

RAILROAD LEASES AND REORGANIZATION: I

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THE decade which has just closed witnessed many trying years for railroads and their security holders. The unprecedented number of reorganization proceedings instituted in those ten years, together with various remedial proposals, tended to focus public attention on their problems. These problems necessarily involve the legal framework within which the railroad industry is carried on, an important segment of which is the long term lease. Railroad history has been such that in earlier periods of financial stress the mortgage device has played the conspicuous role, while the part of the lease has been relatively obscure. Between 1930 and 1940, however, with an increasing number of important lessee railroads in reorganization under Section 77 of the Bankruptcy Act¹ or in equity, the lease began to take on greater significance. As a consequence, today many lessees in financial difficulties are realizing that the far-reaching changes which have occurred in transportation may turn the long term lease into a snare and a delusion. Others, still solvent, are exercising greater care in making new leases, and seeking ways and means to modify existing ones. At the same time, holders of securities of lessor companies in many instances are experiencing the acute distress attendant upon the discovery that their securities, hitherto regarded as "gilt-edged," may be worth little more than the paper upon which they are printed.

The extent to which the interests of investors and of the public generally, including shippers and employees, are concerned with railroad leases is readily demonstrable by a few statistical comparisons. At the close of 1937, the latest date for which accurate figures are available, some 60 of the nation's 136 Class I railroads were lessees under 302 railroad leases.² Over twelve percent of a total exceeding 235,000 miles of road

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1. Section 77 of the Bankruptcy Act, enacted in 1933, provided for reorganization of railroads engaged in interstate commerce. 47 STAT. 1474 (1933), amended, 49 STAT. 911 (1935), 49 STAT. 1969 (1936), 11 U. S. C. § 205 (Supp. 1938). Reorganization of corporations other than railroads engaged in interstate commerce was originally provided for in 1934 in Section 77B, 48 STAT. 912 (1934), 49 STAT. 664 (1935), 49 STAT. 965 (1935), 11 U. S. C. § 207 (Supp. 1938), which was replaced in 1938 by Chapter X of the Bankruptcy Act, 52 STAT. 883 (1938), 11 U. S. C. § 501 (Supp. 1938). Section 77, however, was left unchanged in the general overhauling of the Bankruptcy Act in 1938.

2. Class I railroads are operating railroad companies having annual revenues above \$1,000,000. These statistics were derived from STATISTICS OF RAILWAYS IN THE UNITED STATES (1937), prepared by the Bureau of Statistics of the Interstate Commerce Commission, particularly §§ B-I and C. Since December 31, 1937, the total number of lessors has been decreased to some extent by consolidations.

operated by Class I lines was operated subject to lease.³ Approximately fourteen percent of a total unmatured funded debt of almost twelve billion dollars of Class I roads and their lessors constitute obligations of lessors upon which, in one way or another, their lessees are obligated to pay interest.⁴ In addition, about fifteen percent of a total par value of over nine and one half billion dollars of stocks of Class I lines and their lessors represent stocks of lessors, for the dividends upon which their lessees are similarly obligated.⁵ Plainly the stake in leased lines is a considerable one.

The purpose of this Article is to present a comprehensive picture of the railroad lease device from its origin to its present-day status in bankruptcy and equity reorganizations. To do this it has been necessary to divide the Article into two parts. Part II will appear in a subsequent issue. In Part I, the development of the lease device and the typical lease are first described. Then, before considering the impact of a reorganization upon the leased line, the methods used in reorganization proceedings to determine the value of a leased line to its lessee are discussed in detail. Finally, against this background, the progress of a leased line through the reorganization process is traced, commencing with the questions of adoption and rejection of executory leases. Part I then concludes with a discussion of who will operate the leased line during the period in which the lessee is being reorganized.⁶

THE ORIGIN AND DEVELOPMENT OF THE LEASE DEVICE

Even prior to the Civil War the lease device had begun to play a prominent part in the development of American railway systems, principally by facilitating the combination of one road with another. This importance continued undiminished through subsequent years, particularly in the case of the eastern railroads. In the 1830s and 1840s, American railroads were primarily local affairs, financed by local capital and ordinarily operating lines in relatively restricted territories. As one company completed its road and connected with that of another, the advisability of combining them for operating purposes into a single

3. This percentage was calculated from statistics in *id.*, Statement No. 3.

4. This percentage was calculated from the items appearing in *id.*, Statement No. 54F.

5. *Ibid.*

6. In Part II, other matters affecting the leased line in reorganization will be considered, attention being centered mainly on three problems. First, if, in answer to the question with which Part I closes, the trustees of the lessee operate the leased line, how will such operation be accounted for? Second, what claims will the lessor have against the lessee or the lessee's trustees in the reorganization? Finally, what legal alternatives exist with respect to treatment of the lessor and its security holders in the reorganization? Other problems incidental to these three principal ones will, of course, be discussed.

railroad was readily seen. Yet there were practical obstacles to be overcome in carrying out such combinations. For one company to buy the assets or stock of a second company required raising additional capital and at that time great pools of savings were not available. Moreover, the owners of the second company usually wished to retain their investment in their railroad as such. Consequently, some means of combination was necessary which took into account both of these considerations.

Various methods were evolved, two of which deserve specific mention.⁷ One was the creation of the procedure of merger or consolidation as part of the general or special railroad statutes of the individual states; the other, which generally also came to be regulated by state statutes, was the lease device, borrowed from real property law. Both methods were frequently used prior to 1860.⁸ Thereafter came a period of great railway expansion during which the lease came into even more extensive use, and from the close of the Civil War to the present time there has been hardly a year in which at least one railroad lease has not been executed.⁹ From time to time there have been periods of unusual lease-making activity, usually brought about by the development of particular railway systems or by realignments within existing systems.¹⁰

The reasons why seventy or eighty years ago the lease device was preferred in a given situation to outright merger or consolidation are not always clear. Certain general advantages of the lease, however, can be readily understood. From the point of view of the lessee, lease pro-

7. Other methods for combination include the direct purchase of assets of another railroad, the acquisition of control of another road through the purchase of its shares, agreements for joint operation and operating contracts. The last named functionally appears to be but little different from a short term lease. These methods are described in CLEVELAND AND POWELL, *RAILROAD FINANCE* (1912) c. XV. An interesting tabulation of the forms of combination employed in the development of the New England railroad systems between 1840 and 1900 is set forth in BAKER, *FORMATION OF THE NEW ENGLAND RAILWAY SYSTEMS* (1937) 256. This latter work is an invaluable historical commentary.

8. Probably the best known example of the former was the consolidation of the various railroads operating between Albany and Buffalo into the New York Central in 1853. See HUNGERFORD, *MEN AND IRON, THE HISTORY OF THE NEW YORK CENTRAL* (1938) cc. 4, 5 and 6. With other railroads the lease also found favor. The Erie in 1852 leased the lines of the Paterson & Hudson River Railroad and the Paterson & Ramapo River Railroad; the Lackawanna in 1855 leased the Cayuga & Susquehanna Railroad and in 1857 the Warren Railroad.

9. Through 1937 there were only six years in which a lease still in existence was not executed. Approval of leases by the ICC was first required by the Transportation Act of 1920. 41 STAT. 481 (1920), 49 U. S. C. § 5(2) (1934).

10. Between 1868 and 1872, thirty-six leases still in existence today were executed, the roads most active in lease-making being the Pennsylvania, the Lackawanna, the Reading, the Delaware & Hudson, the Jersey Central and the Erie. Between 1887 and 1896, fifty leases were executed, with the Reading, the Boston & Maine, the New Haven and the Erie being most active in this respect. Between 1921 and 1930, fifty-three leases were executed, the roads most active being the Reading, the New York Central, the Pennsylvania and the Seaboard.

cedure was simpler than that for merger or consolidation in those states with statutes under which a lease could be entered into without obtaining the consent of the lessee's shareholders.¹¹ With the lessee's shareholders accordingly having no vote on the question, the problem of dissenting shareholders and their demands for appraisal was absent.¹² In addition, although a lease increased the lessee's fixed charges, the rental being treated as part thereof, nevertheless, it was not regarded as increasing the lessee's outstanding indebtedness. Even where the lessee promised to discharge the lessor's obligations at maturity, these obligations did not appear on the lessee's balance sheet as part of its indebtedness. Furthermore, a lease obviated any increase in the lessee's capital stock, thereby avoiding any statutory limits on the total amount of its capital stock and the necessity of obtaining the consent of its shareholders to the increase. Thus, in given cases, the lease device offered more attractions to the lessee than did statutory merger or consolidation.¹³

From the lessor's point of view, the considerations giving rise to a preference for the lease method might be termed psychological rather than procedural. In almost all states the consent of the lessor's shareholders to the making of the lease had to be obtained, just as in a merger or consolidation.¹⁴ Furthermore, in a few states dissenting shareholders were even given a right to an appraisal.¹⁵ But offsetting this apparent lack of procedural advantages was the fact that by using the lease device the lessor's shareholders could retain their own shares of stock, often a relatively seasoned security; and not only did not have to exchange those shares for shares of a newer and larger enterprise as in merger

11. Today general railroad statutes in 22 states provide for consent of the lessee's as well as the lessor's shareholders. In five states such statutes specify that only the consent of the lessor's shareholders is necessary. In the remaining states there are no provisions requiring consent of shareholders apart from the general corporation statutes.

12. Only four state statutes give dissenting shareholders of the lessee a right to an appraisal. MD. ANN. CODE (Bagby, 1924) art. 23, § 219; N. H. PUB. LAW (1926) c. 246, § 25; N. Y. R. R. LAW, § 261; OHIO GEN. CODE ANN. (Page, 1938) § 8310.

13. See generally CLEVELAND AND POWELL, *op. cit. supra* note 7, at c. XV; BAKER, *op. cit. supra* note 7, at c. XI.

14. General railroad statutes in twenty-eight states require the approval of varying percentages of the lessor's shareholders for the execution of a lease. In five additional states which have no separate railroad statutes, such approval may be necessary under the general corporation statutes.

