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Michael W. Mosman

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COMMENTS

The Proper Application of Marshaling on Behalf of Unsecured Creditors

"Plane, cum tertius creditor primum de sua pecunia dimisit, in locum ejus substituitur in ea quantitate quam superiori exsolvit."[1]

Reaching back to the roots of western law, the equitable doctrine of marshaling has quietly plagued senior creditors for at least a score of centuries. Recently, marshaling has been extended in a novel way that presents an important issue of commercial law. A number of recent decisions in the federal courts,[2] particularly bankruptcy courts, have dealt with the issue of whether marshaling can be applied in favor of unsecured creditors, and if so, under what conditions. The decisions that adopt such an application represent a new addition to a very old doctrine.

This Comment will examine the history of marshaling to show that the doctrine was not originally intended to be used on behalf of unsecured creditors, and will discuss modern rationales for continuing that traditional prohibition. In the context of bankruptcy proceedings, however, some courts, beginning primarily with the court in *In re Jack Green's Fashions for Men—Big & Tall,*[3] have allowed marshaling on behalf of unsecured creditors to he requested by the trustee in bankruptcy. The courts have not clearly explained their reasons for creating

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1. 2 J. STORY, EQUITY JURISPRUDENCE § 856 (14th ed. 1918), a Roman statute, which roughly translated is, "Clearly when the third creditor sends the first against his money, he substitutes in the place of him in that quantity which was formerly resolved."

2. *In re* Jack Green's Fashions for Men—Big & Tall, 597 F.2d 130 (8th Cir. 1979); *In re* Tenn-Ero Corp., 14 Bankr. 884 (Bankr. D. Mass. 1981); *In re* United Medical Research, Inc., 12 Bankr. 941 (Bankr. C.D. Ca. 1981); *In re* Clary House, Inc., 11 Bankr. 462 (Bankr. W.D. Mo. 1981); *In re* Leonardo, 11 Bankr. 453 (Bankr. W.D.N.Y. 1981); *In re* A.E.I. Corp., 11 Bankr. 97 (Bankr. E.D. Pa. 1981); Farmers & Merchants Bank v. Gibson, 7 Bankr. 437 (Bankr. N.D. Fla. 1980).

3. 597 F.2d 130 (8th Cir. 1979).

this exception. This Comment proposes that the doctrine of marshaling should be extended to unsecured creditors within that narrow context. This can be done without incurring any of the harms associated with a wholesale extension of the doctrine of marshaling to unsecured creditors generally. This limited exception to the longstanding prohibition against unsecured creditors is warranted by at least three modern rationales. In addition, its validity will often depend on whether adequate protection is accorded to the independent equities of the other parties involved, including the senior creditor, the debtor, and any guarantors.

I. THE HISTORY OF MARSHALING, AND ITS BASIC ELEMENTS

The doctrine of marshaling was born out of the desire of chancery courts to come to the aid of junior mortgagees. The classical case was propounded by Lord Hardwicke, in *Lanoy v. The Duke & Dutchess of Athol*.[4]

> Suppose a person, who has two real estates, mortgages both to one person, and afterwards only one estate to a second mortgagee, who had no notice of the first; the court, in order to relieve the second mortgagee, have directed the first to take his satisfaction out of that estate only which is not in mortgage to the second mortgagee, if that is sufficient to satisfy the first mortgage, in order to make room for the second mortgagee, even though the estates descended to two different persons.[5]

The reason for the rule was simple: If the senior mortgagee could go against a second item of collateral and by so doing leave the first item open to a junior mortgagee, without thereby damaging himself, it was considered only fair and just that he be required to do so.[6] It was also felt that the ability to defeat entirely the rights of a junior lienholder was a power that did not

4. 26 Eng. Rep. 668 (Ch. 1742).

5. *Id.* at 669.

6. 2 J. STORY, *supra* note 1, at § 853. Justice Story stated the rationale in terms of natural justice when he said:

> The reason is obvious, and has already been stated; for by compelling A, under such circumstances, to take satisfaction out of one of the funds, no injustice is done to him in point of security or payment. And natural justice requires that one man should not be permited, from wantonness, or caprice, or rashness, to do an injury to another. In short we may here apply the common civil maxim, "Sic utere tuo ut non alienum laedas;" and still more emphatically the Christian maxim "Do unto others as you would they should do unto you."

