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Net Income and Judicial Economics

Henry Rottschaefer
New York Bar

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NET INCOME AND JUDICIAL ECONOMICS

A LEGAL system does not function in a vacuum of abstractions. It is part of a general institutional framework of an organized society. Its content is determined by concrete individual and social needs and activities. Hence modern jurisprudence conceives of law as a means for securing interests. The appraisal of its rules and principles requires an evaluation of the significant elements of the situation to which they apply. A narrow, complacent formalism is the penalty of failure in this regard. No one would deny the emphasis modern society places upon its commercial and industrial interests, nor the many points of contact between its legal and economic systems. Their problems are so inextricably interwoven that the proper answer to questions of law frequently turns on correct economic analysis. If the advent of income taxes has done nothing else, it has at least forcibly emphasized that fact. One phase of this inter-relation will be considered in the following discussion, namely, the determination of legal rights involving questions of income.

The income question with which courts deal most frequently is, what constitutes net income. This is a fairly definite concept to the economist and accountant. To them it denotes an objective fact, mathematically ascertainable by applying to the financial facts of operation for a given period a formula of recognized accounting practice. It connotes a definite order of arranging those facts in accordance with economic principles: first, the summation of the items that make up gross income; next, the deduction of outlays properly chargeable in arriving at net income; and last, the disposition of net income.

The principal defect of the legal treatment of income questions has been due to a failure to distinguish between the last two. The difference between them can be explained by applying the requirements of the Interstate Commerce Commission's accounting classifications to a concrete case. If a railroad constructs new mileage out of current earnings, it is not permitted to show the cost as a deduction in computing its net income, but must show it as an appropriation of net income. The distinction was recognized in *G. R. & I. Ry. Co.* v. *Doyle*[1] (a tax case), in the following language:

"It is a well-known fact that corporations in general, both railway and manufacturing companies, often use a part of their net earnings or income in the extension and improvement of their plants and property and business. * * * But amounts so expended in additions are no less income than they would be if paid to the stockholder as dividends."

The proper constituent elements of gross income have received practically no discussion in judicial opinions except in tax cases, which have not been considered herein. The problem frequently arises in receiverships where the receiver, without adopting the lease, continues to operate leased properties during the trial period allowed by law. The receiver is held under such circumstances to satisfy his entire duty by turning over to the lessor the entire net earnings of the demised premises. The net earnings of a leased railroad cannot be correctly computed without imputing to it its proper share of the gross earnings from joint traffic. This question was squarely raised in a case involving a railroad lease under which the rent was to be increased as soon as the "gross revenues" of the leased road exceeded a stipulated sum. The leased lines were operated as an integral part of the lessee's system, and the lessor's right to the increased rental depended ultimately upon fixing a proper measure for the division of the receipts from joint traffic. Unfortunately for this discussion, the case was ultimately settled out of court. Courts have usually held that, in income bond cases, the obligor may not mingle the accounts of the mortgaged property with those of the system of which it is a part. The application of this rule raises the identical question. The decisions point out the situations in which the problem arises, but give no

[1] 245 Fed. 792.

clue to the solution. The Interstate Commerce Commission has frequently dealt with the same or analogous questions in passing on the division of through rates, proportional rates and switching charges. Its rulings would assuredly have weight with any court confronted with the situations suggested in this paragraph, but are beyond the scope of this treatment. In the absence of definite decisions on the first phase of income determination, the cases analyzed are limited to those involving the propriety of income charges and the differentiation between capital and expense.

The distinction between capital and expense was called a "fundamental" one in *Kansas City So. Ry. Co.* v. *U. S.*[2] That case involved the validity of certain accounting regulations of the Inter-State Commerce Commission, requiring the estimated replacement cost (less salvage value) of property abandoned as an incident to making permanent improvements to be charged to operating expenses. The company contended that, due to the extensive abandonment of property incident to shifting part of its line to improve the gradient, the regulation would so reduce the year's net earnings as to render necessary the suspension of dividends on its preferred stock. It wished to charge the abandoned property to profit and loss, the accumulated earnings of the past. The regulation was alleged to be so unreasonable as to constitute a violation of the Fifth Amendment. In discussing this aspect of the case the court said:

> "We are thus brought back to the fundamental distinction between (a) property or capital accounts, designed to represent the investment of the stockholders, and to show the cost of the property as originally acquired, with subsequent additions and improvements; these assets being balanced by the liabilities, including the amount of the capital stock and of bonded and other indebtedness, with net profits or surplus, whether carried under the head of 'profit and loss' or otherwise; and (b) the operating accounts, designed to show, on the one side, gross receipts or gross earnings for the year, and on the other side, the expenditures involved in producing those gross earnings and in maintaining the property, the balance being net earnings."

