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Bankruptcy Law -- The Continued Vitality of the Six-Months Rule in Railroad Receiverships

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NOTES

Bankruptcy Law—The Continued Vitality of the Six-Months Rule in Railroad Receiverships

One hundred years have passed since the United States Supreme Court in *Fosdick v. Schall*[1] first set forth the six-months rule for establishing creditors' priorities in railroad receiverships. The rule, as pronounced by the *Fosdick* Court and amplified in subsequent decisions, gives priority in payment to unsecured creditors who, within a period of six months prior to the initiation of reorganization proceedings,[2] supply materials or services necessary to the continued operation of the railroad.[3] In recent years the rule has been in issue in litigation arising out of receiverships involving the Penn Central Transportation Company,[4] the New York, New Haven and Hartford Railroad Company,[5] and the Tennessee Central Railway Company.[6] In the ongoing Penn Central reorganization, for example, claims under the six-months rule total some $62.5 million.[7]

Despite its continuing importance, the six-months rule has been inconsistently applied during its century of development.[8] The courts,

1. 99 U.S. 235 (1878).

2. The rule is applicable in appropriate railroad reorganization proceedings by virtue of section 77(b) of the Bankruptcy Act, 11 U.S.C. § 205(b) (1970), which provides:

> For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.

3. Although the Supreme Court has never applied the rule outside the railroad receivership context, the lower federal courts have employed the rule in cases involving public or quasi-public corporations. 6 COLLIER ON BANKRUPTCY ¶ 9.13[5], at 1633 (14th ed. J. Moore 1978); *see, e.g., In re* Madison Ry., 115 F.2d 586 (7th Cir. 1940); Crane Co. v. Fidelity Trust Co., 238 F. 693 (9th Cir. 1916), *cert. denied*, 244 U.S. 658 (1917); Louisville & N.R.R. v. Memphis Gaslight Co., 125 F. 97 (6th Cir. 1903).

4. *See In re* Penn Cent. Transp. Co., No. 70-347 (E.D. Pa., filed June 21, 1970).

5. *See In re* New York, N.H. & H.R.R., 278 F. Supp. 592 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

6. *See In re* Tennessee Cent. Ry., 316 F. Supp. 1103 (M.D. Tenn. 1970), *vacated on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972).

7. Affidavit of Aidan Mullett at 11, *In re* Penn Cent. Transp. Co., No. 70-347 (E.D. Pa., filed June 20, 1970).

8. See *In re* Third Ave. Transit Corp., 138 F. Supp. 623 (S.D.N.Y. 1955), *aff'd per curiam*, 230 F.2d 425 (2d Cir. 1956), where the court stated: "The researches of counsel supplemented by such research as has been at my command have not resulted in the discovery of any principle which would account for all of the decisions or even enough of the decisions so that one might say there was a principle behind them." *Id.* at 625.

particularly in recent years, have frequently applied the rule mechanically, without sufficiently analyzing the particular questions before them in relation to the underlying rationale of the rule. This has created confusion concerning the application of the rule and resulted in a number of issues that are in need of resolution.

THE DEVELOPMENT OF THE RULE

The six-months rule is an equitable doctrine that first appeared in a federal equity receivership,[9] *Fosdick v. Schall*. In that case the Supreme Court recognized that the business of all railroad companies is done, to a greater or lesser extent, on credit.[10] When railroad companies encounter financial difficulties, current debts for labor, supplies and equipment are often allowed to accumulate so that mortgage payments may be made and a foreclosure postponed, if not avoided.[11] The Court found this process to be inequitable because: "Every railroad mortgagee in accepting his security impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income."[12] The Supreme Court went on to hold that claims of prereceivership operations creditors[13] were entitled to priority with respect to receivership income, even though that income was subject to the lien of the railroad's underlying mortgage if, during or immediately prior to the receivership, income had been diverted to the benefit of the mortgagees.[14] Equity required that the mortgagees restore any such "diversions" to the "current debt fund."[15] The Court reasoned that every railroad mortgagee impliedly agrees that current debts shall be paid first from current receipts, because without operating creditors no income at all

9. The federal equity receivership was the precursor of the reorganization procedures now applied under section 77 of the Bankruptcy Act, 11 U.S.C. § 205 (1970). Generally, a creditor of a financially distressed railroad would file a creditor's bill in federal court asking that a receivership of the property of the debtor be instituted. Once the receivership was commenced, the debtor was protected from the attacks of subsequent creditors, and its business was continued under the control of the receiver in order that all debts might be paid in an orderly fashion. The formal function of the receivership was ended when the property of the debtor was sold by the court to pay, to the extent possible, the claims of the creditors. *See generally* COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 0.04.

