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Trusts - Construction - Distinction Between "Stock Dividends" and "Stock Spit" for Allocation Purposes

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TRUSTS—CONSTRUCTION—DISTINCTION BETWEEN "STOCK DIVIDENDS" AND "STOCK SPLIT" FOR ALLOCATION PURPOSES—In 1918 a settlor created two identical trusts, the corpus of each consisting of 300 shares of General Electric no-par common stock. The income was to go to life beneficiaries, and at their deaths the principal was to revert to the settlor or his residuary estate. The trust instrument directed the trustee to transfer to the settlor or his executor, "free of all trusts hereby created, any and all stock dividends. . . ." In 1954 the corpus of each trust included 1200 shares of G.E. no-par stock with a stated value of $6.25 per share, there having been two stock splits unaccompanied by any transfer of accumulated earnings to the capital stock account. The corporation then converted each of its outstanding no-par shares into three $5 par value shares and increased its capital stock account from $180,287,046 to $432,688,910.40 by transferring $252,401,864.40 from earned surplus. In exchange for the 2400 no-par shares the trustee received 7200 par value shares. In an action to construe the trust instrument the lower court and the appellate division ordered that seven-twelfths, or 4200, of the new shares be allocated to the settlor's residuary legatee and 1500 shares be allocated to the corpus of each trust.[1] On appeal, *held,* affirmed, one judge dissenting. The new shares attributable to the accumulated earnings transferred to capital account constitute a "stock dividend" within the meaning of the trust

[1] Mathematically 7/12 of the new shares represented new capital transferred from earned surplus.

instrument and are therefore not part of the trust corpora. *Matter of Fosdick,* 4 N.Y. (2d) 646, 152 N.E. (2d) 228 (1958).

The proper allocation of stock issued as a "dividend"[2] on shares held in the corpus of a trust has long been a problem. Most of the decisions involve cases where the trust instrument made no special provision for allocation of stock dividends but simply directed the trustee to pay the income to a life tenant and then distribute the corpus to a remainderman. The question whether the additional shares of stock should be considered income or corpus has caused a well known split of authority.[3] The Pennsylvania rule[4] apportions stock dividends to income to the extent that the earnings transferred to the capital account were accumulated after creation of the trust.[5] The Massachusetts rule[6] allocates all stock dividends to corpus.[7] Although the trust instrument in the principal case contained a provision specifically allocating stock dividends away from the trusts, thus obviating application of either of these rules, the influence of the Pennsylvania rule[8] on the court's decision is apparent for two reasons. First, repeated applications of this rule have established the judicial

2 A corporation distributes no property in a stock dividend. Each shareholder simply has more share units representing the same proportionate interest in the corporation as he had prior to the "dividend." BALLANTINE, CORPORATIONS, rev. ed., §208, p. 482 (1946).

3 See generally Bowles v. Stilley's Exr., (Ky. 1954) 267 S.W. (2d) 707, and 3 SCOTT, TRUSTS, 2d ed., §236.3 (1956). Neither rule is applied where the settlor properly manifested a contrary intention. See 3 SCOTT, TRUSTS, 2d ed., 1819 (1956).

4 For a list of the fifteen jurisdictions which have judicially adopted this rule see 3 SCOTT, TRUSTS, 2d ed., 1813 (1956). In some of these jurisdictions the legislatures have subsequently adopted the Massachusetts rule; however, the Pennsylvania rule is still applied to trusts created prior to the enactment of such statutes. See note 7 infra.

5 Earp's Appeal, 28 Pa. 368 (1857); Nirdlinger's Estate, 290 Pa. 457, 139 A. 200 (1927). The reasoning is that permanent capitalization of earnings destroys the source of potential cash dividends payable to the income beneficiary. See Equitable Trust Co. of New York v. Prentice, 250 N.Y. 1 at 8, 164 N.E. 723 (1928).

