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THE PAST, PRESENT, AND FUTURE
OF INCOME BONDS

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TABLE OF CONTENTS

	Page
LIST OF TABLES	vi
Chapter	
I. INTRODUCTION	1
Definition of Terms	
Delimitations	
Sources of Data	
Related Studies	
Procedures	
Treatment of Data	
II. A REVIEW OF INCOME BONDS	6
The Present Railroad Income Bonds	
Classification and Rating of Railroad	
Income Bonds	
The Railroad Income Bond Market Since	
World War II and Its Significance	
A Review of Preference or New Capital	
Income Bonds	
III. THE ADVANTAGES AND DISADVANTAGES	
OF INCOME BONDS	18
The Advantages and Disadvantages	
of Income Bonds: General	
Advantages for the Issuer	
Advantages for the Purchaser	
Disadvantages to Income Bond Issuers	
Disadvantages to Income Bond Purchasers	
Income Bonds as a Possible Alternative	
To Other Types of Securities	
Income Bonds: An Alternative to	
Common Stock	
Income Bonds: An Alternative to	
Straight Bonds	
Income Bonds: An Alternative to	
Preferred Stock	

IV. ATTITUDES OF INVESTORS AND ISSUERS
TOWARD INCOME BONDS 59

Investors' Attitudes

Universities
Savings Banks
Bank Trust Departments Which
Operate Pension Funds
Bond Funds
Wealthy Individuals
Insurance Companies

Attitudes of Issuers

The Attitude of Issuers Toward
Contract Features, Regulatory
Agencies, and the Future of
Income Bonds
The Uses for Income Bonds
Investment Bankers

V. LEGAL PROBLEMS INVOLVING INCOME BONDS. 76

Early Court Decisions

Examples of Early Court Decisions

The Recognition and Solution of Many
Income Bond Contract Problems

Determining Net Income of
The Issuer Company

Protective Provisions

A Cumulative Provision
Access to Company Books
A Dividend Restricting Clause
Protection of Principal

What Constitutes Income Bond Interest

Distinction Between Interest
And Dividends: General

Tests Based on Pre-1946 Decisions

The Talbot Mills and Kelly
Company Cases

VI. SUMMARY AND CONCLUSIONS	96
Conclusions Considering the Advantages and Disadvantages of Income Bonds	
Situations Where It Is Advantageous To Use Income Bonds	
Conclusions Considering the Attitude of Issuers and Investors	
Conclusions Considering Legal Problems	
Conclusions Considering the Future of Income Bonds	
Suggestions for Further Study	
APPENDIXES	107
Appendix I: Calculations of the Cost of Bond Contract Features	
Appendix II: Explanation of Questionnaires	
BIBLIOGRAPHY	125

LIST OF TABLES

Table	Page
I. High and Low Prices for the Dow-Jones Railroad Income Bond Average, 1958-1965	14
II. Yields for Medium and High Grade Industrial Preferred Stocks, 1954-1964	49

CHAPTER I

INTRODUCTION

Why has the once fallen star of income bonds started to rise after spending over seventy years below the financial horizon? Is it because income bonds provide many of the advantages of debt financing with the non-fixed payments feature of equity financing? Could it be caused by the high yields they carry considering the risk involved? Is it the result of the large tax savings created in many cases? All of these questions are important.

Eighteen years ago income bonds were one of the least respected and most disliked types of securities that a company could issue. Today they have a limited but growing use and an ever increasing acceptance. This study is an attempt to determine and give reasons for the development and use of income bonds in the past, present, and future. It traces the development of income bonds, explains the advantages and disadvantages associated with them, and prognosticates about their future.

Definition of Terms

An income bond may be designed in any number of ways. It can have characteristics varying from many of those that a high quality mortgage bond has to those that a preferred

stock has. The principal of income bonds may be secured by a mortgage, but the mortgage is usually of a junior class. Often if a lien exists, it is not on specific property. Income bonds may also take the form of collateral trust bonds or plain debentures. In many cases other bonds may be issued in the future which will have priority over income bonds.¹

The differentiating feature of income bonds is that interest payments are contingent on earnings. Under some income bond contracts, interest is paid only if earned, plus all other expenditures specified in the bond contract (like maintenance of plant and equipment) must be met.² Interest payments may be of a cumulative nature. When issued in a reorganization situation, a provision is often inserted that accumulation of unpaid interest does not start until some given number of years after the bonds have been issued.

Unlike stocks, income bonds usually come out of reorganization situations. Rarely are they issued for public subscription. They always must have a specific maturity date on which principal must be repaid.³

When an income bond is a result of reorganization, it is often called an "income adjustment" or "adjustment bond." When

¹Encyclopedia of Banking and Finance, 6th Edition, edited by Glenn G. Munn (revised by F. L. Gracia), (Boston, 1962), p. 333.

²Encyclopedic Dictionary of Business Finance, edited by The Editorial Staff of Prentice-Hall, Inc. (Englewood Cliffs, N. J., 1960), p. 307.

³Husband, William H. and James C. Dockeray, Modern Corporation Finance, (Homewood, Ill., 1957), pp. 368-370.

used to procure capital, the name "preference income bond," "preference bond," or "new capital bond" is used. The majority of income bonds are the result of railway reorganizations; however, in the past eighteen years, preference (as compared to adjustment) income bonds have come into increased use.

Delimitations

This study deals entirely with income bonds and places great emphasis on the preference income bonds. Several subjects are of major importance: the use of income bonds as a source of new capital for expanding plant and equipment and increasing working capital; the consideration of income bonds as an alternative to issuing preferred stock, common stock, and straight bonds; and the historical use of income bonds. Legal definitions concerning an income bond for tax purposes are discussed with references to precedent-setting legal cases, but only to make known the legal problems involved, not to solve them.

The questionnaires and interviews dealing with attitudes toward income bonds sampled past and potential buyer and seller opinions. The resulting sample answers are not necessarily meant to obtain conclusive validity, but generally held opinions should be put into focus.

The income bonds considered in this study are those listed in the various Moody's manuals and those listed in The Commercial and Financial Chronicle under new capital flotations.

Sources of Data

In compiling the data for this study, two major sources of information were used:

One, written information on or related to the use of income bonds. This includes textbooks, business journal articles, business services like Moody's, a thesis, income tax rulings, and precedent-setting court cases. The libraries of North Texas State University, Southern Methodist University, and The University of Texas were the principal sources of material.

Two, questionnaires and interviews which covered both the use and feeling toward income bonds. Also, the tax problems connected with income bonds were covered.

Related Studies

One related study was found--"The Future of Income Bonds as a New Capital Source," by Lawrence L. Crum. This study is a Master's thesis written in 1955 at The University of Texas in fulfillment of requirements of a Master's degree in finance. This study attempts to compare the use of income bonds with that of preferred stock in acquiring new capital.

Procedures

A description of income bonds and their general use was determined. Investment bankers and wealthy individuals were interviewed. Questionnaires were sent to five different groups:

1. Universities
2. Bank Trust Departments which handle pension funds

3. Insurance Companies
4. Savings Banks
5. Issuers of Income Bonds.

Readings on the history of income bonds were completed. The history of income bonds in relation to both reorganizational use and new capital use was written. The results of the questionnaires were received and analyzed. The advantages and disadvantages were discussed. The feasibility of using income bonds in place of straight bonds or stock was investigated and set forth. Results from the questionnaires and interviews were described. The general legal problems and definitions involving income bonds were covered with references to court decisions and legal opinions. Conclusions were drawn, and the future of income bonds was discussed.

Treatment of Data

Chapter II covers the history of income bonds. Chapter III is a discussion of the advantages and disadvantages of income bonds and the use of income bonds in place of other securities. Chapter IV discusses the results of the questionnaires and interviews. The legal problems of income bonds will be discussed in Chapter V. Chapter VI contains conclusions about the past, predictions of the future, and suggestions for further study.

CHAPTER II

A REVIEW OF INCOME BONDS

Income bonds were created to cope with financial adversity. Over the past seventy-five years the majority of them were issued because the issuing company was in a state of very probable or present bankruptcy. Only in the present Post-World War II time period has this financial instrument received new uses. The review of income bonds is best categorized into two parts based on use. The first category is that of income bonds issued because of grave financial problems which created the need to maintain what capital the company had and keep it alive. In this first case, the bonds were called adjustment or reorganizational income bonds. The second category is that of bonds issued as a result of financial planning to help maximize profits while maintaining old or providing new capital. These income bonds are called preference or new capital income bonds.

The reorganizational income bond came into being during the last quarter of the Nineteenth Century. In this period many railroads went into receivership. The process which led to these early issues of income bonds usually followed a basic pattern. This pattern is well exemplified by the action taken as the Pennsylvania and Reading Railroad declined from its

once strong financial position.¹ In the late 1870's, adequate income was not available for the company to meet its fixed debt obligations. With this situation present, the company asked all holders of fixed debt securities to allow the company to skip cash payments until the funds were available. In place of cash payments, the debt holders were given payments in scrip. In 1882, when the company failed, claimants of the company met and approved a reorganization of the financial structure of the road in hopes of getting the company solvent and receiving their money. Under the reorganization plan, all fixed debt securities were called in and one of the first income bond issues of record was issued with the approval of the Pennsylvania State Legislature. The name given this \$34,300,000 worth of bonds was deferred income bonds.² The bonds carried an interest rate of 6 per cent of par, had no stipulated time for repayment, and had a priority of claim on earnings behind all other debt holders and stockholders. After dividends to common stockholders (in the amount of 6 per cent of company income) had been paid, plus all debts, plus interest on the income bonds, the claim status of income bond holders moved up. Under the new claim status, the bond holders had an equal right to all earnings to which common stockholders had a right. Most of these deferred income bonds sold for 30 per cent of

¹Stuart Daggett, Railroad Reorganization (Boston, 1924), p. 81 ff.

²Ibid., p. 84.

their par value; thus, they had an effective interest rate of 20 per cent.

The pattern of financial actions a company took before issuing income bonds became a standard pattern which was followed by many railroads in the 1880's. First, the company would find it was in financial difficulty. Second, it would stop cash debt payments and issue scrip debt payments. Third, the company would find its scrip payments unacceptable to its debt holders and be forced to issue income bonds. The interest rate of 6 per cent of par (rarely if ever did the bonds sell at even near par value) and no stipulated repayment date set loose standards for many of the income bonds that followed.

During the 1890's many railroad income bonds proved to be poor investments. Also, contractual problems as to the definition of income and the claim status of bonds issued after income bonds caused few new income bond issues between 1892 and the late 1920's.³

The Present Railroad Income Bonds

Virtually all of the present railroad income bonds were issued after 1925. Most of these came out of the period from 1932 through 1941. The Class I rail carriers issued over one billion dollars worth of income bonds under Section 77 of the National Bankruptcy Act and other railroad legislation.⁴ As in the 1880's, the causes of the financial failures which led to the issuing of income bonds were one, mismanagement; two, overcapitalization; and three, diversification into unprofitable

³Ibid., p. 302 ff.

⁴R. V. Fletcher, Railroad Finance (Washington, D. C., 1947), p. 13-18.

fields. This fact gave income bonds in general a bad name; however, there were a few highly rated issues which came out of voluntary reorganization. The Boston and Maine Income Mortgage $4\frac{1}{2}$'s of 1970, for example, had a rating of "A."

The pattern set in the 1880's leading to the issuing of income bonds was still dominant, but the bond contracts were much more lucid. Definite maturity dates were set even though they often were for periods of over one hundred years. The right of management to pay or not to pay interest on the bonds was better defined. Usually a sinking fund was included. Accounting methods were better stipulated, and clauses covering accumulation of interest (usually starting three to five years from the date of issue) came into wide usage.

Throughout the depression in the Thirties, issuance of income bonds continued to be large. When World War II began, the increased freight and traffic loads caused railroads to operate at near capacity. Profits moved up and funded debt (much of which was income bonds) was decreased greatly. Between 1932 and 1940 the net decrease in debts of Class I, II, and III railways was \$1,512 million. From 1940 through 1945 the decrease was \$2,019 million.⁵ By 1950 the number of railroad income bonds had been greatly reduced. Today, in 1966, seventy-six issues are still outstanding.

The railroad income bonds discussed above have served as an example of all reorganizational income bonds. There are

⁵Ibid., p. 302 ff.

many industries other than railroads which have issued reorganizational income bonds. Most of these non-railroad reorganizational bonds, however, have not remained in the market for more than fifteen years and were not issued in large amounts. This is due primarily to the fact that railroads were allowed to operate in a state of receivership where many other businesses were not. Considering the fact that relatively few of these non-railroad issues are in existence over long periods of time and that they represent no important facet of this discussion, non-railroad reorganizational income bonds will not be discussed further.

Classification and Rating of Railroad Income Bonds

The classification of railroad bonds is made up of three groups based on the number of times bond service charges are earned. Group I is composed of bonds of Class I Railroads on which the service charges are earned two and one-half times each year.⁶ The Atchison, Topeka, and Santa Fe Adjustment 4's of 1995; the Denver & Rio Grande Western 1st, 3's-4's of 1993; and the St. Louis Southwestern 2d income, 4 per cent certificates of 1989 all carry an "A" rating and are in Group I even though they are income bonds. Group II bonds are those issued by companies that have earned the service charges on their bonds one and one-half to two times

⁶David F. Jordan and Herbert E. Dougall, Investments (Sixth Edition, New York, 1952), p. 429.

for the past five years. In this group there are income bonds of Class I railroads with ratings from "A" to "Ca." Many more income bonds are found in this group. Group III is made up of all bonds not in Groups I and II. Most of the income bonds issued by railroads are in this group. Earnings security in this group is very low, ranging from no coverage in poor years to less than one and one-half times charges in good years. These bonds often yield more than 7 per cent. All of these Group III bonds are at best considered speculative.

Most investors have consistently been steered away from railroad income bonds, and only in the past fifteen years has this attitude started to change. The reason for the aversion to railroad income bonds is based on their close connection with reorganization and limited security. Perhaps the greatest factor leading to a lessening of this aversion is the recent improvements in the rail industry and securities analysis. This point is important, for there seems to be a good possibility of future investment profits in these reorganizational securities if selectivity is maintained.

Since 1925 many of the railroad income bonds have proved to be at least good speculative investments. This was helped greatly by the three wars since 1925 (World War II, Korea, and Viet Nam), court decisions allowing railroads to cut costs, and better relations between the I.C.C. and the railroads. This prosperity has provided earnings which can well provide coverage of debt requirements. The fact that most railroad

income bonds sell below eighty-five is indicative of investor caution, which is justified. The average investor realizes that the yields from quality railroad income bonds are not exceptionally lucrative. Also, the securities have not been tested under depression conditions. These facts, however, are to be balanced against the fact that recent income bond interest charges are well within the normal earning power of the issuer. After analyzing the situation, one could conclude that investors seeking wide diversification could quite possibly use high quality income bonds to get above average yields and average safety during periods of strong economic growth like the present one.

Railway income bonds like the Denver and Rio Grande Western first 4's of 1993, yielding 7.5 per cent, could qualify as such an investment. Obviously, a small investor would find no need to even consider this type of investment, but insurance companies and other institutions have been experimenting with the idea. The vice president of finance for the Aetna Life Insurance Company felt that he would definitely consider purchase of quality income bonds of the above type.

Significant is the fact that large investors have not let classification and ratings alone determine the value of railroad income bonds. At best, these bonds carry a rating of "A" and most are rated between "Baa" and "Caa." This fact has not stopped the discriminating analyst from locating the investment grade or quality bonds.

