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CORPORATIONS-ALLOWANCE FOR DEPRECIATION OF REAL ESTATE IN DETERMINING SURPLUS, 34 MICH. L. REV. 287 (1935).

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CORPORATIONS — ALLOWANCE FOR DEPRECIATION OF REAL ESTATE IN DETERMINING SURPLUS — In a proceeding to review the election of directors it became necessary to determine whether or not a certain declaration of dividends was lawful. The Delaware statute provides that dividends may be de-

clared either "out of its [the corporation's] net assets in excess of its capital" or "in case there shall be no such excess, out of its net profits for the fiscal year then current and/or preceding fiscal year."¹ It was admitted that there had been no profits during the current or preceding fiscal year, and it was found that in calculating the surplus no allowance had been made for bad debts against the asset item of loans receivable, and that no allowance had been made for depreciation in a real estate investment. *Held*, that due allowance should be made for bad debts and depreciation on real estate in determining the surplus, and that since the surplus item disappeared when such allowances were made, the dividend was not lawfully declared. *Vogtman v. Merchants' Mortgage & Credit Co.*, (Del. Ch. 1935) 178 A. 99.

Although the decisions are not all in harmony, the majority of American courts require a corporation to make due allowance for depreciation of tangible assets in determining the state of the surplus account for the purpose of declaring dividends.² But the general rule is susceptible of variations within itself, for the statement that a corporation must allow for depreciation would seem to be too broad to serve as a definite course of action for the corporation to follow. There are at least three well-recognized methods of determining depreciation, based on the straight-line theory, the replacement theory, and the 50 per cent theory;³ and it becomes clear upon a moment's reflection that different theories, applying different mathematical formulas, will produce different results, so that, for example, in a given situation it is conceivable that use of the replacement theory will show a paper surplus, while use of the straight-line theory will show the non-existence of a surplus or even an actual impairment of capital.⁴ Thus, the result might be that dividends are lawfully or unlawfully declared, depending upon the accounting system used by the company. The instant case does not lay down any definite method to be followed in determining depreciation, and in this respect is typical of the cases on the subject.⁵ Perhaps, as has been suggested,⁶ the courts have not prescribed any particular method for depreciation for the reason that the straight-line method is generally accepted as the most reasonable. In the instant case the court held that the real estate was overvalued by \$11,445, basing its

¹ Quoted, (Del. Ch. 1935) 178 A. 99 at 101-102.

² REITER, PROFITS, DIVIDENDS, AND THE LAW 124-127 (1926); 2 COOK, CORPORATIONS, 8th ed., 1900-1903 (1923), and cases cited. For a recent discussion and evaluation of the case law on depreciation, see 33 MICH. L. REV. 783 at 794-801 (1935).

³ For an explanation of these three theories, see 33 MICH. L. REV. 783 at 785-794 (1935).

⁴ Under the replacement theory "there is no recognition of actual depreciation nor provision for theoretical depreciation for the period during which the plant is attaining its natural gait." 33 MICH. L. REV. 783 at 790 (1935).

⁵ See 33 MICH. L. REV. 783 at 800 (1935).

⁶ "Dividend cases directly upholding the validity of a straight-line charge for depreciation even by inference are remarkably rare. The writer is inclined to think that this paucity of cases is attributable to a belief in the legal acceptability dictated by the inherent reasonableness of the method as previously discussed." 33 MICH. L. REV. 783 at 800 (1935).

conclusion upon the testimony of an expert on real estate.⁷ The soundness of the method applied by the court is affected by the nature of the asset. The opinion failed to state whether the "real estate" referred to by the court⁸ consisted of land only or of land and buildings. In general, accountants allow for depreciation of buildings, but do not allow for depreciation of land.⁹ A Delaware statute, cited in the instant case,¹⁰ provides that dividends shall not be declared out of profits for the current or preceding fiscal year if the capital "shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount" less than the outstanding preferred stock.¹¹ The court has apparently construed this statute as requiring that land, as well as other assets, be revalued in determining surplus.¹² Since the statute makes no distinction between land and other assets this view is perhaps not unreasonable. If, then, we are to accept the court's premise that land must be revalued, we cannot quarrel with the method used in determining the present value. Since land is not subject to "wear and tear," as are buildings and equipment, the ordinary methods of ascertaining depreciation have no application to land,¹³ and the only reasonable method of determining such present worth is by appraisal. But if the "real estate" in question consists of land and *buildings*, then, for so much of the asset as is represented by buildings, the method employed by the court is not in accord with orthodox accounting principles. Since buildings are subject to the ordinary ravages of time and use, the proper method for ascertaining their present worth, so far as determination of surplus is concerned, is to employ one of the recognized methods of calculating depreciation of tangible assets.¹⁴ It would seem to follow that in such case the court should commit itself to some one of the recognized depreciation methods, and require the corporation to adopt that method and to determine thereby the present worth of the asset; after these steps have been taken, the court can look to the books of the corporation and ascertain therefrom

⁷ 179 A. 99 at 103.

⁸ 178 A. 99 at 102-103.

⁹ For a thorough discussion of the problem of revaluing land, see PATON, ACCOUNTANTS' HANDBOOK, 2d ed., 475-476 (1932); PATON, ACCOUNTING 367-369 (1924). The general rule that land will be carried at cost and will not be revalued applies to land held for investment purposes. 2 KESTER, ACCOUNTING THEORY AND PRACTICE, 2d ed., 211 (1922).

¹⁰ 178 A. 99 at 102.

¹¹ 36 Del. Laws, c. 135, § 16 (1929).

¹² Although the statute in question refers only to a dividend out of "profits for the fiscal year then current and/or preceding fiscal year," its application by the court to the instant case, in which it is admitted that there were no such profits, would not seem unreasonable so far as a declaration of accounting policy in the matter of calculating surplus is concerned, since accountants would use exactly the same methods in calculating surplus as they would in determining the extent of impairment of capital.

¹³ "Land used for business purposes is not in general subject to serious physical deterioration, and hence there is no reason in this case for the systematic recognition of depreciation charges." PATON, ACCOUNTING 368 (1924).

¹⁴ See HATFIELD, ACCOUNTING 85 (1932); 2 KESTER, ACCOUNTING THEORY AND PRACTICE, 2d ed., 324 (1922); PATON, ACCOUNTING 338-343 (1924).

whether or not there is a surplus and whether or not dividends were lawfully declared. It is submitted that this approach would be consistent with general principles of accounting and would induce certainty in corporate practice.

W. A. G.