

# RAILROAD LEASES AND REORGANIZATION: II

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ONE of the most important questions raised in a study of the role of the railroad lease in reorganization is the manner in which the lessee's trustees, in view of their rejection of the lease, will account for operation of the leased line. As pointed out in Part I of this article,<sup>101</sup> the leased line will be actually operated by the lessee's trustees both before and after rejection of the lease. Such operation means that expenses will be incurred in running trains, in maintenance, in making necessary capital improvements and in many other ways. Certain revenues will also result from this operation. Accounting for operation can be defined as ascertaining in dollars and cents whether the operation as a whole is at a profit or loss. The existence of either a profit or a loss has a two-fold consequence for the lessor. It will play a part in determining the final treatment of the lessor in the lessee's plan of reorganization. Moreover, and of importance here, it may have significant consequences during the reorganization proceeding itself.

## THE FINANCIAL RISK OF OPERATION

There first arises the important question of which party is to bear the financial risk of operation by the lessee's trustees. If there is a profit, does it go to the lessor or to the lessee? If there is a loss, which bears it? Is the lessor ever entitled to the stipulated rental? To use the ordinary terminology, is operation of the leased line for the lessor's or the lessee's account?

Under Section 77, as will be shown, operation in most situations is deemed to be for the lessor's account both before and after rejection of the lease. This result may seemingly have far-reaching effects, particularly for the lessor's security holders. If the accounting shows a loss, the amount of the resulting deficit is charged against the lessor. As this charge is regarded as an administrative item, it becomes a lien on the lessor's property in favor of the lessee's estate, ranking prior to all mortgage liens.<sup>102</sup> This may sometimes make the lessor's position

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101. Meck and Masten, *Railroad Leases and Reorganization: I* (1940) 49 YALE L. J. 626, 655 (hereinafter referred to as Part I). The problems of the claims which the lessor will have against the lessee's estate as a consequence of rejection of the lease and the alternatives which exist with respect to the treatment of the lessor and its security holders in the lessee's plan of reorganization will be treated in Part III. Part II deals only with the question of the accounting.

102. As a practical matter, this situation may possibly be avoided in some situations by compromise. In one equity proceeding the claim of the lessee's trustees for a deficit was set off against the lessor's claim for future rent. See *Seaboard Equity Proceeding*,

extremely precarious, for the amount of these prior charges may become so large that, if full effect be given to their priority, the lessee's estate may well become the sole owner of the leased line, leaving nothing for either the lessor's bondholders or shareholders. On the other hand, even though the accounting should reveal a profit with a resultant credit in the lessor's favor, the amount of this credit may be substantially less than the rental stipulated in the lease and the lessor forced into reorganization. The situation may also give the lessee's security holders cause for alarm, for if the loss from operation is sufficiently great, it may in time exceed the value of the lessor's property. It may then be necessary to use assets of the lessee's estate for a time to support operation of the leased line, although, of course, operation may not have to be continued where it is clearly confiscatory.<sup>103</sup>

The decision that operation in most situations is for the lessor's account was not reached without some difficulty, especially in regard to the period between the commencement of the lessee's reorganization and rejection of the lease. That period will be treated separately for

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Order No. 178 (E. D. Va., Apr. 10, 1936) Court Record, pp. 10315, 10319; Order in Ancillary Proceeding (S. D. Fla., Apr. 29, 1936) Court Record, pp. 10458, 10461. It should be noted, however, that the cancellation in that case was by agreement of all the parties and, in particular, that it also included the settlement of a controversy over the use of equipment which was subject to an equipment trust of the lessor. As part of the compromise the lessee's receivers purchased the equipment from the trustee of the equipment trust. Cf. Norfolk Southern Equity Proceeding, Order No. 142-B (E. D. Va., July 6, 1938) Court Record, pp. 5146, 5148 (involving lease of Atlantic & N. C. R. R.).

Certain difficulties seem to inhere in any direct set-off. The claims do not rank on a parity, for the claim of the lessee's trustees generally will be a prior secured claim on the lessor's property while that of the lessor will usually be an unsecured creditor's claim against the lessee's estate. Where, moreover, the deficit has been met by diverting earnings of other properties subject to mortgage or lease, the claim of the lessee's trustees is in a sense for restitution of those earnings, and the parties involved on the two claims constituting the purported set-off may be somewhat different. *Butterworth v. Degnon Contracting Co.*, 214 Fed. 772 (C. C. A. 2d, 1914), *rev'g* 208 Fed. 381 (S. D. N. Y. 1913); cf. *Republic Supply Co. v. Richfield Oil Co.*, 59 F. (2d) 35 (C. C. A. 9th, 1931); *Barber Asphalt Co. v. 42d St. & M. & St. M. Ave. Ry.*, 175 Fed. 154 (S. D. N. Y. 1909), *rev'd on other grounds*, 180 Fed. 648 (C. C. A. 2d, 1910); *Farmers' Loan & Trust Co. v. Northern Pac. R. R.*, 58 Fed. 257 (C. C. E. D. Wis. 1893). The lessor, in addition, may have no claim whatever for future rent against the lessee's estate. See note 103 *infra*.

103. In some instances the lessee's trustees may be said to have the lessor's claim, if any, for future rent as additional security for their claim. But they possibly may not have this additional security under leases where the lessee's obligation is a direct guaranty stamped on the lessor's securities. Despite the rule of operation for the lessor's account, the lessee's security holders may find in these cases that, by reason of exhaustion of the lessor's property, operation, as a practical matter, is for the lessee's account. Relief could be obtained, however, as this result seems to lead to confiscation of the lessee's property. Compare *Erie Proceeding*, Report of Special Master (N. D. Ohio, Feb. 2, 1940) Court Record, pp. 2189, 2199.

the sake of clarity, after consideration has first been given to the period subsequent to rejection.

*Operation for the lessor's account after rejection.* Section 77 is quite explicit on the point that operation is for the lessor's account after the lessee's trustees reject the lease.<sup>104</sup> This same result has been reached in equity receivership reorganizations where it has been justified as fair and proper upon the basis of what might be termed the "consent theory."

The "consent theory," in brief, begins with the idea that the lessee's trustees or receivers, by rejecting the lease, disclaim any further interest in the leased line for the lessee's estate.<sup>105</sup> Yet, if the lessor is unable to operate, someone must keep the trains running. While there remains a duty on the lessee to operate, at least until the ICC sanctions abandonment of operation by the lessee, the primary duty under state law to discharge the obligations of a common carrier rests upon the lessor.<sup>106</sup> By operating the leased line after disaffirmance, the lessee's trustees therefore clearly benefit the lessor through discharging its public obligations and thereby preserving its franchises and property. Since the lessor itself is unable to operate, it is said to acquiesce in the operation by the lessee's trustee.<sup>107</sup> As operation is then at least partly on the lessor's behalf and with its consent, this operation is in fact the lessor's business and should be so treated in the accounting. So goes the argument, and out of it emerges the rule that the lessor should receive the net earn-

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104. Section 77(c) (6).