15. General railroad statutes in seven states definitely provide for appraisal of the shares of a dissenting shareholder in the lessor. DEL. REV. CODE (1935) § 2178; IND. STAT. ANN (Burns, 1933) § 55-2515; MD. ANN. CODE (Bagby, 1924) art. 23, § 219; N. H. PUB. LAW (1926) c. 246, § 25; N. J. REV. STAT. (1937) tit. 48, c. 12, § 132; N. Y. R. R. LAW, § 161; OHIO GEN. CODE ANN. (Page, 1937) §§ 8810-8812. In other states, including Connecticut, Idaho, Illinois, Missouri, Montana and Virginia, there are provisions in the railroad statutes which might be construed to give a dissenter the right to an appraisal. In some instances where a railroad was organized under a special act, the act would provide for dissenting shareholders, sometimes those of the lessee as well as of the lessor. *Boston & M. R. R. v. Graham*, 179 Mass. 62, 60 N. E. 405 (1901).

or consolidation, but in addition received dividends on their shares and interest on their bonds, if any, out of the earnings of the lessee as part of its fixed charges. In many instances, during the first years after the execution of a lease the lessor's shareholders probably continued to regard themselves as shareholders in a small local enterprise. And indeed, in some instances it would appear that they fully anticipated resumption of operation of their own line if the lease did not work out as planned.¹⁶ Nevertheless, in practical effect if not in terminology, if the lease was fully performed by the lessee they had established themselves as creditors of the lessee in an annual amount equal to the rental under the lease.¹⁷

Two slightly different functions of the lease device should be noted. One occurred mainly in the period immediately following the Civil War and the other has appeared more recently in situations involving a parent-subsidiary relationship between the lessee and lessor. The first case was the use of the lease device to facilitate the financing of extensions to and branches of existing roads. The existing company would cause a new corporation to be formed which would immediately lease its projected line to the existing road, the lease to become effective upon completion of construction of the extension or branch. Shares of the new lessor, and sometimes bonds secured by a first lien attaching to the new line as built, would then be sold either to the public or to the lessee (which could then pledge them) to raise the necessary funds for the construction of the proposed lines. The sale of these securities, which for all practical purposes were guaranteed by the lessee's obligation to pay rent, was accomplished much more easily than if the new lessor had been a distinct and separate enterprise, for their purchasers knew that payment of dividends would commence when promised, regardless of the results of the operation of the new road. This method had the added advantage of keeping the leased line free from the liens of the lessee's mortgages, thus rendering less difficult both initial and future financing by the lessee of the particular line subject to the lease.¹⁸ This latter reason is doubtless

16. See BAKER, *op. cit. supra* note 7, at 257. That lessors before and immediately after the Civil War may have contemplated resuming operation of their own lines is borne out by the fact that leases in some cases were entered into for only ten or thirty years. Upon expiration of such short terms, usually new leases for 99 or 999 years were executed. Occasionally a lessor actually did resume operation of its line. See *State v. New Haven & Northampton Co.*, 37 Conn. 153 (1870).

17. In rare instances the lease method was combined with the exchange features of merger or consolidation by offering shares of the lessee in exchange for those of the lessor. See BAKER, *op. cit. supra* note 7, at 68; lease of Old Colony R. R. to the New Haven (1893).

18. Instances of such leases are to be found in the cases of *Southern Ry. v. Franklin & P. R. R.*, 96 Va. 693, 32 S. E. 485 (1899) (lease executed in 1878); *Louisville & N. R. R. v. Schmidt*, 112 Ky. 717, 66 S. W. 629 (1902) (lease executed in 1879), and in the lease of the Lehigh Valley Ry. to the Lehigh Valley R. R., April 14, 1891. See also *Durfee v. Old Colony & F. R. R.*, 87 Mass. 230 (1862).

the principal explanation of the second case — where one railroad owning the entire stock of another, which has been operating independently, brings it into the parent's system by means of a lease rather than by merger or consolidation. In a particular case it may be considerably more advantageous to preserve the possibility of financing payment of maturing bonds of the lessor by means of a new mortgage on the leased line than to rely for that purpose upon the issuance of additional amounts of the lessee's own available mortgage bonds, as would be necessary after merger or consolidation.¹⁹

THE TERMS OF THE TYPICAL RAILROAD LEASE

The railroad lease document itself has an interesting history, especially when considered in connection with the railroad mortgage.²⁰ Early leases were thin pamphlets averaging about ten to twenty printed pages in length and only in rare instances attaining a length of even thirty pages. The typical lease has retained this same length up to the present day, and even its provisions have remained in form and substance largely the same. This retention of simplicity is in striking contrast to the evolution of the railroad mortgage which, during the same period, grew from a relatively thin document to a bulky volume often exceeding one hundred pages crammed with meticulously worded provisions.²¹

The typical railroad lease commences with a leasing and demising clause similar to the granting clause in the typical railroad mortgage. By this clause the lessor's entire railroad property, including right of way,

19. The New York Central, for example, has maintained through the lease device the separate existence of the Cleveland, Cincinnati & St. Louis, with 2,034 miles of road, and that of the Michigan Central, with 1,085 miles, as well as numerous companies with smaller mileages.

20. This section is based on analysis of various leases, including those of which the following railroads are lessees: Canadian Pacific; Chicago, Milwaukee, St. Paul & Pacific; Delaware & Hudson; Erie; Lackawanna; Lehigh Valley; Maine Central; Missouri Pacific; New Haven; Pennsylvania; Reading; Rock Island; St. Louis, Iron Mountain & Southern; Southern Pacific; and Southern.

Limitations of space prevent any real comparison of the legal incidents of the lease with those of the mortgage as they are affected by the reorganization process.

21. The major reason for this difference is clear. While the railroad lease today performs practically the same function as the lease of eighty years ago, the essential function of the railroad mortgage has undergone substantial changes. The early mortgage was created for the sole purpose of raising funds to build small lines of railroad; the function of the modern mortgage, however, is principally to refund bonds secured by prior mortgages and to finance additions and betterments necessary to a wide-flung railway system. Examples of early railroad mortgages are the Consolidated Mortgage of the Pennsylvania Railroad Co. to Wistar Morris, Josiah Bacon and Edmund Smith (1873), and the Mortgage of the Lehigh Valley Railroad Co. to the Fidelity Insurance, Trust and Safe Deposit Co. (1873).

track, equipment, tools, rolling stock and all other fixtures and non-fixtures, is leased to the lessee. Unlike the mortgage, however, the description of the property leased is rarely long, though in some cases schedules have been annexed to show with greater particularity the rolling stock and other assets which have been transferred.²² The essential idea in most cases is that possession of everything owned by the lessor, "lock, stock and barrel," goes over to the lessee for the terms of the lease.

The next important provision is that stating the term. This provision affords the single striking example of change in leases over the years since 1849, which, being the year of execution of the oldest lease now in existence — that of the Erie and Kalamazoo Railroad to the Michigan Southern Railroad Company²³ — is a convenient starting point in a study of existing leases.²⁴ The great majority of existing leases can be classified, according to their terms of years, into three types: (1) the perpetual lease, including all those with terms of 999 years; (2) the 99 year lease; and (3) the short term lease, including all those for ten years or less and leases terminable upon short notice by either party.²⁵ The following tabulation of these types of existing leases by the decades in which they were executed shows the gradual tendency away from the perpetual lease to the short term lease.²⁶

22. See lease of Rensselaer & Saratoga R. R. to the Delaware & Hudson (1871).

23. The New York Central assumed the lease of the Erie & Kalamazoo in 1914. It is an interesting commentary on the lease situation that the Erie & Kalamazoo has no *de jure* existence today, its charter having been forfeited in 1903. Since then it has been recognized as a *de facto* corporation, both in Illinois and Michigan.

24. Other leases were, of course, executed prior to 1849, but they have either expired by their own terms and new leases been entered into, or have been terminated by the absorption of the lessor company by the lessee, usually by the process of merger or consolidation, following the gradual acquisition by the lessee of most of the lessor's capital stock. In 1840 the Eastern Railroad of Massachusetts leased the Eastern Railroad of New Hampshire for 99 years. Subsequently both became part of the Boston & Maine. In 1843 the Housatonic Railroad leased the Berkshire Railroad, and later both became part of the New Haven system. See BAKER, *op. cit. supra* note 7, at 73, n. 2, 147, n. 4.

25. For the purposes of classification, all leases of 900 years or more were classified as perpetual leases; all those of approximately 99 years were classified as 99 years. In addition to the three general classifications, there are certain leases for nondescript terms. Six leases are in existence with terms substantially in excess of 99 years but not sufficiently long to be ranked with perpetual leases. Likewise, there are 33 leases in existence with terms in excess of 10 years but less than 90 years. Finally, there are 10 leases for the term of the lessor's corporate existence.

26. Of course, this tabulation is to a certain degree deceptive. As pointed out in note 16 *supra*, before and immediately following the Civil War there were leases executed for terms of ten to thirty years. These leases upon their expiration were replaced by long term leases. In a study of this nature it was not practicable to ascertain how many of such leases there were. In any event, those leases, being for ten to thirty years, are distinguishable from the modern short term lease, which is much more subject to termination.

	<i>Perpetual Leases</i>	<i>99 Year Leases</i>	<i>Short Term Leases</i>
1851-1860	9	0	0
1861-1870	25	4	0
1871-1880	16	5	1
1881-1890	19	10	1
1891-1900	19	19	1
1901-1910	11	7	3
1911-1920	8	7	2
1921-1930	10	11	19
1931-1939	1	3	8

Indeed, since 1921 the short term lease, usually terminable on thirty or sixty days' notice by either party, has become the most usual type. Today the execution of a lease for even 99 years is a rarity and the expectation that all future leases will tend toward the short term lease terminable on brief notice appears to be warranted.²⁷

Following the leasing and demising clause and the statement of the term come the executory covenants, some by the lessor and others by the lessee. Those of the lessor, except for its covenant to issue its securities to finance additions and betterments made by the lessee to the leased line, are ordinarily formal covenants designed to assure the lessee the full benefits of the lease.²⁸ These covenants are of little practical significance so far as the present discussion is concerned. The principal covenants by the lessee, however, are of greater consequence.

The first of the lessee's covenants is its promise to pay the lessor for the use of the latter's railroad. This payment may be expressly designated as "rent," but just as frequently that specific word will not be found. The payment may be specified either as a fixed sum,²⁹ or as an

27. The long term lease appears to be too inflexible for modern conditions, especially from the lessee's point of view, which is mainly one of reluctance to commit itself over a long period in view of the uncertainty as to the future of the railroad industry. With rapidly changing circumstances a short term lease, terminable upon short notice, gives the lessee an opportunity to rid itself of a burdensome lease apart from reorganization. On the other hand, such a lease places the lessor somewhat at a disadvantage, for even though the short term lease is also terminable at the lessor's option, the likelihood of its ever exercising the option is extremely remote. It is interesting to note that in 1893 Massachusetts provided that no future leases should be for terms longer than 99 years unless special permission of the legislature was obtained. MASS. LAWS ANN. (1935) c. 260, § 63.

28. The typical lease contains a covenant by the lessor to maintain its corporate existence during the term of the lease, a covenant that the lessee shall have exclusive possession and control of the leased railroad, and a covenant that every corporate power necessary to fulfill the purpose of the lease will be exercised. All such covenants are standard in railroad leases, but rarely give rise to any dispute.

29. Examples of this are the lease of the Dexter & Newport Railroad to the Maine Central (1888), and the lease between the President and Managers of the Schuylkill

amount equal to the sum of the interest on the lessor's bonds, if it has any outstanding, of a fixed dividend on the lessor's capital stock, of the rent on any lines of which the lessor may be the lessee, and of a small fixed amount for the expenses of maintaining the lessor's organization.³⁰ The lessee's promise may be to pay the bond interest directly to the lessor's bondholders and the dividends directly to the lessor's shareholders, and it may even be endorsed as a guaranty on the face of the bonds and shares.³¹

Next, there usually follows a covenant by the lessee to pay taxes, which really is part of its obligation to pay for the use of the leased line. These clauses vary considerably, but generally include at least a promise to pay all taxes assessed on the property of the lessor, and in addition, quite frequently a promise to pay all taxes imposed on the lessor's capital stock, on the lessor's franchise, or on the income or receipts from the lessor's property. With the increasing number of different types of state and federal taxes, situations have frequently arisen which were not contemplated at the time of execution of the lease, and as a consequence the proper construction of such tax covenants has often been before the courts.³²

A third covenant of the lessee is its promise to maintain the lessor's property. While language of particular leases varies widely, "in good order and repair" is fairly typical. All such maintenance is usually made an expense to be borne by the lessee. Closely tied in with this covenant is the question of who shall bear the cost of additions and betterments on the leased line. Sometimes the lessee also assumes this cost,³³ but more often some provision, in the form of the covenant of the lessor

Valley Navigation & Railroad Co. and the Philadelphia & Reading Railroad Co. (1861). The amount of the agreed rental, in whatever manner paid, in some states would be affected by applicable statutes. For instance, an Ohio statute enacted in 1873 provided that as to domestic leased lines, the rental reserved should "be at least equal to the net earnings of such leased road for the fiscal year next preceding the one in which said lease is made." OHIO GEN. CODE (Page, 1938) § 8813.