Id.

and should not naturally flow from one's status as a senior lienholder.[7]

The concept was soon expanded to include more than just mortgages.[8] Although at one time Professor Pomeroy had reason to conclude that American law applied marshaling only in limited nonmortgage contexts,[9] it is now clear that marshaling may be required "wherever one has any lien or security on two funds, and another has a subsequent lien on only one of them."[10]

Over time the doctrine of marshaling developed a discrete set of necessary elements, and established itself in the hierarchy of various equities. This hierarchy becomes important because of the rule that any competing equity of equal or greater "weight" acts as a bar to the right to marshal.[11] Courts have required that the two creditors be creditors of the same debtor, and that both items of collateral be owned by the common debtor.[12] Additionally, the application of marshaling is limited to those cases in which "it will not trench upon the rights or operate to the prejudice of the party entitled to the double fund."[13]

While all of these present issues for discussion, the main debate centers around the element that marshaling can be had only as between secured creditors, that an unsecured creditor cannot assert the equity to marshal assets.[14]

It is difficult to determine when the notion of marshaling in favor of an unsecured creditor was first seriously presented to a court. Until recently, the idea was summarily dismissed as though it were an issue not open to discussion.[15] Prior to 1980

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7. *E.g.*, 18 R.C.L. *Marshaling Assets* § 3 (1917).

8. It is difficult to determine precisely when the doctrine of marshaling began to be used outside the context of mortgages, or even if it was ever really limited to that context. At any rate, it appears to be a long established rule in cases in the 1600's that marshaling may be used where one or more of the items of collateral involved is tangible personal property. *See generally* 1 J. POWELL, A TREATISE ON THE LAW OF MORTGAGES 919-22 (1st Am. ed. Hartford & New-Haven 1807) (1st ed. London n.d.).

9. 4 J. POMEROY, EQUITY JURISPRUDENCE § 1414 (5th ed. 1941).

10. 2 J. POMEROY, EQUITY JURISPRUDENCE § 396 (5th ed. 1941).

11. 4 J. POMEROY, *supra* note 9, at § 1414; *see also* Anthes v. Schroeder, 68 Neb. 370, 94 N.W. 611 (1903) (a general discussion of the scope of the doctrine).

12. 4 J. POMEROY, *supra* note 9, at § 1414; *see also* Farmers & Merchants Bank v. Gibson, 7 Bankr. 437 (Bankr. N.D. Fla. 1980); Moser Paper Co. v. North Shore Publishing Co., 83 Wis. 2d 852, 266 N.W.2d 411 (1978).

13. 2 J. STORY, *supra* note 1, at § 853.

14. 4 J. POMEROY, *supra* note 9, at § 1414; *accord* 53 AM. JUR. 2D *Marshaling Assets* § 29 (1970); H. MCCLINTOCK, HANDBOOK OF THE PRINCIPLES OF EQUITY § 205 (2d ed. 1948); 2 J. STORY, *supra* note 1, at §§ 853-856; 18 R.C.L. *Marshaling Assets* § 6 (1917).

15. *See, e.g.*, Wenatchee Prod. Credit Ass'n v. Pacific Fruit & Produce Co., 199

the courts were apparently unanimous: marshaling was unavailable to the unsecured creditor.[16]

II. Modern Rationale for Denying Marshaling Rights to Unsecured Creditors

Despite the courts' historical unanimity, unsecured creditors have sought to require marshaling in several recent cases. The first modern case relied on by unsecured creditors as a basis for requesting marshaling is *In re Jack Green's Fashions for Men—Big & Tall.*[17] That case involved the bankruptcy of a closely held corporation and of its two individual owners. The trustee, in his petition to marshal, requested that a secured creditor of the corporation go against some real property put up as collateral by the individuals. The basis on which the bankruptcy court, the district court, and the court of appeals granted the trustee's petition is not clear. Granting the trustee's request to marshal may even have been inadvertent since the major debts involved were incurred while the corporation was still a partnership, and the court may have been applying certain partnership principles that are very similar to the doctrine of marshaling.[18] At any rate, subsequent courts have either allowed or denied marshaling without discussing how unsecured creditors obtained standing even to request marshaling.[19] The issue of whether to extend the doctrine of marshaling to include unsecured creditors needs to be dealt with expressly. While a limited extension can be justified, there are compelling reasons for avoiding any rule that modifies marshaling to include all unsecured creditors. Even putting to one side the strong arguments in favor of stare decisis, there are three important modern reasons for denying marshaling rights to unsecured creditors.

Wash. 651, 92 P.2d 883 (1939).

