UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

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| IN RE:<br>SUZANNE M. WALSH and<br>JOHN S. WALSH,<br>Debtors. | BK. NO. 90-20494<br>BK. NO. 90-20621 |
| ROBERT S. COOPER, Trustee,<br>Plaintiff,<br>vs.<br>EVELYN C. WALSH,<br>Defendant. | AP NO. 92-2024<br>AP NO. 92-2031 |

DECISION AND ORDER

In the above case, the Court amends its prior Decision of December 21, 1992 on page 16, first paragraph, line seven, to read Rule 3002(c)(6) instead of Rule 3003(c)(6).

IT IS SO ORDERED.

/S/

JOHN C. NINFO, II
UNITED STATES BANKRUPTCY JUDGE

Dated: February 12, 1993

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

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| IN RE: SUZANNE M. WALSH and JOHN S. WALSH, Debtors. | BK. NO. 90-20494<br>BK. NO. 90-20621 |
| ROBERT S. COOPER, Trustee, Plaintiff, vs. EVELYN C. WALSH, Defendant. | AP NO. 92-2024<br>AP NO. 92-2031 |

## DECISION AND ORDER

## BACKGROUND

On March 28, 1990 an Involuntary Petition for Relief under Chapter 7 was filed against the debtor, John S. Walsh ("John Walsh"), and on April 25, 1990 a Chapter 7 Order for Relief was entered. On March 14, 1990 an Involuntary Petition for Relief Under Chapter 7 was filed against the debtor, Suzanne M. Walsh ("Suzanne Walsh"), and on April 12, 1990 a Chapter 7 Order for Relief was entered. Thereafter the same Trustee (the "Trustee") was appointed to administer the separate estates of John Walsh and Suzanne Walsh who are husband and wife.

On their Schedules each of the debtors listed their ownership, as tenants by the entirety, of a residence at 8261 Hemlock Road, Bath,

New York ("Hemlock Road"), and a commercial property located on Route 53 in Bath, New York (the "Commercial Property"). The Schedules indicated that Evelyn C. Walsh ("Evelyn Walsh"), the mother of John Walsh, was the holder of a $110,000 note and mortgage on Hemlock Road (the "Evelyn Walsh Mortgage") and that Norstar Bank ("Norstar") was the holder of a note and mortgage on the Commercial Property (the "Norstar Mortgage") with a balance due of $63,070.20. Neither of the Debtors claimed a homestead exemption with respect to Hemlock Road, but they did claim available alternative personal property cash exemptions.

By motions dated September 12, 1990 and returnable September 28, 1990 the Trustee sought authority to sell the Commercial Property for $108,000. The motions specifically stated that the Commercial Property had previously been appraised for $102,000 and that after the payment of the approximately $66,500 then due Norstar there would be approximately $40,500 available to be split equally between the estates of John Walsh and Suzanne Walsh. Notices of the Trustee's motions were mailed on September 14, 1990 to all parties set forth on the Court's official matrices. The Court's files indicate that at that time Evelyn Walsh was set forth as a creditor on the Court's official matrices for each Debtor's case. No pleadings were interposed and no appearance was made by or on behalf of Evelyn Walsh in connection with the Trustee's motions to sell the Commercial Property. Thereafter, on October 4, 1990 an Order was entered approving the sale of the Commercial Property as proposed by the Trustee which provided for a sale free and clear of liens with liens to attach to the pro-

ceeds. As part of the closing of the sale a discharge of the Norstar Mortgage which was in the original principal amount of $100,000 was received from Norstar in exchange for the approximately $66,500 it claimed was then due on the mortgage. The net proceeds of the sale continue to be held by the Trustee.

On September 19, 1990, prior to the sale of the Commercial Property, a secured claim in the amount of $110,000 was filed on behalf of Evelyn Walsh in the John Walsh Chapter 7 case by her attorney. The only security listed on the secured claim was "a mortgage on the Debtor's house, barn, outbuildings and 110-acre farm at 8261 Hemlock Hill Road, Wheeler, New York" (Hemlock Road). No amended or additional claim was filed by or on behalf of Evelyn Walsh prior to April 29, 1992, the last day set by Court Order for filing claims in the John Walsh Chapter 7 case. Furthermore, the Court's files indicate that no claim was filed by or on behalf of Evelyn Walsh in either the Suzanne Walsh Chapter 7 case, where the time to file claims expired on April 29, 1991, or in the John Walsh Sales, Inc. Chapter 7 case where the time to file claims expired on February 28, 1991.

