Fall 1997

On Considering the Public Interest in Bankruptcy: Looking to the Railroads for Answers

Julie A. Veach

Indiana University School of Law

Follow this and additional works at: https://www.repository.law.indiana.edu/ilj

Part of the Bankruptcy Law Commons

Recommended Citation


Available at: https://www.repository.law.indiana.edu/ilj/vol72/iss4/9

This Note is brought to you for free and open access by the Law School Journals at Digital Repository @ Maurer Law. It has been accepted for inclusion in Indiana Law Journal by an authorized editor of Digital Repository @ Maurer Law. For more information, please contact rvaughan@indiana.edu.
On Considering the Public Interest in Bankruptcy: Looking to the Railroads for Answers†

JULIE A. Veach*

INTRODUCTION

Businesses do not like to consider their possible future financial downfall.¹ Their creditors like even less to think of their investment vaporizing. Consider, though, the employees of an insolvent business. In current bankruptcy law, they have no say in the bankruptcy or reorganization proceedings of their employer/business. Consider, too, the municipalities and the taxing authorities. Though they may be dependent on the business for revenue, current bankruptcy law says they have no interest in the proceedings. Nor do consumers, the community, or industry at large have a legal interest in the reorganization of their member business.

Bankruptcy law should offer a procedural mechanism by which the voices of parties with interests can be heard. It has done so for decades in railroad reorganizations, and it is a worthwhile exercise to explore that history for clues about why Congress decided that the public interest was important to consider in railroad reorganizations. Part I of this Note will sketch the current debate over whether the public interest should be considered in business reorganizations. Part II offers four distinct arguments why the public interest should be considered in business reorganizations. And Part III proposes a statute which would allow, but not require, bankruptcy courts to consider the public interest in business reorganizations. This Note does not argue that the public interest should prevail in every reorganization. Rather, the public interest should be one factor among many considered, and only at the discretion of the bankruptcy judge. The place to begin is with a description of the current debate.

I. THE CURRENT DEBATE ABOUT THE PROPER PLACE OF THE PUBLIC INTEREST IN BANKRUPTCY LAW

There has been simmering a lively debate over the goals of bankruptcy for many years. There are roughly two schools of thought. Many scholars consider bankruptcy to be like a default term in the contract between a debtor and a creditor. Thus, as in a contract dispute, there is no need to look beyond those parties for resolution when the debtor declares bankruptcy. Their disagreement

† © 1997 by Julie A. Veach.

* J.D. Candidate, Indiana University School of Law—Bloomingon, 1997; B.A., Purdue University, 1993. I thank Professor Bruce A. Markell of the Indiana University School of Law—Bloomingon for introducing me to this topic and for his guidance and support.

¹ “Bankruptcy is a gloomy and depressing subject.” CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 3 (1935).
is private, and the law of bankruptcy will resolve it between them alone. In this
mode of thinking, bankruptcy is meant to be a huge, efficient, debt collection
device. This is roughly the law and economics or "L&E" school, the contract
school, or the private law school. This Note will refer to the theory simply as the
"economics" school.

The rival theory incorporates redistributive and public policy elements into
bankruptcy, expanding its scope beyond the debtor and creditors before the
bench and taking into consideration others who have very real but not credit
interests. These others might be employees of the debtor company, consumers,
neighbors, taxing authorities, and the surrounding community. It has further
been suggested to consider bankruptcy from the perspective of communitarianism
or feminist legal theory. This Note will refer simply to the "public interest"
school. Each side criticizes the other.

The economics school argues that the way to encourage capital investment in
business is to decrease the risk of loss. For example, suppose an investor has one
million dollars she is considering investing in a local shoe factory under a
security agreement. As bankruptcy law currently stands, if the shoe factory
defaults, our investor will be first in line to recover her investment on liquidation
or will be a new, secured creditor after reorganization. Also suppose that the
factory, after default, is worth more liquidated than reorganized. If our investor,
say the economists, knows that the judge might keep the factory running after
default for the sake of the public interest, such as employees, then our investor
is less likely to put her capital in the factory. She will do something else with it.
In this manner, considering the public interest discourages investment. Thus the
economists criticize the public interest school.

Among the voices criticizing the economists is that of Professor Karen Gross. She challenges their assumptions and suggests that some interests besides those
of creditors might be worth considering. Professor Gross admits that interests
such as community are difficult to quantify, but she argues that difficulty alone
is not justification for exclusion. She also challenges the assumption that
bankruptcy is not an appropriate arena for addressing community interests. This
assumption, she argues, rests on the notions (with which she disagrees) that
human beings act selfishly, that tastes and choices are unchanging and
exogenous, and that things we value can only be expressed in terms of money.

---

2. Richard V. Butler & Scott M. Gilpatric, A Re-Examination of the Purposes and Goals
3. Id. at 377.
5. See generally id. I would like to acknowledge Professor Gross's new book, Failure and
   Forgiveness: Rebalancing the Bankruptcy System, which appeared in print too late to be cited
   extensively in this Note. The interested reader can refer to this resource for in-depth discussions
   of community interests in bankruptcy law. See generally KAREN GROSS, FAILURE AND
7. Id.
8. Id. at 1038-39.
Furthermore, Professor Gross proposes that bankruptcy law is not an adequate set of default rules; that is, bankruptcy law does not reflect how people actually make decisions. She notes that contract law is increasingly doing “more public assessment which recognizes that even careful planning is not foolproof,” and she encourages the same for bankruptcy law.\(^9\) In her view, better communities mean better lives for everyone, even for creditors and shareholders.\(^{10}\) Thus, the argument goes, bankruptcy law should include provisions taking into account the public interest.

