
Michigan Law Review

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Bankruptcy Law Commons

Recommended Citation
Available at: https://repository.law.umich.edu/mlr/vol73/iss5/4

This Note is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

In an action between a debtor and a creditor, the debtor may seek to reduce his liability by pleading counterclaims. A permissive counterclaim—any claim against the creditor not arising out of the transaction or occurrence that is the subject matter of the creditor's claim1—is typically termed a "setoff" to the extent that it does not

1. "A pleading may state as a counterclaim any claim against an opposing party not arising out of the transaction or occurrence that is the subject matter of the opposing party's claim." FED. R. CIV. P. 15(b).
involve affirmative relief. If the debtor is insolvent and seeks bankruptcy relief, setoffs may result in priorities whereby one creditor gains preference in the distribution of the debtor's estate over other creditors of the same class or even of a superior class. For example, if Jones and Smith are each owed 1000 dollars by the bankrupt Widget Corporation, which has assets of 1000 dollars, they normally would expect to receive 500 dollars each. However, if Jones also owes Widget 1000 dollars (Widget's sole asset is thus Jones's obligation), and Jones sets off Widget's claim against him with his claim against Widget, then Smith will suffer a 1000 dollar loss and Jones will be whole.


4. U.S. CONST. art. 1, § 8, gives Congress the power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." As James Madison argued: "The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may be removed into different states, that the expediency of it seems not likely to be drawn into question." THE FEDERALIST No. 42, at 279 (P. Ford ed. 1898). See generally 1 COLLIER ON BANKRUPTCY ¶ 0.01-10 (14th ed. J. Moore 1974) [hereinafter COLLIER].


6. The text assumes that Jones and Smith are members of the same creditor class and that no other creditors exist who are members of a superior or equal class. See generally 6A COLLIER, supra note 4, ¶ 9.10. The priority afforded by the setoff right may even be superior to the priority of secured creditors in certain instances, however. For example, if the security interest is in accounts receivable, the unsecured creditor who is allowed a setoff will diminish the receivables, thus taking ahead of the secured creditor.

7. It is often argued that such a setoff constitutes a voidable preference under section 60 of the Bankruptcy Act, 11 U.S.C. § 96 (1970). See 4 COLLIER, supra note 4, ¶ 68.02, at 823 n.18. However, if at the time of the transaction the creditor does not have reasonable cause to believe that the debtor is insolvent, section 60 will not apply.
Setoffs are expressly permitted by section 68 of the Bankruptcy Act in straight bankruptcy proceedings. However, there is no corresponding section permitting setoffs under the reorganization provisions—section 77, and chapters X, XI, XII, and XIII. Prior to 1974, the use of setoffs in bankruptcy reorganizations was governed by the Supreme Court’s dictum in Lowden v. Northwestern National Bank & Trust Co. The Supreme Court, dealing with a case involving a section 77 railroad reorganization, stated that “. . . § 68 of the statute does not control the disposition of the controversy ex proprio vigore. It governs, if at all, by indirection and analogy according to the circumstances.” Lowden was generally understood as allowing bankruptcy courts to permit setoffs in reorganizations if warranted by the equities of the situation. One court listed the crucial factors as the value of the assets involved, the temporary or permanent duration of the debtor's inability to pay its debts as they mature, the existence of superior liens, and the existence of an understanding between the debtor and creditor that amounts owed by the creditor to the debtor were to be used to cancel the debtor's obligation. In 1974, however, the Supreme Court decided Baker v. Gold Seal Liquors, Inc., which significantly limited bankruptcy courts' discretion to permit setoffs in section 77 railroad reorganization proceedings. This note will examine the Baker decision and consider its significance with respect to Cumberland Glass Mfg. Co. v. De Witt & Co., 237 U.S. 447 (1915); In re Potter & Stymus Co., 262 F. 955 (2d Cir. 1919). Cf. Crisick v. Second Natl. Bank, 115 F.2d 150 (D.C. Cir. 1940).

8. "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid." Bankruptcy Act § 68a, 11 U.S.C. § 108(a) (1970).

9. Straight bankruptcy proceedings contemplate a liquidation of the debtor's estate. In contrast, reorganization proceedings contemplate a continuation of the bankrupt enterprise pursuant to an extension or partial forgiveness of the bankrupt's debts.

10. 298 U.S. at 160 (1936). The case involved instructions requested by the Court of Appeals for the Eighth Circuit upon certified facts. 298 U.S. at 161. The first question presented to the Supreme Court was "Does the right of set-off recognized by section 68(a) of the Bankruptcy Act apply to reorganization proceedings under section 77 of that act?" 298 U.S. at 162. Asserting that the question was "too general and abstract, its relation to the controversy being indirect and problematical," the Court refused to resolve the issue. 298 U.S. at 166. Because the remaining questions were dependent on a resolution of the first, the Court dismissed the certificate. 298 U.S. at 166.


setoffs under section 77. The focus will be on two issues: the doctrinal and policy justifications for the *Baker* rule and the impact of *Baker* on the summary exclusive jurisdiction of a reorganization court to enter an order barring setoffs in related proceedings. The note will then assess the extent to which *Baker* should govern the treatment of setoffs in Chapter X and XI reorganization proceedings.\(^{14}\)

In *Baker*, the reorganization trustees\(^{15}\) of the Penn Central Railroad instituted an ancillary suit\(^{16}\) against Gold Seal Liquors, Inc., to recover \$6,999.76 in unpaid freight charges.\(^{17}\) Gold Seal counterclaimed, asking \$18,016.77 for loss and damage to its shipments in Penn Central's care. The district court granted the trustee's motion for summary judgment but allowed a setoff on the basis of the counterclaim, resulting in a net judgment of \$11,017.01 for Gold Seal.\(^{18}\) The Court of Appeals for the Seventh Circuit affirmed the judgment; the Supreme Court reversed on writ of certiorari. Justice Douglas, writing for the majority, noted that typically a court has jurisdiction to entertain counterclaims in its final resolution of a conflict, and that, in some instances, the counterclaims may be compulsory.\(^{19}\) However, he found railroad reorganization proceedings to

\[\text{Notes} \quad 935\]

\(^{14}\) Chapter X is essentially concerned with the reorganization of large, publicly held corporations with complicated debt structures. See text at notes 84-86 *infra*. Chapter XI reorganization provisions may be utilized by any "person," including corporations, and are derived from the common law of composition. See text at notes 93-99 *infra*.

