1993

From the Bankruptcy Courts: A Trustee's Power To Compel a Secured Creditor To Pursue Remedies Against a Guarantor: Marshaling Of Assets Revisited Again

Benjamin Weintraub

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

From The Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

A TRUSTEE'S POWER TO COMPEL A SECURED CREDITOR TO PURSUE REMEDIES AGAINST A GUARANTOR: MARSHALING OF ASSETS REVISITED AGAIN

In 1985, we criticized the decision of the Court of Appeals for the Eighth Circuit in *In re Jack Green's Fashions for Men—Big & Tall, Inc.*[1] as a misapplication of the equitable doctrine of marshaling to compel a secured creditor to pursue remedies against a guarantor so as to maximize the distribution to unsecured creditors of the corporate debtor.[2] In that case, the court of appeals upheld the trustee's use of the so-called strong-arm provision, which gives the trustee the rights and powers of a hypothetical judicial lien creditor, to justify such use of the marshaling doctrine.[3]

Our primary criticism of the decision in *Jack Green's Fashions* was that the court ignored the significant "common debtor" requirement for marshaling assets; the doctrine is applicable only when a senior lienor has a lien on two or more properties or funds of the same debtor while the junior lienor has a lien on only one of those properties or funds. The doctrine is not applicable where the properties subject to the liens are owned by two separate debtors, such as a corporate debtor and a guarantor. Another criticism of the decision was that it did not give due regard to the requirement that marshaling not prejudice the senior lienor by causing delay or increased expense.

Although we expressed in our article the view that the strong-arm power under Section 544(a) of the Bankruptcy Code was not intended, and should not be interpreted, to give the trustee the power to compel marshaling of assets at all, we also concluded that:

> Except in rare cases where fraud or other inequitable conduct justifies

* Special Counsel to the law firm of Kaye, Scholer, Fierman, Hays & Handler, New York, N.Y.; member of the National Bankruptcy Conference.

** Benjamin Weintraub Distinguished Professor of Bankruptcy Law, Hofstra University School of Law, Hempstead, N.Y.; Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson, New York, N.Y.; member of the National Bankruptcy Conference.

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

[2] See Weintraub & Resnick, "Compelling a Senior Lienor to Pursue Remedies Against a Guarantor—A Misapplication of the Marshaling Doctrine," 18 U.C.C.L.J. 178 (1985).

[3] See 11 U.S.C. § 544(a), derived from § 70(c) of the former Bankruptcy Act. The court in *Jack Green's Fashions* focused on § 70(c) of the Act.

piercing the corporate veil so as to treat a corporate debtor and a shareholder guarantor as the same entity, the marshaling doctrine should 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.[4]

In the seven years since our article on *Jack Green's Fashions*, other courts have recognized the trustee's ability to use Section 544(a) to compel marshaling of assets. In 1986, we wrote again on this subject,[5] but that time applauding the *Tampa Chain*[6] decision of the bankruptcy court in the southern district of New York which, although relying on the trustee's powers under Section 544(a) to give the trustee standing to seek marshaling of assets against a guarantor, limited the marshaling doctrine to situations where inequitable conduct justifies piercing the corporate veil of the debtor and the equitable subordination of the guarantor's subrogation claim against the debtor.

We again revisit the subject of marshaling of assets to report on an interesting district court decision, *In re Vermont Toy Works, Inc.*,[7] that illustrates further limitations, including important procedural requirements, regarding the use of the marshaling doctrine to compel a secured creditor to exhaust its remedies against a guarantor.

Vermont Toy Works[8]

The debtor, Vermont Toy Works, Inc., is a Vermont corporation that was engaged in the manufacturing of finished wood products. The officers and directors were a family consisting of David Winer, his wife Janet, and his son Gordon. David Winer was the sole shareholder of the corporation. In November 1984, the debtor corporation borrowed from Chittenden Trust Company the sum of $150,000. The loan was secured by a security interest in the debtor's assets and the personal guarantees of David and Janet Winer. Additionally, David and Janet Winer executed an agreement that authorized the debtor to pledge as additional collateral $125,000 worth of securities owned by David and Janet Winer. In April 1985, Chittenden subordinated $50,000 of its security interest in the debtor's machinery and equipment to Vermont Industrial Development Au-

[4] 18 U.C.C. L.J. at 181–182.