This author does not profess a superior understanding of the term “public interest.” But it is very difficult to continue to explore this subject without an attempt at definition. Of course, there is no single all-purpose definition of the “public interest,”\(^{11}\) but there are suggestions that the public interest is broader than the interests of widows and orphans. The language that is so commonly used now, “affected with a public interest,” is ancient—its use by the Supreme Court of the United States dates to 1876.\(^{12}\) But the use of the term throughout the history of bankruptcy law is confused. Judges interpreting the term in bankruptcy law\(^3\) could not agree on what the “public interest” was. In the area of railroad reorganizations, while some thought the public was best served by preserving the claims of the secured creditors,\(^4\) others thought the “public interest” was the interests of the passengers, the shippers, and the consumers of the shipped goods.\(^5\) Some courts tried to strike a balance.\(^6\) The only certainty in the definition of the public interest is the absence of unanimity.

---

\(^9\) Id. at 1044.
\(^{10}\) See id. at 1032-34.
\(^{11}\) Even Professor Gross admits that defining community is one of “numerous complex questions.” Id. at 1031.
\(^{12}\) LORD CHIEF JUSTICE HALE, DE PORTIBUS MARIS, 1 HARG. LAW TRACTS 78, cited in Munn v. Illinois, 94 U.S. 113, 126 (1876). The question in dispute in *Munn* was whether the State of Illinois could prescribe a maximum rate for the storage of grain in grain warehouses. *Id.* at 123. Chief Justice Waite stated:

> Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use, but, so long as he maintains the use, he must submit to the control.

*Id.* at 126. The Chief Justice had in mind the health and safety of people who needed clean, wholesome, affordable grain. The Chicago warehouses were a bottleneck through which much of the grain produced in the Midwest passed before moving on to other parts of the Midwest and the country. *Id.* at 130-31.


The scholars who are involved in the debate define the public interest, by default, as the interests of those, beside the debtor, who have not invested capital in whatever business is in bankruptcy. Perhaps they are using the definition only as a term of convenience, a shorthand, instead of spelling out “those parties who do not have a credit interest in the business.” This definition is too narrow. Secured and unsecured creditors are members of the public, and their financial health is vital to the health of the national economy. Creditors are those who provide capital. Without capital, financial growth is inconceivable. Thus, creditors’ interests can not be excluded from the “public interest.” Although creditors’ interests are often juxtaposed with the interests of others such as employees, neighbors, and communities, to leave creditors out of the discussion is to reject the reality that they contribute to the wealth of all. And certainly, the public interest should include the interests of debtors. Therefore, for the purposes of this Note, the public interest will be defined to include the interests of anyone who has a stake, financial or otherwise, in the business in bankruptcy.

Having glanced at the current debate over whether to consider the public interest in bankruptcy law, and having sketched a broad definition of the public interest, it is time to ask whether bankruptcy law should take the public interest into account.

II. WHY CONSIDER THE PUBLIC INTEREST IN BUSINESS REORGANIZATIONS?

This Part begins with a brief history of railroad reorganizations. For over sixty years, no railroad has been reorganized without someone protecting the public interest. In addition this Part will point out another provision in the modern Bankruptcy Code that calls for the consideration of the public interest. Beyond these specific provisions, this Part will look briefly at the goals of bankruptcy. If bankruptcy is more than just a huge debt collection machine, it might be wise to take into account broader interests. And finally, this Part will point out that there are benefits to simply thinking about the public interest without necessarily changing the result in a particular case.

17. Professor Gross comments, “saying that community interests are important and must be taken into account in the bankruptcy process does not mean that the other interests that bankruptcy seeks to protect, such as those of creditors and equity holders, are forgotten.” Gross, supra note 4, at 1032-33 (emphasis in original).


19. “Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall contain only provisions that are consistent with the interests of creditors and equity security holders and with public policy with respect to the manner of selection of any officer, director, or trustee under the plan and any successor to such officer, director, or trustee.” 11 U.S.C. § 1123 (a)(7) (1994) (emphasis added).
A. It's Nothing Radical—It's Been Done Before in the Railroads

1. State of the Railway Industry in the Early Twentieth Century

In their earliest days, railroads were financially healthy. To raise capital they sold stock. Around 1850, however, railroads began using the corporate mortgage in lieu of stock sales to finance themselves. Excess optimism caused railroads to take on more debt than they could safely carry. Heavy mortgages and light revenues forced many railroads to default on their obligations. Yet for these insolvent railroads, bankruptcy was not possible under the statutory law of the time. The ensuing panic gave birth to the use of the equity receivership.

2. Methods of Railroad Reorganization Before 1933

The equity receivership involved foreclosing and selling the debtor-railroad’s property to a new company, formed solely to take over the old railroad company, and generally consisting of the bondholders (secured creditors) of the old company. The actual receiver was a disinterested person, appointed by a court, to hold only the mortgaged property until the rights to the property were determined judicially. In an interesting twist to the equity receivership,

21. Id.
22. Id. at 380.
25. Id. at 380.
26. Id. at 378. The novel Wabash receivership set the stage for the receivership problems of the early twentieth century. The Wabash Railroad Company, and not its bondholders as had been the custom, petitioned the court to appoint a receiver for itself. The court obliged. Afterwards, the technique developed of a friendly creditor that the railroad company selected,
generally the only group with the organization and capital to purchase the railroad was the bondholders themselves, the original secured creditors. After much judicial delay, the equity receiver would transfer the railroad property to the new company consisting of the old secured creditors, free of unsecured debt.27 This equity receivership process spawned much criticism.