\(^{15}\) The court must appoint a trustee or trustees in a section 77 proceeding upon approval of the debtor's petition. Bankruptcy Act § 77(c)(1), 11 U.S.C. § 205(c)(1) (1970). Trustees must be appointed in chapter X reorganizations if the indebtedness of the debtor exceeds \$250,000, and may be appointed if the indebtedness is under \$250,000. Bankruptcy Act § 156, 11 U.S.C. § 556 (1970). Trustees are charged with the duty of preserving the assets of the debtor for the benefit of all parties in interest. Bankruptcy Act § 47, 11 U.S.C. § 75 (1970).

\(^{16}\) The courts of the United States hereinbefore defined as courts of bankruptcy ... are hereby invested ... with ... jurisdiction ... to:

(20) Exercise ancillary jurisdiction over persons or property within their respective territorial limits in aid of a receiver or trustee appointed in any bankruptcy proceedings pending in any other court of bankruptcy. Provided, however, that the jurisdiction of the ancillary court over a bankrupt's property which it takes into its custody shall not extend beyond preserving such property and, where necessary, conducting the business of the bankrupt, and reducing the property to money, paying therefrom such liens as the court shall find valid and the expenses of ancillary administration, and transmitting the property or its proceeds to the court of primary jurisdiction.

11 U.S.C. § 11(a) (1970). Ancillary suits are independent proceedings brought in courts other than the bankruptcy court in which the petition was filed. Ancillary proceedings generally are brought in aid of the bankruptcy court of primary jurisdiction when jurisdiction is not obtainable in that court. See 1 COLLIER, *supra* note 4, ¶ 2.34. Questions pertaining to the general administration of the debtor's estate may not be entertained in an ancillary court. Lazarus v. Prentice, 234 U.S. 263 (1914).


\(^{19}\) 417 U.S. at 468-69.
be an exceptional class of cases, in which counterclaims that result
in setoffs are inapposite. The majority acknowledged that section
68 expressly allows setoffs in straight bankruptcy proceedings, but
it refused to incorporate by analogy the policy judgment embodied
in that section into the section 77 railroad reorganization provisions.
Two rationales were advanced to support the distinction. First, the
Court stated that reorganization bankruptcies have a different ultimate
objective than straight bankruptcies, and that to permit setoffs
would frustrate that objective: "The problem of the bankruptcy
Reorganization Court is somewhat different than the problem of the
straight bankruptcy court. Liquidation is not the objective. Rather,
the aim is by financial restructuring to put back into operation a
going concern." Since the collection of amounts owed the bankrupt
is necessary to keep its cash inflow sufficient for operating purposes,
and because to allow setoffs could significantly reduce that cash in­
flow, the court felt that setoffs violated the basic statutory purpose of
reorganization proceedings. The Court buttressed its conclusion
by noting that the preservation of an ongoing railroad was "in the
public interest," and implied that the allowance of setoffs could
jeopardize that interest.

Second, the majority sought to distinguish straight bankruptcies
from railroad reorganization proceedings on the basis of the language
of section 77(e): "[T]he Reorganization Court shall approve a plan
if it is fair and equitable, affords due recognition to the rights of
each class of creditors and stockholders, and will conform to the
requirements of the law of the land regarding the participation of
the various classes of creditors and stockholders." Recognizing that
setoffs are in effect priorities, allowing a member of a subordinate
creditor class to collect on his debt ahead of a member of the same

20. 417 U.S. at 468-69. See note 8 supra and accompanying text.
22. The Penn Central in fact faced a severe liquidity problem. See N.Y. Times,
Dec. 21, 1974, at 37, col. 7 (late city ed.) (Penn Central faces cash shortage of $85.4
million for operations by end of February 1975); id., Dec. 4, 1974, at 63, col. 1 (late
city ed.) (Penn Central suffered $130.2 million operating loss in first 10 months of
1974). Liquidity is essential to the continued operation of a debtor in reorganization.
Without liquid capital the debtor could not meet its short-term obligations, such as
wages, and would collapse without having had the opportunity to resolve its long­
range problems.
23. 417 U.S. at 471. The overriding public interest in railroad reorganizations is
the maintenance of a viable national railroad system. In re Denver & R.G.W. R.R.,
38 F. Supp. 106, 115 (D. Cal. 1940), See generally Swaine, Present Status of Railroad
Reorganizations and Legislation Affecting Them, 18 N.Y.U. L.Q. 161 (1941). See also
Ecker v. Western Pac. R.R., 318 U.S. 448 (1943); Bankruptcy Act § 77(d), 11 U.S.C.
§ 205(d) (1970), requiring the Interstate Commerce Commission to certify that a rail­
road reorganization plan "will be compatible with the public interest" before the
plan may be implemented.
or a superior class, the Court found that setoffs were inconsistent with the "fair and equitable" standard enunciated in the statute: "The allowance or disallowance of setoff may seem but a minor part of the architectural problem. But to the extent that it is allowed, it grants a preference to the claim of one creditor over the others by the happenstance that it owes freight charges that the others do not. That is a form of discrimination to which the policy of § 77 is opposed. As a general rule of administration for § 77 Reorganization Courts, the setoff should not be allowed." In promulgating this "general rule," the Court departed from the position taken by most lower courts and commentators, who cited Lowden and maintained that bankruptcy courts could, in their assessment of the equities of individual cases, decide to apply section 68 setoff principles to reorganizations.

