

THE JUDICIAL AND ADMINISTRATIVE MECHANISM OF SECTION 77

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Among the most important amendments to Section 77 of the Bankruptcy Act¹ proposed at the last two sessions of Congress, are those which involve what court shall be charged with the performance of the judicial functions in the administration of the Act, and what shall be the relative functions of this judicial tribunal and the Interstate Commerce Commission. These amendments, and the considerations underlying them, are the subject of this discussion.

Such legislation must, of course, be framed with a recognition of the inherent peculiarities of the work at hand. One of the most important of these peculiarities is that the reorganization of a railroad affects the public interest. The public is interested in the unimpaired capacity of the railroad to render efficient and economical service. An unreasonable capital structure, which burdens the property with excessive charges and threatens it with financial disruption, is clearly inconsistent with that public interest. As a corollary, the public interest requires the provision of a capital structure which will contribute to the good credit of the railroad and thus permit securing the necessary new capital from time to time through appropriate mediums for future financing. It has been generally conceded that the equity reorganizations effected before the passage of Section 77 did not adequately meet these necessities, and this was one of the reasons offered for the enactment of the section. Actually, the public interest also requires such a reorganization of the physical operations of the property as will tend to improve and protect its economic integrity by releasing it from the deadweight of unproductive facilities through abandonments and from excessive competition through consolidations. If the process were rightly arranged, this kind of physical reorganization would precede or accompany the corporate reorganization. But the domination of legislation for the railroads by labor, and the politicians' willingness that the economic efficiency of the property be sacrificed for the protection and providing of employment, apparently makes such action impossible. Attention is thus being given only to corporate reorganizations, whereas atten-

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¹ Bankruptcy Act, §77, 11 U. S. C. A., §205 (hereinafter referred to as "Section 77").

tion should likewise be directed to operating reorganizations designed to effect economic stability. The assumption thus is that, regardless of the shallowness of the water, you can make a boat float by merely reducing its draft, that soundness can be created by reducing capitalization without increasing the earnings.

A second major aspect of railroad reorganizations is the technical nature of the questions involved in the determination of the size and character of the new corporate structure and of the allocation to the claimants entitled to participate of the securities permitted under the authorized capitalization. The fundamental question is what economic substance presently and prospectively exists in the property and how that substance may fairly be divided among those security owners whose interests have not been wiped out by irremediable shrinkage of the economic substance. While legal questions are involved, the answer rests primarily in very technical fact considerations. These have to do with such issues as the cost, value and earning power of the property as a whole, and of the component parts separately subject to the various mortgage liens. The value of the component parts must be weighed both from the standpoint of what they contribute to the railroad system as a whole and what value they would have if severed. Similar analysis and conclusions as to terminal properties and leased lines are necessary. These issues are technical and involve considerations peculiar to the industry. It would be a mistake to regard them as primarily, or simply, legal questions, to be readily handled by a court not familiar with the railroad technique.

These considerations indicate that the aid of a trained and technical agency is required for the best administration of these cases. When Section 77 was enacted, it was believed that the courts had shown themselves unable to discern the unsoundness of plans presented to them by persuasive private groups not primarily concerned with the public interest. The courts had been too much inclined to approve, without careful scrutiny, plans accepted by large votes of the controlling interests. Consequently Section 77 required the Interstate Commerce Commission to pass on all of the elements of the plan. Because of its experience and its other similar functions, the Commission was the natural choice of Congress. The Commission was given an important role. Under the provisions of Section 77, the court can approve a plan only when it has had the Commission's approval.² Plainly, this arrangement secures the desired reform. But it has the defect that the required concurrence of the two separate agencies upon the plan may result in delay. While, in the hearings before the House and Senate committees, no one was able, nor attempted, to establish that, in any of the relatively simple cases which by now have reached the courts, there actually has been substantial delay because of such disagreement, the arrangement probably does involve some hazard. Should there be such a dual responsibility in both the Commission and the court? In view of the technical character of the determinations, should they be entrusted to the federal district courts or to a special court?

² §77(d).