16. *See, e.g.*, Merrill v. National Bank, 173 U.S. 131 (1899); Lewis v. United States, 92 U.S. 618 (1875); Union Bank v. Laird, 15 U.S. (2 Wheat.) 390 (1817) (per Justice Story, author of the multivolume Equity Jurisprudence (14th ed. 1918)); Scharff v. Meyer, 133 Mo. 428, 35 S.W. 858 (1896). (While *Scharff* has been cited for the proposition that marshaling is unavailable to unsecured creditors, the facts in *Scharff* presented no opportunity for marshaling in any context, let alone in the context of unsecured creditors).

17. 597 F.2d 130 (8th Cir. 1979).

18. *In re* United Medical Research, Inc., 12 Bankr. 941, 942 (Bankr. C.D. Ca. 1981).

19. *See supra* note 2.

A. *Cumulative Rights under the Uniform Commercial Code*

Section 9-501 of the Uniform Commercial Code reads:

> (1) When a debtor is in default under a security agreement, a secured party has the rights and remedies provided in this Part and except as limited by subsection (3) those provided in the security agreement. He may reduce his claim to judgment, foreclose or otherwise enforce the security interest by any available judicial procedure. If the collateral is documents the secured party may proceed either as to the documents or as to the goods covered thereby. A secured party in possession has the rights, remedies and duties provided in Section 9-207. The rights and remedies referred to in this subsection are cumulative.[20]

The generally accepted view of the purpose of 9-501 is to allow "secured creditors to choose amongst various available remedies in order to initially foreclose and sell the most liquid collateral (in a commercially reasonable manner) in order to expedite recovery upon an indebtedness due from a debtor."[21] However, marshaling on behalf of junior *secured* creditors is recognized as a legitimate judicially created exception to 9-501.[22]

The author of a recent article[23] suggests that in cases in which article 9 of the U.C.C. is relevant, section 9-501 may be reason enough to deny marshaling rights to unsecured creditors. The author is concerned that if marshaling were extended to include unsecured creditors, the lending community would be more reluctant to extend new credit to those borrowers who traditionally have guaranteed their loans with "bonus" collateral, that is, collateral taken in addition to the primary collateral. Lenders would be unhappy with the possibility of being forced to resort to the "bonus" collateral instead of to the security of first choice.[24]

B. *Release of Singly Charged Collateral*

A similar argument about lender reaction stems from an-

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20. U.C.C. § 9-501 (1981).

21. Labovitz, *Marshaling Under the U.C.C.: The State of the Doctrine*, 99 BANKING L.J. 440, 441 (1982).

22. *See, e.g.*, Community Bank v. Jones, 278 Or. 647, 566 P.2d 470 (1977); Shedoudy v. Beverly Surgical Supply, Co., 100 Cal. App. 3d 730, 161 Cal. Rptr. 164 (1980).

23. Labovitz, *supra* note 21, at 441.

24. *Id.* at 446.

other facet of the doctrine of marshaling. Some courts have held that if the senior lienholder, with notice of a junior secured creditor's lien, releases any part of the security to which he alone has access, then the amount of his security on the remaining collateral will be reduced proportionately.[25] The rationale is that by releasing some collateral the senior lienor has made it that much more likely that he will have to go against the doubly charged collateral. Also, without such a rule, a senior creditor could effectively nullify the rights that marshaling gave to junior creditors,[26] by releasing all secondary security which could be subjected to marshaling. Under present law the senior lienor's security on the nonreleased collateral is reduced only with respect to junior creditors of whom he has notice. Some courts have even refused to reduce his lien unless the junior creditor actually notified the senior that he would be expected to satisfy his claim first out of the singly charged security.[27]

It could be argued that if senior creditors are forced to reduce their remaining security by the amount of any released security, to the benefit of unsecured creditors, they will be much more hesitant to release security.[28] As a result, a very desirable commercial practice will be cut back.

This might be true if marshaling were extended to unsecured creditors generally. However, under the rule subsequently proposed by this Comment,[29] marshaling rights would go only to those unsecured creditors represented by a trustee in bankruptcy. For that reason, any dangers to the practice of releasing securities would be greatly diminished. Applying by analogy the rules concerning release of securities, a senior lienholder would have his lien reduced only for the benefit of a trustee of whom he had notice, or who had forewarned him that he would be expected to go first against the singly charged lien. If the senior lienholder has any knowledge of the existence of a trustee in bankruptcy, it is highly unlikely that he would be releasing any

25. *E.g.*, Continental Supply Co. v. Marshall, 152 F.2d 300, *cert. denied*, 327 U.S. 803 (1946).

26. *E.g.*, Harris v. Cheshire, 189 N.C. 219, 126 S.E. 593 (1925).