[2] 231 U. S. 423.

Although admitting that the alternative treatment contended for by the carrier might be equally reasonable, it held that the regulation was not invalid. It recognized the absolute necessity of making and observing the distinction between capital and expense for the Commission's proper performance of its regulatory duties.

The public interest in rate cases requires that fundamental distinction to be carefully adhered to. The control now exercised over the accounts of public service industries by public boards has universally enforced its observance. Before the day of such effective supervision, courts uniformly protected those interests by closely following correct accounting principles. The reasonable rate which the public can be required to pay must cover all operating expenses and provide in addition a fair return on the property devoted to its use. Justice to the public demands the rigorous exclusion of capital expenditures from operating expenses; and requires that permanent accretions to property paid for out of earnings be charged to income after, not before, reaching the net return. Every expenditure for additions and betterments increases the rate base *pari passu,* whether it is included in operating expenses or not. Their inclusion therein merely builds up a secret reserve of property not shown among the book assets. If book figures were taken as conclusive evidence of fair value in rate cases, the only injury to the public would be the overcharge made in the first instance. Contemporary appraisals are, however, always relied on to establish such values, and these inevitably include the property built up through loading the expense accounts with capital items. No case has yet held that property thus acquired is not to be considered in determining the rate base. Unless expense charges are rigorously limited to true expense items, the public may find itself compelled to pay a fair return on what is in substance its own capital contribution. Because expenditures for additions and improvements "increased the value of the company's property to the extent of such expenditures," they were thrown out of operating expenses in *Cotting* v. *Kansas City Stockyards,*[3] and practically every later rate case. The rule does not prohibit a public service company

[3] 82 Fed. 850. Cons. Gas. Co. v. N. Y., 157 Fed. 849; Spring Valley Water Works v. San Francisco, 192 Fed. 137.

from using its earnings for additions; it merely requires them to be paid for with its own share.

The proper observance of this separation is necessary not only to protect the public against the companies, but also to secure a fair distribution of the burden of capital costs as between different consumers. The essential fact about capital is that it gives off a series of services extending over more than a single income period. It squares better with the equities of the situation to require its cost to be borne by all users of those services than to load it on those that use them during the period when the outlay is made. As stated by the Supreme Court in *Ill. Cent. R. Co.* v. *I. C. C.*:[4] "On principle it would seem * * * as if expenditures for additions to construction and equipment, as expenditures for original construction and equipment, should be reimbursed by all of the traffic they accommodate during the period of their duration, and that improvements that will last many years should not be charged wholly against the revenues of a single year." On the whole, where public rights have turned on the proper analysis of income questions, courts have acquitted themselves very creditably.

The picture is not as uniformly favorable when considering cases in which purely private claims were contingent on income factors. These most often involved the rights of various classes of corporate security holders to interest or dividends. The income bond cases furnish the best illustrative material. The distinctive characteristic of an income bond is that the payment of interest is contingent upon the existence of net income. It was frequently issued to junior lien holders in railroad reorganizations. The interest was invariably non-cumulative. The psychological effect of calling it a bond was to induce in the owner a feeling of security that subsequent events usually belied. It was a standing temptation to corporate officials to perpetrate what, if not actual legal fraud, was a close blood relation. This, coupled with the perfunctory manner in which the mortgage trustee usually performed its duties, resulted in controversies that ultimately landed in the courts.

The federal court for the western district of Louisiana recently passed on the right of income bondholders to interest under the

[4] 206 U. S. 441.

following state of facts.[5] The Texas & Pacific Railway Company had issued a series of such bonds pursuant to the reorganization agreement of 1886. The mortgage securing it provided for the payment of interest "out of the net income of the Railway Company, as the same may be determined by the board of directors." In casting the income account to determine whether there was any net income, the directors charged it with all manner of capital items. These were generally concealed among the operating expenses until the regulations of the Interstate Commerce Commission made that practice illegal. Thereafter income was appropriated for capital requirements prior to arriving at what the company considered net income under the bond and mortgage. These facts were not denied. The contract was construed as vesting the directors "with discretion to determine that the net income of the road was such portion of the gross earnings as might remain unexpended after the pressing needs of the road had been taken care of."

The directors were held not to have been "reduced to the level of auditors and bookkeepers to mathematically determine what is net income, according to the theoretical dictum of expert accountants." This conclusion was based in part upon the argument that safety and economy of operation, the charter duties of the company to the public, and the mortgage provisions themselves required the road to be improved and built up, and that a company whose borrowing powers were exhausted could do these things only out of earnings. The mortgage provisions relied on were the usual mortgagor's covenants found in such instruments, whether securing income or fixed interest bonds. They have never before been interpreted as intended to define the contingency on which interest was payable on income bonds, and owe their importance in this case to an illogical application of the rule that the intention of the parties is to be gathered "from the four corners of the instrument." The bondholders must have intended the directors to have that power, says the court, because at the time of issue it was apparent that interest could not be earned for some time to come, and perhaps not at all unless the road were improved. Had the court realized

[5] B. F. Bush, Receiver, v. The Texas & Pac. R. R. Co., not officially reported.

the full implication of its decision on the economic interests of the bondholders, it could not have been convinced by its own arguments.

