THE PROBLEMS OF THE LEASED LINE

JOHN F. MECK, JR.*

The part played by the leased line in railroad reorganizations prior to those of the present day seems to have been rather inconspicuous. In those earlier reorganizations, railroads, on the whole, were still in an era of expansion. While serious lease problems occasionally arose, they were generally capable of being solved without too much difficulty and without undue hardship to either lessor or lessee. Today, however, the picture has been altered. Changes in transportation which have affected all railroads adversely have accentuated leased line problems. There are more problems than formerly and, in addition, they seem to be more serious. At the same time care must be taken not to overemphasize the difficulties of leased lines. A majority of those whose lessees are undergoing reorganization have given rise to but few issues. Some, however, because of unusual circumstances in their particular instances, involve perplexing problems. It is this somewhat “pathological” type of case with which we are principally concerned in this brief survey of leased line problems.

Lease rentals are an important part of the fixed charges of many railroads. During solvency of the lessee there is no way, save with the lessor’s consent, of reducing the amount of rent. But in reorganization this obligation may be drastically modified or even wiped out completely by reason of the power in the lessee’s trustees to reject leases. It is a powerful weapon and it is its exercise that creates the more acute problems.

In any study of the leased line it must be borne in mind that the variations in railroad leases are tremendous. Almost every lease differs, in some slight detail at least, from every other lease. Nevertheless, certain general similarities do exist, not only in lease instruments themselves, but also in the origin and development of various lessors. From these some generalizations can be drawn which are helpful in providing a background for understanding the status of the leased line in reorganization of its lessee.

* B.A., 1933, Dartmouth College; L.L.B., 1936, Yale University. Member of the New York Bar. Assistant Professor of Law, Yale University School of Law. Author of the articles on problems of leased lines cited in note 1, infra.

1 The purpose of this article is merely to indicate some of the major problems. It is in no sense intended to be definitive. A more detailed discussion, together with a more complete collection of the authorities, is contemplated in a series of articles in the Yale Law Journal, two of which already have been published. Meck & Masten, Railroad Leases and Reorganization: I (1940) 49 YALE L. J. 626; Meck, Railroad Leases and Reorganization: II (1940) 49 YALE L. J. 1401.


3 See p. 511, infra.
The lease device appeared on the scene shortly after the building of the first American railroads. Its use soon became widespread as a convenient means of combining two or more independently operated railroads. While a majority of leases in existence today were entered into prior to 1900, the lease has continued to be used up to the present. Aside from a few unusual variations, most railroad leases follow in form the pattern of the real property lease. The lessor transfers to the lessee the use of its property for a term of years. In some instances this term may be as short as one year, but it is more likely to be 99 years, or even 999 years, and often it is expressly made perpetual. Ordinarily everything the lessor owns goes over “lock, stock and barrel” to the lessee for the duration of the lease. In return the lessee agrees to pay a stipulated rental, generally to the lessor company, although it is not unusual for its promise to run directly to the lessor’s security holders. The lessee also always promises to maintain the leased property and to return the road to the lessor upon termination of the lease in a certain specified condition.

It is extremely difficult to ascertain precisely what was in the minds of the parties making the lease as of the date of its execution. In some situations, however, it seems that the parties clearly intended nothing more than an ordinary landlord-tenant relationship. In others they seem to have merely been using the lease form to achieve all the consequences of a transfer of actual ownership of the leased line to the lessee. This impression is strengthened in many cases by the course of events since that time.

