IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA

Richmond Division

In re EDWIN PAUL WILSON,	)	
	)	
Debtor,	)	
	)	
JOHN W. GUINEE, JR., TRUSTEE,	)	
	)	Bankruptcy No. 84-1415-A
Appellee,	)	Civil Action No. 88-0502-A
	)	
v.	)	
	)	
HERALD P. FAHRINGER and MARIAN S. ROSEN,	)	
	)	
Appellants.	)	

ORDER

This matter is before the Court on appeal from the Bankruptcy Court. For the reasons stated in the accompanying Memorandum Opinion, the judgment of the Bankruptcy Court is REVERSED, and the case is REMANDED with instructions to apply the doctrine of sale in the inverse order of alienation, and to allow the Appellants attorneys' fees and ten per cent interest as provided in the Travelers deed of trust.

Let the clerk send a copy of this Order to all counsel of record.

oct. 4, 1988
DATE

Richard L. Williams
UNITED STATES DISTRICT JUDGE

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HERALD P. FAHRINGER and MARIAN S. ROSEN,	)	
	)	
Appellants.	)	

MEMORANDUM OPINION

This matter is before the Court on appeal from the Bankruptcy Court. Appellants Fahringer and Rosen claim that the Bankruptcy Court should have applied the equitable doctrine of sale in inverse order of alienation or marshalling of assets to their claim for attorney's fees from the estate of the debtor, Edwin Wilson. Alternatively, they claim that they should be subrogated to the rights of Travelers Insurance Company, which held a deed of trust on the property in question.

I

In the 1970's, Wilson and his wife, Barbara, owned three farms, Bollingbrook, Maxwelton and Elmwood as tenants by the entirety. They executed a $1.8 million deed of trust against the three properties with Travelers in 1978. In December 1981, the Wilsons were divorced, thereby becoming tenants in common.

Barbara Wilson brought a partition suit in Fauquier County Circuit Court in 1982 (Complaint attached as Exhibit 1).

Around the same time, indictments began to be returned against Wilson, and he employed Fahringer and Rosen to defend him. Wilson was convicted in Virginia in 1982, and again in Texas on February 4, 1983; the fees he had contracted to pay Fahringer and Rosen were largely unpaid. On February 5, 1983, anticipating that fees might reach $1 million, Wilson executed a warranty deed conveying his interest in Bollingbrook to Fahringer and Rosen, which was recorded on February 9 (attached as Exhibit 2). At the same time, Fahringer and Rosen each executed another agreement with Wilson in which they promised to release title to Bollingbrook once their fees were paid, but retained the right to sell Bollingbrook to satisfy their claims, if necessary, and return the surplus to Wilson (attached as Exhibits 3 and 4). A week later, on February 17, 1983, the IRS recorded a $23 million tax lien on all three farms.

In August 1983, Barbara Wilson had Fahringer and Rosen substituted for her former husband as parties in the partition suit. This was Fahringer and Rosen's first actual knowledge of either the Travelers or the IRS lien. In November, 1983, the U.S. intervened to protect its tax lien interest.

At this point, the Bankruptcy Court still had not come into the picture. In March, 1984, the commissioner in chancery declared, among other things, that Fahringer and Rosen owned Bollingbrook in fee as tenants in common with Barbara Wilson.

The Circuit Court approved that report in May, and stated that lien creditors need not be parties to the partition suit because their interests could not be prejudiced (order attached as Exhibit 5).

On September 28, 1984, there were still no buyers for any of the property, and the Circuit Court ordered all three farms to be sold at public auction on October 2, 1984, denying a special commissioner's motion to sell Bollingbrook alone. The Court there explicitly reserved its ruling on how to prorate the sales proceeds among the various creditors, encouraging the parties to reach some agreement.

In the last week of September, 1984, Rose Marie Bogley contacted the special commissioners about purchasing Bollingbrook, and a sale agreement under which Bogley would purchase Bollingbrook for $2.1 million was entered into on October 1 and approved by the Circuit Court at 8:45 a.m. on October 2, the day the sales were to take place. At 10:00 a.m. the same day, the Circuit Court learned of Wilson's petition for bankruptcy, and the sales were stayed. This was the first notice to any party of the bankruptcy proceeding.