6 For a list of the nineteen jurisdictions which have judicially adopted this rule, see 3 SCOTT, TRUSTS, 2d ed., 1814 (1956) and 1958 Supp. See note 7 infra concerning statutory adoption of the Massachusetts rule.

7 Minot v. Paine, 99 Mass. 101 (1868). The rule was adopted primarily as a matter of expediency to avoid the necessity of going behind corporate action to determine the source of the earnings capitalized. The Uniform Principal and Income Act, §5 [9B U.L.A. 373-374 (1957)] is a statutory version of the Massachusetts rule. For a list of the twenty-three jurisdictions which have adopted the Uniform Principal and Income Act, see 3 SCOTT, TRUSTS, 2d ed., §241A, p. 1921 (1956) and 1958 Supp. The statute has been held not to apply to trusts created prior to enactment. Crawford Estate, 362 Pa. 458, 67 A. (2d) 124 (1949); Warden Trust, 382 Pa. 311, 115 A. (2d) 159 (1955). But cf. In re Allis' Will, (Wis. 1959) 94 N.W. (2d) 226, holding that the statute can be applied retroactively.

8 New York adopted the Pennsylvania rule in Matter of Osborne, 209 N.Y. 450, 103 N.E. 723 (1913). A 1926 New York statute provides that, unless the trust instrument directs otherwise, stock dividends are allocated to corpus. 40 N.Y. Consol. Laws (McKinney, 1949) §17-a. But it is not applicable to trusts created before 1926. See Matter of Lindsay, 11 Misc. (2d) 374, 109 N.Y.S. (2d) 600 (1952).

view that the term "stock dividend" refers to any pro-rata distribution by a corporation among its shareholders of additional shares of its own stock,[9] accompanied by a transfer from earned surplus[10] to the capital stock account of an amount at least equal to the par value of the additional shares.[11] Second, the Pennsylvania rule rejects the idea that the value of the trust corpus should be maintained intact.[12] Since an increase in the number of shares outstanding usually results in a proportionate decrease in the price per share,[13] an allocation of the additional shares away from corpus results in a depression of the value of the corpus.[14] In the principal case the majority of the court reaffirmed the traditional definition by construing "stock dividends" to mean those shares in a distribution, the par value of which is represented by earned surplus transferred to the capital stock account. The effect of this construction was a diminution of more than 50 percent in the value of that portion of the trust corpus consisting of G.E. stock.[15] The dissenting opinion rested upon the belief that the settlor could not have intended such a depletion of corpus and urged that the court abandon as an "outworn legal fiction" the established definition of a stock dividend.[16] In its place the dissenting judge proposed

[9] A dividend of stock in another corporation is a distribution of property, not a stock dividend. City Bank Farmers Trust Co. v. Ernst, 263 N.Y. 342, 189 N.E. 241 (1934). A dividend which the trustee can elect to take either in cash or in stock of the declaring corporation is considered a cash dividend even if he elects to receive stock. Kellogg v. Kellogg, 166 Misc. 791, 4 N.Y.S. (2d) 219 (1938), affd. sub nom. Kellogg v. Neale, 254 App. Div. 812, 5 N.Y.S. (2d) 506 (1938).

[10] Where capital surplus is capitalized, a share distribution is considered a stock split rather than a stock dividend. Matter of Lissberger, 189 Misc. 277, 71 N.Y.S. (2d) 585 (1947), affd. 273 App. Div. 881, 78 N.Y.S. (2d) 199 (1948). See Waterhouse's Estate, 308 Pa. 422 at 429, 162 A. 295 (1932). But see Matter of Thoms, 3 Misc. (2d) 784, 152 N.Y.S. (2d) 939 (1956).