The Railroad Income Bond Market Since
World War II and Its Significance

The railroad income bond market is influenced by three significant factors--"flat" trading, taxes, and youth. When a bond is traded "flat," it means that the total selling price of the bond does not include the interest accumulated by the seller since the last interest payment date.⁷ Consequently, after an interest payment is made, the price of the bond will drop by the amount of the payment just as a stock price drops when shares are traded ex-dividends. This fact helps to explain the wide swings which occur in railroad income bond prices during a year. "Flat" trading also creates a tax situation which is to the advantage of the purchaser. The Internal Revenue Service considers only the accrued interest from the date of purchase as income. All payments made prior to the date of purchase are considered returns on capital. If a bond was purchased on March 31, 1964, and an \$80 interest payment was received on October 1, 1964, the owner would report only \$20 of the interest payment for tax purposes. The \$60 left would be considered to have come off the purchase price of the bond. Purchasers of the bond on or before June 31, 1964, would report none of the October payment. Obviously, this fact is advantageous to large investors. The "flat" trading has been discontinued in some bonds but still exists in many rail

⁷Sidney M. Robbins, "A Bigger Role for Income Bonds," Harvard Business Review (November-December, 1955), p. 101-102.

and preference income bonds. As the income bond market is still young and has not been tested by depression, the practice of trading these bonds "flat" will continue for some time to come.

In the past ten years there has been some reduction in the number of railroad adjustment bonds--seventy-eight were outstanding in 1954 compared to sixty-seven in 1965 (a decrease of 14 per cent). This fact, plus an increase in investor demand and railroad profits, has led to a relatively strong market for the bonds. Exemplifying this is the Dow-Jones Railroad Income Bond Average appearing daily in the Wall Street Journal. Since 1958 the average has moved up and now is at an eight-year high.

TABLE I
HIGH AND LOW PRICES FOR THE DOW-JONES
RAILROAD INCOME BOND AVERAGE
1958 THROUGH 1965

Year	Price	
	High	Low
1958	68.83	50.42
1959	72.72	63.82
1960	65.40	56.27
1961	58.85	54.83
1962	60.85	53.57
1963	70.65	60.42
1964	78.57	69.52
1965	82.32	74.12

Although most of these bonds are presently selling at a discount, the discount will continue to be reduced if retirement of the issues and investor interest continue along the present trend.

The above stated facts about the railroad income bond market leads to the conclusion that although all these bonds were "children of adversity," many have grown to a position of maturity and relative respectability. These bonds are still not a popular investment medium due to their contractual weaknesses and connection with reorganization. Some of these securities, however, have become well regarded by institutional investors like insurance companies. A few have even become "investment grade" securities.⁸ The Atchison, Topeka, and Santa Fe Income 4's of 1995 are such an issue. Moody's Transportation Manual⁹ lists eight such issues that are rated "A." The fact that the Dow-Jones Railroad Income Bond Average has maintained a constant upward trend for eight years (see Table I) gives validity to the theory that these contingent interest securities have overcome much of the scorn that investors long had for them. In the next ten years, railroad adjustment bonds should achieve much more acceptance; however, short supply of the issues will limit

⁸Investment grade being defined as the term is in Securities Analysis, by Benjamin Graham, David L. Dodd, and Sidney Cottle (fourth edition, New York, 1962), p. 47-50.

⁹Moody's Transportation Manual, 1965 (New York: Moody's Investors Service, Inc., 1965), p. a101.

their use. There is a chance, however, that preference railroad income bonds may come into enough use to cause the railroad income bond market to continue and even expand. In 1955 the Interstate Commerce Commission approved the use of preference income bonds by the New York, Chicago, and St. Louis, and the Chicago, Rock Island, and Pacific Railroads for refinancing. Perhaps this type of security will be used in place of or in addition to retained earnings and equipment trust obligations to finance long-term capital ventures. This could happen should fixed debts of the carriers become sizable.

A Review of Preference or New Capital Income Bonds

The second major category of income bonds is that of preference or new capital income bonds. It is the type of income bond with which this thesis deals. The review of railroad income bonds of the adjustment type was included because the record of adjustment income bonds is scrutinized by all considering purchase or issuance of preference income bonds.

In 1955 the Interstate Commerce Commission approved the use of preference income bonds by the New York, Chicago, and St. Louis, and the Chicago, Rock Island, and Pacific Railroads. The revenue received from the sale of these bonds was used for refinancing. These were two of the first noteworthy preference income bond issues. They represented a complete reversal of the traditional use of income bonds and the attitude which the

Interstate Commerce Commission had toward their use.¹⁰ Actually preference income bonds had been in use since 1926 when Consolidated Warehouses, Inc., issued them to expand facilities. In 1947 Armour and Company issued \$35 million worth of the bonds. This issue was important because of its size and the fact that large insurance companies were willing to purchase preference income bonds. Much more important, however, was the fact that a government regulatory agency (the I.C.C.) saw that this type of security could have a place in the capital structure of large companies. By allowing railroads to use preference income bonds, the bond had its acceptability greatly enhanced. The remainder of this thesis will deal with preference income bonds and the reasons for and against their use, plus a review of the preference income bonds outstanding.

¹⁰W.H.S. Stevens, "The Reorganization of Railroad Corporations Under the Bankruptcy Act," Journal of Business, University of Chicago, (September, 1942), p. 378 ff.

CHAPTER III

THE ADVANTAGES AND DISADVANTAGES OF INCOME BONDS

As with all securities the income bond has both advantages and disadvantages for the purchaser and the issuer. In many cases what is advantageous to one is to the disadvantage of the other; however, certain advantages and disadvantages are as great for one as for the other. Between the absolute black disadvantage and absolute white advantage there also exist factors which might be described as "absolute grays." Since the income bond contract can contain provisions which make it very closely related to a stock, or at the opposite pole of the compass, a bond, the advantages and disadvantages must be viewed in a perspective which includes not only the possible provisions of the contract, but also the price of the bond on the market and the financial aspirations of the investor. Two uses for the bond will be considered: the use of the bonds in place of a given type of security for the purpose of raising additional capital, and the use of the bonds as a replacement for a given type of security.

The Advantages and Disadvantages of Income Bonds: General

The various advantages and disadvantages of income bonds will be divided as to advantages for the issuer or purchaser

and disadvantages for the issuer or purchaser. When considering the forthcoming facts, one must remember that almost no single advantage or disadvantage can be adequately judged until the entire contract is judged along with such factors as the earning power of the company.

Advantages for the Issuer

Costs.--Obviously, the cost of income bonds is above that of almost all other debt instruments. Yet, in relation to such securities as preferred stock, the cost may be relatively inexpensive. Cost must be considered not only in relation to actual dollar amounts but also in relation to other alternatives. When all facts are considered, the cost of using income bonds in given situations is found to be less than generally believed and sometimes the least expensive of the alternatives available.

Tax Savings.--As income bond interest is a business expense, it is tax deductible, as is all interest. In later sections this point is discussed much more fully concerning legal problems and the comparison of the cost of income bonds to equity securities. There is always the remote possibility that the present tax deduction on income bond interest may be discontinued. This, however, has proved to be a very remote possibility. In 1954 a new Internal Revenue Act was passed. The authors of the act attempted to stop the possibility that a non-debt instrument could be created that would fit the legal qualifications of a debt instrument. In so doing the authors did away with income

bond interest as a business expense. When this point was brought to the attention of the authors, they changed the wording so as to allow this deduction to remain.¹ This was not a greatly debated subject. The legislators were quite willing to change the wording and did so. This indicates a willingness on the part of Congress to allow the deduction to remain.² The attitude of the Internal Revenue Service toward this tax question has been obtained through a letter written to the research division of the service in January, 1966.

J. R. Turner, Acting Director, Research Division, stated that he saw no future change in the present policy toward such deductions. The policy is discussed in this thesis under the topic of legal problems (see Table of Contents).

A second form of tax savings dealing with income bonds is created by the timing of interest payments. This is a special case which would require an income bond which was cumulative and which allowed the board of directors to make capital asset repairs and replacements before paying the interest on the bonds. If the company found itself in financial difficulty, the directors would discontinue interest payments. When the difficulty began to lift, the directors could pay the accumulated interest. This would make the bondholders happy. Then for

¹Hearings Before the Committee on Finance, United States Senate, 83d Congress, 2d Session, on H.R. 8300 (Washington, 1954), pp. 1763-1766; 1774-1778.

²Sidney M. Robbins, "A Bigger Role for Income Bonds," Harvard Business Review, XL (Nov.-Dec., 1955), p. 107.

several years they could again stop paying the interest while spending the interest funds to pay for repairs and replacements. By continuing this process until the company got its profits to above subsistence level, the company would save taxes. The bondholders might not accept such a policy, but some of the railroads seemed to have followed this policy while getting out of financial difficulty. They would never admit this and could build a good case for their actions on other grounds. Whatever the reason for the timing of the railroad's payments to income bondholders, the timing seems to have been beneficial. Perhaps this is just a coincidence. Admittedly, the tax savings would be relatively small, but this, when combined with depreciation from replacements, could help keep taxes lower and help speed the recovery of the profits of the company.

Interest payable only if earned.--This is the major reason for the existence of income bonds. The obvious advantage of being able to forego the cost of debt when earnings are unavailable without risking forced sales and other actions by bondholders is self-explanatory. Although the bondholder will not like the loss of funds, he is contractually bound to accept it. The legal problems concerning discontinuance of payments are discussed at length later.

Leverage and capital structure advantages.--Income bonds allow the issuing company to increase its leverage without increasing fixed debt costs in future periods when earnings

might be unavailable. The fact that income bonds have a fixed maturity date on which they must be paid off may seem to be disruptive to the company's capital structure. This fact does, however, seem less important when the very distant maturity date of most bonds is viewed--some as long as one hundred years from issue. Also, having a maturity date, even though distant, serves to force the corporation to plan and adapt its capital structure to meet its changing needs. Most financial experts consider this imperative under modern economic conditions.

Control--In modern times control of stockholders' votes has become of the utmost importance in many corporations. Obviously, when issued, a bond does nothing to dilute the number of votes. The only possible way that control could be decreased through issuance of income bonds is by offending some stockholders by the issuance of the bonds. Also, the bonds could possibly contain a clause allowing bondholders to vote after several skipped interest payments.

Private placement--Private placement is one of the less expensive methods of placing issues. After examining the "commission reports" of the top twenty and other insurance companies in the U. S. for the year 1964, the fact that private placement is often used by issuers of quality income bonds is obvious. Several large companies held part of at least one of

the larger income bond issues.³ No bonds that carried low ratings were held by these companies. Income bonds of low class usually are sold or traded to the public and company stockholders. Only a few non-railroad companies sell quality income bonds on the open market. Budget Finance Corporation is one of these. It has \$6,000,000 of 6's due in 2012 that are traded on the New York exchange. Railroad income bonds, both quality and other types, are well represented on the stock exchange and traded actively.⁴

These six advantages stated above are the main reasons for income bonds being issued.⁵ Of the six, the tax deductibility of the payments for interest and the payment of interest on an if earned basis are the outstanding advantages. If either of these features should be made illegal, there would be no reason for the bonds being used, for common stock, preferred stock, or fixed interest bonds could be used more efficiently.

³Some of the large insurance companies which hold income bonds in their portfolios are Metropolitan Life, Aetna Life, Southland Life, Mutual Life, Massachusetts Mutual Life, and New York Life.

⁴Frank J. St. Clair, Editor-In-Chief, Moody's Transportation Manual, June 1965, (New York, 1965), p. a 101.

⁵Under reorganization situations caused by financial difficulty, income bonds are often issued for reasons in addition to those already stated. One of the most important is to maintain a portion of the status position of bondholders when much of the status must be removed. This is exemplified by fixed interest railroad bondholders who were forced to take income bonds (see Financial Organization and Management of Business by Charles W. Gerstenburg, 4th rev. ed., Englewood Cliffs, N. J., Prentice-Hall, 1959, pp. 137-139).

Advantages for the Purchaser

Protective features.--The contracts for income bonds offer many protective features to cover various contingencies. These are discussed under the chapter dealing with legal problems. Such features would be sinking funds, first and second mortgages, interest reserves, voting rights in cases of excessive payment default, accumulation of interest, etc. As important as all of these features is the fact that over the years court decisions have taken many of the questions out of income bond contracts. A purchaser of an income bond can usually get lawyers to determine with reasonable assurance what rights the holder and issuer have in any given situation.

Market advantages.--The income bond market is small and very active. After viewing the Dow-Jones Railroad Income Bond Average, the fact that the high and low price for the year usually moves between seven and fifteen points is noted.⁶ Other income bonds of industrial companies not in private placement are less active because of their small number. Usually they are not traded on the exchange. These, however, are often convertible into common stock and, therefore, may get rapid fluctuation after years of relative non-movement. The movement of these bond prices is, of course, not always to the purchaser's advantage, but does offer the speculative purchaser a chance

⁶Wall Street Journal, second Friday in January, 1959 through 1965.

for great market movement.⁷ The investor purchaser will find that some of the high rated bonds are stable. The Atchison, Topeka, and Santa Fe Adjustment 4's of 1995 are an outstanding example of this stability and carry an "A" rating. Adding to the stability of some highly rated income bonds is the fact that they are not traded flat. Flat trading has an effect on the market price of the bonds similar to a stock going ex-dividends. This fact accounts for some of the price vacillation which occurs in stable income bonds which are traded flat and in speculative income bonds.

Perhaps the greatest help to the purchaser of income bonds is the increased public acceptance of this type of bond which creates a larger market. No actual quantitative value can be put on this fact, but simply having experienced and recognized people in the finance field occasionally write articles about the bonds has been a definite help in destroying the large amount of misunderstanding which has surrounded the bonds. Articles appearing in such publications as Business Week, Forbes, Barrons, and many professional publications, although not always complimentary, have brought this type of bond to the attention of the public.

Yield and security.--In many cases a strong argument can be made to prove that income bonds, while yielding more than

⁷Between 1949 and 1953 Capital Airlines convertible income debentures varied in price from $35\frac{1}{2}$ to 132. In 1952 the movement was from $78\frac{1}{2}$ to 90, according to Moody's Transportation Manual 1953, p. 1376.

other securities such as some preferred stocks, also provide more security. This argument will be presented in detail when discussing preferred stocks and income bonds.

Security for an income bond is usually viewed in relation to what provisions are made in the bond contract and the future earning power of the issuer. Another type of protection is present in income bonds issued in industries governed by such organizations as the Interstate Commerce Commission and the Utility Commission. Companies in the industries being considered are those such as railroads, airlines, and public utilities. These companies have an obligation to the public often based on their near or actual monopolistic position in the areas which they serve. To keep these companies from taking advantage of their protected position, the regulatory agencies involved have been given the power to set rates. If the company can find a way to save on taxes, it may well do so, using the saving to increase assets or do other things. In the case of an income bondholder, the tax savings created by using the bond instead of stock is partially paid directly to the bondholder in interest which is higher than that on fixed interest securities. The bondholder also gets the added security of having the company expand. In some cases expansion of assets will allow reduced rates, which will increase even more the earning of the company or at least let them remain stable. This is not a self-perpetuating situation, but it would definitely add to the bondholder's assurance of acquiring his

principal when the bond matures and his interest.⁸ Admittedly, the one biggest form of security is often missing when the potential purchaser wishes to purchase income bonds. Past and future earning power of the issuer often is insufficient. This, however, is not always the case. The Baltimore and Ohio Railroad $4\frac{1}{2}$'s due 2010 were selling 68 in 1957. This provided a yield of 6.6 per cent. This would not seem unreasonable except that the bond had paid interest since 1930, the general condition of the road had been improving, and the bond had more than 2.5 times coverage.⁹ In many of the cases where income bonds were issued for replacing preferred stock or new capital uses, the issuer company was strong and had good potential. Corning Glass, National Can Corporation, and Monsanto Chemical Company are three outstanding examples of this. These companies have long earned much more than the normal fixed charges required by analysts. Corning Glass had 19 times and 24 times fixed charge coverage in the years 1964 and 1965 respectively. Monsanto Chemical had 6 times and 8 times in the same period. National Can had approximately 4 times and 5 times respectively.¹⁰ Since issuance, all of the bonds of these companies have shown strong coverage records.

⁸Frank A. Halford, "The Sleeping Giant--Income Bonds," Financial Analysts Journal, XX (January-February, 1964), pp. 73-74.

⁹I. U. Cobleigh, "Income Bonds--Railroad Bond Market In Search of Maximum Yields," Commercial and Financial Chronicle, (October 31, 1957), p. 6.

¹⁰Moody's Industrial Manual 1965, pp. 1744, 1880, 1505.

