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Trusts-Apportionment of Stock Dividends-Principal and Income

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TRUSTS—APPORTIONMENT OF STOCK DIVIDENDS—PRINCIPAL AND INCOME.— This was a suit by the life beneficiary of a trust to get such an interpretation of the trust agreement as would compel the trustee to treat stock dividends received upon shares held in the trust as income to go to such life beneficiary. The trustee had, in the absence of any specific expression of the settlor's in respect to stock dividends, treated such dividends as principal belonging to the corpus of the trust. Held, that stock dividends received upon shares held in trust are principal and not income distributable among life beneficiaries.[1] This question had never before been passed upon by the Indiana courts.

In determining who is entitled to a stock dividend upon shares held in trust, as between the life tenant and remainderman, it is generally held that the intent of the settlor must govern, if sufficiently indicated in the trust instrument and not contrary to a statute or rule of policy.[2] When, however,

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[1] Powell et al. v. Madison Safe Deposit & Trust Co. et al. (1935), 196 N. E. 324.

[2] Gibbons v. Mahon (1890), 136 U. S. 549, 10 Sup. Ct. 1057; In re Robinson's Trust (1907), 218 Pa. St. 481, 67 Atl. 775.

there is no evidence of the settlor's intent, courts have reached various results in determining whether the stock dividend should be treated as income to go to the life tenant, or as principal to go to the remainderman.

The problem was first presented in England, where, prior to 1887, all unusual or extraordinary dividends were held to be capital, whether in the form of cash or stock, and were given to the remainderman exclusively.[3] The later English rule, laid down in *Bouche v. Sproule*[4] in 1887, resembles very closely the Massachusetts rule *(infra)* in that the intent and purpose of the corporation in the individual instance is controlling as to whether the dividend shall be called income or capital. In that case the court held that as regards corporations which had the power of either distributing their profits as dividends or of converting them into capital, the intention of the corporation in declaring the dividend was decisive as to whether it should be considered income or capital in a trust. As this rule controls in England today[5] great importance attaches to the intention and purpose expressed by the directors for the declaration of the dividend, as this is the basis upon which apportionments are made by the courts between capital and income.

In the United States the problem came before the Massachusetts court in the early case of *Minot v. Paine*[6] and the so-called "Massachusetts rule" was developed as a solution. The rule, as simply stated by the court in that case, is "to regard cash dividends, however large, as income, and stock dividends, however made, as capital." The court expressly acknowledged the rule to be one of expediency rather than one which scientifically apportioned the dividends according to the time they were earned. This rule was adopted by the Indiana court in the instant case. After reviewing the Massachusetts and Pennsylvania rules, the court stated "This is the Massachusetts rule, which we feel to be sound in principal, and which has the advantage of simplicity in operation. We therefore adopt it."[7]

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[3] Brander v. Brander (1799), 4 Ves. Jr. 185, 31 Eng. Repr. 815; Paris v. Paris (1804), 10 Ves. Jr. 185, 32 Eng. Repr. 815; Irving v. Houston, 4 Paton (Scot.) 921; Witts v. Steere (1807), 13 Ves. Jr. 363, 33 Eng. Repr. 330; Clayton v. Gresham (1804), 10 Ves. Jr. 288, 32 Eng. Repr. 855.

[4] L. R. 12 App. Cases 397, 57 L. T. (N. S.) 345.

[5] Bouche v. Sproule (1887), L. R. 12 App. Cases 397; Jones v. Evans (1913), 1 Ch. Div. 23; Re Alsbury (1890), L. R. Ch. Div. 237; Re Hatton (1917), 1 Ch. Div. 357.

[6] (1868), 99 Mass. 101.

[7] Other courts following the Massachusetts rule are Supreme Court of United States—Gibbons v. Mahon (1890), 136 U. S. 549, 10 Sup. Ct. 1057.

Connecticut—Mills v. Britton (1894), 64 Conn. 4, 29 Atl. 231.

District of Columbia—Lanston v. Lanston (1923), 290 Fed. 315.

Illinois—DeKoven v. Alson (1903), 205 Ill. 309, 68 N. E. 930.

Maine—Thatcher v. Thatcher (1918), 117 Me. 331, 104 Atl. 515.

Michigan—In re Joy's Estate (1929), 247 Mich. 418, 225 N. W. 878.