30. A lease of this kind is that of the West Jersey and Seashore Railroad to the Pennsylvania (1930).

31. Covenants by the lessee to pay the rent directly to the lessor's shareholders and bondholders occur in the leases of the Warren Railroad to the Lackawanna (1857), and the Georgia Midland Railway Co. to the Southern Railway (1896). An example of a "stamped" guaranty is to be found in the lease of the Northern Railroad Co. of New Jersey to the Erie (1899). In financial circles stocks of railroad lessors are commonly referred to as "guaranteed" whether or not a guaranty is stamped on the face of the shares.

32. As taxes increase, a lessor whose lease does not provide for payment of taxes by the lessee will often find that a flat payment originally more than adequate to pay the taxes assessed against the lessor will today be almost entirely used for that purpose.

33. This is true of the lease of the Rensselaer & Saratoga R. R. to the Delaware & Hudson (1871) (cost assumed in part only); lease of the Catawissa Railroad to the Philadelphia & Reading R. R. (1896).

referred to above, is made either for the direct financing of such additions and betterments by the issuance of further amounts of the lessor's stocks and bonds at the lessee's request, or for the reimbursement of the lessee for additions and betterments previously made by the issuance of such securities to the lessee, to be resold or not as conditions may warrant.³⁴ Similar to the foregoing situation is that arising from the necessity of providing for the payment of lessor's bonds outstanding at the date of the lease as they subsequently mature. In a few leases the lessee simply agrees to pay the principal of such bonds when they mature,³⁵ but more frequently the lessor covenants to issue new bonds to refund the maturing issue.³⁶

In the main, the foregoing are the significant covenants in the typical lease, and, as will be seen later, they play a significant part if the lessee should eventually be forced to seek reorganization. There have not been mentioned, of course, certain standard covenants found in almost all leases, or certain unusual covenants found only in particular leases.³⁷

One important provision remains for discussion. In nearly every railroad lease there is a clause providing that upon failure to pay rent or upon breach of other covenants by the lessee, the lessor may reenter its property and declare the lease forfeited. This clause was included to avoid the common law rule which permitted a lessee to remain in possession of the leased line for the balance of the term despite its failure

34. For example, the lease of the Pittsburgh, Fort Wayne & Chicago Railway to the Pennsylvania (1869); lease of the Montreal and Atlantic Railway Co. to the Canadian Pacific (1931).

35. The lease between the Warren Railroad Co. and the Lackawanna (1857) provides that upon maturity of the lessor's bonds, the lessee should "purchase and take an assignment" of such bonds, which it then might hold as valid obligations of the lessor, even though matured.

36. For example, the lease between The United Canal and Railroad Companies of N. J. and the Pennsylvania (1871) provides that upon maturity of the various obligations of the lessors, they will deliver to the lessee a corresponding amount of their bonds, which the lessee may use to extinguish the maturing obligations. It is also provided that "If the avails of the bonds * * * shall be greater than their par value, the excess shall inure to the benefit of the lessee; but if they shall be insufficient for the purpose the deficiency shall be made good by the lessee."

37. Another standard covenant of the lessee is its promise to discharge the duties imposed by law upon the lessor, such as its duty as a common carrier. More unusual covenants are those permitting the lessee to abandon operation of portions of the leased line which become unprofitable [lease of East Pennsylvania R. R. to Philadelphia & Reading R. R. (1869)]; covenants by the lessee to make annual payments into a sinking fund for the benefit of the lessor's security holders [lease of United Canal & R. R. Cos. of N. J. to Pennsylvania R. R. (1871)]; covenants for arbitration of disputes over the proper construction of the lease and even as to the amount of the rental payments in the event of changing conditions [lease between Central P. R. R. and Southern Pacific Co. (1885)]; and covenants by the lessee to supply the lessor's officers with free passes over the railroad for the duration of the lease [lease between Philadelphia, G. & N. R. R. and Philadelphia & Reading R. R. (1870)].

to pay rent, the lessor's only remedy being an action for the unpaid rent as it became due.³⁸ Usually, the lease requires continuance of the breach for some period of time, such as thirty, sixty or ninety days, before the lessor may declare the lease forfeited and become entitled to reenter. But while this reentry clause was intended to enable the lessor to recover its property, to take advantage of it would ordinarily mean that the lessor would lose its bargain with respect to rent for the balance of the lease term. Under the common law doctrine, in force in a majority of jurisdictions, upon reentry the lease became non-existent and the lessee had no further obligation to pay rent. Consequently, if the lessor reentered, the rent for the balance of the lease would be lost, though it might have hundreds of years yet to run.³⁹ Naturally clauses were devised to meet this common law rule. In the case of the ordinary real property lease many different forms of covenants were designed, with more or less success, to protect the lessor more adequately.⁴⁰ But in the railroad lease no such development has taken place beyond a simple clause to the effect that termination and reentry by the lessor is to be without prejudice to its right to sue for damages for breach of the terms of the lease.⁴¹

POSITION OF THE LESSOR DURING THE TERM OF THE LEASE

Once a lease has been executed and all its incidents carried out, the lessor ceases to be an operating railroad. In most instances the ultimate effect is that the lessor goes out of the railroad business, not just temporarily, but for all time; where the lessor is also a subsidiary of the lessee, it ceases activity well-nigh completely. Only in the case of leases for a very short term, which constitute less than one-third of those existing, is it likely that the lessor contemplates ever reentering the railroad business.⁴²

38. See generally BENNETT, *LANDLORD AND TENANT* (1939) 84, 85; GERDES, *CORPORATE REORGANIZATION* (1936) §§ 683-686 inclusive. In some states this is specifically provided for by statute. For example, OHIO GEN. CODE ANN. (Page, 1938) § 8813.

39. GERDES, *op. cit. supra* note 38, at §§ 684, 685; FINLETTER, *PRINCIPLES OF CORPORATE REORGANIZATION* (1937) 271, 272; Clark, Foley and Shaw, *Adoption and Rejection of Contracts and Leases by Receivers* (1933) 46 HARV. L. REV. 1111, 1118; Douglas and Frank, *Landlords' Claims in Reorganization* (1933) 42 YALE L. J. 1003, 1006; Schwabacher and Weinstein, *Rent Claims in Bankruptcy* (1933) 33 COL. L. REV. 213.

40. Covenants of this type are discussed in GERDES, *op. cit. supra* note 38, at § 686. See also *William Filene's Sons Co. v. Weed*, 245 U. S. 597 (1918).

41. See lease of Pennsylvania, O. & D. R. R. to Pennsylvania R. R. (1926). Article Twelfth provides in part: "It is further declared and agreed that such re-entry shall not waive or prejudice any claim or right of the Lessor to or for damages against the Lessee on account of such non-payment of rent or non-performance or breach of the terms of this lease, and all such claims and rights are expressly preserved to said Lessor."

42. Even as to such leases, it is probable that many of the lessors were wholly unable to resume railroad operations at the end of an earlier lease and had to accept a short term lease as the only course open.

As we have seen, in the typical case the lessee takes over almost everything the lessor owns at the date of the lease, in some instances even investments in securities in other corporations.⁴³ Revenues and expenses of operation of the leased line are indistinguishably mingled with those of the remainder of the lessee's system, and except where, for example, a lease provides for rental payments in terms of revenues of the leased line, no attempt is likely to be made to ascertain whether the leased line actually earns its rental or not. The lessee's operating department may, and often does, have some idea whether a particular line is valuable to the system or not, but no doubt there have been instances where upon a segregation of system earnings, railroad officials have been surprised to learn what a leased line has been earning as part of the system. From the lessee's, as well as the lessor's, point of view, the whole atmosphere becomes a system atmosphere and the underlying legal situation of separate and distinct entities is likely to be almost forgotten.

The lessor company, of course, maintains its corporate existence and office as it has covenanted to do in the lease.⁴⁴ Though great variations exist between different lessors, particularly between those which are subsidiaries of lessees and those which are independent, generally a typical lessor's board of directors and officers have little to do. The board of directors ordinarily meets at least once a year and authorizes the issuance of an annual report.⁴⁵ At such meetings it may receive reports from its officers on the operation by the lessee of the lessor's line. From time to time it must declare and authorize the payment of dividends.⁴⁶ Nor are the duties of the officers numerous. Where the lessee has majority control, the necessary matters may be attended to as part time work by an officer of the lessee, and even where the lessor is independent, it is unlikely that a full-time officer will be required. Though the rent is paid by the lessee directly to the lessor's security holders, lists of shareholders and registered bondholders must still be kept. Other matters which may require attention include joining in all dispositions of real property and all acquisitions of new real estate, and in general doing

43. An example of this is the lease between the East Pennsylvania R. R. and the Philadelphia & Reading R. R. (1869).

44. The office itself will probably be two or three rooms in some office building, and where the lessor is controlled by the lessee through stock ownership, it may be nothing more than a single room or a desk in the general office or a regional office of the lessee. For example, of the thirty-six lessor companies which executed leases between 1868 and 1872 inclusive, sixteen have their offices in the general office of the lessee, while of fifty-three leases in the decade of 1921 to 1930, forty lessors have no offices separate from those of their lessees.

45. Boards of some lessors meet more often. For example, that of the United New Jersey Railroad & Canal Co. meets quarterly.

46. Certainly the declaration of dividends by formal act of the board of directors is necessary where the rent is paid to the lessor and then distributed to its shareholders.

all other acts essential to afford the lessee the full benefits of the lease.⁴⁷ Occasionally a lessor will retain some assets such as securities of other companies, and in such a case the officer or officers may have to give attention to his portfolio.⁴⁸

From this short description it can be seen that an ordinary lessor company, during the term of the lease, may have become ill-prepared to deal with problems which arise if its lessee encounters financial difficulties. From the standpoint of personnel alone, there may be no one connected with the lessor company capable of taking the initiative on its behalf. The lessor's treasury ordinarily will be bare of funds with which action may be financed.⁴⁹ Consequently, in the case of the typical lessor, it is probable that if any action is to be taken it will have to be directly by the lessor's security holders or their representatives on their own behalf.

THE LESSOR AND REORGANIZATION OF THE LESSEE

The tranquil existence of many lessor companies and their security holders ended abruptly in the depression years after 1929.⁵⁰ As railroads

47. For example, condemnations may have to be conducted in the lessor's name and the lessor may have to be a party to contracts with reference to public and private crossings.

48. Thus, the balance sheet of the Boston & Albany, a large independently controlled lessor, as of December 31, 1938, carried under "Investments" the figure of \$6,394,611; the balance sheet of The Rensselaer and Saratoga R. R. Co., a small independent lessor, on the same date showed under "Other Investments" the figure of \$130,070.

