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DIVIDENDS—INCOME OR CORPUS IN LIFE ESTATES?

William C. MacLean [1]

FOR years the dispute between life beneficiaries and remaindermen to corporate dividends or distributions during a life interest has presented a problem to the student of the law. The cash dividend so common in early corporation finance received first consideration in the courts. In later years, corporation finance evolved many different types of dividends, other than the cash dividend, and this development has caused a modification, and, in some instances, has required a reversal of the earlier decisions of the courts.

Dividends are a corporate profit set aside, declared, and ordered by the directors to be paid to the stockholders on demand or at a fixed time.[2] In a technical, as well as in an ordinary acceptation, dividends are that portion of the profits which the corporation by its directors, sets apart for ratable division among its shareholders. Until the dividend is actually declared by the directors, these corporate profits belong to the corporation and not to the stockholders.[3] Before being declared as dividends, corporate profits are liable for the corporate indebtedness the same as other assets of the corporation.[4] Originally cash dividends were the most common form of dividends, and for years the only type, but corporation finance in its more recent development has found justification for dividends payable in stock, in bonds, in script, or in the property of the corporation.

When a corporation has profits which are not in the form of money or cash, but are in the form of property,

1 Member of the Chicago Bar. Associated with Defrees, Buckingham, Jones and Hoffman.

2 In re Wilson's Estate, 85 Ore. 604.

3 Mobile & O. R. Co. v. Tennessee, 153 U. S. 486.

4 DeKoven v. Alsop, 205 Ill. 309.

and the company wishes to anticipate the time when the property may be or will be sold for cash and the cash distributed by a money dividend, then a script dividend is declared. Theoretically, a script dividend is a dividend of certificates giving the holder certain rights which are specified in the certificate itself. Sometimes the certificate entitles the holder to a sum of money payable with interest at a certain time after date, or at the option of the company, or even when the company shall have sufficient surplus to pay the certificates in full.[5] A script dividend may be rescinded after declaration providing no script has actually been issued.[6] Frequently script dividends are issued because a corporation cannot issue additional capital stock, the entire capital stock being already issued; sometimes they are issued to avoid taxes, and in many instances to increase the transferable interests without conferring upon the holder of the interest any voting power. It is possible, therefore, for script dividends to be practically the same as shares of stock, except, however, that the script has no voting power.[7]

A property dividend is, as the name implies, a division of the property of the corporation. For example, where a company has in its treasury, stock in another company, and distributes it among its stockholders, then such a dividend is a property dividend.[8] A dividend or distribution of the company's bonds among its stockholders is a property dividend providing the value of the corporation stock is not thereby impaired after the corporate debts are deducted from the assets.[9]

Stock dividends are dividends of the stock of the corporation. Such a dividend is legal providing an equivalent amount of profits are permanently added to the corporate property. Improvements of the corporate property or extensions of the business from the earned

[5] In re Robinson's Trust, 218 Pa. 481.

[6] Staats v. Biograph Co., 236 Fed. 454.

[7] Commonwealth v. Union Traction Co., 192 Pa. St. 507.

[8] Allegheny v. Pittsburg, A. & M. P. Ry. Co., 179 Pa. St. 414.

[9] In re De Soto Coal Mining & Development Co., 218 Fed. 892.

profits are frequently the basis for declaring stock dividends.[10] Although many believe it so, a stock dividend is not a withdrawal of the assets of the corporation—the stockholders own identically the same aliquot proportion of the assets as formerly. The stockholders actually gain nothing, and the corporation parts with nothing. The function of a stock dividend is to place in the hands of the stockholders an instrument whereby they can conveniently detract from the value of the shares of stock which they formerly held in order to vest new and equal rights in the person or persons to whom they might transfer the new shares of stock. Whatever of value passes to the purchasers of those new shares is withdrawn, not from the assets of the company itself, but from the antecedent equity or interest which is vested in the stockholders making the particular sale.[11] Some states regulate stock dividends by constitution. The Illinois Constitution contains a restriction upon stock dividends of railroads.[12]

Where an estate holds shares of stock and the income from the shares of stock is to go to the life tenant and the remainder to another party, it is often a perplexing and difficult problem whether the life tenant or the remainderman is entitled to the stock dividends or the unusual and extraordinary cash dividends. Courts of different jurisdictions have differed in the application of the rules governing this subject. In general there are three well defined rules or theories for the proper treatment of the distribution of corporate dividends or distributions during the life interest. These rules are known as the American or Pennsylvania rule, the Massachusetts rule, and the English rule.

Since the Pennsylvania rule prevails in nearly every state in the Union, it has been denominated the American rule. This rule proceeds upon the theory that the court, in disposing of stock or property or unusual cash divi-

10 Alsop v. DeKoven, 205 Ill. 309.

11 Great Western Min. & Mfg. Co. v. Harris, 198 U. S. 561.

12 Constitution of 1870, Art. XI, sec. 13.

dends, as between life tenant and remaindermen, may properly inquire as to the time when the fund out of which the extraordinary dividend is to be paid was earned or accumulated, and also as to the method of accumulation. In case it is found to have accrued or been earned before the life estate arose, it may be held to be principal, and, without reference to the time when it is declared or made payable, to belong to the corpus of the estate, and not to go to the life tenant. But when it is found that the fund, out of which the extra dividend is paid, accrued or was earned, not before, but after the life estate arose, then it may be held to be income and belong to the tenant for life. This equitable rule prevails not only in Pennsylvania where it was first declared, but also in California, Connecticut, Delaware, Iowa, Kentucky, Maine, Maryland, Michigan, Minnesota, New Hampshire, New York, North Carolina, South Carolina, Tennessee, Vermont, and Wisconsin.

In the absence of a contrary provision by statute, or in the will or other instrument creating the life interest, ordinary current dividends are payable, without apportionment, to the life beneficiary, if declared during the continuance of the life interest, and to the remainderman if declared before the commencement or after the termination of the life interest.

