No. 20-310

IN THE

Supreme Court of the United States

ROBERT JAMES KEACH, Estate Representative of the Post-Effective Date Estate of Montreal, Maine, and Atlantic Railway, Ltd.,

Petitioner,

v.

NEW BRUNSWICK SOUTHERN RAILWAY COMPANY LIMITED and MAINE NORTHERN RAILWAY COMPANY,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF FOR PETITIONER

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INTRODUCTION

Respondents' brief in opposition is notable for what it does not dispute. Respondents do not dispute that the courts of appeals are sharply divided regarding the scope of the six-months rule. They do not dispute that the First Circuit expressly acknowledged the division of authority and took a side. And they do not meaningfully dispute that the First Circuit's broad interpretation of the six-months rule conflicts with the priority scheme that would otherwise apply under the Bankruptcy Code and, by requiring more claims to be paid in full, will harm railroads' ability to reorganize.

Instead, respondents seek to sidestep the split by arguing it is not implicated here. They contend that the question this case presents is whether their claims should have priority over claims of other *unsecured* creditors, while the question dividing the courts of appeals relates only to priority over claims of *secured* creditors. Respondents are wrong.

The First Circuit drew no distinction between priority over secured claims and priority over unsecured claims, instead simply asking whether, under the six-months rule, respondents' claims "must be paid in full *before other claims*," App. 2a (emphasis added), and concluding that they must. It was unnecessary to specify the priority with greater precision, since the estate's assets were sufficient to pay both secured claims and priority unsecured claims in full. The question the First Circuit decided was whether the six-months rule grants respondents' claims—which would otherwise be general unsecured claims—*any priority at all*. The court expressly recognized the circuit split on that question and reaffirmed its adoption of the minority view.

Respondents note that this Court's decisions articulating the six-months rule in *Fosdick* v. *Schall*, 99 U.S. 235 (1879), and *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905), and subsequent court of appeals decisions have asked whether unsecured creditors should have priority over secured creditors. But that is because the six-months rule is a remedy for improper diversion of a failing railroad's funds from unsecured operating creditors to secured creditors. While respondents claim that the six-months rule also grants administrative-expense priority to pre-petition operating expenses absent diversion, that is precisely the issue on which the courts have disagreed. Respondents' attempt to evade the question presented thus merely begs that question.

On the merits, respondents fail to support their sweeping view of the six-months rule, citing no authority for it beyond the First Circuit's misreading of *Miltenberger* v. *Logansport, Crawfordsville & Southwestern Railway Co.*, 106 U.S. 286 (1882). *Gregg* refuted that misreading and forecloses respondents' position.

Finally, respondents' attempt to manufacture a vehicle problem is frivolous. They contend petitioner waived the question presented by providing in the plan that respondents' claims would be paid in full, but the plan provided for full payment *only if the courts decided respondents' claims were entitled to priority.* Petitioner has consistently maintained that respondents' claims are *not* entitled to priority. The First Circuit rejected respondents' assertions of waiver, and they should not detain this Court. This case is an ideal vehicle to resolve the "pure question of law" presented, App. 10a, which has divided the courts for decades and is critically important to railroad reorganizations.

I. THIS CASE IMPLICATES AN ENTRENCHED CIRCUIT SPLIT ON THE SCOPE OF THE SIX-MONTHS RULE

Respondents concede that there is a long-standing circuit split over whether the six-months rule requires a diversion of income to secured creditors. They argue, however, that the split relates only to whether diversion is required for unsecured claims to obtain priority over *secured* claims. According to respondents, there is no dispute that the six-months rule grants necessary expenses incurred in the six months before bankruptcy priority over other *unsecured* claims, without any requirement of diversion. Respondents claim that is all the First Circuit decided, and its decision thus did not implicate the split.

Respondents' arguments are wrong on all counts, starting with what the First Circuit held. The First Circuit never held that respondents' claims had priority only over other unsecured claims, but not secured claims. Indeed, the First Circuit never once mentioned that distinction. Rather, it framed the question before it simply as whether respondents' claims "qualified as … 'Six Months Rule' claims … and so must be paid in full before other claims." App. 2a. While it held that respondents' claims were six-months claims, it did not specify exactly what priority the claims warranted under the six-months rule. Pet. 26-30.

