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Correspondence: “Payment of Dividends Before Restoring Impaired Capital”; Growth of Professional Ethics; James Whitaker Fernley

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Correspondence

"Payment of Dividends Before Restoring Impaired Capital"

Editor, The Journal of Accountancy:

SIR: In the March, 1923, issue of THE JOURNAL OF ACCOUNTANCY there appeared a paper written by C. F. Schlatter concerning the *Payment of Dividends before Restoring Impaired Capital.*

This article, prepared by Mr. Schlatter, sets forth the proposition that according to the law at the present time it is illegal to pay dividends before restoring impaired capital, and further, contains the statement, "Of course it is understood that a corporation formed to work a wasting property * * * need pay no attention to depletion and that in such cases dividends will be paid partly from profits and partly from capital."

In the May, 1923, issue of THE JOURNAL OF ACCOUNTANCY, R. L. Floyd takes exception to the statement of Mr. Schlatter regarding the payment of dividends by corporations formed to work a wasting property, and in his article quoted in detail the Illinois statute which, like the statutes in a great number of states, prohibits the "payment of dividends before restoring impaired capital." His claim appears to be that Mr. Schlatter has not substantiated his statement by sufficient authority.

Mr. Schlatter, by way of replication, in the same May issue, admits the existence of the Illinois statute, and further, that Illinois and those states which have similar statutes have done nothing more than place upon the statute books a reiteration of the common law. For, Mr. Schlatter points out, the payment of dividends before restoring capital which has become impaired has been prohibited by common law long before the passage of these statutes. He then submits a number of quotations from leading authors, such as Fletcher, Morawetz, Cook, Clark, and others, who are recognized as authorities in the field of corporation law, and also cites a number of cases, all of which seem to lead to the conclusion that although it is illegal to pay dividends before restoring impaired capital, a corporation formed to work a wasting property is an exception to this rule, and therefore does not come under the statutes aforementioned.

Mr. Floyd then replies in the August, 1923, issue of THE JOURNAL OF ACCOUNTANCY to the effect that the text-books on corporation law are not reliable as a means of ascertaining the authority on such a question, and further, that the cases cited, and the quotations therefrom, do not hold squarely upon the point, but contain *dicta* which is not to be relied upon in deciding a question of such import. Mr. Floyd in the August issue adds to the list of cases cited by Mr. Schlatter the case of *Lee vs. Neuchatel Asphalt Company* (L. R. 41, Ch. 1), which he contends appears to be the leading case upon the question of wasting assets as it applies to the point in issue, but that the facts are too complex, and the decisions of the various judges are those no well-informed judge of today would follow.

In the case of *Lee vs. Neuchatel Asphalt Company,* the facts are very well set out in the opinion of Cotton, L. J., who says: "The action is

brought by one ordinary shareholder, on behalf of himself and all the other ordinary shareholders against the company and the directors, one of whom has been appointed to represent the preference of shareholders. In order to understand the nature of the case, it is necessary to state shortly the nature of the formation of the company. There were six companies, which were in various ways entitled to the benefit of, and were working a concession for the carrying on of mines near Neuchatel, which produced the asphalt. The present company was formed by the amalgamation of these six companies. The nominal capital of the company is £1,150,000, divided into £10 shares. No money was paid when the present company was formed, but the assets of the previous companies were taken over by the present company, and out of the 115,000 shares in the company 113,000, representing a nominal capital of £1,137,000, were given to the six old companies, and the concession and the rights which were made over were taken as being assets to answer that share capital.

"The object of the action is, on behalf of the ordinary shareholders, to prevent a dividend from being paid out of the excess of the receipts of the company above its expenditures for the year 1885. On what ground is that put? The articles justify the declaration of a dividend by a general meeting without making any reserve for the renewal or replacing of any lease or of the company's interest in any property or concession, but that is said to be *ultra vires*. The plaintiff puts his case in three ways. The first point I understand to be this: that a great part of the capital of the company has been lost. Now, what is meant by 'capital'? If it is meant that any part of the assets has been lost, in my opinion that is wrong. I do not say that no part of the assets has ever been lost, but on the evidence before us the assets of this company are of greater value than at the time of the formation of the company in 1873. They then had, it is true, a concession, but for a shorter period than this one they have now got, and the royalty was very heavy. Now they have a longer time for the concession to run than they had in 1873, and they have got very much more profitable terms than they had at the first. In my opinion, so far as there being any loss of assets, the company has now in its possession a larger amount of assets than it had at the time it was formed. Of course the present case is very different from that of a company where money has been paid on all the shares. That case is open to very different considerations. Here all that was taken by this company from the first companies was their assets, and in my opinion those assets have increased in value, so that as a matter of fact that first point entirely fails.

