Seton Hall University School of Law

Out of the Past: Railroads & Sovereign Debt Restructuring

Stephen J. Lubben

DRAFT

For presentation at:
Sovereign Debt Restructuring:
The View From the Legal Academy

Georgetown Law Center
February 26-27, 2004

Out of the Past: Railroads & Sovereign Debt Restructuring

Stephen J. Lubben*

Railroad receiverships are suddenly relevant again. Long before the enactment of the first corporate reorganization statutes in the early 1930s, the federal courts developed a method of reorganizing financially distressed corporations, especially railroads, within the existing architecture of the equity receivership. From 1850 to 1932 these receiverships were the only way to reorganize a large American corporation. The last major railroads to go through receiverships completed the process many, many decades ago,[1] yet today, more than twenty years into the problem of wide-spread sovereign financial distress,[2] several leading scholars have begun to ask if railroad receiverships might hold important insights into the issue of sovereign debt restructuring, or at least inform the analysis.[3]

---

* Associate Professor of Law, Seton Hall University School of Law. Comments are welcome and can be directed to me at lubbenst@shu.edu.

1 For some insight into one of the last major railroad receiverships, see Badenhausen v. Guaranty Trust Co. of New York, 145 F2d 40 (4th Cir. 1944) (addressing the receivership of the Seaboard Air Line Railway, which commenced in 1930).

2 For a recent review of the history, see Ronald J. Silverman & Mark W. Deveno, *Distressed Sovereign Debt: A Creditor's Perspective*, 11 AM. BANKR. INST. L. REV. 179 (2003).

3 *See, e.g.*, Patrick Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World*, IMF Staff Paper, Vol. 50 (2003) (on file with author); William W. Bratton & G. Mitu Gulati, *Sovereign Debt Restructuring and the Best Interest of Creditors*, at p. 71 (http://ssrn.com/abstract=387880); Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY

The analogy between the railroads of old and the sovereign nations of today rests on two key points. First, like sovereign borrowers today, early American railroads faced financial distress without the benefit of an applicable bankruptcy statute. Second, liquidation was no more an option for the railroads than it is for a sovereign nation. In this context, the development of the equity or railroad receivership would seem to hold many promising lessons for reorganization of today's troubled sovereign borrowers.

This paper takes a closer look at the analogy between railroads and countries to see if it holds beyond its superficial appeal. In particular, I examine how railroad receiverships addressed the problems of holdouts and individual creditor action, the key stumbling blocks for most of today's approaches to sovereign debt restructuring.[4] I argue that

---

L.J. 1317, 1326-28 (2002) [hereinafter, Buchheit & Gulati, *Collective Will*]; Barry Eichengreen, *Restructuring Sovereign Debt*, – J. ECON. PERSP. – (forthcoming) (draft on file with author); Barry Eichengreen, Kenneth Kletzer & Ashoka Mody1, *Crisis Resolution: Next Steps*, NBER Working Paper No. W10095 (Revised Draft, June 2003) (on file with author & available on NBER web page). *See also* Anne O. Krueger, Sovereign Debt Restructuring Mechanism: One Year Later, remarks at the Banco de Mexico's Conference on Macroeconomic Stability, Financial Markets and Economic Development (November 12, 2002) ("U.S. bankruptcy procedures, for instance, were an outgrowth of attempts to deal with numerous railroad failures in the 1850s at a time when there were no formal bankruptcy institutions.") (available at www.imf.org/external/np/speeches/2002/111202.htm).

[4] *See* Christopher C. Wheeler & Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation*, 39 STAN. J. INT'L L. 253 (2003) (focusing on the holdout problem); *see also* G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 637-38 (2001) (arguing that holdouts are "one of the primary barriers to orderly sovereign debt restructurings and, hence, one of the sources of global

receiverships overcame these problems in ways that could be useful with respect to sovereign borrowers, although the utility of receiverships should not be overstated.