Justice Stewart, in a concurring opinion joined by Justice Powell, sought to maintain the lower court interpretation of Lowden by resting the decision in Baker on an alternate theory. Significantly, the concurring Justices perceived the majority's holding as a shift in the law: "By announcing a doctrine barring judicial setoffs as a 'general rule' the Court in the present case adopts a rationale inconsistent with Lowden, which quite clearly envisioned a case-by-case analysis of the propriety of each attempted setoff in the light of equitable considerations."

Justice Rehnquist, dissenting, also argued that the majority view was a departure from Lowden: "Nothing could be more inconsistent with Lowden than the flat order of the Reorganization Court, entered at the commencement of the reorganization proceedings, to the effect that no setoffs were to be allowed, unless it be that part of the Court's opinion in this case stating that 'as a general rule of

25. 417 U.S. at 473. See text at notes 5-7 supra.
26. 417 U.S. at 474.
27. "Since § 68 does not create any new right but merely recognizes the doctrine of set-off as authorized by legal and equitable principles and provides a means for enforcement in bankruptcy, there would not seem to be any potent reason why § 68 should not apply in Chapter X reorganizations. The decisions, under . . . Chapter X, as well as . . . Chapters XI and XII, have, without authoritative dissent, regarded § 68 as fully applicable in the respective proceedings involved." 6A COLLIER supra note 4, ¶ 9.09, at 307-08. See also In re Cuyahoga Fin. Co., 136 F.2d 18 (6th Cir. 1943) (ch. X); In re Rosenbaum Grain Corp., 103 F.2d 656 (7th Cir. 1939) (ch. X); In re Bush Terminal Co., 93 F.2d 661 (2d Cir. 1938) (ch. X); Lowden v. Iowa Des Moines Natl. Bank & Trust Co., 10 F. Supp. 450 (D.C. Iowa 1935), aff'd, 84 F.2d 855 (8th Cir.), cert. denied, 299 U.S. 584 (1936).
28. Justice Stewart would have decided the case on jurisdictional grounds. See text at notes 69-71 infra.
29. 417 U.S. at 476.
administration for § 77 Reorganization Courts, the setoff should not be allowed.” 31

The majority responded summarily that “Lowden v. Northwestern National Bank & Trust Co. . . . is not to the contrary.” 32 Nevertheless, it felt compelled to state that “[m]uch law has been fashioned in the reorganization field since 1936, the date of that decision. The contours of plans have emerged which have given new meaning and insight into the statutory words ‘fair and equitable.’ ” 33 It is puzzling that the majority refused to take the final step of overruling its dictum in Lowden. Perhaps the Court simply felt that, as dictum, Lowden could be overruled without so stating explicitly. However, this would be an unlikely way to deal with a dictum that has guided lower courts for thirty years. 34 The Court’s opinion more likely should be read as indicating that the core principle of the Lowden dictum—that there is no hard and fast rule as to the allowance of setoffs—is not rejected. Rather, the Court sought only to limit the current scope of the Lowden dictum. By phrasing its result as a “general rule,” 35 and suggesting that no “exceptional circumstances” could justify the setoff in Baker, 36 the Court implied that setoffs would be allowed in section 77 reorganizations in certain situations. Instead of presuming that the policy of section 68 could be applied to railroad reorganizations, the Court, as a consequence of new insights into the meaning of the “fair and equitable” language in section 77(e), created a strong presumption against the allowance of setoffs. Thus, the opinion shifts the burden of justifying the setoff to the counterclaiming creditor.

The operation of the Baker rule is to some extent unclear. On the one hand, certain tests previously employed to determine whether to allow setoffs under Lowden will no longer be dispositive. For example, the precedential value of a line of post-Lowden cases that allowed setoffs when an understanding was reached by the parties that the debtor’s deposits with the creditor were to be used to cancel the debtor’s obligations 37 is now dubious. Under Baker such understandings may not provide the creditor who is a party to the understanding with a right to share in the debtor’s assets that outweighs the rights of other similarly classified or superior creditors; such dis-

31. 417 U.S. at 482, quoting the majority opinion, 417 U.S. at 474 (emphasis original).
32. 417 U.S. at 474 n.13.
33. 417 U.S. at 474 n.13.
34. 417 U.S. at 475-76 n.2 (Stewart, J., concurring).
35. 417 U.S. at 474.
36. 417 U.S. at 474 n.13.
37. See, e.g., Tyler v. Marine Midland Trust Co., 128 F.2d 927 (2d Cir. 1942). See also Susquehanna Chem. Corp. v. Producers Bank & Trust Co., 174 F.2d 783, 787 (3d Cir. 1949); text at note 12 supra.
parate treatment would run afoul of the Court's interpretation of the "fair and equitable" language of section 77(e). On the other hand, although the exceptions to the Baker rule were not defined, situations of extreme inequity can be hypothesized that may justify allowance of setoffs. For example, the "unclean hands" of a creditor have been held to justify subordinating his claim to the claims of other creditors in the same class. 38 Thus, if Jones and Smith are the only creditors of the Widget Railroad, which is being reorganized under section 77, and if Jones has caused the bankruptcy through fraudulent misdealings with Widget, the courts may still allow Smith to set off Widget's claim against him with his claim against Widget, thus subordinating Jones' claim.

