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DIVIDEND POLICY—AS AFFECTED BY DEPRECIATION AND DEPLETION

“The same elements of value for rate making may be accorded different authority when considered for income tax purposes, or for the purpose of determining the right of directors to pay dividends.”¹

THIS is perhaps nowhere more easily demonstrated than in the case of depreciation and depletion. It is the purpose of this note to consider the significance of depreciation and depletion for the legality of corporate dividend declarations.

Depreciation is generally thought of as the loss of value through wear and tear or decay of property.² For example, a machine depreciates in value by merely the passage of time. If it is in use, it is worn out; if it is not in use, it decays or rusts or otherwise loses value. Also, a machine that will do a certain job in ten hours may be made obsolete by another machine that will do the job in one hour.³ Thus the value may depreciate by reason of technical developments. All of these factors must be considered in arriving at a method of depreciation. Usually engineers, taking all things into consideration, estimate that a certain machine, building, etc., will last for so many years;⁴ thereupon, the cost of the machine will be prorated over this period as a charge to depreciation expenses, thus lessening the value of the property by a set amount each year until it is entirely written off the books.⁵

¹ Guaranty Trust Co. v. Grand Rapids, G. H. & M. Ry., 7 F. Supp. 511, 519 (W. D. Mich. 1931), *modified and aff'd sub nom.*; United Light & Power Co. v. Grand Rapids Trust Co., 85 F. (2d) 331 (C. C. A. 6th, 1936), *cert. granted on petition of receiver*, 299 U. S. 534 (1936), *dism'd per stipulation of counsel*, 299 U. S. 618 (1936); *cert. denied on petition of United Light & Power Co.*, 299 U. S. 591 (1936), (1937) 31 ILL. L. REV. 670. This language is quoted with approval in Gallagher v. New York Dock Co., 19 N. Y. S. (2d) 789, 807 (Sup. Ct. 1940).

² For other and more technically correct definitions see PATON, ACCOUNTANTS' HANDBOOK (3rd ed. 1947) 711; HOAGLAND, CORPORATION FINANCE (2d ed. 1938) 326.

³ For a discussion as to the propriety of having a separate "reserve" for obsolescence, see PATON, *op. cit. supra* note 2, at 730-34.

⁴ For other methods of arriving at rates see PATON, *op. cit. supra* note 2, at 765 *et seq.*

⁵ Cost is now, in general, the accepted base upon which to compute depreciation. See FPC v. Hope Natural Gas Co., 320 U. S. 591, 606 (1944). This decision is a latent acceptance of the cost theory as ably advanced in a dissent by Justice Brandeis in United Rail-

Depletion, on the other hand, is comparable to the consumption of a stock of raw materials. A property, such as oil, gas, mineral deposits, and sometimes timber stands,⁶ is being taken from its natural depository or stock pile and will eventually be exhausted. This type of loss in value goes on only in direct proportion to the working of the property. Of course, the difficulty in connection with depletion is to determine just how much material is in the stock pile. While any observer can perceive that the supply is being used, it is hard to say with accuracy how much is there in the first place. In the case of an oil well, one knows that eventually the pool of oil will be exhausted, but it is very hard to get an accurate measurement of how many barrels of oil are in the pool. This method is called "real" depletion as opposed to "percentage" depletion to be discussed later.⁷

The accounting method generally used for reflection of these losses of value by depreciation and depletion is that of "reserve" accounts. Such accounts are set up on the corporation's books by having a debit item called "Depreciation (or Depletion) Expense." This is offset by a credit item called "Reserve for Depreciation (or Depletion)." At the end of the year an entry is made debiting "Expense" and crediting the "Reserve" account with the proper amount. Then the "Expense" account is charged against "profit and loss" as is any other expense item such as wages, materials, rent, etc. The "Reserve" is usually carried as a deduction from

ways & Electric Co. of Baltimore v. West, 280 U. S. 234, 255 (1929). For discussions of the different bases upon which depreciation may be computed see Norman Fitzhugh, *Accounting for Depreciation and Depletion* (1939) 45 W. VA. L. Q. 134, 137; PATON, *op. cit. supra* note 2, at 712-19. The above method of apportioning the base (cost) is the so-called "straight line" method. It, too, is the generally accepted one. See PATON, *op. cit. supra* note 2, at 751 *et seq.*; also Note (1935) 33 MICH. L. REV. 783 for discussions of it and other methods of apportionment.