105. Part I, *supra* note 101, at 639, 647.

106. *Pennsylvania Steel Co. v. New York City Ry.*, 198 Fed. 721 (C. C. A. 2d, 1912); *Seaboard Equity Proceeding*, Order No. 143-B (E. D. Va., July 13, 1934) Court Record, p. 7786; Order in Ancillary Proceeding (S. D. Fla., Oct. 23, 1934) Court Record, p. 8228; *cf. Friendly, Amendment of the Railroad Reorganization Act (1936)* 36 COL. L. REV. 27, 48. The lessee's public duty to operate arose only with the Transportation Act of 1920. SHARFMAN, *THE INTERSTATE COMMERCE COMMISSION (1935)* Pt. III, Volume A, c. XIII. It may be doubtful that this duty exists at all where the lessor itself is able to operate—*i.e.*, wholly apart from §77(c) (6), a lessee may abandon operation of a leased line without ICC approval where the lessor itself will continue operation. But see *Friendly, supra* at 47; *Webster Bank v. Palmer*, 111 F. (2d) 215, 218 (C. C. A. 2d, 1940).

For the most thorough discussion of whether the lessor or the lessee has the primary duty to operate see *Erie Proceeding*, Interim Report of Special Master (N. D. Ohio, March 27, 1939) Court Record, pp. 1979, 2003. After considering the arguments concerning the primary and the public duty to operate, the special master said (Court Record, p. 2008): "The rule that upon rejection of a lease the receiver or trustee of the lessee is accountable from the beginning to the lessor for any net earnings derived from the leased property and may, if operation results in a loss, charge the same to the lessor, is based upon equitable considerations without regard to the question of upon which party rests the public duty to operate." (Italics supplied). The Report was affirmed by the district court. Court Record, p. 2021.

107. See *Pennsylvania Steel Co. v. New York City Ry.*, 198 Fed. 721, 730 (C. C. A. 2d, 1912). Contrast §77(c) (6) under which this consent is actual rather than implied.

ings which result from operation of the leased line, and if there are no net earnings, that the lessor is liable for the amount of the deficit.<sup>108</sup>

As a workable rule of thumb, operation of the leased line for the lessor's account has the merit of relative ease of application, at least once the method for the accounting has been determined. This rule, moreover, seems consistent with the pattern of the law of landlord and tenant whence the railroad lease device was derived. The fairness of the rule, of course, may well have been much more apparent in the nineteenth century receiverships where it had its origin. In most of those cases the leases were relatively recent at the dates of the receiverships. The lessors were generally able to resume operation themselves and there was no great likelihood of indefinite operation by the lessee's receivers.<sup>109</sup> But even today the rule seems by and large a reasonable method of dealing with the situation. Rejection of the lease is indicative of lack of value in the leased line. If it is valueless, the lessor is free to seek complete abandonment and salvage what it can before deficits from operation wipe out any interest for the lessor's security holders. There is no reason why the lessor interests cannot make this decision. On the other hand, the leased line may have some value whereas the stipulated rental may be unduly burdensome. The lessee's trustees may be willing to enter into a new lease with a modified rental. If such is the case, no injury to the lessor is likely to occur for there will probably be net earnings, and, if there are none, the deficit will not be sizeable. Even if there is a deficit, retention of the leased line makes it likely that some compromise will be worked out whereby the deficit will be cancelled against the lessor's claim for future rent.<sup>110</sup>

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108. *Pennsylvania Steel Co. v. New York City Ry.*, 198 Fed. 721 (C. C. A. 2d, 1912); *Westinghouse Elec. & Mfg. Co. v. Brooklyn R. T.*, 6 F. (2d) 547 (C. C. A. 2d, 1925); *cf. Mercantile Trust Co. v. Farmers' Loan & Trust Co.*, 81 Fed. 254 (C. C. A. 8th, 1897); *American Brake Shoe & Foundry Co. v. New York Rys.*, 282 Fed. 293 (S. D. N. Y. 1920), *aff'd*, 282 Fed. 523 (C. C. A. 2d, 1922); *Ames v. Union Pac. Ry.*, 74 Fed. 335 (C. C. D. Neb. 1896); *Ames v. Union Pac. Ry.*, 60 Fed. 966 (C. C. E. D. Neb. 1894); *Park v. New York, L. E. & W. R. R.*, 57 Fed. 799 (C. C. S. D. N. Y. 1893); *New York, P. & O. R. R. v. New York, L. E. & W. R. R.*, 58 Fed. 268 (C. C. N. D. Ohio 1893); *Central Trust Co. v. Wabash, St. L. & P. Ry.*, 23 Fed. 863 (C. C. E. D. Mo. 1885).

109. The lessors resumed operating their own lines in *United States Trust Co. v. Wabash Western Ry.*, 150 U. S. 287 (1893) (within eighteen months); *Quincy & R. R. v. Humphreys*, 145 U. S. 82 (1892) (within fourteen months); *Ames v. Union Pac. Ry.*, 74 Fed. 335 (C. C. D. Neb. 1896) (within ten months); *Ames v. Union Pac. Ry.*, 60 Fed. 966 (C. C. E. D. Neb. 1894) (within three months); *Farmers' Loan & Trust Co. v. Northern Pac. Ry.*, 58 Fed. 257 (C. C. E. D. Wis. 1893) (within six weeks). Today, of course, many lessors could resume operation if their security holders were willing to finance it. See note 134 *infra*.

110. Compare note 102 *supra*.

On the accounting it was held that operation during the period when the payments were made was for the lessee's account, and the receiver was denied recovery of the difference between the amount paid and the net earnings of the leased line. The Second Circuit Court of Appeals emphasized the fact that the payments created a special equity in the lessor's favor because, so long as they were made, the lessor "would not and indeed could not, demand a return of its premises."

Ten years later the same court, in *Westinghouse Electric & Mfg. Co. v. Brooklyn Rapid Transit*,<sup>118</sup> issued an opinion understandable on its facts, but severely limiting by its language the applicability of the *Second Avenue* case. The facts in the *Westinghouse* case were substantially similar to those in the *Second Avenue* case save that the net earnings of the leased line for the trial period exceeded the items of rent which the receiver had actually paid during that time.<sup>119</sup> Although these items were small in amount, their payment prevented any default occurring under the lease. When the first major installment of rent and large tax items fell due, the receiver rejected the lease. Later, on the accounting for the trial period, the lessee's receiver sought to retain the net earnings by claiming that he had been operating under the lease and for the lessee's account, and consequently was liable only for the stipulated rental.<sup>120</sup> After rejecting the receiver's contention as patently inequitable, the court went on to express the view that accounting proceedings should not be settled by resort to rigid rules.<sup>121</sup> According to the orthodox manner of applying the "consent theory," however, the receiver's contention was correct, for his payments prevented the occurrence of any default and in practical effect continued the lease in force.

The equity decisions, in general, seem to indicate that the "consent theory" and the accounting rule based upon it are no more than general equitable principles which will not be followed where they produce an unjust result. Stated differently, the rule of operation for the lessor's account will ordinarily be applied unless, to use the language of the cases, "special equities" are present. Apart from a particular case it is not possible to predict precisely what constitute these "special equities,"

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118. 6 F. (2d) 547 (C. C. A. 2d, 1925).

119. This seems to be the inference to be drawn from the facts stated, though the court's statement is none too clear. The court in *Palmer v. Palmer*, 104 F. (2d) 161 (C. C. A. 2d, 1939) placed this construction on the facts. One of the counsel in the *Westinghouse* case has also informed the author that these were the facts.