Even if the exact dimensions of the Baker holding are uncertain, it is clear that fewer setoffs will be allowed under Baker than were allowed under Lowden. Both of the rationales advanced to support this shift in judicial attitude are open to question. Justice Douglas' first argument was based on the protection of the debtor's cash inflow. 39 Liberal allowance of setoffs would permit creditors to reduce their payments to the debtor by the amount of the outstanding debts owed them, perhaps slowing incoming cash payments to such an extent that the railroad would be unable to meet its expenses. But, although the Baker rule does protect cash inflow from setoffs, it goes too far, and unnecessarily rigidifies a reorganization court's ability to seek an equitable solution to the problems of counterclaiming creditors. There are several means of achieving the ultimate objective of a railroad reorganization—revitalization of an ongoing rail line—without completely eliminating the priority of setoffs. For example, the bankruptcy courts could postpone and preserve setoff priorities until the corporation has restabilized its position. 40 The objectives of the act would be satisfied and the congressional policy behind section 68 of recognizing a priority for setoffs in straight bankruptcies would be respected in section 77 proceedings. Also, the amount of the setoff in some cases may be insignificant in relation to the debtor's cash flow. Disallowing setoffs in such cases obviously cannot be justified by the need to protect the debtor's liquidity.

38. See Pepper v. Litton, 308 U.S. 295, 305-06 (1939); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). Taylor established the "deep rock doctrine." The Court subordinated the claims of Standard Gas to those of other creditors against its subsidiary, Deep Rock Oil Co., on a showing that Standard had launched Deep Rock as an undercapitalized entity and had thereafter mismanaged the company for its own benefit.

39. See note 22 supra and accompanying text.

40. This would be consistent with the view that a bankruptcy court's power to affect the rights of creditors is limited to such measures as are, given the circumstances, least prejudicial to those rights. In line with this view, reorganization plans that have not yet been confirmed by the reorganization court have been characterized as "little more than a provisional sequestration to give protection for the future." Lowden v. Northwestern Nat'l Bank & Trust Co., 298 U.S. 169, 164 (1936).
Perhaps the rigidity of the Baker rule may be attributable to concern for administrative convenience,\textsuperscript{41} equity,\textsuperscript{42} or a fear that the lower courts will abuse their discretion.\textsuperscript{43} These considerations were not mentioned in the Baker opinion, however, and their significance is speculative at best.

The second rationale advanced by Justice Douglas to justify the Baker rule—the "fair and equitable" requirement of section 77(e)\textsuperscript{44}—is not independently determinative. As Justice Rehnquist pointed out in dissent, the allowance of a setoff in section 77 reorganizations is no more inequitable than the allowance of setoffs in straight bankruptcy proceedings: "[T]he Court's observation that the allowance of a setoff grants a preference . . . to say that the Bankruptcy Act's strictures against preferences apply with as much force to ordinary bankruptcies as to reorganizations, and yet § 68 of the Act specifically allows this type of 'preference' in an ordinary bankruptcy proceeding."\textsuperscript{46} Justice Rehnquist's position is sound, but it deserves a more thorough elucidation.

Although the straight bankruptcy provisions contain no explicit requirement that treatment of creditors be "fair and equitable," the bankruptcy court operates as a court of equity, under express statutory directives that for the most part give secured creditors priority over unsecured creditors\textsuperscript{46} and treat similarly situated unsecured creditors equally.\textsuperscript{47} The "fair and equitable" requirement in section 77 has been defined in analogous terms: "There is a hierarchy of claims, the owner of the equity coming last. Wages owing workers running the trains have a high current priority. Secured creditors have by law a priority in the hierarchy. Unsecured creditors usually are pooled together. They may receive new securities, perhaps stock."\textsuperscript{48} Thus, the general policy considerations behind the "fair and equitable" requirement in section 77 are not so different from those behind the Baker rule.
and equitable" language are, for the most part, reflected in the application of the straight bankruptcy provisions.

Section 68, which allows setoffs in straight bankruptcy proceedings, is an explicit exception to these creditor treatment policies and is grounded in a congressional judgment about the equity of setoffs. Accordingly, the policy that creditors receive "fair and equitable" treatment is not independently a valid reason for refusing to allow setoffs under section 77; Congress has decided that similar creditor treatment policies under the straight bankruptcy provisions do not exclude setoffs. As Justice Rehnquist noted, this argument is particularly persuasive in light of section 77(l): "In proceedings under this section and consistent with the provisions thereof, . . . the duties of the debtor and the rights and liabilities of creditors . . . shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed." In other words, the provisions governing straight bankruptcy apply with equal force to reorganization proceedings unless they are inconsistent with reorganization provisions. A justification other than the general rule on creditor class treatment contained in the "fair and equitable" language of section 77(e) thus must be found to distinguish creditor treatment in straight bankruptcies from creditor treatment in reorganization proceedings.

A possible argument against Justice Rehnquist's position rests upon a technical construction of the "fair and equitable" language discussed above. Many have interpreted the "fair and equitable" language to lay down a rule of absolute priority: "As . . . a term of art, it requires that as between secured and unsecured creditors, and between unsecured creditors and stockholders, the priority of the senior interest over the junior in the distribution of equities in the corporate assets [be] absolute." If the "fair and equitable" language is construed as an indication of a legislative intent to exclude exceptions to the general hierarchical treatment of creditor classes under section 77, then the section 68 policy with respect to setoffs should not be carried over to section 77 proceedings.

The Baker rule does have several practical advantages. By disallowing setoffs in most cases, Baker may bring about a simplification of railroad reorganization proceedings, and perhaps a consequent


50. "The language of subsection (l) of § 77, even more emphatically than the Lowden decision, would seem to unconditionally mandate the application of the rule regarding setoffs contained in § 68 of the Bankruptcy Act to railroad reorganizations such as this." 417 U.S. at 482.


52. 9 COLIER, supra note 4, ¶ 9.18.
reduction in cost. Presumably the difficult equitable question whether to allow a setoff will arise less frequently because the creditor seeking a setoff in the reorganization court will bear the heavy burden of demonstrating "exceptional circumstances." In addition, the Baker rule is in accord with the common practice of reorganization courts to grant on a motion by the trustee a general injunction restraining all creditors from seeking setoffs in ancillary suits. The order is typically issued at the time the reorganization petition is approved, and has become standard practice in reorganization proceedings.

