

8FED.CAS.—2

Case No. 4,137.

DUNCAN ET AL. V. MOBILE & O. R. CO. ET AL.

{2 Woods, 542.}¹

Circuit Court, S. D. Alabama.

June Term, 1876.

RAILROAD MORTGAGES—FORECLOSURE—APPLICATION OF INCOME TO
FLOATING DEBT—POWER OF COURT.

The president and directors of a railroad company had contracted a floating debt to pay interest on its bonds, and for supplies and repairs for which certain persons interested in the road had become individually liable. *Held*, in a suit in equity brought by the trustees of the first mortgage on the railroad property, to foreclose the same, that the court had no power without the consent of the bondholders to direct the application of the income of the road to the payment of the floating debt, although it was made to appear that it could be paid on favorable terms, and that it was equitable and probably for the interest of the bondholders that such application should be made.

Petition filed, in a suit in equity.

On the 3d of February, 1876, [William B] Duncan and [A. Foster] Elliott, trustees of the first mortgage executed by the defendant company, filed a petition in this court in this case, in which they represented that as such trustees they were, under the order of this court, in possession of the defendant company's road and real and personal property, which they were administering under the order of the court; that a large portion of the property of the company was unproductive and contributed little to the payment of its debts; that from April, 1861, to the year 1866, the railroad company was deprived of remunerative business by reason of the civil war; that its property was wasted and its debt greatly increased by accumulation of unpaid interest, so that at the close of the war the company was embarrassed, if not insolvent; that this increase of debt was funded, and it was expected that there would be an increase in the demand for the services of the road, and a great improvement in the resources and growth of the country. These expectations had not been realized, and for the last two years preceding the filing of the petition, there had been stagnation and decrease of business, resulting in a default of the payment of interest and a taking possession of the road by the trustees under the power of their deed of trust. The petition further stated that the interest bearing bonded debt of the company was \$11,500,000, on which the annual interest was \$900,000, which, under existing circumstances, the road was unable to pay; that in 1874, the company made default in the payment of its interest, and that during a part of the year 1873, and in 1874 and 1875, in order to maintain its credit, had contracted a floating debt to the amount of \$582,385.52, which was expended in payment of interest, and for supplies, materials and equipments. A portion of this debt, it was alleged, was secured by a pledge of bonds and other securities of the company, the par value of which exceeded the debt, but which would not sell for more than a third or fourth of the debt; another portion was secured by the individual indorsement of persons who had been president and directors of the company, and who gave their names and credit to maintain the credit of the company, and to purchase supplies; another part of the debt was held by the patrons and customers of the company, secured by third mortgage bonds, having little market value. The petition further stated that it was the hope and expectation of the trustees that there should be a reorganization of the company by the owners of the bonds becoming the owners of the railroad, and that for that purpose a removal of these floating claims might be desirable to the bondholders, if the same could be done on favorable conditions and with their consent. The petitioners alleged that in their opinion, the debt could be compounded and settled at much less than its face, and that by its settlement a number of the bonds and securities of the company would be preserved from sacrifice, but that the petitioners had no authority to employ for that purpose the moneys which have come into their possession as trustees. Petitioners did not admit that the holders of the floating debt had any legal claim upon

the moneys in their hands arising from the income and receipts of the road since it has been in their hands; but they prayed for a reference to a master to report whether it was legal or proper to pay said floating debts, or any portion of them, as a compromise; that the trustees and representatives of the several classes of bondholders might be notified of the reference, and their action thereon reported to the court, and how far they consented to and approved said application, and that the master report what is prudent, legal or proper to be done in the premises. A reference was made to the master, as prayed in the petition, and after taking testimony and hearing argument, he filed his report. It appeared from the report, that the trustees of the several deeds of trust, executed by the railroad company, as well as the railroad company itself, were notified of the reference and were represented before the master. The master reported the floating debt to be \$529,598.34, of which \$114,932.34 was a gold obligation. Of this total, \$120,023 was contracted for supplies, and the residue, \$406,048.48, was received upon loans, and went into the general fund of the company, and to that extent released the accruing receipts and created a fund sufficient to meet the accruing interest. The master finds that the sum of \$327,332 thus raised was probably applied to the payment of interest. The master further re-reported that with the use of \$230,000 in money, and the use of county bonds already pledged to the payment of this floating debt, the whole could be compromised and discharged. The master further reported that it would be equitable to use the income of the road for the purpose mentioned; and that on several accounts it would be good policy, and recommended the application of \$230,000 of the income to this object.

George N. Stewart, Robert H. Smith, and Wm. G. Jones, in support of the master's report, cited *Ludlow v. Grayall*, 11 Price, 58.

E. L. Andrews, contra.

WOODS, Circuit Judge. Briefly stated, the grounds upon which this recommendation is based by the master, and upon which the confirmation of his report was urged by counsel, are: (1), That the whole of the money represented by this floating debt has in good faith gone to the bondholders, partly and chiefly by paying their interest coupons; and as to the residue, by the improvements

and betterments of the railroad property; and (2), that a large amount of the bonds of the company are hypothecated for the payment of this floating debt; and (3), that the settlement of this floating debt, by payment or compromise, is essential to such management of the property or reorganization of the company, as will preserve the valuable franchises, privileges and exemptions of the existing corporation. I have been unable to come to the conclusion, that the recommendations of this report ought to be adopted by the court. The debt, which it is proposed to pay out of the income of the road, is a floating debt, partly secured by bonds, etc., inferior in rank to the great mass of bonds making up the bonded debt of the defendant company. The company has failed to pay the interest on those bonds having the superior lien, and for that reason the trustees of the first mortgage have taken possession of the road for the purpose, among others, of applying its income to the payment of the interest, and if there should be a surplus, to the principal of these bonds. The proposition is to apply, for the reasons stated, the income which the first mortgage bondholders are entitled to, to the payment of the floating debt. The fact that the floating debt was contracted in good faith for the benefit of the railroad company's property, and therefore for the benefit of the bondholders, is true of perhaps all such debts. But that does not give the floating debt creditors any ground upon which to claim that their debt should be paid [first Galveston R. Co. v. Cowdrey, 11 Wall. \[78 U. S.\] 482](#). But I do not understand that the floating debt creditors claim this application of the income of the road as a legal right. It stands simply on the ground that to refuse their payment, would be inequitable. But I cannot invade the legal rights of others to relieve the floating debt creditors from the position in which they have voluntarily placed themselves. The facts that a large amount of inferior securities of the railroad company, now hypothecated for the floating debt, would be released by its payment, and that a reorganization of the company would be greatly facilitated and the valuable franchises of the company thereby preserved by the proposed payment of the floating debt, are doubtless strong considerations, when addressed to the bondholders themselves. But can this court waive the rights of the bondholders, because we might think it would turn out to their advantage? Can we make a contract for them, because we think it would be a good contract? Have we the power to take money which belongs to them and give it to others without their consent, because we think it would be for their interest? They have not consented to this diversion of their money, and no one who is authorized to do so has consented for them. For the trustees to undertake to give assent for the bondholders is clearly outside of their powers and duties, which are plainly prescribed in the deed of trust. This court is, in my judgment, without any power to make the decree recommended by the report. To undertake to do it would be to invade the legal rights of the bondholders, and if established, as within the power of a court of equity, would shake the credit of railroad securities throughout the world. I must, therefore, decline to adopt the recommendations of the master.

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{NOTE. For opinion on final hearing, see Case No. 4,136.}

¹ [Reported by Hon. William B. Woods, Circuit Judge, and here reprinted by permission.]