10. 99 U.S. at 252.

11. *Id.*

12. *Id.*

13. An "operations creditor" may be defined as an unsecured creditor who supplied labor or materials necessary to the continued operation of the railroad. *See* COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 9.13[5], at 1635 & n.38.

14. 99 U.S. at 252-53.

15. *Id.*

would be produced and the value of the mortgage would be considerably undermined.[16]

In *Burnham v. Bowen*,[17] the Supreme Court expanded upon the *Fosdick* doctrine, declaring that current income itself, whether collected prior to or during the receivership and regardless of diversions, was encumbered by current debts arising out of the operations of the railroad that produced the income.[18] Thus, the Court held that current debts should be paid first, out of either prereceivership or receivership income.[19] The *Burnham* Court also held that if diversions to the benefit of the mortgagees from current income occurred, the current creditor could have resort to the corpus of the mortgaged property to the extent of the diversions.[20] Further, the current creditor could insist on a sale of the property to the extent of the diversions if he had not been paid.[21]

Despite the *Burnham* Court's expansion of the *Fosdick* rule, the Supreme Court did not intend to give current creditors an unqualified priority over mortgagees. In *Kneeland v. American Loan & Trust Co.*,[22] the Court restricted the application of the six-months rule by emphasizing that the priority of mortgage liens over the corpus should ordinarily be displaced only when diversions had occurred.[23] The Court reprimanded those lower courts that had liberally allowed invasions of the corpus of mortgaged property in order to satisfy the claims of current creditors, stating: "[T]he appointment of a receiver vests in the court no absolute control over the property, and no general authority to displace vested liens. . . . It is the exception and not the rule that such priority of liens can be displaced."[24]

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16. *See* Burnham v. Bowen, 111 U.S. 776, 780 (1884).

17. 111 U.S. 776 (1884).

18. *Id.* at 780-81.

19. *Id.* at 782. *See also* Virginia & Ala. Coal Co. v. Central R.R. & Banking Co., 170 U.S. 355, 365, 369 (1898). Receivership income is, however, first devoted to the expenses of the receivership. COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 0.04, at 40.

20. 111 U.S. at 782.

21. *Id.* at 782-83. In a later case, St. Louis, A. & T.H.R.R. v. Cleveland, C., C. & I. Ry., 125 U.S. 658 (1888), the Court explained that the current creditor must show as a condition precedent to its right to resort to the corpus that the diversion occurred after the railroad became indebted to it. *Id.* at 672.

22. 136 U.S. 89 (1890).

23. The priority of the mortgage lien may also be displaced through rare application of the necessity of payment rule. *See* note 30 *infra*. *See also* Gregg v. Metropolitan Trust Co., 197 U.S. 183 (1905); Miltenberger v. Logansport Ry., 106 U.S. 286 (1882); Moore v. Donahoo, 217 F. 177 (9th Cir. 1914), *cert. denied*, 235 U.S. 706 (1915); Carbon Fuel Co. v. Chicago, C. & L.R.R., 202 F. 172 (7th Cir. 1912).

24. 136 U.S. at 97-98.

In *Southern Railway v. Carnegie Steel Co.*,[25] the Supreme Court, after reviewing its earlier cases dealing with the current creditors' priority,[26] defined the class of creditors entitled to assert the priority as including only those creditors who supplied materials and services necessary to the operation of the railroad in reliance upon the current income of the railroad, as opposed to its general credit, for payment.[27] Thus, in *Southern Railway* the Court granted priority to a supplier of steel rails, while in *Lackawanna Iron & Coal Co. v. Farmers' Loan & Trust Co.*,[28] decided the same day as *Southern Railway*, the Court denied priority to another supplier of steel rails because the latter supplier had relied on the general credit rather than the current income of the railroad.[29]

The Supreme Court's development of the six-months rule culminated in *Gregg v. Metropolitan Trust Co.*[30] In *Gregg*, a creditor who had supplied a small quantity of railroad ties shortly before receivership proceedings began sought to have his debt satisfied from the corpus of the estate. Although the Court recognized that the claimant had a valid equitable lien on current income in the hands of the receiver, it found that no such fund of surplus earnings existed.[31] Moreover, the Court found that no diversions had occurred by which the mortgagees had profited.[32] This finding affirmed the court of appeals' holding[33] that no diversion had occurred when payments on capital improvements and other expense items that benefited the mortgagees were more than matched by funds obtained by the railroad through borrowings and receipts not considered to be part of current railroad

25. 176 U.S. 257 (1900).