49. This is particularly true where the interest and dividends on the lessor's securities are paid directly by the lessee, for then the lessor will generally have no income whatever aside from the small amount received to maintain its corporate status. Where the lessor receives the rental payment itself and disburses interest and dividends to its security holders, its position may be somewhat improved because it may be possible at least to withhold dividend payments. However, further factors may be present as, for example, where taxes must be paid out of the rental it is not unlikely that taxes may have increased over the years to a point that little can be set aside for emergencies.

50. The discussion which follows centers around Section 77 of the Bankruptcy Act. Dissatisfaction with the substantive principles of law affecting leased lines which had been worked out in equity receiverships was not one of the causes motivating the enactment of Section 77, nor did that statute make many changes in those principles. For the most part, it may be assumed that comment herein regarding proceedings under Section 77 is also applicable to proceedings in equity, with due allowance for the obvious procedural differences within the framework of which the substantive principles are applied. In addition to the cases and authorities cited, the present study is also based upon a detailed examination of the printed court records in proceedings under Section 77 for the reorganization of the following railroads: Chicago, G. W. R. R. (N. D. Ill.); Chicago, M., St. P. & P. R. R. Co. (N. D. Ill.); Chicago & N. R. R. (N. D. Ill.); Chicago, R. I. & P. Ry. (N. D. Ill.); Denver & R. G. W. R. R. (D. Colo.); Erie R. R. (N. D. Ohio); Minneapolis, St. P. & S. S. M. Ry. (D. Minn.); New York, N. H. & H. R. R. (D. Conn). Somewhat less detailed examination has been made in the following pending equity receiverships: Central of Georgia Ry. (S. D. Ga.); Norfolk S. R. R. (E. D. Va.); Seaboard A. L. R. R. (E. D. Va.). With the exception of the Missouri P. R. R.

operating part of their mileage under leases either filed petitions for reorganization or came to the brink of filing such petitions, the interests not only of their own security holders but also of their lessors were necessarily affected.⁵¹ It is not essential to this discussion to consider the causes which, in recent years, have forced an unprecedented number of railroads, including many lessee roads, into reorganization. Suffice it to point out that, together with bond interest and other items, lease rentals are an important part of the fixed charges of the typical lessee railroad,⁵² and that, as in the past, burdensome lease rentals have been among the factors combining to make reorganization necessary.⁵³

When a proceeding for the reorganization of a lessee railroad is commenced, the legal position of its lessors is immediately affected, for both in equity and under Section 77 the lessee's receivers or trustees may elect to adopt or reject its executory leases.⁵⁴ Thus it becomes possible for the lessee to be relieved of lease obligations which have become burdensome. In the remainder of this Article we shall follow the lessor through the lessee's reorganization proceeding, indicating problems which may arise and condition the final treatment of the lessor upon the termination of the proceeding. It will be seen that this depends primarily upon the answer to the single question: what is the value of the leased line to the lessee? Or to put it another way, is it worth the annual price called for by the lease?

(Section 77) and the Wabash Ry. (equity), these are the principal Class I lessee railroads now in process of reorganization. The proceeding for the reorganization of the Central R. R. of New Jersey, under Section 77, was only recently instituted.

51. All the reorganizations listed in note 50 *supra* were instituted after 1929. In addition, at least two other important Class I railroads operating part of their mileage under lease have had financial difficulties, the Baltimore & Ohio and the Lehigh Valley. Both these companies are working out voluntary reorganizations under the so-called "Voluntary Adjustment Bill" [Chapter XV of Bankruptcy Act, Pub. L. No. 242, 76th Cong., 1st Sess. (July 28, 1939)]. It should be noted that at the hearings on the bill before the Senate Committee on Interstate Commerce, May 10-12, 1939, several proposals were offered for the purpose of expressly including the power to modify leases within the grant to the bankruptcy courts constituted under the bill. These proposals, labeled "clarifying" amendments by their sponsors, were not adopted, and as finally enacted, the bill authorized such courts to exercise "original jurisdiction, as provided in this chapter, for postponements or modifications of debt, interest, rent, and maturities or for modifications of the securities or capital structures of railroads." Such postponements or modifications can take place only after obtaining the consent of the security holders affected. No trustees are appointed under the bill as enacted and the power to elect to adopt or reject existing leases is not granted in proceedings under it.

52. The Lackawanna is the prime example of a railroad with fixed charges made up almost entirely of rentals under leases. In 1938 its total rentals amounted to \$7,452,330, while its interest on funded debt amounted to a relatively meagre \$162,360.

53. See DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* (1934) 1215, 1216.

54. This is the only way a lessee may free itself entirely or bring about a modification of its lease obligations without obtaining the consent of its lessors.

THE DETERMINATION OF VALUE

In a complex railroad system, the formation of a judgment as to the value of different parts of the system separately subject to mortgage or lease is a complicated matter of statistical and financial analysis, made even more difficult by the interplay of factors not susceptible of expression in numerical terms.⁵⁵ In reorganization, earnings and earning power are the primary bases upon which a new financial structure is created. Since the parts of a system are valuable to it chiefly in terms of earnings and earning power, various studies have been devised to measure such earnings, each intended to disclose elements of value inherent in the line in question. The most important of these studies is the segregation study, intended to disclose what portion, if any, of the net income from the operation of the system as a whole is attributable to the mortgaged or leased line alone. In addition, there is the severance study, which attempts to ascertain in terms of effect upon the net income of the mortgaged or leased line, as well as the remainder of the system, the consequences which would follow if the line in question were to be operated independently of the remainder of the system or in conjunction with another railway system with which it may connect, thus becoming a competitor of the mortgagor or lessee. Particular circumstances may furnish the impetus for the preparation of other studies by those interested in the line in question, as well as by the lessee's trustees.⁵⁶ If negligible earnings, or losses, are shown by the segregation studies, this may point the way to detailed surveys of possible abandonments, of possible economies in operation, and of factors influencing the available traffic in the territory served by the line being studied.

Such a brief statement is hardly adequate to disclose the nature of these studies. Certain of them, however, are of such importance, particularly the segregation and severance studies, as to warrant more detailed discussion.

1. *Segregation study.* By segregation of income is meant the allocation of the various items of operating revenues and expenses of a railroad system to its different mortgaged as well as leased lines in such a way as to show the income properly allocable to each when operated as part of the system.⁵⁷ The need for such a segregation arises out of the

55. It is not intended to convey the impression that "value" as used in the preceding sentence is concretely definable. At the best it is possible only to indicate certain elements which go to make up "value."

56. Among these may be an effort on the part of the former to show that a "contribution" is made to the earnings of the system by reason of traffic received from and delivered to the line in question. This, however, is a matter closely, if not inextricably, related to studies of severance value.

57. The operations of a railroad system are, of course, conducted for the greatest benefit of the system as a whole, and not necessarily to secure the maximum earnings of any particular portion of the system.

fact that the uniform accounting rules of the Interstate Commerce Commission do not apportion the earnings of a system among its member parts, but reflect only the operation of a system as a whole. Since a good part of the system revenues and expenses are generally common to two or more of the mortgaged or leased lines, methods must be devised for their proper division among these parts of the system. In practice the various methods of making this allocation are combined in what is known as a "segregation formula." Certain of the major facts about segregation formulas should be pointed out here.

In the reorganization of railroad systems in equity receiverships, segregation formulas were developed in particular cases to meet practical needs. Under Section 77, the probability of similar needs was recognized, and subsection (c)(10) specifically provides that the reorganization court may direct the keeping of such records and accounts as will permit an allocation of earnings and expenses to each of the mortgaged and leased lines making up the debtor's system. The same subsection further provides for reference by the court to the ICC for its recommendations as to the method or formula by which the segregation shall be made.

The usual procedure in carrying out a segregation study is first to work out the formula and then apply it to operating revenues and expenses for a test period. Such a test period may be of only several months' duration, but will probably be a year or more. The actual application of the formula is ordinarily performed by the lessee's accounting department, and involves a detailed analysis of all items of operating revenues and expenses for the entire system during the test period. Each item of revenue and expense as defined in the ICC's uniform system of accounts is either allocated directly, or in the manner prescribed in the formula, to the particular mortgage or lease line or lines which gave rise to it. For present purposes, the way in which this allocation is carried out will be discussed only in terms of leased lines.

Items of revenues and expenses in connection with both passenger and freight service which are local to a leased line can be credited or charged directly to that line. But items which are applicable in part to a leased line and in part to another portion of the lessee's system must be allocated to each in as fair and equitable a manner as circumstances permit. The proper division of such items between the parts of the lessee's system is the chief concern of the formula. By and large the methods by which this division is made are as follows:

In apportioning *revenues* under the formula, an attempt is usually made to follow the methods in use between independent railroads in the surrounding territory. Passenger revenues are divided on a strict mileage basis, since this is the common practice between railroads. An example of this method as employed in a system formula is as follows: if a passenger rides one hundred miles on system lines, of which twenty-five

miles are on a leased line, one-fourth of the fare received by the system will be allocated to the leased line. The division of freight revenues, however, is more complicated, since rate divisions between independent railroads are governed by considerations, such as bargaining power, the relative weight of which it is impossible to analyze and hence to apply in different situations. In so far as generalization is possible, it may be said that rate divisions between railroads attempt to recognize the relative service performed by each, the principal types of which are road haul and terminal service, the latter comprising costs of origination, interchange and termination. A large part of a railroad's expenses are incurred in the assembly of traffic into trains and its switching to freight houses, yards or consignees' sidings after trains have arrived at their destinations, as distinguished from the expense of hauling it over the road. In divisions of freight revenues between independent railroads, this fact is recognized in various ways, sometimes by the allotment of a flat percentage (usually in the case of short lines connecting with trunk lines), sometimes by allotting a minimum percentage of the rate, usually twenty-five per cent, no matter how short the haul, and sometimes by using factors based in part upon the local rates of each carrier. A method which has come into use more recently, especially in the East, consists of adding "constructive" mileage to the road haul mileage of each carrier in order to compensate the carrier for the terminal and interchange service which it renders. Revenues are then divided in proportion to the sum of the actual and constructive mileage on each road. As applied in segregation formulas this method operates about as follows: if a carload of iron ore is carried one hundred miles over system lines including twenty-five miles over a leased line, and is terminated on the leased line, the leased line receives a proportion of the system revenues from the shipment in the ratio that the leased line's total of actual and constructive mileage in connection with the shipment bears to the similar total for the system. This method is believed by many to produce more accurate results and to be better adapted for segregation purposes than the others which have been mentioned. The "constructive" mileage allowance for application in a particular case is arrived at by first determining average terminal and road mileage costs per car, and then translating the terminal cost into equivalent "constructive" miles.⁵⁸

Expenses in connection with both passenger and freight service which cannot be directly allocated to a particular line are allocated to the several lines involved on various appropriate bases, including, in the same formula, mileage pro rates, "use factors," and other similar devices. In

58. See New York, S. & W. R. R. Reorg., Finance Docket No. 11681, Dec. 14, 1939, with respect to the use of a constructive mileage block where a terminal mortgage division has no line haul.

addition, most formulas attempt to provide for certain intra-system charges and credits not normally shown in a railroad's income account, in order to carry out fully and equitably the distribution of revenues and expenses between the various parts of the system.⁵⁹ These include such charges and credits as for handling on a leased line locomotive fuel to be used on another part of the lessee's system, and for interest on equipment and facilities owned by the lessee but used in connection with service maintained on a leased line or vice versa. In the case of the former, the charges and credits are computed under the formula on the basis of the estimated cost of the movement; in the case of the latter, charges and credits are computed as an annual percentage of the investment involved.

