

The Apportionment of Stock Distributions in Trust Accounting Practice

Arthur W. Machen Jr.

Follow this and additional works at: <http://digitalcommons.law.umaryland.edu/mlr>



Part of the [Estates and Trusts Commons](#)

Recommended Citation

Arthur W. Machen Jr., *The Apportionment of Stock Distributions in Trust Accounting Practice*, 20 Md. L. Rev. 116 (1960)

Available at: <http://digitalcommons.law.umaryland.edu/mlr/vol20/iss2/2>

This Article is brought to you for free and open access by the Academic Journals at DigitalCommons@UM Carey Law. It has been accepted for inclusion in Maryland Law Review by an authorized administrator of DigitalCommons@UM Carey Law. For more information, please contact smccarty@law.umaryland.edu.

Maryland Law Review

VOLUME XX

SPRING, 1960

NUMBER 2

The Apportionment of Stock Distributions In Trust Accounting Practice

ARTHUR W. MACHEN, JR.*

This inquiry deals with the question, "What is income?" — a question inherent in the terms "life estates" and "future interests." It is a question which will be raised in one form or another so long as transfers are made for the immediate benefit of one person and the ultimate benefit of another.

The purpose of this study is to analyze how the courts, and particularly the courts of Maryland, have answered this question in respect of corporate distributions received on securities held by trust estates. This study will be divided into six subsections to be considered in the following order:

- I — Definition of Terms
- II — The Law as to Pre-1929 Trusts
- III — The Law as to Trusts Created between 1929 and 1939
- IV — The Law as to Post-1939 Trusts Governed by the Uniform Principal and Income Act¹
- V — The *Donaldson* and *Apponyi* Cases
- VI — The Problem Restated

I — DEFINITION OF TERMS

For present purposes, the following definitions are adopted:

(1) A "*dividend*" is a distribution of corporate assets by a corporation to its stockholders. Its essential characteristic is a *severance* of corporate property, followed by a distribution of that property to the stockholders of the corporation.

(2) A "*cash dividend*" is a dividend paid in cash.

* A.B. 1942, Princeton University, LL.B. 1948, Harvard Law School; Member, Baltimore City Bar.

¹ 7 MD. CODE (1957) Art. 75B.

(3) An "ordinary cash dividend" is a cash dividend paid at regular intervals, representing a periodic division of corporate profits.

(4) An "extraordinary cash dividend" is a cash dividend paid at irregular intervals, and is usually motivated by some object other than the division of corporate profits.

(5) A "stock dividend" is a distribution by a corporation of its stock pro rata to its stockholders, intended as a substitute for or an increment to an ordinary cash dividend. It is usually a small distribution in relation to the stock previously outstanding — generally not over 25% — and it has no appreciable effect on the market value of the stock in public trading.² The term is a misnomer in its use of the word "dividend" since no "severance" of corporate assets is involved, and the proportional interest of each stockholder in the capital and surplus of the company will be the same after the distribution as it was before.³ Accumulated earnings are transferred from surplus to capital stock account but are not, as in the case of a cash dividend, distributed to the stockholders. To be sure, a stockholder receives something of value which he can convert into cash if he wants to, and to this extent the distribution may seem superficially to resemble a cash dividend. It should be remembered, however, that if a stockholder spends his cash dividends, his equity interest in the corporation remains unchanged. But if he sells a stock dividend and spends the proceeds, he reduces his proportional interest in the corporation.

(6) A "true stock split" is a distribution by a corporation to its stockholders of stock of a different par or stated value in exchange for the stock previously outstanding, resulting in a larger number of shares at a correspondingly lower par or stated value but with no change in the com-

² Rule of the New York Stock Exchange entitled "Statement on Stock Dividends" dated July 21, 1955. This Rule establishes that stock distributions representing less than 25% of the shares previously outstanding are stock dividends and must be capitalized by a charge to earned surplus equal to the current fair value, i. e. the current market value adjusted for the effect of the distribution itself. A distribution representing 100% or more of the stock previously outstanding is a "split", and only the par value need be capitalized. See also: Accounting Research Bulletin No. 11 issued on November 15, 1952, by the Committee on Accounting Procedure of the American Institute of Accountants, advocating substantially the same rules.

³ Some courts have so held. See, for example, *Stipe v. First National Bank*, 208 Or. 551, 301 P. 2d 175, 186 (1956) holding that a stock dividend is not a "dividend" at all, but is "nothing more than in incident or process in corporate bookkeeping." And see: PATON, *ADVANCED ACCOUNTING*, (1947) 587, commenting on "the questionable use of the term 'dividend' in describing the phenomenon."

ppany's total capital outstanding.⁴ Since both the corporation and the stockholders thus remain in exactly the same equity position after the split as they were before, its principal results are the reduction of the market price of the stock and the stimulation of its marketability. These results are not usually accomplished by the stock dividend.⁵

(7) A "modern stock split" (admittedly a term coined for purposes of this discussion) is a distribution by a corporation to its stockholders of a sufficient number of new shares of stock, usually at least equivalent to 100% of the stock previously outstanding, to reduce the market value of the stock to levels attractive to the average investor of 100-share lots, thereby broadening the base of stockholder ownership.⁶ The manner in which the split is accomplished on the corporate books is of no particular significance. It may, like a "true stock split", be supported entirely by a reduction in par value,⁷ and in such a case the two terms may be considered synonymous. Or, unlike the "true stock split," it may be accompanied by no change at all in the par value⁸ or even by an increase in par.⁹ Sometimes a modern stock split is supported by a charge to capital surplus or paid-in surplus; or, it may be supported by a charge in part to capital surplus, in part to paid-in surplus, or, in whole or in part, to earned surplus.¹⁰ Even,

⁴ McCormick v. Frisch, 199 Md. 181, 186, 85 A. 2d 793 (1952). See also: BALLANTINE, CORPORATIONS (Rev. ed. 1946) 483.

⁵ For a clear statement of the difference between a stock dividend and a stock split, see the remarks of Leland I. Doan, President of Dow Chemical Co., at the annual stockholders' meeting of September 12, 1956. Among other things, he observed:

"... If you declare a stock dividend of 25 or 50 or 100%, it in no way reflects your earnings performance and really amounts to a stock split rather than a dividend because the market value of the shares is usually reduced proportionately..."

⁶ The Rules of the New York Stock Exchange cited above in footnote 2 provide that distributions of between 25% and 100% of the stock previously outstanding are presumptively splits, but that each distribution falling in this category must be independently analyzed to determine its proper status.

⁷ As, for example, the 1953 stock split of American Gas & Electric Company, supported entirely by a reduction in par from \$10 to \$5 per share. This distribution was referred to in Donaldson v. Mercantile-Safe Deposit & Trust Co., 214 Md. 421, 425, 135 A. 2d 433 (1957).

⁸ As, for example, the two Texas Company splits discussed in the Donaldson case, *ibid.*

⁹ As, for example, the 1956 split of American Gas & Electric Co., also discussed in the Donaldson case, *supra*, n. 7, where par value was increased from \$5 to \$10 per share.

¹⁰ In the Donaldson case, 214 Md. 421, 426, 135 A. 2d 433 (1957), the court considered the 1951 split of American Gas & Electric Company which was partly supported by a charge to capital surplus and to earned surplus. The General Electric split of 1954, considered in the Apponyi

however, where some or all of the par value of the new stock is supported by a capitalization of earned surplus, the distribution is not a "dividend."¹¹ It does not represent a "severance" of corporate assets in any sense of the word. It differs essentially from a "stock dividend" in that it does not represent a substitute for or an increment to an ordinary cash dividend. To the extent that earnings are capitalized, it may, to be sure, resemble a large or hybrid stock dividend. But corporate acts are to be judged in terms of their cause, their effect and their outward appearance. One who equates a modern stock split with a stock dividend does so because of some of their similarities in effect and in outward appearance but despite their fundamental differences in motivating cause.

II — THE LAW AS TO PRE-1929 TRUSTS

In the case of *Thomas v. Gregg*,¹² decided in 1894, the Court of Appeals was asked to determine how a 20% stock dividend declared and paid by the Baltimore & Ohio Railroad in 1892 should be treated for trust accounting purposes. The question was one of first impression in this State, and the court found itself "not helped, but rather embarrassed"¹³ by the large number of relevant and conflicting decisions in other States.

The court first reviewed the cases decided in Massachusetts, the decisions now forming the basis of the so-called "Massachusetts Rule." Its basic principle is that "ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income. . . ."¹⁴ Although easy to apply, the rule seemed

case, 220 Md. 275, 152 A. 2d 184 (1959), represented the capitalization of earned surplus and capital reduction surplus.