That is understandable, because the estate had sufficient assets to pay both secured claims and priority unsecured claims (but not non-priority unsecured claims) in full. It was thus immaterial whether respondents' claims ranked ahead of secured claims or behind them; in either case, respondents' claims would be fully paid if they were entitled to priority under the six-months rule. Pet. 13. The issue before the First

Circuit was not what *kind* of priority respondents' claims should have, but whether they should have *any priority at all*.

The First Circuit recognized that this issue was the same issue presented in *Fosdick*, *Gregg*, and the cases interpreting them—a "pure question of law," App. 10a, that turned on the "scope of the Six Months Rule," App. 12a. Was the six-months rule confined to a remedy for an improper diversion of income to secured creditors, or did it confer priority on a broader set of expenses incurred during the six months before bankruptcy, without regard to diversion? App. 15a-20a.

The First Circuit explained that its prior decision in *In re Boston & Maine Corp.*, 634 F.2d 1359 (1st Cir. 1980), had adopted the broader view. App. 18a-21a. *Boston & Maine* read this Court's decision in *Miltenberger* to expand the six-months rule beyond a "*Fosdick*-based diversion principle" to encompass "a concern about ensuring equal treatment" of claims for necessary operating expenses incurred before and during the bankruptcy. App. 19a. Accordingly, *Boston & Maine* held that the six-months rule conferred priority on all necessary operating expenses incurred in the six months before bankruptcy in reliance on payment from the railroad's current income, without any diversion requirement. App. 21.

Boston & Maine did not, however, hold that the claims at issue were entitled only to priority over other unsecured claims. To the contrary, it instructed the district court to grant the claims priority under the six-months rule, 634 F.2d at 1382, without disturbing the district court's ruling that the "priority of qualified six months creditors is *superior to the claims of … secured creditors*," 468 F. Supp. 996, 1002 (D. Mass. 1979) (em-

phasis added). That outcome was entirely consistent with *Boston & Maine*'s "equal treatment" rationale because the district court (operating under the pre-Code statute) had held that administrative expenses had priority over secured claims. S*ee id.* at 1009. Likewise, the First Circuit below merely reaffirmed *Boston & Maine*'s holding; it did not limit the "equal treatment" aspect of the six-months rule to priority only over other unsecured claims, as respondents contend.

Regardless, even if the First Circuit had held that respondents were entitled only to priority over other unsecured claims—and it did not—its decision would still split with other circuits, which have correctly held that priority under the six-months rule is limited to a remedy for improper diversion. The First Circuit itself recognized in *Boston & Maine* that other courts had rejected its reading of *Miltenberger* as expanding the six-months rule to encompass an "equal treatment" concern. 634 F.2d at 1375-1377. The decision below likewise acknowledged its conflict with other courts of appeals that have "read the Supreme Court's precedent to impose a *Fosdick*-based diversion requirement for … Six Months Rule claims." App. 24a. Respondents cannot explain why the First Circuit would have chosen sides in a circuit split if that split were not implicated by the case before it.

Nor do the other decisions forming part of the split support respondents' distinction. Rather, they make clear that, in cases without diversion, pre-petition operating creditors are general unsecured creditors lacking *any* priority. In *Martin Metal Manufacturing Co.* v. *United States & Mexican Trust Co.*, 225 F. 961 (8th Cir. 1915), for example, the court held that, absent diversion, the six-months rule did not take a pre-petition operating expense "from the class of general claims and

place it in the class of preferential claims." *Id.* at 964; *see id.* at 962 (affirming order "allowing the claim … as a general creditor"); *see also Moore* v. *Donahoo*, 217 F. 177, 180 (9th Cir. 1914) (absent diversion, six-months rule affords no priority to "claim of a general creditor"). Likewise, in *In re New York, New Haven & Hartford Railroad Co.*, 405 F.2d 50 (2d Cir. 1968), the Second Circuit held that "[w]hether the six months creditors receive priority depends" on the diversion of "a 'current debt fund' … for the benefit of [secured] bondholders." *Id.* at 52. Without such diversion, "nothing … would lead to the grant of a special preference for [pre-petition operating] claims." *Id.*[1] Respondents' distinction between priority over secured claims and over unsecured claims finds no purchase in these decisions.