The several bills presented to the House propose different answers. S. 1869 which passed the Senate in 1939 was prepared by the legal staff employed by the Senate Committee on Interstate and Foreign Commerce in connection with its investigations of railroad financing and has been under consideration by the House Committee on the Judiciary at the present session. It vests in the Commission the determination of those elements of the plan which affect the public interest, which determination shall be final if sustained by substantial evidence.³ This framework is to be prescribed by the Commission after hearings to be held before any plans are submitted to the court. The Commission is specifically enjoined to disregard the questions pertaining to the distribution of the authorized securities to the various classes of creditors and stockholders and is to make its determination of the detail of the capital structure *in abstracto*.⁴ With this prescription of the capital structure before it, the court then holds hearings and considers the provisions of the plan allocating the authorized securities to the respective claimants, without the benefit of the Commission's views as to that phase of the reorganization.⁵

While Section 77 vests jurisdiction in the ordinary federal district courts, S. 1869 provides for a special reorganization court composed of five members,⁶ to be located at Washington,⁷ and to combine both administrative and judicial functions, the court being empowered to promulgate its own reorganization plans.⁸ The theory of the bill is that a specially qualified court can properly be substituted for the specially qualified commission in handling this part of the plan.

The bill⁹ proposed for the consideration of the Judiciary Committee by Hon. Walter Chandler (formerly chairman of the Subcommittee on Bankruptcy and Reorganization of the House Committee on the Judiciary) is quite different. It assumes that the primary responsibility for the reorganization should be placed in the court, which, however, shall act with the advice of the Commission. The Commission is required to hold hearings and to pass on all the elements of the plan.¹⁰ The court is then free to approve a plan in disregard of the Commission's¹¹ report. Plainly, the purpose of this proposal is to secure expedition through the elimination

³ §77(d), as amended by S. 1869, 76th Cong., 1st Sess. (1939), p. 40, provides that the Commission at the initiation of the reorganization shall determine the expectable future average income upon which a plan may safely be based and the maximum total capitalization, fixed charges, amount of fixed interest bearing debt, cumulative contingent charges, non-cumulative contingent charges, amount of contingent interest bearing debt, and cumulative dividend requirements. Such determinations are basic to the reorganization standards set forth in subsection (u) and, when fixed, would definitely fix the capital structure.

The page references to S. 1869, herein, are to the House Committee Print of June 1, 1939, a Comparative Print of S. 1869 as it passed the Senate and existing law.

⁴ §77(d), as amended by S. 1869, p. 41.

⁵ *Id.*, pp. 42-43.

⁶ *Id.* §3, p. 5.

⁷ S. 1869, §2(a), p. 2.

⁸ *Id.* §13, p. 78.

⁹ Committee Print of the Committee on the Judiciary of the House, entitled "A Bill to Amend Section 77 of the Bankruptcy Act by Substituting Chapter XVI Therefor," 76th Cong., 3d Sess. (1940) (hereinafter referred to as the "Chandler Draft").

¹⁰ Chandler Draft, §943, p. 57.

¹¹ *Id.* §949, p. 59, §951, p. 60.

of the need of any concurrence between the court and the Commission, and through the substitution of the primary responsibility of the court for a dual responsibility in both the court and the Commission.

Mr. Chandler's draft would also materially strengthen the court's own machinery, but without going outside the existing structure. It does this by providing for a special three-judge court to be convened in each case, two members to be circuit judges¹²—a provision similar to the special court procedure now employed in injunction cases.

H. R. 9447, introduced in the House by Hon. Charles F. McLaughlin who succeeded Mr. Chandler as chairman of the Subcommittee on Bankruptcy and Reorganization of the House Committee on the Judiciary, presents another alternative. It adopts the three-judge court proposed by Mr. Chandler¹³ and reaches a midway position with reference to the functions of the court and the Commission. All of the testimony as to the plan is to be heard before the Commission and the Commission is to state in its report findings prescribing substantially the same elements of the capital structure as are required in S. 1869.¹⁴ These findings as to the public-interest aspects of the plan "shall be prima facie conclusive and every presumption of correctness shall be indulged in favor of such findings."¹⁵ The findings of the Commission with reference to the allocation of the authorized securities among the claimants are protected by no such presumption, and the court is left free to modify the plan or to approve a different plan, as it may find to be required by the facts or the law.¹⁶ H. R. 9447, based upon the subcommittee's consideration of the several bills just discussed and the testimony heard by the subcommittee in protracted hearings at which there was a full presentation of views, is apt to be reported out favorably by the House Committee on the Judiciary and to be considered by the House as the basis of future legislation.