The Baker rule, however, may defeat the expectations of business creditors who have extended credit on the basis of their counterbalancing obligation to the debtor. The typical case is that of the financing institution that extends unsecured credit in reliance on the fact that the debtor maintains sums on deposit with the institution. Under the Baker rule, the institution would be liable for the entire amount of the bankrupt debtor's accounts; it would not be able to set off those accounts against the sums owed to it by the debtor as a result of the extension of credit. Undoubtedly, such institutions will become more wary of extending unsecured credit in light of Baker.

One should also consider the domino effect that the Baker rule may have on the stability of the national railroad system. Among a railroad's largest creditors will be the other railroads with which the debtor road has interlining agreements. The more traffic two railroads shuttle between themselves, the more likely it is that large overlapping debts and credits will accumulate. Prohibiting setoffs

---

53. The administration of a debtor's estate is a very expensive process. See, e.g., Note, The Cost of Corporate Reorganization Under the Chandler Act, 52 Harv. L. Rev. 1349 (1939).


55. The banker's lien on deposits, the right of retention and set-off of mutual debts, are frequently spoken of as though they were synonymous, while in strictness, a set-off is a counterclaim which the defendant may interpose by way of cross-action against the plaintiff. But, broadly speaking, it represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other. That right is constantly exercised by businessmen in making book entries whereby one mutual debt is applied against another. Studley v. Boylston Natl. Bank, 229 U.S. 523, 528 (1913).

56. Denying banks a right of setoff would in many cases make banks hesitate to honor checks given to third persons, would precipitate bankruptcy, and so interfere with the course of business as to produce evils of serious and far-reaching consequence." Studley v. Boylston Natl. Bank, 229 U.S. 523, 529 (1913).

57. "There is no statutory compulsion for interconnecting rail carriers to utilize any particular method of collecting fares and freight charges for a through-routed shipment. But, as a practical matter, only one such method is feasible. That is for a single carrier . . . to collect the entire fare, and then remit to the interline carriers their pro rata portions." In re Penn Cent. Transp. Co., 486 F.2d 519, 531 (3d Cir. 1973) (Adams, J., concurring), cert. denied, 415 U.S. 950 (1974).
by a creditor railroad may put a serious financial strain on that railroad; in effect it must at least for some time bear the cost of interlining the debtor's passengers and freight while paying for all of its own traffic interlined by the debtor. Such a situation may cause the creditor also to seek reorganization or other bankruptcy relief. Multiple or chain reorganizations may be the result.\textsuperscript{58}

To some extent the dangers of the domino effect can be averted because a reorganization plan under section 77 must be approved by creditors of each voting class holding two thirds of the amount of total claims of the class.\textsuperscript{59} Although the bankruptcy court can confirm a plan that has not been approved by each class if the plan is "fair and equitable,"\textsuperscript{60} creditor approval is significant in the plan's formulation and in the judge's decision.\textsuperscript{61} If a plan threatens to force additional reorganizations, the creditors will balk at approving it. Furthermore, the Interstate Commerce Commission has a veto power over any railroad reorganization plan promulgated pursuant to section 77,\textsuperscript{62} and it would act to protect the national railroad system. Nevertheless, the \textit{Baker} rule is unfortunate to the extent that it forces a choice between risking a domino effect and preventing the debtor line from reorganizing.

The \textit{Baker} decision also raises questions about the extent of a section 77 reorganization court's summary jurisdiction. Summary procedures permit informal, abbreviated decision-making processes. A plenary suit, on the other hand, is typically a regular civil action with summons, formal pleadings, full trial, and possibly a jury. The differences have been summarized as follows:

The main characteristic differences between a summary proceeding and a plenary suit are: The former is based upon petition, and proceeds without formal pleadings; the latter proceeds upon formal pleadings. In the former, the necessary parties are cited in by order to show cause; in the latter, formal summons brings in the parties other than the plaintiff. In the former, short time notice of hearing

\textsuperscript{58} At least one court has attempted to solve this problem by finding a "trust relationship" between railroads; a reorganization railroad's debt to other railroads is viewed as property of the creditor, held in trust by the debtor, and thus not susceptible to general pro rata distribution among creditors. \textit{See In re Penn Cent. Transp. Co.}, 486 F.2d 519 (3d Cir. 1973), \textit{cert. denied}, 415 U.S. 990 (1974). Judge Adams, concurring in \textit{Penn Central}, suggested that the treatment of interline freight and passenger accounts should be considered sui generis; interline railroads should be given a preferred position in railroad reorganization proceedings with respect to owed freight and passenger revenues. 486 F.2d at 533.


\textsuperscript{60} Bankruptcy Act § 77(e), 11 U.S.C. § 205(e) (1970).

\textsuperscript{61} If the plan is not approved by creditors holding two thirds in amount of the total of the allowed claims of each class, the judge must make additional findings to ascertain whether the rejection was reasonable. Bankruptcy Act § 77(e), 11 U.S.C. § 205(e) (1970).

is fixed by the court; in the latter, time for pleading and hearing is fixed by statute or by rule of court. In the former, the hearing is quite generally upon affidavits; in the latter, examination of witnesses is the usual method. In the former, the hearing is sometimes ex parte; in the latter, a full hearing is had.63

A section 77 reorganization court has the statutory jurisdiction summarily to issue orders concerning the administration of the debtor's assets;64 thus, summary jurisdiction may be exercised with respect to such matters as the appointment of receivers and trustees and the priority of creditors' claims. A reorganization court also may exercise summary jurisdiction with respect to controversies that arise between claimants and the debtor's trustee or receiver regarding property claimed to be part of the debtor's estate, if the court has actual or constructive possession of the property.65 If, on the other hand, the controversy involves property in the actual or constructive possession of a third person asserting a bona fide adverse claim, the bankruptcy court cannot summarily determine that person's claim upon a petition by the trustee unless the adverse claimant consents to the court's jurisdiction.66 Without consent, the trustee must bring a plenary suit in a court of appropriate jurisdiction.67

