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THE COMMERCIAL BASIS FOR RAILWAY
RECEIVERSHIPS.

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During the year 1893 there were placed in the hands of receivers 76 railway companies, small and large, owning 29,380 miles of line and representing stocks and bonds to the amount of \$1,754,806,000, being one-sixth of the railway mileage and one-sixth of the railway capital of the country. These figures of capitalization do not include car trust notes, floating debts or other liabilities, which would add considerably to the total. At present about one-fourth of the entire railway mileage of the country is being operated by these officers of the courts.

These large figures suggest at once the importance which the question of railway receiverships has assumed of late through the inability of railway companies to meet their obligations. The practice of operating insolvent railways through court officers appointed for the purpose is not yet definitely settled either as to the methods of working or as to the legal doctrines involved, the whole matter being yet in a state of evolution. It is the boast of our law that it changes to meet the changing demands of commerce, as business becomes more complex and the rules governing it necessarily more

involved; so as regards railway receiverships our present situation is the result of a compromise between the terms of railway mortgages and the commercial conditions under which railway operations are carried on.

The original idea of appointing a receiver to take charge of the property of a firm or individual was that the business might be wound up with as little delay as possible and the assets sold and distributed to the creditors in some equitable proportion. As corporations became more common, taking the place of firms and individuals, the same idea was applied to them when insolvent. They were placed in the hands of receivers in order that their affairs might be closed up with the least possible delay by dividing the assets among the creditors in the proportion to which it was shown they were entitled. It was inevitable that the question of the proper method of treating insolvency among railway companies should arise. From small beginnings the number of miles of railway in the United States increased rapidly until now, judged by the magnitude of the property invested and the amount of business done, the railways form perhaps our largest industry, certainly one of the most complex. Through one cause or another it was inevitable that bankruptcy should increase among these rail carriers as their mileage increased; and in such cases also it was natural, as in the cases of firms or small corporations, that receivers should be appointed pending a settlement of the insolvent debtor's affairs. But here a new question arose. A trading firm or corporation unable to pay its debts could be wound up and its assets distributed to its creditors without loss to the community. Other traders could take their places and business would go on as before; but it was otherwise with the railways. It was quickly seen that great states and sections of states dependent upon the continued operation of these railways for the transaction of their every day business, for supplies of clothing and manufactured goods and even for meat and bread. Whatever the outcome the trains must be kept running. Since, in the course of time, local railways had grown into systems, it was found that the interests involved in these systems were so enormous that their combined assets

could not easily be sold as one parcel to any one person or company, or sold separately without breaking up the systems. Hence, until the serious questions of reorganization or sale were settled, the receivers of these systems must continue to run the trains in the interest of the public. As these necessary adjustments were often found very complicated, requiring a long time for negotiations and final agreement, the receivers appointed by the courts were placed for the time being in the position of railway managers. They were confronted with technical problems of much practical importance. They were required to become familiar with disputed questions concerning reasonable rates and their ramifications. The conflicting claims of cities and towns as to charges which should be relatively fair to each were pressed upon their attention. In short, it was required that receivers should be able to formulate for the operation of the properties in their charge a policy which should be equitable to the capitalists whose money was invested in the road, to all the sections served by the railway and to the general traveling and shipping public. Needless to say the success of such a task required men of administrative ability with the further result that the courts through their appointed officers were obliged to decide upon the details of administration.

It was the practice at first for receivers to be asked for solely by the creditors of the company in order that their property might be held together and protected against the seizure of certain parts of the system, particularly against creditors who might destroy the value of the property as a whole. Usually the corporation appeared before the court in opposition to the motion so that, if receivers were appointed at all, the court acted upon information brought to its knowledge after a severe legal struggle. The idea that the corporation itself could ask for an appointment of a receiver for its own property originated with the late Jay Gould, whose contention in the Wabash cases in this respect was afterwards affirmed by the Supreme Court of the United States, which held that a company could itself ask for the protection of the court if such was for the best interest of all concerned. Under this

