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PREFERENCES OF PRERECEIVERSHIP CLAIMS IN EQUITY RECEIVERSHIPS†

By Jefferson B. Fordham*

I

One of the most interesting phases of American legal history of the decade of the 1870s was the rapid development of the law governing receiverships.1 A number of factors including the great financial crisis of the period, overexpansion and corruption led to numerous railroad receiverships. The courts were confronted with a complex problem in the foreclosure of railroad mortgages for the solution of which, as they soon realized, the rules governing ordinary foreclosures were not adequate. The public interest in the continued operation of railroads was commanding. Moreover it was clear that there was scant, if any, market for a railroad system as a whole and to disintegrate a system or line for purposes of foreclosure sale would obviously render it much less valuable to the securityholders.

With the crystallization of the conviction that a railroad must be kept a "going concern" there came a realization of the importance of providing for the expense thereof as well for the period

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just prior to receivership as during receivership. Since railroad mortgages almost universally embrace income the only way to give operating expenses a favored position was effectually to displace pre-existing contract liens to the extent of such expenses. The judicial solution of the problem was the rule now commonly termed the "six months" rule.

Though first enunciated by the Supreme Court in 1879 in the case of *Fosdick v. Schall* the general idea upon which the rule was grounded had already undergone some development in lower federal and in state courts. Instances were not uncommon of the preferential payment of prereceivership operating expenses with the concurrence of the bondholders. Probably the most influential figure in the development of the rule was Circuit Justice Thomas Drummond of the seventh circuit. Though at first committed to the belief that a railroad mortgage is the same as an ordinary real property mortgage his experience with railroad receiverships brought about a change in his views. It is said that the order made by him and his associate, District Judge Gresham, appointing a receivership for the Louisville, New Albany and Chicago Railroad Company in 1870 was the first order ever made in a contested suit which directed preferential payment of prereceivership operating expenses.

In 1878 in the case of *Turner v. Indianapolis, B. and W. Railway Company* Judge Drummond undertook to state the reasons for this "practise," as it had by that time come to be in the seventh circuit. He pointed out that a railroad is a matter of public concern and that the "public as well as private interests require its continual operation." He expressed the conviction that it would be well-nigh impossible as a practical matter to continue the operation of a railroad in receivership without making some allowance for accrued operating expenses. This, he thought, might properly be done by making such payment a condition upon which the appointment of receivers would be granted or by a subsequent order made upon

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3See, for example, Gurney v. Atlantic and Great Western Ry. Co., (1874) 58 N. Y. 354.
4Gresham, Life of Walter Quinton Gresham 372.
5Gresham, Life of Walter Quinton Gresham 370, 371. Mrs. Gresham records that as early as 1859 in appointing a receiver in the Chicago and Alton receivership Judge Drummond had directed payment of certain accrued operating expenses but with the consent of the bondholders.
the theory that the condition was implied at the outset.

In an earlier Kentucky case in which preferential payment of prereceivership wage claims was upheld the mortgage did not cover income and by Kentucky law the mortgagee had no legal right to possession after default. So the court declared that the claim of the mortgagee to priority as to receivership income was based at best upon an equitable right addressed to the discretion of the court and the court in the exercise of its discretion might attach reasonable conditions to the enjoyment of the right. Here the services and materials of labor and supply claimants had contributed to the preservation of the property for the bondholders and the public. Moreover, it was desirable to “allay the discontent” of the workers. It was concluded, therefore, that preferential payment of their claims might reasonably be required.

In the same year, 1876, the circuit court of the city of Richmond, Virginia, contributed a very interesting bit of theory to support a preference for wage claims antedating a railroad receivership. These claims had accrued largely after the mortgagor had defaulted. The court took the position that since the mortgagees had failed to act upon default they might properly be taken by the railroad employees to be holding out the company's officers as their agents for the preservation of the property. Accordingly, it was held that the mortgagees were estopped to deny the authority of the company officers as their agents to incur liability for wages. The suggestion that one must exercise his security at once upon default could not but have been startling at the time of this decision. Today, of course, nothing is startling.

With the opinion of the Supreme Court in Fosdick v. Schall the six months rule took more positive form. Schall had furnished a railroad company certain cars under an agreement by which he reserved title till full payment, which was to be made in installments. There was a default in the payments over six months before the company went into receivership in mortgage foreclosure. These cars were not included in the foreclosure sale but were later

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7 Douglas v. Cline, (1876) 12 Bush. (Ky.) 608.
8 There was a notion lurking in the views of the court that it was a case of "he who seeks equity may be required to do equity." But, as pointed out by Mr. Justice Cofer in dissenting, this maxim applies only as between the immediate parties and not in favor of third parties such as wage claimants in these cases.
ordered restored to Schall. The court below further ordered the receiver to pay Schall a certain amount out of funds in court as rental for the cars for the six months prior to the receivership. To the extent of this last order the decree was reversed on appeal since the cars were held under a conditional sale agreement without stipulation for the payment of rent. It will be observed that Schall retained title to the cars to secure himself and did not look to current income for payment.

But in his opinion in the cause Mr. Chief Justice Waite proceeded to lay down a rule of preference for prereceivership operating expenses in railroad cases. 1. In view of the peculiar public nature of a railroad a court of equity might in its discretion with reference to the appointment of receivers attach as a condition to the granting of a receivership an order that existing debts for labor, or supplies or permanent improvements be paid out of the income of the receivership. 2. Even in the absence of this condition earnings diverted from the payment of these debts to the benefit of the bondholders might be restored from the income of the receivership. 3. And if receivership income, which was subject to the preference, was diverted to the benefit of the bondholders, the corpus of the property was answerable.

To justify this result it was said that a railroad mortgagee impliedly agrees when he takes his security that it shall not apply to gross income but only to net income after satisfaction of current operating expenses. This happy thought by assuming an important fact afforded some theoretical basis for the desired result and offers to students of legal history another instance of the development of law through the use of fictions.10

Despite the exceptional character of this rule of preference,11 its application eventuates in preferring a major part of the unse-

10One recalls the famous statement of Sir Henry Sumner Maine, "there are three agencies by which law is brought into harmony with society—Legal Fiction, Equity, and Legislation." Ancient Law, Introduction, p. xvii.

11As a general proposition it is not questioned that the appointment of a receiver does not affect existing legal priorities. As was said by Mr. Justice Holmes in Wm. Filene's Sons v. Weed, (1918) 245 U. S. 597, 38 Sup. Ct. 211, 62 L. Ed. 497, which case involved a consent receivership under a creditor's bill, "When the courts without statute take possession of all the assets of a corporation under a bill like the present and so make it impossible to collect debts except from the court's hands, they have no warrant for excluding creditors, or for introducing supposed equities other than those determined by the contracts that the debtor was content to make and the creditors to accept."
cured indebtedness, to the extent of the income, of a railroad. There are frequently no large unsecured debts or aggregate of them over and above operating expenses.

II

Three principal theories have been developed in support of the type of preference under discussion. The theory of *Fosdick v. Schall* as molded in subsequent decisions has become known as the "net income" theory.