Regardless of the terms of a particular lease instrument and the original intent of the parties, practically all leased lines have had similar histories after the lease has been executed. Generally the lessor company has become an almost dormant entity. Its property has been merged into the lessee’s system and is indistinguishable from the rest of the lessee’s property. Not infrequently the lessor’s entire capital stock has been acquired by the lessee. Sometimes a large proportion of its bonded debt has been similarly acquired. But whether the lessor is independently controlled or not, in the majority of cases there is little likelihood of it ever again becoming an operating company.
THE PROBLEMS OF THE LEASED LINE

It is with this brief background that we turn to the status of the leased line in the reorganization of its lessee. As pointed out above, the most significant problems arise upon rejection of the lease by the lessee’s trustees. Their power to reject leases, together with their concomitant power to adopt, has long been established in equity receivership practice and its existence under Section 77 has never been questioned.12 The term “rejection,” however, is somewhat a misnomer and requires some explanation. It is fundamental that the lessee’s trustees do not become obligated upon a lease by reason of their appointment. Such an obligation, binding upon the lessee’s estate for the duration of the reorganization, can be created by their electing to adopt the lease. But the situation with respect to rejection is quite different. No rejection can occur in a logical sense for, having no liability, there is nothing to reject. What really occurs is an election “not to adopt,” whereby the lessee’s trustees simply affirm the continuance of a state of nonliability.18

The lessee’s trustees may reject (or adopt) a lease at any time after the reorganization has begun. They are said to have a reasonable time in which to reach a decision. Occasionally they will act immediately, but more often nothing will happen for at least six months.14 In some instances no action whatever will be taken during the entire proceeding.16 But where they do act and reject a lease, one can be reasonably certain that problems will shortly arise. In the main these problems are three, although the third may also arise irrespective of any rejection during the proceeding by the trustees:

(1) Who operates and who bears the financial risk of operation upon rejection of a lease?
(2) What claims does the lessor have as a consequence of such rejection?
(3) How will the leased line be dealt with in the ultimate plan of reorganization of the lessee?

chief obstacle to a resumption of operation is the lessor’s lack of funds. If the lessor’s security holders were willing to supply the funds it is possible that operation might be resumed in some cases without great difficulty.

12 The import of subsections (a) and (c)(2) of Section 77 is clearly that this power exists under the statute. The equity cases include United States Trust Co. v. Wabash Western Ry., 150 U. S. 287 (1893); Quincy, M. & P. R. R. v. Humphreys, 145 U. S. 82 (1892); St. Joseph & St. L. R. R. v. Humphreys, 145 U. S. 105 (1892); Sunflower Oil Co. v. Wilson, 142 U. S. 313 (1892). See Clark, Foley & Shaw, Adoption and Rejection of Contracts and Leases by Receivers (1933) 46 Harv. L. Rev. 1111.

18 The phrases “elect to adopt” and “elect not to adopt” probably characterize most accurately the action which the trustees may take with respect to leases. In this article “rejection” is used in the sense of “election not to adopt.”

14 Where a lease obviously is burdensome, rejection may take place promptly. See New Haven Proceeding, Order No. 23 (D. Conn. Dec. 14, 1935) Ct. Rec. p. 193 (rejection within two months). More likely, however, the first period of six months, given the trustees to reach a decision by the initial order, will be extended from time to time. Often both the lessee and lessor interests are anxious to avoid the taking of any decisive action.

18 The eventual result in such instances in equity was that the old lease would be assumed by the reorganized lessee. This same outcome may be anticipated under §77.
THE OPERATION OF THE LEASED LINE

The lessee's trustees, by rejecting a lease, disclaim any further interest in that leased line for the lessee's estate. But this does not mean they have no duty to operate that line. Operation must be maintained by someone, at least so long as it is not at so great a loss as to be confiscatory.18

This situation is largely taken care of by Section 77(c)(6), which provides in substance that the duty to operate is on the lessor unless the judge finds it impracticable and contrary to the public interest for the lessor to operate. In the event of such a finding, and it is invariably made, the lessee or its trustees must continue operation until some disposition is made of the leased line, whether by complete physical abandonment or otherwise.17 As a practical matter in almost every instance of rejection the lessee's trustees have had to continue operation.