⁶ For further discussion and other borderline illustrations see PATON, *op. cit. supra* note 2, at 617 *et seq.* Patents are sometimes included, but these exhaust by lapse of a certain time and this is usually taken care of by "amortization."

⁷ See note 50 *infra*.

the property being depreciated or depleted so that the item appears on the balance sheet as follows:⁸

Buildings	\$100,000	
Less: Reserve for Depreciation	10,000	\$90,000.

It might be well to point out that this "Reserve" is not an actual outlay of money as is popularly supposed.⁹ Simply, it is the estimate of the lessening in value of the building (or oil well) brought about by the passage of time (or workings of the well). This is done by accountants in an effort to show as truly as possible the present worth of all the properties.¹⁰ These accounts are called "asset valuation accounts."¹¹

As can be seen, these are real losses in value, and an important question of corporate finance is how much emphasis directors of a corporation should put upon these factors in determining whether or not dividends should be declared.¹² At the outset it should be stated that there is a dearth of judicial materials upon the problem for two reasons: in the first place, when dividends are not declared, the law presumes that directors act in good faith and with sound discretion;¹³ and second, when dividends are declared stockholders seldom seem to bother to question whether or not it

⁸ See NOBLE, *PRINCIPLES OF ACCOUNTING* (3rd ed. 1945) or another basic accounting book for further details.

⁹ On rare occasions actual money outlays as a so-called "sinking fund" are provided for. See PATON, *op. cit. supra* note 2, at 624 for a discussion of depletion and at 757-58 for methods of provision for depreciation. See also Note (1938) 24 VA. L. REV. 293 for a discussion of sinking funds in general.

¹⁰ For an excellent recent work on depreciation considerations since the war, see the pamphlet of the Brookings Institution by KIMMEL, *DEPRECIATION POLICY AND POSTWAR EXPANSION* (1946). For a good overall discussion of depreciation problems see DEWING, *FINANCIAL POLICY OF CORPORATIONS* (4th ed. 1941) 554 *et seq.*

¹¹ See HOAGLAND, *op. cit. supra* note 2, at 327.

¹² HOAGLAND, *op. cit. supra* note 2, at 328 says "to what extent depreciation and depletion should be accounted for before dividends are declared legally is another unsettled question."

¹³ *Wabash Ry. v. Barclay*, 280 U. S. 197 (1929). Courts generally interfere only where bad faith, fraud, or other breach of trust is shown. See *City Bank Farmers' Trust Co. v. Hewitt Realty Co.*, 257 N. Y. 62, 177 N. E. 309 (1931).

was a wise policy to declare them; rather they proceed on the assumption that "a bird in hand is worth two in the bush."

It is also worth mentioning that both depreciation and depletion expenses are allowable deductions from federal income taxes.¹⁴ This factor more than any accounting theory has brought these expenses to the forefront of good management policy. That all allowable deductions will naturally be taken for income tax purposes seems to afford a good argument for taking these deductions before declaring dividends.

DEPRECIATION

The Texas statutory provision governing the declaration of dividends provides that

"They [the directors] shall . . . declare and make such dividends of the *profits* from the business of the corporation as they shall deem expedient, or as the by-laws may prescribe."¹⁵

Most cases on the point of depreciation have taken for granted that depreciation should be deducted before declaring dividends. The Texas courts do not seem to have defined the statutory term "profits" available for dividends.¹⁶ The term has been defined in other connections as follows:

" . . . profit . . . is, generally speaking, what remains in the conduct of a business after deducting from the total receipts all the expenses

¹⁴ 52 STAT. 460 (1938), as amended by 56 STAT. 819 (1942), 26 U. S. C. § 23 (1) (depreciation) and (m) (depletion) (1940). For bases for depreciation and depletion, see 52 STAT. 494 (1938), 26 U. S. C. § 114 (1940). For an early case under the first corporation tax statute (1909) *measuring* taxes by gross income which draws a good distinction between depreciation and depletion, see *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 524-26 (1916).