The intervals between the time of payment of ordinary cash dividends on stock are so brief, and the sums divided so small, that no great injustice can be done in denying apportionment. Difficulty in ascertaining the exact amount of profit made during fractions of a dividend period makes apportionment impracticable,[13] and the fact that the chance that the life tenant may benefit from earnings that accrued before the testator's death is in the long run balanced by the chance that the remainderman may benefit from earnings that accrued during the life tenancy.[14]

[13] Earp's Appeal, 28 Pa. St. 368.

[14] In re McKeown's Estate, 263 Pa. 78.

In *In re Brandreth's Estate,*[15] where a dividend was declared by a corporation on the 24th of November, and the person entitled to the dividends for life had died on the preceding 15th of November, and the last preceding dividend was declared on the 28th of October of the same year, it was held that the November dividend was not apportionable between the estate of the life tenant and those entitled in remainder under the New York Code Civ. Proc., sec. 2720, providing for the apportionment of "annuities, dividends, and other payments of every description, made payable or becoming due at fixed periods," notwithstanding that the corporation endeavored to pay dividends monthly; since such payments are dependent upon the amount of the earnings, and are subject to the power of the executive committee to increase or diminish them at its pleasure or convenience. And in *Waterman's Estate,*[16] ordinary dividends declared by a coal company, because the mines were opened during the lifetime of the testator, the court held belonged to the life tenant even though every dividend paid out by the company from money realized from the sale of coal mined, to a certain extent, diminished the assets which make up the value of the capital estate.

The intention of the testator, however, may alter the rule. Where the provisions in the will provided for apportionment and the parties in interest agreed upon the division, an apportionment of ordinary current cash dividends was upheld.[17]

The rule with regard to extraordinary distributions or dividends rejects the character of the dividend as a cash or a stock dividend as the criterion in determining the rights of the parties. On the other hand it inquires as to the time, relative to the commencement of the life estate, covered by the accumulations of earnings from which payment of the extraordinary dividend, whether stock or cash, was made. So far as it is sus-

15 72 N. Y. Supp. 333.

16 279 Pa. 491.

17 In re Barron's Will, 163 Wis. 275.

ceptible to practical operation this rule more nearly approximates justice between the parties in the treatment of this type of dividends.

The doctrine of apportionment of extraordinary dividends between the life tenant and remainderman was first enunciated in *Earp's Appeal.*[18] Although such dividends are presumably payable to the party entitled to the income at the time the dividend is declared, yet this presumption will yield to proof of the facts. Where by an extraordinary dividend the corporate assets are reduced below their value at the time the trust began, then the principal must be reimbursed before anything is awarded to income.[19] An apportionment of dividends is directed by the courts to preserve the integrity of the trust fund.[20] The burden, however, of showing the necessity of apportionment is placed upon the remainderman.[21]

New York rejected the doctrine of apportionment in *In re Kernochan,*[22] and it was not until fifteen years later that it accepted the Pennsylvania rule.[23] In *In re Osborne,*[24] the majority opinion of the court distinguished that case from the earlier cases which either repudiated or at least refused to apply the principle of apportionment. In its opinion the court said:

> In determining who is entitled to a dividend upon stock held in trust, the intention of the testator or the maker of the trust must be carried out, when such intent is clear, so far as such intent does not result in an unlawful accumulation of income. Very many cases arise, however, where the testator or maker of the trust had not considered the possibility of enormous dividends being declared by corporations to effectuate their reorganization or in the division of accumulated profits, made necessary

18 28 Pa. St. 368.

19 McKeown's Estate, 263 Pa. 78.

20 In re Osborne, 209 N. Y. 450.

21 Boyer's Appeal, 224 Pa. 144.

22 104 N. Y. 618.

23 In re Harteau, 204 N. Y. 292.

24 209 N. Y. 450.

by new statutes, changed circumstances, and modern rules and conditions, or, if such testator or maker of the trust had considered such possibility, he failed to express himself in the instrument creating the trust so as to show any clear intention regarding the same. . . . Notwithstanding the difficulty in many cases of apportioning dividends, it is wiser and better to leave an apportionment to courts of equity, in preference to adhering to a rule that depends more upon its simplicity and convenience of enforcement than upon justice and right. The distinction between ordinary and extraordinary dividends is necessary to make a workable rule, and at the same time preserve the integrity of the trust fund. The integrity of the trust fund and the rights of the life beneficiary under the trust should each be considered, determined, and preserved by a court of equity.

New York consistently followed the decision as announced in the above mentioned case but in 1926 in *People ex rel. Clark* v. *Gilchrist*,[25] the Court of Appeals assigned the difficulties and complexities which the courts experienced in the practical application of the Pennsylvania rule as reasons for the adoption of the act of the New York Legislature in amending the Personal Property law. Justice Cardozo in speaking for the court said in part:

The same Legislature that excluded stock dividends from the category of income for the purpose of taxation went farther, and amended the Personal Property Law by enacting that, under any will or deed hereafter made, unless otherwise therein provided, stock dividends shall be principal, and not income of a trust. The rule previously applied had resulted in so many complications and obscurities as to be almost unworkable in practice. It involved elaborate accountings for the purpose of determining how far the dividends were the result of profits accumulated before the creation of the trust, and how far the result of profits accumulated thereafter. The Legislature evinced its will that there should be an end to these complexities hereafter in the administration of the law of trusts.

[25] 243 N. Y. 173.

Although the statute does not in terms or by direct effect substitute the Massachusetts rule for the Pennsylvania rule as regards extraordinary cash dividends, it is not improbable that the courts of New York, without the aid of an explicit statute in that regard, will adopt the other branch of the Massachusetts rule, and award cash dividends to the life tenant, regardless of the period of accumulation of the earnings from which they are declared. In that event the result, so far as extraordinary cash dividends are concerned, will be the same as that which, prior to the adoption of the Pennsylvania rule in the Osborne case, prevailed in New York. The New York statute, by express terms, is applicable only to trusts thereafter created, and not even then if a contrary intention is indicated by the will or other trust instrument. It will undoubtedly be several years before a decision will be available under the new statute. The attention of the reader is called to the case of *In re Norton's Will*[26] in 1927 where the rule of the Osborne case was followed.