Parts of the procedure were considered to be only an empty ritual with no substance behind it. Costs were very high, especially legal fees. After 1920 the Interstate Commerce Commission ("ICC") had to approve the new securities that the emerging reorganized company wished to offer.28 Adding the judgment of the ICC to the whole procedure augmented the delay. There was also criticism that the ICC entered the proceedings too late in the process to have any real authority—it often approved unsound reorganization plans merely to avoid further delays and criticism.29

One of the more serious criticisms was about the length of time an equity receivership proceeding took from start to finish.30 Despite this fact, the equity receivership procedure did not interfere with railroad service to the public. Rather, "because reorganization customarily toned up management and made up for deferred maintenance, receivership usually benefitted the public interest automatically."31 But because of the terrible delays in the equity receivership process, the railroad industry called for legislative assistance.

3. Section 77

The problems of equity receiverships in railroad reorganization persuaded the seventy-second Congress that the time was ripe not just for legislation in the area, but for a new way to repair the capital structure of financially distressed railroads. While no form of bankruptcy relief had ever been available to railroads before,32 Congress and President Hoover changed that in 1933 with a new section to the Bankruptcy Act, section 77.33

Both houses of Congress considered the bill at the tail end of a session, yet both were loath to postpone a decision until after recess. Senators and

---

27. Id. at 382.
28. Id.
29. Id. at 384.
30. See Florence de Haas Dembitz, Progress and Delay in Railroad Reorganizations Since 1933, 7 LAW & CONTEMP. PROBS. 343 (1940).
31. Armistead B. Rood, Protecting the User Interest in Railroad Reorganization, 7 LAW & CONTEMP. PROBS. 495, 495 (1940).
representatives spoke of the current "emergency" of the United States railroads. The ICC, also sensing a need for action, encouraged passage of some form of legislation quickly.

Even under severe time pressure, the legislature insisted that measures in the bill provide for the protection of the public interest in railroad reorganizations. The ICC was seen as a maverick for the protection of the public interest, so the fact that the bill provided for approval of the plan by the ICC as a prerequisite to judicial approval satisfied the Congress that the public interest would be well defended. Thus, Congress passed an amendment to the Bankruptcy Act of 1898, section 77.

The most radical element of section 77 was that it opened federal bankruptcy law to railroads. Rather than utilizing its Commerce Power to legislate on the topic of railroad reorganizations, Congress chose to use its Bankruptcy Power.


35. As one Commission member put it:

A thoroughgoing reform of reorganization procedure in the public interest would go to this root of the matter, and would entrust the working out of an equitable and effective reorganization from the beginning to some well informed, well equipped and disinterested branch of the public service, just as has been done to some considerable extent in the case of banks and insurance companies. ... We should prefer to see an attempt made to deal more fundamentally with this matter, but we realize that the time is short, if anything is to be done at the present session, and that the need for action is urgent.

76 Cong. Rec. 5107 (1933) (letter of Mr. Eastman, Chair of the Legislative Committee of the Interstate Commerce Commission).

36. See, e.g., 76 Cong. Rec. 5108 (1933) (statement of Sen. Hastings):

I am quite certain, with all the authority we have given to the Interstate Commerce Commission, whose duty it is, of course, to see to it that the public interests are protected, that we have gone as far as it is possible to go in that direction. It seems to me it is not possible for any person to complain that under the terms of the bill the public interests are not being properly taken care of.

37. Reorganization of Railroads Engaged in Interstate Commerce, Pub. L. No. 72-420, 47 Stat. 1467, 1474 (1933), repealed by An Act to Establish a Uniform Law on the Subject of Bankruptcies, Pub. L. No. 95-598, 92 Stat. 2549, 2641 (1978) (codified at 11 U.S.C. § 1165 (1994)). In pertinent part, see section 77(d), "[T]he [Interstate Commerce] commission shall render a report in which it shall recommend a plan of reorganization that will, in its opinion be equitable, will not discriminate unfairly in favor of any class of creditors or stockholders, will be financially advisable ... and will be compatible with the public interest." 47 Stat. at 1477.

Within section 77, Congress granted the ICC some guidance in what Congress wanted the ICC to consider before approving a reorganization plan as being in the public interest, specifically in the ICC's role as the setter of rates. Included in considerations were the effect of rates on the movement of traffic, the need for good service at a low price, and the level of revenue needed to fund good service. The Emergency Railroad Transportation Act of 1933, Ch. 91, 48 Stat. 211, 220.

38. U.S. Const. art. I, § 8, cl. 3.

39. U.S. Const. art. I, § 8, cl. 4; Bankruptcy Act of 1898, Ch. 204, § 72-77, 47 Stat. 1467, 1474 (1933).
In many other respects, the section followed the existing practice of equity receiverships. However, section 77 proved to be more of an experiment than a solution, and Congress saw the need to overhaul it only two years later.\(^4\)

In 1935, the Committee on the Judiciary considered long and hard what was working with section 77 and what needed changing. The Committee took into account the recommendations of the Federal Coordinator of Transportation, the ICC, and even President Roosevelt before making its recommendations to the House.\(^4\)

The Committee recommended an amendment to section 77 designed to protect the public interest by giving the reorganizing judge the power to sever a branch of the railroad and sell it, when it was in the public interest to do so, and only after obtaining the blessing of the ICC.\(^4\) In large part, the role of the ICC remained the same as under the original section 77. If anything, the ICC wielded even more power than before. Its essential role as protector of the public interest remained untouched.\(^4\)

4. Judicial Interpretation of Section 77

Whether the legislative history of a statute or its judicial interpretation is more illustrative of the “true law” is not a question this Note will address. But in pursuit of a possible definition and consideration of the public interest in business reorganizations, judicial interpretation of section 77 is worth a glance.