On March 7, 1985, the Trustee filed an adversary proceeding in the Bankruptcy Court to enjoin Fahringer and Rosen from taking any of the sales proceeds, and on March 12 that Court issued a TRO restraining Fahringer and Rosen from seeking a non-bankruptcy determination of the proration issue. The Circuit Court, on March 15, allowed Travelers to satisfy its entire lien from the

Bollingbrook proceeds (the Bankruptcy Court modified the automatic stay to allow the Bollingbrook sale to close), and Bogley took the property free of any liens, which attached to the proceeds. A copy of the Circuit Court's decree ratifying the sale is attached as Exhibit 6. After Travelers satisfied its lien in full from the Bollingbrook proceeds, Barbara Wilson took half of the remainder and Fahringer and Rosen split the other half. Travelers, Fahringer and Rosen agreed to disgorge the funds if a later court order required it.

On May 10, 1985, the Bankruptcy Court refused to apply the equitable principles that are the subject of the appeal. Fahringer and Rosen appealed at that time, but the District Court dismissed it for lack of a final judgment on August 7, 1985. Stipulations were approved August 6, 1987, and the Bankruptcy Court granted a joint motion for Entry of Final Order. This appeal followed. In the meantime, in December of 1986, Maxwelton and Elmwood were sold with a fourth farm in a package deal for $5.2 million, and the liens again attached to the proceeds.

II

1. Fahringer and Rosen's Interest in Bollingbrook

The Fauquier County Circuit Court determined, ten months before the Bankrupcty Court enjoined Fahringer and Rosen from pursuing the proration issue, that Fahringer and Rosen are fee simple owners of Bollingbrook as tenants in common with Barbara

Wilson. Review of this judgment in the Bankruptcy Court is precluded by collateral estoppel.

Collateral estoppel precludes relitigation of an issue that was raised and litigated in a prior proceeding and necessary to the outcome. In re Pigge, 539 F.2d 369, 373 (4th Cir. 1976); In re Daves, 72 B.R. 943, 945 (Bkrtcy. E.D. Va. 1987). The Circuit Court's conclusion that Fahringer and Rosen hold a fee simple as tenants in common with Barbara Wilson meets these requirements.

The issue of ownership was raised in the hearings before the commissioner in chancery, and in his report the commissioner made an explicit finding that Fahringer, Rosen and Barbara Wilson were fee simple tenants in common, and further that Edwin Wilson had no remaining interest in Bollingbrook. No objections were filed to that report by any party, nor did any party appeal the Circuit Court's May, 1984 ratification of those findings. Despite a full and fair opportunity to litigate the issue of ownership, neither the trustee nor the United States (which had intervened before the commissioner's report was filed) made any effort to do so.

Moreover, the Circuit Court necessarily had to determine ownership of the property to resolve the partition suit. Virginia Code §8.01-81 specifies that only certain parties may compel or be compelled to partition, and the Circuit Court had to determine that all necessary parties were properly before the court.

The trustee nevertheless complains that collateral estoppel cannot apply because the Circuit Court never decided what effect

perfection of the IRS lien had on Fahringer and Rosen's interest. The trustee also insists that even if the Circuit Court had reached the issue, its determination could not have been conclusive because the priority of federal tax liens is ultimately a decision for the federal courts. See United States v. Acri, 348 U.S. 211, 213 (1955); W.T. Jones and Company v. Foodco Realty Co., 318 F.2d 881, 886-87 (4th Cir. 1963). If Fahringer and Rosen hold a fee simple interest, then their claim for attorney's fees supersedes the tax lien, see 26 U.S.C. §6323(a); but if they held only a security interest, the IRS lien takes priority as of the date it was recorded because of the well-settled rule that tax liens take priority over inchoate liens. See, e.g., United States v. Equitable Life Assurance Agency, 384 U.S. 323 (1966). Thus, the trustee seems to argue that collateral estoppel cannot apply because the issue of ownership, explicitly decided by the Circuit Court, controls the priority issue that was not (and perhaps could not have been) litigated.

