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Marshaling Against Guarantors: Not a Fool's Errand?

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At first glance, one might conclude, as have some courts, that the application of marshaling, at the request of a bankruptcy trustee against the assets of a guarantor of the debtor's obligation, constitutes a futile gesture. After all, if the doctrine is applied in such an instance, the guarantor would possess a subrogation claim against the estate, and hence, the estate would ultimately find itself in no better position than before. Upon closer examination, however, one might discover that the very basis for marshaling in this situation—inequitable conduct—may also serve as a basis for equitable subordination of the guarantor's claim. If applicable, subordination would prevent the guarantor from attaining a subrogation claim, and thereby preserve the benefit of marshaling. This article briefly examines this concept.

What Is Marshaling?

Courts have referred to the doctrine of marshaling as the "two funds" doctrine. *In re Corso Stein Enters. Inc.*, 79 B.R. 584, 587 (Bankr. D. N.J. 1987). "The Supreme Court has noted that '[t]he equitable doctrine of [marshaling] rests on the principle that a creditor having two funds to satisfy his debt may not, by his application of them to his demand, defeat another creditor who may [have] resort[ed] to only one of the funds.'" In other words, marshaling, when applied, requires a senior creditor to satisfy its claim first from property or a fund in which a junior creditor has no interest. *Chittenden Trust Co.*

v. Sebert Lumber Co. (In re Vermont Toy Works Inc.), 135 B.R. 762, 767 (D. Vt. 1991).

A party seeking the application of marshaling must generally establish the following elements: (1) the existence of two secured creditors with a common debtor, (2) the existence of two funds belonging to the debtor and (3) the right of the senior creditor to satisfy its demand from both funds and the right of the junior creditor to resort to only a single fund, *e.g.*, where a mortgagee holds a senior mortgage on two tracts of land and another mortgagee holds a subordinate mortgage on only one of the tracts. *See Id.*; *Dillon*, 54 B.R. at 138 (allowing second and third lienors to be subrogated to rights of first lienor to payments where failure to apply marshaling would create unfairness to these creditors, the same debtors were involved, and "double" and "single" funds existed). The proponent must establish these elements by clear and convincing evidence. *Vermont Toy Works*, 135 B.R. at 767.

A majority of courts has held that a bankruptcy trustee, as a hypothetical lien creditor under §544(a), has standing to seek marshaling for the benefit of the estate. *Official Comm. of Unsecured Creditors v. Lozinski (In re High Strength Steel Inc.)*, 269 B.R. 560, 573-74



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(Bankr. D. Del. 2001) (citing cases). Where only a single fund exists, the doctrine of marshaling is inapplicable.² Furthermore, the doctrine may not be invoked in a case in which the marshaling of assets for the benefit of a party would result in prejudice to the interests of another party (*Id.*, declining to apply marshaling where no second fund was evident and the party against which marshaling was sought would suffer prejudice); *Maimone v. Columbia Savs. Bank (In re Maimone)*, 41 B.R. 974, 984 (Bankr. D. N.J. 1984) (finding marshaling inapplicable where requiring payment from property would harm junior creditor, but

requiring payment from third party's asset would harm third party).

Exceptions to the "Common Debtor" Requirement

The "common debtor" requirement renders marshaling unavailable in cases in which the two funds consist of an interest in estate property and an interest in property of a non-debtor. *In re Borges*, 184 B.R. 874, 879 n.3 (Bankr. D. Conn. 1995). Because marshaling is an equitable, rather than legal, doctrine, courts have expanded, and recognized exceptions to, this requirement. *In re New Woodbridge Barrel & Drum Co.*, 99 B.R. 221, 223 (Bankr. D. N.J. 1988).

For instance, courts have applied marshaling where a non-debtor, typically a corporate debtor's controlling shareholder or guarantor, qualifies as the "alter ego" of the debtor, or where the non-debtor has rendered the debtor inadequately capitalized.³

Second, courts have recognized that a non-debtor's property, pledged to secure the debtor's obligation and not solely the non-debtor's obligation, may equitably be deemed a "capital contribution" to the debtor and hence subject to marshaling. *In re Wm. Pietsch Co.*, 200 B.R. 207, 210-11 (Bankr. E.D. Wis. 1996) (citing *In re Multiple Servs. Indus. Inc.*, 18 B.R. 635, 636 (Bankr. E.D. Wis. 1982)).

Third, courts have invoked marshaling where the non-debtor has engaged in inequitable conduct such as fraud, breach of fiduciary duty or unjust enrichment. *Field*, 226 B.R. at 183; *Fundex*, 53 B.R. at 779-80.

