HOWE v. LORD DARTMOUTH — AN ANACHRONISM?

By GRAHAM L. FRICKE*

I

One of the criticisms of the rule in *Howe v. Dartmouth*[1] which the Law Institute of Victoria made in 1945 when that body was moving for its amendment was that the rule 'is habitually excluded . . . by every draftsman of a will who remembers its existence'. Dr L. P. Jacks told the story[2] of the devil attending a course of lectures on the meaning of justice, in order that he should know what to *avoid*, but here we have the spectacle of the law student striving assiduously to master the mysteries of the rule in *Howe v. Dartmouth*, to the end that he will know just when to exclude that rule.

As it is realized that a general practice of excluding a rule may be no more than *prima facie* evidence of the unsuitability of that rule, a more fundamental examination of the background and operation of the rule will be undertaken, in the hope of revealing the reasons for the practice in properly drafted wills of excluding the rule in *Howe v. Dartmouth*. It will be asserted that the rule constitutes, as Keeton writes, one of 'the many half-understood and partially-forgotten doctrines of equity, which derived their former importance from a different type of society, and which survive today mainly for the purpose of troubling practitioners',[3] and, one might add, students.

The rule obliges the executor of a will containing successional interests in residuary personalty to convert into authorized investments such part of the residuary personalty as does not consist of authorized investments. Other, less concise, statements of the rule direct conversion of three different categories of residuary personalty: (i) wasting property, (ii) hazardous property, (iii) unauthorized investments; but the first two are included within the genus of 'property exclusive of authorized investments'. The rule is said to be based upon a presumption that the testator intended the property to be enjoyed in accordance with his gift, and since he gave property in succession, effect can only be given to his intention by converting the wasting property into securities of a permanent nature for the benefit of all

* LL.B. Tutor in Law, University of Melbourne.

1 (1802) 7 Ves. 137.

2 In a speech broadcast in February 1938, 'The Relations of Morals to Scientific Progress'.

3 G. W. Keeton, 'The Problem of Law Reform After the War' (1942) 58 *Law Quarterly Review*, 247, 250.

persons interested.[4] This reasoning justifies the duty to convert property within the first two categories—wasting and hazardous property—but it can justify a duty to convert property in the third category only upon the assumption that all unauthorized investments are insecure. The rule, where applicable, directs conversion of wasting and hazardous property, and also all such other existing investments as are not of the recognized character and *are consequently deemed to be more or less hazardous.*[5] The rule does not direct conversion of such unauthorized investments as are hazardous, but willynilly compels the conversion of *all* unauthorized investments.[6] The present-day justification of the rule thus depends largely upon the soundness of the assumption that unauthorized investments are insecure. In a society in which most commercial and manufacturing companies were financially unstable, a rule inflexibly compelling conversion of all unauthorized investments might represent sound policy, even though it occasionally compelled conversion of investments which happened to be secure, for in such a case the general policy of securing a fair apportionment between life tenant and remainderman would override the occasional injustice to the life tenant of an unnecessary conversion. This, it is suggested, was exactly the situation in 1802, when *Howe v. Dartmouth* was decided. But if it can be shown that the commercial structure of society has so changed since then that capital security in companies is the rule, and insecurity the exception,[7] then surely the case is a good one for modifying a rule which compels conversion of all unauthorized investments, regardless of their stability and the financial unwisdom which such a course might involve.[8]

Furthermore this rule has frequently been labelled artificial and the product of a pedantic mind, it very often frustrates the intentions of testators, and it has proved so unpopular that judges have been moved to formulate such hair-splitting refinements and nice distinctions that countless originating summonses have to be taken out to determine whether the rule is applicable. It is suggested that these considerations, and the deleterious effect which over-conservative

[4] W. H. Gover, *Capital and Income* (3rd ed., 1933) 171; *Halsbury's Laws of England* (2nd ed., 1938) xxix, 652.

[5] *Macdonald v. Irvine* (1878) 8 Ch. D. 101, 112, *per* Baggallay L.J. (Italics supplied).

[6] *Cf. Halsbury's Laws of England, loc. cit., supra,* n. 3: 'This rule applies to unauthorized securities retained by trustees pending conversion, whether they are of a wasting nature or not . . .'

