Washington and Lee Law Review

Volume 32 | Issue 2 Article 4

Spring 3-1-1975

Baker V. Gold Seal Liquors, Inc.: Railroad -Reorganization And The Availability Of Setoff Under The Bankruptcy Act

NOTES & COMMENTS

BAKER V. GOLD SEAL LIQUORS, INC.: RAILROAD REORGANIZATION AND THE AVAILABILITY OF SETOFF UNDER THE BANKRUPTCY ACT

Introduction

When a creditor of a bankrupt in proceedings under the Bankruptcy Act[1] also owes a sum to the bankrupt, he generally is allowed to set off his debt to the bankrupt against that which the debtor owes him by invoking section 68[2] of the Act. This setoff provision[3] is founded on the traditional commercial practice of settling accounts through the cancellation of mutual debts.[4] It was incorporated in the Bankruptcy Act to preserve traditional business expectations pro-

---

[1] Act of July 1, 1898, ch. 541, 30 Stat. 544, *as amended,* Act of June 22, 1938, ch. 575, 52 Stat. 840, *as amended,* Act of July 5, 1966, Pub. L. No. 89-496, 11 U.S.C. §§ 1-1103 (1970), *as amended,* 11 U.S.C. §§ 1-1103 (Supp. III, 1973).

[2] Bankruptcy Act § 68, 11 U.S.C. § 108 (1970). Section 68 provides:

> Set-offs and counterclaims.
>
> a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.
>
> b. A set-off or counterclaim shall not be allowed in favor of any debt or of the bankrupt which (1) is not provable against the estate and allowable under subdivision (g) of section 93 of this title; or (2) was purchased by or transferred to him after the filing of the petition or within four months before such filing with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

Id.

[3] Setoff, as discussed in this article, refers only to setoff as provided for in section 68 of the Bankruptcy Act, 11 U.S.C. § 108 (1970). It should not be confused with a setoff which may be allowed under section 60(c) of the Bankruptcy Act, 11 U.S.C. § 96(c) (1970). Section 60(c) provides that if a creditor receives a voidable preference, normally recoverable from him by a trustee of a bankrupt,

> and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.

Id.

[4] J. A. MACLACHLAN, BANKRUPTCY § 288 (1956). *See also* Cumberland Glass Mfg. Co. v. DeWitt, 237 U.S. 447 (1915), in which the Court stated that the setoff provision was "based upon the generally recognized right of mutual debtors." *Id.* at 455.

duced by reliance on the setoff practice,[5] and to prevent uneconomical procedures which might have resulted from its exclusion.[6] Indeed, it would seem unfair to allow a bankrupt to collect the whole amount due from his creditor while only allowing the creditor a fractional return on his claim.[7] Nevertheless, courts managing railroad reorganizations under section 77[8] of the Bankruptcy Act have been hesitant

---

[5] J. A. MACLACHLAN, BANKRUPTCY § 288 (1956).

[6] *Id.* at 338. MacLachlan writes,

> If the law of liquidiation required the two sides of accounts between the parties to be broken down upon the insolvency of one party, so that the representative of the insolvent estate could always enforce the items in his favor in full and only pay a dividend upon the opposing items, all but the least sophisticated business men would be aware of the fact and would conduct themselves accordingly. That would certainly have a chilling effect on business confidence, and would invite uneconomical paper work.

Id.

[7] 4 W. COLLIER, BANKRUPTCY ¶ 68.02, at 853 (14th Ed. 1971) [hereinafter cited as COLLIER].

[8] Bankruptcy Act § 77, 11 U.S.C. §205 (1970). Section 77 provides for the reorganization of a railroad through the combined efforts of a federal district court and the Interstate Commerce Commission. Warren v. Palmer, 310 U.S. 132, 138 (1940). The statute has two basic objectives—"the conservation of the debtor's assets for the benefit of creditors and the preservation of an ongoing railroad in the public interest." New Haven Inclusion Cases, 399 U.S. 392, 431 (1970).

Section 77 proceedings are initiated by the filing of a voluntary petition by any railroad corporation, or by the filing of an involuntary petition by any number of a railroad corporation's creditors who hold at least five percent of its total indebtedness. This petition must be filed with the district court in whose territorial jurisdiction such corporation has had its principal operating office for the preceding six months. The petition must state that the railroad is insolvent or unable to meet its debts as they mature, and that it desires to effect a plan of reorganization. Once satisfied that the above criteria have been met, and that the petition has been filed in good faith, the district judge to whom the petition is addressed must approve it. His approval commences the proceedings and vests in the reorganization court, the court in which the approval order is issued, exclusive jurisdiction over the debtor and its property. Bankruptcy Act § 77(a), 11 U.S.C. § 205(a) (1970).

The remainder of section 77 provides a framework for the continued operation of a debtor railroad and for the formulation and confirmation of a reorganization plan. After approval of the petition, a hearing is held at which the district judge must appoint one or more trustees of the corporation's property. The trustees are authorized to operate the business, and may, with the approval of the judge, obtain additional cash or property through the issuance of certificates for such cash or property. Bankruptcy Act § 77(c), 11 U.S.C. § 205(c)(1)-(3) (1970). Proposed reorganization plans may be filed by the debtor railroad, the trustees, creditors, or stockholders. Proposed plans must be filed with the Interstate Commerce Commission, which has the duty of reviewing and holding hearings on such plans. The ICC may reject, approve, or alter and approve any plan. Once a plan has been approved, however, the ICC must certify the plan to the court with a transcript of all proceedings and a copy of the report and

to allow setoffs.[9] They have pointed to the peculiar status of the debtor railroad[10] and to the rehabilitative intent of the reorganization proceeding,[11] factors which distinguish the reorganization proceeding from straight bankruptcy.[12] As a general rule, the courts have adopted the position that setoff will not be allowed where it is inconsistent with the purpose of section 77.[13] The foremost purpose-related consideration has been the immediate cash need of the debtor,[14] a need that must be fulfilled if the debtor is to continue operations until a reorganization plan can be confirmed. In denying a setoff in its recent

order approving the plan. Bankruptcy Act § 77(d), 11 U.S.C. § 205(d) (1970). After certification to the court, a plan must meet the criteria quoted in note 27, *infra*, for confirmation. Upon final confirmation, a plan is binding on the debtor railroad, the stockholders, and all creditors of the debtor, and the corporation designated in the plan to carry out the provisions of such plan shall be entrusted with the power to do so. The final transfer of all property necessary for the carrying out of the plan to the corporation designated to fulfill that purpose marks the termination of proceedings, and the judge is then empowered to enter an order discharging the trustees and closing the case. Bankruptcy Act § 77(f), 11 U.S.C. § 205(f) (1970).

For a more thorough discussion of section 77 reorganization proceedings, see Haskell, *Railroad Reorganization for Beginners*, 24 ALA. L. REV. 295 (1972); Swaine, *A Decade Of Railroad Reorganization Under Section 77 of the Federal Bankruptcy Act*, 56 HARV. L. REV. 1037 (1943).

For a discussion of the Interstate Commerce Commission's role in reorganization, see Craven, *The Judicial and Administrative Mechanism of Section 77*, 7 LAW & CONTEMP. PROB. 464 (1940).

[9] *See In re* Penn Central Transp. Co., 339 F. Supp. 603 (E.D. Pa. 1972), *aff'd*, 477 F.2d 841 (3d Cir.), *aff'd sub nom.* United States Steel Corp. v. Trustees of Penn Central Transp. Co., 414 U.S. 885 (1973) (summary proceeding in reorganization court denying a number of the Penn Central's shippers the right to use various setoffs against the railroad's trustees' claims for freight charges, and ordering certain shippers to pay the amounts due); Penn Central Transp. Co. v. National City Bank, 315 F. Supp. 1281 (E.D. Pa. 1970), *aff'd*, 453 F.2d 520 (3d Cir.), *cert. denied*, 408 U.S. 923 (1972) (summary proceeding in the reorganization court denying 142 banks in which the Penn Central had deposit accounts the right to setoff the amount the railroad owed them against the deposited funds); *In re* Central R.R., 273 F. Supp. 282 (D.N.J. 1967), *aff'd*, 392 F.2d 589 (3d Cir. 1968) (reorganization court proceeding denying The New York Central Railroad Company the right to set off against The Central Railroad certain portions of their interline freight balances).

