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USE OF MARSHALING TO DEFEAT TRUSTEE IN BANKRUPTCY: EQUITY MISAPPLIED?

In *Caplinger v. Patty,*[1] the Eighth Circuit Court of Appeals applied the equitable doctrine of marshaling of assets to defeat claims of a trustee in bankruptcy against a junior lien creditor who had failed to perfect his security interest in a first fund of the bankrupt but whose security in a second fund was perfected. The court required a senior lien creditor to satisfy his claim from the first fund, thus allowing the junior creditor to claim the second fund. The trustee was left nothing, contrary to the policy of the Bankruptcy Act.[2]

Appellant Caplinger sold real estate and personal property—a gin mill—to the Waldenburg Gin and Supply Co.,[3] in June 1964. The purchase price of 80,000 dollars was satisfied by a 50,000 dollar first mortgage loan on both the realty and personalty. The mortgage was obtained by the purchaser from the Bank of Harrisburg. Caplinger received the balance through a 30,000 dollar second mortgage on the same properties. The bank perfected its security interests in both the real and personal property in accordance with Arkansas law,[4] while Caplinger perfected only his realty interest.[5] Within one year, the bank and Caplinger filed in state court a joint foreclosure action which led to a sale of the property as a single unit.[6] The proceeds from this sale were distributed in accordance with a claimed oral agreement[7] between the

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1. 398 F.2d 471 (8th Cir. 1968).
2. 11 U.S.C.A. § 1 *et seq.* (1964).
3. 398 F.2d at 472. Caplinger was acting as trustee of the Waldenburg Gin & Elevator Supply Company, Inc. The purchaser was a new, unrelated and separate corporation, the stock of which was owned by Mr. and Mrs. Clinton E. Bowling, the bankrupt in this proceeding.
4. ARK. STAT. ANN. § 85-9-401(1)(c)(1961) requires a security interest in personal property to be filed in the office of the Secretary of State and in the office of the clerk of the circuit court and ex-officio recorder of the county in which the debtor does business. ARK. STAT. ANN. § 51-1001 (1947) provides for local recording of real estate mortgages.
5. 398 F.2d at 473. The trustee testified that he searched the appropriate records in the office of the Secretary of State and found no record of a lien on the personal property. Caplinger's attorney, when asked by the referee whether there had been a filing with the Secretary of State, said that his office had prepared the papers and that he had no information that such filing had been made and that he was not representing that such action had been taken. The court of appeals held that this testimony standing unrebutted afforded evidentiary support for a finding that there had been no filing of the personal property interest.
6. *Id.* at 475. The real and personal property were sold together as an operating unit and thus brought more than would have been realized if the real estate and the items of personal property had been sold separately.
7. Record at 25-26. Mr. L. K. Collier, attorney for the Bank of Harrisburg, and Caplinger testified that there was an oral understanding when the foreclosure suit was

two mortgagees and pursuant to the bank's custom of satisfying its claims first from personal property. The foreclosure action and distribution of the proceeds took place within four months of an involuntary bankruptcy petition brought by Waldenburg's general creditors.[8] The real estate and personal property subject to the mortgages of Caplinger and the bank were the total available assets of the bankrupt.

The trustee in bankruptcy sought to set aside Caplinger's receipt of the sale proceeds as a preference under section 60[9] of the Bankruptcy Act. The referee held for the trustee,[10] concluding that Caplinger, having received a preference, did not come into court with clean hands[11] and was thereby barred from asserting the equitable doctrine of marshaling against the bank. Conversely, the referee reasoned, since the trustee had a lien created by section 70(c)[12] of the Act, he could assert the doctrine against the bank and defeat the claim of Caplinger.

The court of appeals agreed that distribution of those proceeds remaining after the bank had satisfied its claim from the personal property fund turned upon application of the marshaling doctrine to the facts of the case.[13] The court, however, disagreed with the referee's results, holding that Caplinger's perfected security interest in the real property, coupled with the oral agreement, justified application in his favor of the general

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filed that the Bank's debt would be satisfied first out of personalty and second out of real estate. He understood this to be the normal procedure in all foreclosures.

8. *Id.* at 1. Three general creditors filed the petition representing claims totalling 10,279.26 dollars on open account unsecured, for goods sold to the corporation.