There are two poles defining the spectrum of the “public interest” in railroad reorganizations: the interests of the creditors in maintaining the debtor-railroad’s assets, and the interest of the public in having adequate, convenient, and uninterrupted passenger and freight transportation. Although some would not


Most of the changes which the Committee recommended dealt with issues of creditors. Particularly troublesome about the original section 77 was the fact that a minority of one-third of the creditors could obstruct a reorganization plan. This caused a great deal of delay in the reorganization proceedings, especially when it came to valuation of vast amounts of railroad property. Id. at 3. Representative Sumners noted from the floor of the House during debates, “[t]he most important change is that whereas under the present law there is required the consent of two thirds of each class, ... it is possible [under the amendments] to have a plan effectuated which has not been approved by two-thirds of each class.” 79 CONG. REC. 13,299 (1935). Congress amended the original section 77 to allow a reorganization judge to approve a reorganization plan even if an entire class of creditors objected, so long as the plan was “fair and equitable” to the objecting creditors. 49 Stat. at 919. Another major concern of the Committee was the enormous cost of the reorganization in the form of fees paid to committees of creditors and reorganization managers, especially since these costs were eventually passed to the users of rail transportation. H.R. REP. NO. 74-1283, at 3.

42. H.R. REP. NO. 74-1283, at 5.

43. In fact, section 77, in its original form and as amended, resulted in a great increase in burden on the ICC, which at least one commentator asserts, took its responsibility as protector seriously. See Dembitz, supra note 30, at 413-16.
think that the interests of the creditors belong in a discussion of the public interest, it is important to remember that creditors make up a large subsection of the public. This Note has defined “public interest” broadly enough to include the interests of creditors as well as those of debtors and others. The courts have been concerned with maintaining rail service for those dependent on it, but the courts have mellowed in their convictions. The 1940s saw the preservation of rail service regardless of the interests of creditors and equity owners. The District Court for Colorado pointed out to litigants, “that Section 77 expresses the public policy which led to its enactment, and demands that the operation of railroads be continued for the benefit of the public, regardless of the interests of their creditors and stockholders.” The Seventh Circuit Court of Appeals called the railroad a “quasi-public institution [which] exists by the favor of the public. Service to the public is the sole consideration for its existence and continued operation.” It is noteworthy that these decisions were handed down during the point of largest proportional use of railroads by passengers and for freight in the history of the nation. This extreme position faded in the next decades (as did reliance on the railroads), but the opposite extreme (considering creditors at the expense of the public) never materialized, perhaps because section 77 specifically called for the consideration of the public interest.

The courts, including the United States Supreme Court, took a more moderate position as to the rights of the public and creditors. The most articulate opinion in the area is the New Haven Inclusion Cases. The Court specifically laid out the two oft-conflicting principles in railroad reorganizations: the conservation of the debtor’s assets for the benefit of creditors and the preservation of an ongoing railroad in the public interest. The Court even adopted a view of the public interest which included, rather than placed in opposition, the interests of creditors. Other courts also mentioned, as purposes of section 77, the balancing

---

44. See supra text accompanying notes 17-18.
47. In re Chicago, 126 F.2d at 368. Contemporary commentators shared this view: “[T]he most important interest in railroads, however, is not the interest of the stockholders, bondholders, labor, or tax-collectors, however public these now may be. The original and primary interest in railroads is the public interest in railroad use and service . . . .” Rood, supra note 31, at 496.
48. See NELSON, supra note 22, at 10.
49. See id.
51. As the court stated:
[S]ection 77 also has accorded the Commission primary responsibility for determining wherein lies the “public interest,” which does not refer generally to matters of public concern apart from the public interest in the maintenance of an adequate rail transportation system, but includes “in a more restricted sense,” concern for “the amount and character of the capitalization of the reorganized
of powers between the courts and the ICC,\textsuperscript{52} and defeating the claims of those seeking only nuisance value.\textsuperscript{53}

The courts reacted variously in trying to guess the congressional intent of section 77. Perhaps it is more savvy to say that the courts disagreed on how section 77 should operate, rather than saying the courts were trying to implement congressional intent. The contemporary commentators likewise had varied reactions.

5. Response to Section 77

Section 77, even as revised in 1935, did not solve all of the problems of the equity receivership. The section rather turned reorganization into a legislative mousetrap—easy to get in, hard to get out. Between 1933 and 1940, twenty-eight large railroads\textsuperscript{44} filed petitions under section 77, and not one completed its reorganization during that time.\textsuperscript{55} Four smaller railroads and one electric railroad did successfully complete reorganizations, but they accounted for 0.07\% of the rail miles which were involved in reorganizations during the period up to 1940.\textsuperscript{56} The single largest complaint about the operation of section 77 remained, as in the equity receivership, delay.\textsuperscript{57}

Once the courts, the ICC, and the railroad industry became accustomed to the new procedure, the reorganization process streamlined and became less fraught

---

\textsuperscript{44} See id. at 394.