In particular, railroad receiverships operated in an age when federal equity jurisdiction was at its peak. This allowed the courts to exert significant powers that might not hold today. Moreover, the receiverships were essentially *in rem* proceedings, that allowed a district court to exercise its power irrespective of the geographic dispersal of railroad bondholders. This power is of limited application in the sovereign debt context, as most sovereign assets will be beyond an American court's *in rem* jurisdiction. Finally, and most importantly, a good deal of the receiverships' apparent success in dealing with holdouts came from the generous treatment of existing creditors. This generosity may have limited the long-run effectiveness of the receiverships.[5]

The remainder of this paper proceeds in three parts. Part I outlines the workings of railroad receiverships in general and then focuses the discussion on the ways that receiverships addressed holdouts and individual creditor actions. Part II then presents the strongest case for using receiverships as the basis for a new model of sovereign debt restructuring. This "strong form" version of the analogy exceeds anything presented in the existing literature, but framing the analogy this way highlights the full potential of receiverships in the sovereign debt context. Part III then qualifies the discussion in Part II with a discussion of the limitations of receiverships and the difficulties of applying to sovereign nations a tool that was developed for a set of debtors that may have been, at least in part, uniquely American.

---

financial instability.").

[5] *See* Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. – (forthcoming, Sept. 2004).

In short, I am cautious about the utility of deploying railroad receiverships in the sovereign debt context. Plainly there are historical lessons awaiting application, but I argue that only selective and considered reference to the early days of corporate bankruptcy will translate into meaningful improvement of sovereign debt restructuring.

I. Railroad Receiverships

"Most of the great [American railroads] had been built by fraudulent construction companies, and if perchance a road had been honestly built, there was always an opportunity to correct this oversight by disreputable, but highly profitable, manipulation of its securities."[6] This self-dealing, combined with sprees of overbuilding, meant that railroads faced major bouts of financial distress in 1857, 1873, 1893, 1908, and, of course, the early 1930s.[7] And, in between, the occasional failure of a major road was not out of the question.

Initially railroads were financed entirely, or at least predominately, by equity.[8] By the end of the Civil War, however, railroads had turned to secured bonds for the most of their capital requirements. Indeed, railroads increased their reliance on debt financing throughout the late 1800s and early 1900s, despite their extensive experience with repeated bouts of financial distress, which would seem to counsel for a greater use of equity.[9]

---

6 EDWARD G. CAMPBELL, THE REORGANIZATION OF THE AMERICAN RAILROAD SYSTEM 1893-1900 at 15 (1938).

7 For a more comprehensive review of railroad receiverships, see Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. – (forthcoming, Sept. 2004) (http://ssrn.com/abstract=478981). *See also* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001).

8 WILLIAM Z. RIPLEY, RAILROADS: FINANCE & ORGANIZATION 10-11 (1915). *See also* Alfred D. Chandler, Jr., *Patterns of American Railroad Finance, 1830-50*, 28 BUS. HIST. REV. 248 (1954).

9 Jan Kmenta & Jeffrey G. Williamson, *Determinates of Investment Behavior: United States Railroads, 1872-1941*, 48 REV. ECON. & STATS. 172, 174 (1966).

In short, the railroads were in dire need of an effective tool for addressing financial distress.

But the United States did not enact a permanent bankruptcy statute until the 1898 Bankruptcy Act and railroads, the first large corporate entities, were expressly excluded from the scope of the Act.[10] Moreover, railroads were seen as vital public utilities that simply could not be allowed to fail.[11] Thus, even state debtor-creditor law was off limits to the roads.

In was in this context that leading lawyers and investment bankers worked with the federal courts to develop the railroad or equity receivership,[12] which remained the predominant means of corporate reorganization until the New Deal.[13]

A. A General Discussion of Receiverships

A receivership was commenced by an unsecured creditors' petition to a court, most often a federal court, asking it to

---

[10] Ch. 541, 30 Stat. 544 (the "Bankruptcy Act"), *amended by* Act of June 22, 1938, (the "Chandler Act"), ch. 575, 52 Stat. 840, *repealed by* Bankruptcy Reform Act of 1978 (the "Bankruptcy Code"), Pub. L. No. 95-598, 92 Stat. 2549. *See generally* Vern Countryman, *A History of American Bankruptcy Law*, 81 COM. L.J. 226 (1976).

