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INCOME BONDS AND MORTGAGES.

SECT. 1. *Income bonds defined; forms of.*

Corporate income bonds are those payable out of the net income of the corporation. In form they may be various. They may in terms be negotiable, as where they are payable to bearer or order; or they may be unnegotiable in form, as where they are payable to the obligee without terms of negotiability. They may be payable only out of net income, in which case, if there is no net income, there would be nothing to pay; or they may be payable unconditionally, and whether there shall be net income sufficient for that purpose or not. They may bear a fixed rate of interest, or the rate may be graduated by the amount of the net earnings, or be fixed at a certain per centum of the net earnings. They may provide that interest shall be payable only out of the net income of the current year, or that, in case of arrearages from insufficiency of income of the current year, the interest be paid out of the net income of subsequent years, whenever that is sufficient for the purpose; and they may or may not have interest-coupons attached to them.

SECT. 2. *Income bondholders lien on the income.*

Income bondholders have a specific lien upon the net income of the corporation, and such income is specifically pledged to the use of such bondholders, and it is theirs for the purpose of paying such bonds and interest, according to the terms of the bonds, as soon as it is earned: *Ketchum v. St. Louis*, 101 U. S. 306; *Rutten v. Union Pacific Rd.*, 17 Fed. Rep. 480; 16 Reporter 199; *Galena & Chicago Rd. v. Menzies*, 26 Ill. 121; Jones on Corp., sect. 114.

SECT. 3. *Income bonds constitute an equitable assignment.*

Income bonds constitute an equitable assignment of the net earnings of the corporation as fast as they accrue, and a transfer of the equitable title to the holder. The income is not in existence at the time of its appropriation to the payment of the bonds, but there is an equitable assignment of the net income fund to accrue, and the general principles of equitable assignments would be applicable thereto. It is specifically pledged to the use of the bondholders as soon as it is earned: *Id.*; *Galena & Chicago Rd. v. Menzies*, 26 Ill. 121. The general doctrine on this subject, in equity, is that, if one party, by a valid agreement, appropriates to another a particular fund, arising from profits or income, this constitutes an equitable assignment of it: *Watson v. Duke of Wellington*, 1 Russ. & Myl. (Eng.) 602; *In re Strand Music Hall Co.*, 3 De G., J. & S. 147; *Lewisburgh, &c., Co. v. March*, 91 Penn. St. 26. An agreement setting apart a particular fund for the benefit of a particular creditor creates a lien in equity upon that fund, and raises a trust for the benefit of the creditor: *Ewing v. Arthur*, 1 Humph. (Tenn.) 537; *National Bank v. Coates*, 12 Reporter 514. See, also, *White Water Canal Co. v. Vallette*, 21 How. (U. S.) 414. So authority to collect calls upon corporation stock, given as security for a loan, is a good equitable assignment of it, and valid against the company's subsequent assignee in bankruptcy: *Savings Bank v. Publishing Co.*, 3 Dill. (U. S. C. C.) 287. See, also, *Pickering v. Ilfracombe Rd.*, L. R., 3 C. P. 235. So an agreement conveying railroad shares in the hands of a third party, and transferable by delivery, but subject to prior claims, is an equitable assignment of them: *Robinson v. Nesbitt*, L. R., 3 C. P. 264. This doctrine is not only applicable to assignments of corporate income, by the execution of income bonds and mortgages, but extends generally to all kinds of funds or interests existing or to be created, including the net income and profits of real estate: *Ketchum v. St. Louis*, 101 U. S. 306; *Pinch v. Anthony*, 8 Allen (Mass.) 536; *Smith v. Patton*, 12 W. Va. 541; *Legard v. Hodges*, 1 Ves. Jr. (Eng.) 477; *In re Strand Music Hall Co.*, 3 De G., J. & S. (Eng.) 147; *Power v. Bailey*, 1 Ball & B. (Eng.) 49; *Story's Eq. Jur.* (12 ed.) sect. 1231; *Overton on Liens*, sect. 32.