26. *Id.* at 273-86.

27. *Id.* at 286.

28. 176 U.S. 298 (1900).

29. *Id.* at 316-17. *See also* Virginia & Ala. Coal Co. v. Central R.R. & Banking Co., 170 U.S. 355, 365 (1898).

30. 197 U.S. 183 (1905). The *Gregg* decision restricts the necessity of payment rule established in Miltenberger v. Logansport Ry., 106 U.S. 286 (1882). The necessity of payment rule allows the receiver to make distributions to current creditors out of the corpus regardless of whether there have been any diversions to the benefit of the mortgagees. *Id.* at 312-13. *Gregg* limited this power to the extraordinary circumstance in which payment of the claim is indispensable to the business of the railroad, as when the claimant supplies essential and otherwise unobtainable materials and threatens to cut off the railroad's supply if not paid. 197 U.S. at 187. *See, e.g.*, Carbon Fuel Co. v. Chicago, C. & L.R.R., 202 F. 172, 174 (7th Cir. 1912).

31. 197 U.S. at 188; *see* Gregg v. Metropolitan Trust Co., 124 F. 721, 721 (6th Cir. 1903), *aff'd*, 197 U.S. 183 (1905).

32. 197 U.S. at 186.

33. 124 F. 721 (6th Cir. 1903), *aff'd*, 197 U.S. 183 (1905).

income.[34] Accordingly, the Supreme Court denied any priority to the six-months claimant.[35]

These early Supreme Court decisions clearly set out the broad framework of the six-months rule. The Court of Appeals for the Eighth Circuit, in a frequently cited passage from its opinion in *Guaranty Trust Co. v. Albia Coal Co.*,[36] reduced that framework to three requirements:

> (1) That the consideration for the claim was a current expense of ordinary operation of the railroad, necessarily incurred to keep it a going concern.
>
> (2) That the claim represents a debt contracted with the expectation or intention of the parties that it was to be paid out of the current earnings of the railroad.
>
> (3) That the claim shall have accrued within six months prior to the appointment of the receiver.[37]

Within this broad framework, however, courts have varied considerably in their applications of the rule. In *Southern Railway* the Supreme Court recognized that its own cases failed to lay down any clearly definable or uniformly applied rule.[38] It is not surprising, then, that subsequent lower court decisions have left a number of issues unresolved.

THE EQUITABLE BASIS OF THE RULE

Several of the early Supreme Court decisions suggest that the basis in equity of the six-months priority is that the current creditors have protected the value of the mortgagees' security by keeping the railroad running.[39] Accordingly, the trustees of the Penn Central Transportation Company argue in that railroad's current reorganization proceeding that

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34. *Id.* at 727.

35. *See* 197 U.S. at 189.

36. 36 F.2d 34 (8th Cir. 1929).

37. *Id.* at 35. The requirement that the claim have accrued within six months was not always strictly applied in the early cases. *See* St. Louis & S.F.R.R. v. Spiller, 274 U.S. 304, 311 (1927). The origin of the six month period as a limitation is unclear. *See, e.g.*, Westinghouse Air Brake Co. v. Kansas City S. Ry., 137 F. 26 (8th Cir. 1905) (six month period needed to avoid secret liens); FitzGibbon, *The Present Status of the Six Months' Rule*, 34 COLUM. L. REV. 230, 240-41 (1934) (six months period borrowed from Illinois statute).

38. 176 U.S. at 285.

39. *See, e.g.*, Union Trust Co. v. Illinois Midland Ry., 117 U.S. 434, 455 (1886); Burnham v. Bowen, 111 U.S. 776, 780 (1884); Union Trust Co. v. Souther, 107 U.S. 591, 594-95 (1882). *See also In re* New York, N.H. & H.R.R., 405 F.2d 50, 52 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

> the six months' priority is premised upon the granting of some special benefit or enrichment by operations creditors in the six-month period prior to bankruptcy, and on the receiving of that benefit or enrichment by other creditors who therefore can be expected to bear the burden of compensatory special treatment for the operations creditors.[40]

If, however, the continued operation of the railroad has served only to decrease the value of the mortgagees' security through extensive operating losses, the trustees conclude that there is no equitable reason to give priority to the six-months creditors over the mortgage liens.[41]

The trustees' analysis, however, fails to account for the cases that have refused to apply the six-months rule in reorganizations of private corporations other than railroads.[42] As these cases illustrate, the basis of the rule is the significant public interest in the continued operation of the railroads.[43] In ordinary receiverships, the only interests at stake are those of the mortgagees and the various claimants; in railroad receiverships, the public's interest in continued railroad operation is paramount. Given the often tenuous financial condition of railroads, frequently complicated by a heavy mortgage burden,[44] it would in many cases be difficult for railroads to obtain the materials and labor necessary for operation if railroads offered only their general credit as security for operating creditors. Public policy therefore demands that these claimants be given assurances of payment in the event of a bankruptcy.