120. See 6 F. (2d) 547, 550 (C. C. A. 2d, 1925).

121. The *Second Avenue* case gives the general impression that the lessee's receiver tried to keep the lease as long as it was beneficial but rid himself of it at the moment it became detrimental—a stage of the proceedings which apparently could be foreseen. The whole tenor of the court's opinion is that the receiver was trying to make too much of a good thing.

although on a few occasions equity courts have given some indications.<sup>122</sup> But Section 77 found this situation on the whole largely undefined.

Turning now to Section 77, the principal case raising the issue of financial risk of operation is *Palmer v. Palmer*,<sup>123</sup> which involved an appeal from a decree of the district court in the New Haven proceeding confirming an accounting by the New Haven trustees for their operation of a leased line of the Old Colony Railroad. This decision is so important that a full statement of its facts is desirable. On October 23, 1935, the New Haven filed a petition for reorganization under Section 77. In its original order approving the petition the court directed the payment of "such sums as may be necessary to comply with the obligations of the debtor . . . under leases."<sup>124</sup> Pursuant to this order one payment of the amount stipulated in the lease as rental was made as it fell due. Subsequent to this payment, a second order was entered on November 30, 1935 providing that in the event of disaffirmance of any leases "the operation of the leased properties shall have been and said payments shall be deemed to have been made for the account of the lessors."<sup>125</sup> On June 1, 1936, having found that a deficit had been incurred in operating the Old Colony's line, the trustees rejected the Old Colony lease. The trustees thereafter sought to charge the Old Colony with the amount of that deficit, as well as with capital expenditures and payments made to the Old Colony prior to the date of rejection of amounts stipulated in the lease. On the appeal, the right to charge the Old Colony for the deficit, capital expenditures and payments was contested only as to the period prior to disaffirmance. The lessor interests contended that the payments to the lessor were unconditional payments of rent which prevented the lessor from exercising its right to reenter, and that under the "consent theory" the operation of the leased line therefore could

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122. In *Pennsylvania Steel Co. v. New York City Ry.*, 198 Fed. 721, 730 n. (C. C. A. 2d, 1912) the court pointed out that special equities might exist "when the leased property is in itself non-producing and yet is a benefit to the system as a whole, *e.g.*, a depot or terminal, and would undoubtedly be established in a case where a leased road is not wholly non-producing, but the net earnings furnish no fair criterion of its value to the system, *e.g.*, a feeder or connecting line." Cf. *North Kansas City Bridge & R. Co. v. Leness*, 82 F. (2d) 9 (C. C. A. 8th, 1936) (leased bridge). *Contra*: *Pennsylvania Steel Co. v. New York City Ry.*, 219 Fed. 939, 958 (S. D. N. Y. 1914). A "special equity" may also possibly arise where conduct of the lessee's trustees or of the lessee's security holders may have misled the lessor into believing that the lease would not be rejected. See *Dayton Hydraulic Co. v. Felsenthal*, 116 Fed. 961, 965 (C. C. A. 6th, 1902).

123. 104 F. (2d) 161 (C. C. A. 2d, 1939), *cert. denied*, 60 Sup. Ct. 120, 121 (U. S. 1939).

124. New Haven Proceeding, Order No. 1 (D. Conn., Oct. 23, 1935) Court Record, pp. 5, 7. But it also provided that performance should not constitute or be evidence of any waiver of the right to disaffirm (Court Record, pp. 7, 9).

125. New Haven Proceeding, Order No. 17 (D. Conn., Nov. 30, 1935) Court Record, pp. 131, 132.

not have been for the lessor's account, but must have been for the account of the lessee. This contention was rejected by the court, which held that the operation of the leased line had been for the lessor's account since the beginning of the proceeding. Moreover, the lessee's trustees were held entitled to recover all the payments which had been made during the trial period.<sup>126</sup>

Attention will for the moment be directed solely to the first part of the decision which applied the general rule of operation for the lessor's account. Some payments had been made during the trial period but, unlike the second situation in equity considered above, the payments, except for the first, were expressly conditional. As such, they probably were ineffective to prevent the lessor's right of reentry from maturing. Yet the lessor clearly was physically unable to retake and operate the leased line despite the accrual of its right to do so.<sup>127</sup> The explanation of *Palmer v. Palmer* seems to lie in this last fact, though the court's opinion is not entirely clear as to the exact basis of the decision.

The court on the whole seemed to approach the problem as analogous to the situation in equity where, although no payments whatever had been made, the lessor did not attempt to exercise its right to reenter.<sup>128</sup> The equity precedents — particularly the "relation back" of the trustees' act of rejection to the commencement of the proceeding — were said to compel the result that operation be for the lessor's account. Although the court conceded that the basis of the "relation back" doctrine was not clear, it stated that it had "become too well fixed to be uprooted."<sup>129</sup>

Although the outcome of *Palmer v. Palmer* is justifiable upon the basis of equity practice, the emphasis given to the "relation back" doctrine seems misplaced. As used by this and other courts, the doctrine seems

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126. In holding the payments "recoverable" the court merely meant that the lessee's trustees had a valid claim against the lessor.

127. No one seems to have disputed this fact. The lessor subsequently stated in its own petition for reorganization that "the petitioner has no funds, no equipment and no organization which would enable it to resume operation on a separate basis." *New Haven Proceeding, Petition for Order No. 74* (D. Conn., June 2, 1936) *Court Record*, pp. 731, 733.

128. This theory, however, is weakened by implications in *Palmer v. Palmer* that since the trial period was reasonable, the lessor was barred by operation of law from exercising its right of reentry.

129. 104 F. (2d) 161, 163 (C. C. A. 2d, 1939). The court seemed to feel, however, that the result was not entirely equitable, for it also said, "Yet if the question were to arise for the first time, it would be a little hard to see by what power the court could keep a trustee in possession while he was determining his course, without compelling him meanwhile to fulfill the conditions imposed upon the term; for instance, the payment of any rent, secured by a right of reentry." See also *Central Manhattan Prop., Inc. v. D. A. Schulte, Inc.*, 91 F. (2d) 728, 729 (C. C. A. 2d, 1937) where the court said that the effect of this result is to permit the lessee "to play fast and loose" with the lessor's property.

to add a needless bit of hocus-pocus to the proceeding. An examination of the equity cases reveals that this doctrine was never, as in *Palmer v. Palmer*, applied as a means of reaching a result, but was merely a convenient manner of stating a result reached upon other grounds.<sup>130</sup> The courts have always agreed that a trustee or receiver is not obligated on a lease merely by reason of his appointment. He may, however, create an obligation binding upon the lessee's estate by electing to adopt a lease. If he does, his act of adoption can really be said to relate back to the commencement of the proceeding. But this is not so in the case of rejection. Since the trustee or receiver is not liable, what is there to reject?<sup>131</sup> The term "reject" is itself a misnomer, for what actually occurs is an election "not to adopt."<sup>132</sup> The trustee or receiver making an election is simply notifying the lessor that there will be no adoption. As no liability ever was created on behalf of the lessee's estate the rejection simply affirms the continuance of a state of non-liability. Since there is thus no liability under the lease for the period prior to rejection, upon what basis, if any, shall the operation be deemed to have taken place? Once again, resort to the "consent theory" indicates that operation is for the lessor's account. To refute an implication of its consent to operation by the lessee's trustees, the lessor must establish its willingness and ability to operate. In *Palmer v. Palmer* the lessor presumably was entitled to claim that a default had occurred because of the conditional nature of the rental payments. But it made no demand for its properties; even had such a demand been made it would have been ineffective because it was not made in good faith.<sup>133</sup> The lessor made no effort to put itself into a position of ability to operate.<sup>134</sup> The lessor must therefore be pre-

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130. See especially *Pennsylvania Steel Co. v. New York City Ry.*, 198 Fed. 721, 730, 733, 744 (C. C. A. 2d, 1912). This is also the general tenor of cases which arose during the depression of 1893, some of which are cited *supra* notes 108 and 109, and seems to be the purport of the cases cited in *Palmer v. Palmer* at 163 as precedent for the relation back of the rejection.