SECT. 4. *Distinction between income bonds and common mortgages.*

One distinction, at least, between an income bond and a common

mortgage, is that the former, transfers the income as fast as it accrues, while the latter only gives a conditional right, usually permitting the mortgagor to retain possession of the mortgaged property, and to receive the income thereof so long as he retains possession of it; and generally the mortgagee has no right to the income until he has taken possession of the mortgaged property by virtue of the mortgage; and this rule is applicable to the mortgage of a railroad company where the mortgage covers not only real estate, but the franchises, tolls, rents and profits of the corporation: *Galveston Rd. v. Cowdrey*, 11 Wall. 459; *American Bridge Co. v. Heidelberg*, 94 U. S. 798; *Boston Bank v. Reed*, 8 Pick. (Mass.) 459; Jones on Corp., sect. 114; 1 Washb. on Real Prop. 360; *Gilman v. Ill. Tel. Co.*, 91 U. S. 603; *Teal v. Walker*, 111 Id. 242. The mortgagee must take possession or have a receiver appointed and placed in possession of the mortgaged property before the rents and profits can be made available for the satisfaction of the mortgage; and until this is done the income bondholders may require the appropriation of the net income to the satisfaction of their bonds, although issued subsequently to the execution of the mortgage: *Id.*; *Galena & Chicago Rd. v. Menzies*, 26 Ill. 121. By taking possession under a prior mortgage, the mortgagee could prevent the application of net income to the payment of income bonds: *Gilman v. Ill. & Miss. Tel. Co.*, 91 U. S. 603.

SECT. 5. *Where income bonds are secured by mortgage.*

Income bonds may also be secured by a mortgage, in which case the mortgagee would have the benefit of both securities; but even in case of income mortgages, it has been held that there would be an implied right of the mortgagor to retain possession and receive the earnings of the mortgaged property, until the mortgagee takes possession for default. Until that time the mortgagor would have an implied right to the possession and to receive the earnings and apply them to the payment of any floating debts of the corporation, or to make improvements of the corporate property in the discretion of the directors, and within the scope of the chartered powers of the corporation; and this right of possession of the mortgagor is sometimes expressly provided for in the mortgage: *Gilman v. Ill. & Miss. Tel. Co.*, *supra*; *American Bridge Co. v. Heidelberg*, 94 U. S. 798; *Miss. Valley Rd. v. United States Exp. Co.*, 81 Ill. 534.

Before foreclosure or possession taken under a railroad mortgage

for default, even the net earnings of the company would be liable to garnishment, whatever may be the stipulations of the mortgage as to the right of possession: *Miss. Valley Rd. v. United States Exp. Co.*, *supra*; *Merchants' Bank v. Petersburg Rd.*, 24 Pitts. L. J. 192; *Bath v. Miller*, 51 Me. 341; 53 Id. 308; *Noyes v. Rich*, 52 Id. 115; *Smith v. Eastern Rd.*, 124 Mass. 154; *Ellis v. Boston, &c., Rd.*, 107 Id. 1; Jones on Corp., sects. 114, 115; 1 Jones on Mort. (3d ed.) sect. 670.

SECT. 6. *An income mortgage may provide for income before taking possession.*

A corporate mortgage may be executed without bonds and may itself provide for the appropriation of the net income to the payment of the sum secured by it, with interest, and thereby appropriate such fund, without the necessity of taking possession, of the mortgaged property by the mortgagee; and in such a case there would be an equitable assignment of the fund, and a lien created thereon as fast as it accrued, the same as in case of a simple income bond. The mortgagee would have all the rights of an income bondholder, and the additional rights and security which the mortgage gives. And after net earnings have been ascertained and set apart by the corporation for the payment of money secured by income bonds or mortgages, or as a sinking fund for the final redemption of such bonds or mortgage debts they would not be liable to garnishment at the suit of other creditors of the corporation: see *Pullan v. Cincinnati & Chic. Rd.*, 4 Biss. (U. S. C. C.) 35; 5 Biss. 237; *Jessup v. Bridge*, 11 Ia. 572; *Dunham v. Isett*, 15 Id. 284; *Mississippi Valley Rd. v. United States Exp. Co.*, 81 Ill. 534; *Galena & Chic. Rd. v. Menzies*, 26 Id. 121; *Clay v. East Tenn. Rd.*, 6 Heisk. (Tenn.) 421; 1 Jones on Mort., sect. 772; 2 Rorer on Railr., sects. 1377, 1378. As to the rights of different classes of bondholders, see *Galveston Rd. v. Cowdrey*, 11 Wall. 459.

SECT. 7. *Remedy of the income bondholder in case of a diversion of earnings.*

The funds set apart or equitably assigned for the payment of income bonds, or income mortgages, cannot be diverted by the corporation to other purposes. There is in such a case an equitable lien upon them, and the holder of the bonds or mortgages may follow the funds into whosoever hands they may be traced. The

net earnings would constitute a trust fund, and his lien will cover any property into which they may have been converted, except where it is in the hands of a *bona fide* purchaser for value: Story's Eq. Jur. (12 ed.) 1252; *Union Trust Co. v. Souther*, 107 U. S. 591; *Fosdick v. Schall*, 99 Id. 235; *Calhoun v. St. Louis & S. E. Rd. Co.*, 9 Biss. (U. S. C. C.) 330; *Texas v. Hardenberg*, 10 Wall. 68; *Union Trust Co. v. Walker*, 107 U. S. 596. If the net earnings have been diverted for permanent improvements or otherwise, and the property has been sold under a mortgage made subsequently to the execution of a bond the court will restore the income out of the proceeds of the sale: *Id.*; and securities purchased with the trust funds will be substituted for them: *Harford v. Lloyd*, 20 Beav. (Eng.) 10; *Fosdick v. Schell*, 99 U. S. 235.

