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Benjamin Weintraub

Alan N. Resnick
Maurice A. Deane School of Law at Hofstra University

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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

COMPELLING A SENIOR LIENOR TO PURSUE REMEDIES AGAINST A GUARANTOR—A MISAPPLICATION OF THE MARSHALING DOCTRINE

Assume that a creditor is owed $100,000 and has a senior security interest in the debtor's equipment valued at $100,000, as well as a personal guarantee of another entity secured by a lien on the guarantor's assets also valued at $100,000. Another creditor who is owed $25,000 has a junior security interest in the same equipment owned by the debtor, but has no personal guarantee. Upon the debtor's liquidation in bankruptcy, if the senior lienor proceeds against the debtor's equipment without proceeding against the guarantor, it is easy to see that the junior lienor would be considered an unsecured creditor in the bankruptcy case and there would be no equity in the equipment left for general creditors. But if the senior lienor fully recovers from the personal guarantor, the junior lienor would be treated as a fully secured creditor and, upon liquidation, general creditors would share in the $75,000 remaining equity in the equipment.

This scenario raises two important questions: (1) whether the junior lienor may compel the senior lienor to exhaust its remedies against property owned by the personal guarantor based on the doctrine of the marshaling of assets and (2) whether the trustee may compel the senior lienor to exhaust its remedies against the guarantor's assets based on the marshaling doctrine, so as to maximize recovery by unsecured creditors. Although affirmative answers to both these questions are supported by the 1979 decision of the Court of Appeals for the Eighth Circuit in *In re Jack Green's Fashions for Men—Big & Tall, Inc.*,[1] compelling the senior lienor to pursue the guarantor's assets is a misapplication of the marshaling of assets doctrine.

Marshalling in Principle

The marshaling doctrine may be stated as follows: If a senior

* Counsel to the law firm of Levin & Weintraub & Crames, New York City; member of the National Bankruptcy Conference.

** Benjamin Weintraub Distinguished Professor of Bankruptcy Law, Hofstra University School of Law, Hempstead, New York; associate member of the National Bankruptcy Conference.

[1] 597 F.2d 130 (8th Cir. 1979).

lienor has a lien that extends to and covers two funds or potential funds owned by the debtor, and if a junior lienor has recourse to only one of those funds to satisfy the debt due to him, the senior lienor may be required to exhaust the fund available to him exclusively before proceeding against the fund that is also available to the junior lienor.[2] The principle underlying this doctrine was described by the Supreme Court in *Meyer v. United States*[3]:

> [T]he equitable doctrine of marshaling [sic] rests upon 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 resort to only one of the funds. (Citation omitted.)
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> [M]arshaling is not bottomed on the law of contracts or liens. It is founded instead in equity, being designed to promote fair dealing and justice. . . . It deals with the rights of all who have an interest in property involved and is applied only when it can be equitably fashioned as to all of the parties.[4]

In the *Jack Green's* case, a bank had a security interest in the business assets of a corporate debtor, as well as liens on real estate owned by the controlling shareholders of the corporation and their wives who were guarantors of the corporate obligation. The trustee in the corporation's bankruptcy case sought an order compelling the bank to exhaust its remedies against the real estate owned by the guarantors before resorting to the corporation's business assets. Of course, the trustee was attempting to maximize corporate assets available for distribution to unsecured creditors by forcing the bank to obtain payment from assets that were unavailale to the bankruptcy estate. Without extensive discussion, except for reference to the district court's unpublished opinion, the court of appeals affirmed the decisions of the lower courts granting the trustee's marshaling request.

> In this case it 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 real estate mortgaged to it. To permit such a course would leave the general creditors of the business with nothing.[5]

Three Criticisms of *Jack Green's*

The holding in *Jack Green's* is still alive in the Eighth Circuit, but it is not doing well in other

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[2] See, e.g., DuPage Lumber & Home Improvement Center Co., Inc. v. Georgia-Pacific Corp., 34 Bankr. 737 (N.D. Ill. 1983); *In re* McElwaney, 40 Bankr. 66 (M.D. Ga. 1984); *In re* United Retail Corp., 33 Bankr. 150 (D. Hawaii 1983).

[3] 375 U.S. 233 (1963).

[4] *Id.* at 236-237.

[5] 597 F.2d at 133.

courts.[6] There are three reasons why the court misapplied the marshaling of assets doctrine and why other courts have rejected the holding of that case.

First, the doctrine applies when there are two or more *lien* creditors. Unsecured creditors have no right to compel a secured creditor to resort to certain collateral as opposed to other collateral. In *Jack Green's*, the bank was the only secured creditor and it was the trustee, as representative of the *unsecured* creditors, who sought the marshaling order. Apparently, although not expressly stating it, the court recognized the trustee as having judicial lien creditor status pursuant to Section 70(c) of the former Bankruptcy Act.[7] However, many courts have rejected the notion that the trustee, as a hypothetical lien creditor under Section 70(c) of the former Act or Section 544(a) of the present Bankruptcy Code, has standing to compel the marshaling of assets. As noted by the bankruptcy court in *In re McElwaney*,[8] "[t]o allow the Trustee to invoke the marshaling doctrine, by virtue of his status as a hypothetical lien creditor would be a use of the strong-arm clause not contemplated by Congress." Another court, in *In re Larry's Equipment Service, Inc.*,[9] had commented:

> Marshaling is not equitable if applied for the benefit of a trustee to the detriment of a secured and properly perfected junior lien creditor. To permit marshaling in the manner sought by the trustee, in this case, would frustrate the objective of the Bankuptcy Code and conflict with the doctrine itself by prejudicing the rights of a superior class of creditors.[10]

The second criticism of the *Jack Green's* decision focuses on the so-called common debtor requirement. A necessary element for imposing the marshaling doctrine is that *one debtor* has two funds and that one secured creditor has liens on both funds while a junior lienor has a lien on only one fund.[11] When a creditor has a lien on assets owned by the principal

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[6] See, e.g., *In re* Computer Room, Inc., 24 Bankr. 732 (N.D. Ala. 1982); DuPage Lumber & Home Improvement Center Co., Inc. v. Georgia-Pacific Corp., 34 Bankr. 737 (N.D. Ill. 1983); see also Karasik & Kolodney, "The Doctrine of Marshaling Under the Bankruptcy Code," 89 Com. L.J. 102 (1984).

[7] See also *In re* Spectra Prism Indus., Inc., 28 Bankr. 397 (9th Cir. App. Panel 1983), holding that the trustee may use its lien creditor status under § 544(a) to block a marshaling order requested by a junior lienor. The *Spectra Prism* case was criticized by the authors in Weintraub & Resnick, "Marshaling of Assets in Bankruptcy Cases: The Specter of *Constance v. Harvey* Appears Again," 16 U.C.C.L.J. 384 (1984). Nonetheless, the recent case of *In re* Center Wholesale, Inc., 759 F.2d 1440 (9th Cir. 1985) follows the majority opinion of *In re* Spectra Prism Indus., *supra*.

[8] 40 Bankr. 66, 70-71 (M.D. Ga. 1984).

[9] 23 Bankr. 132 (D. Me. 1982).

[10] *Id.* at 134; see also *In re* Computer Room, Inc., 24 Bankr. 732 (N.D. Ala. 1982).

[11] See, e.g., *In re* Childers, 44 Bankr. 23 (N.D. Ala. 1984); *In re* Maimone, 41 Bankr. 974, 984 (D.N.J. 1984) ("This doc-

debtor, and a lien on assets owned by a guarantor, the "common debtor" requirement is missing. In *DuPage Lumber & Home Improvement Center Co., Inc. v. Georgia-Pacific Corp.*,[12] a district court emphasized the importance of adhering to the common debtor requirement:

> The requirement that both funds be in the hands of a common debtor is not merely a formal or technical requirement; rather, it limits marshaling to cases for which the marshaling doctrine purports to provide the rule of decision. The marshaling doctrine embodies and implements a judgment as to the proper distribution of one debtor's assets, as among a senior mortgagee, a junior mortgagee, and the debtor's general creditors. When guarantors and other debtors are added to the picture, then new questions arise. The marshaling doctrine simply does not purport to provide a rule for deciding whether a junior mortgagee can require the senior mortgagee to satisfy its claim out of the assets of a second debtor.[13]

The third criticism of the *Jack Green's* decision is that the court overlooked or minimized the effects of the added expense and inconvenience that the marshaling order would cause the secured creditor by having to pursue remedies against the guarantors' real estate. Courts have held that marshaling is not applicable where there will be prejudice to the senior creditor, such as delay and increased expenses.[14] In the usual case, pursuing guarantors requires the commencement of separate litigation, foreclosure proceedings, and other expensive and time-consuming procedures. It would be ironic, as well as inconsistent with the Uniform Commercial Code's policy of giving secured parties cumulative remedies,[15] for a secured lender to be prevented or delayed in recovering against the principal debtor solely because it took the extra precaution of obtaining a personal guarantee.

Conclusion

Except in rare cases where fraud or other inequitable conduct justifies piercing the corporate veil so as to treat a corporate debtor and a shareholder guarantor as the same entity,[16] the marshaling of assets doctrine should

trine obviously cannot be applied, however, when the other asset is also owned or liened by parties other than the debtor.").

[12] 34 Bankr. 737 (N.D. Ill. 1983).

[13] *Id.* at 740-741.

[14] See, e.g., *In re* United Retail Corp., 33 Bankr. 150 (D. Hawaii 1983); *In re* Leonardo, 11 Bankr. 453 (W.D.N.Y. 1981).

[15] See U.C.C. § 9-501(1).

[16] "Facts sufficient to sustain a piercing of the corporate veil may establish independent and separate equities which may overcome a deficiency in the common debtor requirement." *In re* Rich Supply House, Inc., 43 Bankr. 68, 70 (N.D. Ill. 1984); see also *In re* United Medical Research, Inc., 12 Bankr. 941 (C.D. Cal. 1981); Karasik & Kolodney, "The Doctrine of Marshaling Under the Bankruptcy Code," 89 Com. L.J. 102 (1984).

not be used to compel a secured creditor to pursue remedies against a guarantor's assets. Application of the marshaling doctrine to compel foreclosure on a guarantor's property violates the common debtor requirement and imposes on the senior lienor additional expenses and undue delay in obtaining payment. In any event, the trustee as a hypothetical lien creditor under Section 544(a) should not have standing to seek marshaling. Giving the trustee such standing goes well beyond the policy of Section 544(a), which is to allow the trustee to avoid secret or unperfected security interests. The application of the marshaling doctrine in bankruptcy cases should be limited to situations where there are two actual lien creditors and where the senior creditor has liens on two funds *owned by the debtor,* while the junior creditor has a lien on only one of those funds.