¹¹ See: Barber, *Are Accounting Requirements for Stock Dividends Obsolete?*, published in the November, 1958 issue of "The Analysts Journal", a publication of the National Federation of Financial Analysts Societies. The author points out (at p. 70) that in modern corporate accounting practice, the traditional distinctions between the various surplus accounts have lost most of their significance, and that today the balances in these funds are switched around for tax reasons, for labor bargaining purposes and a host of other motives totally unrelated to the distribution of income to stockholders.

¹² 78 Md. 545, 28 A. 565 (1894).

¹³ *Ibid.*, 549.

¹⁴ *Gibbons v. Mahon*, 136 U. S. 549, 559 (1890); *Minot v. Paine*, 99 Mass. 101 (1868); 2 *Scott, Trusts* (1956), § 236.5. The states which followed the Massachusetts Rule and those which followed the Pennsylvania Rule are catalogued in a Note, 44 A.L.R. 2d 1277. A third and much less popular rule is known as the "Kentucky Rule" which awards all extraordinary dividends, whether of stock or cash, to the life tenant. This rule was abrogated by judicial decision. *Bowles v. Stille's Executor*, 267 S.W. 2d 707, 44 A.L.R. 2d 1273 (Ky. 1954).

arbitrary and uncomprising. Then the court went on to consider the Pennsylvania Rule emanating from the early leading case, *Earp's Appeal*.¹⁵ This case required the apportionment of a stock dividend between principal and income in proportion to the corporate earnings accumulated prior to the testator's death and those accumulated after his death. This rule is difficult to apply but represents an attempt to balance the equities between two classes of trust beneficiaries.

Faced with this sharp cleavage between the Massachusetts and the Pennsylvania Rules, our Court of Appeals in *Thomas v. Gregg* adopted the rule which seemed at the time to bring the fairest result in the case at bar. The directors of the Baltimore & Ohio Railroad had, in this instance, made it plain that the 20% stock dividend was justified as a matter of business policy because it was fully supported by current earnings. A clearer example could scarcely be found, therefore, to illustrate a stock dividend as above defined — a distribution paid in stock as a substitute for a cash dividend. It seemed unfair to the life tenant to invoke the Massachusetts Rule, and thereby to assign the entire dividend to principal, thus denying the life tenant the right to share in a distribution of corporate earnings which was clearly labeled as such by the paying corporation. Influenced largely by these equitable considerations, the Court of Appeals adopted the Pennsylvania Rule in *Thomas v. Gregg*, and directed an apportionment of the 20% stock dividend which the trustee in that case had received.

The next case in this series is *Quinn v. Safe Deposit & Trust Co.*¹⁶ Here, a testamentary trustee, holding shares of stock in the Canton Company, received from that corporation an extraordinary cash dividend of \$4,000. Canton had maintained a sinking fund for the payment of certain bonds of the Union Railroad, but this fund was later freed of the obligation when Northern Central Railway Company, for valuable consideration, agreed to pay all subsequent installments of interest and also the principal on maturity. The cash and ground rents in the sinking fund thus having been released, the directors of Canton decided to keep the ground rents and to distribute most of the cash to the stockholders. Out of the \$4,000 received by the trustee from this distribution, \$3,814 had been earned prior to the testator's death, and the balance of \$186 had been

¹⁵ 23 Pa. 368 (1857).

¹⁶ 93 Md. 285, 48 A. 835 (1901).

earned since the inception of the trust. The lower court, relying on *Thomas v. Gregg*, decreed an apportionment between principal and income in the same ratio.

The Court of Appeals reversed. Distinguishing *Thomas v. Gregg* in that it had involved a 20% stock dividend, not an extraordinary cash dividend, and that what was here distributed "had not been capitalized", the court held the entire \$4,000 to be income distributable to the life tenants. Even though more than 90% of the cash distributed had been earned prior to the inception of the trust, the remaindermen were not allowed to share in the distribution at all.

The decision is patently inconsistent with *Thomas v. Gregg*. In the earlier case, the dividend was held apportionable in respect of earnings realized before and after the inception of the trust. In the later case, 100% of the distribution — and an extraordinary cash dividend at that — was awarded to the life tenants even though more than 90% of the dividend had been earned before their right to share in the income had begun.¹⁷

In the earlier case, the court held that as to earnings accumulated "before the life estate commenced, it is but just and in accordance with the intention of the testator, so far as it is shown, that such earnings be treated as capital."¹⁸ In the *Quinn* case, this theory of fairness was ignored, and most of the earnings which had accrued "before the life estate commenced" were nonetheless ordered paid to the life tenant.

One of the arguments in support of the adoption of the Pennsylvania Rule in *Thomas v. Gregg* is that the 20% stock dividend there involved was the equivalent of an extraordinary cash dividend which the directors of the paying corporation elected to pay in stock. To apply the Massachusetts Rule to these facts would cause the distribution to be paid entirely to the life tenants if paid in cash, but entirely to the remaindermen if paid in stock. The inconsistency of this result (which is more apparent than

¹⁷ When the distribution is capitalized, as it was in *Thomas v. Gregg*, *supra*, n. 12, both life tenant and remainderman share in its benefits without an apportionment. The new stock will ultimately be paid to the remainderman, and meanwhile the life tenant receives the income therefrom. The effect of apportionment is to give the life tenant a larger and more immediate benefit, but the remainderman still shares in the distribution. In the *Quinn* case, *supra*, n. 16, however, where the dividend "had not been capitalized", the payment to the life tenant in its entirety deprived the remainderman of any share at all in the distribution. *A fortiori*, therefore, should there not be an apportionment where earnings made before the inception of the trust are distributed without capitalization?

¹⁸ *Supra*, n. 12, 560.

real) seemed to justify the invocation of the Pennsylvania Rule of apportionment, so that both classes of trust beneficiaries might be permitted to share in a distribution of income covering their respective interests in the estate — and regardless of whether the directors of the paying corporation elected to make the distribution in stock or in cash.¹⁹

If this is the rationale of *Thomas v. Gregg*, it was certainly disregarded in *Quinn v. Safe Deposit & Trust Co.* And it is not without interest that the *Quinn* case relies for its authority primarily on Massachusetts cases and the decisions of other states following the Massachusetts Rule,²⁰ even though the State of Maryland had by that time been committed to the Pennsylvania Rule by the decision in *Thomas v. Gregg*. Surprisingly enough, the *Quinn* case is frequently cited as a decision under the Pennsylvania Rule.²¹

This brings us to the next case dealing with an extraordinary cash dividend — *Foard v. Safe Deposit & Trust Co.*²²

In this case, a corporation sold certain stock which it had purchased with earnings accumulated prior to the testator's death. Out of the proceeds of sale, the corporation paid a 100% cash dividend labeled as a "special distribution" to its stockholders, of whom one was the trustee in the case at bar. The Court of Appeals held "this unusual dividend" traceable to the sale of assets "which had been bought with earnings of the company prior to Mr. Foard's death, and prior even to the making of his will."²³ Consequently, the entire \$50,000 received by the trustee was held to be principal, and no part thereof became payable to the life tenant.

Obviously, this result is inconsistent with the holding in the *Quinn* case. There, the dividend was made possible by the liquidation of a sinking fund. Here, the dividend

¹⁹ See particularly the reasoning of the court, 78 Md. 545, 557, and the rhetorical question and answer:

"... Are they [the life tenants] to be deprived of all interest in the dividend simply because it was made payable 'in common stock of the company?' We think not."

²⁰ Some commentators writing contemporaneously with the *Quinn* decision were even led to believe that the case "closely limits if it does not virtually overrule" *Thomas v. Gregg*. See, for example: 2 MACHEN, CORPORATIONS (1908) 1150, § 1389.

²¹ Atlantic Coast Line Dividend Cases, 102 Md. 73, 79, 61 A. 295 (1905); Northern Central Dividend Cases, 126 Md. 16, 28, 29, 94 A. 338 (1915); *Krug v. Mercantile T. & D. Co.*, 133 Md. 110, 114, 104 A. 414 (1918).

²² 122 Md. 476, 89 A. 724 (1914).

²³ *Ibid.*, 481.

was made possible by the liquidation of certain stocks held by the paying corporation. In the *Quinn* case, the court emphasized the fact that the paying corporation had decided to keep the ground rents which it had received from the sinking fund, and to distribute to the stockholders the cash received from the same source. This suggested that what was kept was "capital" and what was distributed was "income." In the *Foard* case, however, the whole amount distributed was held to be capital.

Finally, it is of interest that in the *Foard* case the entire distribution was supported by earnings accumulated prior to the inception of the trust, and in the *Quinn* case substantially all of the distribution also represented earnings for this same period. Yet in the *Foard* case the whole distribution was held to be *principal*, and in the *Quinn* case the whole distribution was held to be *income*.²⁴

We now turn to the pre-1929 cases dealing with stock distributions.