[7] *Infra,* Part III.

[8] 'When a man invests his savings in foreign bonds, he risks his capital for the sake of the increased income, and if by will he leaves all his property to his wife for life, he intends her to enjoy the same income, subject to the same risk. But in cases of this kind the Court of Chancery, in the exercise of its grandmotherly jurisdiction, takes upon itself to make a new will for the testator: the bonds must be sold, and the proceeds invested in trustee securities. A few years ago this would have meant reducing the widow's income by a third or more, contrary to the intention of the testator.' (1916) 32 *Law Quarterly Review,* 342-343.

trustee law has upon the economy, outweigh the value of occasionally protecting the remainderman.

II

> A great number of authorities . . . shew an inclination on the part of successive Judges to allow small indications of intention to prevent the application of the general rule . . . Nor is it, in my opinion, a matter of surprise that Judges should have entertained and acted upon such views, when we call to mind the circumstances of the case in which the rule was enunciated by Lord Eldon, and of those to which it has been subsequently applied . . . In *Howe v. Lord Dartmouth* the property bequeathed was but once described; the same thing was to be enjoyed by the tenant for life and by the reversioner, and by conversion alone could this be effected. If the application of the rule had been confined to cases as simple as *Howe v. Earl of Dartmouth*, the propriety of so applying it could hardly have been questioned, and one cannot but feel that by its extension the wishes and intentions of testators have been frequently defeated.[9]

The history of the rule subsequent to 1802 was indeed one of extension: in the principle case itself the duty was stated in terms of a duty to convert 'perishable' property, and it should be noted that the bank stock there was redeemable. In such a case the object of the testator can only be effected by conversion into permanent annuities, and the purpose of the rule is well implemented. But the process of judicial development is frequently one of progressive crystallization, during which the original rationale is lost sight of. In this case a rule, originally formulated to implement a testator's intention that interests in succession should be enjoyed, hardens into an inelastic rule compelling conversion of all unauthorized investments, which are 'deemed to be more or less hazardous.' More often than not this rule has the effect, not of implementing, but of defeating, testators' intentions, for its usual effect is to improve the position of the remainderman at the life tenant's expense, whereas testators are more often concerned to provide an adequate income for the life tenant.

An awareness of the injustice of the rule, and its tendency to defeat testamentary intentions, has led many judges 'to allow small indications of intention to prevent the application of the rule',[10] and to lean against conversion 'as strongly as is consistent with the supposition that the rule itself is well founded.'[11] This itself is undesirable, for the drawing of fine distinctions has left this part of the law in such an amorphous condition that particular situations are frequently difficult to characterize, so that it is very often necessary to take out

9 *Macdonald v. Irvine* (1878) 8 Ch. D. 101, 113, *per* Baggallay L.J.
10 *Morgan v. Morgan* (1851) 14 Beav. 72, 82, *per* Romilly M.R.
11 *Hinves v. Hinves* (1844) 3 Hare 609, 611-612, *per* Wigram V.C.

an originating summons for the court's opinion.[12] Underhill devotes several pages[13] to the explanation of when the rule is not applicable – it does not apply to settlements *inter vivos,* it does not apply to property given specifically, it does not apply where a contrary intention is expressed or where the rule is impliedly negatived, and so on. The mass of litigation which the rule has led to has provided much work for lawyers over the last century and a half, but when a rule has such a complicating effect, its adherents should be able to point to many compensating advantages in order to justify its retention.

III

As we have seen, nothing was said in *Howe v. Dartmouth* itself about a duty to convert any unauthorized securities other than 'perishables' – the duty to convert all unauthorized investments was a matter for subsequent judicial exegesis. But the rule, as it is stated today, seems to have become fixed before the end of the first half of the nineteenth century. As thus stated it postulates the insecurity of unauthorized investments.[14] It has already been hinted[15] that this assumption is no longer justified. We turn now to an examination of subsequent developments which have contributed to the present-day stability of commercial enterprises. The main development of this nature has been an increased insight into the function of accounting.

