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LESSORS' CLAIMS UNDER SECTION 77 OF THE BANKRUPTCY ACT

IN TIMES of economic depression when traffic revenues decline sharply,¹ railroads have found it necessary to reduce fixed charges which typically absorb an abnormally large share of income.² Burdensome leases often constitute a large part of such charges;³ and although a desire to abrogate them has not been the chief reason for reorganization,⁴ it has by no means been an unimportant factor.⁵ In reorganizations accomplished through equity receiverships, the lessor whose lease had been rejected was in an unenviable situation. In view of the strict adherence to the historical concept of rent as issuing from the land and as not due until the period for which it was reserved had passed, the lessors were generally permitted to prove claims only for damages actually suffered up to the end of the period for the filing of claims.⁶ This disinclination to depart from the precepts of ancient English property law, which was evinced by the majority of jurisdictions,⁷ had the further result of precluding any resort to the doctrine of anticipatory breach generally accepted in the case of the ordinary executory contract involving personalty.⁸

1. See Annual Report of Interstate Commerce Commission (1935) 4, 113, 154-55; Rodgers & Groom, *Reorganization of Railroad Corporations under Section 77 of the Bankruptcy Act* (1933) 33 COL. L. REV. 571.

2. See CLARK, *ECONOMICS OF OVERHEAD COSTS* (1923) 258.

3. The classic example is the lease of the Wisconsin Central to the Northern Pacific, which had much to do with the latter's collapse in 1893. See CLEVELAND & POWELL, *RAILROAD FINANCE* (1912) 217, 218; RIPLEY, *RAILROAD FINANCE AND ORGANIZATION* (1927) 394.

4. See RIPLEY, *op. cit. supra* note 3, at 378.

5. *Ibid.*, at 394.

6. Gardiner v. William S. Butler & Co., 245 U. S. 603 (1918); Rogers v. United Grape Products, 2 F. Supp. 70 (W. D. N. Y. 1933); Wake Development Co. v. Auburn-Fuller Co., 71 F. (2d) 702 (C. C. A. 9th, 1934); see 2 GERDES, *CORPORATE REORGANIZATIONS* (1936) §§ 687, 688; Clark, Foley and Shaw, *Adoption and Rejection of Leases by Receivers* (1933) 46 HARV. L. REV. 1111, 1119; Douglas and Frank, *Landlords' Claims in Reorganizations* (1933) 42 YALE L. J. 1003, 1006.

In bankruptcy, the rule was even more strict, for any claim not in existence at the time of the filing of the petition was barred. *Manhattan Properties v. Irving Trust Co.*, 291 U. S. 320 (1934); *Kothe v. R. C. Taylor Trust*, 280 U. S. 224 (1930). See generally Fallon, *Lessors as Creditors in Bankruptcy* (1934) 4 BROOKLYN L. REV. 11; Keegan, *Rights of Landlord and His Bankrupt Tenant* (1935) 21 A. B. A. J. 379; Littell, *Provaibility of Claims for Future Rent or Damages* (1932) 7 WASH. L. REV. 307; Schwabacher and Weinstein, *Rent Claims in Bankruptcy* (1933) 33 COL. L. REV. 213.

7. *Leo v. Pearce Stores Co.*, 54 F. (2d) 92 (E. D. Mich. 1931); *Grayson v. Mixon*, 176 Ark. 1123, 5 S. W. (2d) 312 (1928); *Curran v. Smith-Zollinger Co.*, 157 Atl. 432 (Del. 1931); *Chemical Bank v. Deposit Co.*, 156 Ill. 522, 41 N. E. 225 (1895); *Wilson v. National Refining Co.*, 126 Kan. 139, 266 Pac. 941 (1928); *Womble v. Leigh*, 195 N. C. 282, 142 S. E. 17 (1928); *In re Reading Iron Works*, 150 Pa. 369, 24 Atl. 617 (1892).