¹⁵ TEX. REV. CIV. STAT. ANN. (Vernon, 1925) art. 1329 (italics supplied). See also TEX. PEN. CODE ANN. (Vernon, 1947 Supp.) art. 1083 (a), for penalties for declaring dividends "out of any funds other than actual earnings."

¹⁶ See 2 HILDEBRAND, TEXAS CORPORATIONS (1942) § 472 where he says that Texas courts have never actually decided whether this means surplus or merely net profits. Roughly, surplus is the amount by which the value of assets exceeds the value of liabilities plus capital stock. Net profits, as seen from the definition in the case *infra* note 17, can exist without a surplus. It is not the purpose of this article to bring up this controversy, but only generally to state that the better accounting principles demand that there be a surplus before dividends can be declared.

incurred in carrying on the business. . . . To such expenses may be charged taxes, upkeep, depreciation, and interest. . . ."¹⁷

A similar view as to the propriety of deducting depreciation was taken in two early English cases¹⁸ in which Jessel, M. R., declared:

" . . . before you can ascertain the net profits, a sum of money ought to be set aside as representing the amount in which the wear and tear of the [railway] line has so far depreciated it in value as that that sum will be required for the next year or next two years."¹⁹

One court has gone so far as to take judicial notice of depreciation and says that no corporation would be regarded as well conducted which did not deduct for depreciation before dividends are declared.²⁰

The most recent case on the point is *Cannon v. Wiscassett Mills Co.*,²¹ in which the Supreme Court of North Carolina held that a valuation of the profit for dividend purposes, as set by the lower court, without considering a deduction for depreciation was error.²²

It can thus be seen that there is now almost unanimity of judicial opinion that depreciation should be provided for, consistently with good accounting theory, before dividends can be de-

¹⁷ *Dealers' Granite Corporation v. Faubion*, 18 S. W. (2d) 737 (Tex. Civ. App. 1929). The language is quoted approvingly, although not on the point of depreciation, in *Stapper v. Van Valkenburgh & Vogel*, 128 S. W. (2d) 466, 468 (Tex. Civ. App. 1939), *writ of error dismissed, judgment correct*. Most of the language of this sort in the cases has been taken from 2 COOK ON CORPORATIONS (6th ed. 1906) 1479.

¹⁸ *Dent v. London Tramways Co.*, 16 Ch. D. 344 (1879) and *Davison v. Gillies*, 16 Ch. D. 347, n. (1879).

¹⁹ *Davison v. Gillies*, 16 Ch. D. 347n, 348n (1879). See note 9 *supra* for references on actual outlays of money.

²⁰ *People ex rel. Jamaica Water Supply Co. v. State Board of Tax Commissioners*, 190 N. Y. 39, 89 N. E. 587 (1909); *accord*, *National Newark & Essex Banking Co. of Newark v. Durant Motor Co. of New Jersey*, 124 N. J. Eq. 213, 1 A. (2d) 316 (Cl. of Ch. 1938), *aff'd*, 125 N. J. Eq. 435, 5 A. (2d) 767 (Er. & App. 1939).

²¹ 195 N. C. 119, 141 S. E. 344 (1928).

²² For a detailed and sensible discussion, see *Guaranty Trust Co. v. Grand Rapids, G. H. & M. Ry.*, 7 F. Supp. 511 (W. D. Mich. 1931) (see note 1 *supra*). For a Texas decision not directly in point but which discusses depreciation, see *Dealers' Granite Corporation v. Faubion*, 18 S. W. (2d) 737 (Tex. Civ. App. 1929) (see note 17 *supra*).

