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SUPREME COURT OF THE UNITED STATES.

Nos. 254 and 255.—OCTOBER TERM, 1945.

254	S. R. A., Inc., Petitioner, vs. State of Minnesota.	} On Writs of Certiorari to the Supreme Court of the State of Minnesota.
255	S. R. A., Inc., Petitioner, vs. State of Minnesota.	

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Mr. Justice REED delivered the opinion of the Court.

A question as to the power of the State of Minnesota to tax realty within the boundaries of that state, when the legal title remains in the United States ~~under a state act of cession in accordance with the exclusive legislation clause of the United States Constitution, Article 1, Section 8, Clause 17,~~ is presented by this writ of certiorari.¹

~~of ceding jurisdiction~~

The realty in question was conveyed to the United States in 1867 as a site for a building to house a post office, a custom's office and offices for various departments and agencies of the United States. The building was eventually vacated and the property sold in 1939 by the Director of Procurement of the Department of the Treasury under the authority of an act for the disposal of surplus federal real estate. 49 Stat. 885.

It was purchased on public sale and improved by petitioner who was in full possession with right of user at the time of the levy of the tax under an executory contract of sale between it and the United States. That contract provided for a cash payment and annual instalments, possession by petitioner so long as it met the terms of the contract, and for repossession by the United States, with retention of prior instalments of the purchase price, upon the purchaser's failure to comply with any term or condition of the

¹ No. 255, S. R. A., Inc. v. State of Minnesota, is in all respects like No. 254, except that the state tax was laid for the year 1941. This opinion in No. 254 governs the result and the same judgment of affirmance is directed. See 219 Minn. 517; — U. S. —.

contract. Upon repossession, the United States was authorized to resell the realty and recover any resulting deficiency from the petitioner. All obligations due under the contract had been met by petitioner. The major portion of the contract price had not fallen due and was unpaid. The contract permitted leases to others by the petitioner in subordination to the rights of the United States. The contract required the United States to execute and deliver a quit claim deed for the realty to the petitioner upon its completion of the requirements of the contract.

With the ownership of the property in the situation just described, taxes for general and special purposes were levied on the property for 1940 under the usual Minnesota procedure. The tax was on the realty, "subject to fee title remaining in the United States of America." Petitioner duly filed its objections in the proper state district court, pursuant to statute. 1 Minn. Stat. (1941) Ch. 278. So far as concerns this review, the objection to the tax was based on a claimed exemption of the realty from state taxation because title to all of the premises was in the United States. The exemption was sustained by the trial court. The Supreme Court of Minnesota reversed its judgment and denied exemption. *In re Petition of S. R. A., Inc.*, 213 Minn. 487. On retrial, the lower court held the realty liable for the tax and declared a lien "upon such parcel of land as against the estate, right, title, interest, claim or lien, in law or equity, of every person, company or corporation, subject however to the prior rights, liens and interests of the United States of America." This second judgment was affirmed on appeal. *In re Petition of S. R. A., Inc.*, 219 Minn. 493.

Certiorari was sought under Section 237(b) of the Judicial Code.

It was granted because of the importance and uncertainty of the subject of the right of a state to tax realty sold by the United States in possession of a buyer from the Government under a contract of sale with uncompleted conditions for execution and delivery of the muniments of title. — U. S. —.²

The supremacy of the Federal Government in our Union forbids the acknowledgment of the power of any state to tax property of the United States against its will. Under an implied Constitu-

² Varying results have been reached by other courts in similar situations. *Lincoln Co. v. Pacific Spruce Corp.*, 26 F. 2d 435; *Ken Realty Co. v. Johnson*, 138 F. 2d 809; *Mint Realty Co. v. Philadelphia*, 218 Pa. 104; *Copp v. State*, 69 W. Va. 439; *A. B. R. Corp. v. City of Newark*, 133 N. J. L. 34. See also *Bancroft Investment Corp. v. City of Jacksonville*, — Fla. —, decided January 15, 1946.

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The right of a state to tax realty directly depends primarily upon its territorial jurisdiction over the area. The realty of petitioner had been conveyed to and used by the United States for the essential governmental activities which authorized the exercise of its exclusive legislative jurisdiction.⁴ Exclusive legislative power is in essence complete sovereignty.⁵ That is, not only is the federal property immune from taxation because of the supremacy of the Federal Government but state laws, not adopted directly or impliedly by the United States, are ineffective to tax or regulate other property or persons upon that enclave.⁶ It would seem that

³ Compare *Mayo v. United States*, 319 U. S. 441, with *Alabama v. King & Boozer*, *supra*, and *United States v. Allegheny County*, *supra*, p. 176, notes 1 and 2, and cases cited. See *Wilson v. Cook*, No. 328, 1945 Term, decided March 4, 1946.

⁴ Art. 1, Sec. 8, Cl. 17:

"The Congress shall have Power . . .

"To exercise exclusive Legislation in all Cases whatsoever, over such District (not exceeding ten Miles square) as may, by Cession of particular States, and the acceptance of Congress, become the Seat of the Government of the United States, and to exercise like Authority over all Places purchased by the Consent of the Legislature of the State in which the Same shall be, for the Erection of Forts, Magazines, Arsenals, dock-Yards, and other needful Buildings; . . ."

⁵ *Fort Leavenworth R. R. Co. v. Lowe*, 114 U. S. 525, 532-33; *United States v. Unzeuta*, 281 U. S. 138; *Surplus Trading Co. v. Cook*, 281 U. S. 647, 652-56; *Bowen v. Johnston*, 306 U. S. 19.

⁶ *Stewart v. Sadrakula*, 309 U. S. 94; *Surplus Trading Co. v. Cook*, *supra*, note 5.

the United States obtained this property in compliance with cession by Minnesota of exclusive sovereignty. Act of February 9, 1867, Minn. Laws 1867 Jan., p. 125. The acceptance by the United States at this time of the power ceded is presumed.⁷ So far as we are aware, this Court has never directly passed upon the effect on federal sovereignty of the property's transfer by the United State to private hands.

In this instance there was no specific words in the contract which were intended to retain sovereignty in the United States. There was no express retrocession by Congress to Minnesota, such as sometimes occurs.⁸ There was no requirement in the act of cession for return of sovereignty to the state when the ceded territory was no longer used for federal purposes.⁹ In the absence of some such provisions, a transfer of property held by the United States under state cessions pursuant to Article 1, Section 8, Clause 17, of the Constitution would leave numerous isolated islands of federal jurisdiction, unless the unrestricted transfer of the property to private hands is held without more to revest sovereignty in the states. As the purpose of Clause 17 was to give control over the sites of governmental operations to the United States, when such control was deemed essential for federal activities, we are of the opinion that the sovereignty of the United States would end with the reason for its existence. The Government's unrestricted transfer of property to nonfederal hands is a relinquishment of the exclusive legislative power.¹⁰ Recognition has been given to this result as a rule of necessity.¹¹ If such a step is necessary, Minnesota showed its

⁷ *Fort Leavenworth v. Lowe*, *supra*, p. 528; *Benson v. United States*, 146 U. S. 325, 330; *Mason Co. v. Tax Comm'n*, 302 U. S. 186, 207.

At the time of the purchase, 5 Stat. 468, later incorporated in R. S. § 355, was in force. As it required consent of the state of the situs before expenditures of public money by the United States on locations purchased for needful buildings, it is to be presumed that all requirements were satisfied. R. S. § 355 has been consistently construed to require full sovereignty in the United States. 8 Op. A. G. 102; 10 Op. A. G. 34; 20 Op. A. G. 611; 31 Op. A. G. 265; 38 Op. A. G. 341; 39 Op. A. G. 285. R. S. § 355 has been superseded. 40 U. S. C. 255; *Adams v. United States*, 319 U. S. 312.

⁸ 30 Stat. 668; 9 Stat. 35.

⁹ Compare *Palmer v. Barrett*, 162 U. S. 399; *James v. Dravo Contracting Co.*, *supra*, 144; *Surplus Trading Co. v. Cook*, *supra*, 656.

¹⁰ Compare *Palmer v. Barrett*, *supra*, with *Arlington Hotel Co. v. Fant*, 278 U. S. 439.

¹¹ *Fort Leavenworth R. R. Co. v. Lowe*, 114 U. S. 525, 542: "It is necessarily temporary, to be exercised only so long as the places continue to be used for the public purposes for which the property was acquired or reserved

acceptance of a supposed retrocession by its levy of a tax on the property. Whether or not exclusive legislative power continues in the United States over this property so as to forbid state taxation depends upon whether there was a transfer of the property by the contract of sale.

Turning to the contract, we find in it no characteristics which differentiate it from the normal executory contract for the sale of land with partial payments. Under federal law such a contract transfers to the purchaser the equity in the land. That equity is realty. It was owned by the vendee. The United States retains only a legal title as security. In substance it is in the position of a mortgagee.¹² Minnesota has the same rule. *In re Petition of S. R. A., Inc.*, 219 Minn. 493, 507; 213 Minn. 487, 495, 499. Therefore when petitioner entered into possession of this real estate under its contract of purchase, the taxed property by the transfer became subject to the territorial jurisdiction of Minnesota.¹³

Territorial jurisdiction in Minnesota does not dispose of this tax problem. The nub of this case, that is the exemption from state taxation of property to which the United States holds legal title, remains. Minnesota took care to leave unassessed whatever interest the United States holds. The levy and judgment was "subject to fee title remaining in the United States of America." 219 Minn. at 496. Although Minnesota real estate taxes are assessed on the parcel of land as a "unitary item" including "all rights and privileges," the state does not claim that a tax sale will divest the fee title of the United States. 213 Minn. at 493, 499. Apparently the state is of the view that the equitable interest alone

from sale. When they cease to be thus used, the jurisdiction reverts to the State."

The Federal Cession Clause was not applicable to the place under consideration, Fort Leavenworth, Kansas. Page 528. The reference to federal control of "reserved" land probably relates to the supremacy of the United States for the management of governmental affairs in the absence of exclusive legislative power. See page 539. As the Fort Leavenworth case itself demonstrates, the United States does not have power of exclusive legislation on reserved public lands without state consent. See *Wilson v. Cook*, No. 328, 1945 Term, slip opinion, p. 9.

¹² *Lenman v. Jones*, 222 U. S. 51; *Gunton v. Carroll*, 101 U. S. 426, 430-31; *Bissell v. Heyward*, 96 U. S. 580; *Secombe v. Steele*, 20 How. 90, 103-104. Compare 8 Thompson, Real Property, Secs. 4579, 4582; 2 Sugden, Vendors (14th Ed.), 375. See *Lowery v. Peterson*, 75 Ala. 109. Compare Restatement, Conflict of Laws § 209.

¹³ We reserve, without expression of opinion, the question as to the legislative status of this property, if it is repossessed by the United States. See the cases cited in note 10, *supra*.

may be sold under its laws, leaving the fee of the United States in its position of priority over any interests which may be transferred by the tax sale. 213 Minn. at 497; 219 Minn. at 513. Such a construction of the state law is binding upon this Court. It does not impinge upon federal rights. So long as that situation exists, the determination of the state cannot be challenged here. The possibility of repossession by the United States is not enough to block a tax sale in which the paramount rights of the United States are protected. *Baltimore Shipbuilding & Dry Dock Co. v. Baltimore*, 195 U. S. 381-82; *New Brunswick v. United States*, 276 U. S. 547, 556; *United States v. Alabama*, 313 U. S. 274, 282.¹⁴

Petitioner's argument goes beyond the question of the enforcement of the assessed tax. It is bottomed on the implied constitutional immunity from state taxation of property for which the United States holds title subject to unfulfilled conditions. In *Van Brocklin v. Tennessee*, 117 U. S. 151, that state sought to tax realty of the United States which was not held for the purposes or under the authority of the Cession Clause. Certain lots had been purchased by and conveyed to the United States pursuant to a federal tax sale. 12 Stat. 423, § 7. These lots were later transferred by deed or certificate of release to private owners. 17 Stat. 331; 18 Stat. 313. Tennessee assessed its own taxes upon the property for the years during which title to the lots was in the United States and attempted to collect them from the private owners after the transfer. Tennessee's claim was founded on the absence of state cession. This Court refused to permit the state's action, saying at page 179:

"While the United States owned the land struck off to them for the amount of the taxes because no one would pay more for it, and until it was sold by the United States for a greater price, or was redeemed by the former owner, the United States held the entire title as security for the payment of the taxes; and it could not be known how much, if anything beyond the amount of the taxes the land was worth. To allow land, lawfully held by the United States as security for the payment of taxes assessed by and due to them, to be assessed and sold for State taxes, would tend to create a conflict between the

¹⁴ As the case was tried below on the theory of direct or implied immunity because the fee was in the United States, we neither consider nor decide the effect of a tax sale of petitioner's rights on its contract with the United States. See *Wilson v. Cook*, No. 328, 1945 Term, p. 5, slip opinion. Compare 41 U. S. C. § 15 with *Freedmen's Saving Co. v. Shepherd*, 127 U. S. 494.

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officers of the two governments, to deprive the United States of a title lawfully acquired under express acts of Congress, and to defeat the exercise of the constitutional power to lay and collect taxes, to pay the debts and provide for the common defence and general welfare of the United States."

The posture of the land sought to be taxed in the *Van Brocklin* case differentiates it from that presently under consideration. The United States there held complete title as a purchaser at a tax sale. The right to redeem was a matter of grace. The statute might have authorized the sale of the land to any purchaser without regard to the former owner. The United States, here, as we have demonstrated above has transferred equitable ownership to the purchaser and has only a legal title as security for the unpaid purchase price. See *United States v. Allegheny County*, 322 U. S. 174, 188.

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purchase.

Petitioner presses various land grant cases upon us as announcing the controlling rule.¹⁵ The principle which petitioner extracts from these cases is that alienation of United States property does not pass an interest to the vendee taxable by a state until all conditions precedent for the delivery of the deed have been complied with. In the present case, petitioner asserts, the full amount of the purchase price must be paid before the state can tax. Such a rule can be extracted by the literal reading of certain phrases in the land grant cases.¹⁶ The reason for the rule was said, in the earlier cases, to be that a state tax sale would defeat the government lien for surveying or other costs because the state sale would pass a title free from lien of the United States.¹⁷ As heretofore shown, page 6 *supra*, this ground for refusing power to Minnesota to tax is not present in this case, since Minnesota holds that the lien of the United States will remain paramount.

Irwin v. Wright involved the taxability by a state of property

¹⁵ *Railway v. Prescott*, 16 Wall. 603; *Railway Co. v. McShane*, 22 Wall. 444; *Northern Pacific R. R. Co. v. Traill County*, 115 U. S. 600; *Irwin v. Wright*, 258 U. S. 219.

¹⁶ *Irwin v. Wright*, *supra*, 228, 229, 232, 233; *Northern Pacific R. R. Co. v. Traill County*, *supra*, at 609; *Railway Co. v. McShane*, *supra*, at 462.

¹⁷ 16 Wall. at 608; 22 Wall. at 462; 115 U. S. at 610. See also *Colorado Co. v. Commissioner*, 95 U. S. 259. In the *McShane* case, itself, which clearly set out the above reason for non-taxability, it was recognized that the federal right of pre-emption for the benefit of settlers would not be affected by a state tax sale. This Court therefore reversed its former judgment in the *Prescott* case that land held by the railroads subject to this pre-emption could not be taxed by a state. 22 Wall. at 461. Congress promptly terminated the land tax exemption after the Traill County decision by subjecting railroad land grants to state taxation before payment of conveyancing costs. 43 U. S. C. § 882.

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occupied by an entryman under the Reclamation and Homestead Acts who had not received his required final certificate of land clearance, pages 227, 228, 232. The reason for the rule against state taxation until the equitable title passes from the United States to the entryman was there placed upon the policy of the Government to require those who sought government land to perform the required conditions of residence or improvement before beneficial title, subject to state taxation, passes from the United States to the locator. This transfer was said not to take place until the certificate was issued. Page 231. After compliance with the condition and before patent, the state could tax.¹⁸

We think the public policy of national development and federal tax collection justify the limitation on state taxing power announced by the foregoing decisions. We do not, however, conclude that their rationale leads to an exemption from state taxation of all lands in which the United States holds legal title as security for the purchase price. To say that the payment of the purchase price is a necessary condition precedent to the loss of federal immunity is to make the rule too mechanical. It should be sufficiently flexible to subject real private rights, disentangled from federal policies to state taxation. This has been the holding in mining claims.¹⁹ Where beneficial interest has passed to a vendee, the retention of legal title does not give a significant difference from the situation of a deed with a lien retained or a mortgage back to secure the purchase money.

That was the interpretation given the facts in *New Brunswick v. United States*, 276 U. S. 547.²⁰ The City of New Brunswick under authority of New Jersey sought to tax lots in the possession of purchasers from the Housing Corporation, a corporation wholly owned by the United States and therefore treated as the United States. These purchasers had paid enough of the purchase price—ten per cent—to entitle them to deeds under their contracts but had not paid the entire purchase price. The deeds had not been delivered nor the mortgages executed for the balance as required by the purchase agreement. This Court said: "In equity the situation was then the same as if the Corporation had conveyed title to the purchasers, as owners, and they had mortgaged the lots

¹⁸ *Bethwell v. Bingham County*, 237 U. S. 642, 647.

¹⁹ *Elder v. Wood*, 208 U. S. 226.

²⁰ But see *A. B. R. Corp. v. City of Newark*, 133 N. J. L. 34.

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to the Corporation to secure the unpaid purchase money." Page 555. The Court sustained the tax subject to the paramount lien of the United States. We think the petitioner's Minnesota property is in a similar position. Ownership of the beneficial interest has passed to the petitioner with legal title retained by the United States for security purposes. This should not put this private property in an exempt class.

There is a suggestion that to hold United States property subject to state taxation pending the completion of payment will injuriously affect its salability and therefore interfere with the Government's handling of its affairs. Our recent cases have disposed of this economic argument in a way which is contrary to petitioner's contention. *Alabama v. King & Boozer*, 314 U. S. 1, and cases cited.

The only other contention of petitioner which we need mention is that the state has included the interest of the United States in the valuation of the land, and has therefore subjected that interest to taxation. But no deduction need be made for the interest of the Government since that interest is for security purposes only and is not beneficial in nature. The whole equitable ownership is in the petitioner and the value of that ownership may be ascertained on the basis of the full value of the land. *New Brunswick v. United States*, *supra*, at 556. But cf. *Ken Realty Co. v. Johnson*, 138 F. 2d 809.

Affirmed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

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Mr. Justice REED delivered the opinion of the Court.

A question as to the power of the State of Minnesota to tax realty within the boundaries of that state, when the legal title remains in the United States is presented by this writ of certiorari.¹ The state ceded jurisdiction over the realty in accordance with the exclusive legislation clause of the United States Constitution, Article I, Section 8, Clause 17.

The realty in question was conveyed to the United States in 1867 as a site for a building to house a post office, a custom's office and offices for various departments and agencies of the United States. The building was eventually vacated and the property sold in 1939 by the Director of Procurement of the Department of the Treasury under the authority of an act for the disposal of surplus federal real estate. 49 Stat. 885.

It was purchased on public sale and improved by petitioner who was in full possession with right of user under an executory contract of sale between it and the United States at the time of the levy of the tax. That contract provided for a cash payment and annual instalments, possession by petitioner so long as it met the terms of the contract, and for repossession by the United States, with retention of prior instalments of the purchase price, upon the purchaser's failure to comply with any term or condition of the

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With the ownership of the property in the situation just described, taxes for general and special purposes were levied on the property for 1940 under the usual Minnesota procedure. The tax was stated in the assessment to be on the realty "subject to fee title remaining in the United States of America." Petitioner duly filed its objections in the proper state district court, pursuant to statute. 1 Minn. Stat. (1941) Ch. 278. So far as concerns this review, the objection to the tax was based on a claimed exemption of the realty from state taxation because title to all of the premises was in the United States. The exemption was sustained by the trial court. The Supreme Court of Minnesota reversed that judgment and denied exemption. *In re Petition of S. R. A., Inc.*, 213 Minn. 487. On retrial, the lower court held the realty liable for the tax and declared a lien "upon such parcel of land as against the estate, right, title, interest, claim or lien, in law or equity, of every person, company or corporation, subject however to the prior rights, liens and interests of the United States of America." This second judgment was affirmed on appeal. *In re Petition of S. R. A., Inc.*, 219 Minn. 493.

Certiorari was sought under Section 237(b) of the Judicial Code. It was granted because of the importance and uncertainty of the question of the right of a state to tax realty sold by the United States in possession of a buyer from the Government under a contract of sale with uncompleted conditions for execution and delivery of the muniments of title. — U. S. —.²

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the United States obtained this property in compliance with cession by Minnesota of exclusive sovereignty. Act of February 9, 1867, Minn. Laws 1867 Jan., p. 125. The acceptance by the United States at that time of the power ceded is presumed.⁷ This Court apparently has never directly passed upon the effect on federal sovereignty of the property's transfer by the United States to private hands.

In this instance there were no specific words in the contract with petitioner which were intended to retain sovereignty in the United States. There was no express retrocession by Congress to Minnesota, such as sometimes occurs.⁸ There was no requirement in the act of cession for return of sovereignty to the state when the ceded territory was no longer used for federal purposes.⁹ In the absence of some such provisions, a transfer of property held by the United States under state cessions pursuant to Article I, Section 8, Clause 17, of the Constitution would leave numerous isolated islands of federal jurisdiction, unless the unrestricted transfer of the property to private hands is thought without more to revest sovereignty in the states. As the purpose of Clause 17 was to give control over the sites of governmental operations to the United States, when such control was deemed essential for federal activities, it would seem that the sovereignty of the United States would end with the reason for its existence and the disposition of the property. We shall treat this case as though the Government's unrestricted transfer of property to nonfederal hands is a relinquishment of the exclusive legislative power.¹⁰ Recognition has been given to this result as a rule of necessity.¹¹ If such a step

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¹¹ *Fort Leavenworth R. R. Co. v. Lowe*, 114 U. S. 525, 542: "It is necessarily temporary, to be exercised only so long as the places continue to be used for the public purposes for which the property was acquired or reserved

is necessary, Minnesota showed its acceptance of a supposed retrocession by its levy of a tax on the property. Under these assumptions the existence of territorial jurisdiction in Minnesota so as to permit state taxation depends upon whether there was a transfer of the property by the contract of sale.

Turning to the contract, we find in it no characteristics which differentiate it from the normal executory contract for the sale of land with partial payments. Under federal law such a contract transfers to the purchaser the equity in the land. That equity is realty. It was owned by the vendee. The United States retains only a legal title as security. In substance it is in the position of a mortgagee.¹² Minnesota has the same rule. *In re Petition of S. R. A., Inc.*, 219 Minn. 493, 507; 213 Minn. 487, 495, 499. Therefore when petitioner entered into possession of this real estate under its contract of purchase, the taxed property by the transfer became subject to the territorial jurisdiction of Minnesota.¹³

Territorial jurisdiction in Minnesota does not dispose of this tax problem. The nub of this case, that is the immunity from state taxation of property to which the United States holds legal title, remains. Minnesota took care to leave unassessed whatever interest the United States holds. The levy and judgment was "subject to fee title remaining in the United States of America." 219 Minn. at 496. Although Minnesota real estate taxes are assessed on the parcel of land as a "unitary item" including "all rights and privileges," the state does not claim that a tax sale will divest the fee title of the United States. 213 Minn. at 493, 499. Apparently the state is of the view that the equitable interest alone may be sold under its laws, leaving the fee of the United States in its position of priority over any interests which may be trans-

from sale. When they cease to be thus used, the jurisdiction reverts to the State."

2 The Federal Cession Clause was not applicable to the place under consideration, Fort Leavenworth, Kansas. Page 528. The reference to federal control of "reserved" land probably relates to the supremacy of the United States for the management of governmental affairs in the absence of exclusive legislative power. See page 539.

¹² *Lenman v. Jones*, 222 U. S. 51; *Gunton v. Carroll*, 101 U. S. 426, 430-31; *Bissell v. Heyward*, 96 U. S. 580; *Secombe v. Steele*, 20 How. 90, 103-104. Compare 8 Thompson, *Real Property*, Secs. 4579, 4582; 2 Sugden, *Vendors* (14th Ed.), 375. See *Lowery v. Peterson*, 75 Ala. 109. Compare *Restatement, Conflict of Laws* § 209.

¹³ We intimate no view as to the legislative status of this property, if it is repossessed by the United States. See the cases cited in note 10, *supra*.

ferred by the tax sale. ~~213 Minn. at 497~~, 219 Minn. at 513. Such a construction of the state law is binding upon this Court. It does not impinge upon federal rights. So long as that situation exists, the determination of the state cannot be challenged here. The possibility of repossession by the United States is not enough to block a tax sale in which the paramount rights of the United States are protected. *Baltimore Shipbuilding & Dry Dock Co. v. Baltimore*, 195 U. S. 381-82; *New Brunswick v. United States*, 276 U. S. 547, 556; *United States v. Alabama*, 313 U. S. 274, 282.¹⁴

Petitioner's argument goes beyond the question of the enforcement of the assessed tax. It is bottomed on the implied constitutional immunity from state taxation of property for which the United States holds title subject to unfulfilled conditions. In *Van Brocklin v. Tennessee*, 117 U. S. 151, that state sought to tax realty of the United States which was not held for the purposes or under the authority of the Cession Clause. Certain lots had been purchased by and conveyed to the United States pursuant to a federal tax sale. 12 Stat. 423, § 7. These lots were later transferred by deed or certificate of release to private owners. 17 Stat. 331; 18 Stat. 313. Tennessee assessed its own taxes upon the entire property for the years during which title to the lots was in the United States and attempted to collect them from the private owners after the transfer. Tennessee's claim was founded on the absence of state cession. This Court refused to permit the state's action, saying at page 179:

"While the United States owned the land struck off to them for the amount of the taxes because no one would pay more for it, and until it was sold by the United States for a greater price, or was redeemed by the former owner, the United States held the entire title as security for the payment of the taxes; and it could not be known how much, if anything beyond the amount of the taxes the land was worth. To allow land, lawfully held by the United States as security for the payment of taxes assessed by and due to them, to be assessed and sold for State taxes, would tend to create a conflict between the officers of the two governments, to deprive the United States of a title lawfully acquired under express acts of Congress,

¹⁴ As the case was tried below on the theory of direct or implied immunity because the fee was in the United States, we neither consider nor decide the effect of a tax sale of petitioner's rights on its contract with the United States. See *Wilson v. Cook*, No. 328, 1945 Term, p. 5, slip opinion. Compare 41 U. S. C. § 15 with *Freedmen's Saving Co. v. Shepherd*, 127 U. S. 494.

and to defeat the exercise of the constitutional power to lay and collect taxes, to pay the debts and provide for the common defence and general welfare of the United States.”

The posture of the land sought to be taxed in the *Van Brocklin* case differentiates it from that presently under consideration. The United States there held complete title upon the assessment dates as a purchaser at a tax sale. The entire bundle of rights in the property was assessed by Tennessee. As a matter of grace, the United States had granted a right to the taxpayer to redeem. It was like an option to purchase. The statute might have authorized the sale of the land to any purchaser without consideration for the former owner. The United States, here, as we have demonstrated above had transferred at the time of the assessment equitable ownership to the purchaser and has only a legal title as security for the unpaid purchase price. See *United States v. Allegheny County*, 322 U. S. 174, 188.

Petitioner presses various land grant cases upon us as announcing the controlling rule.¹⁵ The principle which petitioner extracts from these cases is that alienation of United States property does not pass an interest to the vendee taxable by a state until all conditions precedent for the delivery of the deed have been complied with. In the present case, petitioner asserts, the full amount of the purchase price must be paid before the state can tax. Such a rule can be extracted by the literal reading of certain phrases in the land grant cases.¹⁶ The reason for the rule was said, in the earlier cases, to be that a state tax sale would defeat the government lien for surveying or other costs because the state sale would pass a title free from lien of the United States.¹⁷ As heretofore shown, page 8 supra, this ground for refusing power to Minnesota

¹⁵ *Railway v. Prescott*, 16 Wall. 603; *Railway Co. v. McShane*, 22 Wall. 444; *Northern Pacific R. R. Co. v. Traill County*, 115 U. S. 600; *Irwin v. Wright*, 258 U. S. 219.

¹⁶ *Irwin v. Wright*, *supra*, 228, 229, 232, 233; *Northern Pacific R. R. Co. v. Traill County*, *supra*, at 609; *Railway Co. v. McShane*, *supra*, at 462.

¹⁷ 16 Wall. at 608; 22 Wall. at 462; 115 U. S. at 610. See also *Colorado Co. v. Commissioner*, 95 U. S. 259. In the *McShane* case, itself, which clearly set out the above reason for non-taxability, it was recognized that the federal right of pre-emption for the benefit of settlers would not be affected by a state tax sale. This Court therefore reversed its former judgment in the *Prescott* case that land held by the railroads subject to this pre-emption could not be taxed by a state. 22 Wall. at 461. Congress promptly terminated the land tax exemption after the *Traill County* decision by subjecting railroad land grants to state taxation before payment of conveyancing costs. 43 U. S. C. § 882.

to tax is not present in this case, since Minnesota holds that the lien of the United States will remain paramount.

Irwin v. Wright involved the taxability by a state of property occupied by an entryman under the Reclamation and Homestead Acts who had not received his required final certificate of land clearance, pages 227, 228, 232. The reason for the rule against state taxation until the equitable title passes from the United States to the entryman was there placed upon the policy of the Government to require those who sought government land to perform the required conditions of residence or improvement before beneficial title, subject to state taxation, passes from the United States to the locator. This transfer was said not to take place until the certificate was issued. Page 231. ~~Until the certificate was issued the possession of the entryman was the means by which the Government furthered its public policy of land settlement.~~ After compliance with the condition and before patent, the state could tax.¹⁸

We think the public policy of national development and federal tax collection justify the limitation on state taxing power announced by the foregoing decisions. We do not, however, conclude that their rationale leads to an exemption from state taxation of all lands in which the United States holds legal title as security for the purchase price. To say that the payment of the purchase price is a necessary condition precedent to the loss of federal immunity is to make the rule too mechanical. It should be sufficiently flexible to subject real private rights, disentangled from federal policies, to state taxation. This has been the holding in mining claims.¹⁹ Where beneficial interest has passed to a vendee, the retention of legal title does not give a significant difference from the situation of a deed with a lien retained or a mortgage back to secure the purchase money.

That was the interpretation given the facts in *New Brunswick v. United States*, 276 U. S. 547.²⁰ The City of New Brunswick under authority of New Jersey sought to tax lots in the possession of purchasers from the Housing Corporation, a corporation wholly owned by the United States and therefore treated as the United States. These purchasers had paid enough of the purchase price—

¹⁸ *Bethwell v. Bingham County*, 237 U. S. 642, 647.

¹⁹ *Elder v. Wood*, 208 U. S. 226.

²⁰ But see *A. B. R. Corp. v. City of Newark*, 133 N. J. L. 34.

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ten per cent—to entitle them to deeds under their contracts but had not paid the entire purchase price. The deeds had not been delivered nor the mortgages executed for the balance as required by the purchase agreement. This Court said: “In equity the situation was then the same as if the Corporation had conveyed title to the purchasers, as owners, and they had mortgaged the lots to the Corporation to secure the unpaid purchase money.” Page 555. The Court sustained the tax subject to the paramount lien of the United States. We think the petitioner’s Minnesota property is in a similar position. Ownership of the beneficial interest has passed to the petitioner with legal title retained by the United States for security purposes. This should not put this private property in an exempt class.

There is a suggestion that to hold United States property subject to state taxation pending the completion of payment will injuriously affect its salability and therefore interfere with the Government’s handling of its affairs. Our recent cases have disposed of this economic argument in a way which is contrary to petitioner’s contention. *Alabama v. King & Boozer*, 314 U. S. 1, and cases cited.

The only other contention of petitioner which we need mention is that the state has included the interest of the United States in the valuation of the land, and has therefore subjected that interest to taxation. But no deduction need be made for the interest of the Government since that interest is for security purposes only and is not beneficial in nature. The whole equitable ownership is in the petitioner and the value of that ownership may be ascertained on the basis of the full value of the land. *New Brunswick v. United States*, *supra*, at 556.

Affirmed.

Mr. Justice JACKSON took no part in the consideration or decision of these cases.

SUPREME COURT OF THE UNITED STATES.

No. 473.—OCTOBER TERM, 1945.

John D. Pennekamp and the Miami Herald Publishing Company Pe- titioners, vs. The State of Florida.	}	On Writ of Certiorari to the Supreme Court of the State of Florida.
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Mr. Justice REED delivered the opinion of the Court.

This proceeding brings here for review a judgment of the Supreme Court of Florida, — Fla. —; 22 So. 2d 875, which affirmed a judgment of guilt in contempt of the Circuit Court of Dade County, Florida, on a citation of petitioners by that Circuit Court.

The individual petitioner was the associate editor of the Miami Herald, a newspaper of general circulation, published in Dade County, Florida, and within the jurisdiction of the trial court. The corporate petitioner was the publisher of the Miami Herald. Together petitioners were responsible for the publication of two editorials charged by the citation to be contemptuous of the Circuit Court and its judges in that they were unlawfully critical of the administration of criminal justice in certain cases then pending before the Court.

Certiorari was granted to review petitioners' contention that the editorials did not present a clear and present danger of high imminence to the administration of justice in the cases referred to or otherwise by the court or judges who were criticized and therefore the judgment of contempt was invalid as violative of the petitioners' right of free expression in the press. The importance of the issue in the administration of justice at this time in view of this Court's decision in *Bridges v. California*, 314 U. S. 252, three years prior to this judgment in contempt, is apparent.

Bridges v. California fixed reasonably well marked limits around the power of courts to punish newspapers and others for comments upon or criticism of pending litigation. The case placed

orderly operation of courts as the primary and dominant requirement in the administration of justice. Pages 263, 265, 266. This essential right of the courts to be free of intimidation and coercion was held to be consonant with a recognition that freedom of the press must be allowed in the broadest scope compatible with the supremacy of order. A theoretical determinant of the limit for open discussion was adopted from experience with other adjustments of the conflict between freedom of expression and maintenance of order. This was the clear and present danger rule. The evil consequence of comment must be "extremely serious and the degree of imminence extremely high before utterances can be punished." Page 263. It was, of course, recognized that this formula, as would any other, inevitably had the vice of uncertainty, page 261, but it was expected that from a decent self-restraint on the part of the press and from its repeated application by the courts standards of permissible comment would emerge which would guarantee the courts against interference and allow fair play to the good influences of open discussion. As a step toward the marking of the line, we held that the publications there involved were within the permissible limits of free discussion.

In the *Bridges* case the clear and present danger rule was applied to the stated issue of whether the expressions there under consideration prevented "fair judicial trials free from coercion or intimidation." Page 259. There was, of course, no question as to the power to punish for disturbances and disorder in the court room. Page 266. The danger to be guarded against is the "substantive evil" sought to be prevented. Pages 261, 262, 263. In the *Bridges* case that "substantive evil" was primarily the "disorderly and unfair administration of justice." Pages 270, 271, 278.¹

The Constitution has imposed upon this Court final authority to determine the meaning and application of those words of that instrument which require interpretation to resolve judicial issues. Under the compulsion of that responsibility, we are compelled to examine for ourselves the statements in issue and the circumstances under which they were made to see whether or not they do carry a threat of clear and present danger to the impartiality

¹ Compare *Schenck v. United States*, 249 U. S. 47, 52; *Thornhill v. Alabama*, 310 U. S. 88, 105; *Carlson v. California*, 310 U. S. 106, 113; *Board of Education v. Barnette*, 319 U. S. 624, 633.

of the courts or whether they are of a character which the principles of the First Amendment, as adopted by the Due Process Clause of the Fourteenth Amendment, protect.² When the highest court of a state has reached a determination upon such an issue, we give most respectful attention to its reasoning and conclusion but its authority is not decisive. Were it otherwise the constitutional limits of free expression in the Nation would vary with state lines.³

While there was a division of the Court in the *Bridges* case as to whether some of the public expressions by editorial comment transgressed the boundaries of a free press and as to the phrasing of the test, there was unanimous recognition that California's power to punish for contempt was limited by this Court's interpretation of the extent of protection afforded by the First Amendment. *Bridges v. California*, *supra*, at 297. Whether the threat to the impartial administration of justice must be a clear and present or a grave and immediate danger, a real and substantial threat or one which is close and direct depends upon a choice of words. Under any one of the phrases, reviewing courts are brought in cases of this type to appraise the comment on a balance between the desirability of free discussion and the necessity for fair adjudication.

The editorials of November 2d and 7th, 1944, which caused the court to issue the citation are set out below.⁴ Accompanying the

² *Gillow v. New York*, 268 U. S. 652, 666; *Near v. Minnesota*, 283 U. S. 697, 707.

³ *Bridges v. California*, 314 U. S. 252, 267. Compare *Chambers v. Florida*, 309 U. S. 227, 228; *Hooven & Allison Co. v. Evatt*, 324 U. S. 652, 659.

⁴ November 2, 1944:

"*Courts Are Established—*

For the People.

"The courts belong to the people. The people have established them to promote justice, insure obedience to the law and to Punish Those Who Willfully Violate It.

"The people maintain the courts by providing the salaries of officials and setting up costly chambers and courtrooms for the orderly and dignified procedure of the tribunals.

"Upon the judges the people must depend for the decisions and the judicial conduct that will insure society—as a whole and in its individuals—against those who would undermine or destroy the peace, the morality and the orderly living of the community.

"In Order that the courts should not be amenable to political or other pressures in their determination of matters placed before them, Florida Circuit judges are called upon to face the electorate less often than are other elective office holders.

"So long are their terms, in fact, that in Dade county no Circuit judge, and only one judge of another court, has come to the bench by public choice

first editorial was a cartoon which held up the law to public obloquy. It caricatured a court by a robed compliant figure as a judge on the bench tossing aside formal charges to hand a document, marked "Defendant dismissed," to a powerful figure close at his left arm and of an intentionally drawn criminal type. At the right of the bench, a futile individual, labeled "Public Interest" vainly protests.

The citation charges that the editorials

"did reflect upon and impugn the integrity of said Court and the Judges thereof in imputing that the Judges of said Court 'do recognize and accept, even go out to find, every possible technicality of the law to protect the defendant, to

in the first instance. All the others have been named by a governor to fill a vacancy caused by death or resignation, or similar circumstance.

"Judicial terms in Dade county run:

- 1—Six years each for six Circuit judges.
- 2—Four years each for two Civil Court of Record judges.
- 3—Four years for the judge of the Criminal Court of Record.
- 4—Four years for the judge of the Court of Crimes.
- 5—Four years for County judge.
- 6—Four years for Juvenile court judge.

"These twelve judges represent the majesty and the sanctity of the law. They are the first line of defense locally of organized society against vice, corruption and crime, and the sinister machinations of the underworld.

"It is beyond question that American courts are of, by and for the people.

"Every accused person has a right to his day in court. But when judicial instance and interpretative procedure recognize and accept, even go out to find, every possible technicality of the law to protect the defendant, to block, thwart, hinder, embarrass and nullify prosecution, then the people's rights are jeopardized and the basic reason for courts stultified.

"The seeming ease and pat facility with which the criminally charged have been given technical safeguard have set people to wondering whether their courts are being subverted into refuges for lawbreakers.

"This Week the people, through their grand jury, brought into court eight indictments for rape. Judge Paul D. Barns agreed with the defense that the indictments were not properly drawn. Back they went to the grand jury for representation to the court.

"Only in the gravest emergency does a judge take over a case from another court of equal jurisdiction. A padlock action against the Brook Club was initiated last spring before Judge George E. Holt, who granted a temporary injunction.

"After five months, the case appeared Tuesday out of blue sky before Judge Marshall C. Wiseheart at the time State Attorney Stanley Milledge was engaged with the grand jury.

"Speedy decision was asked by counsel despite months of stalling. The State Attorney had to choose between the grand jury and Judge Wiseheart's court.

"The judge dismissed the injunction against the club and its operators. The defense got delay when it wanted and prompt decision from the court when it profited it.

"On Oct. 10 Judge Holt had before him a suit by the state to abate a nuisance (bookmaking) at the Tepee Club.

block, thwart, hinder, embarrass and nullify prosecution,' which said acts by you tend to create a distrust for said court and the judges thereof in the minds of the people of this county and state and tend to prevent and prejudice a fair and impartial action of the said Court and the Judges thereof in respect to the said pending case[s]."

After setting out details of alleged willful withholding and suppression of the whole truth in the publications, the citation further charges that

"you, by said cartoon and editorial, have caused to be represented unto the public that concerning the cases of (A) the eight indictments for rape, (B) the said Brook Club case, and

"Five affidavits of persons who allegedly visited the premises for the purpose of placing bets were introduced by the state over the objection of the defendants.

"Judge Holt ruled them out, explaining in denying the injunction against the Teepee Club:

"The defendant cannot cross-examine an affidavit. The court cannot determine who is testifying and whether belief can be placed upon such testimony . . . The fact that such affidavits were taken before the State Attorney does not give them any additional weight or value."

"This may be good law, exact judicial evaluation of the statutes. It is, however, the character of legal interpretation which causes people to raise questioning eyebrows and shake confused heads in futile wonderment.

"If Technicalities are to be the order and the way for the criminally charged either to avoid justice altogether or so to delay prosecution as to cripple it, then it behooves our courts and the legal profession to cut away the deadwood and the entanglements.

"Make it possible for the state's case, the people's case, to be seen with equal clarity of judicial vision as that accorded accused lawbreakers. Otherwise technicalities and the courts make the law, no matter what the will of the people and of their legislators."

November 7, 1944:

"*Why People Wonder.*

"Here is an example of why people wonder about the law's delays and obstructing technicalities operating to the disadvantage of the state—which is the people—in prosecutions.

"After stalling along for months, the defense in the padlock case against the Brook Club appeared before Judge Marshall C. Wiseheart for a decision. The State Attorney was working with the grand jury. The court knocked out the injunction. There was speed, dispatch, immediate attention and action for those charged with violation of the law. So fast that the people didn't get in a peep.

"That's one way of gumming up prosecution. Another is to delay action. On March 29, Coy L. Jaggears, bus driver, was sentenced to fifteen days in city jail by Judge Cecil C. Curry on conviction of beating up a taxicab operator.

