



## JHK LEGAL

# Marshalling: protecting your position as a subordinate secured creditor where a debtor becomes insolvent.

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You're in the fortunate position of securing a debt with a registered mortgage over real property owned by your debtor. However, your mortgage is registered second in priority to that of a first registered mortgage in favour of another creditor. Your debtor becomes insolvent and the first mortgagee exercises its right of sale over the property against which your mortgage is registered. The proceeds of the sale pay a portion of the first mortgagee's secured debt, with no surplus to cover your secured debt in full or in part and leaving you unsecured.

Fortunately, the law of equity will intervene in applicable circumstances to reduce any prejudice to subordinate creditors, by virtue of the equitable doctrine of marshalling. The doctrine of marshalling may also be applied to liens, charges and other forms of security – for the purposes of this article, we will focus exclusively on the application of marshalling in the context of mortgages as a form of security.



### What is the equitable doctrine of 'Marshalling'?

Marshalling is a principle which may be relied on by a second registered security holder in certain circumstances for further protection. In circumstances where the principle applies, the second registered security holder is able to access the security held by the first registered security holder, with respect to another security interest, rather than lose its security altogether.

### Context within which the doctrine of marshalling will apply

The doctrine is best demonstrated with a working example, as follows:

- Parties and Properties:
  - **Debtor** is a common debtor of Entity A and Entity B.

- **Entity A** has a first ranking mortgage over two properties owned by Debtor: **Property A** and **Property B**.
- **Entity B** has a second ranking mortgage over **Property A**, only.
- Debtor becomes insolvent or is otherwise in default of an agreement with Entity A.
- Entity A decides to exercise its power of sale with respect to Property A, being the property the subject of a common interest between Entity A and Entity B.
- The proceeds of the sale of Property A do not discharge the debt owed by Debtor to Entity A, i.e. there is no equity in Property A.
- Accordingly, Entity B loses its security in Property A – what’s next for Entity B?

In this example, the law of equity will intervene to ensure Entity B is not prejudiced by a decision of Entity A to exercise its power of sale over the property of its choice. In applying the doctrine of marshalling, Entity B is subrogated to Entity A’s mortgage over Property B for enforcement purposes – Entity B, through the doctrine of marshalling, will take the security position of Entity A, the first ranking mortgage.

### Does the doctrine of marshalling apply?

In determining whether a subordinate secured creditor has a claim to the doctrine of marshaling, close consideration must be applied to the following:

1. In most circumstances, whether there is a common debtor between the first ranking secured creditor and the subordinate secured creditor (though, exceptions to this rule apply);
2. Where there is a legally binding agreement between the debtor and the first ranking secured creditor to sell the common property; the subordinate secured creditor’s right to marshal may be extinguished;
3. A secured debt must be owing to the subordinate secured creditor as at the time the common property is sold by the first ranking creditor.

### Recent case law: *Burness v Hill [2019] VSCA 94* (“*Hill*”)

The recent decision in *Hill* provides practical commentary on the considerations the Court will have with respect to a creditor’s claim to marshal securities.

#### Key Facts:

- A solicitor, Mr Hill, was representing Mr Love in a complex litigation matter;
- In order to secure payment of his legal fees with respect to the litigation matter, Mr Hill registered a second mortgage over Property A, owned by Mr Love
- The Commonwealth Bank of Australia (the “CBA”) already had a first mortgage registered over Property A, and first ranking mortgages registered over various other properties owned by Mr Love
- Mr Hill commenced legal proceedings in the County Court of Victoria against Mr Love and obtained Judgment by way of a clause in a Deed of Settlement providing Mr Love’s consent to Judgment.

- Mr Love was made bankrupt pursuant to a sequestration order and a Trustee was appointed to his bankrupt estate
- Mr Hill later commenced proceedings in the Supreme Court of Victoria for the purposes of evoking the marshalling doctrine and stand in the shoes of the CBA in order to discharge the debt owed by Mr Love to Mr Hill

### **The Supreme Court of Victoria (SCV) Decision:**

His Honour Sifris J. of the SCV held that Mr Hill was entitled to marshal the CBA's security with respect to property over which Mr Hill did not have security, thereby subrogating to the CBA's first ranking mortgage to the extent of the debt secured by Mr Hill's original, second ranking mortgage.

The property over which Mr. Hill did not hold security was sold by the CBA

### **The Position of the Trustee of the Bankrupt Estate of Love**

On appeal by the Trustee in the Court of Appeal, the Trustee contended that the marshalling doctrine could not be applied to the current factual scenario and made the following submissions:

- a. at the time of sale of the common property, the consent Judgment in favour of Hill had not been entered and therefore was not secured by the mortgage registered over the common property
- b. between the CBA and Mr Love, it had been agreed that the properties would be sold in a particular order; the common property was coincidentally the first to be sold pursuant to the agreement;
- c. the terms on which the County Court proceeding against Mr Love was settled extinguished Mr Hill from enforcing his right to marshal;
- d. Mr Hill's claim was estopped pursuant to the principles established in *Ashun*<sup>1</sup>.

### **The Court of Appeal (CoA) Decision:**

In reaching its final decision, the CoA considered the elements of the doctrine of marshalling, which provides that a creditor is entitled to marshalling where:

- "...(i) his debt is secured by a second mortgage over property ('the common property'),*
- (ii) The first mortgagee of the common property is also a creditor of the debtor,*
- (iii) The first mortgagee also has security for his debt in the form of another property ('the other property'),*
- (iv) the first mortgagee has been repaid from the proceeds of sale of the common property,*
- (v) the second mortgagee's debt remains unpaid, and*
- (vi) the proceeds of sale of the other property are not needed (at least in full) to repay the first mortgagee's debt.*

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<sup>1</sup> *Port of Melbourne Authority v Anshun Pty Ltd* [1981] HCA 45  
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*In such a case, the second mortgagee can look to the other property to satisfy the debt owed to him<sup>2</sup>.*

The CoA further held:

- a. securities with respect to fluctuating debts may be marshalled, even in circumstances where following the sale of the security property, the debt increases;
- b. the terms of settlement did not extinguish Mr Hill's right to marshal as the debt continued to exist
- c. the factual scenario need not establish that the first mortgagee's decision to sell the common property was *arbitrary* or *capricious* – that is, even in circumstances where there is perceived arrangement (which is non-binding) between the debtor and first mortgagee to sell the properties in a particular order, marshalling may still apply.  
(NB: For the sake of completeness, in the event there *is* a binding arrangement between the debtor and first mortgagee, a claim to marshal security will not be available to a subordinate secured creditor.)

### How can JHK Legal help?

The equitable doctrine of marshalling is an extremely useful tool for subordinate creditors when faced with the insolvency or otherwise default by a debtor. It is important that creditors are aware of the circumstances in which their ability to marshal securities may be extinguished and how to avoid this.

If you require further information with respect to the doctrine of marshalling, or if you are seeking tailored advice as to your current security position with respect to your debtor(s), please contact our office on 03 9927 3600 or by email at [melbourne@jhklegal.com.au](mailto:melbourne@jhklegal.com.au) to discuss how we may be able to assist you.

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<sup>2</sup> *National Crime Agency v Szepietowski* [2014] AC 338.

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