Finally, marshaling has been applied against non-debtor shareholders solely for the equitable purpose of preserving a distribution for the debtor's unsecured creditors. *Berman v. Green (In re Jack Green's Fashions for Men Big & Tall Inc.)*, 597 F.2d 130, 133 (8th

³ *In re Field*, 226 B.R. 178, 183 (Bankr. D. S.C. 1998) (quoting *Borges*, 184 B.R. at 879, n.3); *Fundex Capital Corp. v. Balaber-Strauss (In re Tampa Chain Co.)*, 53 B.R. 772, 778-79 (Bankr. S.D.N.Y. 1985). Incidentally, at least one court has recognized that if the shareholder constitutes an alter ego, then his or her assets ostensibly already constitute property of the estate, thereby rendering resort to marshaling unnecessary. *See, e.g., In re Dealer Support Servs. Int'l. Inc.*, 73 B.R. 763, 765, n.3 (Bankr. E.D. Mich. 1987) ("Moreover, if the real estate of the guarantor were treated as property of the estate, there would be no need to marshal to achieve the trustee's objective. The trustee in this action seeks to enlarge the estate for the benefit of unsecured creditors. That purpose would be accomplished if the guarantor's property were held to be property of the estate. The benefit to unsecured creditors would accrue not by virtue of marshaling, but by virtue of bringing the guarantor's property into the estate.")

¹ *Dee Wood Indus. Inc. v. Jack Dillon Constr. Co. (In re Jack Dillon Constr. Co.)*, 54 B.R. 136, 137 (Bankr. D. N.J. 1984) (quoting *Sowell v. Fed. Reserve Bank*, 268 U.S. 449, 456-57 (1925)).

² *Telefest Inc. v. VU-TV*, 591 F.Supp. 1368, 1382 (D. N.J. 1984) (citing *Mastan Co. v. S.S. Sapphire Sandy*, 293 F.Supp. 68, 74 (D. N.J. 1968), *aff'd*, 418 F.2d 177 (3d Cir. 1969), *cert. denied*, 397 U.S. 1009 (1970)).

Cir. 1979) (“[I]t would be in the highest degree inequitable to allow the bank to exhaust the business assets of the corporate bankrupt without first looking to the [shareholders’] real estate mortgaged to it. To permit such a course would leave the general creditors of the business with nothing.”) A number of courts, however, have criticized such a liberal construction of the doctrine.⁴

The Effect of Subrogation

A potential limitation on the use of these exceptions against a guarantor exists. Section 509(a) of the Bankruptcy Code provides in relevant part: “[A]n entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.” 11 U.S.C. §509(a). Furthermore, under common law, “upon the payment by the guarantor of the debt, the debtor’s obligation to the creditor becomes an obligation to the guarantor not a new debt, but by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor’s shoes.” *Putnam v. Comm’r.*, 352 U.S. 82, 85 (1956) (citing cases).

Under such law, a guarantor that pays a creditor’s claim against a debtor possesses a subrogation claim against the debtor. Some courts have reasoned that by virtue of this law, application of marshaling against a guarantor ultimately yields no net benefit for unsecured creditors, and as a result, they have refused to allow such an application. For example, in *In re Leviton Constr. Co.*, 122 B.R. 530, 532 (Bankr. S.D. Ohio 1991), the court denied a chapter 7 trustee’s request that a bank be compelled to first seek collection of a debt from a guarantor rather than the estate on the grounds that “even if the bank proceeds against...the guarantor, payments upon the debt will result in subrogation rights to the guarantor” and “[t]he effect of the subrogation rights to the guarantor will prevent unsecured creditors from benefiting from enforced collection of the bank’s debt from [the guarantor].” Likewise, in *United States v. Friend (In re A.E.I. Corp.)*, 11 B.R. 97, 100 (Bankr. E.D. Pa. 1981), the court rejected a marshaling argument on the basis that “[a]s guarantors of the [debtor], the [guarantors] would be subrogated to the rights of [the creditor], thus defeating the trustee’s hoped-for advantage.”⁵

⁴ See, e.g., *In re Robert E. Derecktor of Rhode Island Inc.*, 150 B.R. 296, 300 (Bankr. D. R.I. 1993) (“*Jack Green’s* has been criticized as improperly extending the traditional scope of the [marshaling] doctrine.” (citing cases)); *In re Elsinore Shore Assocs.*, 91 B.R. 238, 263 (Bankr. D. N.J. 1988) (“*The [Jack Green’s]* [C]ourt simply relied on equitable principles and extended the doctrine of [marshaling]. No specific finding of fraud was made, and the court did not argue that it was piercing the corporate veil. No other cases have gone as far as the Eighth Circuit in *Jack Green’s*.”)