131. As between the parties (lessor and lessee) the lease may continue until the lessor terminates it by declaring it forfeited and reentering. But no liability ever arises so far as the estate of the lessee, which the trustees hold "in trust" for its creditors, is concerned.

132. See Part I, note 101 *supra*, at 647, n. 67.

133. *American Brake Shoe & Foundry Co. v. New York Rys.*, 282 Fed. 293 (S. D. N. Y. 1920), *aff'd*, 282 Fed. 523 (C. C. A. 2d, 1922).

134. See note 128 *supra*. As most lessors hope that their leases will be adopted, they ordinarily make no effort to prepare for operation in the event of rejection. Compare *North Kansas City Bridge & R. Co. v. Leness*, 82 F. (2d) 9 (C. C. A. 8th, 1936); *Dayton Hydraulic Co. v. Felsenthal*, 116 Fed. 961, 965 (C. C. A. 6th, 1902). Moreover, since the usual lessor company is without any sizeable funds, it lacks the financial ability to get ready to become an operating company even though the necessary equipment and personnel can be obtained. Nor are the lessor's security holders usually willing to make contributions for this purpose.

sumed to have acquiesced in the operation by the lessee's trustees for its account.<sup>135</sup>

#### THE RECOVERABILITY OF PAYMENTS MADE DURING THE TRIAL PERIOD

A second issue in *Palmer v. Palmer* was whether the payments made by the lessee's trustees during the trial period were recoverable.<sup>136</sup> The lessor contended that since they were made voluntarily they could not be recovered, even though operation were for the lessor's account. It will be recalled that all but the first of the several payments of the amounts that were stipulated in the lease as rent were made after the entry of an order providing that in the event of subsequent disaffirmance, these payments should "be deemed to have been made for the account of the lessors and shall be recovered, set-off or made and charged on the earnings and/or properties of the lessor prior to any mortgage or other lien thereon."<sup>137</sup> This order was served on the president and attorney of the lessor.<sup>138</sup>

The court ruled that the lessor had express notice of the conditional nature of all the payments but the first and that upon rejection they might be recovered. This result is readily understandable for the condition upon which the payments were made and accepted naturally became operative upon rejection of the lease. Since nothing was due on account in view of the deficit from operation, the entire amount of the payments was recoverable. This same result would follow, it seems, even if disaffirmance were considered to take effect only as of the date of the act of rejection, assuming, as seems to be the case, that the reorganization court and the trustees had the power to make conditional payments. Hence, the conditional nature of the payments alone could govern the decision without reference to any rule of "relation back."

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135. See note 128 *supra*. Emphasis of certain facts also might have afforded a slightly different basis for the court's decision. The order of November 30, 1935, provided that in the event of rejection of any leases "the operation of the leased properties shall have been . . . for the account of the lessors." New Haven Proceeding, Order No. 17 (D. Conn., Nov. 30, 1935) Court Record, pp. 131, 132. It might be argued that the lessor interests are bound because they took no action with respect to this order. But this type of contention is perhaps a trifle too legalistic to carry much weight in proceedings of this character. See New Haven Proceeding, Memorandum on Trustees' Report of Administration of Old Colony R. R. (D. Conn., July 2, 1938) Court Record, pp. 4511, 4515 (district court opinion in *Palmer v. Palmer*).

136. The sharp division drawn here between the issues in *Palmer v. Palmer* may not be entirely clear from the opinion itself.

137. New Haven Proceeding, Order No. 17 (D. Conn., Nov. 30, 1935) Court Record, pp. 131, 132; *Palmer v. Palmer*, 104 F. (2d) 161, 163 (C. C. A. 2d, 1939).

138. See 104 F. (2d) 161, 163 (C. C. A. 2d, 1939).

The court then went even further to hold that the trustees might also recover the first payment on the theory that, save in some unidentified special circumstances, all payments made after the institution of the lessee's reorganization proceeding were conditional, whether or not the lessor was given express notice of the condition. The court stated that the lessor knew from the beginning of the proceeding that it was dealing with trustees who had the power to reject leases. The lessor was therefore "charged with notice of the provisional character of all transactions." This statement, it should be noted, is susceptible of broader application than to the mere question of payments. It might also possibly be applied to the general question of the risk of operation of the leased line to serve as a foundation for holding that operation during the trial period was for the lessor's account. This would further diminish any need for reference in that connection to the "relation back" doctrine. However, the court, though its opinion is not clear, seemed to feel that the recovery of this particular first payment somehow also involved that doctrine. Here, too, the court might better have avoided the idea of "relation back" as furnishing any basis for the result.

From the lessee's point of view, *Palmer v. Palmer* affords several means for avoiding these intricate problems in connection with payments in future proceedings under Section 77. If payments are made at all, prior entry of an order stating explicitly that, in the event of ultimate rejection of the lease, such payments are for the lessor's account, and explicitly making the payments recoverable, will prevent many disputes. Indeed, such a provision could be and now normally is included in the initial order approving the lessee's petition under Section 77.<sup>139</sup> Furthermore, the court stated in *Palmer v. Palmer* that no payments are necessary to prevent the lessor from asserting its right of reentry under the lease during the trial period.<sup>140</sup> For this reason, perhaps, instances where payments are made will become less frequent and the problems of *Palmer v. Palmer* will arise less often.<sup>141</sup>

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139. A provision of this sort has been included in the initial order in two proceedings which have been commenced since the New Haven Proceeding. See Erie Proceeding, Order No. 1 (N. D. Ohio, Jan. 18, 1938) Court Record, pp. 5, 6; Jersey Central Proceeding, Order No. 1 (D. N. J., Oct. 30, 1939) Court Record, pp. 7, 13.

140. See 104 F. (2d) 161, 163 (C. C. A. 2d, 1939). The applicability of this statement to the case of a lessor ready and able to operate, however, is not free from doubt. See *infra*, p. 1413.

141. In some instances, however, there will still be good reason for making payments, *e.g.*, where it is to the lessee's interest to prevent the occurrence of a default on the lessor's bonds. Payments may also be made to avoid litigation where a lessor claims ability and readiness to operate. See Jersey Central Proceeding, Stipulation and Order No. 32 (D. N. J., March 11, 1940) Court Record, p. 545.