Briefly the Supreme Court has modified its views as expressed in the *Fosdick Case* as follows: In *Burnham v. Bowen* it was decided that it was not necessary to the preference as against income that there be a condition upon the appointment of the receiver to that effect or that there be a diversion of income before the receivership in order to subject receivership income to the preference. In the decade following the *Fosdick Case* the lower federal tribunals had become disposed to apply the rule to unsecured claims generally by conditioning the appointment of receivers upon their preferential payment. In *Kneeland v. American Loan and Trust Company* the Supreme Court condemned this tendency unsparingly, declaring that payment of only those claims entitled to preference under the six months rule as laid down by that Court might be made a condition to the appointment of a receiver. In subsequent decisions it has been held that the rule applies only to necessary operating expenses and thus not to claims for permanent improvements. It was expanded to allow preference against corpus in the event of diversion of income to the benefit of bondholders whether the diversion took place during receivership or a limited period prior thereto, but under the net income theory no preference against corpus would ever be recognized in the absence of diversion of income, which was subject to the preference, to

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12(1883) 111 U. S. 776, 4 Sup. Ct. 675, 28 L. Ed. 596. In this case a claim was presented for coal supplied a railroad during the year preceding receivership. The company's failure to pay the debt before the receivership was due to the fact that the expense of operating the road and preserving the security was greater than the income. The court below applied the income of the receivership to permanent improvements. This was held to be such a diversion as to entitle "creditors of the income" to preference against corpus.

13(1889) 136 U. S. 89, 10 Sup. Ct. 950, 34 L. Ed. 397.

the benefit of bondholders. As thus developed the import of the net income theory is this:

1. All necessary operating and maintenance expenses of a public service company are entitled to preferential payment out of current gross income.

2. In the event of a receivership the preference will be allowed claims of this class which arose within a short period before the receivership:
   a. The claims must be for necessary operating and maintenance expenses.
   b. The claims must have arisen within a limited time before the receivership; six months is set as a working but not inflexible limit.
   c. There must have been an expectation of payment out of current income.

3. The preference extends both to the income of the six months' period and that of the receivership.

4. The preference extends to corpus only when there has been a diversion of income, which was subject to the preference, to the benefit of the bondholders, and then only to the extent of the diversion.

In the second place there is the so-called "necessity of payment" theory under which if the payment of certain classes of pre-existing debts is necessary to the continued operation of such a property as a railroad in receivership the court may order preferential payment thereof even out of corpus, if income is inadequate, without respect to any diversion of income. It was written into the law by the Supreme Court in the case of Miltenberger v. Logansport Railway Company. There the receiver had sought authority to pay claims for traffic balances incurred in part before the receivership on the plea that payment was indispensable to the business of the road. The Supreme Court approved the granting of the requested authority, declaring:

"Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes, out of the earnings of the receivership, or even the corpus of the property, under the order of the court with a priority of lien."

In its latest utterance upon the question the Supreme Court after denying the application of the net income theory to corpus in the absence of a showing of diversion of income to the benefit of the bondholders distinguished the Logansport Case on the ground that there the preference against corpus was allowed not simply because the claim was based upon necessary operating expenses but because it was necessary to the business of the road that the claims be paid.

The third theory has been termed the “going concern” theory. In Gregg v. Metropolitan Trust Company, the case last cited, three justices dissented in an opinion which embodied the going concern theory. It is the sense of this theory that expenses necessary to keep a railroad a going concern are entitled to preference against corpus if the income is inadequate to satisfy them and this whether there have been diversions of income or not. The dissenters maintained that:

“a railroad from its nature and public responsibilities must be kept a going concern. This is the supreme necessity and affords the test of the equity invoked for the claim. It cannot depend upon diversion of income or upon the existence of income.”

III

A consideration of the cases may be stretched, for convenience, upon the framework of the net income theory. It is the dominant theory.

1. What are necessary operating and maintenance expenses? There has never been any doubt that wages of employees are necessary operating expenses. Obviously without operatives a business

10In United States v. Guaranty Trust Co., (1930) 280 U. S. 478, 50 Sup. Ct. 212 the rule had been applied by the court below in granting certain claims preference over a debt due the federal government but the Supreme Court found it unnecessary to consider it in affirming the decision.


18Mr. Justice Harlan and Mr. Justice White concurred in the dissenting opinion of Mr. Justice McKenna.

19An interesting commentary upon the basis of the preference in favor of wage claims appears in Finance Co. of Pennsylvania v. Charleston, C. and C. R. Co., (C.C.S.C. 1892) 49 Fed. 693. District Judge Simonton declared that the usual order in the appointment of a receiver requiring payment of pre-existing wage claims for the six months period before the receivership was not based upon an equity in wage claimants but “It is a personal protection given to them by the court ex gratia, moved thereto by the fact that this class depend upon their
cannot be carried on. But there has been some question as to who were operatives within the sense of the rule. It would seem that any employee, whether of managerial rank or a day laborer, who had contributed to the continued operation or preservation of the business and property, should be entitled to the preference, assuming that the other requirements of the rule were satisfied. But it has been held that the rule does not apply in favor of the president of the insolvent company since he was in a position to know the condition of his railroad and was not bound to furnish his services a day after his compensation seemed uncertain. This reasoning is aside from the point. His knowledge of the bad financial condition of his company is likely to impel an executive officer to exert himself abnormally to the end that the business may be saved. If he continues to serve in a time of stress and assists in preserving the mortgage security he should not be ousted from preferential rank because he knew of the company’s condition. The more compelling reasoning supporting a denial of preference to managerial officers is that they are responsible for the bad condition of business.

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Thus in Louisville, Evansville and St. Louis R. v. Wilson, (1891) 138 U. S. 501, 11 Sup. Ct. 405, 34 L. Ed. 1023, the Supreme Court, though finding that a lawyer who had been retained for a special purpose and not as general counsel did not come within a general order preferring “wages of employees,” held that he was entitled to preference to the value of his services which enured to the benefit of the security-holders. The court declined to follow a contrary holding on the first point by the New York court of appeals in Gurney v. Atlantic and G. W. R. Co., (1874) 58 N. Y. 354. An order upon the appointment of a receiver requiring payment from income of all wages due employees for services within ninety days before the same does apply to the claim of counsel who is retained under a regular salary. Finance Co. of Pennsylvania v. Charleston, C. and C. Ry. Co., (C.C.S.C. 1892) 52 Fed. 526.


tion of the business. If that is the fact, preference may well be denied.

Claims for original or new construction are deemed not to come within the rule. Permanent improvements are treated likewise. In Southern Railway Company v. Carnegie Steel Company preference was sought for a claim for steel rails furnished for use on a 3,320 mile railway system. The claim plus interest aggregated over $150,000. The rails were supplied under two contracts made six weeks apart, the first covering about 2,800 tons and the second 1,656 tons of rails. It appeared that there was urgent need for these rails to render the road safe for passengers and freight. The Supreme Court held the claim to be one for operating expenses within the rule.

In Lackawanna Iron and Coal Company v. Farmers' Loan and Trust Company, decided by the Supreme Court upon the same day as the Carnegie Case, a claim for steel rails was held to be one for reconstruction and not an operating expense. There a road with a mileage of over 500 miles had by two contracts made four months apart bought 5,020 and 5,009 tons of rails respectively. The claim totalled nearly $450,000. The need for these new rails was described by the special master who reported upon the claim as "imperative." The court declared this claim to be one for construction and not for repairs. So it was said that "sound principle forbids that a court of equity should imply an agreement upon the part of mortgage creditors to subordinate their claims to such debts as those due to the Lackawanna Company."