Baker was an appeal from a federal district court that had allowed a setoff in contravention of a summary order previously issued by the reorganization court.68 Justice Stewart, in his concurring opinion, argued that the summary jurisdiction of the reorganization court over the debtor’s property made the order binding upon all other courts, and that no inquiry by the Supreme Court into the scope of the

---

63. Central Republic Bank & Trust Co. v. Caldwell, 58 F.2d 721, 731-32 (8th Cir. 1932).
68. The trustees of Penn Central brought a plenary action in the District Court for the Northern District of Illinois to recover freight charges owed Penn Central by Gold Seal. The Penn Central Railroad was concurrently undergoing reorganization proceedings in the District Court for the Eastern District of Pennsylvania. The reorganization court in Pennsylvania had issued an order which provided in part that [all] persons, firms and corporations, holding collateral heretofore pledged by the Debtor as security for its notes or obligations or holding for the account of the Debtor deposit balances or credits be and each of them hereby [is] restrained and enjoined from selling, converting or otherwise disposing of such collateral, deposit balances or other credits, or any part thereof, or from offsetting the same, or any part thereof, against any obligation of the Debtor, until further order of this Court.
417 U.S. at 478 n.4.
reorganization court's discretion to allow or disallow setoffs was warranted:

Section 77a gives the Reorganization Court "exclusive jurisdiction of the debtor and its property wherever located." . . . It has been commonly accepted in the federal courts that "property" within the meaning of this section includes intangibles such as choses in action. . . . It follows, therefore, that the respondent's debt to the Penn Central fell within the "exclusive jurisdiction" of the Reorganization Court immediately upon the approval of the petition for reorganization. While such jurisdiction may not empower the Reorganization Court to enforce the cause of action, . . . it certainly does empower the court to protect the "property" and to immunize it from diminution through setoff or counterclaim. To hold otherwise would be inconsistent with the function of the Reorganization Court to consolidate and protect the assets of the petitioning corporation.69

Because a reorganization court's summary power is exclusive, it must be respected by all other courts and can be attacked only on direct review.70 Justice Stewart would thus have reversed the lower court in Baker for not adhering to the general restraining order of the reorganization court against creditor offsets. His position finds support in recent federal case law dealing with the Penn Central reorganization.71

Justice Stewart’s position assumes two subpropositions, both of which have precedential support and flow logically from the congressional purposes underlying section 77's reorganization provisions. First, Justice Stewart assumes (and the majority agreed72) that a chose in action is property of the debtor, and thus subject to the jurisdiction of the reorganization court.73 Justice Rehnquist, however, asserts in his dissenting opinion that the claim that Gold Seal sought to set off was not "property that was actually or constructively in the possession of the trustees . . . . While the Reorganization Court undoubtedly had plenary authority over the trustees, and over the 'property' of the debtor, it certainly does not have such jurisdiction over whatever funds of respondent might be used to satisfy a judgment against him in favor of the trustees."74 Justice Rehnquist’s argument misses the

69. 417 U.S. at 476-77 (emphasis original).
70. Thompson v. Magnolia Petroleum Co., 309 U.S. 478, 483 (1940); Stout v. Green, 131 F.2d 995, 997 (9th Cir. 1942).
72. 417 U.S. at 472 n.7.
73. 417 U.S. at 476-77 (Stewart, J., concurring), citing 2 Collier, supra note 4, ¶ 23.05[4], at 485. Debts owed a bankrupt commonly have been viewed as within the constructive possession of the bankruptcy court, enabling the court summarily to determine the rights of the various claimants. See, e.g., Lahey v. Trachman, 130 F.2d 748, 750 (2d Cir. 1942); In re Worrall, 79 F.2d 88, 90 (2d Cir. 1935).
74. 417 U.S. at 480.
distinction between the enforcement of a chose in action—which requires personal jurisdiction over the adverse party—and the preservation of a chose in action pursuant to the reorganization court's duty to preserve the debtor's property. The reorganization court in Baker was not enforcing the chose in action (the debt owed by the creditor to the debtor); the trustee was enforcing the debt in a plenary suit in a different court. The reorganization court, apparently having determined that setoffs against the debt were inappropriate in the case before it, was merely protecting the chose in action wherever it was enforced. Such protection is justifiable because a chose in action, which may reflect an account receivable, for example, is a common corporate asset that may be bought and sold in the same way as a physical asset. It represents potential cash inflow, and an attempt to revitalize a corporation by reorganization requires protection of the corporation’s cash flow as well as protection of its tangible assets.

Second, Justice Stewart assumes that the reorganization trustee can institute a plenary suit against a creditor in a district court and at the same time bring with him a reorganization court decree that limits the district court's jurisdiction to allow creditor setoffs. By so doing, the trustee seeks relief in the district court without submitting himself to the full jurisdiction of that court, which would include jurisdiction to allow counterclaims and setoffs. While this proposition runs contrary to the thrust of Federal Rule of Civil Procedure 19(b), which explicitly allows the pleading of permissive counterclaims, it has been recognized that bankruptcy reorganizations are unlike other civil actions. The goal of corporate revitalization is facilitated when the trustee is able to pursue his claims unhindered by the risk of potential asset depletions.

75. See text at notes 80-83 infra.

76. See text at note 22 supra.


The interest of the court in any reorganization is greater than . . . the prevention of diminution of assets and the achievement of an equitable adjustment among claimants. It has the further object of preserving the corporation as a going concern. 'To prevent the attainment of that object is to defeat the very end the accomplishment of which was the sole aim of the section, and thereby to render its provisions futile.'


