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Article 10

Distribution of Corporate Dividends Between Life Tenant and Remainderman

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It is plain that the action of the courts in holding that there was a real and substantial basis for the distinction made between the two sets of associations or orders was a correct conclusion. In the one case we find an apparent tendency to make the secrecy surrounding its purposes and membership a cloak for acts and conduct inimical to personal rights and public welfare, while in the other class there is a total absence of such tendency.

As to the last contention of petitioner, that the classification is an arbitrary one in that it is confined to associations having a membership of twenty or more persons, the Supreme Court ruled that such legislation is not unreasonable. A state may well decide for itself that an association of less than twenty persons would have only a negligible influence and any measure to restrain it would not be necessary.

The opinion of Mr. Justice Van Devanter indicates clearly that the Supreme Court will give a petitioner every consideration on his plea of unconstitutionality, yet they will refuse to interfere with the inherent police power of the sovereign state to regulate its internal affairs.

W. E. C.

DISTRIBUTION OF CORPORATE DIVIDENDS BETWEEN LIFE TENANT AND REMAINDERMAN.—The courts are frequently called upon to decide whether a particular distribution of a corporation to its stockholders is income for the benefit of a life tenant or capital to be added to the corpus of the trust estate for the benefit of the remainderman.

Over fifty years ago the New York Court of Appeals said that "It will be the duty of the Court, when the occasion arises, to seek to settle the question upon principle and establish a rule for the guidance of trustees and others" [1] but the court is still without a definite rule, determination in each case resting upon its own facts and circumstances.[2]

Decisions on the subject have opened the door to much confusion as an examination of a few cases under the various rules will show.

Early English Rule.

The early English rule, now partially obsolete, established as far back as 1799, states that all ordinary cash dividends shall be paid to

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[1] Riggs v. Cragg, 89 N. Y. 487 (1882).

[2] *In re* Osborne, 209 N. Y. 450, at 475, 103 N. E. 723, at 730 (1913).

the life tenant and all extraordinary dividends whether in cash or stock shall be paid to the remainderman.[3]

This rule was followed as late as 1856, though cases may be cited where extraordinary dividends, declared in different forms, were adjudged to belong to the life tenant.[4] At a later date we have a decision[5] which gives to the life tenant dividends declared out of surplus which was earned prior to the commencement of the life estate. Thus we see that the English rule, for a long period of time, was in a chaotic state, somewhat akin to our present condition.

Later English Rule.

From these conflicting decisions another rule was finally evolved in 1887,[6] similar in many respects to the Massachusetts rule, laid down in 1868.[7] Cash dividends "however large and no matter when earned" were to be regarded as income and "stock dividends however earned as capital" giving the former to the life tenant and the latter to the remainderman. In Bouche v. Sproule,[8] the leading case on the subject in England, Lord Herschel adopted the formula of the court below holding that when a testator creates a trust, the corpus of which is composed of corporate stock, the corporation has the power to distribute the profits either by way of cash dividends or to convert such dividends into corporate stock, to be used as capital and that the testator is presumed to have had knowledge on the subject and that he intended that the beneficiaries should abide by the decision of the directors of such corporation regarding dividends. It was decided, that the life tenant should receive that which the corporation declares by way of cash dividends, and the remainderman, that which is declared by way of stock dividends.

The respective rights of life tenants and remaindermen are therefore determined by the action of directors of the corporation, without regard to the testator's intentions.

In some of the later English cases, where the extraordinary dividend or bonus was declared in cash, with the proviso that one-half of such dividend was to be applied against the purchase of new stock, then about to be issued by the corporation, the courts held that such portion of the dividend with which the stock was to be

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[3] Brander v. Brander, 4 Ves. Jr. 800, 31 English reprint 414 (1799); Irving v. Houston, 4 Paton (Slot) 521. Cf. Witts v. Steer, 13 Ves. Jr. 363, 33 English reprint 330 (1807).

[4] Johnson v. Johnson, 15 Jur. 714 (1850); Price v. Anderson, 5 Sim. 473, 60 English reprint 703 (1847); Preston v. Melville, 16 Sim. 163, 60 English reprint 835 (1848); Paris v. Paris, 10 Ves. Jr., 185-32 English reprint 815 (1804).

[5] *In re* Hopkins, L. R. 18 Eq. 696, 43 L. J., Ch. N. S. 722, 30 L. T. N. S. 627, 22 Week. Rep. 687 (1874).

[6] Bouche v. Sproule, L. R. (12 App. Cases) 397, 56 L. J., Ch. N. S. 1037, 57 L. T. N. S. 345, 36 Week. Rep. 193 (1887).

