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LIENS OF THE RECEIVERSHIP OF A BUSINESS CORPORATION.—PART I.

The scope of a receiver's powers, in the event of the insolvency of a business corporation, has been much discussed of late in the courts. We propose, in this article, to examine briefly some of the recent decisions touching the right of a receiver to continue a private business and incur expenses that shall be prior charges on the fund.

When a receiver is appointed for an insolvent corporation, the matter may affect the interests of (a) the owners; (b) the lien creditors, of various classes; (c) the unsecured or general creditors of the corporation; (d) the creditors of the receiver, and (e) the public. Manifestly the relative importance to be attached to these various interests will depend in part upon the theory of the receivership, and in part upon the nature of the business. It must be remembered that originally a receiver could be appointed at the suit of a creditor having an equitable lien[1] to collect the rents and profits of

[1] "The rule about receivers is very clear. A mortgagee who has the legal estate cannot have a receiver, for he has nothing to do but to take possession. An eqitable mortgagee may, but he cannot if the first is in possession." Per Eldon, L. C. Berney *v.* Sewell, 1 J. & W. 627 (1820); Gresley *v.* Adderley, 1 Swanst. 573 (1818); Howell *v.* Ripley, 10 Paige, 43 (1843).

an estate for his benefit,[1] but without prejudice to superior liens;[2] then, if a superior lien of the same nature were not paid, the holder of it might have this receiver removed and his own appointed in the stead of the first.[3] In such a case, and under such a theory of the practice, the question here to be considered cannot well arise. Now, it is more customary to give notice to all parties and appoint a receiver to receive and preserve the property or fund in dispute *pendente lite*, and hold it impartially for the benefit of all parties, as their interests may appear.[4] These interests conflict in many cases: a lien creditor may wish an immediate sale that would sacrifice the owner's interests, or, again, the interests of the public may require the business to be continued and expense thereby incurred to the prejudice of the liens. This last condition is most often presented in the case of a railroad, since "a railroad is authorized to be constructed more for the public good to

[1] In the latter case Walworth, C., said, *inter alia*: "When a receiver is appointed in a suit, he is appointed for the benefit of such of the parties in that suit as, it shall afterwards appear, were entitled to the fund in controversy, but not for the benefit of strangers to the suit. If the receivership interferes with the right of a stranger, he may apply to the court to be heard *pro interesse suo*, and his rights will be protected against any inequitable interference by the officer of the court. But the appointment of a receiver does not give to a mere stranger to the suit the benefit of the proceedings in that cause, so as to authorize him to claim that which he would not have been entitled to if such a receiver had never been appointed."

[2] Berney *v.* Sewell, 1 J. & W. 627 (1820), *supra*. See also the forms in Seton on Decrees: *Decree Appointing Receiver of Estate in Mortgage.* "Let a proper person be appointed, etc., *without prejudice to the rights of any mortgagee or mortgagees* of the said estates, or any or either of them, [*or* but the appointment of such receiver is *not to affect any prior incumbrancers* upon the said estates who may think proper to take possession of the said estates by virtue of their respective securities."] Seton on Decrees, 219. *Decree Appointing Receiver on Application of Judgment Creditors.* "Let a proper person be appointed to receive the rents and profits of the real estate, etc., *but without prejudice to the right of any prior incumbrancer;* and if any prior incumbrancer is in possession, then without prejudice to such possession, etc." *Ib.*, 220.

[3] See, in general, 3 Daniell's Chan. Prac., ** 1951–2; Wiswall *v.* Sampson, 14 How. 52 (1852), and the foregoing cases.