Missouri—Hayes v. St. Louis Union Trust Co. (1927), 317 Mo. 1028, 298 S. W. 91.

Nebraska—United States Trust Co. v. Cowin (1931), 121 Nebr. 427, 237 N. W. 284.

Ohio—Lamb v. Lehman (1924), 110 Ohio St. 59, 143 N. E. 276.

Rhode Island—Rhode Island Hospital Trust Co. v. Tucker (1931), 51 R. I. 507, 155 Atl. 661.

Virginia—Kauffman v. Charlottesville Woolen Mills Co. (1896), 93 Va. 673, 25 S. E. 1003.

This rule does not apply to cash dividends made by a corporation when the dividends are in fact a distribution from funds obtained by a sale of permanent capital or physical assets,[8] nor does it include dividends which represent an increment of capital assets from a source other than earnings,[9] the dividends in both these instances going to the corpus as principal. Neither does the rule apply when the stock distributed among the stockholders is that of another corporation purchased with funds earned during the tenancy,[10] nor when a corporation declares a cash dividend from earnings and votes an increase of the capital stock to a like amount on the same day, the owners of the shares having the option of taking the cash or using the dividend to pay for the newly voted stock.[11] In both of these instances the dividend was held to be income to go to the life beneficiary.

Another solution was reached by the Kentucky courts in 1892 when in *Hite v. Hite*[12] the rule was laid down that as between a life beneficiary in corporate stock and the remainderman, a stock dividend will be treated as income if it in fact represents a profit earned by the corporation. Under the rule thus laid down, all dividends, ordinary and extraordinary, stock and cash, are considered income to go to the life cestui if they in fact represent a distribution of earnings, no matter when such earnings were accumulated.[13] This rule is now followed by a small minority.[14]

The Pennsylvania courts treated the question in a still different manner when in Earp's Appeal[15] the court decided that the life tenant was entitled to such portion of the income of the corporation as was earned and distributed during his term, whether in the form of cash or stock dividends.

West Virginia—Security Trust Co. v. Rammelsburg (1918), 82 W. Va. 701, 97 S. E. 122.

Statutes of Connecticut (Conn. Gen. Stat. 1930, § 4966), Georgia (Ga. Civil Code 1926, § 3667), New York (Laws 1926, c. 843), and Oregon (Ore. Laws 1931, c. 371, § 5) have adopted rules for dividend distribution substantially like the Massachusetts rule.

8 Heard v. Eldredge (1872), 109 Mass. 258 (a dividend declared by a corporation from money received for property condemned by eminent domain proceedings).

9 Gilkey v. Paine (1888), 80 Me. 319, 14 Atl. 205 (distribution of shares purchased with proceeds of bond issue considered capital).

10 Grey v. Hemenway (1912), 212 Mass. 239, 98 N. E. 789; Smith v. Cotting (1918), 231 Mass. 42, 120 N. E. 177; United States v. Phellis (1921), 275 U. S. 156, 42 Sup. Ct. 63.

11 Hyde v. Holmes (1908), 198 Mass. 287, 84 N. E. 318.

12 93 Ky. 257, 20 S. W. 778.

13 Cox v. Gaulbert (1907), 148 Ky. 407, 147 S. W. 25; Goff v. Evans (1927), 217 Ky. 664, 290 S. W. 490; Lightfoot v. Beard (1929), 230 Ky. 488, 20 S. W. (2nd) 90.

14 Bryan v. Aikin (1913), 10 Del. Ch. 446, 86 Atl. 674; DuPont v. Peyton (1927), 15 Del. Ch. 255, 136 Atl. 149; Lightfoot v. Beard (supra); Goff v. Evans (supra).

15 (1857), 28 Pa. 368.

16 Pritchett v. Nashville Traction Co. (1896), 96 Tenn. 472, 36 S. W. 1064; in In re Duffill's Estate (1919), 180 Cal. 748, 183 Pac. 337, the court said: "The determination of the directors of a corporation as to the source of its dividends has no persuasive effect upon the court when it is required to decide whether a stock dividend constitutes income which goes to the tenant for lie or for years, or principal to be held for the benefit of the remainderman."