"The arrest precipitated the notorious bus strike. As a result, Jaggears walked out of jail after posting \$200 appeal bond. The appeal never got further.

"There you have the legal paradox, working two ways, but to the same purpose against prosecution. Speed when needed. Month after month of delay when that serves the better."

(C) the Teepee Club case, that the Judges of this Court [had not] fairly and impartially heard and decided the matters in said editorial mentioned and have thereby represented unto the general public that notwithstanding the great public trust vested in the Judges of this Court that they have not discharged their duties honorably and fairly in respect to said pending cases as hereinbefore set forth, all of which tends to obstruct and interfere with the said Judges as such in fairly and impartially administering justice and in the discharging of their duties in conformity with the true principles which you have so properly recognized in the forepart of said editorial above quoted as being incumbent upon them and each of them; . . ."

Petitioners were required to show cause why they should not be held in contempt.

Petitioners answered that the publications were legitimate criticism and comment within the federal guaranties of free press and created no clear and present danger to the administration of justice. They sought to justify the publications by stating in their return to the rule that the facts stated in the editorials were correct, that two of the cases used as examples were not pending when the comments were made, since orders of dismissal had been previously entered by the Circuit Court, and that they as publicists

"had the right if not the duty openly and forcefully to discuss these conditions to the end that these evils that are profoundly disturbing to the citizens of this county, might be remedied. The publications complained of did nothing more than discuss the generally recognized weakness and breakdown in the system of law enforcement and call for its improvement."

It is not practicable to comment at length on each of the challenged items. To make our decision as clear as possible, we shall refer in detail only to the comments concerning the "Rape Cases." These we think fairly illustrate the issues and are the most difficult comment for the petitioners to defend.

As to these cases, the editorial said:

"This Week the people, through their grand jury, brought into court eight indictments for rape. Judge Paul D. Barns agreed with the defense that the indictments were not properly drawn. Back they went to the grand jury for representation to the court."

We shall assume that the suggestion that "judicial instance and interpretative procedure . . . even go out to find, every possible technicality of the law to protect the defendant . . . and nullify prosecution" refers to the quashing of the rape indictments as well as other condemned steps. The comment of the last two paragraphs evidently includes these dismissals as so-called legal technicalities.

The citation charged that the prosecuting officer in open court agreed that the indictments were so defective as to make reindictment advisable. Reindictments were returned the next day and before the editorial. It was charged that these omissions were a wanton withholding of the full truth.

As to this charge, the petitioners made this return:

"That as averred in the citation, a motion was made to quash the indictment in Case 856, the ruling upon which would control in the other cases mentioned. Whereupon the representative of the State Attorney's Office stated in effect that he believed the original indictment was in proper form, but to eliminate any question he would have these defendants immediately re-indicted by the Grand Jury which was still then in session. And thereupon, the Judge of said Court did sustain the motion to quash with respect to Case No. 856.

The record of the Criminal Division of the Circuit Court, set out in the findings of fact at the hearing on the citation in contempt, shows that in case No. 856 the court upheld the defendants' motion to quash "with the approval of the Assistant State Attorney" and quashed the remaining indictments on his recommendation. Reindictment of the accused on the next day, prompt arraignment and setting for trial also appears. We accept the record as conclusive of the facts.

We read the Circuit Court's judgment to find that the comment on the Rape Cases contained only "half-truths," that it did not "fairly report the proceedings" of the court, that it contained "misinformation." The judgment said:

"To report on court proceedings is a voluntary undertaking but when undertaken the publisher who fails to fairly report does so at his own peril.

"We find the facts recited and the charges made in the citation to be true and well founded; . . ."

Pennekamp was fined \$250 and the corporation \$1,000.00.

The Supreme Court of Florida restated the facts as to the Rape Cases from the record. 22 So. 2d at 881. It then reached a conclusion as to all of the charges and so as to the Rape Cases in the words set out below.⁵ After further discussion of the facts, the Court says:

"In the light of this factual recitation, it is utter folly to suggest that the object of these publications was other than to abase and destroy the efficiency of the court."

To focus attention on the critical issue, we quote below from the decision of the Supreme Court of Florida certain excerpts which we believe fairly illustrate its position as to the applicable law.⁶

From the editorials, the explanations of the petitioners and the records of the court, it is clear that the full truth in regard to the quashing of the indictments was not published. We agree that the editorials did not state objectively the attitude of the

⁵ 22 So. 2d 875, 882: "So the vice in both the editorials was the distorted, inaccurate statement of facts and with that statement were scrambled false insinuations that amounted to unwarranted charges of partisanship and unfairness on the part of the judges.

"The record was available in all these cases and it does not reveal a breadth of suspicion on which to predicate partisanship and unfairness on the part of the judges. It is shown rather that they acted in good faith and handled each case to the very best advantage possible. There was no judgment that could have been entered in any of them except the one that was entered. If the editorials had stated the facts correctly, nothing but a correct conclusion could have been deduced and there would have been no basis for contempt but here they elected to publish as truth a mixture of factual misstatement and omission and impose on that false insinuation, distortion, and deception and then contend that freedom of the press immunizes them from punishment."

⁶ 22 So. 2d 875, 884, 885, 886:

"A newspaper may criticize, harass, irritate, or vent its spleen against a person who holds the office of judge in the same manner that it does a member of the Legislature and other elective officers, but it may not publish scurrilous or libelous criticisms of a presiding judge as such or his judgments for the purpose of discrediting the Court in the eyes of the public. Respect for courts is not inspired by shielding them from criticism. This is a responsibility of the judge, acquired over the years by the spirit in which he approaches the judicial process, his ability to humanize the law and square it with reason, the level of his thinking, the consistency of his adherence to right and justice, and the degree to which he holds himself aloof from blocs, groups, and techniques that would sacrifice justice for expediency."

"Courts cannot function in a free country when the atmosphere is charged with the effusions of a press designed to poison the mind of the public against the presiding judges rather than to clarify the issues and propagate the truth about them. The latter was the press that Mr. Jefferson visioned when he promulgated the thesis, 'Our liberty depends on the freedom of the press and that cannot be limited without being lost.'"

"Freedom to punish one's views is a principle of universal practice, but when the press deliberately abandons the proprieties and sets out to poison its pabulum or to sow dragons' teeth and dispense canards for the purpose of doing another a wrong, it is no different category from a free man that

judges. We accept the statement of the Supreme Court that under Florida law, "There was no judgment that could have been entered in any of them except the one that was entered." And, although we may feel that this record scarcely justifies the harsh inference that the truth was willfully or wantonly or recklessly withheld from the public or that the motive behind the publication was to abase and destroy the efficiency of the courts, we accept in this case the conclusion of the Florida courts upon intent and motive as a determination of fact.⁷ While the ultimate power is here to ransack the record for facts in constitutional controversies, we are accustomed to adopt the result of the state courts' examination.⁸ It is the findings of the state courts on disputed facts or the undisputed facts themselves which furnish the basis for our appraisal of claimed violations of federal constitutional rights.⁹

does likewise. The most rigid safeguard thrown around a free press would not protect appellants from falsely publishing or announcing to the world that the clergy of Miami were in sympathy with the practice of polygamy or were fostering other doctrines equally obnoxious to approved moral standards."

"The theory of our system of fair trial is that the determination of every case should be induced solely by evidence and argument in open court and the law applicable thereto and not by any outside influence, whether of private talk or public print."

"The State Courts touch the public more frequently than the Federal Courts and they have many reasons to enforce orderly administration that would not arise in the Federal Courts. If that power is to be construed by what appellants contend to be the pattern in the Bridges and Nye cases, then more than one hundred years of state law and decisions on the subject are turned into confusion or set at naught. . . .

"We do not think this can be the law. The Bridges case was disposed of on authority of the 'clear and present danger' cases, which are not analogous to most of the state cases because they arise from a different state of the law. The ultimate test in the Bridges case requires that the 'substantive evil must be extremely serious and the degree of imminence extremely high before the utterances can be punished.' Even if this test is to the rule in the State Courts, they are authorized to apply it by their own law and standards and unless the application is shown to be arbitrary and unreasonable, their judgment should not be disturbed. The law in Florida permits the most liberal exercise possible of freedom of the press but holds to account those who abuse it.

"We therefore hold that the cartoon and the editorials afford ample support for the judgment imposed and that the issues were properly adjudicated under Florida law."

⁷ See IX Wigmore, Evidence (3d Ed.) § 2557. *Crawford v. United States*, 212 U. S. 183, 203.

⁸ *Drivers Union v. Meadowmoor Co.*, 312 U. S. 287, 293-94; *Lisenba v. California*, 314 U. S. 219, 238.

⁹ *Chambers v. Florida*, 309 U. S. 227, 239; *Ashcraft v. Tennessee*, 322 U. S. 143, 152, 153, 154; *Malinski v. New York*, 324 U. S. 401, 404.

The acceptance of the conclusion of a state as to the facts of a situation leaves open to this Court the determination of federal constitutional rights in the setting of those facts.¹⁰ When the *Bridges* case was here, there was necessarily involved a determination by the California state court that all of the editorials had, at least, a tendency to interfere with the fair administration of criminal justice in pending cases in a court of that state. Yet this Court was unanimous in saying that two of those editorials had no such impact upon a court as to justify a conviction of contempt in the face of the principles of the First Amendment. We must, therefore, weigh the right of free speech which is claimed by the petitioners against the danger of the coercion and intimidation of courts in the factual situation presented by this record.

Free discussion of the problems of society is a cardinal principle of Americanism—a principle which all are zealous to preserve.¹¹ The admitted freedom of discussion which follows the termination of every judicial inquiry is deemed inadequate to emphasize properly to the public the danger to our welfare of supposed judicial neglect of the principles of justice.¹² It does not follow that public comment of every character upon pending trials or legal proceedings may be as free as a similar comment after complete disposal of the litigation. Between the extremes there are areas of discussion which an understanding publicist will appraise in the light of the proprieties and in the light of the effect on himself and on the public of creating a clear and present danger to the fair and orderly judicial administration. Courts must have power to protect the interests of prisoners and litigants before them from unseemly efforts to pervert judicial action. In the borderline instances where it is difficult to say upon which side the alleged offense falls, we think the specific freedom of public comment should weigh heavily against a possible tendency to influence pending cases. Freedom of discussion should

¹⁰ See the cases in the preceding paragraph. *Footnote*

¹¹ *Murdock v. Pennsylvania*, 319 U. S. 105, 115; *West Virginia v. Barnett*, 319 U. S. 624, 639; *Thomas v. Collins*, 323 U. S. 516, 527, 530.

¹² 314 U. S. at 269:

"No suggestion can be found in the Constitution that the freedom there guaranteed for speech and the press bears an inverse ratio to the timeliness and importance of the ideas seeking expression. Yet, it would follow as a practical result of the decisions below that anyone who might wish to give public expression to his views on a pending case involving no matter what problem of public interest, just at the time his audience would be most receptive, would be as effectively discouraged as if a deliberate statutory scheme of censorship had been adopted."

be given the widest range compatible with the essential requirement of the fair and orderly administration of justice.

While a disclaimer of intention does not purge a contempt, we may at this point give consideration to the sworn answer of petitioners that their purpose was not to influence the court. An excerpt appears below.¹³ For circumstances to create a clear and present danger to judicial administration, a solidity of evidence should be required which it would be difficult to find in this record. Compare *Baumgartner v. United States*, 322 U. S. 665, 670; *Schneiderman v. United States*, 320 U. S. 118.

The comments were made about judges of courts of general jurisdiction—judges selected by the people of a populous and educated community. Their effect on juries which might eventually try the offenders is too remote for discussion. One does not need to be insensible to the effect of public criticism.¹⁴ by a strong local newspaper to have doubts as to whether the editorials and cartoon could be classed as a clear and present danger to fair judicial action on the pending cases. Certainly it cannot be said that the success or failure of an effort to influence the course of justice is significant in a contempt proceeding. Comment on pending cases may affect judges differently. It may influence some judges more than others. Some are of a more sensitive fiber than their colleagues. The law deals in generalities and cannot depend on the varying degrees of moral courage or stability which individual judges may possess. We are not willing to say under the circumstances of this case that these editorials are a clear and present danger to the fair adminis-

¹³ "These respondents deny any intent by either said editorial or said cartoon either in words or otherwise to interfere with fair and impartial justice in the State of Florida and deny that the large character in the cartoon was beside the judge and on the bench and being heard, recognized and favored, but, on the contrary, these respondents respectfully show that it was the intention of said editorial and said cartoon to condemn and criticize the system of pleading and practice and procedure created by the laws of Florida, whereby such cases could long be delayed and then could be dismissed upon technical grounds in the manner herein shown."

We add Mr. Pennekamp's statement of the editorial policy of the Miami Herald:

"We are ourselves Free—Free as the Constitution we enjoy—Free to truth, good manners and good sense. We shall be for whatever measure is best adapted to defending the rights and liberties of the people and advancing useful knowledge. We shall labor at all times to inspire the people with a just and proper sense of their conditions, to point out to them their true interest and rouse them to pursue it."

¹⁴Cf. Sullivan, Contempts by Publication, page 1.

tration of justice in Florida. Cf. *Near v. Minnesota*, 283 U. S. 697, 714-15.

What is meant by clear and present danger to a fair administration of justice? Certainly this criticism of the judge's inclinations or actions in these pending non-jury proceedings could not directly affect such administration. This criticism of his actions could not affect his ability to decide the issues. A jury might be misled by publication of inadmissible evidence; a judge might be misled by manufactured testimony.¹⁵ Here there is only criticism of judicial action already taken, although the cases were still pending on other points or might be revived by rehearings. For such injuries the judge has such remedy in damages for libel as do other public servants.

It is suggested, however, that even though intellectual processes cannot be affected by reflections on his personal integrity, a judge may be influenced by a desire to placate the accusing newspaper to retain public esteem and secure reelection presumably at the cost of unfair rulings against an accused. — So. 2d —. In this case too many fine drawn assumptions against the independence of judicial action must be made to call such a possibility a clear and present danger to justice. There must be a judge of less than ordinary fortitude without friends or support or a powerful and vindictive newspaper bent upon a rule or ruin policy. There must be a public unconcerned with or uninterested in the truth or the protection of their judicial institutions. If, as the Florida courts have held and as we have assumed, the petitioners deliberately distorted the facts to abase and destroy the efficiency of the court, those misrepresentations with the indicated motives manifested themselves in the language employed by petitioners in their editorials. The Florida courts see in this objectionable language an open effort to use purposely the power of the press to destroy without reason the reputation of judges and the competence of courts. This is the clear and present danger they fear to justice. (Although we realize that we do not have the same intimate relations with the people of Florida that is enjoyed by the Florida courts, we have no doubt that Floridians in general would react to these editorials in substantially the same way as citizens of other parts of our common country.)

¹⁵ Compare *Hazel-Atlas Co. v. Hartford Co.*, 322 U. S. 238.

As we have pointed out, we must weigh the impact of the words against the protection given by the principles of the First Amendment as adopted by the Fourteenth to public comment on pending court cases. We conclude that the danger under this record to fair judicial administration has not the clearness and immediacy necessary to close the door of permissible public comment. When that door is closed, it closes all doors behind it.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

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SUPREME COURT OF THE UNITED STATES.

No. 473.—OCTOBER TERM, 1945.

John D. Pennekamp and the Miami Herald Publishing Company Pe- titioners,	} On Writ of Certiorari to the Supreme Court of the State of Florida.
vs. The State of Florida.	

[]

Mr. Justice REED delivered the opinion of the Court.

This proceeding brings here for review a judgment of the Supreme Court of Florida, — Fla. —; 22 So. 2d 875, which affirmed a judgment of guilt in contempt of the Circuit Court of Dade County, Florida, on a citation of petitioners by that Circuit Court.

The individual petitioner was the associate editor of the Miami Herald, a newspaper of general circulation, published in Dade County, Florida, and within the jurisdiction of the trial court. The corporate petitioner was the publisher of the Miami Herald. Together petitioners were responsible for the publication of two editorials charged by the citation to be contemptuous of the Circuit Court and its judges in that they were unlawfully critical of the administration of criminal justice in certain cases then pending before the Court.

Certiorari was granted to review petitioners' contention that the editorials did not present "a clear and present danger of high imminence to the administration of justice by the court" or judges who were criticized and therefore the judgment of contempt was invalid as violative of the petitioners' right of free expression in the press. The importance of the issue in the administration of justice at this time in view of this Court's decision in *Bridges v. California*, 314 U. S. 252, three years prior to this judgment in contempt, is apparent.

Bridges v. California fixed reasonably well marked limits around the power of courts to punish newspapers and others for comments upon or criticism of pending litigation. The case placed orderly operation of courts as the primary and dominant require-

ment in the administration of justice. Pages 263, 265, 266. This essential right of the courts to be free of intimidation and coercion was held to be consonant with a recognition that freedom of the press must be allowed in the broadest scope compatible with the supremacy of order. A theoretical determinant of the limit for open discussion was adopted from experience with other adjustments of the conflict between freedom of expression and maintenance of order. This was the clear and present danger rule. The evil consequence of comment must be "extremely serious and the degree of imminence extremely high before utterances can be punished." Page 263. It was, of course, recognized that this formula, as would any other, inevitably had the vice of uncertainty, page 261, but it was expected that from a decent self-restraint on the part of the press and from the formula's repeated application by the courts standards of permissible comment would emerge which would guarantee the courts against interference and allow fair play to the good influences of open discussion. As a step toward the marking of the line, we held that the publications there involved were within the permissible limits of free discussion.

In the *Bridges* case the clear and present danger rule was applied to the stated issue of whether the expressions there under consideration prevented "fair judicial trials free from coercion or intimidation." Page 259. There was, of course, no question as to the power to punish for disturbances and disorder in the court room. Page 266. The danger to be guarded against is the "substantive evil" sought to be prevented. Pages 261, 262, 263. In the *Bridges* case that "substantive evil" was primarily the "disorderly and unfair administration of justice." Pages 270, 271, 278.¹

The Constitution has imposed upon this Court final authority to determine the meaning and application of those words of that instrument which require interpretation to resolve judicial issues. With that responsibility, we are compelled to examine for ourselves the statements in issue and the circumstances under which they were made to see whether or not they do carry a threat of clear and present danger to the impartiality and good order of the courts or whether they are of a character which the principles of the First Amendment, as adopted by the Due Process

¹ Compare *Schenck v. United States*, 249 U. S. 47, 52; *Thornhill v. Alabama*, 310 U. S. 88, 105; *Carlson v. California*, 310 U. S. 106, 113; *Board of Education v. Barnette*, 319 U. S. 624, 633.

Clause of the Fourteenth Amendment, protect.² When the highest court of a state has reached a determination upon such an issue, we give most respectful attention to its reasoning and conclusion but its authority is not final. Were it otherwise the constitutional limits of free expression in the Nation would vary with state lines.³

While there was a division of the Court in the *Bridges* case as to whether some of the public expressions by editorial comment transgressed the boundaries of a free press and as to the phrasing of the test, there was unanimous recognition that California's power to punish for contempt was limited by this Court's interpretation of the extent of protection afforded by the First Amendment. *Bridges v. California*, *supra*, at 297. Whether the threat to the impartial and orderly administration of justice must be a clear and present or a grave and immediate danger, a real and substantial threat, one which is close and direct or one which disturbs the court's sense of fairness depends upon a choice of words. Under any one of the phrases, reviewing courts are brought in cases of this type to appraise the comment on a balance between the desirability of free discussion and the necessity for fair adjudication, free from interruption of its processes.

The editorials of November 2d and 7th, 1944, which caused the court to issue the citation are set out below.⁴ Accompanying the

² *Gitlow v. New York*, 268 U. S. 652, 666; *Near v. Minnesota*, 283 U. S. 697, 707.

³ *Bridges v. California*, 314 U. S. 252, 267. Compare *Chambers v. Florida*, 309 U. S. 227, 228; *Hooven & Allison Co. v. Evatt*, 324 U. S. 652, 659.

⁴ November 2, 1944:

"*Courts Are Established—*

For the People.

"The courts belong to the people. The people have established them to promote justice, insure obedience to the law and to Punish Those Who Willfully Violate It.

"The people maintain the courts by providing the salaries of officials and setting up costly chambers and courtrooms for the orderly and dignified procedure of the tribunals.

"Upon the judges the people must depend for the decisions and the judicial conduct that will insure society—as a whole and in its individuals—against those who would undermine or destroy the peace, the morality and the orderly living of the community.

"In Order that the courts should not be amenable to political or other pressures in their determination of matters placed before them, Florida Circuit judges are called upon to face the electorate less often than are other elective office holders.

"So long are their terms, in fact, that in Dade county no Circuit judge, and only one judge of another court, has come to the bench by public choice

first editorial was a cartoon which held up the law to public obloquy. It caricatured a court by a robed compliant figure as a judge on the bench tossing aside formal charges to hand a document, marked "Defendant dismissed," to a powerful figure close at his left arm and of an intentionally drawn criminal type. At the right of the bench, a futile individual, labeled "Public Interest" vainly protests.

The citation charges that the editorials

"did reflect upon and impugn the integrity of said Court and the Judges thereof in imputing that the Judges of said Court 'do recognize and accept, even go out to find, every possible technicality of the law to protect the defendant, to

in the first instance. All the others have been named by a governor to fill a vacancy caused by death or resignation, or similar circumstance.

"Judicial terms in Dade county run:

- 1—Six years each for six Circuit judges.
- 2—Four years each for two Civil Court of Record judges.
- 3—Four years for the judge of the Criminal Court of Record.
- 4—Four years for the judge of the Court of Crimes.
- 5—Four years for County judge.
- 6—Four years for Juvenile court judge.

"These twelve judges represent the majesty and the sanctity of the law. They are the first line of defense locally of organized society against vice, corruption and crime, and the sinister machinations of the underworld.

"It is beyond question that American courts are of, by and for the people.

"Every accused person has a right to his day in court. But when judicial instance and interpretative procedure recognize and accept, even go out to find, every possible technicality of the law to protect the defendant, to block, thwart, hinder, embarrass and nullify prosecution, then the people's rights are jeopardized and the basic reason for courts stultified.

"The seeming ease and pat facility with which the criminally charged have been given technical safeguard have set people to wondering whether their courts are being subverted into refuges for lawbreakers.

"This Week the people, through their grand jury, brought into court eight indictments for rape. Judge Paul D. Barns agreed with the defense that the indictments were not properly drawn. Back they went to the grand jury for representation to the court.

"Only in the gravest emergency does a judge take over a case from another court of equal jurisdiction. A padlock action against the Brook Club was initiated last spring before Judge George E. Holt, who granted a temporary injunction.

"After five months, the case appeared Tuesday out of blue sky before Judge Marshall C. Wiseheart at the time State Attorney Stanley Milledge was engaged with the grand jury.

"Speedy decision was asked by counsel despite months of stalling. The State Attorney had to choose between the grand jury and Judge Wiseheart's court.

"The judge dismissed the injunction against the club and its operators. The defense got delay when it wanted and prompt decision from the court when it profited it.

"On Oct. 10 Judge Holt had before him a suit by the state to abate a nuisance (bookmaking) at the Tepee Club.

block, thwart, hinder, embarrass and nullify prosecution,' which said acts by you tend to create a distrust for said court and the judges thereof in the minds of the people of this county and state and tend to prevent and prejudice a fair and impartial action of the said Court and the Judges thereof in respect to the said pending case[s]."

After setting out details of alleged willful withholding and suppression of the whole truth in the publications, the citation further charges that

"you, by said cartoon and editorial, have caused to be represented unto the public that concerning the cases of (A) the eight indictments for rape, (B) the said Brook Club case, and

"Five affidavits of persons who allegedly visited the premises for the purpose of placing bets were introduced by the state over the objection of the defendants.

"Judge Holt ruled them out, explaining in denying the injunction against the Tepee Club:

"The defendant cannot cross-examine an affidavit. The court cannot determine who is testifying and whether belief can be placed upon such testimony . . . The fact that such affidavits were taken before the State Attorney does not give them any additional weight or value."

"This may be good law, exact judicial evaluation of the statutes. It is, however, the character of legal interpretation which causes people to raise questioning eyebrows and shake confused heads in futile wonderment.

"If Technicalities are to be the order and the way for the criminally charged either to avoid justice altogether or so to delay prosecution as to cripple it, then it behooves our courts and the legal profession to cut away the deadwood and the entanglements.

"Make it possible for the state's case, the people's case, to be seen with equal clarity of judicial vision as that accorded accused lawbreakers. Otherwise technicalities and the courts make the law, no matter what the will of the people and of their legislators."

November 7, 1944:

"*Why People Wonder.*

"Here is an example of why people wonder about the law's delays and obstructing technicalities operating to the disadvantage of the state—which is the people—in prosecutions.

"After stalling along for months, the defense in the padlock case against the Brook Club appeared before Judge Marshall C. Wiseheart for a decision. The State Attorney was working with the grand jury. The court knocked out the injunction. There was speed, dispatch, immediate attention and action for those charged with violation of the law. So fast that the people didn't get in a peep.

"That's one way of gumming up prosecution. Another is to delay action. On March 29, Coy L. Jaggears, bus driver, was sentenced to fifteen days in city jail by Judge Cecil C. Curry on conviction of beating up a taxicab operator.

"The arrest precipitated the notorious bus strike. As a result, Jaggears walked out of jail after posting \$200 appeal bond. The appeal never got further.

"There you have the legal paradox, working two ways, but to the same purpose against prosecution. Speed when needed. Month after month of delay when that serves the better."

(C) the Teepee Club case, that the Judges of this Court [had not] fairly and impartially heard and decided the matters in said editorial mentioned and have thereby represented unto the general public that notwithstanding the great public trust vested in the Judges of this Court that they have not discharged their duties honorably and fairly in respect to said pending cases as hereinbefore set forth, all of which tends to obstruct and interfere with the said Judges as such in fairly and impartially administering justice and in the discharging of their duties in conformity with the true principles which you have so properly recognized in the forepart of said editorial above quoted as being incumbent upon them and each of them; . . ."

Petitioners were required to show cause why they should not be held in contempt.

Petitioners answered that the publications were legitimate criticism and comment within the federal guaranties of free press and created no clear and present danger to the administration of justice. They sought to justify the publications by stating in their return to the rule that the facts stated in the editorials were correct, that two of the cases used as examples were not pending when the comments were made, since orders of dismissal had been previously entered by the Circuit Court, and that they as editors

"had the right if not the duty openly and forcefully to discuss these conditions to the end that these evils that are profoundly disturbing to the citizens of this county, might be remedied. The publications complained of did nothing more than discuss the generally recognized weakness and breakdown in the system of law enforcement and call for its improvement."

It is not practicable to comment at length on each of the challenged items. To make our decision as clear as possible, we shall refer in detail only to the comments concerning the "Rape Cases." These we think fairly illustrate the issues and are the most difficult comments for the petitioners to defend.

As to these cases, the editorial said:

"This Week the people, through their grand jury, brought into court eight indictments for rape. Judge Paul D. Barns agreed with the defense that the indictments were not properly drawn. Back they went to the grand jury for representation to the court."

We shall assume that the suggestion that the statement, "judicial instance and interpretative procedure . . . even go out to find, every possible technicality of the law to protect the defendant . . . and nullify prosecution," refers to the quashing of the rape indictments as well as other condemned steps. The comment of the last two paragraphs evidently includes these dismissals as so-called legal technicalities.

The citation charged that the prosecuting officer in open court agreed that the indictments were so defective as to make reindictment advisable. Reindictments were returned the next day and before the editorial. It was charged that these omissions were a wanton withholding of the full truth.

As to this charge, the petitioners made this return:

"That as averred in the citation, a motion was made to quash the indictment in Case 856, the ruling upon which would control in the other cases mentioned. Whereupon the representative of the State Attorney's Office stated in effect that he believed the original indictment was in proper form, but to eliminate any question he would have these defendants immediately re-indicted by the Grand Jury which was still then in session. And thereupon, the Judge of said Court did sustain the motion to quash with respect to Case No. 856.

The record of the Criminal Division of the Circuit Court, set out in the findings of fact at the hearing on the citation in contempt, shows that in case No. 856 the court upheld the defendants' motion to quash "with the approval of the Assistant State Attorney" and quashed the remaining indictments on his recommendation. Reindictment of the accused on the next day, prompt arraignment and setting for trial also appears. We accept the record as conclusive of the facts.

We read the Circuit Court's judgment to find that the comment on the Rape Cases contained only "half-truths," that it did not "fairly report the proceedings" of the court, that it contained "misinformation." The judgment said:

"To report on court proceedings is a voluntary undertaking but when undertaken the publisher who fails to fairly report does so at his own peril.

"We find the facts recited and the charges made in the citation to be true and well founded; . . ."

This finding included the fact that reindictments were then pending in the "Rape Cases." Defendant's assignments of error chal-

lenged the ruling that the matters referred to in the editorials were pending and the Supreme Court of Florida ruled that the cases were pending. 22 So. 2d at 883:

"We also agree that publications about a case that is closed no matter how scandalous, are not punishable as contempt. This is the general rule but the Florida Statute is more liberal than the rule."

Cf. Florida Statutes 1941, § 38.23 and § 932.03; see also 22 So. 2d at 886.

In *Bridges v. California*, 314 U. S. 252, 271-78, dissent 297-302, this Court looked upon cases as pending following completed interlocutory actions of the courts but awaiting other steps. In one instance it was sentence after verdict. In another, a motion for a new trial.

Pennekamp was fined \$250 and the corporation \$1,000.00.

The Supreme Court of Florida restated the facts as to the Rape Cases from the record. 22 So. 2d at 881. It then reached a conclusion as to all of the charges and so as to the Rape Cases in the words set out below.⁵ After further discussion of the facts, the Court said:

"In the light of this factual recitation, it is utter folly to suggest that the object of these publications was other than to abase and destroy the efficiency of the court."

To focus attention on the critical issue, we quote below from the decision of the Supreme Court of Florida certain excerpts which we believe fairly illustrate its position as to the applicable law.⁶

⁵ 22 So. 2d 875, 882: "So the vice in both the editorials was the distorted, inaccurate statement of facts and with that statement were scrambled false insinuations that amounted to unwarranted charges of partisanship and unfairness on the part of the judges.

"The record was available in all these cases and it does not reveal a breath of suspicion on which to predicate partisanship and unfairness on the part of the judges. It is shown rather that they acted in good faith and handled each case to the very best advantage possible. There was no judgment that could have been entered in any of them except the one that was entered. If the editorials had stated the facts correctly, nothing but a correct conclusion could have been deduced and there would have been no basis for contempt but here they elected to publish as truth a mixture of factual misstatement and omission and impose on that false insinuation, distortion, and deception and then contend that freedom of the press immunizes them from punishment."

⁶ 22 So. 2d 875, 884, 885, 886:

"A newspaper may criticize, harass, irritate, or vent its spleen against a person who holds the office of judge in the same manner that it does a member of the Legislature and other elective officers, but it may not publish scurrilous or libelous criticisms of a presiding judge as such or his judg-

From the editorials, the explanations of the petitioners and the records of the court, it is clear that the full truth in regard to the quashing of the indictments was not published. We agree with the Supreme Court that the "Rape Cases" were pending at the time of the editorials. We agree that the editorials did not state objectively the attitude of the judges. We accept the statement of the Supreme Court that under Florida law, "There was no judgment that could have been entered in any of them except the one that was entered." And, although we may feel

ments for the purpose of discrediting the Court in the eyes of the public. Respect for courts is not inspired by shielding them from criticism. This is a responsibility of the judge, acquired over the years by the spirit in which he approaches the judicial process, his ability to humanize the law and square it with reason, the level of his thinking, the consistency of his adherence to right and justice, and the degree to which he holds himself aloof from blocs, groups, and techniques that would sacrifice justice for expediency." "Courts cannot function in a free country when the atmosphere is charged with the effusions of a press designed to poison the mind of the public against the presiding judges rather than to clarify the issues and propagate the truth about them. The latter was the press that Mr. Jefferson visioned when he promulgated the thesis, 'Our liberty depends on the freedom of the press and that cannot be limited without being lost.'"

"Freedom to publish one's views is a principle of universal practice, but when the press deliberately abandons the proprieties and sets out to poison its pabulum or to sow dragon's teeth and dispense canards for the purpose of doing another a wrong, it is no different category from a free man that does likewise. The most rigid safeguard thrown around a free press would not protect appellants from falsely publishing or announcing to the world that the clergy of Miami were in sympathy with the practice of polygamy or were fostering other doctrines equally obnoxious to approved moral standards."

"The theory of our system of fair trial is that the determination of every case should be induced solely by evidence and argument in open court and the law applicable thereto and not by any outside influence, whether of private talk or public print."

"The State Courts touch the public more frequently than the Federal Courts and they have many reasons to enforce orderly administration that would not arise in the Federal Courts. If that power is to be construed by what appellants contend to be the pattern in the Bridges and Nye cases, then more than one hundred years of state law and decisions on the subject are turned into confusion or set at naught. . . .

"We do not think this can be the law. The Bridges case was disposed of on authority of the 'clear and present danger' cases, which are not analogous to most of the state cases because they arise from a different state of the law. The ultimate test in the Bridges case requires that the 'substantive evil must be extremely serious and the degree of imminence extremely high before the utterances can be punished.' Even if this test is to [be] the rule in the State Courts, they are authorized to apply it by their own law and standards and unless the application is shown to be arbitrary and unreasonable, their judgment should not be disturbed. The law in Florida permits the most liberal exercise possible of freedom of the press but holds to account those who abuse it.

"We therefore hold that the cartoon and the editorials afford ample support for the judgment imposed and that the issues were properly adjudicated under Florida law."

that this record scarcely justifies the harsh inference that the truth was willfully or wantonly or recklessly withheld from the public or that the motive behind the publication was to abase and destroy the efficiency of the courts, we accept in this case that conclusion of the Florida courts upon intent and motive as a determination of fact.⁷ While the ultimate power is here to ransack the record for facts in constitutional controversies, we are accustomed to adopt the result of the state courts' examination.⁸ It is the findings of the state courts on undisputed facts or the undisputed facts themselves which ordinarily furnish the basis for our appraisal of claimed violations of federal constitutional rights.⁹

The acceptance of the conclusion of a state as to the facts of a situation leaves open to this Court the determination of federal constitutional rights in the setting of those facts.¹⁰ When the *Bridges* case was here, there was necessarily involved a determination by the California state court that all of the editorials had, at least, a tendency to interfere with the fair administration of criminal justice in pending cases in a court of that state. Yet this Court was unanimous in saying that two of those editorials had no such impact upon a court as to justify a conviction of contempt in the face of the principles of the First Amendment. We must, therefore, weigh the right of free speech which is claimed by the petitioners against the danger of the coercion and intimidation of courts in the factual situation presented by this record.

Free discussion of the problems of society is a cardinal principle of Americanism—a principle which all are zealous to preserve.¹¹ Discussion that follows the termination of a case may be inadequate to emphasize the danger to public welfare of supposedly wrongful judicial conduct.¹² It does not follow that public com-

⁷ See IX Wigmore, Evidence (3d Ed.) § 2557. *Crawford v. United States*, 212 U. S. 183, 203.

⁸ *Drivers Union v. Meadowmoor Co.*, 312 U. S. 287, 293-94; *Lisenba v. California*, 314 U. S. 219, 238.

⁹ *Chambers v. Florida*, 309 U. S. 227, 239; *Ashcraft v. Tennessee*, 322 U. S. 143, 152, 153, 154; *Malinski v. New York*, 324 U. S. 401, 404.

¹⁰ See the cases in the preceding paragraph, note 8.

¹¹ *Murdock v. Pennsylvania*, 319 U. S. 105, 115; *Board of Education v. Barnette*, 319 U. S. 624, 639; *Thomas v. Collins*, 323 U. S. 516, 530.

¹² *Bridges v. California*, 314 U. S. at 269:

"No suggestion can be found in the Constitution that the freedom there guaranteed for speech and the press bears an inverse ratio to the timeliness and importance of the ideas seeking expression. Yet, it would follow as a practical result of the decisions below that anyone who might wish to give public expression to his views on a pending case involving no matter what

ment of every character upon pending trials or legal proceedings may be as free as a similar comment after complete disposal of the litigation. Between the extremes there are areas of discussion which an understanding publicist will appraise in the light of the effect on himself and on the public of creating a clear and present danger to the fair and orderly judicial administration. Courts must have power to protect the interests of prisoners and litigants before them from unseemly efforts to pervert judicial action. In the borderline instances where it is difficult to say upon which side the alleged offense falls, we think the specific freedom of public comment should weigh heavily against a possible tendency to influence pending cases. Freedom of discussion should be given the widest range compatible with the essential requirement of the fair and orderly administration of justice.

While a disclaimer of intention does not purge a contempt, we may at this point call attention to the sworn answer of petitioners that their purpose was not to influence the court. An excerpt appears below.¹³ For circumstances to create a clear and present danger to judicial administration, a solidity of evidence should be required which it would be difficult to find in this record. Compare *Baumgartner v. United States*, 322 U. S. 665, 670; *Schneiderman v. United States*, 320 U. S. 118.

The comments were made about judges of courts of general jurisdiction—judges selected by the people of a populous and educated community. They concerned the attitude of the judges toward those who were charged with crime, not comments on evi-

problem of public interest, just at the time his audience would be most receptive, would be as effectively discouraged as if a deliberate statutory scheme of censorship had been adopted."

13 "These respondents deny any intent by either said editorial or said cartoon either in words or otherwise to interfere with fair and impartial justice in the State of Florida and deny that the large character in the cartoon was beside the judge and on the bench and being heard, recognized and favored, but, on the contrary, these respondents respectfully show that it was the intention of said editorial and said cartoon to condemn and criticize the system of pleading and practice and procedure created by the laws of Florida, whereby such cases could long be delayed and then could be dismissed upon technical grounds in the manner herein shown."

We add Mr. Pennekamp's statement of the editorial policy of the Miami Herald:

"We are ourselves Free—Free as the Constitution we enjoy—Free to truth, good manners and good sense. We shall be for whatever measure is best adapted to defending the rights and liberties of the people and advancing useful knowledge. We shall labor at all times to inspire the people with a just and proper sense of their conditions, to point out to them their true interest and rouse them to pursue it."

dence or rulings during a jury trial. Their effect on juries that might eventually try the alleged offenders against the criminal laws of Florida is too remote for discussion. Comment on pending cases may affect judges differently. It may influence some judges more than others. Some are of a more sensitive fiber than their colleagues. The law deals in generalities and external standards and cannot depend on the varying degrees of moral courage or stability in the face of criticism which individual judges may possess any more than it can depend on the personal equations or individual idiosyncrasies of the tort-feasor. *The Germanic*, 196 U. S. 589, 596; *Arizona Employers' Liability Cases*, 250 U. S. 400, 422, 432. We are not willing to say under the circumstances of this case that these editorials are a clear and present danger to the fair administration of justice in Florida. Cf. *Near v. Minnesota*, 283 U. S. 697, 714-15.

What is meant by clear and present danger to a fair administration of justice? No definition could give an answer. Certainly this criticism of the judge's inclinations or actions in these pending non-jury proceedings could not directly affect such administration. This criticism of his actions could not affect his ability to decide the issues. Here there is only criticism of judicial action already taken, although the cases were still pending on other points or might be revived by rehearings. For such injuries a judge has such remedy in damages for libel as do other public servants.

It is suggested, however, that even though his intellectual processes cannot be affected by reflections on his purposes, a judge may be influenced by a desire to placate the accusing newspaper to retain public esteem and secure reelection presumably at the cost of unfair rulings against an accused. In this case too many fine drawn assumptions against the independence of judicial action must be made to call such a possibility a clear and present danger to justice. There must be a judge of less than ordinary fortitude without friends or support or a powerful and vindictive newspaper bent upon a rule or ruin policy. There must be a public unconcerned with or uninterested in the truth or the protection of their judicial institutions. If, as the Florida courts have held and as we have assumed, the petitioners deliberately distorted the facts to abase and destroy the efficiency of the court, those misrepresentations with the indicated motives

- omission

- omission

manifested themselves in the language employed by petitioners in their editorials. The Florida courts see in this objectionable language an open effort to use purposely the power of the press to destroy without reason the reputation of judges and the competence of courts. This is the clear and present danger they fear to justice. Although we realize that we do not have the same close relations with the people of Florida that is enjoyed by the Florida courts, we have no doubt that Floridians in general would react to these editorials in substantially the same way as citizens of other parts of our common country.

As we have pointed out, we must weigh the impact of the words against the protection given by the principles of the First Amendment, as adopted by the Fourteenth, to public comment on pending court cases. We conclude that the danger under this record to fair judicial administration has not the clearness and immediacy necessary to close the door of permissible public comment. When that door is closed, it closes all doors behind it.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

SUPREME COURT OF THE UNITED STATES.

No. 473.—OCTOBER TERM, 1945.

John D. Pennekamp and the Miami Herald Publishing Company Pe- titioners, vs. The State of Florida.	}	On Writ of Certiorari to the Supreme Court of the State of Florida.
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Mr. Justice REED delivered the opinion of the Court.

This proceeding brings here for review a judgment of the Supreme Court of Florida, — Fla. —; 22 So. 2d 875, which affirmed a judgment of guilt in contempt of the Circuit Court of Dade County, Florida, on a citation of petitioners by that Circuit Court.

The individual petitioner was the associate editor of the *Miami Herald*, a newspaper of general circulation, published in Dade County, Florida, and within the jurisdiction of the trial court. The corporate petitioner was the publisher of the *Miami Herald*. Together petitioners were responsible for the publication of two editorials charged by the citation to be contemptuous of the Circuit Court and its judges in that they were unlawfully critical of the administration of criminal justice in certain cases then pending before the Court.

Certiorari was granted to review petitioners' contention that the editorials did not present a clear and present danger of high imminence to the administration of justice in the cases referred to or otherwise by the court or judges who were criticized and therefore the judgment of contempt was invalid as violative of the petitioners' right of free expression in the press. The importance of the issue in the administration of justice at this time in view of this Court's decision in *Bridges v. California*, 314 U. S. 252, three years prior to this judgment in contempt, is apparent.