In the *Atlantic Coast Line Dividend Cases*²⁵ decided in 1905, the court held a 20% stock dividend and an extra 5% dividend payable in certificates of indebtedness, both of which had been charged to "surplus net earnings", were apportionable dividends under the Pennsylvania Rule. Since they were supported entirely by earnings accumulated since the death of the testator, they were payable entirely to the life tenant. This case is a straightforward reaffirmation of the Pennsylvania Rule as stated in *Thomas v. Gregg, supra*.

The next case in the series is *Coudon v. Updegraff*,²⁶ in which the trustees had received a 100% "stock dividend" from the Whitaker Iron Company. This case is far more significant because of its facts than for any particular contribution to the law. In the latter respect, the case merely reaffirms once more the Pennsylvania Rule, relying especially on *The Atlantic Coast Line Dividend Cases*. The facts presented in *Coudon v. Updegraff* seem of special interest, however, first, because the distribution was equal to 100% of the stock previously outstanding, and, secondly,

²⁴ The inconsistency between the *Quinn* and *Foard* cases has elsewhere been noted. See 4 BOGERT, TRUSTS (1948) 337 (§ 845), n. 34, indicating that although the Maryland court in the *Foard* case "purports to follow the Pennsylvania Rule," the *Quinn* case seems "to the opposite effect." In *Lindau v. Community Fund of Baltimore*, 188 Md. 474, 479, 53 A. 2d 409 (1947), the court quoted with approval a statement from *Matter of Osborne*, 209 N.Y. 450, 103 N.E. 723 (1913), indicating that extraordinary cash dividends are apportionable. *Query*: What is the law today as to extraordinary cash dividends in pre-1929 estates?

²⁵ 102 Md. 73, 61 A. 295 (1905).

²⁶ 117 Md. 71, 83 A. 145 (1911).

because the distribution was not accompanied by any change in par value. This distribution thus becomes almost indistinguishable from the "modern stock split", as hereinabove defined. This point will prove of special interest later when we consider the *Donaldson* and *Apponyi* cases.

The next significant decision is entitled *Northern Central Dividend Cases*,²⁷ an opinion dealing with several trust estates which had received a 40% stock distribution from the Northern Central Railroad. The distribution was brought about by a dispute between the minority stockholders of Northern Central and the Pennsylvania Railroad, the majority stockholder. The minority had charged that Northern Central had unreasonably accumulated its profits without any dividends, all to the benefit of Pennsylvania and to the detriment of the minority interests. As part of the settlement of this dispute, Northern Central declared and paid a 40% stock dividend. The court held the distribution to be apportionable under the Pennsylvania Rule.

In the resolution of Northern Central's stockholders approving an increase in authorized capital sufficient to cover the stock dividend, it was declared that the distribution was to be taken—

"... as and for a stock dividend upon the company's present outstanding capital stock, representative of and based on expenditures for additions and betterments of the company's property made from time to time out of its surplus earnings to a larger amount in the aggregate, and which might otherwise have been available for and distributable as dividends among its stockholders, if the Directors had so determined. . . ."²⁸

In holding the distribution apportionable, the Court of Appeals decided

"... to follow the precedent established in *Quinn v. The Safe Deposit and Trust Company*, and in the *Atlantic Coast Line Dividend Cases*, and hold the declarations of the company and its stockholders that the dividend represents earnings or income binding upon all parties to these appeals."²⁹

²⁷ 126 Md. 16, 94 A. 338 (1915).

²⁸ *Ibid.*, 21. (Emphasis added.)

²⁹ *Supra*, ns. 27, 28. Some courts would hold that the corporate act of dedicating earnings to capital creates an inequity which can only be rectified by apportionment, but only to the extent that future dividends

In defense of the decision in the *Northern Central case*, one can argue that the stock distribution was really a three-step transaction telescoped into one — i. e. the corporation could have used its earnings to pay a cash dividend, which, in turn, the stockholders might then have reinvested in the company through a subscription to new stock. Then the company could have used the proceeds of the stock subscription for “additions and betterments of the company’s property.” This three-stage transaction, sometimes referred to as a “compulsory investment,” would have left the stockholders in exactly the same situation in which they found themselves after the 40% stock dividend. Therefore, it can be argued, the stock dividend should be treated as an apportionable distribution of income.

The fallacy in this argument lies in its major premise. The corporation did *not in fact* distribute cash *as income*, nor indeed was there any reinvestment by the shareholders in new stock in the same company. Instead, the corporation had previously elected to capitalize its earnings by spending them on capital improvements. Then, under a good deal of pressure, it agreed to distribute to its stockholders shares of stock representing this additional capital. The earnings, however, remained in the corporate till. Manifestly, therefore, what the corporation did in fact was quite different in form and substance from what in theory it “could have done.”³⁰

are limited thereby. Thus, for example, in the case of *In re Terhune*, 142 A. 2d 684 (N.J. Super. App. Div. 1958), the court found it “necessary to determine whether any funds which could benefit the life tenants in the future have been irrevocably transferred to an account, the proceeds of which will redound solely to the benefit of the remainderman.” In that case the capitalization of earnings by crediting capital surplus was held not to require apportionment because under controlling corporate law dividends could still be paid out of capital surplus. The earnings which were credited to capital stock account, however, were placed “in a category from which no future dividends could be declared”, and hence to that extent an apportionment was ordered. This rationale has been repeatedly approved by the courts of New Jersey. *Day v. Faulks*, 79 N.J. Eq. 66, 81 A. 354 (1911), *aff’d*, 81 N.J. Eq. 173, 88 A. 384 (1912); *Plainfield Trust Co. v. Bowlby*, 107 N.J. Eq. 68, 151 A. 545 (1930); *In re Wehrmane’s Estate*, 41, N.J. Super. 158, 124 A. 2d 334 (1956), *aff’d*, 23 N.J. 205, 128 A. 2d 681 (1957). The rule is now, apparently, in force in Pennsylvania. *In re Cunningham’s Estate*, 395 Pa. 1, 149 A. 2d 72 (1959). This so-called “New Jersey Rule” has been flatly rejected in Maryland. *Northern Central Dividend Cases*, *supra*, n. 27; *Apponyi v. Mercantile-Safe Deposit & Trust Co.*, 220 Md. 275, 152 A. 2d 184 (1959).

³⁰ Admittedly, the expense and trouble of a public offering of securities under modern federal regulation may have combined with tax considerations to stimulate the use of the modern stock split as a means of accomplishing the permanent conversion of accumulated earnings into working capital. Whatever the validity of this reasoning today, it can have little application to the distribution of the *Northern Central case* in 1915.

The next case on the list is *Miller v. Safe Deposit & Trust Co.*,³¹ also involving the same Northern Central dividend discussed above. This opinion adds nothing new to the story of the Pennsylvania Rule in Maryland, but it does emphasize that the date of the creation of the trust is the significant date for purposes of applying the rules of apportionment to original investments, and the acquisition date in the case of subsequently acquired investments. Under the authority of this case, it would seem that the death of an intervening life tenant after the testator's death has no effect at all in applying the rules of apportionment. In other words, after a particular distribution has been characterized as apportionable, then the portion allocable to income is payable to the party who is currently entitled to the income from the trust.³² The Pennsylvania Rule as applied in Maryland does not require apportionment of income between successive life tenants.

The *Miller* case was followed by the decision in *Baldwin v. Baldwin*,³³ an opinion which explains the "intact value test" as part of the rules of apportionment in this State. It holds that the "actual" or "intact" value of the stock in the hands of the trustee at the inception of the trust, determined with relation to the corporate books and *not to market value*, must be maintained for the benefit of the remaindermen, and to the extent that any apportionable stock dividend would impair that book value, the application of the Pennsylvania Rule must be modified.³⁴

The *Baldwin* case is also of interest because, like *Coudon v. Updegraff*, it involved a 100% distribution of stock, supported entirely by earnings accumulated since the inception of the trust. On the surface, therefore, both cases dealt with stock distributions which meet our defini-

³¹ 127 Md. 610, 96 A. 766 (1916).

³² In the *Miller* case, 127 Md. 610, 615, 96 A. 766 (1916), the court indicated that the determination of the beneficiary entitled to the income is to be made as of the declaration date of the dividend. Presumably, this means in the absence of a specified record date. Compare: 2 MD. CODE (1957) Art. 23, § 40(c) (2); 2 SCOTT, TRUSTS (1956) 1809, § 236.2.

³³ 159 Md. 175, 150 A. 282 (1930).

