TAB 10

Marshalling

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<u>Marshalling: A Remedy for a Junior Creditor</u>

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Marshalling is an equitable remedy available to protect the recovery of a junior creditor against the arbitrary action or whims of a senior creditor. Simply stated, the doctrine of marshalling dictates that, "[w]here there are two creditors of the same debtor, one creditor having a right to resort to two funds for payment of his debt, and the other a right to resort to one fund only, the court will "marshal" or arrange the funds so that both creditors are paid as far as possible."[2] This paper will provide a high level overview of the doctrine of marshalling, including pre-conditions to use, methods of implementation and scope of application.

<u>The Doctrine of Marshalling</u>

The doctrine of marshalling is an old equitable remedy that can be traced back as far as the mid-seventeenth century.[3] The modern root of the doctrine can be found in the oft cited English case of *Aldrich v. Cooper* (*"Aldrich"*), where Lord Eldon stated the doctrine as follows:

> ...a person having two funds shall not by his election disappoint the party having only one fund, and equity, to satisfy both, will throw him, who has two funds, upon that which can be affected by him only, to the extent that the only fund, to which the other has access may remain clear to him.[4]

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[2] P. V. Baker, *Snell's Principles of Equity*, 28th ed (London: Sweet & Maxwell, 1982) at 416; see also *First Investors v Veeradon Developments* (1988), 84 A.R. 364, 47 D.L.R. (4th) 446 (Alta CA.) at para 15 [*"First Investors"*]; *Brown v Canadian Imperial Bank of Commerce*, [1985] 50 OR (2d) 420 [*"Brown"*]; *Montreal Trust v Montreal Trust Co. of Canada*, [1988] 48 D.L.R (4th) 385 (BCCA).

[3]Bruce MacDougall, "Marshalling and the Personal Property Security Acts: Doing unto Others..." 28 U. Brit. Colum. L Rev. 91 1994 at pg. 101. *See* also *Aldrich v Cooper,* (1803), 8 Ves 382, 32 ER 402 (LC) at p. 395; *Culpepper v Aston* (1682), 22 ER 873; Moses Lachman, "Marshaling Assets in Bankruptcy: Recent Innovations in the Doctrine" (1985) 6 Cardozo L. Rev 671.

[4] *Aldrich v Cooper,* (1803), 8 Ves. 382, 32 ER 402 (LC) at pg. 395.

Historically, the doctrine arose from cases involving real property mortgages, however, case law in England and Canada throughout the 20th century expanded the doctrine to personal property security.[5] More recently, the Ontario Court of Appeal in *807933 Ontario Inc. v Allison (Trustee of)* adopted the definition of marshalling set out in *Aldrich*. In a subsequent decision, the Court of Appeal noted that, fundamentally, the purpose of the doctrine of marshalling is to regulate the rights of creditors as among themselves.[6] The Court further noted that in so regulating the rights of two creditors, courts should be careful not to interfere with the paramount claim of the superior creditor to pursue its remedy against either fund. Instead, the doctrine provides that if the superior creditor resorts to the fund which the inferior creditor alone can resort, the inferior creditor should not be prejudiced.[7]

The goal of allocating a debtor's assets so as to satisfy all secured creditors equitably, without prejudicing the senior creditor's position is usually achieved in one of two ways: either the court will compel the senior creditor to resort to the singly secured fund to satisfy its claim, or it will allow the junior creditor to subrogate to the senior creditor's claim to the singly secured fund. A number of common law rules (pre-conditions and bars) to the application of marshalling have developed over time. However, the equitable nature of the doctrine of marshalling gives courts the flexibility to craft relief that is specific to the circumstances of each case.

Pre-Conditions for Marshalling

In *Green v. Bank of Montreal ("Green")*[8], the Ontario Court of Appeal restated the basic criteria that must be met before the equitable doctrine of marshalling can be applied: (i) two or more creditors must share a single common debtor; and (ii) the senior creditor must have a claim against two of the debtor's funds, while the junior creditor, ranking behind the doubly secured creditor, has recourse to only one.[9] Each requirement will be examined below.

1. Single Common Debtor

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[5] For example, see *Bread Man Inc.*, [1978] 21 O.R. (2d) 59 (Ont. S.C.) [*"Bread Man"*] and *Fiatallis North America v. Pigott Construction*, (1992) 3 P.P.S.A.C. (2d) 30 (Ont. Crt. Jus. (Gen Div.)) [*"Fiatallis"*].

[6] *Green v. Bank of Montreal,* (1999) 15 P.P.S.A.C. (2d) 156, 1999 CarswellOnt 3954 (Ont. C.A.).