[7] *Infra* Note 14.

[8] *Supra* Note 8.

purchased belonged to the corpus, thus for all practical purposes construing one-half of the cash dividend as a stock dividend.[9] This was based on the theory that the trustee (stockholder) had no option to take the cash dividend, but by the terms of the very declaration had to purchase the stock.

In still another case where the option to accept the cash dividend in lieu of new stock was given to the trustee (stockholder), and he exercised the option, the court held that the life tenant was entitled o as much of the cash as was used to purchase the new stock, but since it was selling at a premium, the trustee was bound to apply such premium to the corpus.[10]

There is also a decision to the effect that because of the premium value attaching to such stock dividend, where the trustee (stockholder), having the option to take the dividend in cash or in stock, exercises the right to the latter, the life tenant is entitled to a charge thereon to the extent of the cash dividend, while the stock itself belongs to the corpus.[11] Thus we see the English courts, while obviously guided by the so-called Massachusetts rule, at times applied the rule of apportionment.

Massachusetts Rule.

The Massachusetts rule "is to regard cash dividends however large as 'income' and stock dividends however made, as 'capital,' awarding the former to the life tenant and the latter to the remainderman."[12] This, as already stated, parallels to some extent the English rule.

Although adopted by the United States Supreme Court[13] it has been repudiated in many jurisdictions. In one Pennsylvania case[14] the court characterized the rule as follows:

> "The rule * * * is a very simple and convenient one and may relieve courts of much trouble, but it is certainly not one that commends itself for its justice and equity. * * * To us it seems a bungling rule of law that at one time would give what is indisputably income to the remainderman and, at another, what is clearly capital to the life tenant."

Obviously, this rule is inequitable in its effects upon the rights of the life tenant. This is clearly illustrated by some of the English cases cited above, wherein his rights are dependent upon the judgment of the board of directors.

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[9] Ellis v. Barfield, 64 L. T. N. S. 625 (1891).

[10] *In re* Malam, 3 Ch. 578, 63 L. J., Ch. N. S. 797, 71 L. T. N. S. 655 (1894).

[11] *In re* Hume, 27 times L. R. 461, 55 Sol. Jo. 536 (1911).

[12] Minot v. Payne, 99 Mass. 108, 96 Am. Dec. 705 (1868).

[13] Gibbons v. Mahon, 136 U. S. 549, 10 Sup. Ct. Rep. 1057, 34 L. ed. 525 (1890).

[14] Vinton's Appeal, 99 Penn. St. 434.

If the life tenant is entitled to all the income, why should he be deprived of any of the earnings, merely because the directors of the corporation have decided to convert such earnings into corporate stock?

Kentucky Rule.

The Kentucky rule awards all dividends, ordinary or extraordinary, cash or stock, whether earned before or subsequent to the commencement of the life tenancy, to the life tenant provided that such dividends do not deplete the principal of the trust.[15] This, in the final analysis, and excepting apportionment, would be the most equitable rule, if in addition to what it stands for it would define what is meant by "corpus."

Shall we deem the corporate stock, making up the trust estate, of a value equal to (a) the market value, (b) book value or (c) par value of the stock and in the event of no par value stock, the proportionate share paid for such stock into the treasury of the corporation?

(A) The corpus of the trust is represented by certain shares of stock, aggregating a certain percentage of the total outstanding shares of the corporation and in our present highly developed economic world the market value of the shares is subject to the influence of many factors.

It would be inequitable to consider the market value of the stock as a basis for computing the value of the trust estate, as of the date of the beginning of the life tenancy, because if we should accept the provision, that all dividends of whatever nature and description shall belong to the life tenant, provided the corpus is not impaired, it would be palpably unjust to establish, as a criterion of value, so fluctuating and uncertain a measure as market value.

(B) The book value of a share of stock is not, for the purposes of the question here discussed, a good measure of its value. Where the book value consists of intangible assets, such as good will, subsequently replaced from earnings by actual assets, the rule has a harsh effect upon the interest of the life tenant.

A well-known corporation, upon reorganizing its capital structure, set up, as a part of its book value an asset of $50,000,000 represented by "good-will" and subsequently the board of directors by proper resolution and in the best interests of the corporation charged off from this good-will account the sum of $10,000,000 yearly, for a period of five years, and substituted therefor, tangible assets from earnings. In a situation of this kind, how is the book value to be

[15] Hite v. Hite, 93 Ky. 257, 19 L. R. A. 173, 40 Am. St. Rep. 189, 20 S. W. 778 (1892); Cox v. Gaulbert, 148 Ky. 407, 147 S. W. 25.

judged as affecting the life tenant's income, if we apply the Kentucky rule?