Bridges v. California fixed reasonably well marked limits around the power of courts to punish newspapers and others for comments upon or criticism of pending litigation. The case placed

orderly operation of courts as the primary and dominant requirement in the administration of justice. Pages 263, 265, 266. This essential right of the courts to be free of intimidation and coercion, physical or moral, was held to be consonant with a recognition that freedom of the press must be allowed in the broadest scope compatible with the supremacy of order. A theoretical determinant of the limit for open discussion was adopted from experience with other adjustments of the conflict between freedom of expression and maintenance of order. This was the clear and present danger rule. The evil consequence of comment must be "extremely serious and the degree of imminence extremely high before utterances can be punished." Page 263. It was, of course, recognized that this formula as would any other, inevitably had the vice of uncertainty, page 261, but it was expected that from a decent self-restraint on the part of the press and from its repeated application by the courts standards of permissible comment would emerge which would guarantee the courts against interference and allow fair play to the good influences of open discussion. As a step toward the marking of the line, we held that the publications there involved were within the permissible limits of free discussion.

In the *Bridges* case the clear and present danger rule was applied to the stated issue of whether the expressions there under consideration prevented "fair judicial trials free from coercion or intimidation." Page 259. There was, of course, no question as to the power to punish for disturbances and disorder in the court room. Page 266. The danger to be guarded against is the "substantive evil" sought to be prevented. Pages 261, 262, 263. In the *Bridges* case that "substantive evil" was primarily the "disorderly and unfair administration of justice." Pages 270, 271, 278.¹

The Constitution has imposed upon this Court final authority to determine the meaning and application of those words of that instrument which require interpretation to resolve judicial issues. Under the compulsion of that responsibility, we are compelled to examine for ourselves the statements in issue and the circumstances under which they were made to see whether or not they do carry a threat of clear and present danger to the impartiality

¹ Compare *Schenck v. United States*, 249 U. S. 47, 52; *Thornhill v. Alabama*, 310 U. S. 88, 105; *Carlson v. California*, 310 U. S. 106, 113; *Board of Education v. Barnette*, 319 U. S. 624, 633.

of the courts or whether they are of a character which the principles of the First Amendment, as adopted by the Due Process Clause of the Fourteenth Amendment, protect.² When the highest court of a state has reached a determination upon such an issue, we give most respectful attention to its reasoning and conclusion but its authority is not decisive. Were it otherwise the constitutional limits of free expression in the Nation would vary with state lines.³

While there was a division of the Court in the *Bridges* case as to whether some of the public expressions by editorial comment transgressed the boundaries of a free press and as to the phrasing of the test, there was unanimous recognition that California's power to punish for contempt was limited by this Court's interpretation of the extent of protection afforded by the First Amendment. *Bridges v. California, supra*, at 297. Whether the threat to the impartial administration of justice must be a clear and present or a grave and immediate danger, a real and substantial threat or one which is close and direct depends upon a choice of words. Under any one of the phrases, reviewing courts are brought in cases of this type to appraise the comment on a balance between the desirability of free discussion and the necessity for fair adjudication.

The editorials of November 2d and 7th, 1944, which caused the court to issue the citation are set out below.⁴ Accompanying the

² *Gillow v. New York*, 268 U. S. 652, 666; *Near v. Minnesota*, 283 U. S. 697, 707.

³ *Bridges v. California*, 314 U. S. 252, 267. Compare *Chambers v. Florida*, 309 U. S. 227, 228; *Hooven & Allison Co. v. Evatt*, 324 U. S. 652, 659.

⁴ November 2, 1944:

"Courts Are Established—

For the People.

"The courts belong to the people. The people have established them to promote justice, insure obedience to the law and to Punish Those Who Willfully Violate It.

"The people maintain the courts by providing the salaries of officials and setting up costly chambers and courtrooms for the orderly and dignified procedure of the tribunals.

"Upon the judges the people must depend for the decisions and the judicial conduct that will insure society—as a whole and in its individuals—against those who would undermine or destroy the peace, the morality and the orderly living of the community.

"In Order that the courts should not be amenable to political or other pressures in their determination of matters placed before them, Florida Circuit judges are called upon to face the electorate less often than are other elective office holders.

"So long are their terms, in fact, that in Dade county no Circuit judge, and only one judge of another court, has come to the bench by public choice.

first editorial was a cartoon which held up the law to public obloquy. It caricatured a court by a robed compliant figure as a judge on the bench tossing aside formal charges to hand a document, marked "Defendant dismissed," to a powerful figure close at his left arm and of an intentionally drawn criminal type. At the right of the bench, a futile individual, labeled "Public Interest" vainly protests.

The citation charges that the editorials

"did reflect upon and impugn the integrity of said Court and the Judges thereof in imputing that the Judges of said Court 'do recognize and accept, even go out to find, every possible technicality of the law to protect the defendant, to

in the first instance. All the others have been named by a governor to fill a vacancy caused by death or resignation, or similar circumstance.

"Judicial terms in Dade county run:

- 1—Six years each for six Circuit judges.
- 2—Four years each for two Civil Court of Record judges.
- 3—Four years for the judge of the Criminal Court of Record.
- 4—Four years for the judge of the Court of Crimes.
- 5—Four years for County judge.
- 6—Four years for Juvenile court judge.

"These twelve judges represent the majesty and the sanctity of the law. They are the first line of defense locally of organized society against vice, corruption and crime, and the sinister machinations of the underworld.

"It is beyond question that American courts are of, by and for the people. Every accused person has a right to his day in court. But when judicial instance and interpretative procedure recognize and accept, even go out to find, every possible technicality of the law to protect the defendant, to block, thwart, hinder, embarrass and nullify prosecution, then the people's rights are jeopardized and the basic reason for courts stultified.

"The seeming ease and pat facility with which the criminally charged have been given technical safeguard have set people to wondering whether their courts are being subverted into refuges for lawbreakers.

"This Week the people, through their grand jury, brought into court eight indictments for rape. Judge Paul D. Barns agreed with the defense that the indictments were not properly drawn. Back they went to the grand jury for representation to the court.

"Only in the gravest emergency does a judge take over a case from another court of equal jurisdiction. A padlock action against the Brook Club was initiated last spring before Judge George E. Holt, who granted a temporary injunction.

"After five months, the case appeared Tuesday out of blue sky before Judge Marshall C. Wiseheart at the time State Attorney Stanley Milledge was engaged with the grand jury.

"Speedy decision was asked by counsel despite months of stalling. The State Attorney had to choose between the grand jury and Judge Wiseheart's court.

"The judge dismissed the injunction against the club and its operators. The defense got delay when it wanted and prompt decision from the court when it profited it.

"On Oct. 10 Judge Holt had before him a suit by the state to abate a nuisance (bookmaking) at the Tepee Club.

block, thwart, hinder, embarrass and nullify prosecution,' which said acts by you tend to create a distrust for said court and the judges thereof in the minds of the people of this county and state and tend to prevent and prejudice a fair and impartial action of the said Court and the Judges thereof in respect to the said pending case[s]."

After setting out details of alleged willful withholding and suppression of the whole truth in the publications, the citation further charges that

"you, by said cartoon and editorial, have caused to be represented unto the public that concerning the cases of (A) the eight indictments for rape, (B) the said Brook Club case, and

"Five affidavits of persons who allegedly visited the premises for the purpose of placing bets were introduced by the state over the objection of the defendants.

"Judge Holt ruled them out, explaining in denying the injunction against the Teepee Club:

"The defendant cannot cross-examine an affidavit. The court cannot determine who is testifying and whether belief can be placed upon such testimony . . . The fact that such affidavits were taken before the State Attorney does not give them any additional weight or value."

"This may be good law, exact judicial evaluation of the statutes. It is, however, the character of legal interpretation which causes people to raise questioning eyebrows and shake confused heads in futile wonderment.

"If Technicalities are to be the order and the way for the criminally charged either to avoid justice altogether or so to delay prosecution as to cripple it, then it behooves our courts and the legal profession to cut away the deadwood and the entanglements.

"Make it possible for the state's case, the people's case, to be seen with equal clarity of judicial vision as that accorded accused lawbreakers. Otherwise technicalities and the courts make the law, no matter what the will of the people and of their legislators."

November 7, 1944:

"*Why People Wonder.*

"Here is an example of why people wonder about the law's delays and obstructing technicalities operating to the disadvantage of the state—which is the people—in prosecutions.

"After stalling along for months, the defense in the padlock case against the Brook Club appeared before Judge Marshall C. Wiseheart for a decision. The State Attorney was working with the grand jury. The court knocked out the injunction. There was speed, dispatch, immediate attention and action for those charged with violation of the law. So fast that the people didn't get in a peep.

"That's one way of gumming up prosecution. Another is to delay action. On March 29, Coy L. Jaggears, bus driver, was sentenced to fifteen days in city jail by Judge Cecil C. Curry on conviction of beating up a taxicab operator.

"The arrest precipitated the notorious bus strike. As a result, Jaggears walked out of jail after posting \$200 appeal bond. The appeal never got further.

"There you have the legal paradox, working two ways, but to the same purpose against prosecution. Speed when needed. Month after month of delay when that serves the better."

(C) the Teepee Club case, that the Judges of this Court [had not] fairly and impartially heard and decided the matters in said editorial mentioned and have thereby represented unto the general public that notwithstanding the great public trust vested in the Judges of this Court that they have not discharged their duties honorably and fairly in respect to said pending cases as hereinbefore set forth, all of which tends to obstruct and interfere with the said Judges as such in fairly and impartially administering justice and in the discharging of their duties in conformity with the true principles which you have so properly recognized in the forepart of said editorial above quoted as being incumbent upon them and each of them; . . ."

Petitioners were required to show cause why they should not be held in contempt.

Petitioners answered that the publications were legitimate criticism and comment within the federal guaranties of free press and created no clear and present danger to the administration of justice. They sought to justify the publications by stating in their return to the rule that the facts stated in the editorials were correct, that two of the cases used as examples were not pending when the comments were made, since orders of dismissal had been previously entered by the Circuit Court, and that they as publicists

"had the right if not the duty openly and forcefully to discuss these conditions to the end that these evils that are profoundly disturbing to the citizens of this county, might be remedied. The publications complained of did nothing more than discuss the generally recognized weakness and breakdown in the system of law enforcement and call for its improvement."

It is not practicable to comment at length on each of the challenged items. To make our decision as clear as possible, we shall refer in detail only to the comments concerning the "Rape Cases." These we think fairly illustrate the issues and are the most difficult comment for the petitioners to defend.

As to these cases, the editorial said:

"This Week the people, through their grand jury, brought into court eight indictments for rape. Judge Paul D. Barns agreed with the defense that the indictments were not properly drawn. Back they went to the grand jury for representation to the court."

We shall assume that the suggestion that "judicial instance and interpretative procedure . . . even go out to find, every possible technicality of the law to protect the defendant . . . and nullify prosecution" refers to the quashing of the rape indictments. The comment of the last two paragraphs evidently refers to these dismissals as so-called legal technicalities.

The citation charged that the prosecuting officer in open court agreed that the indictments were so defective as to make reindictment advisable. Reindictments were returned the next day and before the editorial. This was charged as a wanton withholding of the full truth.

As to this charge, the petitioners made this return:

"That as averred in the citation, a motion was made to quash the indictment in Case 856, the ruling upon which would control in the other cases mentioned. Whereupon the representative of the State Attorney's Office stated in effect that he believed the original indictment was in proper form, but to eliminate any question he would have these defendants immediately re-indicted by the Grand Jury which was still then in session. And thereupon, the Judge of said Court did sustain the motion to quash with respect to Case No. 856.

The record of the Criminal Division of the Circuit Court, set out in the findings of fact at the hearing on the citation in contempt, shows that in case No. 856 the court upheld the defendants' motion to quash "with the approval of the Assistant State Attorney" and quashed the remaining indictments on his recommendation. Reindictment of the accused on the next day, prompt arraignment and setting for trial also appears. We accept the record as conclusive of the facts.

We read the Circuit Court's judgment to find that the comment on the Rape Cases contained only "half-truths," that it did not "fairly report the proceedings" of the court, that it contained "misinformation." The judgment said:

"To report on court proceedings is a voluntary undertaking but when undertaken the publisher who fails to fairly report does so at his own peril.

"We find the facts recited and the charges made in the citation to be true and well founded; . . ."

Pennekamp was fined \$250 and the corporation \$1,000.00.

The Supreme Court of Florida restated the facts as to the Rape Cases from the record. 22 So. 2d at 881. It then reached a

conclusion as to all of the charges and so as to the Rape Cases in the words set out below.⁵ After further discussion of the facts, the Court says:

"In the light of this factual recitation, it is utter folly to suggest that the object of these publications was other than to abase and destroy the efficiency of the court."

To focus attention on the critical issue, we quote below from the decision of the Supreme Court of Florida certain excerpts which we believe fairly illustrate its position as to the applicable law.⁶

From the editorials and the explanations of the petitioners, it is clear that the full truth in regard to the quashing of the indictments was not published. We agree that the editorials did not state objectively the attitude of the judges. We accept the

⁵ 22 So. 2d 875, 882: "So the vice in both the editorials was the distorted, inaccurate statement of facts and with that statement were scrambled false insinuations that amounted to unwarranted charges of partisanship and unfairness on the part of the judges.

"The record was available in all these cases and it does not reveal a breadth of suspicion on which to predicate partisanship and unfairness on the part of the judges. It is shown rather that they acted in good faith and handled each case to the very best advantage possible. There was no judgment that could have been entered in any of them except the one that was entered. If the editorials had stated the facts correctly, nothing but a correct conclusion could have been deduced and there would have been no basis for contempt but here they elected to publish as truth a mixture of factual misstatement and omission and impose on that false insinuation, distortion, and deception and then contend that freedom of the press immunizes them from punishment."

⁶ 22 So. 2d 875, 884, 885, 886:

"A newspaper may criticize, harass, irritate, or vent its spleen against a person who holds the office of judge in the same manner that it does a member of the Legislature and other elective officers, but it may not publish scurrilous or libelous criticisms of a presiding judge as such or his judgments for the purpose of discrediting the Court in the eyes of the public. Respect for courts is not inspired by shielding them from criticism. This is a responsibility of the judge, acquired over the years by the spirit in which he approaches the judicial process, his ability to humanize the law and square it with reason, the level of his thinking, the consistency of his adherence to right and justice, and the degree to which he holds himself aloof from blocs, groups, and techniques that would sacrifice justice for expediency."

"Courts cannot function in a free country when the atmosphere is charged with the effusions of a press designed to poison the mind of the public against the presiding judges rather than to clarify the issues and propagate the truth about them. The latter was the press that Mr. Jefferson visioned when he promulgated the thesis, 'Our liberty depends on the freedom of the press and that cannot be limited without being lost.'"

"Freedom to punish one's views is a principle of universal practice, but when the press deliberately abandons the proprieties and sets out to poison its pabulum or to sow dragons' teeth and dispense canards for the purpose of doing another a wrong, it is no different category from a free man that does likewise. The most rigid safeguard thrown around a free press would not protect appellants from falsely publishing or announcing to the world

statement of the Supreme Court that under Florida law, "There was no judgment that could have been entered in any of them except the one that was entered." And, although we may feel that this record scarcely justifies the harsh inference that the truth was willfully or wantonly or recklessly withheld from the public or that the motive behind the publication was to abase and destroy the efficiency of the courts, we feel it incumbent upon us to accept that conclusion of the Florida courts upon intent and motive as a determination of fact which is within their competence and not ours. Where the evidence in an examination of a federal question reasonably justifies a preliminary factual finding by state courts, or is in dispute, we accept their decision as the most efficient instrumentality for resolving disputes of fact. While the ultimate power is here to ransack the record for facts in constitutional controversies, an effort to avoid federal constitutional difficulties is not apparent,⁷ we adopt the result of the state courts' examination.⁸ It is the findings of the state courts on disputed facts or the undisputed facts which furnish the basis for our

that the clergy of Miami were in sympathy with the practice of polygamy or were fostering other doctrines equally obnoxious to approved moral standards."

"The theory of our system of fair trial is that the determination of every case should be induced solely by evidence and argument in open court and the law applicable thereto and not by any outside influence, whether of private talk or public print."

"The State Courts touch the public more frequently than the Federal Courts and they have many reasons to enforce orderly administration that would not arise in the Federal Courts. If that power is to be construed by what appellants contend to be the pattern in the Bridges and Nye cases, then more than one hundred years of state law and decisions on the subject are turned into confusion or set at naught. . . .

"We do not think this can be the law. The Bridges case was disposed of on authority of the 'clear and present danger' cases, which are not analogous to most of the state cases because they arise from a different state of the law. The ultimate test in the Bridges case requires that the 'substantive evil must be extremely serious and the degree of imminence extremely high before the utterances can be punished.' Even if this test is to the rule in the State Courts, they are authorized to apply it by their own law and standards and unless the application is shown to be arbitrary and unreasonable, their judgment should not be disturbed. The law in Florida permits the most liberal exercise possible of freedom of the press but holds to account those who abuse it.

"We therefore hold that the cartoon and the editorials afford ample support for the judgment imposed and that the issues were properly adjudicated under Florida law."

⁷ *Norris v. Alabama*, 294 U. S. 587, 590; *Creswill v. Grand Lodge K. of P.*, 225 U. S. 246, 261; *Ancient Egyptian Order v. Michaux*, 279 U. S. 737, 744; *Moore v. Dempsey*, 261 U. S. 65.

⁸ *Drivers Union v. Meadowmoor Co.*, 312 U. S. 287, 293-94; *Lisenba v. California*, 314 U. S. 219, 238.

appraisal of claimed violations of federal constitutional rights.⁹

The acceptance of the conclusion of a state as to the facts of a situation leaves open to this Court the determination of federal constitutional rights in the setting of those facts.¹⁰ When the *Bridges* case was here, there was necessarily involved a determination by the California state court that all of the editorials had, at least, a tendency to interfere with the fair administration of criminal justice in pending cases in a court of that state. Yet this Court was unanimous in saying that two of those editorials had no such impact upon a court as to justify a conviction of contempt in the face of the principles of the First Amendment. We must, therefore, weigh the right of free speech which is claimed by the petitioners against the danger of interference with the fair operation of courts in the factual situation presented by this record.

Free discussion of the problems of society is a cardinal principle of Americanism—a principle which all are zealous to preserve.¹¹ The admitted freedom of discussion which follows the termination of every judicial inquiry is deemed inadequate to emphasize properly to the public the danger to our welfare of supposed judicial neglect of the principles of justice.¹² It does not follow that public comment of every character upon pending trials or legal proceedings may be as free as a similar comment after complete disposal of the litigation. Between the extremes there are areas of discussion which an understanding publicist will appraise in the light of the proprieties and in the light of the effect on himself of creating a clear and present danger to the fair and orderly judicial administration. Courts must have power to protect the interests of prisoners and litigants before them from unseemly efforts to pervert judicial action. In

⁹ *Chambers v. Florida*, 309 U. S. 227, 239; *Ashcraft v. Tennessee*, 322 U. S. 143, 152, 153, 154; *Malinski v. New York*, 324 U. S. 401, 404.

¹⁰ See the cases in the preceding paragraph.

¹¹ *Murdock v. Pennsylvania*, 319 U. S. 105, 115; *West Virginia v. Barnett*, 319 U. S. 624, 639; *Thomas v. Collins*, 323 U. S. 516, 527, 530.

¹² 314 U. S. at 269:

"No suggestion can be found in the Constitution that the freedom there guaranteed for speech and the press bears an inverse ratio to the timeliness and importance of the ideas seeking expression. Yet, it would follow as a practical result of the decisions below that anyone who might wish to give public expression to his views on a pending case involving no matter what problem of public interest, just at the time his audience would be most receptive, would be as effectively discouraged as if a deliberate statutory scheme of censorship had been adopted."

the borderline instances where it is difficult to say upon which side the alleged offense falls, we think the specific freedom of public comment should weigh heavily against a possible tendency to influence pending cases.

While a disclaimer of intention does not purge a contempt, we may at this point give consideration to the sworn answer of petitioners that their purpose was not to influence the court. An excerpt appears below.¹³ For circumstances to create a clear and present danger to judicial administration, a solidity of evidence should be required which it would be difficult to find in this record. Compare *Baumgartner v. United States*, 322 U. S. 665, 670; *Schneiderman v. United States*, 320 U. S. 118.

The comments were made about judges of courts of general jurisdiction—judges selected by the people of a populous and educated community. Their effect on juries which might eventually try the offenders is too remote for discussion. One does not need to be insensible to the effect of public criticism.¹⁴ by a strong local newspaper to have doubts as to whether the editorials and cartoon could be classed as a clear and present danger to fair judicial action on the pending cases. Certainly it cannot be said that the success or failure of an effort to influence the course of justice is significant in a contempt proceeding. Comment on pending cases may affect judges differently. It may influence some judges more than others. Some are of a more sensitive fiber than their colleagues. The law deals in generalities and cannot depend on the varying degrees of moral courage or stability which individual judges may possess. We are not

¹³ "These respondents deny any intent by either said editorial or said cartoon either in words or otherwise to interfere with fair and impartial justice in the State of Florida and deny that the large character in the cartoon was beside the judge and on the bench and being heard, recognized and favored, but, on the contrary, these respondents respectfully show that it was the intention of said editorial and said cartoon to condemn and criticize the system of pleading and practice and procedure created by the laws of Florida, whereby such cases could long be delayed and then could be dismissed upon technical grounds in the manner herein shown."

We add Mr. Pennekamp's statement of the editorial policy of the Miami Herald:

"We are ourselves Free—Free as the Constitution we enjoy—Free to truth, good manners and good sense. We shall be for whatever measure is best adapted to defending the rights and liberties of the people and advancing useful knowledge. We shall labor at all times to inspire the people with a just and proper sense of their conditions, to point out to them their true interest and rouse them to pursue it."

¹⁴Cf. Sullivan, Contempts by Publication, page 1.

willing to say under the circumstances of this case that these editorials are a clear and present danger to the fair administration of justice in Florida. Cf. *Near v. Minnesota*, 283 U. S. 697, 714-15.

What is meant by clear and present danger to a fair administration of justice? Certainly this criticism of the judge's inclinations or actions in these pending non-jury proceedings could not directly affect such administration. This criticism of his actions could not affect his ability to decide the issues. A jury might be misled by publication of inadmissible evidence; a judge might be misled by manufactured testimony.¹⁵ Here there is only criticism of judicial action already taken, although the cases were still pending on other points or might be revived by rehearings. For such injuries the judge, like other public servants, has his remedy in damages for libel.

It is suggested, however, that even though his legal rulings cannot be affected by reflections on his personal integrity, a judge may be influenced by a desire to placate the accusing paper to retain public esteem and secure reelection presumably at the cost of unfair rulings against an accused. — So. 2d —. In this case too many fine drawn assumptions against the independence of judicial action must be made to call such a possibility a clear and present danger to justice. There must be a judge of less than ordinary fortitude without friends or support or a powerful and vindictive newspaper bent upon a rule or ruin policy. There must be a public unconcerned with or uninterested in the truth or the protection of their judicial institutions. If, as the Florida courts have held and as we have assumed, the petitioners deliberately distorted the facts to abase and destroy the efficiency of the court, those misrepresentations with the indicated motives manifested themselves in the language employed by petitioners in their editorials. The Florida courts see in this objectionable language an open effort to use purposely the power of the press to destroy without reason the reputation of judges and the competence of courts. This is the clear and present danger they fear to justice. Although we realize that we do not have the same intimate relations with the people of Florida that is enjoyed by the Florida courts, we have no doubt that Floridians in general

¹⁵ Compare *Hazel-Atlas Co. v. Hartford Co.*, 322 U. S. 238.

would react to these words in substantially the same way as citizens of other parts of our common country.

As we have pointed out, we must weigh the impact of the words against the protection given by the principles of the First Amendment as adopted by the Fourteenth to public comment on pending court cases. We conclude that the danger under this record to fair judicial administration has not the clearness and immediacy necessary to close the door of permissible public comment. When that door is closed, it closes all doors behind it.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

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SUPREME COURT OF THE UNITED STATES.

No. 361.—OCTOBER TERM, 1945.

Burton-Sutton Oil Company, In- corporated, Petitioner, <i>vs.</i> Commissioner of Internal Revenue.	} On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.
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Mr. Justice REED delivered the opinion of the Court.

The taxpayer, the petitioner here, is the operating company for the production of oil from Louisiana lands. The taxpayer acquired a contract from J. G. Sutton, grantee in the contract, that imposed upon the grantee the obligation to develop the oil land. For that purpose the contract transferred to the grantee all oil rights previously obtained by S. W. Sweeney by a lease from the owners of the land, the Cameron-Parish School Board. Through another transaction the grantor in the Sutton contract, the Gulf Refining Company of Louisiana, acquired these rights from Sweeney. An underlying oil royalty was retained by the School Board and an overriding oil royalty by Sweeney. The contract between Gulf and Sutton required the grantee-operator, who is now this taxpayer, to pay to the grantor, Gulf, 50% of the proceeds of the oil produced and sold from the land, deducting from the proceeds certain itemized expenses of the producer. Those expenses are so general in character that it may be said fairly that Gulf was to receive 50% of the net from operations.

The issue here is the correctness of the taxpayer's manner of handling this 50% net from operations, paid to Gulf, in its return for federal income tax for its fiscal years ending during 1936, 1937 and 1938 under the Revenue Acts of 1934 and 1936. The taxpayer deducted these payments of 50% of net income from its income for each of the years from the oil sold from the property. It claimed that Gulf retained an economic interest in the oil in place to the extent of this 50% payment. The Tax Court upheld the Commissioner's inclusion of an amount equal to these 50% payments in the taxpayer's gross income. They

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were included by the Commissioner in the income on the theory that the 50% payments represented capital investment by the taxpayer. That is, they were a part of the cost of the lease. 3 T. C. 1187. If this theory is correct, it is proper to add an equivalent sum, as the Commissioner did, to the taxpayer's gross income.¹ The Circuit Court of Appeals affirmed the Tax Court. *Burton-Sutton Oil Co. v. Commissioner*, 150 F. 2d 621.

A decision on the category of expenditures to which these 50% disbursements belong affects both the operators who make them and the owners, lessors, vendors, grantors, however they may be classed, who receive them. If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other.² The decision below conflicts in principle with *Commissioner v. Felix Oil Co.*, 144 F. 2d 277. The *Kirby* case, recently decided, involved payments of a share of net income by a producer but differs from this case because the lessor there was a landowner who reserved a royalty as well as a share in the net profits. Consequently, we granted certiorari. — U. S. —.

The applicable provisions in the Revenue Acts for 1934 and 1936 and the Regulations thereunder are substantially the same for the two Acts. We insert below those that seem pertinent.³

¹ The Commissioner and the Tax Court allowed the taxpayer depletion upon its entire income, so adjusted, under Section 114(b).

² *Kirby Petroleum Co. v. Commissioner*, No. 56 this Term, decided January 28, 1946, slip opinion pages 4 and 5; *Anderson v. Helvering*, 310 U. S. 404, 407.

³ Revenue Act of 1936, Ch. 690, 49 Stat. 1648:

"SEC. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. . . . In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . ."

"SEC. 114. Basis for Depreciation and Depletion.

(b) *Basis for Depletion.*—

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. . . ."

The issue of the character of these 50% payments is not settled, however, by the statutes or regulations. These prescribe the federal income tax accounting procedure after a determination that an expenditure of an operator is or is not a rent, a royalty or an ordinary business expense, but throw little light on what is a rent or royalty.

In the *Kirby* case, we held that a payment of a share of the net profits from oil production by the operator to the owner of the land was a rent or royalty and taxable to the landowner as income from the oil property. Therefore the owner could take from the payment the 27½ per centum allowance for depletion provided by Section 114(b)(3). The reason given in the *Kirby* case for holding that the payment of a part of the net return from the property to the landowner was a royalty or rent,⁴ was that the owner had a capital investment—an economic interest—in the oil with a possibility of profit from that interest or investment solely from the extraction of the oil. As hereinbefore indicated, the landowner in the *Kirby* case had retained also a one-sixth oil royalty and had received a bonus. It was conceded that as both the bonus and the royalty represented a return for the sale in part of the lessor's investment in the oil in place, the lessor was entitled to depletion on both.⁵

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

"ART. 23 (m)-1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—

(g) The term 'gross income from the property,' as used in sections 114(b)(3) and 114(b)(4)(A) and articles 23(m)-1 to 23(m)-28 of Regulation 94 . . . means the following:

In the case of oil and gas well, 'gross income from the property' as used in section 114(b)(3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. . . .

"In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property.' . . ."

⁴ A reading of Section 114(b)(3) shows that the "gross income from the property" means income from the oil and gas wells on the property. *Helvering v. Twin Bell Syndicate*, 293 U. S. 312; *Helvering v. Producers Corp.*, 303 U. S. 376, 382. Other income would not be depletable under that section. "Rents or royalties" in the section are those payable for the privilege of extraction.

⁵ *Kirby Petroleum Co. v. Commissioner*, *supra*, p. 2; *Burnet v. Harmel*, 287 U. S. 103, 111; *Murphy Oil Co. v. Burnet*, 287 U. S. 209, 302.

The respondent urges that in the *Kirby* case it was the lessor's economic interest in the oil itself, or its proceeds, because of the bonus and royalty rights, which made the net profit payments subject to depletion in the lessor's hands; that net profits received are not depletable unless the recipient is entitled also to oil royalties.⁶ Consequently, the Government contends that in this case where there is only a share in profits due to the assignee, Gulf, the *Kirby* case conclusion on the right to depletion should not be extended but that the judgment below should be affirmed on the ground that the profit payment was a part of the purchase price. In dealing with the operator's exclusion from gross income of agreed payments to lessors or assignors of oil leases out of net profits and with the lessor's or assignor's rights to depletion, the Tax Court has not followed consistently the principle that a reserved royalty was necessary to make a net profit payment depletable to the lessor and deductible from gross income from the property by the operator.⁷ A number of the Tax Court cases

⁶ The principle upon which the Tax Court and the Circuit Court of Appeals decided this case for respondent differs from respondent's present contention. This principle was that an obligation to pay a part of net proceeds is a personal covenant of the obligee and was the purchase price for the assignment. *Burton-Sutton Oil Co. v. Commissioner*, 150 F. 2d 621, 622; 3 Tax Court 1187, 1194, relying upon *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588, 590-91; 44 B. T. A. 624, 627; *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372.

⁷ In *Green v. Commissioner*, 26 B. T. A. 1017, the lessor was allowed depletion on a net income payment in addition to his royalty on the ground that the net income payment was like a bonus.

In *Marrs McLean v. Commissioner*, 41 B. T. A. 565, 573, which was decided after the *Elbe* case, the Tax Court said a transfer of leases for cash and a share of the profits was a sale. Where only a three-fourths interest in the lease was transferred and the transferor was to have one-fourth of the net profits, depletion was allowed the assignor.

In *Felix Oil Co. v. Commissioner*, docket No. 107148, decided December 18, 1942, a lessor corporation that had leased its oil lands for a cash payment plus 50% of the net profits as defined in the lease and no royalty, was held to have "retained an interest in the oil in place" through its ownership of the land. "Clearly, petitioner retained an interest in the oil produced because it could compel the lessee to sell 50 percent of the production elsewhere if it became dissatisfied with amounts realized by the lessee." Memorandum op., p. 7. See *Commissioner v. Felix Oil Co.*, 144 F. 2d 277, affirming. Compare *A. B. Innis v. Commissioner*, T. C. Docket Nos. 2735-2736, June 29, 1945.

In *Kirby Petroleum Co.*, 2 T. C. 1258, 1261, the Tax Court relied on the latter ruling in *Marrs McLean* and held that the lessor could deplete its net profits payment, as well as its royalty. It later explained this ruling as based on the Kirby Company's retention of a "one-sixth oil royalty, thus

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on depletion and deduction cited in the preceding note did involve reserved royalties as well as payments of net profits. The *Felix Oil Company* and *A. B. Innis* did not. It seems generally accepted that it is the owner of the capital investment or economic interest in the oil in place who is entitled to the depletion. *Gracey v. Commissioner*, 5 T. C. 296, 302; *Kirby Petroleum Co. v. Commissioner*, *supra*. We do not agree with the Government that ownership of a royalty or other economic interest in addition to the right to net profits is essential to make the possessor of a right to a share of the net profit the owner of an economic interest in the oil in place.

To let the character of the net profit payments turn wholly on the ownership of a royalty of some sort by the one who received the net profit would make the right to depletion a form of words. No such mechanical application of a national tax act is desirable. Compare *Burnet v. Harmel*, 287 U. S. 103, 110-11. This taxpayer's acquisition of Sutton's contract with Gulf places the taxpayer in Sutton's situation as operator of the School Board lease under that instrument. The School Board and Sweeney, the original lessees, unquestionably have royalties which would compel a determination that the net income payments, if paid to them under the taxpayer's contract, in addition to their royal-

reserving to itself an interest in the oil in place." *Estate of Dan A. Japhet*, 3 T. C. 86, 93.

In the *Japhet* case, depletion on net profits from an assignee's operation was denied an assignor of a lease who had received a cash payment but had not reserved a royalty. It was said no "economic interest" was reserved.

I In *A. B. Ennis*, T. C. Docket Nos. 2735-2736, June 29, 1945, a similar problem arose as to deductibility by gold lease operators from their gross income of a share in net profits paid to the sub-lessor of the lease. The Tax Court found no difference between such a payment to a sub-lessor and one to a lessor. Both were said to have economic interests and therefore depletable rights. *Felix Oil Co.*, *supra*, was followed and *Quintana*, *supra*, distinguished as a sale by assignment rather than sublease. *Williams Bar Dredging Co. v. Commissioner* is in accord. T. C. Docket Nos. 3284, 4074, June 30, 1945.

2, In *Quintana Petroleum Co.*, 44 B. T. A. 624, an operator-assignee acquired an oil lease by an agreement that called for payment by the assignee to the assignor of one-fourth of the net proceeds from the leased property with no reservation of royalty. The Board concluded that the assignment was a purchase and ~~only depletion~~ was allowable. *affirmed 143 F.2 588* *for amounts paid to assignor*

In *Gracey v. Commissioner*, 5 T. C. 296, 302, decided June 21, 1945, the Tax Court under similar circumstances followed *Quintana* and held an operator-assignee was entitled to depletion on gross production but could not exclude the net profit payment to his assignee from his gross as the transfer of the lease in consideration of a net profit payment only was a sale.

ties, were subject to depletion. It does not logically follow, it seems to us, that the mere receipt of the net income payments by different lessors or assignors can change the character of the taxpayer's arrangements from leases to purchases.

If this had been a payment in cash by the taxpayer to Gulf of a per cent of the gross sale price of the oil, there would have been a lease and an exclusion of the payment from the taxpayer's gross income from the property. *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, 321. It seems unsound to hold that by the adoption of a plan whereby the expenses of extraction are divided and the share increased, the taxpayer's arrangement is changed from a lease to a purchase.

The fact that the taxpayer is an assignee of a lease instead of a lessee has not been deemed significant in determining whether or not the taxpayer had an economic interest in the oil in place. The rights of the operator are the same. *Palmer v. Bender*, 287 U. S. 551, 558; *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, 321. Nor has the title to the oil in place been considered by this Court as decisive of the capital investment of the taxpayer in the oil.⁸ Ownership of the property depleted would ordinarily be required for the application of depletion or depreciation. Congress, however, has recognized the peculiar character of the business of extracting national resources.⁹ Leases are a method of exploitation of the land for oil and payments under leases are "income to the lessor, like payments of rent."¹⁰ Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves financial benefits arising from and dependent upon the extraction of the oil,¹¹ Congress

⁸ 287 U. S. at 557: "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."

⁹ 287 U. S. at 558: "Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute." *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364; *Burnet v. Harmel*, 287 U. S. 103, 109-10; *Bankers Pocahontas Coal Co. v. Burnet*, 287 U. S. 308; *Kirby Petroleum Co. v. Commissioner*, *supra*, p. 3.

¹⁰ *Stratton's Independence v. Howbert*, 231 U. S. 399, 413-14.

¹¹ *Burnet v. Harmel*, 287 U. S. 103, 107-8.

¹² See *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370.

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provided as early as the Revenue Act of 1918¹² for equitable apportionment of the depletion allowance between lessor and lessee to correct a recognized existing inequality.¹³ In the present case the assignor of the petitioner had an economic interest in the oil in place. Under the contract with petitioner its assignor, as did all other holders of such interest, looked to the special depletion allowances of Section 114(3) to return whatever capital investment it had. The cost of that investment to the beneficiary of the depletion is unimportant. It is the lessor's, lessee's or transferee's "possibility of profit" from his rights "dependent solely upon the extraction and sale of the oil" which marks the economic interest in the oil. See *Kirby Petroleum Co. v. Commissioner*, *supra*, page 4.

¹² 40 Stat. at Large, §§ 214(a)(10), 234(a)(9).

¹³ H. Rep. No. 767, 65th Cong., 2d Sess., September 3, 1918, Deductions (5) and for corporations, Deductions (4).

The inequality under the Revenue Act of 1916, 39 Stat. 759, Sec. 5, Eighth (a), is not entirely clear. Regulations 33, Income Tax, promulgated January 2, 1918, p. 86; Regulations 45, 1920 ed., Income Tax, promulgated January 28, 1921, p. 76.

referred to arose from the preferred treatment given the owner over the lessee. See Hearings, House Committee on Ways & Means, 65 Cong. 2 sess. pp 455, 516, 523-28, 530-31.

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SUPREME COURT OF THE UNITED STATES.

No. 361.—OCTOBER TERM, 1945.

Burton-Sutton Oil Company, In- corporated, Petitioner, vs. Commissioner of Internal Revenue.	} On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.
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Mr. Justice REED delivered the opinion of the Court.

7 The taxpayer, the petitioner here, is the operating company for the production of oil from Louisiana lands. The taxpayer acquired a contract from J. G. Sutton, grantee in the contract, that imposed upon the grantee the obligation to develop the oil land. For that purpose the contract transferred to the grantee all oil rights previously obtained by S. W. Sweeney by a lease from the owners of the land, the Cameron Parish School Board. Through another transaction the grantor in the Sutton contract, the Gulf Refining Company of Louisiana, acquired these rights from Sweeney. An underlying oil royalty was retained by the School Board and an overriding oil royalty by Sweeney. The contract between Gulf and Sutton required the grantee-operator, who is now this taxpayer, to pay to the grantor, Gulf, 50% of the proceeds of the oil produced and sold from the land, deducting from the proceeds certain itemized expenses of the producer. Those expenses are so general in character that it may be said fairly that Gulf was to receive 50% of the net from operations.

7 The issue here is the correctness of the taxpayer's manner of handling this 50% net from operations, paid to Gulf, in its return for federal income tax for its fiscal years ending during 1936, 1937 and 1938 under the Revenue Acts of 1934 and 1936. The taxpayer deducted these payments of 50% of net income from its income for each of the years from the oil sold from the property. It claimed that Gulf retained an economic interest in the oil in place to the extent of this 50% payment. The Tax Court upheld the Commissioner's inclusion of an amount equal to these 50% payments in the taxpayer's gross income. They were included by the Commissioner in the income on the theory that the 50% payments represented capital investment by the taxpayer. That is, they were a part of the cost of the lease.

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3 T. C. 1187. If this theory is correct, it is proper to add an equivalent sum, as the Commissioner did, to the taxpayer's gross income.¹ The Circuit Court of Appeals affirmed the Tax Court. *Burton-Sutton Oil Co. v. Commissioner*, 150 F. 2d 621.

A decision on the category of expenditures to which these 50% disbursements belong affects both the operators who make them and the owners, lessors, vendors, grantors, however they may be classed, who receive them. If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other.² The decision below conflicts in principle with *Commissioner v. Felix Oil Co.*, 144 F. 2d 277. The Kirby case, ~~recently decided~~, involved payments of a share of net income by a producer but differs from this case because the lessor there was a landowner who reserved a royalty as well as a share in the net profits. Consequently, we granted certiorari. — U. S. —

The applicable provisions in the Revenue Acts for 1934 and 1936 and the Regulations thereunder are substantially the same for the two Acts. We insert below those that seem pertinent.³

¹ The Commissioner and the Tax Court allowed the taxpayer depletion upon its entire income, so adjusted, under Section 114(b).

² *Kirby Petroleum Co. v. Commissioner*, No. 56 this Term, decided January 28, 1946, slip opinion pages 4 and 5; *Anderson v. Helvering*, 310 U. S. 404, 407.

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"SEC. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. . . . In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . ."

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(b) *Basis for Depreciation.*—

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. . . ."

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(g) The term 'gross income from the property,' as used in sections 114(b)(3) and 114(b)(4)(A) and articles 23(m)-1 to 23(m)-28 of Regulation 94 . . . means the following:

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Kirby Petroleum
Co. v. Commissioner
No. 56 this Term,
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28, 1946

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The issue of the character of these 50% payments is not settled, however, by the statutes or regulations. These prescribe the federal income tax accounting procedure after a determination that an expenditure of an operator is or is not a rent, a royalty or an ordinary business expense, but throw little light on what is a rent or royalty.

In the *Kirby* case, we held that a payment of a share of the net profits from oil production by the operator to the owner of the land was a rent or royalty and taxable to the landowner as income from the oil property. Therefore the owner could take from the payment the 27½ per centum allowance for depletion provided by Section 114(b)(3). The reason given in the *Kirby* case for holding that the payment of a part of the net return from the property to the landowner was a royalty or rent,⁴ was that the owner had a capital investment—an economic interest—in the oil with a possibility of profit from that interest or investment solely from the extraction of the oil. As hereinbefore indicated, the landowner in the *Kirby* case had retained also a one-sixth oil royalty and had received a bonus. It was conceded that as both the bonus and the royalty represented a return for the sale in part of the lessor's investment in the oil in place, the lessor was entitled to depletion on both.⁵

The respondent urges that in the *Kirby* case it was the lessor's economic interest in some of the oil itself, or its proceeds, because of the bonus and royalty rights, which made the net profit payments subject to depletion in the lessor's hands; that net profits received are not depletable unless the recipient is entitled also to

In the case of oil and gas well, 'gross income from the property' as used in section 114(b)(3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. . . .

"In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property.' . . ."

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⁵ *Kirby Petroleum Co. v. Commissioner*, *supra*, p. 2; *Burnet v. Harmel*, 287 U. S. 103, 111; *Murphy Oil Co. v. Burnet*, 287 U. S. 299, 302.