9. 11 U.S.C.A. § 96(a)(1) (1964) provides:

> A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedant debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

Section 96(b) further provides:

> Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. . . .

10. Record at 44.

11. *Id.* at 42. The court of appeals later rejected the unclean hands basis of the referee's decision on the grounds that the trustee had not supported that contention in his brief on appeal. It held that there was nothing in Caplinger's conduct to bring the unclean hands doctrine into play. 398 F.2d at 475.

12. 11 U.S.C.A. § 110(c):

> . . . The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights remedies and power of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.

13. 398 F.2d at 475.

equitable principles upon which marshaling is based.[14] These factors, therefore, were construed to place Caplinger in a better position than the trustee to assert the doctrine. Caplinger thus was deemed entitled to retain his agreed share of the proceeds of the foreclosure sale.[15]

Although the definition of marshaling has been stated in a variety of ways, a representative statement of the doctrine is:

> . . . Where one creditor has security on two funds of his debtor, and another creditor has security for his debt on only one of those funds, the latter has a right in equity to compel the former to resort to the other fund, if it is necessary for the satisfaction of both creditors, provided it will not prejudice the rights or interests of the party entitled to the double fund nor do injustice to the common debtor, nor operate inequitably on the interests of other persons. . . .[16]

Marshaling ordinarily applies where there are two separate funds of a common debtor.[17] The creditor with single security asserts the doctrine against the doubly-secured creditor[18] in order to achieve at least partial satisfaction of his claim. The fact that real estate and personal property are sold together does not defeat the right to demand marshaling.[19] In *Caplinger,* the gin mill may properly be described as consisting of two funds, one the realty and the other the personalty.[20]

The court of appeals held that the circumstances were proper for marshaling. According to the court, Caplinger had a perfected security interest in the real property. The court reasoned that since ". . . nothing in the Bankruptcy Act . . . [gives] a trustee a preference over secured creditors having liens in existence more than four months prior to

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14. *Id.* at 476.

15. *Id.*

16. Ayres v. Husted, 15 Conn. 504, 515-16 (1843); *accord,* Meyer v. United States, 375 U.S. 233 (1963); Lowell v. Federal Reserve Bank, 268 U.S. 449 (1925); *see also* 55 C.J.S. *Marshaling Assets and Securities* § 1 (1948); 4 POMEROY'S EQUITY JURISPRUDENCE § 1414 (2d ed. 1919).

17. Central Lumber Co. v. Jacks, 222 Ala. 475, 478, 132 So. 721, 724 (1931); Gaines v. Hill, 147 Ky. 445, 448, 144 S.W. 92, 94 (1912); *see also* 18 RULING CASE LAW, *Marshaling Assets* § 5 (1917).

18. Newby v. Fox, 90 Kan. 317, 320, 133 P. 890, 891 (1913):

> It has been said that a marshaling of securities cannot be required by a "single creditor" (one having a lien only on a single fund) who is himself bound to the "double creditor" (one having a lien on both funds).

19. Craig v. Miller, 41 S.C. 37, 19 S.E. 192 (1893); *see also* Robert Moody & Son v. Century Savings Bank, 239 U.S. 374 (1915); 55 C.J.S. *Marshaling Assets and Securities* § 8 (1948).

20. A lien claimant who has a lien on a lot and on the improvements thereon may be required in equity to exhaust his lien on the lot before proceeding against the improvements, by one who has a lien on the improvements and not upon the lot. Braden Co. v. Lancaster Lumber Co., 170 Okla. 30, 38 P.2d 575 (1934).

bankruptcy. . . ," Caplinger was in a better position to assert the marshaling doctrine than was the trustee.[21] The fact that the trustee held a prior lien on the personal property at the time of the oral agreement between the bank and Caplinger was not considered determinative. The trustee had contended that his prior claim over Caplinger as to the personal property and his third-class lien on the real property made him a doubly-secured creditor,[22] thereby precluding the junior lienor from asserting the doctrine to the trustee's detriment.[23]

On its face, this case would not seem to be a normal marshaling situation, since here there were three contending creditors instead of the usual two. The bank possessed the senior liens because of its perfected first mortgage on both properties. Caplinger held a perfected second lien on the real property, while the trustee in effect had a second lien on the personal property. The trustee's effective third lien on the real property was immaterial to disposition of the proceeds once the bank had satisfied its claim, since the senior creditors clearly could exhaust the fund. Thus Caplinger and the trustee were at least on equal footing to assert marshaling against the bank.