What form such legislation should take is now a question to be considered in light of the present advanced status of the pending cases. The weighing on a theoretical plane of the advantages of a technically informed commission as compared with a special and technically informed court must be subordinated to the practical considerations that we now have a technically informed and fully staffed commission fully functioning on reorganization matters and that there would be delays as well as hazards (due to the chances of the selection of inappropriate personnel) were a special court now to be established. By the time Congress adjourns this year, the Commission will have certified to the respective courts its completed plans in cases involving 90% of the mileage of the railroads in bankruptcy.¹⁷ In the hearings before

¹² *Id.* art. VII, p. 20.

¹³ H. R. 9447, art. VII, p. 16.

¹⁴ *Id.*, p. 47.

¹⁵ *Id.* §943, pp. 46-47.

¹⁶ *Id.* §949, p. 48, §951, p. 50.

¹⁷ *House Hearings*, Pt. 2, p. 239-240. The references herein to "*House Hearings*" are to the *Hearing before the Special Subcommittee on Bankruptcy and Reorganization of the Committee on the Judiciary, House of Representatives, on S. 1869, 76th Cong, 1st Sess. (1939) Ser. No. 11.*

the Senate and House committees there appeared representatives of the trustees, the stockholders, the creditors, the Reconstruction Finance Corporation, the labor unions, and the staff which has conducted the investigations into railroad finance carried on by the Senate Interstate Commerce Committee, among others. None of these interests made any attack on the soundness of the general principles employed by the Commission in its work. Were the Commission's principles fundamentally unsound, or consistently unfair to any of the various interests thus represented, the fact would have been made known. It is true that S. 1869 provides new standards which would base the capitalization on the capitalized earnings of the last twelve years,¹⁸ and which would produce reductions on the capitalization exceeding the drastic reductions which have been made by the Commission. But this proposal was so poorly supported by the Senate committee staff as to receive no support from any other interest, and falls far short of demonstrating the unsoundness of the Commission's work. Practically then, there seems to be little ground for substituting at this time a special judicial agency for this technical quasi-judicial agency, as S. 1869 proposed.

Nor can any very accurate conclusions be drawn with reference to whether a plan which looks for technical skill to a special court is preferable to one which relies upon a commission; because, while the question is readily debatable and the theoretical considerations pro and con fairly obvious, such considerations are actually outweighed by the practical question of what men the appointive power would select for such a new court—and that no man knoweth, not even a clairvoyant. It is, of course, the motivation, energy, and intelligence of the men who constitute such agencies which fix their standard of performance. Of this, the ill-fated Commerce Court is proof. However theory may have indicated the expected efficiency with which it might have accomplished its purpose, the personnel selected was, apparently, actually responsible for its failure. The Interstate Commerce Commission is a trained and experienced agency of fifty years' experience, and has that intimate knowledge of the railroad problem which no court, even if a special court, could have initially or could attain without long training and experience. It is, further, above politics, and it, and its friends, have vigorously resisted any attempt to subvert its objective-mindedness, the significance of which will appear from consideration of the apparent purposes of some of the proponents of a special court.

Whatever might be the merits of a special court, as an original question to have been considered in 1933, certainly the particular kind of special court proposed in S. 1869 and as explained by Mr. Max Lowenthal who drafted the bill, had nothing to recommend it. The purpose of S. 1869 was the reorganization of the railroads according to new standards which were prescribed in the bill¹⁹ and which were so drastic as to have required the rejection of all that the Commission had done and the rewriting of its plans according to newly imposed standards. The drastic capital reductions intended to be accomplished by this program are indicated by the table

¹⁸ §77(u)(3), as amended by S. 1869, p. 75.