The Circuit Court's determination of title admittedly resolves the lien priority issue by vesting title in holders who may not be subject to the lien, but that is no reason to deny full faith and credit to the state court determination. For collateral estoppel to bar an issue from consideration, the prior proceeding need not have resolved every subsequent issue that might be affected; the litigation and decision of the ownership

question is sufficient to preclude its reconsideration in federal court.[1]

2. Sale in Inverse Order of Alienation

Fahringer and Rosen first claim that the Bankruptcy Court should have applied the doctrine of sale in inverse order of alienation. That doctrine provides that where a debtor conveys property subject to a lien, the lienor shall satisfy its lien out of property retained by the debtor, and if those funds are insufficient the lienor must resort to the most recently conveyed parcels first. Fidelity and Casualty Co. v. Massachusetts Mutual Life Insurance Co., 74 F.2d 881 (4th Cir. 1935); O'Quinn v. Hazel Land Corporation, 131 Va. 253, 108 S.E. 643 (1921). The doctrine recognizes that purchasers who do not assume the lien have a right to expect the debtor to pay the encumbrance, and that later purchasers can protect themselves better than early purchasers.

Fahringer and Rosen concede the seniority of Travelers' lien, but argue that they did not assume the lien and that the

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[1]This conclusion raises a jurisdictional issue. Because Bollingbrook is owned entirely by Fahringer, Rosen and Barbara Wilson, it is not part of the debtor's estate. Even so, 28 U.S.C. §1334 confers broad jurisdiction on the bankruptcy courts to hear all cases in which "'the outcome . . . in any way impacts upon the handling and administration of the bankrupt estate.'" In re Majestic Energy Corp., 835 F.2d 87, 90 (5th Cir. 1988) (quoting Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3rd Cir. 1984). Bankruptcy courts may hear all "core" proceedings under 28 U.S.C. §157, which are "those that intimately involve the debtor-creditor relationship . . . or those that must be resolved in order to administer the estate." In re Mesa Intercontinental, inc., 79 B.R. 669, 671 (Bkrtcy. S.D. Tex. 1987). Had the Bankruptcy Court granted relief to Fahringer and Rosen, it would have forced Travelers to satisfy part of its lien from Maxwelton and Elmwood, which are clearly part of the debtor's estate.

doctrine requires Travelers first to satisfy its lien out of the proceeds of Maxwelton and Elmwood, in which Edwin Wilson retains a one-half fee interest. Although the doctrine "does not apply when there is evidence of an intent that the doctrine should not be invoked," In re Dan Hixson Chevrolet Co., 20 B.R. 108, 111 (Bkrtcy. N.D. Tex. 1982), here Edwin Wilson conveyed his fee interest to Fahringer and Rosen by general warranty deed. A general warranty covenants that the grantees take free of encumbrances and that the grantor remains responsible for their satisfaction, clearly indicating an intent that any senior lienholders must pursue property retained by Wilson before turning to Fahringer and Rosen, who stand merely as sureties. Cf. In re Boswell Land and Live-Stock, Inc., 86 B.R. 665 (D. Utah 1988); 12B Michie's Juris. Marshalling of Assets §8 (1987). The trustee suggests that because Fahringer and Rosen had constructive knowledge of the lien, the parties intended that Bollingbrook remain available for satisfaction of Travelers' lien. But constructive knowledge is no bar to application of the inverse order doctrine, as countless courts have applied the doctrine even where, unlike Fahringer and Rosen, the grantee had actual knowledge of the encumbrance. See Annot., 131 A.L.R. 4 (1941).

The trustee raises several other objections, most grounded in the corollary that inverse order of alienation will not be applied where it would prejudice the interests of the senior lienholder or third parties. First, the trustee insists that

when the Bankruptcy Court refused to apply the doctrines, purchasers for Maxwelton and Elmwood were nowhere in sight, and even if the property were sold Travelers would be forced to litigate with the trustee as to whether the automatic stay should be lifted. Whatever the state of affairs when the Bankruptcy Court made its decision, there is now absolutely no prejudice to Travelers in applying the doctrine. One-half of Maxwelton and Elmwood are owned by Barbara Wilson, and are not subject to the trustee's control because they are not part of the bankrupt's estate. Therefore, since Barbara Wilson is fully liable on the Travelers note, Travelers can claim half of the proceeds from each of the three farms without even notifying the trustee, much less litigating the issue. Even if the trustee did control those funds, and to the extent they are insufficient to satisfy Travelers' lien, there is still no necessity to litigate: all the parties agree that Travelers holds the paramount lien and must be satisfied before any other creditor. Although the sale of Maxwelton and Elmwood may once have been uncertain, the properties have now been sold, and all that remains is a paper transaction to divide the proceeds. Essentially, there is one large pool of proceeds, and the only remaining issue is the simple one of whether to divide it so that all are paid or so that Fahringer and Rosen are excluded. (The IRS and the unsecured creditors may be shortchanged, but their interests are clearly subordinate to Fahringer and Rosen's). Since the pie can be cut in a way that protects more interests without prejudice to