[10] *See* Lowden v. Northwestern Nat'l. Bank & Trust Co., 298 U.S. 160, 164 (1936), in which the Court discusses the uncertainty of the actual financial status of the debtor and the outcome of reorganization proceedings as considerations which discourage the automatic application of section 68 to railroads undergoing section 77 reorganization. This case is discussed in the text accompanying notes 48-68 *infra*.

[11] *See* cases cited at note 9 *supra*.

[12] Straight bankruptcy, as used in this article, refers to the liquidation of a party and the distribution of his assets to his creditors provided for in Chapters I through VII of the Bankruptcy Act. 11 U.S.C. §§ 1-112 (1970).

[13] *See* cases cited at note 9 *supra*.

[14] *See* cases cited at note 9 *supra*.

decision in *Baker v. Gold Seal Liquors, Inc.*,[15] however, the Supreme Court departed significantly from this traditional rationale.

In *Baker*, the trustees[16] of the property of the Penn Central Transportation Company, a corporation in reorganization under section 77 of the Bankruptcy Act,[17] initiated an action for unpaid freight charges against Gold Seal Liquors, Inc., in the United States District Court for the Northern District of Illinois.[18] The defendant shipper counterclaimed for loss and damage to various shipments of merchandise handled by the Penn Central for the defendant's account.[19] On the trustees' motion for summary judgment in favor of both their own and Gold Seal's claims, the sole issue was whether the court should allow the setoff of one judgment against the other.[20] The trustees contended that a setoff was contrary to the purposes of reorganization. In addition, they pointed to Orders number 1 and 571 of the Penn Central reorganization court,[21] which restrained setoffs, and to

---

[15] 94 S.Ct. 2504 (1974).

[16] Section 77(c)(1) of the Bankruptcy Act, 11 U.S.C. § 205(c)(1) (1970), provides for the appointment of one or more trustees of the railroad upon approval of a petition for reorganization under section 77; section 77(c)(2), 11 U.S.C. § 205(c)(2) (1970), outlines the duties and powers of the trustees appointed.

[17] The reorganization court for the Penn Central is the United States District Court for the Eastern District of Pennsylvania, which approved Penn Central's petition for reorganization on June 21, 1970. Penn Central Transp. Co. v. National City Bank, 315 F. Supp. 1281, 1282 (E.D. Pa. 1970).

[18] The trustees brought this action in the Illinois district court because Gold Seal disputed the freight claim. Appendix to Petitioner's and Respondent's Briefs at A7, Baker v. Gold Seal Liquors, Inc., 94 S.Ct. 2504 (1974). Unless the debtor of a railroad in reorganization consents to the jurisdiction of the reorganization court, or unless there is no claim adverse to the railroad's claim, the railroad must seek adjudication in a plenary proceeding. *In re* Lehigh & Hudson River Ry., 468 F.2d 430, 433-34 (2d Cir. 1972). *See* 2 COLLIER ¶ 23.05, at 484-85.

[19] The Supreme Court has acknowledged that no carrier may provide services of carriage on credit. Fullerton Lumber Co. v. Chicago, M., St. P. & Pac. R.R., 282 U.S. 520 (1931). The Court has, however, permitted a shipper to collect by setoff, or counterclaim, upon claims which it may have against the carrier for loss or damage when the carrier brings suit to recover freight charges. Chicago & N.W. Ry. v. Lindell, 281 U.S. 14 (1930).

[20] The amounts of both parties' claims were stipulated prior to the trustees' motion for summary judgment. Appendix to Petitioner's and Respondent's Briefs at A11-A15, Baker v. Gold Seal Liquors, Inc., 94 S.Ct. 2504 (1974).

[21] The reorganization court for the Penn Central, the United States District Court for the Eastern District of Pennsylvania, issued Order number 1 on approval of the railroad company's petition for reorganization, June 21, 1970, Penn Central Transp. Co. v. National City Bank, 315 F. Supp. 1281, 1282 (E.D. Pa. 1970), and Order number 571 as a result of the proceeding in *In re* Penn Central Transp. Co., 339 F. Supp. 603 (E.D. Pa. 1972). Order number 1 contained the following provisions:

9. All persons and all firms and corporations, whatsoever and

that court's consistent refusal to apply section 68.[22] Nevertheless, finding no authority for the entry of separate judgments, the district court allowed a net judgment for Gold Seal.[23] The Seventh Circuit

---

> wheresoever situated, located or domiciled, hereby are restrained and enjoined from interfering with, seizing, converting, appropriating, attaching, garnisheeing, levying upon, or enforcing liens upon, or in any manner whatsoever disturbing any portion of the assets, goods, money, deposit balances, credits, choses in action, interests, railroads, properties or premises belonging to, or in the possession of the Debtor as owner, lessee or otherwise, or from taking possession of or from entering upon, or in any way interfering with the same, or any part thereof, or from interfering in any manner with the operation of said railroads, properties or premises or the carrying on of its business by the Debtor under the order of this Court and from commencing or continuing any proceeding against the Debtor, whether for obtaining or for the enforcement of any judgment or decree or for any other purpose, provided that suits or claims for damages caused by the operation of trains, buses, or other means of transportation may be filed and prosecuted to judgment in any Court of competent jurisdiction, and provided, further, that the title of any owner, whether as trustee or otherwise, to rolling stock equipment leased or conditionally sold to the Debtor, and any right of such owner to take possession of such property in compliance with the provisions of any such lease or conditional sale contract, shall not be affected by the provisions of this order.
>
> 10. All persons, firms and corporations, holding collateral heretofore pledged by the Debtor as security for its notes or obligations or holding for the account of the Debtor deposit balances or credits be and each of them hereby are restrained and enjoined from selling, converting or otherwise disposing of such collateral, deposit balances or other credits, or any part thereof, or from offsetting the same, or any thereof, against any obligation of the debtor, until further order of this Court.

Baker v. Gold Seal Liquors, Inc., 94 S.Ct. 2504, 2510 n.4 (1974). Order number 571 reads,

> AND NOW, this 31st day of January, 1972, it is Ordered that the petition of the Trustees for an order directing shippers to pay amounts due Debtor (Document No. 400) is GRANTED IN PART, and all persons, firms and corporations served with a copy of said petition are enjoined, until further order of this Court, from setting off or attempting to set-off against obligations due and owing to the Debtor on account of charges for services of carriage any claim or claims which they may have against the Debtor, arising prior to June 21, 1970, but any such claim or claims may be filed and proved in accordance with Order No. 164 in this proceeding. This Order shall be deemed to be without prejudice to the right of any such shipper to claim such priority as may be proper.

Brief for Respondent at 1a, Baker v. Gold Seal Liquors, Inc., 94 S.Ct. 2504 (1974).

[22] *See In re* Penn Central Transp. Co., 339 F. Supp. 603 (E.D. Pa. 1972); Penn Central Transp. Co. v. National City Bank, 315 F. Supp. 1281 (E.D. Pa. 1970).