## THE RISK OF OPERATION WHERE THE LESSOR IS ABLE TO OPERATE

A situation remaining for discussion is that in which the lessor is ready and able to take back and operate the line. The immediate and acute issue is the duration of the trial period. How long can the lessor be held off while the lessee's trustees are deciding whether or not to adopt the lease?

In the equity receiverships there was little difficulty. The courts seemed agreed that the lessee's receivers were entitled only to a very short time to make their decision. This period seems ordinarily to have been no longer than the grace period provided in the lease itself, whereby no right of reentry matured until thirty, sixty or ninety days after failure to pay rent.<sup>142</sup> For the short trial period itself, operation probably was for the lessor's account.<sup>143</sup> But when the period had expired the lessor was entitled to its property. If the lessee's receivers insisted on retaining the leased line and opposed the lessor's attempt to reenter, upon the accounting the lessor was entitled to full rent for the period during which it had been kept off the property.<sup>144</sup>

In present-day Section 77 reorganizations, the fashion is for the trustees to delay in reaching a decision on adoption of a lease. In the usual case of the lessor which cannot operate anyway, the frequent extensions of time may, perhaps, be for the most part harmless.<sup>145</sup> Often the lessor is very anxious to postpone the trustees' decision as long as possible. Furthermore, the general assumption seems to be that the court may prevent a lessor from retaking its properties for this period without payment of any rent whatever.<sup>146</sup> But where the lessor is ready and able to operate, the propriety of both of these tendencies is open to doubt. Should the trial period be extended indefinitely in such instances? If it is so extended, should not operation be held to be for the lessee's own account?<sup>147</sup>

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142. It seems that in *United States Trust Co. v. Wabash Western Ry.*, 150 U. S. 287 (1893) and *Quincy, M. & P. R. R. v. Humphreys*, 145 U. S. 82 (1892), for example, the lessors, if they so desired, could have had their leased lines back approximately a month after their lessees went into receivership. Actually they did not take them back for eighteen and fourteen months respectively.

143. On the one occasion in which this issue was squarely raised, the result was contrary to the statement in the text, for the lessee's receivers were held for the stipulated rental. *Farmers' Loan & Trust Co. v. Northern Pac. Ry.*, 58 Fed. 257 (C. C. E. D. Wis. 1893), distinguished in *American Brake Shoe & Foundry Co. v. New York Rys.*, 282 Fed. 523, 533 (C. C. A. 2d, 1922). Other decisions seem to imply that operation during the short trial period is for the lessor's account. See *Quincy, M. & P. R. R. v. Humphreys*, 145 U. S. 82 (1892); *Ames v. Union Pac. Ry.*, 60 Fed. 966 (C. C. E. D. Neb. 1894).

144. *United States Trust Co. v. Wabash Western Ry.*, 150 U. S. 287, 309 (1893).

145. See note 156 *infra* and accompanying text.

146. *Palmer v. Palmer*, 104 F. (2d) 161 (C. C. A. 2d, 1939).

147. One lessor seems about ready to put these questions in issue. See *Jersey Central Proceeding, Petition of Lehigh Coal & Nav. Co.* (D. N. J. 1939) Court Record, p. 67. A compromise for six months has postponed any immediate action in that case.

In answer to the first of these questions, it seems likely that in modern reorganizations the length of the trial period will and should be somewhat longer than that accorded under old equity practice. The preparation of segregation and severance studies cannot take place overnight.<sup>148</sup> Furthermore, as a dictum in *Palmer v. Palmer* stated, it is probable that during this trial period the lessee's trustees may hold off the lessor without paying rent.<sup>149</sup> This precise question has never been decided under Section 77, nor does it merit any lengthy consideration for it leads mainly into a none too fruitful discussion of analogies. Undeniably the general trend of the decisions, starting with the *Rock Island* case,<sup>150</sup> has been to protect the corporate debtor and its property from claimants attempting to assert their rights upon the debtor's default, at least in the early stages of the proceeding.<sup>151</sup> Under former Section 77B a few courts held, for rather inarticulate reasons, that a landlord may be enjoined from retaking the leased premises.<sup>152</sup> Indeed, the only exception to this cloak of protection thrown about the corporate debtor is in the case of the conditional vendor of chattels where permission to retake the conditionally sold chattel is generally granted despite the resulting effect upon the reorganization of the debtor.<sup>153</sup> Though the legal analogy between that situation and the

148. See Part I, *supra* note 101, at 640, 645.

149. Since payments had been made in *Palmer v. Palmer*, and since the lessor there was not ready and willing to operate, the question whether the court would hold off the lessor without payment of rent was hardly in issue.

150. *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R. I. & P. Ry.*, 294 U. S. 648 (1935).

151. In the *Rock Island* case a pledgee of collateral was restrained from selling upon the debtor's default, principally upon the ground that such a sale "would seriously embarrass and probably prevent the formulation and consummation of a plan of reorganization." There is no doubt today as to the power of the court to issue such restraining orders; courts have in some instances gone further than seems warranted by the *Rock Island* decision. *In re Chicago & N. W. Ry.*, 18 F. Supp. 932 (N. D. Ill. 1936). In many proceedings the usage has developed of including a blanket restraint in the initial order. As the proceeding progresses, there has been some disposition to vacate these orders. *Merchants Nat. Bank v. New York, N. H. & H. R. R.*, 102 F. (2d) 923 (C. C. A. 2d, 1939); *In re Prudence Co.*, 90 F. (2d) 587 (C. C. A. 2d, 1937). In other types of situations, a mortgagee in possession has been ousted from the premises by a trustee appointed under former § 77B. *Grand Boulevard Inv. Co. v. Strauss*, 78 F. (2d) 180 (C. C. A. 8th, 1935). Other courts have refused to oust the mortgagee but nevertheless have barred any exercise of his remedies. *In re Reighard v. Higgins Enterprises, Inc.*, 90 F. (2d) 569 (C. C. A. 3d, 1937); *In re Shelburne*, 91 F. (2d) 190 (C. C. A. 3d, 1937); *In re Francis E. Willard Nat. Hospital*, 82 F. (2d) 804 (C. C. A. 7th, 1936).

152. *In re Penn Victor Dairies*, 12 F. Supp. 126 (E. D. Pa. 1935); *In re Chase Commissary Corp.*, 11 F. Supp. 288 (S. D. N. Y. 1935); *cf. Seaboard Terminals Corp. v. Western Md. Ry.*, 108 F. (2d) 911 (C. C. A. 4th, 1940).

153. *In re Lake's Laundry*, 79 F. (2d) 326 (C. C. A. 2d, 1935), *cert. denied*, 296 U. S. 622 (1935), (1936) 4 GEO. WASH. L. REV. 419; *In re Pointer Brewing Co.*, 105 F. (2d) 478 (C. C. A. 8th, 1939); *cf. In re White Plains Ice Service Co.*, 109 F. (2d) 913 (C. C. A. 2d, 1940). *Contra: In re White Truck & Transfer Co.*, C. C. H. Bankr. Serv. ¶ 2326.07 (S. D. Cal. 1934).

railroad lease may be fairly close, there is little practical resemblance between the two situations.

