A Comparative Analysis of Income Bonds and Preferred Stock

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A COMPARATIVE ANALYSIS OF INCOME BONDS AND PREFERRED STOCK

Corporate securities are ordinarily classified into the two general categories of stocks and bonds, or those which are evidence of ownership of the corporate business and those which are evidence of indebtedness of the corporation. However, these two classifications admit of various subdivisions depending upon the provisions of the stock contract or bond indenture. Indeed, there are those which are difficult to classify under either and could be called "hybrids" by those who desire categorically to classify them according to the usual stock and bond grouping. The most common securities of this so-called hybrid type are preferred stocks and income bonds.

Although the term "preferred" as used with reference to stock is not sufficiently explanatory of the true nature of the stock, yet it does serve to convey the impression that stock of this type differs from the common shares of the issuing corporation. Usually preferred stock certificates provide that there shall be a fixed rate of dividend thereon, and that such dividends will be declared before any declaration on the common stock. These two provisions tend to make preferred stock resemble bonds somewhat more than stock. Preferred stock differs from common insofar as the preferred contract provides; otherwise, no distinctions

3 See Hoagland, Corporation Finance (2d ed. 1938) 56.
4 See 2 Hildebrand, Texas Corporations (1942) § 480.
5 Of course, other evidence such as the charter or articles of incorporation, and by-laws can also be considered in determining the rights of preferred stockholders. Continental Ins. Co. v. Minneapolis, St. P. & S. S. M. R., 290 Fed. 87 (C. C. A. 8th, 1923).
exist. The distinctions embodied in preferred contracts may be limitations or additions.⁶

This class of stock was first most prominently used in the financial structure of corporations during the expansion period of railroads and canals for the purpose of attracting investors who disliked the low interest rates on bonds, but who were also skeptical of dubious common stocks.⁷ Again some use was made of this type of security during the reorganization of railroads in 1895, but it has been employed most extensively for the purpose of securing fresh capital or as a bonus for the purchase of common stock.⁸

Income bonds, on the other hand, had their earliest principal use almost exclusively as an expedient exchange for fixed charge securities resorted to in connection with the reorganization of railroads.⁹ The rate of interest stipulated for in such bonds is payable only when there is a net income earned during any given interest period sufficient to justify it.¹⁰ Thus the bond is very similar to preferred stocks. It is important to note that the infrequent use of the income bond, except in reorganization, has been largely due to the “bad name” which it has come to have with investors. This, however, is a rather unfair indictment of this type of security because the earlier use of this financial device was largely experimental and invariably on the part of corporations which had little chance of financial recovery in any event.

Thus preferred stock and income bonds have a basic similarity in that the corporate issuer is not obliged in the case of either

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⁶ The conditions and limitations included in preferred stock contracts have been grouped into four main classes. Simply, they are: (1) provisions having to do with preferences as to dividends; (2) redemption provisions and the shareholder’s lien on the corporation property; (3) limitations on the management as to dissipations of assets; and (4) participation provisions.

⁷ See Hoagland, supra note 3.

⁸ See Dewing, Corporation Finance (1922) 34.

⁹ See Dewing, op. cit. supra note 1, at 44.

¹⁰ See Berl, The Vanishing Distinction Between Creditors and Stockholders (1928) 76 U. of Pa. L. Rev. 814.

¹¹ See 6 Fletcher, Cyclopedia of Corporations (1932) § 2644 and cases cited therein.
type of security to pay when there are no earnings, in the absence of cumulative provisions. It is the purpose of this note to consider certain aspects of these two types of securities, with special reference to their potential utility in effectuating the financial policy of corporate enterprise.

**Nature of the Issuer's Obligation to Pay a Return**

Preferred shareholders are generally considered part owners of the corporate business as in the case of common shareholders; therefore, the relation of debtor and creditor does not exist between the corporation and such shareholders, except as to declared dividends. The fact that an earned surplus exists does not ipso facto give the preferred holders a legal right to dividends; that the declaration of such dividends is within the discretion of the directors is supported by the overwhelming weight of authority. Therefore, the courts have been reluctant to decree dividends at the suit of the preferred stockholders. Nevertheless, where the shareholders can establish a clear case of bad faith or abuse of this discretion on the part of the directors, equitable relief has been given. There is no serious argument against such an extensive degree of discretion, since the owners of any enterprise, corporate or otherwise, must shoulder the basic risks. To hold that directors are obligated, when sufficient earnings are realized, to pay dividends on preferred stocks would shift the larger part of the risk to the common shareholders and would tend to give the preferred holders a position for which they never bargained when they purchased an interest in the business.

