary and excessive fees. *Berg & Berg v. Sherwood Partners, Inc.* 131 Cal. App.4th 802 (2005).
- B. A California appellate court held that a landlord violated Civil Code Section 1950.7 in failing to return a security deposit to the assignee where the lease contained no waiver of the provisions of Section 1950.7 and the actual damages at the time of surrender of the premises were less than the security deposit. The landlord could **NOT** offset future damages against the security deposit because Section 1950.7 allows a security deposit to be applied only against unpaid rent that has accrued as of the date called for in the statute for the return of the deposit. *Sherwood Partners, v. 250 LLC* , 131 Cal. App.4th 703 (2005).