The inference is drawn that the court is without the judicial power to restrain the landlord from resuming the possession of its property. The general principle may be conceded. We have, however, another principle which is applicable. This is that, the property and affairs of the debtor having been committed to the care of the court, it cannot permit any interference with the performance of its duty. Under section 77B (the predecessor of chapter X), a part of that duty is to supervise and pass upon a plan of reorganization of the debtor so as to enable it to continue its business under its own management. All rights to the assertion of remedies against the debtor are necessarily suspended until one of the final objectives of the section 77B proceeding has been reached.
through setoffs that the reorganization court has already determined to be unwarranted. For example, when the creditor has possession of property claimed by the trustee as a part of the debtor’s estate, the problem of obtaining personal jurisdiction may require that the trustee pursue his claim in an ancillary court of appropriate jurisdiction. The debtor’s estate may be reduced without justification if the ancillary court has the jurisdiction to set the trustee’s right to the property off against the claim of the creditor against the debtor’s estate, in violation of an order of a reorganization court.

The majority opinion in Baker ignored the jurisdictional problem and considered the extent of a railroad reorganization court’s discretion to allow setoffs, announcing its general rule against allowance of setoffs. In one sense, the result is baffling. The Court, reviewing a district court decision that allowed a setoff in contravention of a reorganization court decree, reversed the district court on the ground that reorganization courts generally do not have the power to allow setoffs, even though the reorganization court in Baker actually enjoined all setoffs. The result would make sense if the majority assumed without comment that the reorganization court actually had not enjoined all setoffs, a matter Justice Stewart considered “not wholly free from doubt.” However, the introductory language of the majority opinion seemed to acknowledge the reorganization court’s prohibition of setoffs, and the prohibition was recognized as such by both the concurring and dissenting opinions. Strictly speaking, then, the Court’s treatment of the merits of the district court’s allowance of the setoff may imply that the district court had some discretion not to heed the reorganization court’s order. Such a retreat from the exclusivity of a reorganization court’s summary jurisdiction would be surprising. The more logical explanation is that Justice Douglas chose not to deal with the jurisdictional point but rather to lay down a general rule for all courts about the propriety of setoffs in bankruptcy reorganizations. His failure to rest on or even to mention the district court’s violation of the reorganization court’s order was perhaps a technical flaw in the opinion, because it

---

78. See text at notes 66-67 supra. This assumes that the property is not merely a chose in action, such as a debt, which would be in the possession of the debtor and thus within the jurisdiction of the reorganization court. Note, however, that the reorganization court could still issue an order prohibiting a setoff against the creditor’s claim, because technically the order would prohibit the setting off of the debtor’s right to the property—a chose of action within the court’s jurisdiction—rather than a setting off of the property itself.

79. See note 78 supra.

80. 417 U.S. at 477 (concurring opinion).

81. 417 U.S. at 468.

82. 417 U.S. at 477.

83. 417 U.S. at 482.
could give rise to unwarranted implications, but it should not be read as a harbinger of a major doctrinal shift.

The balance of this note discusses Baker's applicability to reorganizations other than section 77 railroad reorganizations. By analogy, Baker may be extended at least to reorganizations under chapter X of the Bankruptcy Act. Chapter X is a reorganization scheme generally designed for use by large corporate debtors with complex financial problems. It is an accommodation of the public's interest in protecting stockholders and promoting the health of economically significant enterprises and the private interests of the corporation's creditors and management.

Chapter X, like section 77, requires that a reorganization court find a proposed plan to be "fair and equitable" before it may be confirmed. It is accepted doctrine that the meaning of the term "fair and equitable" is the same in chapter X as in section 77. Thus, to the extent that the Court's decision in Baker rests on a construction of the "fair and equitable" language of section 77, its reasoning applies with equal force to reorganizations under chapter X.

The argument in Baker concerning the public's interest in revitalizing financially insecure railroads and the consequent necessity to preserve cash inflow by limiting setoffs also extends to chapter X. Chapter X reflects the strong national economic interest in the revitalization of large corporate debtors. Large corporations employ many workers and are major suppliers and customers. In addition, they support the general advance of technology. While the public interest in revitalization of large corporations in general is perhaps less specific than the public interest in revitalization of railroads, it is still quite important. If the threat to the debtor's liquidity posed

---

86. See S. REP. No. 2073, 75th Cong., 3d Sess. 6-9 (1938); H.R. REP. No. 3012, 74th Cong., 2d Sess. 4 (1936); Doub, Corporate Reorganizations Under Chapter X of the National Bankruptcy Act, 3 Md. L. Rev. 1 (1938); Wham, Some Recent Developments in Corporation Reorganizations, 18 N.Y.U. L. Rev. 352 (1941).
89. See note 23 supra and accompanying text.
90. See text following note 39 supra.
91. S. REP. No. 2073, supra note 86, at 7; Wham, supra note 86, at 352-53. See also Hearings on H.R. 6439 Before the House Comm. on the Judiciary, 75th Cong., 1st Sess. 163-64 (1937) [hereinafter House Hearings].
by the use of the setoff device cannot be tolerated (absent exceptional circumstances) in light of the purpose of section 77, then setoffs also cannot be tolerated under chapter X in light of the importance of liquidity to the revitalization of the corporate debtor.

Whether Baker should apply to chapter XI reorganizations is a more complicated question. Chapter XI is rooted in the common law of composition and arrangement. It was enacted concurrently with chapter X, and the two chapters were designed to be mutually exclusive alternatives. Chapter X is the appropriate reorganization vehicle when the debtor is large, when there is a complex capital structure that needs adjustment, and when creditors are widespread and as a practical matter unable to participate effectively. The typical chapter XI debtor is likely to be smaller, or to have less complex financial problems. Moreover, the relief granted under chapter XI is more limited than that granted under chapter X, perhaps taking the form of a simple extension or composition without extinguishment of any debts. The rights of secured creditors theoretically


97. Chapter XI is a statutory variation of the common-law composition of creditors and, unlike the broader scope of Chapter X, is limited to an adjustment of unsecured debts. It was sponsored by the National Association of Credit Men and other groups of creditors’ representatives whose experience had been in representing trade creditors in small and middle-sized commercial failures. . . . The contrast between the provisions of Chapter X, carefully designed to protect the creditor and stockholder interests involved, and the summary provisions of Chapter XI is quite marked. . . . [T]he basic purpose of Chapter XI [is] to provide a quick and economical means of facilitating simple compositions among general creditors who have been deemed by Congress to need only the minimal disinterested protection provided by that Chapter.