From these decisions it appears that the difference between repairs and reconstruction is simply one of degree. What might be repairs on a large line would probably be deemed reconstruction upon a small one. So far as the interest of the public (and that of the security holders in most cases) is concerned the

26(1900) 176 U. S. 257, 20 Sup. Ct. 347, 44 L. Ed. 458
outlay is necessary in either case. But assuming the validity of the "operating expenses" thesis this sort of distinction properly follows, of course.

In the lower federal courts the distinction has been applied rather strictly to claims for equipment. Thus a claim for thirty-three ballast cars against a railroad with one hundred sixty-eight miles of line has been held not to be an operating expense. On the other hand, incidental additions to equipment and repairs to existing equipment are considered current operating expenses.

Supplies and materials within the meaning of the rule contemplate anything consumed or built into the property itself, as is the case with materials furnished for repairs, as necessary to the ordinary operation of the business and the preservation of its property. Fuel and power are the commonest examples of these operating necessities in railroad cases.

Traffic balances have been held for the most part to come within the rule. A very compelling consideration here is the good sense of keeping the good will of connecting lines. But

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28 Rodger Ballast Car Co. v. Omaha, K. C. and E. R. Co., (C.C.A. 8th Cir. 1907) 145 Fed. 629. In Manchester Locomotive Works v. Truesdale, (1890) 44 Minn. 115, 46 N. W. 301, 9 L. R. A. 140 the purchase of a locomotive was held to be one for permanent equipment and the seller was denied preference. See also Crane Co. v. Fidelity Trust Co., (C.C.A. 9th Cir. 1916) 238 Fed. 693.


32 In the fourth circuit a claim for digging a canal which was necessary to afford water power which would enable a light and power company to provide light for a city though treated upon the company's books a construction account was held to be a necessary expense within the rule. Virginia Power Co. v. Lane Bros., (C.C.A. 4th Cir. 1909) 174 Fed. 513. In other circuits, the ninth, for example, there is little doubt but that the claim would have been deemed one for construction and denied preference. Crane C. v. Fidelity Trust Co., (C.C.A. 9th Cir. 1916) 238 Fed. 693.


34 This is the force behind the decision in Miltenberger v. Logansport, (1882) 106 U. S. 286, 1 Sup. Ct. 140, 27 L. Ed. 117, in which the necessity of payment theory was born. But the application of this theory in favor of traffic balances has been denied in the eighth circuit. Chicago and Alton R. Co. v. United States and Mexican Trust Co., (C.C.A. 8th Cir. 1915) 225 Fed. 940.
claims for rent of leased lines are deemed not to be necessary operating expenses.\textsuperscript{35} As a practical matter the use of a leased line may be quite necessary to the reasonably successful operation of a railroad. That may appear in a case where the leased line is the road's only direct access to a great shipping center. In the cases denying preference to claims for rent the courts have relied heavily upon the ground that in the given case the lessor did not rely upon current income for payment,\textsuperscript{36} a factor to be considered in the further course of this paper.

In \textit{Union Trust Company v. Morrison}\textsuperscript{37} it appeared that a railroad company had sought to enjoin levy by a judgment creditor upon its rolling stock. Relief was granted upon the company giving bond to pay the judgment if the injunction was dissolved. In the subsequent receivership of the company the surety upon the bond petitioned, after satisfying the judgment, for preferential payment of his claim. Preference was allowed on the theory that the surety made a bona fide effort to preserve the property after the mortgage was in arrears and after the right of the mortgagee to take possession had accrued. It is difficult to sustain this result. If preference is to be allowed here it might just as well be urged, other factors being equal, that the judgment creditor after securing his judgment on any character of claim may obtain a preference by agreeing not to sue out execution on the mortgaged property or that one who loaned the company funds with which to pay the judgment thereby obtained a preference.\textsuperscript{38}


\textsuperscript{36}In \textit{Thomas v. Western Car Co.}, (1892) 149 U. S. 95, 13 Sup. Ct. 824, 37 L. Ed. 663, where the claim was for the rental of railroad cars the court in denying preference relied in part upon the ground that the car company was not in the position of a laborer working day by day but was able to bargain for itself and must be regarded as having contracted upon the personal responsibility of the railroad company. Query: Is not the backbone of the personal credit of a railroad its earning power so that to assume from the power and standing of the claimant that it is relying upon whatever credit the company has over and above its property and earning power is hardly warranted?

\textsuperscript{37}(1888) 125 U. S. 591, 8 Sup. Ct. 1004, 31 L. Ed. 825.

\textsuperscript{38}But in Whitely v. Central Trust Co. of New York, (C.C.A. 6th
The decisions are so clearly harmonious in denying to tort claims the character of necessary operating expenses under our rule that it may seem idle to give the matter special attention. However, the justification lies in the more practical aspect of the subject. Practice, though conformable to the letter of the rule, does not effect the expected result of the application thereof.

Though there are earlier decisions to be found, the case of *St. Louis Trust Company v. Riley* is the leading authority in point. It was held that a tort claim accruing five months before receivership did not come within the rule. The court reasoned that a:

"claim for damages for the negligence of the mortgagor lacks the indispensable element of a preferential claim. It is not based upon any consideration that inures to the benefit of the mortgage security. Wages, traffic balances, and supplies produce or increase income and preserve the mortgaged property. Repairs and improvements increase the value of the security of the bondholders. But the negligence of the mortgagor neither produces an income nor enhances the value of the property."

The force of this reasoning is inescapable.

But the courts have effected preference for tort claims in two ways despite the usual rule. In the early days of the rule the courts not infrequently made preferential payment of tort claims among others a condition upon which a receivership would be granted. But these decisions now have no binding force if the *Riley* decision is correct since the Supreme Court has ruled that only such claims may be preferred by this device as are entitled to preference under the rule as necessary operating or maintenance expenses. The second way in which tort claims

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40 (C.C.A. 8th Cir. 1895) 70 Fed. 32. The Supreme Court has not passed upon the question. It stated the problem recently in *St. Louis and S. F. R. Co. v. Spiller*, (1926) 274 U. S. 304, 47 Sup. Ct. 635, 74 L. Ed. 1060 but found it unnecessary to consider it since the claim presented was several years old.

have been effectually preferred has been the allowance of preferences to sureties on appeal bonds in tort cases against the mortgagor on the theory of the Morrison Case that they save the property from probable judicial sale (subject to the mortgage) which would injure its security value. This device is of no great consequence.

The supreme court of Georgia has taken a lonely but defiant stand to assert that a judgment claim for tort is equitably entitled to a preference against income of a railroad in receivership. The opinion is pitched in tones of righteous conviction.

"Every direct authority known to us is against us. Nevertheless we are right and these authorities are all wrong as time and further judicial study of the subject will manifest. The mistake made by the courts and judges has been that they treat the problem of preferential debts as having but one pole, the affirmative pole of benefit,—ignoring the negative pole altogether."

So far as the decisions disclose the prophecy of the court has failed of realization in the thirty odd years since the decision was rendered. But in the actual conduct of receiverships, railroad receiverships in particular, the Georgia court might find much to comfort it. It is clear that the tendency is to pay tort claims out of the first money available in the hands of the receivers so long as there is no positive objection on the part of the bondholders. In fact, it is the opinion of lawyers with intimate knowledge of receivership practice that bondholders are foolish to oppose preferential payment of tort claims.