Disadvantages to Income Bond Issuers

Income bond issuers have to face some rather objectionable facts. The major cost problems are not just in issuing the bond, but also in relation to limits and obligations the bond contract creates. A smaller problem is the effect of income bonds on the capital structure of the corporation. Measurements of the various facets of these problems are very difficult to obtain with acceptable accuracy. Many of the attempts to give quantitative value to these "absolute gray" factors are perhaps to be eternally frustrated, for psychological factors are definitely involved and other necessary information is not available due to company policies.

Cost.--The cost of issuing income bonds is not simply the cost of issuing and a discounted value of the future principal and interest payments. It involves the future costs of the limits and obligations the bond contract creates and also the amount of change in the attitude of present and potential debt and equity investors.

Professional opinion as to the additional cost of using income bonds has been given by few. These few have never tried to measure costs of contract limits. Professor Sidney Robbins in 1955 asked investment bankers to measure the additional cost of issuing income bonds in terms of the net yield penalty that an issuer would face. The replies from thirty of sixty-eight questionnaires sent were varied. Answers ranged from 0.21 to

much over 1.00 percentage points.¹¹ The nonconformity in the answers is attributed to lack of experience with high quality or other income bonds. The past experience of those questioned could also be highly influential. People who were financially hurt during railroad reorganizations do not forget the unfortunate facts easily.

In letters sent in 1966 to twenty-three present or possible purchasers of income bonds, those questioned were asked if the higher rate on income bonds was of primary importance. Yes, was the reply of fifteen out of twenty-three answers. In additional comments added to the questionnaire, the opinion was given that the interest rate would have to be substantially higher than that for regular bonds issued by the same company. Such comments as "Much higher!" and "A great deal higher," were often given. Of the groups to which letters were sent [Bank Trust Departments (five), Investment Bankers, (three), Insurance Companies (five), Universities (nine), Savings Banks (five), and Bond Funds (three)] only those who would not purchase any income bonds did not care about the higher interest.

Another professional estimate of the cost of income bonds is given in an article by Frank A. Halford, in which he states that in the case of utilities 5 per cent income bonds could be issued to retire preferred stock carrying a 5 per cent rate. In the article the after-tax coverage of total debt would be

¹¹ Robbins, "A Bigger Role for Income Bonds," p. 109.

between 2.75 times and 3.26 times.¹² All the above opinions as to the additional interest cost of using income bonds are somewhat indeterminate until the various features of the bond contracts are examined. Such factors as convertibility could have a very definite effect on what interest would be acceptable in the market.

The cost of special contract features like convertibility are exceptionally hard to measure. A sinking fund provision is no real problem, but what about a provision that the company will not pay dividends until one, working capital is at a given level; two, certain loans were paid off; or three, specified subsidiaries were sold? Other provisions that could be very expensive are restrictions on purchases of new subsidiaries and capital assets. There are times when purchases of given assets could well make a small electronics firm an industrial leader. All these factors are potential future costs that must be considered when the total cost of the bond is figured. (See Appendix I: Calculations of the Cost of Bond Contract Features.)

Psychological factors are another problem that help income bonds keep relatively low ratings and, therefore, higher costs. These ratings often create unforeseen problems. Insurance companies are forced to set up a "Mandatory Security Fluctuation Reserve,"--a reserve of 20 per cent--for income bonds just as for bonds that are considered not amply secured. Also, any premium must be written off in the year of acquisition,

¹²Halford, "The Sleeping Giant--Income Bonds," p. 76.

discounts cannot be taken into income, and the security must be carried at fluctuating value. This fact might discourage some insurance companies and, thereby, cut off a large group of purchasers if the bonds could not be bought at par.

Capital structure.--The capital structure of a firm is often important when the company is checked financially. Many analysts will not like any additions to funded debt. This could be at worst a small problem, but perhaps one of many that could become large. This would be particularly true if later the company desired to create a large bond issue.¹³

Disadvantages to Income Bond Purchasers

Income bond purchasers find three big disadvantages facing them. These problems have to do with the interest payments, the security behind the bond, and the public distaste for the bonds as a whole.

Interest payments.--Interest payments must be made only if the company earns the payments under the terms of the contract. What constitutes earnings and when it must be paid as interest has been discussed in the chapter on legal problems. This is the outstanding disadvantage of income bonds for purchasers. Obviously, other factors such as high interest payments, liens, and dividend restrictions tend to greatly lessen this disadvantage. The problem of the purchaser is simply to determine

¹³Harry C. Guthman and H. E. Dougall, Corporate Financial Policy (Englewood Cliffs, N.J., 1962), p. 148-151.

how much the provisions of the contract are worth in relation to his risk and his alternatives.

Another disadvantage related to interest payments is that of the cumulative feature, if the particular bond has one. The usual cumulative feature seems to be from three to five years. There are bonds, however, which are cumulative to maturity. Most cumulative features do not go into effect until several years after the bond has been issued unless it is a quality bond, in which case the feature becomes effective immediately. Should the purchaser have a fifty-year bond with a three-year cumulative feature that takes effect five years from issue, the company could pay only three out of fifty years and still meet the bond contract provisions provided it had no more funds during the fifty years. The company would be out of business long before then, but the holder would still lose. This points up the fact that three years is really a very short cumulative clause. Compared with the bonds that offer no cumulative clause, however, it offers much more protection and helps to keep the company basically honest. The fact that the board of directors of the issuer has a great influence on interest payments is discussed fully under legal problems.

Security behind the bond.--Many income bonds are inadequately secured. This fact creates the problem of insurance and trust funds having to keep a reserve as discussed in the preceding section.¹⁴ The mortgage lien of income bonds.

¹⁴Ibid., p. 150.

is of value only to the bondholder in the case of default on principal or in the event that the company fails to meet its obligations and becomes insolvent. This is true because interest payments are contingent on the earnings of the company. The fact that a lien exists, however, will give the holder a well defined position in the case of issuer default. A good example of this is the Atchison, Topeka, and Santa Fe Railroad Adjustment 4's of 1895. By virtue of their mortgage lien, they had higher priority than two subsequent issues of convertible debentures which were called in 1945.

Sinking funds may give security, but they may hamper the most outstanding security of all--earning power. At the other extreme from excessive sinking fund provisions is the completely undersecured bond or a bond secured by a secondary mortgage.

Public distrust of income bonds.--Although there has been a greater acceptance of income bonds over the last fifteen years, the purchaser of income bonds still finds them considered not much better than stocks when they are offered as collateral. Also, bond funds and trust departments find some customers none too pleased to find them listed among assets.

Income Bonds as a Possible Alternative To Other Types of Securities

This section examines the possible use of income bonds as an alternative (in given situations) to the use of three other types of securities:

1. common stock,
2. straight bonds, and
3. preferred stock.

The comparison of income bonds to each of the three will be in two areas. The first area will consider the situations where income bonds would be used as a replacement for the security when the security is already outstanding. The second area will consider situations where income bonds might be issued instead of the security as a means of supplying new capital for the company. The first area would simply rearrange the existing capital structure without changing it. The second would increase the amount of capital plus rearranging the capital structure.

Income Bonds: An Alternative
To Common Stock

Income bonds as a replacement for common stock.--No situation seems to have existed where income bonds were used as a replacement for outstanding common stock of a company issuing income bonds. There may have been cases where the bonds were issued for this purpose, but none are noted in the publications listed in the bibliography. If a case should exist, it might well have been a case where the company wished to retire large amounts of common to decrease the voting stock outstanding. This could not be done without the consent of the stockholders. Another reason for such an action might be a case similar to a situation where a large stockholder was

forced by legal action to relinquish his shares, but had no buyer. In this case the court might approve some type of trade by which the stockholder could comply with the orders of the court and still receive a return on his investment. A trade of this type might have been allowed years ago but now would cause action by the Internal Revenue Service even if a court approved such action. Today, even if a trade of income bonds for common stock were to be acceptable to all courts, either the company or the stockholders would probably not agree to the use of income bonds. If the company is going to get the stockholders to make the trade, the bonds will have to be of high quality. If it (the company) would be offering high quality income bonds, it would be strong enough to offer high quality straight bonds which would be cheaper for the company and more secure for the stockholders. Should the company not be able to issue high quality income bonds, the stockholders would probably wish to keep their voting rights.

Issuing income bonds instead of or along with common stock.--

The reasons for using income bonds instead of or along with common stocks are approximately similar to the general advantages for income bonds listed at the first of this chapter. Voting control is often a very important factor when considering stock issues, and income bonds have been used at times to stop or limit dilution of voting control. Also, income bonds may be favorably looked on in some cases because they provide strong leverage and tax savings, which stocks do not.

An excellent example of the use of income bonds in place of part of a common stock issue or along with a stock issue is the merger of Consolidated Film Industries, Inc., and Republic Pictures. Republic Pictures and Consolidated were first merged into Setay Corporation, which then changed to Republic Corporation. Through the merger, each share of Consolidated no par \$2 preferred stock including dividend arrearage thereon, was exchanged for \$13 of income debentures, one new share of preferred, and two new common shares in Setay Corporation. Each of Consolidated's \$1 par common was exchanged for $\frac{3}{4}$ of a share of Setay common. Each share of Setay common (\$1 par) was exchanged for $6\frac{1}{2}$ shares of the new Republic Corporation.¹⁵ Why would income bonds be used instead of using all common stock? Foremost is the fact that Consolidated stockholders did not want common stock without voting rights, and they disliked the uncertain future of the company. Republic Pictures could not offer acceptable straight bonds or purchase the stock outright with cash because of their poor financial position and the fact that they did not want holders of consolidated securities to vote in the new corporation. The only possible solutions were preferred stock or income bonds. Income bonds were used because of the non-dilution and the tax savings they offered even though they were not of exceptional quality.¹⁶

¹⁵Frank J. St. Clair, Editor-In-Chief, Moody's Industrial Manual June 1965, (New York, 1965), p. 762.

¹⁶Charles W. Gerstenberg, Financial Organization and Management of Business, (Englewood Cliffs, N.J., 1960), p. 137-139.

A case where income bonds were used in place of common stock is that of the Sheraton Corporation of America. To completely understand the reasoning behind the decision of the company, some of the general policy of the corporation should be known.¹⁷ According to the president of the corporation, long-run profits are generally the guiding factor in decisions. Short-run earnings are given only moderate consideration. Three facts point up this policy. First, the corporation "plows back" a large per cent of each year's earnings into maintenance and improvements. This creates large charges to expenses, but greatly enhances future earnings. Second, the policy has been and will be to create and maintain large amounts of depreciation. This depreciation has been twice that of its major competitor's since 1950. Noteworthy is the fact that Sheraton assets have greatly increased in value and this is mainly due to improvements, not inflation. Depreciation will not allow this fact to show up in its proper proportion on the statements; therefore, security analysts must find some way of putting in this increased value when considering the company. Third, the company is usually willing to buy very poor, rundown hotels and pay large amounts to modernize them. A long period of time is often required to get a large return on the investment, but this policy has provided the return and been very successful except that it makes earnings look low. With these facts known and the current market price of Sheraton stock at one-half intrinsic value, the

¹⁷"Financing Reviewed," Commercial and Financial Chronicle, (May 13, 1957), p. 12.

company felt that it would not issue more stock. Bonds could be issued, but this would add to an already high fixed debt and create long-term fixed charges. Also, additional assets which might be needed for mortgaging could be kept until later. By paying relatively high interest of $6\frac{1}{2}$ per cent (considering the 1956 bond market) and making the bonds callable, the company could get the capital it required--\$6,000,000. This money went primarily into the general fund and was used to acquire new assets. By the end of 1958 almost all of the first issue of income bonds, \$15,000,000, were sold at strong prices. Undoubtedly, being covered 3.5 times helped to sell the bonds as did the fact that the earnings of the company had steadily increased on a three-year average since 1950.

Here is an outstanding example of the use of new capital income bonds in place of issuing stock. The corporation had such success with its first issue in 1956 that again in 1959 it issued new capital income bonds for further expansions--\$34,000,000 of $7\frac{1}{2}$'s due 1989; \$31,218,400 outstanding as of June 1, 1965.

The Sheraton Hotel Corporation of America found income bonds an effective replacement for common and preferred stock as have other corporations. Yet, usually a rather unique situation like that of Sheraton Corporation is involved if income bonds are issued where the company was giving great consideration to using common stock. This is usually the case because most corporations find straight bonds cheaper and

encounter no great problems with them. Some experts go so far as to say that most corporations really gain only a very small part of what an income bond is supposed to save when compared to a common stock. John Childs feels the restrictions on debt, dividends, and legal problems make them a trap for unschooled investors and issuers.¹⁸ Perhaps he is correct in some cases, yet some corporations have used them successfully.

Income Bonds: An Alternative
To Straight Bonds

There is only one reason to use income bonds instead of straight bonds and perhaps no reason to use income bonds to replace straight bonds that were issued in the past. The only feature which a straight bond cannot have that an income bond can have is the clause providing that interest is paid only if earned. Some companies which have a good possibility of highly fluctuating earnings over long periods of time may find new capital income bonds beneficial. If the issuer was hit by financial problems, he could discontinue payments on the bonds and cause relatively less panic than if the bonds were straight bonds. A good example of this is the 1955 skipped payment on the Chicago and North Western Railroad's $4\frac{1}{2}$'s due 1991. The company had no great financial crisis, for the bondholders understood their position and knew their legal rights. They simply accepted

¹⁸John F. Childs, Long-term Financing (Englewood Cliffs, N. J., 1961), p. 121-122.

their risk and paid for it.¹⁹ This is the only reason new capital income bonds would be used instead of straight bonds, provided the company was not in a situation where no more straight bonds would be accepted by the market.

Budget Finance Corporation is a good example of a company in a business which faces a strong need for capital along with a need for limiting fixed debt charges over long periods of time. Being in the consumer loan business, the company faces factors over which it has little control but by which it can be greatly influenced. One of these factors is the ever-increasing legislative action which has a tendency to usually lower or curtail possible future profits. New maximum interest laws and other laws have perhaps given more respectability to the entire industry, but have probably forced the company to raise its loan standards or take more risk. Whatever the factors, the corporation has found income bonds to be a means of reducing interest debt requirements while still acquiring capital. Budget Finance Plan has four different issues of income bonds outstanding, worth over \$10,000,000.²⁰ These issues have had a price range in 1964 between $97\frac{1}{2}$ and $99\frac{1}{2}$. One issue of \$3,000,000 worth sold in 1962 at 95, with the company getting 91.5 in proceeds after payment of underwriters.²¹ This may

¹⁹Robbins, "A Bigger Role for Income Bonds," p. 108.

²⁰Letter from Joseph Jones, Vice President and Treasurer, Budget Finance Plan, January 31, 1966.

²¹Moody's Transportation Manual June 1965 (New York, 1965), p. 1212.

seem like a very high price to pay for funds; but with their erratic earnings, straight bonds would not be much more economical. As additional protection, the income bonds are callable.

Income Bonds: An Alternative
To Preferred Stock

Without doubt the most interesting use of preference income bonds and one of the largest modern uses of income bonds is to replace preferred stock. There are no available statistics on how many companies have used income bonds to replace preferred stock, but there have been many. Some of the companies using income bonds for this purpose are:

1. New York, Chicago, and St. Louis Railroad,
2. Chicago Rock Island and Pacific Railroad Company,
3. National Press Building Corporation,
4. Armour and Company,
5. Western Pacific Railroad Company,
6. Erie Railroad,
7. Curtis Publishing Company, and
8. Associated Gas and Electric Company.

Even with many large corporations issuing income bonds to replace preferred stock, there is still debate as to the advantages of this action. Some financial experts feel that income bonds can offer the same benefits as preferred stock,

plus the additional benefit of tax savings.²² Others in the financial community are not convinced.²³

Can income bonds with the contingent payments feature of preferred stock and some of the advantages of a fixed interest bond better serve the purpose that preferred stock is now serving? To answer this question, preferred stock and preference income bonds must both be examined. Then the problem must be scrutinized from the point of view of both investor and issuer. Having thus perceived the factors involved in the problem, conclusions can be drawn.

