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Marshaling in Bankruptcy: Questioning the Recent Expansions to the Common Debtor Requirement

The 1980s, and now the 1990s, have shown an ever-increasing number of start-up ventures. In order to secure credit for their fledgling companies, entrepreneurs generally have to personally guaranty loans made to their companies. In addition, major creditors often require small corporations to grant security interests in corporate property. However, smaller creditors do not require security interests in property or personal guarantees from the corporation's principals.¹ The entrepreneur is thereby able to leverage² his company by the increased use of unsecured (and non-guaranteed) credit provided by trade creditors.

In the case of bankruptcy, the secured party³ receives the value of its security from the estate⁴ and the remaining estate property is distributed to the unsecured creditors. If there is no remaining property, the unsecured creditors get nothing, and the secured creditor is able to satisfy any deficiency by exercising its rights

1. Small creditors like office supply merchants generally do not require security interests or guarantees because the value of the goods being sold are nominal and the administrative expenses involved in procuring security interests would be prohibitive. These small creditors can protect themselves by demanding "cash on delivery" if they believe that the buyer is a credit risk. Larger creditors, like equipment lessors, require security interests and personal guarantees because the value of the goods being leased to the buyer are high enough to warrant the administrative expenses incurred to protect the creditor.

2. *Black's Law Dictionary* 816 (West, 5th ed 1979) defines leverage as "the use of a smaller investment to generate a larger rate of return through borrowing."

3. *Black's Law Dictionary* 1215 (West, 5th ed 1979) defines a secured party as a "lender, seller or other person in whose favor there is a security interest . . .," and a secured creditor as a "creditor who holds some special pecuniary assurance of payment of his debt, such as a mortgage, collateral, or lien."

4. In bankruptcy, the creditor's status as a secured party is determined through Section 506 of the Bankruptcy Code. 11 USC § 506 (1990). After achieving secured status in bankruptcy, the secured party may request a relief from stay under § 362(d). 11 USC § 362(d) (1990). If the relief of stay is granted, the secured party is free to use state law, including common law, to recover on its claim. *Id.* If the relief from stay is not granted, the secured party must rely on the Bankruptcy Code to protect its claim. If the petitioner files under Chapter 7, Sections 724(b) and 725 provide for the distribution of property to lienholders of the property. 11 USC §§ 724, 725 (1990). Under Chapter 11, the secured party is protected by Section 1129(7), which requires that any claim holder within a class that is impaired by the reorganization plan either vote for the plan, or receive the same amount under the plan as they would in a liquidation under Chapter 7. 11 USC § 1129(7) (1990).

under the personal guaranty. Therefore, normally, the entrepreneur's liability on the guaranty is limited to the difference between the loan amount and the liquidation value of the property securing the loan. Does the entrepreneur, then, have a false sense of security as to his exposure on the guaranty being limited to the difference between the amount of the loan and the value of the property securing it? He may, if the bankruptcy court in his jurisdiction follows the recent expansions of the equitable doctrine of marshaling.⁵

The main issue posed by this comment is when should a personal guarantor of a corporate debt⁶ be considered a 'common debtor' with the corporation, so that the doctrine of marshaling can be applied. The comment will first introduce the marshaling doctrine using a traditional fact pattern. Thereafter, the procedural requirements that must be met to bring forth a motion to marshal assets will be discussed. The next section of the comment will describe the expansions of the marshaling doctrine. Following is an application of each expansion to a hypothetical fact situation. The final section of this comment will call for the judiciary to limit the expansion of the doctrine to those factual situations where the individual guarantor has acted inequitably or where there is sufficient evidence to pierce the corporate veil.

MARSHALING IN GENERAL

Traditionally, the marshaling doctrine arose in a real estate context. For example, suppose Adams owns two lots, Blackacre and Whiteacre, each with a liquidation value of \$100,000, after costs. Adams borrows \$125,000 from First Bank and grants a lien in favor of First Bank on both properties to secure the loan. Later, Adams borrows an additional \$25,000 from Second Bank, granting Second Bank a lien in Blackacre alone. The following diagram may help in visualizing the transactions:

5. *Black's Law Dictionary* 878 (West, 5th ed 1979) defines marshaling as: arranging, ranking or disposing in order; particularly, in the case of a group or series of conflicting claims or interests, arranging them in such an order of sequence, or so directing the manner of their satisfaction, as shall secure justice to all persons concerned and the largest possible measure of satisfaction to each.

Note that the correct spelling of marshaling is with one "l," although some courts use a double "l." *In re Vermont Toy Works, Inc.*, 82 Bankr 258, 265 n 2 (Bankr D Vt 1987).

6. Hereinafter, the terms "guarantor" and "guaranty" shall mean a personal guarantor or guaranty of a corporate debt.

<p>Fund 1: Blackacre Owned by: Mr. Adams Value = \$100,000 First Bank Lien = \$125,000 Second Bank Lien = 25,000</p>
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<p>Fund 2: Whiteacre Owned by: Mr. Adams Value = \$100,000 First Bank Lien = \$125,000</p>

At this point, First Bank enjoys a senior secured interest in Blackacre and the only secured interest in Whiteacre. Second Bank has a junior (to First Bank) secured interest only in Blackacre.

If Adams defaults on the loan, the only way that First Bank can recover completely is to foreclose on both properties, receiving \$100,000 from the first property and \$25,000 from the second. Because First Bank has first priority in both properties, it can choose the order of foreclosure. If it decides to foreclose on Blackacre first, the entire \$100,000 liquidation value will go to First Bank, along with \$25,000 from the foreclosure of Whiteacre. Second Bank would be left completely unsecured. However, if First Bank forecloses on Whiteacre first, both parties will be able to recover fully.

The marshaling doctrine was developed to avoid the inequity involved in permitting a senior secured creditor from acting in such a way as to prevent a junior creditor from fully recovering on its claim. Marshaling is an equitable doctrine designed to promote fair dealing and justice.⁷ "The 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 those funds."⁸ Thus, a junior creditor may move to compel marshaling if the senior creditor is acting in such a way as to prevent the junior creditor from having its charge satisfied. However, marshaling will not be compelled if the senior secured creditor would be prejudiced.⁹

Judge Conrad, in *In re Vermont Toy Works, Inc.*,¹⁰ stated that,

7. *Meyer v United States*, 375 US 233, 237 (1963).

8. *Sowell v Federal Reserve Bank*, 268 US 449, 456-57 (1925).

9. *Matter of Dealer Support Servs. Int'l, Inc.*, 73 Bankr 763, 766 (Bankr E D Mich 1987). Chief Judge Brody refused to require marshaling of the shareholder guarantors' assets when the guarantors' assets were kept separately and the shareholder guarantors did not act in such a way as to justify treatment of their assets as belonging to the debtor corporation. *Dealer Support Services*, 73 Bankr at 765.