[4] 3 Daniell's Chanc Prac., * 1949; High on Receivers, § 1; Davis *v.* Gray, 16 Wa 218 [illegible]

be subserved than for private gain . . . The public retain rights of vast consequence in the road and its appendages with which neither the company nor any creditor or mortgagee can interfere. They take their rights subject to the rights of the public, and must be content to enjoy them in subordination thereto. It is, therefore, a matter of public right by which the courts, when they take possession of the property, authorize the receiver, or other officer in whose charge it is placed, to carry on in the usual way those active operations for which it was designed and constructed, so that the public may not suffer detriment by the non-user of the franchises."[1] From this need was developed what is known as the *Rule in Fosdick* v. *Schall.*

The Supreme Court of the United States had sustained, in *Wallace* v. *Loomis*,[2] an order appointing receivers of a railroad, with authority to raise funds for the repairs and operation of the road by the issue of certificates that should be prior in lien to the existing incumbrances. The opinion of the court was delivered by Bradley, J., who said, *inter alia:* "The power of a court of equity to appoint managing receivers of such property as a railroad, when taken under its charge as a trust fund for the payment of incumbrances, and to authorize such receivers to raise money necessary for the preservation and management of the property, and make the same chargeable as a lien thereon for its repayment, cannot, at this day, be seriously disputed. It is a part of that jurisdiction, always exercised by the court, by which it is the duty to protect and preserve the trust funds in its hands. It is, undoubtedly, a power to be exercised with great caution, and, if possible, with the consent or acquiescence of the parties interested in the fund."

The basis of this practice was thus stated in *Fosdick* v. *Schall:*[3] "The power rests upon the fact that, in the administration of the affairs of the company, the mortgage creditors have got possession of that which in equity belonged to the

[1] Barton *v.* Barbour, 104 U. S. 126, 135 (1851).
[2] 97 U. S. 146 (1897).
[3] 99 U. S. 235 (1878).

whole or a part of the general creditors. Whatever is done, therefore, must be with a view to a restoration, by the mortgage creditors, of that which they have thus inequitably obtained. It follows that, if there has been in reality no diversion, there can be no restoration, and that the amount of restoration should be made to depend upon the amount of the diversion."

As the court has already explained,[1] "the income out of which the mortgagee is to be paid is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment and useful improvements. Every railroad mortgagee, in accepting his security, impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income. . . . The mortgagee has his strict rights, which he may enforce in the ordinary way. If he asks no favors, he need grant none; but if he calls upon a court of chancery to put forth its extraordinary powers and grant him purely equitable relief, he may, with propriety, be required to submit to the operation of a rule which always applies in such cases, and do equity in order to get equity. The appointment of a receiver is not a matter of strict right. Such an application always calls for the exercise of judicial discretion; and the chancellor should so mould his order that, while favoring one, injustice is not done to another."

This decision was soon afterwards re-stated in *Burnham* v. *Bowen*,[2] as follows: "If current earnings are used for the benefit of mortgage creditors before current expenses are paid, the mortgage security is chargeable in equity with the restoration of the fund which has been thus improperly applied to their use."

It follows from this that, if the receiver is appointed at the instance of a judgment creditor, the material man has no relief of this character, because as to such a creditor there has been no diversion.[3]

[1] *Id.*, 252, 253.
[2] 111 U. S. 776 (1883).
[3] Kneeland *v.* American Loan and Trust Co., 136 U. S. 90 (1889).

Since the rule was first enunciated, the question has been repeatedly before the Supreme Court of the United States in decisions we need not now discuss. The rule has gradually been enlarged to include necessary supplies purchased and wage claims incurred immediately before the receivership, the general expenses of the receivership itself, rentals of leased lines, and various other matters. Moreover, the basis of the rule is made also the need, both in the interests of the property and of the public, of continuing the railroad as a going concern. Properly to protect these claims, therefore, they are in many cases given a lien upon the *corpus* of the fund, as well as upon the income collected by the receiver.[1]

For a full discussion of this subject the reader is referred to High on Receivers, § 3946, *et seq.*, where many authorities are cited. What has been said here may serve to explain the efforts made to apply the same rule to ordinary business corporations.

The Supreme Court of the United States has not yet passed upon the matter, but thus alluded to it in *Wood* v. *Guarantee Trust Co.*:[2] "The doctrine of *Fosdick* v. *Schall* has never yet been applied in any case except that of a railroad. The case lays great emphasis on the consideration that a railroad is a peculiar property, of a public nature, and discharging a great public work. There is a broad distinction between such a case and that of a purely private concern. We do not undertake to decide the question here, but only point it out."