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oil royalties.⁶ Consequently, the Government contends that in this case where there is only a share in profits due to the assignee, Gulf, the *Kirby* case conclusion on the right to depletion should not be extended but that the judgment below should be affirmed on the ground that the profit payment was a part of the purchase price. In dealing with the operator's exclusion from gross income of agreed payments to lessors or assignors of leases out of net profits and with the lessor's or assignor's rights to depletion, the Tax Court has not followed consistently the principle that a reserved royalty is necessary to make a net profit payment depletable to the lessor and deductible from gross income from the property by the operator.⁷ A number of the Tax Court cases

⁶ The principle upon which the Tax Court and the Circuit Court of Appeals decided this case for respondent differs from respondent's present contention. This principle was that an obligation to pay a part of net proceeds is a personal covenant of the obligee and was the purchase price for the assignment. *Burton-Sutton Oil Co. v. Commissioner*, 150 F. 2d 621, 622; 3 Tax Court 1187, 1194, relying upon *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588, 590-91; 44 B. T. A. 624, 627; *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372.

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5 *Burton-Sutton Oil Co. vs. Com'r of Internal Revenue.* 5

on depletion and deduction cited in the preceding note did involve reserved royalties as well as payments of net profits. The *Felix Oil Company* and *A. B. Innis* did not. We do not agree with the Government that ownership of a royalty or other economic interest in addition to the right to net profits is essential to make the possessor of a right to a share of the net profit the owner of an economic interest in the oil in place. The decision in *Kirby* did not rest on that point.

To let the character of the net profit payments turn wholly on the ownership of a royalty of some sort by the one who received the net profit would make the right to depletion a form of words. No such mechanical application of a national tax act is desirable. Compare *Burnet v. Harmel*, 287 U. S. 103, 110-11. This taxpayer's acquisition of Sutton's contract with Gulf places the taxpayer in Sutton's situation as operator of the School Board lease. The School Board and Sweeney, the original lessees, unquestionably have royalties which would compel a determination that the net income payments were subject to depletion if paid to them in addition to their royalties. It does not logically follow, it seems to us, that the mere receipt of the net income payments by different lessors or assignors can change the character of the taxpayer's arrangements from leases to purchases.

It seems generally accepted that it is the owner of the capital investment or economic interest in the oil in place who is entitled to the depletion. *Anderson v. Helvering*, 310 U. S. 404, 407; *Gracey v. Commissioner*, 5 T. C. 296, 302; *Kirby Petroleum Co. v. Commissioner, supra*. Whether the instrument creating the rights is a lease, a sublease or an assignment has not been deemed significant from the federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place. *Palmer v. Bender*, 287 U. S. 551, 557, 558; *Helvering v. Twin Bell* a

distinguished as a sale by assignment rather than sublease. *Williams Bar Dredging Co. v. Commissioner* is in accord. T. C. Docket Nos. 3284, 4074, June 30, 1945.

In *Quintana Petroleum Co.*, 44 B. T. A. 624, an operator-assignee acquired an oil lease by an agreement that called for payment by the assignee to the assignor of one-fourth of the net proceeds from the leased property with no reservation of royalty. The Board concluded that the assignment was a purchase and no deduction of the amount of net profits paid as allowable. See also *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588.

In *Gracey v. Commissioner*, 5 T. C. 296, 302, decided June 21, 1945, the Tax Court under similar circumstances followed *Quintana* and held an operator-assignee was entitled to depletion on gross production but could not exclude the net profit payment to his assignee from his gross as the transfer of the lease in consideration of a net profit payment only was a sale.

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Thompson Oil Co. v. Burnet, 287 U. S. 352, 357. Nor has the title to the oil in place been considered by this Court as decisive of the capital investment of the taxpayer in the oil.⁸ Technical title to the property depleted would ordinarily be required for the application of depletion or depreciation. It is not material whether the payment to the assignor is in oil or in cash which is the proceeds of the oil, *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, 321. Nor that some of the payments were in the form of a bonus for the contract. *Burnet v. Harmel*, 287 U. S. 103, 111. Congress, however, has recognized the peculiar character of the business of extracting ~~national~~ resources.⁹ Leases are a method of exploitation of the land for oil and payments under leases are "income to the lessor, like payments of rent."¹⁰ Receipts from oil sales are gross income to the operator and subject to statutory deductions. Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves through their control over the exploitation of the land valuable benefits arising from and dependent upon the extraction of the oil,¹¹ Congress provided as early as the Revenue Act of 1918¹² for equitable apportionment of the depletion allowance between them to correct what was said to be an existing inequality in the law or its administration.¹³

⁸ 287 U. S. at 557: "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."

⁹ 287 U. S. at 558: "Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute." *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364; *Burnet v. Harmel*, 287 U. S. 103, 109-10; *Bankers Petroleum Co. v. Burnet*, 287 U. S. 308; *Kirby Petroleum Co. v. Commissioner*, *supra*, p. 3.

¹⁰ *Stratton's Independence v. Howbert*, 231 U. S. 399, 413-14.

¹¹ *Burnet v. Harmel*, 287 U. S. 103, 107-8.

¹² See *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370; *Palmer v. Bender*, 287 U. S. 551, 556.

¹³ 40 Stat. 1057, 1067, 1078, §§ 214(a)(10), 234(a)(9).

¹⁴ H. Rep. No. 767, 65th Cong., 2d Sess., September 3, 1918, Deductions (5) and for corporations, Deductions (4).

The inequality referred to under the Revenue Act of 1916, 39 Stat. 759, Sec. 5, Eighth (a), arose from the preferred treatment given the owner over the lessee. See Hearings, House Committee on Ways and Means, 65th Cong., 2d Sess., pp. 455, 516, 523-28, 530-31. Regulations 33, Income Tax, promulgated January 2, 1918, p. 86; Regulations 45, 1920 ed., Income Tax, promulgated January 28, 1921, p. 76.

The applicable law for allowance of depletion in oil and gas wells appears in Sec. 114(b)(3). It is identical with I. R. C. Sec. 114(b)(3). This sec-

-17,

Art. 170,

Art. 201

In the present case, the assignor of the petitioner before assignment had an economic interest in the oil in place through its control over extraction. Under the contract with petitioner, its assignor retained a part of this interest—fifty per cent of net. Like the other holders of such economic interest through royalties, the petitioner looked to the special depletion allowances of Section 114(b)(3) to return whatever capital investment it had. The cost of that investment to the beneficiary of the depletion under Section 114(b)(3) is unimportant. Depletion depends only upon production. It is the lessor's, lessee's or transferee's "possibility of profit" from the use of his rights over production, "dependent solely upon the extraction and sale of the oil," which marks an economic interest in the oil. See *Kirby Petroleum Co. v. Commissioner*, *supra*, page 4. Through retention of certain rights to payments from oil or its proceeds in himself, each of these assignors ~~to others~~ of partial exploitation rights in oil lands has maintained a capital investment or economic interest in the oil or its proceeds.¹⁴ As the oil is extracted and sold that economic interest in the oil in place is reduced and the holder or owner of the interest is entitled to his equitable proportion of the depletion as rent or royalty. The operator, of course, may deduct such payments from the gross receipts.

Of course, such a transferor, whether the landowner or any intermediate assignor, may completely divest himself of any interest, economic or otherwise, in the extraction of the oil. As the record shows no reservation of an economic interest by Sutton, the assignee of Gulf and the assignor of petitioner, he appears to have done so in this case. See *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372. While, as pointed out above, the payment of proceeds in cash, the form of the instrument of transfer and its effect on the title to the oil under local law are not decisive of the right

tion is the result of administrative experience with oil and gas depletion. Hearings, Sen. Com. on Finance, 69th Cong., 1st Sess., p. 233; Hearings, House Com. on Ways and Means, p. 1006. See H. Rep. No. 1, 69th Cong., 1st Sess., December 7, 1925, Discovery Value, § 204(c)(2), 44 Stat. 16. For discussion see *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, and *Kirby Petroleum Co. v. Commissioner*, *supra*, p. 3. Depletion is now an arbitrary percentage allowance based on production from the wells without regard to cost or value of the property.

¹⁴ A participation in net profits disassociated from an economic interest does not enable a recipient of such profits to benefit from depletion. *Helvering v. O'Donnell*, 303 U. S. 370,

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69th Cong.

to participation in depletion under Sections 23(m) and 114(b)(3), there must be a determination under federal tax law "to decide whether the transferor has made an absolute sale or has retained" such economic interest as we have just described in the preceding paragraph. *Kirby Petroleum Co. v. Commissioner*, *supra*, page 6. We have said that the instrument should be construed as a sale when a large cash payment was made with a reserved payment that could be satisfied by future sales of the transferred property without extraction of the oil. Obviously there could be no depletion without extraction. *Anderson v. Helvering*, 310 U. S. 404, 412. On the other hand, we have construed an assignment of oil leases for cash and a deferred payment, "payable out of oil only, if, as and when produced," as the reservation of an economic interest in the oil—not a sale. *Thomas v. Perkins*, 301 U. S. 655.

32 The Government contends that *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372, controls this case. The transfer of the leases in *Elbe* was held an absolute sale. There the transfer was for cash, deferred payments in cash, if the assignee did not take advantage of a stipulation for abandonment, and a one-third interest in the net profits of the assignee. It was further provided that *Elbe*, the assignor after the transfer, should have "no interest in or to said properties, except in the case of an abandonment of the property by the assignee." This provision for the transfer of all interest of the assignor was emphasized as a significant part of the agreement for transfer. The issue upon which this Court passed was the classification of the deferred payments. Were they gross income from the property or receipts from a sale of the leases? These deferred payments were not payable out of oil sales but were payable absolutely, unless there was an abandonment. This Court concluded that the addition of a provision for the payment of a share of net profits did not qualify "in any way the effect of the transactions as an absolute sale." Page 375. In view of what we have said in this and in the *Kirby Petroleum* case as to the economic interest in the oil of a recipient of a share of net profits, the holding of *Elbe* should not be extended to the facts of this agreement.

The assignor, Gulf, in the assignment here involved, required the grantee to drill promptly, to account for production, to pay over fifty per cent of receipts, less agreed costs and expenses, and to sell the production on defined terms to grantor, if grantor de-

sired to purchase. This last clause did not appear in the Elbe contract. Such a transfer of rights to exploit could not, we think, properly be construed as a sale. It is rather an assignment to the operator, petitioner here, of the right to exploit the property¹⁵ with a reservation in the assignor of an economic interest in the oil.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

¹⁵ See the discussion of Felix Oil Co. in note 7, *supra*.

SUPREME COURT OF THE UNITED STATES.

No. 704.—OCTOBER TERM, 1945.

Irene Morgan, Appellant,
vs.
 Commonwealth of Virginia. } Appeal from the Supreme
 Court of Appeals of the State
 of Virginia.

[]

Mr. Justice REED delivered the opinion of the Court.

This appeal brings to this Court the question of the constitutionality of an act of Virginia,¹ which requires all passenger motor vehicle carriers, both interstate and intrastate,² without discrimination,³ to separate the white and colored passengers in their motor busses so that contiguous seats will not be occupied by persons of different races at the same time. A violation of the requirement of separation by the carrier is a misdemeanor.⁴ The driver or other person in charge is directed and required to increase or decrease the space allotted to the respective races as may be necessary or proper and may require passengers to change their seats to comply with the allocation. The operator's failure to enforce the provisions is made a misdemeanor.⁵

These regulations were applied to an interstate passenger, this appellant, on a motor vehicle then making an interstate run or trip. According to the statement of fact by the Supreme Court of Appeals of Virginia, appellant, who is a Negro, was traveling on a motor common carrier, operating under the above-mentioned statute, from Gloucester County, Virginia, through the District of Columbia, to Baltimore, Maryland, the destination of the bus. There were other passengers, both white and colored. On her refusal to accede to a request of the driver to move to a back seat, which was partly occupied by other colored passengers, so

¹ Virginia Code of 1942, §§ 4097 to 4097dd inclusive. The sections are derived from an act of General Assembly of Virginia of 1930. Acts of Assembly, Va. 1930, p. 343.

² *Id.*, §§ 4097z, 4097m, 4097s; *Morgan v. Commonwealth*, 184 Va. 24, 39.

3 *Id.*, § 4097aa.

⁴ *Id.*, § 4097z; § 4097bb.

⁵ *Id.*, § 4097bb.

so as to permit the seat that she vacated to be used by white passengers, a warrant was obtained and appellant was arrested, tried and convicted of a violation of Section 4097dd of the Virginia Code.⁶ On a writ of error the conviction was affirmed by the Supreme Court of Appeals of Virginia. 184 Va. 24. The Court of Appeals interpreted the Virginia statute as applicable to appellant since the statute "embraces all motor vehicles and all passengers, both interstate and intrastate."⁷ The Court of Appeals refused to accept appellant's contention that the statute applied was invalid as a delegation of legislative power by a concurrent holding "that, no power is delegated to the carrier to legislate The statute itself condemns the defendant's conduct as a violation of law and not the rule of the carrier." No complaint is made as to these interpretations of the Virginia statute by the Virginia court.⁸

The errors of the Court of Appeals that are assigned and relied upon by appellant are in form only two. The first is that the decision is repugnant to Clause 3, Section 8, Article I of the Constitution of the United States,⁹ and the second that powers reserved to the states by the Tenth Amendment include the power

⁶ "4097dd. Violation by passengers; misdemeanors, ejection.—All persons who fail while on any motor vehicle carrier, to take and occupy the seat or other space assigned to them by the driver, operator or other person in charge of such vehicle, or by the person whose duty it is to take up tickets or collect fares from passengers therein, or who fail to obey the directions of any such driver, operator or other person in charge, as aforesaid, to change their seats from time to time as occasions require, pursuant to any lawful rule, regulation or custom in force by such lines as to assigning separate seats or other space to white and colored persons, respectively, having been first advised of the fact of such regulation and requested to conform thereto, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall be fined not less than five dollars nor more than twenty-five dollars for each offense. Furthermore, such persons may be ejected from such vehicle by any driver, operator or person in charge of said vehicle, or by any police officer or other conservator of the peace; and in case such persons ejected shall have paid their fares upon said vehicle, they shall not be entitled to the return of any part of same. For the refusal of any such passenger to abide by the request of the person in charge of said vehicle as aforesaid, and his consequent ejection from said vehicle, neither the driver, operator, person in charge, owner, manager nor bus company operating said vehicle shall be liable for damages in any court."

⁷ Cf. *Smith v. State*, 100 Tenn. 494; *Alabama, etc., R. Co. v. Morris*, 103 Miss. 511; *Southern R. Co. v. Norton*, 112 Miss. 302.

⁸ Compare *Hebert v. Louisiana*, 272 U. S. 312, 317; *General Trading Co. v. Tax Comm'n*, 322 U. S. 335, 337.

⁹ "Section 8. The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;"

to require an interstate motor passenger to occupy a seat restricted for the use of his race. Actually, the first question alone needs consideration for if the statute unlawfully burdens interstate commerce, the reserved powers of the state will not validate it.¹⁰

We think, as the Court of Appeals apparently did, that the appellant is a proper person to challenge the validity of this statute as a burden on commerce.¹¹ If it is an invalid burden, the conviction under it would fail. The statute affects appellant as well as the transportation company. Constitutional protection against burdens on commerce is for her benefit on a criminal trial for violation of the challenged statute. *Hatch v. Reardon*, 204 U. S. 152, 160; *Federation of Labor v. McAdory*, 325 U. S. 460, 463.

The legality of a statute compelling racial segregation of interstate passengers in vehicles moving interstate, against a challenge that its application results in an unconstitutional burden on commerce, has not been passed on by this Court.¹² As Congress has been granted power to regulate commerce among the several states, the states' power to regulate that commerce is restricted. The limits of the restriction on state power to legislate on matters affecting interstate commerce may be in effect expanded or contracted by congressional action. Congress may adopt a rule that aids the enforcement of valid state laws in a way that states would be powerless to do.¹³ Or Congress may by withholding action leave regulation to the states where state action can be had without interference with the national source of commerce.¹⁴ Or Congress may by undertaking regulation of commerce in certain phases manifest a purpose to bar otherwise valid state regulation in the same general field.¹⁵

¹⁰ *Case v. Bowles*, No. 261 this Term, decided February 4, 1946, slip opinion p. 6.

¹¹ Cf. *Edwards v. California*, 314 U. S. 160, 172, n. 1.

¹² When passing upon a rule of a carrier that required such segregation, this Court said, "And we must keep in mind that we are not dealing with the law of a state, attempting a regulation of interstate commerce beyond its power to make." *Chiles v. Chesapeake & O. R. Co.*, 218 U. S. 71, 75.

¹³ *In re Rahrer*, 140 U. S. 545, 562; *Ky Whip & Collar Co. v. I. C. R. Co.*, 299 U. S. 334, 352.

¹⁴ *Cooley v. Board of Wardens*, 12 How. 299, 319; *The Minnesota Rate Cases*, 230 U. S. 352, 402; *Kelly v. Washington*, 302 U. S. 1, 10.

¹⁵ *Napier v. Atlantic Coast Line*, 272 U. S. 605, 611; *Cloverleaf Co. v. Patterson*, 315 U. S. 148, 154-56.

The precise degree of ~~that~~ restriction on state power cannot be fixed generally or indeed not even for one kind of state legislation, such as taxation or health or safety.¹⁶ There is a recognized abstract principle, however, that may be taken as a postulate for testing whether particular state legislation in the absence of action by Congress is beyond state power. This is that the state legislation is invalid if it unduly burdens that commerce in matters where uniformity is necessary—necessary in the constitutional sense of useful in accomplishing a permitted purpose.¹⁷ Too true, it is that the principle lacks in precision. Although the quality of such a principle is abstract, its application to the facts of a situation created by the attempted enforcement of a statute brings about a specific determination as to whether or not the statute in question is a burden on commerce. Within the broad limits of the principle, the cases turn on their own facts.

In the field of transportation, there have been a series of decisions which hold that where Congress has not acted and although the state statute affects interstate commerce, a state may validly enact legislation which has predominantly only a local influence on the course of commerce.¹⁸ It is equally well settled that, even

¹⁶ Cf. *Gevin, etc. Inc. v. Henneford*, 305 U. S. 434, 439; *Mitz v. Baldwin*, 289 U. S. 346, 352; *Welch Co. v. New Hampshire*, 306 U. S. 79, 84.

¹⁷ *Southern Pacific v. Arizona*, 325 U. S. 761, 766-71.

¹⁸ *Statutes or orders dealing with safety of operations*: *Smith v. Alabama*, 124 U. S. 465 (Alabama statute requiring an examination and license of train engineers before operating in the state); *Nashville, &c. Railway v. Alabama*, 128 U. S. 96 (Statute requiring examination of railroad employees as to vision and color blindness); *N. Y., N. H. & H. Railroad v. New York*, 165 U. S. 628 (N. Y. statute forbidding the use of furnaces or stoves in passenger cars); *Erb v. Morasch*, 177 U. S. 584 (Municipal ordinance limiting speed of trains in city to 6 miles an hour); *Atlantic Coast Line v. Georgia*, 234 U. S. 280 (Georgia statute requiring electric headlights on locomotives); *Morris v. Duby*, 274 U. S. 135 (Weight restrictions on motor carriers imposed by order of Oregon highway commission); *Sproles v. Binford*, 286 U. S. 374 (Size and weight restrictions on trucks imposed by Texas statute); *S. C. Hwy. Dept. v. Barnwell Bros.*, 303 U. S. 177 (Statute restricting weight and size of motor carriers); *Maurer v. Hamilton*, 309 U. S. 598 (Penna. statute forbidding the use of its highways to any vehicle carrying any other vehicle over the head of the operator of the vehicle); *Terminal Assn. v. Trainmen*, 318 U. S. 1 (Illinois statute requiring cabooses on freight trains).

Statutes or orders requiring local train service: *Gladson v. Minnesota*, 166 U. S. 427 (State statute requiring intrastate train to stop at county seat to take on and discharge passengers); *Lake Shore & Mich. South. Railway v. Ohio*, 173 U. S. 285 (Statute requiring three trains daily, if so many are run, to stop at each city containing over 3,000 inhabitants as applied to interstate trains); *Atlantic Coast Line v. N. Car. Corp. Com'n*, 206 U. S. 1 (Order regulating train service, particularly requiring train to permit con-

where Congress has not acted, state legislation or a final court order is invalid which materially affects interstate commerce.¹⁹ Because the Constitution puts the ultimate power to regulate commerce in Congress, rather than the states, the degree of state legislation's interference with that commerce may be weighed by federal courts to determine whether the burden makes the statute unconstitutional, while the courts could not invalidate federal legislation for the same reason because Congress has authority to burden commerce if that seems to it a desirable means of accomplishing a permitted end.

nection at junction point); *Mo. Pac. Ry. Co. v. Kansas*, 216 U. S. 262 (Order directing the operation of intrastate passenger train service over given route).

Statutes dealing with employment of labor—full crew laws, etc.: *Chicago, R. I. & Pac. Ry. Co. v. Arkansas*, 219 U. S. 453 (Arkansas full crew law applied to interstate trains); *St. L. & Iron Mtn. Ry. v. Arkansas*, 240 U. S. 518 (Arkansas full crew laws applied to switching yards and terminals); *Missouri Pacific R. Co. v. Norwood*, 283 U. S. 249 (Arkansas full crew laws applied to freight and switching crews).

¹⁹ *Statutes or orders dealing with safety of operations*: *Kansas Southern Ry. v. Kaw Valley Dist.*, 233 U. S. 75 (Order requiring railroad to remove its bridges over river for flood control purposes); *South Covington Ry. v. Covington*, 235 U. S. 537 (Ordinances regulating the number of passengers to be carried in and the temperature of an interurban street railway car invalid; those requiring rails on front and rear platform, ventilation and cleaning valid); *Seaboard Air Line Ry. v. Blackwell*, 244 U. S. 310 (Georgia Blow Post Law requiring train to blow whistle and slow down at each grade crossing where numerous grade crossings were involved. Cf. *Southern Railway Co. v. King*, 217 U. S. 524, where plea held insufficient to permit proof of burden of the statute on interstate commerce); *Southern Pacific Co. v. Arizona*, 325 U. S. 761 (Statute limiting number of cars in freight train to 70 and passenger cars to 14).

Statutes or orders requiring local train service: *Illinois Central Railroad Co. v. Illinois*, 163 U. S. 142 (Statute applied to require fast mail train to detour from main line in order to stop at station for the taking on and discharge of passengers); *Cleveland, &c. Ry. Co. v. Illinois*, 177 U. S. 514 (Ill. statute requiring interstate train to stop at each station); *Mississippi R. R. Com. v. Illinois Cent. R. R.*, 203 U. S. 335 (Order of commission requiring interstate train to stop at small town); *Atlantic Coast Line v. Wharton*, 207 U. S. 328 (S. C. statute and railroad commission order requiring interstate train to stop at small towns); *St. Louis S. W. Ry. v. Arkansas*, 217 U. S. 136 (Statute and order requiring delivery of freight cars to local shippers); *Herndon v. Chi., Rock Island & Pac. Ry.*, 218 U. S. 135 (Statute requiring interstate train to stop at junction point); *Chi., B. & Q. Ry. v. Wisconsin R. R. Com.*, 237 U. S. 220 (Wisconsin statute requiring interstate train to stop at villages containing 200 or more inhabitants); *Missouri, Kans. & Tex. Ry. Co. v. Texas*, 245 U. S. 484 (Order requiring trains to start on time and fixing time allowed for stops en route); *St. Louis & S. F. Ry. v. Pub. Serv. Comm.*, 254 U. S. 535 (Order requiring through trains to detour through a small town); *St. L.-S. F. Ry. v. Pub. Serv. Comm.*, 261 U. S. 369 (Order requiring that interstate trains be stopped at small town).

This statute is attacked on the ground that it imposes undue burdens on interstate commerce.²⁰ It is said by the Court of Appeals to have been passed in the exercise of the state's police power to avoid friction between the races. But this Court pointed out years ago "that a State cannot avoid the operation of this rule by simply invoking the convenient apologetics of the police power."²¹ Burdens upon commerce are those actions of a state which directly "impair the usefulness of its facilities for such traffic."²² That impairment, we think, may arise from other causes than costs or long delays. The traveler as well as the carrier must be free from undue interferences. A burden may arise from a state statute which requires interstate passengers to order their movements on the vehicle in accordance with local rather than national requirements.

On appellant's journey, this statute required that she sit in designated seats in Virginia.²³ Changes in seat designation might be made "at any time" during the journey when "necessary or proper for the comfort and convenience of passengers." This occurred in this instance. Upon such change of designation, the statute authorizes the operator of the vehicle to require, as he did here, "any passenger to change his or her seat as it may be necessary or proper."²⁴ An interstate passenger must if necessary repeatedly shift seats while moving in Virginia to meet the seating requirements of the changing passenger group. On arrival at the District of Columbia line, the appellant would have had freedom to occupy any available seat and so to the end of her journey.

Appellant's argument, properly we think, includes facts in the problem of racial separation in interstate motor transportation beyond those immediately involved in this journey under the

²⁰ In this posture of the case, problems of the Fourteenth Amendment are not present, directly. See *Plessy v. Ferguson*, 163 U. S. 537, 543; *McCabe v. A. T. & S. F. Ry. Co.*, 235 U. S. 151, 160-62.

²¹ *Kansas Southern Ry. v. Kaw Valley Dist.*, 233 U. S. 75, 79.

²² *Illinois Central Railroad Co. v. Illinois*, 163 U. S. 142, 154.

²³ The Virginia Code of 1942, section 67, defines a colored person, for the purpose of the Code, as follows: "Every person in whom there is ascertainable any negro blood shall be deemed and taken to be a colored person" Provisions for vital statistics make a record of the racial lines of Virginia inhabitants. Sections 1574 and 5099a.

²⁴ § 4097bb.

Virginia statutory regulations. To properly appraise the weight of the burden of the Virginia statute on interstate commerce, related statutes of other states are important to show whether there are cumulative effects which may make local regulation impracticable. We are told that eighteen states prohibit racial separation on public carriers.²⁵ Eleven require separation on motor carriers.²⁶ Of these Alabama applies specifically to interstate passengers with an exception for interstate passengers with through tickets from states without laws on separation of passengers.²⁷ The language of the other acts, like this Virginia statute before the Court of Appeals' decision in this case, may be said to be susceptible to an interpretation that they do or do not apply to interstate passengers.

In states where separation of races is required in motor vehicles, a method of identification as white or colored must be employed. This may be done by definition. Any ascertainable Negro blood identifies a person as colored for purposes of separation in some states.²⁸ In the other states which require the separation of the races in motor carriers, apparently no definition generally applicable or made for the purposes of the statute is given. Court definition or further legislative enactments would be required to clarify

²⁵ Cal. Civ. Code (Deering), 1941, Sec. 51-54; Colo. Stat., 1935, Ch. 35, Sec. 1-10; Conn. Gen. Stat. (Supp. 1933), Sec. 1160b; Ill. Rev. Stat., 1941, Ch. 38, Sec. 125-128g; Ind. Stat. (Burns), 1933, Sec. 10-901, 10-902; Iowa Code, 1939, Sec. 13251-13252; Kan. Gen. Stat., 1935, Sec. 21-2424; Mass. Laws (Michie), 1933, Chap. 272, Sec. 98, as amended 1934; Mich. Comp. Laws (Supp. 1933), Sec. 17, 115-146 to 147; Minn. Stat. (Mason), 1927, Sec. 7321; Neb. Comp. Stat., 1929, Ch. 23, Art. 1; N. J. Rev. Stat., 1937, Sec. 10:1-1 to 10:1-9; N. Y. Laws (Thompson), 1937, (1942, 1943, 1944 Supp.), Ch. 6, Sec. 40-42; Ohio Code (Throckmorton), 1933, Sec. 12940-12941; Pa. Stat. (Purdon), Tit. 18, Sec. 1211, 4354 to 4655; R. I. Gen. Laws, 1938, Ch. 606, Sec. 27-28, Ch. 612, Sec. 47-48; Wash. Rev. Stat. (Remington), 1932, Sec. 2686; Wis. Stat., 1941, Sec. 340.75.

²⁶ Ala. Stat. 1940, Tit. 48, Sec. 268; Ark. Stat., 1937 (Pope), Sec. 6921-6927, Laws 1943, p. 379; Fla. Stat., 1941, Sec. 352-02-352.08; Ga. Code, 1933, Sec. 68-616; La. Gen. Stat. (Dart), 1939, Sec. 5307-5309; Miss. Code, 1942, Sec. 7785; N. C. Gen. Stat. 1943, Sec. 62-109; 47 Okla. Stat. Ann., 201-210; S. C. Code, 1942, Sec. 8530 (1); Tex. Rev. Civ. Stat. (Vernon) 1936, Art. 6417; Tex. Pen. Code (Vernon) 1936, Art. 1661.1; Va. Code, 1942, Sec. 4097z-4097dd.

²⁷ Ala. Stat. 1940, Tit. 48, Sec. 268.

²⁸ Ala. Code, 1940, Tit. 1, Sec. 2 and Title 14, Sec. 360; Ark. Stat. (Pope), 1937, Sec. 1200 (separate coach law); Ga. Code (Michie Supp.), 1928, Sec. 2177; Okla. Const., Art. XXIII, Sec. 11; Va. Code (Michie), 1942, Sec. 67.

the line between the races. Obviously there may be changes by legislation in the definition.²⁹

The interferences to interstate commerce which arise from state regulation of racial association on interstate vehicles has long been recognized. The factual situation just set out emphasizes the soundness of this Court's early conclusion in *Hall v. DeCuir*, 95 U. S. 485. People of all races travel today more extensively than in 1877 when it was decided. The changes in transportation brought about by the coming of automobiles does not seem of great significance in the problem. Accustomed as most are to freedom of choice in accommodation, local restrictions naturally are irksome. Therefore, the reasoning of the *DeCuir* case grows in impressiveness.

The *DeCuir* case arose under a statute of Louisiana interpreted by the courts of that state and this Court to require public carriers "to give all persons travelling in that State, upon the public conveyances employed in such business, equal rights and privileges in all parts of the conveyance, without distinction or discrimination on account of race or color." Page 487. Damages were awarded against Hall, the representative of the operator of a Mississippi river steamboat that traversed that river interstate from New Orleans to Vicksburg, for excluding in Louisiana the defendant in error, a colored person, from a cabin reserved for whites. This Court reversed for reasons well stated in the words of Mr. Chief Justice Waite.³⁰ As our previous discussion dem-

²⁹ Compare Va. Code, 1887, Sec. 49, providing that those who had one-fourth or more Negro blood were to be considered colored. This was changed in 1910 (Acts, 1910, p. 581) to read one-sixteenth or more. It was again changed in 1930 by Acts, 1930, p. 97, to its present form, i. e., any ascertainable Negro blood. See note 23, *supra*.

³⁰ 95 U. S. at 489:

"It was to meet just such a case that the commercial clause in the Constitution was adopted. The river Mississippi passes through or along the borders of ten different States, and its tributaries reach many more. The commerce upon these waters is immense, and its regulation clearly a matter of national concern. If each State was at liberty to regulate the conduct of carriers while within its jurisdiction, the confusion likely to follow could not but be productive of great inconvenience and unnecessary hardship. Each State could provide for its own passengers and regulate the transportation of its own freight, regardless of the interests of others. Nay more, it could prescribe rules by which the carrier must be governed within the State in respect to passengers and property brought from without. On one side of the river or its tributaries he might be required to observe one set of rules, and on the other another. Commerce cannot flourish in the midst of such embarrassments. No carrier of passengers can conduct his

onstrates, the transportation difficulties arising from a statute that requires commingling of the races, as in the *DeCuir* case, are increased by one that requires separation, as here.³¹ Other federal courts have looked upon racial separation statutes as applied to interstate passengers as burdens upon commerce.³² A regulation of the number of passengers on interstate street cars was held invalid in *South Covington Ry. v. Covington*, 235 U. S. 537, 547. This Court said at 547-48:

"If Covington can regulate these matters, certainly Cincinnati can, and interstate business might be impeded by conflicting and varying regulations in this respect, with which

business with satisfaction to himself, or comfort to those employing him, if on one side of a State line his passengers, both white and colored, must be permitted to occupy the same cabin, and on the other be kept separate. Uniformity in the regulations by which he is to be governed from one end to the other of his route is a necessity in his business, and to secure it Congress, which is untrammelled by State lines, has been invested with the exclusive legislative power of determining what such regulations shall be. If this statute can be enforced against those engaged in inter-state commerce, it may be as well against those engaged in foreign; and the master of a ship clearing from New Orleans for Liverpool, having passengers on board, would be compelled to carry all, white and colored, in the same cabin during his passage down the river, or be subject to an action for damages, 'exemplary as well as actual,' by any one who felt himself aggrieved because he had been excluded on account of his color."

See *Louisville, &c. Railway Co. v. Mississippi*, 133 U. S. 587, 590-91.

³¹ *South Covington, &c. Ry. Co. v. Kentucky*, 252 U. S. 399, relied upon by appellee, does not decide to the contrary of the holding in *Hall v. DeCuir*. In that case a carrier corporation was convicted in the Kentucky courts of violation of a state statute that required it to furnish cars with separate compartments for white and colored. It operated street cars interstate over the lines of another corporation that owned tracks that were wholly intrastate. The Court of Appeals of Kentucky held the conviction good on the ground that the offending act was the operation of the intrastate railroad in violation of the state statute. It was said that the statute did not apply to an interstate passenger. *S. C. & C. Street Ry. Co. v. Commonwealth*, 181 Ky. 449, 454. The Court of Appeals referred at that point to *Chiles v. Chesapeake & Ohio Ry. Co.*, 125 Ky. at 304: "It is admitted that section 795-801 of the Kentucky Statutes, requiring all railroad companies to furnish separate coaches for transportation of white and colored passengers, and imposing upon the company and conductors a penalty for refusing or failing to carry out the provisions of the law, does not apply to appellant, who was an interstate passenger; it being conceded that the statute is only operative within the territorial limits of this State, and effective as to passengers who travel from one point within the State to another place within its border." This Court accepted this application of the state statute and said it "is not a regulation of interstate commerce." Page 403. Probably what was meant by the opinions was that under the Kentucky act the company with wholly intrastate mileage must operate cars with separate compartments for intrastate passengers.

³² *Anderson v. Louisville & N. R. Co.*, 62 Fed. 46, 48; *Washington, B. & A. Electric R. Co. v. Waller*, 289 Fed. 598.

it might be impossible to comply. On one side of the river one set of regulations might be enforced, and on the other side quite a different set, and both seeking to control a practically continuous movement of cars. As was said in *Hall v. DeCuir*, 95 U. S. 485, 489, 'commerce cannot flourish in the midst of such embarrassments.' "

In weighing the factors that enter into our conclusion as to whether this statute so burdens interstate commerce or so infringes the requirements of national uniformity as to be invalid, we do not disregard the fact that conditions vary between northern or western states such as Maine or Montana, with practically no colored population; industrial states such as Illinois, Ohio, New Jersey and Pennsylvania with a small, although appreciable, percentage of colored citizens; and the states of the deep south with percentages of from twenty-five to nearly fifty per cent colored, all with varying densities of the white and colored race in certain localities. Some local efforts to promote amicable relations in difficult areas by legislative segregation in interstate transportation were sure to emerge from such an environment. And no state law can reach beyond its own border nor bar transportation of passengers across its boundaries, diverse seating requirements for the races in interstate journeys result. As there is no federal act dealing with the separation of races in interstate transportation, we must decide the validity of this Virginia statute on the challenge that it interferes with commerce, as a matter of balance between the exercise of the local police power and the need for national uniformity in the regulations for interstate travel. It seems clear to us that seating arrangements for the different races in interstate motor travel require a single, uniform rule to promote and protect national travel. Consequently, we hold the Virginia statute in controversy invalid.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

SUPREME COURT OF THE UNITED STATES.

No. 704.—OCTOBER TERM, 1945.

Irene Morgan, Appellant,	} Appeal from the Supreme Court of Appeals of the State of Virginia.
<i>vs.</i>	
Commonwealth of Virginia.	

[]

Mr. Justice BURTON dissenting.

On the application of the interstate commerce clause of the Federal Constitution to this case, I find myself obliged to differ from the majority of the Court. I would sustain the Virginia statute against that clause. The issue is neither the desirability of the statute nor the constitutionality of racial segregation as such. We are not asked to consider whether the Virginia statute, regulating seating arrangements for interstate passengers in motor vehicles, violates the Fourteenth Amendment or is in conflict with a federal statute. The Court holds this statute unconstitutional but for one reason. It holds that the burden imposed by the statute upon the nation's interest in interstate commerce so greatly outweighs the contribution made by the statute to the state's interest in its public welfare as to make it unconstitutional.

The undue burden upon interstate commerce thus relied upon by the Court is not complained of by the Federal Government, by any state, or by any carrier. This statute has been in effect since 1930. The carrier concerned is operating under regulations of its own which conform to the statute. The statute conforms to the policy adopted by Virginia as to steamboats (1900), electric or street cars (1902-1904), and railroads (1906).¹ Its validity has been unanimously upheld by the Supreme Court of Appeals of Virginia. The argument relied upon by the majority of this Court to establish the undue burden of this statute on interstate commerce is the lack of uniformity between its provisions and those of the laws of other states on the subject of the racial separation of interstate passengers on motor vehicles.

¹ Steamboats: Acts of 1900, p. 340; electric or street cars: Acts of 1902-1904, p. 990; railroads: Acts of 1906, pp. 236-237. Va. Code Ann., 1942, §§ 4022-4025; 3978-3983; 3962-3968.

If the mere diversity between the Virginia statute and comparable statutes of other states is so serious as to render the Virginia statute invalid, it probably means that the comparable statutes of those other states, being diverse from it and from each other, are equally invalid. This is especially true under that assumption of the majority which disregards sectional interstate travel between neighboring states having similar laws, to hold "that seating arrangements for the different races in interstate motor travel require a *single, uniform rule to protect national travel.*" (Italics supplied.) More specifically, the opinion of the Court indicates that the laws of the eleven contiguous states of Virginia, North Carolina, South Carolina, Georgia, Florida, Alabama, Mississippi, Louisiana, Arkansas, Texas and Oklahoma require racial separation of passengers on motor carriers, while those of 18 other states prohibit racial separation of passengers on public carriers. On the precedent of this case, the laws of the 11 states requiring racial separation apparently can be invalidated because of their sharp diversity from the laws in the rest of the Union, or, in a lesser degree, because of their diversity from one another. Such invalidation, on the ground of lack of nationwide uniformity, may lead, unintentionally, to the questioning, on that ground, of the validity of the laws of the 18 states now prohibiting racial separation of passengers, for those laws likewise differ sharply from laws on the same subject in other parts of the Union and, in a lesser degree, from one another. In the absence of federal law, this may eliminate state regulation of racial separation in the seating of interstate passengers on motor vehicles and leave the regulation of the subject to the respective carriers.

The present decision will lead to the questioning of the validity of statutory regulation of the seating of intrastate passengers in the same motor vehicles with interstate passengers. The decision may also result in increased lack of uniformity between regulations as to seating arrangements on motor vehicles limited to intrastate passengers in a given state and those on motor vehicles engaged in interstate business in the same state or on connecting routes.

One weakness in the appellant's case is the lack of facts and findings essential to demonstrate the existence not merely of a minor burden upon interstate commerce, but of such a serious and major burden upon the national interest in interstate com-

merce as to outweigh whatever state or local benefits are attributable to the statute and which would be lost by its invalidation. The Court recognizes that it serves as "the final arbiter of the competing demands of state and national interests"² and that it must fairly determine, in the absence of Congressional action, whether the state statute actually imposes such an undue burden upon interstate commerce as to invalidate it. In weighing these competing demands, if this Court is to justify the invalidation of this state statute, it must, first of all, be satisfied that the many years of experience of the state and the carrier that are reflected in this state law should be set aside. It represents the tested public policy of Virginia regularly enacted, long maintained and currently observed. The officially declared State interests, even when affecting interstate commerce, should not be laid aside summarily by this Court in the absence of Congressional action. It is only Congress that can supply affirmative national uniformity of action.

In *Southern Pacific Co. v. Arizona*, 325 U. S. 761, 768-769, 770, this Court said:

"In the application of these principles some enactments may be found to be plainly within and others plainly without state power. But between these extremes lies the infinite variety of cases, in which regulation of local matters may also operate as a regulation of commerce, in which reconciliation of the conflicting claims of state and national power is to be attained only by some appraisal and accommodation of the competing demands of the state and national interests involved.³

"But in general Congress has left it to the courts to formulate the rules thus interpreting the commerce clause in its application, doubtless because it has appreciated the destructive consequences to the commerce of the nation if their [i. e. the courts'] protection were withdrawn, . . . , and has been aware that in their application *state laws will not be invalidated without the support of relevant factual material which will 'afford a sure basis' for an informed judgment.*⁴ . . . Meanwhile, Congress has accommodated its legislation, as have the states, to these rules as an established feature of our constitutional system. There has thus been left to the states

² *Southern Pacific Co. v. Arizona*, 325 U. S. 761, 769.

³ See *Parker v. Brown*, 317 U. S. 341, 362; *Di Santo v. Pennsylvania*, 273 U. S. 34, 44.

⁴ *Terminal Assn. v. Trainmen*, 318 U. S. 1, 8.

wide scope for the regulation of matters of local state concern, even though it in some measure affects the commerce, provided it does not materially restrict the free flow of commerce across state lines, or interfere with it in matters with respect to which uniformity of regulation is of predominant national concern." (Italics supplied.)

The above quoted requirement of a factual establishment of "a sure basis" for an informed judgment by this Court calls for a firm and demonstrable basis of action on the part of this Court. In the record of this case there are no findings of fact that demonstrate adequately the excessiveness of the burden, if any, which the Virginia statute has imposed upon interstate commerce, during the many years since its enactment, in comparison with the resulting effect in Virginia of the invalidation of this statute.⁵ The Court relies largely upon the recital of a nationwide diversity among state statutes on this subject without a demonstration of the factual situation in those states, and especially in Virginia. The Court therefore is not able in this case to make that necessary "appraisal and accommodation of the competing demands of the state and national interests involved" which should be the foundation for passing upon the validity of a state statute of long standing and of important local significance in the exercise of the state police power.