Where the preferred share contract provides that the dividends shall be non-cumulative, the court should more rigidly scrutinize

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12 See 2 Hildebrand, supra note 4.
14 Knight v. Alamo Mfg. Co., 190 Mich. 223, 157 N. W. 24 (1916). See Kehl, Corporate Dividends (1941) 167: "Even when the preferred dividend right is non-cumulative, it is held that directors have much the usual discretion in refusing to declare dividends from earnings."
15 See Note (1937) 10 Rocky Mt. L. Rev. 201.
the fides of the directors since a failure to declare dividends for that period will preclude any return to the shareholder for the dividend period in question. One writer\textsuperscript{16} has taken the view that where preferred dividends are non-cumulative and the preferred shareholders prove sufficient earnings, bad faith on the part of the directors should be presumed. This seems desirable in view of such shareholders' weak position with regard to corporate profits.

When, however, the dividends are cumulative, the corporation must declare accrued dividends before any declaration of common dividends; thus, theoretically at least, the shareholder's position as to profits is protected, since failure to declare the dividends neither relieves the corporation of its obligation therefor nor destroys the holder's prospects for an eventual payment. Too much emphasis, however, is not to be placed upon this cumulative aspect, inasmuch as in some cases where accrued dividends have been large, concerns have reduced them by inducing the preferred holders to exchange their stock for newly issued certificates which are equal in face value to the exchanged security plus the amount of the accrued dividends; in other cases new shares have been issued in the amount of the accumulations and distributed to the preferred holders.\textsuperscript{17} In either event the corporation avoids a cash outlay, and large dividends may thereupon be declared for the common shareholders. A consistent policy of this nature may result in a meagre realization of money dividends by preferred holders.

Although the existence of net income does not give the preferred stockholders an enforceable claim to a dividend, such is not the case with regard to the right of income bondholders to interest. When the net income for a given period is sufficient to pay the interest on the income bonds, failure to do so constitutes

\textsuperscript{16} See KEHL, op. cit. supra note 14, at 168.

\textsuperscript{17} If earnings are made but dividends are not paid, then the accumulations are subject to the risks of business.
a default which is actionable at law. Therefore, when a net income has been declared, there is no discretion in the directors as to whether they will pay the interest as in the case of preferred dividends. For the courts to recognize such a discretion would leave the income bondholder in substantially the same position as the stockholders without the rights and privileges of the shareholders but with all the risks of ownership.

Litigation by income bondholders has been principally in equity for an accounting and a declaration of net income by court decree. Some of the earlier cases did not allow such relief, but later cases did recognize the cause of action on the ground of a fiduciary relation between the directors and the bondholders or, as some of the courts said, where bad faith could be shown. Whether there is a net income is largely discretionary with the corporate managers, and the problem involves the application of accounting principles. The cases reveal that expenses, reasonable betterments, depreciation, renewals, repairs and alterations have been held deductible before the court makes a finding of net income; and the amount to be allowed for these items is discretionary with the directors. The court will review the exercise of this discretion only upon a showing of bad faith. Certainly the court should look more closely where the interest on the bonds is non-cumulative. Much of this litigation could be avoided if the bond indenture were properly drawn so as to specify with greater particularity the circumstances under which net profits will be declared.


21 Morse v. Bay State Gas Co. of Delaware, 91 Fed. 938 (C. C. D. Del. 1897).


Thus where there is a net income for a given period, the corporation is obligated to pay the stipulated interest on the income bonds, but it is under no legal duty to declare a dividend on preferred stock; however it must employ the profits properly with regard for the preferred holders. Further, the corporation must exercise good faith in determining net income where income bonds are outstanding.