Courts following this decision have bound themselves to go behind the form of the dividend and ascertain just when the profits out of which it was declared were earned by the corporation.[16] "The effect of this rule is to give to the life tenant the income which has been earned since the trust came into being, but, at the same time, to preserve the value of the corpus as it was at the date of the death of the testator, or to use a more convenient term, to preserve the intact value of the estate."[17] The intact value is found by dividing the corporation's capital and surplus at the time when the trust begins to hold the stock by the total number of shares outstanding at the time, and multiplying the result by the number of shares held in the trust.[18] This rule has a substantial following.[19]

The Kentucky rule is the most vulnerable of the three doctrines. It has the advantage of simplicity of administration, but this is more than counterbalanced by its tendency to favor the life cestui at the expense of the remainderman, who, getting no portion of any dividend, ordinary or extraordinary, may be forced to accept a corpus in which the total value of the stock holdings in a particular corporation has been diminished by the awarding of stock and other extraordinary dividends to the life cestui. Too much emphasis is placed upon expediency with a corresponding sacrifice in accuracy of distribution.

If the Pennsylvania rule is applied, however, the pendulum swings to the opposite extreme, expediency of administration being sacrificed to gain a precise apportionment of each extraordinary dividend between capital and income. In making the apportionment, the value of the corpus must remain unimpaired, and an inquiry must be made to ascertain the value of the stock in the corpus as of the date of acquisition, the rule contemplating that only that portion of the stock dividend which was declared against earnings accumulated since the acquisition shall be classified as income.[20] A difficulty at once presents itself. If the stock represents shares in one of our modern industrial empires, will not the task of determining what portion of the stock

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[17] Re Nirdlinger's Estate (1927), 290 Pa. 457, 139 Atl. 200. In Stokes' Estate (1913), 240 Pa. 277, 87 Atl. 971, a corporation declared a $5.00 dividend upon stock of which the corpus had 171 shares. At date of testator's death the corporation had a capital stock of $60,008,000 and an accumulated surplus of $27,219,779. After his death an additional $3,110,868 was earned and added to the surplus. The amount of the dividend was 10% of the capital stock and amounted to $6,060,800. The court held that the lower court erred in awarding the live tenants only 3,110,868/30,330,647ths of the dividend, holding that it should have awarded the life interest 3,110,868/6,060,800ths of the $855 dividend going to the trust.

[18] Bogert on Trusts and Trustees (1935), sec. 848, p. 2456.

[19] California—In re Duffil's Estate (1919), 180 Cal. 748, 183 Pac. 337.
Maryland—Thomas v. Gregg (1894), 78 Md. 545, 28 Atl. 565.
New Hampshire—Holbrook v. Holbrook (1907), 74 N. H. 201, 66 Atl. 124.
New Jersey—Van Doren v. Olden (1868), 19 N. J. Eq. 176, 97 Am. Dec. 650.
Iowa—Kalbach v. Clark (1907), 133 Iowa 215, 110 N. W. 599.
Pennsylvania—Earp's Appeal (1857), 28 Pa. 368.
South Carolina—Wallace v. Wallace (1911), 90 S. C. 61, 72 S. E. 553.
Tennessee—Pritchett v. Nashville Trust Co. (1896), 96 Tenn. 72, 36 S. W. 1064.
Vermont—In re Heaton's Estate (1915), 89 Vt. 550, 96 Atl. 21.
Wisconsin—Soehnlein v. Soehnlein (1911), 146 Wis. 330, 131 N. W. 739.

[20] Re Sloan's Estate (1922), 258 Pa. 368, 102 Atl. 31.

dividend was declared against earnings accumulated since the trust obtained the shares be too costly to be practical? As the corporate balance sheet is only prima facie evidence of the value of the corporate assets, the trustee may be compelled to go behind these primary figures given by the corporation and determine the true condition. If the stock has been in the trust for a number of years and the corporation has handled millions of dollars in the interim, the expense and time required for the search would be great. If but a few shares were held by the trust, might not the expense of such an investigation easily eat up the entire dividend? And even after such an investigation by the trustee it is possible that the life cestui or remainderman will demand an adjudication of the apportionment with the consequent delay and expense attendant upon such litigation.