Furthermore, Judge Brody stated that to require a senior secured creditor to "institute foreclosure proceedings, pay off the balance of the existing land contract, and suffer the inherent delays and expense of a foreclosure proceeding" would be prejudicial to the senior secured creditor. *Id* at 766.

10. 82 Bankr 258 (Bankr D Vt 1987). Judge Conrad held that the shareholder guarantor had acted inequitably, breached his fiduciary duty, participated in unfair overreaching and insider preferences, had grossly undercapitalized the company and had failed to observe

"Ordinarily, marshaling, as an equitable remedy with natural justice at its keystone, will not be applied if its application results in substantial injustice, undue delay or demonstrable injury to a party in interest."¹¹ Thus, marshaling has been denied where the assets to be marshaled were exempt assets and the senior creditor would face delay and expense in foreclosing.¹² However, in *Matter of Multiple Servs. Indus., Inc.*,¹³ Judge Clevert invoked the marshaling doctrine, even though the secured creditor was required to wait for a foreclosure sale of the marshaled assets.¹⁴

Thus, the traditional elements of marshaling are:

1. The existence of two creditors of the same debtor; and
2. The existence of two funds belonging to a common debtor; with
3. Only one of the creditors having access to both funds;¹⁵ with
4. The absence of prejudice to the senior secured creditor if the doctrine is applied.¹⁶

corporate formalities. *Vermont Toy Works*, 82 Bankr at 333. He further held that the inequitable conduct on the part of the shareholder guarantor warranted piercing of the corporate veil and that the senior secured creditor would not be prejudiced by the invocation of marshaling and, thus, marshaling would be applied. *Id.* at 334.

11. *Id.* at 321, citing 53 Am Jur 2d Marshaling Assets § 13 (1970).

12. *In re Leonardo*, 11 Bankr 453, 455 (Bankr W D NY 1981); *Victor Gruen Assocs., Inc. v Glass*, 338 F2d 826, 830 (9th Cir 1964). In *Leonardo*, the debtor had given security interests in his equipment and inventory to three creditors: Central Trust Company (hereinafter "CenTrust"), Westinghouse Credit Corporation (hereinafter "WCC") and the Small Business Administration (hereinafter "SBA"). *Leonardo*, 11 Bankr at 454. In addition, the debtor had given CenTrust a second mortgage on his residence and an assignment of the debtor's life insurance policies. *Id.* The residence had a value of \$43,000, a first mortgage of \$19,000, the CenTrust mortgage and a federal tax lien of \$19,000. *Id.* The debtor claimed a \$10,000 homestead exemption on the residence and an exemption of the life insurance policies under New York law. *Id.* WCC and SBA moved the court to compel CenTrust to marshal against the principle residence and the life insurance policies. *Id.* The bankruptcy court refused to invoke marshaling based on the prejudice to CenTrust because of the delay and increased expenses involved if marshaling were applied. *Id.* at 455.

In *Gruen*, the Ninth Circuit held that marshaling cannot be invoked where the senior creditor will be prejudiced or has an increased risk of loss. *Gruen*, 338 F2d at 830.

But note *Matter of Multiple Servs. Indus., Inc.*, 18 Bankr 635, 637 (Bankr E D Wis 1982), where Judge Clevert held that when the senior creditor objected to a marshaling order due to risk of loss, expense and delay, the senior secured creditor would not be prejudiced, and marshaling would be conditionally granted if the trustee maintained sufficient funds to fully satisfy the senior secured creditor. *Multiple Servs.*, 18 Bankr at 637.

13. 18 Bankr 635 (Bankr E D Wis 1982).

14. *Multiple Servs.*, 18 Bankr at 637, citing *Gruen*, 338 F2d 826 (9th Cir 1964), where the Ninth Circuit found that if the trustee in bankruptcy retains sufficient assets to satisfy any deficiency to the secured party upon application of the marshaling doctrine, there is no prejudice to the secured party, even if he has to wait for the foreclosure sale of the marshaled assets. *Multiple Servs.*, 18 Bankr at 637.

15. *Meyer v United States*, 375 US 233, 236-37 (1963).

16. *Gruen*, 338 F2d at 830. The Ninth Circuit held that where there is a risk of loss

Applying the elements to the hypothetical, if First Bank decides to foreclose on Blackacre first, Second Bank could request the invocation of the marshaling doctrine. Second Bank will be successful in convincing the court to compel First Bank to foreclose on Whiteacre first, because all four elements of marshaling are met:

1. First Bank and Second Bank are two creditors of the same debtor, Adams; and
2. Blackacre and Whiteacre are two funds belonging to the common debtor, Adams; with
3. Only one of the creditors, First Bank, having access to both funds, Blackacre and Whiteacre, whereas Second Bank is limited to only one fund, Blackacre; with
4. The absence of prejudice to the senior secured creditor, First Bank, because it would have to foreclose on both properties anyway, only the order of foreclosure is changed by invocation of the doctrine.

However, when an individual guarantees a corporate debt, he is not considered a "common debtor" with the corporation because the corporation is a separate entity. Judge Sauls expressed this concept in *Farmers and Merchants Bank v Gibson*,¹⁷

to a senior secured creditor, marshaling will not be compelled. Id.

17. 7 Bankr 437 (Bankr N D Fla 1980). Judge Sauls held that where a shareholder guaranteed a working capital loan with personally owned assets, these assets may be considered an equitable contribution of capital, under a reliance theory, and thus subject to marshaling. *Gibson*, 7 Bankr at 441. Judge Sauls further stated that in order to reduce potential prejudice to the bank (the senior secured creditor), the bank would be permitted to recover from property in the corporate name, and that its lien would be transferred to the trustee through equitable subrogation. Id at 443. The trustee would then be able to marshal the assets of the guarantor since they have been deemed equitable contributions to capital. Id.

However, this order was vacated and remanded in *Peacock v Gibson*, 81 Bankr 79 (N D Fla 1981), by District Judge Higby. Judge Higby held that there was insufficient evidence to show that the assets of the guarantors should be deemed an equitable contribution of capital. *Peacock*, 81 Bankr at 80-81.

On remand, Judge Sauls found the issue moot in *Farmers and Merchants Bank v Gibson*, 81 Bankr 81, 81-82 (Bankr N D Fla 1984), because there was no surplus after the bank had foreclosed on all corporate and non-homestead assets of the guarantors, and was still not fully satisfied. *Gibson*, 81 Bankr at 81-82. Since the trustee would only be able to marshal homestead property, which is exempt from claims by the trustee, there would be no assets that the trustee could marshal. Id. Therefore, the prior orders were vacated. Id.

Judge Sauls' decision was affirmed by Judge Higby in *Gibson v Farmers and Merchants Bank*, 81 Bankr 84, 87 (N D Fla 1986). Though the marshaling issue was moot, it is reasonable to expect that the district court would accept the contribution to capital exception to marshaling, if there was sufficient evidence to show a contribution of capital by the guarantor. *In re San Jacinto Glass Indus., Inc.*, 93 Bankr 934, 940 (Bankr S D Tex 1988), citing *Gibson*, 81 Bankr at 87.