In March 1992 the Trustee commenced adversary proceedings against Evelyn Walsh to avoid the Evelyn Walsh Mortgage as preferential. The Trustee's complaints alleged that the Evelyn Walsh Mortgage was executed by John Walsh on February 17, 1989, but was not recorded with the Steuben County Clerk's office until October 13, 1989, which was within one year of the filing of the respective involuntary petitions. (Since Suzanne Walsh never executed the Evelyn Walsh Mortgage, the

Court believes the Trustee commenced the Adversary Proceeding in the Suzanne Walsh case only to ensure that there is no future assertion of any kind that the Evelyn Walsh Mortgage covers the ownership interest of Suzanne Walsh in Hemlock Road.) The Evelyn Walsh Mortgage entered into between John Walsh, as mortgagor, and Evelyn Walsh, as mortgagee, states that "this mortgage is made to secure a debt of the Mortgagor to the Mortgagee for $110,000. This debt is comprised of $50,000 of loans and $60,000 of indemnification liability on loan guarantees and security for loans to the Mortgagor."

An Answer was interposed on behalf of Evelyn Walsh in each of the adversary proceedings denying that the recording of the Evelyn Walsh Mortgage on October 13, 1989 was a preferential transfer and, for the first time in the administration of the John and Suzanne Walsh cases, asserting that she had the right to the proceeds of the sale of the Commercial Property which the Trustee is holding. Evelyn Walsh asserts that in October 1989 after Norstar realized on approximately $60,000 of collateral which she had pledged to it as a co-guarantor with the Debtors of certain of the obligations of John Walsh Sales, Inc., she became subrogated to the rights of Norstar against the Debtors, including its rights under the Norstar Mortgage. It appears from documentation submitted on her behalf that Evelyn Walsh pledged to Norstar a $40,000 certificate of deposit on February 28, 1989 and a $20,000 certificate of deposit on March 20, 1989, in each case as collateral for her limited guarantees of the obligations of John Walsh Sales, Inc. It also appears that on January 30, 1986 Suzanne Walsh

had executed and delivered a $100,000 limited guarantee to Norstar in connection with the obligations of John Walsh Sales, Inc. and that on June 20, 1985 John Walsh had executed a $20,000 limited guaranty in favor of Norstar and on April 20, 1977 had executed a $25,000 limited guaranty in favor of Norstar, in each case in connection with the obligations of John Walsh Sales, Inc. In addition, it appears that on January 30, 1986 John S. Walsh and Suzanne Walsh executed the Norstar Mortgage in favor of Norstar securing any and all of their debt to Norstar, direct or contingent. A letter dated July 9, 1990 from Norstar to the attorney for the Debtors, attached as an exhibit to the response of Evelyn Walsh to the Trustee's motion for summary judgment and in support of her cross motion for summary judgment, appears to indicate that the October 18, 1989 application by Norstar of the certificates of deposit pledged by Evelyn Walsh resulted in at least one loan of John Walsh Sales, Inc. being paid in full.

After a May 29, 1992 pre-trial conference, these cases were assigned to the Court's trial calendar on July 27, 1992. On July 27, 1992 the Trustee brought a motion for summary judgment in each of the adversary proceedings. Responses to the motions for summary judgment were interposed on behalf of Evelyn Walsh and on her behalf cross-motions for summary judgment were made to dismiss the Trustee's complaint and for the Court to determine that, as a subrogee of Norstar, Evelyn Walsh was entitled to the proceeds from the sale of the Commercial Property and that she could either offset these amounts against the Trustee's claim, if upheld, that her mortgage on Hemlock Road was

avoidable as preferential or, in the alternative, that the Trustee pay over to her, as a subrogee, these proceeds.

Thereafter there were several oral arguments before the Court and submissions made by the parties.

The Court finds that there are material issues of fact to be determined in connection with whether the Debtor John Walsh was insolvent on October 13, 1989 when the Evelyn Walsh mortgage was recorded, and therefore denies the Trustee's motion for summary judgment. As to the motions for summary judgment on the counterclaims of Evelyn Walsh that as a subrogee she has a right to all or a portion of the proceeds of the sale of the Commercial Property which the Trustee is holding, the Court denies her motions for summary judgment and dismisses her counterclaims on the merits.

From the facts and circumstances of this case, the Court declines to exercise its equitable discretion under Section 509 or otherwise to find that Evelyn Walsh has the right to all or any part of the funds on hand with the Trustee from the sale of the Commercial Property, and finds that any subrogation rights that she may have had were waived or barred by the Doctrine of Equitable Laches and her failure to file a claim for such rights or asserting them in connection with the sale of the Commercial Property.