98. In comparing chapter XI to chapter X, the Supreme Court noted: The debtor generally remains in possession and operates the business under court supervision, § 342. A trustee is only provided in the very limited situation where a trustee in bankruptcy has previously been appointed, § 334. There is no requirement for a receiver, but the Court “may” appoint one if it finds it to be “necessary,” § 335. The plan of arrangement is proposed by, and only by, the debtor, §§ 306(1), 322, 357, and creditors have only the choice of accepting or rejecting it. Acceptances may be solicited by the debtor even before filing of the Chapter XI petition and, in fact, must be solicited before court review of the plan, § 336(4). There are no provisions for an independent study by the court or a trustee, or for advice by them being given to creditors in advance of the acceptance of the arrangement. In short, Chapter XI provides a summary procedure whereby judicial confirmation is obtained on a plan that has been formulated and accepted with only a bare minimum of independent control or supervision.


are unaffected by a chapter XI plan, although in practice such creditors often are enjoined from executing upon their security interests.

To the extent that Baker rested on an absolute priority doctrine derived from the "fair and equitable" language of section 77, the case should not apply to reorganizations under chapter XI. There is no requirement in chapter XI that a plan be "fair and equitable," and Congress has required that creditors in a chapter XI arrangement be given only minimal protection.

The public interest rationale of the Baker decision also cannot be carried over to chapter XI. Chapter XI is the product of lobbying by trade creditors' associations that sought an alternative to the cumbersome provisions of chapter X. The interests it protects are those of trade creditors; the court need not find the reorganization plan to be in the public interest, but only that it is "for the best interests of the creditors." This requirement is typically interpreted to mean only that the plan would pay creditors more than they would receive were the debtor to liquidate in a straight bankruptcy proceeding. Thus, to the degree that Baker rests on the public interest in the revitalization of railroads, it should not be applied by analogy to chapter XI arrangements. The interests protected by chapter XI are overwhelmingly private.

The Commission on Bankruptcy Laws has proposed a new chapter VII, which consolidates present chapters X and XI into one reorganiz-
zation scheme. While the proposed Act specifically recognizes the right of setoff in reorganization cases, it qualifies that right by providing that a petition filed "by or against a debtor eligible for relief under [the reorganization] chapter shall operate as a stay of the setoff of any obligation to the debtor against any claim owing by the debtor . . . ." Thus, the new Act codifies the trustee's typical practice in section 77 and chapter X reorganizations of obtaining an injunction against setoffs at the time of the filing of the petition. However, if a hearing is brought by creditors, the burden of showing that the stay of setoffs is an appropriate exercise of the court's power is on the trustee or the debtor in possession. This burden can be met only by demonstrating that the person asserting the right of setoff is adequately protected.

Interestingly, the proposed chapter contains the "fair and equitable" language currently found in section 77 and chapter X. Since the new Act also expressly allows setoffs, it is apparently inconsistent with the majority holding in Baker, which found the "fair and equitable" language of section 77 to bar setoffs except in "exceptional circumstances." Unless the "fair and equitable" language of the new Act can be distinguished from the same language in section 77, the Baker Court's interpretation of that language will be open to question if the Act is passed. It is possible, however, that the Baker rule will survive. The argument that setoffs can seriously impair cash flow and thus hinder the revitalization of an organization whose existence is crucial to the public welfare would retain its significance under the proposed Act. Furthermore, Justice Douglas asserted in a footnote in Baker that "[i]n a straight bankruptcy case, . . . the Court construed § 68 as 'permissive rather than mandatory' and as to which the bankruptcy court 'exercises its discretion . . . upon the general

---

109. "The allowable claim of a creditor shall be set off against a mutual debt owed to the debtor by the creditor except to the extent that (1) the allowable claim was transferred to one asserting the right of setoff after the date of the petition, or (2) the allowable claim was transferred to one asserting the right of setoff within three months before the date of the petition at a time when the debtor was insolvent. For the purposes of this subdivision, the debtor is presumed to have been insolvent during the three months prior to the date of the petition." Proposed Bankruptcy Act § 5-201(a).
110. Proposed Bankruptcy Act § 7-204(e).
111. Proposed Bankruptcy Act § 7-204, Comment 1.
112. Proposed Bankruptcy Act § 7-204(b).
113. Proposed Bankruptcy Act § 7-204(b).
115. See text at notes 35-36 supra.
116. The new act would relax the requirement of the "fair and equitable" standard as presently applied by the courts, however. REPORT, supra note 54, § 7-310, Note, at 254.
principles of equity.' "117 The footnote implies that, even when set-offs are explicitly allowed by statute, they may be denied if the equities of the particular situation so warrant. Under this interpretation, Baker could continue to stand for the proposition that setoffs should be allowed only in "exceptional circumstances.""118


118. It could be argued that, since the new Act states that "[t]he allowable claim of a creditor shall be setoff against a mutual debt . . .," (emphasis added), see note 109 supra, courts would have no remaining equitable discretion to deny setoffs. However, the language of section 68a of the current Act, 11 U.S.C. § 108(a), also states that "one debt shall be setoff against the other . . ." (emphasis added), and the Supreme Court has held this language is "permissive rather than mandatory." See text at note 64 supra.

The effect of Baker may also be felt with respect to section 7-204 of the Proposed Act, which provides that the debtor's petition acts as a stay of all setoffs, provided that the trustee proves "that the person asserting the right of setoff is adequately protected." Baker indicates that setoffs are disfavored in the reorganization context, and the case may prompt courts to give a liberal reading to the term "adequately protected" so that stays of setoffs may be routinely granted.