53. In re Chicago & N.W. Ry. Co., 126 F.2d 351 (7th Cir. 1942); see also 5 ROBERT P. STEPHENSON, COLLIER ON BANKRUPTCY § 77.02, at 475-85 (James Wm. Moore & Lawrence P. King eds., 14th ed. 1978) (discussing “nuisance value makers”).

54. By “large railroad” I mean one having annual operating revenues of over $1 million.

55. Dembitz, supra note 30, at 393-94.

56. See id. at 394.


A main cause for delay was the requirement that reorganizations follow the rule of Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913). Boyd stood for the principles that shareholders in a reorganized corporation can be liable for the obligations of the original debtor-corporation; and, that if reorganization managers made a fair offer to all creditors (not just secured creditors), courts would respect the reorganized corporation and not impose successor liability. Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 STAN. L. REV. 69, 81 (1991). Another cause for delay was the disproportional amount of litigation resulting from questions of the power of the ICC and the courts to bind security holders against their will. The new elaborate procedures and due process requirements of section 77 overburdened the ICC. See Dembitz, supra note 30, at 413-14; Swaine, supra, at 162. The most awesome cause for delay, however, was simply the unwillingness of the parties to face their financial woes squarely and reorganize. See Dembitz, supra note 30, at 416-17.
with delay. A few problems only needed a one-time solution. For example, *Northern Pacific Railway Co. v. Boyd* settled some doubt about the role of the ICC in railroad reorganizations once and for all. Other problems of interpreting section 77 disappeared after a judicial resolution, allowing the parties and the courts to proceed to the business of reorganizing. Section 77 nestled itself into the Bankruptcy Code of 1898 and remained there for eighty years until Congress rebuilt bankruptcy law in 1978.

6. Section 77 Reincarnated as Section 1165 of the Bankruptcy Code of 1978

In the late 1960s there grew a movement to overhaul the American system of bankruptcy law, both for consumers and businesses. One of the fruits of that movement was the creation of the Commission on the Bankruptcy Laws of the United States (the "Bankruptcy Commission") in 1970. The Bankruptcy Commission did an exhaustive study of the history of American bankruptcy law. It called upon academics and judges in the field for their experiences with the ancient 1898 Code and their opinions about reform. Specific to this Note, the Bankruptcy Commission studied and made recommendations about reform in the area of railroad reorganizations.

Particular to the theme of public interest, the Bankruptcy Commission noted three ways Congress had tried to protect the public interest through section 77. First, liquidation was not an option for railroads under the Bankruptcy Act of 1898 and its amendments. Nor was there a way to convert a reorganization proceeding to a liquidation proceeding, as there is now. Second, the ICC had a substantial supervisory role in the reorganization process. Third, the reorganizing court had the power to approve a reorganization plan without the assent of a majority of creditors and stockholders, so long as it was fair and equitable to do so. The Bankruptcy Commission considered the first observation, that there was no provision for liquidation, to be outdated. Sometimes, concluded the Bankruptcy Commission, it might be more in the public interest to liquidate an unprofitable railroad than to let it rot in or after reorganization. There was no longer an absolute necessity for continuing the operation of a railroad that is in financial straits. Thus, the Bankruptcy Commission made recommendations addressing the concerns which remained

---

60. *See* Dembitz, *supra* note 30, at 411-12.
61. There were other minor amendments to section 77 between 1935 and 1978 that are not relevant to this Note.
65. REPORT, *supra* note 63, at 263-64.
66. *Id.* at 264-65.
from the era of equity receiverships, and also the concerns which had built up since the enactment of section 77 in the 1930s.

The problem of delay had not improved much by the enactment of section 77. As commentators of the 1940s noticed, much delay was due to the extensive role of the ICC. Specifically addressing this concern, the Bankruptcy Commission said, "the role of the ICC in a railroad reorganization case should be . . . one of a supervisory and advisory nature with the ICC acting essentially to represent the particular public interest affected by the proceedings in which they participate."67 The Bankruptcy Commission recommended that the ICC retain its standing to be heard in a reorganization proceeding without the permission of the court, but that this standing be limited to the district court level (that is, the ICC should have no right to appeal). The one affirmative power that the Bankruptcy Commission recommended that the ICC retain was the power to authorize (or not) the abandonment of rail lines. In other respects, the role of the ICC was to be advisory only.68 In sum, the goal of the Bankruptcy Commission in its recommendations was "to provide relief to the courts, the parties, the debtor, the trustees, and the public generally. It is considered that much waste, delay, and inefficiency would be eliminated while, at the same time, the rights of the various parties remain fully protected."69

With the ICC stripped of most of the power it wielded for a century, who would defend the public interest in railroad reorganizations? The court itself would. In 1978 Congress enacted a new Bankruptcy Code.70 Within railroad reorganizations, section 1165 requires the court itself "to take into account the 'public interest' in the preservation of the debtor's rail service."71

So, in limited instances in bankruptcy law, Congress requires that the court consider the public interest. In reading about the current debate over whether to consider the public interest in bankruptcy law, it is crucial to keep in mind that the law already does—the concept is not new. Even nearing the twenty-first century when rail dependence is lower than it has been in decades, no court may approve a railroad reorganization plan if it is not, in the court's view, in the public interest.