[11] Matter of Osborne, note 8 supra. See Matter of Horrmann, 3 App. Div. (2d) 5, 157 N.Y.S. (2d) 704 (1956), noted 42 CORN. L. Q. 595 (1957). Unless the earnings are capitalized simultaneously with the issue of new stock, there is no stock dividend. Matter of Strong, 198 Misc. 7, 96 N.Y.S. (2d) 75 (1950), affd. 277 App. Div. 1157, 101 N.Y.S. (2d) 1021 (1950). But see Soles v. Granger, (3d Cir. 1949) 174 F. (2d) 407. It should be noted that jurisdictions which apply the Massachusetts rule also accept this definition of a stock dividend. See Fisher v. Paine, 210 Ore. 429, 311 P. (2d) 438 (1957).

[12] The Pennsylvania rule requires only that the book value of the stock in the corpus be maintained at the same level as at the creation of the trust. See Nirdlinger's Estate, note 5 supra, at 463.

[13] See PATON AND PATON, CORPORATION ACCOUNTS AND STATEMENTS 128 (1955). However, small share distributions of less than 20% or 25% of the number of shares previously outstanding do not usually affect the market value per share. See comment, 32 N.Y. UNIV. L. REV. 878 at 884 (1957).

[14] See note 15 infra.

[15] The market price per share of General Electric stock was 112¼ before announcement of the stock dividend (WALL STREET J., April 20, 1954, p. 22) and 39⅝ after the distribution (id., June 14, 1954, p. 22). Thus the market value of the G.E. stock in the corpus of each trust fell from $134,700 to $59,438.

[16] Principal case at 656. In support of his proposition that the traditional definition

adoption of the view currently accepted in the financial community, which limits the term "stock dividend" to distributions in which the number of additional shares is less than 25 percent of the total number of shares previously outstanding[17] and the new shares are capitalized out of earned surplus at their fair value.[18] It would seem that the majority was correct in avoiding speculation over the settlor's intent by construing the words "stock dividends" in the light of their accepted meaning in both the courts and the financial community at the time the trust was created.[19] The question arises, however, whether the same decision should be reached in a case involving a trust created since the advent of the current non-legal definition. This definition is realistic in its recognition that there is little practical difference between a large stock dividend and a stock split. Only in a small stock dividend, where the market value per share remains substantially unchanged,[20] does the shareholder receive what can with any propriety be called a "dividend."[21] Yet it would seem beyond the function of the courts to remake the traditional definition of a "stock dividend," despite the desirability of such a step. Judicial reluctance to take this step is understandable and until the legislatures recognize the need for revision of the legal definition of a stock dividend, the principal case will stand as a guidepost to those who wish to avoid substantial diminution in the value of a trust corpus. The application of a provision allocating "stock dividends" away from corpus should in some precise way be expressly limited to stock dividends which do not appreciably depress the market value per share.

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is too inflexible and should be abandoned, the dissent relied on authority to the effect that a stock dividend has been held not to occur when the transfer from earned surplus to capital was not made simultaneously with the distribution of the new shares. See Matter of Strong, note 11 supra.

17 Any distribution larger than 25% is considered a stock split. BUSINESS WEEK, April 19, 1958, p. 113.

18 The fair value should approximate the current market price, adjusted to reflect the increase in the number of shares. NEW YORK STOCK EXCHANGE, COMPANY MANUAL, Aug. 15, 1955, §A13, p. 235. The dissenting judge took the position advocated in a comment, 32 N.Y. UNIV. L. REV. 878 (1957), and viewed the distribution as a stock split, not a stock dividend.

19 The current view of the New York Stock Exchange was announced only in 1943. NEW YORK STOCK EXCHANGE, STATEMENT ON STOCK DIVIDENDS, Oct. 7, 1943, pp. 2-3. Very large stock dividends were not unknown at the time of the creation of the trust in the principal case. See Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919), involving a 1900% stock dividend by Ford in 1908.

20 See note 13 supra.

21 It has been strongly argued that there is never any distinction from the shareholder's standpoint between a stock "dividend" transaction and a straight stock split. See PATON AND PATON, CORPORATION ACCOUNTS AND STATEMENTS 128-131 (1955).