[5] See Weintraub & Resnick, "Subordination of the Guarantor's Subrogation Rights—The Marshaling Doctrine Revisited," 18 U.C.C. L.J. 364 (1986).

[6] 53 Bankr. 772 (Bankr. S.D.N.Y. 1985).

[7] 135 Bankr. 762 (D. Vt. 1991).

[8] For a detailed description of the facts in the case, see the seventy-six-page bankruptcy court decision at 82 Bankr. 258 (Bankr. D. Vt. 1987). "The opinion of the bankruptcy court set forth in detail the facts of the case; familiarity with that opinion is assumed, and only an abbreviated version of the facts relevant to this appeal is stated below." 135 Bankr. at 765.

thority, which had loaned the debtor $49,300 as a secured loan.

Chittenden also extended personal loans of $493,500 to David and Janet Winer. These personal loans were secured by mortgages on real estate and a pledge of the same securities that secured the corporate loans. The proceeds of the personal loans were invested in the debtor corporation to provide working capital. By mid-November 1985, the corporate debtor defaulted on its loan obligations to Chittenden, and the following month Chittenden and the Vermont Industrial Development Authority took possession of the corporate debtor's collateral consisting of machinery and equipment. The corporation waived its rights to redeem the collateral.

Only three days after the debtor's machinery and equipment were taken into possession, Chittenden and Vermont Wood Industries, Inc., then a six-week old corporation in which David Winer was president and treasurer, chairman of the board, and a 50 percent shareholder,[9] entered into an agreement whereby Chittenden leased the debtor's machinery and equipment to Vermont Wood. The lease agreement also contained an option for Vermont Wood to purchase the machinery and equipment for an amount equal to the outstanding declining principal balance on the corporate debtor's loan.

Involuntary Petition

Several weeks later, unsecured creditors filed an involuntary Chapter 7 petition against the corporate debtor to attempt to prevent the sale of the machinery and equipment to Vermont Wood. Sebert Lumber Co., one of the petitioning creditors, simultaneously moved for an order prohibiting the debtor from selling the machinery and equipment. The bankruptcy court denied Sebert's motion based on Section 303(f) of the Code,[10] which permits a debtor to continue its business during the time between the filing of an involuntary petition and entry of an order for relief. The court also referred to the possibility that Sebert could obtain relief at some later time under the Code provisions relating to the automatic stay and voidable preferences.[11]

Concerned that the bankruptcy court's reference to the automatic stay and preference provisions of the Code was "placing a cloud" on its title to the repossessed machinery and equipment, Chittenden filed a motion entitled "Complaint for Declaratory Judgment Or Motion For Relief From Automatic Stay."[12] The bankruptcy court ordered that the machinery and equipment be sold by Chittenden, as agent for the

[9] Id. at 766 n. 1. Vermont Wood's other 50 percent shareholder, Arthur Jacobson, provided the financial investment necessary to fund the corporation and had the power to name two of Vermont Wood's three directors.

[10] 11 U.S.C. § 303(f).

[11] The bankruptcy court cited 11 U.S.C. §§ 362(a)(6), 547.

[12] 135 Bankr. at 766.

trustee, to Vermont Wood pursuant to the prepetition contract and that Chittenden's security interest attach to the proceeds, but also ordered that the proceeds be held in an interest-bearing account pending the outcome of the hearing on the motion.