[23] The decision of the District Court for the Northern District of Illinois, delivered

similarly disposed of the trustees' contentions on appeal.[24] Stating that it was the trustees who had invoked the jurisdiction of the district court, the court of appeals found "nothing in the principles of 'judicial comity' to require the Illinois court to withhold the full exercise" of that jurisdiction.[25]

The setoff issue was presented to the Supreme Court on writ of certiorari.[26] In reversing the decision below, the Court gave little attention to the reorganization court's Orders or to the traditional consideration of a reorganization debtor's need for operating capital. Instead, it focused on the plan of reorganization to be formulated for the rehabilitation of the debtor. The Court emphasized the "fair and equitable" requirement[27] imposed on section 77 plans. This requirement, which originated in early equity receivership reorganization cases, mandates the full satisfaction of a higher priority creditor's claim before a lower priority creditor is allowed any recovery on his claim under the reorganization plan.[28] Noting that the allowance of a setoff constitutes a form of priority which must be consistent with this absolute priority requirement, the Court struck down the district court's setoff as a discriminatory preference in favor of Gold Seal over the Penn Central's other creditors. The Court, however, did not confine itself to a decision on the issue presented. Characterizing reorg-

---

on March 16, 1972, is unreported. Baker v. Gold Seal Liquors, Inc., No. 70 C 3205 (N.D. Ill., March 16, 1972).

[24] 484 F.2d 950 (7th Cir. 1973).

[25] *Id.* at 951.

[26] Certiorari was granted at 414 U.S. 1156 (1974).

[27] Section 77(e) of the Bankruptcy Act, 11 U.S.C. § 205(e) (1970), states, in pertinent part, that the reorganization court shall approve a plan if it is

> . . . fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders . . .

Id.

[28] The Supreme Court established the conjunction between principles of fairness and equity and the absolute priority rule in an equity receivership case. Northern Pac. Ry. v. Boyd, 228 U.S. 482, 504 (1913). The absolute priority rule has been extended to railroad reorganization by the "fair and equitable" requirement of section 77(e). Group of Institutional Investors v. Chicago, M., St. P. & Pac. R.R., 318 U.S. 523, 541-42 (1943). *See* Ecker v. Western Pac. R.R., 318 U.S. 448, 477-83 (1943). In a reorganization case involving a recapitalization, the Surpeme Court outlined the rule as follows:

> The important element is the allocation of the securities so as to preserve to creditors the advantage of their respective priorities. That is to say, senior claims first receive securities of a worth sufficient to cover their face and interest before junior claims receive anything.

Ecker v. Western Pac. R.R., 318 U.S. 448, 483 (1943).

anization setoffs as preferences contrary to the "fair and equitable" policy of section 77, the Court also stated that as a general rule section 77 courts should not allow setoffs.[29]

A Closer Look at the Rationale: Inconsistency and the Lowden Precedent

The initially striking feature of the Court's opinion in *Baker* is the apparent limitation of the general rule which proscribes section 77 reorganization courts from permitting setoffs.[30] This limitation seems inappropriate since the issue in *Baker* was not the propriety of a section 77 court's setoff, but that of a non-reorganization court. The anomaly may be avoided, however, by reading the proscription as applying to all courts entertaining a suit to which a section 77 debtor is a party. The Court must have intended such a reading since the rationale underlying the general rule was utilized to reverse the decision of a non-reorganization court.[31] Further, the Court's rule cannot be understood as authorizing a reorganization court to split a net judgment entered in a plenary proceeding when it is presented to the reorganization court as a liquidated claim. Splitting would require the partition of a net judgment into two distinct judgments, one for the debtor railroad and one for the creditor, in order to circumvent the setoff effect. The alteration of net judgments in this manner would controvert the general prohibition against collateral attacks.[32] In the instant case, there was apparently no question of the Illinois

[29] 94 S.Ct. 2504, 2509 (1974). Mr. Justice Stewart, with whom Justice Powell joined, concurred in the majority result, but argued against the general rule and in favor of denying the setoff on the basis of the reorganization court's orders. 94 S.Ct. at 2509-10. Mr. Justice Rehnquist dissented on the ground that section 77(l) of the Bankruptcy Act, 11 U.S.C. § 205(l) (1970), unconditionally mandates the application of section 68 in railroad reorganization. 94 S.Ct. at 2511. For the text and a discussion of section 77(l), see notes 76-77 and accompanying text *infra*. He also argued in the alternative that the Illinois district court had discretion whether to permit setoff, and that the trustees had failed to show that allowance of the setoff "would be inconsistent with [the] higher priorities of reorganization." 94 S.Ct. at 2512-13.

[30] The majority's concluding sentence reads as follows: "As a general rule of administration for § 77 Reorganization Courts, the setoff should not be allowed." 94 S.Ct. at 2509.

[31] See the discussion of the history of the case in the text accompanying notes 25-28 *supra*.

[32] "Full faith and credit" requires that a reorganization court give conclusive effect to a judgment rendered in another court which had jurisdiction over the parties and the subject matter. Alteration or modification of such a judgment must occur through standard appellate procedures. Any deviation from this practice would constitute a violation of historical precedent as well as the policy behind full faith and credit.

district court's power to adjudicate both claims.[33] The general rule promulgated by the Supreme Court, then, must apply to all courts which confront the issue of setoff in a suit to which a section 77 debtor is a party. This appears to be the understanding of Justice Stewart, who discussed the announced doctrine in his concurring opinion as if it were to be applied in all setoff cases to which a section 77 debtor is a party.[34]

Mr. Justice Stewart, with whom Justice Powell joined, would have denied the setoff on the alternative ground that the reorganization court's orders enjoined such action. His concurrence was founded on the reorganization court's " 'exclusive jurisdiction of the debtor and its property wherever located.' "[35] Mr. Justice Stewart admitted that this did not give the reorganization court power to enforce the cause of action,[36] but he argued that it did "empower the court to protect the 'property' and to immunize it from diminution through setoff or counterclaim."[37] It should be noted that although a reorganization court may have the power to enjoin setoffs within the jurisdiction of other courts,[38] such action apparently was not taken in the Penn Central proceedings. Both Order number 1 and Order number 571 were directed against non-judicial setoffs.[39] In addition, Order 571

[33] The trustees initiated the action in a court possessing jurisdiction over Gold Seal, and the action of the Supreme Court made clear that the Illinois district court also had jurisdiction to entertain the courterclaim. 94 S.Ct. at 2506.

[34] See Justice Stewart's concurring opinion in which he commented that the majority's new rule, directly applicable to section 77 debtors, apparently will be applied in all cases involving judicial setoffs to which such debtors are parties. 94 S.Ct. at 2509-10.

[35] 94 S.Ct. at 2510, *citing* Bankruptcy Act § 77(a), 11 U.S.C. § 205(a) (1970) (emphasis deleted).

[36] As discussed in note 18, *supra,* a summary proceeding in the reorganization court cannot be utilized for adjudication of the claim of the trustees when it is adversely contested and when the defendant does not consent to the court's jurisdiction. *See* note 18 *supra; In re* Roman, 23 F.2d 556, 558 (2d Cir. 1928) (L. Hand, J.).

[37] 94 S.Ct. at 2510.

[38] The majority in *Baker* cited a federal case from Michigan, Baker v. Southeastern Mich. Shippers Co-operative Ass'n, 376 F. Supp. 148, 156 (E.D. Mich.1973), which held that the Penn Central reorganization court's Orders prevented other courts from allowing setoffs. 94 S.Ct. at 2508 n.10. Although the majority did not accept the reasoning of this case as exemplified in the Stewart-Powell contention, their apparent rejection of it was based on the content of the Orders and not on the inability of a reorganization court to take such action. *See* notes 39-41 and accompanying text *infra.* Thus the lower court decision and the concurring opinion of Justice Stewart may provide authority for section 77 courts to enjoin setoffs by other courts in future reorganization proceedings.

[39] Paragraphs 9 and 10 of Order number 1 and Order number 571 specifically restrained the creditors of the Penn Central from effecting setoffs. No mention was

applied only to those persons, firms, and corporations actually served with a copy of the petition in *In re Penn Central Transportation Co.*,[40] a summary proceeding in the reorganization court which precluded the setoff of damage claims for most of the Penn Central's creditors. Gold Seal was neither served with nor named in the petition initiating that action.[41] Thus, it appears that although the concurring Justices may have been correct with respect to a reorganization court's general power to enjoin setoffs, they overlooked the actual content of the orders issued in the proceedings prior to *Baker*.