**DISCUSSION**

Evelyn Walsh asserts that she has a right to the monies the Trustee is holding from the sale of the Commercial Property by reason of subrogation based either on the general equitable doctrine of legal subrogation or the provisions of 11 U.S.C. §509.[1]

New York Jurisprudence provides an overview of the equitable doctrine of legal subrogation.

> Legal subrogation . . . is founded on the facts and circumstances of each particular case and the principles of natural justice. It is a doctrine . . . based upon equitable principles, designed to further justice, and to prevent unjust enrichment. The doctrine of subrogation applies where it is equitable that a person furnishing money to pay a debt should be substituted for the creditor, or in place of the creditor, and it must be administered in such a manner as to accomplish what is just and fair between the parties. It has been adopted by equity to compel the ultimate discharge of an obligation by the person who in justice, equity, and good conscience ought to pay it. Although not a matter of strict right, subrogation is a highly favored remedy, and the courts are inclined to extend, rather than restrict, its application, but it will not be extended beyond the requirements of equity and justice.

23 N.Y. Jur. 2d Contribution, Indemnity and Subrogation § 25-44 (1982).

Section 509 of the Bankruptcy Code[2] on the other hand recognizes

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[1]The Court in In re Spirtos, 103 B.R. 240 (Bankr. C.D.Cal. 1989) found that Section 509 is not the only source of a right to subrogation in bankruptcy cases but that the general principle of equitable subrogation also is applicable.

[2]§ 509. Claims of codebtors.
(a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has

and codifies the equitable principle of subrogation in certain circumstances. However, Section 509 must be read together with the other provisions and in concert with the underlying policies of the Bankruptcy Code to ensure that on the facts and circumstances of any given bankruptcy case overall equity and justice is accomplished.

Courts have generally held that to be subrogated to the rights of a creditor, even under Section 509, a potential subrogee must satisfy five criteria, as follows:

> 1) Payment must have been made by the subrogee to protect his own interest.
>
> 2) The subrogee must not have acted as a volunteer.
>
> 3) The debt paid must be one for which the subrogee was not primarily liable.

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secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.

(b) Such entity is not subrogated to the rights of such creditor to the extent that --

(1) a claim of such entity for reimbursement or contribution on account of such payment of such creditor's claim is --

(A) allowed under section 502 of this title;

(B) disallowed other than under section 502(e) of this title; or

(C) subordinated under section 510 of this title; or

(2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.

(c) The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.

4) The entire debt must have been paid.

5) Subrogation must not work any injustice to the rights of others.

In re Trasks' Charolais, 84 B.R. 646, 648 (Bankr. D.S.D. 1988). However, "[s]ubrogation is a consequence which equity attaches to certain conditions. It is not an absolute right but one which depends on the equities and attending facts and circumstances of each case." 73 Am. Jur. 2d Subrogation §11 (1974). The Court must therefore consider the facts and circumstances of this case to determine if Evelyn Walsh is a subrogee in the bankruptcy case.

**A. SUBROGATION UNDER 11 U.S.C. 509**

Generally, when one co-guarantor pays the obligation of the primary obligor, that co-guarantor becomes subrogated to the rights of the creditor against the principal and, as between co-guarantors, in an appropriate case may become subrogated to the rights of the creditor against the other co-guarantor, but only to the extent of their proportionate share. See United States v. Ryder, 110 U.S. 729, 733, 28 L.Ed. 308, 309, 4 S.Ct. 196 (1884). However, co-guarantors could specifically agree that there would be greater or no subrogation rights between them.

Even if Section 509(a) in appropriate circumstances were found to provide a right of subrogation to the extent of a proportionate share among co-guarantors when one co-guarantor, which has secured its guarantee, goes bankrupt after another co-guarantor has paid the guaran-

teed debt, on the facts and circumstances of this case the Court will not exercise its equitable discretion in favor of Evelyn Walsh. Allowing such subrogation in this case would be inequitable in that it would work an injustice to the rights of others, thus not satisfying the fifth criteria set down in Trasks' Charolais and in addition, any such right has been waived. 84 B.R. at 648

**B. THE EQUITABLE DOCTRINE OF SUBROGATION**

1. **Waiver.** In a bankruptcy case when considering whether to find that a claim of equitable subrogation should be recognized, and when reading Section 509 together with the other provisions and in concert with the underlying policies of the Bankruptcy Code, one can only conclude that it is expected and required that an entity which claims such subrogation rights will come forward at the earliest possible time and advise the Court and other parties to the proceeding of the claimed subrogation rights. This is especially true when these claimed rights are the result of a pre-petition payment by a co-guarantor of the obligation of a non-debtor primary obligor and are being asserted against a bankrupt co-guarantor. Requiring the claimant to assert such rights is necessary to ensure that: (1) such claimed subrogation rights are finally determined by the Court; (2) the bankruptcy estate can be administered in an orderly manner; and (3) other parties in interest receive notice and full disclosure of the claimed subrogation rights and related remedies, and therefore are in a position to properly prosecute and fully participate in the case.