It is commonly said that the function of the depreciation allowance in accounting is to maintain capital intact. If this is so, and if the practice of the accounting profession is to make the proper depreciation allowances, then there is little danger of the position of the remainderman being jeopardized by the retention of unauthorized shares by the executor.

Present accounting doctrine conceives of depreciation as a deferred charge to revenue, as a means, that is, of allocating the cost of any asset – such as plant and machinery – that will be consumed in operations over a period of time, to those periods during which it is used. Its cost is treated as a prepaid operating expense, to be distributed over the years of service of the asset. This is done generally by dividing the difference between the purchase price of the plant and the estimated scrap-value on retirement by a figure representing the estimated number of years during which the asset will be used. The figure arrived at – the annual depreciation allowance – must be taken into account before one can say what are the annual profits available for distribution as dividends. If a company discloses 'profits' arrived at without taking into account the depreciation in value, owing to wear and tear, or effluxion of time, suffered by its fixed assets by their

[12] Underhill advises this. *Law Relating to Trusts and Trustees* (10th ed., 1950), 280.
[13] *Ibid., Article* 47. [14] *Supra,* n. 4. [15] *Supra,* n. 7.

use in earning income, and then distributes such 'profits' among the shareholders by way of dividends, it will, in fact, have effected a return of capital to shareholders to the extent to which depreciation has been ignored. Suppose that a company spends £160,000 on machinery to be used in the manufacture of goods for sale. It is estimated that the machinery will last fifteen years, and that, at the end of this period it will require to be scrapped, and will have a scrap-value of £10,000. It is evident that over the fifteen-year period the cost of manufacturing the company's goods will be, not only the amount paid for wages and other current working expenses from week to week, but also the amount of £150,000 representing the net expenditure on the machinery. If sufficient of the company's earnings are not retained over the fifteen years to recoup this amount, then the company will, in fact, have returned the net investment in machinery by way of dividend (assuming it has distributed all its 'profits') to its shareholders. Today it is realized that it is essential to the continuity of business enterprises that a proportion of the inevitable expiration in value of fixed assets be treated as an integral cost of operating the business before profits can be ascertained, but the important point for the purposes of this article is that this realization represents part of a development subsequent to the decision in *Howe v. Dartmouth.*

For in 1802 accounting doctrine was comparatively immature. The influence of the corporation in improving accounting doctrine[16] is a later development.[17] For although the need to pay dividends out of profits alone is now 'accepted as almost axiomatic and needing no further justification . . . in order to ensure real continuity of existence . . . this has not always been equally obvious; in the earlier days the reasons for this restriction of dividends were being formulated and the principles by which the available profits should be calculated

[16] Littleton, *Accounting Evolution to 1900*, (1933) 206, emphasizes the theory that a corporation is a continuing enterprise, and that money invested in the corporation's stock is not a 'venture' from which a profit or loss will materialize, when a 'division' is made, but is rather a long lived 'investment' from which periodic returns will flow. If the corporation lives up to this expectation it must constantly and carefully distinguish between that which is capital and that which is income. The power of expressing the difference between these two elements is one of the basic characteristics of double entry book-keeping, and the accurate computation of the actual periodic income is one of the chief functions of accounting. Therefore, so far as the corporation made such a distinction in elements increasingly important, just so far it stimulated the expansion of book-keeping into accounting.

'The central accounting issue in a corporation concerns the amount of profit available for dividends. This in turn is primarily a matter of preserving the proper distinctions between capital and income. It is at this point that the corporation influences accounting most.'

[17] *Ibid.*, 214-215. 'A survey of the *Revised Reports* (English) 1785-1866 and John Mew's *Digest of English Case Law* fails to reveal much of interest during this time concerning profits and dividends. The corporation cases brought before the courts dealt mostly with questions of corporate powers to contract and to borrow, or with the powers and liabilities of directors, actions brought by or against shareholders in allotment of shares, calls upon subscription contracts and so on. But in the '60's and '70's numerous cases were adjudicated which dealt with questions of profits or dividends.'

were being determined.'[18] Littleton, after making a close study of the available records traces the nascent development of accounting doctrine to the mid-nineteenth century:

'. . . Yet even the best bookkeeping practice reflected a very simple concept of depreciation. The treatment accorded a depreciating property in the accounts was to enter it at the end of a period on the credit "as if sold". The method was a strict analogy to the goods account of the oldest texts. Depreciation apparently was not regarded as expense or cost but as loss, as "decay from use" . . .

