Journal of Accountancy

Volume 35 | Issue 5 Article 9

5-1923

Correspondence: "Payment of Dividends before Restoring Impaired Capital”

R. L. Floyd

Charles F. Schlatter

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation

Floyd, R. L. and Schlatter, Charles F. (1923) "Correspondence: "Payment of Dividends before Restoring Impaired Capital”," *Journal of Accountancy*: Vol. 35: Iss. 5, Article 9.
Available at: https://egrove.olemiss.edu/jofa/vol35/iss5/9

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Correspondence

"Payment of Dividends before Restoring Impaired Capital"

Editor, The Journal of Accountancy:

SIR: In the article *Payment of Dividends before Restoring Impaired Capital* in your issue of March, 1923, the author among other things, says:

"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," and in his concluding paragraph explains that

"In making this investigation of the law of dividends, the truth was sought without attempting to prove one side right and the other wrong."

Certainly no investigation of the proposition quoted is disclosed in the article and, with equal certainty, no proof is offered of its correctness. There are text-writers who have also made the same assertion but that does not make it the law. The author appears to have given no consideration to the statutes of his own state, Illinois, in making that statement. Many states have statutes of similar tenor.

The Illinois statute, par. 23, chap. 32, penalizes a dividend if the corporation's "capital is thereby impaired" and defines "capital" for that section as "the aggregate amount paid in on its shares of stock issued and outstanding." The very clear import of this statute is specifically to prohibit any dividend either wholly or partly from capital. The statute provides an entirely different procedure for the return of capital, requiring much more formality than the mere declaration of a dividend, as shown by the following extracts from the statutes.

Chap. 32, par. 202. "Whenever the board of directors * * * of any corporation * * * may desire * * * to decrease the capital stock * * * they may call a special meeting of the stockholders of said corporation."

Par. 204. "At any such meeting * * * votes representing two-thirds of all the stock of the corporation shall be necessary for the adoption of the proposed change of * * * amount of capital stock."

Par. 205. "A certificate thereof verified * * * and under seal of said corporation, shall be filed in the office of the secretary of state, and a like certificate filed for record in the office of the recorder of deeds * * *."

Par. 206 requires publication in a newspaper of notice of changes.

Par. 34. "The articles of amendment shall set forth: * * *

"(2) The amount of reduction and the manner in which it shall be effected.

"* * * the capital stock may be reduced by the surrender of every stockholder of his shares and the issue to him in lieu thereof of a proportional decreased number of shares * * *."

In the light of these provisions there can be little doubt that in Illinois, at least, directors have no authority to declare dividends from capital until they have the approval of the holders of two-thirds of the shares at a meeting specially called for that purpose.

Yours very truly,

Chicago, Illinois, March 23, 1923. R. L. FLOYD.

Editor, The Journal of Accountancy:

SIR: May I have a little of your space to answer Mr. Floyd's questions upon and objections to my paper, *The Payment of Dividends before Restoring Impaired Capital* which appeared in the March, 1923, number of THE JOURNAL?

Mr. Floyd says: "Certainly no investigation of the proposition quoted (that corporations formed to work wasting properties need pay no attention to depletion) is disclosed in the article and, with equal certainty, no proof is offered of its correctness."

The article in question was prepared as a result of an investigation of a point upon which authorities in all three fields, accounting, finance and law, were not in agreement; therefore all proofs presented were upon that point. Because the authorities were in agreement concerning depletion, it was not thought necessary to prove what seemed to be accepted as true by all; therefore, no proof was offered.

First, let us consider the statute of Illinois to which he refers, which is in this respect similar to the statutes of nearly all the other states in the United States. This statute is for the greater part only a written form of the common law which underlies and permeates the statute law. It is true that the statute does prescribe certain penalties and certain details of procedure not found in the common law, but with these we are not concerned. By common law, even were there no such statute as he quotes, capital could not be returned to the stockholders except by due process of law. The common law prohibits any dividend payment either wholly or partly from capital just as surely and just as specifically as does the Illinois statute. Let us clearly understand that this is the rule by common law in all the states and by statute in most of them. Next let us consider the exception; that corporations formed to work a wasting property need pay no attention to depletion before determining the amount available for dividends.

Fletcher, Morawetz, Cook, Clark and others, in their works on corporation law, agree that the corporation formed to work a wasting asset does not come under the rule. Mr. Floyd says that the fact that such writers assert that this is the law does not make it the law, which is true enough; but surely when men with the standing that these men have in the field of law state what they believe to be the law, they must have good cause for their assertions. But be that as it may, the best proof of the law is its interpretation and application by the courts, which we shall proceed to show.