The court in *In re Waterman's Estate*[27] awarded a dividend, which distributed to each stockholder in specie a proportionate part of Liberty Loan bonds purchased from profits wholly accumulated during the testator's lifetime, to the corpus of the estate. And in *Bourne* v. *Bourne*[28] the stock in a subsidiary corporation acquired by the parent corporation from its surplus accumulated prior to the testator's death was awarded to the remainderman. And we find that subscription privileges are an incident belonging to stock in the corpus of the estate, and therefore pertain to capital and belong to the remainderman regardless of whether such privilege is a so-called right or a mere option.[29]

Although the general rule is that dividends representing the proceeds of a sale of the capital assets belong to

[26] 224 N. Y. Supp. 77.

[27] 279 Pa. 491.

[28] 240 N. Y. 172.

[29] Sturgis v. Roche, 204 N. Y. Supp. 859.

the remainderman, there is an exception in *Matter of Accounting of Ithaca Trust Company*[30] where the corporation contemplated such dividends as the primary source of income and obtained the proceeds in the ordinary course of its business. The corporation was formed for the purpose of buying, selling, managing, and owning lands and for cultivating the lands and marketing their products. The primary source of income contemplated was the profits arising from the sales of lands at an increase over their cost. The dividends in this case were paid to the trustee over the period of the life estate, but the trustee allotted only a portion to the life tenant. The court said that the testator, before his death, had received many large dividends from the sale of lands, and that during his life no charges had been made in the principal's account of the corporation by reason of these dividends, but that they had been paid from profit and loss, and that the same procedure was continued during the life tenancy, at the close of which the corporation emerged with its capital investment unimpaired, and with a residuum of capital assets largely exceeding in value the capital assets as they stood at the beginning of the period. The court observed that it was no answer to this to say that it was a practice of the company to denominate receipts from sales of land as ''principal'' for such purpose, the classification adopted by the company's treasurer when he sent out the dividend checks or a tax report of the company not being decisive.

In *In re Eisner's Estate*[31] the court discussed fully the question of whether rights on stock are income or capital. The case follows what appears to be the general rule, regarding rights to subscribe to additional capital stock in the same corporation as a part of the corpus. In discussing the privilege of subscribing to stock in

30 237 N. Y. 577.
31 175 Pa. St. 120.

another corporation the court held that the profit derived from the right to subscribe belonged to the tenant for life, rather than the remainderman. This is mentioned specifically in view of the decision in *Sturgis* v. *Roche*,[32] wherein the New York court held the right pertained to capital and hence belonged to the corpus.

Of the jurisdictions committed to the Pennsylvania rule, the courts of Pennsylvania and New York have stated and explained most clearly the basis of apportionment in case the extraordinary dividend from earnings, whether stock or cash, was earned partly before and partly after the commencement of the life interest. The fundamental principle underlying the Pennsylvania rule is the time when the dividend was earned, relative to the commencement of the life interest. Yet, it should be remembered, that the time when the dividend was earned is the same whether the dividend is in cash or in stock. Another point, however, to be considered is that, while a cash dividend of a given per cent may properly be treated as earned during the life interest if the surplus or undivided earnings which have accumulated during the life interest equal or exceed that per cent of the capital stock of the corporation provided there has been no impairment of the book or intrinsic value of the stock as of the commencement of the life interest, yet this does not necessarily follow as to a stock dividend, since the new shares will participate in the capital assets and the surplus or undivided earnings that had accumulated before the commencement of the life interest. Quite properly it would seem that the stock dividend cannot properly be regarded as earned during the life interest unless the surplus or undivided earnings which accumulated during that period have been sufficient to make the book value of the shares, both old and new, equal to or in excess of the book value of the shares as of the time of the commencement of the life interest.

[32] 204 N. Y. Supp. 859.

Mr. Justice Clark in speaking for the court in *Appeal of Smith*[33] said:

> It is well settled in this state that, when the stock of a corporation is by the will of a decedent given in trust, the incomes thereof for the use of a beneficiary for life, with remainder over, the surplus profits which have accumulated in the lifetime of the testator, but which are not divided until after his death, belong to the corpus of his estate; while the dividends of earnings made after his death are income, and are payable to the life tenant no matter whether the dividend be in cash or script of stock.

The facts in *Earp's Appeal*[34] are interesting and can well be stated at this point. Robert Earp died November 17, 1848. He then had 580 shares of stock in a manufacturing corporation, which were worth at that time, including the accumulated surplus, $125 per share. This value was ascertained by an actual sale of 40 shares at that price, leaving the estate possessed of 540 shares. The surplus fund continued to increase for six years until 1854, when, instead of dividing the surplus in money among the stockholders, they were given a dividend of 150 per cent of their holdings in new certificates of stock. The estate received 810 shares of new stock bringing the total holdings up to 1,350 shares. At the testator's death, the 540 shares which he owned were worth at $125 per share, the sum of $67,500. When the stock dividend was declared, the market value of the shares fell to $80 per share and the 1,350 shares were then worth, the sum of $108,000. The court held that the difference in value, $40,500, represented the amount of profit arising or accruing upon the stock after the death of the testator, and as such was all awarded to the life tenants. The estate received a sufficient number of shares valued at $80 per share to make the value of the estate equal the value at the date of the testator's death.

33 140 Pa. St. 344.
34 28 Pa. St. 368.

The method of determining the value of the stock at the time of the testator's death as used in *Earp's Appeal* was commented upon in *In re Stokes' Estate,*[35] where the court quoted from *Moss' Appeal*[36] in its opinion:

The fallacy of this theory consists in the fact of estimating the one hundred and forty shares, not at their actual value at the time of the transaction, but at their market value, three years afterwards. A more uncertain rule could not well be imagined. It would make the rights of the parties depend upon the condition of the stock market, which is as variable as the tides, without their regularity. Market values are well enough upon a question of distribution, where the parties are about to realize; but upon the question of values between the life tenants and the remaindermen, a judicial decree must go down through the shifting sands of the stock market until it reaches the solid rock of actual values. The application of any other rule might work serious injustice. It is well known that within the last year the stock of more than one large corporation has varied in price over 100 per cent.