'Although it was more correct to look at depreciation in this light than to ignore it completely, this simple concept was nevertheless an inadequate view of the real nature of depreciation. *But there is little evidence of fresh ideas regarding depreciation until the middle of the nineteenth century.*'[19]

Another writer puts the date of this development even later than this:

'Accounting principles remained virtually unchanged until the last quarter of the (nineteenth) century, when an awareness . . . of the necessity for providing for future contingencies, took shape in the setting up of provisions for amortization and for renewals and the funds to finance them.'[20]

Again another writer agrees with Littleton's view: 'The enormous advancement of technique in manufacturing, transportation and exchange, the vast emancipative enrichment of social legislation during the first half of the nineteenth century have combined without much doubt to give the 1850's a special significance *vis-à-vis* accountancy progress, culminating in the first attempts to establish the technique as a profession.'[21]

When the dates of incorporation of the various Accountancy Institutes are also considered,[22] one must concede that the evidence is overwhelming that a renaissance in accounting doctrine took place in the latter half of the nineteenth century.

We have seen then that the annual depreciation allowance is used today as a means of synchronizing the costs of operating a business with the periods over which those costs are being incurred in a society where continuous enterprises are the rule and single ventures of limited duration the exception. We have also seen that 'cost of production' conception of depreciation was stimulated by the evolution of

[18] *Ibid.*, 215. [19] *Ibid.*, 227 (italics supplied).

[20] N. K. Hill, 'Accounting Developments in a Public Utility Company in the Nineteenth Century,' (1955) 6 *Accounting Research*, 388.

[21] N. A. H. Stacey, *English Accountancy 1800-1954* (1954).

[22] They are, *inter alia:* Scottish Society of Accountants, 1854. Incorporated Society of Liverpool Accountants, 1870. Institute of Accountants (London), 1870. Manchester Institute of Accountants, 1873. Sheffield Institute of Accountants, 1877. Institute of Chartered Accountants in England & Wales, 1880. Institute of Chartered Accountants in Ireland, 1888.

the corporation,[23] but that in the early nineteenth century the continuous venture was a new development and the need to recoup capital by means of the depreciation reserve was not so clearly perceived as it is now. The commercial structure was being transformed from one primarily comprised of discrete ventures of limited duration to one the main feature of which is the permanent enterprise, but inevitably there was a doctrinal time lag. In this 'formative period of accountancy'[24] the occasions must have been frequent on which the failure to perceive the relation of depreciation to net income led to the ignominious winding-up of ventures. For without the present-day appreciation of the need for a continuous enterprise to take depreciation into account before ascertaining profits available for dividend distribution, the chances of dividends being paid out of what is really capital are considerably increased. When this occurred the inevitable result would be liquidation and the payment of a portion of the face value of the shares to the shareholders at the date of liquidation. It is a fair speculation that this was a frequent occurrence in the early nineteenth century.[25] In just such a society the rule in *Howe v. Dartmouth* would have been an eminently desirable technique for preserving a balance between life tenant and remainderman. But the need to protect the remainderman implicit in the rule in *Howe v. Dartmouth* is not nearly so acute today.

IV

We have seen that the provision for depreciation greatly contributes to the capital security of a company, and it is clear that it is customary today for this provision to be made. As Barton says:

> There does not seem to be any doubt as to what is the customary procedure amongst honestly and prudently conducted companies in the matter of making adequate provision for depreciation (used in the proper sense) of fixed assets before arriving at divisible profits. This practice is so customary that even our Income Tax legislation permits of reasonable deductions under this heading, as part of the expenditure properly incurred in the production of income. Whilst this is not, of course, conclusive, it is evidence that such a charge can almost universally be regarded as proper.[26]

[23] *Supra*, n. 16.

[24] A. C. Littleton, *op. cit., supra*, n. 16, 165.