In the event that the directors decide that during this five-year period while the corporation is squeezing the water out of its stock and making replacement with tangible assets, that all dividends shall be declared in the form of stock instead of cash, shall the life tenant begin to enjoy the dividends at once or must his enjoyment be postponed to a time when the intangible assets shall have been replaced by physical assets. After the five-year period when the $50,000,000 good-will asset shall have been replaced by physical assets, the book value will not have changed in actual figures, yet, the book value after the five-year period consisting as it will of tangible instead of intangible assets, will have benefited the remainderman at the expense and loss of the life tenant. The corpus will have been augmented by earnings clearly belonging to the life tenant.

(C) It follows, that since we cannot accept either the market value or book value as a measure of valuing the trust estate at the commencement of the tenancy, we should adopt the par value of the stock as the unit of measurement, when the stock has a par value and when it is of no par value, the proportionate share of the assets of the corporation paid into the corporation for such share.

If we adopt the Kentucky rule, supplemented by a provision that the shares of stock composing the corpus shall be valued (1) as of their par value or (2) when they are of no par value, their proportionate share of the paid-in capital, there will be no danger of impairment of capital, since by law a corporation may not declare dividends except from earnings.[16] The safety of the capital structure of the corporation, and indirectly that of the corpus, is thereby assured.

The Kentucky rule was adopted and followed by the courts of New York for many years until repudiated by the *Osborne* case.[17]

Subsequent to the remarks of Judge Andrews [18] the first case in which the Court of Appeals had the opportunity to consider the question of corporate dividends as they affect the life tenant and remainderman was in 1897.[19] In that case, the court applied the Kentucky rule and even though the earnings had accumulated during a period of ten years, six of which preceded the commencement of the life estate, it was held that while the corporation may convert earnings into capital, in so far as the interests of the life tenants and remainderman are concerned, they are not affected by the mere fact of the ownership of the earnings. The court held that the accumulated earnings "were in substance a distribution of profits" and awarded the entire dividend to the life tenant.

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[16] Stock Corporation Law, Sec. 58.

[17] *Supra* Note 2.

[18] *Supra* Note 1.

[19] McLouth v. Hunt, 154 N. Y. 179, 48 N. E. 548 (1897).

Five years later,[20] the court after considering the question in the light of McLouth v. Hunt,[21] awarded by a unanimous decision the entire fifty per cent. stock dividend to the life tenant and stated:

> "That which the directors of a corporation distribute among its stockholders, without intrenchment upon the capital, must be comprehended within the term 'profits' and *we should assume that the testator intended, that what might be paid in that way should belong to the beneficiary.* It was simply a mode of distributing profits earned by the employment of capital."

The court also gave voice to this significant remark:

> *"That the value of the shares of stock has been lessened by a dividend, is a fact of no relevancy in determining the question of, whether the dividend is to be regarded as income to the life tenant or as capital to the remainderman."*

Again, where one corporation declared a cash dividend from earnings accumulated over a period of twenty-six years, eighteen of which preceded the commencement of the life tenancy, and another corporation declared a stock dividend from accumulations during the testator's life, both dividends were treated as income and awarded to the life tenant.[22]

In Thayer v. Burr,[23] where a dividend was declared in the form of bonds, it was held that that portion of the bonds which represented earnings belonged to the life tenant and only such portion as represented the increased value of certain securities, held by the corporation, belonged to the remainderman. The rule as laid down in the previous cases was not questioned.

In 1912 the Court of Appeals decided the *Osborne* case.[24] The court below decided the question in accordance with the Kentucky rule outlined in the cases cited above[25] but the Court of Appeals, Judge Gray dissenting, modified the judgment and laid down the following rule:[26]

1. Ordinary dividends, regardless of the time when the surplus out of which they are payable was accumulated, should be paid to the life beneficiary of the trust.

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[20] Lowry v. Farmer's Loan & Trust Co., 172 N. Y. 137, 64 N. E. 796 (1902). (Italics ours.)

[21] *Supra* Note 19.

[22] Robertson v. de Brulatour, 188 N. Y. 301, 80 N. E. 938 (1907).

[23] Thayer v. Burr, 201 N. Y. 155, 94 N. E. 604 (1911).

[24] *Supra* Note 2.

[25] *Supra* Notes 21, 22, 24, 25.

[26] *Supra* Note 2 at 477.