[11] *See, e.g.*, Central Bank & Trust Co. v. Greenville & W. R. Co., 248 F. 350, 352 (D.S.C. 1917) ("Persons in private business may abandon it at their whim or pleasure. Not so with a railroad. It is a public highway.").

[12] DOLORES GREENBERG, FINANCIERS AND RAILROADS 1869-1889 at 24 (1980) ("When the country slumped into depression after the panic of 1857, [bankers] took further steps to protect bondholder interests and gained their first experience in the intricacies of railroad bankruptcy, receivership, and reorganization.").

[13] Charles Jordon Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 21-22 (1995).

exercise its equity jurisdiction and appoint a receiver to take control of the debtor's assets.[14] Almost simultaneously, the debtor-railroad would file an answer admitting the allegations in the creditor's complaint and agreeing to the receivership.[15] The court would appoint one or more receivers to take control of the debtor's property.

The railroad's managers and its investment bankers would then form committees for each class of the road's securities and the committees then solicited deposits of these securities.[16]

---

14 Central Life Sec. Co. v. Smith, 236 F. 170, 173-74 (7th Cir. 1916); *see also* EDWARD SHERWOOD MEADE, CORPORATION FINANCE 409-410 (1910) (describing the process used to commence a receivership).

15 Edward H. Levi & James W. Moore, *Bankruptcy and Reorganization: A Survey of Changes II*, 5 U. CHI. L. REV. 219, 225 (1937) ("The defect of a lack of a judgment creditor with execution returned unsatisfied... was... cured by the debtor's consent to the appointment of a receiver").

16 HASTINGS LYON, CORPORATE FINANCE: PART II 230 (1916) ("At the same time that the creditor's bill making the application for receivership was being prepared the management was also forming a bondholders' protective committee."). A 1930s commentator on railroad investments explained that the deposit process

> was accomplished by means of placing the bonds themselves in the custody of a bank or trust company, usually in New York, designated as "depository." The depository handed the bondholder a "certificate of deposit," which was virtually a receipt for his bond, under the terms of a "deposit agreement." This was an elaborate printed document delegating practically unlimited authority to the Protective Committee to deal with the bonds according to its discretion and judgment. In the case of large bond issues, listed on security exchanges, certificates of deposit were usually promptly listed for trading.

The various committees would agree upon a reorganization plan, appointing a new, blanket reorganization committee to effectuate the plan.

A bondholder would commence a foreclosure sale and the road's assets would be sold to a new legal entity.[17] In most cases, however, the purchasing party was a representative of the reorganization committee, which was allowed to "credit bid" the face amount of the securities deposited with the committee.[18]

Since there was no voting on the reorganization plan, dissent or consent to the plan was accomplished by depositing or withholding securities from the committee.[19] Dissents were also ostensibly protected by the court's setting an "upset price," which represented the minimum the road could sell for at the sale.[20] Claimants could either dissent and demand cash

---

HAROLD PALMER, INVESTMENT SALVAGE IN RAILROAD REORGANIZATIONS 55 (1938).

17 Arthur S. Dewing, *The Procedure of Contemporary Railroad Reorganization*, 9 AMER. ECON. REV. 1, 28-29 (1919).

18 *Id.* at 29.

19 *See* William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 YALE L.J. 565, 570 (1934) ("The large number of depositors, their notorious inertia and failure to respond, and the difficulty of reaching them make it necessary to adopt a rather simple rule of thumb to determine whether they have or have not accepted the plan. The failure to withdraw probably is one of the few satisfactory rules of thumb available.") (footnotes omitted).

20 Dewing, *Contemporary Railroad Reorganization*, *supra* note __, at 29-31.

equal to their share of the upset price, or agree to the plan and receive new securities in the reorganized railroad.