In the case of *In re Osborne,*[37] on a motion to amend the remittitur, the New York court practically followed the opinion of the Pennsylvania court in the Stokes case. In both cases the underlying principle is not the division of the dividend stock or cash between the corpus or income in the proportions of the amounts of earnings that accumulated before, and the amount that accumulated after, the stock became subject to the life interest, but merely the compensation of the corpus for the diminution, in consequence of the dividend, of the intrinsic values of the shares as of the time they became subject to the life interest. The court in granting the motion to amend the remittitur said:

The intrinsic value of the trust investment is to be ascertained by dividing the capital and the surplus of the corporation existing at the time of the creation of the trust by the number of

[35] 240 Pa. 277.
[36] 83 Pa. St. 264.
[37] 209 N. Y. 450.

shares of the corporation then outstanding, which gives the value of each share, and that amount must be multiplied by the number of shares held in the trust. The value of the investment represented by the original shares after the dividend has been made is ascertained by exactly the same method. The difference between the two shows the impairment of the corpus of the trust. . . . If the dividend is in stock, the amount of impairment in money must be divided by the intrinsic value of a share of the new stock, and the quotient gives the number of shares to be retained to make the impairment good; the remaining shares going to the life beneficiary. Market value, good will, and the like considerations cannot be considered in apportioning a dividend.

The court in *Lang* v. *Lang's Executors*[38] considered that undivided earnings although not carried to the surplus account give value to the stock and form a part of the capital of the testator's estate. Although the presumption is that dividends are earned at a uniform rate day by day, this may be rebutted. The dividend in the Lang case, although unusual in amount, was assumed to have been paid from earnings of the fiscal year during which the testator died, and hence was not an extraordinary dividend in the sense in which the term has been used generally heretofore in this paper.

In *Ballantine* v. *Young*,[39] the stockholders were given the right to subscribe for two new shares of stock at par for every old share held. Contemporaneously a special cash dividend of 200 per cent was declared. The trustees took the cash dividend and used it to pay for the new stock and naturally the question arose as to who is entitled to the dividend. In discussing the case the court states:

Is this an ordinary or an extraordinary dividend? It seems to be extraordinary for three reasons: (1) It was declared in addition to the regular dividend; (2) it was much larger, exceeding the net profits made in the preceding year; and (3) it

38 57 N. J. Eq. 325.
39 79 N. J. Eq. 70.

was evidently made for the special purpose of enabling the stockholders to avail themselves of the new subscription. . . . I, therefore, think . . . that the dividend is apportionable between principal and income in the ratio that the surplus at the testator's death bears to the surplus accumulated thereafter up to the time the dividend was declared.

From an accurate accounting basis it would seem that the book or intrinsic value after a stock dividend, for purpose of comparison with the book or intrinsic value as of the date of the commencement of the life interest, should exclude any appreciation in the value of the capital assets that may have taken place during the continuance of the life interest. Quite frequently industrial engineers make new appraisals of the capital assets with the result that the new values placed upon those assets after the appraisal exceed the values placed upon the same assets before the appraisal. In such case, if the appreciation in the values is reflected in the book value, then an adjustment should be made so that the parties remain in relatively the same position as formerly in respect to the intrinsic value of the shares which may reasonably be traced to income after the commencement of the life interest.

There are a few cases in the reports in jurisdictions committed to the Pennsylvania rule where the entire stock dividend has been awarded to income and no apportionment has been made. For example in *Appeal of Philadelphia Trust, Safe Deposit & Ins. Co.,*[40] *In re Baldwin,*[41] and *Ashurst* v. *Potter*[42] the reason is attributable directly to the fact that the stock dividend was earned entirely after the commencement of and during the life interest.

Under the Pennsylvania rule the following conclusions may be drawn:

1. The entire amount of an extraordinary cash divi-

[40] 16 Atl. 734 (Pa. Sup.).
[41] 209 N. Y. 601.
[42] 29 N. J. Eq. 625.

dend, declared during the life interest, from corporate earnings that accumulated during the life interest, goes to income.

2. The entire amount of an extraordinary cash dividend, declared during the life interest, from corporate earnings that accumulated wholly before the commencement of the life interest, goes to corpus.

3. The entire amount of an extraordinary cash dividend, declared during the life interest, from earnings which accumulated partly before and partly after the commencement of the life interest, is apportioned between corpus and income in such a way as to compensate corpus for the loss, because of that dividend, of the intrinsic or book value of the shares as of the date that they became subject to the life interest.

4. A stock dividend, declared during the life interest, which was earned wholly during the life interest and which does not reduce the intrinsic value of the original shares as of the date they became subject to the life interest, goes entirely to income.

5. A stock dividend, declared during the life interest, which was earned wholly before the commencement of the life interest, goes entirely to corpus.

6. A stock dividend, declared during the life interest, which was earned partly before and partly during the life interest, is apportioned in such a way as to compensate corpus for the loss, in consequence of the dividend, of the intrinsic or book value of the original shares as of the date they became subject to the life interest.

7. Intrinsic or book values of the stock rather than the market values are the controlling factors in determining whether there has been impairment of the corpus of the stock as it stood at the date the shares became subject to the life interest.

The Massachusetts rule was stated in *Minot* v. *Paine and Others*[43] as "a simple rule is to regard cash dividends, however large, as income, and stock dividends, however made, as capital." In subsequent cases, the rule has been affirmed and elaborated. Many writers, however, believe that this rule works great hardship and injustice in many cases. The rule, therefore, is not rigidly adhered to; and the courts, in deciding whether the distribution is a stock or a cash dividend, may consider the actual and substantial character of the transaction and not merely its nominal character. This rule prevails generally in Georgia, Rhode Island, and Illinois in addition to Massachusetts.

As early as 1839, the estate was denied any share in a cash dividend declared in April following the testatrix's death in January.[44] The last dividend received by the testatrix was in the October preceding her death. The court based its decision upon the ground that the dividend was incapable of apportionment.