Inasmuch as a corporation is an entity distinct from its stockholders or officers, as between a senior creditor of the corporation, who can also look to its stockholders or officers if he has a guaranty, and a junior creditor who has no guaranty and thus can only look to the corporate assets, the necessary condition of a common debtor does not exist, absent a basis for disregarding the corporate entity.¹⁸

Because of the common debtor requirement, courts generally do not compel a secured creditor to marshal a guarantor's assets in lieu of the debtor's assets, even when the guarantor is the sole shareholder of the corporation.¹⁹ Though the elements of marshaling are clearly not met when a guarantor's assets are being marshaled, the bankruptcy court in *Vermont Toy Works* stated,

Bankruptcy Courts are Courts of Equity. They are the gatekeepers of the fair allocation of assets to creditors. As such, when faced with facts which demand a remedy for inequitable conduct they have fashioned various exceptions to marshaling's technical requirements of two or more funds, one of which would otherwise be considered a non-estate asset.²⁰

The recognized expansions of the "common debtor" requirement are based on:

- A. General Equity Principles
- B. Equitable Contributions to Capital
- C. Inequitable Conduct of the Parties
- D. Piercing of the Corporate Veil²¹

The following hypothetical fact pattern will be utilized to demonstrate the application of the expansions of the common debtor requirement. Your client, Mr. Doe, is president of ABC Corporation (hereinafter "ABC"). ABC is a closely-held corporation in the start-up phase with Mr. Doe as its sole shareholder. Mr. Doe had approached First Bank for a line of credit of \$300,000

18. *Gibson*, 7 Bankr at 440.

19. *Id.*

20. *Vermont Toy Works*, 82 Bankr at 290.

21. It should be noted that once a guarantor is forced to make good on his guaranty, through an application of marshaling or otherwise, the guarantor becomes "subrogated to all the rights of the creditor against the principal debtor, including the security given to secure the debt." *Allen v See*, 196 F2d 608, 610 (10th Cir 1952). Because of the subrogation rights of the guarantor, there would be negligible difference in the position of undersecured creditors in bankruptcy. Thus, in bankruptcy, it is also necessary to show the necessity for equitable subordination of the guarantor's claim. See *Vermont Toy Works*, 82 Bankr at 331-32. *Black's Law Dictionary* 1279 (West, 5th ed 1979) defines subordination as "the act or process by which a person's rights are ranked below the rights of others." Section 510(c) of the Bankruptcy Code expressly authorizes the court to use equitable subordination principles when determining the priority of claims. 11 USC § 510(c) (1990).

Please note that detailed analysis of the doctrines of equitable subrogation and equitable subordination are beyond the scope of this comment.

three years ago when he incorporated. Mr. Doe believed that without the line of credit, ABC would not succeed. First Bank was willing to extend the credit, but only upon the condition that ABC would grant a blanket lien on all inventory, accounts receivable, and personal property then and thereafter owned by ABC. In addition, First Bank required Mr. Doe to personally guaranty the full amount of the line of credit.

Although Mr. Doe wanted ABC to succeed, he was not willing to increase his exposure for the sake of ABC. Mr. Doe, therefore, completed financial projections that showed that the value of First Bank's security interest would always exceed the amount of the line. Mr. Doe was confident with these numbers, and he therefore fulfilled First Bank's conditions by granting a security interest in the aforementioned assets and signing a personal guaranty for the full amount of the debt.

Two years later, ABC needed more capital. Second Bank was approached for a term loan of \$50,000. Although Second Bank did not require a personal guaranty, it did require a security interest in the inventory, accounts receivable and personal property then and thereafter owned by the corporation (a junior lien to First Bank). Mr. Doe immediately granted the security interest and took the money. He used \$10,000 of the loan proceeds to repay his student loans. The remainder was used as working capital.

Although ABC has grown from a single employee company to over thirty employees, the company's financial situation has declined over the last year. ABC owes the full amounts of both loans, in addition to over \$200,000 owed to fifty trade creditors. Mr. Doe has asked for advice regarding his personal liability if ABC files for protection from creditors under Chapter 7 of the Bankruptcy Code. The liquidation value of the inventory, accounts receivable and personal property is currently \$250,000. Although ABC filed tax returns for each of the past three years and maintained detailed financial records, it has not maintained records of director or shareholder meetings (because Mr. Doe was and still is the sole shareholder and director of the corporation). Trade creditors were given the two banks as credit references. Mr. Doe recently won the lottery and currently has a personal net worth that exceeds \$1,000,000.

First Bank would prefer to recover under its security interest in the corporate assets, because it is planning on a continued business relationship with Mr. Doe. Both Second Bank and the trustee in bankruptcy want to pursue a marshaling strategy, so that their

claims are satisfied. The following diagram is a pictorial representation of the relationships between the parties:

Fund 1: ABC Corp. Assets Owned by: ABC Corp. Value = \$250,000 First Lien = \$300,000 Second Lien = 50,000 Trade Creditors = 200,000	Fund 2: Mr. Doe's Assets Owned by: Mr. Doe Value = \$1,000,000 First Guaranty: \$300,000
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The traditional elements of marshaling are not met in this fact pattern because there is no common debtor. Therefore, if Second Bank and the trustee are to succeed, they must come within an expansion of the common debtor requirement that the court will accept.

But before Second Bank can bring the marshaling motion before the court, it must meet the following procedural requirements:

- A. Jurisdiction
- B. Standing
- C. Due Process
- D. Burden of Proof

PROCEDURAL REQUIREMENTS

A. *Jurisdiction*

The marshaling doctrine falls within the jurisdictional powers of the bankruptcy court.²² However, before marshaling can be compelled, the court must have jurisdiction over both funds or all necessary parties.²³

B. *Standing*

The marshaling doctrine was developed to protect secured creditors. Accordingly, secured creditors have standing to pursue the marshaling strategy.²⁴

According to the United States Supreme Court in *Lewis v Manufacturers Nat'l*,²⁵ the trustee in bankruptcy has the same status

22. "The bankruptcy courts have long had the power to marshal the debtor's assets in order to effectuate on [sic] equitable distribution of funds to creditors of the debtor's estate." *In re Tampa Chain Co.*, 53 Bankr 772, 777 (Bankr S D NY 1985), citing *Meyer*, 375 US at 236-37.

23. *Vermont Toy Works*, 82 Bankr at 290.