¹⁹ §77(u), as amended by S. 1869, pp. 73-77.

in the footnote.²⁰ If such a destruction of property values has actually occurred and should now be recognized in a reduced capital structure, the reductions should be made in accordance with the law of the land. But they should be made by the objective-minded processes of a judiciary free from political pressure. The essence of the railroad problem lies in the simple issue whether, under the democratic process with its criss-cross of tensions from pressure groups, our railroad regulation can express enough intelligence to allow the railroads to survive. Railroad labor, whose political power enables its domination of railroad legislation, is manifesting an active interest in the reorganization of the railroads²¹ on the assumption, supposedly, that a marked reduction of railroad debt and fixed charges will allow the diversion to the wage earners of a greater part of the railroad earnings. Against this background, Mr. Lowenthal's blunt explanation of the purpose of a special court stands in bold relief. He said before the Senate Committee on Interstate Commerce:

In the second place, this special court will be functioning in Washington, to a large extent, immediately under the eye of Congress. Whatever one may want to say of it, I think it is fair to say that that has a salutary effect.²²

Such a court would be under the eye of Congress with respect to a matter of national concern, because I think that what has been said so far this morning has made it quite plain that sound railroad reorganization is a matter of national concern.²³

²⁰ Table taken from *House Hearings*, Pt. 2, p. 243, being a comparison of the capitalization authorized in reorganization plans by the Interstate Commerce Commission or its examiners, with the 12-year earnings capitalization basis as proposed in S. 1869, and the Interstate Commerce Commission valuation.

| | Interstate Commerce Commission or examiner's report | Bonds and preferred stock | Common no-par stock, number of shares | 12-year average capitalized at 5 percent (S. 1869) | Commission cost of reproduction, plus lands and working capital |
|-----------------------|---|---------------------------|---------------------------------------|--|---|
| | (1) | (2) | (3) | (4) | (5) |
| Milwaukee..... | Examiner..... | \$339,489,000 | 2,915,214 | \$249,680,000 | \$648,659,000 |
| Northwestern..... | Interstate Commerce Commission. | 329,074,000 | 1,208,998 | 246,000,000 | 656,298,000 |
| Rock Island..... | Examiner..... | 179,357,000 | 1,271,406 | 211,700,000 | 421,546,000 |
| Erie..... | do..... | 251,359,000 | 2,554,736 | 277,560,000 | 385,070,000 |
| Missouri Pacific..... | Interstate Commerce Commission. | 423,722,500 | 1,367,846 | 343,160,000 | 494,920,000 |
| New Haven..... | Examiner..... | *365,000,000 | | 347,790,000 | 423,520,000 |
| Frisco..... | do..... | 177,898,000 | 621,022 | 190,920,000 | 244,119,000 |
| Western Pacific..... | Interstate Commerce Commission. | 65,819,000 | 319,441 | 33,250,000 | 98,956,000 |

* Total capitalization.

NOTE.—The data in columns (2) and (3) were secured from the Bureau of Finance and are taken from the reports of the Commission and its examiners. The data in columns (4) and (5) are taken from the table found on page 779 of the printed hearings before the House committee.

²¹ *House Hearings*, Pt. 1, pp. 487 et seq., 594 et seq., 707 et seq.

²² *Hearings before the Senate Committee on Interstate Commerce on S. 1869*, 76th Cong., 1st Sess.

(1939) 114.

²³ *Ibid.*

I think there is great value, however, in giving a court that is under the eye of Congress the responsibility for seeing that things go well even in the small matters, the so-called local matters.²⁴

This court, from Washington, would have supervised the actual operation of 30% of the mileage of the country, such bureaucratic and centralized responsibility apparently being regarded as desirable for the right conduct of "local matters."