doctrine few of our large railway systems are now placed in any but "friendly" hands. In such cases the matter is all planned out beforehand and the men chosen. Any creditor of the company, friendly to the administration, may allege that the corporation owes him money that it cannot pay, and as every going concern has plenty of creditors in the ordinary course of business, such a convenient creditor is usually not hard to find. To this complaint, usually prepared in secret, some one of the company's officers arranges a reply confessing the truth of the charge. All parties concerned, each with the respective documents, and without notice to the other creditors or to the public, apply to the judge, perhaps at night, who forthwith grants the application and appoints the receivers already arranged for. That this procedure opens the door to the possibility of great abuse of corporate interests needs no argument. That on the whole the plan has worked fairly well is owing to the high character of our judiciary and also of the officers in charge of our great corporations. Yet it is not reassuring to holders of stocks, bonds or floating debt to know that a conspiracy between any small creditor and any one of the principal officers of a corporation may throw the control of the whole property of the company into the hands of the court. Unquestionably, the appointment of former officers of the company as receivers leads to the charge at times that those who had wrecked the company are still left in power. Moreover, the door is open to abuses such as the difficulty easily thrown in the way of a thorough investigation into the company's condition, which it may be the wish of the old managers to thwart, but which may be necessary before an equitable plan of reorganization can be evolved. Yet the affairs of our large corporations have become so complicated that only those long familiar with them are capable of administering them without losses both to owners of the road and to shippers. This business fact has so far controlled the action of the courts in the appointing of old officers of the insolvent corporation as receivers, though usually other men not previously connected with the company, but representing important interests as well as the sections through which the

road runs, are chosen to serve with them. Laws have been introduced in various states to check the abuses to which the methods of receiverships have given rise, but while these statutes have done good as to certain matters of detail, the commercial facts of which we have spoken have been strong enough thus far to prevent any material modification of the policy.

The immediate cause of a railway receivership is usually the floating debt. Strictly speaking, the expression "Floating Debt" means the money borrowed by a company on collateral and made payable on demand or within a short time. The term, however, is sometimes used to cover other debts of the corporation, such as for supplies which have been bought but not paid for. A railway which is fairly prosperous can arrange to pay its bond interest in a period of depression without showing signs of distress. Every large business concern, such as a manufactory, must arrange for a depreciation of plant and machinery before setting aside earnings applicable to interest or dividends. The reason for this is that were a contrary course to be pursued, the stock or bond holders would very shortly find themselves in possession of a worthless property. In factories the expected losses from depreciation are usually arranged for by setting aside a certain sum of money from the earnings yearly, but the practice of railways is different. It is the custom with them to renew or replace road bed, track and equipment from year to year as fast as these deteriorate or become worn out, charging the cost directly to working expenses. By these means the whole plant is kept up to its standard at the expense of the earnings, the effect being the same as though specific sums had been set aside from income each year. This method of arranging for depreciation allows the railways to vary the amount of replacement from year to year according as the seasons are prosperous or the reverse. In a good year more may be spent upon the road bed and track and for the purchase of new equipment to replace the old at the cost of working expenses, than perhaps was proportionately required. Then in poor years not so much of this sort of work may be done, allowing a larger pro-

portion of gross income to be payable to bond and stockholders. This saving in the working expenses by a stoppage of repairs to the plant is usually the first resort of the railway manager when pressed for immediate money to pay bond interest. Then there are always demands for new capital for improvements necessary to be made by every railway as its traffic increases. Ordinarily, bonds are sold to meet these capital charges. If, because of a lack of confidence on the part of the investing public, or a lack of credit as regards this particular company, such bonds can not be sold, except perhaps at a great sacrifice, then the management proceed to borrow the necessary money for these capital improvements and perhaps for the then due bond interest. Usually, the company must hypothecate with the bankers from whom the money is borrowed, bonds either of the company itself or such as are held in its treasury and controlling subsidiary lines, important to the integrity of the system, so that the banker's loan may be fully secured. If matters go from bad to worse, if it appear to the lender that the situation of the company is becoming more and more critical so that he is beginning to doubt the real value of the collaterals held by him, he then calls for his money, if it is loaned on demand, or gives notice that he will ask for it when the same matures. If the company can not arrange to borrow the amount from some one else, and if it is confronted with the sale of all its securities at bankrupt prices, the managers may resolve to confess their own insolvency, before a public confession is made by the sale of the securities held by the banker. Perhaps, just at this moment, a large amount of interest is due to bond holders. In such a case the railway managers may choose to default on the bond interest and take the money for payment to the floating debt holders, in order to save for the company the collateral which the bankers may hold, and which may be essential to the control of parts of the system, but which would very likely go for a song if pressed for immediate sale. While, therefore, floating debts do not differ from other obligations of the company except in form, they have come to be recognized in Wall Street as a source of great danger in any period of business

depression or lack of credit. If this money borrowed on demand or on short notice can be funded into bonds having years to run, the company cannot suffer through a demand upon it for the principal, but is safe so long as the interest is promptly paid. This reasoning has led railway companies at times to adopt the plan of selling long time bonds in order to pay off the floating debt, even though the price received should be far below par. But such a course compels the company to pay a very high rate of interest during the whole life of the bonds and is considered such bad financing that such sales are taken in Wall Street as an acknowledgment that the company is hard pressed—with results to the credit of the corporation almost as bad as though the distress had been openly acknowledged. Under these circumstances “friendly” receivers are asked for so that interest may be withheld from the bond holders and used to take up the obligations of the company immediately pressing, particularly in cases where a failure to meet those obligations would entail severe losses upon the system for all time.