8. See cases cited *supra* note 6; 2 GERDES, *CORPORATE REORGANIZATIONS* (1936) §§ 682-684; Clark, Foley, and Shaw, *supra* note 6, at 1118; Douglas and Frank, *supra*

Moreover, under the common law rule in force in many states, re-entry by the lessor at once terminated the lessee's liability for subsequently accruing rent,⁹ so that any further rights of the former were of necessity predicated upon whatever covenants of indemnity the lease might contain. These factors were responsible for the development of various types of covenants dealing with indemnity and liquidated damages.¹⁰ But few covenants were successful in enlarging the field of provability,¹¹ and the lessor's attempt to prove a claim for future rent under a broken lease was doomed to failure in the great majority of cases.

To remedy many of the abuses inherent in railroad reorganization under equity receivership procedure, Section 77 was enacted in 1933¹² and comprehensively amended in 1935.¹³ The amended act affects lessors' rights in two important particulars. First, the definition of the term "creditor" includes the holder of a claim under an unexpired lease; and second, in the event of the rejection of such a lease the amount of the claim is to be determined "in accordance with principles obtaining in equity proceedings."¹⁴ A recent decision in the New Haven reorganization is the first to undertake the interpretation of these statutory provisions.¹⁵

The plaintiff had leased its trolley properties in 1906 to the New York, New Haven and Hartford Railroad Co. for a term of 999 years at a stipulated rental. In 1935, the New Haven filed a petition for reorganization under Section 77 and its trustees subsequently rejected the lease. The lessor company filed a claim for damages, computed as the difference between the re-

note 6. at 1006. The same rule applied in bankruptcy. *Central Trust Co. v. Chicago Auditorium Ass'n*, 240 U. S. 581 (1916).

9. See McCormick, *Rights of the Landlord upon Abandonment of the Premises by the Tenant* (1925) 23 MICH. L. REV. 211; Schnebly, *Operative Facts in Surrenders* (1927) 22 ILL. L. REV. 117.

10. See 2 GERDES, *CORPORATE REORGANIZATIONS* §§ 685-687; Clark, Foley and Shaw, *supra* note 6, at 1120-1122.

11. *Manhattan Properties v. Irving Trust Co.*, 291 U. S. 320 (1934); *In re Shaffer*, 124 Fed. 111 (D. C. Mass. 1903); *In re Cushman*, 3 F. (2d) 449 (S. D. N. Y. 1924); *In re Van Fleet*, 4 F. Supp. 332 (W. D. Pa. 1933); *Cotting v. Harper, Lewis & Co.*, 220 Mass. 273, 107 N. E. 931 (1915); *884 West End Ave. Corp. v. Pearlman*, 234 N. Y. 589, 138 N. E. 458 (1922). *Contra*: *Wm. Filene's Sons Co. v. Weed*, 245 U. S. 597 (1918); *Gardiner v. William S. Butler & Co.*, 245 U. S. 603 (1918); *Irving Trust Co. v. Perry*, 293 U. S. 307 (1934).

12. 47 STAT. 1474 (1933).

13. 49 STAT. 911 (1935), as amended 49 STAT. 1969, 11 U. S. C. § 205 (Supp. 1936).

14. 49 STAT. 914 (1935), 11 U. S. C. § 205 (b) (Supp. 1936). The statute reads: "In case an executory contract or unexpired lease of property shall be rejected, or shall not have been adopted by a trustee . . . any person injured by such non-adoption or rejection shall . . . be deemed to be a creditor of the debtor to the extent of the actual damage or injury determined in accordance with principles obtaining in equity proceedings."