There are at least three reasons behind this practice of preferring tort claims. 1. Usually a considerable reduction in the amount of tort claims may be effected by compromising them and settling in cash. 2. Such payment is highly conducive to the preservation of the goodwill of the company. This, of course,

44(1888) 125 U. S. 591, 8 Sup. Ct. 1004, 31 L. Ed. 825.

47To give its point more illumination the court resorted to a unique graphic illustration which appears in the report of the case as reported in the Southeastern Reporter.
is the reason bondholders should not oppose the preference. 3. The burden of torts falls heavily very often upon those who are injured or their dependents and it would bear hard with them to go uncompensated. This is the "negative pole of burden" upon which the Georgia court founded its argument.

The first two of these reasons were stated by the court in an order in the Chicago, Milwaukee and St. Paul Railway Company receivership.47 By that order the receivers were authorized to compromise and settle by cash payments out of available funds in their hands all sorts of tort claims arising out of the pre-receivership use and operation of the road. The payment was to be made insofar as it would "in the judgment of the receivers result in a substantial saving to the property in receivership and in preserving the good will of the railroad." Similar payments have been authorized and made in other important receiverships. In the "Frisco" receivership Judge Sanborn authorized payment by the receivers of a judgment for personal injuries obtained by an employee seven years before the receivership.48 And in the Chicago and Alton receivership the receivers were authorized to pay loss and damage and overcharge claims, which arose before the receivership, on their petition setting out that the claimants had threatened to divert all their traffic from the lines of the petitioners if not paid.49 Here we have the "necessity of payment" theory used to support a preference for tort and quasi-contractual claims.

It is not uncommon to provide for tort claims in a reorganization plan where payment has not been effected in receivership. Where tort claimants are numerous as in the New York City Railway receivership involving seven street railways, committees are appointed to act in behalf of tort claimants and protect their interests in the receivership and reorganization.50 In the Brook-

47 Receivership Record, vol. 6, pp. 4307, 4308.
49 Texas Co. v. Chicago and Alton R. Co. Receivership Record, vol. 4, p. 2039 et seq. Overcharge claims of Armour and Company and others were paid upon the same ground. Receivership Record, vol. 4, pp. 2178-2185. This receivership affords examples of uncontested payments of personal injury claims of employees. See Receivership Record, Orders of June 2 and 15, 1925.
50 The two tort creditors committees in this reorganization vigorously sought to have tort claims classified as current operating expenses within the six months rule but without avail. In Pennsylvania Steel Co. v. New York City Ry. Co., (C.C.N.Y. 1908) 165 Fed. 457 Judge Lacombe ruled that tort claims ranked with general unsecured claims.
lyn Rapid Transit Company Reorganization Plan the offer to
tort claimants was payment in cash to an amount equal to the
principal of the claims without interest. Even in the reorga-
nization of industrial corporations tort claimants are entitled to
consideration. In the Wilson and Company reorganization plan
an offer was made to tort creditors that the new company assume
obligations of their claims.

If the assets of the old company exceed the amount of secured
claims the court may influence the course of events by refusing
to approve the reorganization plan unless some provision be
made therein for tort claims.

By statute in some states tort claims are given a preference in
the event of a receivership. A particular analysis of these statutes
would not be profitable here. As a general observation it may
be said that they create preferences against general assets without
respect to the limitations of the net income theory. In some
instances tort claims are given priority over prior mortgage liens,
but remain inferior thereto under the statutes of other states. Some
of these state statutes apply only to railroad companies while
others apply to corporations generally.

2. What facts evidence a reliance upon current income for
payment? Seldom is there an express reliance upon current in-
come for payment, but circumstances may well be sufficient to

There were later rulings during the long life of this receivership to the
same effect. See (C.C.A. 2d Cir. 1914) 216 Fed. 458. But there were
large uncontested payments to tort creditors; thus an order of May 19,
1924 directed the payment of $273,166.38 to tort creditors of the
Brooklyn Heights R. Co., one of the seven street railway companies
involved. In this receivership the reorganization plan provided for the
issuance of first mortgage bonds to tort creditors in refunding their
claims.

53Receivership Record, vol. 8, pp. 279, 280.
54North Carolina, Code 1927 (Michie), sec. 1140; Trust Co. of
442, 30 L. R. A. 823; Guardian Trust Co. v. Fisher, (1905) 200 U. S.
57, 26 Sup. Ct. 180, 50 L. Ed. 367.
55Michigan, Comp. Laws 1915, sec. 8340; Marshall v. Wabash R.
56See the Michigan Statute, Michigan, Comp. Laws 1915, sec. 8340.
57The North Carolina statute is an example, North Carolina, Code
1927, Michie, sec. 1140.
58The case of Citizens' Trust Co. v. National Equipment and
affords an example of supplies being furnished upon an express agree-
ment for payment out of income. There a light and water company
which had no credit obtained fuel and materials for repairs from
claimant by promising repayment out of earnings when necessary re-
show such a reliance to the satisfaction of the courts. With respect to wage claims apparently no question is ever raised upon this score though one would hardly suppose that workers ever think of the matter further than to place a general reliance upon the company for payment. No specific reliance should be required.

In one case it was agreed in the purchase of coal for a railroad that payment was to be made for coal delivered in any one month "about the first of the succeeding month." The Supreme Court held that there was a reliance upon current income. However, an agreement stipulating for payment upon delivery evidences no intention to rely upon the current income toward the production of which the thing furnished is to contribute. The fact that short term notes are given for current operating expenses does not show non-reliance upon current income, according to the decisions, but simply that the creditor preferred to have commercial paper which it could use rather than have the claim stand upon open account. And renewal of such notes does not defeat the equity.

In at least one case the Supreme Court has laid stress upon the economic position of the claimant. The claimant car company in Thomas v. Western Car Company had reserved the power to end the lease and demand possession of the cars in the event the railroad company, lessee, defaulted as to principal or interest of its bonded and other obligations. The car company was deemed to have relied upon the "responsibility of the railroad company and not the interposition of a court of equity."

"The case of a corporation for the manufacture and sale of cars, dealing with a railroad company, whose road is subject to a mortgage securing outstanding bonds, is very different from that of workmen and employees, or of those who furnish, from day to day, supplies necessary for the maintenance of the railroad."

pairs and extensions had been completed. Preference was allowed though the claim more than six months antedated the receivership since payment was expressly postponed by the parties until the company was in shape to continue operations.


Manchester Locomotive Works v. Truesdale, (1890) 44 Minn. 115, 46 N. W. 301, 9 L. R. A. 140.


(1892) 149 U. S. 95, 13 Sup. Ct. 824, 37 L. Ed. 663.
Granting that the business character of the claimant is a fact of importance to be considered in ascertaining what was looked to for payment it hardly seems warranted to treat reliance upon current income and reliance upon "the interposition of a court of equity" as one and the same. True, it is unessential here to distinguish between primary and remedial rights but the innuendo of the quoted phrase is that the remedy is a purely discretionary matter with a court of equity. However, the force of the court's reasoning lies in the difference in the bargaining power of a great manufacturing company and a lone laborer. Imagine a laborer demanding security for payment of his wages!