Receiverships had been the subject of complaints for decades,[21] but by the Great Depression the Legal Realists/New Dealers set out

> to prevent the notorious evils and abuses of consent receiverships which included, among other things, the polar evils of reorganizations in which stockholders were sometimes permitted to participate at the expense of creditors when there was no excess of value over the debts and in which stockholders, or some of them, were sometimes unfairly squeezed out when such excess value existed.[22]

The receiverships were also expensive and many critics of receiverships argued that the outlandish professional fees tainted those involved. As David Skeel recently summarized, "the Wall Street professionals who organized protective committees in order to negotiate the reorganization seemed to focus more on obtaining generous fees for themselves than on striking a good bargain on

---

[21] JAMES W. ELY, JR., RAILROADS AND AMERICAN LAW 179-80 (2001).

[22] New England Coal & Coke Co. v. Rutland R. Co., 143 F.2d 179, 184-85 (2d Cir. 1944) (Frank, J.) (footnotes omitted); *cf.* Matt Moffett, *After Huge Default, Argentina Squeezes Small Bondholders*, WALL ST. J., January 14, 2004, at A1 (reporting complaints that Argentina was pressuring small bondholders to take excessive reductions in their claims).

behalf of the scattered investors whom they purported to represent. The big losers, of course, were small, individual investors."[23]

And the receiverships often took a very long time, [24] in part because creditors increasingly realized that the receiverships were not entirely resistant to holdout strategies.[25] Thus, when the Supreme Court began to restrict the use of receiverships outside of the railroad context in the early 1920s,[26] even elite New York lawyers began to see the need for a federal corporate reorganization statute.[27]

Congress soon acquiesced — in the case of the railroads, with the enactment of section 77 to the Bankruptcy Act

---

[23] David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (And Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1089 (2000) (footnote omitted).

[24] For example, the Pittsburgh, Shawmut & Northern, which operated approximately 200 miles of track, was taken over by a receiver in August of 1905. The road operated under receivership until 1946, when the receivership was converted to a section 77 bankruptcy proceeding, leading to the abandonment of the railroad in 1947, more than forty years after it first sought protection from its creditors.

[25] Paul D. Cravath, *The Reorganization of Corporations*, in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 202-03 (1916).

[26] *See, e.g.*, Harkin v. Brundage, 276 U.S. 36, 52 (1928).

[27] *See, e.g.*, Robert T. Swaine, *Corporate Reorganization--An Amendment to the Bankruptcy Act--A Symposium*, 19 VA. L. REV. 317 (1933).

in 1933.[28] By 1940 more than 60,000 miles of rail were operated by trustees under section 77,[29] and the use of receiverships dwindled. Receiverships remain a theoretical possibility,[30] although the threat of an involuntary bankruptcy petition terminating the entire endeavor limits their usefulness.[31]

B. Holdouts and Compelled Collective Action

Having completed a general overview of the workings of receiverships, I now focus on two areas of particular interest to students of sovereign financial distress. Specifically, receiverships addressed holdouts and individual creditor suits in ways that may have important implications in the sovereign context and thus merit special illumination.

---

28 Reorganization of Railroads Engaged in Interstate Commerce, Pub. L. No. 72-420, 47 Stat. 1474 (1933), *repealed by* Bankruptcy Reform Act of 1978 (the "Bankruptcy Code"), Pub. L. No. 95-598, 92 Stat. 2549. *See also* Max Lowenthal, *The Railroad Reorganization Act*, 47 HARV. L. REV. 18 (1933); Churchill Rodgers & Littleton Groom, *Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act*, 33 COLUM. L. REV. 571 (1933).

29 Florence de Haas Dembitz, *Progress and Delay in Railroad Reorganizations Since 1933*, 7 LAW & CONTEMP. PROBS. 343, 344 (1940).

30 *See* Guaranty Trust Co. of N.Y. v. Seaboard Air Line Ry. Co., 53 F. Supp. 672 (E.D. Va. 1943) ("Before the passage of the Act of Congress providing for railroad reorganization as a part of the bankruptcy law the only juridical mode of railroad reorganization was in equity. Since then it may be thought that equity for such a purpose is outmoded but not outlawed.").