[25] *Cf.* the words of Sir Owen Dixon, spoken when still at the Bar, in the course of a lecture delivered to the Incorporated Accountants' Students' Society of Victoria on 19 November 1919: 'Today so little difficulty is felt in the failure of a company to pay 20s. in the £ that we forget the frequent suffix "limited" is used to indicate the fact that there is only limited liability upon those interested in the corporation.' Commonwealth Accountants' Students' Society, Pamphlets, 8. ('Some of the consequences which result from the incorporation of companies').

[26] A. E. Barton, 'Is a Company Required to Make Provision for Depreciation of Fixed Assets Before Arriving at Divisible Profits?' (1948) 18 *The Chartered Accountant in Australia*, 687, 696.

Yamey supports this rather obvious statement:

> The majority of responsible business men and all accountants would certainly insist that normal (wear and tear) depreciation must be deducted when calculating divisible profits.[27]

But it might be objected that a mere unsanctioned *practice* would provide little guarantee of capital security; thus it is proposed in this part to enquire whether the law reinforces this practice by imposing a legal obligation to provide for depreciation.

Professor Dicksee declares that 'there is no general requirement of law which *compels* any company to make provision for depreciation before declaring dividends out of its earnings',[28] and there are many who agree with him.[29] Despite this formidable grouping of authority, however, it is submitted that such a view is merely a facile conclusion from the decided cases, which do not warrant such a dogmatic statement. It is perhaps appropriate to observe here that the latest editor of Dicksee states the position with more circumspection, apparently doubting the soundness of the view formerly expressed. That editor, Brian Magee, expresses the following opinion: 'The legal necessity for this provision (for depreciation) has, however, been rendered somewhat doubtful by many decisions which have been given in the courts from time to time . . . It may be stated, however, that the general effect of all these decisions was that *in certain circumstances it might not be necessary* for a company, before declaring a dividend out of profits alleged to have been earned, to provide in that year's accounts for the whole of the loss caused by the depreciation of the whole or some portion of its assets.'[30]

Many of the accountancy commentators[31] have assumed that the case of *Lee v. Neuchatel Asphalte Co.*[32] is authoritative not only in respect of companies formed to work wasting properties but also in respect of permanent enterprises. It is trite law that 'general language used by the court in giving their opinions in any case must always be understood with reference to the subject matter then before them.'[33] Yet certain words of Lindley L.J. in *Lee's* case have been seized upon and quoted out of context to suggest a universal principle that was not intended by the author of those words. His Lordship is quoted as saying that the Companies Acts 'do not require the capital to be made up if lost', and do not prohibit payment of dividends, 'so long as the assets are of less value than the original capital.'[34] The fact that

[27] B. S. Yamey, 'Law relating to Company Dividends' (1941) 4 *Modern Law Review*, 273, 288.

[28] L. R. Dicksee, *Auditing* (16th ed., 1940) 189.

[29] R. F. Fowler, *The Depreciation of Capital Analytically Considered* (1934), 122; E. E. Spicer and E. B. Pegler, *Practical Auditing* (9th ed., 1949), 369; A. A. Fitzgerald, *The Classification of Assets in Accounting Research*, i, (1948-50) 357, 366.

[30] Dicksee, *Auditing* (17th ed., 1951) 273-274.

[31] *Supra*, nn. 28, 29.

[32] (1889) 41 Ch. D. 1.

[33] *Doe v. Guy* (1802) 3 East 123, *per* Lord Ellenborough C.J.

[34] *Supra*, n. 32, 23.

the company's operations comprised the working of a wasting property is ignored, whereas this fact is crucial to any assessment of the *ratio decidendi* of the *Lee* case. At least two members of the Court of Appeal relied on this fact in making their decision. Cotton L.J. observed: 'If this property was 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',[35] while Lindley L.J. preceded some of the observations most frequently quoted with the sentence: 'Now we come to consider how the *Companies Act* is to be applied to the case of a wasting property.'[36] If further proof be needed that Lindley L.J. intended to confine his observations to the case of a wasting property, it is provided by the words of the Lord Justice himself in the subsequent case of *Verner v. General and Commercial Investment Trust Ltd.*[37]: 'It was decided in that case [*Lee v. Neuchatel Asphalte Co.*] . . . that a limited company formed to purchase and work a wasting property, such as a leasehold quarry, might lawfully declare and pay dividends out of the money produced by working such wasting property, without setting aside part of that money to keep the capital up to its original amount.'[38] The latest editor of Dicksee also stresses the 'distinction . . . between the case of a company which is formed with the object of acquiring and working a wasting property and that of a company which may be expected to carry on its business for an indefinite period'[39] in the context of the necessity to provide for depreciation.