[7] *Ibid.* at para. 10.

[8] *Ibid.* at para. 10.

[9] *807933 Ontario v Allison (Trustee of),* [1998] 38 OR (3d) 337 (CA) at para. 13 [*"Allison"*].

With few exceptions, marshalling is limited to situations where two creditors have taken security from a single common debtor. The genesis of this rule can be found in the Ontario decision of *Ernst Bros. Co. v. Canada Permanent Mortgage Corp.*[10] The Court in that case recognized that the application of marshalling will almost universally be in circumstances where there is one debtor and two creditors. That said, the Court noted that the inapplicability of the doctrine to a two debtor scenario does not result from the mere fact that there are two debtors, but rather because it would be inequitable as between those debtors to marshal the security.[11] Thus, in limited circumstances marshalling can be applied where there are two debtors if as between them it is *not* inequitable to do so. The general exception to the common debtor requirement is with respect to sureties and guarantors.

One recent example of circumstances in which a court did not allow marshalling to be applied for failure to meet the common debtor rule was in the case of *807933 Ontario v Allison (Trustee of)*. The facts of *Allison* are as follows: Mr. Allison (the bankrupt) and his wife owned two adjacent pieces of real property. The Allisons financed the properties by borrowing $185,000 on a senior secured basis. The loan was secured by two separate mortgages, one on each of the properties. The bankrupt and Mrs. Allison were also cross-guarantors under the mortgages. The bankrupt entered into an agreement of purchase and sale to sell his parcel of land. The purchase price for the land would satisfy the senior secured obligations (except for a shortfall of approximately $1,600). Prior to the closing of the transaction, the bankrupt made an assignment in bankruptcy. The trustee in bankruptcy subsequently allowed the sale to close, following which the senior secured creditor's mortgage was released as against the bankrupt's parcel (the sold property) and as against Mrs. Allison's property. 807933 Ontario Inc., the appellant and a judgment creditor of the bankrupt, brought a claim against the estate in bankruptcy arguing that the doctrine of marshalling should apply to compel the senior secured creditor to recover its debt from Mrs. Allison's property. At trial, the Court determined that the bankrupt and Mrs. Allison were common debtors, but that the doctrine of marshalling did not apply because 807933 Ontario Inc. was not a secured creditor.[12]

The Ontario Court of Appeal overturned the trial judge's preliminary finding that the bankrupt and Mrs. Allison were common debtors. The Court of Appeal found that while the Allisons were common debtors with respect to the debt owed to the senior secured creditor, they were not common debtors with respect to 807933 Ontario Inc. Mrs. Allison was not under

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[10] *Ernst Bros. Co. v. Canada Permanent Mortgage Corp.*, (1920), 57 D.L.R. 500 (Ont. S.C.A.D.).

[11] *Supra* at note 10.

[12] *807933 Ontario v Allison (Trustee of)*, (1995) 30 C.B.R. (3d) 144 (Ont. S.C.J.).

any obligation to pay the debt owed by the bankrupt to 807933 Ontario Inc. and therefore should not suffer, especially at the hands of an equitable doctrine. The Court went on to say that unless the appellant could establish that it was just and equitable that Mrs. Allison should pay in the first instance, the appellant had no equity to compel the senior secured creditor (who had the right to resort to both funds) to recover against Mrs. Allison's property.

In considering the applicability of marshalling to the facts in *Allison,* the Ontario Court of Appeal recognized that the principal exception to the rule that there must be a single debtor is in circumstances where there is a surety-principal relationship between the debtors. In *Brown v. Canadian Imperial Bank of Commerce*[13], the Ontario High Court found that marshalling could apply where the two debtors were in effect common since they were in a surety-principal relationship. In other words, one debtor is entitled to look to the other debtor to recover its liability to either of the creditors i.e. the first debtor is in effect a creditor of the second debtor. In practical terms, the outcome of the *Allison* case may have been different had Mrs. Allison guaranteed her husband's debts to 807933 Ontario Inc.

2. Two Funds

In order to marshal, in general, there must be a senior creditor with access to two funds to satisfy its debt, but who does not need to exhaust both funds in order to be satisfied.[14] If the senior creditor requires both funds to satisfy the debt, there would be nothing left to marshal to a junior creditor. The common law has refined the 'two-fund rule' as follows:

- <u>The debtor must have both funds at their disposal</u>. Marshalling is not available if the debtor does not have actual access to one or both funds in which the senior creditor has security.[15] For example, in *Fiatallis North America Inc. v Pigott Construction Ltd.,* an unpaid supplier of equipment to Pigott Construction Ltd. argued that the Toronto Dominion Bank (which had security over the equipment) should be required to look to its "other security" before recovering against the equipment. The Court found that the "other security" was a guarantee in favour of the bank, which in the opinion of the Court, did not constitute a fund at the disposal of the debtor.[16]

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[13] *Brown v Canadian Imperial Bank of Commerce,* [1985] 50 OR (2d) 420 at para. 4 [*"Brown"*].