The financial risk of this operation must then be ascertained. Is it to be borne by the lessor or by the lessee's estate? Subsection (c)(6) expressly provides that after rejection operation shall be for the lessor's account—in other words, at the lessor's risk. There is also the period between the commencement of the lessee's reorganization and the date of rejection. Here, too, by the preponderance of authority, operation is deemed to be for the lessor's account.18

Placing the risk of operation upon the lessor has certain important results. The lessor is not entitled to the rental stipulated in the lease for any of the time after the lessee goes into reorganization. Instead it gets the net earnings, if any, of the leased line. If there are no net earnings, and operation is at a loss, the lessor becomes liable to the lessee's trustees for the amount of that loss.19 These amounts of profit or loss are administrative items and entitled to all the priorities accorded that class of claims.20 This fact becomes particularly significant in the case of a loss, for it is charged against the lessor's property as a lien thereon prior to the lien of all mortgages. Operation for the lessor's account, therefore, may have rather serious consequences.21


17 The implication in at least one recent decision that physical abandonment of the leased line is the sole means by which the lessee or its trustees can get rid of this duty to operate is not accurate. See Webster and Atlas Nat. Bank v. Palmer, supra note 16, at 218. A lessor which cannot resume operation immediately may be able to do so at some later date, whereupon the lessee's duty would cease. The reorganized lessee itself might, at some later date, enter into a new lease or some other arrangement with the lessor. Subsection (c)(6) merely offers a temporary solution of the problem.

18 See Meek, supra note 1, at 1401, where the problem of accounting for operation is discussed in detail and the authorities are collected. In a given situation "special equities" may be present which will afford a basis for a different result, but to date no such case has arisen under §77. See Pennsylvania Steel Co. v. New York City Ry., 198 Fed. 721, 720 n. (C. C. A. 2d, 1912).


21 The amount of these prior charges may become so great that the lessee's estate may become the owner of the lessor's property and nothing will be left for the lessor's security holders.
The problem of determining whether a profit or loss exists in operation of a leased line lies within the jurisdiction of the court administering the lessee's reorganization. As an incident of its possession of the leased line, it has been held to be the proper court not only to fix the state of accounts between the lessor and the lessee's trustees, but also, in the event of a loss, to impose a prior lien therefor upon the lessor's property. The normal procedure is for the lessee's trustees to render a report of the results of their operation to the court. An opportunity is given for all parties concerned to file objections, and, after a hearing, the court confirms, revises or otherwise disposes of the report. Such a report may raise several types of problems, but the principal dispute has been over the role of the segregation of earnings formula. Here especially the circumstances of the individual case may be of prime importance.

A further problem may come up in the rare case where a lessor, upon failure of the lessee's trustees to pay the stipulated rental, seeks to retake and operate its own leased line. Immediately the question arises of how long the court administering the lessee's reorganization may restrain the lessor from exercising its right of reentry without complying with the rent provisions of the lease. It seems clear that the lessor may be held off for a reasonable time and in all probability this reasonable time may be considerably shorter than in other instances where the lessor is unable to operate. In other words, the fact that the lessor wishes to reenter may force the lessee's trustees to an earlier decision than otherwise. If the court should permit them to have an unduly long time, operation may be held to have been for the account and at the risk of the lessee's estate for the portion which is deemed in excess of a reasonable time.

Claims of the Lessor Against the Lessee

Rejection of a lease by the lessee's trustees gives the lessor or, under some circumstances, its security holders, certain claims against the lessee's estate for breach of the lessee's covenants. Most important of these is the covenant to pay rent for the duration of the lease, breach of which gives rise to the claim for so-called future rent.

Rent covenants differ materially from lease to lease, but the most usual type is a
promise running directly to the lessor company. Claims arising upon breach of this kind of a covenant have had a checkered career in railroad reorganization. In equity receiverships rent was viewed in the light of its feudal antecedents as issuing from the land and as coming due only when the period for which it was reserved had passed. As a result claims for rent were allowed only to the extent of damages actually suffered up to the final date for filing claims.