Nor are the courts agreed upon the basis that should be used to ascertain the intact value of the stock. The Pennsylvania decisions amply reflect the confusion existing upon this point, the court that originated the rule holding at different times that to determine the extent of the reduction in value of the shares in the corpus occasioned by a declaration of stock dividends (1) the market value of the stock at date of creation of the trust should be compared with the market value at date of such stock dividend,[21] (2) actual assets of the corporation should be compared,[22] (3) the par value of stock plus surplus should be compared,[23] (4) actual values and not book values should be compared,[24] (5) liquidating values of the stock should be compared,[25] and (6) that "going concern value" must be given full weight, the court adding that "under all situations that arise only the intact value is to be considered."[26]

Another criticism of the Pennsylvania rule is that in applying it trustees are prone to overlook the fact that an increase in the book value of shares of stock may represent not an accumulation of earnings, but a write-up of corporate assets occasioned by a rise in the value of land or stock owned by the corporation, which increase generally goes to the corpus as capital. If an apportionment were made on the basis of book value in such a case the life cestui would benefit at the expense of the remainderman.

The Pennsylvania court in *In re Stokes' Estate*[27] seemed to evince a desire for a change in the rule of that state, but later the rule was reaffirmed by the court and the same doctrine applied to stock rights[28] and profits from the sale of corporate stock held in trust.[29] It will be observed that New York, whose courts have followed both the Kentucky[30] and Pennsylvania[31] rules, adopted the Massachusetts rule by statute in 1926.[32]

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[21] Earp's Appeal (1857), 28 Pa. 368.

[22] Smith's Appeal (1891), 140 Pa. 344, 21 Atl. 438.

[23] Stokes' Estate (1913), 240 Pa. 288, 87 Atl. 975.

[24] Thompson's Estate (1918), 262 Pa. 278, 105 Atl. 273.

[25] Dickinson's Estate (1926), 285 Pa. 449, 132 Atl. 352.

[26] Jones v. Integrity Trust Co. (1928), 292 Pa. 149, 140 Atl. 862.

[27] (1913), 240 Pa. 288, 87 Atl. 975. The court here, after referring to and stating the Massachusetts rule, said: "If such rule is desired in Pennsylvania, we think the change should be made by the legislature rather than by the courts."

[28] Jones v. Integrity Trust Co. (1920), 292 Pa. 149, 140 Atl. 862.

[29] In re Nirdlinger's Estate (1927), 290 Pa. 457, 139 Atl. 200.

[30] In re Kernochan (1887), 104 N. Y. 618, 11 N. E. 149.

[31] In re Osborne (1913), 209 N. Y. 450, 103 N. E. 723.

[32] Laws 1926, chap. 843.

In application the Massachusetss rule strikes a medium between the Kentucky and Pennsylvania rules. Like the Kentucky rule it is arbitrary in determining the rights of the life cestui and remainderman, and it is like the Pennsylvania rule in that it makes a rough attempt at apportioning the extraordinary dividends by giving all cash dividends, ordinary and extraordinary,[33] to the life cestui and allotting all stock dividends to the corpus. This rule of thumb apportionment is the main point of attack for critics of the rule, who point out that in the individual case an inequitable distribution might result from the use of such an arbitrary method. This is a valid objection and it must be balanced against the possible uncertainty and impracticability of applying the theoretically perfect Pennsylvania rule.[34] It is true that in application the Massachusetts rule has a tendency to favor the remainderman at the expense of the life cestui in that some portion of the corporate assets capitalized by the stock dividend were probably earned after the trust acquired the stock, but it must also be considered that the Pennsylvania rule might easily do an injustice to the remainderman by throwing on him the burden of proving that part of the stock dividend represents capital and making him bear the expense of searching the corporate records to prove his contention.[35]

The most persuasive argument in favor of the Massachusetts rule is its ease and certainty of application. As it necessitates no detailed examination of the corporate records it is much less difficult and expensive in operation than the more precise Pennsylvania rule, and it also avoids the uncertainty generally attendant upon its use.[36] While it is true that equity should not be denied because of difficulty in ascertaining the respective rights of the life cestui and remainderman, it is equally true that uncertainty as to just what

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33 Except as modified by footnotes 8, 9, 10, and 11.

34 Some supporters of the Massachusetts rule hold that the remainderman has a logical claim to stock dividends, arguing that as the accumulated earnings capitalized by a stock dividend belong to the corpus before the dividend is declared and stock issued against them, the stock dividend should go to the corpus, as the distribution of the stock does not effect an actual distribution of corporate assets but only dilutes the equity in the corporation represented by each individual share. Their argument, however, overlooks the fact that part or all of the earnings so capitalized might represent profits made since the trust acquired the stock and hence be income to go to the life cestui according to the terms of the trust instruments.