"The plaintiff's second point is that the property of the company is not now sufficient to make good the share capital; that assets to provide for that share capital must be made up before any dividend can be declared; that if dividends are declared without that being done, that is to be treated as a return and a division of capital amongst the shareholders, and therefore illegal. In my opinion that is entirely wrong. It is a misapplication of the term 'return of capital.' The word 'capital' is used in many senses: one sense is the nominal capital, that capital which in the case of a company limited by shares is to be defined by the memo-

randum of association. * * * It is impossible that the assets can be stated in the memorandum of association, but the share capital has to be stated. Then it is no doubt the law that the capital, in the sense of the assets of the company obtained for the shares, must not be applied except for purposes of the company. * * * In my opinion there is no obligation in any way imposed upon the company or its shareholders to make up the assets of the company so as to meet the share capital, where the shares have been taken under a duly registered contract, which binds the company to give its shares for certain property without payment in cash. Shares must be paid up in cash, unless under an agreement duly registered there is a contract to allot or give the shares for something different. * * * In my opinion this second point fails as well as the first.

"The third point was to my mind the only one which occasioned any difficulty. It is said that the concession is a wasting property, and as it is a wasting property, that dividing its annual proceeds is dividing part of the capital assets of the company, which are represented by this concession. That was pressed upon us, and that is a difficulty, because it is established, and well established, that you must not apply the assets of the company in returning to the shareholders what they have paid up on their shares, or in paying what they ought to have paid up on their shares. * * * There is nothing in the act which says that dividends are only to be paid out of profits, * * * there is this firmly fixed: that capital assets of the company are not to be applied for any purpose not within the object of the company, and paying dividend is not the object of the company, the carrying on the business of the company is its object. If this property were property of another nature, property which would not be reasonably or properly consumed in providing profit, the case would stand in a very different position. * * * In considering whether this is to be treated as an honest division of profit, or as a division of capital under the guise of declaring a dividend, the court will have regard to the directions of the articles, although, of course, if those articles authorize not a mere division of profit but a division of capital (using 'capital' in the proper sense of the word—by which I mean permanent assets, and assets not to be expended in providing for the profit earned by the company), such a provision will be *ultra vires* and void. Here there was not a division of capital under the form of declaration of dividend by a scheme or plan for dividing assets of the company, the declaration of dividend was in accordance with the articles, and not contrary to the general law, and the court ought not to interfere. In my opinion, therefore, the appeal fails."

Lindley, L. J., gives an opinion which leads to the same conclusion. Lopes, L. J., in concurring with Lindley, L. J., and Cotton, L. J., said: "The capital in an undertaking like this is in its inherent nature wasting. The scheme of this undertaking is that there should be a gradual exhaustion of material; the wasting is the business of the company, and without such gradual exhaustion there would be no revenue. I am unable to see in this case that either capital or the produce of capital has been dealt with in a way which is not authorized."

This case is perhaps the oldest case in which the courts have attempted to decide that corporations or companies formed to work wasting property do not fall within the rule that there cannot be a payment of dividends before restoring impaired capital. It must be remembered that the case of *Lee vs. Neuchatel,* etc., is an English case, and rules and regulations used in forming such companies are somewhat different from those in our own country, yet no court could have held more squarely that the facts constituted an exception to the general rule.

In the case of *Excelsior Water & Mining Co. vs. Pierce* (Cal. 27, Pac. 44), Mr. Floyd admits the truth of the quotation from this case by Mr. Schlatter, but attempts to negative the effect of it by the fact that the enterprise was only partly a mining one. However, it must be remembered that whether an issue is decided affirmatively or negatively, the same rules of law apply. This case stands squarely upon the proposition that the word "capital" under the statutes means the actual amount contributed by the shareholders and forbids the division of capital among the shareholders. But, according to Chief Justice Beatty: "This inhibition, however, did not extend to net proceeds of its mining operations, for a mining corporation, like any other corporation organized for the purpose of utilizing a wasting property—a property that can be used only by consuming it—as a mine, a lease, or a patent, is not deemed to have divided its capital merely because it has distributed the net proceeds of its mining operations, although the necessary result is that so much has been subtracted from the substance of the estate. It may distribute its net earnings although the value of the mine is thereby diminished. But it may not sell the mine, or any part of it, and distribute the proceeds." It is difficult to formulate a more concise statement of the law than that contained in the opinion just quoted, and furthermore, the case of *Lee vs. Neuchatel* is cited and its true worth relied upon.