**DIFFERENCES FOR THE PURPOSE OF FEDERAL TAXATION**

It is sometimes said that whether a security holder is a creditor or stockholder is no longer of significance. While this may be true for many purposes, nevertheless, the distinction must continue to be made for the purposes of federal taxation under § 23 of the Internal Revenue Code,\(^2\) which reads:

"In computing net income there shall be allowed as deductions: ... (b) ... All interest paid or accrued within the taxable year on indebtedness."

Under this provision the cases decided by the federal courts have laid down some general criteria, which, although not too satisfactory, afford a basis for determining whether the payment of a particular return will be deductible. Without attempting here to discuss the decisions, a few of the important considerations which the courts have recognized may be pointed out so as to present a general concept of the problem and its difficulties.

The courts have declared that the fact that a particular security is labeled "stock" or "bond" is not conclusive\(^2\) but is not to be ignored. Thus a so-called income bond may in effect be a stock for taxation purposes. The intention of the parties at the time of the issue is a material consideration but again is not determinative.\(^2\) If there is a maturity date, then this provision is bond-like and is to be weighed. Similarly the absence of a maturity date is

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significant. Where the security is redeemable, the court looks to see whether it is redeemable at the option of the holder or the corporation and weighs the finding accordingly. Voting privileges are deemed to be more consonant with stocks than with bonds; therefore, the presence or absence of such privileges is pertinent to the inquiry. Another consideration is whether the security has a fixed rate of return; in a recent case before the United States Supreme Court involving so-called debentures upon which was to be paid interest from two to ten per cent of income earned, this factor seemed important in the Court’s upholding the decision of the Tax Court that such payments were in effect dividends, hence not deductible. Perhaps the most that can be stated by way of a rule is set forth in the opinion of Judge Hutcheson of the Fifth Circuit Court of Appeals in United States v. South Georgia Ry.:

"... that the question for decision in each case is, not what the payments are called, but what in fact, they are, and that if taken as a whole, the evidence shows a relation of debtor and creditor, the payments made on account of that relation, will be interest, no matter how called, while if taken as a whole, the evidence shows a stockholding relation, the payments made will be dividends, equally no matter how called."

When a corporation proposes to issue a new security, whether for the purpose of raising new capital, or for the purpose of exchange for outstanding securities, regard must be had for this section of the Internal Revenue Code and the decisions thereunder.

Sources of Legal Authority for the Issue of Each Security

Irrespective of the exigencies which call for the issuance of a security, proper legal authority must have been conferred. In the

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28 See note 26 supra.
29 Talbot Mills v. Com'r, 326 U. S. 521 (1946). Another fact which influenced the decision was that the securities in question were exchanged solely for stock.
30 See note 27 supra.
31 For a constructive analysis of this phase of federal taxation, see Winstead, Can Corporations Deduct from Gross Income Dividends on Preferred Stock? (1944) 23 TEx. L. Rev. 39.
case of the income bond, the problem is relatively simple since
issuance thereof would be a proper exercise of the corporation's
power to borrow money. It is significant that this could often be
accomplished by the board of directors, absent the situation where
such issuance would impair prior contract rights of stockholders
or bondholders, without the consent of the stockholders.2 Even in
the absence of a statute granting the corporation power to borrow
money and issue bonds, the power impliedly exists.3 Texas by
statute confers this power upon a profit corporation.4

Preferred stock, however, presents a different picture with ref-
erence to authority for issuance. As a general rule in the absence
of statutory or charter prohibitions or restrictions, the authority
to issue preferred stocks exists, subject to the exception that, if
such issuance will impair prior contract rights of stockholders, the
unanimous consent of all the stockholders must be obtained.5 The
Texas statutes6 provide that where issuance of preferred
stocks is not permitted by the charter, the corporation may issue
with a two-thirds consenting vote of all the outstanding voting
stock.

These differences in authority to issue the respective securities
may become material under certain circumstances. For example,
if the corporation desires to issue a contingent charge security and
the charter embodies no provisions for the issuance of preferred
stock, it may prove exceptionally difficult to obtain the consent of
the prior shareholders; in such a case some form of income bond
may accomplish the desired end quite as well. Contrast with this
situation that where outstanding bonds virtually prohibit further
bonded indebtedness; here perhaps the preferred stock expedient
would be the answer.

