

# ST. LOUIS LAW REVIEW

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Published Quarterly During the University Year by the  
Undergraduates of Washington University Law School.

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## IS THE LIFE TENANT OR REMAINDERMAN OF STOCK ENTITLED TO EXTRAORDINARY CASH OR STOCK DIVI- DENDS?<sup>1</sup>

The question whether a life tenant or remainderman is entitled to extraordinary cash or stock dividends is a matter of the utmost importance under modern business conditions. Large corporate holdings are daily bequeathed by will and it is out of the creation of trust estates by will that the situation under consideration arises necessitating the intervention of the Courts.

All jurisdictions are agreed that the conflicting claims of life tenant and remainderman to an extraordinary dividend rest on the intention of the testator as indicated in the trust instrument. But it is in the absence of definite language disposing of extraordinary dividends that the matter is presented for judicial determination. Phraseology which directs the payment to a specified person during his life of "income," "dividends," "interest, dividends and income," and words of similar import bring before the Courts the query whether the trustee

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<sup>1</sup> 12 L. R. A. N. S-768 and note; 35 L. R. A. N. S. S-563 and note; 50 L. R. A. N. S-510 and note; L. R. A. 1916, D-210, and note.

shall credit an extraordinary dividend to the life tenant or remainderman. No such question occurs in connection with ordinary dividends which are deemed to have been earned as of the date of their declaration, and become property of the holder of the stock at that time.

An ordinary dividend, it may be noted, is distinguished from one of an extraordinary nature in that the former "is periodically declared and distributed among the shareholders of the corporation while the latter is declared and distributed at irregular intervals out of accumulated profits. The length of time during which the directors have allowed profits to accumulate, however, before declaring the dividend affords no satisfactory test as to its nature, as ordinary dividends are sometimes declared out of accumulated profits, and extraordinary ones out of profits recently earned."<sup>2</sup>

The conflict in the authorities relative to the disposition of extraordinary dividends is confined to earnings past or current—a dividend which reduces corporate capital, or which arises from an advance in its value due to reasons other than an accumulation of profits, belongs indisputably to the corpus of the estate.

The first rule formulated on the matter of the ownership of extraordinary dividends was the early English rule,<sup>3</sup> now obsolete, which gave all extraordinary cash or stock dividends to the remainderman as a part of the corpus of the trust fund.

The inconvenience of investigating the corporation's books and the practical ease with which this rule was applied, seems to have been the cause for its adoption. A cynical commentator, however, attributes its confirmation<sup>4</sup> to the influence brought to bear by the Bank of England, when, to the consternation of its directors, the Court intimated its intention of going over the bank's records in order to apportion the dividend between the rival claimants.<sup>5</sup> This view of the law, obviously unfair to the life tenant, has been superseded by the later English rule, which is identical with the Massachusetts Supreme Court rule, in holding all stock dividends to be corpus and all cash dividends, income.<sup>6</sup>

The three rules now in force are the Kentucky rule (formerly the New York and Kentucky rule); the Massachusetts-United States

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<sup>2</sup> 9 Am. and Eng. Encyclopedia of Law, 710.

<sup>3</sup> Brandes v. Brandes, 4 Ves. Jr. 800.

<sup>4</sup> Irving v. Houston, 4 Paton, Sc. App. Cas. 521.

<sup>5</sup> 12 L. R. A. N. S. 775.

<sup>6</sup> Bouch v. Sproule L. R. 12, App. Cas. 397.

Supreme Court rule (sometimes known as the Massachusetts and later English rule); and the Pennsylvania rule.

The Kentucky rule, briefly stated, is this: extraordinary cash dividends, or stock, declared during a life-tenancy out of profits become the property of the life tenant whether such dividends were earned before or after the beginning of his estate.<sup>7</sup>

It will be observed that while the early English rule gave all extraordinary dividends to the remainderman, the Kentucky Court swings to the other extreme and holds that such dividends belong to the life tenant as income. This precept rejects as a criterion of distribution either the nature of the dividend, *i. e.*, whether stock or cash, or an apportionment based upon the time when the profits accumulated with reference to the vesting of the life estate.

The leading Kentucky case,<sup>8</sup> in refusing to apply either of the above tests, says: "The difficulty attending such an inquiry, the impossibility of attaining accuracy, and of ascertaining the many sources from which the profit has been derived, are the reasons for this rule; but it does not also follow that the declaration of the company, as to the character of the dividends, determines its legal status and to whom it shall belong."