In general, the principal criterion seems to be that enunciated in the *Rock Island* case. If permitting the lessor to reenter will prevent the formulation and consummation of the lessee's reorganization, then the lessor may be held off for the trial period.<sup>154</sup> On the other hand, many leased lines may be small branch roads and in no way essential to the lessee's system. In these cases it might be proper to permit the lessor, if it so chooses, to retake almost immediately.<sup>155</sup>

The fact that the lessor is ready and able to operate will, in any event, have the effect of forcing an early decision on adoption by the lessee's trustees. To that extent the lessor will be protected. If the lessor is held off for an unreasonable time, the risk of operation should then be placed on the lessee's estate. Logical application of the "consent theory" would call for this precise result, and equitable considerations are especially strong for holding operation to be for the lessee's account where the lessor is compelled to sit by and constantly be subject to the possibility of a relation back upon rejection of the lease.<sup>156</sup>

#### THE MECHANICS OF ACCOUNTING FOR OPERATION

Many troublesome questions are also involved in computing the profit or loss from operation of the leased line. These matters, unlike the problems heretofore considered, are for the most part practical rather than legal.

The practice in some proceedings under Section 77 is for the lessee's trustees, at periodic intervals, usually of a year, to present to the court "reports of administration" of the lessor's property.<sup>157</sup> Objections to this report may then be filed and a hearing held, or the report may be referred to a special master for that purpose. Thereafter the court will confirm, revise or otherwise dispose of the report. If the leased line is

154. It seems that the lessee's leasehold interest may be held to be property of the lessee and hence provide a basis for the exercise of jurisdiction by the district court.

155. The small branch leased line, of course, is probably the one least likely to be able to resume operation. Often it may never have had an independent existence, and the lease form may simply have been used as a means of financing its construction. See Part I, note 101 *supra*, at 630.

156. The same danger exists in the case of the lessor which is unable and not ready to operate, though the feeling of inequity is not present in the same degree. There the principal harm to the lessor arises from not knowing what to do. Preparation for operation of the line itself, or negotiations with other carriers leading to operation, may be rendered futile if the lessee's trustees adopt the lease. At the same time the lessor is handicapped in taking any steps toward abandonment. However, even though the lessor lacks the ability to operate, it probably is entitled to compel the lessee's trustees to adopt or reject. See *North Kansas City Bridge & R. Co. v. Leness*, 82 F. (2d) 9, 13 (C. C. A. 8th, 1936); *cf. In re Chase Commissary Corp.*, 11 F. Supp. 288 (S. D. N. Y. 1935).

157. The New Haven proceeding is the chief example of this practice.

shown to have been operated at a profit, this amount will constitute a claim of the lessor against the estate of the lessee. If, on the other hand, a deficit is revealed, the amount becomes a charge against the lessor. In other proceedings more informality prevails and, upon rejection, a petition is filed by the lessee's trustees giving the state of the accounts. If there is a deficit, a charge against the lessor's property will be requested, but no periodic formal accounting takes place.<sup>158</sup>

An administration report or a petition of the second type may cover many items. Most important of these will ordinarily be "profit or loss from operation." This includes the profit or loss involved in running passenger and freight trains and all items which constitute operating income or operating expense under the ICC classification of accounts. Another item is "capital expenditures (net)," which ordinarily appears as a charge to the lessor, although a credit may result where extensive salvage operations are carried on.<sup>159</sup> Still other items are credits to or charges against the lessor in connection with fuel used on the system,<sup>160</sup> the use of equipment,<sup>161</sup> or charges against the lessor for taxes levied on its properties which the lessee's trustees have paid,<sup>162</sup> although usually these items are included in the income account.

Despite widely different situations, there is little difficulty in determining the propriety and accuracy of most items, with the exception of "profit or loss from operation" which is a storm center for many points of violent controversy. The principal one revolves about the proper role of the segregation formula. Where a formula was used in equity receiverships, it was generally prepared and applied on rather an informal basis.<sup>163</sup>

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158. See Erie Proceeding, Petition for Order No. 196 (N. D. Ohio, Jan. 15, 1940) Court Record, p. 2077.

159. See New Haven Proceeding, Revised Report of Administration of Property of Hartford & C. W. R. R. for 1938 (D. Conn., Jan. 23, 1940) Court Record, p. 6415 (net credit of \$95,487 to lessor from salvage operations).

160. See New Haven Proceeding, Report of Administration of Property of Old Colony R. R. up to December 31, 1937 (D. Conn., Apr. 19, 1938) Court Record, p. 4221. See also note 159 *supra*.

161. See Seaboard Equity Proceeding, Application No. 143 (E. D. Va., June 12, 1934) Court Record, pp. 7654, 7658. It is unusual for a lessor to own any equipment. In this instance the lease had been entered into as recently as 1927 and the lessor had outstanding its own equipment trust obligations. Compare *In re Chicago, R. I. & P. Ry.*, 108 F. (2d) 410 (C. C. A. 7th, 1939) involving the method of computation of inter-division charges and credits with respect to equipment owned by one mortgage division and used in connection with other divisions.

162. See note 159 *supra*.

163. For an instance where the lessor interests also prepared their own formula see Seaboard Equity Proceeding, Application No. 110 (E. D. Va., Apr. 23, 1933) Court Record, pp. 5456, 5470. The differences between the two formulas were eventually settled as part of a general compromise. Seaboard Equity Proceeding, Order No. 178 (E. D. Va., Apr. 10, 1936) Court Record, p. 10315; Order in Ancillary Proceeding (S. D. Fla., Apr. 29, 1936) Court Record, p. 10458.

Subsection (c)(10), added by the 1935 amendments to Section 77, permitted the court to obtain from the ICC its recommendations as to the method by which the segregation should be made.<sup>164</sup> Since then this reference to the ICC has taken place in some Section 77 proceedings while in others it has not. In the latter, the segregation formula has played much the same role that it played in equity receiverships. It has had some part in determining the relative values of different leased lines and mortgage divisions and it has been used in accounting proceedings to determine the profit or loss involved in maintaining operation over certain lines.<sup>165</sup>

In other Section 77 proceedings the segregation formula has been given more formal recognition and seems to have had more far-reaching consequences. The New Haven proceeding, in connection with the Old Colony and the Boston & Providence leases, affords the most detailed consideration of this question. The segregation formula, developed by the lessee's statistical department in collaboration with experts representing groups of the lessee's creditors, was referred to the ICC under Section 77(c)(10). After several hearings the ICC approved the formula, stating it was "as fair and reasonable as the circumstances will permit."<sup>166</sup> This ICC report was confirmed by the reorganization court and no appeal was taken by the lessor interests.<sup>167</sup> Subsequently, upon presentation by the lessee's trustees of their administration reports for the Old Colony and for the Boston & Providence, both lessors raised numerous objections to the report, most of which involved the proper role to be played by the segregation formula.

In the case of the Old Colony Railroad this question was disposed of in *Palmer v. Palmer*.<sup>168</sup> The lessor's principal contention centered about the entire period of operation by the lessee's trustees. It claimed that, since the lease had been rejected, the formula was no longer applicable, and that the lessor should be treated as a separate road in spite of the continuation of joint operation under Section 77(c)(6). On that basis, it argued, revenues derived from joint rates should be divided according to standards prescribed in Section 15(6) of the Interstate Commerce Act.<sup>169</sup> This contention was rejected by the court, which held that the lessor had had its day in court at the time of reference of the formula to the ICC and confirmation thereof by the court, and that it could not

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164. See Part I, note 101 *supra*, at 640-645.