27. *E.g.*, Ocobock v. Baker, 52 Neb. 447, 72 N.W. 582 (1897).

28. Although the senior creditor will release security only when he deems himself oversecured, the reason he will be much more hesitant to release security if unsecured creditors can charge it against him is that he does not know who they are or how much they are owed. That results in an almost total loss of ability to predict and measure his equity cushion, and so out of caution he will preserve as much of a cushion as he can.

29. *See infra* pt. III.

security anyway.

C. *The Dangers of Competing Equities*

A final, "let sleeping dogs lie" argument was made by the bankruptcy court in *In re United Medical Research, Inc.*[30] The court argued that

> [u]nsecured creditors often receive nothing in a bankruptcy liquidation. Rarely, the unsecured creditors do receive a small dividend. It is not surprising that bankruptcy judges and the appellate courts are tempted to "do equity" for the unsecured creditors. However, as stated in the *Matter of Samuels and Co. Inc.* (CA 5th 1976) 526 F.2d 1238, "[w]e do not sit as federal chancellors confecting ways to escape the state law of commercial transactions when that law produces a result not to our tastes. Doing what seems fair is heady stuff .... Today's heady draught may give the majority a euphoric feeling, but it can produce tomorrow's hangover."[31]

Counseling courts to be reticent about doing wbat seems fair may at first glance seem ironic. Probably, the intended warning is that in rushing forward to accomplish one apparently just result, there is the danger of trampling over less visible but equally deserving equitable rights. Nowhere is this more evident than with marshaling, which will almost always involve the competing equities of the debtor, the senior creditor, and other junior secured creditors.

III. A Proposed Rule

The three arguments just mentioned should cause any court to think twice before extending marshaling rights to unsecured creditors generally. While there may be other equitable principles available for the aid of unsecured creditors generally,[32] marshaling is not one of them. It was carefully calibrated to adjust the equitities of competing lienholders, and because it is so deeply rooted in the law of liens, it becomes too powerful a tool when brought to the aid of unsecured creditors.

However, it is difficult to ignore the possibility that marshaling seems to offer of achieving a more just result in some cases. With the warnings of potential dangers in mind, it is still

30. 12 Bankr. 941 (Bankr. C.D. Ca. 1981).

31. *Id.* at 944.

32. *See infra* note 43 and accompanying text.

possible to modify the doctrine of marshaling in a limited way while avoiding most of the risks involved with extending it to all unsecured creditors.

The courts should create an exception that allows the trustee in bankruptcy, acting on behalf of unsecured creditors, to request marshaling. This exception is strongly supported by the status conferred on the trustee under the Bankruptcy Code.

A. *Rationales for the Rule*

Traditional enunciations of the doctrine of marshaling required that both creditors involved have at the minimum some sort of "lien or charge."[33] The trustee in bankruptcy has that and more. Section 544 of the Bankruptcy Code[34] provides:

> (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained a judicial lien, whether or not such a creditor exists;
>
> (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists[.][35]

This status, given by section 544 to the trustee, more than satisfies any minimum level of "lien or charge" necessary to have standing to request marshaling. As explained in *Collier on Bankruptcy*,[36]

> the trustee's powers, in every case governed by section 544(a), are those which the state law would allow to a supposed or hypothetical creditor of the debtor who, as of the commencement of the case, had completed the legal (or equitable) processes for perfection of a lien upon all the property available for the sat-

33. H. McClintock, *supra* note 14, at § 205.
34. 11 U.S.C. § 544 (1978).
35. *Id.*
36. Collier on Bankruptcy (L. King 15th ed. 1979).

isfaction of his claim against the debtor.[37]

Under the predecessor to section 544, this status had been held to carry with it the "remedies and powers of a judgment creditor holding an execution duly returned unsatisfied."[38]

It appears that the original primary purpose of the predecessor to section 544, as amended in 1910, was to enable the trustee "to strike down secret liens and other transfers that prior thereto had evaded the trustee's attack."[39] The language of section 544 is broader than its predecessor and gives the trustee, at least by the language of the statute itself, all the rights, remedies, and powers that such a lien creditor would receive under the substantive law of the state where the property is located.[40]

It may be that the power to request marshaling on behalf of unsecured creditors was not one of the specific, express powers that Congress intended to give the trustee. Yet there is nothing in the language or legislative history of the statute to prohibit it. Other factors favor such a construction.