The Doctrine of Marshaling of Assets

At the hearing, Sebert was permitted by the court to argue, on behalf of the trustee,[13] that the doctrine of marshaling was applicable to compel Chittenden to pursue its remedies against the Winers as guarantors, thus leaving the proceeds of the machinery and equipment for distribution to unsecured creditors. In the words of the district court:

> The doctrine of marshaling of assets is an equitable principle designed to benefit junior secured creditors. It is traditionally applied when two or more secured creditors claim against one debtor and a senior creditor can reach two properties or funds held by the debtor, whereas, a junior creditor can reach only one. Marshaling requires that the senior creditor first satisfy its claims from the property or fund in which the junior creditor has no interest. . . . The marshaling doctrine is designed to prevent the senior lienor from arbitrarily depriving the junior lienor of his security.[14]

There are three elements that must be proven by clear and convincing evidence before the marshaling doctrine may be employed:

> (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 more than one fund, while the other creditor may resort to only one fund.[15]

In addition, marshaling may not be invoked where it will cause prejudice to the senior creditor or to other parties.[16]

Bankruptcy Court's Decision

The bankruptcy court ordered the debtor's repossessed collateral marshaled. Chittenden was directed to seek relief from the automatic stay to satisfy its loans to the debtor corporation by enforcing the personal guarantees of David and Gordon Winer. To the extent the loans were not satisfied from the guarantors, the bankruptcy court indicated that Chittenden could seek relief from the automatic stay to liquidate the pledged securities. To satisfy the "common debtor" and the "two fund" elements of marshaling, the bankruptcy court merged the assets of David Winer and the corporate

[13] "The bankruptcy court held that absent any specific limitation in the bankruptcy code, Sebert's attorney could present the marshaling defense on behalf of the trustee with the trustee's consent and the court's approval. For the purpose of this opinion, it will be assumed that the trustee may hire the unsecured creditor's attorney as special counsel to prosecute the lawsuit." 135 Bankr. at 766, n.3.

[14] 135 Bankr. at 767.

[15] Id.

[16] See *Id.*

debtor by piercing the corporate veil based on David Winer's inequitable conduct. Accordingly, the bankruptcy court determined that the corporate debtor possessed three funds from which Chittenden could satisfy its loans: the repossessed machinery and equipment, the personal guarantees, and the pledged securities.

The court also found that marshaling assets would not prejudice Chittenden at all because David Winer had sufficient assets to satisfy both the personal and corporate obligations owed to Chittenden. Finally, the bankruptcy court equitably subordinated David Winer's guarantee relationship in order to prevent him from becoming subrogated to Chittenden's secured status after Chittenden satisfies its debts from David Winer's personal guarantee or hypothecated securities.

Issues on Appeal

On appeal,[17] the district court listed four issues that required resolution:

(1) Is the trustee entitled to bring a marshaling of assets action?

(2) Can the marshaling doctrine be applied without David, Janet, and Gordon Winer being parties to the action?

(3) Do the facts presented support a decision to pierce the corporate veil and impose personal liability?

(4) Can the marshaling doctrine be applied in this instance without causing prejudice to the senior lienholder or third parties?[18]

Regarding the first issue, the bankruptcy and district courts, recognizing a split of authority, agreed with those courts that have recognized the trustee's right to seek marshaling of assets.[19] They reasoned that Section 544(a) grants the trustee the rights afforded a hypothetical lien creditor under the applicable state law, that the trustee is considered a secured creditor under Vermont law, and that a secured creditor has the authority to bring a marshaling action.[20] The district court rejected Chittenden's argument that the bankruptcy court's holding "confuses the status of the trustee with those he represents: the traditional requirement is not that marshaling be invoked *by* a secured creditor, but that it be invoked *for* a secured creditor."[21]

---

[17] In addition to the brief filed by Chittenden, the Vermont Bankers' Association filed an amicus curiae brief urging reversal of the bankruptcy court decision.

[18] 135 Bankr. at 767. "This court assumes for the purposes of this opinion that debtor retained an interest in the collateral as of the commencement of the bankruptcy case, which became property of the estate pursuant to 11 U.S.C. § 541(a)(1). Moreover, it will be assumed that this interest was sufficient to grant the estate the authority to invoke the marshaling doctrine with respect to the collateral." Id., n. 4.

[19] The bankruptcy court specifically followed the reasoning in In re Tampa Chain Co., 53 Bankr. 772 (Bankr. S.D.N.Y. 1985).

[20] The district court relied on Section 9-301(3) of the Uniform Commercial Code to show that a judicial lien creditor is considered a secured creditor under Vermont law.