clared.²³ Thus the courts have followed business practice in this respect.²⁴

DEPLETION

In the case of depletion, however, it may be seen from the two leading cases on the point that the course of decision has not been so fortunate. Supposedly standing for the doctrine that depletion need not be considered before a declaration of dividends is the famous English case of *Lee v. Nauchatel Asphalte Company*,²⁵ which involved a mining company with articles of association providing (Art. 100) that the directors "shall not be bound to form a fund, or otherwise reserve moneys, for the renewal or replacing of any lease, or of the company's interest in any property or concession."²⁶ (The articles of association did provide for depreciation). Moreover, the articles provided for two kinds of stock, comparable to modern preferred and common stock. The preferred stock, however, provided for preference only as to dividends, with no preference provided for on dissolution. It was also found as a fact by the trial court that the mines and properties had actually *increased* in value due to new discoveries on the leases. With this situation, a preferred stockholder sued to enjoin payment of a dividend to the common stockholders on the ground that no depletion fund or reserve had been set up by the directors. Plaintiff's counsel contended that the above provisions of the articles were contrary to the law. It was almost a foregone

²³ See *Guaranty Trust Company v. Grand Rapids, G. H. & M. Ry.*, 7 F. Supp. 511 (W. D. Mich. 1931) (see note 1 *supra*) for a discussion of the then (1925) unsettled state of accounting opinion upon the subject and for a holding that such a state of affairs precluded a finding that the directors evidenced a lack of good faith in declaring dividends. As evidenced by PATON, *op. cit. supra* note 2, at 711 *et seq.* there is now accord among accountants that depreciation should be considered.

²⁴ Most corporation statutes are silent on the subject of depreciation and its relation to dividends. A few of the more recently enacted ones (see note 43 *infra*) require that it be deducted, but do not provide how the charges for it should be computed or what factors should be considered. This would not seem to be unsatisfactory, however, since these considerations are for the sound discretion of the directors.

²⁵ 41 Ch. D. 1 (1899).

²⁶ *Id.* at 3.

conclusion that the court should hold for the defendant, if for no other reason than that this was a valid and binding contract on both parties and that the plaintiff had consented that no such reserve need be set up. This case, however, has since been cited almost universally for the proposition that no depletion reserve need be set up in companies that are organized to exploit a wasting asset.²⁷

The other pertinent case, supposedly *contra* to the *Lee* case, is *Wittenberg v. Federal Mining & Smelting Co.*,²⁸ in which there was a fact situation similar to that of the *Lee* case. The plaintiff, a preferred stockholder of the mining concern, sued to enjoin payment of dividends to the common stockholders without first providing for a depletion reserve. However, here the preferred stockholders were also preferred on dissolution. There was also no provision in the charter, as in the *Lee* case, that there should be no depletion reserve. Moreover, there was no increase in value; in fact, there was a substantial decrease since the properties had been worked for a number of years. The court rightly held, construing the then existing Delaware statute,²⁹ that failure to provide for depletion amounted to declaring dividends out of capital and granted the injunction. This decision was affirmed on appeal.³⁰

²⁷ See 2 HILDEBRAND, *TEXAS CORPORATIONS* (1942) 473. In 1 DODD & BAKER, *CASES AND MATERIALS ON BUSINESS ASSOCIATIONS* (1940) 1094, n. 3, the editors say: "although the [*Lee*] case has been treated by American text-writers and by some American courts as a statement of a general common law rule applicable to American as well as English corporations, the case is subject to important comments the significance of which must not be overlooked in dealing with the case in this country: . . . [here the editors quoted Article 100 of the company articles]; and the case is closely related to an English doctrine, of very dubious validity in this country in the absence of statute, that losses, however caused, in 'permanent' or 'fixed' capital assets as distinguished from what are called 'circulating' or 'floating' assets need not be made good before dividends can be declared, if there are current operating profits to cover the dividend." See Weiner, *Theory of Anglo-American Dividend Law; The English Cases* (1928) 28 *COL. L. REV.* 1046.

²⁸ 15 Del. Ch. 147, 133 Atl. 48 (1926).

²⁹ DEL. REV. CODE (1915) §§ 1948 and 1949. These two statutes were virtually the same as the present Texas statutes, TEX. REV. CIV. STAT. (Vernon, 1925) art. 1329 and TEX. PEN. CODE (Vernon, 1947 supp.) art. 1083 (a) taken together. See note 15 *supra*.