[14] MacDougall, *supra* at note 3.

[15] *Fiatallis, supra* at note 5 at para 15.

[16] *Ibid.*

- <u>Both funds must exist at the relevant time</u>. A junior creditor cannot request marshalling if the second fund has not yet materialized.[17] Generally, courts have been loath to artificially create a second fund in order to make marshalling possible. However, there is English and American case law that suggest that some courts have been prepared to relax this requirement in certain circumstances. For example, in *Selco Salvage,* the English court of chancery found that one of the two funds may be a right of set-off[18].

- <u>Both funds must exist by virtue of the same debt</u>. The two-fund rule is not satisfied if a senior creditor's access to two funds relate to two or more separate debts. In other words the security represented by the two funds must have been granted to the senior creditor to secure the same obligation.[19]

One further refinement to the pre-requisites to marshalling was discussed in the lower court decision in *Allison*. Justice Ground clarified that the doctrine of marshalling was limited to secured creditors. Neither unsecured creditors nor the debtor itself may invoke the doctrine. Justice Ground relied on a British Columbia decision which held, "[t]he doctrine [of marshalling] does not extend to all creditors of every degree, it does not apply in favour of an unsecured creditor…".[20] In *Re Bread Man Inc.,* the Court had previously held that unsecured creditors have no better right to the common fund than the debtor does, and since the debtor cannot invoke marshalling, neither should unsecured creditors.[21] Ultimately, the Court of Appeal found that there was no common debtor in *Allison,* so did not need to consider the unsecured creditor issue. However, the appellate body did not overturn the trial judgment, which remains the law in Ontario. It is worth noting that secured creditors may not necessarily have to hold claims of the same status. In *Bank of Nova Scotia v. Adriatic Developments Ltd.,* a judgment creditor with a registered judgment against real property was found to have a claim equal in nature to that of a conventional mortgagee of land.[22]

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[17] *Re Weatherwax* (1940), 22 CBR 96 (Ont. S.C.) at para 54.

[18] MacDougall, *supra* at note3 at pg. 102 citing, *Selco Salvage*, [1988] 2 Lloyd's Rep. 398 (Ch. D.). See also *Gribble v. Stearman & Kaplan, Inc.* 239 A. 2d 573 (Md. Ct. App. 1968).

[19] MacDougall, *supra* at note3 at pg. 102.

[20] *Williamson v Loonstra,* (1973), 34 D.L.R (3d) 275 at para. 12.

[21] *Bread Man, supra* at note 5.

[22] MacDougall, *supra* at note 3, at pg. 109 citing *Bank of Nova Scotia v. Adriatic Developments Ltd.* [1985] 2 W.W.R. 627 (B.C. S.C.) ["*Adriatic*"].

Bars to Marshalling

Marshalling is an equitable doctrine: if it is unjust or unfair to allow the junior creditor to marshal, then the court will not allow it. Consequently, equity will not enforce the doctrine if to do so would prejudice the rights of the senior creditor or a third party. Neither will the court support a request for marshalling that is not brought in a fair and timely fashion.

1. Cannot interfere or prejudice the position of the senior creditor

Marshalling will not be permitted if it would interfere with the superior right of a secured creditor to pursue its remedy against either of the two funds.[23] Marshalling does not rearrange priorities among creditors. The senior creditor retains the right to satisfy its claim out of whichever property it chooses: a superior claim remains a superior claim. This prohibition on prejudicing the senior creditor's position will generally affect the way the doctrine is implemented. As will be discussed below, to avoid prejudicing a senior creditor, the courts may allow a junior creditor to marshal by subrogation, rather than forcing a senior creditor to resort to a certain security against its will.

2. Cannot prejudice third parties

As stated in *Allison*, "[t]he doctrine is applicable unless some other equity prevents its application such as in the case where its application would prejudice third parties",[24] for example, bona fide purchasers and subsequent mortgagees.[25] These parties would not anticipate the risk of marshalling and should therefore be protected from it. Whether an unsecured creditor constitutes a third party for the purpose of barring the application of marshalling was considered in *Re Ledco*.[26]

In *Re Ledco*, the Toronto Dominion bank had a general security interest in the personal property of Ledco, as well as a valid charge against Ledco's real property in respect of the same debt. A numbered company related to Ledco had a second lien interest in Ledco's personal property. On bankruptcy, Ledco had obligations to its unionized employees for wages, vacation pay, pension contributions and severance. The union was concerned that, if the

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[23] *First Investors, supra* note 2 at para 20.