In *People, etc., vs. Roberts, Comptroller* (51 N. E., 293), it was the duty of the comptroller to ascertain the amount of capital employed within the state by corporations conducting part of their business within the state and part without, and, in order to do this, the comptroller was compelled to face squarely the fact that the company was organized for mining purposes, and therefore, fell within the class where capital is naturally impaired. Although challenged by Mr. Floyd, the question whether money accumulated by passing dividends and invested in a railroad outside the state was taxable as capital was decided by determining whether this so-called profit had to be returned to make up the impaired capital. Therefore, it must be decided that, as Mr. Schlatter pointed out, "The decision of the case turned upon the question whether or not the depletion of a mine must be deducted from income before profits for dividends emerge. The court held that depletion need not be considered."

In *Boothe vs. Summit Coal Mining Co.* (104 Pac. 207), a Washington case, Mr. Floyd and Mr. Schlatter are agreed upon the facts, but it is Mr. Floyd's contention that the issue was as to what constituted "profits" in the contract between the parties, and not "dividends." Admitting that "profits" and "dividends" are not the same, it is well established that

dividends cannot be declared unless there are profits. A "dividend," as defined in the case of *People ex rel Pullman Co. vs. Glynn* (114 N. Y. Supp. 460), "is a corporate profit set aside, declared, and ordered by the directors to be paid to the stockholders upon demand or at a fixed time." It is, therefore, obvious that in determining "profits," the question of "dividends" must be borne in mind, and the importance of the effect of declaring "dividends" in a concern where there is a wasting of assets must be carefully noted.

In citing the case of *Mellon, et al. vs. Mississippi Wire Glass Co.* (78 Atl. 710), Mr. Schlatter brings forth the objection from Mr. Floyd that it "was not on the question of whether certain dividends were legal but was upon the interpretation of a contract. There was no allegation that the capital had been impaired." Admitting there was a contract in this case that was before the court for interpretation, the court was compelled to decide whether or not there would be a violation of the rule against impairment of capital, for that was the issue, and the court held that a corporation formed to work a wasting property could pay dividends before restoring the impaired capital.

In *Van Fleet vs. Evangeline Oil Co.* (56 So. 343), a Louisiana case, it appears that prior to the organization of defendant company a quantity of oil from the wells now owned by defendant company had been placed in tanks. After the organization of defendant company, a dividend had been declared, and the plaintiff, a stockholder, asked that a receiver be appointed for the reason that under the laws of Louisiana it is unlawful for a corporation to declare dividends out of capital. The company contended that the dividend was paid from the proceeds of the sale of oil, the product of defendant's wells, and since the taking of oil from the wells tended to exhaust the supply, the capital did not have to be replaced. The court recognized the rule that companies operating mines and other such other properties may properly declare and pay dividends, although the properties become exhausted by the working of them, but went on to say and hold that the oil placed in tanks before the organization of defendant company could not be considered as being a wasting of the property, and therefore, was part of the capital. The court used the argument of the defendant company as the reason for holding that since the oil placed in the tanks before organization of the company was a part of the capital, the company had violated the statute against impairment of capital, and that a receiver should be appointed.

Mr. Floyd closes his article by saying: "The supposed exception as to wasting assets appears to have grown out of rather poorly considered dicta which the courts have put into their opinions while actually deciding the cases on other grounds. In my opinion the decisions show that, as matter of law, corporations working wasting assets do not constitute an exception to the rule that dividends must be paid from profits and not from capital."