³⁰ 15 Del. Ch. 409, 138 A. 347 (Sup. Ct. 1927), 55 A. L. R. 1, note at 8 (1928). See Note (1927) 12 *CORN. L. Q.* 79, Note (1927) 75 *U. OF PA. L. REV.* 350.

Just one month after the appellate decision, however, the Delaware legislature amended the statute³¹ to read that depletion need not be provided for; so that the plaintiff was defeated on the retrial before the chancellor.³² The chancellor's opinion in the first case had thoroughly analyzed most of the cases and indicated that the *Lee* case was distinguishable on the facts.

One later English case³³ has distinguished the *Lee* case and put the question on a wholly equitable basis, the judge saying that "the real question for determination, therefore, is whether there are profits available for distribution, and this is to be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses. There is no single definition of the word 'profits' which will fit all cases."³⁴ He further says of the *Lee* case,

"... plaintiffs contend that the *Lee* case is an authority for this proposition as a universal negative, namely, 'that no company owning wasting property need ever create a depreciation [depletion] fund.' In my opinion, that is not the true result of the decision. It must be remembered that in that case there had been no loss of assets, . . . and the court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation [depletion] fund."³⁵

This would seem to be a proper interpretation of the *Lee* hold-

³¹ 35 Del. Laws (1927), c. 85, § 16, which was substituted for § 1948, note 29 *supra*. It reads as follows: "The directors . . . shall have power to declare and pay dividends upon the shares of its capital stock either out of its annual net profits or out of its net assets in excess of its capital. . . . Subject to any restrictions contained in its certificate of incorporation, the directors of any corporation engaged in the exploitation of wasting assets, without taking into consideration the depletion of such assets resulting from lapse of time or from necessary consumption of such assets incidental to their exploitation . . ." may declare dividends. Amortization of patents may be included as a result of the provision that depletion of assets resulting from lapse of time need not be considered. Notice also the two funds, net profits or surplus, out of which dividends may be declared. This was apparently taken from the similar language in the New Jersey statute (N. J. REV. STATS. (1937) § 14:8-19). See also note 16 *supra*.

³² 15 Del. Ch. 351, 138 Atl. 352 (1927).

³³ *Bond v. Barrow Haematite Steel Co.* [1902] 1 Ch. D. 353.

³⁴ *Id.* at 365.

³⁵ *Ibid.* It is interesting to note that neither the appellants nor the appellees in *Wittenberg v. Federal Mining & Smelting Co.* cited this case in their briefs. See the case with the briefs in the report in 55 A. L. R. 1, 2, 3 (1928).

ing. However, the English cases have never overruled the *Lee* case, and no other decision has been found even distinguishing it. Only occasionally has an English court even cited the *Lee* case.³⁶ The House of Lords expressly refused to comment on the proposition one way or the other in the only case remotely touching the point that it has considered.³⁷ The few American cases in point have followed the *Lee* case without question,³⁸ except of course the *Wittenberg* case.³⁹ This course of decision was aided by two factors; (1) Morawetz in his work⁴⁰ laid down the proposition before the *Lee* case was decided and in later editions cited the case as authority; and (2) accounting principles were not at the outset very definitely formulated, so that there was much difference of opinion even among expert witnesses.⁴¹ The Uniform Business Corporations Act⁴² and the acts of a few states⁴³ besides Dela-

³⁶ See annotations in 9 ENGLISH AND EMPIRE DIGEST (1940) case No. 1105, and supplements of 1941 and 1945.

³⁷ *E.g.*, *Dovey v. Cory*, [1901] A. C. 477.

³⁸ *Excelsior Water & Mining Co. v. Pierce*, 90 Cal. 131, 27 Pac. 44 (1891); *Mellon v. Mississippi Wire Glass Co.*, 77 N. J. Eq. 498, 78 Atl. 10 (Ch. 1910); *Goodnow v. American Writing Paper Co.*, 72 N. J. Eq. 645, 66 Atl. 607 (Ch. 1907), *aff'd*, 73 N. J. Eq. 692, 69 A. 1014 (Er. & App. 1908); *Boothe v. Summit Coal Mining Co.*, 55 Wash. 167, 104 P. 207 (1909).