There have been, however, numerous cases in the inferior Federal courts and in the Supreme courts of the several states. To examine, first, those in the Federal courts, one of the earliest is *Seventh National Bank* v. *Shenandoah Iron Company*,[3] decided soon after *Burnham* v. *Bowen*.[4] Priority was claimed for supplies alleged to have been furnished an iron manufacturing company and for money advanced for wages, but such a company was held not to come within the equitable

[1] Miltenberger *v.* Logansport Railway Co., 106 U. S. 286, 311 (1882), etc., etc.

[2] 12[illegible] U. S. 416 (1888).

[3] 3[illegible] Fed. 436 (1887).

[4] 1[illegible] U. S. 776 (1883).

principles that give the employes of a railroad company a prior lien on its current earnings for the payment of their wages. Paul, J., delivering the opinion, referred to the doctrine of *Fosdick* v. *Schall,* but held it applicable only to railroads, which led him to call the master's allowance of the claims "an innovation on the rights of the prior lienholders of a corporation" of this kind. The same claims were again before him in *Fidelity Ins., Tr. & S. D. Co.* v. *Shenandoah Iron Co.*,[1] when priority was claimed for receiver's certificates representing them. The earlier decision was affirmed, with the remark that "this doctrine has never been applied to mining or manufacturing companies. It is, owing to the *quasi*-public character of such companies, confined to railroad corporations."

The next case is *Farmers' Loan and Trust Company* v. *Grape Creek Coal Company*,[2] in which application was made for leave to borrow money on receiver's certificates to pay certain taxes, etc., and provide working capital for a coal company. This case is generally cited as the leading authority, and we quote at length from the opinion of Judge Gresham:

"When it becomes necessary for a court of chancery to take possession of property which is the subject of litigation, by placing it in the hands of a receiver, all expenses incident to its safe keeping and preservation are properly chargeable against it; and, if there be no income, such expenses will be paid out of the proceeds of the *corpus* before distribution to lien or other creditors. It does not follow, however, that because property of a private corporation or a natural person may be thus protected and preserved before sale, that, in order to raise money to operate it for profit, a court may place a charge upon it in advance of existing liens. Pending a suit to foreclose a mortgage executed by a railroad corporation, the road may be operated by a receiver, and debts contracted for labor, supplies and other necessary purposes before, as well as after, the appointment of a receiver, may be made a first lien upon income, and, if that is not adequate, upon the *corpus* of

[1] 42 Fed. 377 (1889).
[2] 50 Fed. 481 (1892).

the property. In the exercise of this exceptional and extraordinary jurisdiction, which is of comparatively recent origin, courts have entered orders making receiver's certificates first liens on the mortgaged property. This has been done, however, on grounds not applicable to mortgages executed by private corporations. A railroad corporation is a *quasi*-public institution, charged with the duty of operating its road as a public highway. . . . Private corporations owe no duty to the public, and their continued operation is not a matter of public concern. . . . The court is not asked to subvert the lien of the mortgage on the ground that the trustee or bondholders have got possession of anything which, in equity, belongs to general creditors. It is to enable him to operate the mines for the benefit of bondholders, against the wish of part of them, that the receiver desires to be invested with authority to issue certificates which shall be a prior lien upon the property embraced in the trust deed. Extensive as are the powers of courts of equity, they do not authorize a chancellor to thus impair the force of solemn obligations and destroy vested rights. Instead of displacing mortgages and other liens upon the property of private corporations and natural persons, it is the duty of courts to uphold and enforce them against all subsequent incumbrances. It would be dangerous to extend the power which has been recently exercised over railroad mortgages (sometimes with unwarranted freedom), on account of their peculiar nature, to all mortgages. The power does not exist, and the application is denied."