Concluding that the contention of Justices Stewart and Powell was not applicable to the instant case, the majority instead reversed on the ground that the setoff constituted a preference which contravened the absolute priority rule imposed on railroad reorganization plans by the "fair and equitable" language of section 77(e). In initiating their analysis by examining the interrelation between absolute priority and the fair and equitable criteria, the Justices utilized well established principles. The absolute priority rule has long been held to be incorporated in the fair and equitable requirement,[42] and the Supreme Court has carefully outlined the rule as it applies to section 77.[43] The application of the rule to setoff, however, comprehends an unprecedented leap from particular to pervasive coverage.[44]

Before the Court's decision in *Baker*, apparently no court had considered setoff as a form of priority which must yield to the absolute priority requirement. The courts' reluctance to take this step emanates from the language of secton 77. Setoff must necessarily occur before a reorganization plan can be confirmed, yet the fair and equitable requirement applies only to the plan.[45] There is no indication in section 77 that the fair and equitable criteria was intended to relate the protection of the absolute priority rule back to the approval

made of judicial setoffs effected by courts in plenary proceedings. For the text of Orders 1 and 571, see note 21 *supra*.

[40] 339 F. Supp. 603 (E.D. Pa. 1972). *See* note 21 *supra*.

[41] Brief for Respondent at 11, Baker v. Gold Seal Liquors, Inc., 94 S.Ct. 2504 (1974).

[42] Group of Investors v. Chicago, M., St.P. & Pac. R.R., 318 U.S. 523, 541-42 (1943). *See* Ecker v. Western Pac. R.R., 318 U.S. 448, 477-83 (1943).

[43] *See* quote from Ecker v. Western Pac. R.R., 318 U.S. 448, 483 (1943), at note 28 *supra*.

[44] Prior to the Supreme Court's decision in *Baker*, apparently no court had attempted to relate the absolute priority requirement, placed solely on the reorganization plan, back to the filing of the petition for reorganization, thus enabling the rule to be applied to setoff.

[45] *See* text of Bankruptcy Act § 77(e), 11 U.S.C. § 205(e) (1970), included in note 27 *supra*.

of the petition for reorganization. Nevertheless, the majority utilized the fair and equitable criteria by classifying the entire reorganization procedure as "architectural."[46] Assuming that this conceptualization of reorganization and its subsequent extension of the absolute priority rule throughout the reorganization process is justified, there would appear to be no difficulty with the concluding rationale that the preference inherent in setoff is inconsistent with the fair and equitable policy of section 77. However, in utilizing the rule as the foundation for the application of the inconsistency rationale, the majority appears to have overlooked what has formerly been considered a necessary ingredient for the application of that rationale to setoff.

Prior to *Baker,* the utilization of the inconsistency rationale as a basis for denying the application of section 68 to a railroad debtor required that the setoff be inconsistent with an aspect or purpose of reorganization that was different from any aspect or purpose of straight bankruptcy.[47] This condition was established as a necessary part of the inconsistency rationale following the Supreme Court's decision in *Lowden v. Northwestern National Bank & Trust Co.*[48] In *Lowden,* the Court considered whether section 68 of the Bankruptcy Act applied to reorganization proceedings under section 77 of the Act.[49] Although the case was dismissed on the ground that the questions presented were improperly drawn,[50] the Court nevertheless established the following rule for the application of section 68 to railroad debtors:[51]

> [Section 68] governs, if at all, by indirection and analogy according to the circumstances. The rule to be accepted . . . is that enforced by courts of equity, which differs from the rule in bankruptcy chiefly in its greater flexibility, the rule in bankruptcy being framed in adaptation to standardized conditions, and that in equity varying with the needs of the occasion,

---

[46] 94 S.Ct. at 2508.

[47] *See* Lowden v. Northwestern Nat'l. Bank & Trust Co., 298 U.S. 160 (1936); Lowden v. Northwestern Nat'l Bank & Trust Co., 84 F.2d 847 (8th Cir.), *cert. denied,* 299 U.S. 583 (1936) (remand of principal case); and cases cited at note 9 *supra.*

[48] 298 U. S. 160 (1936).

[49] The issue was brought before the Court on certificate from the United States Circuit Court of Appeals for the Eighth Circuit. *Id.* at 161.

[50] The Court dismissed the certificate on the grounds that its questions were "unnecessarily general" and admitted of "one answer in one set of circumstances and a different answer in another, the differentiating circumstances being imperfectly disclosed." *Id.* at 166.

[51] Though dictum, the Court's reasoning in *Lowden* concerning the availability of setoffs against section 77 debtors has been viewed as authoritative. Baker v. Gold Seal Liquors, Inc., 94 S.Ct. 2504, 2509 n.2 (1974). *See, e.g.*, cases cited at note 9 *supra.*

> though remaining constant, like the statute, in the absence of deflecting force.[52]

The pronouncement of this rule was significant not only as a guideline for lower courts, but also in its predication on the differences between straight bankruptcy and reorganization. Before stating the rule, the *Lowden* Court specifically noted that reorganization differed from the liquidation and distribution of assets contemplated in straight bankruptcy.[53] The Court stated that section 68 was intended to apply to straight bankruptcy, and added that the uncertainty of the outcome of reorganization and the final status of the debtor would discourage the automatic application of the setoff provision to section 77.[54] The Court also noted that reorganization required that the trustees possess "the power to gather in the assets and keep the business going,"[55] a necessity if the rehabilitative intent of section 77 was to be realized.

The discussion in *Lowden* of the differences between the two forms of bankruptcy proceedings provides insight into the meaning of "deflecting forces" in the rule established by the Court governing the application of section 68 to railroad reorganization.[56] Apparently, the *Lowden* Court considered that a denial of the application of section 68 to a railroad debtor should be premised upon various aspects of section 77 which were not present in straight bankruptcy. In other words, where the differences between the status of an ordinary bankrupt and that of a debtor railroad, or those between the goals of straight bankruptcy and reorganization, were such that the application of section 68 would be inequitable, setoff should be denied. The rationale behind the Court's attention to these differences is clear. Unless a setoff would interfere with some aspect peculiar to section 77, a denial of the application of section 68 to a railroad debtor, when applicable to a bankrupt, would be contrary to the express provision for setoff in the Bankruptcy Act. In later decisions, although substituting the inconsistency rationale for the testing of equities suggested in *Lowden*, courts have adhered to the reasoning on which the *Lowden* rule was predicated.[57] Not surprisingly, the tests developed as the bases for the application of the inconsistency rationale origi-

---

[52] 298 U.S. 160, 164-65 (1936).

[53] *Id.* at 163.

[54] *Id.* at 163-64.

[55] *Id.* at 164.

[56] *See* text accompanying note 52 *supra.*

[57] *See, e.g.*, Lowden v. Northwestern Nat'l Bank & Trust Co., 84 F.2d 847 (8th Cir.), *cert. denied*, 299 U.S. 583 (1936), and cases cited at note 9 *supra.*

nated from the *Lowden* Court's suggestion of two factors which represented differences sufficient to constitute "deflecting forces."

As criteria for testing the equities of setoff, the *Lowden* Court had suggested the uncertain status of railroads in reorganization proceedings and the necessity that a section 77 debtor be able to acquire operating capital.[58] The former consideration was immediately utilized on remand of the *Lowden* case to the Eighth Circuit.[59] In denying the bank's setoff of railroad bonds against the railroad's deposit account, the court of appeals held that it would be inconsistent with section 77 to allow setoff unless it appeared that "insolvency actually existed and that liquidation and distribution of assets, rather than reorganization and rehabilitation, was in order."[60] The indication was that the uncertain future of a railroad in reorganization operated universally to exclude setoffs until it could be shown that straight bankruptcy proceedings were in order.[61] In this context, the Eighth Circuit's insolvency test was seemingly consistent with the first *Lowden* consideration.[62] The courts, however, have shown a general reluctance to rely on it.[63] Although no reason has been advanced for this rejection, it apparently is due to the absolute result the test would have produced. Utilization of the insolvency test in any case would preclude setoff against a section 77 debtor as long as the railroad was considered reorganizable. Since section 77 is permeated with a strong public interest in continued transportation services,[64]

---

[58] 298 U.S. 160, 163-65 (1936).