Travelers, inverse order of alienation is the fairest way of dividing the funds.

The trustee also argues that the doctrine would prejudice Barbara Wilson: "At the time of the bankruptcy court's decision it was apparent that such a sale [of Maxwelton and Elmwood] might not occur for months or years. Nevertheless, half of the interest that accrued until such a sale would have been chargeable" against Barbara Wilson's interest in the properties and against her personally. Appellee's Br. at 17. As noted, however, the properties have now been sold, and the state of affairs at the time of the earlier decision is irrelevant. Requiring Travelers to disgorge part of the Bollingbrook proceeds in exchange for Maxwelton and/or Elmwood proceeds will not prejudice Barbara Wilson. Even if it would, she is not a third party; because she was not merely a surety or guarantor but principally liable on the Travelers note, she stands in the debtor's shoes. The admonition that the doctrine should not apply to third parties' detriment obviously does not include prejudice to the debtor; the very purpose of the doctrine is to force the debtor to pay his or her own obligations without resorting to property conveyed away by warranty deed.

The trustee's other arguments also lack merit. The trustee insists Fahringer and Rosen waived their right to complain about the distribution of Bollingbrook proceeds by not seeking to delay the sale in the Fauquier County Circuit Court. The Circuit Court, however, explicitly reserved its ruling on distribution of

proceeds, and before it ruled the Bankruptcy Court forbade Fahringer and Rosen from pressing their position in the state forum. The trustee also argues that the doctrine is designed to protect junior creditors from "arbitrary" action by the senior lienholder, and that Travelers' action was not arbitrary because it was authorized by paragraph 22 of the deed of trust. Even if the doctrine is so limited, that criterion is satisfied because Travelers had no contractual right to satisfy its lien out of one property. Paragraph 22 merely provides that if the debtor conveys any of the property, the note shall immediately become due and payable. Travelers therefore has a right to require the Wilsons to pay the full balance of the note, but no contractual right to dictate the source from which the Wilsons pay that obligation.

For these reasons, the Court finds that sale in inverse order of alienation would permit both Travelers and Fahringer and Rosen to satisfy their claims without significant prejudice to Travelers or any other party. To the extent the Internal Revenue Service or unsecured creditors are prejudiced by having less money available, that prejudice is irrelevant because those interests are subordinate to Travelers' and Fahringer and Rosen's.

3. Marshalling of Assets

The doctrine of marshalling provides that where a senior lienholder has two or more funds available to satisfy a lien, and a junior creditor has access to only one of the funds, the senior

lienholder must first resort to the fund that the junior creditor cannot reach. Meyer v. United States, 375 U.S. 233, 236 (1963); In re Frank Meador Buick, 31 B.R. 28, 29-30 (Bkrtcy. W.D. Va. 1983); Hudson v. Dismukes, 77 Va. 242, 248 (1883). The requirements and remedies under marshalling closely parallel those of sale in inverse order of alienation. The only significant difference is that marshalling is applied when the junior interest is a lien or other security interest, and inverse order is applied when the junior interest is a fee. Because this Court is bound by the county court's determination that Fahringer and Rosen hold a fee, sale in inverse order of alienation is the more appropriate doctrine.

4. Subrogation

Fahringer and Rosen also argue that the Bankruptcy Court's order permitting Travelers to satisfy its entire lien from the Bollingbrook proceeds effectively compelled them to pay part of Wilson's debt, and that therefore they should be subrogated to Travelers' rights against Wilson. The Court's ruling on sale in inverse order of alienation will prevent Fahringer and Rosen from having to resort to subrogation, but because the issue affects the amount of their claim the Court reaches the issue and concludes that Fahringer and Rosen are also entitled to subrogation.