24. *Id.*

25. 364 US 603 (1961). In *Lewis*, the debtor had borrowed money from Manufac-

as an existing lien creditor²⁶ would have as of the commencement of the case through the Bankruptcy Act's Strong Arm Statute, Section 110(c).²⁷ The trustee is thus a hypothetical lien creditor whose rights are determined by state law.²⁸ Although the rights of the trustee are determined by state law, the prevalence of Section 9-301(3) of the Uniform Commercial Code,²⁹ which includes the trustee in bankruptcy within the definition of a "lien creditor,"³⁰ should make the resolution of this issue uniform throughout the states that have adopted the Uniform Commercial Code. Once recognized as a secured creditor, the trustee has standing to move for marshaling of the debtor's assets.

turer's National Bank of Detroit (hereinafter "Bank") and gave a chattel mortgage on an automobile as security. *Lewis*, 364 US at 603. Bank did not record the chattel mortgage for four days, leaving a four-day period where the security interest was unperfected. Id at 604. The bankruptcy referee had held that the mortgage was void as against the trustee because a hypothetical creditor could have lent money during the four-day period and had priority over Bank, and since the trustee could take the place of the hypothetical lien creditor by virtue of Section 70c of the Bankruptcy Act, the mortgage was void as against the trustee. Id at 604. The district court overruled the referee, and the Sixth Circuit affirmed the district court. Id at 604-05. Justice Douglas affirmed the decision of the district court and the Sixth Circuit. Id at 610.

26. Black's Law Dictionary 832 (West, 5th ed 1979) defines a lien creditor as "one whose debt or claim is secured by a lien on particular property, as distinguished from a 'general' creditor, who has no such security." A lien creditor is a secured creditor to the extent of the value of his lien.

27. *Lewis*, 364 US at 603. The Court in *Lewis* held that the Bankruptcy Act's Strong Arm Statute, 11 USC § 110(c), gives a trustee in bankruptcy the status of a hypothetical lien creditor, as of the bankrupt's filing of his petition, whether such creditor exists or not. Id at 607.

Section 110(c) of the Bankruptcy Act is the precursor to Section 544 of the Bankruptcy Code. *Vermont Toy Works*, 83 Bankr at 292 n 22. Section 544 provides in relevant part,

(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 such a judicial lien, whether or not such a creditor exists.

11 USC § 544 (1990).

28. *In re Kors, Inc.*, 819 F2d 19, 22 (2d Cir 1987). In *Kors*, the secured party failed to obtain the signature of the debtor on the financing statement. *Kors*, 819 F2d at 23. Therefore, under Vermont law, the security interest was not perfected. Id. Judge Pierce held, "since Vermont law gives a lien creditor rights superior to those of an unperfected security interest, the trustee, pursuant to § 544(a)(1) of the Code, had rights superior to those of the Bank on the date of the bankruptcy filing." Id.

29. UCC § 9-301(3) (1987).

30. See, for example, New York Uniform Commercial Code § 9-301(3) (McKinney 1991).

However, note that Judge Hershner in *Matter of McElwaney*³¹ stated that the trustee has no standing to bring forth a marshaling motion under the Bankruptcy Code's Strong Arm Statute, Section 544,³² because Section 544 was intended to protect the estate from secret liens, not to give the trustee the power to invoke the marshaling doctrine.³³ Nevertheless, Judge Conrad in *Vermont Toy Works* asserted that the *McElwaney* court "duck[ed] the issue" of standing since the *McElwaney* court based its decision on a finding that the senior secured creditor would be prejudiced by the application of the doctrine.³⁴ Judge Conrad also held that the marshaling cause of action (as well as related piercing the corporate veil actions) are property of the estate pursuant to 11 USC § 541(a)(1).³⁵

Though the trustee, who represents the interests of all creditors, has standing to pursue marshaling, an unsecured creditor generally does not have such standing.³⁶ However, "in some cases the doctrine is defined strictly in terms of lien or secured creditors. In other cases, the doctrine is defined in terms of 'interests' that are not limited to secured creditors or even to creditors."³⁷ This is a minority view, but one that could be advanced in the case of great inequities to give unsecured creditors standing to pursue the doctrine.³⁸

31. 40 Bankr 66 (Bankr M D Ga 1984). The debtor had purchased 475 acres of land and assumed the debt owed to Federal Land Bank which was secured by a first lien on the land. *McElwaney*, 40 Bankr at 67. The value of the land exceeded the amount of the debt. Id. The debtor was required to purchase stock in the Federal Land Bank and pledge this stock as well as the land. Id. The Farmers Home Administration had a second lien on the land. Id. When the debtor filed for Bankruptcy (Chapter 7), the trustee moved for the Federal Land Bank to satisfy its claim from the land, with the remainder of the land proceeds to go to Farmers Home Association, leaving the stock as an asset of the estate. Id. Judge Hershner held that the trustee could not invoke marshaling and improve its position to the detriment of the secured creditors through Section 544. Id at 70-71.

32. 11 USC § 544 (1990). See note 27 and accompanying text for the text of Section 544 and its application to the trustee's standing in a marshaling case.

33. *McElwaney*, 40 Bankr at 70-71.

34. *Vermont Toy Works*, 82 Bankr at 295.

35. Id at 297-98. 11 USC § 541(a)(1) states that "all legal or equitable interests of the debtor in property" are property of the bankrupt estate. 11 USC § 541(a)(1) (1990).

36. *In re Mesa Intercontinental, Inc.*, 79 Bankr 669, 672 (Bankr S D Tex 1987). In *Mesa*, the bankruptcy court held that where the proponent of marshaling was an unsecured creditor, it could not successfully pursue marshaling. *Mesa*, 79 Bankr at 672.

37. *Vermont Toy Works*, 82 Bankr at 299, quoting 53 Am Jur 2d Marshaling Assets § 1 (1970).

38. Note that in *Vermont Toy Works* the unsecured creditor's attorney prosecuted the marshaling defense because the trustee was unwilling to expend resources on the defense. However, the relief granted by the bankruptcy court solely benefitted the bankrupt's

The last party in interest, the debtor, cannot invoke the doctrine.³⁹ However, a debtor in possession has the same rights as a trustee in bankruptcy for standing purposes.⁴⁰ Therefore, in a Chapter 11 proceeding, the debtor, as debtor in possession, would have standing to pursue marshaling.

C. *Due Process Requirements*

The shareholder/guarantor must be a party to the bankruptcy proceedings for due process purposes.⁴¹ Also, the "request for marshaling must be brought as an adversary proceeding pursuant to Bankruptcy Rule 7001 *et seq.*"⁴² But, note that an adversary proceeding as defined by Bankruptcy Rule 7001(7) includes a "proceeding to obtain an injunction or other relief."⁴³ Therefore, this

estate. The unsecured creditor benefitted indirectly from his efforts in that there were more assets to be distributed to the unsecured creditors after his successful prosecution of the doctrine. *Vermont Toy Works*, 82 Bankr at 267 n 10.

39. *Sowell v Federal Reserve Bank*, 268 US 449, 456-57. "The debtor may not ordinarily invoke the doctrine, for by doing so he would disregard the express provisions of his contract on which the creditor is entitled to rely." *Sowell*, 268 US at 456-57.

40. Section 1107 of the Bankruptcy Code states, "a debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter." 11 USC § 1107 (1990).