15. *Matter of New York, N. H. & H. R. R.: Claims of Connecticut Ry. & Lighting Co.*, U. S. Dist. Ct. Conn., Sept. 1, 1937.

served rental discounted to present value and the use value of the property for the period of the lease. The court, one year after the period for filing claims had elapsed, refused this request but granted damages to the date of the hearing. In arriving at this conclusion, the court confessed its inability to find any clue to the Congressional intent behind the direction to determine the extent of the claim in "accordance with principles obtaining in equity proceedings," since questions relating to damages are not peculiarly within the field of equity and since there seemed to be no body of precedents to which the words could refer. However, arguing by analogy to the corresponding passages in Sections 63¹⁶ and 77B¹⁷ which impose limitations of one and three years respectively on the amount of future rent provable, the court inferred that some limitation was intended. It accordingly construed the words "actual damage" in the statute¹⁸ to mean "accrued damage," thus precluding any possibility of proving claims for future rent. The granting of damages computed to the date of the hearing was justified on the ground that since the statute rigidly precluded future damages, equitable treatment necessitated the consideration of all claims which did not fall within the statute's bar.

But there are several factors indicating that the words "actual damage" were not intended to be given so narrow a meaning. In the first place, the fact that categorical limitations upon future rent claims were included in Sections 63 and 77B, and not in Section 77, is as indicative of an intent to allow claims in full as of an intent to place some limitation upon them. Furthermore, although none of the preliminary drafts contained specific statements that future rent claims were to be allowed in full, they contained definite indications that this was the intent of the sponsors. By providing that an assignment of future rent claims shall be considered in determining the amount of damages allowed, the original draft of the bill seems to indicate that unassigned claims were to be provable in full.¹⁹ Although this reference to future rent claims was omitted from the committee print of the bill, the latter contained language well calculated to admit of the allowance of claims in full, for the amount of the claim was to be "the extent of the damage or injury."²⁰ To these words the final draft added the word "actual" and the

16. 48 STAT. 924, 11 U. S. C. § 103 (a) (7) (1934).

17. 48 STAT. 915, 11 U. S. C. § 207 (b) (1934).

18. 49 STAT. 914 (1935), 11 U. S. C. § 205(b) (Supp. 1936). See note 14, *supra*.

19. REPORT OF THE FEDERAL COORDINATOR OF TRANSPORTATION, H. R. DOC. NO. 89, 74th Cong., 1st Sess. (1935) 231. The draft read: ". . . any person injured . . . shall . . . be deemed to be a creditor to the extent of such damage or injury, provided that the judge shall consider the circumstances of an assignment of future rent claims . . . in determining the amount of damages allowed an assignee . . ."

20. *Hearings before the Committee of the Judiciary on H. R. 6249, 74th Cong., 1st Sess. (1935) 3.* Deletion of the reference to the assignment of future rent claims undoubtedly indicates a realization that that is a problem peculiar to ordinary corporate reorganization rather than any intent to limit the provability of claims. See note 44, *infra*.

phrase "determined in accordance with principles obtaining in equity proceedings;" but neither in the testimony before the Judiciary Committee,²¹ nor in the reports of the bill to Congress,²² nor in the discussion on the floor²³ is there any indication why the addition was made. If, as seems likely, these words were added because of a desire to leave the final determination to the courts,²⁴ the seemingly innocuous phrase has served its purpose, and no decision will be final until the Supreme Court has spoken.

The lessor's partial victory in the instant case appears to constitute a compromise between, rather than a compliance with, the several rules applying in equity receivership. Although the general rule was that no claim which came into existence after the expiration of the period set for filing claims was provable,²⁵ the minority view was that claims which were sufficiently matured before any order of distribution was made had to be allowed.²⁶ And by computing damages to the date of the hearing, the court granted the lessor compensation for a period of six months after re-entry and repossession of the properties, events which in some jurisdictions terminate all liability on the lease.²⁷

While the decision may make the best of a very ambiguous statute in connection with the question of provability, it leaves unsettled the status of the balance of the lessor's claim. Both in receivership and bankruptcy the unprovable portion of the lessor's claim was not discharged by the litigation.²⁸ In case of liquidation this fact was of little import since the termination of the proceeding left the lessee a corporate shell. But in reorganization one encountered the rule of the *Boyd* case,²⁹ that an unsecured creditor, even though his claim was barred by technical rules of provability, must be granted participation in any plan which grants participation to stockholders. The relevance of this rule to proceedings under Section 77 is a controversial question. It seems fairly clear that the doctrine applied in favor of a lessor who

21. *Id.*, at 13-330.