If a creditor has taken security as by reserving title to equipment furnished till full payment or in the form of collateral securities the inference is that he did not rely upon current income for payment. But it is here that the requirement that reliance be placed upon current income for payment breaks down. In the Morrison Case the Supreme Court upheld a preference in favor of one who had acted as surety upon an injunction bond given in a proceeding to enjoin levy by a judgment creditor upon rolling stock of a railroad although the surety had taken chattel mortgages on locomotives as security. The ruling was made on the ground that the case was a special one based not upon operating expenses but upon a bona fide effort to preserve the mortgaged property. The court observed that the taking of the chattel mortgage indicated a reliance upon the company's property as well as its personal responsibility. Thus the requirement of reliance upon current income is flexible, to say the least. Creditors rely upon any and all security available and it could never be said with assurance that one did or did not rely upon current income alone in the absence of express agreement. The stronger reason for abandoning the requirement is that it is not a test of the equity of the rule.

3. The period in which a claim must have accrued to come within the rule. It was early settled that there is, literally speaking, no "six months" rule. Prior to Fosdick v. Schall federal courts in the seventh circuit in fixing a time limit followed the analogy of the Illinois statute governing liens upon railroads for

64(1888) 125 U. S. 591, 8 Sup. Ct. 1004, 31 L. Ed. 825.
The practice developed of directing preferential payment of prereceivership operating expenses arising within six months of the receivership in the order appointing receivers. This was done as a matter of administrative convenience rather than as settling the point as a matter of law. And the Supreme Court has offered no more definite test of the age requirement than that each case must rest upon its special facts. It did approve the view expressed by Judge Brewer in *Blair v. St. Louis, H. and K. R. Company* that the time limit should be only "such reasonable time as, in the nature of things and in the ordinary course of business, would be sufficient to have such claims settled and paid." But this test bears no definite relation to the basis of preference, which is that the claim is for an expense necessary to the continued operation of the business or the preservation of the property. And thus it has been urged that the time limit in each case should be coterminous with the period for which the labor or supplies, and the like, continued to contribute to the production of income. If that were the rule any claim not barred by limitations which was based upon something, such as new wheels for a locomotive, which continued into the period of the receivership to contribute to the production of income would be entitled to preference. Moreover, suppose labor or supplies necessary for current operation were wasted. There would be no contribution to the production of current income and thus no ground for preference under the strict logic of the net income theory. If that theory is to be applied the last-mentioned test would not be helpful because it is impracticable. In most instances it would be impossible to measure what effect, if any, certain supplies, for instance, had upon income. The test does not cover the case of claims for preserving the property.

It has recently been held in the eighth circuit that claims antedating a receivership more than six months will be given preference under the rule only if there are special circumstances to justify overstepping the six months limit. A claim for minor

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steel products used in keeping a railroad in repair and shipped under a number of invoices calling for payment within thirty days was held in this case to present no such qualifications for preference.\textsuperscript{69} Probably this rather indefinite rule is as far as the courts should go in analyzing a particular claim with respect to its age.\textsuperscript{70} If in a given case it should be shown that a claim for which preference was sought was based upon nothing of value in producing income or protecting the security the court would be compelled to decide whether it was enough that the claim was one for a normal operating expense or that the receiver might rely upon the fact that it was of no actual value to the public or the security holders. It is believed that the first alternative is preferable. It would go hard with the day laborer to lose his wages because he has been kept at work upon an abortive repair job, for instance. Concededly this is not the logic of the net income notion of "debts of the income" as applied to the analysis of a particular claim, but it does maintain the general requirement that to come within the rule a claim must be for an operating expense.

4. The corpus of the mortgaged property is subject to the rule only in the event of the diversion of preferential income to the benefit of the bondholders. This refers both to the gross income of the preferential period and the net income of the receivership,\textsuperscript{71} even though the diversion was directed by the

\textsuperscript{69}An example of a claim presenting such special equities was presented in Citizens' Trust Co. v. National Equipment and Supply Co., (1912) 178 Ind. 167, 98 N. E. 865, 41 L. R. A. (N.S.) 695. A light and water company with its credit exhausted needed materials to complete repairs necessary to its continued operation. Claimant furnished these repairs agreeing to postpone the time of payment till the repairs could be completed and the company producing income from which to pay the claim. The claim arose over six months before the company went into receivership, but it was held that the special facts of the case flexed the usual six months limit to include this situation.

\textsuperscript{70}In Westinghouse Air Brake Co. v. Kansas City So. Ry. Co., (C.C.A. 8th Cir. 1905) 137 Fed. 26, 40 it was said: "The reason that six months is approximately the limited time within which preferential claims must accrue is that there is usually an interval of six months between the dates when installments of interest upon the bonds fall due, and the mortgages generally provide, and the warranted inference is, that, when an installment of interest is paid, current expenses to that time have either been paid, or funds to pay them have been lawfully provided." What connection this suggestion has is none too clear. It would have no meaning in a case where interest payments were several installments in arrears.

court appointing the receiver. That the claim followed the
diversion in point of time does not defeat the preference, but
under the decisions the diversion must have taken place within
the six months period.

The fact of the diversion in itself is not enough to render the
corpus of the property subject to the preference. The diversion
must have been applied to the benefit of the bondholders either
by way of payments upon interest or principal of their bonds or
in betterments upon the property forming their security. Thus
where there has been a diversion of income to the payment of
interest on first mortgage bonds and only the second and third
mortgage bonds are interested in the fund for distribution that
is not subject to the preference.

The opinions carry little analysis of the point whether the
preference against corpus extends to the full amount of the diver-
sion or simply to the amount the bondholders were benefited.
Where the diversion is in money payments there is no question.
The problem centers in the betterment cases. It narrows down
to a matter of unjust enrichment. The amount of recovery based
upon unjust enrichment is measured by the actual extent of
the benefit received and not the amount taken from the claimant.
It appears, however, that preferences under our rule are usually
allowed to the extent of the diversion without reference to this
principle.

Under the necessity of payment and going concern theories
the factor of diversion of income plays no part. The former
theory allows preference against corpus after exhaustion of in-
come in the event payment is necessary to the continued operation

\[72\] Burnham v. Bowen, (1883) 111 U. S. 776, 4 Sup. Ct. 675, 28 L.
Ed. 596; Union Trust Co. v. Souther, (1883) 107 U. S. 591, 2 Sup. Ct.
295, 27 L. Ed. 488.

\[73\] Birmingham Trust and Savings Co. v. Atlanta, B. and A. Ry. Co.,
(D.C. Ga. 1924) 300 Fed. 173. The court clinched its point most effec-
tively in this language: "The case is not one of tracing any particular
fund, but one of fair equitable accounting. Nor is the account between
the divertee and some particular supply creditor, but between the
divertee and the current debt fund in which all the unpaid supply
creditors were interested. Which of them was left unpaid is an
accident of no concern to the divertee."

\[74\] Barnum v. Southern Oregon Traction Co., (1921) 100 Or. 652,
195 Pac. 580.

\[75\] St. Louis, Alton and Terre Haute R. Co. v. Cleveland, C., C. and

\[76\] Woodward, Quasi-Contracts sec. 104.

\[77\] Thus it was in Union Trust Co. v. Souther, (1883) 107 U. S.
591, 2 Sup. Ct. 295, 27 L. Ed. 488.
of the business of the debtor. And under the going concern theory any claim for supplies, or what not, necessary to keep the debtor a going concern is entitled to preference against corpus if not paid out of income.