41. *In re Coors of N. Miss., Inc.*, 66 Bankr 845, 869 (Bankr N D Miss 1986). In *Coors*, the debtor's principal shareholder, Mr. Moak, negotiated several loans with Planters Bank. *Coors*, 66 Bankr at 851. These loans were secured by real property owned by Mr. Moak's wife, Mrs. Betty Moak. *Id.* Mrs. Moak was not a party to the proceedings and, therefore, Judge Houston rejected the plaintiff's motion to marshal the real property owned by Mrs. Moak. *Id.* at 869.

42. *Matter of Mel-O-Gold, Inc.*, 88 Bankr 205, 207 (Bankr S D Iowa 1988).

In *Mel-O-Gold*, an unsecured creditor requested marshaling through an "ordinary" motion. *Mel-O-Gold*, 88 Bankr at 206. Judge Hill held that since the motion was brought on the creditor's "own initiative, not in response to any type of motion by another party," the matter was not before the bankruptcy court in an adversary proceeding and therefore the court lacked jurisdiction to hear the motion. *Id.*

43. Bankr R 7001(7). *In re San Jacinto Glass Indus., Inc.*, 93 Bankr 934, 937 (Bankr D Minn 1988), citing *Mel-O-Gold*, 88 Bankr at 207.

In *San Jacinto*, the debtor purchased equipment through a purchase money loan obtained from Westinghouse Credit Corporation (hereinafter "WCC"). *San Jacinto*, 93 Bankr at 936. This loan was secured by a purchase money security interest and an irrevocable standby letter of credit, to be drawn by WCC upon a showing of default by the debtor. *Id.* The standby letter of credit was personally guaranteed by the debtor's Chairman of the Board. *Id.* First City National Bank of Houston, an unsecured creditor with regards to the equipment and the letter of credit, brought forth a marshaling motion in response to WCC's request for relief from stay and the debtor's motion to sell more assets. *Id.* at 937. Judge Mahoney held that "under Bankruptcy Rule 7001(7), marshaling can be requested in response to any type of motion brought by another party and in that context need not be filed as an adversary proceeding." *Id.* However, First City's motion for marshaling was denied because it had failed to show inequitable conduct by the guarantor, inducement to extend credit, or evidence that would justify piercing of the corporate veil. *Id.* at 941.

requirement is usually met.

D. *Burden of Proof*

The bankruptcy court in *Vermont Toy Works* stated that the proponent of marshaling has the burden of proving the elements or expansions of the marshaling doctrine by clear and convincing evidence.⁴⁴ In addition, the proponent must also show, by clear and convincing evidence, that the secured creditor will not be prejudiced by application of the doctrine.⁴⁵ Therefore, to successfully invoke traditional marshaling, the proponent must prove by clear and convincing evidence that the following elements are present:

1. The existence of two creditors of the same debtor; and
2. The existence of two funds belonging to a common debtor; with
3. Only one of the creditors having access to both funds; with
4. The absence of prejudice to the senior secured creditor if the doctrine is applied.

Based on these traditional requirements of marshaling, especially the common debtor requirement, a court will not compel First Bank to marshal Mr. Doe's assets, in lieu of ABC Corporation's assets, even though Mr. Doe is the sole shareholder of the corporation.⁴⁶ The traditional requirements of marshaling are obviously not present in the hypothetical facts. However, Second Bank may be able to prove, by clear and convincing evidence, one of the recognized expansions of the "common debtor" requirement:

- A. General Equity Principles
- B. Contributions to Capital Theory
- C. Inequitable Conduct of the Parties
- D. Piercing of the Corporate Veil

44. *Vermont Toy Works*, 82 Bankr at 314.

45. *Vermont Toy Works*, 82 Bankr at 323. But see *In re Century Brass Prods.*, 95 Bankr 277 (D Conn 1989), where Judge Cabranes stated:

We see no basis for BOBC [junior creditor] to demonstrate lack of prejudice to GECC [senior creditor] by "clear and convincing evidence." . . . we do hold that, in light of the prejudice to GECC this record suggests, BOBC's failure to submit any evidence at all regarding lack of prejudice allowed a conclusion that marshalling [sic] of assets would indeed prejudice GECC.

Century Brass, 95 Bankr at 280, quoting *Vermont Toy Works*, 82 Bankr at 323. Judge Cabranes found that the possibility that GECC would not be fully satisfied if marshaling were applied was prejudicial to GECC. *Century Brass*, 95 Bankr at 279. On this basis, the district court affirmed the bankruptcy court's decision not to permit marshaling. *Id* at 280.

46. *Gibson*, 7 Bankr at 440. See notes 17, 62-65 and accompanying text.

EXPANSIONS OF THE MARSHALING DOCTRINE

A. *General Equity Principles*

*Berman v Green*⁴⁷ is a leading case for expansion of the doctrine based on general equitable considerations. *Green* is currently the only circuit court decision discussing marshaling in this context. Although the case is highly criticized, both in cases from other circuits⁴⁸ and law reviews,⁴⁹ it is still good law in the Eighth Circuit.⁵⁰

In *Green*, Judge Henley held,

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 [by the individual shareholders]. To permit such a course would leave the general creditors of the business with nothing.⁵¹

47. 597 F2d 130 (8th Cir 1979). In *Green*, the Centennial Bank and Trust of Mission, Kansas, (hereinafter "Centennial Bank") had made loans to the debtor corporation secured by the debtor's assets and the real property holdings of the guarantors. *Green*, 597 F2d at 131. The debtor corporation and the guarantors later filed for bankruptcy. *Id.* at 132. The liquidation value of the business assets was \$28,000, significantly less than the \$65,000 owed Centennial Bank. *Id.* The real estate was valued at \$135,000. *Id.* Judge Henley affirmed the district court's order which affirmed the bankruptcy court's order, that the bank marshal the real estate assets of the guarantors, leaving the business assets, \$28,000, to the trustee. *Id.* Judge Henley's decision was grounded "largely on the basis of Judge Clark's well-reasoned opinion" in the district court. *Id.*

See notes 52-55 and accompanying text for a discussion of Judge Clark's opinion.

48. See, for example, *McElwaney*, 40 Bankr at 71-72, criticizing the *Green* court for not determining whether there would be prejudice to the senior secured creditor before invoking the marshaling doctrine; *In re The Computer Room, Inc.*, 24 Bankr 732, 737 (Bankr N D Ala 1982) (where Judge Wright rejected the *Green* decision, but allowed marshaling because the traditional elements of marshaling were all present); *In re United Medical Research, Inc.*, 12 Bankr 941, 942-43 (Bankr C D Ca 1981) (stating that it was not clear what the *Green* court considered equitable in the case). *Id.*

49. Benjamin Weintraub and Alan N. Resnick, *From the Bankruptcy Courts: Compelling a Senior Lienor to Pursue Remedies Against a Guarantor—A Misapplication of the Marshaling Doctrine*, 18 UCC L J 178, 179-82; Irving D. Labovitz, *Marshaling under the UCC: The State of the Doctrine*, 99 Bank L J 440, 446 (1982).