The history of railroad reorganizations shows that the consideration of the public interest in bankruptcy is not such a novel idea. Parties differed on their definition of the public interest. Some thought it was only the interests of shippers and passengers. Others thought it was the interest of the nation in having a strong capital base for the railroad industry. Perhaps the wisest view was the one that encompassed the interests of all these groups, including the creditors. It would be helpful to see an example of exactly how the consideration of the public interest worked in a railroad reorganization. The next Part describes

67. Id. at 266.
68. Id. at 267.
69. Id. at 271.
71. 11 U.S.C. § 1165 (1994). "In applying [various] sections . . . of this title [concerning railroad reorganizations], the court and the trustee shall consider the public interest in addition to the interests of the debtor, creditors, and equity security holders." Id. (emphasis added).
one citizens' group that successfully intervened to protect its own interests in a railroad reorganization; then the Part sums up the lessons which can be derived from the history of railroad reorganizations.

7. The Old Colony Commuters and Shippers League

The problems of the Old Colony Railroad Company reach back many years. In 1893 the New Haven and Hartford Railroad Company took over the Old Colony via a ninety-nine year lease; the New Haven operated and in effect owned the Old Colony. The New Haven petitioned for section 77 reorganization in 1935. The reorganization trustees decided that the Old Colony lease was unprofitable, and that the Old Colony should operate itself once again. The reorganization court rejected this idea because the Old Colony had neither funds nor organization nor equipment to operate itself. The court ordered the New Haven to continue operating the Old Colony during the reorganization proceedings. Meanwhile, the Old Colony itself petitioned the same court for reorganization under section 77. The New Haven reorganization trustees asked the Massachusetts Department of Public Utilities for permission to cease entirely service to eighty-eight passenger stations, and the Massachusetts Department of Public Utilities began hearings on the matter.

The passengers, understandably, became alarmed. They needed this railway service. The Old Colony provided vital links among Boston, Providence, and New York City. Interested people formed an organization for the sole purpose of representing the public interest in the case. They called themselves the Old Colony Commuters and Shippers League (the "League"). Their goal was to secure rail service for themselves. To accomplish this they petitioned both the Massachusetts Department of Public Utilities and the ICC to force the New Haven, as part of its reorganization plan, to take over the Old Colony and become its legal owner. The League petitioned for tax relief for the New Haven and lobbied for a new railroad tax statute. The League slowly was able to turn the extreme positions of opposing parties into more moderate ones with the potential for compromise. "Quietly and continually, but apparently without antagonizing, [the League] suggests constructive moves for other parties to make."

The history of railroad reorganizations teaches at least five lessons about potentially considering the public interest in modern reorganizations generally.

73. Id. at 499.
74. Id.
75. Id.
76. Id.
77. Id. at 500.
78. Id. at 501.
79. Id. at 498.
80. Id. at 504.
81. Id. at 505.
82. Id. at 505-06.
83. Id. at 505.
First is the simple fact that it has been done before. It is not radical. Second, courts are capable of listening to and considering interests of those other than debtors and creditors. Third, citizens like the Old Colony Commuters and Shippers League can organize themselves, when properly motivated, into groups which are capable of participating meaningfully in a reorganization proceeding, at least in a limited way. Fourth, eliminating the ICC from the reorganizations sped up the process, and complaints about delay and inefficiency have waned. And fifth, courts have allowed railroads to go bankrupt without reorganizing if that was the best possible solution. These reasons for considering the public interest in railroad reorganizations could apply equally to modern business reorganizations. Before explaining how that could be done, this Note will explore three other arguments for considering the public interest in business reorganizations.

B. Appointment of Officers, Directors, and Trustees

The Bankruptcy Code mentions the public interest in one section outside the railroad context. A reorganization plan must contain “only provisions which are consistent with . . . public policy with respect to the manner of selection of any officer, director, or trustee under the plan . . . .”84 This section sounds quite imposing, but in practice it is unclear what its application is.85 This mandatory requirement gives creditors a say in the selection of management of the reorganized entity—in theory creditors could veto the appointment of unsuitable management by invoking this section.86

Thus, the concept of the public interest is not at all foreign to the Code. It has existed for over six decades in the railroad area, and it appears again in the appointment of management for any reorganized entity.

C. Bankruptcy Distinguished from Debt Collection

If bankruptcy is indeed a large, federal machine for debt collection, then the economists are probably correct that there is no need to consider anyone other than the debtor and the creditors. However, this economists’ model of bankruptcy is subject to criticism.

The reason for having a unified, federal law of bankruptcy is that state collection law is too varied to handle the large bankruptcies that arise today. Corporations are now the rule in twentieth-century business, not the partnership of past years. A business that declares bankruptcy is not isolated from the rest of the world, like a debt between two people is more likely to be. A business has employees, suppliers, and customers. Those employees and customers shop in stores near where they work. Suppliers have other customers, and their own

86. One might imagine creditors opposing a management known for poor financial judgment or abusive labor practices.
suppliers. Modern corporations are only one part of a giant web of financial
dependence. To treat a reorganization as if it only affects a few parties with
capital interests is to see the question quite narrowly.

Congress understood this interdependence in the railroad context and acted on
it via section 77 and section 1165. What if a judge were to consider these
interests now, outside the railroad context?

D. To Consider Does Not Necessarily Mean to Change

Section 77 required and section 1165 requires a reorganization judge to
approve a plan only if it is in the public interest. This strong language is steeped
in the history of society's dependence on the railroads, followed by the financial
dependence of the railroads on government. Expanded beyond the familiar
railroad context, the consideration of the public interest, though, need not end in
a decision in favor of the public interest. A judge could consider the public
interest (or the interest of an identified group other than creditors), but not be
persuaded by it. Consideration does not necessarily lead to change.