SECT. 8. *In case of consolidation of the debtor corporation with another.*

A consolidation of one railroad company with another will not extinguish the rights of the income bondholders of either; for, although the consolidated company takes the property and interests of the old companies, it takes them subject to all liens, and the consolidated company would hold the same as trustee for the benefit of the bondholders, and other creditors of the divisional roads: *Harrison v. Union Pacific Rd.*, 13 Fed. Rep. 522; *Skiddy v. Atlantic, Miss. & O. Rd.*, 3 Hughes (U. S. C. C.) 320; *Shields v. Ohio*, 95 U. S. 319. A bondholder's lien is superior to that of a common creditor or stockholder, and adheres both to the property and its proceeds, and this cannot be taken away by consolidation without his consent; unless, perhaps, under some statute existing at the time of the issuing of the bonds: *Id.*; *Ritten v. Union Pac. Rd.*, 17 Fed. Rep. 480; 16 Reporter 199; *Ketcham v. St. Louis*, 101 U. S. 306; *Pullan v. Cincinnati & Chic. Rd.*, 4 Biss. (U. S. C. C.) 35; 5 Id. 237. If the earnings are diverted by the consolidation of the debtor corporation with another corporation, which receives the earnings, the income bondholder may recover them of the latter company: *Id.*; *Ritten v. Union Pac. Rd.*, *supra*; see, also, *Shields v. Ohio*, *supra*; *Curran v. State of Arkansas*, 15 How. (U. S.) 304; *Eaton & Hamilton Rd. v. Hunt*, 20 Ind. 463; *Selma, &c., Rd. v. Harbin*, 40 Ga. 706.

Equity will follow diverted earnings or other equitable funds into the hands of transferees with notice, or without value, and will

pursue the property through all its transmutations, substituting one security for another, wherever its ends will be best accomplished: *Union Trust Co. v. Souther*, 107 U. S. 591; *Fosdick v. Schall*, 99 Id. 235; *Shiddy v. Atlantic, Miss. & O. Rd.*, 3 Hughes (U. S. C. C.) 320; see, also, *Powell v. North Missouri Rd.*, 42 Mo. 63; *Prouty v. Lake Shore Rd.*, 52 N. Y. 363; *Boardman v. Lake Shore & Mich. S. Rd.*, 84 N. Y. 157; *Selma, &c., Rd. v. Harbin*, 40 Ga. 706.

A railroad corporation may mortgage its future earnings, although the road be not *in esse* at the time of the execution of the mortgage, and such earnings, when they have accrued, cannot be attached in the hands of an officer of the corporation, at the suit of a common creditor: *Jessup v. Bridge*, 11 Ia. 572; *Boardman v. Lake Shore & Mich. S. Rd.*, *supra*; see, also, *Buck v. Memphis & Little Rock Rd.*, 4 Cent. L. J. 430. And, perhaps, generally, earnings cannot be attached in that way: *Pettingill v. Androscoggin Rd.*, 51 Me. 370; *Fowler v. Pittsburgh, &c., Rd.*, 35 Penn. St. 22.

SECT. 9. *What operates as an assignment of a fund—illustration of the doctrine.*

It is not essential to constitute a fund, and a lien upon it in favor of a creditor of a corporation or individual, that the assignment be in express terms, but the intention to make it may be inferred from the words used, and the circumstances of the case; *Dillon v. Bernard*, 1 Holmes (U. S. C. C.) 386; *In re Strand Music Hall Co.*, 3 De G., J. & S. 147; *Williams v. Ingersoll*, 89 N. Y. 508. In the case last cited, EARLE, J., said: "The form of words used in making the agreement is not alone to receive attention, but all the circumstances are to be considered. It is a rule in equity that anything that shows an intention to assign on the one side, and from which an intent to receive may be inferred on the other, will operate as an assignment if sustained by a sufficient consideration." But where there was a mere promise to pay a debt out of a certain fund which was not in terms assigned for such payment, it was held that the circumstances were not sufficient to show an intention that the agreement should operate as an assignment of the fund: *Christmas v. Russell*, 14 Wall. 69; see also *Hosack v. Rogers*, 6 Paige (N. Y.) 415; 8 Id. 229; 25 Wend. (N. Y.) 313; *Risley v. Phoenix Bank*, 83 N. Y. 318; Jones on Corp., sect. 75.