An examination of preferred stock and income bonds.--

Preferred stock is an equity security, the major function of which is to raise capital. It usually has a right to dividends, which is limited but prior to the right of common stock. Should the issuing corporation be dissolved, the preferred stockholders have a priority of claim to assets which is above that of common stockholders. While common stockholders have a large voice in the management of the corporation, preferred stockholders usually do not, provided preferred dividends are paid. The reason for issuing preferred stock is basically financial in character, for through its use a corporation can acquire assets more economically than by the use of common stock and with less

²²Some of the experts expressing this view in their writings are Harry C. Guthman, H. E. Dougall, Sidney M. Robbins, William H. Husband, and James C. Dockeray.

²³John F. Childes, and W. E. Pudney (Vice President of Finance for Western Union Telegraph, who supervised an issue of preferred stock in 1966).

obligation than is required when borrowing.²⁴ Since 1945 preferred stock has been used to finance the many modernization, maintenance, and expansion programs of corporations in many industries.

Income bonds as a type of security to be compared with preferred stock are here described as having most of the features discussed in Chapter I. That is, they are considered to be secured by a mortgage (perhaps a second mortgage), are cumulative, contain a sinking fund feature, are callable, do not participate in management, and often have a distant maturity date. With these points helping define the two general types of securities, an examination of the problem can be made.

Examination from the investor's point of view.--Preferred stock and income bonds have similar characteristics in several respects. Both are hybrid types of securities. They both contain some of the characteristics of an equity security, and some of a debt security. The payments of interest or dividends are contingent on the earnings of the corporation. Income bondholders never have voting power, and preferred stockholders receive this power only when dividends have been skipped, if then. Often bankers are apprehensive about taking either type of security as collateral, for they have a somewhat limited market even if otherwise qualified. Preferred is more acceptable than income bonds are, but this is reasonable considering

²⁴Charles L. Prather, Financing Business Firms (Homewood, Illinois, 1955), p. 157.

the larger number of strong companies with preferred outstanding. Income bonds are often issued by weak companies, and the financial community has not been educated to using quality income bonds; therefore, loan officers must first be educated about the bonds before they will consider them.

Assurance of return.--An income bond has a much stronger probability of assured return than a preferred stock. As stated in the bond contract, interest is paid only if earned, but interest is usually cumulative for a period of years. In the case of preferred stock, the return is not necessarily assured, for the dividend is sometimes not cumulative. Income bonds may well produce inconsistent payments. They, however, seem to have a better chance of producing payments than preferred stock. The reasons this chance exists are the strength of the income bond contract and the legal position of the investor.

Strength of the income bond contract.--As discussed in Chapter V, the income bond contract has been court tested for over one hundred years. The clauses covering accounting procedures, powers of the board of directors, issuance of obligations with higher claim status, and rights in case of default on other obligations, are reasonably well understood legally. A preferred stock contract which is free from the possibility of legal manipulation is very hard to create. A preferred stock could be cumulative and still there could be a question as to whether or not the accumulated unpaid dividends

would be recognized. This is true even if the corporation had created enough earning power to pay the arrearage.²⁵ The corporation could avoid payment by merging with a subsidiary of its own.²⁶ This legal subterfuge has not been taken to court since 1939; therefore, the present courts might view a similar attempt to avoid payment as an illegal act. The fact that the 1939 decision has not been overruled still leaves open the possibility of avoiding payment in this manner. There have been other cases where the stockholder felt his contract with the company was obviously clear and found out differently. In one such case the contract stated that declaration of dividends shall be "mandatory" if sufficient net earnings are available. The court, as in other cases, held that the stockholder's claim was left to the discretion of corporate directors.²⁷ Whatever the weaknesses of an income bond contract, the bondholder cannot suffer from such court actions as were discussed here.

Legal position of the investor.--When an income bondholder has a problem he wishes to take to court, he has only to defend his contractual rights as a creditor. This is not the case with the preferred stockholder. Before he can defend his contractual rights, he must establish that these are legally his

²⁵Arthur Stone Dewing, Financial Policy of Corporations (New York, 1953), p. 142-143.

²⁶Harvender v. Federal United Corporation, 24 Del. Ch 96 (1939).

²⁷Dewing, Financial Policy of Corporations, p. 1358.

contractual rights. Whatever the conditions of the contract,
this is true.²⁸

Conclusion: Income bondholders have a better chance for return.--Preferred stockholders seem to have a lesser chance for return on their investment than income bondholders.²⁹ The facts on which this statement is based are the superior strength of the income bond contract and the stronger legal position of the income bondholder. These two facts alone might well make a convincing case, but there are three other factors to augment the evidence that income bonds have more assurance of producing a return.

First, a bond is a debt instrument which will have a priority of claim on corporate income prior to non-debt instruments, of which preferred stock is one. A court case points up this fact. A cumulative feature is stronger when included in an income bond than when included in a preferred stock contract. Courts have ruled that unpaid accumulated interest should be charged against corporate assets at the time when the bond matures or is redeemed, whichever is sooner.³⁰ This means that

²⁸Ibid., p. 1361.

²⁹This conclusion assumes, as stated previously, a comparison of the two types of securities, not a comparison between income bonds of one company and preferred stock of another.

³⁰Dewing, Financial Policy of Corporations, p. 233;
Sears v. Greater New York Development Company, Federal Reporter,
Vol. 51, p. 46.

if the assets are available, income bondholders have a strong legal claim on them. This claim, of course, is behind that of wages, bank loans, and probably all fixed interest bonds, but is above that of preferred stock. Preferred stockholders might well have a priority of claim greatly lower than income bondholders if several groups of borrowers were between the two.

Second, the fact that interest is a business expense and payable before taxes gives the bondholder an advantage. Dividends must be paid after taxes. No difficulty is encountered in conceiving a case where a company could afford to pay income bond interest and then pay taxes, but not be able to pay taxes and then pay preferred stock dividends. The present 48 per cent corporate income tax could make such a large deduction from earnings each year that preferred dividends could not be paid in full or possibly at all. If the company has issued income bonds instead of preferred, the interest is more likely to be paid. The fact must be noted that there are special situations which would cut off this tax advantage for income bonds. Dividends paid from a subsidiary to a parent company are covered by an 85 per cent tax credit, which makes preferred dividends only 15 per cent more expensive than income bond interest in this particular case. This may account for many companies not calling in their preferred. Yet even considering the tax credit on some dividends, income bonds still are cheaper to the issuer from a tax standpoint than preferred dividends.

Third and last, some income bonds are now being issued with a reserve fund feature. This reserve fund is a fund into which the issuing company will pay a given amount during periods of high earnings. In periods of low earnings, the fund will be used to help pay interest on the bonds. Should this feature become prominent, it would greatly assist stabilizing income bond interest payments.

With the exception of voting power, income bonds seem to provide a much better chance for a return on investment than preferred stock. They have a stronger contract and the legal position of the investor is more secure. Claim priority for income bondholders is above that of preferred stockholders. A cumulative feature, if included, is stronger legally, and the tax savings provided by the bond make earnings available for payment of interest easier for the company to acquire.

Protection of principal.--The protection clauses in the income bond contract are discussed in Chapter V. The features which an income bond could have to protect its principal are many, but here only sinking funds and mortgages will be discussed. Most preference income bonds and preferred stocks have sinking funds. These sinking funds help assure the investor of return of his principal, provided payments are made to the fund. Few preferred stocks are backed by a mortgage. Many income bonds are so backed. These mortgages may often be second mortgages, but they are much better than preferred stocks which offer no mortgage. Should the issuing corporation not provide such a

mortgage, the claim of the unsecured (debenture) income bond is still above that of preferred stock. There is also the possibility that even the mortgage secured income bond may not receive even part of the principal invested if the issuer's finances become highly insolvent. All factors considered, the income bond offers more protection of principal than preferred stock.

Amount of return from investment.--Unfortunately there are no comparative statistics available by which income bond yields could be compared to preferred stock yields. Moody's Industrial Manual does have statistics on the average yields for groups of preferred stocks. For ease of discussion the medium and high grade groups of preferred stock will be the only groups of yield statistics which will be considered.

TABLE II
YIELDS FOR MEDIUM AND HIGH GRADE
INDUSTRIAL PREFERRED STOCKS³¹
1954-1964

Year	Medium Grade Industrial Preferred Yields (in per cent)	High Grade Industrial Preferred Yields (in per cent)
1964	4.67	4.28
1963	4.69	4.29
1962	4.81	4.47
1961	4.82	4.60
1960	5.18	4.71
1959	4.99	4.62
1958	5.14	4.34
1957	5.28	4.48
1956	4.74	4.27
1955	4.49	3.90
1954	4.75	3.91
Average	4.95	4.39

³¹Moody's Industrial Manual June 1965 (New York, 1965), p. a24.

The 1954 through 1964 average yield for the medium grade preferred is 4.95 per cent and 4.39 per cent for the high grade preferred. Although there are no statistics to prove beyond doubt that high grade and medium grade income bonds would yield an equal amount, there is strong indication of this fact. This indication is substantiated by looking at several income bond issues in given years. In 1947 Armour issued income bonds at 3-3/4 per cent. In 1953 Corning Glass and McLouth Steel had issues out at 3-3/4 per cent and 5-1/4 per cent respectively. Between 1954 and 1956 American Steel and Pump, Pan American Sulphur, and National Can put out issues at 4 per cent, 5 per cent, and 5 per cent respectively. In 1956 Sheraton Corporation of America issued income bonds at 6-1/2 per cent. Budget Finance Plan, in 1960, put out 6 per cent income bonds. All the above interest rates on income bonds are not what the bonds sold for in the market. Even if each of the bonds sold at par, the average interest rate (4.86 per cent) would be above the average yield on high grade and .09 per cent below medium grade preferred stocks. During the ten-year period, medium grade preferred surpassed the average interest on income bonds during only four years. High grade preferred has never yielded the average interest for income bonds. There is no way to find out what all the income bonds sold for because many of the issues were privately placed. As income bonds have been well known to sell below par, the assumption can be made that the average yield on the income bonds as discussed above is actually much greater

than 4.86 per cent. Assuming this fact, there exists strong but circumstantial evidence that income bonds of the preference type return a higher yield than preferred stocks of approximately the same class.

As preference income bonds and preferred stocks appeal to the same type of investors (institutions and wealthy individuals), are both classed between straight bonds and common stock, and have some similar features, it would not seem unreasonable to suggest that both should sell at approximately the same yield. This is provided they are issued by similar companies in the same industry. If this is true (and it seems to be), then the income bondholder would be getting the same return on his investment while taking less risk.

Whichever of the two methods of determining a comparison of yields on the types of securities is chosen, the basic facts remain. Income bonds and preferred stocks of the type discussed here are not going to have great differences in yields.

Conclusion.--The majority of facts considered in this discussion depict income bonds as a superior investment to preferred stock. Income bonds offer the investor a stronger contract and a more advantageous legal position. Other factors which are more beneficial to the income bondholder are

1. priority of claim above preferred stock,
2. stronger cumulative features,
3. possible reserve clauses,
4. better protection of principal, and
5. an equal or higher yield.

This is not to prove that income bonds will always be a better investment than preferred stock, but there is a much better chance for the investor to acquire a return equal to that of a similar investment in preferred stock and get greater protection, i.e., accept less risk.

Examination from the issuer's point of view.--Having examined the advantages of preferred stock and income bonds from the purchaser's point of view, the question of issuing income bonds or preferred stock will be examined. The discussion will consider two areas: first, the cost of issuing and maintaining the securities; second, the market in which the two securities are sold.

One basic point should be made before embarking on a more detailed discussion. Generally when only two groups are involved in making a bargain, what is advantageous to one group is not to the other and a compromise evolves. Yet, there are cases where a third party is involved. If this third party has something valuable and the other two can get it, the two naturally benefit. In the case of income bonds, both the issuer and the purchaser can benefit by cutting taxes taken by the third party.

Cost of maintaining income bonds and preferred stock.--The basic cost of income bonds has been discussed in general at the beginning of this chapter. Now these costs will be compared to those of preferred stock.

Interest cost compared to dividend costs.--The one biggest cost difference between income bonds and preferred stock is the tax saving acquired when income bonds are used. The simple example below will show how significant this fact is.

THE EFFECT OF INCOME BONDS AND PREFERRED STOCK FINANCING
ON THE EARNINGS OF A HYPOTHETICAL CORPORATION

Earnings After Expenses and Fixed Charges	At 52 per cent Federal Income Tax Rate		At 48 per cent Federal Income Tax Rate	
	Normal Business Conditions	Adverse Business Conditions	Normal Business Conditions	Adverse Business Conditions
<u>A. Using Income Bond Financing</u>				
Balance after operating expenses and fixed charges	\$2,000,000	\$ 800,000	\$2,000,000	\$ 800,000
Interest on 5% income bonds (\$10 million par value)	500,000	500,000	500,000	500,000
Earnings before deduction of federal income tax	\$1,500,000	\$ 300,000	\$1,500,000	\$ 300,000
Federal income tax	780,000	156,000	720,000	144,000
Earnings after federal income tax	\$ 720,000	\$ 144,000	\$ 780,000	\$ 156,000
<u>B. Using Preferred Stock Financing</u>				
Balance after operating expenses and fixed charges	\$2,000,000	\$ 800,000	\$2,000,000	\$ 800,000
Federal income tax	1,040,000	416,000	960,000	384,000
Earnings after federal income tax	\$ 960,000	\$ 384,000	\$1,040,000	\$ 416,000
Dividends on 5% preferred stock (100,000 shares)	500,000	500,000	500,000	500,000
Earnings after federal tax	\$ 460,000	\$ (116,000)	\$ 540,000	\$ (84,000)
		(deficit)		(deficit)

As has already been stated, income bond interest is considered a business expense and, therefore, deducted from profits before taxes while dividends are deducted after taxes. The effect of this tax savings in normal years is simply that the company must earn only the amount required to pay the interest. In the example this amount is \$500,000. To pay that dollar amount for preferred stockholders (considering a 48 per cent tax rate), the company must earn \$961,731. This amounts to an added cost to the company of approximately \$461,731, which must be paid in federal income tax before the preferred stock dividend can be paid. In simple terms, the company must earn almost twice as much to pay the same amount in preferred dividends as it would to pay that amount in income bond interest. In years of adverse business conditions, the company can have a rather large loss in sales and profits before taxes without effecting its debt and equity obligations. A 60 per cent reduction in earnings before taxes and after fixed debt obligations is shown in the example. Even with this large reduction, interest on income bonds can be paid. To have equal reductions in a similar company using preferred stocks would not only leave the company without earnings available for common stock dividends but also a deficit of \$116,000 if preferred dividends were paid. Some proponents of preferred would point out that many income bonds sell below par and, therefore, the savings might be nonexistent. If the bonds did sell below par, the savings to the company would naturally be less. Even with the company receiving less than par, the

effective interest rate would have to be very high to create a situation where the tax savings were completely removed. The company could offer 7 per cent income bonds (under a 52 per cent tax situation and in the normal year described above) and still save \$164,000 per year. With this fact noted, the 2 to 4 per cent additional interest that many income bonds pay does not seem extremely adverse to the issuer. Even if the company saved only a small amount, the fact that this money is often going to some groups other than the government might be considered in the form of good will. As long as the position of the stockholders is enhanced or at least not reduced, they should have no great complaint. In many cases the companies issuing income bonds have given at least a part of the tax savings to the stockholders in additional dividends. Of importance here is the simple fact that few people will be hostile toward the company for saving taxes if this money is put to work for the benefit of the company and, therefore, the stockholders.

The future of income bond tax savings.--How long will the Internal Revenue Service allow this tax savings to remain in existence? As has been stated in Chapter V, there are no plans to do anything that would extinguish this tax savings.³² Probably neither the Internal Revenue Service nor Congress has such plans.

³²This problem is more completely discussed in Chapter V, including the actions of Congress on this issue and the position of the Internal Revenue Service as stated by the director of the Research Division of the Internal Revenue Service.

Not only must the tax savings be considered in the view of using income bonds instead of preferred, but also in the view of possible tax reductions. There may or may not be future corporate tax reductions like that of 1964, but to destroy the effectiveness of using income bonds instead of preferred stocks this reduction would have to be very large. Having considered the possibility of tax law changes, the chance of such law being enacted seems relatively small and nothing about which to be greatly concerned.