Another weakness in the appellant's case is the assumption that racial separation of interstate passengers in motor vehicle carriers requires national uniformity of treatment rather than diversity of treatment at this time. The inaction of Congress is an important indication that, in the opinion of Congress, this issue is better met without nationally uniform affirmative regulation than with it. Legislation raising the issue long has been, and is now, pending before Congress but has not reached the floor of either house.⁶ The fact that 18 states have prohibited in some

⁵ Hall v. DeCuir, 95 U. S. 485, does not require the conclusion reached by the Court in this case. The Louisiana statute in the *DeCuir* case could have been invalidated, at that time and place, as an undue burden on interstate commerce under the rules set out by Chief Justice Stone in *Southern Pacific Co. v. Arizona*, *supra*, and as applied in this dissenting opinion. If the *DeCuir* case is followed as a matter of law without regard to the surrounding facts it would invalidate to-day statutes in New England states prohibiting racial separation in seating arrangements on carriers, which would not be invalidated under the doctrine stated in the *Arizona* case.

⁶ See H. R. 8821, 75th Cong., 3d Sess., 83 Cong. Rec. 74; H. R. 182, 76th Cong., 1st Sess., 84 Cong. Rec. 27; H. R. 112, 77th Cong., 1st Sess., 87 Cong. Rec. 13.

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degree racial separation in public carriers is important progress in the direction of uniformity. The fact that 19 states apparently have not legislated on the issue indicates a lack of need for universal legislative action for or against uniformity. The fact, however, that 11 contiguous states in some degree require, by state law, some racial separation of passengers on motor carriers indicates a different appraisal by them of the needs and conditions in those areas than in others. This recital of existing diversity is evidence against the validity of the assumption by this Court that there exists today a requirement of a single uniform national rule on the subject.

It is a fundamental concept of our Constitution that where conditions are diverse the solution of problems arising out of them may well come through the application of diversified treatment matching the diversified needs as determined by our local governments. Uniformity of treatment is appropriate where a substantial uniformity of conditions exists.

704-D18

Mr. Justice
Reed

from

Burton J.

5/17/46-

SUPREME COURT OF THE UNITED STATES.

Nos. 278, 279, 280, 281 and 282.—OCTOBER TERM, 1945.

Reconstruction Finance Corporation; Insurance Group Committee; Guaranty Trust Company of New York. Trustee, Rio Grande Western Railroad Company Consolidated Mortgage; Central Hanover Bank and Trust Company, Trustee, Rio Grande Western Railroad Company First Trust Mortgage; United States Trust Company of New York, Trustee, Denver and Rio Grande Railroad Company Consolidated Mortgage; and The Chase National Bank of the City of New York, Trustee, Denver and Rio Grande Western Railroad Company Refunding and Improvement Mortgage, Petitioners,

278 vs.
The Denver and Rio Grande Western
Railroad Company, et al.

Same,
vs.

279 The Denver and Salt Lake Western
Railroad Company, et al.

Same,
vs.

280 City Bank Farmers Trust Company,
Trustee Under the Debtor's General
Mortgage.

281 Same,
 vs.
The Denver and Rio Grande Western
Railroad Company, et al.

Same,
vs.

282 Guy A. Thompson, Trustee, Missouri
Pacific Railroad Company, Debtor.

On Writs of Certiorari
to the United States
Circuit Court of Ap-
peals for the Tenth
Circuit.

Mr. Justice REED delivered the opinion of the Court.

The petitioners in these five cases are the owners of claims against the debtor, Denver & Rio Grande Western Railroad Company, or against a secondary debtor, the Denver & Salt Lake

Western Railroad Company. The respondents are the two debtors just named; City Bank Farmers Trust Company, Trustee under the General Mortgage of the principal debtor; and the Trustee of the Missouri Pacific Railroad Company, a large owner of common stock of the principal debtor.

The debtors sought reorganization in the District Court of the United States for the District of Colorado under Section 77 of the Bankruptcy Act,¹ on November 1, 1935. The Interstate Commerce Commission approved the plan of reorganization under consideration in this review on June 14, 1943.² The District Court approved the plan October 25, 1943.³ It was then submitted by the Commission to the creditors of the classes deemed entitled to vote for acceptance or rejection of the plan and a certificate of the result filed in the District Court on July 15, 1944. All classes of voting creditors approved the plan as required by Section 77 except the holders of the Denver's General Mortgage bonds.⁴ On November 1, the District Court held the rejection of the plan by the holders of the General Mortgage was not reasonably justified⁵ and thereafter confirmed the plan on November 29, 1944. Section 77(e).

The plan provided for a reorganization as of January 1, 1943, by the Denver by adjustment of its assets to its liabilities with or without a consolidation with the Salt Lake and the Salt Lake Western to form a system. As no ruling that we are asked or required to make turns upon whether the reorganization is with or without the suggested consolidation, we need not give further consideration to possible differences. In either case, creditors with secured claims against the reorganized roads or against their property were left undisturbed or allocated new securities of the new company, consisting of first mortgage and income bonds, preferred and common stock, in lots, in face amount of the secured claims except for the General Mortgage issue, that the

¹ 11 U. S. C. § 205.

² The plan is printed in *Denver & R. G. W. R. Co. Reorganization*, 254 I. C. C. 349. See for former decisions of the Commission in this reorganization, 233 I. C. C. 515; 239 I. C. C. 583; 254 I. C. C. 5.

³ C. C. H. Bankruptcy Law Service ¶ 54,562.

⁴ The Denver & Rio Grande Western Railroad Company is referred to herein as the debtor or the Denver; The Denver & Salt Lake Western Railroad Company as Salt Lake Western; The Denver & Salt Lake Railway Company as the Salt Lake; The Rio Grande Junction Railway Company as the Junction.

⁵ In *Re Denver & R. G. W. R. Co.*, 62 F. Supp. 384.

Commission and District Court determined, through adoption of the plan, were fair and equitable in the light of the respective priorities, liens and collateral of the various secured claims. All of the securities were given a par value. Interest partly fixed and interest partly contingent on earnings was used to gain play in annual charges. The plan eliminated unsecured claims and allocated common stock in face amount of ten per cent of their claim to general mortgage bonds of the debtor. It was determined that the aggregate of the securities in the plan represented the value of the properties for reorganization purposes and that through prospective earnings there was adequate coverage for the charges.⁶

⁶ 254 I. C. C. at 354 to 357.

Full details appear in the plan, note 2, *supra*, as well as explanation of certain items in the following tables. The tables are printed to give the reader a convenient summary of the plan. 254 I. C. C. 382-83.

CAPITALIZATION AND ANNUAL CHARGES.

	<i>On basis of consolidation with Denver & Salt Lake</i>		<i>Denver & Rio Grande Western without Denver & Salt Lake</i>	
	<i>Principal</i>	<i>Annual Charges</i>	<i>Principal</i>	<i>Annual Charges</i>
Equipment-trust obligations....	\$5,758,000	\$139,989	\$5,758,000	\$139,989
Chase National Bank note....	2,158,458	45,722	2,158,458	45,722
R. F. C. claim.....	.....	.....	13,900,605	556,024
Denver & Salt Lake first-mortgage bonds, 4 percent interest	1,500,000	60,000	.....	.....
Denver & Salt Lake income bonds, 3-1 percent interest..	9,734,000	292,020	.....	.....
	19,150,458	537,731	21,817,063	741,735
New first-mortgage bonds, 3-1 percent interest	38,573,680	1,157,210	33,373,680	1,001,210
Total fixed interest.....	57,724,138	1,694,941	55,190,743	1,742,945
Capital fund, maximum payment .....	.....	750,000	.....	750,000
Prior contingent interest, 1 percent .....	.....	498,318	.....	348,978
Sinking fund for first-mortgage bonds, one-half of 1 percent .....	.....	200,489	.....	182,323
		3,143,748		3,024,246
New income bonds, 4½ percent	29,750,184	1,364,133	21,049,579	972,606
Sinking fund for income bonds, one-fourth of 1 percent....	.....	76,808	.....	58,527
Total debt, interest, payments to funds	87,474,322	4,584,689	76,240,322	4,055,379
New 5-percent preferred stock, par value \$100	32,531,220	1,626,561	32,120,120	1,606,006
New common stock, par value \$100	35,167,585	.....	35,167,585	.....
Total capitalization	155,173,127	.....	143,528,027	.....

Respondents sought review in separate appeals from the order of approval or the order of confirmation or both to the Circuit Court of Appeals for the Tenth Circuit. That court reversed the District Court on all appeals and remanded the reorganization proceedings to the Interstate Commerce Commission for further consideration with the statement, 150 F. 2d at 40,

"Nothing in the opinion shall prejudice or foreclose the rights of the parties to propose a new plan or reorganization or the power of the Commission to formulate, approve, and certify a new plan of reorganization in the light of any relevant facts presented to the Commission in any proceeding under 11 U. S. C. Sec. 205(d)."

DISTRIBUTION OF NEW SECURITIES PER \$1,000 OF PRESENT BONDS WITH ACCRUED INTEREST.

	<i>First- mortgage bonds</i>	<i>Income bonds</i>	<i>Pre- ferred stock</i>	<i>Common stock</i>
Rio Grande Western first trusts (\$15,190,000)	\$970.20	\$349.80	.....	.....
Rio Grande Western consolidated's (\$15,080,000) .....	.....	266.00	\$970.90	\$93.10
Junction firsts (\$2,000,000)	1,061.96	317.21	.....	.....
Denver & Rio Grande consolidated 4's (\$34,125,000)	318.92	217.08	321.60	482.40
Denver & Rio Grande consolidated 4½'s (\$6,382,000)	329.03	223.97	331.80	497.70
Refunding and improvement 5's (\$12,000,000)	250.01	159.61	310.75	692.13
Refunding and improvement 6's (\$2,000,000)	264.61	168.94	328.90	732.55
General 5's (\$29,808,000) .....	.....	.....	.....	146.10

CLAIMS.

	<i>Claims as of Jan. 1, 1943</i>	<i>Undisturbed or extended</i>
Equipment obligations	\$5,758,000	\$5,758,000
Rio Grande Western first-trust 4's	20,050,800	.....
Rio Grande Western consolidated 4's	20,056,400	.....
Rio Grande Junction first 5's	2,758,333	.....
Denver & Rio Grande consolidated 4's	45,727,500	.....
Denver & Rio Grande consolidated 4½'s	8,823,115	.....
Refunding and improvement 5's	16,950,000	.....
Refunding and improvement 6's	2,990,000	.....
General-mortgage 5's	43,548,155	.....
Chase National Bank note	2,158,458	2,158,458
R. R. Credit Corporation note; paid May 17, 1943 .....	.....	.....
R. F. C. notes	13,900,605	.....
Unsecured claims, approximate	440,000	no equity
Total, Denver & Rio Grande Western....	183,161,366	7,916,458

By this remand, the Commission was empowered to proceed anew to consideration of the reorganization in all its phases, § 77(e), including those steps previously taken and approved by the opinion of the Court of Appeals.

That court approved the valuation of the debtor reached mainly by the use of present and prospective earnings. It held that the valuation adopted need not reflect necessarily the money spent for improvements during the trusteeship for reorganization. 150 F. 2d 34, 35. No argument is made against the soundness of these conclusions which are fully supported by the *Western Pacific* and *Milwaukee* cases.⁷ The Circuit Court further held that the Commission was justified in refusing to reopen the hearings just before the entry of its order of June 14, 1943, approving the plan, to hear evidence of the then existing economic conditions and the 1943 earnings of the debtor.⁸

The reversal came from the Circuit Court's holding, contrary to the Commission and the District Court, that free cash in excess of operating capital needs and large earnings from war business after the date of the plan should be for the benefit of the General bondholders. 150 F. 2d 35-38. That court further held that decreases in debt by cash payments, with the consequent reduction of securities that were required to be issued under the plan to cover such debt claims, should inure to the benefit of the same General bondholders. 150 F. 2d 38-39. The Circuit Court disagreed also with the treatment of certain collateral deposited behind the First Consolidated Mortgage of the Rio Grande Western Railway Company and secondarily behind the Generals of the debtor. This is the Utah Fuel stock issue hereinafter discussed. These differences from the conclusions of the District Court led the Circuit Court to hold that the General bondholders were "reasonably justified" in rejecting the plan and that the District Court was without authority to confirm the plan over their veto. § 77(e).

Petitioners sought a writ of certiorari to reverse these rulings of the Circuit Court and, on account of the importance of the issues in the administration of railroad reorganization under Section 77, we granted their petition. — U. S. —.

⁷ *Ecker v. Western Pac. R. Co.*, 318 U. S. 448, 477-83; *Group of Investors v. Milwaukee R. Co.*, 318 U. S. 523, 539-41.

⁸ See 318 U. S. at 543.

The briefs of all the parties here restate the questions presented in the petition for certiorari according to the emphasis the particular party places upon points of controversy. After a general consideration of the background of the plan, we shall give attention to each of the just stated disagreements between the district and appellate court. This will cover the points under review.

The basic problems of railroad reorganization under Section 77 of the Bankruptcy Act have been so recently considered by this Court in the *Western Pacific* and *Milwaukee* cases that only a summary reference to their conclusions here pertinent need be made now. No new enactments have changed the law since those decisions on March 15, 1943. The complexities of the reorganization of a railroad with responsibility to the public and obligations to its security holders was recognized. The impossibility without destruction of efficiency and values of reversing the process of integration to restore the parts that now make up the whole of a system of their original operational function was understood. The various bond issues with different and often overlapping liens, with competing claims for allocation of earnings pending reorganization, presented hard problems for legislative solution. A fair, administratively practical and lasting method was sought. By provisions for adjustment of creditors' claims, Congress intended to avoid the delays, costs and sacrifices of liquidation.⁹ The agencies employed by Congress to accom-

⁹ Applicable provisions of § 77, 11 U. S. C. § 205, are as follows

“(b) A plan of reorganization within the meaning of this section generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, and rent for leased railroads) in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; . . .

“(d) The debtor, after a petition is filed as provided in subsection (a) of this section, shall file a plan of reorganization within six months of the entry of the order by the judge approving the petition as properly filed,

plish reorganizations under Section 77 were the Interstate Commerce Commission and the courts. The answer reached by Congress was that the experience and judgment of the Commission must be relied upon for final determinations of value and of matters affecting the public interest, subject to judicial review to assure compliance with Constitutional and statutory requirements. This was the interpretation of all members of this Court from the language of the act and the evidence of Congressional

... After the filing of such a plan, the Commission, unless such plan shall be considered by it to be prima facie impracticable, shall, after due notice to all stockholders and creditors given in such manner as it shall determine, hold public hearings, at which opportunity shall be given to any interested party to be heard, and following which the Commission shall render a report and order in which it shall approve a plan, which may be different from any which has been proposed, that will in its opinion meet with the requirements of subsections (b) and (c) of this section, and will be compatible with the public interest; or it shall render a report and order in which it shall refuse to approve any plan. In such report the Commission shall state fully the reasons for its conclusions.

“(e) Upon the certification of a plan by the Commission to the court, the court shall give due notice to all parties in interest of the time within which such parties may file with the court their objections to such plan, and such parties shall file, within such time as may be fixed in said notice, detailed and specific objections in writing to the plan and their claims for equitable treatment. The judge shall, after notice in such manner as he may determine to the debtor, its trustee or trustees, stockholders, creditors, and the Commission, hear all parties in interest in support of, and in opposition to, such objections to the plan and such claims for equitable treatment. After such hearing, and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; . . .

“ . . . If the judge shall approve the plan, he shall file an opinion, stating his conclusions and the reasons therefor, and enter an order to that effect, and shall send a certified copy of such opinion and order to the Commission. The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirements of subsection (c) of this section, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such time as the Commission shall specify, together with the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided*, That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that at the time of the finding the corporation is insolvent, or that at the time of the finding the equity of such class of stockholders has no value, or that the plan provides for the payment in cash to such class of stockholders of an amount not less than the value of their equity, if any, . . . *Provided further*, That submission to any class of creditors shall not be necessary if the Commission shall have found, and

purpose in the hearings, reports and discussion.¹⁰ To the courts, Congress confided the power to review the plan to determine whether the Commission has followed the statutory mandates of subsection (e), 318 U. S. at 477, and whether the Commission had material evidence to support its conclusions. 318 U. S. at 477; concurring opinion at 512.

At this point, we restate our conclusion reached in the former cases that the Congressional authority to the Commission to eliminate valueless claims from participation in reorganization is a valid exercise of the federal bankruptcy power. Section 77 was directed at the relief of debtor railroads. Sec. 73, 47 Stat. 1467. Liquidation in depression periods meant that large portions of debts, as well as stock interests in the properties would be irretrievably lost to their holders while reorganization on a capitalization that estimated normal income would support meant the salvage of sound values. We see no more constitutional impedi-

the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by the plan, or that at the time of the finding the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests. . . . The Commission shall certify to the judge the results of such submission.

"Upon receipt of such certification, the judge shall confirm the plan if satisfied that it has been accepted by or on behalf of creditors of each class to which submission is required under this subsection holding more than two-thirds in amount of the total of the allowed claims of such class which have been reported in said submission as voting on said plan, and by or on behalf of stockholders of each class to which submission is required under this subsection holding more than two-thirds of the stock of such class which has been reported in said submission as voting on said plan; and that such acceptances have not been made or procured by any means forbidden by law; *Provided*, That, if the plan has not been so accepted by the creditors and stockholders, the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e); . . .

"If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts."

¹⁰ 318 U. S. at 472, 473, 477; concurring opinion at 512; 318 U. S. at 545.

ment to the elimination of claims against railroad debtors by the Interstate Commerce Commission's determination of values with judicial review as to the sufficiency of the evidence and compliance with statutory standards than we do to their elimination by an accepted bid in a depression market.¹¹ There is no occasion here to reexamine further these recent holdings of this Court in the *Western Pacific* and *Milwaukee* reorganizations.

In examining the contentions of petitioners as to the alleged errors of the Circuit Court of Appeals, we must approach the problems in accordance with our reviewing authority under Section 77. That section embodies the method that Congress selected in 1933¹² and improved in 1935¹³ to put the railroad transportation system of the country in order to meet its debts and perform its duties to the public after the hard years of the recent depression. Our constructions of the chief provisions of the section were handed down in March, 1943. Although the results of reorganizations under the section, as thus construed, have been criticized as unfortunate and changes have been suggested, no different legislation has been enacted.¹⁴ Indeed a different method for reorganization, enacted in 1939 and designed to meet the requirements of railroads not in need of financial reorganization

¹¹ 318 U. S. at 475-76; 318 U. S. at 536-39.

Compare *Wright v. Union Central Ins. Co.*, 311 U. S. 273, 279; *John Hancock Ins. Co. v. Bartels*, 308 U. S. 180, 186; *Gelfert v. National City Bank*, 313 U. S. 221.

¹² 47 Stat. 1474.

¹³ 49 Stat. 911. H. Rep. No. 1283, 74th Cong., 1st Sess., p. 1; S. Rep. No. 1336, 74th Cong., 1st Sess., p. 1; Craven & Fuller, *Amendments of Railroad Bankruptcy Law*, 49 Harv. L. Rev. 1254. See *Ecker v. Western Pacific R. Co.*, 318 U. S. at 470, *et seq.*

¹⁴ H. R. 5924, 79th Cong., 2d Sess.; Hearings on H. R. 4779, 79th Cong., 1st Sess., Serial No. 13; H. Rep. No. 1838, 79th Cong., 2d Sess., p. 3:

"Although all these laws were intended by Congress for the preservation of our railroads and their ownership, the theory has appeared to prevail that the capitalization of companies in section 77 proceedings should in all cases be drastically reduced. That is what has been done consistently and persistently. Under the past administration of section 77, as that statute was interpreted and applied by the Interstate Commerce Commission and affirmed by the Supreme Court, countless thousands of small stockholders already have been wiped out, and their investments, which would now be of great value, were uselessly destroyed. There are many more thousands upon thousands of such stockholders whose investments are imminently threatened with a like fate, unless Congress promptly enacts legislation to prevent such needless loss. And that loss—aggregating over \$2,000,000,000—would be suffered largely by a widely scattered class of citizens (many thousands of whom are employees of these very railroads) who invested their legacies or their savings in one of America's greatest private enterprises, for education of their children, the purchase of homes, or security in old age. It literally may be

of the character provided by Section 77 but only of an opportunity for voluntary adjustments with their creditors, was allowed to lapse on November 1, 1945.¹⁵ This situation leaves clear the duty of the agencies of the Government entrusted with the handling of reorganizations under Section 77, including this Court, to administer its provisions according to their best understanding of the purposes of Congress as expressed in the words of Section 77 read in the light of the contemporaneous discussion in Congress. Changes in economic conditions cannot effect the powers of the reorganization agencies even though such changes may require a reexamination into the present fairness of the former exercise of those powers.

The Denver and Rio Grande Western, the principal debtor, is an important link in transcontinental transportation.¹⁶ The re-

said that these stocks were the favorite investments of widows and orphans and of trustees."

S. Res. 192, 79th Cong., 1st Sess.; S. Rep. No. 925, 79th Cong., 2d Sess.; S. 1253, 79th Cong., 2d Sess.; Hearings on S. 1253, 79th Cong., 1st Sess.; Voluntary Modification of Railroad Financial Structures; Hearings on S. 1253, 79th Cong., 2d Sess., Modification of Railroad Financial Structures, Part 2; S. Rep. No. 1170, 79th Cong., 2d Sess., pp. 1-2:

"The bill (S. 1253) enables railroad companies to adjust their financial affairs quickly, economically, and on a business basis. The procedure it provides will reduce any disturbance of their affairs to a minimum, and will provide the maximum of protection for both the railroads and their investors.

"The existing law, section 77, was enacted in 1933, without hearings and without consideration of any subcommittee or committee of the Senate. It was enacted in the belief that it would help railroads to correct their financial affairs. It was found to do the opposite. It has placed in the hands of Government officials extraordinary power, which they had not requested, over 25 percent of the country's railroad mileage—a power which they have exercised:

- (1) to demolish every part of the financial and corporate structures of those railroads;
- (2) to plan in every respect the financial and corporate future of those railroads;
- (3) to pick men to control those railroads; and
- (4) to decree the forfeiture of \$2½ billion of investments.

"The present bill put an end to every one of those powers and restores the operation of railroads to their managements and the adjustment of their finances to the companies themselves, with the assistance of their security-holders, where necessary."

See A Critical Analysis of Recent Reorganization Decisions of the Supreme Court of the United States, F. C. Nicodemus, Jr., Hearings on H. R. 4779, subsequently H. R. 5924, 79th Cong., 1st Sess., p. 181.

¹⁵ 52 Stat. 1134; 56 Stat. 787. A bill to extend this act to 1950, H. R. 3429, was passed by the House of Representatives on November 1, 1945, 20 Cong. Rec. 10434; H. Rep. No. 1128, 79th Cong., 1st Sess.

¹⁶ Full details of the properties, the elements of rate making value, the corporate history, the capital structure at the beginning of the reorganization

cent availability to the debtor of the Moffett Tunnel and the Dotsero Cut-off (1934) improve its strategic position in the competition for "overhead" or "bridge traffic," that is, traffic that is consigned from and destined to points beyond its lines. The traffic originating on its lines is mixed in character and varies with the general prosperity of the region.

The present Denver, the principal debtor, was organized in 1920. It succeeded the Denver & Rio Grande Railroad Company of 1908 which had in its turn acquired the property of the Rio Grande Western Railway Company, owning the western portion of the present debtor's lines, and of the Denver & Rio Grande Railroad Company of 1886, owning the eastern portion of the present debtor's lines. A connection between the two portions, Rio Grande Junction Railway, is under lease to the debtor who, as lessee and a stockholder, guarantees the Junction bonds. Substantially all of the capital stocks of the Salt Lake and Salt Lake

proceedings, the traffic and earnings appear throughout the various reports of the Commission, particularly the original report in 233 I. C. C. 515. The location and extent of its properties are succinctly described by the Commission at page 518, as follows:

"The Denver's principal eastern termini are Denver and Pueblo, Colo., at each of which points connection is made with the Atchison, Topeka & Santa Fe Railway and the Colorado & Southern Railway. At Denver connection is also made with the Chicago, Burlington & Quincy Railroad, the Chicago, Rock Island & Pacific Railway, and the Union Pacific Railroad; at Pueblo, also with the Missouri Pacific Railroad, which is the Denver's main outlet to the east.

"On the west the main line of the Denver passes through Salt Lake City and terminates at Ogden, Utah. Connection is made with the Union Pacific at each point; at Salt Lake City the Denver also connects with the Western Pacific Railroad and at Ogden with the Southern Pacific. The interchange with the Western Pacific is more important than that with any other western connection.

"The road owned by the Denver consists of 1,256.6 miles of main line and 1,094.9 miles of branch lines. Operated under lease are the Rio Grande Junction Railway . . . extending from Rifle to Grand Junction, Colo., 62.1 miles, the Goshen Valley Railroad, a branch line 8.8 miles in length, and the Salt Lake Western, extending from Dotsero, on the Denver, to Orestod on the Denver & Salt Lake Railway . . . 38.1 miles. Including these leased lines, the Denver operates approximately 1,257 miles of main lines and 1,104 miles of branch lines. Approximately 771 miles of narrow-gage lines are included in the operated mileage.

"In addition to the above-mentioned mileages, the Denver operates over the Salt Lake, between Denver and Orestod, 128.6 miles. This line, together with the Salt Lake Western, constitutes the Dotsero cut-off route. The Salt Lake's ownership embraces the line extending from Utah Junction, near Denver, to the western terminus at Craig, Colo., 220.2 miles. For its Denver terminal, the Salt Lake uses, under a lease, the facilities of the Northwestern Terminal Railroad Company. The Salt Lake derives no revenues from the through traffic moving over the cut-off, since all such traffic is handled by the Denver."

Western, and various other branch lines are owned by the debtor.¹⁷ These corporate arrangements for the operations of the debtor have resulted in the assumption or creation by the debtor of the claims of the various issues, listed in note 6, *supra*.

Just after these reorganization proceedings began, December 31, 1935, the debtor's report showed that its long-term debt was \$120,541,000, and its current liabilities \$24,990,901.63. It had current assets, including cash \$1,257,943.43, of \$5,966,666.93. At the time the plan became effective, December 31, 1942, the report showed long-term debt of \$130,264,826.65 and current liabilities of \$14,172,575.50, and in addition deferred liabilities, chiefly matured interest in default of \$45,582,132.66. There were current assets, including cash \$10,850,149.96, of \$20,983,652.54. As of December 31, 1944, these items were: Long-term debt \$129,358,337.79, current liabilities \$20,539,637.83, and deferred liabilities \$55,310,151.80. The current assets were \$32,665,501.33, including \$19,142,626.96 in cash.

During the period examined the income of the system available for interest was found by the Commission at its lowest in 1936-1938. After adjustment this was \$2,893,255. 233 I. C. C. at 552. In 1941 there was \$5,019,436. 254 I. C. C. at 10. When the present plan was approved by the Commission in June, 1943, the 1942 income available for interest was recognized but the continuance of such earning power was thought to be negated by any sound forecast.¹⁸ 254 I. C. C. at 356.

Earnings during the trusteeship were used to improve the debtor railroad. When the vote was taken in 1944, the real estate and equipment account showed charges of \$43,291,513 during the trusteeship. An estimated ten million of it was between the Commission's approval of the plan, June, 1943, and the Commission's certification of its approval to the court by claimants on July 15, 1944. The retirements are said by the respondent trustee to have been about \$13,000,000, leaving a net addition to capital account of \$30,000,000. Respondents urge that since capitalization was not substantially increased by the Commission between 1938 and

¹⁷ See *Denver & Salt Lake Western R. Co. Construction*, 154 I. C. C. 51; 175 I. C. C. 535; 233 I. C. C. at 520.

¹⁸ The reports show the income available for interest as follows:

1942.....	\$17,044,420.39
1943.....	11,573,667.94
1944.....	8,157,880.25.

1943, the junior creditors got little or nothing for this investment. The improvements may have been wise or unwise. That question is not before us. Railroads even in reorganizations must make additions to take care of public needs or to lower operating costs. See 62 F. Supp. 389. The senior bond interest continued to accumulate during this period. As the capitalization was not increased *pari passu* with the investments, the holders of junior securities received less participation. The Commission did not consider that the earning prospect justified a greater capitalization than the one given and we think its judgment controls the valuation. As was said, *In Re Denver & R. G. W. R. Co.*, 150 F. 2d at 38:

“Neither was the Commission compelled to, nor would it be justified in adding the amount of these expenditures to the capitalized value if in the exercise of sound discretion it felt that the reasonable prospective earnings of the road, after the improvements did not justify it. However, in the face of all this, after satisfying in full the claims of the senior bondholders, the plan of reorganization should have made sure that all excess current assets, as well as all excess war profits yet to accrue, would go to the General Bondholders.”

The last sentence, we think, has the vice of overlooking the reason the Commission gave common stock to the Seniors. See discussion under *Allocation of Securities*.

We note also the contention that the possibility of a national income much higher and interest rates much lower than before World War II should affect valuation based on prospective earnings. Those factors, we think were before the Commission when it made its earnings estimate.

The Commission reached its determination of a sound capital structure for the combined properties with these figures on earnings and investments before it. In addition, of course, the Commission had complete statistical information to guide it from its Bureau of Valuation and its other sections dealing with traffic, rates, earnings, interest, et cetera. The discussion by the Commission will be found in its printed volumes listed in note 2. Proceeding upon the principle accepted in the *Western Pacific* and *Milwaukee* cases,¹⁹ that capitalization based upon earnings is a permissible method of valuation in reorganization, the Commission

¹⁹ 318 U. S. at 482 and 483; 318 U. S. at 539-541.

fixed \$155,173,127 as the sound capitalization. This capitalization under the terms of the issues, with provisions for a capital fund and the sinking funds, carries annual charges at rates varying with the security of \$6,211,250 before dividends on common. See note 6. The decision was unanimous except for one Commissioner who considered the valuation too high by ten per cent. 254 I. C. C. at 379. There can be no doubt that as of June, 1943, there was ample evidence to justify the valuation made by the Commission.

Allocation of Securities. Within the framework of that valuation, the Commission allotted the available securities to the claimants. Securities, including the common stock, were given a face value. The aggregate was too small to allow anything to former stockholders.²⁰ Thus they were eliminated from the reorganization.²¹ For the holders of the General bonds, common stock was available to the amount of ten per cent only of their claim.²² A glance at the proposed distribution in note 6 will show that the claimants did not receive all the new senior securities in the strict order of their old priorities.

The value of a lien on a part of a railroad when the valuation is made from earnings cannot be fixed solely on a mileage basis. Nor is it practicable to issue new securities with a lien limited to the property that was covered by the old lien. There must be segregation of the system earnings to each existing lien and allocation of securities representing the system value to each class of claimants. This was done here as shown in the second table in note 6.²³ Such a method is in full accord with the principle that senior creditors are to retain their relative priority of position in a reorganization. *Group of Investors v. Milwaukee R. Co.*, 318 U. S. at 561-64. Furthermore, junior claims can receive nothing until the senior claims receive securities of a worth or value equal to their indebtedness. 318 U. S. at 483; 318 U. S. at 569. The Generals are definitely junior. 233 I. C. C. at 524.

The Commission did not make a finding that the cash value of the securities awarded the senior claimants as of the effective date of the plan equalled the face of the claims. It did, however, carefully state its reasons for concluding that the com-

²⁰ *Ecker v. Western Pacific R. Corp.*, 318 U. S. at 475-76.

²¹ 233 I. C. C. 578-81.

²² 254 I. C. C. at 359.

²³ See for discussion of the formulae 233 I. C. C. at 581 *et seq.*; 254 I. C. C. at 16 and 359-76.

pensation "flowing under the plan to the various classes of bondholders for the rights surrendered by them" was adequate in the light of the absolute priority rule. 254 I. C. C. at 360. For those classes, other than the Junior Generals, that received common stock, the Commission said that the possibility of "unlimited dividends on common stock" was a factor in offsetting loss of position.²⁴ Thus it is clear that when the Commission made its allocations it had definitely in mind that one thing that gave the senior creditors compensation for the admission of junior claimants to participation in securities before the seniors obtained full cash payment was their chance to share in the unlimited dividends that might be earned and paid on the common stock to have a part in the "lush years." It should be noted that income applicable to dividends was at its highest in 1942 prior to the approval of the plan by the Commission in June, 1943. Therefore the abnormal earnings of 1942 were in the Commission's contemplation when it spoke of the opportunities for "unlimited dividends." Its discussion of the plan assumed that 1943 available earnings might be as large. 354 I. C. C. at 355.

The improved physical condition of the road through expenditures of the trustees for previously deferred maintenance, improvements and new equipment was before the Commission and necessarily entered into their valuation of the property. 233 I. C. C. 531.

There is another important factor, corollary to stock ownership, to be noted in the Commission's allocation of these securities. This factor is that the creditors who received common stock to make them whole obtained with that common stock an interest in all cash on hand or all cash that might be accumulated. Of course, the Commission thoroughly understood this. In fact, it referred to the ten million plus of cash on hand as of January

²⁴ Rio Grande Western consolidated, 254 I. C. C. at 365: "Loss in earnings position and surrender of other rights, in our opinion, are offset by the possibility of increased return permitted by the 4½-percent income bonds, 5-percent convertible preferred stock, unlimited dividends on common stock, and the other features of the plan."

Denver & Rio Grande consolidated, *id.* at 364: "This apparent change in earnings position is offset by the new sinking fund and capital fund and by the increased rate of return obtainable from the new securities, i. e., slightly in excess of 4.5 percent for 64 percent of the claim and unlimited stock dividends for the remainder."

Denver & Rio Grande Western refunding and improvement, *id.* at 366: "They also will receive whatever dividends may be paid on 97,706 shares of common stock."

1, 1943. 254 I. C. C. 353. Immediately following this reference is a full discussion of the cash needs of the road for the year 1943, including additions, betterments and new equipment, and the amount which it was estimated would be in the treasury at the end of the year. That was \$15,600,000. This cash would be reflected in the value of the common stock. The petitioner states that the common stock sold for a high when-issued price of \$31½ on the Stock Exchange in 1945, par \$100. See Commercial and Financial Chronicle, May 13, 1946, p. 2618, where the common is quoted at 29 Bid, 31 Asked. Cash, material and supplies, as well as all other assets and all liabilities of the debtor were represented by the securities. If there is more cash on hand than needed, for taxes, expenses and proper improvements, it is at the disposal of the common stockholders. If money was used to pay indebtedness, there would be a corresponding reduction in the capital structure. Therefore, the plan provided, 254 I. C. C. at 386:

"The new company shall be deemed to have come into possession of the properties as of the effective date of the plan.

" . . . The capitalization of the new company, as of January 1, 1943, after consummation of the plan . . . shall consist substantially of the following securities, excluding those to be pledged, the amounts stated being subject to reduction to the extent, if any, that matured interest proposed to be funded in the plan is paid, and as equipment obligations or other liabilities are paid or reduced . . ."

This allocation we conclude was fair and equitable in so far as respondents are concerned. No question is raised by the senior claimants.

Cash and War Earnings. The Circuit Court of Appeals was of the view that war earnings were of "very little value in estimating the probable future earnings of this property in the peace economy which is to come" and that the Commission was well within its right in disregarding them. 150 F. 2d at 34. This was after the seventeen million earnings of the top year 1942. The appellate court agreed, too, that excess current assets should not be capitalized and that improvements made during the trusteeship for reorganization had been considered by the Commission and District Court in fixing their valuation by past and prospective earnings. 150 F. 2d at 35. The appellate court then made the following ruling:

"The Senior Bondholders were paid in full. They received all the new securities and most of the common stock. Ninety per cent of the General Bondholders' claims were wiped out. They received only a small amount of common stock, ten per cent of their total claim. Adequate operating funds are essential to the operation of a railroad. The Senior Bondholders were entitled to receive in addition to the full amount of their claims, working capital sufficient for proper and efficient operation of the railroad. But anything in excess of what was reasonably necessary for this purpose constituted assets of the insolvent corporation which belonged to the remaining creditors.

"We think it is apparent from the record that there were current assets on hand consisting of cash and securities in excess of what was needed for the efficient operation of the road. As pointed out, the working capital of the debtor had increased from a deficit of \$9,727,230 as of December 31, 1935, to a surplus of \$12,125,863.50 as of December 31, 1944. While these increased net earnings are due in large part to the war and will not continue after the end of the war, and may therefore be disregarded in setting up the capitalized structure based upon prospective earnings, we cannot disregard the fact that these huge surpluses actually exist. Their existence is an accomplished fact. It is also obvious that surpluses will continue to pile up for a reasonable time yet to come. We think any plan which fails to take this into account and which gives the Senior Bondholders their claims in full by substantially delivering the road to them, and gives them the surplus cash actually on hand and further enables them to receive in addition the excess war profits which are reasonably sure to come, is inherently inequitable and unfair, so long as there are classes of creditors whose claims are not fully satisfied."

In our judgment this holding is erroneous.

The effective date of the plan was fixed by the Commission as January 1, 1943. This was in its power.²⁵ The allocation of the securities took into consideration the interest of the secured claims to that date. Any gain or any loss after that time was a benefit or an injury first to the common stockholders and then to security holders in positions senior to them. Assuming that the courts, as courts with equity powers in a bankruptcy matter, might set aside a plan, fair and equitable when adopted by the Commission, on account of subsequent changes in economic conditions of the region

²⁵ *Ecker v. Western Pacific R. Corp.*, 318 U. S. at 509.

Interest accrues on the secured claims until the effective date of the plan. *Group of Investors v. Milwaukee R. Co.*, 318 U. S. at 546. Compare *Ticonic Bank v. Sprague*, 303 U. S. 406.

or the nation,²⁶ it should not be done when the changes are of the kind that were envisaged and considered by the Commission in its deliberations upon or explanations of the plan.

We have pointed out in the section of this opinion dealing with the allocations of the securities that a part of the compensation to senior claimants for their loss of position was the opportunity to participate in war earnings. This was understood by the District Court²⁷ and the Commission.²⁸ Accumulations of cash beyond operating fund needs are in the same category. In dealing with the problem the Commission noted that a five percent dividend on the authorized common would require an income available for interest and dividends of \$7,969,629. The Trustee for General bonds claims no such earnings between 1929 and 1942. Even before the transportation difficulties of 1946, it was obvious that the Commission's judgment was being confirmed by events. See note 18, *supra*.²⁹

²⁶ 318 U. S. 506-509.

²⁷ 62 F. Supp. at 390:

"The \$25,000,000 or more the Trustees have expended in the Improvement Program inures to the benefit of the common stock. If the latter is worth anything it is as much due to these expenditures as to any other factor. This, with the increase in current assets and wartime earnings which counsel seem to believe are permanent, constitute the only equity behind the preferred and common stock."

²⁸ 254 I. C. C. at 356.

²⁹ Mankind's foresight is limited. The uncertainties of future estimates are recognized. It is not without interest to note, however, that on April 15, 1946, the railroads of the United States petitioned the Interstate Commerce Commission for increased freight rates and charges. This was said:

"The situation of the railroads has now become critical and their need for a substantially higher level of freight rates has become imperative. This is the result of an extraordinary combination of war and postwar conditions with which the railroads are confronted, and more particularly the result of three factors of recent development: (1) the increase in wages of railroad employees of 16 cents per hour determined under the procedures of the Railway Labor Act in April, 1946, retroactive to January 1, 1946; (2) large increases, both present and prospective, in the prices of railway materials and supplies; and (3) a sharp decline in volume of railway traffic and an even greater decline in railway revenue.

"The volume of freight and passenger traffic is falling continuously, and it is anticipated that the downward rate will accelerate in the months to come. The revenues will be reduced by reason both of the decline in volume and a return to a more nearly normal composition of traffic. It is estimated that the operating revenues of Class I railroads for 1946, on the basis of the present rates, fares and charges, would be approximately \$6,800,000,000, or 23.5 per cent less than they were in 1945.

"Freight and passenger traffic reached their peaks in 1944. But net railway operating income and net income began to diminish in 1943 on account

The error of the Circuit Court in its holding set out above lies in its assumption that the senior bondholders were paid in full by the securities allotted to them without also accepting the determination of the Commission that the assets represented as of January 1, 1943, and all subsequent earnings were a part also of the common stock that was awarded the senior bondholders.

Decreases in Senior Debt. The plan provides for securities to take the place of the Rio Grande Junction's first 5's in the face amount of \$2,758,333 and for the assumption by the reorganized road of \$5,758,000 equipment obligations. All of these securities are senior to the Generals. The Denver purchased the Junctions and paid \$1,218,000 on the Equipments. This reduced the necessary capitalization by that aggregate sum. The Circuit Court of Appeals was of the opinion that "The value behind these securities which will become an asset of the reorganized company." 62 had been paid in full." 150 F. 2d 39. This ruling, we conclude, was erroneous for the same basic reason that we held the cash and war earnings belong to the owners of the common stock.

We called attention, *supra* page —, to the authority granted the District Court to reduce the capitalization of the new company as interest due on January 1, 1943, or equipment obligations or other liabilities were paid. The District Court acted on this authority and said of the Junctions, "They may be canceled or they may be utilized under the plan in acquisition of new securities which will become an asset of the reorganized company. 62 F. Supp. at —. The Junction bondholders did not vote on the plan. Under our determination that the creditors who received common stock were compensated partly by the assets and future earnings, it is obvious that the use of such assets to retire senior claims is a part of the normal and expected value from holdings

of rising costs of operation. In the face of increasing traffic through 1944, both net railway operating income and net income moved steadily downward after reaching their peak in 1942. With the cessation of hostilities in 1945 there began to be a decline also in gross revenues which is expected to become more pronounced as the abnormal war conditions disappear, disabilities of highway carriers and other agencies of transportation are removed, and the prewar pattern of railway traffic is resumed."

The Denver apparently did not vary greatly from this overall picture. Its net revenue for 1945 from railway operations dropped from \$20,569,809 to \$14,246,504. Its gross operating revenue, however, increased four and a half million. The loss in net was due largely to increased amortization of defense projects.