³⁹ See notes 28, 30 and 32 *supra*. See also *Pardee v. Harwood Electric Co.*, 262 Pa. 68, 105 Atl. 48 (1918). See also *Petroleum Rights Corporation v. Midland Royalty Corporation*, Del. Ch., 167 Atl. 835 (Ch. 1933), in which the Delaware court after the *Wittenberg* case and after the change in the statute held that depletion must be deducted before a balance sheet surplus could exist. It was a somewhat strained fact situation and the statute was not cited nor was any case.

⁴⁰ 1 MORAWETZ, PRIVATE CORPORATIONS (1886) § 442.

⁴¹ See note 23 *supra*. See also pp. 12 and 13 for the quotation from the *Bond* case in which the court used the term "depreciation" where the obviously correct word was "depletion." This would suggest that the word was not in common use at the time of the decision in 1902, if at all.

⁴² MODEL BUSINESS CORPORATIONS ACT § 24 (VII), which is very similar to the Delaware statute cited in note 31 *supra*.

⁴³ See IDAHO CODE ANN. (1932) § 22-129 and LA. GEN. STAT. (Dart, 1939) § 1106, which adopted the Model Act. See also OHIO CODE ANN. (Baldwin, 1938) § 8623-38, which was a forerunner and partial inspiration for the Model Act. See also CAL. CIV. CODE (Deering, 1941) § 346; GA. CODE ANN. (1936) § 22-1835, enacted Ga. Laws 1937-1938, p. 229, § 16; IND. STAT. ANN. (Burns, 1933) § 25-221; Kans. Laws, 1939, c. 152, § 82; MICH. STAT. ANN. (Henderson, 1937) § 21.22; MINN. STAT. (Mason, 1938 supp.) § 7492-21; PA. STAT. (Purdon, 1936) § 2852-701; WASH. REV. STAT. ANN. (Remington, 1932) § 3803-24; and W. VA. CODE ANN. (Michie, 1943) § 3082. See also KEHL, CORPORATE DIVIDENDS (1941) 128-29. See also 1 DODD & BAKER, *op. cit. supra* note 27, at 1102-05

ware⁴⁴ have expressly dealt with the problem. It is submitted, however, that equity and more settled accounting principles will take care of the problem and that these statutory pronouncements will prove to be too dogmatic.⁴⁵

Only one Texas case⁴⁶ has been found even remotely touching the point, and that was in connection with the construction of the meaning of the term "net profits" in a corporation note. One of the incorporators sold some land on which a quarry was located to the corporation. In return therefor, he took a note from the corporation reciting that he would be paid out of "net profits." The court held that depletion (the opinion said amortization) should not be deducted before a payment on the note. Actually, even without considering depletion, there was no profit from which money could be paid on the note. The decision is not directly in point on the problem under discussion, but it is the only decision in the state giving a definition of net profits and also the only one even remotely touching the wasting asset doctrine. There is also some support of the decision from accountants.⁴⁷

From these cases then, there has evolved the so called "wasting asset doctrine" which is to the effect that a corporation that is

for a discussion of the effect of the statutes. For further criticisms and discussion see Weiner, *Theory of Anglo-American Dividend Law: American Statutes and Cases* (1929) 29 COL. L. REV. 460, 481-82.

⁴⁴ See note 31 *supra*.

⁴⁵ *E.g.*, under the Indiana statute (note 43 *supra*) the wasting asset exemption states that it is subject both to the rights of stockholders of different classes and also to the rights of creditors. This, in effect, renders the proviso meaningless. See also 2 HILDBRAND, *TEXAS CORPORATIONS* (1942) § 473.

⁴⁶ *Dealers' Granite Corporation v. Faubion*, 18 S. W. (2d) 737 (Tex. Civ. App. 1929), *no writ of error*.