The only situation where income bonds and preferred stocks are conceivably close to being comparable from a tax standpoint is when a parent company owns preferred stock in a subsidiary. An 85 per cent tax credit is allowed the parent (bondholder) on dividends paid to it from a subsidiary.

In most cases there is a great amount that may be saved by paying interest instead of dividends. In the case of income bonds, however, there are costs which decrease the amount of this savings. All of these costs were discussed earlier in the section, Disadvantages for Income Bond Issuers. The measurement of costs such as keeping a sinking fund and offering other features is very difficult, but should not be ignored. They definitely exist and at best can only be reasoned estimates which are best made by the individual company. It alone can reasonably predict what these costs will amount to over the years. These costs would have to be exceptionally high to even partially offset the tax savings created.

Market for income bonds is greater.--The potential market for income bonds is not exceptionally greater than that for preferred stocks. This is due to the fact that these two securities appeal to the same basic groups. There are special situations, however, which give income bonds a legal advantage. In addition to these situations, the marketing of income bonds is helped by the advantages to the purchaser discussed previously. The major factor that limits the selling of income bonds is the adverse and hostile public feeling toward these bonds which has passed down through the years. This feeling has been slowly disappearing, but until large, strong corporations start to use new capital income bonds and large institutional investors begin to accept more of them, the market for income bonds will remain restricted. In the future these bonds may be accepted and then the greater potential market for them will come into use.

At present the greatest market for income bonds is life insurance companies, which are prohibited from investing in preferred stocks in over one-third of the fifty states. In other states only a small part of the company portfolio can be invested in preferred stocks. Income bonds of strong companies find favor in many life insurance companies because of their high yield, relative safety, and often large issue size. Among other groups, income bonds seemingly get about equal treatment compared to preferred stocks. There are groups which have no use for income bonds, such as savings banks in the State of New York. The state prohibits purchase of the bonds by savings

banks. Universities seem to feel the bonds have no place in their portfolios. The feeling of universities is also prevalent among some bond funds. Both groups feel the bonds do not offer enough earnings in conjunction with capital appreciation, or enough safety. Universities offer similar criticism of preferred stocks in most cases. In effect, the present market for income bonds is largely made up of insurance companies, some bank trust funds, and wealthy individuals.

Income bonds should be issued in place of preferred stock.--
In all cases except possibly those involving the 85 per cent tax credit, income bonds should be issued in place of or to replace preferred stock. Naturally there are exceptional cases where this rule may be incorrect, but generally it should hold true. There is no question that income bonds may be required to sell at a higher yield than preferred and may cause moderate placement problems. These facts, however, seem to be greatly outweighed by the tax savings the bonds create for the company. Why should any company not use legal tax avoidance that will benefit its stockholders and the company, and not hurt debt holders? Many financially strong companies have found use of income bonds instead of preferred stock not to be harmful and, in fact, to provide savings that benefit all involved with the company.

CHAPTER IV
ATTITUDES OF INVESTORS AND ISSUERS
TOWARD INCOME BONDS

Income bonds from their origination have been greatly hindered by the hostile attitude held toward them by the investors and issuers alike. This attitude, as explained in Chapter II, has been built on the unfortunate reorganizational use of income bonds, which was the primary use of the bonds until the 1940's. The non-reorganizational income bonds that have appeared in the last twenty-five years have been viewed with great distrust because of the performance of their ancestors and the past experience of many investors. To inquire about the present feelings of the issuers and investors toward income bonds, a group of questionnaire letters was sent to various groups in the financial community. These answers will help indicate changes in feelings which have occurred since 1955, when investors and issuers were asked some of the same questions by Sidney M. Robbins.¹ The resulting sample answers from the questionnaires are not necessarily meant to obtain conclusive validity but, rather, to put generally held opinions into focus.

¹Sidney M. Robbins, "A Bigger Role for Income Bonds," Harvard Business Review (November-December, 1955), p. 102-103. Besides reasking some of the questions asked by Mr. Robbins, five of the nine questions were new questions which dealt with features of income bond contracts more specifically.

Forty-three letters were sent. The groups polled for their opinions were companies issuing income bonds, universities, bank trust departments which held pension funds, savings banks, insurance companies, and bond funds. In addition to the letters, telephone interviews and personal interviews obtained opinions from investment bankers and wealthy individuals. Considering all methods of sampling opinions, fifty-one opinions were sought and forty-three were received. Many of the questionnaires had several additional written comments, and a few were accompanied by rather lengthy letters, all of which were very helpful. Some of the institutions questioned wished not to be named; others did not object.

Investors' Attitudes

Twenty-one investors were questioned regarding income bonds. The questions were general in nature, covering regulatory agency attitudes and hostility toward income bonds, along with questions about contract requirements that would be considered necessary to make income bonds acceptable purchases. The answers of each group will now be discussed.

Universities

The attitude of universities contacted is very hostile toward any form of income bond. Of the groups polled, they had the most disdain for the bonds and definitely would not be willing to purchase them even if they had "A" ratings. The major reason

for this feeling is that the bonds held by universities are held only for safety reasons and not because of the interest. Bond interest, according to one answer, must always be available when needed, and the least possible risk should be taken when investing in bonds. Almost all of the bonds held by universities are of very high quality and without any optional interest payment features.

The attitude of the universities seems to lack forethought. As Sidney Robbins pointed out in 1955, many universities have large preferred stock holdings. Columbia University, for example, owns almost \$1,000,000 of preferred stock.² Also, universities are not limited by legal restrictions or agency rulings which hinder many other institutions like savings banks and insurance companies. If universities were not tax exempt institutions, they might feel the 85 per cent tax credit applicable to preferred stock dividends was a reason to avoid the bonds, but they are tax exempt.

There has been no great change in the attitude of universities toward income bonds. If anything they have become less accepting of the security. Among the six universities answering the questions put to them, there was little dissent. Acceptability of income bonds was felt to be just as it was fifteen years ago (very little acceptability), and possibly less.

²Letter from Director of Endowment Fund Purchases, Columbia University, January 18, 1966.

Requirements for income bonds that would be even remotely acceptable varied somewhat. This is due to the fact that some of the universities thought of the bonds from a safety viewpoint, while others saw them from an earnings viewpoint. From the latter view, the bonds proved insufficient because of the lack of a chance for capital appreciation; and from the former, they proved insufficient because of the lack of safety.³

Those groups interested in safety felt that the higher interest paid by the bonds was not greatly important, for adequacy of future earnings would be the paramount consideration. A sinking fund was not considered a necessary clause, but a cumulative clause was deemed necessary for a period of at least twenty-five years or longer for a fifty-year bond. When considering the need of income bonds as a possible source of capital appreciation and earnings, the requirements were the same as stated above except that convertibility and a high interest rate were deemed highly important.

Perhaps the universities are correct in their attitude toward income bonds. If they are, then there seems little reason for the large preferred stock holdings in many university portfolios. The chance for capital appreciation would seem to be better in common than in preferred stock. If the university is seeking safety, the funds should be placed in high-grade bonds.

³Only the University of Chicago conceived of the bonds as a source of capital appreciation and earnings. This was done simply to show that even convertible income bonds could not offer the university portfolio what stocks could. Possibly in the case of preferred stocks all the facts have not been examined.

Savings Banks

Many savings banks are prevented from investing in income bonds by state laws, such as those in New York.⁴ The attitude of those banks questioned which could invest was not hostile toward income bonds. The Philadelphia Savings Fund Society Vice President, R. W. Richie, stated that the ". . . society was subject to F.D.I.C. examination, which criticizes any issue rated below 'Baa.'" They, however, ". . . would buy more income bonds of 'A' or better rating."⁵ Other savings banks held the general opinion that if the bonds were rated "A" or above, they would be seriously interested in them. This is a marked change in attitude from that held fifteen years ago. Now, the major problem of these groups is finding high quality income bonds. The requirements that savings banks set for investment grade income bonds are generally much greater than for industrial bonds. One answer, however, stated that the requirements were only modestly greater than for other bonds. The bonds would be required to have a higher interest rate, a sinking fund, and a cumulative clause for a period of five years or more. If quality income bonds were available, there is little doubt that they could be sold to savings banks. The problem is finding income bonds with an "A" or better rating.

⁴New York State Banking Law, Act VI, Sec. 235.

⁵Letter from R. W. Richie, Vice President, Philadelphia Savings Fund Society, January 18, 1966.

Bank Trust Departments Which
Operate Pension Funds

Trust departments contacted are of the general opinion that income bonds are becoming more acceptable. The Bank of America felt that the bonds are more acceptable now than fifteen years ago and that the trend toward more acceptance is increasing.⁶ Only one bank saw less acceptability but stated that the lack of acceptability was decreasing. Here again the problem was finding income bonds of sufficient quality and marketability. The basic trust department requirements for any bond investment seem to consist of three factors. The bond must be of high quality, pay an assured return, and possess reasonable marketability. The marketability problem is very important. Most high quality income bonds such as those of Monsanto Chemical Company are placed privately. A few very large trust departments have used income bonds in pension fund portfolios but only in very small amounts and for "highly aggressive accounts" which will risk private placement.⁷ Other than this, the bonds have not been purchased.

The trust departments showed an interest in the high yield possibilities of the bond. Only one bank felt the high interest on the bonds was not important. This same banker stated

⁶Letter from S. B. Stewart, Executive Vice President and Officer of Trust Activities of the Bank of America, January 29, 1966.

⁷Letter from Ronald Lockwood, Investment Officer, Chase Manhattan Bank, February 10, 1966.

specifically that the main reason for his dislike of income bonds was that he ". . . remembered too many!" from past days.⁸

If banks were to buy income bonds, they would have to be of "A" or better quality. This is quite natural, as the F.D.I.C. takes a rather harsh attitude toward any bond rated below "Baaa." Very few bank trust portfolios or pension portfolios contain "Baa" bonds of any type. The features which an acceptable income bond would have to have are very similar to those the savings banks would require. They would want a sinking fund and a cumulative clause to maturity. None of the bankers were highly concerned with a possible change in the tax laws.

The major reasons that the accounts of a bank trust department usually have no income bonds is simply that high quality income bonds are not available in sufficient quantity on the open market. Considering the legal position of a trust department as a guardian of its customers, there is no reason that income bonds should appear in more than a very few special accounts. If in time high quality income bonds came into use and a strong open market developed, the bank trust portfolios might well hold some of these bonds, especially for pension funds.

Bond Funds

Several bond funds were contacted concerning their views. Only one company, which operates five different investment funds,

⁸Letter from W. W. Young, Vice President, Irving Trust Company, January 26, 1966.

was hostile toward income bonds. The other groups, which represent eighteen funds, were accepting income bonds as a purchasable security. One group, which represents eight funds, was willing to buy income bonds with ratings as low as "Baaa" and "Baa." The general opinion of these bond fund operators was that their respective funds had more acceptance of income bonds than they did fifteen years ago and that this acceptance would remain stable or increase in the future.⁹ The investment requirements for income bonds as the funds described them were greatly above those of straight bonds purchased by the funds. High interest rates were a major reason for the interest of the funds. A sinking fund was considered mandatory by each of the groups questioned. Cumulative clauses were desired, ranging in length from five years to maturity.

Bond funds make up the most interested and receptive public purchasers of income bonds. Here the quality of the bonds is not greatly important to the purchaser. Some of the funds imply, however, that they did not purchase more income bonds because of lack of high quality.

Wealthy Individuals

No wealthy individuals that were contacted had any interest in buying preference income bonds. Two individuals stated that

⁹ Investors Corporation disagreed with this general opinion. They stated that their interest in and acceptance of income bonds had decreased and would continue to decrease. Letter from G. E. MacKinnon, General Counsel and Vice President, Investors Corporation, February 2, 1966.

they remembered many of the bad issues born in the depression. One individual stated he had owned some railroad income bonds that were of the preference type, but this was for speculative purposes only. There are very wealthy individuals who have purchased these bonds or received them in trade for preferred stock, but none could be contacted for their opinions.

Insurance Companies

Insurance companies are the largest purchasers of preference income bonds. Almost every major issue is owned at least in part by life insurance companies. The reason for this is the legal restrictions on purchases of securities by insurance companies. In over one-third of the states, insurance companies are limited in the amount of preferred stock they may own and are allowed to own only small amounts in other states. No state prohibits the ownership of income bonds by insurance companies. This does not mean that there are no requirements concerned with insurance company ownership of income bonds. The National Association of Insurance Commissioners has placed restrictions on the purchase of income bonds by requiring a 20 per cent reserve on income bonds just as for securities deemed to be "not amply secured."¹⁰ Also, individual states have state restrictions.

Even with these restrictions the attitude of insurance companies toward income bonds is more favorable than fifteen

¹⁰Letter from H. N. Chapin, Executive Vice President, Massachusetts Mutual Life Insurance Company, January 25, 1966.

years ago but is not rapidly improving. Perhaps this lack of rapidly increasing acceptance of income bonds is caused by the fact that the higher yield of income bonds can be offset by the use of straight bonds with detachable warrants and convertible features which are more popular. In spite of these facts, some insurance companies still purchase a large number of income bonds, usually through private placement. The major reasons for the purchase of such bonds are the high yield they carry and the laws restricting purchases of preferred stock.

The insurance companies contacted stated that their main complaint about income bonds in general is that they lack quality. Requirements for income bonds deemed purchasable will by necessity be above those for straight bonds. The bonds must carry a relatively high rate of interest considering the market and straight bond issues of the company. Interest would have to be cumulative to maturity, and a sinking fund provided. Aetna, like many life insurance companies, requires a sinking fund on all industrial bonds purchased.¹¹ As has been noted before, the bonds are not unacceptable because they are income bonds but because they are usually issued by non-quality companies. Of the companies willing to purchase income bonds, a quality of "Baaa" or above was required. Only one company, Aetna Life Insurance Company, stated it would consider purchasing income bonds below this quality.¹²

¹¹Letter from Crampton Trainer, Vice President, Aetna Life Insurance Company, February 3, 1966.

¹²Ibid.

Attitudes of Issuers

The above sections described the attitudes of investors toward preference income bonds. Twelve out of fourteen issuers replied to a poll designed to determine their attitudes toward the income bonds they had issued and the use of income bonds in the future. These companies ranged in size from small, tightly held companies like Nassau-Beekman Realty Corporation to large firms like Sheraton Hotel Corporation of America.

The questions asked the fourteen issuers of income bonds dealt with the issuers' opinions about

1. the future of income bonds,
2. the contract features necessary in acceptable income bonds,
3. the regulation of issuing companies, and
4. the uses for income bonds.

The Attitude of Issuers Toward Contract Features, Regulatory Agencies, and the Future of Income Bonds

Ten out of the twelve companies which replied felt that the slight-to-moderate acceptance of income bonds by the financial community in general was not a major deterrent to their use of preference income bonds. Ernest Henderson, Sr., Chairman of the Board of the Sheraton Hotel Corporation of America, stated ". . . there may be some psychological barriers in some people's minds due to the fact that income debentures were ordinarily

associated with reorganizations."¹³ He felt, however, that the attitude of investors was not a major problem.

In the last fifteen years, all but one of the groups answering felt that income bonds had become more acceptable to the financial community in general. When asked what future trend they predicted for the acceptability of the bonds, the answers were varied. Two groups, Armour and Company and Pan American Sulphur, foresee the present attitude of the financial community toward income bonds as a stable situation which will remain throughout the near future. Only one company, Paulsboro Chemical Industries, Inc., foresees a decline in the acceptability of income bonds. This decrease was attributed to a general market shift toward equity financing because of the desire of investors for a greater chance to acquire capital gains. Only three other companies answered the question concerning the future trend of income bond use. All three of these companies foresee increased use of income bonds. They predicted the tax savings will continue to attract new issues of the security. Budget Finance Plan is a good example of this continued use. In June of 1965 they issued \$3,000,000 of 6 per cent Series A Subordinate Capital Income Debentures due June 1, 2010. This was the fourth of four issues made between 1960 and 1965.