Consideration, independent of the result, has some benefits to the litigants and
to the court.

Suppose a body like the Old Colony Shippers and Commuters League were to
appear today. It might be a group of employees and their families, instead of
railroad users. They would benefit by speaking in the reorganization proceeding
even if the judge did not issue a decision favorable to them. Speaking in an open
forum has benefits separate from what follows.

In a discussion of what values underlie procedure, E. Allan Lind noted a
surprising finding from research on procedural justice. The outcome of litigation
is not as important to litigants as one might think. Litigants derive their sense of
justice more from their perception of the fairness in the procedure than from the
outcome of the process. Litigants value an adequate opportunity to tell their
story, especially to unbiased ears.

Aside from the intangible benefit of the satisfaction of being heard, a group
such as the League might even achieve its goal, or at least cause the debtor and
creditors to moderate their positions toward a compromise. A reorganization
judge, given the freedom to do so, might choose to adopt some measures
intended to benefit a class other than creditors. If the judge is going to do so, it
is in the interest of all that the judge does so from the best-informed position
possible. Judging from ignorance can benefit no one.

87. "To weigh merits of (course of action, claim, candidate, etc.)." THE CONCISE OXFORD
DICTIONARY 384 (7th ed. 1982).
88. See generally E. ALLAN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF
IV. HOW TO DO IT

A. Do Nothing

One way to allow for the consideration of the public interest would be to do nothing. It is possible to tell judges what to consider, but it is impossible to know exactly what judges take into account in judging. Judges are aware of the effect of their decisions on employees and communities. Some judges already consider interests of parties who are neither debtors nor creditors in business reorganizations considering, as Congress has mandated, whether a particular reorganization plan will lead to further financial difficulty for the business. However, as a reform, this approach is not quite honest. The Bankruptcy Code mentions the public interest only twice, and only in very specific contexts. If the courts are going to consider the public interest in earnest, there needs to be some kind of statutory push in that direction.

89. "You are sensitive as a judge as to whether or not there are people that are going to be out of work if you rule a certain way. You have to be." Hon. Leif M. Clark, What Constitutes Success in Chapter 11? A Roundtable Discussion, 2 AM. BANKR. INST. L. REV. 229, 233 (1994) (statement of L. Ed Creel III). "Right. I think you do." Id. (response to Mr. Creel’s comment by Hon. James A. Goodman). Also consider the opinion of one reorganization judge:

It is not necessary for present purposes to define exactly when, how, and to what extent the consideration of the public interest may be a determinative factor in the conduct and the resolution of these reorganization proceedings. It suffices to note that it is at least arguable that the public interest factor still must be considered by the reorganization court in a case having a manifest public impact. In re Public Serv. Co., 88 B.R. 546, 556 (Bankr. D.N.H. 1988) (Yacos, Bankruptcy J.) (footnote omitted).

90. Judge James A. Goodman has stated that judges have "some leeway" in considering the public interest in individual decisions to the extent that Congress has indicated that a judge should not confirm a plan unless it appears to the judge unlikely that further reorganization will not follow. Clark, supra note 89, at 233 (statement of Hon. James A. Goodman). The Judge was referring to 11 U.S.C. § 1129(a)(11) (1994), which says that the court should not confirm a plan unless "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan."

91. As one judge put it:

The Code seems to evaluate success primarily in terms of the maximum payout to creditors from the available assets which are to be distributed according to the Code priority scheme. While a judge is aware of the interests of employees and the community, he or she has to be guided by the distributional goal of the Code. Clark, supra note 89, at 234 (statement of Hon. Robert C. McGuire).


Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall contain only provisions that are consistent with the interests of creditors and equity security holders and with public policy with respect to the manner of selection of any officer, director, or trustee under the plan and any successor to such officer, director or trustee.
B. Liberalization of the Idea of "Party in Interest"

One way to allow groups of people with an interest in the reorganization proceeding to step into the forum might be through expansion of the idea of who is a party in interest. Although the Bankruptcy Code gives examples of who might be a party in interest, the Code nowhere defines "party in interest." The case law fills the gap a bit.

Courts agree that the Code does not define "party in interest." Section 1109 grants the right to be heard in a reorganization proceeding to "parties in interest" and lists some predictable examples: debtors, creditors' committees, equity security holders' committees, creditors, equity security holders, and indenture trustees. Sometimes natural persons or other entities not included in the list have asked the court for the right to be heard, claiming to be parties in interest. Courts have responded differently.

At least twice courts have granted legal representation to future, unknown tort claimants. Amatex Corporation and Johns-Manville Corporation each faced enormous tort liabilities, including punitive damages, owed to people harmed by asbestos. Each predicted future liability in such large numbers that their corporation could not continue to operate without reorganization. In a normal tort situation, the claimants would file their suits, get judgments, and be judgment creditors, thus falling within the section 1109 enumeration. Asbestos exposure, however, posed special problems for these reorganizing corporations because the symptoms of disease caused by asbestos exposure may not appear for many years. Both courts decided that the unknown future tort claimants were entitled to legal representation in the present reorganizations. In so holding the courts characterized the determination of party status as one to be done on a case by case basis. The concept of party in interest is elastic. A party in interest is one with a "sufficient stake in the proceeding."