It can readily be seen that the development of segregation formulas is a highly technical matter, requiring considerable statistical and engineering skill. And, as might be expected, their specific provisions, as well as the results of their application, provide opportunities for disagreement over questions in which the practical aspects of railroading play an important part. In proceedings under Section 77 where formulas have been developed and referred to the Interstate Commerce Commission, the most significant parts of the Commission's decisions have been those concerned with points on which disputes have developed.⁶⁰ It should be kept in mind that inasmuch as the conditions surrounding the operation of two railroad systems are never identical, a formula adapted to one railroad system may not meet the necessities of another railroad system in all respects. Nevertheless, within the broad outlines indicated, segregation formulas will tend to conform.

59. These intra-system charges and credits are not, however, levied with the idea that one part of the system should make a profit at the expense of any other part.

60. Among the matters in dispute have been such questions as (1) whether or not the results obtained by apportioning passenger revenues on a straight mileage prorate should be adjusted to reflect differences in terminal expenses; (2) whether charges for use of facilities should be computed upon the basis of rates prevailing between independent railroads in similar instances and for the use of equipment on the basis of the average rate of return on the debtor's equipment trusts, or whether in both cases a different basis should be used, as, for example, the approximate rate of return on the property investment in the debtor's system as a whole, or whether any special return at all should be allowed. See *In re Chicago, R. I. & P. R. R.*, C. C. A. 7th, Dec. 12, 1939 (Court Record 2359), holding that the measure of charges should be fixed and uniform. Other possible difficulties might be whether the test periods used in preparing the formula as well as in its application may not give rise to unsound segregation results, as might occur, for example, if maintenance expenses on portions of the system have been at unusually high or low levels. These are all matters the lessor interests must study and be prepared to deal with at the hearings on the formula before the ICC, if not even earlier. The fact that such difficulties may exist, however, does not necessarily prevent the development of a segregation formula and its approval by ICC which is as fair and equitable to all interests as the circumstances of a particular case permit.

The initiative in preparing a segregation formula has most frequently come from the lessee's security holders or the lessee itself.⁶¹ The stage at which the lessor interests have a proper interest in the development of a formula is not entirely clear. Since the formula is designed to serve, among other things, as a basis for the lessee's trustees to decide whether to elect to adopt or not to adopt a lease, it may be argued that the lessor interests should not participate. Inasmuch as the trustees are trustees for the lessee debtor, their interest in discovering whether a given lease is in fact either profitable or burdensome to the estate which they are administering would seem to be primary. From the long range point of view, however, the fact that the lessor interests will be affected by the results of the application of the formula gives them a clear interest. Whether in a particular case participation from the start in the development of the formula would benefit the lessor interests more than formal criticism of the formula before the reorganization court and the ICC will probably depend upon its circumstances. In any event, once the formula is complete, the lessor interests are entitled to be heard on its fairness both in the reorganization court, itself, and before the ICC, either at hearings on plans or if there is a reference to that body.⁶²

61. The formula in the *Chicago, Indianapolis & Louisville* proceeding, which did not involve any leased lines but is nonetheless relevant, was prepared by ICC Examiners after a protective committee for bonds issued under a divisional mortgage petitioned the court to appoint an appropriate officer of the court, such as a special master, to prepare a formula. Finance Docket 10294, 228 I.C.C. 209 (1938). This petition, together with the answer of the trustees, the court referred to the ICC. In the *New Haven* proceeding the formula was prepared by the debtor's statistical department under the direction of the trustees, in collaboration with railroad experts representing groups of creditors, with whom frequent consultations were held. Finance Docket 10992, 224 I.C.C. 723 (1938). A formula has also been recommended by the ICC for the New York, Susquehanna & Western. Finance Docket 11681 (decided Dec. 14, 1939). In the *Rock Island* proceeding, the formula was originally prepared by representatives of the trustees and was later modified by committees representing issues of the Rock Island's bonds, who had employed experts for the purpose.

Among other proceedings under Section 77 in which formulas have been developed and used, but without specific approval of the court or reference to the ICC, are the proceedings for the reorganization of the St. Louis, San Francisco (formula prepared by the trustees' accounting officers, with frequent conferences with experts representing committees for the debtor's bonds), the Erie (formula prepared by the debtor's special plan committee, consisting largely of operating officers of the debtor, appointed by its board of directors), and the Chicago, Northwestern (formula prepared by the debtor's officers in conjunction with railroad experts representing secured creditors). In at least two pending equity receiverships formulas have been developed. (Seaboard and Central of Georgia).

62. Reference of the formula to the ICC is discretionary with the court. If no party requests a reference, the court may, presumably after a hearing, approve a formula without one. In at least one proceeding (*Rock Island*, see Court Record 2859) appeals have been taken from orders of the court interpreting certain provisions of the formula, and generally speaking no doubt the order approving the formula in its entirety is also appeal-

Although a determination of the income of a leased line when operated as a part of its lessee's system is not the sole criterion of its value to the system, in most cases it is of greatest importance in determining the treatment in the reorganization to which the leased line is entitled. Indeed, in cases where the segregated earnings of a leased line are ample to pay the rental called for by the existing lease, it is usually considered unnecessary to make other tests. In addition, and more immediately, the results of the segregation study not only will play a most important part in determining whether the lessee's receivers or trustees should elect to adopt or reject a lease, but will also furnish a basis for the accounting which will take place between the lessor and the lessee's trustees for the actual operation of the leased line by the latter if they should elect to reject the lease.

There may, however, be elements of value inherent in a particular leased line which, by reason of its fundamental character, a segregation study cannot consider. To disclose these values, segregation studies are frequently supplemented by "severance" and other studies, which usually take the segregation results as their point of departure.

2. *Severance Study.* The value of a leased line to the lessee which is shown by a severance study is the value which the leased line may be said to have because of the consequences which would follow if it were to be separated from the lessee's system and operated either independently or as part of another railroad system. In such a study it is assumed that a complete separation actually has occurred, and that the management of the severed line is not friendly to the remainder of the lessee's system, and will divert from it whatever traffic it can control—but only, of course, where it can do so without loss to itself. The characteristic difference between the value disclosed by a severance study and that shown by a segregation study is that the latter consists of a determination of the income of the leased line based upon the facts of its actual operation as part of the lessee's system, whereas the former is an estimate of the effect upon the lessee's income of a hypothetical, though not impossible, situation.

If a leased line should be separated from its lessee's system, and operated independently, certain results would follow from the point of

able. A request for a reference to the ICC after approval by the court may well raise questions of procedure. For this reason, as well as the fact that the ICC is better qualified to deal with matters of such a highly technical nature (see *In re Chicago Rock Island*, *supra* note 60), the safer course to be followed by parties dissatisfied with a formula would seem to be to request a reference to the ICC prior to approval by the court. Indeed, a court might well expedite the proceedings by referring the formula to the ICC on its own motion early in the reorganization. A request for a reference normally would be made on a petition by the trustees for approval by the court of the formula. However, a reference to the ICC may occur at other points in the proceeding. See §77(c)(10).

view of the remainder of the lessee's system, It would, of course, be freed from a substantial part, if not all, of the expenses charged to the leased line in the segregation study.⁶³ On the other hand, it would lose not only the revenues allocable to the leased line in the segregation study but also, should the leased line be able to divert traffic⁶⁴ away from the lessee, the revenues which it would otherwise receive from the passage of this traffic over its own lines.

In practice, the preparation of a severance study proceeds about as follows, taking as an example a leased line which has segregated income. The point of departure is the amount of this segregated income, which, as has been seen, would be lost to the lessee. Secondly, an estimate is made of expenses charged to the leased line in the segregation study which, after its severance, would have to be born by the lessee. Next, in order to take into account whatever diversion of traffic from the lessee may be probable, still another estimate is made of the revenues which the lessee receives from such traffic as it passes over the lessee's lines. From this is deducted an estimate of those expenses which are chargeable to this traffic under such circumstances but which, assuming diversion, would not remain to be born by the lessee. The difference between the latter two estimates is the loss sustained by the lessee from diversion alone. Finally, by adding to this latter amount the segregated income of the leased line and the expenses charged to it under the segregation study and now to be borne by the lessee, as referred to above, an estimate is reached of the amount which the lessee would lose should the leased line be severed from it and operated independently.⁶⁵

63. Certain of these expenses, as in connection with joint facilities, presumably would have to be born by the lessee after severance of the leased line.

64. In estimating the probable extent of diversions of traffic under such circumstances, the judgment of the lessee's traffic officers is customarily sought, since these men are, by their experience and training, most competent to weigh the factors involved. These factors may include such matters as the location of the leased line, the availability and relative circuitry of competing routes, its connections with competing carriers and the convenience and efficiency of terminal facilities at common points, and many other considerations which influence the movement of traffic.

65. A hypothetical illustration of this calculation would be as follows:

Segregated income of leased line	\$1,000,000	
Expenses assigned to leased line born by lessee after severance	100,000	
		\$1,100,000
Revenues lost by lessee through diversion of traffic by severed leased line	\$2,000,000	
Expenses saved by lessee through non-carriage of diverted traffic	800,000	1,200,000
		\$2,300,000

If the leased line has a segregated loss, obviously its severance will result in gain to the lessee. However, this gain will be diminished by (1) expenses previously charged to

In addition, if the study is complete, estimates will also be made of the revenues and expenses of the severed line after severance, in an effort to ascertain the results of its independent operation. For it is desirable, of course, from the standpoint of both lessor and lessee to determine as accurately as possible not only the net effect of severance upon the remainder of the lessee's system but also the results of separate operation of the leased line.

Obviously, the value disclosed by a severance study is somewhat more speculative and more a matter of opinion than the value disclosed by a segregation study.⁶⁶ Nevertheless, since the objective of a severance study is an effort to measure elements of value which cannot be shown by a segregation study, it is often a necessary adjunct to a segregation study upon which, as has been seen, it heavily relies. A leased line may, under some circumstances, be more valuable to its lessee by reason of its severance value than by reason of its segregation value. Thus, a leased line which can obtain equal or greater benefits by delivering its traffic to other railroads which are competitors of its lessee, and which originates and terminates traffic from which the lessee derives substantial direct revenues, plainly has a value to the lessee over and above the amount of its segregated earnings.

THE POWER TO ELECT TO ADOPT OR REJECT EXECUTORY LEASES

With this background, let us turn now to the reorganization process itself. It has long been established in equity receivership practice that a receiver may elect to adopt or reject⁶⁷ executory leases.⁶⁸ Though

the leased line which, after severance, have to be born by the lessee, and (2) the loss sustained by the lessee as a result of non-passage over its lines of such traffic as the leased line may be able to divert.

Needless to say, in particular cases it may be urged that other considerations tend to increase or decrease severance value. If in fact this is the effect of the considerations, an attempt must be made to express them in numerical terms.

66. Closely akin to the idea of severance value is the notion that a leased line may possess value to the lessee arising out of "contribution" of income to the lessee's system from freight traffic originating or terminating on it.

67. The phrases "elect to adopt" and "elect not to adopt" perhaps most accurately characterize the action which a receiver or trustee may take with respect to executory leases. The receivership cases, however, appear to have used the words "adoption" and "affirmance" as synonymous on the one hand, and "rejection" and "disaffirmance" as synonymous on the other. In this article the words "adopt" and "reject" and "adoption" and "rejection" are used throughout, the latter in the sense of "election not to adopt."