For example, the idea of using the status conferred upon the trustee by section 544 to give him standing to request marshaling meshes neatly with the overall purpose of the Bankruptcy Code. The bankruptcy laws, apart from those aimed towards reorganization, are designed to accomplish an equitable and uniform distribution of assets, according to the relative rights of the parties with an interest in the estate.[41] This goal correlates closely with the purpose of marshaling, through which "the legal rights of creditors are controlled in order to accomplish an equitable distribution of funds in accordance with the relative priorities of different parties entitled to share therein."[42]

Properly applied, marshaling joins with bankruptcy law to become a powerful tool in accomplishing the goal of the Bankruptcy Act. It prevents the arbitrary action of a secured creditor from accomplishing an unequal distribution of assets when a more equitable distribution can be accomplished without doing

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37. 4 Collier on Bankruptcy ¶ 544.02.

38. *In re* Horton, 31 F.2d 795 (W.D. La. 1928) (discussing the purpose of the predecessor to § 544).

39. 4 Collier on Bankruptcy, *supra* note 37, at ¶ 544.01.

40. *Id.* at ¶ 544.02.

41. *See generally* Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested by Articles 2 and 9, 14* Rutgers L. Rev. 518 (1960).

42. *In re* A.E.I. Corp., 11 Bankr. 97, 99 (Bankr. E.D. Pa. 1981).

harm to the secured creditor.

It also allows the trustee to better perform his function of preserving the estate for general creditors since the secured creditor will often have the major part of his debt satisfied from the singly charged collateral, leaving most or all of the doubly charged collateral to the estate.

Bankruptcy courts already exercise equitable powers on behalf of unsecured creditors that are similar in effect to marshaling. For example, the doctrine of equitable subordination[43] allows a bankruptcy court to subordinate some secured claims to those of the unsecured creditor.[44] While the behavior required to trigger the two doctrines is slightly different, the end result is very similar. Thus, equitable subordination provides existing evidence that bankruptcy courts have the power to rearrange priorities on behalf of unsecured creditors.

Marshaling is an equitable principle. Bankruptcy courts in particular are courts of equity.[45] Under the statutory grant of authority given to trustees by section 544, and under equitable and statutory principles that already allow some restructuring of priorities, courts should allow the trustee to petition for marshaling on behalf of general creditors.

IV. Marshaling as a Discretionary Decision: Considerations

The foregoing analysis establishes only that the trustee in bankruptcy should have standing to petition for marshaling. However, to petition for marshaling and to have it granted are two different things. The determination of whether to require marshaling is an equitable decision with the judge.[46] Many considerations go into making that determination. Some of them involve the basic elements necessary for marshaling. Other considerations require weighing the various equities involved. For example, the senior creditor has an equitable right not to be unduly delayed or harmed.[47] Many of the recent cases following in

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43. 11 U.S.C. § 510(c) (1978).

44. *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). For an explanation of the legislative history of § 510, see 3 Collier on Bankruptcy ¶ 510.04 (L. King 15th ed. 1979).

45. Local Loan Co. v. Hunt, 292 U.S. 234 (1934).

46. H. McClintock, *supra* note 14, at § 205.

47. *Id.*

the wake of *In re Jack Green's Fashions for Men—Big & Tall*[48] involve loans to small corporations that are secured or guaranteed by the personal collateral of the major stockholders. In such cases marshaling competes with the equity of a stockholder to have limited liability with respect to corporate creditors,[49] and the right of a guarantor to exoneration.[50] Depending on the type of collateral involved, a court may have to consider the equity of homestead or other exemptions.[51] Stated more generally, a court must be alert to the rights of all who have an interest in the property involved to have marshaling applied "only when it can be equitably fashioned as to all the parties."[52] These rules have long been routinely applied in cases involving secured creditors. However, this routine application cannot be directly carried over to cases involving a trustee representing unsecured creditors. When a trustee is involved, a court must reexamine these factors in a new light, and change their application to take into account the altered equities of the parties involved.

A. Undue Delay

The requirement that marshaling must not cause the principal creditor any harm or undue delay is one of the more effective bars to invoking the doctrine.[53] In many cases the principal creditor will have acquired the second item of collateral as "bonus" security, intending all the while to look to his original, more liquid collateral should he have to realize. For example, several cases subsequent to *In re Jack Green's Fashions for Men* involved the Small Business Administration's practice of securing its guarantee with corporate assets and requiring additional collateral from the officers and principal shareholders of the close corporation.[54] Particularly when the shareholders' collateral is realty, the senior creditor can argue that marshaling would subject him to undue delay.

However, delay is not per se a reason to refrain from mar-

48. 597 F.2d 130 (8th Cir. 1979).

49. Farmers & Merchants Bank v. Gibson, 7 Bankr. 437, 440 (Bankr. N.D. Fla. 1980).

50. *Id.* at 441.