Professor Sidney Robbins of Harvard University stated in 1955 that he thought the adverse feeling toward income bonds was due to the fact that many past income bonds were issued by

¹³Letter from Ernest Henderson, Sr., Chairman of the Board, Sheraton Hotel Corporation of America, March 5, 1966.

companies of weak financial position, not the fact that this particular type of security was used. Only one company that answered a question about this disagreed with Professor Robbins' theory. R. S. Bond of Pan American Sulphur felt that Robbins' theory was correct but stated also that to be well accepted the bonds must be convertible even if issued by a financially strong corporation.¹⁴ This is in direct contrast to the feelings of the Sheraton Hotel Corporation of America.¹⁵ To back their opinion, Sheraton Corporation has \$30,000,000 of nonconvertible income debentures out quoted at 98½ in February, 1966.

There is no way to determine exactly what contract clauses are necessary to make a preference income bond acceptable to the financial community. Obviously, the number of times interest on the bonds is covered by earnings would have a lot to do with the clauses required in the bond contract. The issuers of income bonds were asked if four specific contract clauses would be needed to make a preference income bond acceptable:

1. a sinking fund,
2. a relatively high rate of interest (relative to straight bonds issued by the company),
3. convertibility, and
4. a clause protecting both the issuing company and the buyer should the tax law be changed and interest be considered as dividends.

¹⁴Letter from R. S. Bond, Secretary and Treasurer, Pan American Sulphur Company, January 24, 1966.

¹⁵Op. cit., Letter from Ernest Henderson, Sr., Sheraton Hotel Corporation, February 14, 1966.

Three opinions were given: one, that providing these contract features was a necessity but it would be so expensive that other types of securities like common stock would be more economical to use in almost every case; two, that all these features are not necessary and income bonds could be issued at reasonable costs without them; and three, that these features are not so expensive as to prohibit the use of income bonds. Those holding the first opinion felt that to include all of these features was simply not worth the cost to a company that had any other choice. Income bonds with these four features would be used only by a company in a weak financial position. Those holding the second opinion provided the most interesting answers to the question. Ray E. Stewart of Budget Finance Plan stated, "Unquestionably a sinking fund must be provided."¹⁶ Also, he felt an interest rate must be provided that is higher than that carried by other senior fixed debts of the company. The tax clause and a convertibility feature were not deemed necessary. Sheraton Corporation of America disagreed sharply with the need for a convertible clause. If a convertibility feature would have been required, they would not have issued any of their income bonds.¹⁷ Those holding the third opinion felt that convertibility was very definitely required along with the tax clause.

¹⁶Letter from Ray E. Stewart, Vice President and Treasurer, Budget Finance Plan, January 31, 1966.

¹⁷Letter from Ernest Henderson, Sr., Sheraton Hotel Corporation, February 14, 1966.

All groups felt that a sinking fund and an interest rate above that of straight bonds was a necessity. No estimate of the cost of each of these features was available, but obviously the sinking fund and convertible features would greatly decrease the possibility of the bonds being discounted when sold. One of the major reasons for features like a sinking fund is the influence of regulatory agencies and individual company policy. Many insurance companies, for example, require sinking funds on all industrial bonds they purchase. This fact is important because no specific agency has control to regulate what provisions the issuers put in an income bond contract. Income bonds, then, are governed not by regulation of the issuing company but rather by regulation of the possible purchasers.

The Uses for Income Bonds

The issuers were asked if they would consider the use of income bonds for one, financing of capital expenditures; and two, the recall of preferred stock. In both cases the stipulation was made that this was not to be considered a last-resort situation. Only one company said that income bonds would be used solely as a last resort to finance capital expenditures. None of the companies felt that income bonds were a last-resort means of calling in preferred stock. Naturally, one of the reasons for the use of income bonds to recall preferred stock is the tax savings. Only three companies felt this was a substantial advantage. The other companies saw the tax advantage as only a moderate advantage.

Investment Bankers

Investment bankers must act as purchasers and sellers of income bonds. Their opinion is highly important, for it shows the feelings of underwriters, which have a great influence on the type of security a corporation issues. The attitude of investment bankers questioned about income bonds was hostile.

When asked about the reasons income bonds were not used more often, the reply was simple. The bankers felt they are an expensive way to finance because of their high effective interest rate and the fact that they often must be sold to investors who are often hostile to this basic type of security. Even the strongest corporations seem to take a minimum two-point spread below other debt instruments if a receptive buyer is available.

The tax savings on income bonds is applicable only in those cases where the bonds are issued in place of or to replace preferred stock. Only in this particular case is the tax savings of great advantage.

The replacement of preferred stock is the major use seen for income bonds. New capital income bonds would be recommended only for corporations which had completely depleted the possibilities of other debt instruments. Income bonds might be used in merger situations but only after other possibilities had been diminished. In the future the income bond, it is believed, will be put to the same basic purposes as it has been in the past. No great increase in the use of income bonds was predicted for the future.

When asked if they felt that income bonds were disliked because they usually were issued by financially weak companies and not simply because they were income bonds, the reply was "no." The feeling was that the institutional investors do not change their habits rapidly, nor do the rating services. Both of these groups, the bankers felt, were not easily able to be convinced and, therefore, would not often be willing to examine bonds of the type that had for years been bad investments.

The investment bankers were asked to consider what contract features would be deemed necessary to produce a highly marketable income bond if it were issued by a financially strong corporation and the interest coverage was 2.5 times. A sinking fund was thought to be a very good way to cut down on the high interest rate paid, yet a spread of at least two points above that of straight bonds would be needed. Convertibility was not deemed a requirement, but one banker felt that convertible income bonds could be sold less expensively than common stock in some cases.¹⁸ A second mortgage was not considered necessary, but some type of cumulative clause was. This clause could run from five to twenty-five years in length.

¹⁸Interview with Walter Bader, Vice President and Board Member, First Southwest Corporation, March 22, 1966.

CHAPTER V

LEGAL PROBLEMS INVOLVING INCOME BONDS

Early Court Decisions

The courts of the United States and the member states have done much to shape the use and acceptability of income bonds. Early in their history income bonds acquired a bad name. Court decisions which showed doubt as to the legal status of the bonds were one of the reasons for public doubt about and dissatisfaction with this type of bond. The bond was of "hybrid" character, in some ways similar to a preferred stock, while in other respects it definitely resembled an ordinary bond. Perhaps the doubt shown by the courts may be justified because of the newness of this form of bond and the experimental way in which the issuing companies used the bond. Whatever the reason, the courts were slow in recognizing many of the problems of income bonds and in developing acceptable solutions. Yet, between 1844 and 1946 much was done legally to increase the respectability of the bonds.

Examples of Early Court Decisions

Revealed by examination of early court decisions is the fact that some judges felt the new "hybrid" was inadequate as a form of security while other judges saw no reason for criticism of the security. The income bonds of the Chesapeake and Ohio

Canal Company and the Central Ohio Railroad Company show how court opinions varied.

The income bonds of the Chesapeake and Ohio Canal Company were brought to the attention of the courts several times from 1848 until around 1890. The company was in dire need of capital to complete a canal. The State of Maryland had advanced large sums of money to the company and had a lien on its earnings to secure repayment. To facilitate the issuance of income bonds, the state enacted legislation which surrendered the priority of Maryland's lien and authorized the issuing of income bonds.¹ The company issued "Preferred Bonds," which were given a lien on income of the company. When the canal went into operation in 1867, the company asked the courts to rule on the priority of its creditors to help in the disposition of earnings. The court recognized the priority of claims of the bondholders over those of the State of Maryland. In 1877, when the earnings of the company decreased, the court denied a bondholder's request that the company be put in receivership. The court did, however, order the company to give frequent accounting of its receipts and disbursements, and allowed the bondholders access to the financial records of the company.² This decision gave recognition to the bondholders' rights to information. By 1885 the court was asked to protect the lien of both the bondholders

¹Maryland Laws (1844) c. 281.

²Stewart v. Chesapeake and Ohio Canal Company, 5 Fed. 149 (C.C.D. Md. 1881).

and the state against general creditors who had acquired a judgment against the company. The court referred back to previous Maryland statutes which did not help the bondholders, and also stated that the company could not simply dispose of its revenues as it saw fit. These decisions all were of great help in determining the rights of those holding the new security. With its continued loss of revenue, the company finally was put in receivership over the protest of the state, which wished to have the assets of the company sold. Selling assets would not recover bondholders' investments. By 1902 the company was again making money. While under receivership control, the state sued in another attempt to get the court to force the sale of assets to pay the state. The court ruled against the state (*State v. Cowen*, 83 Md. 549, 35 Atl. 161; 1896). The plight of the bondholders who had spent large amounts of money and could not redeem it through sale of assets was very influential in the court decision. Throughout the years Chesapeake and Ohio Canal Company bondholders received very strong legal protection. In other cases, however, the income bondholders were not able to get the courts to protect them with the same determination. The Central Ohio Railroad Company issued income bonds secured by the income of the road. Later the company proposed to issue third mortgage bonds with priority above that of the income bondholders. The income bondholders asked the courts to enjoin the company from issuing the mortgage bonds on the grounds that this would lower their priority of claim. The

request was refused because the income bond contract did not stipulate against the right of the company to execute other obligations to enable it to finish the road.³ This naturally did not enhance the acceptability of income bonds.

In the case of the Central Ohio Railroad Company and the canal company, the court seemed to be attempting to keep the companies alive. Perhaps this was the main purpose of the courts. If this is true, the numerous other cases that were similar but decided differently by the courts could be explained more vividly. Whatever the reason, court decisions like those involving the Central Ohio Railroad were not uncommon and definitely gave the early income bonds a bad reputation among investors.

The Recognition and Solution of Many Income Bond Contract Problems

With the progression of time, the courts and regulatory commissions have done much to improve and stabilize income bond contracts. Foremost in importance is the work the courts have done with the problems of determining net income of the issuer company and providing protection for the income bondholders.

Determining Net Income of The Issuer Company

Basic within every income bond contract is the stipulation that the issuer company will pay the stated amount of interest

³Garret v. May, 19 Md. 177 (1862).

to the bondholder only if and when earned. Naturally the problem of what constituted earnings arose.

Earnings and the board of directors.--Vividly clear is the fact that the board of directors of a company has a great influence on the earnings of the company through the use of its decision-making power. Directors of most companies represent large holdings of company stock, the dividends of which could be greatly influenced by when and how earnings are available to pay income bond interest. In the early days noncumulative bondholders sometimes found payment withheld until enough earnings were available for payment of the year's bond interest, plus a dividend on the outstanding stock. There are in existence today many ways in which a board can influence earnings. Directors have the responsibility of determining allocations to reserves for depreciation and contingencies. They can often defer payments to subsidiaries and force payments of dividends from subsidiaries with relative ease. The power to make these decisions is by necessity given to the board, and unfortunately the judgment of the board is sometimes legitimately questionable.

The distinction between additions and replacements.--There was a time when determining what constituted an addition or a replacement was often difficult; however, with the advent of the Uniform Accounting Rules of the Interstate Commerce Commission, the question rarely arises.

The determination of depreciation.--Up until 1909 the United States Supreme Court did not recognize depreciation as a business expense. Before the Uniform Accounting Rules came into being, methods of determining depreciation were often varied and unreasonable. Even today the Interstate Commerce Commission and Internal Revenue Service continue to cause changes in calculating depreciation. The amount of depreciation charged will always be a best estimate, but much has been done to control the estimates. Over the last twenty years, the problem has been almost eliminated by the placing of a clause in the bond contract covering the calculation of depreciation or setting up of maximum and minimum charges to this depreciation.

Accounting problems involving subsidiaries.--In 1890 the problem of the parent-subsidiary relationship was viewed by the courts. The Chicago and Eastern Illinois Railroad Company issued income bonds. Several years after the issue the company bought, leased, and built additional lines. These lines proved unprofitable, while the lines in operation when the bonds were issued were still profitable. The bondholders sued to force the company to base their determination of earnings available for bond interest only on the original company lines. The court held that since the bondholders had made their investment based on faith in the earning power of the original lines, the company should calculate earnings based on these lines only.⁴

⁴Spies v. Chicago and E.I.R. Co., 40 Fed. 34 (C.C.S.D.N.Y. 1889).

In 1910 Central of Georgia Railroad income bondholders found a subsidiary problem. The railroad owned the stock of the Ocean Steamship Company, which had paid no dividends for ten years. In this time, however, the subsidiary had loaned the parent company all its net earnings. The earnings (loans) went directly into "General Funds" of the parent and interest was paid on the loans. The Georgia Court ruled that since the loan was not a legitimate loan the payments must be considered dividends and, therefore, earnings of the parent should be corrected and interest on the bonds paid if truly earned.⁵

To protect the bondholder from subsidiary problems involving payment of dividends, the contracts for income bonds now contain a clause making interest payable from consolidated earnings (earnings of the subsidiary and parent combined). This clause, especially when combined with a cumulative interest clause, makes parent-subsidiary dealings virtually ineffective in stopping or delaying interest payments.

The method of accounting used by a subsidiary usually would have little effect on the bondholder's position, because of the Standard Accounting Rules. In some cases where a particularly successful subsidiary is involved, the bondholder might take careful notice of the actions the subsidiary could take, such as issuing its own bonds.

⁵Central of Georgia Railroad v. Central Trust Company, 134 Ga. 472, 67 S.E. 1126 (1910).

The major problems of methods of accounting have been relatively well defined. Very few if any problems exist that cannot be handled by including the proper protective provisions in the bond contract. This does not mean that no accounting problems will again necessitate court action. It does mean, however, that income bond contracts can be written in such a way as to provide acceptable terms for both issuer and bondholder. The terms of the contract will have legal precedence as a basis on which exact understanding can rest.

Protective Provisions

The income bondholder should have some way to be assured of payment of interest when earnings are available, and at least relative assurance of the repayment of principal when due. There is no question that many different provisions are possible; however, it is highly unrealistic to expect that income bonds will ever become triple or even double "A" securities. They should and can offer the bondholder a relative measure of safety. The provisions for protection from various forms of determining net income have been described. Other protective provisions are available and have been used successfully in most instances.

A Cumulative Provision

A provision for accumulation of interest that has not been paid is not a perfect protector even if cumulative to maturity. True, a cumulative provision does provide protection against

manipulation of earnings in the short run. It may even allow the bondholders payment of back interest from surplus at maturity. The provision does not, however, assure the issuer will pay them as earned, nor will it assure the bondholder that a surplus will not be used up by losses during the life of the bond. The accumulation provision does, however, provide a better chance for the bondholder to get his desired return for the use of his money.

Access to Company Books

Having direct legal access to the issuing company records is a very strong protection to the bondholder. Almost no income bonds presently in issue are without this provision. Some contracts provide that the company is to procure an audit yearly by a certified public accountant. Often the contracts provide for a committee to which disputes are to be submitted. Such committees have been able to handle many problems without costly and annoying legal battles.

A Dividend Restricting Clause

A provision that no dividends will be paid until all accumulated interest has been paid is strong protection to the bondholder. When dealing with noncumulative bonds, this provision does not prevent the accumulation of surplus over a number of years, made possible by passing interest on the bonds. Later the surplus will be used to pay both interest and dividends when the surplus can handle the double charges.

Noteworthy also is the fact that restricting dividends does not prevent excessive dividend payments in good years, leaving nothing available in possible future poor times. In cases where excessive payment of dividends is a threat, an ancillary provision can be used providing for an interest reserve to be kept at a given level before dividends or interest can be paid. In some cases a provision allowing bondholders to vote after several defaults on interest payments is possible. This depends on the company.

Protection of Principal

Protection of principal may be acquired in much the same way that protection of interest is achieved. First, note that restrictions on dividends, creation of reserves, and subsidiary transactions are all protectors of principal. Also the principal may sometimes be protected just as other bond principal is protected. Such methods as the use of sinking funds, provisions against new bond issues, and early retirement are a few. The problem with normal types of protection is that many issuers of income bonds have already used these features as protection for other securities, or cannot offer them.

All the protective features discussed above cannot provide earning power on which the success of the bond lives or dies, but they do insure that if the earnings are available the bondholder can receive his interest. Also, the principal can be made relatively safe. These provisions help greatly to reduce

the risk to the investor and may have helped the seller attain better prices for his bonds. At the very least they have caused both parties to realize their legal obligations and have avoided possible misunderstanding.