Judge Paul had the question before him again for consideration a year later in *Fidelity Ins., Tr. & S. D. Co.* v. *Roanoke Iron Company*,[1] and his opinion contains a very satisfactory statement of the law. Proceedings in foreclosure were instituted by the mortgage trustee and the receiver appointed by the court filed a petition praying leave to issue receiver's certificates. It was desired to give these a paramount lien, to obtain funds to carry on the manufacture of iron. This application was opposed by various bondholders and supply lien creditors. The question of the court's right to authorize such

[1] 68 Fed. 623 (1895).

an issue had not been ruled by the Circuit Court in that district, and the number of manufacturing corporations in like case within the district led Judge Paul to consider it very attentively. He refers to the *Rule in Fosdick* v. *Schall*, by this time thoroughly established, and notices the cautions given by the courts in applying it. Thus, Chief Justice Waite, who had enunciated the rule, said, in *Shaw* v. *Railroad Company*,[1] that the courts should not allow money thus to be borrowed by mortgagees to complete an unfinished road except under extraordinary circumstances—rather, the enterprise should be reorganized by converting the bonds into stock and creating a new mortgage, or by some equivalent scheme which would place the matter in the hands of those immediately interested. Judge Paul proceeds:

"The principle on which the doctrine rests is that railroad companies are considered public corporations which are not controlled and managed alone for the personal benefit of the individual stockholders . . . A railroad is created by the will of all the people of the state, as expressed through their representatives, and it exercises its powers and franchises only by their permission . . . It would be a serious calamity to the people of any section of the country to allow a railroad of any importance, constructed for their benefit, to be stopped in its operations for lack of means to keep it alive and pay its running expenses. We cannot deduce from these reasons, for exercising this extraordinary power of a court of equity in dealing with the interests of a railroad company, any authority for the court to deal in the same way with a private corporation. The latter is created solely with reference to the pecuniary advantage of the individuals who take part in its creation and enjoy the benefits to accrue from the profits arising out of its operations. The public has no interest in its existence or continuance other than what may accrue to the people of the particular locality in which a mill, factory or furnace may be established. This is too vague and indefinite to be the subject of the care and protection of a court of equity."

But when Judge Paul laid down the rule in broad terms

[1] 100 U. S. 612 (1879).

that, *without the assent of all the lien creditors*, the court has no power to authorize the receiver of an insolvent business corporation to issue certificates with paramount lien for the purpose of carrying on the business, he was, nevertheless, careful to add the *proviso*, "unless it be necessary to do so in order to preserve the existence of the corporate property and its franchises." The question of preserving the franchises, be it noted, had not yet arisen.

The right recognized in *Fosdick* v. *Schall* and the following cases of claiming priority for supplies furnished immediately before the receivership was invoked in *Snively* v. *Loomis Coal Company*.[1] A vendor's lien was foreclosed and the receiver appointed in the proceedings was directed to continue to operate the company's mines and transact its mercantile business. This case, like the earlier one of *Laughlin* v. *U. S. Rolling Stock Company*,[2] raises the question indirectly, since a claim for supplies furnished a railroad corporation is given its lien to procure the continued operation of the road as a going concern. This reason, the court held, does not apply to a private corporation; the public has no special interest in it, and it may well be closed down during the foreclosure proceedings. Again the assertion is made that contracts of the parties must be free from interference by the courts, and not be impaired by the preference of simple contract claims.

A Circuit Court of Appeals considered the question, for the first time, in *Hanna* v. *State Trust Company*.[3] A land and irrigation company became insolvent, the second mortgagee instituted foreclosure proceedings and a receiver was appointed; authority was sought, against the objection of the first mortgagee, for the issuance of certificates with a paramount lien to pay taxes and raise funds to continue the irrigation business and improve the company's lands. It appeared that the company had sold much land on credit and the fruit trees planted by the purchasers would die unless irrigated. The master reported, furthermore, it was "of vital

[1] 69 Fed. 204 (1895).
[2] 64 Fed. 25 (1894).
[3] 70 Fed. 2 (1895).

importance to the company" that the amounts due on the executory contracts be collected, which could not be done unless the business were continued, and that the purchasers had a right, in justice and equity, to demand the performance of the contracts. It will be observed an effort was made to assimilate the case to that of a railroad operated for the public good. An order was entered accordingly and the first mortgagees appealed.