[59] Lowden v. Northwestern Nat'l Bank & Trust Co., 84 F.2d 847 (8th Cir. 1936).

[60] *Id.* at 855. "Insolvency," as referred to in this article, has the same meaning as in the Bankruptcy Act, § 1(19), 11 U.S.C. § 1(19) (1970).

> A person shall be deemed insolvent within the provisions of this title whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts.

Id.

[61] Prior to stating its insolvency test, the appellate court quoted extensively from the Supreme Court's decision in *Lowden*. 84 F.2d 847, 854-55 (8th Cir. 1936). The test was obviously drawn from the Supreme Court's language concerning the difference in status between a railroad in reorganization and that of a bankrupt. The former is uncertain due to the indefinite outcome of reorganization while the latter, by definition, is certain to be liquidated.

[62] *See* note 61 *supra*.

[63] *See* cases cited at note 9 *supra*.

[64] The consideration of the public interest in section 77 reorganizations has been called an "absolute necessity." Penn Central Transp. Co. v. National City Bank, 315 F. Supp. 1281, 1283 (E.D. Pa. 1970). The Supreme Court has focused on the mandatory

an interest which all but precludes courts from choosing to liquidate railroad debtors,[65] the test would extend protection even to those section 77 debtors who might be more suitable for straight bankruptcy. Such a result would be contrary to the generally permissive tone of the *Lowden* decision,[66] and to the Supreme Court's holding that each case be determined on its particular facts.[67]

As a substitute for the insolvency test and the uncertainty consideration on which it was founded, courts have relied on the second consideration suggested in the *Lowden* decision: the debtor railroad's need for operating capital.[68] The utilization of this consideration in adjudicating the issue of setoff is consistent with both the rehabilitative intent of section 77 and the public interest in railroad survival. If a railroad is to continue to meet the public demand for transportation services while undergoing reorganization, as well as to emerge from reorganization with favorable prospects for the future, it is imperative that its operating capital not be severly diminished by setoff. Specific examples of this reasoning occurred in *In re Central Railroad Co.*[69] and *Penn Central Transportation Co. v. National City Bank.*[70]

In *Central Railroad,* the district court initiated its discussion by reciting the traditional foundation for the utilization of the inconsistency rationale, the differences between straight bankruptcy and railroad reorganization. It noted that these distinctions must not be dis-

consideration of maintaining transportation services in New Haven Inclusion Cases, 399 U.S. 392, 420 (1970); Penn Central Merger and Norfolk & Western Inclusion Cases, 389 U.S. 486, 511 (1968); Reconstruction Finance Corp. v. Denver & R.G.W.R.R., 328 U.S. 495, 535-36 (1946).

[65] Liquidation would most likely involve abandonment of a number of railroad lines being operated during reorganization. Thus, approval of straight bankruptcy for a railroad would be inconsistent with the public interest in continued transportation services. This interest is further secured by the prevention of abandonment of any line without the permission of the ICC or the appropriate state regulatory agency. Bankruptcy Act § 77(o), 11 U.S.C. § 205(o) (1970).

[66] The Supreme Court in *Lowden* called for "weighing the competing equities of the interested factions" in determining whether setoff should be allowed. 298 U.S. at 165-66. The Court then concluded by stating: "When all the facts are known, they may be found to offer no excuse for a departure from the rule in bankruptcy which, as indicated already, is generally, even if not always, the rule in equity as well." *Id.* at 166.

[67] The weighing of the equities contemplated by the Court in *Lowden* requires that each case, with its various equity interests, be decided on its own fact. *See* note 66 *supra.*

[68] *See* cases cited at note 9 *supra.*

[69] 273 F. Supp. 282 (D.N.J. 1967), *aff'd,* 392 F.2d 589 (3d Cir. 1968).

[70] 315 F. Supp. 1281 (E.D.Pa. 1970), *aff'd* 453 F.2d 520 (3d Cir.), *cert. denied,* 408 U.S. 923 (1972).

regarded,[71] and specifically pointed to the difference in purpose, that of bankruptcy being liquidation, and that of reorganization "to save a sick business."[72] In conclusion, the court held that a setoff of interline freight balances would not be consistent with the rehabilitative purpose of section 77. The basis for denying the setoff under the inconsistency rationale was the court's finding that setoffs of the nature attempted in the case "would deprive the Debtor of revenue at a time when such revenue is sorely needed," thus jeopardizing the chances of a successful reorganization.[73]

The same line of reasoning was followed in the *National City Bank* case in which 142 banks had attempted to setoff the Penn Central's debts owing them by applying the railroad's deposit accounts to the amounts owed. The Third Circuit denied the setoffs on the ground that they were inconsistent with the rehabilitative purpose of reorganization. As in *Central Railroad,* the basis for the court's finding of inconsistency in *National City Bank* was its conclusion that the setoffs would severely diminish the railroad's operating capital, and would thus frustrate the railroad's chances for continued operation.[74]

These decisions reveal the full maturation of the inconsistency rationale as founded on the cash need test. In sum, they indicate that in any case in which a setoff might diminish the debtor railroad's operating capital to the extent of threatening the continuation of transportation services and the eventual success of reorganization, the application of section 68 will be denied as inconsistent with the rehabilitative purpose of section 77. In relying on the rehabilitative purpose, the courts adhered to the traditional foundation for the utilization of the inconsistency rationale to deny a setoff, the requirement that only factors of section 77 which are different from straight bankruptcy can serve as a basis for a finding of inconsistency. The courts' adherence to this precedent reveals their continual attention to the reasoning in which the *Lowden* rule was predicated, that it would be contrary to the express provision for setoff in the Bankruptcy Act to deny the application of section 68 to a railroad debtor unless setoff would interfere with a particular aspect of section 77 which was not present in straight bankruptcy. It remains to be considered whether the Supreme Court, in utilizing the absolute priority rule as the basis for the finding of inconsistency in *Baker,* gave ade-

[71] *In re* Central R.R., 273 F. Supp. 282, 287 (D.N.J. 1967).

[72] *Id.* at 288.

[73] *Id.*

[74] Penn Central Transp. Co. v. National City Bank, 453 F.2d 520, 523 (3d Cir. 1972), *aff'd,* 315 F. Supp. 1281 (E.D. Pa. 1970).

quate attention to the different factor precedent and the rationale on which it was based.

A close examination of *Baker* discloses the reason for the majority's departure from the traditional cash need test as the basis for the inconsistency rationale. That test would only support a finding of inconsistency where the application of section 68 might diminish the railroad debtor's operating capital, thus threatening its opportunity for eventual survival. The amount sought to be setoff in *Baker* was only $6,999.76.[75] Difficult sidestepping would have been necessary for the Court to justify a denial of a setoff for such an amount on the basis that the setoff would deplete the debtor's operating capital to the point where it might frustrate the rehabilitative purpose of section 77. Under few circumstances could a setoff of this size be considered to interfere greatly with that purpose. Recognizing this difficulty, the majority invoked the absolute priority rule as the basis for its decision.

On its face, the majority's utilization of the absolute priority rule appears consistent with the statutory pronouncement of the inconsistency rationale. Section 77(l)[76] of the Bankruptcy Act merely requires that a right secured under straight bankruptcy be inconsistent with a provision of section 77 in order for that right to be denied. The precedent indicating that inconsistency must be founded on a factor peculiar to section 77, however, has been adopted as part of section 77(l).[77] The *Baker* majority, although utilizing a particular provision

[75] This was the amount of the stipulated claim of the trustees for the freight charges. In entering the net judgment in favor of Gold Seal, the district court merely subtracted the $6,999.76 from Gold Seal's claim of $18,016.77, thus arriving at the net figure of $11,017.01. Appendix to Petitioner's and Respondent's Briefs at A37, Baker v. Gold Seal Liquors, 94 S.Ct. 2504 (1974).

