

1984

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Recommended Citation

Benjamin Weintraub and Alan N. Resnick, *From the Bankruptcy Courts: Marshaling of Assets in Bankruptcy Cases: The Specter of Constance v. Harvey Appears Again*, 16 UCC L.J. 384 (1984)

Available at: http://scholarlycommons.law.hofstra.edu/faculty_scholarship/882

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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

MARSHALING OF ASSETS IN BANKRUPTCY CASES: THE SPECTER OF *CONSTANCE v. HARVEY*¹ APPEARS AGAIN

One of the cardinal objectives of bankruptcy law is an equitable distribution of the debtor's property among its creditors. This objective is generally achieved when the proceeds of the debtor's property are distributed pro rata among its general unsecured creditors. Thus, we find provisions of the Bankruptcy Code, such as those providing for the recovery of preferences,² designed so that no unsecured creditor will receive more than its fair share of the debtor's assets as against the general creditor body.

This principle of equitable distribution has been firmly established insofar as unsecured credi-

tors are concerned, but is there such a principle affecting secured creditors? Courts of equity have fashioned a way to carry out the same theory of equitable distribution with regard to secured creditors' rights, giving due regard for priorities of liens, under the doctrine of "marshaling of assets." However, the recent case of *In re Spectra Prism Industries, Inc.*³ casts some doubt as to the application of this equitable doctrine in bankruptcy to protect a junior secured creditor's rights against infringement by unsecured general creditors.

In re Spectra Prism Industries, Inc.

The question presented in *Spectra* was whether a trustee in bankruptcy, as a judicial lien creditor by virtue of Section 544⁴ of the Bankruptcy Code, had standing to block the issuance of an order requiring a senior lienholder to marshal its collateral so as to maximize recovery by a junior lienor.

The debtors had three types of collateral with which to satisfy the

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¹ 215 F.2d 571 (2d Cir.), cert. denied, 348 U.S. 913 (1954).

² 11 U.S.C. § 547.

³ 28 Bankr. 397 (9th Cir. App. Panel 1983).

⁴ 11 U.S.C. § 544.

claims of creditors, namely, equipment, inventory, and accounts receivable. Heidelberg West, Inc. (Heidelberg) held the senior lien on the debtor's equipment to secure a debt of \$132,750. The National Acceptance Co. of California (NACC) held a blanket lien against all assets, but junior to the Heidelberg lien against the equipment. Wells Fargo Bank, N.A. (Wells Fargo) had a security interest only on the equipment that was junior to both the other liens. The trustee claimed to have a blanket lien as a judicial lien creditor under Section 544(a) of the Code. A chart of the secured claims and the trustee's position follows:

	<i>Equipment</i>	<i>Inventory</i>	<i>Accounts Receivable</i>
(1) Heidelberg		NACC	NACC
(2) NACC		(Trustee)	(Trustee)
(3) Wells Fargo			
(4) (Trustee)			

Pursuant to court order, the debtor's equipment was sold at a trustee's sale and the Heidelberg lien was extinguished with a portion of the proceeds. The remainder was to be applied to the junior lienors. Since the lien of the NACC exceeded the remainder, Wells Fargo sought and obtained an "Order to Compel Marshaling of Assets and to Determine Priority Rights in Property of the Estate." This order was granted by the bankruptcy court and the trustee appealed it to the bankruptcy appellate panel.

The Principle of Marshaling

The effect of this order was to eliminate the NACC's participation in the proceeds of the equipment, but this did not affect payment of the NACC's claim, which it could satisfy out of the proceeds of the inventory and the receivables. The result would be that all secured creditors would be paid, but nothing left to the trustee as the representative of the unsecured creditors.

The court enunciated the principle of marshaling of assets that had been relied upon by Wells Fargo:

"Marshaling is an equitable doctrine developed historically and traditionally used to prevent a junior lienholder with a security interest in a single property from being squeezed out by a senior lienholder with a security interest not only in that property, but in one or more additional properties. The doctrine requires the senior lienholder to first resort to assets free of the junior lien to avoid the inequity which would otherwise result from the unnecessary elimination of the junior lienholder's security with the increased likelihood the junior creditor will be unable to satisfy its claim."⁵

For marshaling to be imposed by a junior lienholder, there are four basic requirements to be met:

⁵*In re Spectra Prism Indus., Inc.*, 28 Bankr. 397, 398-399 (9th Cir. App. Panel 1983) (quoting *Shedoudy v. Beverly Surgical Supply Co.*, 100 Cal. App. 3d 730, 733, 161 Cal. Rptr. 164 (1980)).

(1) there must be two or more funds; (2) only one creditor may have the right to resort to both funds; (3) there must be an absence of prejudice to the senior lienholder; and (4) the imposition of marshaling must avoid injustice to third persons.