31 Gilchrist v. General Electric Capital Corp., 262 F.3d 295, 303 (4^{th} Cir. 2001).

First, receiverships effectively manufactured an "automatic stay"[32] by using the court's equity jurisdiction to place assets beyond the reach of creditors. As one commentator explained:

> The purpose of the filing of a creditor's bill is to obtain the exclusive administration of the assets of a corporation by a court of equity. An essential feature of the relief there sought is necessarily freedom from attachment, execution and other process against the assets instituted by individual creditors, which would shortly dismember the property and lessen or extinguish its value as a whole. This protection can only be obtained by a receivership.[33]

The court wherein receivership proceedings were commenced was said to have constructive possession of the *res* comprised of the debtor's assets and, having acquired possession, and thus jurisdiction, no other court had authority to interfere with the debtor's property or to control the receivers, who were deemed officers of the appointing court.[34]

Proceeding by way of an *in rem* suit not only avoided the problem of piecemeal attacks on the railroad's assets, but also allowed the court to reorganize any debtor with assets within the district, even though many railroad bondholders would

---

32 *Cf.* 11 U.S.C. § 362.

33 Charles Thomas Payne, *The General Administration of Equity Receiverships of Corporations*, 31 YALE L.J. 685, 686 (1922).

34 *See* Guaranty Trust Co. v Chicago, M. & St. P. R. Co., 13 F.2d 129 (D. Wash. 1929).

not have been subject to personal jurisdiction in the district.[35] This was especially important during the nineteenth century when many railroad bonds were held in Europe.[36]

Once the assets of the railroad were protected by the "equitable umbrella" of the court, the debtor's ability to discourage holdouts turned on the difference between the upset price and the new securities offered under the plan. The parties aimed to set a minimal upset price that would give bondholders every incentive to agree to the plan[37] and commentators often complained that courts too often conceded to low upset prices, designed to coerce creditors to agree to the plan.[38]

Thus, the spread between the upset price and the securities offered under the place effectively discouraged holdouts by giving bondholders little real choice.[39] As will be discussed in

---

35 *Cf.* American Freedom Train Foundation v. Spurney, 747 F.2d 1069 (1st Cir. 1984) (minimum contacts analysis inapplicable in receivership proceedings); Select Creations, Inc. v. Paliafito America, Inc., 852 F.Supp. 740 (E.D. Wis. 1994).

36 *See generally*, DOROTHY R. ADLER, BRITISH INVESTMENT IN AMERICAN RAILWAYS 1834-1898 (1970).

37 Cravath, *The Reorganization of Corporations*, *supra* note __, at 202.

38 Joseph L. Weiner, *The Conflicting Functions of the Upset Price in a Corporate Reorganization*, 27 COLUM. L. REV. 132, 145 (1927).

39 *See* Thomas A. Thacher, *Some Tendencies of Modern Receiverships*, 4 CAL. L. REV. 32, 47 (1915) ("Since the committee formed will in all probability be the only bidder, the property will be sold for a fraction of its value, and the bondholder staying out of the reorganization scheme will receive little. The small bondholder, therefore, has practically no choice.").

Part III, however, the need to gain a critical mass of bondholders that would accept the plan may have limited the extent of the financial restructuring obtained through a receivership. But before reaching the limitations of the receivership analogy, Part II looks at how railroad receiverships might be used in the sovereign context.