As far as could be ascertained, there is no case on record in any state of the United States where depletion of a wasting property was required to have been made up before the declaration of dividends by the directors of the corporation formed to work the property. Also as far as could be ascertained, the question has never come up in any court of record in the state of Illinois; but the question has come up in the courts of a number of other states that have statutes almost identical to those of Illinois, and in every case it was decided that such corporations need pay no attention to depletion.

Chief Justice Beatty, in rendering the decision in the supreme court of California in *Excelsior Water and Mining Company v. Pierce* (27 P. 44) says in regard to the statute, which uses the word "capital" to mean the actual amount contributed by the shareholders and forbids the division of capital among the stockholders: "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." The California statute is in effect the same as the Illinois statute.

The New York statute is similar to that of Illinois. Its court of appeals held in *People v. Roberts* (51 N. E. 293) that the statute does not require that the capital of a mining corporation be maintained. 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.

The state of Washington has a similar statute, yet its supreme court held in *Booth v. Summit Coal Mining Company* (104 P. 207) that to determine profits for dividends it was necessary to consider as an expense the depreciation of the mining plant, machinery, equipment, buildings, and so forth, but on the real estate or the mine itself, which must be depreciated (sic) by reason of the constant removal of coal deposits, no depletion need be considered.

New Jersey has practically the same statute as Illinois. Its court of chancery held in *Mellon et al. v. Mississippi Wire Glass Company* (78 Atl. 710) that the statute does not require that patents be written off over their life periods in order to maintain the capital intact.

The supreme court of Louisiana holds to the same idea in the dicta in the decision of *Van Vleet v. Evangeline Oil Company* (56 S. 343) in which the court quotes Cook. Sommerville, judge, says: "Oil wells and mines may figure as representing parts of the capital stock of corporations, which, of course, are owned for the express purpose of being worked, and it is the business of the owners to work them. They may become exhausted and cease to be real assets, and, as Mr. Cook states (Cook on Corporations, 6th ed., sec. 1486), in such cases it is not necessary to set aside funds for the purpose of purchasing a new mine, and, we add, a new oil well."

In all these cases the corporation was formed to work the wasting asset. At this moment I know of no cases in which this question of depletion came up when the working of the wasting asset was only incidental to the main business of the corporation. The authorities, that is, the law writers, state that such corporations would have to consider depletion before declaring dividends.

It should be borne in mind that statute law is a small part of our law; that courts interpret statutes strictly; that any exception to the common law remains an exception even when the common law has become statute law, unless the statute specifically and directly states that it covers also that which before had been the exception.

Since in a number of states having statutes similar to the statute of Illinois the courts have held that in corporations formed to work a wasting asset depletion need not be considered in declaring dividends, it is only reasonable to believe that when this question comes up in the Illinois courts it will be decided upon the same principles of common law as in the other states. Without a doubt the Illinois courts will follow the precedents established in the decisions quoted herein. Mr. Floyd entirely underestimates the importance of the common law and overrates the statute law if he believes differently.

Yous truly,

Urbana, Illinois, April 2, 1923. CHAS. F. SCHLATTER.

Reynold E. Blight and Herbert A. Wheeler announce the combination of their practices under the firm name of Blight & Wheeler, with offices at 1025 Washington building, Los Angeles, and at Washington, D. C.

Charles R. English and Martin Thal announce the formation of a partnership under the firm name of English & Thal with offices at 1566 Arcade building, St. Louis, Missouri.

George H. Bowers and R. H. Dillingham announce the formation of a partnership under the firm name of Bowers & Dillingham, with offices at 149 Broadway, New York.

Thomas A. Williams, Sydney S. Bourgeois and Frank Benetz announce the formation of a partnership under the firm name of Williams, Benetz & Bourgeois, with offices at 1419 Carondelet building, New Orleans, Louisiana.

Barrow, Wade, Guthrie & Co. announce that Francis Small has been admitted to the firm and will continue in charge of the Philadelphia office.

Maurice N. Newman & Co. announce the removal of their offices to 720 Haas building, Los Angeles, California.

Andrew Hunter, Jr. & Co. announce the removal of their offices to 910-911 American building, Baltimore.

The Glickman Audit Co. announces the removal of its offices to 175 Fifth avenue, New York.