In this case the facts giving rise to the claimed subrogation rights all occurred prior to the filing of the respective bankruptcy petitions. It is clear from the actions of Norstar when it provided a discharge of its mortgage upon the sale of the Commercial Property that Evelyn Walsh had not taken any steps with Norstar pre or post-petition to ensure that any subrogation rights which she might have had were protected and not waived by Norstar. It is also clear that even upon receiving the notices of the sale of the Commercial Property Evelyn Walsh did not take any actions with Norstar, the Trustee or the Bankruptcy Court to ensure that: (1) any subrogation rights she claimed were fully determined (was there a right to full subrogation or only a proportionate share and should the rights be subordinated under Section 510) and if allowed (after a balance of all the equities) were enforced; and (2) that the Trustee and other parties in interest could evaluate the propriety of the sale in view of any such claimed rights and their determination.

In this case there was a sale of the Commercial Property free and clear of liens with liens to attach to the proceeds. Based on the schedules filed by the Debtors, the proof of claim filed by Evelyn Walsh and the representation by Norstar of the amount due on the mortgage, none of which indicated the existence of any subrogation rights, the Trustee completed the sale and obtained a complete discharge of the Norstar Mortgage for a stated amount of the proceeds of sale to which the Norstar mortgage lien attached pursuant to the Court Order. When Norstar delivered the mortgage discharge in these circum-

stances, where the sale was on notice to Evelyn Walsh and she took no actions to preserve whatever subrogation rights she otherwise might have had, she waived such rights, and the delivery of the discharge by Norstar was fully effective in law and in equity to terminate any further rights in the proceeds that Evelyn Walsh may have had by reason of subrogation or otherwise.

This Court is aware that most often commercial lenders who hold multiple guaranties and pledges are focused on their own rights and remedies and the collection of their obligations and are seldom concerned with the rights of subrogation which may be available to co-obligors. The Court is also aware that this is an area often overlooked and misunderstood by co-obligors and their counsel. Nevertheless, this Court believes that parties who elect to become involved in sophisticated commercial transactions must be held to reasonable commercial standards, when as creditors, they become involved in bankruptcy cases and are represented by counsel. In such a case they are expected to fully exercise their rights and remedies in a timely fashion with disclosure, either through the proof of claim process or in connection with specific proceedings, so that the requirements and underlying policies of the Bankruptcy Code and the bankruptcy system can be fulfilled. Having been put on notice of the Trustee's sale, Evelyn Walsh had the opportunity and obligation to ensure that any subrogation rights she might have were not waived by the completion of the sale and a delivery of an unconditional mortgage discharge. Here, even after notice, she allowed Norstar to provide an unconditional

mortgage discharge in exchange for a specific portion of the proceeds. When Norstar did this, the mortgage lien and lien on the sale proceeds were fully discharged and any rights she might have had as a subrogated creditor were terminated.

In this case, all of the actions of Evelyn Walsh and her attorneys ((1) not ensuring that Norstar preserve any subrogation rights she might have pre and post-petition; (2) filing a proof of claim in the John Walsh case before the sale of the Commercial Property which does not assert any subrogation rights; (3) not filing a claim in the Suzanne Walsh or John Walsh Sales, Inc. cases; (4) not participating in the sale of the Commercial Property after receiving notices; and (5) not claiming any subrogation rights until nearly 18 months after the sale of the Commercial Property was completed) are more consistent with an agreement between Evelyn Walsh and the Debtors that she either had no subrogation rights or had no intention of claiming them in their respective bankruptcy cases, with her sole remedy against the Debtors, her co-guarantors, being her claim against John Walsh secured by Hemlock Road.

2. **Proof of Claim or Assertion of Rights**. Numerous courts have found that Section 509 and Section 502 must be read together. In re Trasks' Charolais, 84 B.R. 646, 650 (Bankr. D.S.D.1988); Matter of DiSanto & Moore Assoc., Inc., 41 B.R. 935, 940 (N.D.Cal. 1984). When they are, it is contemplated that a creditor will make an election between any available rights of subrogation and a direct claim for contribution, reimbursement or indemnity against the debtor. Id.