2. Extraordinary dividends, payable from the accumulated earnings of the company, whether payable in cash or stock, belong to the life beneficiary, *unless they entrench in whole or in part upon the capital of the trust fund as received from the testator or maker of the trust or invested in the stock, in which case such extraordinary dividends should be returned to the trust fund or apportioned between the trust fund and the life beneficiary in such a way as to preserve the integrity of the trust fund.*

By this decision the court repudiated the Kentucky rule and adopted the rule of apportionment, or the so-called Pennsylvania rule.

Pennsylvania-New York Rule.

The Pennsylvania rule is to the effect that ordinary dividends on stock held in trust belong to the person entitled to the income, but that extraordinary dividends whether in cash or in stock should be apportioned between the life tenant and the remainderman, the amount accumulated before the creation of the trust being awarded to the latter, that after, to the former.[27]

At first glance, there seems to be a close similarity between the Pennsylvania and the Kentucky rules. Both adjudge ordinary and extraordinary dividends as belonging to the life tenant and both are designed to prevent impairment of the corpus.

There is, however, this basic difference. Under the Pennsylvania rule, the underlying principle is the apportionment of income so that the life tenant shall receive only such earnings as have accumulated during the life tenancy, while under the Kentucky rule, the life tenant receives all earnings, when declared, regardless of the time when accumulated.

Under the Pennsylvania rule, impairment of the corpus begins, when the corporate distribution embraces earnings accumulated prior to the commencement of the trust estate, while under the Kentucky rule, there can be no impairment, excepting when a board of directors shall be guilty of declaring a dividend out of capital in disregard of the statute prohibiting such declarations.[28]

The courts seem to be particularly concerned with guarding the interests of the remainderman and while this solicitude is to be commended, we must not overlook the rights of the life tenant. If we are to favor the rule of apportionmnt, it should apply equitably to both the remainderman and the life tenant. If pressed to its logical conclusion it should follow, that if apportionment is permitted as of the beginning of the life tenancy, in order that the interests of the life tenant may not draw upon the corpus, so in like manner apportionment should be permitted at the end of life tenancy, so that earnings which have accumulated during the life tenancy, shall

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[27] *In re* Earp's Appeal, 28 Penn. St. 368 (1857).

[28] *Supra* Note 18.

belong to the life tenant regardless of whether they are distributed or not and that he shall have the right to dispose of the same by sale, transfer, or assignment, or to bequeath the same or have his interest distributed in the event of intestacy. This right he should enjoy, contingent upon the dividends being declared and said dividends shall be payable when, as and if declared. If we are to have a rule of apportionment, let the rule be one that is equitable.

On the other hand it may be said that in the event such a rule is adopted and apportionment is allowed at the end of the life tenancy, that the undeclared earnings retained by the corporation may later be dissipated by losses incidental to the risks of trade and that such earnings wholly or in part may not be declared in the form of dividends for a very long period of years. The answer to this must be, that the same is true when applied to the corpus under our present rule of apportionment. If any part of the corpus is lost due to fluctuating business conditions, future corporate earnings accumulated during the life tenancy are used to replace the depleted capital of the corporation before any dividends may be declared and in like manner, the life tenant would fare under the apportionment rule herein proposed.

It is quite true, that under our present apportionment rule, as laid down in the *Osborne* case,[29] the life tenant may prove that earnings accumulated during his incumbency were used to replace previous losses of the corporation and that the book value of the corpus is being enhanced at his expense, but such proof is very difficult to adduce.

The rule of apportionment, based as it is on the theory that the corpus be not dissipated, contradicts itself when applied to ordinary dividends.

Let us assume the case of a corporation which has had a consistent dividend-paying record over a period of years. Then, coincidental with the commencement of a life tenant's interest in a trust fund, it fails to earn for the next few years net profits sufficient to pay ordinary dividends. However, desiring to adhere to its uniform dividend policy it continues to declare such ordinary dividends paying the same out of surplus acquired in former years. Such ordinary dividends under this rule belong to the life tenant. Thus in spite of the rule of apportionment the corpus would be impaired to the extent of the dividends declared from the surplus earned prior to the commencement of the life tenancy.

We are then confronted by a situation where it is possible, *by the declarations of ordinary dividends over a period of years, to dissipate the entire surplus,* consisting of earnings accumulated prior to the commencement of the life tenancy and yet we permit such dividends to go to the life tenant, without invoking the rule of apportionment, to protect the corpus.

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[29] *Supra* Note 2.