[24] *Supra* at note 9 at para 12.

[25] *Bread Man, supra* at note 5 at para 17. See also *St. George Credit Union Ltd. v. Zimmer*, [2004] 8 W.W.R. 548 (Sask. Q.B.) for a summary of the types of interests that have been recognized as prejudicial.

[26] *Re Ledco* (2008), 48 C.B.R. (5th) 74 (Ont. S.C.J.) ["*Ledco*"].

related company could employ the doctrine of marshalling to protect its secured interest, there would be nothing left to satisfy the claims of the unsecured employees. The trustee in bankruptcy asked the court whether the employees of a bankrupt company were the type of third parties who could not be prejudiced by the application of marshalling.

The court found that, in the absence of a statutory provision which would protect the employees' interests in the proceeds of sale of Ledco's property (this case being decided prior to the 2009 amendments to the *Bankruptcy and Insolvency Act* and the enactment of the *Wage Earner Protection Program Act*[27]), the employees as unsecured creditors had no greater claim to the property than the bankrupt.[28] It would not be inequitable to marshal in favour of the secured junior creditor. The court concluded unsecured creditors are not the type of third party to be shielded from the effects of marshalling.

3. Timeliness

Since the doctrine of marshalling will not be applied if it would prejudice the rights of third parties, until asserted the doctrine is vulnerable to defeat by subsequent liens or charges on property.[29] Therefore, to be effective, the right to marshal must be asserted in a timely fashion. A tardy junior creditor may lose the ability to adequately protect their secured interest.[30]

Implementation

Marshalling can be achieved in two ways. Either the courts will require the senior creditor to resort to the singly secured fund, or, the courts will allow the junior creditor to subrogate to the senior creditor's interest in that fund. In other words: marshalling by compulsion or marshalling by subrogation. In Canada, there is some debate as to whether a senior creditor can be compelled to resort to the singly secured fund, if interference with the senior creditor's right to pursue its remedy against either fund is in fact a bar to marshalling. In *First Investors Corp. Ltd v. Butler Engineering Ltd.*[31], the Alberta Court of Appeal overturned a decision of the lower court allowing a junior creditor to compel a secured creditor to purchase certain real property (at its appraised liquidation value) in order to satisfy the first mortgage

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[27] S.C. 2005, c. 47, s.1, as am.

[28] *Ledco, supra* at note 26 at para. 13.

[29] *Supra* note 3 at pg. 92.

[30] *Surrey Metro Saving Credit Union v Chestnut Hill Homes*, 1997 CarswellBC 153 (B.S.S.C.).

[31] *First Investors Corp. Ltd. v. Butler Engineering Ltd.* (1988) 47 D.L.R. (4th) 46 (Alta. C.A.).

debt as part of a marshaling remedy. The Alberta Court of Appeal found that the lower court had overlooked the important qualification to marshalling, namely that its application not prejudice the paramount right of the first mortgagee to pursue its remedies as it pleases.[32] That said, citing U.S. case law, the authors of *Falconbridge on Mortgages*, suggest there may be cases in which a court would be justified in interfering with the rights of the senior creditor to pursue its remedies, provided that there is no substantial delay, inconvenience or that it would not render the proceedings more onerous to the senior creditor.[33]

The more common approach to the implementation of the doctrine of marshalling is through subrogation. Essentially, if the senior creditor chooses to recover its debt from the doubly secured fund, the junior creditor is allowed to subrogate to the senior creditor's claim against the singly secured fund. One difficulty that arises from the use of subrogation as a model for implementation is that, as a technical matter, upon the discharge of the senior creditor's indebtedness, there may be nothing left for the junior creditor to be subrogated to. For example, in *Adriatic,* the British Columbia Superior Court did not allow the junior creditor to marshal because, among other reasons, it was too late for the junior creditor to subrogate to The Bank of Nova Scotia's claim against the singly secured property. The Court noted that as the bank's debt had been fully satisfied, it was obligated to discharge the mortgage on the singly secured property.[34] That said, it appears that other courts have not been particularly troubled by this technical issue and have recognized that implementation by subrogation is an appropriate remedy.[35]

<u>Applications of the Doctrine</u>

As noted above, historically, the doctrine of marshalling was applied to secured interests in real property.[36] However, more recently the doctrine has been expanded to cover

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[32] *Ibid.* at para. 16

[33] W.M. Traub (ed.), *Falconbridge on Mortgages*, 5th ed (Toronto: The Cartwright Group Ltd., 2003+).