SECT. 10. *Net earnings or income—mode of ascertaining.*

In general it may be said that net earnings or income is the

excess of receipts of a business over expenditures, or the receipts of a business after deducting the current expenses. The mode of determining the net income of a corporation would usually be the same, whether it be for the purpose of declaring dividends upon the stock, common or preferred, or of applying the same to the payment of income bonds; and usually the controversy in such cases relates to the question as to what are current expenses or other proper items, to be deducted from the gross income, to determine the net earnings or income. It may be observed that controversy on the question may be, and in case of income bonds, now, perhaps, generally is avoided by the conditions or stipulations of the contract, providing what may be paid out of the gross earnings or what shall be regarded as current expenses and deducted from the gross earnings in order to ascertain the net earnings or income. Experience has shown the wisdom of such provisions in cases where doubt or uncertainty may arise on the subject.

In *St. John v. Erie, &c., Rd.*, 10 Blatchf. (U. S. C. C.) 271, Judge BLATCHFORD, said: "Net earnings are properly the gross receipts, less the expenses of operating the road, or other business of the corporation. Interest on debt is paid out of what thus remains, that is, out of the net earnings. When all liabilities are paid, either out of the gross receipts or the net earnings, the remainder is the profit of the stockholders, to go toward dividends, which in that way are paid out of the net earnings:" see also same case, 22 Wall. 136; *Thompson v. Erie, &c., Rd.*, 45 N. Y. 468.

The rule for determining the net profits of a railroad corporation, including proper matters of deduction from the gross earnings, was more fully stated and illustrated by the Master of the Rolls, ROMILLY, in a case before him, as follows: "I am of opinion that all the debts of the company are first payable, other than those which, for want of a better expression, may be called funded debts. For instance, if the defendants have received money by mortgage, under the powers contained in their act, for the purpose of completing their line, this does not constitute such a debt as can be paid off out of the profits before the profits are divided. But on the other hand any debts which have been incurred, and which are due from the directors of the company, either for steam-engines, for rails, for completing stations, or the like, which ought to have been paid off at the time, had the defendants possessed necessary funds for that purpose, those are so many deductions from the profits, which in

my opinion, are not ascertained till the whole of them are paid :” *Corry v. Londonderry, &c., Rd.*, 29 Beav. (Eng.) 263 ; 30 L. J. Ch. 290 ; see also *Union Trust Co. v. Walker*, 107 U. S. 596 ; *People v. Supervisors*, 4 Hill. (N. Y.) 20 ; 7 Id. 504 ; *Karnes v. Rochester, &c., Rd.*, 4 Abb. Pr., N. S. (N. Y.) 107 ; *Utica v. Churchill*, 33 N. Y. 238 ; *People v. Commissioners*, 35 Id. 423 ; 4 Wall. (U.S.) 244 ; *Cunningham v. Vermont, &c., Rd.*, 12 Gray (Mass.) 411 ; *McLaughlin v. Detroit, &c., Rd.*, 8 Mich. 100 ; *Ohio City v. Cleveland, &c., Rd.*, 6 Ohio St. 489 ; *Pullan v. Cincinnati & Chicago Rd.*, 4 Biss. 35 ; s. c. 5 Id. 237.

In the case last cited, the action was upon a mortgage made by the New Castle and Richmond Railroad Company. The decision involved a construction of the mortgage and rested upon the theory that, by the terms of it, the mortgagee should have a specific lien upon the net earnings of the road. The mortgage was made February 25th 1852, to secure bonds to the amount of \$300,000, payable in fifteen years. The mortgage, by its terms, covered and included “the present and future to be acquired property of the New Castle and Richmond Railroad Company, that is to say, the first section of their road from New Castle to Richmond, as aforesaid, with the superstructure, and all rails and other materials used therein, and all rights therein, tolls and income, and any rights thereto or interest therein, together with the tolls or income to be had or levied therefrom, and all franchises, rights and privileges of the said The New Castle and Richmond Railroad Company of, in, to or concerning the same.” Subsequently, that company executed another mortgage on the same property ; and on a sale thereof on foreclosure of the same, July 1st 1860, the defendant purchased the property, and at the time of filing the bill in this case, to wit, November 1864, was in possession of and operating said road as a part of its through line, but had not kept any separate account of the earnings of it. Judge DRUMMOND held, that the plaintiff had a lien upon the net earnings of the road, and that such lien fastened upon the net earnings of the defendant’s road as fast as they accrued ; that the defendant, as successor of the mortgagor, was liable therefor from the time it took possession, but not from the date of the mortgage ; that as the defendant purchased the road subject to and with knowledge of this lien, it ought to have kept separate accounts of the net earnings of this section, and the receiver was directed to make an approximate account of these earn-