2 See 6 Fletcher, op. cit. supra note 11, at § 2650.
3 See 11 Fletcher, op. cit. supra note 11, at § 5284.
Effect of Other Provisions Upon the Quality and Utility of Each Type of Security

While the significant utility of preferred stocks and income bonds, so far as the corporation is concerned, is the contingent payment of returns, still as a security regarded from the investment standpoint little can be said for either unless the respective contracts make the holders' position more definite and desirable. As corporate directors have recognized this, resort has been had to various provisions which may improve the relative position of the holders without sacrificing in any real sense the flexibility of the security.

As noted previously, cumulative provisions have frequently been included in many of the preferred stock and income bond contracts. The extent to which the cumulative feature protects the security holder is dependent upon the wording of the contract. Some preferred stocks have been non-cumulative at the outset, but after a designated lapse of time are thereupon to become cumulative. Especially has this been true of securities of this nature issued as a result of reorganization. Of course the advantage of such a provision is to give the corporate managers greater latitude during the recovery years, while presumably giving the holders an opportunity for a more certain share of the profits. On the other hand the cumulative feature may provide that dividends will only accrue upon the happening of certain conditions precedent, e.g., a provision that in any year in which the corporation earns a certain profit, dividends for that year will accrue if not paid.

Similar cumulative provisions may or may not appear in the income bond indenture. However, it is submitted that the cumulative feature should be intrinsic in the income bond, although the courts hold that the bond is non-cumulative unless otherwise provided. Certainly the income bondholder who is not entitled to cumulative interest is in substantially the same position as a stockholder and in probably a less protected status than the
cumulative preferred holders. Therefore, if the bondholder is in effect to retain his status of a creditor, the cumulative aspect should necessarily be a feature of his security; otherwise the holder will bear the usual risks of the stockholders.

Preference in the distribution of assets is sometimes given preferred holders over the common stockholders. Such a preference is generally considered to be of value by such holders; however, if the assets remain large after the creditors are satisfied, then it may be to the advantage of the preferred holders not to have this preference if they are to get only the par value of their stock.

Common to many preferred contracts are provisions for participation by the holders in the corporate earnings after the common shareholders have received dividends equal to those declared for the preferred. The extent to which such participation is allowed is of course dependent upon the contract, and in the past there have been all sorts of variations; some provide that the common and preferred holders will share equally, while others allow the preferred to participate only up to a certain percentage. Again this privilege is difficult of evaluation except with reference to common shareholders' rights, and it does not operate materially to insure the preferred holders of their return. Provisions for participation have appeared in income bond indentures, but such issues are rare.

Convertibility may be one of the privileges allowed the security holders. Under this provision the holder can at his own election convert his security to a junior one, usually to common stock. Of course the value of this provision depends upon the success of the corporation. The privilege enables the security holder to share in the benefits of the more fruitful years if he desires.

Redemption privileges are often embodied in the contract, but where the security is redeemable at the election of the corporation the holder's investment is subject to discontinuance, probably when the corporation has just become sufficiently successful to render the investment worthy. Therefore, unless the security is redeem-
able at the option of the holder the provision is somewhat more of a detriment than would be its omission.

Although many of the provisions of preferred contracts and income bond indentures are ostensibly protective, history has proved them to be little more in reality than selling points. The needed protection for these contingent charge security holders consists of contractual limitations upon management which will prevent their incurring excessively senior claims by way of bonded and floating indebtedness and also the dissipation of the corporate assets. Just what limitations are to be imposed is largely a question for each concern, but the two basic and conflicting considerations are the protection and definition of the security holder’s position as opposed to the desire to retain sufficient flexibility in the financial policy. It must be admitted that in the majority of instances the preferred shareholder’s position is more in the nature of an outside creditor than of a partner in the business, but without the assurance which the usual holder of a credit obligation possesses. The same is true for the most part with regard to income bondholders. Therefore, if the securities under discussion are to have standing as a desirable security, the corporation must attempt to reconcile the problems arising from these considerations.

Closely allied with limiting provisions upon management are voting rights. The extent of voting rights as regards the holders of these securities has ranged from a right to vote under certain circumstances to the election of the directors where the return of such security has been passed for certain periods. Not only may these rights in effect be very valuable where the management passes to the security holders, but they may operate as a conservative influence on unduly eager directors.

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