[34] *Adriatic, supra* at note 22.

[35] For example, see *Bread Man supra* note 5 and *Fiatallis, supra* note 5.

[36] It should be noted that a form of marshalling is also applied in the administration of estates. In that context, what is called the "marshalling of assets" is employed to rank estate assets for payment of the debts of the estate. Marshalling of assets involves a complex set of rules used to determine how beneficiaries (whose assets are used to repay debts of the estate) will be recompensed from other property of the estate. "Marshalling of assets" is a distinct remedy that should not be confused with the form of marshalling discussed in this paper, that is the "marshalling of securities". For additional information on the use of marshalling in the estates context, see the Law Reform Commission of Saskatchewan's Discussion Paper on the Consolidation of Certain Rules and Statutory Provisions in The Administration of Estates Act, March 2005 at http://sklr.sasktelwebhosting.com/Administration%20of%20Estates.pdf.

debts secured by personal property, including security interests in property registered under provincial personal property security legislation. It is difficult to state with authority the absolute limits of the doctrine's application. As some commentators have observed, "(e)quity gives [the doctrine] its flexibility, adaptability and utility. Equity also gives it its uncertainty and lack of clear boundaries".[37]

1. Personal Property

It is firmly established that marshalling applies to security interests in personal property. There are numerous cases where creditors have marshaled interests in various goods and equipment.[38] However, with the advent of personal property security legislation, the issue of whether marshalling could co-exist with a strict statutory priority scheme was unclear.

In *National Bank of Canada v. Makin Metals*, the trial judge determined that marshalling was not available when priority was determined by the Saskatchewan *Personal Property Security Act*.[39] On appeal, the Saskatchewan Court of Appeal overturned the trial judge and stated in *obiter* that there is substantial Canadian authority that marshalling applies to personal property, and no reason why the doctrine could not be used to supplement the act, which is silent with respect to the doctrine.[40]

The position that marshalling should be available in the context of a personal property security act was advanced by Professor Bruce McDougall in his article "Marshalling and the Personal Property Security Acts: Doing Unto Others". Professor McDougall argued that, so long as no senior creditor was prejudiced, the doctrine would not upset the legislated scheme for regulating priorities.[41]

2. Bankruptcy

Bankruptcy legislation is specifically designed to facilitated the distribution of an insolvent party's assets fairly amongst its creditors in a certain priority. On bankruptcy, the assets of the debtor pass to and vest in the trustee, subject to the rights of any secured creditors. In *Re Bread Man* the court considered whether marshalling was available to junior

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[37] MacDougall, *supra* at note 3 at pg. 91; see also Harvey J. Kirsh, "The Equitable Doctrine of Marshalling in Construction Lien Actions" 39 C.L.R. (3d) 161 at pg. 162.

[38] For example, see *Bread Man supra* note 5 and *Fiatallis, supra* note 5.

[39] *National Bank of Canada v Makin Metals,* [1993] 106 Sask. R 266 (QB);

[40] *National Bank of Canada v Makin Metals*, [1994] 116 Sask. R 237 (CA), reversing [1993] 106 Sask. 266.

[41] MacDougall, *supra* at note3 at pg. 98.

creditors in the context of a bankruptcy.[42] The trustee in bankruptcy of the estate of Bread Man Inc. submitted that the rights of the secured creditors, preserved under the then *Bankruptcy Act*, were limited to the rights specifically provided for in that Act and therefore did not extend to permit the invocation of marshalling.[43]

In rejecting this argument, the court noted that the *Bankruptcy Act* specifically provides that it shall not be deemed to abrogate or supersede the substantive provisions of any other law or statute relating to property and civil rights unless those laws conflict with the act. Since nothing in the *Bankruptcy Act* conflicted with the right to marshal, the court concluded that the remedy was available. Today s.72(1) the *Bankruptcy and Insolvency Act* similarly states that the provisions of the act do not supersede or abrogate other laws.[44] Therefore it is fair to say that the doctrine of marshalling is available to junior creditors of a bankrupt, provided the conditions for marshalling are met. For example, although the Ontario Court of Appeal in *Allison* did not ultimately find that marshalling was warranted, the Court did not find the fact that the marshalling argument was raised in a bankruptcy context particularly troubling.

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[42] *Bread Man, supra* at note 5.

[43] *Bread Man, supra* at note 5 at para. 18.

[44] R.S.C. 1985, c B-3 at s.73(1).