5. The final consideration is the character of business to which the rule applies. It has already appeared herein that the six months rule arose and has received its principal development in railroad receiverships. The Supreme Court has never had occasion to apply the rule to other than railroads. But in the lower federal courts it is well settled that the rule applies to public service corporations generally but not to private business companies. Only in state court decisions has the rule been applied to private business corporations and the state decisions preponderate against such application.

In Drennen v. Mercantile Trust Company a petition praying a preference for wage claims against a coal mining company was upheld upon demurrer. This decision was rendered with full cognizance that the federal courts had never applied the rule to private corporations. The court maintained that the equity of wage and supply claimants lay in that the gross income of a business equitably belonged to them as the producers thereof, which equity depended not at all upon whether the corporation was one of a public character. Granting that the public might not have the same concern in keeping a private business in operation, it was none the less true that the bondholders might have such an

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78 In Wood v. Guarantee Trust Co., (1888) 128 U. S. 416, 9 Sup. Ct. 131, 32 L. Ed. 472, the court found it unnecessary to decide whether the rule applied to a water company because the claims presented were very old. It was said, obiter, that the Court had never applied the rule to other than railroads and attention was invited to the public character of railroads.

79 See, for example, Virginia Power Co. v. Lane Bros., (C.C.A. 4th Cir. 1909) 174 Fed. 513.

80 Spencer v. Taylor Creek Ditch Co., (C.C.A. 9th Cir. 1912) 194 Fed. 635. And with respect to receivers' certificates to fund or discharge pre-existing debts it is held that the courts are without authority "except by the consent of the mortgage lien-holders to supplant their liens by receiver's certificates issued for any obligations other than those arising by way of expenditures for realization and for preserving the property while the business is in course of administration under the receivership." International Trust Co. v. Decker Bros., (C.C.A. 9th Cir. 1907) 152 Fed. 78, 85.

81 First National Bank of Grand Junction v. Wyman, (1901) 16 Colo. App. 468, 66 Pac. 456; Merriam v. Victory Mining Co., (1900) 37 Or. 321, 60 Pac. 997. In both of these cases it was decided that the rule does not apply to mining companies.

82 (1897) 115 Ala. 592, 23 So. 164, 39 L.R.A. 623.
interest. This contention is not without force. If labor and supply claimants are equitably entitled to a preference against gross income, that is enough to sustain the granting of the preference aside from any peculiar public interest in the matter. And if there be no such equity as a matter of private right, the courts have simply been parties to the taking of property without making compensation. The implied consent of the bondholders, of course, is a fiction.

The Alabama decision has found favor in Mississippi. There it was relied upon in applying the rule to a lumber company.\(^8\) The court ordered the payment of prereceivership wage claims out of the first money to come into the hands of the receiver whether it be income or the proceeds of corpus. Whether there was any diversion of income does not appear from the report of the case, but the opinion presents no rationalization of the decision upon that basis. In a later case the same court was urged to apply the rule in favor of a claim for feed furnished a lumber company for oxen used in its business.\(^9\) But it refused to extend the rule to any other than wage claims reasoning that there were no criteria by which it could justly distinguish among other classes of claims those entitled to preference, if any. No mention was made of the usual test, whether the claim was for a necessary operating or maintenance expense.

There is not the same public concern, of course, in the continuation of the business of a private corporation as in the case of a public utility. And it appears that the business of a private corporation may be operated in receivership only for purposes of preservation either against deterioration and loss or of sale as a going concern. Within such limits a court does have a discretion to authorize the operation of a private business in receivership.\(^5\) This operation is for the sole benefit of the secured creditors unless the estate may be expected to bring more than the amount of their claims. Certainly, this being the case, it is a long step to apply the six months rule without the full acquiescence of the securityholders. Unless unsecured creditors of a private business were to be deemed entitled to a preference in any event apart from receivership, it is difficult to see how receivership and operation by a receiver could create such a preference. If the Alabama

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\(^8\) L'Hote v. Boyet, (1905) 85 Miss. 636, 38 So. 1.
\(^9\) A. H. George Co. v. Pigford, (1910) 97 Miss. 332, 52 So. 796.
\(^5\) 1 Clark, Receivers, 2d ed., sec. 396.
court is correct in its position, current expense creditors have a first equity against the income of any business. Under the federal decisions, however, the backbone of the rule is the public concern and not private equities. The federal courts have simply supplied new law to fit a public need.  

IV

The state decisions for the most part follow the net income theory as laid down by the federal Supreme Court. A notable exception has been the course of the Illinois decisions, which follow the going concern theory. Again the necessity of payment theory has been applied in state decisions. In some instances preferences have been allowed against corpus without reference to diversion of income, possibly, no doubt, not because the net income theory was disapproved but because its full content had not been extracted from the federal decisions. However theorized, it is clear that the six months rule is firmly imbedded in American jurisprudence. But a critical examination of the rule may help to bring out more clearly its tendencies. It will be recalled as to the purposes of the rule that it is assumed that it is to the interest both of the securityholders and the public that certain businesses be continuously operated and their

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86 "Granting that what the bondholders have been compelled to do, in paying all debts ordinarily payable out of income, is only what every prudent and fairminded man would have done voluntarily, it can scarcely be disputed that, ill-defined as is the boundary between the domains of ethics and jurisprudence, the rule of conduct thus enforced belongs to the category of those which do not warrant judicial action until they have been impressed with a statutory stamp." Labatt, Preferential Debts of Railway Receivers, (1898) 14 L. Quar. Rev. 51, 66.


88 St. Louis, A. and S. R. Co. v. O'Hara, (1898) 177 Ill. 525, 52 N. E. 734, 53 N. E. 118. Whitaker v. Wabash, Chester, and Western R. Co., (1917) 206 Ill. App. 116. In St. Louis Union Trust Co v. Wabash, etc., R. Co., (1927) 244 Ill. App. 422 it was held that operating expenses arising out of operation by mortgagees with the consent of the mortgagor were entitled to a preference against corpus though no net income was produced.


90 Florida Construction Co. v. Pournell, (1918) 76 Fla. 395, 80 So. 54, 5 A.L.R. 685; Litzenberg v. Jarvis-Conklin Mortgage Trust Co.; (1892) 18 Utah 15, 28 Pac. 871.
property preserved. This can only be done either by making the sound practice of paying current expenses out of current income a rule of law and producing enough current income to pay current charges, or by making the whole property subject to a preference in favor of such claims or by public ownership and operation of businesses in which the public has a more than common interest.

The great problem of government ownership and operation is, happily enough, not for this paper. The much-discussed “miscegenation of government and business” may be a good or a bad connection. It is none the less the fact that this is a not untried way out but one, of course, which the courts alone cannot set in operation.

The six months rule, as has been observed, is one which owes its origin and present force to the courts and not the statute law. The necessity of payment theory of the rule, based upon considerations of expediency rather than equity, is most far-reaching. To apply it freely would admit to preference any claim the holder of which was in an economic position, and actually threatening, so to conduct himself as to bring about serious injury to the given business. Certainly there is no private equity here. Any sort of claim of legal standing whether for operating or maintenance expenses or not might be secured a preference under such a rule. Clearly this leaves the commonweal as the only justification for the necessity of payment theory. It is believed unwise for the courts to arrogate to themselves so great a positive measure of the policy-making power. Private business, moreover, is entitled to a greater measure of certainty than the theory affords. The opinion has been expressed in the eighth circuit that were the question to be presented squarely to the Supreme Court again it would overrule Miltenberger v. Logansport.91

The policy objection may also be urged against the going concern theory. Either theory without the support of statute would permit the courts to prefer an unsecured claim to the legal lien of a prior mortgage against the corpus of mortgaged property without even resting the ruling upon private equities. The economic policy involved may be sound. The objection lies to the way it is put into effect.