The hardship on the lessor of this rule in equity has been alleviated by Section 77. Under the statute the definition of the term "creditor" includes the holder of a claim under an unexpired lease and it further provides that the amount of such a claim shall be determined "in accordance with principles obtaining in equity proceedings." Because of the rather vague language in the statute this alteration in the measure of damages was not immediately effective. A Supreme Court decision, however, accomplished the contemplated change by construing the proper measure under the statute to be the difference between the present value of the rent reserved for the balance of the term of the lease and the present re-rental value of the leased property for that same period of time.

Despite the establishment of this more favorable construction to the lessor, its troubles are far from over. Application of this measure of damages is obviously a difficult one because of the long periods of years or even centuries which many leases have to run before the date of their expiration. In the cases to date somewhat paradoxical results have ensued. Two cases will serve to illustrate the problem. In one the lease was of a street railway system for 999 years, of which 969 years remained at the date the lessee entered reorganization. There was, of course, no problem in ascertaining the present value of the rent reserved for the 969 remaining years. But violent controversy developed over determining the re-rental value. In the trial court the entire claim was disallowed, even for damages accrued to the date of the trial. Holding that the claim must be considered upon the basis of the 969 years and no other, the court ruled that it was impossible to say with any reasonable certainty what the re-rental value was for the balance of the term and that the failure of the lessor to establish such value was fatal to its entire claim. On appeal a more
lenient point of view prevailed as to the certainty with which damages had to be proved. Disregarding the 969 remaining years, the court treated the lease “as if it were for a term of fairly definite forecast.” This period was held to be eight years from the date of the trial, and adding the damages already accrued for three years preceding the trial, the lessor came out with a future rent claim for eleven years in all.66

The second case involved a lease of only 99 years, of which 57 years were unexpired at the date the lessee entered reorganization.67 Again the present value of the rent for the balance of the term involved only a mathematical calculation. But as to the re-rental value, the lessor demonstrated to the court’s satisfaction that the leased line had no such value whatever. The court, therefore, applied the measure of damages set forth above, and the lessor’s claim was allowed in full for the present value of the rent reserved for the unexpired portion of the term.68

Considered separately, perhaps each of the foregoing decisions is reasonable. Taken together, however, they indicate the intricacy of the problems of future rent claims. It appears that the longer the lease the greater will be the difficulties of proof. Lessors with 99-year leases seem in a stronger position so far as proof of such claims is concerned than lessor with perpetual or 999 year leases. Yet, when a 999 year lease was executed, presumably the longer term was a consequence of greater bargaining strength of the lessor involved, and so the better a bargain the lessor drove, the worse off it may be today. Of course, where a leased line has some value, the lessor will have that value in addition to whatever it proves against the lessee’s estate.69

All covenants to pay rent do not run to the lessor itself. In some leases the promise is to pay directly to the lessor’s shareholders a fixed annual dividend on their shares, and to the lessor’s bondholders, if any, the interest on their bonds. These securities are commonly referred to as “guaranteed.”40 Such a covenant may be construed in some cases as a direct promise to the lessor’s security holders, entitling them, as third party beneficiaries, to look directly to the lessee for payment. When these parties attempt to prove claims in the lessee’s reorganization, the variety of provisions and circumstances indicate that particularly knotty problems may be presented.41

---

67 The amount of the claim allowed was $4,411,837.61.
69 The amount of the claim allowed was $39,339,161.
70 In any case of a rejected lease the leased line will at least have some salvage value. Often it will also have some value as a going concern, especially when unprofitable segments of line or types of business can be abandoned. In one case it has been proposed to stop passenger service on a leased line and continue operating it as a freight line only. Erie R. R. Reorg., Answer of Underwriters Trust Co. (N. D. Ohio, Jan. 27, 1940) Ct. Rec. pp. 2181, 2186.
41 This terminology is applied whether or not the “guaranty” is actually stamped on the lessor’s securities.
42 Both bonds and stocks may be involved. In the case of the former, the “guaranty” may be of interest and principal, although it is most likely to be of interest only. These bonds may have a maturity date long prior to the expiration of the lease. Then too, there is the question of what effect is to be given to the fact that the security of the mortgage on the leased line may still be available to the bondholders
Two other of the lessee's covenants also may cause some trouble. They are the covenant to maintain the leased line during the term of the lease and the covenant to return it at the end of the lease in a certain specified condition. Claims for damages for breach of these covenants accrue in full upon disaffirmance of the lease. There is no question of their provability under Section 77 and the only issue is the amount of damages which can be established. Again the outcome depends to a large extent upon the language of the particular covenants in question and the evidence of injury which the lessor is able to produce. Up to the present time the tendency seems to be to set up a fairly strict standard of proof for lessors.42