[21] 135 Bankr. at 768.

Failure to Commence an Adversary Proceeding Joining the Guarantors as Parties

Turning to the second issue, the district court noted that David, Janet, and Gordon Winer were not parties to the proceeding in which the bankruptcy court ordered the marshaling of assets by directing Chittenden to satisfy its loans from the Winers based on their guarantees and from the Winers' securities held as collateral. "In a marshaling action, entities holding the funds to which only a senior creditor can look must be joined as parties. . . . In addition, the Vermont substantive law of marshaling would require that either the parties in interest be before the court or 'at the very least, that the fund should be before the court so that the judgment might operate *in rem*.' "[22]

Chittenden should have instituted an adversary proceeding joining the Winers as parties and framing the issues properly in the pleading. Such an adversary proceeding would also allow other creditors of the Winers to intervene to protect their interests. "This is an adversary proceeding between Chittenden and Sebert requesting declaratory relief. Sebert's pleadings do not mention the marshaling doctrine or piercing the corporate veil. This extraordinary application of the marshaling doctrine was not foreseeable to the Winers or their creditors."[23]

The district court also criticized the bankruptcy court for not requiring proper procedures when equitably subordinating David Winer's claim against the corporate debtor in order to prevent him from using subrogation rights to step into Chittenden's secured status after Chittenden satisfies its debts from David Winer's personal assets. "A claim of equitable subordination based on 11 U.S.C. § 510(c) must be brought in an adverary proceeding."[24]

Finally, the district court held that an adversary proceeding should have been brought against David Winer in order to pierce the corporate veil. In order to satisfy the elements of the marshaling doctrine, the bankruptcy court had merged the assets of David Winer and the corporate debtor by disregarding the corporate entity and piercing the corporate veil. "Admittedly, this veil piercing action does not substantively consolidate David Winer's estate with Debtor's estate but requires him to satisfy his personal guarantee of Debtor's loans. However, in the context of this marshaling action, piercing the corporate veil will cost David Winer approximately $150,000 without the benefit of the procedural protection afforded by an adversary proceeding."[25]

Piercing the Corporate Veil

In a footnote, the district court pointed out an irony in the case.

[22] *Id.*

[23] 135 Bankr. at 769.

[24] *Id.*

[25] 135 Bankr. at 769–770.

"The irony is that if David Winer were a proper party to this action, and the trustee were able to prove sufficient inequitable conduct to pierce the corporate veil, there would be no need to apply the marshaling doctrine to achieve the trustee's objective. . . . Once the veil was pierced and David Winer's assets were merged with the assets of the corporate debtor, unsecured creditors would have access to his personal assets."[26]

Nonetheless, the district court did focus on the merits of the bankruptcy court's decision to pierce the corporate veil. After careful review, the district court held that the bankruptcy court's decision to pierce the corporate veil under the facts of the case had to be set aside as clearly erroneous.

> Courts generally list as reasons for piercing the corporate veil the following: using the corporation to perpetrate a fraud; the personal use of corporate funds; the failure to observe corporate formalities; and undercapitalization. . . . Although the bankruptcy court cited the relevant factors, the evidence is insufficient to support this remedy. The record is devoid of any evidence of fraud or the personal use of corporate funds. For the most part, Debtor observed corporate formalities. Debtor's finances were kept separate and apart from David Winer's finances.[27]

The bankruptcy court's reliance on the debtor's alleged undercapitalization was also found to be erroneous. "There is no reason to conclude that Debtor was undercapitalized simply because it failed. . . . The adequacy of capital is measured as of the time of formation of the corporation. . . . It cannot be said, based on the nature of the business and the size of the corporate undertaking, that $10,000 was inadequate capital."[28] The district court also found that, even if the debtor was undercapitalized, that is not a persuasive reason for disregarding the corporate entity in this case which involves contract creditors: "Undercapitalization alone is not a sufficient ground for disregarding the corporate entity. . . . [B]usinesses that choose to deal with corporations on a credit basis should protect themselves by doing their own investigation of the corporation's financial condition."[29]

Other Factors Rejected

The district court also rejected four other factors enunciated by the bankruptcy court in support of its decision to pierce the corporate veil:

[26] *Id.*, n.5. The court cited In re Dealer Support Servs. Int'l., Inc., 73 Bankr. 763, 765 n.3. (Bankr. E.D. Mich. 1987); In re Luby, 89 Bankr. 120, 127–128 (Bankr. D. Ore. 1988) (once corporate veil is pierced the third element of marshaling—that only senior creditor has a right to both funds—is no longer met because junior creditor would have access to both funds).