Ultimately, respondents' argument simply boils down to their view of the merits. Their contention that the six-months rule grants administrative-expense priority to pre-petition operating expenses even absent diversion is not a reason the question presented should not be granted; it *is* the question presented. Respondents' question-begging approach fails.

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[1] Respondents rely (at 19) on the district court's decision in *New Haven*, but it merely noted that the claimants could renew their request for priority if circumstances changed, including "[i]f … operating revenues are diverted to the mortgagees." 278 F. Supp. 592, 606-607 (D. Conn. 1967). They also rely on *Pennsylvania Steel Co.* v. *New York City Ry.*, 216 F. 458 (2d Cir. 1914), which gave priority to certain pre-petition expenses over other unsecured claims in a rare case involving no secured debt. That case is an outlier and has been criticized, *see, e.g.*, *Boston & Maine*, 468 F. Supp. at 1007 n.11 (noting "great difficulty squaring [*Pennsylvania Steel*'s] reasoning with the fundamental basis for a six months priority" (internal quotation marks omitted)), and the Second Circuit did not acknowledge it when it addressed the six-months rule in *New Haven*, 405 F.2d at 51-52.

II. THE FIRST CIRCUIT'S DECISION IS WRONG

Respondents' efforts to defend the First Circuit's expansive view of the six-months rule also fail. As this Court explained in *Fosdick* and *Gregg*, the six-months rule arose from a specific concern: that railroads would divert current income normally used to pay unsecured operating expenses to secured lenders, who often held liens on all of a railroad's property. If those lenders foreclosed, nothing would be left for the operating creditors who had reasonably relied on current income for payment. In that situation, the six-months rule may entitle such operating creditors to priority over secured creditors in the foreclosure proceeds, on an equitable restitution theory. *Fosdick*, 99 U.S. at 252-254; *Gregg*, 197 U.S. at 186-187; Pet. 23-26.

This Court accordingly held that the six-months rule applies *only* in cases of diversion: "[I]f there has been in reality no diversion, there can be no restoration." *Fosdick*, 99 U.S. at 254; *see Gregg*, 197 U.S. at 186-187 (six-months rule applies only where there has been "a diversion of income by which the mortgagees have profited").

Respondents wrongly suggest (at 8-9, 17-18) that *Fosdick*'s and *Gregg*'s holdings were limited to priority over secured claims, and that *Gregg* acknowledged that the six-months rule grants priority over unsecured claims even without diversion. They point to *Gregg*'s statement that the lower court's decree "establish[ed] [the supplier's] claim as a six months' claim." 197 U.S. at 186. But the Sixth Circuit merely noted that the claim was "of the character entitled to be paid preferably out of the current income" "within the rule of … *Fosdick*"—meaning it was a necessary expense incurred within six months before the receivership in re-

liance on payment from current income—but denied it priority under the six-months rule because "there had been no diversion of income for the benefit of the mortgagees." 109 F. 220, 221-222, 226-229 (6th Cir. 1901). Respondents also cite *Gregg*'s observation that Gregg "may have a claim against surplus earnings"—but the Court stated "that question is not before us." 197 U.S. at 188. Neither comment remotely supports the First Circuit's decision.

In the end, respondents simply repeat (at 6-8, 11, 21-22) the First Circuit's flawed reasoning. The First Circuit, in turn, adopted the view of the *dissent* in *Gregg*, opining that *Miltenberger* broadened the six-months rule to grant priority to pre-petition operating expenses even absent diversion. *Boston & Maine*, 634 F.2d at 1374, 1377-1379; Pet. 11-12, 24-26. The majority in *Gregg* expressly rejected that position, explaining that *Miltenberger* addressed an entirely different question—not a rule of priority, but the doctrine of necessity, which authorized paying pre-petition claims where necessary to obtain necessary goods or services during the receivership. 197 U.S. at 187. *Gregg* expressly held that *Miltenberger* did not expand the six-months rule beyond *Fosdick*'s diversion remedy. *Id.*

Notably, respondents' reliance on *Miltenberger* cannot be squared with the version of the six-months rule they now advance, in which diversion is required when priority is sought over secured claims, and excused only when priority is sought over unsecured claims. *Miltenberger* authorized the payment of unsecured operating claims "out of … the *corpus* of the property," ahead of secured creditors. 106 U.S. at 311. If *Miltenberger* truly involved the six-months rule, as respondents contend, the rule would grant priority not only over unsecured claims, but also over *secured*

claims, without any showing of diversion. Yet, that is precisely the argument *Gregg* rejected—as respondents concede. 197 U.S. at 187-188. Respondents cannot muster any coherent argument reconciling the rule they advocate with *Fosdick* and *Gregg*. Those decisions foreclose respondents' contentions and the First Circuit's holding.