It is often stated that marshaling will not be applied to the detriment of third persons having an equity equal or superior to that of a person seeking to invoke the rule[24] or where it would deprive general creditors of payment of their claims.[25] In this case, since the only assets available to the creditors were the properties in controversy, a distribution based on marshaling necessarily would lead to an inequitable result. The circumstances were therefore not proper for marshaling.

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21. 398 F.2d at 475. The trustee never contested the fact that Caplinger had properly perfected his real estate lien in accordance with state law. His argument was based on § 70(c) (the strong-arm clause) of the Bankruptcy Act which gave him a prior claim to the personal property. The court was not confronted with a relation back issue under § 70(c) as Caplinger had never perfected his personal property interest.

22. *Id.* at 476. The trustee had liens on both funds under § 70(c), but in this case the bank was the senior lienor to both personal and real property and was thus the "doubly secured" creditor contemplated by the marshaling doctrine. The trustee's lien on the personal property was junior to the bank's lien and the lien on the real property was junior to Caplinger's lien. *See* Victor Gruen Associates, Inc. v. Glass, 338 F.2d 826 (9th Cir. 1964).

23. Brief for Appellee at 22.

24. New Bern Oil & Fertilizer Co. v. National City Bank, 28 F.2d 554, 556 (4th Cir. 1928). (". . . The doctrine of marshaling assets applies only when it can be done with justice to the creditor and his debtor, and without prejudice to third persons."); *See also* Marr v. Lewis, 31 Ark. 203 (1876) (widow's homestead on equal grounds with second mortgagees' right to marshal); Stokes v. Stokes, 206 N.C. 108, 173 S.E. 18 (1934) (widow's dower rights superior to junior creditor's right to marshal); Barbin v. Moore, 85 N.H. 362, 159 A. 409 (1932) (claims of life insurance beneficiaries superior to general creditors' right to marshal); *But cf.* Sanborn v. Keefe, 88 N.H. 236, 187 A. 97 (1936) (when equities of both junior creditors are equal, priorty of time test applied); Herbert v. Mechanics Bldg. & Loan Association, 17 N.J. Eq. 497 (1864).

25. *See* Langel v. Moore, 119 Ohio St. 299, 164 N.E. 118 (1928).

Closer analysis affords an alternative soltuion—ratable distribution —which apparently was not suggested to the court. Since it was agreed that the personal property represented about two-thirds and the real estate about one-third of the value of the combined property,[26] Caplinger could be deemed to hold a secured interest in one-third of the remaining proceeds and the trustee in the other two-thirds.[27] This scheme of distribution would give due weight to the positions of both Caplinger and the trustee. Caplinger would not be cut off completely from the proceeds of both funds for failing to perfect his security interests in one fund; the trustee would have protected general creditors in regard to all funds which were available and unsecured.[28] Such a decision would have been a more appropriate exercise of the bankruptcy court's equity powers.

More complex problems are posed by the court's reasoning, based on equitable considerations, that Caplinger should retain the proceeds in spite of having received a preference under section 60. The court placed heavy emphasis on the oral agreement and the custom of the bank. It reasoned that the bankruptcy proceedings had no effect on Caplinger's perfected real property mortgage; hence, Caplinger's receipt of proceeds of a fair and non-fraudulent foreclosure sale was deemed not to violate the Bankruptcy Act.[29]

This holding weakens the trustee's power under section 60(b) by applying broad equitable principles to override the language and policy of the Act. Caplinger's unperfected lien clearly was subject to attack by the trustee under powers granted by the Act.[30] By marshaling in favor of Caplinger, a general creditor as to personalty, the court circumvented these powers with resultant injury to the other general creditors.[31] The

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26. 398 F.2d at 475. The value of the real estate was approximately 21,000 dollars and the personal property 42,000 dollars. The foreclosure sale grossed 63,904.80 dollars and netted 61,500 dollars for the property as a unit. The bank received its full claim of 50,000 dollars, leaving 11,500 dollars for distribution between Caplinger and the trustee.