Although it is possible that in a rare case a creditor could by specific agreement have a combination of both subrogation and direct contribution, reimbursement or indemnity claims against a particular debtor, a creditor who is on notice of the bankruptcy case must advise the Court of any claimed subrogation rights, either through the proof of claim process[3] or as part of any other proceedings of which the creditor has notice and which directly affect that creditor's claimed subrogation rights and remedies. The failure to do so may, as here, constitute a waiver of otherwise available rights and remedies.

3. **Equitable Laches**. "The right to subrogation, being merely equitable, may like other equitable rights, be lost by laches or delay in asserting it." 73 Am. Jur. 2d Subrogation §131 (1974). Courts of equity will withhold relief from those who have delayed the assertion of their claims for an unreasonable time. Willard v. Wood, 164 U.S. 502, 524, 41 L.Ed. 531, 540, 17 S.Ct. 176 (1896). Evelyn Walsh's failure to assert her claimed rights of subrogation until nearly 18 months after the sale of the Commercial Property where there was arguably detrimental reliance and prejudice to others from her inaction should result in the forfeiture of those rights. In this case the Trustee argues that he has detrimentally relied on the failure of Evelyn Walsh to come forward and advise him or the Bankruptcy Court of her claimed subrogation rights, in that he went

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[3]Section 101(5) - "claim" means - a right to payment whether or not such right is . . . legal, equitable (emphasis added), secured or unsecured.

forward and sold the Commercial Property, incurring expenses and in anticipation of receiving a commission, and has taken other steps in the administration of the case which he may not have taken had Evelyn Walsh come forward and advised all interested parties and the Court of her claimed subrogation rights at the inception of the bankruptcy case or at least in connection with the proposed sale of the Commercial Property. The Trustee also asserts that it is possible that other creditors have failed to act in connection with these cases in reliance on the Trustee's sale of the Commercial Property and his realization of substantial proceeds, thought to be available for distribution to them as creditors.

4. **Unjust Enrichment**. In non-bankruptcy cases when a court is asked to exercise its equitable discretion to recognize legal subrogation, most often the balancing of equities is between the party requesting subrogation and that party's co-obligor, who was the principal obligor, and the element of unjust enrichment is a crucial element to be considered in the process of balancing equities. However, in the context of a bankruptcy case, what is often only a two-party analysis, by necessity becomes a more complex analysis. The rights of the other creditors and the requirements and underlying policies of the Bankruptcy Code and the bankruptcy system (such as equality of distribution, orderly administration and finality) must be considered, and the element of the unjust enrichment of the debtor in a Chapter 7 case is of no significance, since generally all creditors will be paid in full before assets are returned to a debtor.

In this case a denial of the claim of subrogation by Evelyn Walsh to the proceeds of the sale of the Commercial Property will only mean that the unsecured creditors will share in those proceeds, and this may even include Evelyn Walsh. The unjust enrichment of the Debtors is not a factor since Evelyn Walsh will be paid in full before any monies will be returned to the Debtors (even in the case of Suzanne Walsh where no claim has yet been filed, Rule 3003(c)(6) would allow Evelyn Walsh to file a claim before funds were returned to the Debtor). In addition, unlike many of the creditors, Evelyn Walsh has an additional means of payment, her mortgage on Hemlock Road.

The Court finds that, even if as between her and the Debtors Evelyn Walsh might otherwise have a claim of subrogation, as opposed to a claim only for reimbursement, contribution or indemnification, to allow subrogation on all of the facts and circumstances of this case would be inequitable because it would work an injustice to the rights of the other creditors. Furthermore, on the facts and circumstances of this case Evelyn Walsh has waived any claim of subrogation and right to such sale proceeds and the doctrine of equitable laches is applicable as to any claim she might have had to the sale proceeds. Any such claims are barred by her failure to file a proof of claim claiming subrogation rights prior to the expiration of the time set by the Court for filing claims or the completion of the sale of the Commercial Property where, even though she was on notice of the sale, she allowed Norstar to discharge the mortgage in consideration of the amount which it claimed was the full amount due, thus fully terminat-

ing the mortgage lien and any rights she might have in the sale proceeds.

IT IS SO ORDERED.

/S/

JOHN C. NINFO, II
UNITED STATES BANKRUPTCY JUDGE

Dated: December 21, 1992