Subrogation is recognized in both Virginia law and the Bankruptcy Code. See Gill v. Rollins Protective Services, 773 F.2d 592, 598 (4th Cir. 1985); 11 U.S.C. §509. Section 509

permits subrogation of anyone "liable with the debtor on, or that has secured, a claim of a creditor against the debtor." The trustee argues that this language limits the right to codebtors: sureties, guarantors, and those primarily liable with the debtor. The state law right, of course, "is broad enough to cover all cases in which one person pays an obligation which in justice and good conscience should have been paid by another." 18 Michie's Juris. Subrogation §4 (1985); see Federal Land Bank v. Joynes, 179 Va. 394, 402, 18 S.E.2d 917 (1942); 73 Am.Jur.2d Subrogation §5 (1974). In particular, purchasers of encumbered property who do not assume the lien stand in much the same position as a surety, and are entitled to subrogation. Armentrout v. Gibbons, 71 Va. (30 Gratt.) 632 (1878).

The trustee offers no authority that §509 has ever been interpreted more restrictively, and the Court concludes that subrogation is appropriate under the Bankruptcy Code. See In the Matter of Bugos, 760 F.2d 731, 734 (7th Cir. 1985) (Section 509 permits subrogation, but state law determines the nature and extent of the right). The Bankruptcy Court compelled Fahringer and Rosen to give up part of their fee interest in Bollingbrook to pay Edwin Wilson's debt. The merely formal objection that Fahringer and Rosen are not technically sureties does not deprive them of the right to subrogation in pursuing reimbursement.

5. The Amount of Fahringer and Rosen's Claim

Finally, even if Fahringer and Rosen are subrogated to Travelers' rights, the parties dispute the amount of the claim.

Fahringer and Rosen argue that they are entitled to all fees incurred to date, plus interest and attorneys' fees for collection efforts as provided in the Travelers deed of trust. The trustee insists that Fahringer and Rosen are not entitled to interest and that the recording of the federal tax lien cut off the growth of their claim.

A party who is subrogated to a creditor's claim is entitled to all the creditor's rights and remedies. Reynolds Metal Co. v. Smith, 218 Va. 881, 241 S.E.2d 794 (1978). Fahringer and Rosen therefore claim the attorneys' fees and 10% interest provided for in the deed of trust. The trustee argues that Wilson never agreed to pay interest on his fees and that attorneys cannot ethically charge interest absent an explicit agreement with the client. Section 502(b)(1) of the Bankruptcy Code disallows claims unenforceable under applicable law. However, §506(b) allows an oversecured creditor like Fahringer and Rosen to recover interest and attorneys' fees in addition to claims allowed under §502, and §506(b) applies notwithstanding contrary state law. Unsecured Creditors Committee v. Walter E. Heller & Co. Southeast, Inc., 768 F.2d 580 (4th Cir. 1985).

As to attorneys' fees, the trustee argues that subrogees under §509(a) are entitled to subrogation "only to the extent of . . . payment." Again, the Court concludes that §509(a) is not more restrictive than common law subrogation principles, and that Fahringer and Rosen stand in Travelers' shoes, entitled to all of its rights under the deed of trust. The last phrase of §509(a)

merely codifies the common law rule that a subrogee need not pay the full amount of the encumbrance to claim a right of subrogation.

The trustee also complains that Fahringer and Rosen's claim, which he argues was no more than an inchoate lien with respect to unperformed services, was cut off by perfection of the federal tax lien. As discussed supra, the tax lien would have had this effect if Fahringer and Rosen did not hold a fee simple interest in Bollingbrook, but the Court is bound by the state court determination on that issue. The trustee apparently concedes that a federal tax lien cannot apply to a fee conveyed before the tax lien was recorded. For the reasons discussed supra, therefore, the Court holds that perfection of the lien did not stop the growth of Fahringer's and Rosen's claim.

The judgment of the Bankruptcy Court is REVERSED, and the case is REMANDED with instructions to apply the doctrine of sale in inverse order of alienation and to allow Fahringer and Rosen attorneys' fees and 10% interest as provided in the Travelers deed of trust.

oct. 4, 1988
DATE

Richard C. Williams
UNITED STATES DISTRICT JUDGE