27. Caplinger would thus receive 3,833 dollars, eighteen per cent of the value of the property on which he had a perfected lien.

28. The remaining proceeds of 7,667 dollars represents the proceeds of those assets which were not secured and would be turned over to the trustee to be distributed among the general creditors.

29. 398 F.2d at 475.

30. 3 COLLIER ON BANKRUPTCY ¶ 60.51 A at 1050.13 (14th ed. J. Moore 1964):

> . . . In all . . . cases, filing is necessary to perfect a security interest so that it can withstand attack by a trustee in bankruptcy. This will be true in ordinary cases of inventory financing, equipment financing, and where accounts are assigned as collateral.
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> In the ordinary case where filing is required, the date of filing will be the date of perfection, *i.e.* the one on which the elements of § 60 will be tested.

31. The purpose of section 60 is to create an insulated four month period during which all creditors of the same class must be treated equally. Shaw v. Walter E. Heller & Co., 385 F.2d 353, 358 (5th Cir. 1967); *see also* J. MACLACHLAN, BANKRUPTCY §

court of appeals apparently relied on the fact that, had bankruptcy proceedings not been instituted, Caplinger could have asserted the marshaling doctrine against the bank; moreover, the court reasoned, the institution of bankruptcy proceedings should not prejudice Caplinger's standing.[32] Such reasoning does not reach the full issue confronting the court. Bankruptcy proceedings had been instituted, and a conflict between equity and the power of the trustee to protect general creditors was apparent. Caplinger, having legally perfected his real property mortgage, was entitled to some portion of his claim under the Bankruptcy Act; however, he was also in receipt of a preference. The application of marshaling in this instance has the practical effect of allowing an oral agreement between the recipient of a preference and a senior co-mortgagee to defeat a trustee in bankruptcy. Giving effect to such an arrangement between creditors subordinates the statutory design of section 60 to the manipulations of interested parties.[33] Thus, the court not only uses this private arrangement to defeat the legislative design but also to legitimate the application of general equitable principles as a substitute for that design.

This result would seem to be inconsistent with the conception of a bankruptcy court as a court of limited jurisdiction. Being of statutory origin, it possesses only such jurisdiction and powers as are expressly or by necessary implication conferred upon it by the Bankruptcy Act.[34]

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253 (1956). Caplinger was in the same class as to the personal property as other general creditors.

32. The argument, however, ignores the fact that § 60 has two purposes: first to prevent the unequal distribution of assets among creditors of the same class, and second to encourage compliance with state recording laws and thereby eliminate equitable liens. Caplinger's need to assert the marshaling doctrine arose by reason of his failing to perfect his interest in the personalty under state law. Thus, the marshaling doctrine for Caplinger became a type of equitable lien defeating the trustee. When the mist created by the confusion of equitable principles is swept aside, it is clear that *Caplinger* presents the case of an indirect transfer for the benefit of a creditor. The effect of forcing the bank to satisfy its claim first out of the personalty was to increase the amount of Caplinger's security, and *to the extent of that increase* Caplinger received a preference.

33. *See* 3 COLLIER ON BANKRUPTCY ¶ 60.01 at 744 (14th ed. J. Moore 1964):

> But it is obvious that, if the creditors and debtor could deal with impunity with the debtor's assets up to the date of bankruptcy, only tag ends and remnants of unencumbered assets would too often remain. Bankruptcy liquidation would be a futile procedure. The Act, therefore, must necessarily invalidate certain transactions that have occured prior to bankruptcy. The sections of the Act that attempt this task are:
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> § 60(a) and (b)....

See also Treister, *The Avoiding Power of a Trustee in Bankruptcy,* 33 L. A. BAR BULL. 357 (1958). *See also* Note *The Commercial Code and the Bankruptcy Act: Potential Conflicts,* 53 NW. U.L. REV. 411 (1958).