The monthly report of revenues and expenses by the Denver for January and February of 1946 shows a decrease of operating revenues from \$10,856,764 to \$8,932,983.

of common stock. The increase of common stock by the Commission to the Generals from five to ten per cent of the bondholders' claims, preliminary to the adoption of the plan, 254 I. C. C. at 352, 359, is partly attributable to a reduction of necessary capitalization. This increase in junior participation differs from that now proposed. The former reduction of senior capitalization could be carried out because earnings prior to the adoption of the plan made it unnecessary to borrow money for reorganization. When proposed capitalization is being based on earnings, a reduction of senior capital without reduction of estimated earnings increases possible junior capital within the scheme. When the reduction of senior capital takes place after the adoption of the plan by use of anticipated earnings or existing cash, there can be no such readjustment of junior participation because assets existing at the adoption of the plan and subsequent earnings are, as we have pointed out, for the benefit of the stockholders in the new company so that through these common stock advantages these new stockholders may be compensated for their loss of payment in full in cash. Of course, this section of the opinion is written and must be read on the assumption that the allocations of common stock are fair and equitable, a matter discussed *supra*.

Mine *Utah Fuel Company Stock.* The Rio Grande Western Railroad Co. in 1899 executed its First Consolidated Mortgage, an indenture to secure its issue of First Consolidated Bonds, maturing April 1, 1949. Rio Grande Western reserved the right to issue additional bonds under the indenture.

The Utah Fuel Company was organized in 1900, with a capitalization of 100,000 shares. In 1901 an agreement was entered into by Rio Grande Western, the trustee under the First Consolidated Mortgage, and the owner of the Utah Fuel stock. The contract provided that the stock would be held by the trustee to secure bonds issued under the First Consolidated Mortgage and that Rio Grande Western would have the right at any time on paying the trustee \$6,000,000 in cash or delivering an equal face amount in First Consolidated bonds to receive the Utah Fuel stock, free of the mortgage lien. Subject to the lien, the stock was transferred to Rio Grande Western. \$6,000,000 in additional First Consolidateds were issued to the owner of the stock.

In 1908, the Denver & Rio Grande Railroad Company was organized and acquired the property of Rio Grande Western, assuming the obligation of its First Consolidated Mortgage bonds

of 1899. The equity of redemption of Denver & Rio Grande Railroad Company in the Utah Fuel stock was sold in 1918 under execution and transferred to the Western Pacific Railroad Corporation.

In 1924 under an agreement among the Denver & Rio Grande Western Railroad Company, the Western Pacific Railroad Corporation, Missouri Pacific Railroad Company, and T. S. Alexander, who by the agreement became trustee of the equity of redemption in the Utah Fuel stock, Western Pacific transferred to T. S. Alexander, Trustee, subject to the pledge under the Consolidated Mortgage its Utah Fuel stock and the debtor transferred to said trustee whatever interest it had in the stock, through certain releases, not here important.

The agreement first provided that the ultimate beneficial interest in the Utah Fuel stock so held was vested one-half in Missouri Pacific and one-half in Western Pacific. Except for certain contingencies not here important, it was provided that the trustee under the 1924 agreement would pay all dividends received by him from the trustee under the Consolidated Mortgage on Utah Fuel stock to the debtor so long as any of the General or Refunding bonds were outstanding.

The agreement further provided that if the General Mortgage or the Refunding or other mortgage of the debtor were foreclosed, the trustee would sell their interest in the Utah Fuel stock subject to the Consolidated Mortgage, if outstanding, and apply the proceeds to the payment of the bonds secured by the equity of redemption in the stock dividing any surplus between Western Pacific and Missouri Pacific.

The General Mortgage and Refunding bonds created in the 1924 reorganization were thus given a lien on the Utah Fuel stock, junior to the lien of the Denver & Rio Grande First Consolidated Mortgage.

Under the plan approved by the Commission and the District Court, the First Consolidated bonds were allotted 20% of their claim in new income bonds, 73% in preferred stock, and 7% in common stock. The plan further provided that:

“The trustee under the Rio Grande Western Railway Company consolidated mortgage shall be permitted to obtain the release of the equities in the stock of the Utah Fuel Company and distribute the stock among the holders of the aforesaid bonds in any manner agreeable to them, or to enforce

its rights as pledgee of the stock of the Utah Fuel Company, the proceeds recovered to be distributed to the holders of the bonds." 254 Icc. at 398-99.

The Commission took the position that this and the other features of the treatment of the First Consolidated bonds were justified as compensation for "loss of earnings position and surrender of their rights"³⁰ under the plan.

The Commission made no definite finding with respect to the value of the Fuel Company stock. The Commission had before it evidence through 1936 with respect to the value of the stock as well as an appraisal of the value of the Fuel Company made for the trustee of the First Consolidated Mortgage, which indicated a value of \$4,653,720. The only dividend paid to the debtor by Utah Fuel under the 1924 agreement was in 1934 and amounted to \$250,000; the debtor in applying its formula for allocation of earnings by mortgage districts credited the Consolidated Mortgage with an income of \$83,333 per annum based on that dividend payment allocated over the three-year period, 1932 to 1934. The status of the stock was considered by the Commission in its original report and its several supplemental reports, and its proposals with respect to the stock remained unchanged.

In proceedings before the District Court in 1943 on objections to the plan, it was revealed that the Fuel Company's net income for 1942 was \$415,000 and for the first seven months of 1943, \$535,869.³¹ The company has no funded debt.

Before the Circuit Court the respondents contended that the holders of the First Consolidated bonds should be compelled either to foreclose this collateral, applying the proceeds to their claim, or credit their claim with the value of the collateral and be allowed new securities only for the balance. The Circuit Court disapproved the treatment of the General bondholders with respect to the Fuel Company stock pointing to the fact that the Commission had permitted "doubts and uncertainties" to remain with respect to the value of the collateral, and that there was a danger that if the collateral had substantial value,

³⁰ See note 24.

³¹ According to Moody's Manual, ~~Dec. 1, 1943, note~~ the net income of the Fuel Company for 1943 was \$865,140, 1944 \$653,901, and earned surplus at the end of the latter year \$4,862,980.

the First Consolidated bondholders might receive more than full payment.

The facts set out above fully support the conclusion of the Commission that the "title to the stock is vested in the Missouri Pacific and Western Pacific." Whatever rights the debtor may have retained after the sale of the stock on execution in 1918 were released to the trustee and the two railroads in 1924. We have then a situation in which the holders of the ultimate beneficial interest in stock which had been pledged previously under a mortgage have permitted that interest to be encumbered by a third person, namely the debtor, as security for its General and Refunding bonds. The rule is settled in bankruptcy proceedings that a creditor secured by the property of others need not deduct the value of that collateral or its proceeds in proving his debt. *Ivanhoe Bldg. & Loan Asso. v. Orr*, 295 U. S. 243. We see no reason why the same should not be true under § 77. See *New York Trust Co. v. Palmer*, 101 F. 2d 1, 3. Therefore the First Consolidated Mortgage bonds were properly permitted to prove the full amount of their debt.

Respondents, however, object that the plan gives the First Consolidated bondholders all the Utah Fuel stock or its proceeds in addition to securities the face value of which amounts to one hundred per cent of their claims. It is thus contended that the plan deprives them of their junior interest in the stock without a determination of the value of that stock, or a finding of the extent to which the Consolidated bondholders have been paid by the new securities to be given them. We do not so read the plan. The plan provides merely that the trustee of the Consolidated Mortgage "shall be permitted to obtain the release of the equities in the stock of the Utah Fuel Company" and distribute the stock or its proceeds to the holders of the bonds. This statement contains at least two requirements to be met before the Consolidated bonds obtain anything from the collateral. The first is that the trustee of the First Consolidated Mortgage be in existence. Even after the plan goes into operation and the old securities are surrendered for cancellation there is no requirement that the trusts terminate since they will continue to hold property other than that of the debtor. § 77(f) does not so require. Hence whatever action the trustee takes may be commenced prior to or after the ~~execution~~ of the plan. This will

~~No objection~~
appears on
behalf of the
The Refunding
Bondholders
have no
objection

Section
which deals with
the effect of
confirmation &
the discharge
of the debtor
from liabilities

Carrying out →

permit the respondent, trustee under the General Mortgage, which would continue in existence for the purpose, to take the necessary steps to safeguard its rights in the collateral on behalf of the Generals.³²

The second requirement, which is explicit in the plan, is that the trustee obtain the release of the equities in the stock. ~~The predominant, if not the only existing equity in the stock is that of respondent trustee of the Generals.~~ The Generals have an absolute right under the terms of the 1901 pledge and the 1924 agreement to all the proceeds of the stock over \$6,000,000 and a right also to any part of the proceeds not needed to make the First Consolidated bonds whole. ~~Petitioners concede in their brief here that enforcement of the pledge "can be brought about only through judicial proceedings."~~ They correctly point out that in such proceedings full protection can be given to all those who have any junior interest in the stock. Respondents fear that the General bondholders and the mortgage trustee will not be in existence and so unable to protect themselves has been above demonstrated to be without foundation in fact.

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The result is that this aspect of the plan did not in any way change or affect existing rights in the collateral. The respondents may show in the judicial proceedings which must be brought by the trustee of the First Consolidated Mortgage that the First Consolidated bonds have been fully paid by the securities awarded them under the plan, if such be the fact, or the respondent, trustee of the General, may itself bring a proceeding against the trustee of the First Consolidated mortgage for a determination of the rights of the Generals. Petitioners concede, as they must, that they are not entitled to more than full payment and that they are under a duty to account to the respondents for any surplus remaining after they have been made whole.³³

feature

³² Obviously, the Fuel stock or its proceeds could be distributed to record holders of the old securities as of the date or dates of distribution of the new securities.

³³ There is a certain illogic in the position of First Consolidated bonds in asserting any rights in the collateral at all. If, as they concede and we now hold, they are entitled to be paid in full in new securities without regard to the collateral, it ~~can~~ be assumed that they have been fully paid by the new securities given them since they do not complain of their treatment under the plan. Since they are entitled only to full payment it would seem to follow that they have no rights against the collateral. We should not be taken as deciding this question, however, since we leave it to an independent suit in which there is jurisdiction over the proper parties.

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The treatment of the Utah Fuel stock in the plan is ~~for~~ consistent with the Commission's disposition of certain collateral pledged with the Reconstruction Finance Corporation and the Railroad Credit Corporation by parties other than the debtor to secure notes of the debtor in the *Western Pacific* case. *Western Pac. R. Co. Reorganization*, 233 I. C. C. 409, 432. The Commission permitted the pledges to retain the collateral and this Court approved that action, saying, "This collateral, other than the refunding bonds, was therefore left with the pledgees with its position unaffected by any direct action of the Commission." *Ecker v. Western Pacific R. Corp.*, *supra*, at 506.

Reasonableness of Rejection. As the conclusions of the Circuit Court of Appeals as to the allocation of securities, the treatment by the Commission of cash, war earnings, and decrease in debt with priority over the Generals differed from those made by this Court in its opinion, that court's conclusion that the General bondholders were reasonably justified in rejecting the plan followed naturally. 150 F. 2d 40. Section (e) gives power to a class, here the General bondholders, to reject the plan subject to the power of the District Court, after certification of the result of the submission, to "confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e)." 11 U. S. C. § 205; see note 9, *supra*.³⁴ The plan was confirmed after appropriate findings. 63 F. Supp. at 390.

This provision for confirmation of a plan despite rejection by a class appeared in the draft for the 1935 amendments. Apparently it caused no particular comment.³⁵ We think that the provisions

³⁴ H. Rep. No. 1283, 74th Cong., 1st Sess., p. 18. S. Rep. No. 1336, 74th Cong., 1st Sess., p. 3.

³⁵ H. Rep. No. 1283, 74th Cong., 1st Sess., p. 18, S. Rep. No. 1336, 74th Cong., 1st Sess., p. 3, contains the following statement: "Further, the consent of two-thirds of each class of stockholders must be acquired, unless, by an elaborate valuation proceeding, it is proved that the value of the property is so low that the stock has no interest. This is an effective obstruction. . . .

"In order to remedy these defects, S. 1634, as amended, provides that two-thirds of those of each class who vote upon a plan will bind the dissenters or those failing to vote. But it also provides that the court may make effective

for confirmation by the courts over the creditors' objection are within the bankruptcy powers of Congress. Those powers are adequate to eliminate claims by administrative valuations with judicial review and they are adequate to require creditors to acquiesce in a fair adjustment of their claims, so long as the creditor gets all the value of his lien and his share of any free assets.³⁶

The grounds accepted by us in former sections of this opinion as sustaining, as of January 1, 1943, the valuation of the road, the allocation of the securities, and the treatment of cash, war earnings and capital reductions establish that for the act of confirmation over the objection of the General bondholders, the finding of the judge that the plan then made "adequate provision for fair and equitable treatment" of the dissenters was justified. 62 F. Supp. at 390. There is no doubt that the plan then conformed to subsection (b) and the other requirements of the first paragraph of subsection (e). Note 9 *supra*.

This leaves for consideration the question of whether, the plan being fair and equitable as of June, 1943, effective January 1, 1943, the Generals were reasonably justified in rejecting the plan by ballots cast between April 26 and July 15, 1944.

As we have pointed out under *Allocation of Securities, supra*, the Commission's plan was adopted after 1942, the year of greatest profit and with anticipation on the part of the Commission that there might be other "big" years but with realization that the war profits were not a sound basis for higher valuation. Current reports of earnings were a part of the record. Nothing that respondents have called to our attention indicates any improvement

a fair plan where the parties do not agree. . . . If two-thirds of each class consent, the plan will bind the remainder of each class. But the judge may make the plan effective, even if not so accepted, if he finds that it conforms to the requirements just stated, provides fair and equitable treatment for the interests of those rejecting it, and that their rejection is not reasonably justified in the light of the respective rights and interests. These provisions give complete due process of law from a procedural standpoint, there being provision for full hearings both before the commission and the court. Within the broad powers of Congress under the bankruptcy clause as recently declared by the Supreme Court in *Continental Illinois Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co.* (55 Sup. Ct. Rep. 595), the provisions also afford due process of law in fully protecting the property rights which are involved.'

See also Hearings, House Judiciary Committee, 74th Cong., 1st Sess., on H. R. 6249, Serial 3, pp. 16 and 22.

³⁶ *Wright v. Union Central Ins. Co.*, 311 U. S. at 278, and discussion at pp. 8 and 9, *supra*.

in economic conditions or prospects in July, 1944, or any date since, over June, 1943, which would justify a treatment different from that accorded the claimants in 1943.³⁷ The question of the reasonableness or the unreasonableness of the rejection of the plan does not vary by virtue of any change of conditions since its approval by the District Court October 23, 1943. Under subsection (e), note 9 *supra*, the judge automatically confirms a plan after a vote of classes of creditors if satisfied that two-thirds of each class have accepted. If there is a rejection then there is a reexamination of the plan to assure that those who dissent have had fair and equitable treatment. Apparently the reexamination for this treatment does not differ from that for the original court approval under the first paragraph of subsection (e). It does, however, center upon the rights of those who rejected the plan.

A rejection would not be reasonably justified unless the dissenters had a valid reason for their vote. As is shown by Judge Symes' discussion of their objections,³⁸ their reasons were the payment of the Junction bonds with consequent release of capitalization for junior securities and the inadequate valuation, particularly in view of the large additions to plants from earnings. We think that we have demonstrated that there was an adequate basis for the valuation, see page 12 *et seq.*, and that the decreases in senior debt were not for the account of the junior creditors. See p. 18, *supra*. Respondents offer no other ground for their votes in rejection.

Congress with its purpose to stop the blockade of sound reorganization by classes of creditors with the veto power of the 1933 statute, note 35, *supra*, certainly did not intend to leave a class with the same power of interference because in its reasonable judgment that class thought the valuation was erroneous or the senior creditors were paid in full by the face value of securities. If a plan gives fair and equitable treatment to dissenters, the elements which make the plan fair and equitable cannot be the basis for a reasonably justified rejection. If only those elements are relied upon, as here the rejection is reasonably justified.

Of course, this does not mean that if a plan is approved as fair and equitable by the Commission and court, there cannot be a reasonable justification for its rejection by a class of claimants

³⁷ Cf. *I. C. C. v. Jersey City*, 322 U. S. 503, 515.

³⁸ 61 F. Supp. 384.

For view of
the District
Judge
with
the
the
his finding
that
the rejection
was unreasonable
is entitled
to great
weight
see Rule
52 Fed.
Rules Civ.
Proc.

not

on submission. Reasons to make their rejection reasonable may arise thereafter. For example, unanticipated, large earnings might develop. We see no reasonable justification here for the action of the General bondholders.

In conclusion, we shall add that the foregoing opinion has been written without reliance upon the duty of the Commission to plan reorganizations with an eye to the public interest as well as the private welfare of creditors and stockholders.³⁹ This the Commission has done. Our failure to comment strongly upon that feature of the plan should not be interpreted as an intimation upon our part that it is not important. These respondents cannot be called upon to sacrifice their property unreasonably so that a depression-proof railroad system might be created. But they invested their capital in a public utility that does owe an obligation to the public. The Insurance Group Committee, with fiduciary responsibility to the myriad holders of policies, and the other investors or speculators in senior bonds as well as the holders of General bonds or other investors or speculators in junior security issues, by their entry into a railroad enterprise assumed the risk that in any depression or any reorganization the interests of the public would be considered as well as theirs.

The judgment is ~~affirmed in part~~ and reversed in part and the case remanded to the District Court for further proceedings.

It is so ordered.

³⁹ § 77(d), note 9 *supra*. 318 U. S. at 473; 318 U. S. at 544.

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Reconstruction Finance Corporation; Insurance Group Committee; Guaranty Trust Company of New York, Trustee, Rio Grande Western Railroad Company Consolidated Mortgage; Central Hanover Bank and Trust Company, Trustee, Rio Grande Western Railroad Company First Trust Mortgage; United States Trust Company of New York, Trustee, Denver and Rio Grande Railroad Company Consolidated Mortgage; and The Chase National Bank of the City of New York, Trustee, Denver and Rio Grande Western Railroad Company Refunding and Improvement Mortgage, Petitioners,

On Writs of Certiorari
to the United States
Circuit Court of Ap-
peals for the Tenth
Circuit.

Same,

Same,

Same,

Same,

[]

The petitioners in these five cases are the owners of claims against the debtor, Denver & Rio Grande Western Railroad Company, or against a secondary debtor, the Denver & Salt Lake

Western Railroad Company. The respondents are the two debtors just named; City Bank Farmers Trust Company, Trustee under the General Mortgage of the principal debtor; and the Trustee of the Missouri Pacific Railroad Company, a large owner of common stock of the principal debtor.

The debtors sought reorganization in the District Court of the United States for the District of Colorado under Section 77 of the Bankruptcy Act,¹ on November 1, 1935. The Interstate Commerce Commission approved the plan of reorganization under consideration in this review on June 14, 1943.² The District Court approved the plan October 25, 1943.³ It was then submitted by the Commission to the creditors of the classes deemed entitled to vote for acceptance or rejection of the plan and a certificate of the result filed in the District Court on July 15, 1944. All classes of voting creditors approved the plan as required by Section 77 except the holders of the Denver's General Mortgage bonds.⁴ On November 1, the District Court held the rejection of the plan by the holders of the General Mortgage was not reasonably justified⁵ and thereafter confirmed the plan on November 29, 1944. Section 77(e).

The plan provided for a reorganization as of January 1, 1943, by the Denver by adjustment of its assets to its liabilities with or without a consolidation with the Salt Lake and the Salt Lake Western to form a system. As no ruling that we are asked or required to make turns upon whether the reorganization is with or without the suggested consolidation, we need not give further consideration to possible differences. In either case, creditors with secured claims against the reorganized roads or against their property were left undisturbed or allocated new securities of the new company, consisting of first mortgage and income bonds, preferred and common stock, in lots, in face amount of the secured claims except for the General Mortgage issue, that the

¹ 11 U. S. C. § 205.

² The plan is printed in *Denver & R. G. W. R. Co. Reorganization*, 254 I. C. C. 349. See for former decisions of the Commission in this reorganization, 233 I. C. C. 515; 239 I. C. C. 583; 254 I. C. C. 5.

³ C. C. H. Bankruptcy Law Service ¶ 54,562.

⁴ The Denver & Rio Grande Western Railroad Company is referred to herein as the debtor or the Denver; The Denver & Salt Lake Western Railroad Company as Salt Lake Western; The Denver & Salt Lake Railway Company as the Salt Lake; The Rio Grande Junction Railway Company as the Junction.

⁵ In *Re Denver & R. G. W. R. Co.*, 62 F. Supp. 384.

Commission and District Court determined, through adoption of the plan, were fair and equitable in the light of the respective priorities, liens and collateral of the various secured claims. All of the securities were given a par value. Interest partly fixed and interest partly contingent on earnings was used to gain play in annual charges. The plan eliminated unsecured claims and allocated common stock in face amount of ten per cent of their claim to General Mortgage bonds of the debtor. It was determined that the aggregate of the securities in the plan represented the value of the properties for reorganization purposes and that through prospective earnings there was adequate coverage for the charges.⁶

⁶ 254 I. C. C. at 354 to 357.

Full details appear in the plan, note 2, *supra*, as well as explanation of certain items in the following tables. The tables are printed to give the reader a convenient summary of the plan. 254 I. C. C. 382-83.

CAPITALIZATION AND ANNUAL CHARGES.

	On basis of consoli- dation with Denver & Salt Lake		Denver & Rio Grande Western without Denver & Salt Lake	
	Principal	Annual Charges	Principal	Annual Charges
Equipment-trust obligations....	\$5,758,000	\$139,989	\$5,758,000	\$139,989
Chase National Bank note.....	2,158,458	45,722	2,158,458	45,722
R. F. C. claim.....	.....	.....	13,900,605	556,024
Denver & Salt Lake first-mort- gage bonds, 4 percent interest	1,500,000	60,000	.....	.....
Denver & Salt Lake income bonds, 3-1 percent interest..	9,734,000	292,020	.....	.....
	19,150,458	537,731	21,817,063	741,735
New first-mortgage bonds, 3-1 percent interest	38,573,680	1,157,210	33,373,680	1,001,210
Total fixed interest.....	57,724,138	1,694,941	55,190,743	1,742,945
Capital fund, maximum pay- ment .....	.....	750,000	.....	750,000
Prior contingent interest, 1 per- cent .....	.....	498,318	.....	348,978
Sinking fund for first-mortgage bonds, one-half of 1 percent .....	.....	200,489	.....	182,323
		3,143,748		3,024,246
New income bonds, 4½ percent	29,750,184	1,364,133	21,049,579	972,606
Sinking fund for income bonds, one-fourth of 1 percent....	.....	76,808	.....	58,527
Total debt, interest, payments to funds	87,474,322	4,584,689	76,240,322	4,055,379
New 5-percent preferred stock, par value \$100	32,531,220	1,626,561	32,120,120	1,606,006
New common stock, par value \$100	35,167,585	.....	35,167,585	.....
Total capitalization	155,173,127	.....	143,528,027	.....

Respondents sought review in separate appeals from the order of approval or the order of confirmation or both to the Circuit Court of Appeals for the Tenth Circuit. That court reversed the District Court on all appeals and remanded the reorganization proceedings to the Interstate Commerce Commission for further consideration with the statement, 150 F. 2d at 40,

"Nothing in the opinion shall prejudice or foreclose the rights of the parties to propose a new plan or reorganization or the power of the Commission to formulate, approve, and certify a new plan of reorganization in the light of any relevant facts presented to the Commission in any proceeding under 11 U. S. C. Sec. 205(d)."

DISTRIBUTION OF NEW SECURITIES PER \$1,000 OF PRESENT BONDS WITH ACCRUED INTEREST.

	<i>First- mortgage bonds</i>	<i>Income bonds</i>	<i>Pre- ferred stock</i>	<i>Common stock</i>
Rio Grande Western first trusts (\$15,190,000)	\$970.20	\$349.80	.....	.....
Rio Grande Western consolidated's (\$15,080,000) .....	.....	266.00	\$970.90	\$93.10
Junction firsts (\$2,000,000)	1,061.96	317.21	.....	.....
Denver & Rio Grande consolidated 4's (\$34,125,000)	318.92	217.08	321.60	482.40
Denver & Rio Grande consolidated 4½'s (\$6,382,000)	329.03	223.97	331.80	497.70
Refunding and improvement 5's (\$12,000,000)	250.01	159.61	310.75	692.13
Refunding and improvement 6's (\$2,000,000)	264.61	168.94	328.90	732.55
General 5's (\$29,808,000) .....	.....	.....	.....	146.10

CLAIMS.

	<i>Claims as of Jan. 1, 1943</i>	<i>Undisturbed or extended</i>
Equipment obligations	\$5,758,000	\$5,758,000
Rio Grande Western first-trust 4's	20,050,800	.....
Rio Grande Western consolidated 4's	20,056,400	.....
Rio Grande Junction first 5's	2,758,333	.....
Denver & Rio Grande consolidated 4's	45,727,500	.....
Denver & Rio Grande consolidated 4½'s	8,823,115	.....
Refunding and improvement 5's	16,950,000	.....
Refunding and improvement 6's	2,990,000	.....
General-mortgage 5's	43,548,155	.....
Chase National Bank note	2,158,458	2,158,458
R. R. Credit Corporation note; paid May 17, 1943 .....	.....	.....
R. F. C. notes	13,900,605	.....
Unsecured claims, approximate	440,000	no equity
Total, Denver & Rio Grande Western....	183,161,366	7,916,458

By this remand, the Commission was empowered to proceed anew to consideration of the reorganization in all its phases, § 77(e), including those steps previously taken and approved by the opinion of the Court of Appeals.

That court approved the valuation of the debtor reached mainly by the use of present and prospective earnings. It held that the valuation adopted need not reflect necessarily the money spent for improvements during the trusteeship for reorganization. 150 F. 2d 34, 35. The soundness of these conclusions is fully supported by the *Western Pacific* and *Milwaukee* cases.⁷ The Circuit Court further held that the Commission was justified in refusing to reopen the hearings just before the entry of its order of June 14, 1943, approving the plan, to hear evidence of the then existing economic conditions and the 1943 earnings of the debtor.⁸

The reversal came from the Circuit Court's holding, contrary to the Commission and the District Court, that free cash in excess of operating capital needs and large earnings from war business after the date of the plan should be for the benefit of the General bondholders. 150 F. 2d 35-38. That court further held that decreases in debt by cash payments, with the consequent reduction of securities that were required to be issued under the plan to cover such debt claims, should inure to the benefit of the same General bondholders. 150 F. 2d 38-39. The Circuit Court disagreed also with the treatment of certain collateral deposited behind the First Consolidated Mortgage of the Rio Grande Western Railway Company and secondarily behind other issues of the debtor. This is the Utah Fuel stock issue hereinafter discussed. These differences from the conclusions of the District Court led the Circuit Court to hold that the General bondholders were "reasonably justified" in rejecting the plan and that the District Court was without authority to confirm the plan over their veto. § 77(e).

Petitioners sought a writ of certiorari to reverse these rulings of the Circuit Court and, on account of the importance of the issues in the administration of railroad reorganization under Section 77, we granted their petition. — U. S. —.

⁷ *Ecker v. Western Pac. R. Co.*, 318 U. S. 448, 477-83; *Group of Investors v. Milwaukee R. Co.*, 318 U. S. 523, 539-41.

⁸ See 318 U. S. at 543.

The briefs of all the parties here restate the questions presented in the petition for certiorari according to the emphasis the particular party places upon points of controversy. After a general consideration of the background of the plan and respondents' contentions to support the judgment besides the defenses applicable to petitioners' certiorari, we shall give attention to each of the just stated disagreements between the district and appellate court. This will cover the points under review.

The basic problems of railroad reorganization under Section 77 of the Bankruptcy Act have been so recently considered by this Court in the *Western Pacific* and *Milwaukee* cases that only a summary reference to their conclusions attacked by respondents need be made now. No new enactments have changed the law since those decisions on March 15, 1943. The complexities of the reorganization of a railroad with responsibility to the public and obligations to its security holders were recognized. The impossibility without destruction of efficiency and values of reversing the process of integration to restore the parts that now make up the whole of a system of their original operational function was understood. The various bond issues with different and often overlapping liens, with competing claims for allocation of earnings pending reorganization, presented hard problems for legislative solution. A fair, administratively practical and lasting method was sought. By provisions for adjustment of creditors' claims, Congress intended to avoid the delays, costs and sacrifices of liquidation.⁹ The agencies employed by Congress to accom-

⁹ Applicable provisions of § 77, 11 U. S. C. § 205, are as follows

"(b) A plan of reorganization within the meaning of this section generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, and rent for leased railroads) in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; . . .

"(d) The debtor, after a petition is filed as provided in subsection (a) of this section, shall file a plan of reorganization within six months of the entry of the order by the judge approving the petition as properly filed,

plish reorganizations under Section 77 were the Interstate Commerce Commission and the courts. The answer reached by Congress was that the experience and judgment of the Commission must be relied upon for final determinations of value and of matters affecting the public interest, subject to judicial review to assure compliance with Constitutional and statutory requirements. This was the interpretation of all members of this Court from the language of the act and the evidence of Congressional

... After the filing of such a plan, the Commission, unless such plan shall be considered by it to be prima facie impracticable, shall, after due notice to all stockholders and creditors given in such manner as it shall determine, hold public hearings, at which opportunity shall be given to any interested party to be heard, and following which the Commission shall render a report and order in which it shall approve a plan, which may be different from any which has been proposed, that will in its opinion meet with the requirements of subsections (b) and (c) of this section, and will be compatible with the public interest; or it shall render a report and order in which it shall refuse to approve any plan. In such report the Commission shall state fully the reasons for its conclusions.

“(e) Upon the certification of a plan by the Commission to the court, the court shall give due notice to all parties in interest of the time within which such parties may file with the court their objections to such plan, and such parties shall file, within such time as may be fixed in said notice, detailed and specific objections in writing to the plan and their claims for equitable treatment. The judge shall, after notice in such manner as he may determine to the debtor, its trustee or trustees, stockholders, creditors, and the Commission, hear all parties in interest in support of, and in opposition to, such objections to the plan and such claims for equitable treatment. After such hearing, and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; . . .

“ . . . If the judge shall approve the plan, he shall file an opinion, stating his conclusions and the reasons therefor, and enter an order to that effect, and shall send a certified copy of such opinion and order to the Commission. The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirements of subsection (c) of this section, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such time as the Commission shall specify, together with the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided*, That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that at the time of the finding the corporation is insolvent, or that at the time of the finding the equity of such class of stockholders has no value, or that the plan provides for the payment in cash to such class of stockholders of an amount not less than the value of their equity, if any, . . . *Provided further*, That submission to any class of creditors shall not be necessary if the Commission shall have found, and

purpose in the hearings, reports and discussion.¹⁰ To the courts, Congress confided the power to review the plan to determine whether the Commission has followed the statutory mandates of subsection (e), 318 U. S. at 477, and whether the Commission had material evidence to support its conclusions. 318 U. S. at 477; concurring opinion at 512.

At this point, we restate our conclusion reached in the former cases that the Congressional authority to the Commission to eliminate valueless claims from participation in reorganization is a valid exercise of the federal bankruptcy power. Section 77 was directed at the relief of debtor railroads. Sec. 73, 47 Stat. 1467. Liquidation in depression periods meant that large portions of debts, as well as stock interests in the properties, would be irretrievably lost to their holders, while reorganization on a capitalization that estimated what normal income would support meant the salvage of sound values. We see no more constitutional impedi-

the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by the plan, or that at the time of the finding the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests. . . . The Commission shall certify to the judge the results of such submission.

"Upon receipt of such certification, the judge shall confirm the plan if satisfied that it has been accepted by or on behalf of creditors of each class to which submission is required under this subsection holding more than two-thirds in amount of the total of the allowed claims of such class which have been reported in said submission as voting on said plan, and by or on behalf of stockholders of each class to which submission is required under this subsection holding more than two-thirds of the stock of such class which has been reported in said submission as voting on said plan; and that such acceptances have not been made or procured by any means forbidden by law; *Provided*, That, if the plan has not been so accepted by the creditors and stockholders, the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e); . . .

"If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts."

¹⁰ 318 U. S. at 472, 473, 477; concurring opinion at 512; 318 U. S. at 545.

ment to the elimination of claims against railroad debtors by the Interstate Commerce Commission's determination of values with judicial review as to the sufficiency of the evidence and compliance with statutory standards than we do to their elimination by an accepted bid in a depression market.¹¹ There is no occasion here to reexamine further these recent holdings of this Court in the *Western Pacific* and *Milwaukee* reorganizations.

In examining the contentions of petitioners as to the alleged errors of the Circuit Court of Appeals, we must approach the problems in accordance with our reviewing authority under Section 77. That section embodies the method that Congress selected in 1933¹² and improved in 1935¹³ to put the railroad transportation system of the country in order to meet its debts and perform its duties to the public after the hard years of the recent depression. Our constructions of the chief provisions of the section were handed down in March, 1943. Although the results of reorganizations under the section, as thus construed, have been criticized as unfortunate and changes have been suggested, no different legislation has been enacted.¹⁴ Indeed a different method for reorganization, enacted in 1939 and designed to meet the requirements of railroads not in need of financial reorganization

¹¹ 318 U. S. at 475-76; 318 U. S. at 536-39.

Compare *Wright v. Union Central Ins. Co.*, 311 U. S. 273, 279; *John Hancock Ins. Co. v. Bartels*, 308 U. S. 180, 186; *Gelfert v. National City Bank*, 313 U. S. 221.

¹² 47 Stat. 1474.

¹³ 49 Stat. 911. H. Rep. No. 1283, 74th Cong., 1st Sess., p. 1; S. Rep. No. 1336, 74th Cong., 1st Sess., p. 1; Craven & Fuller, *Amendments of Railroad Bankruptcy Law*, 49 Harv. L. Rev. 1254. See *Ecker v. Western Pacific R. Co.*, 318 U. S. at 470, *et seq.*

¹⁴ H. R. 5924, 79th Cong., 2d Sess.; Hearings on H. R. 4779, 79th Cong., 1st Sess., Serial No. 13; H. Rep. No. 1838, 79th Cong., 2d Sess., p. 3:

"Although all these laws were intended by Congress for the preservation of our railroads and their ownership, the theory has appeared to prevail that the capitalization of companies in section 77 proceedings should in all cases be drastically reduced. That is what has been done consistently and persistently. Under the past administration of section 77, as that statute was interpreted and applied by the Interstate Commerce Commission and affirmed by the Supreme Court, countless thousands of small stockholders already have been wiped out, and their investments, which would now be of great value, were uselessly destroyed. There are many more thousands upon thousands of such stockholders whose investments are imminently threatened with a like fate, unless Congress promptly enacts legislation to prevent such needless loss. And that loss—aggregating over \$2,000,000,000—would be suffered largely by a widely scattered class of citizens (many thousands of whom are employees of these very railroads) who invested their legacies or their savings in one of America's greatest private enterprises, for education of their children, the purchase of homes, or security in old age. It literally may be

of the character provided by Section 77 but only of an opportunity for voluntary adjustments with their creditors, was allowed to lapse on November 1, 1945.¹⁵ This situation leaves clear the duty of the agencies of the Government entrusted with the handling of reorganizations under Section 77, including this Court, to administer its provisions according to their best understanding of the purposes of Congress as expressed in the words of Section 77 read in the light of the contemporaneous discussion in Congress. Changes in economic conditions cannot effect the powers of the reorganization agencies even though such changes may require a reexamination into the present fairness of the former exercise of those powers.

Valuation. The Denver and Rio Grande Western, the principal debtor, is an important link in transcontinental transportation.¹⁶

said that these stocks were the favorite investments of widows and orphans and of trustees."

S. Res. 192, 79th Cong., 1st Sess.; S. Rep. No. 925, 79th Cong., 2d Sess.; S. 1253, 79th Cong., 2d Sess.; Hearings on S. 1253, 79th Cong., 1st Sess.; Voluntary Modification of Railroad Financial Structures; Hearings on S. 1253, 79th Cong., 2d Sess., Modification of Railroad Financial Structures, Part 2; S. Rep. No. 1170, 79th Cong., 2d Sess., pp. 1-2:

"The bill (S. 1253) enables railroad companies to adjust their financial affairs quickly, economically, and on a business basis. The procedure it provides will reduce any disturbance of their affairs to a minimum, and will provide the maximum of protection for both the railroads and their investors.

"The existing law, section 77, was enacted in 1933, without hearings and without consideration of any subcommittee or committee of the Senate. It was enacted in the belief that it would help railroads to correct their financial affairs. It was found to do the opposite. It has placed in the hands of Government officials extraordinary power, which they had not requested, over 25 percent of the country's railroad mileage—a power which they have exercised:

- (1) to demolish every part of the financial and corporate structures of those railroads;
- (2) to plan in every respect the financial and corporate future of those railroads;
- (3) to pick men to control those railroads; and
- (4) to decree the forfeiture of \$2½ billion of investments.

"The present bill put an end to every one of those powers and restores the operation of railroads to their managements and the adjustment of their finances to the companies themselves, with the assistance of their security-holders, where necessary."

See A Critical Analysis of Recent Reorganization Decisions of the Supreme Court of the United States, F. C. Nicodemus, Jr., Hearings on H. R. 4779, subsequently H. R. 5924, 79th Cong., 1st Sess., p. 181.

¹⁵ 52 Stat. 1134; 56 Stat. 787. A bill to extend this act to 1950, H. R. 3429, was passed by the House of Representatives on November 1, 1945, 20 Cong. Rec. 10434; H. Rep. No. 1128, 79th Cong., 1st Sess.

¹⁶ Full details of the properties, the elements of rate making value, the corporate history, the capital structure at the beginning of the reorganization

The recent availability to the debtor of the Moffett Tunnel and the Dotsero Cut-off (1934) improve its strategic position in the competition for "overhead" or "bridge traffic," that is, traffic that is consigned from and destined to points beyond its lines. The traffic originating or terminating on its lines is mixed in character and varies with the general prosperity of the region.

The present Denver, the principal debtor, was organized in 1920. It succeeded the Denver & Rio Grande Railroad Company of 1908 which had in its turn acquired the property of the Rio Grande Western Railway Company, owning the western portion of the present debtor's lines, and of the Denver & Rio Grande Railroad Company of 1886, owning the eastern portion of the present debtor's lines. A connection between the two portions, Rio Grande Junction Railway, is under lease to the debtor who, as lessee and a stockholder, guarantees the Junction bonds. Substantially all of the capital stocks of the Salt Lake and Salt Lake

proceedings, the traffic and earnings appear throughout the various reports of the Commission, particularly the original report in 233 I. C. C. 515. The location and extent of its properties are succinctly described by the Commission at page 518, as follows:

"The Denver's principal eastern termini are Denver and Pueblo, Colo., at each of which points connection is made with the Atchison, Topeka & Santa Fe Railway and the Colorado & Southern Railway. At Denver connection is also made with the Chicago, Burlington & Quincy Railroad, the Chicago, Rock Island & Pacific Railway, and the Union Pacific Railroad; at Pueblo, also with the Missouri Pacific Railroad, which is the Denver's main outlet to the east.

"On the west the main line of the Denver passes through Salt Lake City and terminates at Ogden, Utah. Connection is made with the Union Pacific at each point; at Salt Lake City the Denver also connects with the Western Pacific Railroad and at Ogden with the Southern Pacific. The interchange with the Western Pacific is more important than that with any other western connection.

"The road owned by the Denver consists of 1,256.6 miles of main line and 1,094.9 miles of branch lines. Operated under lease are the Rio Grande Junction Railway . . . extending from Rifle to Grand Junction, Colo., 62.1 miles, the Goshen Valley Railroad, a branch line 8.8 miles in length, and the Salt Lake Western, extending from Dotsero, on the Denver, to Orestod on the Denver & Salt Lake Railway . . . 38.1 miles. Including these leased lines, the Denver operates approximately 1,257 miles of main lines and 1,104 miles of branch lines. Approximately 771 miles of narrow-gage lines are included in the operated mileage.

"In addition to the above-mentioned mileages, the Denver operates over the Salt Lake, between Denver and Orestod, 128.6 miles. This line, together with the Salt Lake Western, constitutes the Dotsero cut-off route. The Salt Lake's ownership embraces the line extending from Utah Junction, near Denver, to the western terminus at Craig, Colo., 220.2 miles. For its Denver terminal, the Salt Lake uses, under a lease, the facilities of the Northwestern Terminal Railroad Company. The Salt Lake derives no revenues from the through traffic moving over the cut-off, since all such traffic is handled by the Denver."

Western, and various other branch lines are owned by the debtor.¹⁷ These corporate arrangements for the operations of the debtor have resulted in the assumption or creation by the debtor of the claims of the various issues, listed in note 6, *supra*.

Just after these reorganization proceedings began, December 31, 1935, the debtor's report showed that its long-term debt was \$120,541,000, and its current liabilities \$24,990,901.63. It had current assets, including cash \$1,257,943.43, of \$5,966,666.93. At the time the plan became effective, December 31, 1942, the report showed long-term debt of \$130,264,826.65 and current liabilities of \$14,172,575.50, and in addition deferred liabilities, chiefly matured interest in default of \$45,582,132.66. There were current assets, including cash \$10,850,149.96, of \$20,983,652.54. As of December 31, 1944, these items were: Long-term debt \$129,358,337.79, current liabilities \$20,539,637.83, and deferred liabilities \$55,310,151.80. The current assets were \$32,665,501.33, including \$19,142,626.96 in cash.

During the period examined the income of the system available for interest was found by the Commission at its lowest in 1936-1938. After adjustment this was \$2,893,255. 233 I. C. C. at 552. In 1941 there was \$5,019,436. 254 I. C. C. at 10. When the present plan was approved by the Commission in June, 1943, the 1942 income available for interest was recognized but the continuance of such earning power was thought to be negated by any sound forecast.¹⁸ 254 I. C. C. at 356.

Earnings during the trusteeship were used to improve the debtor railroad. When the vote was taken in 1944, the real estate and equipment account showed charges of \$43,291,513 during the trusteeship. An estimated ten million of it was between the Commission's approval of the plan, June, 1943, and the Commission's certification on July 15, 1944, to the court of its approval by claimants. See 254 I. C. C. at 354 and 382 for explanation of new equipment program to meet the war situation. The retirements are said by the respondent trustee to have been about \$13,000,000, leaving a net addition to capital account of \$30,000,000.

¹⁷ See *Denver & Salt Lake Western R. Co. Construction*, 154 I. C. C. 51; 175 I. C. C. 535; 233 I. C. C. at 520.

¹⁸ The reports show the income available for interest as follows:

1942.....	\$17,044,420.39
1943.....	11,573,667.94
1944.....	8,157,880.25.