The court appointing receivers, thus asked for, usually stipulates that debts incurred in the operation of a road for six months shall be paid by the receivers. At first blush it would appear that such an order entails hardship upon the creditors of the company, yet upon examination it will be found to be equitable. Transportation is conducted as a cash business. Travelers and shippers are required to pay their money down before taking their journey or receiving their property. Since a railway must be run in the interest of the general public, and since this involves the theory that its working expenses must be paid, it is clear that the expenses of to-day are properly chargeable to the gross receipts of to-day paid in cash by the patrons of the road. But as we have seen, in periods of distress, the managers in order to postpone a confession of bankruptcy in the hopes that the temporary trouble may be tided over, begin to put off payments for wages or for coal, rails, ties and supplies of all descriptions which they may continue to buy, because necessary for the continued operation of the trains. In this way, at the date of appointment of

receivers, every bankrupt road has large arrears of wages and accounts to be made up. As these current obligations are really chargeable to the receipts of the several months past, and as these receipts have been taken to pay bond interest or for other purposes in the interest of the bond holders, it is proper that the prior claims for current expenses should be made up from the first receipts of the road under the receivership. If there is any complaint to be made on the part of the bond holder it is that the knowledge of these facts has not been brought to their attention; but usually in such a matter the managers of the road act in good faith, in the hopes that better times may enable them to pay up the back debts, and save the indirect losses to the bond holders, which a public confession of the real situation would at that time have caused.

The heavy expenses confronting the receivers at the time of their appointment are met partly from defaulted bond interest and perhaps from receivers' certificates. At first these certificates, made a first lien on the property, were authorized very sparingly by the courts and only in cases shown beyond dispute to be necessary. Gradually such issues were extended, until the present practice is for authorization of certificates for any purpose which the court may be led to believe is for the ultimate benefit of the road. In this way another mortgage is put ahead of the regular mortgage, whose bonds, held by the public, have been supposed and declared to be a prior lien upon the road. The force of circumstances often thus impairs the rights of existing mortgages though these be drawn in strong legal language. Foreclosure is also a right expressly granted by the mortgaging company to the holders of its bonds if in default, but in practice this right is subject to modification. It should be recollected that a railway plant, costing perhaps \$50,000 per mile, is worth but a fraction of that sum in itself as real estate and old iron. What is really mortgaged is the income received from transportation. If that income is reduced from business causes, the value of the company's bonds is correspondingly reduced. As just said, the directors, at the first appearance of a decline in profits, economize in depreciation expenses, hoping for better times.

If the decline continues and a receivership ensues, the passing of the property into the hands of the court is an acknowledgment of facts regarding impairment of income which are true, though not before generally known. Hence the issue of receivers' certificates commercially represents the impairment of income just referred to, but which at the time was not enforced against the bondholders. Railway mortgages are not sacred because of the strong legal terms in which they are drawn, but are dependent upon success in the business of transportation, differing in this respect from real estate mortgages which rely more upon the prosperity of the whole community. The legal doctrine of certificates is in a state of evolution, with a tendency to approximate its working to the business circumstances. English debentures are not foreclosable, being mortgages upon the railway income only, and thus more truly than American mortgages, represent the real situation. Our practice of railway receiverships is thus a development of our own circumstances and a sort of compromise between the too-strong language of our mortgages and the actual conditions of the business of transportation.

A receiver may decline to pay the rentals due to leased lines or the interest owing on guaranteed bonds if these lines are at the time of the receivership unprofitable, no matter how necessary to the parent company these branches may once have been. But the old contracts are still legally in force against the company, and can be thrown off only by a sale of the franchise and property to a new corporation. Such a sale sometimes would involve a forfeiture of valuable charter rights; and in such reorganizations committees usually try to formulate some plan which shall bring the fixed charges below the minimum profits by allotting the necessary losses among all classes of securities in proportion to their respective values to the system as a whole; a process which does not regard the liens of the mortgages so much as the worth of the lines they cover. But with plans of reorganization, the receiver properly should have nothing to do.