As regards ordinary current dividends, the Massachusetts rule is much the same as the Pennsylvania or American rule. Almost without exception, unless the express language of the will provides a different result, the ordinary current dividends are given to the life tenant or beneficiary—if declared during the continuance of the life interest, and to the remainderman—if declared before or after the termination of the life interest.

Dividends, according to the general rule, belong to the owner of the shares at the time the dividend is declared and not to the owner at the time of payment. However, in *Nutter* v. *Andrews*,[45] the court drew a distinction between a case where the resolution declaring the dividend merely postpones the time of the payment and where it specifies the time and manner for determining the stockholders entitled to receive the dividend. There

43 99 Mass. 101.

44 Foote, Appellant, etc., 22 Pick. 299.

45 246 Mass. 224.

it was concluded that the rights of the estate of a life beneficiary should be determined by the effect of the vote to the same extent as if the beneficiary had been stockholder of record, and the dividends should be paid to the residuary legatee and not to the estate of the life tenant. This case also held that payments which the lessee of the corporation made directly to the stockholders of the corporation instead of to the corporation itself—for convenience—constitute dividends within the rule of ordinary current dividends not apportionable in case of the death of the life beneficiary between dividend periods.

That the majority of the Massachusetts rule cases refer to the action of the corporation as controlling is no doubt caused primarily by the fact that the instrument creating the trust had not manifested the explicit intention of the testator as to whether the particular distribution in the form of unusual stock or unusual cash dividends should be regarded as income or corpus, or should be apportioned between the two. It is extremely difficult for the maker of a will to foresee all possible contingencies, and to provide in each particular instance what shall be income and what shall be corpus. Therefore, it should be remembered at the outset that this particular rule, like all other rules upon the subject, appears to have been adopted as the rule in respect to dividends and other distributions when the creator of the trust did not anticipate or provide. In Massachusetts and in those jurisdictions adopting the rule, the intention of the corporation, not as to the respective rights of the parties but as to the nature of the distribution or declaration of the rights of the shareholders—whether it amounts to cash or a stock dividend, a capitalization of assets, or a distribution of earnings—is practically controlling. In *Minot* v. *Paine,* the court said the following regarding the stock dividend:

It is obvious that, if the directors had made no stock dividend, but had invested the income in permanent improvements, making no increase in the number of shares, the improvements

would have been capital, belonging to the legatees in remainder. So, if they had thus invested it, and, instead of increasing the number of shares, had increased their par value, the shares would have been mere capital, and not income, as to the shareholders, though increased in value by the application of the net income of the road to that purpose. So, when they increased the number of shares, each share of all the stock in the corporation is in its nature capital. The new shares take their place among the old ones; and each of the old shares thereby becomes a less proportion of the whole stock than it was before, and is entitled to a less proportion of dividends declared than it was before. It may be that dividends are less per cent than they would otherwise have been, and in such case the old stock is diminished in value, and the interest of the remaindermen is injuriously affected. But, on the other hand, the effect may be, by increasing the business of the road, to increase the dividends and the market value of the old stock. But neither courts nor trustees can investigate such matters with accuracy; and in many cases no investigation can be made. A trustee needs some plain principle to guide him; and the *cestuis que trust* ought not to be subjected to the expense of going behind the action of the directors, and investigating the concerns of the corporation, especially if it is out of our jurisdiction. A simple rule is, to regard cash dividends, however large, as income, and stock dividends, however made, as capital. The court are of opinion that this rule is more in conformity with the legal and equitable rights of shareholders than any other that has been suggested. It is also in conformity with the decisions of the court, so far as the subject has been considered.

Ordinarily the United States Supreme Court follows the law of the state from which the case was appealed in its decisions. The case of *Gibbons* v. *Mahon*[46] came before the court from the District of Columbia, so the question presented was clearly one for the independent decision of the higher court, unaffected by any duty to follow a state rule upon the subject. The court used

[46] 136 U. S. 549.

this language in supporting its adoption of the Massachusetts rule:

Whether the gains and profits of a corporation should be so invested and apportioned as to increase the value of each share of stock for the benefit of all persons interested in it, either for a term of life or of years, or by way of remainder in fee, or should be distributed and paid out as income to the tenant for life or for years, excluding the remainderman from any participation therein, is a question to be determined by the action of the corporation itself, at such times and in such manner as the fair and honest administration of its whole property and business may require or permit, and by a rule applicable to all holders of like shares of its stock; and cannot, without producing great embarrassment and inconvenience, be left open to be tried and determined by the courts, as often as it may be litigated between the persons claiming successive interests under a trust created by the will of a single shareholder, and by a distinct and separate investigation, through a master in chancery or otherwise, of the affairs and accounts of the corporation, as of the dates when the provisions of the will of that shareholder take effect, and with regard to his shares only. In ascertaining the rights of such persons, the intention of the testator, so far as manifested by him, must of course control; but when he has given no special direction upon the question as to what shall be considered principle and what income, he must be presumed to have had in view the lawful power of the corporation over the use and apportionment of its earnings, and to have intended that the determination of the question should depend upon the regular action of the corporation with regard to all its shares.

In *Gardiner* v. *Gardiner*[47] the trustees with the consent of the necessary number of shareholders voted to issue new preferred shares "in payment of the dividend arrears on the preferred shares now outstanding." Some of the new preferred shares were issued to a trustee under a will which, among other things, provided for the payment of the income of the trust fund to certain bene-

[47] 212 Mass. 508.

ficiaries for life. In awarding the dividend to corpus, Justice Braley said:

It is the substance, however, and not the technical form of the transaction which determines the result. If the vote can be interpreted as a voluntary recognition of the preferred shareholders' contractual rights, which might not be enforced until the winding up of the association, even then it was not intended as a distribution of the salable shares based upon actual earnings. The capitalization had been deliberately increased as there were no profits for division, and if the financial outlook at the time had improved, a surplus of future net earnings sufficient to meet the outlay could not have been reasonably anticipated. . . . After the enlargement of the permanent capital the property of the association neither had been increased nor diminished, and the preferred shareholders when the new shares will have been issued will represent according to their holdings the same proportional preferences, which in the event of liquidation entitles them to priority over the common shareholders.