68. *United States Trust Co. v. Wabash Ry.*, 150 U. S. 287 (1893); *St. Joseph, St. L. R. R. v. Humphreys*, 145 U. S. 105 (1892); *Quincy, M. & P. R. R. v. Humphreys*, 142 U. S. 82 (1892); *Sunflower Oil Co. v. Wilson*, 142 U. S. 313 (1892); *American Brake Shoe & F. Co. v. New York Rys.*, 282 Fed. 523 (C. C. A. 2d, 1922); *American Brake Shoe & F. Co. v. New York Rys.*, 282 Fed. 293 (S. D. N. Y. 1920); *Pennsylvania Steel Co. v. New York C. Ry.*, 219 Fed. 939 (S. D. N. Y. 1914); *Pennsylvania Steel Co. v. New York C. Ry.*, 192 Fed. 135 (S. D. N. Y. 1911); *Dayton Hydraulic Co. v. Felsenthal*,

authority to make such an election is not expressly conferred upon trustees appointed under Section 77, nevertheless, in view of the clear import of subsections (a) and (c)(2) there can be little question of its existence. Moreover, it is implicitly recognized in subsection (b). Section 77 contains no provisions which even impliedly negative it, and, without exception, present practice accepts its existence.

The early equity cases also made the period within which election may take place subject to the test of reasonableness. Here, as in most instances, the test is a relative one. What constitutes a reasonable time evokes the familiar phrase that it "must be determined by all the facts and circumstances surrounding the particular case in hand."⁶⁹ In pending reorganizations the initial orders generally not only expressly grant the authority, but, in addition, prescribe the period, almost invariably six months, within which it may be exercised.⁷⁰ In practice this is not a rigid limitation, for extensions are liberally granted for further periods of the same duration, or, occasionally, "until further order of the Court."⁷¹ Such extensions may, at times, place a lessor somewhat at a disadvantage. In cases where the orders effecting them are entered

116 Fed. 961 (C. C. A. 6th, 1902); *Platt v. Philadelphia & R. R. R.*, 84 Fed. 254 (C. C. A. 3d, 1898); *Mercantile Trust Co. v. Farmers Loan & Trust Co.*, 81 Fed. 254 (C. C. A. 8th, 1897); *Central R. R. & Banking Co. v. Farmers Loan & Trust Co.*, 79 Fed. 158 (S. D. Ga. 1897); *Empire Distilling Co. v. McNulta*, 77 Fed. 700 (C. C. A. 7th, 1897); *Clyde v. Richmond & D. R. R.*, 63 Fed. 21 (1894); *Ames v. Union P. Ry.*, 60 Fed. 966 (D. S. C. 1894); *New York, P. & O. R. v. New York, L. E. & W. R.*, 58 Fed. 268 (N. D. Ohio 1893); *Farmers Loan & Trust Co. v. Northern Pac. R. R. Co.*, 58 Fed. 257 (E. D. Wis. 1893); *Park v. New York, L. E. & W. R. R.*, 57 Fed. 709 (S. D. N. Y. 1893). See Clark, Foley and Shaw, *Adoption and Rejection of Contracts and Leases by Receivers* (1933) 46 HARV. L. REV. 1111.

69. *American Brake Shoe & Foundry Co. v. New York City Rys.*, 282 Fed. 293, 297 (S. D. N. Y. 1920); *Northern Kansas City Bridge & R. R. Co. v. Leness*, 83 F. (2d) 9, 13 (C. C. A. 8th, 1936); *General Finance Corp. v. New York S. Rys.*, 54 F. (2d) 1008, 1009 (C. C. A. 2d, 1932); *Westinghouse Elec. & Mfg. Co. v. Brooklyn Rapid Transit Co.*, 6 F. (2d) 547, 549 (C. C. A. 2d, 1925).

70. Typical of the language employed for this purpose is that contained in Order No. 1 (Feb. 28, 1935), Court Record 5, in the *Chicago, Great Western* proceeding: "(4) That the Debtor may in its discretion or at any time prior to September 1, 1935, or prior to such other date as may be provided by further order of this Court, disaffirm any of its existing contracts or leases." While variations in language appear in orders in other proceedings, the effect is the same. If, as in the above excerpt, no reference is made to trustees to be subsequently appointed, the usual provision in the order appointing trustees is to grant such trustees "all the right, privileges, powers and duties" previously granted to the debtor. Present practice in equity receiverships sanctions an express grant to the receiver of authority to elect to adopt or reject, the language used being substantially the same as in proceedings under Section 77. Cf. Clark, Foley and Shaw, *supra* note 39, at 1122.

71. *Rock Island Proceeding*, Order No. 71 (May 1, 1935), Court Record 806. Such extensions are generally granted upon petition of the debtor's trustees, and in practice, through successive orders, preserve the authority to elect to adopt or reject throughout the proceeding, in the absence of objection by the lessor interests.

ex parte, any determination of whether or not a reasonable time has elapsed must be instituted, presumably by subsequent separate motion, by the lessor, which will have the burden of proving that the extension is unreasonable.⁷² Normally it would seem to be to the advantage of the lessor interests to take the initiative, either in seeking to force election or in obtaining payments under lease. However, even such action by the lessor interests may be of only temporary value, because of the possibility that rejection may take place in the plan of reorganization, regardless of prior adoption.⁷³

The problem of whether a particular lease should be adopted or rejected is a matter of business judgment.⁷⁴ For the first of many times during the reorganization proceeding the value of the leased line to the lessee's system becomes the significant consideration. However, so far as election is concerned, the determination of value does not involve at this point in the proceeding an effort to arrive at the true value of the leased line to the lessee. It merely involves answering the question whether the leased line is worth the annual price called for by the lease. This distinction is important, for while the trustees may need detailed information to decide whether a particular leased line, whose lease calls for an annual rental of say \$300,000, warrants the payment of precisely \$200,000, \$150,000, \$100,000 or no price whatever, they may need no such detailed information to decide that the payment of \$300,000 annually is not warranted. In other words they may be able to tell that the leased line is not worth to the lessee the rental called for by the existing lease, though they are as yet unable to tell exactly what the rental, if any, should be. So at an early stage in the reorganization proceeding the trustees may be able to advise the court that one lease should be rejected, even though at the same stage they are not in a position to advise the court that certain other leases should be adopted.⁷⁵ As a practical matter, this would seem to mean that adoption may not occur, while rejection may occur, early in the reorganization.

However, even though the trustees do recommend rejection at an early stage in the proceeding, the various studies previously described will presumably have been commenced, and some results may be available to guide the trustees. In every instance the trustees will have such information as is known to the lessee's operating staff. While this latter may

72. For example of the typical motion and order extending the time to disaffirm, see Missouri Pacific Proceeding, Motion and Order Nos. 88 (Sept. 27, 1933), Court Record 531, 535. On the other hand all parties, including the lessor, may agree to an indefinite extension.

73. See p. 651 *infra*.

74. See *Mercantile Trust Co. v. Farmers Loan & Trust Co.*, 81 Fed. 254, 259 (C. C. A. 8th, 1897).

75. On the other hand, the trustees may merely petition for instructions as to how to deal with the lease, presenting the relevant facts to the court at hearing.

not be as comprehensive as desirable, nevertheless it is apt to be of considerable aid in deciding whether benefits accruing to the lessee from the leased line warrant payment of the rental called for by the lease.

THE MANNER OF ELECTION

In contrast with the importance of its effect upon existing legal relationships, the formal act of election is very simple, consisting generally of the lessee's trustees' sending by registered mail to the particular lessor a notice stating that pursuant to authority granted by the court, the trustees adopt or reject the lease.⁷⁶ After mailing such a notice it has been customary in cases pending under Section 77 for the trustees to file with the reorganization court a report stating that the notice has been mailed to the lessor.

Although this represents the "formal" manner of election, receivers and trustees must be careful in their actions prior to taking such a step. Courts of equity have, in several instances, held receivers to have adopted existing leases by actions of an informal nature.⁷⁷ Moreover, it is clear

76. In Section 77 proceedings, the orders authorizing the trustees to reject usually state specifically the manner of rejection. Although these orders may expressly authorize only rejection, the corresponding authority to adopt would seem to be implied, and in such cases the manner of adoption would presumably be the same as the manner of rejection expressly indicated. For example, in the Denver & Rio Grande Western Proceeding, Order No. 1 (Nov. 1, 1935), Court Record 8, provides: "Such disaffirmance shall be indicated by notice, in writing, to that effect, served on the other party or parties to such contract, and filed herein." Orders in other proceedings generally have expressly stated that the notice may be mailed to the lessor, requiring only proof of mailing. For example, Chicago & Northwestern Proceeding, Order No. 1 (June 28, 1935), Court Record 9.

77. *Gaston v. Rutland R. R.*, 35 F. (2d) 685 (C. C. A. 2d, 1929); *Peabody Coal Co. v. Nixon*, 226 Fed. 20 (C. C. A. 8th, 1915); *Platt v. Philadelphia & R. R. R.*, 84 Fed. 535 (C. C. A. 3d, 1898); *Central Trust Co. v. Continental Trust Co.*, 86 Fed. 517 (C. C. A. 8th, 1898); *Carswell v. Farmers Loan & Trust Co.*, 74 Fed. 88 (C. C. A. 6th, 1896); *In re Mallow Hotel Corp.*, 17 F. Supp. 872 (E. D. Pa. 1937); *Menke v. Willcox*, 275 Fed. 57 (S. D. N. Y. 1915); *Pennsylvania Steel Co. v. New York City Ry.*, 192 Fed. 135 (S. D. N. Y. 1911); *Thomas v. Cincinnati, N. O. & T. P. Ry.*, 77 Fed. 667 (S. D. Ohio 1896); *Clyde v. Richmond & D. R. R.*, 63 Fed. 21 (D. S. C. 1894).