51. *In re* Leonardo, 11 Bankr. 453, 455 (Bankr. W.D.N.Y. 1981).

52. Meyer v. United States, 375 U.S. 233, 239 (1963).

53. *See* Merrill v. National Bank, 173 U.S. 131, 138 (1899).

54. *In re* A E.I. Corp., 11 Bankr. 97 (Bankr. E.D. Pa. 1981); *In re* Clary House, Inc., 11 Bankr. 462 (Bankr. W.D. Mo. 1981); *In re* United Medical Research, Inc., 12 Bankr. 941 (Bankr. C.D. Ca. 1981).

shaling. There must be some showing that it is unreasonable, that it works some harm.

> It is true that delay to the prior creditor has been sometimes spoken of as a bar to the relief here asked, but we are not ready to subscribe to the doctrine that mere delay is sufficient to compel the court to deny the relief when no other injury is involved. Some delay is a necessary consequence of the enforcement of all rights, and, if a possible delay would defeat the right of a junior creditor to have the assets of his debtor marshaled, such marshaling would rarely, if ever, take place.[55]

The delay argument has even less weight in a bankruptcy case. When a petition is filed under chapters seven, nine, eleven, or thirteen, section 362[56] operates as an automatic stay upon lien enforcement and other actions affecting the property of the estate, the property of the debtor, or property in the custody of the estate.[57] It would be difficult for the principal to argue that he is suffering undue delay by having to go against the secondary collateral since section 362 temporarily restrains him from realizing on the prime collateral anyway.[58] It may even be in the principal creditor's best interest to go against the secondary collateral, without being required to do so by a court-imposed order of marshaling.

If the secured creditor can quickly have the stay lifted, his "delay" argument is revitalized. Section 362 provides for lifting of the stay under some circumstances. The operation of these provisions is complex, and difficult issues concerning adequate protection[59] of the secured creditor's interests arise in deciding when to lift the stay. One of the ways the secured creditor can seek to lift the stay is to show that no equity is left in the property for the trustee to distribute.[60] If the secured creditor can demonstrate that the purpose of the stay is no longer valid since all the equity in the property is covered by his security interest, the stay will be lifted and the creditor will be permitted to real-

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55. Gotzian v. Shakman, 89 Wis. 52, 57, 61 N.W. 304, 306 (1894) (the senior creditor's singly charged collateral was realty).

56. 11 U.S.C. § 362 (1978).

57. 2 Collier on Bankruptcy ¶ 362.01 (L. King 15th ed. 1979).

58. *But see infra* pt. IV C.

59. 11 U.S.C. § 362(d)(1) (1978); *see also* 2 Collier on Bankruptcy, *supra* note 57, at ¶ 362.07.

60. 11 U.S.C. § 362(d)(2) (1978). In a reorganization it must be shown that the property is not necessary for an effective reorganization, in addition to showing a lack of equity.

ize on his collateral.

In this type of case the trustee can once again use marshaling to bring about a more equitable distribution. If the principal creditor argues that no equity is left in the property, the trustee can reply that if marshaling is required, and the creditor forced to go against separate collateral, the burden on the primary collateral will be greatly reduced. Because the senior creditor would have to satisfy most or all of his secured obligation from the singly charged collateral, there would often be some equity left in the property subject to the stay. Thus, by requesting marshaling the trustee can obviate the senior creditor's argument for lifting the stay. This will allow not only for a more equitable distribution of assets, but also for a longer imposition of the stay, which can be of great benefit to the debtor.

B. The Common Debtor

One basic element of marshaling that is sometimes ignored in the rush to "do equity" for the unsecured creditor is the requirement of a common debtor. To understand its importance, it is helpful to look at the typical fact pattern found in the line of cases beginning with *In re Jack Green's Fashions for Men.*[61] The lender makes a loan to a closely held corporation. The loan is obtained for working capital. To secure the loan the corporation puts up its assets. In addition, the corporate officers and principal shareholders undertake to personally guarantee the loan. They secure that obligation by mortgages on their homes. Subsequently, the corporation files for bankruptcy.

While these facts superficially seem to present a classic case for marshaling, the missing element is that the corporation and the individual guarantors[62] are separate entities, and thus there is no common debtor owning both funds.