The Supreme Court's "implied agreement"[45] in *Fosdick v. Schall* is best seen as an unconvincing rationalization by the Court for its, at that time, novel derogation of the mortgage liens.[46] The equities of current creditors' claims are the same whether the corporation in receivership is of public or merely private concern; it is the public interest in the continued operation of the nation's railroads that justifies the six-months rule's unique reordering of receivership priorities.[47] Thus, the

40. Memorandum in Support of Trustees' Position with Respect to Six Months' Claims at 1, *In re* Penn Cent. Transp. Co., No. 70-347 (E.D. Pa., filed June 20, 1970).

41. *Id.* at 2.

42. *See In re* Pusey & Jones Corp., 295 F.2d 479, 480 (3d Cir. 1961). *But see* Dudley v. Mealey, 147 F.2d 268, 271 (2d Cir. 1945).

43. *See, e.g.*, Pennsylvania Steel Co. v. New York City Ry., 208 F. 168, 182 (S.D.N.Y. 1913), *aff'd*, 216 F. 458 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915). *But see* Gregg v. Mercantile Trust Co., 109 F. 220, 227-28 (6th Cir. 1901).

44. *See In re* Penn Cent. Transp. Co., No. 70-347 (E.D. Pa., filed June 20, 1970).

45. *See* text accompanying notes 9-16 *supra*.

46. *See* Wham, *Preference in Railroad Receiverships*, 23 ILL. L. REV. 141, 142-43 (1928).

47. Even when courts have considered the issue of benefit, they have often assumed that the

only equitable condition precedent for the application of the rule is that the materials or services provided by the claimant be necessary to the continued operation of the railroad.

CURRENT OPERATING EXPENSES

In order to qualify for the six-months priority, a claim must be based on a current expense arising from the ordinary operation of the railroad.[48] Materials and supplies directly associated with the operation of a railroad, such as rails or ties for normal track maintenance, fuel, power and normal replacements for worn-out equipment, along with the services associated with the provision of such materials, clearly qualify as current expenses.[49]

Purchases of new equipment and new construction, as distinguished from repairs, however, do not fall within the preferred class of claims, no matter how imperative the need therefor.[50] The cases suggest that the distinction lies in whether additions to equipment are being made, and whether the repairs merely restore the damaged property or serve to improve its quality.[51]

If the justification for the six-months priority rests upon the public interest in the continued operation of the railroad, however, the test ought to be whether the expense was necessary and proximately related to the physical operation of the road. Thus, a supplier of new cars needed to replace aged, deteriorated cars should be entitled to the protection of the six-months priority. A railroad should not be forced by its search for credit to undertake stopgap repairs in lieu of buying new

continued operation of the railroad has benefited the value of the mortgagees' security. *See, e.g.*, *In re* Tennessee Cent. Ry., 316 F. Supp. 1103, 1113 (M.D. Tenn. 1970), *vacated on other grounds*, 463 F.2d 73 (6th Cir.), *cert. denied*, 409 U.S. 893 (1972). This assumption rests on the theory that a forced sale of a nonoperating railroad would obtain a reduced price as compared to a similar sale of an operating property. For example, the good will attendant to an operating railroad would presumably not be a factor in the sale of a railroad that had earlier ceased operations. Although this assumption has been criticized as unrealistic given the possibility of an early reorganization before the railroad's financial difficulties become so acute as to force the cessation of operations, *see In re* New York, N.H. & H.R.R., 278 F. Supp. 592, 598 n.10 (D. Conn. 1967), *aff'd*, 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969), no court has yet rejected a six-months claim on the ground that the claimant produced no benefit to the mortgage creditors.

48. *See* FitzGibbon, *supra* note 37, at 235-38.

49. *Id.* Priority has been denied, however, to many items normally included in any accounting methodology as operating expenses. This category includes tort claims, *see, e.g.*, St. Louis Trust Co. v. Riley, 70 F. 32 (8th Cir. 1895), debts for special legal services, the printing of time tables, and premium payments for general liability insurance. *See* FitzGibbon, *supra* note 37, at 236-37.