In *Clyde v. Richmond & D. R. R.*, *supra*, remaining in possession of the leased property beyond the "reasonable time" was held to amount to an adoption of the lease by the receivers. In *Gaston v. Rutland R. R.*, *supra*, it was held that a lease, though once rejected, had been reinstated and adopted by the receivers when they accepted an offer of the lessor to permit them to use the leased line on the same terms as the previously disaffirmed lease. Though such instances exist, actions taken by receivers within the "reasonable time" have generally not been held to constitute adoption unless a "positive indication" of their intent to take over the lease is present. *Peabody Coal Co. v. Nixon*, *supra*. Negotiations looking to a modification of the existing lease will not ordinarily be held to amount to adoption. *Carswell v. Farmers Loan & Trust Co.*, 74 Fed. 88 (C. C. A. 6th, 1896); *Pennsylvania Steel Co. v. New York City Ry.*, 192 Fed. 135 (S. D. N. Y. 1911); *Platt v. Philadelphia & R. R. R.*, 84 Fed. 535 (C. C. A. 3d, 1898); *Thomas v. Cincinnati, N. O. & T. P. Ry.*, 77 Fed. 667 (S. D. Ohio 1896).

that the burden of showing such informal affirmance rests with the lessor, although this has not been stated by the courts in so many words. However, care has been taken in proceedings under Section 77 and in present day equity reorganizations, as well, that no act of the trustees or receivers shall be construed as an adoption of any lease. Ordinarily the initial order approving the petition specifies that "no conduct or user of rights by the Debtor or payments made by the Debtor as rent or otherwise, . . . or any other acts or omissions by the Debtor" except the formal notice, shall be deemed to constitute an election to adopt any lease.⁷⁸

THE EFFECTS OF ADOPTION

During the pendency of the reorganization proceeding, the same consequences ensue upon adoption of a lease under Section 77 as in equity. In both instances the terms of the lease will be in effect throughout the entire proceeding. In equity, whether or not after adoption of a lease by the receiver, the company organized to take over the lessee's properties on foreclosure sale would be required to assume the lease is not entirely clear. Decrees of sale exist which have permitted the purchasers to elect whether to adopt or reject leases. Such power, however, does not seem to have extended to leases previously adopted by the receiver, but only to those upon which no action was taken during the reorganization proceeding.⁷⁹ Nevertheless, it seems, as a practical matter, that adoption by a receiver has usually meant that the lease would be assumed unmodified by the new company. In proceedings under Section 77, however, a second opportunity to elect has been specifically conferred by subsection (b) of the statute, which provides that a plan of reorganization "may reject contracts of the debtor which are executory in whole or in part, including unexpired leases."⁸⁰ Despite this express grant of authority in the

78. Chicago, M. St. P. & P. Proceeding, Order No. 1 (June 29, 1935), Court Record 49. For variations in language, see Denver & Rio Grande W. Proceeding, Order No. 1, Court Record 8 and Chicago & Great Western Proceeding, Order No. 1 (Feb. 23, 1935), Court Record 5, where the orders merely provided that "continued operation" and "performance of any such lease" should not constitute adoption of any lease. As to the effectiveness of such provisions, see *Kansas City Pipe Line Co. v. Fidelity Title & Trust Co.*, 217 Fed. 187 (C. C. A. 8th, 1914).

79. See Chicago Great Western Equity Proceeding (*Humbird v. Chicago G. W. Ry.*), Final Decree (July 10, 1909) Court Record 347, 358; *Minneapolis & St. L. Equity Proceeding*, Final Decree (Jan. 8, 1929, as amended). *Kansas City Terminal Ry. v. Central Union Trust Co.*, 28 F. (2d) 177, 180 (C. C. A. 8th, 1928). See also the final decree in the *Erie Reorganization* of 1896. One group of writers has indicated the purchaser was not bound by a receiver's adoption of a lease in the absence of a provision in the decree of sale imposing the obligation upon it. See Clark, Foley and Shaw, *op. cit. supra* note 39, at 1127.

80. Subsection (b) further provides: "The adoption of an executory contract or unexpired lease by the trustee or trustees of a debtor shall not preclude a rejection of such contract or lease in a plan of reorganization approved hereunder, and any claim resulting from such rejection shall not have priority over any other claims because such contract or lease had been previously adopted."

statute, it does not seem likely that reorganization plans in Section 77 proceedings will often reject leases which previously have been adopted. In no pending reorganization in which plans have been proposed by the Interstate Commerce Commission has such a proposal been made, and it is probable that rejection in a plan of reorganization will occur only in unusual cases where a radical alteration in circumstances has taken place between the date of adoption by the trustees and confirmation of the plan. Consequently, upon adoption by the trustees it can be said that the lessor may reasonably look forward to fulfillment of the lease contract.

THE EFFECTS OF REJECTION

It is upon the election of the trustees to reject a lease that the problems of the lessor interests become most apparent, for such action presumably means that the trustees have concluded either that the leased line has no value whatever to the lessee's system, or that, although perhaps of some value, it still would, under the terms of the lease, be burdensome to the estate which they are administering. In either event the lessor interests must act to protect themselves, and, if the situation is the former, at least salvage what they can; if the latter, seek to prevent unwarranted modification of the lease.

In the main, upon rejection four questions will appear which must be answered during the course of the reorganization proceedings. Upon the answers to these questions, together with the answer to the fundamental and primary question of the value of the leased line, the ultimate fate of the lessor interests in the reorganization will chiefly depend. These questions are:

(1) Is it necessary and advisable for the lessor to be placed in equity receivership or to file under Section 77?

(2) Who will operate the leased line during the proceeding for reorganization of the lessee?

(3) If the trustees for the debtor lessee operate the leased line, how will such operations be accounted for?

(4) What claims against the lessee will the lessor and its security holders have for breach of the lessee's covenants in the lease?

1. Status of the lessor upon rejection. It will be recalled that the typical lessor is little more than a corporate shell, whose activities, save for such formal acts as are needed to maintain its corporate existence, have almost completely ceased. Payment of its bond interest, dividends and taxes has ordinarily been taken care of directly by the lessee under the terms of the lease, and even if actually handled by the lessor, such payments have for the most part involved purely mechanical activity. The lessor's treasury is ordinarily bare of sizeable funds, and if payments under the lease cease, it is not likely to have any other source of income.

If the lessor has bonds outstanding, it will consequently be unable to pay the bond interest and all the consequences of such non-payment may follow. Even if no bonds are outstanding, taxes upon its properties will continue to accrue. Without resources, the lessor company itself is not apt to be well prepared to wage an effective fight in the reorganization and the burden of financing such a fight will presumably fall upon the holders of its securities.⁸¹

Under these circumstances and with the probability that its own security structure will have to be readjusted, the institution of reorganization proceedings for the lessor may possibly be the only practicable course. While resort to equity presumably is possible, under Section 77 several preliminary questions arise. Will the lessor petition for reorganization under Section 77 separately or in the same proceeding with its lessee? As originally enacted in 1933, Section 77 provided for two types of situations where a lessor could file a petition with the court having jurisdiction of the debtor lessee and ask to be reorganized "in connection with or as part of" the reorganization of the lessee. One was where the debtor owned the majority of stock of "any corporation;" the other where the debtor operated substantially all the properties of the lessor under a lease.⁸² Both situations were affected by the 1935 amendments to Section 77, the first by a provision that only "railroad" corporations, rather than "any" corporations, in which the debtor lessee owned a majority of the capital stock "having power to vote for the election of directors" could file in the lessee's proceeding.⁸³ The second was completely eliminated.⁸⁴ As a consequence majority stock control of the lessor by the debtor lessee is now a *sine qua non* to the lessor's power to file a petition in the lessee's proceeding, and it has been accepted that a railroad lessor is a "railroad" corporation within the statute.

If the lessee has a majority stock interest in the lessor, and if the lessor accordingly seeks reorganization under Section 77 in its lessee's proceeding, unified administration of the properties of lessee and lessor under the same trustees is possible.⁸⁵ Even if majority stock ownership by the lessee is absent, it is still possible for the lessor to file a completely

81. Although this may be true at the outset of the proceeding, nevertheless it seems to be clear that, within the limits prescribed by subsection (c)(12) of Section 77, the activities of the lessor interests may be compensated out of the estate of the lessor, if the lessor also is in reorganization, and perhaps even out of the estate of the lessee. In any event the procedure prescribed by subsection (c)(12) will have to be followed, with maximum permissible allowances being fixed by the ICC.

82. 47 STAT. 1474 (1933) (repealed).

83. 49 STAT. 911 (1935), 11 U. S. C. § 205 (Supp. 1938).

84. The removal of this provision is ably criticized in Friendly, *The 1935 Amendment of the Railroad Reorganization Act* (1936) 36 COL. L. REV. 1, 49.

85. If a possibility of adversity of interests should arise, the court may appoint special counsel to represent the lessor's estate.

independent petition in the court having charge of the lessee's proceeding, provided the lessor's principal executive office is in the territorial jurisdiction of that court and its lines are not wholly within a single state in a different jurisdiction. However, if this is done, unlike the situation where the lessor files as a subsidiary, separate proceedings are necessary for the two companies, and presumably different trustees would be appointed.

If the lessor's principal executive office is in a territorial jurisdiction other than that of the court in which the lessee is being reorganized, the lessor cannot file in the same court as the lessee and the two proceedings must be conducted in different courts. This at once may present problems. The trustees appointed for the lessor will almost certainly be different from persons appointed for the lessee. With two courts and two sets of trustees involved, opportunities for disputes, especially as to jurisdiction, may be multiplied. Particularly may this be so concerning matters arising out of the operation of the lessor's properties, since, as a practical matter, the court administering the lessor's proceeding will in all probability have to provide for the continued operation of these properties by the lessee's trustees, at least for the time being.⁸⁶

If the lessor files under Section 77 in the lessee's proceeding, and if the lessee's trustees are appointed trustees of the lessor also, the powers previously given to them in the former capacity will simply be granted to them as trustees of the lessor, and in matters affecting both estates they will act as trustees of both estates. Where the lessor's proceeding is in another court and different trustees are appointed, it will progress as an independent proceeding under Section 77, with such exceptions as may necessarily arise out of the operation of the lessor's properties by the lessee's trustees. In both cases, the lessor's trustees will be charged with the preservation of the lessor's estate for its creditors, one aspect of which, for example, may be the initiation of efforts to obtain relief from burdensome obligations, including contracts and leases, which the lessor itself may have entered into prior to leasing its properties to its own lessee.

86. In one proceeding under Section 77 the lessor's trustees under such circumstances have contested the jurisdiction of the court administering the lessee's proceeding to determine, as between the two estates, the accounting for such operation prior to disaffirmance. *In re New York, N. H. & H. R. R.*, 26 F. Supp. 28 (D. Conn. 1939), (1939) 52 HARV. L. REV. 1356, *modified sub nom. Warren v. Palmer*, C. C. A. 2d, Dec. 18, 1939. An application for writ of certiorari from the decision of the Circuit Court of Appeals for the Second Circuit is pending as this is written. The case involves the question of whether the district court administering the lessee's reorganization and operating the lessor's properties with the approval of the lessor's court had jurisdiction, as against the lessor's court (a separate district court in another circuit), to determine the amount of the claim of the lessee's trustees against the lessor's estate for deficits incurred in the operation of the lessor's line for the lessor's account, and to impose a prior lien for that amount upon the lessor's properties, which were in the custody of the lessee's trustees.

2. *Operation of the leased line before and after rejection.* As we have seen, at the time reorganization of the lessee is commenced, the lessor ordinarily will not be in a position to resume the operation of its own line. Nor could it do so immediately if it were able, because under most leases there must first be default in payment of rent, followed by a period usually of at least thirty days, before the lessor can take steps to declare the lease forfeited and to reenter its property. Even after such default and such subsequent period the lessor may be prevented from reentering; for if, nevertheless, a reasonable time for the lessee's trustees to elect to adopt or reject has not yet elapsed, the reorganization court can restrain the lessor from interfering with the possession of the leased line by the trustees. It has recently been stated that the right of the trustees to such a reasonable time is paramount to the lessor's right to reenter after breach of the lease.⁸⁷ Consequently, as a practical matter even a lessor which is able and willing to reenter is in a difficult position, inasmuch as the court is not apt of its own volition to determine whether a reasonable time has elapsed or not. If the right of reentry is to be worth anything at all, plainly the lessor must take the initiative in forcing a determination of that question. On the other hand, in the more usual situation where the lessor is unable to resume operation either itself or by arrangement with another railway system, it will benefit from the continued operation of the leased line which it is the duty of the court to insure in the public interest. Indeed, it has been held that a demand by the lessor for return of its property when it is unable to resume operation is not made in good faith and for that reason will be given no effect.⁸⁸

Consequently, unless the lessor is actually ready and able to take back its properties and operate them and takes steps to that end, it would seem unlikely that operation of its property by the lessee's receiver or trustees will be affected prior to election to adopt or reject the lease. But upon rejection the situation changes and in a proceeding under Section 77, subsection (c)(6) comes into play. This subsection provides as follows:

"If a lease of a line of railroad is rejected, and if the lessee, with the approval of the judge, shall elect no longer to operate the leased line, it shall be the duty of the lessor at the end of a period to be fixed by the judge to begin the operation of such line, unless the judge, upon the petition of the lessor, shall decree after hearing that it would be impracticable and contrary to the public interest for the lessor to operate the said line, in which event it shall be the duty of the lessee to continue operation on or for the account of the lessor until the abandonment of such line is authorized by the Commission

87. *Palmer v. Palmer*, 104 F. (2d) 161 (C. C. A. 2d, 1939), *cert. denied*, 60 Sup. Ct. 120, 121 (U. S. 1939).