We come to the net income theory. It is subject to a number

91 Chicago and Alton R. Co. v. United States and Mexican Trust Co., (C.C.A. 8th Cir. 1915) 225 Fed. 940.
of objections, both theoretical and practical, all of which need not be restated here. Its basic assumption, that bondholders impliedly agree that their security so far as it extends to income shall extend only to net income, is an obvious fiction. So far as the public interest is concerned, there is no reason not to extend the rule to construction claims. Moreover, the requirement of the rule that to merit a preference one must have relied upon current income for payment is difficult to apply and bears no necessary relation to the purpose of the rule. Despite such objections it is believed that the net income theory has merits.

In the first place, how else can a corporation with its property fully mortgaged be expected to discharge its current obligations other than from current income? Obviously a business which cannot meet current charges from current earnings is in a bad way. The net income theory simply requires the application of income first to current operating and maintenance expenses. Only when gross income properly applicable to such expenses is diverted to the benefit of the secured creditors does it touch the corpus of the property of the debtor and then only to the extent of the diversion. True, the equity allowed here has been measured according to the amount of the diversion instead of the benefit to the security holders, but it could hardly be otherwise. As a matter of administration it would be very troublesome, if not impossible, to estimate the extent of benefit received from the diversion.

V

In a number of states general statutes have been passed which rank priorities in receiverships.92 The order of priority varies but in general it may be stated as follows: 1. Expenses of the receivership; 2. taxes or debts due the United States;93 3. taxes

92But this is true in only a minority of the states which have legislation on the subject. In most of them no further legislation has been enacted with the exception of wage preference statutes.

93Debts due to the United States are given preference by federal statute, U. S. Rev. Stat., sec. 3466, 2 Fed. Stat. Ann., 2 ed., p. 216, 31 U. S. C. A. sec. 191. The subject has been very ably treated by Paxton Blair, Priority of the United States in Equity Receiverships, (1925) 39 Harv L. Rev. 1. Since the publication of Mr. Blair's article the Supreme Court has held that taxes are debts within the meaning of the federal preference statute so that it is not necessary to rely upon the prerogative of the sovereign as a basis for priority as was done in Liberty Mutual Ins. Co. v. Johnson Shipyards Co., (C.C.A. 2nd Cir. 1925) 6 F. (2d) 752, Price v. United States, 1926 U. S. 492, 46 Sup. Ct. 18, 70 L. Ed. 373; Strite v. United States (1926) 269 U. S. 503, 46 Sup. Ct. 182, 70 L. Ed. 379. See further United States v. Butterworth-Judson Corp. (1926) 269 U. S. 504, 46
or debts due to state or local governments; 4. wage claims; 5. all other claims duly proved and allowed. The New York statute enacted in 1929, is exceptional in that it ranks wage claims first. Debts and taxes due to the United States are given second rank. No mention is made of prior mortgages, but the terms of the statute induce the belief that it was not intended that their priorities be displaced.

Where the statute applies in terms simply to receiverships for purposes of distribution, as in Iowa, it would not cover the case of a receivership erected to administer or preserve but not to wind up and distribute a property. On the other hand, the Wisconsin statute would apply to either type of receivership since it is expressly referable to cases where receivers are appointed "to manage, conduct, settle, adjust or close up" a business. The New York statute applies to receiverships generally and would fall into this category.

Since these statutes rank priorities generally, the conclusion is warranted that they exclude further application of the six months rule. In adopting this view the Massachusetts court declared:

"We are not aware of any inherent power of this court to diminish the rights conferred on the mortgagee by [law], or to sanction the allowance of preferences or priorities between a secured and an unsecured creditor by taking them up where they were left by the requirements of our laws, and extending the right of participation further than the law permits."


The Minnesota statute, Mason's Minn. Stat. 1927, sec. 8013 ranks claims in this order with the exception that it places claims of employees under the workmen's compensation act just ahead of wage claims.

New York, Laws 1929, ch. 650, sec. 180 et seq. The fact that the statute ranks judgments fourth among preferred claims tends to show that the priority of special contract liens was not intended to be displaced since the latter are not mentioned but surely would outrank general liens.

Iowa, Code 1927, secs. 12719, 11717.

In McDaniel v. Osborne, (Ind. App. 1904) 72 N. E. 601 it was held that a statute giving wage claims a preference against an estate placed in the hands of a receiver did not apply to a temporary receivership set up to preserve the property pending mortgage foreclosure.

Wisconsin, Statutes 1927, sec. 268, 17.

This would not be the case, of course, with a statute which did not apply to temporary receiverships.

Old Colony Trust Co. v. Medfield, (1913) 255 Mass. 156, 102 N. E. 484.
And in New Jersey it has been held that even a wage preference statute which did not purport to rank priorities generally precluded judicial application of the six months rule.\textsuperscript{103} The court reasoned that this statute represented the views of the legislature as to what pre-existing claims should be entitled to preference in receivership cases since the inference from the preferring of only one class of such claims was that it was intended that no other class be preferred. This bit of rationalization is not entirely satisfying. Wage preference statutes are enacted to advance a special object—the protection of those dependent upon current earnings for their livelihood. The New Jersey legislature might well have enacted such a statute without a thought as to other possible classes of preferred claims.

Do these statutes which apply to receiverships for purposes of management govern in federal equity receiverships? There is no square decision upon the point. But there are expressions from lower federal courts to the effect that the federal tribunals sitting as courts of equity are not bound by state wage preference statutes.\textsuperscript{104} On the other hand, federal courts give effect to statutory liens for state taxes in equity receiverships as a matter of obligation.\textsuperscript{105}

Where state preference statutes are aimed to govern simply in a system of state court receiverships they are binding on state courts only. It is clear that the state legislatures could not enlarge the equity jurisdiction of the federal courts,\textsuperscript{106} but they can enlarge the substantive rights of individuals, which rights the federal courts are obligated to recognize.\textsuperscript{107} In \textit{Pusey and Jones Company v. Hanssen}\textsuperscript{108} the Supreme Court held that a Delaware statute empowering the chancellor to appoint a receiver

\textsuperscript{105}Northern Finance Corp. v. Byrnes, (C.C.A. 8th Cir. 1925) 5 F. (2d) 11.
\textsuperscript{106}Pusey and Jones Co. v. Hansen, (1923) 261 U. S. 491, 43 Sup. Ct. 454, 67 L. Ed. 763.
\textsuperscript{108}(1923) 261 U. S. 491, 43 Sup. Ct. 454, 67 L. Ed. 763.
upon the petition of a simple contract creditor was not binding upon federal courts. But the preference statutes go much further. They are not framed to give a mere procedural advantage but to give certain classes of claims relatively greater force as against a debtor. This view gains support from a dictum by Mr. Justice Brandeis, who wrote the opinion on the Hanssen Case.

"A receiver appointed by a federal court takes property subject to all liens, priorities, or privileges existing or accruing under the law of the state." 100

The problem is important because the preponderance of large receiverships are thrown into the federal courts. There is little doubt but that all these statutes might be made controlling in the federal cases by making the preferred claims statutory liens.