It may even be suggested that Lord Justice Lindley's self-assessment of the *ratio* of the *Lee* case is too widely stated insofar as it suggests that in no circumstances need the transitory concern provide for depreciation. Plaintiffs in *Bond v. Barrow Haematite Steel Co. Ltd.*[40] made the mistake of failing to take into account the special circumstances of the *Lee* case when they relied on it 'as an authority for this proposition as a universal negative, namely, "that no company owning wasting property need ever create a depreciation fund." '[41] As Farwell J. goes on to observe, 'that is not the true result of the decision. It must be remembered that in that case there had been no loss of assets. The company's assets were larger than at its formation, and the court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund.'[42] Another special feature of that particular transitory enterprise which must have contributed to the court's decision condoning the failure to provide for depreciation was that its articles provided that the directors should not be bound to reserve moneys for the renewal

[35] *Ibid.*, 17. [36] *Ibid.*, 24. [37] [1894] 2 Ch. 239. [38] *Ibid.*, 265.
[39] Dicksee, *Auditing* (17th ed. B. Magee 1951), 274. *Cf.* n. 56, *infra*.
[40] [1902] 1 Ch. 353. [41] *Ibid.*, 367, *per* Farwell J. [42] *Ibid.*

or replacing of any lease, or of the company's interest in any property or concession.[43]

The foregoing analysis of *Lee v. Neuchatel*[44] disposes of that case, but how can we account for the case of *Verner v. General and Commercial Investment Trust Ltd.*?[45] This may also be distinguished, as Barton suggests, on the ground that the assets in question were investments which had 'fluctuated', not depreciated, and the depreciation concept of expired capital outlay (expounded above in Part III) is impervious to fluctuations in market value of assets. Gilman puts this last point well when he says:

> Based upon this 'going business' convention, no attempt is made on December 31 of each year to value all the assets of a company on a realizable basis. Rather the emphasis is shifted to the amortizing of initial costs.
> Clearly this shift represents an important change of viewpoint, since the resulting asset figures are not influenced by market price fluctuations ascribable to the law of supply and demand.[46]

And compare:

> There were, therefore, three stages in the development of fixed asset accounting, the first involving actual realization, followed by the second involving fictitious realization by valuation, and third a recovery of original cost based upon a preliminary estimate of the length of the asset's life. Unlike the first two, the third is not influenced by varying market prices and attempts merely to distribute the cost of the asset over the years which benefit from its use.[47]

In the light of this, surely Barton is right when he suggests that 'there is nothing in this judgment [in *Verner's* case] applicable to the question of, say, depreciation of machinery, due to the manufacture of goods which produce the profit.'[48] Barton's conclusion is that:

> So far as I have been able to ascertain, there does not seem to have been any case, dealing directly with the question of the obligation on a company to provide for depreciation (in its true sense), since the cases of *Davison v. Gillies* (1879) 16 Ch. D. 347, and *Dent v. London Tramways Company* (1880) 16 Ch. D. 344. If we exclude from consideration those cases dealing with depletion of assets, due to such assets being themselves consumed by their use as stock-in-trade (wasting assets), and those cases dealing with variations in the value of fixed assets, due to influences not associated with their use in the business (fluctuating assets), there appears to be no definite decision, so far as limited companies are concerned, later than the two London Tramway cases just referred to.[49]

It is true that authority is meagre—which merely indicates how

[43] (1889) 41 Ch. D. 1, 22.
[44] For this analysis I am indebted to A. E. Barton, *op. cit., supra*, n. 26.
[45] [1894] 2 Ch. 239. [46] Stephen Gilman, *Accounting Concepts of Profit*, (1939), 81.
[47] *Ibid.*, 87. [48] A. E. Barton, *op. cit.*, 693. [49] *Ibid.*, 695.