II. Railroads & Sovereign Debt Restructuring

Few authors have argued for the direct application of receiverships proceedings to the problem of sovereign financial distress, but this section takes up that task. The closest prior scholars have come to embracing receiverships as something other than a general source of ideas can be found in Buchheit and Gulati's recent observations that a "sovereign bond issuer of the early twenty-first century is in much the same spot as the distressed corporate or railroad bond issuer of the early twentieth century."[40] Indeed, these authors go on to argue that "under appropriate circumstances there may be civil procedures available in U.S. federal courts that will accommodate a creditor-led, but court-supervised, sovereign debt workout."[41]

But ultimately it is clear that even Buchheit and Gulati are not directly urging the use of receiverships – rather they propose the use of class actions suits,[42] a solution that may be brewing with respect to Argentina[43] and which was proposed as an

---

40 Buchheit & Gulati, *Collective Will*, supra note __, at 1322.

41 *Id.*

42 *Id.* at 1352.

43 Angela Pruitt, *U.S. Ruling a Setback for Argentina: Holders of Defaulted Debt Can Pursue Compensation Trough Court System*, WALL ST. J., January 2, 2004, at B4 (reporting that a district court had approved a class action with regards to two classes of bonds).

alternative to prepackaged chapter 11 cases[44] more than a decade ago.[45]

A stronger argument for the analogy between railroads and sovereigns starts with the twin observations made at the outset of this paper: statutory bankruptcy law and liquidation is or was unavailable in both cases. But the argument also stretches to observe that while railroad debt was most often secured, often with tranches secured by various parts of the railroad, the parties recognized that the inability to liquidate a railroad, and the specialized nature of the collateral, effectively neutralized the

---

44 As I explained in an earlier article

> A true prepack [*i.e.*, a prepackaged chapter 11 case] involves a prepetition solicitation of votes on a plan. A partial prepack involves both a prepetition solicitation (e.g., of bondholders) and a postpetition solicitation (e.g., of equity). Partial prepacks are usually done to avoid having to conduct a "registered prepack," which is subject to review and comment by the SEC, and takes substantially longer than a nonregistered prepack.

Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANKR. L.J. 509, 516 (2000) (footnote omitted).

45 *See* Bryant B. Edwards et al., *Mandatory Class Action Lawsuits as a Restructuring Technique*, 19 PEPP. L. REV. 875, 905 (1992). In a somewhat similar vein is a proposal to use declaratory judgment actions to avoid the solicitation problems associated with a prepackaged bankruptcy. Stephen H. Case & Mitchell A. Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federated Declaratory Judgment Act for Instant Reorganizations*, 1991 ANN. SURV. AM. L. 75. Neither proposal seems to have gained any traction. *Cf.* Richard L. Epling, *Are Rule 23 Actions a Viable Alternative to the Bankruptcy Code?*, 23 SETON HALL L. REV. 1555 (1993).

traditional benefits of the security interest.[46] Thus railroads were functionally like today's sovereign debtors who rarely issue any significant amount of secured debt.[47]

Finally, railroads were also like the sovereign debtors of today in that repeated rounds of financial distress did not seem to deter investors from returning to the market – railroads, especially the growing railroads of the Gilded Age, and developing nations are both capital intensive enterprises, with little ability to leave the capital markets for good. Over the long haul, investors dealing with these sorts of repeat borrowers will find a way to recoup prior losses.

The utility of the receivership analogy can be given further concreteness by considering how a hypothetical sovereign debtor might use the receivership process. Consider an imaginary sovereign nation – Freedonia – that has issued several tranches of unsecured bonds, which are held by a mix of investors throughout the world. Freedonia has attempted to seek a consensual workout with its bondholders, but the bondholders are themselves fractured and Freedonia fears that it will soon face lawsuits and attempts to attach its assets located abroad.

Freedonia could petition a district court to take charge of its assets located within the United States. Presumably this filing would take place in the Southern District of New York,

---

[46] *See* Thomas L. Greene, *Changes in the Form of Railroad Capital*, 4 Q. J. ECON. 449, 449 (1890) ("[I]n the cased of a railroad mortgage, the lien upon the land, bridges, and equipment is almost worthless except as the property is valuable for the one purpose of transportation . . . The mortgage in the last analysis is not upon the real estate, but upon the income.").