165. See *Blaine v. Cheston*, 110 F. (2d) 395, 397 (C. C. A. 7th, 1940).

166. See *New Haven Proceeding*, Report of ICC, Division 4 (Apr. 9, 1938) Court Record, pp. 4241, 4255; *Palmer v. Palmer*, 104 F. (2d) 161, 165 (C. C. A. 2d, 1939).

167. *New Haven Proceeding*, Order No. 283 (D. Conn., May 25, 1938) Court Record, p. 4399.

168. 104 F. (2d) 161 (C. C. A. 2d, 1939).

169. *Id.* at 165.

now subject the confirming order to collateral attack. The court added, moreover, that although Section 77(c)(10) did not literally cover a case where a lease had been rejected, the situation was the same after rejection as before it, and proper construction of the statute called for its application in both situations.

In the Boston & Providence case, the ultimate decision on the merits still remains undetermined even in the district court.<sup>170</sup> In *Warren v. Palmer*,<sup>171</sup> the United States Supreme Court decided only that the district court administering the lessee's reorganization had jurisdiction to determine the amount of profit or loss involved in its operation of the Boston & Providence.<sup>172</sup> The Second Circuit Court of Appeals, however, gave some consideration to the merits of the case,<sup>173</sup> holding that the lessor, having appeared before the ICC upon reference of the formula, could not later attack the segregation formula itself.<sup>174</sup> At the same time, the court pointed out that the lessor was free to oppose the manner in which the lessee's trustee applied the segregation formula in their administration of the lessor's property.<sup>175</sup> On the surface this affords the lessor considerable leeway, for as a practical matter it is difficult to distinguish between a direct attack on the formula itself and an indirect attack by opposing the method of its application.<sup>176</sup>

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170. The application of the segregation formula in the Boston & Providence accounting is being attacked on several grounds. New Haven Proceeding, Objections of Trustees of Boston & Providence R. R. (D. Conn., March 11, 1939, and March 28, 1940) Court Record, pp. 5459, 6677. One ground is the failure to accord the lessor its proper legal status as an independent carrier. This same contention was made by the Old Colony and overruled in *Palmer v. Palmer*. After *Palmer v. Palmer*, however, the Old Colony trustees again raised this point in the 1938 accounting. New Haven Proceeding, Objections of Old Colony Trustees (D. Conn., Apr. 24, 1940) Court Record, pp. 6801, 6802. Most of the other objections raise practical issues which have always been before the reorganization courts. Compare *Ames v. Union Pac. Ry.*, 74 Fed. 335 (C. C. D. Neb. 1896).

171. 60 Sup. Ct. 865 (U. S. 1940).

172. *Warren v. Palmer* also held that the court administering the lessee's reorganization had jurisdiction, in case of a loss, to fix the charge as a prior lien on the lessor's property, even though the lessor itself was in reorganization in a different district. See p. 1419 *infra*.

173. *Palmer v. Warren*, 108 F. (2d) 164 (C. C. A. 2d, 1940).

174. Compare *Blaine v. Cheston*, 110 F. (2d) 395 (C. C. A. 7th, 1940) (order approving formula reserved all parties the right to move to amend formula).

175. This holding was largely based upon a clause in the order of the district court rejecting the lease reserving for future determination "the existence and amount of the obligation." See 108 F. (2d) 164, 169 (C. C. A. 2d, 1940).

176. See, *e.g.*, New Haven Proceeding, Objections of Trustees of Boston & Providence R. R. (D. Conn., Mar. 28, 1940) Court Record, p. 6677. Perhaps this result is desirable, for in many respects a segregation formula is an approximation of what is fair and reasonable. Yet an absolutely accurate formula cannot be devised. In its report upon reference of the formula, the ICC said in regard to proration of revenues and expenses, "The results obtained by either of the above methods necessarily are somewhat con-"

THE PROFIT OR LOSS ESTABLISHED BY THE STATUS  
OF AN ACCOUNTING

Once the amount of profit or loss involved in operating the leased line has been established, it is necessary to determine the status of the credit or charge. If the account shows a credit to the lessor, that amount is generally an administrative expense of the lessee's trustees and entitled to all the priorities of such a claim. If, on the other hand, there is a deficit, the amount is usually a charge against the lessor and entitled to a prior lien on its property. Many questions arise in this connection—some of them purely jurisdictional—involving both the trial period and the time after rejection.

Different situations may be involved. The lessee and lessor may be in a joint reorganization in the same district court.<sup>177</sup> The lessee and lessor may both be in Section 77 reorganizations in different district courts, either in the same or different circuits.<sup>178</sup> The lessor may be in a Chapter X reorganization.<sup>179</sup> Again, the lessor may not be in reorganization at all. Yet, in all these cases, the leased line is being operated by the lessee's trustees under the supervision of the district court which is reorganizing the lessee. That court has actual possession of the lessor's physical property. As an incident of that possession, has it jurisdiction to determine the amount of the credit or charge to the lessor arising upon the accounting? If a charge is involved, has the court power to fix a prior lien for the amount of the charge against the lessor's property?

In *Warren v. Palmer*,<sup>180</sup> a case involving the extreme situation where the lessor was in a Section 77 reorganization in another district court in another circuit, the Supreme Court held, as indicated above, that the lessee's court had full jurisdiction to determine the amount of profit or loss and possessed the power to fix a prior lien on the lessor's property for the amount of a deficit. Emphasizing the public importance of the continuation of rail service on leased lines, subsection (c)(6) was held to reveal a legislative intent to confer on the lessee's court full powers

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tural. It is doubtful, however, whether any method may be devised which would eliminate all conjecture and, at the same time, be practicable of application." New Haven Proceeding, Report of ICC, Division 4 (Apr. 9, 1938) Court Record, pp. 4241, 4254. All earnings and expenses of a leased line are not, of course, segregated pursuant to the formula. In the case of some lessors, a large proportion of revenues and expenses arise locally and are credited or charged directly to the leased line. In other cases, practically all revenues and expenses go under the formula. See Part I, note 101 *supra*, at 641.

177. This is expressly permitted by Section 77 where the lessee has a majority stock interest in the lessor. See Part I, note 101 *supra*, at 653.

178. *E.g.*, the New Haven (lessee) is in reorganization in the district court for Connecticut in the Second Circuit, the Boston & Providence (lessor) in the district court for Massachusetts in the First Circuit.

179. *E.g.*, the Northern Railroad of New Jersey, lessor to the Erie, has filed in a Chapter X proceeding.

180. 60 Sup. Ct. 865 (U. S. 1940).

to carry out effectively its duty of continuing operation. This decision seems eminently justified both on grounds of precedent and for purely practical reasons. Any other result would have further complicated a problem already too complex.