³⁴ The same rule obtains in Pennsylvania. In *re King's Estate*, 361 Pa. 629, 66 A. 2d 68 (1949); In *re Stokes' Estate*, 240 Pa. 277, 87 A. 971 (1913); *Smith's Estate*, 140 Pa. 344, 21 A. 438 (1891); *Biddie's Appeal*, 99 Pa. 278 (1882); *Moss' Appeal*, 83 Pa. 264 (1877). In *Arrott's Estate*, 383 Pa. 228, 118 A. 2d 187 (1955), however, the Pennsylvania court held that as to securities *purchased* by the trust (as distinguished from those originally acquired) the market value at the time of the purchase is the intact value to be preserved. The Maryland courts have not followed this sensible refinement. *Query*: What better method could be found to measure the corpus to be preserved "intact" than the dollar amount of cash corpus which was used to buy the investment?

tion of a "modern stock split." Again, this point will prove of interest later when we take up the *Donaldson* case.

The latest stock distribution case in the series is *Lindau v. Community Fund of Baltimore*.³⁵ Although the case was decided after the adoption of the Uniform Principal and Income Act, it was not governed by the Act because the trust estate was created prior to June 1, 1939.³⁶ Even apart from this fact, however, the Act would not in any event have controlled because the trust instrument contained the following provisions dealing with principal and income:

" . . . all stock dividends to the extent that they are paid out of current earnings for the current fiscal or preceding year shall likewise be treated as income as of the date of their payment; but all other stock dividends shall be treated as corpus of the trust estate."³⁷

In the light of this mandate in the controlling instrument, the court ruled that a 20% stock dividend was apportionable. The case is of special interest today because it shows how the discredited Pennsylvania Rule can be invoked as to post-1939 transfers when the will or deed of trust contains a provision similar to that quoted above.³⁸

Although the *Lindau* case marks the last in the series of decision dealing with distributions of stock of the distributing company and their apportionment under the Pennsylvania Rule (except for the *Donaldson* and *Apponyi* cases to be considered separately hereinbelow), the picture would not be complete without a brief discussion of several other decisions involving questions of principal and income and hence directly or indirectly related to the Pennsylvania Rule.

(1) In *Smith v. Hooper*,³⁹ the court held that profits realized by a trustee on the sale of capital assets (i. e. profits which are customarily referred to these days as "capital gains") do not constitute income which must be distributed to the life tenant. Accordingly, there was no need for applying the Pennsylvania Rule of Apportionment.⁴⁰

³⁵ 188 Md. 474, 53 A. 2d 409 (1947).

³⁶ The effective date of the Uniform Principal and Income Act, 7 MD. CODE (1957) Art. 75B.

³⁷ *Supra*, n. 35, 477.

³⁸ 7 MD. CODE (1957) Art. 75B, § 2, permits the testator or settlor to "direct the manner of ascertainment of income and principal and the apportionment of receipts and expenses . . ."

³⁹ 95 Md. 16, 54 A. 95 (1902).

⁴⁰ The rule is apparently otherwise in Pennsylvania. *McKeown's Estate*, 263 Pa. 78, 106 A. 189 (1919).

(2) In *Safe Deposit v. Bowen*,⁴¹ the court followed the decision in *Smith v. Hooper*, and held that there was no problem of apportionment where a trustee surrendered preferred stock with unpaid accumulated dividends in exchange for cash, new preferred stock, debenture notes, and common stock. This reorganization was likened to a sale, and the new securities were held to belong to corpus "in their entirety."⁴²

(3) In *Girdwood v. Safe Deposit & Trust Co.*,⁴³ the court held that rights to subscribe to new stock, when exercised by the trustee, constituted corpus of the estate, and, accordingly, no problem of apportionment under the Pennsylvania Rule was raised.

(4) In *Ex Parte Humbird*,⁴⁴ the court ruled that the trustee's profit realized on the sale of its timber lands and cash dividends paid to a trustee by a lumber company out of the proceeds of sale of the company's timber lands, were, in both cases, corpus. The profits on the sale of trust assets were clearly governed by *Smith v. Hooper*. The cash dividend, however, was more troublesome because of the argument that it should be distributed *in toto* to the life tenants as an extraordinary cash dividend under the authority of *Quinn v. Safe Deposit & Trust Co.* The court of Appeals ruled, however, that the *source* of the dividend controlled — in this case the liquidation of the corporation's timber land — that this dividend does not represent income earned in the ordinary course of the company's business, and that it must therefore, be treated in its entirety as non-distributable corpus.

(5) In *Washington County Hospital v. Hagerstown Trust Co.*,⁴⁵ the court relied on the distinction that the profits there distributed were made in the ordinary course

⁴¹ 188 Md. 482, 53 A. 2d 413 (1947).

⁴² A recent case in Pennsylvania came to the opposite conclusion, applying the Pennsylvania Rule in a trust estate created before the adoption of the Uniform Principal and Income Act in that state in 1945. In *re King's Estate*, 361 Pa. 629, 66 A. 2d 68 (1949). There, the new stock received in exchange for the accumulated arrearages in dividends on the old preferred was held distributable as income after the intact value of the old stock had been preserved.

⁴³ 143 Md. 245, 122 A. 132 (1923); the rule is apparently otherwise in Pennsylvania, *Jones v. Integrity Trust Co.*, 292 Pa. 149, 140 A. 862 (1928), although the prior cases were in some conflict. *Nirdlinger's Estate*, 290 Pa. 457, 139 A. 200 (1927); *Eisner's Estate*, 175 Pa. 143, 34 A. 577 (1896); *Wiltbank's Appeal*, 64 Pa. 256 (1870). The *Jones* case held that stocks purchased through the exercise of rights are to be treated as an apportionable stock dividend, but in the later case of *Waterhouse's Estate*, 308 Pa. 422, 162 A. 295 (1932), it was held that the proceeds from the sale of rights are presumptively principal.

⁴⁴ 114 Md. 627, 80 A. 209 (1911).

⁴⁵ 124 Md. 1, 91 A. 787 (1914).

of the distributing corporation's business, and not, as in the *Humbird* case, from "economic laws operating independently of the corporate agency or existence."⁴⁶ This suggests that profits derived from the sale of land will be treated as income where the corporation actively contributes to its enhancement in value and where such a sale is a regular part of the corporation's business. On the other hand, if similar real estate is owned by another corporation which indolently relies on "economic laws" to raise the value of its property, then the profits on the sale will be treated as principal. The distinction seems somewhat nebulous.

(6) In *Spedden v. Norton*,⁴⁷ the court ruled that "liquidating dividends" payable in cash by a real estate development company should be treated as corpus in the hands of the trustee until the intact value of the stock at the time of the inception of the trust has been recouped. Thereafter, presumably, these dividends would represent a division of profits and hence distributable as income.

In this respect, it is interesting to note this flat statement by the court:

" . . . An extraordinary dividend declared after the testator's death from earnings realized before that event, would be allocated to the corpus of the trust under his will."⁴⁸

In support of this proposition, the court cited eight cases, including *Quinn v. Safe Deposit & Trust Co.* As hereinbefore noted, the *Quinn* case held just the reverse. An extraordinary cash dividend declared and paid after the testator's death derived to the extent of about 90% from earnings realized before that event, was in that case held to be not principal but income in its entirety and payable 100% to the life tenant.

(7) The next case in this group is *Krug v. Mercantile Trust and Deposit Co.*,⁴⁹ where a stock dividend payable in stock of another corporation was held to be income. This distributing corporation was held to be in the business of buying and selling securities, so that in a very real sense the profits distributed were earnings realized in the regular course of its business. The distribution would have

⁴⁶ *Supra*, n. 44, 640.

⁴⁷ 159 Md. 101, 150 A. 15 (1930). Compare *Jones Estate*, 377 Pa. 473, 105 A. 2d 353 (1954), holding that liquidating dividends are apportionable in that state.

⁴⁸ *Ibid.*, 105.

⁴⁹ 133 Md. 110, 104 A. 414 (1918).

been treated as income even under the Principal and Income Act.⁵⁰

(8) In *Rosenburg v. Lombardi*,^{50a} the Court of Appeals held that capital gains dividends of regulated investment companies are to be treated as income of pre-1939 trust estates. Since the investment company's securities profits are earned in the ordinary course of its business, this holding is consistent with the principles laid down in the *Krug* case, *supra*, and with the weight of authority in other jurisdictions.^{50b}

III — THE LAW AS TO TRUSTS CREATED BETWEEN 1929 AND 1939

In 1929 the State of Maryland made its first attempt to solve this problem by statute. It was not a signal success. The statute provided as follows:

"All rents, annuities, dividends and periodical payments in the nature of income, payable under the provisions of any will, deed or other instrument executed after the first day of July, 1929 shall like interest on money lent, be considered as accruing from day to day, and shall be apportionable in respect of time accordingly, unless otherwise expressly stated by the instrument under which they are payable; but no ac-

⁵⁰ 7 MD. CODE (1957) Art. 75B, § 5(1). The Act follows the Massachusetts Rule in holding that dividends paid in securities of companies other than the paying corporation are to be treated as income. Courts of other jurisdictions have held that, even under the Pennsylvania Rule, stock dividends payable in securities of corporations other than the paying corporation, when charged to earned surplus on the books of the paying corporation, are income. See, for example, the New York cases dealing with the Standard Oil distributions, collected in Note, 130 A.L.R. 492, 591.