[76] Bankruptcy Act § 77(l), 11 U.S.C. 205(l) (1970), provides as follows:

> In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication has been filed and a decree of adjudication has been entered on the day when the debtor's petition was filed.

Id.

[77] In adjudicating the issue of setoff against a section 77 debtor, apparently no court mentioning section 77(l) has utilized an aspect or purpose not peculiar to section 77 as the basis for denying a setoff under the inconsistency rationale. The predecessor to section 77(l) was specifically referred to in Lowden v. Northwestern Nat'l Bank & Trust Co., 84 F.2d 847 (8th Cir.), *cert. denied,* 299 U.S. 583 (1936). Other courts, see cases cited at note 9, *supra,* have not discussed section 77(l), but in utilizing the inconsistency rationale to deny setoffs, have adhered to the different factor precedent.

of section 77 to reverse the district court's setoff, did not discuss this precedent. It might be suggested, however, that they intended adherence to the different factor precedent to be understood from their direct reference to the fair and equitable language of section 77, language not present in the straight bankruptcy provisions. Indeed, it might be contended that because the order of priority established by this language is different from that in straight bankruptcy, the utilization of the absolute priority rule as the foundation for the inconsistency rationale is consistent with the precedent.[78] But this reasonsing is unpersuasive.

Straight bankruptcy also comprehends the payment of the claims of creditors according to an order of priorities,[79] and although the order may differ from that of section 77, the underlying purpose for the establishment of the priority requirements in both forms of bankruptcy proceedings is identical. The priority rules were enacted and are maintained to ensure the fair and equitable treatment of creditors.[80] The rules embody equitable considerations which are applicable to both railroad reorganization and straight bankruptcy. The differences in priority between both forms of bankruptcy proceedings do not alter the purpose served by their respective priority requirements. In essence, then, no substantial difference between straight bankruptcy and section 77 can be discerned from their dissimilar rules of priority. The majority's utilization of the absolute priority rule as the basis for the application of the inconsistency rationale thus reveals an apparent disregard for the different factor precedent and the ra-

---

[78] The order of compensation required by the absolute priority rule has been described as follows:

> Beginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may properly participate. Thus the principle is applied as between senior and junior secured creditors, between secured creditors and unsecured creditors, between unsecured creditors and stockholders, between different classes of stockholders, and, of course, between secured creditors as a whole and stockholders.

6A COLLIER ¶ 11.06, at 613-17 (footnotes omitted).

The order of compensation required by the priority rule of straight bankruptcy is outlined in Bankruptcy Act § 64, 11 U.S.C. § 104 (1970).

[79] *Id.*

[80] The language of section 77(e) of the Bankruptcy Act, 11 U.S.C. § 205(e), conveys the purpose underlying the absolute priority rule in railroad reorganization. *See* text of section 77(e) at note 27 *supra.*

The Supreme Court has expressed the purpose of the priority rules for straight bankruptcy. *See* United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959); Nathanson v. NLRB, 344 U.S. 25 (1952).

tionale on which it was based. Indeed, the denial of the district court's setoff on the ground that it interferes with a particular aspect of section 77 which is also present in straight bankruptcy seems contrary to the express provision for setoff in the Bankruptcy Act. This contrary effect points to a second problem with the *Baker* decision.

Although certain provisions of straight bankruptcy require that a bankrupt's creditors be paid according to a particular order of priority, section 68 is still applied in these proceedings. Where it is applied, there can be little doubt that to some extent lower priority creditors receive a preference over those who would normally receive before them. The courts, however, faced with the express provision for setoff in section 68, have seen fit to endorse this preference.[81] They have noted that the setoff provision is based on the principle that "in the case of mutual debts, it is only the balance which is the real and just sum owing by or to the bankrupt."[82] Indeed, the courts have held that the enactment of section 68 approves a preference which recognizes this principle:

> Without such enactment, it could be argued that any attempt to offset mutual debts or credits between the estate and a creditor would amount to a preference under § 60 and would, therefore, be invalid. But the Act, instead, has recognized the possible injustice which would thus result and which would, for example, compel a creditor to prove his claim in full and accept possible dividends thereon and at the same time pay in full his indebtedness to the estate.[83]

In light of the express provision for setoff in the Bankruptcy Act, authorizing the approval of the setoff preference despite the order of priority in straight bankruptcy, the *Baker* majority's utilization of the priority rule of section 77 to reach the opposite result appears unwarranted. The rationale behind the application of section 68 maintains that it is more equitable to fulfill the expectations of mutual debtors[84] and to prevent the injustice of allowing a bankrupt to collect the whole amount due from his creditor while only giving the creditor a factional return on his claim.[85] These equitable considerations override the policy of fair participation for creditors guaranteed by the priority rules of straight bankruptcy. There seems to be no

[81] *See* 4 COLLIER ¶ 68.02, at 853 and cases cited therein.

[82] Prudential Ins. Co. of America v. Nelson, 101 F.2d 441, 443 (6th Cir.), *cert. denied*, 308 U.S. 583 (1939).

[83] 4 COLLIER ¶ 68.02, at 853 (footnotes omitted).

[84] J.A. MACLACHLAN, BANKRUPTCY § 288, at 338 (1956).

[85] *See* 4 COLLIER ¶ 68.02, at 853 and cases cited therein.

essential difference between the absolute priority rule of section 77 and the priority order of straight bankruptcy, both based on the protection of fair participation, to justify a denial of these equities in railroad reorganization. The majority's reliance on that rule as the basis for denying the setoff under the inconsistency rationale thus not only reveals an insensitivity to the different factor precedent, but also creates a conflict between straight bankruptcy and reorganization under section 77.[86]

The Implications of the Rule

After denying the setoff in *Baker* as a preference inconsistent with the fair and equitable policy of section 77, the majority characterized most reorganization setoffs as preferences, and established the general rule that such setoffs should not be allowed against railroad debtors. Regardless of whether the rationale utilized by the majority is considered improvident, the rule promulgated on the basis of this reasoning probably will be applied by courts confronted with the issue of setoff against a section 77 debtor. In this context, further investigation must be made into the effect of the rule and the probable extent of its application.

In establishing its general rule the Supreme Court alluded to "exceptional circumstances" which in equity might justify the discriminatory preference granted by setoff,[87] yet the majority provided no guidelines as to the nature of these circumstances. Until further litigation, a situation wherein setoff might be allowed under the exceptional circumstances language can only be a matter of conjecture. On its face, however, the rule seems to indicate that the application of section 68 to a debtor railroad will be totally precluded.

The rule contemplates that all creditors, even those within the priority class of the party seeking setoff, must be considered in order to determine whether a setoff will grant a preference in contravention of the absolute priority requirement. If a reorganization plan provided for recapitalization, and a determination was made that a certain class of creditors would not be allowed to participate in the issuance of new securities,[88] a setoff secured by a creditor of this class

[86] The essence of the conflict lies in the application of section 68 to straight bankruptcy proceedings, even where it contravenes the order of priority, as opposed to the denial of its application in section 77 on the ground that it violates the absolute priority rule.

[87] 94 S.Ct. at 2509 n.13.

[88] A reorganization plan providing for recapitalization requires a determination of the amount of securities to be issued according to a valuation of the debtor's earning

would certainly constitute a discriminatory preference. It appears, then, that the general rule will only allow the application of section 68 when setoff is sought by a member of any class of creditors who are going to be fully compensated under the reorganization plan. This understanding suggests the conclusion that setoff will be totally precluded in section 77. The application of section 68 would be of little value to a creditor receiving full compensation under a reorganization plan. In addition, the equitable rationale underlying the setoff provision[89] would not be applicable to such a creditor, and it is doubtful that a court would jeopardize a railroad's chances of rehabilitation by granting a setoff to a creditor merely because he desired to be compensated under section 68 rather than under a reorganization plan. Since the application of section 68 is of no value to a creditor receiving a full return on his claim, and cannot be secured by a creditor who stands to gain more than he would under the plan, the Court's general rule must be viewed as absolute.[90]

Nor does it appear that this rule will be limited solely to section 77. The rule's genesis may cause its extension into reorganization proceedings under Chapter X of the Bankruptcy Act.[91] Like section

power. 5 COLLIER ¶ 77.18, at 550 and cases cited therein. If this amount proves insufficient to compensate all creditors, the securities will be allocated first to the top priority creditors and then in descending order to those of lower priority. Thus, certain classes of creditors may be totally excluded from participation in the reorganization plan.