50. *See* Lackawanna Iron & Coal Co. v. Farmers' Loan & Trust Co., 176 U.S. at 315.

51. *See, e.g.*, Crane Co. v. Fidelity Trust Co., 238 F. 693, 698 (9th Cir. 1916), *cert. denied*, 244 U.S. 658 (1917).

equipment. The six-months rule should, in any event, be strictly applied to avoid unnecessary invasions of the vested contract rights of railroad mortgagees.[52] The courts ought to examine carefully whether the asserted expense was indeed necessary; the rule should not serve to subsidize the unwise expansion of a financially unstable railroad.

Reliance on Current Operating Income

As a further prerequisite for the six-months priority, a claimant must demonstrate reliance on the current operating income of the railroad for payment, as opposed to reliance on the general credit of the corporation.[53] The six-months rule is designed to allow the railroad to acquire materials and supplies that creditors would otherwise be reluctant to sell because of a lack of security. Thus, when a claimant relies on some form of security other than the generalized hope that railroad operations will generate sufficient income to pay current debts, it should not be entitled to the six-months priority. The claimant's reliance upon the railway's general credit is determined by reference to the amount of the debt, the time and terms of payment, and all other circumstances attending the transaction.[54] It is not necessary to provide direct evidence of the parties' expectation that the suppliers would be paid out of current earnings.[55]

Reliance on current income is perhaps best defined by way of contrast, in terms of those factors that indicate a reliance upon the general credit of the railroad. When a claimant receives security, it is presumed that it relied upon the security and not upon current earnings.[56] Further, when payment is unreasonably deferred, it is presumed that reliance was based upon the long-term financial condition of the company.[57] Also, an unusually large expenditure, out of the ordinary course of business of the railroad, may indicate that the general credit of the railroad, rather than its current income, was relied upon.[58]

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52. *See* Johnson Fare Box Co. v. Doyle, 250 F.2d 656, 657 (2d Cir.) (per curiam), *cert. denied*, 357 U.S. 938 (1958); Kneeland v. American Loan & Trust Co., 136 U.S. at 97-98.

53. *See, e.g.*, Lackawanna Iron & Coal Co. v. Farmers' Loan & Trust Co., 176 U.S. at 316-17.

54. Southern Ry. v. Carnegie Steel Co., 176 U.S. at 285.

55. Pennsylvania Steel Co. v. New York City Ry., 216 F. 458, 471 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915).

56. *See* Thomas v. Western Car Co., 149 U.S. 95, 112 (1893).

57. *E.g.*, Bound v. South Carolina Ry., 58 F. 473, 480-81 (4th Cir. 1893) (payment deferred for eight months).

58. *E.g.*, Rodger Ballast Car Co. v. Omaha, K.C. & E.R.R., 154 F. 629, 633 (8th Cir. 1907).

It is not fatal to a current creditor's six-months claim, however, to have taken the notes of the railroad debtor. In *Southern Railway* the Supreme Court, emphasizing the small quantity of materials supplied in that case and the short credit terms of the transaction, granted priority to a six-months claimant even though the claimant took the debtor's promissory note. As the Court recognized, the use of the notes merely showed that the creditor preferred to have its debt evidenced by negotiable commercial paper rather than to stand on open account.[59]

THE CURRENT DEBT FUND

The six-months priority attaches first to the current debt fund, also known as the current expense fund.[60] Surprisingly, in the one hundred years during which case law concerning the six-months rule has developed, only one court has sought to define the current debt fund.[61] In *In re New York, New Haven & Hartford Railroad*,[62] the Court of Appeals for the Second Circuit stated:

> We hold that the availability of a current expense fund under the six-months rule is to be determined by generally accepted accounting practices, including those prescribed by the Interstate Commerce Commission, and that under those practices the current expense fund is to be computed by deducting operating expenses and depreciation from operating revenues.[63]

The Interstate Commerce Commission Annual Reports and generally accepted accounting practices, upon which the *New Haven* court relied in defining the current debt fund,[64] are based on accrual accounting

59. 176 U.S. at 290.

60. *See* Guaranty Trust Co. v. Albia Coal Co., 36 F.2d at 35. In theory, the priority could attach first to the unmortgaged property of the railroad. *See* Pennsylvania Steel Co. v. New York City Ry., 208 F.168 (S.D.N.Y. 1913), *aff'd*, 216 F. 458 (2d Cir. 1914), *cert. denied*, 238 U.S. 632 (1915). It is unlikely, however, that the modern railroad forced into reorganization will have any unmortgaged assets. It certainly will not have unmortgaged assets sufficient to satisfy all its six-months creditors. *See In re* Penn Cent. Transp. Co., No. 70-347 (E.D. Pa., filed June 20, 1970).