50. See *Matter of Clary House, Inc.*, 11 Bankr 462 (Bankr W D Mo 1981), where the bankruptcy court granted marshaling of assets of the guarantor and denied equitable subrogation to the guarantor where the guarantor's liability was equivalent to that of a co-maker's because the guarantor had waived presentment and demand in the guaranty agreement. *Clary*, 11 Bankr at 466-67. Furthermore, the bankruptcy court held that when property other than that which otherwise would go into the estate is available to the secured creditor, "it would be in the highest degree inequitable to allow the (creditor) to exhaust the assets of the (estate) without first looking to the real estate mortgaged to it. To permit such a course would leave the general creditors of the (estate) with nothing."

Id. at 467, quoting *Green*, 597 F2d at 133.

51. *Green*, 597 F2d at 133.

The Eighth Circuit then affirmed the bankruptcy court's order that the bank marshal the assets of the individual shareholders.⁵²

Although the cases criticize *Green*, this may be due to the Eighth Circuit opinion's lack of explanation of the inequities involved, though Judge Henley stated that he relied on the district court's findings in making his decision.⁵³ Unfortunately, the district court's opinion was not submitted for publication until 1986, seven years after the Eighth Circuit's decision.⁵⁴ The district court's opinion merely suggested that the marshaling order was based on "general equitable principles."⁵⁵ Judge Clark of the district court decided that the interests of general equitable principles should prevail and he invoked marshaling, even when the parties did not act inequitably.⁵⁶

In summary, a court accepting the General Equity Principles expansion of the marshaling doctrine would compel marshaling when it would be highly inequitable for marshaling not to be applied.⁵⁷

B. Contributions to Capital Theory

The Contribution to Capital Expansion is based on the assertion that a personal guaranty can be considered an equitable contribution to the capital of a corporation.⁵⁸ Judge Buschman in *In re Tampa Chain Co.*⁵⁹ stated that,

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.⁶⁰

52. *Id.* at 132.

53. "We affirm the ruling of the district court and do so largely on the basis of Judge Clark's well reasoned opinion." *Id.*

54. *Berman v Green*, 65 Bankr 317 (Bankr W D Mo 1978).

55. *Berman*, 65 Bankr at 320.

56. *Id.*

57. *Green*, 597 F2d at 133. See notes 46-51 and accompanying text.

58. *Farmers and Merchants Bank v Gibson*, 7 Bankr 437, 441 (Bankr N D Fla 1980). See note 17 and notes 62 to 65 and accompanying text.

59. 53 Bankr 772 (Bankr S D NY 1985). In *Tampa Chain*, the shareholder guarantor was found to have acted inequitably by abusing the corporation's funds. *Tampa Chain*, 53 Bankr at 779. Judge Buschman held that the shareholder's guaranty was an equitable contribution of capital and invoked marshaling on those grounds. *Id.* at 778. See notes 69-73 and accompanying text.

60. *Tampa Chain*, 53 Bankr at 778, suggesting a comparison of *Berman v Green*, 597 F2d 130 (8th Cir 1979), *In re Multiple Servs. Indus., Inc.*, 18 Bankr 635 (Bankr E D Wis 1982), and *Gibson*, 7 Bankr at 440-41 with *In re The Computer Room*, 24 Bankr at 735 n 4, and *In re United Medical Research, Inc.*, 12 Bankr 941, 943 (Bankr C D Cal 1981).

The bankruptcy court in *In re United Medical Research, Inc.*⁶¹ extended this reasoning and stated that "on principle there is no difference between a stockholder loan to a corporation and that stockholder loaning his credit to the corporation by securing his guarantee of a corporate debt with individual assets."⁶²

The leading case in this area is *Farmers and Merchants Bank v Gibson*.⁶³ The *Gibson* court held that where a sole shareholder guaranteed a working capital loan, and the secured creditor was relying solely on the guarantor and not the debtor corporation for repayment, the guarantee will be viewed as a contribution to capital, and marshaling would be appropriate.⁶⁴ Judge Sauls, in *Gibson*, stated that the foreseeable result of obtaining a working capital loan, based on the personal guaranty of a shareholder of the corporation, was the "inducement of others to innocently commence or continue to extend supplies or services to the principal on credit."⁶⁵ Thus, when the business failed, the "balance of equities tip[ped] in favor of the creditors of the principal."⁶⁶

This theory is based in equity, and therefore "the contributions to capital exception to marshaling should not be applied unless

61. 12 Bankr 941 (Bankr C D Cal 1981).

62. *United Medical Research*, 12 Bankr at 944. In *United Medical Research*, the principal shareholders had guaranteed a Small Business Administration loan and pledged their real property to secure the guarantees. Id at 941-42. The trustee moved for marshaling of the real property of the guarantors. Id at 942. After finding that the shareholder guarantors of the debtor corporation had not acted inequitably, Judge Elliott quoted *Frasher v Robinson*, 458 F2d 492 (9th Cir 1972), where the Ninth Circuit, finding that the shareholder lender had not acted inequitably, held that,

Claims of majority shareholders will be subordinated when the majority shareholders have been involved in fraud, overreaching, or other inequitable conduct. However, absent inequitable conduct, *bona fide* claims based upon loans from majority shareholders will not be subordinated to the claims of other creditors.

United Medical Research, 12 Bankr at 944, quoting *Frasher*, 458 F2d at 493 (emphasis in original, citations omitted).

Judge Elliott, in stating that there was no difference between a shareholder loan to a corporation and a shareholder guaranteeing a loan to the corporation, concluded that without any inequitable conduct on the part of the shareholder guarantor, it would not be appropriate to subordinate the guarantor's claims (presumably after the rights of the secured creditors were equitably subrogated to the guarantors), and therefore, he refused to apply the marshaling doctrine (presumably because there would be no net effect on the assets of the debtor, as the guarantors would be subrogated to the Small Business Administration's interests). *United Medical Research*, 12 Bankr at 944.

See note 21 for a discussion on equitable subrogation and subordination.

63. 7 Bankr 437 (Bankr N D Fla 1980). See note 17 for the facts and procedural history of *Gibson*.

64. *Gibson*, 7 Bankr at 441.

65. Id.

66. Id.

there also exists sufficient inequitable conduct to warrant its application."⁶⁷ The proponent of marshaling must show either that excessive control was exerted by the guarantors, that the guarantees were treated as a capital contribution, or that the corporation was undercapitalized.⁶⁸

C. *Inequitable Conduct*

When the guarantor of a debt conducts his affairs inequitably, a court is more likely to compel marshaling.⁶⁹ An example of inequitable conduct is found in *Tampa Chain*, where within the first three months after receiving a loan from Fundex Corporation, the guarantors diverted 56% of all cash disbursements to themselves, their relatives, or controlled entities.⁷⁰ In finding the shareholder guarantor's conduct inequitable, Judge Buschman quoted *Matter of Harvest Milling Co.*,⁷¹ which held:

Inequitable conduct is that conduct which may be lawful, yet shocks one's good conscience. It means, *inter alia*, a secret or open fraud, lack of good faith or guardianship by a fiduciary; an unjust enrichment, not enrichment by bon chance, astuteness or business acumen, but enrichment through another's loss brought about by one's own unconscionable, unjust, unfair, close or double dealing or foul conduct.⁷²

Inequitable conduct was evidenced by certain "badges of fraud" in *Tampa Chain*.⁷³

67. *Vermont Toy Works*, 82 Bankr at 319.