In *Coolidge* v. *Grant*[48] a corporation earned but passed, or paid the preferred stock dividends in part, because of a desire "to conserve the company's resources." To adjust the payment of overdue dividends the corporation gave the shareholders the option of accepting a "stock dividend." The court followed the rule laid down in the Gardiner case and in *Mills* v. *Britton*[49] and awarded the dividend to the principal of the trust.

The facts in *Boston Safe Deposit and Trust Company* v. *Adams*[50] were slightly different, and the dividend was awarded to the tenant for life. A dividend was declared and paid out of the accumulated surplus of net profits or undivided earnings and issued in the form of corporate notes representing the arrears of past cumulative dividends which might have been previously declared. Again the action of the corporation was controlling for the court held that a dividend declared and paid out of

48 251 Mass. 352.
49 64 Conn. 4.
50 219 Mass. 175.

earnings or the accumulated surplus of net profits had the features of a dividend from earnings and therefore should be awarded as income to the left tenant.

The benefit of a right given by a corporation to its stockholders to subscribe at par or at any other fixed amount less than the book or intrinsic value, for a new issue of its own stock, whether sold or exercised is awarded to the remainderman.[51] In *Davis* v. *Jackson*[52] Justice Holmes in speaking for the court said "if the trustees had sold their rights the proceeds would have represented the detriment to the old shares caused by the issue of new ones, and would have belonged to capital." In *Hyde* v. *Holmes*,[53] it was said that the rule had no practical application because the trustees had cash funds on hand when the cash dividend was declared and the stock rights attached to the stock when the stock was increased. Cash dividends were invested and the court ruled that the new stock be held in trust for the benefit of the trust, subject to the duty to pay over to the life tenant the amount of the cash dividends which had been invested therein. An excellent statement of the general rule was given by Justice Knowlton and is quoted in part:

> We are of the opinion that the value of rights to subscribe for an increase of stock, to be issued by a corporation . . . must be treated as property capitalized by the corporation. The value of the new stock is made up of the par value which is paid in by the subscriber, and an additional sum equal to the difference between the par value and its market value. This additional sum inheres in the new stock to be issued, and is a part of the capital of the corporation. It cannot be used or availed of otherwise than as a mere right or privilege, except in connection with the ownership of the new stock, which is capital.

Although the Massachusetts court held that a stock right was income for the purposes of the state income

51 Atkins v. Albree and another, 94 Mass. 359.
52 152 Mass. 58.
53 198 Mass. 287.

tax amendment, yet it did not assume to overrule its established decisions that such a right was capital and not income as between the life tenant and the remainderman.

Distributions of the corporation in the form of executory promises, like bonds, notes, or certificates of indebtedness—when absolute in their obligation and not conditional—are regarded as cash dividends when made from earnings and when they do not represent capital assets. Courts take the point of view that payment in executory obligations rather than in money must be treated as a mere matter of convenience to the corporation—an option upon which the directors may decide at will.[54] The fact that an extra bank dividend was declared payable in a certificate of deposit is therefore immaterial. Such a dividend is substantially a cash dividend to be credited to the stockholder upon the books of the bank, and it is no longer the property of the bank.[55]

The court in the case of *Millen et al.* v. *Guerrard et al.*[56] allowed certificates of indebtedness, in addition to the regular cash dividends, of forty dollars per share to be awarded to the life tenant. It was not apparent whether the earnings, which were used in improvements of the company's property and formed the basis of the dividend, were made prior or subsequent to the testatrix's death. The court in its argument said, "Bonds of the company, or promissory notes of it, or certificates of indebtedness by it, are not accretions to its stock, nor in any legal sense a part of its corpus. Indeed, they are just the opposite."

The court in *D'Ooge* v. *Leeds*[57] allowed to the remainderman as a part of the corpus, "bonds" containing no binding obligation to pay any amount, but merely giving the holder a contingent right to be paid out of the securities which had previously been held by the company in

[54] Boston Safe Deposit & Trust Co. v. Adams, 219 Mass. 175.
[55] Humphrey et al. v. Lang et al., 169 N. C. 601.
[56] 67 Ga. 284.
[57] 176 Mass. 558.

the surplus fund. The court in commenting upon the action of the company—Adams Express Company, a joint stock association—said:

If this company had been a corporation, and had wished to make a dividend of preferred stock to its shareholders, it would have done it in just this way. There has been no dividend of any money or property among the shareholders. There has been merely a change in the form of ownership in the property by dividing it into two classes, and by making a different provision in regard to dividends for each class, and by giving one class a preference over the other in its right to the assets on final liquidation. . . . That the principal represented by the so-called "bonds" is to remain in the company, and to be used as capital, is too plain for discussion. The bonds give only a contingent, equitable interest in certain property of the company. . . . The very nature of the bonds presupposes that, as an investment, they are to be as permanent as the capital stock of the company, for by their terms they cannot be paid until the debts of the company are all provided for. . . . It was a more formal capitalization of earnings which previously had been capitalized in substance and effect.

Where a corporation sells the major portion of its plant, equipment, and stock on hand and retains only subsidiary properties which it plans to operate subsequently, and receives in payment therefor from the purchasing company the latter's stock and cash, all of which is distributed to the stockholders as a dividend, such stock dividend represents in fact a partial liquidation and distribution of the capital by the corporation and therefore belongs to the corpus.[58] However, where a dividend is in the stock of another corporation but represents an investment of profits of the declaring corporation, rather than a partial liquidation or distribution of the capital, it is regarded as income belonging to the life tenant.[59]

In *Gray* v. *Hemenway,*[60] an appeal was made to the

58 Mercer et ux. v. Buchanan et al., 132 Fed. 501.

59 Union & New Haven Trust Co. v. Taintor, 85 Conn. 452.

60 223 Mass. 293.

court to direct the disposition of a dividend of the Union Pacific Railway Company. The Union Pacific declared a dividend, partly in cash and partly in the stock of the Baltimore and Ohio purchased from the Oregon Short Line Railroad Company just before the declaration of the dividend. The stock dividend was declared in contemplation of the reduction of the regular dividend rate, and the amount and character of the extra dividend was determined with a view to compensate the stockholders for the reduction. The directors expressly declared the dividend to be out of surplus profits of the company, and since the surplus assets of the Union Pacific were more than sufficient to pay the entire dividend, it was possible that the payment in fact be out of surplus. The court held that the Baltimore and Ohio shares were a part of the property of the Union Pacific used in its business, as current assets, but were not permanently capitalized, and therefore were available for dividends, and as such belonged to the life tenant.

