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From the Bankruptcy Courts: Subordination of the Guarantor's Subrogation Rights—The Marshaling Doctrine Revisited

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SUBORDINATION OF THE GUARANTOR'S SUBROGATION RIGHTS—THE MARSHALING DOCTRINE REVISITED

A recent inquiry from one of our readers with reference to our article[1] on marshaling of assets poses the question of whether unsecured creditors or the debtor's estate will ultimately benefit if the principle of marshaling is applied to compel a secured creditor to foreclose on a guarantor's collateral. The reader suggests that in such a case, the guarantor ordinarily would step into the shoes of the secured creditor by virtue of the equitable principle of subrogation, and would thereby have the right to exhaust the debtor's collateral and leave the debtor's estate and unsecured creditors in the same position they would have been in absent application of the marshaling doctrine. This suggestion is sound and is consistent with the conclusion of our article:

> 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, the marshaling of assets doctrine should not be used to compel a secured creditor to pursue remedies against a guarantor's assets.[2]

It is important to note that the "rare cases" where marshaling should be ordered involve situations where the guarantor's subrogation to the lienor's position should not be allowed because of the equitable doctrine of subordination.[3] For example, in *In re Rich Supply House, Inc.*,[4] which we cited in footnote 16 of our article, the court held that "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."[5] Once these facts have been found and the guarantor's property has become the property

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1 "Compelling a Senior Lienor to Pursue Remedies Against a Guarantor —A Misapplication of the Marshaling Doctrine," 18 U.C.C.L.J. 178 (1985) (hereinafter referred to as "article").

2 *Id.* at 181-182.

3 See 11 U.S.C. § 510(c).

4 43 Bankr. 68 (N.D. Ill. 1984).

5 *Id.* at 70.

of the debtor, it follows that the same facts that pierced the corporate veil lead, of necessity, to the equitable doctrine of subordination to prevent the guarantor from stepping into the shoes of the secured creditor.

The *Tampa* Case

The recent case of *In re Tampa Chain Company, Inc.*[6] is directly in point. Tampa Chain was founded for the purpose of manufacturing jewelry. It started business on March 30, 1982, upon obtaining from Fundex Capital Corporation ("Fundex") a working capital loan in the face amount of $194,760 which was secured by a security interest in Tampa Chain's inventory, receivables, and other assets. There was no question as to the validity and perfection of the security interest. From the face amount of the loan, there had been deducted $74,760 for interest at 20.85 percent, legal fees and filing costs, leaving net proceeds of $118,086.50.

On July 25, 1983, an involuntary petition under chapter 7 was filed against Tampa Chain, and after the order for relief, a trustee took possession of its assets which were liquidated, realizing approximately $200,000. Fundex sought an order pursuant to Section 725 of the Bankruptcy Code directing the trustee to turn over to it a portion of certain inventory proceeds, sufficient to satisfy Fundex's secured claim, attorneys' fees, costs and charges allowed under Section 506(b). The trustee, in response, sought a marshaling order requiring Fundex to first proceed against Wolf and Rachael Reichard as guarantors of Tampa Chain's debt to Fundex and then against the cooperative apartment ("Co-op") supporting the Reichards' guarantee before proceeding against the debtor's estate or, in the alternative, an order equitably assigning Fundex's rights to the collateral in the event the trustee must satisfy Fundex's lien out of the debtor's estate.

Findings of Fact

After the trial of the issues, the court made the following significant findings of fact. First, the loan was made not on the strength of the collateral owned by Tampa Chain, or the likelihood that Tampa Chain would successfully repay it, but on the protection afforded by the Reichards' mortgaging their three bedroom Co-op to secure payment of their guarantee of the loan. Tampa Chain at the time had no assets, a paltry $2,500, no operating history, and no capital. Fundex agreed to make the loan notwithstanding the poor operating history of its owners, the guarantors, and others in

[6] 13 Bankr. Ct. Dec. 792 (S.D.N.Y. 1985).

another corporation partially owned by Wolf Reichard, known as M.C. Merchandising, Inc. ("M.C."). The loan was granted only after an officer of Fundex inspected the Co-op and received the consent of the Co-op board and concluded that the Co-op had an estimated value of $300,000. Other agreements with the Reichards bolstered Fundex's position with respect to its ability to cash out the Co-op in the event of a default. Consistent with Fundex's reliance on the Co-op for payment, Fundex did not determine whether Tampa Chain bought the inventory or the equipment that it stated that it would buy with the loan proceeds, nor did it monitor the operations.