[27] 137 Bankr. at 770. The court commented that certain corporate formalities, such as directors' meetings, "are nonsensical when applied to small privately-held corporations and should be given little, if any, weight in a veil piercing action."

[28] 135 Bankr. at 771.

[29] *Id.*

(1) an alleged preferential transfer by the debtor to David Winer in the amount of between $5,000 and $20,000 in repayment of personal loans; (2) a certain settlement agreement that provided David Winer with a secured demand note of the debtor for $48,000 in payment of unpaid rent; (3) sale by the debtor of a corporate asset to David Winer; and (4) Chittenden's foreclosure on its security interest in the debtor's collateral, which the bankruptcy court viewed as an attempt by David Winer to improperly release his assets that guaranteed the corporate loan.

The district court, reviewing the events regarding the debtor's financial problems and leading to the filing of the involuntary petition, also rejected the bankruptcy court's finding that Chittenden and David Winer wrongfully conspired to create the demise of the debtor and to steer a valuable corporate opportunity to a new corporation, Vermont Woods. By the fall of 1985, the debtor was no longer able to continue operations without the help of outside investors. It did not have working capital to purchase materials and several large customers had refused to pay their bills. In addition, the new corporation was financed by Arthur Jacobson, Vermont Woods' other 50 percent shareholder. "Subsequently, Debtor and Chittenden engaged in a loan workout plan by liquidating the collateral and minimizing the deficiency. The workout plan had the same effect upon unsecured creditors as the [C]hapter 7 liquidation, because Chittenden had a perfected security interest in the collateral."[30]

Prejudice to Chittenden

Finally, the district court found that marshaling of assets was not available in this case in any event because Chittenden, as senior secured creditor, would be prejudiced by having to proceed against the Winers on a personal guarantee instead of resorting to liquid collateral held in escrow. Moreover, by exhausting $150,000 of personal assets of the Winers to obtain payment of the corporate debt, marshaling would reduce the likelihood that Chittenden would be able to collect on its personal loans given to David Winer. Although the bankruptcy court concluded that David Winer had sufficient assets to pay all corporate and personal obligations owed to Chittenden, the district court noted that Chittenden "argues persuasively" that Winer had insufficient assets to pay all of his loans.[31]

For all the reasons discussed above, the district court reversed the marshaling order of the bankruptcy court and remanded the case for further proceedings in accordance with its opinion.

[30] 135 Bankr. at 773.

[31] *Id.*, n.11. Again criticizing the procedural aspects of the proceeding, the district court commented that "[a]n adversary proceeding would certainly assist in the proper determination of this question. *See Vermont Toy*, 82 Bankr. at 283 (bankruptcy court forced to 'assume' there are no mortgages on David Winer's home)." *Id.*

Conclusion

The district court opinion in *Vermont Toys* serves to remind us of how difficult it is for a bankruptcy trustee to successfully use the strong-arm powers under Section 544(a) and the marshaling doctrine to compel a secured creditor to exhaust its remedies against a guarantor before proceeding against the debtor's collateral. In any event, it is unquestionably beyond the scope of the marshaling doctrine to force a secured creditor with an interest in a sufficient amount of segregated cash collateral to instead pursue individual guarantors. The decision also emphasizes the importance of following appropriate procedures when attempting to use the marshaling doctrine. One of the bankruptcy court's fundamental errors was in allowing this type of proceeding to continue as a motion without all appropriate parties being joined, including the guarantors. Clearly, an adversary proceeding against the guarantors and Chittenden should have been required.[32]

[32] See Part VII of the Federal Rules of Bankruptcy Procedure on adversary proceedings.