In *Old Colony Trust Company* v. *Jameson et al.*[61] a dividend on stock of the General Electric Company was paid in stock of the Electric Bond and Share Securities Corporation. The shares distributed as a dividend represented an investment of accumulated profits. Had the directors sold the shares and divided the proceeds among their stockholders, the dividend would have been a proper cash dividend belonging to the life tenant. Therefore, the court awarded the dividend as a cash dividend. This is interesting, because the directors of the General Electric Company intended the shares of the Electric Bond and Share Corporation to be held as capital for income tax purposes.

At a stockholders' meeting in the case of *Davis* v. *Jackson*,[62] an increase in the capital stock was voted and the stockholders were permitted to take one new share for every four held by them. At a meeting of the directors held on the same day immediately following the stock-

[61] 256 Mass. 179.
[62] 152 Mass. 58.

holders' meeting, an extra dividend of twenty-five dollars per share was declared. This dividend was just sufficient enough to enable the stockholders to pay for their new stock if they so desired. The earnings of the company were sufficient to pay the dividend; but if they were used to pay the dividend, it was then necessary to raise an amount to pay for additions made to capital, and which had increased the value of the stock at least 25 per cent above the par value of the old stock. Justice Holmes in awarding the dividend to the life tenant said in part:

> The dividend was declared as a cash dividend, and it represented what, originally at least, were earnings of the company. In justice, the earnings of the company ought to go to the life tenants. If the only thing to be considered by the corporation was the relation between tenants for life and remaindermen, it would have no right to devote income to increasing capital. If it wished to increase its plant, it would have to do it by borrowing money or by issuing more stock. In fact, it has the right to appropriate income to permanent improvements, because it has a right to manage its affairs in the way it deems best for them. But where the form of its transaction has not that effect there is no reason why the courts should be astute to bring it about. The remaindermen rely upon the fact that before the dividend was declared, debts to an equal amount had been incurred for permanent improvements. But the mere incurring of a debt for capital, did not, of itself, amount to an appropriation to capital of all the income on hand. The corporation was still free to choose how it would deal with its gains. When it did choose it elected to distribute them.

The investment of the profits of a corporation in permanent work, improvements, or extensions does not render a cash dividend declared by the corporation out of the proceeds of a sale of such improvements capital, instead of income. Such dividend, being a cash dividend, belongs to the life tenant and not to the remaindermen.[63]

[63] Smith v. Dana, 77 Conn. 543.

The authority for the preceding statement made plain the meaning of *capital* as used to determine the rights of life tenant and remainderman. The word is to be taken in its strict sense "to designate specifically the fund, property, or other means contributed or agreed to be contributed by the share owners as the financial basis for the prosecution of the business of the corporation." The term *capital* has sometimes been used loosely to indicate undistributed profits which have, in the discretion of the directors, been invested in permanent works. But the use of profits in such a manner does not alter the form of the assets; so the directors can, also in their discretion, withdraw assets so utilized and return them to their original form of surplus to be distributed among stockholders as the directors might have chosen to do in the first instance.

In *Gray* v. *Hemenway,*[64] in an earlier case than the one of the same name previously discussed, a dividend was declared out of surplus of accumulated profits by the Delaware, Lackawanna & Western Railroad in the form of stock in the Lackawanna Company. The court awarded the dividend to the life tenant and said in part:

> The use made by the corporation of a part of its surplus fund in taking shares of the stock of another company was, as we have said, an investment rather than a capitalization thereof by applying it upon the road or other permanent works of the company itself. It was none the less an investment that doubtless was intended to be indirectly advantageous by allowing the company to obtain a shorter line of railroad as well as directly profitable from its capability of returning a fair income. . . . The decisive fact is that this was an investment rather than a permanent application of the company's own property. It remained in the control of the directors; and their action taken in good faith in paying it out as a dividend to the stockholders is not to be reviewed by us.

Stock dividends, although representing earnings invested in improvements, are awarded to the remainder-

[64] 212 Mass. 239.

men without inquiring whether any part of the dividend was earned after the death of the testator.[65] Under the Massachusetts rule declared in *Minot* v. *Paine,* and in subsequent cases, the period covered by the accumulation of the earnings is immaterial. The Massachusetts rule was followed in Rhode Island in *Brown & Larned, Petitioners,*[66] where a stock dividend was declared from surplus.

The rule was again applied in *Coolidge* v. *Grant*[67] by awarding to corpus for the benefit of the remaindermen all the shares of new preferred stock received by the trustees pursuant to the action of the directors, who—in order to adjust accumulated unpaid dividends on each share of cumulative preferred stock—declared a dividend in cash and also a stock dividend payable in cumulative prior preference stock at par to such shareholders as elected to receive it on named conditions. The vote to pay this stock dividend was prefaced by a recital that the company, after paying the cash dividend, would "have a surplus in its profit and loss account in excess" of the remaining overdue dividends "accumulated from earnings and invested in real and personal property." From the report it appears that the corporation earned its dividends annually during the entire period of the trust, but passed the dividends or paid them in part because of a desire "to conserve the company's resources." The court in its opinion said:

> The dividend in the case at bar was avowed by the directors in their vote to be a "stock dividend." There is no suspicion that this avowal was not made in good faith. A declaration by the officers of a corporation made honestly is entitled to great weight in determining the nature of a dividend. It was in substance and effect precisely what the directors said it was. It was the issuance of stock for full value in payment of an obligation of the corporation. When issued it was on an equality with all other stock of the same class. The amount of it became at once capital to be continued in the business of the corporation.