In order to accomplish the purposes of the proposed legislation, this "court" was to be half court and half administrative agency, was to combine both judicial and nonjudicial functions, provision being made that the "court" should have power to promulgate its own plans for the reorganization.²⁵ It was to be staffed with a bureau of experts, legal and otherwise, in order that it might perform its nonjudicial functions.²⁶ The proposal that the "court" promulgate its own plans was unconstitutional. Nonjudicial functions cannot be conferred upon the "constitutional" courts of the United States, that is, upon the courts which are the depository of the judicial power of the government, a power which, under Section 1 of Article III of the Constitution "shall be vested in one supreme court, and in such inferior courts as the Congress may from time to time ordain and establish."²⁷ The court proposed would clearly have been a constitutional court in this sense.²⁸

This confusion of functions was, it seems, thoroughly undesirable. The "court" would have been empowered by the statute to "promulgate its own plans" for submission to itself. They necessarily would be adverse to the interests of many of the parties appearing before it. This impairment of the judicial function, together with the proposed deliberate subjection of the court to political influence, deprived the proposal of the support of practically all those who appeared before the House committee.²⁹ The proposal was to sacrifice sound principle for power.

There is no apparent reason to set up a special court now for the purpose of this litigation. It is better to strengthen the judicial machinery without going outside the existing structure. Mr. Chandler's proposal of a three-judge court was incorporated without substantial change in H. R. 9447, which provides for the creation of a special court in each case by the addition to the district judge of two circuit judges.³⁰ This proposal comes from the precedent of the procedure in injunction suits. The district judge continues in the administration of the operation of the property, and has the support of two circuit judges upon the approval of the plan,³¹ the tentative form of which is prepared by the district judge,³² and upon other major problems of especial difficulty, such as the selection of the trustees,³³ the allowance of compensa-

²⁴ *Id.* at 123.

²⁵ S. 1869, §13, p. 78.

²⁶ *Id.* §2, p. 3.

²⁷ *Keller v. Potomac Electric Company*, 261 U. S. 428 (1923); *Muskrat v. U. S.*, 219 U. S. 346 (1911); *Gordon v. U. S.*, 117 U. S. 697 (1864).

²⁸ *Ex parte Bakelite Corporation*, 279 U. S. 438 (1929); *O'Donoghue v. U. S.*, 289 U. S. 561 (1933). For a thorough argument with reference to the various phases of the proposal of S. 1869, see *House Hearings*, Pt. 2, p. 237.

²⁹ *Id.*, p. 248.

³⁰ H. R. 9447, §851, p. 16.

³¹ *Id.* §§950-953, pp. 49-52.

³² *Id.* §949, p. 49.

³³ *Id.* art. IX, pp. 17-20.

tion and expenses³⁴ and other important matters upon which the district judge may seek assistance.³⁵ Within the existing judicial structure, the hand of the court is strengthened. This is enough where the Commission, as a technical agency, long experienced, has brought to the consideration of the plans that technical insight which theoretically might be possessed by a special court.

What then should be the scope of the Commission's function? Should it pass on all the elements of the plan, or only on those affecting the public interest?

Under the provisions of Section 77 the Commission passes on every element of the plan. Its findings are final in that the court cannot approve a plan which has not had the approval of the Commission.³⁶ Two objections have been urged against this arrangement: that it tends to create delay by requiring a concurrence of both tribunals and that it makes the Commission's decision final on what are purely judicial questions. It is argued that while the Commission might properly have such authority with reference to the determination of the capital structure, the allocation of securities involves merely private rights, with reference to which the Commission (a nonjudicial body) should act merely as adviser or, as provided in S. 1869,³⁷ should not function at all.

The first objection has merit. While in the simple cases which thus far have reached the courts, the Commission has acquiesced at once in the courts' modifications of the Commission's plans, yet it would seem that, in a complicated case, the necessity of agreement on every point of the plan might well produce substantial and embarrassing delay. It seems appropriate that, with reference to the provisions dealing with the allocation of securities, the court should have the power to modify the plan as the evidence or law may require, without a reference back to the Commission.

As to the second of these objections: As intimated in our opening paragraphs, the fact determinations underlying the prescription of a proper capital structure—these being the elements of the plan affecting the public interest—are nevertheless of a technical character. They involve an understanding of the earning power of the property and of its parts, which is provable ordinarily by complicated and quite unsatisfactory formulae and other evidence which bears upon the severance and contributive value of mortgaged divisions, and the appraisalment of terminals and leased lines. These questions are complicated with the consideration of the fairness of through-rate divisions, rate adjustments, the adequacy of maintenance, and various accounting problems. It is probably appropriate that the Commission's findings should be protected by presumptions, as far as due process permits, and be subjected only to a limited review by the court. This was the effect of the amendments proposed by S. 1869³⁸ and H. R. 9447.³⁹

Both bills, however, place the allocation among the claimants of the securities authorized by the prescribed capital structure in a different category on the assump-

³⁴ *Id.* art. XIX, pp. 61-65.