What Constitutes Income Bond Interest

The previous discussions have dealt with legal problems and contract provisions of income bonds which were faced by relatively early issuers and purchasers of income bonds. Many of these problems were noted and solved before 1920. During the years of roaring twenties and depression thirties, the cases involving "hybrid" securities in relation to what constitutes interest or dividends became more prevalent. The reason for the increase in this type of case was the increase in the number of "hybrid" securities and the increased tax placed on earnings. Companies issuing income bonds began to receive increasing scrutiny by the Internal Revenue Service.

In effect the various tax and other courts were asked to determine what constituted a debt instrument. If the "hybrid" security was a debt instrument, the payments by the issuing company to the instrument holder were interest and tax deductible business expenses. In many cases the company would lose millions of dollars if it could not deduct these payments. Because of tax and other savings, many companies found court battles worth the cost.

Distinction Between Interest
and Dividends: General

Income bonds are classed as a "hybrid" security by the courts. This is obviously due to the fact that contracts can be written that have many of the qualities of a triple "A" debenture bond. The courts have even today found no simple "rule of thumb" to solve the problem of classification of these new "hybrid" securities.

When a "hybrid" security is being dealt with, the problem of classifying the security requires consideration of each of the cases individually. The court will consider the history of the company and issuance of the security. The court also will, ". . . examine the nature of the transaction evidenced by the security in order to realistically understand the meaning and purpose of the actual provisions contained within."⁶

Until 1946 there had been numerous lower court decisions dealing with the problem. In 1946 two cases reached the Supreme Court. Both cases involved income bonds; one group issued by the John Kelly Company, the other by the Talbot Mills Corporation. Both the cases dealt with payments of the same type; however, the payments of the Kelly Company were ruled interest, while those of the Talbot Mills Company were ruled dividends. Although the Supreme Court decision was an important and precedent-setting decision, the previous lower

⁶Jacob Mertins, Jr., Law of Federal Income Taxation, (New York, 1961), Vol. IV, p. 24.

court decisions are, today, still very relevant.⁷ Considering these facts, most court decisions today are based on two overlapping groups of factors. The first are the tests developed by lower courts prior to the 1946 Supreme Court decisions. The second are based on the results of the Kelly Company and Talbot Mills cases.

Tests Based on Pre-1946 Decisions⁸

There are ten of these tests. They are not listed in order of importance, for the importance of the individual test has now been ruled to be dependent on the situation. There was a time when various courts put emphasis on one or more tests; however, with the Supreme Court rulings of 1946, no one of the following ten tests was given outstanding importance in all cases dealing with the subject. Listed below is a brief description of the ten basic tests.

1. Did the parties at the time of issuance of the original documents intend to create a relationship of debtor to creditor? The language used in the contract will be considered to indicate the contention of the parties.

2. What nomenclature and labels have been used? Interest is not made a dividend by simply changing a name. The burden of proof is on the issuing company to show that the document

⁷Ibid., pp. 24-30.

⁸Ibid., pp. 30-53.

is in fact of a character other than that implied by its name, if necessary.

3. Does the obligation have a fixed or ascertainable date of definite maturity? The fact that the obligation has a date on which a definite sum must be paid marks the distinction between a creditor and a shareholder. The definite time designates a creditor. A maturity based on that time when the corporation is liquidated is not a fixed date.

4. Does the instrument give a preferred position as to the payment of interest and principal at maturity? If the holder of the obligation has the right to share in the assets of the corporation in case of dissolution, then the holder is strongly presumed to be a stockholder, not a creditor.

5. Do the holders of the security have voting powers? Voting power is not usually granted to a creditor; however, voting power given in case of default does not designate a noncreditor.

6. Does the instrument bear a fixed rate of interest? The fact that interest is payable exclusively out of profits will not in itself destroy the debt nature of a corporate debenture. Where the provision for payment of "interest" was treated by the taxpayers' board of directors as one which obligated them to make payments when and only when profits were available, the payment obligation is not characteristic of interest, but rather characteristic of dividends.

7. Does the instrument have redemption or retirement provisions? A redemption or retirement provision is

characteristic of indebtedness, but these provisions alone will not change the natural equity to that of debt instruments.

8. Is the obligation to pay interest and/or principal unconditional? The creditor must be entitled in all cases to repayment of money loaned. The shareholder is entitled to nothing prior to liquidation, where the creditor is entitled to payment from the corpus of a debtor's property, regardless of whether or not there is a surplus of earnings. The debtor is to be paid independently of the risk of success. This distinction marks a vital difference between the shareholder and the creditor.

9. Is the instrument redeemable at the election of the holder? This does not constitute a debt.

10. What is the amount of risk involved? Debt holders usually are considered to have less risk than equity holders.

The Talbot Mills and Kelly Company Cases

The Talbot Mills and Kelly Company cases are discussed here because they are the only Supreme Court cases dealing with the question of the distinction between interest and dividends.⁹ In both cases the companies were close family-held companies.

The Kelly Company issued to its stockholders income debentures which had a maturity date of December 31, 1956, and an interest rate of 8 per cent. The total amount authorized for issue was \$250,000. At the time of issue the company had

⁹Ibid., p. 53.

a capital structure which included 1,110 shares of no par value common stock and 1,124 shares of \$100 par value preferred stock. The interest on the debentures was to be paid out of earnings and was noncumulative. The income debenture holder had a priority of claim above that of stockholder, but below that of all other creditors. Bondholders had no right to participate in the management of the Kelly Company. If the company should default on payments to bondholders, a collection procedure was provided for in the bond contract. Although the original issue was available only to stockholders, part of the income debenture issue was available to the public on an assignment basis while the remaining part was issued in exchange for preferred stock which was retired soon after receipt of it by the company. Of the total \$150,000 worth of debentures issued, \$114,648 worth was in exchange for preferred stock. The preferred, when exchanged for the bonds, had a guaranteed dividend of 6 per cent at the exchange price. That part of the bond issue which was purchased, not exchanged for preferred, was paid for out of dividends received by company stockholders. Persons who owned stock in the Kelly Company were the only original purchasers of the bond. When the original transactions concerning the bonds were completed, common stock was owned in the same proportions by the same stockholders as before the issuance of the bonds.¹⁰

¹⁰Supreme Court Reporter, 326-328, United States (vol. 66, October term, 1945) p. 301.

Talbot Mills was a corporation that had 5,000 shares of capital stock with a par value of \$100 per share. The company recapitalized in 1939. Each stockholder exchanged $\frac{4}{5}$ of his stock for registered notes with a face value equal to the total par value of the stock retired. In other words, the company issued \$400,000 worth of notes to the stockholders for $\frac{4}{5}$ of their stock.¹¹ The interest on the notes was variable, ranging from 2 per cent to 10 per cent depending on the profits earned by Talbot Mills Corporation. The notes were transferable only by the owner's endorsement and the notation of the transfer by the company. Interest was cumulative, but the board of directors of the company could defer payment; however, dividends could not be paid until all interest on the notes was paid. A limit was placed on the right of the corporation to mortgage its real estate. In addition to these contract clauses, the board of directors had the right to make the notes subordinate to any obligation maturing no later than December 1, 1964. During the years considered by the court, the Talbot Mills Corporation paid the maximum 10 per cent interest.

Before reaching the Supreme Court, the Tax Court held that the Kelly Company payments were interest, while the Talbot Mills payments were considered dividends. The Circuit Courts of Appeal reversed the Kelly Company ruling and affirmed the Talbot Mills Ruling. The Supreme Court sustained the Tax Court in

¹¹Ibid., pp. 301-302.

both cases.¹² The major advantage of the Supreme Court decision was the determining that there is no one decisive factor which makes this type of obligation a risk investment in a corporation, or a debt. Mr. Justice Reed, in delivering the opinion of the court, states that although instruments considered were "hybrid" in nature, ". . . the characteristics of all the obligations in question and the surrounding circumstances were of such a nature . . . [to allow] the determiners to reach a conclusion. . . ." ¹³ The court did not deem the capital structure of the companies as deviating from normal and, therefore, did not consider either excessive debt or nominal stock investments.

In the Kelly case the court held the payments to be interest because:

. . . there were sales of debentures as well as exchanges of preferred stock for debentures, a promise to pay a certain annual amount, if earned, a priority for debentures over common stock, the debentures were assignable without regard to transfer of stock, and a definite maturity date in the reasonable future. These indicia of indebtedness support the Tax Court conclusion that the annual payments were interest on indebtedness. ¹⁴

In the Talbot Mills case, however, the court found that the fluctuating annual interest payments and the limiting of notes to stockholders for their stock were the factors which

¹²Conn. v. John Kelly Co., 146 F (2d) 466 (CCA 7th, 1944), and Talbot Mills v. Conn., 146 F (2d) 809 (CCA 1st, 1944).

¹³Supreme Court Reporter, 326-328, United States (vol. 66, October Term, 1945) p. 302.

¹⁴Ibid., p. 302.

differentiated the two cases and which made the Talbot Mills payments classifiable as dividends.¹⁵

Mr. Justice Rutledge dissentingly states his belief that both payments should be considered dividends. He felt that the difference between interest and dividends should not be decided on such "microscopic details." Both companies, he believed, were simply trying to maintain the advantages of stock while converting stock into "debentures." He points out that:

. . . in both instances the original stock and replacing security were closely held. There was no substantial change in the distribution after the "reorganization." The difference between the stock and the substituted security was so small in its effect upon the holders' substantial rights¹⁶ that for all practical purposes it was negligible.

The decision of the Supreme Court in both cases did not greatly change the methods used prior to 1946 to solve similar cases. If anything, the court strengthened the ten tests set up prior to 1946. It also made most explicit the fact that no one criterion is able to determine the question. The taxpayer is still burdened with proving he is paying interest, not dividends.

The one new test that has been established since 1946 is that of "thin" or "inadequate" capitalization.¹⁷ This test is simply an examination of the debt to equity ratio of the company.

¹⁵Ibid., p. 302.

¹⁶Ibid., pp. 304-305.

¹⁷Institute on Federal Taxation (New York, 1959), pp. 771-826.

No definite ratio has been set, but the tax commissioner will give close examination to companies with "hybrid" securities and disproportionately high debt structures.¹⁸ In the near future the business purpose test which began long ago may become another important factor. At present, it is not.¹⁹

¹⁸Revenue Procedures, Cumulative Bulletin (Washington, December, 1962), p. 527.

¹⁹Ibid.

CHAPTER VI

SUMMARY AND CONCLUSIONS

This study was undertaken for the purpose of determining and giving reasons for the development and use of income bonds in the past, present, and future. Although there is a brief review of the history of reorganizational income bonds in Chapter II, the study deals almost entirely with the use of new capital or preference income bonds. Chapter III covers the advantages and disadvantages of income bonds and the possibilities of issuing them to replace or in place of other types of securities. The attitude of investors and issuers toward preference income bonds was covered in Chapter IV. Legal problems involving income bonds were discussed in Chapter V. In Chapters II through V, many conclusions appeared. Here the major conclusions already stated will be reiterated, and some important new conclusions will be discussed. Using these conclusions the future of preference income bonds will be predicted. There is no need to prognosticate upon the future of reorganizational income bonds, for their future will be similar to their past. That is, they will be pressed into use in times of depression and recession or whenever a company finds it has no other choice.

Conclusions Considering the Advantages and Disadvantages of Income Bonds

The advantages of issuing income bonds only outweigh the disadvantages when certain financial situations exist. For the issuer the basic advantages that were set forth are as follows. Cost advantages were present only in situations where few if any other debt (as opposed to equity) financing possibilities existed. In situations where income bonds were more economical to use, a combination of factors was involved. Paramount is the fact that income bond interest is a business expense, which means no corporate income tax must be paid on interest that bondholders receive. Compared to paying dividends, paying interest saves the issuer the tax that would be levied on funds used to pay dividends. Income bonds give the issuer a method of using debt without having fixed payments in times when earnings to pay interest are not available. In times when using other debt securities is not practical, income bonds may be used and placed privately where equity securities might not be placed in a manner which is as economical. Also, bondholders have no voting rights; therefore, control of the company is not diluted.

The purchasers of income bonds have the following basic advantages. The bond contract often contains features for protecting both interest and principal, like sinking funds, mortgages, interest reserves, and accumulation clauses. The most important protection, however, is the fact that over the last one hundred years, the courts have set legal precedents

that allow the purchaser to know almost exactly what his rights are and what rights the issuer has in almost all situations. The market for income bonds has been improved by better understanding of how to analyze income bonds. Also, articles appearing in many publications have helped destroy many of the misconceptions surrounding the bonds. Perhaps the greatest advantage the purchaser received is a higher yield on his investment for the risk he is taking, compared to the yield that could be received from other securities (notably preferred stock) carrying a similar risk.

Both the income bond purchaser and the issuer must face several objectionable facts. The cost of issuing income bonds is higher than that of almost any other debt security, and often contract features offset the tax savings created by using income bonds instead of equity securities. A method of measuring the cost of many contract features is not available. The purchaser of income bonds must recognize that even high quality income bonds might miss interest payments. The security behind the bonds often is not strong, and because of this, many regulatory agencies must look on the bonds with distrust. This distrust is deep-seated within many sectors of the financial community. Although it is changing, great lengths of time may be required before these sectors are convinced that there are investment quality income bonds.

Situations Where It Is Advantageous
To Use Income Bonds

There is no question that certain situations exist where preference income bonds can be the most advantageous type of security to issue, considering the alternatives available and the goals of the corporation involved. Income bonds were considered as a replacement for common stock, preferred stock, and straight bonds. Also, they were considered as a type of security to issue instead of the above three securities.

Situations where preference income bonds should be used as a replacement for other types of securities were found in only one case. There were no cases found where preference income bonds have been issued to replace common stock or straight bonds. One practical reason that they might be used to replace common stock would be to allow a company to stop dilution of a large block of stock which had been voting as a block. A large stockholder might wish to keep some of his relatives from having a part in the management of a company but still desire to see that they received income from the company. If the company disliked the possibility of issuing straight bonds, income bonds could provide income to the relatives, be less costly to the company to maintain than preferred stock, and give more assurance of return than non-voting common or preferred stock. This reason for replacing common stock with income bonds is a very specialized case.

One situation does exist where in almost all cases income bonds should be issued to replace another type of security. This is the case of replacing preferred stock. Income bonds provide enough additional savings because of the tax advantage they have over preferred that they should be issued to replace preferred stock. The preferred stockholder gets a more secure and an equally profitable security if he takes the bond or the cash value of the preferred should he not be allowed to take the income bond. Another reason the bondholder is better off is that he gets to share in the increased financial strength of the company by getting increased earnings coverage of interest through the funds provided by the tax savings.

There are several situations where preference income bonds can and should be issued in place of or along with other securities. In the case of common or preferred stock, the following factors usually exist. The company does not desire to issue more straight bonds. Voting control dilution is not desired, and the use of preferred stock does not provide the tax savings that income bonds do. Important here is the fact that in some cases the existing stockholders do not wish to give up part of their possible future earnings by selling a share of the corporation to get capital. In other cases convertible income bonds are issued because they may be issued at less expense than common stock and control will theoretically not be lost until some time in the future.

The only reason that preference income bonds should be used instead of straight bonds is the case where the earnings of the company could or do fluctuate rapidly but probably will be strong over the long run. Income bonds give the company a way of avoiding taxes just as straight bonds do, plus the advantage of skipping an interest payment without creating a panic among all creditors.

Conclusions Considering the Attitude
of Issuers and Investors

The attitude of investors.--The attitude of investors ranged from complete hostility to moderate or strong acceptance. The greatest amount of dislike for income bonds was expressed by the universities questioned. They would not buy even "A" rated income bonds. Part of the reason for this attitude was the feeling that universities needed bonds only when the income the bond produces was vital and could not be left to chance. If this was not the case, then the funds involved should be put into growth or blue chip stocks. The attitude of the universities is somewhat strange as they hold large quantities of preferred stock, which yields no more than the bonds and does not have as strong a contractual position. An explanation for the lack of income bond purchases by universities could be a desire to slowly dispose of both the preferred stock and income bond type of security. Wealthy individuals questioned also had a very hostile attitude toward income bonds. This is based on

past experience from the "thirties" and the lack of a large, readily available market. Also, most wealthy individuals probably would not consider income bonds worth the time involved in analyzing them.