Respondents urge that since capitalization was not substantially increased by the Commission between 1938, when the first draft of a plan came from the Commission's staff, and 1943, the junior creditors got little or nothing for this investment. The improvements may have been wise or unwise. That question is not before us. Railroads even in reorganizations must make additions to take care of public needs or to lower operating costs. See 62 F. Supp. 389. The senior bond interest continued to accumulate during this period. As the capitalization was not increased *pari passu* with the purchases, the holders of junior securities received less participation. The Commission did not consider that the earning prospect justified a greater capitalization than the one given and we think its judgment controls the valuation. As was said by the Circuit Court of Appeals in *In re Denver & R. G. W. R. Co.*, 150 F. 2d at 38:

"Neither was the Commission compelled to, nor would it be justified in adding the amount of these expenditures to the capitalized value if in the exercise of sound discretion it felt that the reasonable prospective earnings of the road, after the improvements did not justify it. However, in the face of all this, after satisfying in full the claims of the senior bondholders, the plan of reorganization should have made sure that all excess current assets, as well as all excess war profits yet to accrue, would go to the General Bondholders."

The last sentence, we think, has the vice of overlooking the reason the Commission gave common stock to the Seniors. See discussion under *Allocation of Securities*.

We note also the contention that the possibility of a national income much higher and interest rates much lower than before World War II should affect valuation based on prospective earnings. Those factors, we think, were before the Commission when it made its earnings estimate.

The Commission reached its determination of a sound capital structure for the combined properties with these figures on earnings and investments before it. In addition, of course, the Commission had complete statistical information to guide it from its Bureau of Valuation and its other sections dealing with traffic, rates, earnings, interest, et cetera. The discussion by the Commission will be found in its printed volumes listed in note 2. Proceeding upon the principle accepted in the *Western Pacific* and

Milwaukee cases,¹⁹ that capitalization based upon earnings is a permissible method of valuation in reorganization, the Commission fixed \$155,173,127 as the sound capitalization. This capitalization under the terms of the issues, with provisions for a capital fund and the sinking funds, carries annual charges at rates varying with the security of \$6,211,250 before dividends on common. See note 6. The decision was unanimous except for one Commissioner who considered the valuation too high by ten per cent. 254 I. C. C. at 379. There can be no doubt that as of June, 1943, there was ample evidence to justify the valuation made by the Commission.

Allocation of Securities. Within the framework of that valuation, the Commission allotted the available securities to the claimants. Securities, including the common stock, were given a face value. The aggregate was too small to allow anything to former stockholders.²⁰ Thus they were eliminated from the reorganization.²¹ For the holders of the General bonds, common stock was available to the amount of ten per cent only of their claim.²² A glance at the proposed distribution in note 6 will show that the claimants did not receive all the new senior securities in the strict order of their old priorities.

The value of a lien on a part of a railroad when the valuation is made from earnings cannot be fixed solely on a mileage basis. Nor is it practicable to issue new securities with a lien limited to the property that was covered by the old lien. There must be segregation of the system earnings to each existing lien and allocation of securities representing the system value to each class of claimants. This was done here as shown in the second table in note 6.²³ Such a method is in full accord with the principle that senior creditors are to retain their relative priority of position in a reorganization. *Group of Investors v. Milwaukee R. Co.*, 318 U. S. at 561-64. Furthermore, junior claims can receive nothing until the senior claims receive securities of a worth or value equal to their indebtedness. 318 U. S. at 483; 318 U. S. at 569. The Generals are definitely junior. 233 I. C. C. at 524.

The Commission did not make a finding that the cash value

¹⁹ 318 U. S. at 482 and 483; 318 U. S. at 539-541.

²⁰ *Ecker v. Western Pacific R. Corp.*, 318 U. S. at 475-76.

²¹ 233 I. C. C. 578-81.

²² 254 I. C. C. at 359.

²³ See for discussion of the formulae 233 I. C. C. at 581 *et seq.*; 254 I. C. C. at 16 and 359-76.

of the securities awarded the senior claimants as of the effective date of the plan equalled the face of the claims. It did, however, carefully state its reasons for concluding that the compensation "flowing under the plan to the various classes of bondholders for the rights surrendered by them" was adequate in the light of the full priority rule. 254 I. C. C. at 360. For those classes, other than the Junior Generals, that received common stock, the Commission said that the possibility of "unlimited dividends on common stock" was a factor in offsetting loss of position.²⁴ Thus it is clear that when the Commission made its allocations it had definitely in mind that one thing that gave the senior creditors compensation for the admission of junior claimants to participation in securities before the seniors obtained full cash payment was their chance to share in the unlimited dividends that might be earned and paid on the common stock to have a part in the "lush years." It should be noted that income applicable to dividends was at its highest in 1942 prior to the approval of the plan by the Commission in June, 1943. Therefore the abnormal earnings of 1942 were in the Commission's contemplation when it spoke of the opportunities for "unlimited dividends." Its discussion of the plan assumed that 1943 available earnings might be as large. 354 I. C. C. at 355.

The improved physical condition of the road through expenditures of the trustees for previously deferred maintenance, improvements and new equipment was before the Commission and necessarily entered into their valuation of the property. 233 I. C. C. 531.

There is another important factor, corollary to stock ownership, to be noted in the Commission's allocation of these securities. This factor is that the creditors who received common stock to make them whole obtained with that common stock an interest

²⁴ Rio Grande Western consolidated, 254 I. C. C. at 365: "Loss in earnings position and surrender of other rights, in our opinion, are offset by the possibility of increased return permitted by the 4½-percent income bonds, 5-percent convertible preferred stock, unlimited dividends on common stock, and the other features of the plan."

Denver & Rio Grande consolidated, *id.* at 364: "This apparent change in earnings position is offset by the new sinking fund and capital fund and by the increased rate of return obtainable from the new securities, i. e., slightly in excess of 4.5 percent for 64 percent of the claim and unlimited stock dividends for the remainder."

Denver & Rio Grande Western refunding and improvement, *id.* at 366: "They also will receive whatever dividends may be paid on 97,706 shares of common stock."

in all cash on hand or all cash that might be accumulated. Of course, the Commission thoroughly understood this. In fact, it referred to the ten million plus of cash on hand as of January 1, 1943. 254 I. C. C. 353. Immediately following this reference is a full discussion of the cash needs of the road for the year 1943, including additions, betterments and new equipment, and the amount which it was estimated would be in the treasury at the end of the year. That was \$15,600,000. This cash would be reflected in the value of the common stock. The petitioner states that the highest when-issued Stock Exchange price in 1945 for the common stock was \$31½, par \$100. See Commercial and Financial Chronicle, May 13, 1946, p. 2618, where the common is quoted at 29 Bid, 31 Asked. Cash, material and supplies, as well as all other assets and all liabilities of the debtor were represented by the securities. If there is more cash on hand than needed, for taxes, expenses and proper improvements, it is at the disposal of the common stockholders. If money was used to pay indebtedness, there would be a corresponding reduction in the capital structure. Therefore, the plan provided, 254 I. C. C. at 386:

"The new company shall be deemed to have come into possession of the properties as of the effective date of the plan.

" . . . The capitalization of the new company, as of January 1, 1943, after consummation of the plan . . . shall consist substantially of the following securities, excluding those to be pledged, the amounts stated being subject to reduction to the extent, if any, that matured interest proposed to be funded in the plan is paid, and as equipment obligations or other liabilities are paid or reduced"

This allocation we conclude was fair and equitable in so far as respondents are concerned. No question is raised as between themselves by the senior claimants.

Cash and War Earnings. The Circuit Court of Appeals was of the view that war earnings were of "very little value in estimating the probable future earnings of this property in the peace economy which is to come" and that the Commission was well within its right in appraising them lightly. 150 F. 2d at 34. This was after the seventeen million earnings of the top year 1942. The appellate court agreed, too, that excess current assets should not be capitalized and that improvements made during the trusteeship for reorganization had been considered by the Commis-

sion and District Court in fixing their valuation by past and prospective earnings. 150 F. 2d at 35. The appellate court then made the following ruling:

"The Senior Bondholders were paid in full. They received all the new securities and most of the common stock. Ninety per cent of the General Bondholders' claims were wiped out. They received only a small amount of common stock, ten per cent of their total claim. Adequate operating funds are essential to the operation of a railroad. The Senior Bondholders were entitled to receive in addition to the full amount of their claims, working capital sufficient for proper and efficient operation of the railroad. But anything in excess of what was reasonably necessary for this purpose constituted assets of the insolvent corporation which belonged to the remaining creditors.

"We think it is apparent from the record that there were current assets on hand consisting of cash and securities in excess of what was needed for the efficient operation of the road. As pointed out, the working capital of the debtor had increased from a deficit of \$9,727,230 as of December 31, 1935, to a surplus of \$12,125,863.50 as of December 31, 1944. While these increased net earnings are due in large part to the war and will not continue after the end of the war, and may therefore be disregarded in setting up the capitalized structure based upon prospective earnings, we cannot disregard the fact that these huge surpluses actually exist. Their existence is an accomplished fact. It is also obvious that surpluses will continue to pile up for a reasonable time yet to come. We think any plan which fails to take this into account and which gives the Senior Bondholders their claims in full by substantially delivering the road to them, and gives them the surplus cash actually on hand and further enables them to receive in addition the excess war profits which are reasonably sure to come, is inherently inequitable and unfair, so long as there are classes of creditors whose claims are not fully satisfied."

In our judgment this holding is erroneous.

The effective date of the plan was fixed by the Commission as January 1, 1943. This was in its power.²⁵ The allocation of the securities took into consideration the interest of the secured claims to that date. Any gain or any loss after that time was a benefit or an injury to the new common stockholders and then sometimes to security holders in positions senior to them. Assuming that the

²⁵ *Ecker v. Western Pacific R. Corp.*, 318 U. S. at 509.

Interest accrues on the secured claims until the effective date of the plan. *Group of Investors v. Milwaukee R. Co.*, 318 U. S. at 546. Compare *Ticonic Bank v. Sprague*, 303 U. S. 406.

courts, as courts with equity powers in a bankruptcy matter, might set aside a plan, fair and equitable when adopted by the Commission, merely on account of subsequent changes in economic conditions of the region or the nation,²⁶ it should not be done when the changes are of the kind that were envisaged and considered by the Commission in its deliberations upon or explanations of the plan.

We have pointed out in the section of this opinion dealing with the allocations of the securities that a part of the compensation to senior claimants for their loss of position was the opportunity to participate in war earnings. This was understood by the District Court²⁷ and the Commission.²⁸ Accumulations of cash beyond operating fund needs are in the same category. In dealing with the problem the Commission noted that a five percent dividend on the authorized common would require an income available for interest and dividends of \$7,969,629. The Trustee for General bonds claims no such earnings between 1929 and 1942. Even before the transportation difficulties of 1946, it was obvious that the Commission's judgment was being confirmed by events. See note 18, *supra*.²⁹

²⁶ 318 U. S. 506-509.

²⁷ 62 F. Supp. at 390:

"The \$25,000,000 or more the Trustees have expended in the Improvement Program inures to the benefit of the common stock. If the latter is worth anything it is as much due to these expenditures as to any other factor. This, with the increase in current assets and wartime earnings which counsel seem to believe are permanent, constitute the only equity behind the preferred and common stock."

²⁸ 254 I. C. C. at 356.

²⁹ Mankind's foresight is limited. The uncertainties of future estimates are recognized. It is not without interest to note, however, that on April 15, 1946, the railroads of the United States petitioned the Interstate Commerce Commission for increased freight rates and charges. This was said:

"The situation of the railroads has now become critical and their need for a substantially higher level of freight rates has become imperative. This is the result of an extraordinary combination of war and postwar conditions with which the railroads are confronted, and more particularly the result of three factors of recent development: (1) the increase in wages of railroad employees of 16 cents per hour determined under the procedures of the Railway Labor Act in April, 1946, retroactive to January 1, 1946; (2) large increases, both present and prospective, in the prices of railway materials and supplies; and (3) a sharp decline in volume of railway traffic and an even greater decline in railway revenue.

"The volume of freight and passenger traffic is falling continuously, and it is anticipated that the downward rate will accelerate in the months to come. The revenues will be reduced by reason both of the decline in volume

The error of the Circuit Court in its holding set out above lies in its assumption that the senior bondholders were paid in full by the securities allotted to them without also accepting the determination of the Commission that the assets represented as of January 1, 1943, and all subsequent earnings were a part also of the common stock that was awarded the senior bondholders.

Decreases in Senior Debt. The plan provides for securities to take the place of the Rio Grande Junction's first 5's in the face amount of \$2,758,333 and for the assumption by the reorganized road of \$5,758,000 equipment obligations. All of these securities are senior to the Generals. The Denver purchased the Junctions and paid \$1,218,000 on the Equipments. This reduced the necessary capitalization by that aggregate sum. The Circuit Court of Appeals was of the opinion that "The value behind these securities in no wise belonged to the senior bondholders, because they had been paid in full." 150 F. 2d 39. This ruling, we conclude, was erroneous for the same basic reason that we held the cash and war earnings belong to the owners of the common stock.

We called attention, *supra* page 16, to the authority granted the District Court to reduce the capitalization of the new company as interest due on January 1, 1943, or equipment obligations or other liabilities were paid. The District Court acted on this authority and in its approval of the plan said of the Junctions, "They may be canceled or they may be utilized under the plan in

and a return to a more nearly normal composition of traffic. It is estimated that the operating revenues of Class I railroads for 1946, on the basis of the present rates, fares and charges, would be approximately \$6,800,000,000, or 23.5 per cent less than they were in 1945.

"Freight and passenger traffic reached their peaks in 1944. But net railway operating income and net income began to diminish in 1943 on account of rising costs of operation. In the face of increasing traffic through 1944, both net railway operating income and net income moved steadily downward after reaching their peak in 1942. With the cessation of hostilities in 1945 there began to be a decline also in gross revenues which is expected to become more pronounced as the abnormal war conditions disappear, disabilities of highway carriers and other agencies of transportation are removed, and the prewar pattern of railway traffic is resumed."

The Denver apparently did not vary greatly from this overall picture. Its net revenue for 1945 from railway operations dropped from \$20,569,809 to \$14,246,504. Its gross operating revenue, however, increased four and a half million. The loss in net was due largely to increased amortization of defense projects.

The monthly report of revenues and expenses by the Denver for January and February of 1946 shows a decrease of operating revenues from \$10,856,764 to \$8,932,983.

acquisition of new securities which will become an asset of the reorganized company." C. C. H., Bankruptcy Law Service Decisions 1942-1945, ¶54,562 at p. 55,635. The Junction bondholders did not vote on the plan. Under our determination that the creditors who received common stock were compensated partly by the assets and future earnings, it is obvious that the use of such assets to retire senior claims is a part of the normal and expected increment from holdings of common stock. The increase of common stock by the Commission to the Generals from five to ten per cent of the bondholders' claims, preliminary to the adoption of the plan, 254 I. C. C. at 352, 359, is partly attributable to a reduction of necessary capitalization. This increase in junior participation differs from that now proposed. The former reduction of senior capitalization could be carried out because earnings prior to the adoption of the plan made it unnecessary to borrow money for reorganization. When proposed capitalization is being planned on earnings, a reduction of senior capital without reduction of estimated earnings increases possible junior capital within the scheme. When the reduction of senior capital takes place after the adoption of the plan by use of anticipated earnings or existing cash, there can be no such readjustment of junior participation because assets in the balance sheet at the adoption of the plan and subsequent earnings are, as we have pointed out, for the benefit of the stockholders in the new company so that through these common stock advantages these new stockholders may be compensated for their loss of payment in full in cash. Of course, this section of the opinion is written and must be read on the assumption that the allocations of common stock are fair and equitable, a matter discussed *supra*.

Utah Fuel Company Stock. The Rio Grande Western Railroad Co. in 1899 executed its First Consolidated Mortgage, an indenture to secure its issue of First Consolidated Bonds, maturing April 1, 1949. Rio Grande Western reserved the right to issue additional bonds under the indenture.

The Utah Fuel Company was organized in 1900, with a capitalization of 100,000 shares. In 1901 an agreement was entered into by Rio Grande Western, the trustee under the First Consolidated Mortgage, and the owner of the Utah Fuel stock. The contract

provided that the stock would be held by the trustee to secure bonds issued under the First Consolidated Mortgage and that Rio Grande Western would have the right at any time on paying the trustee \$6,000,000 in cash or delivering an equal face amount in First Consolidated bonds to receive the Utah Fuel stock, free of the mortgage lien. Subject to the lien, the stock was transferred to Rio Grande Western. \$6,000,000 in additional First Consolidateds were issued to the owner of the stock.

In 1908, the Denver & Rio Grande Railroad Company was organized and acquired the property of Rio Grande Western, assuming the obligation of its First Consolidated Mortgage bonds of 1899. The equity of redemption of Denver & Rio Grande Railroad Company in the Utah Fuel stock was sold in 1918 under execution and transferred to the Western Pacific Railroad Corporation.

In 1924 under an agreement among the Denver & Rio Grande Western Railroad Company, the Western Pacific Railroad Corporation, Missouri Pacific Railroad Company, and T. S. Alexander, who by the agreement became trustee of the equity of redemption in the Utah Fuel stock, Western Pacific transferred to T. S. Alexander, Trustee, subject to the pledge under the Consolidated Mortgage its Utah Fuel stock and the debtor transferred to said trustee whatever interest it had in the stock, through certain releases, not here important.

The agreement first provided that the ultimate beneficial interest in the Utah Fuel stock so held was vested one-half in Missouri Pacific and one-half in Western Pacific. Except for certain contingencies not here important, it was provided that the trustee under the 1924 agreement would pay all dividends received by him from the trustee under the Consolidated Mortgage on Utah Fuel stock to the debtor so long as any of the General or Refunding bonds were outstanding.

The agreement further provided that if the General Mortgage or the Refunding or other mortgage of the debtor were foreclosed, the trustee would sell their interest in the Utah Fuel stock subject to the Consolidated Mortgage, if outstanding, and apply the proceeds to the payment of the bonds secured by the equity of redemption in the stock dividing any surplus between Western Pacific and Missouri Pacific.

The General Mortgage and Refunding bonds created in the 1924 reorganization were thus given a lien on the Utah Fuel

stock, junior to the lien of the Denver & Rio Grande First Consolidated Mortgage.

Under the plan approved by the Commission and the District Court, the First Consolidated bonds were allotted 20% of their claim in new income bonds, 73% in preferred stock, and 7% in common stock. The plan further provided, 254 I. C. C. at 398-99, that:

"The trustee under the Rio Grande Western Railway Company consolidated mortgage shall be permitted to obtain the release of the equities in the stock of the Utah Fuel Company and distribute the stock among the holders of the aforesaid bonds in any manner agreeable to them, or to enforce its rights as pledgee of the stock of the Utah Fuel Company, the proceeds recovered to be distributed to the holders of the bonds."

The Commission took the position that this and the other features of the treatment of the First Consolidated bonds were justified as compensation for "loss of earnings position and surrender of their rights"³⁰ under the plan.

The Commission made no definite finding with respect to the value of the Fuel Company stock. The Commission had before it evidence through 1936 with respect to the value of the stock as well as an appraisal of the value of the Fuel Company made for the trustee of the First Consolidated Mortgage, which indicated a value of \$4,653,720. The only dividend paid to the debtor by Utah Fuel under the 1924 agreement was in 1934 and amounted to \$250,000; the debtor in applying its formula for allocation of earnings by mortgage districts credited the Consolidated Mortgage with an income of \$83,333 per annum based on that dividend payment allocated over the three-year period, 1932 to 1934. The status of the stock was considered by the Commission in its original report and its several supplemental reports, and its proposals with respect to the stock remained unchanged.

In proceedings before the District Court in 1943 on objections to the plan, it was revealed that the Fuel Company's net income for 1942 was \$415,000 and for the first seven months of 1943, \$535,869.³¹ The company has no funded debt.

³⁰ See note 24.

³¹ According to Moody's Manual [Resp. br. 29, note] the net income of the Fuel Company for 1943 was \$865,140, 1944 \$653,901, and earned surplus at the end of the latter year \$4,862,980.

Before the Circuit Court the respondents contended that the holders of the First Consolidated bonds should be compelled either to foreclose this collateral, applying the proceeds to their claim, or credit their claim with the value of the collateral and be allowed new securities only for the balance. The Circuit Court disapproved the treatment of the General bondholders with respect to the Fuel Company stock pointing to the fact that the Commission had permitted "doubts and uncertainties" to remain with respect to the value of the collateral, and that there was a danger that if the collateral had substantial value, the First Consolidated bondholders might receive more than full payment.

The facts set out above fully support the conclusion of the Commission that the "title to the stock is vested in the Missouri Pacific and Western Pacific." Whatever rights the debtor may have retained after the sale of the stock on execution in 1918 were released to the trustee and the two railroads in 1924. We have then a situation in which the holders of the ultimate beneficial interest in stock which had been pledged previously under a mortgage have permitted that interest to be encumbered by a third person, namely the debtor, as security for its General and Refunding bonds. The rule is settled in bankruptcy proceedings that a creditor secured by the property of others need not deduct the value of that collateral or its proceeds in proving his debt. *Ivanhoe Bldg. & Loan Asso. v. Orr*, 295 U. S. 243. We see no reason why the same should not be true under § 77. See *New York Trust Co. v. Palmer*, 101 F. 2d 1, 3. Therefore the First Consolidated Mortgage bonds were properly permitted to prove the full amount of their debt.

Respondents, speaking only for the General bondholders, object that the plan gives the First Consolidated bondholders all the Utah Fuel stock or its proceeds in addition to securities the face value of which amounts to one hundred per cent of their claims. The Refunding bondholders make no objection. It is thus contended that the plan deprives them of their junior interest in the stock without a determination of the value of that stock, or a finding of the extent to which the Consolidated bondholders have been paid by the new securities to be given them. We do not so read the plan. The plan provides merely that the trustee of the Consolidated Mortgage "shall be permitted to obtain the release of the

equities in the stock of the Utah Fuel Company" and distribute the stock or its proceeds to the holders of the bonds. This statement contains at least two requirements to be met before the Consolidated bonds obtain anything from the collateral. The first is that the trustee of the First Consolidated Mortgage be in existence. Even after the plan goes into operation and the old securities are surrendered for cancellation there is no requirement that the trusts terminate since they will continue to hold property other than that of the debtor. Section 77(f), which deals with the effect of a confirmation and the discharge of the debtor from liability, does not so require. Hence whatever action the trustee of the Consolidated takes may be commenced prior to or after the consummation of the plan. This will permit the respondent, trustee under the General Mortgage, which would continue in existence for the purpose, to take the necessary steps to safeguard its rights in the collateral on behalf of the Generals.³²

The second requirement, which is explicit in the plan, is that the trustee obtain the release of the equities in the stock. The junior lienors have an absolute right under the terms of the 1901 pledge and the 1924 agreement to all the proceeds of the stock over \$6,000,000 and a right also to any part of the proceeds not needed to make the First Consolidated bonds whole. The trustee of the Consolidated concedes in its brief here that enforcement of the pledge "can be brought about only through judicial proceedings." It correctly points out that in such proceedings full protection can be given to all those who have any junior interest in the stock. Respondents' fear that the General bondholders and the mortgage trustees for the junior interests will not be in existence and so unable to protect themselves has been above demonstrated to be without foundation in fact.

The result is that this feature of the plan did not in any way change or affect existing rights in the collateral. The respondents may show in the judicial proceedings which must be brought by the trustee of the First Consolidated Mortgage that the First Consolidated bonds have been fully paid by the securities awarded them under the plan, if such be the fact, or the respondent, trustee of the General, may itself bring a proceeding against the

³² Obviously, the Fuel stock or its proceeds could be distributed to record holders of the old securities as of the date or dates of distribution of the new securities.

- omission

trustee of the First Consolidated mortgage for a determination of the rights of the Generals. Petitioners concede, as they must, that they are not entitled to more than full payment and that they are under a duty to account to the respondents for any surplus remaining after they have been made whole.³³

The treatment of the Utah Fuel stock in the plan is consistent with the Commission's disposition of certain collateral pledged with the Reconstruction Finance Corporation and the Railroad Credit Corporation by parties other than the debtor to secure notes of the debtor in the *Western Pacific* case. *Western Pac. R. Co. Reorganization*, 233 I. C. C. 409, 432. The Commission permitted the pledges to retain the collateral and this Court approved that action, saying, "This collateral, other than the refunding bonds, was therefore left with the pledgees with its position unaffected by any direct action of the Commission." *Ecker v. Western Pacific R. Corp.*, *supra*, at 506.

Reasonableness of Rejection. As the conclusions of the Circuit Court of Appeals upon the allocation of securities, the treatment by the Commission of cash, war earnings, and decrease in debt with priority over the Generals differed from those made by this Court, that court's conclusion that the General bondholders were reasonably justified in rejecting the plan followed naturally. 150 F. 2d 40. Section (e) gives power to a class, here the General bondholders, to reject the plan subject to the power of the District Court, after certification of the result of the submission, to "confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e)." 11 U. S. C.

³³ There is a certain illogic in the position of First Consolidated bonds in asserting any rights in the collateral at all. If, as they concede and we now hold, they are entitled to be paid in full in new securities without regard to the collateral, it may be that they have been fully paid by the new securities given them since they do not complain of their treatment under the plan. Since they are entitled only to full payment it would then seem to follow that they have no rights against the collateral. We should not be taken as deciding this question, however, since we leave it to an independent suit in which there is jurisdiction over the proper parties.

§ 205; see note 9, *supra*.³⁴ The plan was confirmed after appropriate findings. 63 F. Supp. at 390.

This provision for confirmation of a plan despite rejection by a class appeared in the draft for the 1935 amendments. Apparently it caused no particular comment.³⁵ We think that the provisions for confirmation by the courts over the creditors' objection are within the bankruptcy powers of Congress. Those powers are adequate to eliminate claims by administrative valuations with judicial review and they are adequate to require creditors to acquiesce in a fair adjustment of their claims, so long as the creditor gets all the value of his lien and his share of any free assets.³⁶

The grounds accepted by us in former sections of this opinion as sustaining, as of January 1, 1943, the valuation of the road, the allocation of the securities, and the treatment of cash, war earnings and capital reductions establish that for the act of confirmation on November 19, 1944, over the objection of the General bondholders, the finding of the judge that the plan then made "adequate provision for fair and equitable treatment" of the dissenters was justified. 62 F. Supp. at 390. In view of the District judge's familiarity with the reorganization, this finding has

³⁴ Clauses (2) to (3) are not involved. They relate to expenses, fees and costs.

³⁵ H. Rep. No. 1283, 74th Cong., 1st Sess., p. 18. S. Rep. No. 1336, 74th Cong., 1st Sess., p. 3, contains the following statement: "Further, the consent of two-thirds of each class of stockholders must be acquired, unless, by an elaborate valuation proceeding, it is proved that the value of the property is so low that the stock has no interest. This is an effective obstruction. . . .

"In order to remedy these defects, S. 1634, as amended, provides that two-thirds of those of each class who vote upon a plan will bind the dissenters or those failing to vote. But it also provides that the court may make effective a fair plan where the parties do not agree. . . . If two-thirds of each class consent, the plan will bind the remainder of each class. But the judge may make the plan effective, even if not so accepted, if he finds that it conforms to the requirements just stated, provides fair and equitable treatment for the interests of those rejecting it, and that their rejection is not reasonably justified in the light of the respective rights and interests. These provisions give complete due process of law from a procedural standpoint, there being provision for full hearings both before the commission and the court. Within the broad powers of Congress under the bankruptcy clause as recently declared by the Supreme Court in *Continental Illinois Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co.* (55 Sup. Ct. Rep. 595), the provisions also afford due process of law in fully protecting the property rights which are involved."

See also Hearings, House Judiciary Committee, 74th Cong., 1st Sess., on H. R. 6249, Serial 3, pp. 16 and 22.

³⁶ *Wright v. Union Central Ins. Co.*, 311 U. S. at 278, and discussion at pp. 8 and 9, *supra*.

especial weight with us. See Rule 52 F. R. C. P. There is no doubt that the plan then conformed to subsection (b) and the other requirements of the first paragraph of subsection (e). Note 9 *supra*.

This leaves for consideration the question of whether, the plan being fair and equitable as of June, 1943, effective January 1, 1943, the Generals were reasonably justified in rejecting the plan by ballots cast between April 26 and July 15, 1944.

As we have pointed out under *Allocation of Securities, supra*, the Commission's plan was adopted after 1942, the year of greatest profit and with anticipation on the part of the Commission that there might be other "big" years but with realization that the war profits were not a sound basis for higher valuation. Current reports of earnings were a part of the record. Nothing that respondents have called to our attention indicates any improvement in economic conditions or prospects in July, 1944, or any date since, over June, 1943, the date of the Commission's approval of the plan, which would justify a treatment different from that accorded the claimants in 1943.³⁷ The challenge to the reasonableness or the unreasonableness of the rejection of the plan is not based on any change of conditions since its approval by the District Court October 23, 1943. Under subsection (e), note 9 *supra*, the judge automatically confirms a plan after a vote of classes of creditors if satisfied that two-thirds of each class have accepted. If there is a rejection, there is a reexamination of the plan to assure that those who dissent have had fair and equitable treatment. Apparently the reexamination for this treatment does not differ from that for the original court approval under the first paragraph of subsection (e). It does, however, center upon the rights of those who rejected the plan.

A rejection would not be reasonably justified unless the dissenters had a valid reason for their vote. As is shown by Judge Symes' discussion of their objections to confirmation,³⁸ their reasons were the payment of the senior obligations with consequent claimed release of capitalization for junior securities and the inadequate valuation, particularly in view of the large additions to plants from earnings. We think that we have demon-

³⁷ Cf. *I. C. C. v. Jersey City*, 322 U. S. 503, 515.

³⁸ 62 F. Supp. 384.

strated that there was an adequate basis for the valuation, see page 10 *et seq.*, and that the decreases in senior debt were not for the account of the junior creditors. See pp. 19-20, *supra*. Respondents offer no other ground for their votes in rejection.

Congress with its purpose to stop the blockade of sound reorganization by classes of creditors with the veto power of the 1933 statute, note 35, *supra*, certainly did not intend to leave a class with the same power of interference because in its reasonable judgment that class thought the valuation was erroneous or the senior creditors were paid in full by the face value of securities. If a plan gives fair and equitable treatment to dissenters, the elements which make the plan fair and equitable cannot be the basis for a reasonably justified rejection. If only those elements are relied upon, as here, the rejection is not reasonably justified.

Of course, this does not mean that if a plan is approved as fair and equitable by the Commission and court, there cannot be a reasonable justification for its rejection by a class of claimants on submission. Reasons to make their rejection reasonable may arise thereafter. For example, unanticipated, large earnings might develop. We see no reasonable justification here for the action of the General bondholders.

In conclusion, we shall add that the foregoing opinion has been written without heavy reliance upon the duty of the Commission to plan reorganizations with an eye to the public interest as well as the private welfare of creditors and stockholders.³⁹ The Commission had this duty in mind. Our failure to comment more upon that feature of the plan should not be interpreted as an intimation upon our part that it is not important. These respondents cannot be called upon to sacrifice their property so that a depression-proof railroad system might be created. But they invested their capital in a public utility that does owe an obligation to the public. The Insurance Group Committee, with fiduciary responsibility to the myriad holders of policies, and the other investors or speculators in senior bonds as well as the holders of General bonds or other investors or speculators in junior security issues, by their entry into a railroad enterprise assumed the risk that in any depression or any reorganization the interests of the

³⁹ § 77(d), note 9 *supra*. 318 U. S. at 473; 318 U. S. at 544.

public would be considered as well as theirs. That public interest in an efficient transportation system justifies the Commission's requirements for reasonable maintenance and improvement of the properties and for a capitalization with fair prospects for dividends on all classes of securities.⁴⁰

The judgment of the Circuit Court of Appeals is reversed and the orders of the District Court of October 25, 1943, approving the plan, and of November 29, 1944, confirming the plan, are affirmed.

The cause is remanded to the District Court for further proceedings.

It is so ordered.

Mr. Justice JACKSON took no part in the consideration or decision of these cases.

⁴⁰ See concurrence of Commissioner Eastman, Western Pac. R. Co. Reorganization, 233 I. C. C. at 437.

SUPREME COURT OF THE UNITED STATES.

Nos. 278, 279, 280, 281 and 282.—OCTOBER TERM, 1945.

Reconstruction Finance Corporation;
Insurance Group Committee; Guar-
anty Trust Company of New York,
Trustee, Rio Grande Western Rail-
road Company Consolidated Mort-
gage; Central Hanover Bank and
Trust Company, Trustee, Rio Grande
Western Railroad Company First
Trust Mortgage; United States Trust
Company of New York, Trustee,
Denver and Rio Grande Railroad
Company Consolidated Mortgage; and
The Chase National Bank of the City
of New York, Trustee, Denver and
Rio Grande Western Railroad Com-
pany Refunding and Improvement
Mortgage, Petitioners,

278 *vs.*
The Denver and Rio Grande Western
Railroad Company, et al.

Same,
279 *vs.*
The Denver and Salt Lake Western
Railroad Company, et al.

Same,
280 *vs.*
City Bank Farmers Trust Company,
Trustee Under the Debtor's General
Mortgage.

Same,
281 *vs.*
The Denver and Rio Grande Western
Railroad Company, et al.

Same,
282 *vs.*
Guy A. Thompson, Trustee, Missouri
Pacific Railroad Company, Debtor.

On Writs of Certiorari
to the United States
Circuit Court of Ap-
peals for the Tenth
Circuit.

[]

Mr. Justice REED delivered the opinion of the Court.

The petitioners in these five cases are the owners of claims against the debtor, Denver & Rio Grande Western Railroad Company, or against a secondary debtor, the Denver & Salt Lake

Western Railroad Company. The respondents are the two debtors just named, hereinafter sometimes referred to as the Denver, and the Trustee of the Missouri Pacific Railroad Company, a large owner of common stock of the principal debtor.

The debtors sought reorganization in the District Court of the United States for the District of Colorado under Section 77 of the Bankruptcy Act,¹ on November 1, 1935. The Interstate Commerce Commission approved the plan of reorganization under consideration in this review on June 14, 1943.² The District Court approved the plan October 25, 1943.³ It was then submitted by the Commission to the creditors of the classes deemed entitled to vote for acceptance or rejection of the plan and a certificate of the result filed in the District Court on July 15, 1944. All classes of voting creditors approved the plan as required by Section 77 except the holders of the Denver's general mortgage bonds.⁴ On November 1, the District Court held the rejection of the plan by the holders of the general mortgage was not reasonably justified⁵ and thereafter confirmed the plan on November 29, 1944. Section 77(e).

The plan provided for a reorganization as of January 1, 1943, by the Denver by adjustment of its assets to its liabilities with or without a consolidation with the Salt Lake and the Salt Lake Western to form a system. As no ruling that we are asked or required to make turns upon whether the reorganization is with or without the suggested consolidation, we need not give further consideration to possible differences. In either case, creditors with secured claims against the reorganized roads or against their property were left undisturbed or allocated new securities of the new company, consisting of first mortgage and income bonds, preferred and common stock, in lots, in face amount of the secured claims except for the general mortgage issue, that the

¹ 11 U. S. C. § 205.

² The plan is printed in *Denver & R. G. W. R. Co. Reorganization*, 254 I. C. C. 349. See for former decisions of the Commission in this reorganization, 233 I. C. C. 515; 239 I. C. C. 583; 254 I. C. C. 5.

³ C. C. H. Bankruptcy Law Service ¶ 54,562.

⁴ The Denver & Rio Grande Western Railroad Company is referred to herein as the debtor or the Denver; The Denver & Salt Lake Western Railroad Company as Salt Lake Western; The Denver & Salt Lake Railway Company as the Salt Lake; The Rio Grande Junction Railway Company as the Junction.

⁵ In *Re Denver & R. G. W. R. Co.*, 62 F. Supp. 384.

Commission and District Court determined, through adoption of the plan, were fair and equitable in the light of the respective priorities, liens and collateral of the various secured claims. All of the securities were given a par value. Interest partly fixed and interest partly contingent on earnings was used to gain play in annual charges. The plan eliminated unsecured claims and allocated common stock in face amount of ten per cent of their claim to general mortgage bonds of the debtor. It was determined that the aggregate of the securities in the plan represented the value of the properties for reorganization purposes and that through prospective earnings there was adequate coverage for the charges.⁶

⁶ 254 I. C. C. at 354 to 357.

Full details appear in the plan, note 2, *supra*, as well as explanation of certain items in the following tables. The tables are printed to give the reader a convenient summary of the plan. 254 I. C. C. 382-83.

CAPITALIZATION AND ANNUAL CHARGES.

	On basis of consoli- dation with Denver & Salt Lake		Denver & Rio Grande Western without Denver & Salt Lake	
	Principal	Annual Charges	Principal	Annual Charges
Equipment-trust obligations....	\$5,758,000	\$139,989	\$5,758,000	\$139,989
Chase National Bank note.....	2,158,458	45,722	2,158,458	45,722
R. F. C. claim.....	.....	.....	13,900,605	556,024
Denver & Salt Lake first-mort- gage bonds, 4 percent interest	1,500,000	60,000	.....	.....
Denver & Salt Lake income bonds, 3-1 percent interest..	9,734,000	292,020	.....	.....
	19,150,458	537,731	21,817,063	741,735
New first-mortgage bonds, 3-1 percent interest	38,573,680	1,157,210	33,373,680	1,001,210
Total fixed interest.....	57,724,138	1,694,941	55,190,743	1,742,945
Capital fund, maximum pay- ment .....	.....	750,000	.....	750,000
Prior contingent interest, 1 per- cent .....	.....	498,318	.....	348,978
Sinking fund for first-mortgage bonds, one-half of 1 percent	.....	200,489	.....	182,323
		3,143,748		3,024,246
New income bonds, 4½ percent	29,750,184	1,364,133	21,049,579	972,606
Sinking fund for income bonds, one-fourth of 1 percent....	.....	76,808	.....	58,527
Total debt, interest, payments to funds	87,474,322	4,584,689	76,240,322	4,055,379
New 5-percent preferred stock, par value \$100	32,531,220	1,626,561	32,120,120	1,606,006
New common stock, par value \$100	35,167,585	.....	35,167,585	.....
Total capitalization	155,173,127	.....	143,528,027	.....

Respondents sought review in separate appeals from the order of approval or the order of confirmation or both to the Circuit Court of Appeals for the Tenth Circuit. That court reversed the District Court on all appeals and remanded the reorganization proceedings to the Interstate Commerce Commission for further consideration with the statement, 150 F. 2d at 40,

"Nothing in the opinion shall prejudice or foreclose the rights of the parties to propose a new plan or reorganization or the power of the Commission to formulate, approve, and certify a new plan of reorganization in the light of any relevant facts presented to the Commission in any proceeding under 11 U. S. C. Sec. 205(d)."

DISTRIBUTION OF NEW SECURITIES PER \$1,000 OF PRESENT BONDS WITH ACCRUED INTEREST.

	<i>First- mortgage bonds</i>	<i>Income bonds</i>	<i>Pre- ferred stock</i>	<i>Common stock</i>
Rio Grande Western first trusts (\$15,190,000)	\$970.20	\$349.80	.....	.....
Rio Grande Western consolidated's (\$15,080,000) .....	.....	266.00	\$970.90	\$93.10
Junction firsts (\$2,000,000)	1,061.96	317.21	.....	.....
Denver & Rio Grande consolidated 4's (\$34,125,000)	318.92	217.08	321.60	482.40
Denver & Rio Grande consolidated 4½'s (\$6,382,000)	329.03	223.97	331.80	497.70
Refunding and improvement 5's (\$12,000,000)	250.01	159.61	310.75	692.13
Refunding and improvement 6's (\$2,000,000)	264.61	168.94	328.90	732.55
General 5's (\$29,808,000) .....	.....	.....	.....	146.10

CLAIMS.

	<i>Claims as of Jan. 1, 1943</i>	<i>Undisturbed or extended</i>
Equipment obligations	\$5,758,000	\$5,758,000
Rio Grande Western first-trust 4's	20,050,800	.....
Rio Grande Western consolidated 4's	20,056,400	.....
Rio Grande Junction first 5's	2,758,333	.....
Denver & Rio Grande consolidated 4's	45,727,500	.....
Denver & Rio Grande consolidated 4½'s	8,823,115	.....
Refunding and improvement 5's	16,950,000	.....
Refunding and improvement 6's	2,990,000	.....
General-mortgage 5's	43,548,155	.....
Chase National Bank note	2,158,458	2,158,458
R. R. Credit Corporation note; paid May 17, 1943 .....	.....	.....
R. F. C. notes	13,900,605	.....
Unsecured claims, approximate	440,000	no equity
Total, Denver & Rio Grande Western....	183,161,366	7,916,458

By this remand, the Commission was empowered to proceed anew to consideration of the reorganization in all its phases, § 77(e), including those steps previously taken and approved by the opinion of the Court of Appeals.

That court approved the valuation of the debtor reached mainly by the use of present and prospective earnings. It held that the valuation adopted need not reflect necessarily the money spent for improvements during the trusteeship for reorganization. 150 F. 2d 34, 35. No argument is made against the soundness of these conclusions which are fully supported by the *Western Pacific* and *Milwaukee* cases.⁷ The Circuit Court further held that the Commission was justified in refusing to reopen the hearings just before the entry of its order of June 14, 1943, approving the plan, to hear evidence of the then existing economic conditions and the 1943 earnings of the debtor.⁸

The reversal came from the Circuit Court's holding, contrary to the Commission and the District Court, that free cash in excess of operating capital needs and unexpectedly large earnings from war business after the date of the plan should be for the benefit of the general bondholders. 150 F. 2d 35-38. That court further held that decreases in debt by cash payments, with the consequent reduction of securities that were required to be issued under the plan to cover such debt claims, should inure to the benefit of the same general bondholders. 150 F. 2d 38-39. The Circuit Court disagreed also with the treatment of certain collateral deposited behind the first consolidated mortgage of the Rio Grande Western Railway Company and secondarily behind the generals of the debtor. This is the Utah Fuel stock issue hereinafter discussed. These differences from the conclusions of the District Court led the Circuit Court to hold that the general bondholders were "reasonably justified" in rejecting the plan and that the District Court was without authority to confirm the plan over their veto. § 77(e).