35 In Nirdlinger's Estate (supra), the court stated that "An extraordinary dividend paid out of accumulated earnings presumptively belongs to the life tenant, but it is shown that the distribution impairs the intact value of the estate, the court will make an apportionment," and in Boyer's Appeal (1909), 224 Pa. 144, 73 Atl. 320, the court held that "As every dividend presumptively goes to the life tenant, the burden is on the remainderman to show any impairment of principal."

36 The uncertainty as to what the final apportionment may be is exemplified by Jones v. Integrity Trust Co. (supra), where the court said: "The question involved in this case is: How shall certain stock, received by the defendant trust estate as the result of an extra-ordinary stock dividend of 25 per cent be divided between the corpus of the trust and the life tenant who is entitled to the income thereof? To this, the court below, appellant, and appellee, have each given a different answer. It is certain, therefore, that two of them must be wrong; in reality all three are." Apparently there is no basis upon which to predict what will be the finally adjudicated rights of the parties when the Pennsylvania rule is invoked.

these rights are can be a cause of great inequity and should consequently be avoided when possible.

The U. S. Supreme Court has substantiated the Massachusetts rule by holding that "stock dividends representing merely surplus profits transferred to the capital account are not taxable to the shareholders as income within the meaning of the Income Tax Law of 1913."[37] The Uniform Principal and Income Act has also adopted the Massachusetts rule.[38]

The American Law Institute in its restatement of the Law of Trusts has adopted the Pennsylvania rule, stating that "extraordinary dividends declared during the period, whether in cash or in shares of the corporation or in other property, are income to the extent and only to the extent that they are declared out of earnings of the corporation which accrued subsequent to the creation of the trust or the acquisition of the shares by the trustee."[39] Bogert, however, in his recent work "Trusts and Trustees" states that "It is believed that the trend of recent opinion has been that the Massachusetts rule is the more desirable doctrine" and takes the position that from a practical point of view the Massachusetts rule is the best of the three rules followed today.[40] The fact that recent decisions in states where the question has come up for the first time have expressly adopted the Massachusetts rule[41] seems to support his contention. M. E. W.

CONTRACTS—ENFORCEMENT OF NEGATIVE COVENANTS BY INJUNCTION.—Defendant, upon entering employment of plaintiff as head salesman and branch manager, covenanted that he would not during the employment nor within eighteen months thereafter, engage in the business of selling merchandise handled by the plaintiff, either directly or indirectly, for himself or for others in any territory in which he had worked. After working for more than three years, the employment was terminated and a month later the defendant began selling merchandise of the type described in the contract. Plaintiff brought suit asking an injunction against the defendant restraining him from soliciting or diverting plaintiff's patronage. From a judgment sustaining a demurrer to plaintiff's complaint, the plaintiff appeals. Held, under the facts stated, the restraint would not be unreasonable or against public policy and the demurrer of the defendant should have been overruled. Reversed.[1]

Express negative covenants which restrict one person from competing with another or from accepting employment with a competitor, may be analyzed from the viewpoint of the subject-matter of the contract of which the covenants are a part. The division according to this classification would be:

(1) Covenants pertaining to or included in contracts of employment.
    (a) Covenants not to compete during the term of the employment.
    (b) Covenants not to compete after the termination of the employment.
(2) Covenants not to compete which are ancillary to the sale of a business or profession and its good will.

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[37] Towne v. Eisner (1917), 245 U. S. 418, 38 Sup. Ct. 158; Eisner v. Macomber (1920), 252 U. S. 189, 40 Sup. Ct. 189.
[38] Oregon Laws (1931), chap. 371, sec. 5.
[39] Sec. 236, subsec. (b), p. 492. [40] Sec. 857, p. 2483.
[41] In re Joy's Estate (1929), 247 Mich. 418, 225 N. W. 878; Hayes v. St. Louis Union Trust Co. (1927), 317 Mo. 1028, 298 S. W. 91.
[1] Grand Union Tea Co. v. Walker (1935), 195 N. E. 277 (Ind. Sup. Ct.).