[47] Bratton & Gulati, *Sovereign Debt Restructuring and the Best Interest of Creditors*, *supra* note __, at p. 41.

or perhaps Delaware, with but a few ancillary receiverships in the handful of other major cities where the sovereign might have assets.[48] This would prevent individual creditor actions throughout the United States and channel all litigation against Freedonia to a single forum. Other jurisdictions where Freedonia has assets may allow for similar receivership proceedings, which could be coordinated with the American receivership.[49]

Financial institutions could then form committees for each of Freedonia's various classes of securities and the committees would solicit deposits of these securities. Once constituted, committee representatives and Freedonia would meet to negotiate the reorganization plan.

Once a plan was agreed upon, the process of implementing it would have to be modified from the railroad context – plainly it makes little sense to employ the artifice of the asset sale in the sovereign context, and upset prices would have no real meaning. So Freedonia could offer creditors either a bundle of new securities (and maybe some cash) under the plan or their proportionate share of the assets subject to the receivership, which would represent what the creditor would obtain in a hypothetical chapter 7 liquidation of Freedonia's American assets. The receivership court could then issue an injunction prohibiting creditors from attempting to recover anything outside of the receivership process – a move that resembles an approach one

---

48 *See* 28 U.S.C. § 754 (modern statutory procedure for ancillary receiverships).

49 *Cf.* Mentink v. World Time Corp. of America, 131 F.R.D. 210 (S.D. Fla .1990) (Dutch receiver had standing to bring breach of contract action in United States district court).

railroad receivership commentator advocated to eliminate the ritualistic formalities of the foreclosure sale.[50]

Under this scheme, Freedonia's American assets – present assets and those anticipated to pass through the country in the near future – provide a floor to what can be offered to creditors. In effect, giving creditors the choice between their share of the debtor's assets or a new bundle of securities imposes a kind of "best interests of creditors" test on the process, which provides some protection against the use of the receivership process for the simple end of transferring wealth from creditors to borrowers.[51]

From the standpoint of the sovereign borrower, facing litigation from all sides and the potential that holdout creditors will disrupt its financial transactions and even its physical presence in the United States, the brief story of Freedonia's trip through receivership is undoubtedly very appealing. The next part of this paper sketches the limitations of receiverships – and thus provides a bit of reality.

---

50 *See* James N. Rosenberg, *Reorganization--The Next Step*, 22 COLUM. L. REV. 14 (1922); *see also* James N. Rosenberg, *The Aetna Explosives Case -- A Milestone in Reorganization*, 20 COLUM. L. REV. 733 (1920).

51 11 U.S.C. §1129(a)(7). Section 1129(a)(7)(A) requires that each holder of a claim or interest either accept the plan or else receive or retain "property of a value, as of the effective date of the plan, that is not less than the amount that such holder would ... receive or retain if the debtor were liquidated under chapter 7 ... on such date." The need for sovereign borrowers to return to the market also limits opportunistic behavior.

III. The Limitations of Receiverships

This final portion of the paper highlights three key limitations that temper the story told in the prior section. While it is beyond the competence of this short paper to fully address each of these or the many other issues connected with importing receivership practice into the sovereign context, this section provides an important basic grounding for any such move.

The first fundamental limitation on any use railroad receiverships in a modern context is the simple fact that the nature of the federal courts has changed considerably since the age of the receiverships. Railroad receiverships operated in an age when federal equity jurisdiction was at its peak – but the New Deal saw a substantial reduction in the extent of the federal court's equitable powers.[52] Moreover, recall that railroad receivership law developed pre-*Erie*,[53] in an age when the federal courts enjoyed greater freedom to develop new legal structures from whole cloth. These institutional changes may circumscribe a district judge's willingness to experiment in an area of the law that has been dormant for decades.

Second, receiverships, as *in rem* proceedings, are inherently limited to addressing property that can come within the control of the district court and there is good reason to doubt any

---

52 *See* Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, *supra* note __, at __.