Second, by the end of June 1982, 56 percent of the proceeds of the loan made by the Tampa Chain were disbursed to or for the benefit of Wolf Reichard, his wife's brother, his friends or others. As a result, "in the first four months of its brief life," Tampa Chain had $23,000 in sales and spent all of the $118,000 advanced by Fundex. Although Wolf Reichard claimed that he made capital contributions in excess of the withdrawals, the court discounted these contributions, focusing on what happened in the early months of operations and the substantial withdrawals during that period.

Third, although the Reichards ultimately contributed up to $261,000 to the corporation, expenditures of $315,000 of Tampa Chain's funds were disbursed throughout its history for either the direct or ultimate benefit of Reichard, his brother-in-law, and other companies owned by the family, such as M.C., which operated on Tampa Chain's premises. Inventory was transferred to M.C. for which Tampa Chain never received payment. The result of such transfers was a financial revival of M.C., which was able to run its own business as well as to make large "loans" of cash to Wolf Reichard to pay other monthly charges for the Reichards' Co-op and to transfer money to his personal friends.

Fourth, Rachael Reichard also profited by Tampa Chain paying $60,000 to a pawn shop to redeem her personal jewelry, and paying $5,783 of maintenance obligations on the Co-op owned by her and her husband.

Was the Trustee a Secured Creditor?

After discussing the principle of marshaling (which requires the senior creditor to exhaust the single charged fund before satisfying its claim against the doubly charged fund so as to do equity between the senior and junior lienors), the court turned to the Reichards' objection that the trustee was not a junior creditor. The Reichards had cited both *In* re Computer Room[7] and In re McElwaney,[8] which held that the trustee was not allowed to invoke the doctrine of marshaling by virtue of a status as a hypothetical lien creditor; for to do so would "frustrate the Code's general policy of leaving creditors in the status they enjoy under state law, by enacting unsecured creditors over secured creditors."[9] The court, however, rejected the argument holding that Section 544(a)(2) of the Code is a principal exception to that policy and such rights and powers are to apply in a marshaling context. "In New York, an unsatisfied execution creditor has rights to the personal property of a debtor served with a writ of execution superior to all but prior secured creditors and bona fide purchasers for value. N.Y. Civ. Prac. Law § 5202(a) (McKinney 1978). The trustee is thus to be deemed a secured creditor."[10]

The Common Debtor Requirement

Having established the trustee as a secured creditor, the court turned to the requirement that marshaling traditionally "required that both sources of payment belong to a common debtor. *Ordinarily,* this requirement is not met where the two funds sought to be marshaled are held separately by a corporation and its shareholder even though he guaranteed corporate debt."[11] This statement led to a search for a separate fund to complement the common fund.

> Several courts have held that when a guarantor who is also a controlling shareholder provides the lender with the primary collateral needed to obtain a working capital loan to either initiate or continue the operation of the debtor corporation, the "common debtor" requirement is satisfied and the equitable remedy of marshaling is available. . . . Under such circumstances, the collateral pledged by the guarantor/shareholder is held, by those courts permitting marshaling, to be the equivalent of a capital contribution to the corporation which a court in equity should consider as a fund for the corporation itself, so that there is a "common debtor."[12]

Having stated the principle of "capital contribution" constituting a fund so as to create a common debtor with two funds which had been espoused by several courts, the bankruptcy court observed that:

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[7] 24 Bankr. 732 (N.D. Ala. 1982). See article, note 1 *supra,* at 180.

[8] 40 Bankr. 66 (M.D. Ga. 1984). See article, note 1 *supra,* at 180.

[9] *In re* Tampa Chain Co., 13 Bankr. Ct. Dec. at 794.

[10] *Id.*

[11] *In re* Tampa Chain Co., 13 Bankr. Ct. Dec. at 794. (emphasis added).

[12] *Id.* at 794-795. The court cited as authority Farmers & Merchants Bank v. Gibson, 7 Bankr. 437 (N.D. Fla. 1980).