65 Minot v. Paine and others, 99 Mass. 101.
66 14 R. I. 371.
67 251 Mass. 352.

Under the Massachusetts rule the following conclusions may be drawn:

1. The entire amount of an extraordinary cash dividend, declared during the life interest from corporate earnings that accumulated during the life interest, goes to income.

2. The entire amount of an extraordinary cash dividend, declared during the life interest from earnings that accumulated wholly before the commencement of the life interest, goes to income.

3. The entire amount of an extraordinary cash dividend, declared during the life interest from earnings which accumulated partly before the commencement and partly after the commencement of the life interest, goes to income.

4. A stock dividend which was earned wholly during the life interest and which does not reduce the intrinsic value of the original shares as of the date they became subject to the life interest, goes entirely to corpus, when declared during the life interest.

5. A stock dividend which was earned wholly before the commencement of the life interest and was declared during the life interest, goes entirely to corpus.

6. A stock dividend which was earned partly before and partly during the life interest, goes entirely to corpus, although declared during the life interest.

7. Dividends in the form of stock rights belong to corpus.

8. Dividends in the form of script, bonds, or other executory obligations, when absolute in their obligation and not conditional, are regarded as cash dividends and go entirely to income.

9. Dividends in the form of stock of other corporations representing a partial liquidation and distribution of the capital of the company belong to corpus. When the dividend represents an investment of profits of the

declaring corporation it is regarded as income and goes to the life tenant.

10. Dividends representing earnings invested in improvements go entirely to the life tenant as income.

Illinois adheres to the Massachusetts rule. In 1903 the case of *DeKoven* v. *Alsop*[68] was decided by the Illinois Supreme Court. Prior to that time there had been no occasion for an extended opinion by our court upon the subject of dividends in life estates, and little of importance can be found in the reports. The question for determination of the court in that case was whether three classes of dividends should be considered income or capital under the terms of the will. The first of these classes of dividends was an extraordinary cash dividend of twenty per cent upon the shares of stock of the Pullman Palace Car Company; the second class consisted of the issue of certificates of stock known as "stock-dividends;" and the third class consisted of certain rights and privileges of subscribing to stock of five corporations. Because three unusual problems were presented for the first time to the court, this case has long been termed the leading case in Illinois upon this subject.

Mr. Justice Wilkin in the opinion of the court at the outset relied upon *Minot* v. *Paine,* and followed the trend of cases supporting the Massachusetts rule, and the three classes of dividends were awarded in the following manner: First, extraordinary cash dividends, declared after the stockholder's death, consisting of money held during his lifetime in the company's treasury as undivided profits, was awarded to the life tenant as income. Second, stock dividends which evidenced a conversion by the corporation into capital of earnings accumulated during the stockholder's lifetime, was awarded to the remaindermen as a part of the corpus of the trust estate. Third, funds derived by trustees from the "rights to subscribe" for additional stock at par are part of the trust estate in the original stock, held for the remainder-

[68] 205 Ill. 309.

men after paying the "net income" to the life tenant, whether the trustee subscribed to the stock or sold the right to others.

Shortly after *DeKoven* v. *Alsop* was decided, the court was again requested to pass upon the right to stock dividends in *Blinn* v. *Gillett*[69] and the DeKoven case was cited and affirmed by the court. The court in its opinion stated emphatically that the DeKoven case had carefully considered all phases of the problem and unhesitatingly adopted it.

The following year, 1905, another case involving the right to a stock dividend was appealed to the Supreme Court.[70] Again Mr. Justice Wilkin affirmed the DeKoven case by holding that as between the life tenant entitled to the net income and the remaindermen entitled to the principal of a trust estate invested in capital stock, a stock dividend is part of the principal and goes to the remaindermen. And so the DeKoven case was upheld for the second time within two years and is the established doctrine in this state.

The latest cases in Illinois upon this subject were decided in December, 1930.[71] A bill was filed in the Circuit Court of Cook County to construe an indenture of trust to determine whether a certain sum of money which came into the hands of the trustees constituted net income to the life beneficiary or belonged to the corpus of the estate.

The trustees of the estate held in the trust among other items of property 125 shares of stock of the Tribune Company. The special charter issued to the Tribune provided for purchase and holding of real estate. In 1902 the company completed the erection of a building at the corner of Dearborn and Madison Streets in Chicago. This building was disposed of in 1925 to a corporation known as the Dearborn and Madison Build-

69 208 Ill. 473.

70 Billings v. Warren, 216 Ill. 281.

71 Lloyd v. Lloyd, 341 Ill. 461.

ing Corporation. In exchange for conveyance of the building and leaseholds, the Tribune Company received 40,600 shares of stock in the Dearborn and Madison Corporation, which were then distributed *pro rata* to the stockholders of the Tribune. Stone and Keplinger then purchased all these shares directly from the stockholders at $100 per share, and the trustees in this case received the sum of $255,750. Resolutions were adopted unanimously by both stockholders and directors of the Tribune Company, providing that when a conveyance had been consummated and the stock of the Dearborn and Madison Building received by the Tribune Company, it should be reissued to the stockholders of the Tribune Company *pro rata,* according to their respective holdings, "as a dividend . . . out of the last accumulated earnings of this corporation." The court in its opinion again unqualifiedly reaffirmed the Massachusetts rule as the established and logical law. The intention of the directors of the corporation is always given effect, under the Massachusetts doctrine, and in this case the intent as expressed by the resolution that the dividend should be paid out of the last accumulated earnings. Quite properly the court decided that the dividend in this case constituted income to the life beneficiaries under the terms of the indenture of trust.

Although many students believe the Massachusetts rule which is followed consistently by the court in Illinois works great hardship and injustice in many cases, yet the Pennsylvania rule requires elaborate accountings and results in so many complications and obscurities that it is almost unworkable in practice. Illinois will do well to continue its consistent policy in this branch of the law.