The opinion of the Circuit Court of Appeals is exhaustive. Caldwell, Cir. J., refers to the authorities relating to railroads and to those just examined in the United States Circuit and District Courts, involving private corporations, but relies chiefly on *Raht* v. *Attrill*,[1] a case to be considered presently. The opinion of Judge Caldwell deals so clearly with the whole question that we quote from it at length:

"The amended bill would seem to be founded on the theory that a private corporation conducting any kind of business may, when it becomes insolvent, obtain immunity from the compulsory payment of its debts by procuring a junior mortgagee, or some other creditor, to file a bill alleging the insolvency of the corporation, and praying for the appointment of a receiver with authority to manage and conduct its business. Upon the filing of such a bill, it is supposed to be competent for the court, in addition to appointing a receiver to carry on the business of the corporation, to enjoin its creditors, including the holders of the prior liens on its property, from collecting their debts by due course of law, and to continue such injunction in force so long as the court, in its discretion, sees fit to carry on the business of the insolvent corporation. When a receiver is appointed under such a bill, he usually makes haste, as the receiver did in this case, to assure the court that, if he only had some capital to start on, he could greatly benefit the estate by carrying on the business that bankrupted the corporation. In this case, the company being insolvent and its property mortgaged for more than it was worth, there was no way of raising money to set the receiver up in business, except by the court giving

[1] 106 N. Y, 423 (1887).

its obligations, in the form of receiver's certificates, and making them a paramount lien on all the property of the corporation, by displacing the appellants' prior liens thereon. As commonly happens in cases of this character, the receiver, the insolvent corporation and the junior mortgagee united in urging the court to arm its receiver with the desired powers. They ran no risk in so doing. The corporation was insolvent, and a foreclosure of the prior mortgage would leave the junior mortgagee without any security; so that it had nothing to lose, and everything to gain, in experiments to enhance the value of the mortgaged property, so long as the cost of those experiments was made a prior lien thereon. The effect of the proceeding was to burden the prior mortgagee with the whole cost of the expenditures and experiments made for the betterment of the property on the petition, and for the benefit of the insolvent corporation and the junior mortgagee. The representation is always made, in such cases, that the receiver can carry on the business much more successfully than was done by the insolvent corporation. This commonly proves to be an error. But, if it were true, it would afford no ground of equitable jurisdiction, for it is not a function of a court of equity to carry on the business of private corporations, whether solvent or insolvent. It is obvious that if the holders of the first mortgages and the other creditors of the insolvent corporation were allowed to proceed, in the customary and lawful mode, to collect their debts, it would put an end to the business of the receiver, and they are therefore enjoined from foreclosing their mortgages or collecting their debts. The chancery court thus assumes, in effect, all the powers and jurisdiction of a court of bankruptcy or insolvency, but without any bankrupt or insolvent law to guide or direct it in the administration of the estate. Its only guide is that varying and unknown quantity called 'judicial discretion.' The powers claimed for a court of equity in such cases are, indeed, much greater than a court of bankruptcy can exercise. There never was a bankrupt court, under any bankrupt act, authorized, at its discretion, to displace or nullify valid liens on the bankrupt's property, or itself to create liens paramount

thereto. . . . If junior lien creditors of an insolvent private corporation could do what has been attempted in this case, every private corporation operating a sawmill, gristmill, mine, factory, hotel, elevator, irrigating ditches, or carrying on any other business pursuit, would speedily seek the protection of a chancery court, and those courts would soon be conducting the business of all the insolvent private corporations in the country. If it were once settled that a chancery court, through a receiver appointed on the petition of a junior mortgagee, could carry on the business of such insolvent corporations at the risk and expense of those holding the first or prior liens on the property of the corporation, such liens would have little or no value. It is no part of the duty of a court of equity to conduct the business of insolvent private corporations, any more than it is to carry on the business of insolvent natural persons. If it may take under its control the property of an insolvent private corporation, and authorize a receiver to carry on its business, and make the debts incurred by the receiver in so doing paramount liens on all the property of the corporation, and enjoin its creditors in the meantime from collecting their debts, it is not perceived why it may not proceed in the same way with the estate of an insolvent natural person. . . .

Taxes are the first and paramount lien on all property, and must be paid. When taxes are due on property in the hands of a receiver, and he has no funds to pay them, the court will authorize him to borrow money for that purpose and make the obligation given for the money so borrowed a prior lien on the property on which the taxes were due. This is not fixing a new or additional lien on the property, or displacing any prior lien. It is simply changing the form of the lien from one for taxes to one for money borrowed to pay the taxes."