61. Many of the cases speak of the income available to satisfy the six-months claims and the corpus, to the extent that it may be invaded by the six-months creditors, as together constituting the current debt fund. *See, e.g., In re* New York, N.H. & H.R.R., 405 F.2d 50, 52 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969). In this Note, however, the two sources of funds will be discussed separately. In this section, the focus will be on determining the existence of an income fund.

62. 405 F.2d 50 (2d Cir. 1968), *cert. denied*, 394 U.S. 999 (1969).

63. *Id.* at 52.

64. The Supreme Court has used a variety of terms in referring to the current debt fund: net earnings, Southern Ry. v. Carnegie Steel Co., 176 U.S. at 285; income, Virginia & Ala. Coal Co. v. Central R.R. & Banking Co., 170 U.S. 355, 368 (1898); surplus earnings, Kneeland v. American Loan & Trust Co., 136 U.S. at 96; current income, St. Louis, A. & T.R.R. v. Cleveland, C., C. & I. Ry., 125 U.S. 658, 673 (1888); current earnings, Burnham v. Bowen, 111 U.S. at 780; and current

principles. Accrual accounting reflects receivables and expenses as they are earned or owed, rather than as they are paid.[65] Thus, the accrual accounting system reflects the actual financial position of the railroad over an extended period of time.

The six-months claimant is, by definition, a short-term creditor; he does not look to the complete, actual financial position of the debtor railroad but to something more akin to its short-term cash flow position. The accrual accounting method, therefore, unduly penalizes six-months creditors. If the existence of a current debt fund is determined by accrual accounting methods, the fund to which the priority of six-months claimants may attach will be reduced by the amount of their claims even though those debts have not yet been paid. This occurs because, in order to reach net income, expenses are deducted from revenues as those expenses are incurred, not as they are paid.

In rejecting the argument that accrual accounting principles should not apply in determining the availability of a current debt fund, the court in *New Haven* stated that the six-months creditors, at the time they supplied the materials or services to the debtor railroad, had no right to expect that accrued expenses would not be paid.[66] The six-months creditors, however, might well expect that their claims would be given priority over all other unpaid debts and "paper" expenses in the current income of the railroad.[67] Certainly, the inclusion of paper transactions such as depreciation in the calculation of expenses exacerbates the failure to reflect properly the nature of the six-months rule. Since the six-months creditor must rely upon the railroad's short-term ability to pay its current debts, the reduction of the current expense fund by a noncash item such as depreciation, which does not directly impair the railroad's short-term cash or current receipts position, is improper.

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receipts, Fosdick v. Schall, 99 U.S. at 252. These terms do not, however, adequately define the accounting basis for determining whether a current debt fund exists.

In *In re* New Hope & Ivyland R.R., 353 F. Supp. 608, 611 (E.D. Pa. 1973), the court defined current income as the "excess of current receipts over current expenses." This does not, however, establish whether an accrual or a cash method of accounting should be used or what expenses should be considered current expenses. It was not necessary for the court in *New Hope* to reach these issues because it denied the six-months priority on the ground that the railroad was acquiring a capital asset.

65. H. FINNEY & H. MILLER, PRINCIPLES OF FINANCIAL ACCOUNTING 89 (1968).

66. 405 F.2d at 52.

67. *Cf.* Thomas v. Western Car Co., 149 U.S. 95 (1893) (six-months claimants must rely "upon the interposition of a court of equity").

It would be erroneous, however, to say that the current debt fund should be defined simply as the cash and current receipts of the railroad. That definition does not recognize that the six-months priority can only attach to cash and current receipts *on hand*—the six-months rule makes no provision for the return of monies already paid out to other current creditors. To define the current debt fund, therefore, as the *total* of the railroad's cash and current receipts during the applicable period is to overvalue the fund. The current debt fund is better defined as the cash and current receipts on hand to pay current debts. This definition is supported by a statement of the Supreme Court in *Gregg*: "It is agreed that the petitioner may have a claim against surplus earnings, if any, in the hands of the receiver . . . ."[68] The *Gregg* Court thus seemed to imply that the current debt fund to which the six-months claimant has priority consists of the earnings on hand, rather than the net financial position of the railroad.[69]