^{50a} Decided May 12, 1960; opinion not yet reported. (Case No. 163, September Term, 1959.)

^{50b} The out-of-state court decisions have generally held such capital gains dividends to be income. See: In re Byrne's Estate, 81 N.Y.S. 2d 23 (1948); In re Bruce's Trust, 81 N.Y.S. 2d 25 (1948); In re Hurd's Will, 120 N.Y.S. 2d 103 (1953); In re Appleby's Estate, 175 N.Y.S. 2d 176 (1958); In re Rosenthal's Estate, 110 N.Y.S. 2d 483 (1951); Coates v. Coates, 304 S.W. 2d 874 (Mo. 1957); Lovett Estate (No. 2), 78 D. & C. Rep. 21 (Orphans Court of Luzerne Co., Pa., 1951). However, these cases have met with strong criticism from some learned commentators and strong support from others. See, Shattuck, *Capital Gains Distributions — Principal or Income*, 88 Trusts & Estates 160, 429 (1949); Young, *A Dissent on Capital Gains Distributions*, 88 Trusts & Estates 230 (1949); Rogers, *Capital Gains Distributions*, 90 Trusts & Estates 300 (1951); Rogers, *Capital Gains Dividends — A Suggestion for Draftsmen*, 20 Fordham L. Rev. 79 (1951); Anderson, *Should Capital Gains Distributions Be Principal or Income?*, 90 Trusts & Estates 331 (1951); Putney, *Capital Gains Dividends*, 95 Trusts & Estates 22 (1956); Cohan and Dean, *Apportionment of Stock Proceeds*, 106 U. Pa. L. Rev. 157, 181 (1957); 3 Scott, *Trusts* (1956) 1844, § 236.14.

tion shall be brought therefor until the expiration of the period for which the apportionment is made."⁵¹

The application of this statute to the problem of apportionment in Maryland was first considered by the Court of Appeals in *Zell v. Safe Deposit & Trust Co.*,⁵² decided in 1938. There, it was held that the statute above quoted had no application to an ordinary cash dividend paid by a company with an irregular dividend-paying record because the dividend was not paid with reference to any fixed period of time. The English authorities so holding seemed especially persuasive, since the Maryland Act followed closely the language of the English Act on Apportionments.⁵³

Although the *Zell* case illustrates the ineffectiveness of the 1929 Act, it is difficult to find fault with the reasoning of the court as applied to the facts there presented. The case does show, however, how unwise it is to extend the concept of apportionment to all corporate distributions. The apportionment of dividends between successive beneficiaries may be appealing to one's sense of fair play, but experience has shown that the only forms of income which lend themselves to this treatment are those in which the factor of time is an inherent characteristic. Thus, we have heard little or no criticism of the use of daily accrual tables for apportioning such fixed periodic payments as rent, annuities, interest on loans, etc. But when we apply these same rules to other forms of income which are not pegged to the passage of time, we become engulfed in a maze of troubles—troubles which are graphically illustrated by the Maryland decisions dealing with the Pennsylvania Rule and the 1929 Act.

No better illustration of this point could be found than in the strange case of *Heyn v. Fidelity Trust Company*,⁵⁴ decided by the Court of Appeals in February 1938, only a few weeks after the *Zell* case. An eight-page majority opinion by Judge Sheehan, the author of the *Zell* decision, was modified after reargument by a seventeen-page majority opinion written by Judge Offutt. Judge Parke registered a vigorous twenty-five page dissent.

⁵¹ MD. LAWS (1929) Ch. 495, 8 MD. CODE (1957) Art. 93, § 305(c).

⁵² 173 Md. 518, 196 A. 298 (1938).

⁵³ In re Jowitt (1922) L. R., 2 Ch. Div. 442; In re Muirhead (1916) L. R. 2 Ch. 181; In re Wakely (1920) 2 Ch. 205; In re Sale (1913) 2 Ch. 697; Carr v. Griffith (1879) 12 Ch. D. 655; In re Taylor's Trusts (1905), 1 Ch. 734; In re Armitage (1893) 3 Ch. 337; Marjoribanks v. Dansey (1923) 2 Ch. 307; In re Sandbach (1933) Ch. D. 505.

⁵⁴ 174 Md. 639, 197 A. 292 (1938).

The case dealt with several different classes of dividends, but for present purposes the most interesting facet is the holding that a payment on account of arrearages in dividends on cumulative preferred stock is an extraordinary distribution not governed by any fixed period of time and, hence, not controlled by the 1929 Act. Having come to this conclusion, the majority of the court then fell back on the Pennsylvania Rule to find the distribution entirely income paid out of earnings accumulated after the inception of the trust, and, hence, payable to the life tenant.⁵⁵ This overruled Judge Sheehan's previous conclusion that this same distribution was in the nature of a liquidating dividend, and was to be treated entirely as corpus.

As a result of the *Heyn* decision, it would seem that the 1929 Act has no force at all today except as to the apportionment of regular cash dividends, interest, rent, etc. on a daily accrual basis, in trusts created in the 1929-1939 period.

The major contribution of the *Heyn* case may be found in Judge Parke's brilliant dissent. After reviewing the earlier Maryland cases on apportionment, he urged the adoption of a "simple, arbitrary, universal rule" which like the Massachusetts Rule, would make in most cases for substantial justice.

Any hope that the 1929 Act might bring this result had been surely and swiftly killed by the decisions in the *Zell* and *Heyn* cases, but the Legislature was quick to respond to Judge Parke's suggestion. In 1939 Maryland became one of the first states to enact the Uniform Principal and Income Act.⁵⁶

IV — THE LAW AS TO POST-1939 TRUSTS GOVERNED BY THE UNIFORM PRINCIPAL AND INCOME ACT.

The Principal and Income Act is one of the most successful products of the National Conference on Uniform State Laws. There is perhaps no better test of a statute's true merit than its effect on litigation, and on this score the Principal and Income Act passes with flying colors. Since

⁵⁵ Note the seeming inconsistency between this result and that in *Safe Deposit v. Bowen*, 188 Md. 482, 53 A. 2d 413 (1947), discussed in text, *supra*, p. 101.

⁵⁶ Only five states had adopted the Act prior to 1939—namely Florida, Louisiana, North Carolina, Oregon and Virginia. Three other states besides Maryland joined the group in 1939: Alabama, Connecticut and Utah. To date, 21 states have adopted the Act, including Pennsylvania, the home state of the Pennsylvania Rule (1945).

its adoption in Maryland in 1939, now over twenty years ago, not one single case has reached the Court of Appeals for a construction of its terms. In other states, the record is almost as good.⁵⁷ The statute is clear in its language, simple in its application and uniform in its result.

For all practical purposes, the Principal and Income Act adopts the Massachusetts Rule. All distributions in stock of the paying corporation, whether in the form of stock dividends or stock splits, are treated as principal, and all distributions in cash are treated as income.⁵⁸ When the trustee has the option of receiving a distribution in cash or in stock of the paying corporation, it is treated as the equivalent of a cash dividend and, therefore, income, regardless of the election made by the trustee.⁵⁹ Distributions payable in securities or obligations of other corporations are treated as income.⁶⁰ Rights to subscribe to securities of the distributing corporation and the proceeds of sale thereof are deemed to be principal, but rights to subscribe to securities in *other* corporations, and the proceeds of sale thereof, are treated as income.⁶¹ The Act contains special rules governing liquidations, mergers, consolidations and reorganizations.⁶²

As noted in the *Lindau* case, the Principal and Income Act permits the testator to prescribe some other method for the "ascertainment of income and principal and the apportionment of receipts and expenses."⁶³ Sometimes it is necessary to resort to this privilege to satisfy the wishes of the creator of the trust, and some testators will want to leave the matter to the discretion of the trustee. But all too often, it seems, the draftsmen of modern wills are prone to copy one of several forms dealing with principal and income, forms which were in vogue during the hey-day of the Pennsylvania Rule. Generally speaking, these clauses contribute nothing but confusion when used in present-day trust instruments.⁶⁴ The subject has been adroitly covered

⁵⁷ See the publication of the Act in Uniform Laws Annotated with annotations.