deeply settled is the practice of making provision for depreciation – but unfortunately it must be noted that Barton's researches did not take him as far as the case of *In re Kingston Cotton Mill Company* (No. 2),[50] a decision, it must be admitted, contrary to the present thesis. In that case Vaughan Williams J. held that it was not necessary for an ordinary trading company to provide for depreciation. His Lordship said in the course of his judgment, 'It is true that the present case is not the case of a company formed to work a necessarily wasting property as was the case in *Lee v. Neuchatel Asphalte Co.*, nor the case of an investment company as in *Verner's* case; but I think that this case falls within the principles of those two cases read together.'[51]

On the other hand, *Re Kingston Cotton Mills* is a decision of a single judge sitting in the Chancery division, and against it must be balanced the decision of Jessel M.R. in a case referred to by Barton, *Davison v. Gillies*,[52] which was neither cited by counsel nor referred to by the court in the *Kingston Cotton Mills* case. *Davison v. Gillies* took the form of a motion by the plaintiff suing on behalf of himself and all the other shareholders of the London Tramways Company for an injunction to restrain the defendants, the directors of the company, *inter alia* from applying any part of the assets of the company which represented capital in the payment of dividends on the shares in the company. The ground of the motion was that the company's tramways had become worn out, thus necessitating a large expenditure for repairs, no due provision for which had been made by the company in their accounts; and that consequently the company had no right to pay the dividends which had been declared until these repairs had been provided for, or, in other words until the capital so lost had been reinstated. In the course of his judgment in which he granted the injunction sought, Jessel M.R. observed:

> Then I have to consider the question, What are net profits? A tramway company lay down a new tramway. Of course the ordinary wear and tear of the rail and sleepers, and so on, causes a sum of money to be required from year to year in repairs. It may or may not be desirable to do the repairs all at once; but if at the end of the first year the line of tramway is still in so good a state of repairs that it requires nothing to be laid out on it for repairs in that year, still, 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 line has, I may say, so far depreciated it in value as that that sum will be required for the next year or two years.[53]

His Lordship concluded:

> That being so, on the present evidence I am satisfied that there are no profits at present available for division. It may happen that there would

[50] [1896] 1 Ch. 331. [51] *Ibid.*, 348. [52] (1879) 16 Ch. D. 347. [53] *Ibid.*, 348.

have been profits if the company had properly applied the surplus of former years.[54]

Another case favouring Barton's view of the law is that of *Thomas v. Crabtree*,[55] which was not, however, concerned with a limited company. In that case the profits of a business were payable to a tenant for life. The trustees charged against the profits, not only the cost of repairs of the machinery used in the business, but also a yearly sum for depreciation at the rate of seven and a half per cent. The life tenant objected to this charge, but the court upheld the action of the trustees. The life tenant's appeal to the Court of Appeal was unsuccessful. Counsel for the life tenant specifically referred to the case of *Lee v. Neuchatel*, but Buckley L.J. replied that 'in such a case all profits arising from the wasting property is divisible without any deduction for the depreciation in value of the wasting property. This is because the object of the company was to acquire a wasting property and to divide all the profits. That is not so here. The profits of this business are not ascertained until a sufficient sum has been deducted to meet the depreciation of the machinery.'[56] Barton's understanding of the *Verner* case[57] is also supported by the words of Lord Justice Buckley which follow the above passage:

> One of the witnesses in his affidavit referred to the 'saleable value' of this machinery. That is not the right standard. Here it is the value of the machinery for the purpose of this business, not the saleable value.[58]

Concluding the examination of English law on this matter, the present writer wishes to adopt the conclusion of Barton:

> . . . This raises the question as to whether a company which wears out or exhausts fixed assets in the process of manufacturing, housing or disposing of goods can show its true profits, unless provision is made out of income to cover this depreciation. We have here to guide us the two London tramway cases, the dictum of Mr Justice Farwell in *Bond v. The Barrow Haematite Steel Co. Ltd.*, the judgment of the Court of Appeal in *Thomas v. Crabtree*, and the indication by the Courts that directors of a company are expected to conform with the procedure and standards set up by prudently and honestly conducted businesses of a like nature. To my mind there does not appear to be much doubt that, in such a company, reasonable provision for depreciation of fixed assets must be made before profits available for dividend are arrived at.[59]

But there is another consideration affecting the Victorian position — in section 367 we have an unalterable statutory prohibition against the payment of dividends out of capital.[60] English statutes since 1845

[54] *Ibid.*, 350. [55] (1912) 106 L.T. 49. [56] *Ibid.*, 51.
[57] *Supra*, n. 48. [58] (1912) 106 L.T. 49, 51. [59] Barton, *op. cit.*, 699.
[60] Section 367 of the Companies Act 1938 provides that: 'No dividend shall be payable to the shareholders of any company except out of profits' and imposes penalties of fines and imprisonment for the breach of this injunction.

have included a similar provision *as an article of Table A,* but the Victorian legislature introduced this provision as part of the statute in 1896.[61] The difference between a provision of Table A, which may be rejected or varied if desired, and a provision in the operative part of a statute, compelling all companies to comply, clearly appears from the judgment of Cotton L.J. in *Lee v. Neuchatel*:

> But we must consider exactly how the case stands. There is nothing in the Act which says that dividends are only to be paid out of profits. There is a provision to that effect in Table A, and that rather favours the view that the matter of how profits are to be divided and dealt with, and out of what fund dividends are to be declared, is a matter of internal regulation.[62]

The decisions which have been discussed in this part were all concerned with provisions in articles of association, and not with a statutory obligation such as section 367, so that it is probable, even conceding the correctness of Mr Justice Vaughan Williams' application of the *Lee* decision to an ordinary trading company, that Victorian companies are obliged to provide for depreciation.

V

Conclusion

It is possible to make many criticisms of the rule in *Howe v. Dartmouth,* for example that it frequently frustrates testators' intentions, that it represents a gratuitous intrusion, that it is generally excluded in properly drafted wills, that it leads to the drawing of over-sophisticated distinctions and has given rise to an immense amount of litigation. The strength and number of these criticisms have encouraged many to suggest its total exclusion from the law; the Victorian Law Institute roundly declared in 1945 that 'there is little doubt that the law would be better without the rule.'[63] The present argument, while it does not lead one to advocate such a root and branch abolition, suggests that the case for modifying the rule is a good one, on the ground that the hazard which attended most investments at the time when the rule was being hammered out no longer exists. The modification suggested would take the lines either of increasing the number of authorized investments for the purposes of the rule, or of framing a new duty in terms of an obligation to convert obviously hazardous investments or those in companies formed to work wasting assets.

It has been seen that the present conception of depreciation as 'amortized cost' is a fairly recent one and that it has brought with it

61 Act No. 1482 s. 48. 62 (1889) 41 Ch. D. 1, 17.
63 Report dated 17 August 1945 (18/4, 8. 1947-7561) 17.

a realization of the necessity of taking into account the inevitable gradual deterioration of fixed assets as an integral cost of operating the business. It is realized that this must be done before one can ascertain the net profits available for distribution as dividends. The infrequency of legal action is evidence that the practice of providing for depreciation is almost universal. And reinforcing this practice in modern society is the pressure of taxation. Finally, while it is not clear from the authorities whether there is a legal obligation to provide for depreciation, this very uncertainty may make directors reluctant to ignore depreciation. As Yamey says:

> The sole danger to management lies in the vagueness of the law. This, and the severe penalties which may follow the court's veto of a dividend payment, may deter the management from declaring a dividend in borderline cases.[64]

In Victoria, the danger of infringing section 367 of the Companies Act 1938 is especially strong.

All things considered, then, there is little likelihood today of the proper provision not being made. This and other developments have rendered interests in shares today much less hazardous, and the effect of this is to reduce the chances of endangering the remainderman's interest by retaining 'unauthorized' investments to such an extent that it is suggested that we are paying too high a price in protecting him in this way.

[64] *Op. cit. (supra*, n. 27), 289.