The Circuit Court of Appeals for the Fifth Circuit took a much less rigorous view of its duty in another case involving a corporation whose operations affected the public.[1] There was, to be sure, the difference that in one the receiver was appointed in foreclosure proceedings, and in the other because

[1] General Electric Co. *v.* Whitney, 74 Fed. 664 (1896).

of allegations of insolvency and mismanagement. The defendant had a profitable contract to light the city of New Orleans, and another contract under which the receipts from the first were assigned. The receiver was, therefore, permitted to perform one and repudiate the other, thus in effect protecting the holders of liens on the corporation's property at the expense of other creditors holding liens on the corporation's income. The court well said: "It cannot be contended that the court should be required to operate the property without funds to meet its necessary running expenses, for the physical impossibility involved is the patent answer to such a contention." Yet is not the course adopted by the court quite as unreasonable, even if more feasible?

The later Federal cases call for no extended notice. In *Newton* v. *Eagle & Phœnix Mfg. Co.*,[1] the corporation prayed the court to require the receivers (who were apparently appointed by reason of the corporation's insolvency) to pay the maturing mortgage interest, and thereby prevent a default that would have entitled the trustee to proceed to enforce the trust deed. This could be accomplished only by an issue of receiver's certificates, with lien prior to the bonds whose interest would thus have been paid, and prior also to other preferred claims. The court properly enough refused to sanction such an illusory payment as this, resting the decision on the opinion of Judge Gresham, in *Farmers' Loan and Trust Co.* v. *Grape Creek Coal Co.*[2]

In *Doe* v. *Northwestern Coal and Transportation Co.*[3] the general rule is reiterated and enforced as to lien holders who had not consented to the issue of receiver's certificates, but those who had consented were postponed to them.

From this review of the authorities it appears that the Supreme Court of the United States has not yet been called upon to consider how far the *Rule in Fosdick* v. *Schall* is applicable to a private corporation. The court has suggested, however, that the rule may not apply, and it has assigned to the rule,

[1] 76 Fed. 418 (1896).
[2] 50 Fed. 481 (1892).
[3] 78 Fed. 62 (1896).

especially in the later decisions, a basis inconsistent with the nature and duties of a private corporation.

The Circuit Courts of Appeal have decided the question directly only once. The right to borrow money to pay taxes was conceded, but the power of the court to charge an estate with liens to secure the continued operation of a business conducted for private profit, important though that business might be to the corporation's customers, was denied in the strongest terms. In this instance the business was the furnishing of water for irrigation, a business vitally affecting the prosperity of the farmers and fruit growers in the arid sections of the West, and one that may well some day be classed among those to be conducted by the state.

The only other case before a Circuit Court of Appeals involved the furnishing of light to a city—another semi-public enterprise. Here the court aided the receiver by restoring to him current income diverted and assigned by the corporation to obtain funds for immediate use. Without this additional revenue the receiver could not have met his current expenses, but the assignee had a good title and the contract producing the revenue was beneficial to the receiver; we submit, therefore, that enjoining the city from making payment to the assignee was tantamount to divesting liens, as is done in dealing with railroads. The action is justified on general grounds, yet the nature of the business may have influenced the decision.

The Circuit and District Courts have dealt with applications for leave to issue receiver's certificates in cases of corporations engaged in coal mining and in iron and general manufacturing. The purpose of the applications was to secure working capital and to give preference to claims for wages earned and supplies furnished immediately before the receivership. These courts have uniformly disclaimed such power as an invasion of vested rights. On the other hand, when the claim to be paid had the paramount lien in any event, like taxes, and immediate payment was desirable, the certificates were authorized. Of course, when those whose interest would be affected gave their consent, the question could not arise.

In general, therefore, we may regard the rule as well settled

in the Federal courts. It will be interesting, nevertheless, to see what will be done, should the case arise of a corporation having by statute the monopoly of operating a ferry or of supplying a city with light or water.

Erskine Hazard Dickson.

(To be continued.)