34. Chicago Bank of Commerce v. Carter, 61 F.2d 986, 988 (8th Cir. 1932). *See also* Benton Coal Co. v. Franklin Coal Co., 67 F.2d 796, 797 (8th Cir. 1933):

> [A bankruptcy court does not have] plenary jurisdiction in equity; but is confined in the application of the rules and principles of equity to the jurisdiction con-

Equitable principles control only where the Bankruptcy Act is silent.[35] Section 60(a) has expressly defined the essential elements of a preference and section 60(b) the power of the trustee to avoid such a preference. Caplinger's failure to perfect his interest in the personal property and his receipt of the proceeds clearly presents a situation with which the statute can deal. While the U.S. Supreme Court has said that equity is an "overriding" consideration of bankruptcy administration,[36] such a statement provides little guidance in a particular factual context and has not gone unchallenged. In *Shaw v. Walter E. Heller & Co.*,[37] the court rejected an appeal for the application of equitable principles, citing Mr. Justice Harlan to the effect that

> [t]he Court's principle contention seems to be that equitable considerations oblige it to release the bank from liability. Its premise plainly is that equity is here a solvent to which we may appropriately resort; I am unable to accept this premise. This is not a case in which the statute is imprecise. Nor is it a case in which the legislature's intentions have been mishapen by the statute's words. . . .[38]

The fallacy in the court's approach is that it felt constrained to choose between the statutory scheme and its equitable predilections, without recognizing that it could do equity *within* the statutory framework. The court's basic error was in viewing Caplinger as the mere recipient of a

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ferred upon it by the provisions of the Bankruptcy Act. . . .

Bardes v. First Nat'l Bank 178 U.S. 524 (1900); *In re* Barnett, 12 F.2d 73, 81 (2d Cir. 1926); *In re* Judith Gap Commercial Co., 5 F.2d 307 (9th Cir. 1925); *In re* Chemo Puro Mfg. Corp., 202 F. Supp. 140, 142 (S.D.N.Y. 1962) ("The general equity power of federal courts is clearly superseded by and must be confined within the Bankruptcy Act and related statutes.") *But see* Pepper v. Litton, 308 U.S. 295, 303-04 (1939), *citing* Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934):

> Courts of bankruptcy are constituted by §§ 1 and 2 of the Bankruptcy Act and by the latter section are invested with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings. Consequently this court has held that for many purposes courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.

See also Young v. Higbee Co., 324 U.S. 204, 210 (1945):

> But historically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets; to protect the creditors from one another.

See generally J. MacLachlan, Bankruptcy § 27 (1956).

35. *In re* Romanac, 245 F. Supp. 882, 886 (W.D. Va. 1965).

36. Bank of Marin v. England, 385 U.S. 99, 103 (1966):

> Yet we do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction.

37. 385 F.2d 353 (5th Cir. 1967).

38. *Id.* at 358, citing 385 U.S. at 106.

preference. In fact, Caplinger received a preference only in so far as he received any proceeds from the sale of the personalty. The amount he received from sale of the realty was his due as a secured creditor.

Since neither Caplinger nor the trustee was in a position to assert marshaling, and since the property was sold as an undifferentiated unit, it cannot be said—either in fact or legal contemplation—that the bank satisfied its claim out of one fund to the exclusion of the other. Since resolution of the problem before the court requires engaging in the legal fiction that two funds existed, the further fiction that the bank satisfied its claim ratably from each "fund" seems warranted. Hence, since the bank took 81.3 per cent of the total 61,500 dollar fund,[39] it should be deemed to have taken 81.3 per cent of each "separate" fund, or 33,333 dollars from personalty and 16,667 dollars from realty. There then remained for distribution to other creditors 7,667 dollars in the personalty fund and 3,833 dollars in the realty fund, or a total of 11,500 dollars. Caplinger received the entire sum. To the extent of 7,667 dollars, the amount remaining in the personalty fund, Caplinger received a preference. But Caplinger was entitled to the amount he received from the realty fund by virtue of his standing as a secured creditor, and nothing in the Act subordinates the rights of such a secured creditor to the powers of the trustee.[40]

Thus, the court's description of Caplinger as the recipient of a preference was inexact. By viewing him as having received a preference only to the extent that he received proceeds from the fund to which he was unsecured, the court could have adhered to the statutory language while accomplishing substantial justice between the parties.

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39. See notes 26-28 *supra* and accompanying text.
40. See text accompanying note 21 *supra*.
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