88. *American Brake Shoe & Foundry Co. v. New York Rys.*, 282 Fed. 523 (C. C. A. 2d, 1922).

in accordance with the provisions of Section 1 of the Interstate Commerce Act as amended."

By speaking at the outset of the lessee's right, subject to the approval of the judge, to elect "no longer to operate the leased line," and then later requiring the lessee to continue operation of "said line" if the judge finds it impracticable and contrary to the public interest for the lessor to do so, the first portion of this subsection appears to mean that the lessee's trustees may, absent such a finding by the judge, turn over the operation of the entire leased line to the lessor without first obtaining the approval of the ICC. That this was the intent seems to be even more clearly indicated by the language making it the "duty" of the lessor to begin operation of its line, and the fact that judge makes the finding "upon petition of lessor." In situations apart from equity as well as Section 77 the approval of the ICC under Section 1(18) of the Interstate Commerce Act has apparently been regarded by it as necessary before abandonment of operation of a leased line by the lessee.⁸⁹ And there are instances in which the ICC has exercised jurisdiction over similar abandonments of operation by lessee's receivers in equity, after the lease has been rejected.⁹⁰ Under Section 77 the question of whether subsection (c)(6) was intended to permit the lessee's trustees, without first obtaining approval of the ICC, to turn over operation of the leased line to a lessor ready and able to resume its operation is as yet unanswered, for in proceedings pending under the statute, operation of the leased lines involved has, after rejection, been continued by the lessee's trustees for the account of the lessor pursuant to the final clause of subsection (c)(6).

But apart from this question, it would at least seem clear that the first clause of subsection (c)(6) is concerned with abandonment of operation of the leased line in its entirety by the lessee's trustees. Since the concluding portion of that subsection apparently deals with complete physical abandonment of the leased line,⁹¹ no attempt seems to have been

89. Lehigh Valley Proposed Abandonment, 202 I. C. C. 659 (1935) (lease had expired). But in this case the lessor made no effort to resume operation of its line. Cf. Operation by Louisiana & A. Ry., 145 I. C. C. 228 (1928); Chicago & A. R. R. v. Toledo, P. & W. Ry., 146 I. C. C. 171 (1928), Commissioner Eastman dissenting. This question does not, however, appear to have been passed upon by the courts.

90. Norfolk & S. R. R., Receiver's Abandonment, 221 I. C. C. 258 (1937); Seaboard Air Line Ry., Receiver's Abandonment, 202 I. C. C. 543 (1934), Commissioner Mahaffie, dissenting. This question does not appear to have been passed upon by the courts. But the lessor need not apply to the ICC for authority to resume operation of its line after default of the lessee's receivers. Norfolk & S. R. R., Receiver's Abandonment, 221 I. C. C. 258, 260 (1937).

91. See Friendly, *supra* note 84, at 48. Subsection (o) of Section 77, dealing with complete physical abandonment, is, of course, available to trustees of a lessor undergoing reorganization. In addition, it is available to the trustees of the lessee in connection with complete physical abandonment of all or part of the leased line. See note 97 *infra*.

made in this subsection to cover one other important field of action with respect to operation of the leased line by the lessee's trustees, that is, partial abandonment of operation by curtailment and partial discontinuance of service.⁹² The procedure for effecting such partial abandonment may, under certain circumstances, become a matter of considerable importance, as, for example, where it may be anticipated that elimination of unprofitable services will bring about more favorable segregation results.

This was substantially the situation in the recent Supreme Court case of *Palmer v. Commonwealth*,⁹³ which involved one phase of the pending New Haven reorganization proceeding. The trustees of the New Haven, who were operating the Old Colony's lines pursuant to subsection (c)(6) after disaffirmance of the Old Colony's lease, applied to the Massachusetts Department of Public Utilities for leave to abandon eighty-eight passenger stations in Massachusetts, most of which were located on the lines of the Old Colony, which was being operated at a large deficit. Hearings before that body were prolonged to such an extent that, apparently despairing of any action by the state authorities, the lessor interests petitioned the reorganization court for an order directing the trustees to abandon these local services. The court, after hearing, granted the relief sought.⁹⁴ This decision was reversed by the Circuit Court of Appeals for the Second Circuit, with one Judge dissenting.⁹⁵

The Supreme Court's decision, sustaining the circuit court, was interpreted in some quarters as a triumph for the Massachusetts authorities. Analysis of Mr. Justice Frankfurter's opinion, however, points to the conclusion that the victory, though complete prior to confirmation of a plan, nevertheless was more pyrrhic than otherwise. Curtailment and partial discontinuance of railroad service are, it was noted in the opinion, matters over which the powers of the states have been preserved in spite of gradual expansion of federal control over other purely intrastate activities of interstate carriers. In order to withdraw this "old and familiar" power from the states, Congress must be found to have used language appropriate to so drastic a change. Such language Mr. Justice Frankfurter was unable to find in Section 77 except in connection with the plan of reorganization, and indeed, he said, the interrelation between the jurisdiction of the ICC and that of the district court which Section 77 creates, indicates that Congress did not intend matters of this kind to be decided by the district court without the assistance and approval of the ICC. However, since the statute gives the ICC no jurisdiction over such matters prior to its action upon a complete plan of reorgan-

92. And properly so, since such partial abandonment of operation may be warranted on lines other than those subject to leases which have been rejected by the trustees.

93. 60 Sup. Ct. 34 (U. S. 1939).

94. New Haven Proceeding, Order No. 289 (July 9, 1938), Court Record 4544.

95. *Sub nom.* Converse v. Commonwealth, 101 F. (2d) 48 (C. C. A. 2d, 1938).

ization for the debtor, until the point for confirmation of a plan is reached, the power of state regulatory bodies is paramount. But under the clear authority of subsection (f) of Section 77, it is plain the ICC may include provisions in the plan of reorganization which it approves and which do "supplant state authority" with respect to precisely the type of question before the Supreme Court.⁹⁶ Nevertheless, many questions will probably arise in this connection.⁹⁷

Turning to the final clause of subsection (c)(6), other difficulties are apparent. Assuming the district court has decreed that it is impracticable and contrary to the public interest for the lessor to operate, how long must the lessee's trustees continue to operate? Can such operation be required to continue if the leased line is operated at a deficit which can only be met by the appropriation of funds from the estate of the lessee? Can the lessor reenter at a subsequent time, when able to prove its ability to operate? All these, and doubtless other problems, are latent within the statutory language. From one standpoint, this final clause would seem to be designed merely as a temporary solution of what to do with the leased line. So interpreted, it would contemplate operation by the lessee's trustees only until some other arrangement is made, and would be no bar to subsequent reentry by the lessor, to a merger or consolidation with the reorganized lessee, should that be desirable, or to some different disposition of the leased line.⁹⁸ On the other hand, since lines whose leases have been rejected have often been distinct liabilities to their lessees, the statutory language can be regarded as contemplating primarily either of two things: resumption of operation by the former lessor, either at once or after a period in which to make the necessary preparations, or complete physical abandonment of the line.

In pending proceedings under Section 77, few of these questions have thus far been raised. Upon disaffirmance, lessor companies have in most instances, promptly or within a brief period thereafter, filed petitions under Section 77, ordinarily as subsidiary debtors, if able to meet the

96. Subsection (f) provides: "Upon confirmation of a plan, the debtor and other corporation . . . organized . . . for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relative thereto, under and subject to the supervision and control of the judge, the laws of any State or the decision or order of any State authority to the contrary notwithstanding."

97. For example, is it intended that the reorganization plan shall specify in detail the services to be discontinued, and the curtailments to take place? What evidence must be introduced before the ICC to support such provisions? When can such curtailments and discontinuances, if approved by the ICC, be put into effect?

98. Subsection (b) provides: "A plan of reorganization within the meaning of this section . . . (5) shall provide adequate means for the execution of the plan, which may include . . . the merger or consolidation of the debtor with another corporation or corporations."

jurisdictional requirements.⁹⁹ These petitions have been treated not only as petitions under Section 77, but also, in effect, as petitions under subsection (c) (6) for a decree that the lessee should, at least for the time being, continue to operate the leased line in the public interest for the account of the lessor.¹⁰⁰

(This Article will be concluded in a subsequent issue)

99. Erie Proceeding, Petition No. 54 (June 29, 1938), Court Record 571; New Haven Proceeding, Petition No. 74 (June 3, 1936), Court Record 731; Denver & Rio Grande Western Proceeding, Petition No. 2 (Oct. 30, 1935), Court Record 17.

100. However, even if the lessor does not file under Section 77, it can, of course, file the petition described in subsection (c) (6) requesting continuance of operation by the lessee's trustees. For example, in the *Erie Reorganization*, the Avon, Genesee & Mt. Morris R. R. petitioned the court administering its lessee's reorganization for leave to intervene and for an order directing the lessee's trustees to perform the lease in full. (Court Record 1443-1454). Intervention was granted but determination of the remaining matters was reserved. (Court Record 1465-1466). Subsequently, in a petition which alleged that studies showed the total expenses of operating the leased line to be greater than the total operating revenues, the lessee's trustees asked the court to approve their election no longer to operate the leased line, and to fix a time at the end of which it would become the duty of the Avon to resume operation of its own properties. (Court Record 1469-1470). This election was approved and determination of the other matter reserved. (Court Record 1483-1485). Thereafter the Avon petitioned the court for a finding that it was impracticable and contrary to the public interest for it to operate its properties, and for an order directing the lessee's trustees to operate the property for the account of the lessee's estate, pending decision by the ICC on an abandonment application previously filed by the Avon. (Court Record 1473-1477). The court found it impracticable for the Avon to resume operation, but directed the lessee's trustees to operate the leased line for the Avon's account from the date of the order. (Court Record 1541). The lessee's trustees then sought the court's permission to join in the Avon's abandonment application, which was granted, together with authority to abandon the line upon issuance by the ICC of the necessary certificate. (Court Record 1559-1562, 1565-1566).

Subsection (o) of Section 77 grants the ICC jurisdiction over complete abandonment of property of the debtor. Accordingly, where trustees have been appointed for the lessor, applications in their names fall directly within the subsection. Where, as in the case of the Avon, trustees have not been appointed, nevertheless the ICC's jurisdiction over application by the lessee's trustees cannot be questioned in view of § 1 (18) of the Interstate Commerce Act. *Central A. & E. R. R., Trustee's Abandonment*, 221 I. C. C. 170 (1937).