The decision shows that general principles not only do not solve concrete cases, but may even afford a convenient protection against the necessity of a too rigorous analysis of difficult technical points. Substantial rights and interests are always sacrificed when abstract principles are formally applied in disregard of the actualities of the situation. If net income is what this court says it is, it becomes a variable function of directorial discretion, and the creditor's right to interest is made to depend on the debtor's will and judgment, subject only to the limits of non-fraudulent dealing. This is a correct statement of the powers of directors over the declaration of dividends on stock; their duty towards income bondholders should in fairness be measured by some more objective standard. The consequences of such a subjective test on the relative economic positions of the income bondholders and stockholders are so contrary to current notions of justice that reason dictates its adoption only as a last resort. The case of *Edwards* v. *International Pavement Co.*[6] involved a bond in which the definition of net income violated every correct principle. The bond expressly authorized the directors to deduct every outlay, whether for expense or capital purposes, in determining net income. Nothing can be done in such a case to protect those who have incorporated their folly in contract form. The folly of one should not, however, be made the measure of the rights of wiser and more careful bargainers; nor should a presumption exist in construing a contract that the parties intended a fool's bargain. If one interpretation produces results both reasonable and just, and another the opposite effects, it is neither good law nor sense to adopt the latter. The court in the Texas & Pacific case was confronted with that alternative; it chose the worse position. This will be apparent from a consideration of the following implications of its doctrine.

Income bondholders are creditors, not stockholders. No one would dispute the proposition that they did not loan their capital from motives of philanthropy, but solely to get an income. It is equally certain that, given parties of fairly equal bargaining skill

[6] 227 Mass. 206.

and power, a lender would not contract to waive interest during the time that the borrower was increasing his wealth through the use of the former's capital. A definition that permits the deduction of capital expenditures in computing the net income by which the duty to pay interest is fixed converts an income bond into just such an agreement. At the beginning of any income period the corporate assets amount to a given sum contributed by both the bondholders and stockholders. The balance of the gross earnings from operation after deducting operating expenses and fixed charges—that is, those outlays for which the corporation receives assets that are entirely consumed during the period in producing those earnings—constitute net additions to corporate property. It is immaterial in what form this increment is retained; its application to capital improvements represents a mere conversion in the form of assets, neither increasing nor decreasing them.

Permitting capital expenditures to be deducted in arriving at net income is thus equivalent to authorizing the debtor to retain for its own uses an equal part of the net property accretion for the period, to appropriate to itself a part of the true net earnings. The debtor could avoid the payment of interest during the entire life of the bonds by carrying on a sufficiently large program of additions and improvements. It would thus secure the free use of the capital of others, not only while increasing its own wealth, but just because of that fact. A portion of the annual earnings might conceivably be reserved to provide a sinking fund to retire the income bonds at maturity, and creditors thus be compelled to pay the principal of their claim with what they would otherwise have received as interest. The doctrine affects the debtor's position as favorably as it affects the creditor's adversely. The retention of the net earnings *pari passu* increases corporate surplus or decreases the deficit, and proportionately enhances the real value of the stock. This constitutes as real a receipt of the retained or reinvested earnings by the stockholder as if they had been distributed as dividends. The surplus belongs to him, and can subsequently be capitalized by a stock dividend.

Thus the creditor's claim for interest is subordinated to that of the stockholder to appropriate the first fruits of the venture in which their joint capital is embarked. The bondholder benefits only in the increased security of his principal, a reason sometimes alleged to justify the doctrine. The argument rests on a misconception in the case of long term bonds, except during the last ten or fifteen years of their life. The present value of the principal of such bonds is less than the present value of the series of interest payments except during such later period, the length of which varies with the discount rate applied. The argument, therefore, imputes to the bondholders a willingness to sacrifice the greater for the less. The foregoing analysis of the implications of the doctrine here discussed shows its absurdity.