68. *Id* at 317.

69. *Vermont Toy Works*, 82 Bankr at 319, referring to *Tampa Chain*, 53 Bankr at 772.

70. *Tampa Chain*, 53 Bankr at 775.

71. 221 F Supp 836 (D Or 1963). In *Harvest Milling*, Judge East found no evidence of inequitable conduct on the part of a corporate creditor, Concentrates Inc., even when the bankrupt debtor held shares in the creditor corporation. *Harvest Milling*, 221 F Supp at 838-39. The court held that without evidence of inequitable conduct, equitable subordination of the creditor's claim was not warranted. *Id*.

72. *Tampa Chain*, 53 Bankr at 779, quoting *In re Harvest Milling*, 221 F Supp at 838, and also quoted with approval in Andrew DeNatale and Prudence B. Abram, *The Doctrine of Equitable Subordination As Applied to Nonmanagement Creditors*, 40 Bus Law 417, 424 n 35 (1985)(emphasis in original).

73. In *Tampa Chain*, Judge Buschman stated that the corporate records showed "continuous use of Tampa Chain as a personal piggy bank [by its shareholders]. . .," and that the case was one of "abuse of corporate funds." *Tampa Chain*, 53 Bankr at 779-80. See also note 58 and accompanying text.

The Second Circuit in *In re Kaiser*, 722 F2d 1574 (2d Cir 1983), stated that badges of fraud could be used to find the actual intent to commit fraud. *Kaiser*, 722 F2d at 1582. The Second Circuit listed the following as badges of fraud,

concealment of facts and false pretenses by the transferor, reservation by him of rights in the transferred property, his absconding with or secreting the proceeds of

Thus, under this expansion, when the proponent of marshaling can show inequitable conduct on the part of the guarantor, a court acting in equity may view the guarantor and the corporation as a common debtor, and thereby allow the invocation of marshaling.

D. *Piercing of the Corporate Veil*

Piercing the corporate veil is used by courts to disregard the separateness of the corporate entity and its shareholders. Judge Conrad in *Vermont Toy* listed ten factors that courts have used to determine the appropriateness of piercing the corporate veil.⁷⁴

Piercing the corporate veil is perhaps the most recognized expansion of marshaling's common debtor requirement.⁷⁵ Although piercing of the corporate veil is recognized as an expansion of the common debtor requirement, many courts have declined to invoke the doctrine because the proponent has not met the high standard of proof, clear and convincing evidence, required to rebut the presumption of separate entities.⁷⁶

the transfer immediately after the receipt, the existence of an unconscionable discrepancy between the value, of property transferred and the consideration received therefor, . . . lack or inadequacy of consideration, family, friendship, or close association relationship between the parties, the retention of possession, benefit, or use of the property in question, the financial condition of the party sought to be charged before and after the transaction, and shifting of assets by the debtor to a corporation wholly controlled by him.

Id at 1582-83 (citations omitted).

74. *Vermont Toy Works*, 82 Bankr at 307. The factors listed by Judge Conrad are, (1) The corporate fiction is used as a means of perpetrating fraud; (2) A corporation is organized and operated as a mere tool or business conduit of another corporation; (3) The corporate fiction is employed as a means to the end of avoiding existing legal or moral obligations; (4) Failure to observe proper corporate formalities or there is an absence of corporate records or meetings; (5) Gross undercapitalization or thin capitalization; (6) Non-functioning of other officers or directors; (7) Corporation is a mere facade for the operations of the dominant stockholder(s); (8) Insolvency of the debtor corporation; (9) Siphoning or commingling of corporate funds by the dominant stockholder; and, (10) The corporate fiction is used to achieve or perpetrate monopoly.

Id (citations omitted). See also 18 Am Jur 2d Corporations §§ 43-54 (1985).

75. *Vermont Toy Works*, 82 Bankr at 320. See *Tampa Chain*, 53 Bankr at 778 (which accepted the piercing the corporate veil expansion, but decided to invoke marshaling on the separate grounds of the contribution of capital expansion); *Gibson*, 7 Bankr at 440 (accepting the piercing expansion but also refusing to pierce the corporate veil when the contribution to capital expansion was available to impose marshaling against the guarantor); *Vermont Toy Works*, 82 Bankr at 321 (holding that "marshaling's 'common debtor' requirement is met where there are sufficient facts to warrant piercing of the corporate's veil to reach and join the alter ego's assets with those of the senior creditor").

76. *Vermont Toy Works*, 82 Bankr at 320. See for example, *Matter of Dealer Support Servs. Int'l, Inc.*, 73 Bankr 763, 765 (Bankr E D Mich 1987), where the bankruptcy court held that although it accepted the alter ego expansion of the doctrine, the trustee had

APPLICATION OF THE DOCTRINE

An analysis of the ABC Corporation hypothetical under each expansion follows:⁷⁷

A. *General Equity Principles*

The expansion of the doctrine based on general equitable principles is met. It is clear from the fact pattern that if First Bank is permitted to recover from the corporate assets, Fund 1, first, there will be no assets available to satisfy Second Bank or the trade creditors. Under any circumstances, First Bank will have to proceed against Mr. Doe on the personal guaranty if it is to be fully satisfied, because the liquidation value of the corporate assets (\$250,000) is less than the debt owed (\$300,000). Therefore there is no prejudice to First Bank if it is forced to marshal the personal assets of Mr. Doe. Because Second Bank and the trade creditors would be left with nothing if First Bank's decision to liquidate the corporate assets first is permitted, a court accepting the expansion of the common debtor requirement based on general equitable principles would allow marshaling under this fact pattern.

B. *Contribution to Capital*

The requirements of this expansion of the doctrine are not necessarily met under the above fact pattern. There is no indication that First Bank relied solely on the personal guaranty to make the loan. In fact, the financial projections provided by Mr. Doe indi-

not alleged inequitable conduct on the part of the guarantors. Thus, even if a court were to accept the application of the doctrine, without the equitable subordination of the guarantor's subrogation claim, the order to marshal assets would be futile. *Dealer Support Servs.*, 73 Bankr at 765-66.