22. H. R. REP. No. 1283, 74th Cong. 1st Sess. (1935); SEN. REP. No. 1336, 74th Cong., 1st Sess., Calendar No. 1388 (1935).

23. 79 Cong. Rec. 13293, 13764 (1935).

24. *Cf.* Friendly, *Amendment of the Railroad Reorganization Act* (1936) 36 COL. L. REV. 27, 50-52.

25. See note 6, *supra*.

26. *Filene's Sons Co. v. Weed*, 245 U. S. 597 (1918); *New York Sec. & Trust Co. v. Lombard Ind. Co.*, 73 Fed. 537 (C. C. W. D. Mo. 1896); *Pennsylvania Steel Co. v. New York City Ry.*, 198 Fed. 721 (C. C. A. 2d. 1912).

27. See note 9, *supra*. The Supreme Court has recently decided that the provability of a claim under the corresponding provision of § 77B is unaffected by a re-entry which, under the operative state law, terminated the leasehold. *City Bank Co. v. Irving Trust Co.*, 299 U. S. 433 (1937).

28. 42 STAT. 354 (1922), 11 U. S. C. § 35 (1934); *People v. Metropolitan Surety Co.*, 205 N. Y. 135, 98 N. E. 412 (1912); see COLLIER, *BANKRUPTCY* (Gilbert's ed. 1937) § 533.

29. *Northern Pacific Ry. v. Boyd*, 228 U. S. 482 (1913).

had been left with an unprovable claim for rent in an equity receivership.³⁰ Furthermore, if the principle is applicable under Section 77,³¹ it would seem to apply in favor of lessors, for they are included within the statutory definition of creditors.³² But the doctrine of the *Boyd* case was based on the premise that granting participation to stockholders without making any provision for undischarged claims was in effect a fraudulent transfer. Section 77(b) provides that the term "creditors" shall include all holders of claims of whatever character "whether or not such claims would otherwise constitute provable claims under this Act,"³³ and Section 77(f) provides that when a plan of reorganization has been confirmed, the property "shall be free and clear of all claims of the debtor, its stockholders and creditors," and the debtor "shall be discharged from its debts and liabilities."³⁴ It may thus be argued that the statute removes the right which the rule created, since there are no longer any undischarged claims upon which to base the doctrine. On the other hand, it is arguable that the requirements of Section 77(e), that the reorganization plan be "fair and equitable" and that it "conform to the requirements of the law of the land regarding participation of the various classes of stockholders,"³⁵ are specific directions to apply the equitable principle of the *Boyd* case. But in view of the fact that the Supreme Court has recently held that the doctrine does not apply in favor of lessors under Section 77B,³⁶ where the pertinent provisions are not dissimilar,³⁷ it seems unlikely that it will be held to apply in favor of lessors in Section 77. Furthermore, it is clear that if the rule of the *Boyd* case is held to apply, the decision in this case is practically meaningless, for lessor's claims will be wiped out only in those rare cases where stockholders do not participate in the reorganization.³⁸

Whether or not the rule of the *Boyd* case applies, any answer to the problem of provability must depend in large part upon practical considerations. The lessor railroad whose lease has been rejected and whose property has been relet at a lower figure is naturally anxious to have its claim allowed in full, but several factors militate against this result. In the first place, the

30. *Hamer v. New York Rys.*, 244 U. S. 266 (1917); *Howard v. Maxwell Motor Co., Inc.*, 269 Fed. 292 (S. D. N. Y. 1920); see Douglas and Frank, *supra* note 6, at 1022.