After all these claims for breach of the lease have been passed upon, and allowance made for any counterclaims the lessee may have, the final amount will be fixed. This amount almost always will be a general unsecured creditor's claim on a parity with all other such claims.

The Lessor in the Lessee's Plan of Reorganization

The consummation of a plan is the ultimate objective in any reorganization. The formulation of this plan commences almost with the proceeding itself and progresses simultaneously with the matters heretofore discussed.48

Where the lessee's plan of reorganization provides for assumption of the original lease by the reorganized lessee, whether or not it has been previously adopted by the trustees, no problems of importance arise. But acute problems are presented where the lease has been rejected or the plan calls for some disposition of the leased line other than by adoption of the lease.44 The plan in theory must deal with the lessor in at least two capacities: as an unsecured creditor and as owner of the leased line. In the former capacity the lessor will receive the same treatment as other unsecured creditors. In the latter, however, the lessor will be treated in accordance with the value of the line to the lessee. In one instance it may be desirable to retain the leased line as part of the reorganized lessee's system; in another it may be preferable from the lessor's point of view to cut the leased line from its system. None of the proceedings under Section 77 involving leased lines has reached the stage of final consummation. However, sufficient progress has been made to indicate the problems involved.

Where retention of a leased line has been decided upon, several possible methods are available. One is to provide in the plan for a modified lease, whereby the leased line is kept part of the system under a lease which in all probability will have a


44 Only one plan, of course, will eventually be put into force. During the proceeding there may be several plans proposed by the debtor and by various groups of security holders.

44 Where a leased line is of great value to the lessee, it may, nevertheless, be retained by some means other than a lease. Under §77(b) it is possible to reject in the plan a lease which has previously been adopted by the trustees.
lower rental and a shorter duration. A second method of retention is through merger or consolidation, for which Section 77 specifically provides. Different consequences, however, ensue than those which follow upon retention under the original or a modified lease. Upon merger or consolidation the lessor company automatically ceases to exist, and its line and other property becomes the property of the reorganized lessee. Its security holders exchange their securities for those of the lessee in accordance with the arrangements made in the plan.

If retention of the leased line is not deemed desirable, no provision whatever will be made in the lessee’s plan. If the lease has not already been rejected by the lessee’s trustees, it may be rejected in the plan and the future of the leased line will be left for determination by other means. Conceivably this might mean subsequent resumption of operation by the lessor company. Perhaps some other railway system may be interested in acquiring the leased line. More likely, however, since failure to provide for the leased line in the lessee’s plan is indicative of unfavorable operating results, application will be made to the I. C. C. for permission to abandon the leased line completely.

The leased line situation involves one very practical problem with respect to carrying out the lessee’s plan of reorganization. It is simple enough to provide in the plan for a modified lease, merger or consolidation, or some other arrangement, but there may be some difficulty in binding the lessor and its security holders to those provisions. At least three different situations may arise.

(1) One situation is where the lessee owns a majority of the lessor’s capital stock. If the lease has been rejected it is likely that the lessor itself will also have to go into reorganization. Section 77 permits such a lessor to file its petition in the lessee’s proceeding as a subsidiary debtor. If the leased line is to be retained, a single plan will be formulated for both lessee and lessor. This plan, if approved by the I. C. C. and the court, can be made binding upon the lessor’s security holders upon acceptance by two thirds of each class. This joint reorganization facilitates the retention of the leased line, particularly in overcoming difficulties under state laws.