⁴⁷ See pamphlet by Joseph McElroy, C. P. A., *DEPLETION OF OIL AND GAS PROPERTIES* (1923) 34, for the observation that "as long as the income from a (oil or gas) property exceeds the lifting costs it is profitable to operate that property, despite any depletion or depreciation charges. . . . Accountants' statements must be practical, and correct technical treatment may be discarded or modified if it is liable to lead to errors of policy. For these reasons, it is suggested that in presenting operating statements, the operating profit for each property should be first ascertained before considering depletion charges." However, it should be pointed out that Mr. McElroy was talking about an individual proprietorship in the above article and not a corporation. This may or may not be his view as to a corporation.

exploiting a wasting asset need not provide for depletion before declaring dividends. Not only does this permit a declaration of dividends out of capital, but also some decisions⁴⁸ and text writers⁴⁹ say that it leaves a corporation free to declare dividends out of net profits when there is no surplus due to reasons other than depletion. This seems an absurd extension of a doctrine that lets wasting asset companies get around the law by permitting them to impair capital by dividend payments without paying the consequences. Anyone getting depletion gets a great tax advantage in any event⁵⁰ without their being given a double advantage by declaring dividends out of capital. The only exception to the doctrine thus far engrafted is where a company is in the business of exhausting many properties and in a continuing business of it and contemplating the exploitation of more than one lease. Such companies must then take depletion on the theory that the depletion works like depreciation to provide a fund or reserve for new equipment. It is argued that creditors are protected in these instances even though no depletion is taken. However, it is submitted that the capital stock figure of any corporation is the figure that creditors look to for protection; and it would seem that creditors of a wasting asset company are entitled to the same protection as those of any other company, even though it may be far greater than the actual debts of the company.

With reference to depletion, then, in a corporation where there are preferred stockholders—preferred as to dividends and dissolution—and common stockholders, it would seem that depletion should be deducted before dividends are declared. The capital should be kept intact so that on dissolution there will be some-

⁴⁸ See *Bailey v. Guaranty Liquidating Corporation*, 16 Cal. App. (2d) 401, 60 P. (2d) 579 (1936).

⁴⁹ BALLANTINE ON CORPORATIONS (rev. ed. 1946) § 251; 11 FLETCHER, CYCLOPEDIA OF CORPORATIONS (perm. ed.) § 5347.

⁵⁰ See statutes cited note 14 *supra* which provide for an option in the taking of depletion either by the "real" method or by the "percentage" method whichever is higher. The "percentage" method allows the corporation to deduct 27½ per cent of the gross income from the wasting property each year. This is allowed even though the entire cost of the property may be recovered many times by depletion.

thing to divide among the preferred stockholders. This is also a good device for the protection of creditors, particularly the long-term ones. However, in a close corporation, or in one where there is only common stock, as far as dividends are concerned it would seem that the decision should be up to the stockholders as to whether they want to save anything for dissolution or to take all the profits and capital out of the corporation in the form of dividends (assuming they are not violating any state statute).

CONCLUSION

It would seem that depreciation should be considered as a real expense and should always be deducted before dividends are declared.⁵¹ It also would seem that the *Lee* case should be carefully limited to the facts on which it was decided; the view that it amounts to an unequivocal declaration that depletion need not be considered should be forgotten altogether.⁵² Preferred stockholders and bondholders and long-term creditors should make certain that the charter, or at least the by-laws, contain a provision expressly providing for depreciation and depletion reserves. By such an express provision, almost certain conflict could easily be avoided.

Robert G. Storey, Jr.

⁵¹ The late Dean Hildebrand in 2 TEXAS CORPORATIONS (1942) 311 says that "when our judges become better acquainted with the rules of accounting, their statements concerning the declaration of dividends will be more accurate." This is perhaps a bit dogmatic. It would seem that as accounting practices become more standardized and more nearly approach a science, it will follow that the judges' opinions will become more conformative. But, the judge must take the word of experts in fields where he has only a general knowledge and when the experts differ, so do the judges.

⁵² For annotations on the general topic of considerations before declaring dividends see Notes 55 A. L. R. 8 (1928), 76 A. L. R. 885 (1932), and 109 A. L. R. 1381 (1937). As Professor Ralph J. Baker of Harvard has observed, "if one has a preference on assets, under the *Lee* doctrine, depletion can get to the point where he has a preference on a hole in the ground." See also discussion in PATON, *op. cit. supra* note 2, at 1040-41.