Courts have held some parties not to have a sufficient stake in the proceeding. Generally in doing so, the courts have weighed the interest of the would-be party in interest against the interests of the debtor and the court in an efficient
proceeding—a proceeding as simple as possible, with as little delay as possible. Courts also refer to the idea of bankruptcy as a large debt collection service when denying party in interest status.103

In a leading case, In re Public Service Co.,104 the court did not decide whether to grant party in interest status to various groups which wanted to participate in the reorganization of the Public Service Company of New Hampshire.105 Most pertinent to the topic of the public interest, several consumers groups moved for party in interest status.106 The court discussed the competing interests involved with the groups’ motions. The court wanted to avoid overburdening the reorganization process by allowing too many parties to enter. However, the groups wanting in had very real interests that the reorganization process affected, whether they were allowed to speak or not.107 The court decided not to decide. "[C]ourts generally try to avoid deciding party in interest and intervention questions in the abstract . . . . I conclude that the path of wisdom is to defer deciding these matters until they can be presented in more specific contexts . . . ."108

The court was indeed wise. It answered the efficiency concern noted in Ionosphere Clubs and Addison by not allowing in anyone who wanted to ramble about anything, but rather admitting those parties who wanted to articulate a specific concern about a contained area of the proceeding. Those parties wishing to speak confined their comments to what was relevant to their cause, satisfying their need to participate and be heard by a neutral decisionmaker. The court found the right harmony between the judiciary’s (and the debtor’s and creditors’) desire for efficiency and the need for affected party satisfaction and informed decisionmaking.

The law, then, does not (beyond “sufficient stake” language) answer the question of who may enter a reorganization proceeding. Some examples are apparent. The group might be one that is already in place to represent the interests of its constituency on a variety of issues, such as a labor union. The group might be one established to achieve political victories. Such a group might have organized itself like the Old Colony Commuters and Shippers League did in 1939. Adopting the approach of Public Service, the court could weigh the benefits of allowing these groups to be heard against the costs in delay and confusion on the proceeding.


106. These groups included the Business and Industry Association of New Hampshire, the Citizens Within the 10 Mile Radius, Inc., the Seacoast Anti-Pollution League, and the Campaign for Ratepayers’ Rights. See Public Serv., 88 B.R. at 548.

107. Id. at 554.

108. Id. at 554-55 (emphasis in original).
There are benefits both to the parties seeking interest and to the proceeding. By giving these kinds of groups the right to be heard in a reorganization court, the judicial system is improving itself in at least two ways. First, it is increasing the satisfaction of its users by allowing them to voice their real-life concerns in a fair arena. Second, if the judge decides the public interest is worth considering, then the judge is better informed about the effect of possible decisions and in a better position to rule.

Giving these groups a voice does no harm. If the judge decides that the public interest is not compelling enough to alter the plan of the creditors and debtor, the judge can ignore the group and rule notwithstanding having heard them. The group, however, still carries away its satisfaction at having been heard.

C. A New Statute, Less Strong Than Section 1165—"The judge may consider the public interest."

Changing the idea of a party in interest does little good if judges are still bound to consider only the "payoff," the distribution of assets among the debtor and creditors. Judges need some kind of statutory permission to consider the public interest.

Congress decided in 1933 that judges must not confirm a railroad reorganization plan unless it was in the public interest to do so, because Congress had decided that the railroads always involved the public interest. No judge in a railroad reorganization had to decide whether the public interest was affected, or how much it was affected. Congress had already done that through section 77 and then section 1165. A consideration of the public interest in modern business reorganizations would require a judge not only to decide whether to rule in such a way that the creditors make some sacrifice for the public interest, but whether the public interest is worth taking into account in a particular reorganization at all. Thus, a new statute would have to be more flexible than section 77 and section 1165 were. A new statute would have to be permissive, not commanding. It would grant the judge the authority to consider the public interest if the judge thinks it is better to do so than not. This author would propose the following language: "In ruling on a reorganization plan, the bankruptcy judge may consider the interests of any person or group who will be affected by the reorganization."

CONCLUSIONS

The debates over the consideration of the public interest in bankruptcy law focus on what the traditional goals of bankruptcy are and what, perhaps, they should be. The arguments come from history, economics, communitarianism, and feminist legal theory. To say the Bankruptcy Code does not take into account the public interest is folly. By looking at the historical reasons for the consideration of the public interest in railroad reorganizations, it becomes possible to ask whether those reasons are extinct, or whether they apply to other types of reorganizations today.

Through a more flexible approach to considering the public interest, judges can build on the power they already have to take interests of those other than creditors into account. Broadening the definition of party in interest in
reorganization proceedings benefits those parties who want to be heard as well as the court that must decide how to proceed.

Independent of any conclusions about the appropriateness of considering the public interest in reorganizations, I hope this Note contributes to the debate about expanding the bankruptcy law to allow those who have very real, albeit not credit, interests to be heard. The arguments of the economists are persuasive, but so are those of scholars interested in a broader, more humane law of bankruptcy. As Mill put it:

However unwillingly a person who has a strong opinion may admit the possibility that his opinion may be false, he ought to be moved by the consideration that however true it may be, if it is not fully, frequently, and fearlessly discussed, it will be held as a dead dogma, not a living truth.\textsuperscript{109}

\textsuperscript{109} JOHN STUART MILL, ON LIBERTY 34 (Alburey Castell ed., Harlan Davidson 1947) (1859).