INVASIONS OF CORPUS

Assuming that the current debt fund, however defined, is insufficient to satisfy all the six-months claims, the six-months creditors may, in certain circumstances, look to the corpus of the mortgaged property. The general rule as to invasions of the corpus in order to pay properly qualified six-months claims was firmly established by the Supreme Court in *Gregg*, in which the Court held that the corpus of the mortgaged property could ordinarily be charged with the six-months claims only if, and to the extent that, there had been diversions from income to the benefit of the mortgagees.[70]

The Supreme Court had earlier defined "diversion" as the payment of mortgage interest, the purchase of new equipment, or the acquisition of valuable additions out of the earnings which ought, in

68. 197 U.S. at 183.

69. In terms of generally accepted accounting principles, perhaps the closest analog to the suggested definition would be the statement of changes in financial position, which reflects working capital flow. *See* J. SMITH & K. SKOUSEN, INTERMEDIATE ACCOUNTING 680, 684 (1977). This statement is of primary importance to the short-term creditor as it reveals the financial resources that will be available within a short period of time for debt payment. R. SCHATTKE, H. JENSEN & V. BEAN, FINANCIAL ACCOUNTING 12 (1974). Funds from borrowings should be excluded from any definition of current debt fund in that they do not represent earnings or income from the operations of the railroad.

70. 197 U.S. at 186-87. The corpus may also be invaded in order to pay current creditors under the necessity of payment rule. *See* note 30 *supra*. It is clear that the necessity of payment rule can have no relevance after the railroad has ceased operations, as is the case in the current Penn Central proceedings. *See* Moore v. Donahoo, 217 F. 177, 182 (9th Cir. 1914), *cert. denied*, 235 U.S. 706 (1915) (necessity of payment rule premised on creditor's ability to halt operations).

equity, to have been dedicated to current debts.[71] Thus, payments for the benefit of mortgagees out of income that should have been devoted to reduction of current debt give rise to a right in current creditors to invade the corpus to the extent of the diversion. Taxes paid, however, even though they redound to the benefit of the mortgagees, do not constitute a diversion.[72] In addition, diversions that occurred prior to the creation of the six-months creditor's debt claim confer no right to invade the corpus because the creditor at that time had no special equity in current earnings.[73]

The Supreme Court's decision in *Gregg* established that when payments for the benefit of mortgagees are offset by "free funds"—capital funds derived from sources not connected with the operation of the railroad, such as investments or borrowings—no diversion has occurred.[74] Although this proposition has not been discussed in any recent case, it is based on sound logic as long as the free funds are regarded as reimbursement *pro tanto* to the fund subject to the six-months claims.

Despite the Supreme Court's holding in *Gregg* that there can be no invasion of the corpus in order to satisfy six-months claims unless there previously has been a diversion from current earnings to the benefit of mortgagees, a line of cases in the Fourth Circuit has developed a current creditor's right to invade the corpus regardless of diversions.[75] In *Southern Railway v. Flournoy*,[76] the court held that income diversion to mortgagees is not a prerequisite to corpus invasion "where there are found—as special circumstances—all elements constituting the pre-eminent equity."[77] The *Flournoy* court, however, apparently confused the six-months rule with the necessity of payment rule.[78] The necessity of payment rule, as set forth in *Gregg*, allows invasions of corpus without any prior diversions only in the extraordinary situation in which actual *payment* of the claim is essential to the continued operation of

71. Fosdick v. Schall, 99 U.S. at 253.

72. Texas Co. v. International & G.N. Ry., 237 F. 921 (5th Cir. 1916).

73. Fordyce v. Omaha, K.C. & E.R.R., 145 F. 544 (W.D. Mo. 1906).

74. *See* Gregg v. Metropolitan Trust Co., 197 U.S. 183 (1905), *aff'g* 124 F. 721 (6th Cir. 1903).

75. *See, e.g.*, Southern Ry. v. Flournoy, 301 F.2d 847 (4th Cir. 1962); Virginia Passenger & Power Co. v. Lane Bros., 174 F. 513 (4th Cir. 1909), *cert. denied*, 215 U.S. 610 (1910); Finance Co. v. Charleston, C. & C.R.R., 62 F. 205 (4th Cir. 1894).

76. 301 F.2d 847 (4th Cir. 1962).

77. *Id.* at 851.

78. *See In re* New York, N.H. & H.R.R., 278 F. Supp. at 602-03 n.15.

the road.[79] The special circumstances alluded to in the *Flournoy* decision[80] did not meet this standard. Thus the case, and the attendant Fourth Circuit line of decisions, must be regarded as wrongly decided.