The Effect of Subordination

One need look no further than the Code itself, however, to discover that this right of subrogation is itself not without limit. Section 509(b)(1)(C) of the Code provides: “Such entity [referred to in §509(a)] is not subrogated to the rights of such creditor to the extent that a claim of such entity for reimbursement or contribution on account of such payment of such creditor’s claim is subordinated under §510 of this title.” 11 U.S.C. §509(b)(1)(C). Section 510(c)(1), in turn, provides, in relevant part: “[A]fter notice and a hearing, the court may, under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim.” 11 U.S.C. §510(c)(1). Generally, a court may exercise its power of equitable subrogation when the following circumstances exist: (1) the claimant engaged in inequitable conduct; (2) the misconduct results in injury to the creditors of the bankrupt or confers an unfair advantage on the claimant; and (3) equitable subrogation of the claim does not contravene the provisions of the Code. *United States v. Noland*, 517 U.S. 535, 538-39 (1996) (citing *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977)).

Based on this law, the very conduct that triggers marshaling against a guarantor may warrant equitable subordination of the guarantor’s subrogation claim pursuant to 11 U.S.C. §510(c) and, concomitantly, preserve the benefit of marshaling. For instance, in *Chittenden Trust Co. v. Sebert Lumber Co. (In re Vermont Toy Works Inc.)*, 82 B.R. 258, 331-33 (Bankr. D. Vt. 1987), *rev’d. on other grounds*, 135 B.R. 762 (D. Vt. 1991), the court held that a guarantor’s inequitable conduct, consisting of breach of fiduciary duty, gross under-capitalization, contributions to capital, failure to observe corporate formalities and maintenance of an alter-ego relationship, among other acts, triggered the application of marshaling and required subordination of his guaranty in order to prevent him from attaining subrogation to the secured creditor’s status.⁶

Moreover, some courts denying the application of marshaling against a guarantor have expressly noted the lack of grounds for subordination of the guarantor’s claim. For example, in *Dealer*, in which a chapter 7 trustee sought the application of marshaling

⁵ Cf. *Central Trust Co., N.A. v. Burchett (In re Willson Dairy Co.)*, 30 B.R. 67, 71 (Bankr. S.D. Ohio 1983) (holding that marshaling did not apply because “the surety has a right of subrogation to the position of the senior lienholder which...is an equity superior to that of the debtor’s other creditors”).

⁶ See, also, *Comm. of Creditors v. Central Penn Nat’l. Bank (In re Ludwig Honold Mfg. Co.)*, 34 B.R. 645, 647 (Bankr. E.D. Pa. 1983) (observing that “[marshaling] would be allowed only if the sureties were guilty of certain types of inequitable conduct” and that “[s]uch conduct may preclude the sureties’ use of the equitable doctrine of subrogation”).

against a bank, the court noted that “if the bank were compelled to first seek payment of the debt under the guaranty and the guarantors paid the bank’s claim, the guarantors would be subrogated to the rights of the bank against the debtor, unless the guarantors were guilty of conduct which would justify subordinating the guarantors’ subrogated claim.” *Dealer*, 73 B.R. at 766. It held that compelling marshaling, in the absence of such conduct, would constitute an “exercise in futility.” *Id.* Likewise, in *Stuhley v. U.S. Small Business Admin. (In re United Medical Research Inc.)*, 12 B.R. 941, 944 (Bankr. C.D. Cal. 1981), the court declined to apply marshaling against shareholder guarantors where the record failed to show evidence of fraud, overreaching or other inequitable conduct, *i.e.*, a basis for subordination of their claims.⁷ Cf. *Pittsburgh Nat’l. Bank v. Lomb (In re Lomb)*, 74 B.R. 711, 711-12 (Bankr. W.D. Pa. 1987) (holding that “neither the unsecured creditors nor the debtor’s estate would benefit from application of the doctrine of [marshaling] against [the bank]...since if [the bank] were ordered to satisfy its joint claim against the debtor and [the non-debtor party] from [the non-debtor party’s] assets...[the non-debtor party] would be subrogated under Code §509 to all the rights of the secured creditor...there being no adequate grounds for equitable subordination of [the non-debtor party’s] claim under §510, and would thereby have the right to exhaust the subject collateral in satisfaction of his claim and leave the debtor’s estate and the unsecured creditors in the same position they would have been in absent application of the [marshaling] doctrine”).

Conclusion

Assuming that the conduct at issue is sufficiently inequitable to warrant subordination, application of the marshaling doctrine against the assets of a guarantor can produce a benefit to the estate. ■

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⁷ Although some commentators have noted that application of marshaling against the assets of a guarantor may precipitate an adverse impact upon the commercial marketplace, see, e.g., Lachman, Moses, “Marshaling Assets in Bankruptcy: Recent Innovations in the Doctrine,” 6 Cardozo L. Rev. 671, 685-86 (1985) (“If creditors know that they may be ordered to proceed against undesirable collateral at the request of a trustee, they may be skeptical about granting such secured loans”), the need to deter inequitable conduct presumably outweighs the interest of creditors in avoiding the necessity of proceeding against undesirable collateral.