³⁵ §77(d).

³⁶ §77(d), as amended by S. 1869, p. 40.

³⁷ *Id.* §852, p. 16.

³⁸ *Id.*, as amended by S. 1869, p. 41.

³⁹ H. R. 9447, §943, p. 47.

tion that the allocation involves primarily legal questions of private right. Thus, S. 1869 deprives the Commission of any power or duty to pass upon such allocations,⁴⁰ and H. R. 9447 leaves the Commission merely in an advisory position.⁴¹ These proposals rest on a distinction that is more plausible than real. In the allocation of the securities certain legal questions involving questions of private right are involved, of which the best examples are such as pertain to the priority of liens and the difficult questions arising as to the scope of after-acquired property clauses. These questions of law are, however, questions which can be certified by the Commission to the court under S. 1869,⁴² the Chandler Draft,⁴³ and H. R. 9447.⁴⁴ Actually, the allocation of securities in many cases rests as much on the kind of technical fact determinations just described as does the determination of the capital structure. The treatment, for example, to be accorded the securities protected by a lien on the segment of a line covered by a particular mortgage rests in determinations of exactly that character.

It is, furthermore, apparent that there are practical difficulties in the proposed arrangement whereby the Commission shall make a finding in abstract with reference to the permissible capitalization and the amount of securities of the respective classes of securities which are allowed, without regard for (or as specifically provided by S. 1869, with the definite injunction not to consider) what type of securities are required for allocation to the various claimants. The cloth is required to be cut without regard for the size or shape of the shoulders or arms which the parts of the coat are to be made to fit, and the judgment of the Commission is thwarted through its being forbidden to observe the whole problem.

These considerations lead us to believe that the Commission should pass on all the provisions of the plan. Certainly any court should be glad to have, and we believe should not be deprived of, the advice of this experienced and skilled authority with reference to the allocation of the securities to the security holders, since their rights depend directly upon the valuation of the whole property and of the part to which their lien pertains—questions lying in technical considerations not ordinarily within the scope of much consideration by the courts and of the same sort as those which govern the determination of the capital structure. Under such circumstances, when the Commission is now thoroughly skilled and staffed and has had long experience with the problem at hand, there is much to be said in favor of providing that its fact findings with reference to both types of questions should be protected by the same presumption and should not be upset if sustained by substantial evidence. Whether so protected or not, the courts, we believe, will hesitate to disturb such fact findings, in view of the complexity of the cases, the size of the records, and the prestige of the Commission. The court would always be free to upset any plan not sound from the standpoint of legal principles.

⁴⁰ §77(d), as amended by S. 1869, p. 41.

⁴¹ H. R. 9447, §949, p. 48, §951, p. 49.

⁴² Chandler Draft, §843, p. 18.

⁴³ S. 1869, §12, p. 78.

⁴⁴ H. R. 9447, §843, p. 14.

In any consideration, however, of procedural reforms, it would be a mistake to believe that intelligence and expedition necessarily will be produced by such adjustments. Progress frequently lies, it is true, in defeating retrogression—in the defeat, as in the instance of S. 1869, of proposals having their foundation in the aim to secure certain ends at the sacrifice of principles which are more important. For the time, a mere rearrangement of forms and functions may stimulate the expression of a greater intelligence and efficiency, just as the stirring up of a feather bed may temporarily make it better serve its purpose. But in the end, a renovation of procedure is no substitute for the sense of rightness and the intelligence of the able judge or commissioner. Plainly, real progress in procedural reform lies in what can be done to light the consciousness of those men who administer, and, in a very real sense, are, the law itself and its enforcement. It is the spirit that quickeneth and the statutory letter is no substitute for that life.