The testator in creating a trust consisting of corporate stock is necessarily actuated by either of two intentions: (a) That all dividends that may be declared by the corporation shall go to the life tenant or (b) that there shall go to the life tenant only such dividends as are earned during the life tenancy.

If it be the former, then the testator intends that, during a limited period of time, the life tenant should enjoy that which the testator would have enjoyed had he been alive. Were he alive, any dividends declared would have been considerd by him as income. It follows, therefore, that all dividends declared over and above the par value of the stock (or all dividends on shares of no par value) should go to the life tenant no matter when earned and no matter how declared, just as they would have gone to the creator of the trust were he here to receive them.

If it be the latter theory, then it is clear that the death of the life tenant should not rob him of such earnings as were accumulated during his incumbency, merely because the dividends have not been declared prior to the termination of his tenancy.

Judicial opinion seems to indicate that if any other rule were adopted and a testator desired to provide that only a portion of the Corporate distribution be given to the life tenant (only such earnings as have accumulated during the life tenancy), that such a provision would be in violation of our statutes against accumulations. Yet our rule of apportionment, if not modified as hereinbefore suggested, permits accumulations for the benefit of the remainderman. Where the corporation declares ordinary dividends and no apportionment is permitted at the end of the life tenancy, the accumulated earnings remaining undeclared during the life tenancy permit the corpus to mount in value to a point never contemplated by the testator and this we permit in violation of the rights of the life tenant to the income, contrary to the intentions of the settlor.

Although it has been the policy of this state to prevent the accumulation of income in trust funds, even in the form of stock dividends,[30] it is now permitted by an amendment to the Personal Property Law [31] which provides that, in the absence of any contrary provision in the instrument of trust, all stock dividends shall belong to the corpus.

This amendment accomplishes still more. It modifies the rule as laid down in the *Osborne* case [32] as far as it affects stock dividends, and its effect is partially to adopt the much-criticized and oft-repudiated Massachusetts rule [33] to the effect that all stock dividends shall belong to the corpus.

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[30] Matter of Megrue, 170 App. Div. 653, affirmed 217 N. Y. 623, 111 N. E. 1091 (1916).

[31] Personal Property Law, Sec. 17A.

[32] *Supra* Note 2.

[33] *Supra* Note 14.

This section adds still another complication to our already vexatious problem and permits the very accumulation contrary to the policy of our courts and the statutes against accumulations.[34]

Our conclusion is, therefore, that the Kentucky rule with the modification hereinbefore suggested provides an equitable rule of distribution, *i. e.*, that all dividends from earnings whether they be ordinary or extraordinary, whether declared in cash, bonds, scrip or stock, whether accumulated from earnings prior or subsequent to the creation of the trust estate, shall go to the life tenant.

The safety of the corpus is amply protected from impairment by statutes which prohibit declarations of dividends unless declared out of earnings.

If, however, a rule of apportionment is deemed necessary, it is submitted that it should be applied for the benefit of both the life tenant and remainderman.

The life tenant will therefore be charged with the earnings accumulated prior to the commencement of the life tenancy, and the remainderman will be charged with an amount equal to the earnings accumulated during the life tenancy. In this way we retain the rule of apportionment. Let us extend it so that in its application it will treat both the life tenant and remainderman equitably, not sacrificing the interests of the former for the benefit of the latter.

B. F.

CORPORATIONS—CONTRACT TO PURCHASE ITS OWN STOCK—MUTUALITY.—In England, unless expressly authorized, a corporation has no power to acquire its own stock.[1] The reason attributed for this rule is that such a purchase effects a reduction of the capital of the corporation, thereby tending to fraud. In most jurisdictions in the United States, including New York, it is well established that in the absence of express restriction, a corporation may purchase its own stock, providing it is not to the prejudice of creditors or stockholders.[2] It is entitled to buy in its own stock out of surplus, but if the purchase would render the corporation insolvent, such an act would be deemed ultra vires, and too, under the Penal Law,[3] a direc-

[34] Bourne v. Bourne, 240 N. Y. 172, 148 N. E. 180 (1925).

[1] Trevor v. Whitworth, L. R., 12 App. Cas. 409 (1887).

[2] City Bank of Columbus v. Bruce, 17 N. Y. 507 (1858); Vail v. Hamilton, 85 N. Y. 453, 457 (1881); Joseph v. Raff, 82 App. Div. 47, 54, 81 N. Y. Supp. 546, aff'd 176 N. Y. 611, 68 N. E. 1118 (1903); Cook on Corporations, Vol. 1 (7th ed) Sec. 311.

[3] Sec. 664.