III. THIS CASE IS AN IDEAL VEHICLE FOR RESOLVING THE IMPORTANT QUESTION PRESENTED

As a last resort, respondents attempt (at 25-29) to conjure a vehicle problem, claiming that petitioner waived the question presented. That claim is baseless.

Respondents contend that petitioner waived the argument that the six-months rule requires diversion by failing to raise it in bankruptcy court. But the First Circuit expressly rejected that contention, App. 14a n.2, addressing petitioner's argument on the merits. There is thus no impediment to this Court's review.

Respondents also argue that petitioner waived the right to dispute priority because the plan classified respondents' claims as priority claims and set aside funds to pay them. That argument strains the bounds of fair advocacy. Those plan provisions were specifically designed to allow plan confirmation to proceed while maintaining both parties' rights to argue the priority issue. Under the plan, respondents' claims would be entitled to priority and paid in full *only if* they were "[a]llowed … as Claims under section 1171(b)." Order Confirming Plan (Dkt. No. 1801), Ex. A (Plan) §2.4. Far from waiving petitioner's right to argue that respondents' claims did not qualify as six-months claims under §1171(b), the plan expressly preserved that right.

Likewise, respondents' judicial-estoppel argument (at 29) is not only waived for failure to raise it below, C.A. Appellees Br. (May 20, 2019), but meritless. Petitioner never conceded respondents were entitled to priority; the plan was not confirmed due to any such concession; and respondents have not been prejudiced, because the plan preserved both parties' rights to litigate priority.

Finally, respondents do not seriously dispute the importance of the question presented. They note (at 23-24) that some of the decisions addressing the question are old, but do not dispute that they remain good law and continue to govern railroad reorganizations in their respective circuits. Nor do respondents dispute that more railroads will likely need to seek bankruptcy protection in response to the current economic downturn and pandemic.

In any event, the fact that railroad bankruptcies do not happen every day does not make them unimportant or shield them from this Court's review. To the contrary, Congress established a special statutory regime for railroad reorganizations precisely because they implicate "the public interest" in a way other bankruptcies do not. 11 U.S.C. §1165. Railroads transport a large share of essential commodities, particularly in the energy sector, and railroad failures strike at the core of the nation's economy. Pet. 31-32.

The question presented could hardly be more fundamental to railroad reorganizations: It involves the priority scheme governing how creditors are paid. *See Czyzewski* v. *Jevic Holding Corp.*, 137 S. Ct. 973, 983-984 (2017) (the "priority system constitutes a basic underpinning of business bankruptcy law" and is "fundamental to the Bankruptcy Code's operation"). Uncer-

tainty regarding this basic aspect of bankruptcy is inherently inefficient and detrimental to all stakeholders.

And the First Circuit's rule is particularly harmful. Respondents do not dispute that it will be far harder for railroads to reorganize if they must pay virtually all operating expenses incurred in the six months before bankruptcy in full. But that is the practical result of the First Circuit's rule. Contrary to respondents' suggestion (at 24-25), the First Circuit's test for six-months claims is hardly onerous. The claim need only have been "necessary" to operations (as expenses incurred by a distressed railroad usually are) and made in expectation of payment from current income (as "nearly all general creditors undoubtedly expect," *Martin Metal*, 225 F. at 964).[2] Many claims will easily meet it, undermining railroads' prospects for rehabilitation and harming the public interest Congress recognized.

In short, this is the perfect opportunity for the Court to resolve a deep-rooted and persistent division of authority over the basic contours of railroad reorganizations—a pure question of law, squarely and cleanly presented, with profound implications for one of the country's key industries. The Court should grant review.

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[2] While respondents argue that they were the only creditors granted six-months priority here, MMA had sufficient income to pay operating claims before bankruptcy. It was forced into bankruptcy by a sudden disaster, rather than the typical slide into insolvency in which many operating claims go unpaid.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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