⁵⁸ 7 MD. CODE (1957) Art. 75B, § 5(1).

⁵⁹ *Ibid.*

⁶⁰ *Ibid.* Cf. n. 50, *supra*.

⁶¹ 7 MD. CODE (1957) Art. 75B, § 5(2).

⁶² 7 MD. CODE (1957) Art. 75B, § 5(3).

⁶³ 188 Md. 474, 477, 53 A. 2d 409 (1947). This deed of trust contained a clause reading:

"All stock dividends to the extent they are paid out of current earnings for the current fiscal or preceding year shall likewise be treated as income as of the date of their payment; but all other stock dividends shall be treated as corpus. . . ."

⁶⁴ *Query*: In the clause used in the *Lindau* trust and quoted in the previous note, what is a "stock dividend?" Does the term include a

by the Statute, and most attempts to deal with it in the controlling instrument accomplish nothing except to bring the case back within the discredited and discarded Pennsylvania Rule.

V. — THE DONALDSON AND APPONYI CASES

The *Donaldson* case⁶⁵ presented the following facts: In 1957 the life tenant of a testamentary trust created by a testator who died in 1908 brought a bill in equity to compel an apportionment of three "modern stock splits," i. e. those of The Texas Company in 1951 and 1955 and of American Gas & Electric Co. in 1956. The Texas Company distributions were each 2-for-1, and the American Gas & Electric Co. distribution was 1½-for-1. Neither distribution of The Texas Company was supported by any reduction in par value, and the American Gas & Electric Co. distribution even involved an increase in par from \$5.00 to \$10.00 per share. None of the three distributions, therefore, qualified as a "true stock split" which traditionally results only in a reduction in par value and a corresponding increase in the number of shares outstanding.

The trustee argued that the "modern stock split" was a different *genre* from the "true stock split", and that the discredited Pennsylvania Rule should not be extended to cover this new phenomenon of corporate finance.⁶⁶ In support of this contention, the trustee pointed to the resolutions of the corporate directors establishing as a motive for each distribution the reduction of market value of the stock to levels more attractive to the average investor.

The trustee also stressed the Rules of the New York Stock Exchange requiring the capitalization of *market value* of the new shares in the case of stock dividends representing 25% or less of the stock previously outstand-

"modern stock split" of the type discussed *infra* in the *Donaldson* and *Apponyi* cases? Would the answer be different if the clause had directed that "all stock dividends be treated as income" without reference to the capitalization of earnings? Would the entire stock distribution be payable as income? Or would there still be an apportionment based on the three tests of the Pennsylvania Rule? See: *Matter of Fosdick*, 4 N.Y. 2d 646, 152 N.E. 2d 228 (1958).

⁶⁵ *Donaldson v. Mercantile-Safe Deposit & Trust Co.*, 214 Md. 421, 135 A. 2d 433 (1957).

⁶⁶ This contention was supported by the holding of the Surrogate's Court of Monroe County, N.Y., in *re Lindsay's Will*, 11 Misc. 2d 374, 109 N.Y.S. 2d 600 (1952), but this decision was patently inconsistent with other New York cases, such as *In re Lissberger's Estate*, 271 App. Div. 804, 64 N.Y.S. 2d 370 (1946); *In re Strong's Will*, 198 Misc. 7, 96 N.Y.S. 2d 75 (1950); and *In re Davis' Estate*, 11 Misc. 2d 372, 128 N.Y.S. 2d 152 (1953), the last named case involving the same 1951 Texas Company split which was presented in *Donaldson*.

ing.⁶⁷ Distributions of 100% or more of the stock previously outstanding are, however, treated as splits, and only the par value need be capitalized. Distributions between 25% and 100% are presumptively splits, but must be individually judged on their own facts. These rules, so argued the trustee, show that in modern financial and accounting practice there is a very real distinction between a small distribution of stock representing a division of earnings and a large one representing a split-up of the corporate equity into smaller lots at more attractive prices for the average investor. The sharp increase in the number of these splits in the post-war period suggests further that they are a by-product of the contemporary period of inflation.

These arguments are persuasive but run afoul of the principle of *stare decisis*. As we have already noted above, both *Coudon v. Updegraff*⁶⁸ and *Baldwin v. Baldwin*⁶⁹ involved the application of the Pennsylvania Rule of Apportionment to 100% "stock dividends" — distributions which differ from our definition of "modern stock splits" only in that they were not modern. This poses an interesting question for the student of jurisprudence: At what point must the principle of *stare decisis* yield to changing social and economic concepts? In his decision in the Circuit Court in the *Donaldson* case Judge Reuben Oppenheimer answered this question by saying: "Legal questions arising out of corporate actions are no more to be decided in a vacuum drained of the social and economic context of the times in which we live than are questions of civil liberties and due process of law."

The Court of Appeals reversed. Holding itself bound by *stare decisis*, the court ordered an apportionment of the three stock distributions received by the *Donaldson* trustee. Unless one is willing to accept Judge Oppenheimer's jurisprudential approach, it is difficult to criticize the decision of the Court of Appeals.

In further defense of *Donaldson*, one may wonder what formula the court could have devised to restrict the application of the Pennsylvania Rule to "modern stock splits" and yet preserve its application to "stock dividends." The Rules of the New York Stock Exchange might suffice for distributions under its jurisdiction, but what about stocks

⁶⁷ Discussed *supra*, n. 2. In this context, the term "market value" is used in the sense of "current value adjusted for the effect of this distribution."

⁶⁸ 117 Md. 71, 83 A. 145 (1912).

⁶⁹ 159 Md. 175, 150 A. 282 (1930).

not listed on this exchange? And what if these rules should change? Would it be fair to resolve a question of trust accounting in terms of such variable rules or even in terms of a fixed listing agreement between the distributing corporation and a stock exchange?⁷⁰ Could it not be argued that the decision of the lower court in the *Donaldson* case would have created as many problems as it would solve?^{70a}

As a result of the long line of Maryland decisions culminating in the *Donaldson* case, the Pennsylvania Rule in this state may be said to involve the independent application of three tests, and the life tenant receives the least number of shares resulting from each of them. These three tests are as follows:

(1) *The life tenant may receive no more than those shares which represent the proportion of earnings capitalized.* Thus, if a 2-for-1 stock distribution of 100 shares were received by the trustee, equivalent to one share for each of the 100 shares originally owned by the trust, and if the distribution were supported 80% by a charge to earned surplus and 20% to capital surplus, no more than 80 new shares could be apportioned to income. The remaining 20 new shares, plus the 100 old ones, or 120 in all, would stay in principal.

(2) *The life tenant may receive no more than those shares which represent earnings capitalized and earned during the holding period of the stock by the trustee.* Thus, in the example given above, if the 80% charge to earned surplus exceeded the earnings realized by the paying corporation during the period that the stock was held by the trustee, so that, let us say, only 70% of the total distribution represented the capitalization of such earnings, then the life tenant could receive no more than 70 shares out of the 100 new shares paid to the trustee. The remaining 30 new shares, or 130 in all, would stay in principal. Manifestly, the application of this test introduces a factor of approximation, if not guess-work, into the calculation, since

⁷⁰ In the case of *In re Terhune*, 50 N.J. Super. 414, 142 A. 2d 684 (1958), the New Jersey court refused to be bound by the listing agreement between Socony Mobil Oil Co. and the New York Stock Exchange under which earnings which are capitalized to support a stock dividend can no longer be used to pay dividends even if credited to capital surplus rather than capital stock account. Instead, the court insisted on looking to controlling corporation law in applying the New Jersey Rule which limits the apportionment to that portion of the capitalized earnings which are credited to an account from which future cash dividends cannot be paid.

^{70a} For a recent criticism of a stock exchange rule from a trust accounting point of view, see McCaffrey, *Stock Dividend or Split*, 99 *Trusts & Estates* 366 (April 1960).

precise earnings figures are rarely available for any given holding period.