[89] *See* text accompanying note 7 *supra.*

[90] The absolute effect suggests questions regarding the *Baker* decision's consistency with another proposition advanced by the *Lowden* Court, that adjudication of the issue of the application of section 68 to railroad debtors would be on a case-by-case basis. *See* note 67 and accompanying text *supra.* Mr. Justice Stewart pointed out the majority's apparent inconsistency with the *Lowden* decision in this respect. 94 S.Ct. at 2509 n.2. In response, the majority raised the exceptional circumstances consideration; however, there appears to be no situation in which such a consideration would operate. It might be concluded, then, that the Supreme Court has now seen fit to draw a general rule, an act the *Lowden* Court felt was unwise: "What we disclaim at the moment is a willingness to put the law into a strait-jacket by subjecting it to a pronouncement of needless generality." 298 U.S. at 166. In light of the majority's insensitivity to the different factor precedent, thus creating the conflict between section 77 and straight bankruptcy, the wisdom of providing the general rule on the absolute priority foundation is subject to serious question.

[91] Bankruptcy Act §§ 101-276, 11 U.S.C. §§ 501-676 (1970). Chapter X was enacted in 1938 as a replacement for section 77B of the Bankruptcy Act, Act of June 7, 1934, ch. 424, § 77B, 49 Stat. 912. For an extensive discussion of section 77B, see Comment, *Developments in the Law, Reorganization Under Section 77B of the Bankruptcy Act 1934-1936,* 49 HARV. L. REV. 1111 (1936). For a general analysis, see Friendly, *Some Comments on the Corporate Reorganizations Act,* 48 HARV. L. REV. 39 (1934). The procedures of Chapter X, though more detailed, are similar to those of section 77 which are outlined at note 8 *supra.* One major exception is the substitution

77, Chapter X requires that the reorganization plan be "fair and equitable."[92] Chapter X also provides for the exclusion of rights secured under Chapters I through VII of the Bankruptcy Act when those rights are inconsistent with the provisions of Chapter X.[93] Due to the simultaneous development of section 77 and section 77B, the predecessor of Chapter X, the utilization of precedent under one as controlling under the other has been common practice.[94] Assuming a continuation of this practice, there is no reason why the fair and equitable criteria of Chapter X will not be utilized to deny setoffs against debtors in Chapter X reorganizations under the *Baker* rationale. As in the early railroad reorganization cases, the absolute priority rule has been assimilated with the fair and equitable requirement in corporate reorganizations.[95] It also has been held to apply specifically to Chapter X's requirement that reorganization plans be fair and equitable.[96] Thus, a trustee of a corporation in reorganization under

---

of the Securities and Exchange Commission in the role of the Interstate Commerce Commission. For discussion of the role of the Securities and Exchange Commission in Chaper X reorganization, see Frank, *Epithetical Jurisprudence and The Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U.L.Q. REV. 317 (1941). For discussion of the major features and the operation of Chapter X, see Billyou, *A Decade of Corporate Reorganization Under Chapter X*, 49 COLUM. L. REV. 456 (1949); Doub, *Corporate Reorganizations Under Chapter X of the National Bankruptcy Act*, 3 MD. L. REV. 1 (1938); Gerdes, *Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act*, 52 HARV. L. REV. 1 (1938); Heebe, *Corporate Reorganization Under Chapter X of the Bankruptcy Act*, 16 LOYOLA L. REV. 27 (1970).

[92] Bankruptcy Act § 221, 11 U.S.C. § 621 (1970).

[93] Bankruptcy Act § 102, 11 U.S.C. § 502 (1970).

[94] Bankruptcy Act § 77, 11 U.S.C. § 205 (1970) was enacted in 1933. Act of March 3, 1933, 47 Stat. 1467, 1474, ch. 204. Chapter X was originally enacted as § 77B in 1934. Act of June 7, 1934, 48 Stat. 911, ch. 424. A particular example to the interchangeable precedent practice is shown in the courts' adoption of the different factor precedent established in *Lowden* as controlling in setoff cases involving Chapter X debtors. The two most frequently cited cases on the allowance of setoff against Chapter X debtors, Susquehanna Chem. Corp. v. Producers Bank & Trust Co., 174 F.2d 783 (3d Cir. 1949), and *In re* American Coils Co., 74 F. Supp. 723 (D.N.J. 1947), include direct reference to *Lowden*. In addition, the rationale utilized to deny setoff in both cases, that it would impede the rehabilitative purpose of Chapter X, is derived from *Lowden*. The foundation for that rationale was the cash need test used by railroad reorganization courts in the decisions cited at note 9 *supra*. Both *Susquehanna* and *American Coils* preceded those cases in their adoption of this test. Susquehanna Chem. Corp. v. Producers Bank and Trust Co., 174 F.2d 783, 787-88 (3d Cir. 1949); *In re* American Coils Co., 74 F. Supp. 723, 725-26 (D.N.J. 1947).

[95] Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

[96] Marine Harbor Properties, Inc. v. Manufacturers Trust Co., 317 U.S. 78, 86 (1942).

Chaper X, utilizing the *Baker* precedent, need only show that a setoff will create a discriminatory preference contravening Chapter X's absolute priority requirement in order to secure a denial of that setoff. A court's recognition that most setoffs will contravene the absolute priority rule can only lead to the establishment of a general rule preventing the application of section 68 to Chapter X debtors.

Only one distinction may be drawn between the probable effect of the general rule in section 77 proceedings and its effect in reorganizations under Chapter X. Except where a corporation in a Chapter X proceeding serves a dominant public interest, the equitable consideration attached to this interest in railroad reorganizations will be excluded. Although the formulation of the *Baker* rule was not dependent on the existence of this interest, the future application of the rule in section 77 will protect the public.[97] The exclusion of the public interest as an equitable consideration in Chapter X, may thus aid a creditor in establishing an exceptional circumstance. Until the courts offer some guidelines as to what constitutes an exceptional circumstance, however, it should be concluded that the rule in *Baker* will apply with equal force to Chapter X reorganizations.

It should be noted, however, that the general rule promulgated in *Baker* may be obviated by the passage of the Proposed Bankruptcy Act of 1973.[98] The Proposed Act was submitted to Congress in July of 1973 by the Commission on the Bankruptcy Laws of the United States. It contains provision for new chapters governing railroad and corporate reorganizations. One significant change in the proposed laws is the addition of a provision dealing with reorganization setoffs.

---

[97] The exclusion of setoffs protects against diminution of the debtor's operating capital, thus aiding the trustees in their effort to continue providing transportation services.

[98] The Proposed Act was drafted by the Commission on the Bankruptcy Laws of the United States and filed with the Commission's Notes as the REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES (pts. I & II) on July 30, 1973. The Commission's proposals have been introduced in the Senate and the House. *See* Bankruptcy Act of 1973, S. 2565, 93d Cong., 1st Sess. (1973); H.R. 10792, 93d Cong., 1st Sess. (1973). The Proposed Act and Notes on each section are contained in II REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES. Hearings were held before the House Committee on the Judiciary on December 10, 1973. *See* 2 CCH CONGRESSIONAL INDEX 5093 (1973-74). The Proposed Act is still under consideration by that Committee.

For discussion of reorganization proceedings under the Proposed Act, see Trost, *Corporate Reorganization Under Chapter VII of the "Bankruptcy Act of 1973": Another View*, 48 AM. BANKR. L.J. 111 (1974); Weintraub and Levin, *Chapter VII (Reorganizations) As Proposed By the Bankruptcy Commission: The Widening Gap Between Theory and Reality*, 47 AM BANKR. L.J. 323 (1973).