Petitioners sought a writ of certiorari to reverse these rulings of the Circuit Court and, on account of the importance of the issues in the administration of railroad reorganization under Section 77, we granted their petition. — U. S. —.

⁷ *Ecker v. Western Pac. R. Co.*, 318 U. S. 448, 477-83; *Group of Investors v. Milwaukee R. Co.*, 318 U. S. 523, 539-41.

⁸ See 318 U. S. at 543.

The briefs of all the parties here restate the questions presented in the petition for certiorari according to the emphasis the particular party places upon points of controversy. After a general consideration of the background of the plan, we shall give attention to each of the just stated disagreements between the district and appellate court. This will cover the points under review.

The basic problems of railroad reorganization under Section 77 of the Bankruptcy Act have been so recently considered by this Court in the *Western Pacific* and *Milwaukee* cases that only a summary reference to their conclusions here pertinent need be made now. No new enactments have changed the law since those decisions on March 15, 1943. The complexities of the reorganization of a railroad with responsibility to the public and obligations to its security holders was recognized. The impossibility without destruction of efficiency and values of reversing the process of integration to restore the parts that now make up the whole of a system of their original operational function was understood. The various bond issues with different and often overlapping liens, with competing claims for allocation of earnings pending reorganization, presented hard problems for legislative solution. A fair, administratively practical and lasting method was sought. By provisions for adjustment of creditors' claims, Congress intended to avoid the delays, costs and sacrifices of liquidation.⁹ The agencies employed by Congress to accom-

⁹ Applicable provisions of § 77, 11 U. S. C. § 205, are as follows

"(b) A plan of reorganization within the meaning of this section generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, and rent for leased railroads) in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; . . .

"(d) The debtor, after a petition is filed as provided in subsection (a) of this section, shall file a plan of reorganization within six months of the entry of the order by the judge approving the petition as properly filed,

plish reorganizations under Section 77 were the Interstate Commerce Commission and the courts. The answer reached by Congress was that the experience and judgment of the Commission must be relied upon for final determinations of value and of matters affecting the public interest, subject to judicial review to assure compliance with Constitutional and statutory requirements. This was the interpretation of all members of this Court from the language of the act and the evidence of Congressional

... After the filing of such a plan, the Commission, unless such plan shall be considered by it to be prima facie impracticable, shall, after due notice to all stockholders and creditors given in such manner as it shall determine, hold public hearings, at which opportunity shall be given to any interested party to be heard, and following which the Commission shall render a report and order in which it shall approve a plan, which may be different from any which has been proposed, that will in its opinion meet with the requirements of subsections (b) and (c) of this section, and will be compatible with the public interest; or it shall render a report and order in which it shall refuse to approve any plan. In such report the Commission shall state fully the reasons for its conclusions.

“(e) Upon the certification of a plan by the Commission to the court, the court shall give due notice to all parties in interest of the time within which such parties may file with the court their objections to such plan, and such parties shall file, within such time as may be fixed in said notice, detailed and specific objections in writing to the plan and their claims for equitable treatment. The judge shall, after notice in such manner as he may determine to the debtor, its trustee or trustees, stockholders, creditors, and the Commission, hear all parties in interest in support of, and in opposition to, such objections to the plan and such claims for equitable treatment. After such hearing, and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; . . .

“ . . . If the judge shall approve the plan, he shall file an opinion, stating his conclusions and the reasons therefor, and enter an order to that effect, and shall send a certified copy of such opinion and order to the Commission. The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirements of subsection (c) of this section, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such time as the Commission shall specify, together with the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided*, That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that at the time of the finding the corporation is insolvent, or that at the time of the finding the equity of such class of stockholders has no value, or that the plan provides for the payment in cash to such class of stockholders of an amount not less than the value of their equity, if any, . . . *Provided further*, That submission to any class of creditors shall not be necessary if the Commission shall have found, and

purpose in the hearings, reports and discussion.¹⁰ To the courts, Congress confided the power to review the plan to determine whether the Commission has followed the statutory mandates of subsection (e), 318 U. S. at 477, and whether the Commission had material evidence to support its conclusions. 318 U. S. at 477; concurring opinion at 512.

At this point, we restate our conclusion reached in the former cases that the Congressional authority to the Commission to eliminate valueless claims from participation in reorganization is a valid exercise of the federal bankruptcy power. Section 77 was directed at the relief of debtor railroads. Sec. 73, 47 Stat. 1467. Liquidation in depression periods meant that large portions of debts, as well as stock interests in the properties would be irretrievably lost to their holders while reorganization on a capitalization that estimated normal income would support meant the salvage of sound values. We see no more constitutional impedi-

the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by the plan, or that at the time of the finding the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests. . . . The Commission shall certify to the judge the results of such submission.

"Upon receipt of such certification, the judge shall confirm the plan if satisfied that it has been accepted by or on behalf of creditors of each class to which submission is required under this subsection holding more than two-thirds in amount of the total of the allowed claims of such class which have been reported in said submission as voting on said plan, and by or on behalf of stockholders of each class to which submission is required under this subsection holding more than two-thirds of the stock of such class which has been reported in said submission as voting on said plan; and that such acceptances have not been made or procured by any means forbidden by law; *Provided*, That, if the plan has not been so accepted by the creditors and stockholders, the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e); . . .

"If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts."

¹⁰ 318 U. S. at 472, 473, 477; concurring opinion at 512; 318 U. S. at 545.

ment to the elimination of claims against railroad debtors by the Interstate Commerce Commission's determination of values with judicial review as to the sufficiency of the evidence and compliance with statutory standards than we do to their elimination by an accepted bid in a depression market.¹¹ There is no occasion here to reexamine further these recent holdings of this Court in the *Western Pacific* and *Milwaukee* reorganizations.

In examining the contentions of petitioners as to the alleged errors of the Circuit Court of Appeals, we must approach the problems in accordance with our reviewing authority under Section 77. That section embodies the method that Congress selected in 1933¹² and improved in 1935¹³ to put the railroad transportation system of the country in order to meet its debts and perform its duties to the public after the hard years of the recent depression. Our constructions of the chief provisions of the section were handed down in March, 1943. Although the results of reorganizations under the section, as thus construed, have been criticized as unfortunate and changes have been suggested, no different legislation has been enacted.¹⁴ Indeed a different method for reorganization, enacted in 1939 and designed to meet the requirements of railroads not in need of financial reorganization

¹¹ 318 U. S. at 475-76; 318 U. S. at 536-39.

Compare *Wright v. Union Central Ins. Co.*, 311 U. S. 273, 279; *John Hancock Ins. Co. v. Bartels*, 308 U. S. 180, 186.

¹² 47 Stat. 1474.

¹³ 49 Stat. 911. H. Rep. No. 1283, 74th Cong., 1st Sess., p. 1; S. Rep. No. 1336, 74th Cong., 1st Sess., p. 1; Craven & Fuller, *Amendments of Railroad Bankruptcy Law*, 49 Harv. L. Rev. 1254. See *Ecker v. Western Pacific R. Co.*, 318 U. S. at 470, *et seq.*

¹⁴ H. R. 5924, 79th Cong., 2d Sess.; Hearings on H. R. 4779, 79th Cong., 1st Sess., Serial No. 13; H. Rep. No. 1838, 79th Cong., 2d Sess., p. 3:

"Although all these laws were intended by Congress for the preservation of our railroads and their ownership, the theory has appeared to prevail that the capitalization of companies in section 77 proceedings should in all cases be drastically reduced. That is what has been done consistently and persistently. Under the past administration of section 77, as that statute was interpreted and applied by the Interstate Commerce Commission and affirmed by the Supreme Court, countless thousands of small stockholders already have been wiped out, and their investments, which would now be of great value, were uselessly destroyed. There are many more thousands upon thousands of such stockholders whose investments are imminently threatened with a like fate, unless Congress promptly enacts legislation to prevent such needless loss. And that loss—aggregating over \$2,000,000,000—would be suffered largely by a widely scattered class of citizens (many thousands of whom are employees of these very railroads) who invested their legacies or their savings in one of America's greatest private enterprises, for education of their children, the purchase of homes, or security in old age. It literally may be

of the character provided by Section 77 but only of an opportunity for voluntary adjustments with their creditors, was allowed to lapse on November 1, 1945.¹⁵ This situation leaves clear the duty of the agencies of the Government entrusted with the handling of reorganizations under Section 77, including this Court, to administer its provisions according to their best understanding of the purposes of Congress as expressed in the words of Section 77 read in the light of the contemporaneous discussion in Congress. Changes in economic conditions cannot effect the powers of the reorganization agencies even though they may require a reexamination into the present fairness of the former exercise of those powers.

The Denver and Rio Grande Western, the principal debtor, is an important link in transcontinental transportation.¹⁶ The re-

said that these stocks were the favorite investments of widows and orphans and of trustees."

S. Res. 192, 79th Cong., 1st Sess.; S. Rep. No. 925, 79th Cong., 2d Sess.; S. 1253, 79th Cong., 2d Sess.; Hearings on S. 1253, 79th Cong., 1st Sess.; Voluntary Modification of Railroad Financial Structures; Hearings on S. 1253, 79th Cong., 2d Sess., Modification of Railroad Financial Structures, Part 2; S. Rep. No. 1170, 79th Cong., 2d Sess., pp. 1-2:

"The bill (S. 1253) enables railroad companies to adjust their financial affairs quickly, economically, and on a business basis. The procedure it provides will reduce any disturbance of their affairs to a minimum, and will provide the maximum of protection for both the railroads and their investors.

"The existing law, section 77, was enacted in 1933, without hearings and without consideration of any subcommittee or committee of the Senate. It was enacted in the belief that it would help railroads to correct their financial affairs. It was found to do the opposite. It has placed in the hands of Government officials extraordinary power, which they had not requested, over 25 percent of the country's railroad mileage—a power which they have exercised:

- (1) to demolish every part of the financial and corporate structures of those railroads;
- (2) to plan in every respect the financial and corporate future of those railroads;
- (3) to pick men to control those railroads; and
- (4) to decree the forfeiture of \$2½ billion of investments.

"The present bill put an end to every one of those powers and restores the operation of railroads to their managements and the adjustment of their finances to the companies themselves, with the assistance of their security-holders, where necessary."

See A Critical Analysis of Recent Reorganization Decisions of the Supreme Court of the United States, F. C. Nicodemus, Jr., Hearings on H. R. 4779, subsequently H. R. 5924, 79th Cong., 1st Sess., p. 181.

¹⁵ 52 Stat. 1134; 56 Stat. 787. A bill to extend this act to 1950, H. R. 3429, was passed by the House of Representatives on November 1, 1945, 20 Cong. Rec. 10434; H. Rep. No. 1128, 79th Cong., 1st Sess.

¹⁶ Full details of the properties, the elements of rate making value, the corporate history, the capital structure at the beginning of the reorganization

cent availability to the debtor of the Moffett Tunnel and the Dotsero Cut-off (1934) improve its strategic position in the competition for "overhead" or "bridge traffic," that is, traffic that is consigned from and destined to points beyond its lines. The traffic originating on its lines is mixed in character and varies with the general prosperity of the region.

The present Denver, the principal debtor, was organized in 1920. It succeeded the Denver & Rio Grande Railroad Company of 1908 which had in its turn acquired the property of the Rio Grande Western Railway Company, owning the western portion of the present debtor's lines, and of the Denver & Rio Grande Railroad Company of 1886, owning the eastern portion of the present debtor's lines. A connection between the two portions, Rio Grande Junction Railway, is under lease to the debtor who, as lessee and a stockholder, guarantees the Junction bonds. Substantially all of the capital stocks of the Salt Lake and Salt Lake

proceedings, the traffic and earnings appear throughout the various reports of the Commission, particularly the original report in 233 I. C. C. 515. The location and extent of its properties are succinctly described by the Commission at page 518, as follows:

"The Denver's principal eastern termini are Denver and Pueblo, Colo., at each of which points connection is made with the Atchison, Topeka & Santa Fe Railway and the Colorado & Southern Railway. At Denver connection is also made with the Chicago, Burlington & Quincy Railroad, the Chicago, Rock Island & Pacific Railway, and the Union Pacific Railroad; at Pueblo, also with the Missouri Pacific Railroad, which is the Denver's main outlet to the east.

"On the west the main line of the Denver passes through Salt Lake City and terminates at Ogden, Utah. Connection is made with the Union Pacific at each point; at Salt Lake City the Denver also connects with the Western Pacific Railroad and at Ogden with the Southern Pacific. The interchange with the Western Pacific is more important than that with any other western connection.

"The road owned by the Denver consists of 1,256.6 miles of main line and 1,094.9 miles of branch lines. Operated under lease are the Rio Grande Junction Railway . . . extending from Rifle to Grand Junction, Colo., 62.1 miles, the Goshen Valley Railroad, a branch line 8.8 miles in length, and the Salt Lake Western, extending from Dotsero, on the Denver, to Orestod on the Denver & Salt Lake Railway . . . 38.1 miles. Including these leased lines, the Denver operates approximately 1,257 miles of main lines and 1,104 miles of branch lines. Approximately 771 miles of narrow-gage lines are included in the operated mileage.

"In addition to the above-mentioned mileages, the Denver operates over the Salt Lake, between Denver and Orestod, 128.6 miles. This line, together with the Salt Lake Western, constitutes the Dotsero cut-off route. The Salt Lake's ownership embraces the line extending from Utah Junction, near Denver, to the western terminus at Craig, Colo., 220.2 miles. For its Denver terminal, the Salt Lake uses, under a lease, the facilities of the Northwestern Terminal Railroad Company. The Salt Lake derives no revenues from the through traffic moving over the cut-off, since all such traffic is handled by the Denver."

Western, and various other branch lines are owned by the debtor.¹⁷ These corporate arrangements for the operations of the debtor have resulted in the assumption or creation by the debtor of the claims of the various issues, listed in note 6, *supra*.

Just after these reorganization proceedings began, December 31, 1935, the debtor's report showed that its long-term debt was \$120,541,000, and its current liabilities \$24,990,901.63. It had current assets, including cash \$1,257,943.43, of \$5,966,666.93. At the time the plan became effective, December 31, 1942, the report showed long-term debt of \$130,264,826.65 and current liabilities of \$14,172,575.50, and in addition deferred liabilities, chiefly matured interest in default of \$45,582,132.66. There were current assets, including cash \$10,850,149.96, of \$20,983,652.54. As of December 31, 1944, these items were: Long-term debt \$129,358,337.79, current liabilities \$20,539,637.83, and deferred liabilities \$55,310,151.80. The current assets were \$32,665,501.33, including \$19,142,626.96 in cash.

During the period examined the income of the system available for interest was found by the Commission at its lowest in 1936-1938. After adjustment this was \$2,893,255. 233 I. C. C. at 552. In 1941 there was \$5,019,436. 254 I. C. C. at 10. When the present plan was approved by the Commission in June, 1943, the 1942 income available for interest was recognized but the continuance of such earning power was thought to be negated by any sound forecast.¹⁸ 254 I. C. C. at 356.

The Commission reached its determination of a sound capital structure for the combined properties with these figures on earnings before it. In addition, of course, the Commission had complete statistical information to guide it from its Bureau of Valuation and its other sections dealing with traffic, rates, earnings, interest, et cetera. The discussion by the Commission will be found in its printed volumes listed in note 2. Proceeding upon the principle accepted in the *Western Pacific* and *Milwaukee* cases,¹⁹ that capitalization based upon earnings is a permissible

¹⁷ See *Denver & Salt Lake Western R. Co. Construction*, 154 I. C. C. 51; 175 I. C. C. 535; 233 I. C. C. at 520.

¹⁸ The reports show the income available for interest as follows:

1942.....	\$17,044,420.39
1943.....	11,573,667.94
1944.....	8,157,880.25.

¹⁹ 318 U. S. at 482 and 483; 318 U. S. at 539-541.

method of valuation in reorganization, the Commission fixed \$155,173,127 as the sound capitalization. This capitalization under the terms of the issues, with provisions for a capital fund and the sinking funds, carries annual charges of \$6,211,250 before dividends on common. See note 6. The decision was unanimous except for one Commissioner who considered the valuation too high by ten per cent. 254 I. C. C. at 379. There can be no doubt that as of June, 1943, there was ample evidence to justify the valuation made by the Commission.

Allocation of Securities Within the framework of that valuation, the Commission allotted the available securities to the claimants. Securities, including the common stock, were given a face value. The aggregate was too small to allow anything to former stockholders.²⁰ Thus they were eliminated from the reorganization.²¹ For the holders of the General bonds, common stock was available to the amount of ten per cent only of their claim.²² A glance at the proposed distribution in note 6 will show that the claimants did not receive all the new senior securities in the strict order of their old priorities.

The value of a lien on a part of a railroad when the valuation is made from earnings cannot be fixed solely on a mileage basis. Nor is it practicable to issue new securities with a lien limited to the property that was covered by the old lien. There must be segregation of the system earnings to each existing lien and allocation of securities representing the system value to each class of claimants. This was done here as shown in the second table in note 6.²³ Such a method is in full accord with the principle that senior creditors are to retain their relative priority of position in a reorganization. *Group of Investors v. Milwaukee R. Co.*, 318 U. S. at 561-64. Furthermore, junior claims can receive nothing until the senior claims receive securities of a worth or value equal to their indebtedness. 318 U. S. at 483; 318 U. S. at 569. The Generals are definitely junior. 233 I. C. C. at 524.

The Commission did not make a finding that the cash value of the securities awarded the senior claimants as of the effective

²⁰ *Ecker v. Western Pacific R. Corp.*, 318 U. S. at 475-76.

²¹ 233 I. C. C. 578-81.

²² 254 I. C. C. at 359.

²³ See for discussion of the formulae 233 I. C. C. at 581 *et seq.*; 254 I. C. C. at 16 and 359-76.

date of the plan equalled the face of the claims. It did, however, carefully state its reasons for concluding that the compensation "flowing under the plan to the various classes of bondholders for the rights surrendered by them" was adequate in the light of the absolute priority rule. 254 I. C. C. at 360. For those classes, other than the Junior Generals, that received common stock, the Commission said that the possibility of "unlimited dividends on common stock" was a factor in offsetting loss of position.²⁴ Thus it is clear that when the Commission made its allocations it had definitely in mind that one thing that gave the senior creditors compensation for the admission of junior claimants to participation in securities before the seniors obtained full cash payment was their chance to share in the unlimited dividends that might be earned and paid on the common stock. It should be noted that income applicable to dividends was at its highest in 1942 prior to the approval of the plan by the Commission in June, 1943. Therefore the abnormal earnings of 1942 were in the Commission's contemplation when it spoke of the opportunities for "unlimited dividends."

The improved physical condition of the road through expenditures of the trustees for previously deferred maintenance, improvements and new equipment was before the Commission and necessarily entered into their valuation of the property. 233 I. C. C. 531.

There is another important factor, corollary to stock ownership, to be noted in the Commission's allocation of these securities. This factor is that the creditors who received common stock to make them whole obtained with that common stock an interest in all cash on hand or all cash that might be accumulated. Of course, the Commission thoroughly understood this. In fact, it

²⁴ Rio Grande Western consolidated, 254 I. C. C. at 365: "Loss in earnings position and surrender of other rights, in our opinion, are offset by the possibility of increased return permitted by the 4½-percent income bonds, 5-percent convertible preferred stock, unlimited dividends on common stock, and the other features of the plan."

Denver & Rio Grande consolidated, *id.* at 364: "This apparent change in earnings position is offset by the new sinking fund and capital fund and by the increased rate of return obtainable from the new securities, i. e., slightly in excess of 4.5 percent for 64 percent of the claim and unlimited stock dividends for the remainder."

Denver & Rio Grande Western refunding and improvement, *id.* at 366: "They also will receive whatever dividends may be paid on 97,706 shares of common stock."

referred to the ten million plus of cash on hand as of January 1, 1943. 254 I. C. C. —. Cash, material and supplies, as well as all other assets and all liabilities of the debtor were represented by the securities. If there is more cash on hand than needed, for taxes, expenses and proper improvements, it is at the disposal of the common stockholders. If money was used to pay indebtedness, there would be a corresponding reduction in the capital structure. Therefore, the plan provided, 254 I. C. C. at 386:

"The new company shall be deemed to have come into possession of the properties as of the effective date of the plan.

" . . . The capitalization of the new company, as of January 1, 1943, after consummation of the plan . . . shall consist substantially of the following securities, excluding those to be pledged, the amounts stated being subject to reduction to the extent, if any, that matured interest proposed to be funded in the plan is paid, and as equipment obligations or other liabilities are paid or reduced"

Cash and War Earnings. The Circuit Court of Appeals was of the view that war earnings were of "very little value in estimating the probable future earnings of this property in the peace economy which is to come" and that the Commission was well within its right in disregarding them. 150 F. 2d at 34. This was after the seventeen million earnings of the top year 1942. The appellate court agreed, too, that excess current assets should not be capitalized and that improvements made during the trusteeship for reorganization had been considered by the Commission and District Court in fixing their valuation by past and prospective earnings. 150 F. 2d at 35. The appellate court then made the following ruling:

"The Senior Bondholders were paid in full. They received all the new securities and most of the common stock. Ninety per cent of the General Bondholders' claims were wiped out. They received only a small amount of common stock, ten per cent of their total claim. Adequate operating funds are essential to the operation of a railroad. The Senior Bondholders were entitled to receive in addition to the full amount of their claims, working capital sufficient for proper and efficient operation of the railroad. But anything in excess of what was reasonably necessary for this purpose consti-

tuted assets of the insolvent corporation which belonged to the remaining creditors.

"We think it is apparent from the record that there were current assets on hand consisting of cash and securities in excess of what was needed for the efficient operation of the road. As pointed out, the working capital of the debtor had increased from a deficit of \$9,727,230 as of December 31, 1935, to a surplus of \$12,125,863.50 as of December 31, 1944. While these increased net earnings are due in large part to the war and will not continue after the end of the war, and may therefore be disregarded in setting up the capitalized structure based upon prospective earnings, we cannot disregard the fact that these huge surpluses actually exist. Their existence is an accomplished fact. It is also obvious that surpluses will continue to pile up for a reasonable time yet to come. We think any plan which fails to take this into account and which gives the Senior Bondholders their claims in full by substantially delivering the road to them, and gives them the surplus cash actually on hand and further enables them to receive in addition the excess war profits which are reasonably sure to come, is inherently inequitable and unfair, so long as there are classes of creditors whose claims are not fully satisfied."

In our judgment this holding is erroneous.

The effective date of the plan was fixed by the Commission as January 1, 1943. This was in its power.²⁵ The allocation of the securities took into consideration the interest of the secured claims to that date. Any gain or any loss after that time was a benefit or an injury first to the common stockholders and then to security holders in positions senior to them. Assuming that this Court, as a court with equity powers in a bankruptcy matter, might set aside a plan, fair and equitable when adopted by the Commission, on account of subsequent changes in economic conditions,²⁶ it should only be done when the changes are of the kind that were not envisaged by the Commission in its deliberations upon or explanations of the plan.

We have pointed out in the section of this opinion dealing with the allocations of the securities that a part of the compensation to senior claimants for their loss of position was the opportunity

²⁵ *Ecker v. Western Pacific R. Corp.*, 318 U. S. at 509.

Interest accrues on the secured claims until the effective date of the plan. *Group of Investors v. Milwaukee R. Co.*, 318 U. S. at 546. Compare *Ticonic Bank v. Sprague*, 303 U. S. 406.

²⁶ 318 U. S. 506-509.

to participate in war earnings. This was understood by the District Court²⁷ and the Commission.²⁸ Accumulations of cash beyond operating fund needs are in the same category. In dealing with the problem the Commission noted that a five percent dividend on the authorized common would require an income available for interest and dividends of \$7,969,629. Even before the transportation difficulties of 1946, it was obvious that the Commission's judgment was being confirmed by events. See note 18, *supra*.²⁹

²⁷ 62 F. Supp. at 390:

"The \$25,000,000 or more the Trustees have expended in the Improvement Program inures to the benefit of the common stock. If the latter is worth anything it is as much due to these expenditures as to any other factor. This, with the increase in current assets and wartime earnings which counsel seem to believe are permanent, constitute the only equity behind the preferred and common stock."

²⁸ 254 I. C. C. at 356.

²⁹ Mankind's foresight is limited. The uncertainties of future estimates are recognized. It is not without interest to note, however, that on April 15, 1946, the railroads of the United States petitioned the Interstate Commerce Commission for increased freight rates and charges. This was said:

"The situation of the railroads has now become critical and their need for a substantially higher level of freight rates has become imperative. This is the result of an extraordinary combination of war and postwar conditions with which the railroads are confronted, and more particularly the result of three factors of recent development: (1) the increase in wages of railroad employees of 16 cents per hour determined under the procedures of the Railway Labor Act in April, 1946, retroactive to January 1, 1946; (2) large increases, both present and prospective, in the prices of railway materials and supplies; and (3) a sharp decline in volume of railway traffic and an even greater decline in railway revenue.

"The volume of freight and passenger traffic is falling continuously, and it is anticipated that the downward rate will accelerate in the months to come. The revenues will be reduced by reason both of the decline in volume and a return to a more nearly normal composition of traffic. It is estimated that the operating revenues of Class I railroads for 1946, on the basis of the present rates, fares and charges, would be approximately \$6,800,000,000, or 23.5 per cent less than they were in 1945.

"Freight and passenger traffic reached their peaks in 1944. But net railway operating income and net income began to diminish in 1943 on account of rising costs of operation. In the face of increasing traffic through 1944, both net railway operating income and net income moved steadily downward after reaching their peak in 1942. With the cessation of hostilities in 1945 there began to be a decline also in gross revenues which is expected to become more pronounced as the abnormal war conditions disappear, disabilities of highway carriers and other agencies of transportation are removed, and the prewar pattern of railway traffic is resumed."

The Denver apparently did not vary greatly from this overall picture. Its net revenue for 1945 from railway operations dropped from \$20,569,809

The error of the Circuit Court in its holding set out above lies in its assumption that the senior bondholders were paid in full by the securities allotted to them without also accepting the determination of the Commission that the assets represented as of January 1, 1943, and all subsequent earnings were a part also of the common stock that was awarded the senior bondholders.

Decreases in Senior Debt. The plan provides for securities to take the place of the Rio Grande Junction's first 5's in the face amount of \$2,758,333 and for the assumption by the reorganized road of \$5,758,000 equipment obligations. All of these securities are senior to the generals. The Denver purchased the Junctions and paid \$1,218,000 on the equipments. This reduced the necessary capitalization by that aggregate sum. The Circuit Court of Appeals was of the opinion that "The value behind these securities in no wise belonged to the Senior Bondholders, because they had been paid in full." 150 F. 2d 39. This ruling, we conclude, was erroneous for the same basic reason that we held the cash and war earnings belong to the owners of the common stock.

We called attention, *supra* page —, to the authority granted the District Court to reduce the capitalization of the new company as interest due on January 1, 1943, or equipment obligations or other liabilities were paid. The District Court acted on this authority and said of the Junctions, "They may be canceled or they may be utilized under the plan in acquisition of new securities which will become an asset of the reorganized company. 62 F. Supp. at —. The Junction bondholders did not vote on the plan. Under our determination that the creditors who received common stock were compensated partly by the assets and future earnings, it is obvious that the use of such assets to retire senior claims is a part of the normal and expected value from holdings of common stock. Of course, this section of the opinion is written and must be read on the assumption that the allocations of common stock are fair and equitable, a matter discussed later.

Utah Fuel Company Stock. The Rio Grande Western Railroad Co. in 1899 executed its First Consolidated Mortgage, an in-

to \$14,246,504. Its gross operating revenue, however, increased four and a half million. The loss in net was due largely to increased amortization of defense projects.

The monthly report of revenues and expenses by the Denver for January and February of 1946 shows a decrease of operating revenues from \$10,856,764 to \$8,932,983.

indenture to secure its issue of First Consolidated Bonds, maturing April 1, 1949. Rio Grande Western reserved the right to issue additional bonds under the indenture.

The Utah Fuel Company was organized in 1900, with a capitalization of 100,000 shares. In 1901 an agreement was entered into by Rio Grande Western, the trustee under the First Consolidated Mortgage, and the owner of the Utah Fuel stock. The contract provided that the stock would be held by the trustee to secure bonds issued under the First Consolidated Mortgage and that Rio Grande Western would have the right at any time on paying the trustee \$6,000,000 in cash or delivering an equal face amount in First Consolidated bonds to receive the Utah Fuel stock, free of the mortgage lien. Subject to the lien, the stock was transferred to Rio Grande Western. \$6,000,000 in additional First Consolidateds were issued to the owner of the stock.

In 1908, the Denver & Rio Grande Railroad Company was organized and acquired the property of Rio Grande Western, assuming the obligation of its first consolidated mortgage bonds of 1899. The equity of redemption of Denver & Rio Grande Railroad Co. in the Utah Fuel stock was sold in 1918 under execution and transferred to the Western Pacific Railroad Corporation.

In 1924 under an agreement among the Denver & Rio Grande Western Railroad Company, the Western Pacific Railroad Corp., Missouri Pacific Railroad Co. and T. S. Alexander, who by the agreement became trustee of the equity of redemption in the Utah Fuel stock, Western Pacific transferred to T. S. Alexander, Trustee, subject to the pledge under the Consolidated Mortgage its Utah Fuel stock and the debtor transferred to said trustee whatever interest it had in the stock, through certain releases, not here important.

The agreement first provided that the ultimate beneficial interest in the Utah Fuel stock so held was vested one-half in Missouri Pacific and one-half in Western Pacific. Except for certain contingencies not here important, it was provided that the trustee under the 1924 agreement would pay all dividends received by him from the trustee under the Consolidated Mortgage on Utah Fuel stock to the debtor so long as any of the General or Refunding bonds were outstanding.

The agreement further provided that if the General Mortgage or the Refunding or other mortgage of the debtor were foreclosed, the trustee would sell their interest in the Utah Fuel stock subject to the Consolidated Mortgage, if outstanding, and apply the proceeds to the payment of the bonds secured by the equity of redemption in the stock dividing any surplus between Western Pacific and Missouri Pacific.

Recheck

The General Mortgage and Refunding bonds created in the 1924 reorganization were thus given a lien on the Utah Fuel stock, junior to the lien of the Denver & Rio Grande First Consolidated Mortgage.

Under the plan approved by the Commission and the District Court, the First Consolidated bonds were allotted 20% of their claim in new income bonds, 73% in preferred stock, and 7% in common stock. The plan further provided that:

"The trustee under the Rio Grande Western Railway Company consolidated mortgage shall be permitted to obtain the release of the equities in the stock of the Utah Fuel Company and distribute the stock among the holders of the aforesaid bonds in any manner agreeable to them, or to enforce its rights as pledgee of the stock of the Utah Fuel Company, the proceeds recovered to be distributed to the holders of the bonds."

The Commission took the position that this and the other features of the treatment of the First Consolidated bonds were justified as compensation for "loss of earnings position and surrender of their rights"³⁰ under the plan.

stock The Commission made no definite finding with respect to the value of the Fuel Company stock. The Commission had before it evidence through 1936 with respect to the value of the stock as well as an appraisal of the value of the Fuel Company made for the trustee of the First Consolidated Mortgage, which indicated a value of \$4,653,720. The only dividend paid to the debtor by Utah Fuel under the 1924 agreement was in 1934 and amounted to \$250,000; the debtor in applying its formula for allocation of earnings by mortgage districts credited the Consolidated Mortgage with an income of \$83,333 per annum based on that dividend payment allocated over the three-year period, 1932 to 1934. The status of the stock was considered by the

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³⁰ See note 24.

Commission in its original report and its several supplemental reports, and its proposals with respect to the stock remained unchanged.

In proceedings before the District Court in 1943 on objections to the plan, it was revealed that the Fuel Company's net income for 1942 was \$415,000 and for the first seven months of 1943, \$535,869.³¹ The company has no funded debt.

Before the Circuit Court the respondents contended that the holders of the First Consolidated bonds should be compelled either to foreclose this collateral, applying the proceeds to their claim, or credit their claim with the value of the collateral and be allowed new securities only for the balance. The Circuit Court disapproved the treatment of the General bondholders with respect to the Fuel Company stock pointing to the fact that the Commission had permitted "doubts and uncertainties" to remain with respect to the value of the collateral, and that there was a danger that if the collateral had substantial value, the First Consolidated bondholders might receive more than full payment.

The facts set out above fully support the conclusion of the Commission that the "title to the stock is vested in the Missouri Pacific and Western Pacific." Whatever rights the debtor may have retained after the sale of the stock on execution in 1918 were released to the trustee and the two railroads in 1924. We have then a situation in which the holders of the ultimate beneficial interest in stock which had been pledged previously under a mortgage have permitted that interest to be encumbered by a third person, namely the debtor, as security for its General and Refunding bonds. The rule is settled in bankruptcy proceedings that a creditor secured by the property of others need not deduct the value of that collateral or its proceeds in proving his debt. *Ivanhoe Bldg. & Loan Asso. v. Orr*, 295 U. S. 243. We see no reason why the same should not be true under § 77. See *New York Trust Co. v. Palmer*, 101 F. 2d 1, 3. Therefore the First Consolidated Mortgage bonds were properly permitted to prove the full amount of their debt.

Respondents, however, object that the plan gives the First Consolidated bondholders all the Utah Fuel stock or its proceeds in

³¹ According to Moody's Manual [*Resp. br. 29, note*] the net income of the Fuel Company for 1943 was \$865,140, 1944 \$653,901, and earned surplus at the end of the latter year \$4,862,980.



addition to securities the face value of which amounts to one hundred per cent of their claims. It is thus contended that the plan deprives them of their junior interest in the stock without a determination of the value of that stock, or a finding of the extent to which the Consolidated bondholders have been paid by the new securities to be given them. We do not so read the plan. The plan provides merely that the trustee of the Consolidated Mortgage "shall be permitted to obtain the release of the equities in the stock of the Utah Fuel Company" and distribute the stock or its proceeds to the holders of the bonds. This statement contains at least two requirements to be met before the Consolidated bonds obtain anything from the collateral. The first is that the trustee of the First Consolidated Mortgage be in existence. Even after the plan goes into operation and the old securities are surrendered for cancellation there is no requirement that the trusts terminate since they will continue to hold property other than that of the debtor. § 77(f) does not so require. Hence whatever action the trustees take may be commenced prior to or after the execution of the plan. This will permit the respondent, trustee under the General Mortgage, which would continue in existence for the purpose, to take the necessary steps to safeguard its rights in the collateral on behalf of the Generals.³²

The second requirement, which is explicit in the plan, is that the trustee obtain the release of the equities in the stock. The predominant, if not the only existing equity in the stock is that of respondent trustee of the Generals. The Generals have an absolute right under the terms of the 1901 pledge and the 1924 agreement to all the proceeds of the stock over \$6,000,000 and a right also to any part of the proceeds not needed to make the First Consolidated bonds whole. Petitioners concede in their brief here that enforcement of the pledge "can be brought about only through judicial proceedings." They correctly point out that in such proceedings full protection can be given to all those who have any junior interest in the stock. Respondents' fear that the General bondholders and the mortgage trustee will not

*other than
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Consolidated
bonds*

³² Obviously, the Fuel stock or its proceeds could be distributed to record holders of the old securities as of the date or dates of distribution of the new securities.

be in existence and so unable to protect themselves has been above demonstrated to be without foundation in fact.

The result is that this aspect of the plan did not in any way change or affect existing rights in the collateral. The respondents may show in the judicial proceedings which must be brought by the trustee of the First Consolidated Mortgage that the First Consolidated bonds have been fully paid by the securities awarded them under the plan, if such be the fact, or the respondent, trustee of the General, may itself bring a proceeding against the trustee of the First Consolidated mortgage for a determination of the rights of the Generals. Petitioners concede, as they must, that they are not entitled to more than full payment and that they are under a duty to account to the respondents for any surplus remaining after they have been made whole.³³

The treatment of the Utah Fuel stock in the plan is fully consistent with the Commission's disposition of certain collateral pledged with the Reconstruction Finance Corporation and the Railroad Credit Corporation by parties other than the debtor to secure notes of the debtor in the *Western Pacific* case. *Western Pac. R. Co. Reorganization*, 233 I. C. C. 409, 432. The Commission permitted the pledgees to retain the collateral and this Court approved that action, saying, "This collateral, other than the refunding bonds, was therefore left with the pledgees with its position unaffected by any direct action of the Commission." *Ecker v. Western Pacific R. Corp., supra*, at 506.

³³ There is a certain illogic in the position of First Consolidated bonds in asserting any rights in the collateral at all. If, as they concede and we now hold, they are entitled to be paid in full in new securities without regard to the collateral, it must be assumed that they have been fully paid by the new securities given them since they do not complain of their treatment under the plan. Since they are entitled only to full payment it would seem to follow that they have no rights against the collateral. We should not be taken as deciding this question, however, since we leave it to an independent suit in which there is jurisdiction over the proper parties.

cent availability to the debtor of the Moffett Tunnel and the Dotsero Cut-off (1934) improve its strategic position in the competition for "overhead" or "bridge traffic," that is, traffic that is consigned from and destined to points beyond its lines. The traffic originating on its lines is mixed in character and varies with the general prosperity of the region.

The present Denver, the principal debtor, was organized in 1920. It succeeded the Denver & Rio Grande Railroad Company of 1908 which had in its turn acquired the property of the Rio Grande Western Railway Company, owning the western portion of the present debtor's lines, and of the Denver & Rio Grande Railroad Company of 1886, owning the eastern portion of the present debtor's lines. A connection between the two portions, Rio Grande Junction Railway, is under lease to the debtor who, as lessee and a stockholder, guarantees the Junction bonds. Substantially all of the capital stocks of the Salt Lake and Salt Lake

proceedings, the traffic and earnings appear throughout the various reports of the Commission, particularly the original report in 233 I. C. C. 515. The location and extent of its properties are succinctly described by the Commission at page 518, as follows:

"The Denver's principal eastern termini are Denver and Pueblo, Colo., at each of which points connection is made with the Atchison, Topeka & Santa Fe Railway and the Colorado & Southern Railway. At Denver connection is also made with the Chicago, Burlington & Quincy Railroad, the Chicago, Rock Island & Pacific Railway, and the Union Pacific Railroad; at Pueblo, also with the Missouri Pacific Railroad, which is the Denver's main outlet to the east.

"On the west the main line of the Denver passes through Salt Lake City and terminates at Ogden, Utah. Connection is made with the Union Pacific at each point; at Salt Lake City the Denver also connects with the Western Pacific Railroad and at Ogden with the Southern Pacific. The interchange with the Western Pacific is more important than that with any other western connection.

"The road owned by the Denver consists of 1,256.6 miles of main line and 1,094.9 miles of branch lines. Operated under lease are the Rio Grande Junction Railway . . . extending from Rifle to Grand Junction, Colo., 62.1 miles, the Goshen Valley Railroad, a branch line 8.8 miles in length, and the Salt Lake Western, extending from Dotsero, on the Denver, to Orestod on the Denver & Salt Lake Railway . . . 38.1 miles. Including these leased lines, the Denver operates approximately 1,257 miles of main lines and 1,104 miles of branch lines. Approximately 771 miles of narrow-gage lines are included in the operated mileage.

"In addition to the above-mentioned mileages, the Denver operates over the Salt Lake, between Denver and Orestod, 128.6 miles. This line, together with the Salt Lake Western, constitutes the Dotsero cut-off route. The Salt Lake's ownership embraces the line extending from Utah Junction, near Denver, to the western terminus at Craig, Colo., 220.2 miles. For its Denver terminal, the Salt Lake uses, under a lease, the facilities of the Northwestern Terminal Railroad Company. The Salt Lake derives no revenues from the through traffic moving over the cut-off, since all such traffic is handled by the Denver."

Western, and various other branch lines are owned by the debtor.¹⁷ These corporate arrangements for the operations of the debtor have resulted in the assumption or creation by the debtor of the claims of the various issues, listed in note 6, *supra*.

Just after these reorganization proceedings began, December 31, 1935, the debtor's report showed that its long-term debt was \$120,541,000, and its current liabilities \$24,990,901.63. It had current assets, including cash \$1,257,943.43, of \$5,966,666.93. At the time the plan became effective, December 31, 1942, the report showed long-term debt of \$130,264,826.65 and current liabilities of \$14,172,575.50, and in addition deferred liabilities, chiefly matured interest in default of \$45,582,132.66. There were current assets, including cash \$10,850,149.96, of \$20,983,652.54. As of December 31, 1944, these items were: Long-term debt \$129,358,337.79, current liabilities \$20,539,637.83, and deferred liabilities \$55,310,151.80. The current assets were \$32,665,501.33, including \$19,142,626.96 in cash.

The income of the system available for interest during the period was found by the Commission at its lowest in 1936-1938. After adjustment this was \$2,893,255. 233 I. C. C. at 552. In 1941 there was \$5,019,436. 254 I. C. C. at 10. When the present plan was approved by the Commission in June, 1943, the 1942 income available for interest was recognized but the continuance of such earning power was thought to be negated by any sound forecast.¹⁸ 254 I. C. C. at 356.

The Commission reached its determination of a sound capital structure for the combined properties with these figures on earnings before it. In addition, of course, the Commission had complete statistical information to guide it from its Bureau of Valuation and its other sections dealing with traffic, rates, interest, et cetera. The discussion by the Commission will be found in its printed volumes listed in note 2. Proceeding upon the principle accepted in the *Western Pacific* and *Milwaukee* cases,¹⁹ that capitalization based upon earnings is a permissible method of

¹⁷ See *Denver & Salt Lake Western R. Co. Construction*, 154 I. C. C. 51; 175 I. C. C. 535; 233 I. C. C. at 520.

¹⁸ The reports show the income available for interest as follows:

1942.....	\$17,044,420.39
1943.....	11,573,667.94
1944.....	8,157,880.25.

¹⁹ 318 U. S. at 482 and 483; 318 U. S. at 539-541.

valuation in reorganization, the Commission fixed \$155,173,127 as the sound capitalization. This capitalization under the terms of the issues, with provisions for a capital fund and a sinking fund for the first mortgages carries annual charges of \$6,211,250 before dividends on common. See note 6. The decision was unanimous except for one Commissioner who considered the valuation too high by ten per cent. 254 I.C.C. at 379.