Perhaps a few words by way of defining "dictum" would not be amiss. "'Dictum' is of two kinds, 'obiter' and 'judicial.' 'Obiter dictum' is an expression of opinion by the court or judge on a collateral question

not directly involved or mere argument or illustration originating with him, while 'judicial dictum' is an expression of opinion on a question directly involved, argued by counsel, and deliberately passed on by the court, though not necessary to a decision. While neither is binding as a decision, judicial dictum is entitled to much greater weight than the other and should not be lightly disregarded." In re *Chadwick's Will* (82 Atla. 918, 1919); *Words and Phrases,* Vol. 2, p. 32. "Wherever a question fairly arises in the course of a trial, and there is a distinct decision thereon, the court's ruling in respect thereto can in no sense be considered as mere 'dictum.'" *New York Central & H. R. R. Co. vs. Price* (150 Fed. 330, 332); *Words and Phrases,* Vol. 2, p. 32. The statement that the cases cited contain nothing but *dicta* is not based upon a clear and comprehensive understanding of the manner of deciding issues arising in the course of a lawsuit. There is a comparatively small amount of *dicta* in these cases cited, and the greater amount of that is *judicial dicta* which is given considerable weight under the *doctrine of stare decisis.*

Mr. Floyd in his last reference to the case of *Lee vs. Neuchatel,* etc., states that: "If a board of directors declares a dividend and its declaration or the books or evidence adduced shows that it is partly from capital it will come in direct conflict with the statute and no justification will be found in the cases cited, as they specially hold that in those cases capital was not impaired * * *."

True enough, if a dividend is declared partly from profits and partly from capital, the declaration or the payment, or both, of such dividend is in direct conflict with the statute of Illinois and similar statutes in other states, but there are exceptions to a great number of rules, and one of these exceptions is to the statute referred to. What is the law remains the law until it is changed by legislative enactment, or until an exception is established by subsequent court decisions. Admitting again the existence of the statutes against impairment of capital, an exception is established by the cases set out as to the declaration of dividends by corporations formed to work wasting assets, such as mines, leases, patents, etc., and the exception is to the effect that there may be a declaration and payment of dividends before restoring the impaired capital. If the capital were not impaired, such an exception would be unnecessary, for then there would not be a violation of the statutes. It is to be deplored that there is not a greater number of cases in which this question has arisen and has been decided, but the chief reason may be that the stockholders in such ventures are satisfied with the returns on their investment and what appears to them to be a logical and just management.

If this issue were to arise tomorrow, it would not be a certainty that the court having jurisdiction would decide the case according to the weight of authority which the cases cited indicate. Neither would it be a certainty that the supreme court of any state would not reverse its previous decision upon any issue, for the mind of the jurist is awake to the fact that issues have been wrongly decided and that necessary changes must come about. Undoubtedly, the jurists hearing the earliest cases on the

issue before us were keenly aware of the necessity of just such an exception as we find therein established, and acted accordingly.

After a complete and exhaustive study of the several noted authors on corporation law and of the cases cited herein, with the idea in mind of determining whether or not an exception to the general rule against payment of dividends before restoring impaired capital has been established by them, there is no other alternative than to hold that where a corporation is formed to operate a mine, lease, patent, etc., which is in its inherent nature wasting, dividends may be declared before impaired capital is restored.

Yours truly,

Cleveland, Ohio, November 26, 1923. B. T. DAVIDSON.

Growth of Professional Ethics

Editor, The Journal of Accountancy:

SIR: The reading of Mr. Nau's paper, *Growth of Professional Ethics,* published in the January JOURNAL, has afforded the writer a great deal of pleasure. Though only a student of accountancy, I am one of a number the goal of whose aspirations is membership in the Institute, and cannot refrain from expressing the satisfaction which I experience when I observe what thought and effort the leaders of the profession are devoting toward the attainment of the highest ideals for their calling.

We students should feel deeply grateful for these efforts and do all we possibly can to aid in the accomplishment of whatever has not been done to bring their efforts to a successful conclusion, and thereafter, to maintain the high standard which will have been procured.

Personally, I can see the results of the efforts which have been put forth. Business men and the public generally are daily becoming more inclined to consider members of the profession, and especially Institute members, as men of the highest integrity, and, as Mr. Nau says, the recognition which the treasury department of our government has given to the Institute's code of ethics is a big step forward in this work.

Thanking you very kindly for this article as well as for numerous others which come to me through THE JOURNAL, I am,

Yours truly,

Andrews, S. C., January 4, 1924. C. T. BELL.

James Whitaker Fernley

James Whitaker Fernley, for many years a member of the American Institute of Accountants and a certified public accountant of Pennsylvania, died on January 8, 1924. Mr. Fernley was one of the organizers of the Pennsylvania Institute of Certified Public Accountants in 1897 and aided in securing passage of the C. P. A. law in that state, later serving as president of the state board of examiners. He also served as president and vice-president of the Pennsylvania Institute. Mr. Fernley contributed much towards the development of the accounting profession in his state.