However, there may be "supervening equities which must be considered,"[63] which can cause a court to look past the technical

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61. *In re* Tenn-Ero Corp., 14 Bankr. 884 (Bankr. D. Mass. 1981); *In re* United Medical Research, Inc., 12 Bankr. 941 (Bankr. C.D. Ca. 1981); *In re* Clary House, Inc., 11 Bankr. 462 (Bankr. W.D. Mo. 1981); *In re* Leonardo, 11 Bankr. 453 (Bankr. W.D.N.Y. 1981); *In re* A.E.I. Corp., 11 Bankr. 97 (Bankr. E.D. Pa. 1981); Farmers & Merchants Bank v. Gibson, 7 Bankr. 437 (Bankr. N.D. Fla. 1980).

62. "Guarantor" is used here in the same sense that it is used in RESTATEMENT OF SECURITY § 82 (1941). The Restatement does not distinguish hetwen "guarantor" end "surety." It states where a distinction is still made, recognizing the difference can be crucial.

63. 1 J. STORY, EQUITY JURISPRUDENCE § 645 (14th ed. 1918).

separation of the two debtors and view them in equity as one. What constitutes such a supervening equity has been the subject of some recent debate in the bankruptcy courts.

In *Farmers & Merchants Bank v. Gibson,*[64] the bank made a working capital loan to a car dealership corporation. The loan was secured by the assets of the corporation. The bank also obtained the personal guaranty of the president and his wife. Their guaranty was secured by mortgages on their home and on other real estate. Upon bankruptcy the trustee argued for marshaling. The bank countered that there was no common debtor.

The bankruptcy court noted that a corporation and its stockholders are not technically a common debtor of the corporate creditors. The only way they could be viewed as one would be through some "basis for disregarding the corporate entity."[65] The court also noted the guarantor's right of exoneration as a competing equity. It explained that "[h]ere again, absent unusual equitable circumstances, this right in equity to require first satisfaction from the principal's assets is a right equal or superior in rank to the right of the corporate creditors seeking to marshal."[66]

The *Gibson* court spoke in terms of facts that would justify "disregarding the corporate entity." Yet the standard it actually applied was lower than the traditional one governing the circumstances under which it is appropriate to "pierce the corporate veil." The court concluded that when the guaranty had been for a business debt for the purpose of obtaining working capital, it would be deemed a contribution to capital. Any right of exoneration or contribution would be abrogated, and the right to marshaling would take precedence.[67] The rationale was that

> the foreseeable and likely result of obtaining such working capital, partly on the strength of the guarantor's personal liability and any property which the guarantor may have specifically pledged to secure such guarantee, is the inducement of others to innocently commence or continue to extend supplies or services to the principal on credit.[68]

The California bankruptcy court in *In re United Medical*

64. 7 Bankr. 437 (Bankr. N.D. Fla. 1980).
65. *Id.* at 440.
66. *Id.* at 441.
67. *Id.*
68. *Id.*

Research, Inc.[69] disagreed. The case involved functionally similar facts: a corporate loan secured by all the corporate assets and guaranteed by the officers and principal stockholders. Their guaranties were secured by deeds of trust on three parcels of realty. The court agreed with the apparent standard set forth in *Gibson,* but criticized the result as inconsistent with that standard.

> Without finding that the corporate president or his wife were guilty of any inequitable conduct that would justify piercing the corporate veil, Judge Sauls [in *Gibson*] concluded, at Page 442, that equity required marshaling because the visible result of obtaining a working capital loan by pledging personal assets, including personal exempt assets, '. . . is the likely inducement of others to innocently commence or continue to extend supplies or services to the principal on credit.'[70]

The court went on to explain its concerns about straining to allow marshaling for unsecured creditors by setting up a weak standard for the common debtor requirement.

> It is poor policy for courts to upset legitimate business transactions because of some vague concept of equity. We tend to forget that these decisions affect future commercial transactions. Advantageous and proper loans to corporations may be frustrated because shareholders would be fearful of having their personal assets marshaled for corporate creditors should they guarantee a corporate debt.[71]

The court then denied a request by the trustee for marshaling. It reasoned that no representation had been made of any facts that would justify disregarding the corporate entity, implying that the court placed the factual showing necessary to allow marshaling against the corporation's guarantor on a par with the showing necessary for piercing the corporate veil. The court noted that the guarantors had not "been guilty of fraud, overreaching, or other inequitable conduct."[72]

These two opposing views may simply represent the larger tension of how to deal with closely held corporations. Close corporations often take on characteristics of partnerships or even sole proprietorships. Courts in other contexts look past the cor-

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69. 12 Bankr. 941 (Bankr. C.D. Ca. 1981).
70. *Id.* at 943.
71. *Id.*
72. *Id.* at 944.

porate structure of close corporations under less compelling facts than would be required for larger corporations.[73] The very nature of the close corporation may justify such treatment. The shareholders' right of limited liability is partially offset by the increased power or control they have over the close corporation. The factual showing necessary to justify equitable subordination[74] under normal circumstances may be inappropriately strict with a close corporation.