Savings banks in some states are prohibited by law from investing in income bonds. In areas where they can invest in them, the general attitude of those questioned was acceptance only of income bonds that were rated "A" or better. The bond would have to have a high interest rate, a sinking fund, and a cumulative clause. When questioned, bank trust departments which operate pension funds were of the general opinion that they were becoming more acceptant of income bonds. More high quality bonds would be purchased by them if they were available and were of "A" or better rating. In the case of savings banks and trust departments, the major problem was the lack of high quality income bonds in large quantities with marketability.

All but one of the bond funds questioned were very receptive to the idea of purchasing income bonds. Quality was not as important as how high the yield on the bond was. Bonds rated as low as "Baa" were acceptable.

Insurance companies are the largest purchasers of preference income bonds. The major reasons for the purchase of these bonds are the laws in many states which prohibit the purchase of preferred stock.

If large quantities of income bonds of high quality ("Baaa" or better) were available, all but two of the insurance

companies replying to a questionnaire felt they would be very willing to accept them, usually through private placement.

Attitude of issuers.--The attitude of the issuers toward income bonds usually was related to the market reception of the bond. Almost all companies polled were not troubled by the only slight to moderate acceptance of income bonds by the financial community in general. They found income bonds an acceptable method of financing considering the financial atmosphere in the company and the state of the money market. Most of the companies answering the questionnaires felt that income bonds were not disliked as a security type but because they were issued by financially weak concerns.

When considering what contract features quality preference income bonds must have, the issuers were not in general agreement. All agreed that a sinking fund and a high interest rate were necessary, but no basic agreement as to the need for accumulation and convertibility clauses was expressed.

Only one of the companies questioned felt that income bonds could not be used as either a source of new capital or as a replacement for preferred stock. All the other companies questioned felt either one or both of the uses for income bonds was acceptable. If the bonds had the features described above and reasonable coverage, most issuers felt a market for the issue could be found if it were used for either of the purposes mentioned above.

Investment bankers.--Generally, investment bankers disliked the idea of using income bonds because of the high effective interest rate and the large effort required to sell some of the past issues. One banker felt pension funds operating from their tax-free havens might some day be the biggest purchasers of income bonds.

Conclusions Considering Legal Problems

There are presently very few legal problems involving income bonds of either the preference or reorganizational type. This fact is the result of years of court decisions which have set precedents as to what income bonds are and how the bond contracts of various types are to be interpreted.

Tax law is an important factor when dealing with income bonds. Should the tax advantage of income bonds over equity securities be removed, there would be few if any reasons to use income bonds. The Department of Internal Revenue was questioned as to the possibility of a change in tax law covering income bonds. The reply was that no change in the law was pending in Congress and they saw no reason that the present law would be changed.

Conclusions Considering the Future of Income Bonds

There will be no dazzling extravaganza in the future with income bonds as the star performer. The bonds will continue to play approximately the same bit part they have always played, with at best only an outside chance of becoming a featured performer. The major use of the bonds will be to

replace preferred stock for some time in the future. Eventually most of the preferred will be replaced and the major use of income bonds will be as a new capital source. Corporations will continue to use preference income bonds only after straight bonds have been issued and the company has what it considers a high debt ratio. Quite possibly many companies which find they must make rapid expansions on a grandiose scale will turn to income bonds as Sheraton Hotel has done in the past with great success. Should this situation exist, then there would be a rapid upswing in the number of income bond issues. Another possibility, less likely than the one above, is that many companies will find that they can issue convertible income bonds more economically than common stock. Should this idea be proved conclusively and gain buyer acceptance as a means of financing, preference income bonds could become a very large part of the market in ten years.

What chance is there that the possibilities for the future will become reality? The idea that a market for high quality income bonds is available as soon as high quality income bonds are has been discussed in several places herein. According to this idea, the issuing of high quality income bonds will create a desire to issue more income bonds. When accepted, more will be issued and a "snowball" situation will develop over time. This idea goes back to 1955 and before.

One great problem is involved which tends to greatly slow the snowball. This is the fact that investment bankers dislike

income bonds. They have a great influence in the financial community and are the largest and most influential advisors for issuers of securities. The contention here is that the investment banker and the financial community in general are very resistant to any attempts to change their environment and the use of the tools with which they work. Perhaps with time there will be a very large use of preference income bonds, but this time is definitely not in the near future unless extraordinary circumstances should come into being. The general future trends in the use of income bonds are as follows. The bonds will be used more and more to replace preferred stock. New capital uses of the bonds will increase also, but more than ten years will be required to have income bonds representing more than a very small per cent of the securities issued even though the dollar amount of issues will increase.

Suggestions for Further Study

The greatest problem involved in investigating income bonds is the lack of general statistical and price information about them. Some effort should be made to determine the number of income bonds in private placement and the general type of pricing situations involved. Also, a study should be made to determine the costs of income bond contract features and the position of pension funds in the income bond market.

APPENDIXES

Appendix I: Calculations of the Cost of Bond Contract Features

In Chapter III the problem of how to determine the cost of various security contract features was discussed. Why should this be such a great problem? Should not it be possible to develop a mathematical formula for measuring the value of the many possible security contract features? If formulas of this type were developed, a company could get an estimate of the cost of adding contract features (sweeteners) and compare this cost to the cost of using other types of securities and features. Obviously, the measure would be based solely on prognostications about the issuer's long-term future; but even with this and other possibilities for errors, the problem would be brought into focus. Several respected people in the financial community have suggested that convertible income bonds are cheaper to issue than common stock. The long-range effect is the same and the company gets lower costs for the use of the funds. Would it be unwise to make such a move? Should the company issue convertible preferred or common stock instead? A group of mathematical formulas should be developed that can determine or at least help determine this type of question. The scope of this thesis prevents even an attempt to develop these formulas, but the problem can and should be solved.

Appendix II: Explanation of Questionnaires

As the attitude of the financial community toward income bonds is extremely important in determining the use of the bonds, questionnaires were sent to many present and potential buyers and sellers of income bonds. A total of fifty questionnaires were sent, and forty-three replies were received. Obviously, this sample of opinions has no statistical validity. Not all the questionnaires were alike. Examples of each type of questionnaire used and the groups it was sent to are listed below.

Questionnaire Letters Sent to Fourteen
Issuers of Income Bonds

5020 Park Lane
 Dallas, Texas 75220
 January 21, 1966

Presently I am writing a thesis entitled, "The Past, Present, and Future of Income Bonds," for a masters degree in business at North Texas State University. Your kindness in answering the following questions as fully as possible will be greatly appreciated.

The questions deal only with non-reorganizational income bonds. This includes all income bonds that were not the result of financial measures taken to avoid or cope with bankruptcy. Non-reorganizational income bonds (also called "preference income bonds" and "new capital income bonds") are issued for many reasons, such as:

1. to call in preferred stocks,
2. to finance mergers, and
3. to expand facilities.

Examples of this type of income bond are those issued by Monsanto Chemical Company, Corning Glass Works, National Can Corporation, and Hiller Helicopter.

Most of the following questions can be answered by a simple check, a "yes," or a "no."

1. Was (or would) the issuance of non-reorganizational income bonds by your organization be considered a last resort as a means of financing:
 - a. Capital expenditures?

yes)
 no) check one

January 21, 1966

b. The recall of preferred stock?

 yes)
 no) check one

2. Would the tax savings created by issuing income bonds instead of preferred stock be considered a:

Check (Slight advantage?
 Moderate advantage?
one (Substantial advantage?

3. Is the present financial community's slight-to-moderate acceptance of income bonds as a method of financing considered a major deterrent to your organization's use of income bonds?

 yes)
 no) check one

4. What is the attitude toward income bonds of professional, state, or federal agencies with which your company deals? Check the following and name the agency in the space provided.

 a. They find them completely acceptable.

Name of agency(ies):

 b. They find them moderately acceptable.

Name of agency(ies):

 c. They find them slightly acceptable.

Name of agency(ies):

 d. They find them unacceptable.

Name of agency(ies):

January 21, 1966

_____ e. The agencies I know of have never commented on their feelings toward income bonds.

5. Do you feel income bonds have become more acceptable to the financial community in the last fifteen years?

_____ yes)
 _____ no) check one

6. Do you foresee any increasing or decreasing use of non-reorganizational income bonds in the future?

Comment:

7. Sidney M. Robbins, in the "Harvard Business Review" (November-December 1955), found that most income bonds are unacceptable to investors because of the weak financial position of companies issuing them, not the fact that the bonds were income bonds. Do you feel this is the case today?

Comment:

8. To create an "investment grade" income bond, Professor Robbins felt the bond contract must provide:

- a. a sinking fund,
- b. a relatively high rate of interest,
- c. convertibility, and
- d. a clause protecting both the issuing company and the buyer should the tax law change and interest on the bond be considered as stock dividends.

January 21, 1966

Many financial experts feel that to design an income bond that is "investment grade" is so expensive that the issuing company would be better off using some type of stock or another type of bond. Do you feel as many of the financial experts do?

Comment:

Answers to these questions are essential to completing my masters thesis on this subject. Your assistance is appreciated. Self-addressed, stamped envelope is enclosed for your convenience.

Appreciatively,

Fen Vesecky

Enc.

Questionnaire Letters Sent to Purchasers
and Possible Purchasers
of Income Bonds

The following letter was sent to:

1. Bank Trust Departments
that have pension funds,
2. Insurance Companies,
3. Universities, and
4. Savings Banks.

5020 Park Lane
Dallas, Texas 75220
January 18, 1966

Presently I am writing a thesis entitled, "The Past, Present, and Future of Income Bonds," for a masters degree in business at North Texas State University. Your kindness in answering the following questions as fully as possible will be greatly appreciated.

The questions deal only with non-reorganizational income bonds. This includes all income bonds that were not the result of financial measures taken to avoid or cope with bankruptcy. Non-reorganizational income bonds (also known as "preference income bonds" and "new-capital income bonds") are issued for many reasons, such as:

1. to call in preferred stock,
2. to finance mergers, and
3. to expand facilities.

Examples of this type of income bond are those issued by Monsanto Chemical Company, Corning Glass Works, National Can Corporation, and Hiller Helicopter.

Most of the following questions can be answered by a simple check, a "yes," or a "no."

1. Name any professional, state, or federal agency that you know of which discourages or forbids the use of income bonds even if the bonds have a better-than-average rating.

January 18, 1966

Check the box, or list the agencies in the space provided.

I know of no agencies that discourage or forbid the purchase of income bonds.

- 1.
- 2.
- 3.
- 4.
- 5.

Additional comments:

2. Do you feel the organization with which you are associated has _____ more, or _____ less (check one) acceptance of income bonds than it did fifteen years ago? Do you think that in the future this trend will:

_____ increase,)
 _____ decrease, or) check one
 _____ remain stable)

Additional comments:

3. Are the requirements for income bonds which you would consider purchasable _____ greatly, _____ moderately, _____ slightly, or _____ the same as (check one of the preceding) the requirements for regular bonds?
4. Income bonds almost always have a higher rate of interest than regular bonds. Do you consider this of great importance when purchasing income bonds?

Comment:

5. Is a sinking fund feature considered almost mandatory when viewing income bonds for possible purchase?

_____ "yes")
 _____ "no") check one

January 18, 1966

6. A cumulative interest feature is usually included in income bonds. What time period would usually be acceptable for accumulation of back interest for a fifty (or more) year income bond:

3 years
 5 years
 greater than 25 years
 to maturity

7. Income bond interest is now considered a business expense by the Internal Revenue Service as is regular bond interest.

Income bonds usually contain a clause to protect the investor should the tax law be changed and interest on income bonds be viewed like dividends. Does this type of clause dissolve any concern you might have over a possible change in the tax law covering income bonds?

Comment:

8. Would your organization purchase more income bonds if they were of a quality and quantity equal to or slightly greater than Baa, Ba, and B bonds sold in the market today?

Comment:

9. When income bonds are issued instead of other non-bond securities, a tax savings is created as was explained in Question 7. Benjamin Graham suggests that part of the tax savings should be used to create or add to a sinking fund. Other authorities feel that the tax savings should be used to create

January 18, 1966

a "reserve fund" for payment of bond interest should it not be earned. Would you prefer the sinking fund idea over the reserve fund idea? Why?

Answers to these questions are essential to completing my masters thesis on this subject. Your assistance is appreciated. Self-addressed, stamped envelope is enclosed for your convenience.

Appreciatively,

Fen Vesecky

Enc.

The following letter was sent to several bond funds
or companies operating bond funds.

5020 Park Lane
Dallas, Texas 75220
January 21, 1966

Presently I am writing a thesis entitled, "The Past, Present, and Future of Income Bonds," for a masters degree in business at North Texas State University. I have been informed that the operators of the following of your company bond funds may have considered purchasing income bonds:

1. B-2, medium grade bonds,
2. B-3, low priced bond fund,
3. B-4, discount bond fund.

Your kindness in answering the following questions as fully as possible will be greatly appreciated. Three copies of this letter will be included in the hope that this will facilitate the answering of the questions by those in charge of each fund. The questions deal only with non-reorganizational income bonds. This includes all income bonds that were not the result of financial measures taken to avoid or cope with bankruptcy.

Non-reorganizational income bonds (also known as "preference bonds" and "new capital income bonds") are issued for many reasons, including:

1. to call in preferred stock,
2. to finance mergers, and
3. to expand facilities.

January 21, 1966

Examples of this type of income bond are those issued by Monsanto Chemical Company, Corning Glass Works, National Can Corporation, and Hiller Helicopter.

Most of the following questions can be answered by a simple check, a "yes," or a "no."

1. Name any professional, state, or federal agency that you know of which discourages or forbids the use of income bonds even if the bonds have a better-than-average rating.

Check the box, or list the agencies in the space provided.

I know of no agencies that discourage or forbid the purchase of income bonds.

- 1.
- 2.
- 3.
- 4.
- 5.

Additional comments:

2. Do you feel the organization with which you are associated has _____ more, or _____ less (check one) acceptance of income bonds than it did fifteen years ago? Do you think that in the future this trend will:

_____ increase)
 _____ decrease, or) check one
 _____ remain stable)

Additional comments:

3. Are the requirements for income bonds which you would consider purchasable _____ greatly, _____ moderately, _____ slightly, or _____ the same as (check one of the preceding) the requirements for regular bonds?

January 21, 1966

4. Income bonds almost always have a higher rate of interest than regular bonds. Do you consider this of great importance when purchasing income bonds?

Comment:

5. Is a sinking fund feature considered almost mandatory when viewing income bonds for possible purchase?

_____ "yes")
 _____ "no") check one

6. A cumulative interest feature is usually included in income bonds. What time period would usually be acceptable for the accumulation of back interest for a fifty (or more) year income bond:

Check (_____ 3 years
 one (_____ 5 years
 (_____ greater than 25 years
 (_____ to maturity

7. Income bond interest is now considered a business expense by the Internal Revenue Service as is regular bond interest.

Income bonds usually contain a clause to protect the investor should the tax law be changed and interest on income bonds be viewed like dividends. Does this type of clause dissolve any concern you might have over a possible change in the tax law covering income bonds?

Comment:

8. Would your organization purchase more income bonds if they were of a quality and quantity equal to

or slightly greater than Baa, Ba, and B Bonds sold in the market today?

Comment:

9. When income bonds are issued instead of other non-bond securities, a tax savings is created as was explain in Question 7. Benjamin Graham suggests that part of the tax savings should be used to create or add to a sinking fund. Other authorities feel that the tax savings should be used to create a "reserve fund" for payment of bond interest should it not be earned. Would you prefer the sinking fund idea over the reserve fund idea?

Why?

Answers to these questions are essential to completing my masters thesis on this subject. Your assistance is appreciated. Self-addressed, stamped envelope is enclosed for your convenience.

Appreciatively,

Fen Vesecky

Enc.

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