Section 7-204 of the Proposed Act provides for an automatic stay of all setoffs against reorganization debtors upon the filing of a petition for reorganization.[99] If this provision is passed in current proposed form, the preclusion of setoffs now guaranteed by the *Baker* rule will be procured under bankruptcy legislation.[100] If section 7-204 is omitted, however, it appears that the *Baker* rule will extend into reorganization proceedings under the Proposed Act.

In drafting the Proposed Act, the Commission suggested a substantial modification of the fair and equitable requirement for reorganization plans. It appears, however, that this modification will not affect the actual order of priority required for the distribution of

---

[99] II REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES 237-38. Section 7-204 provides:

> Stay of Setoff and Use of Property Subject to Right of Setoff.
>
> (a) A petition filed by or against a debtor eligible for relief under this chapter shall operate as a stay of the setoff of any obligation to the debtor against any claim owing by the debtor until the stay is terminated by the bankruptcy court, or the case is dismissed or converted to one under Chapter V or Chapter VI, but such stay shall not affect the right of the creditor to withhold payment to or on the order of the debtor, except when otherwise ordered pursuant to subdivision (c).
>
> (b) Pursuant to the Rules of Bankruptcy Procedure and section 4-501(b) and (c), a creditor may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions as will adequately protect the creditor. The trustee or debtor shall have the burden of proving that the person asserting the right of setoff is adequately protected.
>
> (c) The court may order the person asserting the right of setoff to pay to the trustee or to the debtor if a trustee has not been appointed, the amount of the obligation sought to be offset if the stay is not terminated pursuant to subdivision (b). However, the court shall require as a condition of the order that the trustee or debtor furnish such protection as will adequately protect the person who is asserting the right of setoff. The turstee or the debtor shall have the burden of proving that the person asserting the right of setoff is adequately protected.

Id.

Section 7-204 is applicable to railroad reorganization under section 9-101 of the Proposed Act. II REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES 273.

[100] The passage of proposed section 7-204 will also relieve the conflict between reorganization and straight bankruptcy created by the *Baker* decision. That conflict is grounded in the *Baker* Court's inattentiveness to the *Lowden* precedent and the express provisions for setoff in the Bankruptcy Act. Legislative amendment providing for a stay of all reorganization setoffs will dissolve the conflict by statutorily countering the provisions for setoff in straight bankruptcy.

securities under a reorganization plan. Section 7-310(d)(2)(B) of the Proposed Act provides in part that the court shall confirm a plan if

> there is a reasonable basis for the valuation on which the plan is based and the plan is fair and equitable in that there is a reasonable probability that the securities issued and other consideration distributed under the plan will fully compensate the respective classes of creditors and equity security holders of the debtor for their respective interests in the debtor or his property.[101]

This language seems to indicate that the only change intended is a relaxation of the former standard for confirmation requiring exact compensation for the claims surrendered by the creditors. Such an interpretation is supported by the Commission's Notes, which state that the provision is not intended to alter the absolute priority requirement that securities be allocated to higher priority creditors before junior interests are allowed to participate.[102] They indicate, instead, that the modification is intended only to provide for easier affirmation of a plan due to the switch to the "reasonable probability" requirement.[103] Since *Baker* is premised upon the absolute priority requirement, and given the unaltered order of priority under the Proposed act, it should be concluded that if the new chapter is passed with the omission of section 7-204 and the inclusion of section 7-310(d)(2)(B), the *Baker* rule will probably be extended to protect debtors in reorganization under it.

Conclusion

In light of the possible impact of the Supreme Court's decision in *Baker,* it may be advanced that the majority paid too little attention to the different factor precedent established in *Lowden* and subsequent decisions. The Court's utilization of the absolute priority rule will probably effect a total preclusion of setoffs in all reorganization proceedings, thus frustrating traditional business expectations and precipitating uneconomical precautions on the part of creditors.[104]

---

[101] II REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES 252. The requirements for confirmation of a reorganization plan outlined in section 7-310(d) are applicable to railroad reorganization under section 9-503(d) of the Proposed Act. II REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES 288.

[102] II REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, 254 n.9.

[103] *Id.* at 254-55 n.9.

[104] *See* note 6 and accompanying text *supra.*

Moreover, the implementation of the rule appears to create a conflict between straight bankruptcy and reorganization. On the other hand, it may be suggested that the result is desirable in light of the rehabilitative purpose of section 77 and the public interest in railroad survival. The preclusion of setoffs, regardless of the underlying rationale therefore, protects the debtor's operating capital from depletion, thus helping to preserve an ongoing railroad. These interests, however, were adequately protected under the traditional cash need test. Indeed, it appears that this test, with minor modification, could have produced the same result in *Baker*.

The amount of the setoff in *Baker* was relatively small, but the Court could have concentrated on an aggregated amount of all possible setoffs against the Penn Central. In any case, this approach should provide a figure sufficient to preclude the application of section 68 under the cash need test.[105] A minor problem would have developed, however, since most of the possible setoffs against the Penn Central had previously been denied by the reorganization court. Having no account of the remaining amount that might be setoff, the Court would have had difficulty justifying a denial under the altered test. It might, however, have emphasized those reorganization court cases which had denied setoff, and established a case of unique unfairness. Given the equitable nature of setoff,[106] the Court could easily have concluded that it would be unfair to allow Gold Seal a setoff when such action had previously been denied other creditors.[107]

If the Court had adopted this approach and had desired to proceed further, it might have authorized an aggregated amount cash need test and expressly approved a reorganization court's power to enjoin setoffs as suggested in Justice Stewart's concurring opinion. The

[105] The aggregated amount approach contemplates the addition of all setoffs that might be effected against a corporation in reorganization. The sum of these possible setoffs should, in most cases, provide a figure, the amount of which if setoff, would severely diminish the operating capital of a corporation and thus threaten its chance of rehabilitation. The principle beyind this approach is that it would be unfair to allow setoff to some creditors at a time when a debtor could afford it, and at another time to deny setoff to other creditors because the debtor's operating capital would be severely diminished. Thus, the utilization of an aggregated amount approach in applying the cash need test would provide uniformity throughout reorganization, and avoid the discrimination opposed by the majority without raising a conflict between straight bankruptcy and reorganization.

[106] *See* text accompanying note 7 *supra*.

[107] Such a holding would have been consistent with the equitable determination suggested by the Supreme Court in *Lowden*. *See* text accompanying notes 52, 57 *supra*.

In addition, this rationale was utilized in conjunction with the cash need test as a basis for denying the setoffs sought in *In re* Penn Central Transp. Co., 339 F. Supp. 603, 608 (E.D. Pa. 1972).

combination of these two concepts would grant a reorganization court the power, at the time a petition for reorganization was approved, to evaluate the circumstances surrounding setoff and decide whether section 68 would be applicable within the reorganization process. Such a procedure would be consistent with the different factor precedent, the test being founded in a purpose peculiar to section 77, and although in most cases setoff would not be allowed the absolute effect of the *Baker* decision would be avoided.

In light of the alternative means for decision, it appears that the majority's utilization of the absolute priority rule as a basis for the application of the inconsistency rationale may have been unwise. Although the general rule pronounced in *Baker* may have a beneficial effect in its protection of the rehabilitative purpose of section 77 and the public interest in railroad survival, these interests were adequately protected under the cash need test. Furthermore, the utilization of the absolute priority rule departs unjustifiably from the different factor precedent long observed by courts applying the inconsistency rationale. Although it may be argued that the general rule protects valid section 77 interests and establishes a uniformity long overdue in railroad reorganization, the rationale of the *Baker* decision disregards long established precedent, and in so doing, creates what appears to be an unnecessary conflict between straight bankruptcy and reorganization.

CHARLES LYNCH CHRISTIAN, III