VI

The clearest sort of application of the six months rule is the preference of wage claims. It appears that the only preferential payments receivers are wont to make without special court order are wage claims and small traffic balances. 12 Supply claims are usually preferred only after submission to a special master. In addition to being thus favored, wage claimants almost universally have the benefit of statutes creating laborers' liens upon the products of their labor and statutes giving wage claims a preference or lien against the assets of an insolvent person, firm or company. 111 It is with the latter class of statutes that this discussion is concerned.

Wage preference statutes vary widely in the different states. The following analysis, however, may suggest their principal content and effect.

1. Character and Amount of Claim. In some states wage claims are preferred in full without limitation upon the time in which they must have accrued, 112 while in others the preference


110 Byrne, Foreclosure of Railroad Mortgages, which is lecture No. 2 of Some Legal Phases of Corporate Financing, Reorganization and Regulation, by Stetson and others, p. 77, 96.

111 In New Jersey, it is to be remembered, the wage preference statute is deemed to exclude the application of the six months rule. Massey v. Camden and T. Ry. Co., (1911) 78 N. J. Eq. 535, 80 Atl. 557.

is limited to so many months' wages due.\textsuperscript{113} For the most part, however, preference is limited to claims either accrued\textsuperscript{114} within or for services performed\textsuperscript{115} within periods ranging from two months\textsuperscript{116} to one year\textsuperscript{117} before receivership and to amounts ranging from fifty\textsuperscript{118} to five hundred\textsuperscript{119} dollars.

2. \textit{To Whom the Preference Extends.} The preference created is intended to benefit all regular\textsuperscript{120} workers, below managerial rank. Some statutes expressly exclude corporate officers.\textsuperscript{121} That of Montana, among others, sets out specifically what employees are benefited—"miners, mechanics, salesmen, servants, clerks, or laborers."\textsuperscript{122} The Georgia statute is applicable only to railroad employees.\textsuperscript{123}

3. \textit{Against Whom Preference is Given.} Some of these statutes are directed against corporate debtors only. The run of them include both domestic corporations and foreign corporations doing business in the state;\textsuperscript{124} one refers only to railroad companies.\textsuperscript{125} The majority are directed against any employer, whether an individual, a firm or a corporation.\textsuperscript{126}

4. \textit{Rank of the Preference with Respect to Pre-existing Liens.} A paucity of decisions renders it difficult to treat of this point. Statutes providing that "employees shall first be paid in full" have been construed not to create a preference superior to prior mortgage liens.\textsuperscript{127} In a few instances wage claims are clearly given

\textsuperscript{113}Delaware, Corp. Act., sec. 57, as amended by Delaware Laws of 1929, ch. 137.
\textsuperscript{115}Connecticut, Gen. Stats. of Conn. 1918, sec. 4920; North Carolina, Code 1927, Michie, sec. 1197.
\textsuperscript{116}California, Code of Civil Procedure 1923, sec. 1204.
\textsuperscript{117}Massachusetts, Gen. Laws 1921, ch. 216, sec. 118.
\textsuperscript{118}Indiana, Burns' Ann. Ind. Stats. 1926, sec. 9342, 9343.
\textsuperscript{119}Georgia, Code 1926, Michie, sec. 2793.
\textsuperscript{120}Garretson v. Delaware State Fair Ass'n, (1925) 14 Del. ch. 367, 128 Atl. 919. One employed to muster a band to advertise a state fair by band parades was here found to be beyond the range of a wage preference statute because he was not regularly employed on a wage basis. See also Phoenix Iron Co. v. Roanoke Bridge Co., (1915) 169 N. C. 517, 86 S. E. 184.
\textsuperscript{121}See the Delaware Corp. Act., sec. 57, as amended by Delaware Laws 1929, ch. 137.
\textsuperscript{122}Montana, Rev. Code 1921, sec. 8616. See also the Idaho statute, Idaho, Comp. Stats. 1919, sec. 7376.
\textsuperscript{123}Georgia, Code 1926, Michie, sec. 2793.
\textsuperscript{124}See the Delaware Corp. Act., sec. 57, as amended by Delaware Laws 1929, ch. 137.
priority over pre-existing secured claims. This result is upheld upon the familiar theory that the statute enters into all contracts creating liens after its enactment since a law forms a part of all subsequent agreements within its purview. A few wage preference statutes expressly declare that wage claims shall take rank inferior to prior mortgages. In Missouri wage claims are made superior to all claims not specifically secured.

5. Rank as among Other Preferred Claims. Here again one notes a dearth of judicial assistance. The problem of allocating a fund to various preferred claims may become quite complicated. Its solution is a full subject for study by itself. So far as the statutes go, one finds that claims under workmen’s compensation acts have been given the same rank as wages in several instances; wage claims are usually outranked by government claims; and claims of materialmen may be made inferior to wage claims. A number of wage preference statutes create statutory liens in favor of wage claims.

It readily appears that wage preference statutes do not follow the analogy of the six months rule. Unlike the “debts of the income” of the net income theory these statutory preferences are not limited primarily to income but extend directly to corpus. They apply to any character of corporation and are not controlled by considerations of public convenience. Rather they are

127Seymour v. Berg, (1907) 227 Ill. 411, 81 N. E. 339; McDaniel v. Osborne, (1905) 166 Ind. 1, 75 N. E. 647.
132See Blair, Priority of the United States in Equity Receiverships, (1925) 39 Harv. L. Rev. 1. Note especially his solution of the three cornered problem of preferring the United States to wage claimants, wage claimants to mortgagees and mortgagees to the United States.
135Kentucky, Carroll's Ky. Stats. 1922, sec. 2488.
framed to protect a particular class in the economic scheme of things. The general preference statutes are also not analogous to the six months rule. The preference is not limited to current expenses; corpus is directly subject to preference; no reliance upon current income is required.

**CONCLUSION**

It will have been observed that for the most part the field of judicial action cut out by the federal courts in creating the six months rule has not been taken away or recharted by statute. However much the rule may be attacked as a usurpation of legislative power or an outrage to vested interests the more impressive fact remains that by resort to such devices the courts have proved themselves capable, in this instance at least, of adaptation to modern conditions. Certainly it should be some satisfaction to those who deplore the current tendency to transfer business once handled exclusively by the courts to the administration of our rapidly-increasing administrative agencies to consider with what effectiveness the courts have shared with counsel in the molding of the equity receivership into an effectual process to reorganize and rehabilitate such important members of our economic structure as the great railway systems. A distinct majority of the important railway systems of the land have passed through the mill of the equity receivership.

Obviously the problems of administration in such receiverships have been tremendous. Not the least important administrative device that has been developed is the six months rule. Granting logical shortcomings the fact remains—the system has worked. The courts have acted upon the conviction that truly some shows must go on.

Chief Justice Waite has received little consideration for a place among the ranks of our great judges. To the mind of the writer, his opinions in two famous cases alone, *Fosdick v. Schall*\(^{136}\) and *Munn v. Illinois*,\(^{137}\) evince in his judicial work that high quality so essential to great effectiveness on our supreme bench—statesmanship. As Taney had done before him Waite "dipped into the future."

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\(^{137}\)(1876) 94 U. S. 113, 24 L. Ed. 77.