48 If the lessor company is also in reorganization, material changes may take place in its capital structure. Even if it is not in reorganization, its security holders may be offered and may be willing to accept less in the way of dividends and interest. 49 77(b).

49 The two methods suggested are by no means the only ones available. Still another method would be an acquisition of the leased line by way of purchase in return for securities of the reorganized lessee.

45 77(b).

Cf. Chicago, R. I. & P.-Ry. Reorg., Petition for and Order No. 174 (N. D. Ill., March 15, 1940) Ct. Rec. pp. 2971, 2977 (abandonment of operation by the lessee’s trustees of the White and Black River Valley Ry.). Where operating losses are so great as to be confiscatory, it may be that no I. C. C. permission is necessary in order to abandon.

47 77(a).

46 Where the leased line is not to be retained the lessee’s plan will make no provision for it. In such a case the court, unless it is possible to reorganize the lessor separately, would probably dismiss the proceedings as to the lessor. Thereafter, several alternatives remain, one of which is liquidation of the lessor.

48 Under 77(f), upon confirmation the plan may be carried out, “the laws of any State or the decision or order of any State authority to the contrary notwithstanding.” This provision would have particular significance in overriding state merger and consolidation statutes, the appraisal provisions of which might create real difficulties.
The situation is materially different if the lessee does not own a majority of the lessor's stock and the lessor itself is not in reorganization. Upon rejection of the lease, although the leased line remains in the custody of the lessee's trustees, it is not part of the lessee's estate and security holders having interests in it cannot be bound in the lessee's reorganization. Consequently, if the lessee's plan provides for a modified lease or merger or consolidation, such a provision is little more than an offer to the lessor. Acceptance of this offer will be determined, not by submitting the lessee's plan to the lessor's security holders, pursuant to Section 77, but according to the law of the state where the lessor is incorporated. So far as shareholders are concerned appraisal statutes may create difficulties. If bondholders are affected, little short of unanimous consent to any changes may become essential. There is no way in which dissenters can be bound.  

A third situation is where, although the lessee does not own a majority of the lessor's capital stock, rejection of the lease forces the lessor into a reorganization of its own. If the territorial jurisdictional requirements can be satisfied, this proceeding may take place in the same court in which the lessee's proceeding is pending, but the two proceedings would be separate. In other cases this will not be possible and the lessor's reorganization may take place in a different district court in a different circuit.

If the two reorganizations are in the same court it may be possible to work out related plans for the lessee and lessor. Upon acceptance and confirmation in the separate proceedings, dissenters may be bound. Here also it will be possible to override any state laws. Even where different courts are involved, this same procedure is possible, although as a practical matter it will be considerably more difficult.

Conclusion

In the brief compass of this article it has been possible only to point out some of the major problems which have arisen in connection with leased lines. The process of solving them is still in an intermediate stage and the ultimate outcome is not wholly clear. As reorganizations of lessee railroads progress the practice is becoming more and more settled, and, as disputes are resolved in one proceeding, precedents will be afforded for others. While statutory amendments might obviate some of the issues, the final solution is not that simple. On the whole the problems of leased lines are part of the problems of the entire railroad industry. While the lease device, to some extent, has served to accentuate these problems and to create a few additional ones, the future of leased lines cannot be charted separately from that of all railroads.

The dilemma in this type of situation is well illustrated in the Chicago, M., St. P. & P. reorganization, although a case of rejection was not involved. The lessee Terre Haute was not in reorganization, despite the fact that the lessee owned 97% of its stock. To carry out the lessee's plan it was essential to reduce the interest rate on the lessor's bonds. In its report on the plan the I. C. C. indicated that practically unanimous consent of the lessor's bondholders was necessary. Chicago, M., St. P. & P. R. R. Reorg., Fin. Doc. No. 10682, (Feb. 12, 1940) mimeo. rep. at 77-85.

Sectional differences and local pride occasionally may interfere with cooperation between two district courts.