(3) *The life tenant may receive no more than those shares which would leave intact the book value of the investment in the hands of the trustee reckoned as of its acquisition date.* Thus, in the example given above, if the book value of the investment at the time of its acquisition were, let us say, \$10.00 per share, or a total of \$1,000 for the 100 shares originally owned by the trustee, and if, after the stock distribution, the book value of the paying corporation's stock were \$6.00 per share, then it would take a total of $166\frac{2}{3}$ shares at \$6.00 each to maintain in principal the original book value of \$1,000. Hence, to avoid an impairment of book value, only $33\frac{1}{3}$ shares of new stock could be paid to the life tenant, and the remaining $66\frac{2}{3}$ shares would have to stay in principal. Since the book value test, or Test No. 3, thus results in the least number of shares to be apportioned to income from the application of all three tests, it is the one which would be applied in the hypothetical case presented. It would be noted, however, that the application of this test, like Test No. 2, introduces even more approximation and guess-work into the calculation, since precise book value figures are also rarely available for the two measuring dates. Moreover, book values are even less indicative of intrinsic worth than published earnings figures because a corporation's various capital and surplus accounts may be affected by corporate accounting practices which are wholly unrelated to its business record.⁷¹

After the decision in the *Donaldson* case, there came the case of *Mercantile-Safe Deposit & Trust Company v. Apponyi*,⁷² a consolidated test case instituted to clarify the application of the above stated rules to the seven million dollars worth of stock held by one trust company and subject to the *Donaldson* case. In this latest, if not the last word on the subject, the Court of Appeals reaffirmed the *Donaldson* rule even where it required the distribution, as income to a life tenant, of \$137,000 worth of stock in a

⁷¹ See: PATON, *ADVANCED ACCOUNTING* (1947) 347, commenting on the widespread depression practice of writing down the value of assets in plant account and charging the write-down to a capital reduction surplus. One large company is reported thus to have written off \$50,000,000 in plant account at one fell swoop. If this company had later made a stock distribution subject to apportionment under the *Donaldson* case, the "book value test" would have been something like an elastic yardstick. The day before the write-down, the test would have given one result, and on the day after, a very different one.

⁷² 220 Md. 275, 152 A. 2d 184 (1959).

trust estate of about \$450,000.⁷³ The court rejected the trustee's contention that, in applying the book value test, adjustments should be made for changes in the purchasing power of the dollar, and ruled that the modern stock split as hereinabove defined is to be treated as an apportionable "stock dividend" to the extent that earnings are capitalized.⁷⁴ Hereafter, it would seem immaterial that the paying corporation may have labeled the distribution as a "split", a "split-up" or words to that effect. To the extent that the three tests of the Pennsylvania Rule are satisfied, the distribution is apportionable regardless of its label.⁷⁵

The law is "settled," said the court, "and we shall not unsettle it." In other words, the Pennsylvania Rule is here to stay as to pre-1939 trusts not governed by the Uniform Act.⁷⁶

Eventually, the problem will solve itself by the passage of time, but, meanwhile, and possibly for another seventy-five or hundred years, the trustees of this State will have to struggle with the application of the Rule to an ever increasing number of new situations—regular stock dividends designed to effect distribution of a company's entire net annual income,⁷⁷ stock dividends and splits issued in

⁷³ The distributions involved in the consolidated cases were the General Electric split of 1954, the American Cyanamid split of 1957, as well as the same Texas Co. and American Gas & Electric Co. splits which were presented in *Donaldson*. Of these, and by far the largest was the General Electric split of 1954 which the New York courts had held apportionable under the Pennsylvania Rule. In *re Fosdick's Trust*, 4 N.Y. 2d 646, 152 N.E. 2d 228 (1958). The Supreme Court of Pennsylvania held otherwise in *In re Cunningham's Estate*, 395 Pa. 1, 149 A. 2d 72 (1959). For a discussion of the recent Pennsylvania cases, see *Cohan*, *Pandora's Box Revisited*, 98 *Trusts & Estates* 655 (1959), and *Niles*, *Fosdick, Cunningham and Chaos*, 98 *Trusts & Estates* 924 (1959).

⁷⁴ This proposed "refinement" of the Rule was suggestive of the recent Pennsylvania case. In *re Harvey's Estate*, 395 Pa. 62, 149 A. 2d 104 (1959), which permitted the book value of the investment in stock of an insurance company to be adjusted to reflect changes in the market value of the insurance company's invested portfolio.

⁷⁵ See: In *re Tealdi's Trust*, 16 Misc. 2d 685, 182 N.Y.S. 2d 68 (1958), dealing specifically with the problem of nomenclature and holding that Standard Oil and Proctor & Gamble distributions, both labeled as "stock splits" or "split-ups", are to be treated as "stock dividends" to the extent that earnings are capitalized.

⁷⁶ Although the trustee's contentions in the Apponyi case met with scant favor in the Court of Appeals, they were given a gracious nod of approval in a recent case note in the *University of Pennsylvania Law Review*, 108 Pa. L. Rev. 147 (1959). The Note concludes with the statement: "The argument made by the trustee in the present case offers a reasonable solution to the problems of fulfilling the settlor's intent, compensates for inflation and coincides with more recent views on the nature of corporate stock distributions."

⁷⁷ See: for example, the unusual announcement of Commonwealth Edison Co. of September 2, 1958, that henceforth it expects to pay a base quarterly cash dividend and also an annual "supplementary stock dividend" substantially equivalent to the balance of the company's net annual earnings.

connection with the consolidation of two or more companies,⁷⁸ death sentence spin-offs in compliance with orders under federal regulatory statutes,⁷⁹ and a host of other hybrid corporate transactions on a scale which was never dreamed of when *Thomas v. Gregg* was decided in 1894.⁸⁰

The application of the Pennsylvania Rule to modern corporate distributions also causes serious inconveniences in trust administration. The calculation of the American Gas & Electric Co. apportionment in *Donaldson* required the determination of corporate earnings and book values for five different acquisition dates and their application to eleven different sets of mathematical computations stretching out over three folded printed pages in the record extract. The court referred casually to "these complicated calculations", but anyone who has shared the experience of studying them cannot but be appalled at their complexity. "These complicated calculations" conjure up the vision of a conscientious lawyer or trust officer trying in vain to comply with the law against insuperable odds. The late Judge Parke, himself a distinguished country lawyer, visualized this same picture when he extolled the simplicity of the Massachusetts Rule and urged in his dissent in the *Heyn* case that the 1929 Act be construed so

⁷⁸ As, for example, the 1958 stock distributions of Springfield Fire & Marine Co. in connection with the acquisition of Monarch Life Insurance Co.

⁷⁹ For example, the stock divestiture provisions of the federal court decree which were upheld by the Supreme Court in *United States v. Crescent Amusement Co.*, 323 U. S. 173, 189 (1944), a leading anti-trust case.

⁸⁰ Another serious complication develops from the application of principles of conflict of laws to the apportionment problem. *Query*: If the Apponyi trust had been created by a Massachusetts domiciliary under a will made and probated in that state but naming a Maryland trust company as trustee, would the Massachusetts Rule or the Pennsylvania Rule have been applied? Or, suppose the situation were reversed and a Massachusetts trust company were named as trustee in a pre-1939 will of a Maryland domiciliary? Is the question one of "construction" to be determined by the law of domicile, or is it one of "administration?" *See*: *Bank of New York v. Shillito*, 14 N.Y.S. 2d 458 (Sup. Ct. Westchester Co., 1939), holding that the question is one of construction and applying the law of the testator's domicile to the hypothetical question above stated. Compare: *Fell v. McReady*, 236 App. Div. 390, 259 N.Y.S. 512, 522, aff'd. 263 N.Y. 602, 109 N.E. 718 (1933); *Cadbury v. Parrish*, 89 N.H. 464, 200 A. 791 (1938); *Selleck v. Hawley*, 331 Mo. 1038, 56 S.W. 2d 387 (1936); *LAND, TRUSTS IN THE CONFLICTS OF LAWS*, 14 (1940) 178-179. *RESTATEMENT, CONFLICT OF LAWS* (1934), §§ 297-299, inclusive, suggests that the question may be one of administration to be decided, in some cases, by the law of situs of the trust rather than of the state of the testator's domicile. Although the question does not seem to have been squarely raised in the Maryland cases, the decisions in *Smith v. Mercantile Trust Co.*, 199 Md. 264, 86 A. 2d 504 (1952), *Staley v. Safe Deposit and Trust Company*, 189 Md. 447, 56 A. 2d 144 (1947) and *Prince de Bearn v. Winans*, 111 Md. 434, 74 A. 626 (1909) suggest that the Shillito holding might meet with favor in the Maryland courts.

as to bring about the same result. He said in this connection:

“ . . . it [the Massachusetts Rule] relieves the fiduciary of many heavy responsibilities, such as ascertaining the intact or original dollar value of the trust corpus; or whether the dividend is declared from surplus which was earned before or after, or partly before or after the operative date of the instrument creating the successive rights; and, if accumulated partly before and after either the operative date of the instrument or the termination, during the period of the operation of the instrument, of a successive right of income, what are the relative amounts of the income which had accumulated before and after such points of division. The discharge of such duties would oblige the fiduciary to obtain information from the corporation, which he may act upon and so run the risk of its accuracy. If he should desire to go back of such information and assure himself of the true condition of the corporation, he would require expert aid, and, the greater the length of time included by his inquiry, the more costly it would become, especially if the corporation is of foreign origin or location. Not every fiduciary would be competent nor possess the facilities to fulfill these obligations, nor is every trust or fund possessed of the financial resources to acquire the necessary information. So a fiduciary would be frequently compelled to choose among expensive investigation, litigation, or the assumption of a risk which he ought not to bear. These considerations argue for the reasonableness of the construction of the statute here maintained.”⁸¹

VI — THE PROBLEM RESTATED

It is too late to construe the 1929 Act as the equivalent of the Massachusetts Rule — as Judge Parke has recommended. And in the light of the *Apponyi* decision, it is certainly too late to ask the court to abrogate the rule by judicial decision, as was done in New Hampshire.⁸² However, there are several ways in which the apportionment

⁸¹ 174 Md. 639, dis. op. 684-685.