It is unclear how depreciation should be regarded for purposes of the six-months rule. A diversion, as noted above, may be defined as any payment that enhances the interests of the mortgagees. Conversely, depreciation represents the decreasing value of the mortgage corpus over time. The question arises, then, whether depreciation should properly be regarded as an offset to diversionary amounts spent on additions and improvements by the debtor railroad. In the *New Haven* case, the district court held that operating creditors have no equitable claim on revenues to the extent of depreciation, asserting that such creditors have no equitable right to be protected from the economic fact of depreciation.[81] In an earlier case, *Flint v. Danbury & Bethel Street Railway*,[82] however, the Connecticut Supreme Court rejected an attempt by mortgagees to offset diversions for interest payments with depreciation expenses. In effect, the court held this would dedicate current earnings to the mortgagees to the extent of depreciation, contrary to the equitable principles of the rule.[83]

In this context it is important to note that it is the addition or betterment that constitutes the enhancement of mortgaged property and, hence, the diversion. Depreciation would have occurred irrespective of whether any improvements were made to the mortgaged property. The two items, improvements and depreciation, are therefore not related and should not be combined as offsets. As discussed above,[84] depreciation is a paper transaction that does not affect the debtor railroad's short-term ability to pay current debts and thus should not serve to reduce the fund available for the payment of six-months claims.

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79. *See* note 30 *supra.*

80. The "pre-eminent equity" asserted by the *Flournoy* court consisted of a combination of the six-months and necessity of payment rules. *See* 301 F.2d at 850-51. The claims for traffic balances that were granted priority in *Flournoy, id.* at 853-56, however, did not meet the stringent requirements of the necessity of payment rule.

81. 278 F. Supp. 592, 604 (D. Conn. 1967), *aff'd,* 405 F.2d 50 (2d Cir. 1968), *cert. denied,* 394 U.S. 999 (1969).

82. 101 Conn. 13, 125 A. 194 (1924).

83. *Id.* at 20-21, 125 A. at 197.

84. *See* text accompanying notes 67 & 68 *supra.*

CONCLUSION

The utility of the six-months rule has suffered from a failure by many courts to properly analyze the basis of the rule. The rule is designed to protect the public's interest in the continued operation of the nation's railroads by assuring payment of operations creditors despite the precarious credit position of many railroads. The courts should not render illusory the protection offered by the rule by the application of inappropriate accounting standards; nor should the rule's purpose be compromised by the improper exclusion of the cost of necessary new purchases, or the inappropriate inclusion of charges for such items as depreciation. The six-months rule has not lost its relevance in the one hundred years since its inception—it has merely been misapplied.

ALAN E. KRAUS

Copyright Law—One Step Beyond Fair Use: A Direct Public Interest Qualification Premised On The First Amendment

In keeping with the copyright clause of the United States Constitution,[1] the purpose of the copyright statute[2] is to enhance the public welfare by promoting the growth of learning and culture.[3] To accomplish this purpose, Congress has accorded the copyright holder certain

This Note has been entered in the Nathan Burkan Memorial Competition.

1. U.S. CONST. art. I, § 8, cl. 8: "The Congress shall have Power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."

2. Copyrights Act, Pub. L. No. 94-553, 90 Stat. 2541 (1976) (codified at 17 U.S.C.A. §§ 101-810 (West 1977)). The Copyrights Act of 1976 revised Title 17 of the United States Code (governing copyrights) in its entirety. The new provisions became effective January 1, 1978, except §§ 118, 304(b) and 801, which became effective October 19, 1976. The substantive issues discussed in this Note concerning provisions of the former copyright statute are equally relevant to the new provisions.

3. *See* H.R. REP. No. 2222, 60th Cong., 2d Sess. 9 (1909) (copyright act intended "not primarily for the benefit of the author, but primarily for the benefit of the public"). *See also* Berlin v. E.C. Publications, Inc., 329 F.2d 541, 543-44 (2d Cir.), *cert. denied*, 379 U.S. 822 (1964); HOUSE COMM. ON THE JUDICIARY, 87TH CONG., 1ST SESS., COPYRIGHT LAW REVISION—REPORT OF THE REGISTER OF COPYRIGHTS ON THE GENERAL REVISION OF THE U.S. COPYRIGHT LAW 5 (Comm. Print 1961); Cohen, *Fair Use in the Law of Copyright*, 6 ASCAP COPYRIGHT L. SYMP. 43, 49 (1955).