See also *In re Coors of N. Miss., Inc.*, 66 Bankr 845, 867 (Bankr N D Miss 1986); *Matter of Franchise Systems, Inc.*, 46 Bankr 158, 163 (Bankr N D Ga. 1985); *In re Rich Supply House, Inc.*, 43 Bankr 68, 70 (Bankr N D Ill 1984); *DuPage Lumber & Home Improvement Co. v Georgia-Pacific Corp.*, 34 Bankr 737, 741 (N D Ill 1983); *In re Plad, Inc.*, 24 Bankr 676, 679 (Bankr M D Tenn 1982); *Matter of Harrold's Hatchery and Poultry Farms, Inc.*, 17 Bankr 712, 717 (Bankr M D Ga 1982), which all accepted the piercing expansion of the marshaling doctrine, but refused to invoke marshaling because of the proponent's failure to carry his standard of proof or to allege sufficient facts to warrant piercing of the corporate veil.

77. The following analysis assumes that all procedural requirements are met. Specifically, it is assumed that the bankruptcy court has jurisdiction over the parties, Second Bank and the trustee have standing, the marshaling issue is presented in an adversary proceeding, and all facts have been stipulated to and therefore meet the burden of proof requirement of clear and convincing evidence. See notes 22-44 and accompanying text for a breakdown of the procedural requirements.

cated that the corporate assets would at all times exceed the amount owed First Bank. In addition, though Mr. Doe acted inequitably when he used the proceeds from the second loan to repay his student loans, this act alone may not suffice to show, by clear and convincing evidence, that Mr. Doe acted inequitably.

However, ABC was undercapitalized from the beginning. Mr. Doe, knowing that the company needed capital, obtained the \$300,000 loan from First Bank when he incorporated. It can also be shown that the trade creditors relied on the fact that the two banks loaned large amounts to ABC in extending credit to the company.

If the court accepts *United Medical Research's* extreme approach that any personal guaranty of a corporate debt is a contribution to capital,⁷⁸ the court will require marshaling under this expansion of the common debtor requirement.

Overall, the court may invoke marshaling based on the reliance of the trade creditors, the initial undercapitalization (recognized by Mr. Doe when he incorporated), and the slightly inequitable conduct on the part of Mr. Doe.

C. *Inequitable Conduct*

Mr. Doe's only inequitable conduct was the use of \$10,000 of the Second Bank loan proceeds to repay his student loans. However, this was only 20% of the second loan proceeds, and less than 3% of the total bank loan proceeds. Mr. Doe's conduct has not revealed a pattern of fraud or inequitable conduct. His one act should be insufficient to invoke this expansion of the common debtor requirement.

D. *Piercing the Corporate Veil*

There is insufficient evidence to rebut the presumption of separate entities by piercing the corporate veil. Although the corporation was inadequately capitalized when it was formed, Mr. Doe realized this and obtained the necessary capital through the First Bank loan. In addition, the corporation was not an alter ego or instrumentality of Mr. Doe, nor was the corporation used to perpetuate fraud or inequitable conduct. Though the corporation did not follow all corporate formalities, it did file separate tax returns and detailed financial records were maintained. Overall, there is

78. 12 Bankr at 943. See note 61 and accompanying text.

insufficient evidence to pierce the corporate veil, and this expansion of the common debtor requirement could not be used by a bankruptcy court to invoke marshaling.

In summary, marshaling would be permitted in the above fact pattern under the general equitable principles and possibly the contribution to capital expansions of the common debtor requirements. Marshaling would not be invoked under the inequitable conduct or piercing the corporate veil expansions.

CONCLUSION

The weakness of the first two expansions of the marshaling doctrine are exemplified by this result. Many corporations use the financial tool of leverage to fund their growth and success. With the use of leverage, the risk of failure increases because there is more financial pressure on the corporation. If a jurisdiction follows the general equitable or contribution to capital expansions of the marshaling doctrine, small business owners that use leverage face the threat of having their personal assets marshaled to satisfy any and all debts of the corporation. In addition, the use of leverage is a useful and well-recognized financial tool that would be taken out of the hands of would-be entrepreneurs and small business owners. This would nullify one of the most important benefits of having a corporate entity: limited liability.

There is no need for this extreme approach because most creditors, even trade creditors, have procedures for assessing credit risk and making the decision to extend credit or not. Under these expansions, junior or unsecured creditors are able to improve their position, to the detriment of the guarantor, merely because they made a poor credit decision.

In addition, most new jobs in the United States economy are created by small businesses and entrepreneurs.⁷⁹ These ventures are generally started by an entrepreneur with an idea and some

79. John Case, *The New Economy: The Disciples of David Birch*, 11 Inc. 39 (January 1989). Although estimates of the number of new jobs created by small businesses (less than one hundred employees) vary, small businesses create a significant number of new jobs in the economy. Case, *The New Economy* at 40 (cited within this note). Mr. Birch estimated that small businesses created 82% of the new jobs created between 1969 and 1976. *Id.* This figure was disputed by researchers at the Brookings Institute, but the variations between the two studies were insignificant compared to variations between different states and different time periods. *Id.* During economic recession or slow growth, the percentage of jobs created by small businesses increases, and vice versa. *Id.* In fact, between 1969 and 1986, the percentage of new jobs created by small companies ranged from 38% to 100%, with all but one time period having 53% of new jobs or more created by small companies. *Id.* at 39

capital. Many times, the entrepreneur must seek outside financing, including debt, in order to achieve growth. As stated earlier, most large creditors require both a security interest in corporate assets and a personal guaranty.⁸⁰ The business owner should be able to estimate his potential exposure on the personal guaranty using his financial projections. Based on these estimates, he can decide whether to accept the loan or not.

If a jurisdiction applies the general equity or contribution to capital expansions of the marshaling doctrine, a business owner can have unlimited liability, regardless of his personal actions. In light of the availability of credit reports and credit risk awareness among all businesses, it is not necessary or desirable to give imprudent creditors the ability to improve their position at the expense of the guarantor as this would have a chilling effect on entrepreneurship. As Judge Elliott stated in *United Medical Research*:

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.⁸¹

These concerns are not valid, however, when a court invokes marshaling based on inequitable conduct on the part of the guarantor or piercing of the corporate veil. When the personal guarantor acts fraudulently or inequitably, justice would not be served by allowing the guarantor to harm creditors through his inequitable conduct, yet not be personally liable for his misappropriation of funds or other fraudulent conduct. In addition, by definition, if the corporate veil is pierced, the guarantor and the corporation are the same. Therefore, the inequitable conduct and piercing the corporate veil expansions of the common debtor requirement of marshaling are acceptable because these exceptions are based on the activities of the personal guarantor. The guarantor is still able to limit his exposure by not acting inequitably and maintaining the corporation as a separate entity. Thus, acceptance of these expansions of the marshaling doctrine will not have a dramatic effect on entrepreneurs' willingness to risk their personal funds to start-up new businesses and create jobs.

Therefore it is urged that the judiciary limit the expansion of

80. See note 1 and accompanying text.

81. *United Medical Research*, 12 Bankr at 943.

the marshaling doctrine to the inequitable conduct and piercing the corporate veil expansions. This limitation will yield a just result when the personal guarantor acts improperly (either inequitably or by not maintaining a separate entity), while allowing an entrepreneur the ability to estimate and limit his personal exposure when deciding to start a venture.

Mäny Emamzadeh