The sole element at issue was the fourth requirement. The trustee asserted that in his capacity as a hypothetical judicial lien creditor under Section 544(a)(1), he is prejudiced because assets "potentially belonging to the estate, are lost as a result of the marshaling order."⁶ A majority of the appellate panel agreed that under Section 544(a), the trustee is granted all "rights and powers that a creditor holding a judicial lien would have had after prevailing in a simple contract action, whether or not such creditor exists in fact."⁷ In other words, since "the trustee is given status under § 544(a)(1) to act as a judicial lien creditor, he obtains the right and power to protect the assets of the estate to the same degree that any judicial lien creditor would be able to."⁸

Notwithstanding its own circuit's decision in *Forester v. Steward*⁹ denying a request for a marshaling order by a trustee in bankruptcy, the appellate panel focused on the decision of a California appellate court in *Shedoudy*

v. Beverly Surgical Supply Co.,¹⁰ which stands for the proposition that a judgment creditor under state law is a junior claimant entitled to a marshaling order. The "validity, nature, and effect of liens are governed by the law of the state where the property is situated."¹¹ *Shedoudy* recognizes that "such a [judgment] creditor could indeed be prejudiced" by a marshaling order and "that creditor should, therefore, be permitted to block such a motion."¹² The majority in *Spectra* reasoned that the trustee under Section 544(a) has the same right to block a marshaling order as enjoyed by a judgment creditor under California law. Accordingly, the marshaling order of the bankruptcy court was vacated. In essence, the appellate panel's holding eliminates the use of the marshaling doctrine in bankruptcy cases because general unsecured creditors that naturally are affected by marshaling may, through the trustee as a judicial lien creditor, block such an order.

The Dissent

The dissenting judge noted that "if the parties were not involved with bankruptcy, there is no question that marshaling would be properly granted over objections by general unsecured credi-

⁶ *In re Spectra*, 28 Bankr. at 399.

⁷ *Id.*

⁸ *Id.*

⁹ 529 F.2d 310 (9th Cir. 1976).

¹⁰ 100 Cal. App. 3d 730, 161 Cal. Rptr. 164 (1980).

¹¹ *In re Spectra*, 28 Bankr. at 399.

¹² *Id.* at 400.

tors."¹³ Therefore, the essential issue is "whether the fictional status of a judgment creditor granted to the trustee" under Section 544 "was intended to be used in a marshaling context for the purpose of displacing a validly secured creditor in order to provide general unsecured creditors access to assets which otherwise would be unavailable to them."¹⁴

The dissent did not dispute that the language of Section 544, as well as the language of Section 70(c) of the former Bankruptcy Act, endows the trustee with a judgment lien. "[C]ases under these sections rarely, if ever, hinge on the lien as an intrinsic *property right* of the trustee. The great number of decisions dealing with these sections have tested the validity or viability of transfers or claims on the debtor's property against the abstract standard of the hypothetical judgment creditor as if the trustee were of this character."¹⁵ The purpose of the section was to effectuate the "defeasance of secret, undisclosed, or unperfected claims so as to bring about equality of distribution among creditors."¹⁶ In the instant case, as far as Wells Fargo was concerned, it did not have an undisclosed or imperfect claim that was defeasible by a judgment creditor, but had a valid, perfected claim. "In-

vocation of § 544 is therefore inappropriate."¹⁷

The dissent noted that *Lewis v. Manufacturer's Bank of Detroit*,¹⁸ decided by the U.S. Supreme Court under former Section 70(c), was pertinent. There the secured creditor filed its chattel mortgage five months before bankruptcy but four days after execution of the mortgage instead of immediately as required by Michigan law at the time. The trustee attempted to avoid the mortgage because during the period between execution and perfection the trustee as a hypothetical lien creditor under former Section 70(c) could have senior lien rights. The Supreme Court, however, held that to grant the trustee such relief "would give the trustee power to set aside transactions which no creditor could void and which injured no creditor. That construction would enrich unsecured creditors at the expense of secured creditors, creating a windfall merely by reason of the happenstance of bankruptcy."¹⁹

The dissent reasoned that Section 544(a) was not intended to prevent marshaling in bankruptcy cases despite the literal reading of that section. It also disagreed with the majority's reliance on *Shedoudy* that deals with California state law. "It does not inter-

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* (emphasis added).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ 364 U.S. 603 (1961).

¹⁹ *Id.* at 608.

pret nor affect application of section 544."²⁰

Conclusion

The decision in *Spectra* is similar to the error of the Court of Appeals for the Second Circuit in *Constance v. Harvey*,²¹ as well as the subsequent case of *Conti v. Volper*.²² Taking a literal approach to the application of former Section 70(c), the court of appeals in *Constance* gave a trustee the power to avoid a validly perfected security interest by reaching back in prebankruptcy time to fictionalize the extension of credit prior to perfection of the lien. In essence, the court allowed the avoidance of a lien that no creditor could have avoided in the absence of bankruptcy. *Constance* was overruled by *Lewis*. Indeed, Justice Harlan, who

wrote the opinion in *Constance* as a circuit judge, was a justice of the Supreme Court when the court considered the *Lewis* case. In concurring in the court's decision, he candidly admitted to error: "I think it is appropriate to say that I have long since come to the view that the second opinion in *Constance*, 214 F.2d 575, was ill-considered. I welcome this opportunity to join in setting the matter right."²³

The reasoning of *Lewis* should have been dispositive of the *Spectra* case. On the date of the filing of the petition, Wells Fargo had a valid lien that could not be attacked by the trustee. Had Wells Fargo not perfected its lien, it would be vulnerable to attack by the trustee, who would then have preserved it for the benefit of the estate. It is doubtful that Congress intended to eliminate the doctrine of marshaling of assets in bankruptcy cases when it enacted the Code. For this reason, the dissenting opinion in *Spectra* presents the sounder view.

²⁰ *In re Spectra*, 28 Bankr. at 401.

²¹ 215 F.2d 571 (2d Cir.), cert. denied, 348 U.S. 913 (1954).

²² 132 F. Supp. 205, aff'd, 229 F.2d 317 (2d Cir. 1956); see Weintraub, Levin & Beldock, "The Strong-Arm Clause Strikes the Belated Chattel Mortgage," 25 Fordham L. Rev. 261 (1956) for the history of § 70c, the predecessor of § 544.

²³ *Lewis*, 364 U.S. at 610.