However, justifying marshaling despite the shareholders' right of limited liability and the guarantors' right of exoneration should not be done so lightly that the mere act of guaranteeing a corporate loan is sufficient. If such a guarantee is to be deemed a contribution to capital for the purpose of satisfying the requirement of a common debtor, some greater justification should be required.

This is particularly true considering the practice of some lenders of obtaining a guarantor behind all loans to small businesses. The court should look beyond the mere act of guaranteeing the loan to the economic realities. If the corporation had sufficient assets to secure the loan, and the principal shareholders acted as guarantors simply to comply with the lender's standard practice, then the shareholders should be able to stand behind their rights of exoneration and limited liability and defeat any attempt to marshal. If, however, the debt/equity ratio of the corporation was such that no reasonable lender would make the loan without such a guaranty, then the guarantor and his company should be viewed as a common debtor, thus satisfying that requirement for marshaling.

C. The Equity of the Debtor

A final factor for the judge to consider before deciding to allow marshaling is the equity of the debtor. With marshaling, when something is given, something necessarily is taken away. If the court denies marshaling, the debtor will often come out of bankruptcy with some valuable property that he would have lost had marshaling been permitted since marshaling sends the secured creditor against some item of "bonus" collateral that he would not otherwise have utilized as payment for the debt.

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73. *See, e.g.*, Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975).

74. *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939).

If the debtor has bargained for a loan and given collateral as security, he will not be able to avoid marshaling solely on the ground that he would be better off if there were no marshaling. But often additional equities will come into play. One of the most persuasive of these is the homestead exemption.

In most states the homestead exemption is a matter of statute, and its exact application will depend on the statute's particular wording. The general rule, however, is that the debtor has a right to have his nonexempt property exhausted before his exempt property can be resorted to. This right overcomes the right to marshal.[75] The rationale is that marshaling in such a context places a greater burden on the exempt property than the debtor himself agreed to, greater even than the burden the law places on such property, by subjecting his home to realization by the senior creditor before the principal collateral has been utilized. Marshaling would effectively nullify the homestead exemption.[76]

Courts recognize the social desirability of the homestead exemption. They require something of greater equitable weight than the doctrine of marshaling to avoid it.[77] As one bankruptcy court recently stated:

> If the doctrine [of marshaling] is invoked in this case, the debtor will be denied the benefit of the homestead exemption claimed by him under CPLR 5206 and the life insurance exemption claimed by him under New York Insurance Laws § 166. As a result, the debtor and his family would lose their home and the beneficiaries of the insurance policies might be left destitute when the debtor passes away.
>
> The homestead and insurance exemptions reflect a legislative policy, both state and federal, to provide an honest debtor with a fresh start. They were drafted with the understanding that justice is not served by leaving the debtor and his family homeless and on the brink of financial ruin. A court of equity will not permit impairment of exemptions unless for good cause shown and such a showing requires more than just the creditors' interest in being paid. The creditor must show that the debtor does not deserve the benefit of the exemptions he claims.[78]

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75. *See, e.g.*, Nolan v. Nolan, 155 Cal. 476, 101 P. 520 (1909).

76. *See generally* 18 R.C.L. *Marshaling Assets* § 12 (1917) and cases cited *supra* note 2.

77. *In re* Leonardo, 11 Bankr. 453 (Bankr. W.D.N.Y. 1981).

78. *Id.* at 455. *But see* Farmers & Merchants Bank v. Gibson, 7 Bankr. 437 (Bankr. N.D. Fla. 1980), in which the court holds that pledging exempt property as security for a

V. Conclusion

Throughout most of its long history, marshaling has been unavailable to unsecured creditors. This Comment proposes an exception which would give standing to the trustee in bankruptcy to request marshaling on hehalf of the unsecured creditors of the estate. This exception allows the trustee to preserve more of the estate for the general creditors without harming the senior creditors. Courts applying this exception must be careful to prevent impairment by the trustee of competing, equally deserving equities, including the right of a shareholder to limited liability and the right of a senior creditor not to be unduly delayed or harmed. In particular, the homestead exemption is a competing equity of such magnitude that any attempts to use marshaling to send a senior creditor against the debtor's home, without some additional very weighty justification, must fail.

Michael W. Mosman

corporate loan causes the exempt property to be regarded as a contribution to capital.