> [A] more widespread acceptance is the notion that where the corporate veil should be pierced upon the application of traditional doctrine, equity will subject the property of individual shareholders to the claims of corporate creditors thereby satisfying the "common debtor" requirement for marshaling. . . . Pursuant to that doctrine, the corporate veil will be disregarded in fraud, inadequate capitalization and alter ego cases.[13]

Holding that neither the *alter ego* theory nor the inadequate capitalization doctrine applied in the case at bar, since separate books and records were kept by the debtor from those of the Reichards and subsequent contributions of capital had been made by Wolf Reichard, the court was "reluctant to find a 'common debtor' merely through a lender's supplying working capital pursuant to a loan collateralized by a debtor's assets merely because a guaranty was also collateralized by personal assets as in *Jack Green's Fashions* and *Multiple Services*."[14] The court observed that it need not consider the issues raised in those cases, which were criticized in our previous article. The court distinguished those issues from the instant case "where the senior creditor looked to the collateral for the guaranty of the loan for protection and where the evidence amply demonstrates highly inequitable conduct by the shareholders/guarantors."[15] The court further stated that:

> Finding a common debtor . . . has the effect of first liquidating the collateral posted by the corporate principals and requiring them to share equally with or be subordinated to their claim against the debt or upon subrogation. Equitable subordination, as a companion doctrine of the disregard of the corporate veil, lies where the principal(s) engaged in fraud or other inequitable conduct to the harm of creditors or an unfair advantage to the claimant and is not contrary to principles of bankruptcy law.[16]

The inequitable conduct of the guarantor was summarized by the court as the "continuous use of Tampa Chain as a personal piggy bank from which the Reichards withdrew much of Tampa's initial capitalization" which was replenished through depositing Wolf Reichard's own funds and then by transferring approximately $770,000 in inventory to another family-owned company "on hard-

[13] *In re* Tampa Chain Co., 13 Bankr. Ct. Dec. at 795.

[14] *Id.* The court was referring to *In re* Jack Green's Fashions for Men—Big and Tall, Inc., 597 F.2d 130 (8th Cir. 1979), and *In re* Multiple Services Indus., Inc., 18 Bankr. 635 (E.D. Wis. 1982).

[15] *In re* Tampa Chain Co., 13 Bankr. Ct. Dec. at 795.

[16] *Id.* The court cited as authority Stuhley v. United States Small Business Administration (*In re* United Medical Research, Inc.) 12 Bankr. 941 (C.D. Cal. 1981).

ly commercial terms."[17] Added to this were other badges of fraud, such as lack of adequate consideration, close family relationships between the parties, retention of possession, benefit or use of the property in question, and, finally, the financial condition of the party sought to be charged before and after the transaction in question.

No attempt was made by Fundex to defend Wolf Reichard's conduct, but it argued that there was less evidence to connect Rachael Reichard with his course of dealing, that she was not a shareholder and held the Co-op as a tenant by the entirety. The court held to the contrary; that she was a shareholder, that she benefited from some of the transactions, that she redeemed her personal jewelry by Tampa paying $60,000 of its funds, and that monies from Tampa and M.C. were used for the Co-op. "For all these reasons the common debtor requirement is satisfied."[18]

Moreover, Fundex would not be prejudiced by marshaling, since any deficit resulting from the sale of the Co-op would be protected by application to the doubly charged fund in the possession of the trustee. The court, however, disallowed interest for late charges because the charges were, in effect, penalties and no proof had been offered by Fundex of actual loss. However, attorneys' fees were allowed since the promissory note obligated the debtor upon default of any installment to "pay all costs of collection, including reasonable attorney's fees." The court overruled the trustee's objection that this was not a collection matter, but the agreement to consider 20 percent as reasonable was subject to the court's determination.

Conclusion

The *Tampa* case is readily identified as one of the "rare cases" in which we favor use of the marshaling doctrine to compel a lienor to proceed against a guarantor's collateral. Does this mean that every guarantee collateralized by personal property requires the lender to maintain a constant surveillance and monitoring over the principal debtor's business activities on penalty of finding the marshaling doctrine being applied? The court was careful to indicate, as we emphasized above, that "*Ordinarily* this requirement [of a common debtor] is not met where the two funds sought to be marshaled are held separately by a corporation and its shareholder even though he guaranteed corporate debt."[19] We

[17] *In re* Tampa Chain Co., 13 Bankr. Ct. Dec. at 796.

[18] *Id.*

[19] *Id.* at 794.

limit the case to situations where reliance is primarily on the guarantor's collateral and not on the net worth of the principal debtor, and sufficient facts exist to warrant the piercing of the corporate veil based on inequitable or fraudulent conduct. Under such circumstances Section 510(c) should be applied to subordinate the guarantor's claim of subrogation.