Some of the arguments of the preceding paragraph were clearly stated by the supreme court of Georgia in *Cent. of Ga. Ry. Co.* v. *The Central Trust Co. of New York.*[7] It discussed the company's right to deduct additions and betterments in arriving at net income in the following language:

> "Relatively to stockholders, directors have a broad discretion in the application of income to the improvement of corporate property, instead of apportioning some of it to dividends. But an income bondholder, whose interest is only payable from the net income of the year in which the interest accrues, occupies a more favored position than that of a stockholder. A diversion of net income to betterments and expansion of the physical properties to the withholding of an annual dividend does not mean a loss to the stockholder, as the stockholder indirectly gets the dividend in the presently enhanced value of his stock. The bondholder, whose right to interest is immediate, which interest is forever lost if not paid from the income of the year in which the interest accrues, derives no present benefit from the diversion of income to betterments, but sustains a loss so far as interest is concerned, which can never be recouped. Even if the payment of the principal of his debt is better assured by successive diversions of income, the income, if not paid, is for-

[7] 135 Ga. 472. Other income bond cases discussing various aspects of this question are: Barry v. M., K. & T. Ry. Co., 27 Fed. 1; *Id.*, 34 Fed. 829; Hubbard v. Galveston, H. & S. A. Ry. Co., 200 Fed. 504; Yazoo & M. V. R. Co. v. Martin, 47 So. 667; *Id.*, 48 So. 739.

> ever lost. And then, too, a bond payable 50 years hence has practically no commercial value unless there is some assurance of interest pending its maturity."

This language reflects a clear perception of the importance of a correct definition of net income on the financial interests of the parties. Creditors do not usually bargain for such results. A judicial construction of a contract that produces them is almost certain to rest on incorrect analysis. The Georgia court did not reject "the refinements of later day theories," but made them a measure of directorial powers in dealing with the interests of contingent creditors. It observed the distinction between capital and expense. Expenditures for enlarging the plant, equipment trust payments in excess of the depreciation on the equipment covered by the agreements, and amounts reserved for sinking funds were all disallowed as deductions in computing net income under the bond. No one will question that this decision accords better with current notions of justice than that in the other case, that it appraises the equities of the situation with a finer regard for fair business dealing and a better grasp of fundamentals.

The interests of income bondholders and others with rights contingent on net income have usually been defeated through the improper correlation of two problems. Courts frequently stress the point in such cases that directors, as practical men, retain their authority to build up the mortgaged property. Such is the undoubted rule in the absence of specific contract limitations.[8] That, however, does not logically mean that they have the power to charge the expenditures incurred in exercising that authority in any manner they see fit. To deduce the latter power from the former authority involves a vicious *non sequitur,* based on an incorrect understanding of what is meant by determining net income. The two questions are frequently confused and identified. The one involves considerations of business policy; the other is concerned with the manner of recording the financial results of such policies. A contract may very well leave directors full discretion in respect of the former

[8] Spies v. C. & E. I. R. Co., 40 Fed. 34; Day v. O. & L. E. R. Co., 107 N. Y. 129. In connection with the Day case, see also Thomas v. N. Y. & G. L. R. Co., 139 N. Y. 163; Buell v. B. & O. S. W. R. Co., 53 N. Y. S. 749.

and yet impose limits in regard to the latter. The first essential to the correct determination of the rights of income bondholders and those in similar circumstances is to make the above distinction. The court made it in *Mackintosh* v. *Flint & P. M. R. Co.*[9] in the following language: "The policy thus adopted and pursued by the actual management assumed that the contingent rights and interests of the provisional certificate holders were entirely subject to the discretion of the directors, or those in control of the road, in deciding, not only what expenditures should be made, but how they should be charged, as between operating and construction." Where the two are confused the second is almost invariably answered incorrectly. The absence of specific limitations in respect of what expenditures may be made is construed as blanket authority to charge them at will. The definite limitation on the power to charge expenditures that the term net income itself implies receives no recognition, and thus the most effective guaranty of justice to contingent creditors is lost.

It is usual to give the grounds for a particular approach to a subject at the beginning rather than at the close of the discussion. This order has been deliberately reversed in the belief that the reasons would be more easily stated and better understood by adopting that course. No definition of income, gross or net, emerges from the analysis of the cases reviewed; none was intended. The aim has been to present a picture of the process of translating economic fact into legal rule. The effectiveness of law as a social instrument varies directly with the extent to which it takes account of the extra-legal factors of the situation that it aims to control. The rules it prescribes for economic relations will conform to accepted and well-founded views of justice about in proportion as correct economic analysis contributes to their content. That is as true of other economico-legal problems as of that one herein selected for illustrative purposes, for the relation between law and economics is a subject

[9] 34 Fed. 582. It is this that explains the statement of the New York court in the Day case, note 8, *supra,* that the bond was "at most an agreement to pay dividends if dividends are earned," and the decision in the Texas & Pacific case, text, *supra,* that no interest was payable if the earnings had been applied by the directors to additions and betterments authorized by them.

with ramifications as extensive as the points of contact between the legal and economic systems of modern society are numerous and diverse.

Of the New York Bar. HENRY ROTTSCHAEFER.