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Robert L. Floyd

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## Correspondence

### "Payment of Dividends before Restoring Impaired Capital"

Editor, *The Journal of Accountancy*:

SIR: I had hoped that my letter, if it should be published, would bring out a more thorough discussion of the supposed exception to the well-established rule that dividends cannot be paid from capital than that vouchsafed by Professor Schlatter in his reply which you published in your May number with my letter. The decisions usually cited in support of the doctrine that corporations formed to work wasting property may pay dividends partly from profits and partly from capital do not support that doctrine when carefully examined.

In the case of *Lee v. Neuchatel Asphalte Co.* (L. R. 41 Ch.D. 1) which appears to be considered the leading case on this point several judges reached the same conclusion by different courses of reasoning, some of which it is not likely that a well-informed judge would now follow. The facts are highly complex; the corporation was formed to take over the assets of six other companies consisting of works, equipment and other assets besides concessions for the removal of asphalt. Later there was a readjustment of the concessions.

The trial judge said: "The present concession is for a longer period, extends over a wider area and is held on more favorable terms than the former." He also said: "Unless it can be shown that, after payment of the dividend, the assets now belonging to the defendant company will fall short of those belonging to the company at the time of its formation, it cannot in my judgment be said that the dividend is being paid out of capital."

An appellate judge said: "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." The decision was rendered in 1889.

Another of the judges said: "There is nothing at all in the acts about how dividends are to be paid nor how profits are to be reckoned; all that is left, and very judiciously and properly left, to the commercial world. It is not for an act of parliament to say how accounts are to be kept. What is to be put into a capital account, what into an income account, is left to men of business."

I shall now discuss the cases cited by Prof. Schlatter in his reply.

The opinion in the case of *Excelsior Water & Mining Co. v. Pierce* (90 Cal., 131, 27 Pac., 44), besides using the language quoted by him, also states: "In this case it appears that out of the net earnings, amounting to \$457,000, only \$241,000 were paid in dividends, while \$216,000, or nearly one-half, was applied in payments of the debts of the corporation, originally assumed in the acquisition of its capital stock and afterwards incurred in making permanent improvements thereon. It further appears that a large and valuable part of plaintiff's capital consists of property other than its mining ground, which will remain after the mine is exhausted; and there is evidence in the record, though there is no finding to that effect, that the mine itself has been but slightly encroached upon.

It does not appear that any creditor has been defrauded or his claim even endangered; and, in short, there is nothing to show that the capital of the plaintiff has been impaired."

In the case of *People ex rel. United Verde Copper Co. v. Roberts* (51 N.E., 293) the court said: "It appears by undisputed evidence that the purchase of the bonds and stock was made with the surplus money of relator; and as the theory (that depletion must be charged against earnings) adopted by the comptroller to show to the contrary is unsupported by evidence or authority, it follows \* \* " etc.

The court also said: "It is common knowledge that there are copper mines which have yielded enormous returns for years, and at present show no signs of exhaustion, but rather increased development. We are of the opinion that this speculative theory as to mining in general does not overcome the positive proof that these bonds and stocks were purchased by the surplus moneys of the relator." In this case the real question at issue was as to "the amount of capital stock employed within this state for the purpose of computing the franchise tax."

In the case of *Boothe v. Summit Coal Mining Co.* (104 Pac. 207) correctly summarized by Prof. Schlatter, the issue was not the legality of dividends but what constituted "profits" in a contract between the parties. As Rudkin, C. J., says in his concurring opinion, "'Profits' and 'dividends' are not necessarily synonymous terms."

The case of *Mellon et al. v. Mississippi Wire Glass Co.* (78 Atl., 710) was not on the question of whether certain dividends were legal but was upon the interpretation of a contract. There was no allegation or evidence that the capital had been impaired.

The case of *Van Fleet v. Evangeline Oil Co.* (56 So., 343) does contain the dictum quoted by Prof. Schlatter. The court also says, however: "The payment of the dividend of \$35 on each share was not only not intended by the board of directors to be paid out of the earnings or profits of the company; but as stated by Mr. Mellon the largest stockholder of defendant: 'The \$35 dividend really represents liquidation and not earnings. \* \* \* The only value remaining in the plant is salvage.' The method of dissolving and liquidating defendant company which appears to have been adopted by the board of directors is not authorized by the charter of defendant, and it is not in conformity with the laws of New Jersey or Louisiana."

The case of *Lee v. Neuchatel Asphalte Co.*, which is the case almost always cited on this point, only holds that the matter of determining whether or not a charge against earnings should be made for depletion is entirely in the discretion of the directors if they act fairly and honestly in reaching such a decision. This is far different from saying that they "need pay no attention to depletion" and that dividends may be paid "partly from capital."

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 specifically hold that in those cases capital was

not impaired, except in the case of *Van Vleet v. Evangeline Oil Co.* where a liquidating dividend was held to be illegal because it was an impairment of capital. This case emphasizes the point I am making as the court states that the dividend was "not intended by the board of directors to be paid out of the earnings or profits of the company."

I have been unable to find a case in which a dividend paid from capital was upheld as legal, although I do not claim that my search has been exhaustive. 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 a 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.

There is certainly enough doubt as to the soundness of the supposed exception to make it desirable to use great caution in acting upon it, as the penalty for paying dividends out of capital is quite severe.

Yours very truly,

ROBERT L. FLOYD

Chicago, Illinois, May 7, 1923.

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## American Institute of Accountants

### REGIONAL MEETING

**Poland Springs, Maine, June 22 to 23, 1923.**

A regional meeting of the New England section of the American Institute of Accountants was held at Poland Springs, Maine, June 22 and 23, 1923. There were about 50 registrations. At the banquet held on the evening of June 22nd, there were informal addresses, and at the business session held June 23rd a paper entitled *Professional Ethics* was read by Herbert F. French. A sketch of the history of Maine was presented by Chester A. Jordan. Election of officers for the region resulted as follows: President, Frederick Bond Cherrington; secretary, Chester R. Union; treasurer, Arthur Taft Chase.

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### Massachusetts Chapter of American Institute of Accountants

At a meeting of the Massachusetts Chapter of the American Institute of Accountants held May 28, 1923, the following directors were elected: Hollis H. Sawyer, Stanley G. H. Fitch, Frederick Bond Cherrington, Arthur T. Chase and J. Edward Masters.

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### Massachusetts Society of Certified Public Accountants, Inc.

At the annual meeting of the Massachusetts Society of Certified Public Accountants, Incorporated, held May 28, 1923, the following officers were elected: Hollis H. Sawyer, president; Stanley G. H. Fitch, vice-president; Frederick Bond Cherrington, secretary and Arthur T. Chase, treasurer. In addition to the officers the following were elected members of the executive committee: J. Edward Masters, Charles F. Rittenhouse and George S. Clarkson. Rupert W. Jaques was elected auditor.