31. The rule applied to a sale of corporate assets in bankruptcy proceedings. *Kingston v. American Car and Foundry Co.*, 55 F. (2d) 132 (C. C. A. 8th, 1932), *cert. den.*, 285 U. S. 560 (1932); see Douglas and Frank, *supra* note 6, at 1013.

32. See note 14, *supra*.

33. 49 STAT. 913 (1935), 11 U. S. C. § 205 (b) (Supp. 1936).

34. 49 STAT. 920 (1935), 11 U. S. C. § 205 (f) (Supp. 1936).

35. 49 STAT. 918 (1935), as amended 49 STAT. 1969, 11 U. S. C. § 205 (e) (1) (Supp. 1936).

36. *Kuehner v. Irving Trust Co.*, 299 U. S. 445 (1937).

37. 48 STAT. 919, 11 U. S. C. § 207 (f) (1934).

38. The New Haven reorganization may be such a case. See (1937) 145 COMMERCIAL AND FINANCIAL CHRONICLE 1746.

characteristic expansion of railroad systems during periods of business prosperity, the desire to monopolize transportation in a given region,³⁹ and ownership of the leased line by the promoters of the system have often produced exorbitant rentals for extremely long terms.⁴⁰ Consequently, when the road is placed in the reorganization court, lessors have extremely large claims for damages, the full allowance of which would seriously dilute the participation of other creditors whose rights rest upon a more solid foundation. Secondly, the fact that there is no unrestricted market for railroad properties from which to deduce estimates of rental values makes an accurate ascertainment of the amount of damage practically impossible. Finally, while in the reorganization of many other types of business the lessor often suffers loss through the vacating of the property, this possibility is precluded in railroad reorganizations because the public interest demands the operation of all railroads until the Interstate Commerce Commission has decreed otherwise,⁴¹ and because the necessity of maintaining the integrity of the entire system will usually compel the lessee to re-lease the lessor's line.⁴² The arguments for full allowance of the lessor's claim are also cogent. There is usually no connecting line other than the lessee's to which the lessor may re-lease; and as the latter has inevitably allowed its operating organization to disintegrate in reliance upon a long term lease, the parent organization has a distinct advantage in bargaining for new rentals⁴³ which might well be counterbalanced by allowing claims for future rent. Moreover, the possibility that a professional trouble maker might buy up lessor's claims, an evil with which corporate reorganizations have often been plagued,⁴⁴ seems remote in view of the size of the claims involved and the close association of all the parties in an integrated railroad system.⁴⁵ In the last analysis, these considerations seem fairly evenly balanced, and therefore the best solution appears to be judicial pronouncement of, and adherence to, a definite rule.

39. The New York, New Haven & Hartford R. R. furnished a notable example during the years 1903-1913. Investigation of New York, N. H. & H. R. R., 220 I. C. C. 505, 506-510 (1937); RIPLEY, *op. cit. supra* note 3, at 466-473.

40. Railroad leases are generally of extremely long duration. See RIPLEY, *op. cit. supra* note 3, at 419.

41. 41 STAT. 477 (1920), 49 U. S. C. § 1 (18) (1934); *cf.* Bankruptcy Act § 77 (c) 6, 49 STAT. 915 (1935), 11 U. S. C. § 205 (Supp. 1936).

42. Though reorganization may result in the dropping of unproductive subsidiary lines, the more usual effect is actually to increase the mileage. See CLEVELAND AND POWELL, *op. cit. supra* note 3, at 264.

43. *Ibid.*

44. This was particularly a feature of the epidemic of chain-store bankruptcies. See Jacobson, *Landlord's Claims under Section 77B of the Bankruptcy Act (1936)* 45 YALE L. J. 422, 433.

45. The original draft of the 1935 amendment to Section 77 contained a specific provision for future rent claims which had been assigned. But this provision was stricken from the final bill. See notes 19 and 20, *supra*.