⁸² *Langdell v. Dodge*, 100 N.H. 118, 122 A. 2d 529 (1956), overruling *Holbrook v. Holbrook*, 74 N.H. 201, 66 A. 124 (1907). See also: *Bowles v. Stilley's Executor*, 267 S.W. 2d 707, 44 A.L.R. 2d 1273 (Ky. 1954) overruling the Kentucky Rule by judicial fiat.

problem may be controlled, and perhaps even solved, in the years that lie ahead:

(1) Now that the law is settled as to the "modern stock split", a trustee may, in appropriate cases and with the consent of the life tenants, have to consider whether the application of the Pennsylvania Rule should be obviated by selling a particular stock after an announcement of the split but before the stock of record date arrives.⁸³ The proceeds of sale will, under *Smith v. Hooper*,⁸⁴ be principal, and after the split has been effected, the trustee can, if desired, buy back the same investment in the larger number of shares resulting from the split, or, of course, he can buy some other investment. This will usually entail a capital gains tax and some risk of market fluctuations, but the principal of the trust will, it is believed, be better off to pay this tax and take the risk of an increase in the price of the stock in the intervening period than to submit to the depleting effect of the Pennsylvania Rule.⁸⁵

In many cases the trustee may be able to secure the advance consent of the life tenants to such a sale and repurchase. Frequently, the life tenants do not, or should not want the stock distributable to them under the *Donaldson* rule since such receipts can cause serious federal estate tax complications.⁸⁶ It is believed that more often than not such a sale and repurchase might be welcomed by the life tenants and that the resulting capital gains tax would be a small price to pay for the saving to be realized in federal estate taxes. If, however, the life tenants object, such a sale and repurchase cannot be recommended.⁸⁷

⁸³ For a discussion of the date as of which the identity of the income beneficiary is to be determined see *supra*, n. 32. Obviously, any sale to obviate the application of the Pennsylvania Rule would have to be made before the record date to avoid receipt of the new stock by the trustee and a corresponding change in the market value of the old stock.

⁸⁴ 95 Md. 16, 54 A. 95 (1902).

⁸⁵ See: Dunham, *Trustee's Dilemma As To Principal-Income*, 98 *Trusts & Estates* 932 (1959), and authorities therein cited. As the author observes, a trustee's duty of impartiality is put to a severe test if he sells in anticipation of a stock distribution.

⁸⁶ As a result of the *Apponyi* decision, for example, an elderly life tenant was given outright, as income, about \$137,000 worth of stock which, if kept in the corpus of the estate, would have passed tax-free at her death. Although the record shows that this life tenant very much wanted to receive this distribution, other life tenants who feel differently may encounter gift tax problems if they refuse to accept their apportionments.

⁸⁷ Such a sale and repurchase might be challenged on the authority of the second *Bowen* case. [*Bowen v. Safe Deposit & Trust Co.*, 188 Md. 490, 53 A. 2d 416 (1957)], involving a sale by a trustee of defaulted bonds after a plan of reorganization has been announced. There, the Court of Appeals held that the proceeds of sale should be apportioned between income and

(2) Draftsmen of wills and deeds of trust should be warned to refrain from writing clauses which will only perpetuate the Pennsylvania Rule as to post-1939 estates. It would seem that in general the best procedure to follow is to omit all provisions dealing with principal and income, and to let the statute take care of the matter. In some cases, to be sure, the Pennsylvania Rule may bring the result desired by the creator of the trust, and in others the testator may want to leave the matter to the discretion of the trustee. In every such case, however, the consequences of such clauses should be thoroughly understood by the draftsman and explained to the testator.

(3) The General Assembly should be urged to enact a statute amending the Principal and Income Act to extend its application to all corporate stock distributions made after the effective date of the amendment, regardless of the date of the creation of a particular trust estate. Although the courts of Pennsylvania and New Jersey have regarded such legislation as "retroactive" and hence inapplicable to existing trusts,⁸⁸ there is respectable authority to the contrary. The Supreme Court of Wisconsin has recently upheld the application of the Wisconsin Act to all pre-existing estates, on the rationale that trust beneficiaries have no vested constitutional rights in future earnings of companies in which the trust has invested securities; and that although the income beneficiaries are entitled to receive "income", this right does not carry with it the right to freeze for all time the concept of *what is*

principal in the ratio that the accrued but unpaid interest bore to the unpaid principal. The court emphasized that these bonds, unlike stocks, carried fixed obligations as to both interest and principal, and that for trust accounting purposes, therefore, it was only equitable that the proceeds of sale should be apportioned between the life tenants entitled to the income and the remainderman entitled to the principal. Because of this distinction, it is not believed that the second Bowen case would bar the suggested sale and repurchase of stocks subject to modern stock splits—especially since the Court of Appeals in the first Bowen case, (*Safe Deposit & Trust Co. v. Bowen*, 188 Md. 482, 487, 53 A. 2d 413 (1947)) reported only a few pages earlier in the same volume of the Maryland Reports, reaffirmed its adherence to *Smith v. Hooper* and its rule that "proceeds of sale or increase in the value of corporate stocks" are not apportionable.

⁸⁸ *In re Crawford's Estate*, 362 Pa. 458, 67 A. 2d 124 (1949); *In re Pew's Estate*, 362 Pa. 468, 67 A. 2d 129 (1949); *In re Steele's Estate*, 377 Pa. 250, 103 A. 2d 459 (1954); *In re Warden's Trust*, 382 Pa. 458, 67 A. 2d 124 (1955); *In re Fera*, 26 N.J. 131, 139 A. 2d 23 (1958); *In re Wehrman's Estate*, 41 N.J. Sup. 158, 124 A. 2d 334 (1956 Ch. Div.), *aff'd*. 23 N.J. 205, 128 A. 2d 681 (1957). Unlike the first Pennsylvania Principal and Income Act, the New Jersey Act did not purport to apply to existing trust estates, and the comments in point which are made in the above cited cases are dicta.

income.⁸⁹ After all, many trust concepts are subject to change over the years, and some of them have a direct bearing on the amount of income which the life tenants receive — as, for example, the rate of the trustee's commissions which is not considered frozen at the percentages in effect when the trust was created unless the trust instrument expressly so provides.

The commentators have been eloquent in urging statutory relief for the dilemma caused by the recent apportionment cases in Pennsylvania and New York. See, for example, a recent comment concluding that "a retroactive statute relating to stock dividends would be sustained in most states — especially if the statute were restricted to hybrid dividends . . ."⁹⁰ Although the Maryland Court of Appeals has been traditionally hostile to all forms of "retroactive legislation" in the fields of testamentary and trust law, a persuasive argument could be made that the legislation here proposed is not "retroactive" at all in the constitutional sense. Manifestly, the statutory solution is the only truly effective method of controlling the apportionment chaos, and it seems to this writer well worth the effort.

(4) And, finally, as new and different situations come before the courts for interpretation and the application of the Pennsylvania Rule, the nature of the problem should be laid before the bench in terms which clearly explain it in its historical perspective. In this regard, if this study has clarified in some small measure some of the many inconsistencies of the Pennsylvania Rule as applied in this State since 1894, it will have fulfilled its purpose.

⁸⁹ In *re Allis' Will*, 6 Wis. 2d 1, 94 N.W. 2d 226 (1959), noted with approval in 73 Harv. L. Rev. 605 (1960).

⁹⁰ Russell D. Niles, *Fosdick, Cunningham & Chaos*, 98 Trusts & Estates 924 (1959). And see also a recent casenote in 73 Harv. L. Rev. 605, 606, suggesting that the validity of a retroactive application of such a statute should turn on three factors: (1) the nature of the public interest in the legislation, (2) the extent to which preenactment rights are affected and (3) the nature of those rights.