53 Erie R. Co. V. Tompkins, 304 U.S. 64 (1938) (federal courts must follow and apply both state statutes and state case law in deciding cases unless the case is governed by federal statutes or the Constitution).

extra-territorial application of federal *in rem* jurisdiction.[54] Plainly a sovereign borrower could never move all of its assets to the United States, so a receivership proceeding may be at most a partial solution to a sovereign's financial distress. A European bondholder could have its rights to proceed against American assets limited by a receivership proceeding, but the receivership would have no say on whether that bondholder could then proceed against a bank account in London or a state-owned ship docked in Hong Kong.[55] The full benefits of a receivership would be realized only if similar proceedings could be commenced in all relevant jurisdictions – or at least the jurisdictions where significant assets reside. And all of this assumes a sovereign who is willing – or required – to leave assets in the United States and other commercially relevant jurisdictions.

Finally, and most importantly, there are good reasons to question whether railroad receiverships were very effective at addressing railroads' financial problems. In a forthcoming empirical study, I report that the average railroad that reorganized under a receivership subsequently failed at a rate more than twice as high as railroads that had never gone through a receivership and almost three times as high as modern chapter 11 debtors.[56] Having undergone a receivership before World War I made a railroad more than two and a half times (i.e., 150%) more

---

[54] *See* United States v. Ross, 196 F.Supp. 243, 245 (S.D.N.Y. 1961), *modified*, 302 F.2d 831 (2d Cir. 1962).

[55] American bankruptcy courts face similar problems enforcing the automatic stay in cases involving multi-national corporate debtors. *See, e.g.,* In re McLean Industries, Inc., 68 B.R. 690 (Bankr. S.D.N.Y. 1986).

[56] Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, *supra* note __, at __.

likely to undergo another receivership or bankruptcy after the War.[57] These findings clearly should give any sovereign debtor pause.

The reasons for the high failure rates are plainly open to debate, but one explanation turns on the simple fact that troubled railroads were almost entirely dependent on creditor goodwill to make the receivership process work. If too many bondholders opted to take the upset price, and exit the railroad, the process would fail. To get a critical mass of accepting creditors, railroads may have been forced to foreswear the kind of extensive debt reduction that their situation demanded.

A similar problem could develop for a sovereign borrower that attempted to use the receivership process outlined in Part II – the package of securities offered under the plan would have to be sufficiently tempting to get enough bondholders to forgo their claim to a portion of the debtor's local assets. That is, the present value of the assets that a bondholder could obtain in a direct suit would have to be less than the present expected value of the securities issued under the plan, and these securities clearly would have to include a risk premium to reflect the chance of non-payment. Obviously, the risk premium could become large enough to swamp the benefits of the receivership – the borrower would then recreate the debt burden that lead to its initial financial distress – but without such a risk premium the reorganization would fail.

Without an adequate risk premium, so many bondholders would opt for their share of the debtor's readily obtainable assets – the pseudo-liquidation option – that the court would have little choice but to terminate the receivership.

---

57 *Id.* at __.

Accordingly, the debtor would have a strong incentive to propose a plan where the expected value of the securities issued under the plan is substantially in excess of the value of the liquidation option. In essence, the debtor might have a incentive to undercut the effectiveness of its own reorganization efforts to obtain the Pyrrhic benefits of a widely accepted plan.

All of which is to suggest that there are substantial hurdles to be addressed before a sovereign debtor could deploy the railroad receivership model in modern times. Railroad receiverships undoubtedly offer important insights for modern practice. Moreover, the ability to use a receivership to channel all domestic litigation into a single forum might itself have significant benefits,[58] even if the procedural means of reorganization used by the railroads should be discarded in favor of more useful tools. For example, a receivership could be commenced to facilitate an exchange offer that used exit consents to encourage (coerce) bondholder participation.[59] The key is to avoid any overenthusiastic suggestion that historical railroad receiverships provide a ready-made tool to end the debates about sovereign debt restructuring.

---

[58] This, after all, has been a stated goal for some time. *See* Frederick Tung, *Is International Bankruptcy Possible?*, 23 MICH J INTL L 31, 34-35 (2001).

[59] On the use of exit consents in sovereign debt restructuring, see Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59 (2000).