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BANKRUPTCY--SIX MONTHS RULE--APPLICATION OF THE RULE TO PRIVATE CORPORATIONS

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RECENT DECISIONS

BANKRUPTCY—SIX MONTHS RULE—APPLICATION OF THE RULE TO PRIVATE CORPORATIONS—The debtor, being reorganized under chapter 10 of the Bankruptcy Act, was a hotel corporation which owned and operated a hotel in Albany. The reorganization plan which was approved below is being challenged for the reason, among others, that the plan gives preference to certain unsecured creditors. These creditors had furnished supplies to the hotel for a short time before the receiver was appointed in the foreclosure suit which precipitated the bankruptcy proceeding. The trustee allowed the priority on the ground that the supplies were necessary to keep the hotel a going concern and that the six months rule, applicable to railroads and other public service companies, applied. *Held*, in so far as the supplies were furnished within six months of the receivership and so far as they were necessary to keep the hotel open, they were proper preferred claims. *Dudley v. Mealey*, (C.C.A. 2d, 1945) 147 F. (2d) 268.[1]

As is indicated in its opinion, the Court had to discard the rule as laid down in many lower court cases when it decided to apply the six months rule to private corporations.[2] Since its birth by way of obiter dictum in *Fosdick v. Schall*,[3] the rule has crystallized in some respects, but the reason or reasons for the rule have never been agreed on, either by the courts or by writers.[4] One of the bases on which many courts have relied to restrict application of the rule to railroads, or, at most, to other public utility companies, is that the public has an interest, paramount to that of the secured creditors, in keeping the company operating. There-

[1] Cert. den., 325 U.S. 873, 65 S. Ct. 1415 (1945).

[2] Principal case at 271, and cases cited there. There have been a very few cases in which the rule has been applied to private corporations, most of them by the state courts, 2 GERDES, CORPORATE REORGANIZATION, § 675 (1936). Nevertheless, the great weight of authority does not allow application of the rule to private corporations, id. at p. 1083. A good example of court opinion is found in Keelyn v. Carolina Mut. Telephone & Telegraph Co., (C.C. S.C. 1898) 90 F. 29 at 30: "It [the rule] certainly cannot be applied to corporations of a purely private character."

There was no doubt that this rule of preference applied to bankruptcy cases under section 77 or 77B of the Bankruptcy Act, 2 GERDES, CORPORATE REORGANIZATION, 1041 (1936); Fitzgibbon, "The Present Status of the Six Months' Rule," 34 COL. L. REV. 230 at 232 (1934). A similar provision for inclusion of such preferences was omitted in chapter 10 of the Bankruptcy Act of 1938. Most writers agree that a specific provision is not necessary, however: FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 382-83 (1939); Gerdes, "Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act," 52 HARV. L. REV. 1 at 29 (1938). This conclusion is certainly sustained by such cases as the present one.

[3] 99 U.S. 235 (1878).

[4] For a good history of the development of the six months rule see, FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 373 ff. (1939). See also, 2 GERDES, CORPORATE REORGANIZATION, §§ 665-681 (1936); Fitzgibbon, "The Present Status of the Six Months' Rule," 34 COL. L. REV. 230 (1934).

fore, those who help keep it running are entitled to protection.[5] But has not our conception of that in which the public has an interest changed considerably in the last fifty years? Today the public can be said to be vitally affected by the financial status of many, if not all corporations of any size.[6] An argument could be made that a hotel is a public service institution in a very real sense and so in the present case the public has a vital interest in the continued operation of the corporation.[7] The court, however, preferred to justify its conclusion on a broader basis, and rightly so, it is submitted. In the words of Judge L. Hand, " . . . upon the continued operation of a hotel its good will depends . . . Unless the tradesmen with whom it must deal can be protected [as insolvency approaches] . . . it must begin to trade upon a cash basis, which may be difficult, or even impossible. Some priority to them may be as essential to the preservation of the business [prior to insolvency] . . . as it is later. [The rule arose primarily out of the public's interest but] . . . the interests of the lienors themselves may make equally imperative some protection to supply creditors." [8] As one authority put it, suppliers of materials and labor needed in everyday operation, current expenses if you please, assume they will be paid out of current earnings, and credit is given with that usually unexpressed understanding.[9] The court in the present case would seem to be basing its conclusion on just such a concept. Although this writer has never seen the exact phrase used in cases or texts, is not such a reason based fundamentally on an *accountant's approach* to the problem? [10] The genesis of the terms, "current expenses" and "current earnings," is not found in court thinking or writing; rather the ac-

[5] Keelyn v. Carolina Mut. Telephone & Telegraph Co., (C.C. S.C. 1898) 90 F. 29 at 30; International Trust Co. v. Decker Bros., (C.C.A. 9th, 1907) 152 F. 78. For a summary of cases see, Fitzgibbon, "The Present Status of the Six Months' Rule," 34 COL. L. REV. 230 at 233, note 8 (1934).

[6] What better example can be found than the General Motors Strike of 1945-46? See the President's message to Congress relating to the labor problem and big business, NEW YORK TIMES, Dec. 3, 1945, 18:3, 4; and his message to the people, NEW YORK TIMES, Jan. 4, 1946, 2:2.

[7] Surely nobody could be found during the present housing crisis who would say the public has no interest in keeping a hotel open. See the discussion in TIME, Dec. 24, 1945, pp. 22, 23.

[8] Principal case at 271.

[9] 2 GERDES, CORPORATE REORGANIZATION 1044-47 (1936). See also Bowen v. Hockley, (C.C.A. 4th, 1934) 71 F. (2d) 781 at 785; Hirth, "Priority of Claims in Public Utility Receiverships," 27 MICH. L. REV. 241 at 243, 244 (1929); Fitzgibbon, "The Present Status of the Six Months' Rule," 34 COL. L. REV. 230 at 233 (1934).

For fuller discussions of the various reasons, showing the variety both in the reasons and in the phrasing of them, see: FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 379-85 (1939); 2 GERDES, CORPORATE REORGANIZATION 1040 (1936); Fitzgibbon, "The Present Status of the Six Months' Rule," 34 COL. L. REV. 230 (1934).

[10] The Alabama court would seem to be talking about just such a basis in Drennen v. Merchantile Trust & Deposit Co., 115 Ala. 592 at 614, 23 S. 164 (1896).

countant is the one who generated these concepts.[11] One writer has suggested that the six months rule actually grew out of a history of insolvency proceedings replete with cases in which secured creditors very frequently agreed to payment of such current expense items on a preferred basis, without question and without the intervention of any court.[12] If such is the case, our premise would seem vindicated: that fundamentally the reason for the priority of such claims is recognized accounting practice. If that premise is accepted there would be no reason for holding the six months rule not applicable to bankrupt private corporations.[13]

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[11] Hirth, "Priority of Claims in Public Utility Receiverships," 27 MICH. L. REV. 241 at 249 ff. (1929), sets out at some length the kinds of claims that have been allowed in the cases. In every case the opinions are replete with accounting terms and the reasons given for allowing or disallowing such claims under the six months rule are essentially those of an accountant.

[12] Fitzgibbon, "The Present Status of the Six Months' Rule," 34 COL. L. REV. 230 at 232, note 3 (1934).

[13] See note 9, supra. One writer, however, has argued that, since the rule is an arbitrary, judge-made one, it should not be extended except by an act of Congress, FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 384 (1939).