Not all items of deficit, however, are entitled to be charged as prior liens on the lessor's property. Some may constitute only general creditors' claims against the lessor. In *Palmer v. Palmer*, to which we once again return, three types of items were claimed to be entitled to priority: operating deficits, capital expenditures and the conditional rental payments which were held to be recoverable. Priority of lien was conceded as to the amount of operating deficits and capital expenditures occurring after rejection of the lease and filing of the lessor's own petition under Section 77. But the lessor disputed the priority of those two items in so far as they arose prior to rejection of the lease. It argued that since these items arose prior to institution of its own reorganization, they should be treated like any other pre-receivership claim. Thus, they could be given preference only if they were within the two classes of claims generally accorded priority: claims within the "six months" rule and claims within the "necessity of payment" rule. The lessor contended that none of the trustees' claims were of this character.

These contentions were overruled and the prior lien imposed on the ground that it was an established rule of equity reorganizations that the expenses of preservation and administration of a trust estate constitute a first lien upon the trust property superior to the claims of any cestuis. The court stated that the lessee's trustees were entitled to be subrogated to the claims and security of those persons who had supplied the goods or furnished the services necessary to operate the leased line. This right to subrogation was not restricted to claims arising within six months before the date of the lessor's Section 77 petition, but extended to all disbursements making up the deficit which were "six months" claims in nature, regardless of when they were incurred.<sup>181</sup> Restricting the lessee's trustees to claims arising within six months immediately preceding the lessor's petition was deemed to limit too severely the time within which the trustee could elect to adopt or reject the lease, for otherwise the risk of non-reimbursement would be too great.

As to the third item of the trustees' claim — the conditional payments made during the trial period — the court held that no prior lien could be charged. Even though the district court's order had attempted to give them this priority<sup>182</sup> it was held ineffective to achieve that result because

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181. The language of the court was: ". . . for all disbursements making up the deficit it has a claim prior to the lien of the bondholders, to the extent that the claims paid would have been prior to that lien, if they had been incurred within six months of petition filed." 104 F. (2d) 161, 165 (C. C. A. 2d, 1939).

182. See New Haven Proceeding, Order No. 17 (D. Conn., Nov. 30, 1935) Court Record, pp. 131, 132.

neither the lessor nor its bondholders, whose lien was being displaced, had been parties to the proceeding at the date of entry of the order.

#### THE ACCOUNTING SITUATION — CONCLUSION

In some respects the present technique of handling the accounting for operation of the leased line seems to create a rather unsatisfactory state of affairs. Possibly an overhauling of Section 77 with the view of simplifying leased line problems would be beneficial. At the same time the rewriting of any statute may serve only to obscure and to complicate the very questions it sets out to resolve, or to create even greater inequities. The present method, at least, is gradually working toward a solution of the various problems and is probably as fair and reasonable as existing circumstances permit.

As pointed out earlier, the rule of operation for the lessor's account seems proper for the period after rejection of the lease.<sup>183</sup> In general, the same may also be said for the period prior to rejection. It should be remembered, however, that in equity practice this rule never was rigid and inflexible, but merely an expression of the fairest result in the most frequently recurring factual situation. The present tendency, if it exists, for this equitable principle to solidify into an unyielding rule should not be encouraged. Furthermore, many of the equity precedents involved street railway reorganizations. Perhaps some attention should be given to the differences, if any, which exist between street railways and interstate carriers.<sup>184</sup>

No unfairness is likely to occur in the rare case where the lessor is ready and able to operate.<sup>185</sup> Even where a lessor is unable to operate but wishes to clear up the insecurity of its status, it probably can and should be entitled to force the lessee's trustees to elect to adopt or to reject.<sup>186</sup> Where considerable uncertainty exists as to the value of the leased line, it may be particularly desirable to ascertain whether any other procedures are available. If no action to adopt or reject is taken for several years, the consequences of an eventual rejection may be serious, especially where the lessor has been lulled into a feeling of security. One solution has been reached in the current equity receivership of the Seaboard Air Line Railway in connection with its leased lines known collectively as the Seaboard-All Florida Lines.<sup>187</sup> A little over two months after the appoint-

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183. See p. 1404 *supra*.

184. For example, street railways generally present no problems with respect to terminals. Their business is solely passenger traffic and through a check on fares and transfers it is possible to determine with some accuracy exactly what each part of the system is worth.

185. See p. 1415 *supra*.

186. See note 156 *supra*.

187. Seaboard Equity Proceeding, Order No. 13 (E. D. Va., Feb. 28, 1931) Court Record, p. 1059. All parties agreed to entry of the order.

ment of receivers for the lessee, the receivers applied to the equity court for permission to continue operation of the leased lines upon some fair basis until a final decision could be reached as to adoption or rejection. The basis agreed upon in substance was that the lessee's receivers were to receive all income from the leased lines and to pay all operating expenses excluding any charge for depreciation. The receivers were not to be liable for the stipulated rental, nor for interest on the lessors' bonds which the lessee had guaranteed. Nor were the receivers to be liable for the "earnings, if any, derived from the operation of the leased lines." The lessors, in turn, were not to be liable for any deficits resulting from operation of the leased lines.<sup>188</sup> In the interval the receivers were directed to study the entire situation with regard to the leased lines and to endeavor to reach a suitable agreement with the lessors for continued operation. This purely temporary solution has continued up to the present time.<sup>189</sup> "The solution in the Seaboard receivership was evolved in the light of its own peculiar circumstances. In other cases different solutions may be available to meet the exigencies of individual leases.<sup>190</sup> Where nothing unusual which would call for any different rule is present, the general rule of operation for the lessor's account may be applied. This approach seems, on the whole, preferable to any of the alternative solutions which have been proposed up to this point.<sup>191</sup>

[*To be concluded*]

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188. Reduced to a minimum, the arrangement simply was that the lessee's receivers were to receive all revenues from the leased lines and to bear all expenses. In return the lessors were relieved from any obligation for deficits which might ensue.

189. Seaboard Equity Proceeding, Orders Nos. 31 (June 30, 1931), 48 (Sept. 28, 1931), 75 (June 17, 1932), 93 (Dec. 21, 1932) Court Record, pp. 2656, 2979, 4343, 5054. See also Order in Ancillary Proceeding (S. D. Fla., Aug. 21, 1939) Court Record, p. 15149.

190. An arrangement somewhat similar to that made with regard to the Seaboard-All Florida Lines was recently made in the Erie proceeding under Section 77. The original order provided for this arrangement to last only two months from May 1, 1940, through June 30, 1940. There is no indication as to what arrangement will be made as to operation after June 30. Erie Proceeding, Order No. 220 (N. D. Ohio, Apr. 26, 1940) Court Record, p. 2647. Compare also Norfolk Southern Equity Proceeding, Order No. 142-B (E. D. Va., July 6, 1938) Court Record, pp. 5146, 5148.

191. One such proposal submitted by Mr. Eugene S. Taliaferro is in substance as follows: (1) prior to rejection of a lease, operation shall be for the lessee's account and the stipulated rental shall be paid as an administration expense; (2) upon rejection the lessor may elect within 30 days to operate; (3) if the lessor does not elect to operate, the lessee's trustees shall continue to operate the leased line at the lessee's risk for a period of nine months, but the lessee's trustees shall pay to the lessor not the rent but only the net income, if any, derived from operation of the line; (4) the court administering the lessee's reorganization shall have exclusive jurisdiction of the lessor and its property wherever located; (5) the court may direct the lessees to continue operation of the leased line after the nine months period has expired, but this operation shall be for the lessor's account.