Kentucky agrees with Massachusetts as to the impracticability of an apportionment, but, unlike Massachusetts, refuses to let the corporate act in declaring stock or cash determine its owner.

Dicta favoring Kentucky<sup>9</sup> are found in several cases, but we know of no State following Kentucky when the dividends were out of *profits*, which had clearly accumulated, partly before and partly during the life estate.

New York formerly subscribed to the Kentucky doctrine, but in the well-considered case of *In re Osborne*<sup>10</sup> aligned itself definitely with the apportionment rule promulgated by the Courts of Pennsylvania.

The Pennsylvania rule was first enunciated in the leading case of *Earp's Appeal*.<sup>11</sup> It is in substance this: The Court, as a criterion

<sup>7</sup> *Hite v. Hite*, 93 Ky. 257; *Cox v. Gaulbert*, 148 Ky. 407.

<sup>8</sup> *Hite v. Hite*, 93 Ky. 257.

<sup>9</sup> *Bryan v. Aiken*, 45 L. R. A. N. S-477; *Kalbach v. Clark*, 133 Iowa 215.

<sup>10</sup> *In re Osborne*, 209 N. Y. 450.

<sup>11</sup> *Earp's Appeal*, 28 Pa. 368; *Stokes' Estate*, 240 Pa. 277; *Re Heaton*, L. R. A., 1916, D-201; *Miller and Payne*, 105 Wis. 354; *In re Baldwin*, 209 N. Y. 601; *Smith's Estate*, 140 Pa. 344; *In re Osborne*, 209 N. Y. 450; *Thomas v. Gregg*, 78 Md. 545; *Holbrook v. Holbrook*, 74 N. H. 201; *Ballantine v. Young*, 79 N. J. Eq. 70; *Goodwin v. McGaughey*, 108 Minn. 248.

for determining the respective rights of life tenant or remainderman, takes into consideration the time in which an extraordinary dividend, either cash or stock, is earned with relation to the beginning of the life estate. If profits have accumulated before the life tenancy commences and a dividend is declared therefrom after its inception, the dividend belongs to the corpus of the estate, since it was not earned during the life estate. By a parity of reasoning all profits earned during the life tenancy belong to the life tenant, and if the profits have accumulated partly before and partly during the life tenancy, the extraordinary dividends, either stock or cash, are divided between remainderman and life tenant, respectively, in proportion to the amount of profits accumulated before and after the life estate's inception.

It will be observed that the Pennsylvania rule rejects the character of the dividend as a basis upon which to determine the rights of the parties and looks entirely to the time of the earning of the dividend as a test.

The Massachusetts-Supreme Court rule is, succinctly stated, "to regard cash dividends, however large as income, and stock dividends, however made, as capital."<sup>12</sup> This principle disregards entirely the question of the time in which the profits making up the dividend have accumulated; the *form* of the dividend as declared by the directors of the corporation, acting in good faith, definitely decides its owner.<sup>13</sup>

One of the outstanding cases in this line of decisions is *Gibbons v. Mahon*,<sup>14</sup> which reasons with vigor and clearness, thus: "Therefore, when a distribution of earnings is made by a corporation among its stockholders, the question whether such a distribution is an apportionment of additional stock representing capital, or a division of profits and income, depends upon the substance and intent of the action of the corporation as manifested by its vote or resolution; and ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income, of each share.

"A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders

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<sup>12</sup> *Minot v. Paine*, 99 Mass. 108.

<sup>13</sup> *Mansfield v. Mansfield*, 79 Conn. 634; *DeKoven v. Alsop*, 205 Ill. 309; *In re Brown*, 14 R. I. 371; *Billings v. Warren*, 216 Ill. 281; *Hyde v. Holmes*, 198 Mass. 287; *Spooner v. Phillips*, 16 L. R. A. 461.

<sup>14</sup> *Gibbons v. Mahon*, 136 U. S. 549.

are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest." Later in the case is this language: "A dividend is something with which the corporation parts, but it parted with nothing in issuing this new stock. It simply gave new evidence of ownership which always existed."

The recent United States Supreme Court case of *Towne v. Eisner*<sup>15</sup> has affirmed *Gibbons v. Mahan* and has quoted it with approval, re-enunciating the doctrine that a stock dividend belongs to the corpus of an estate, and therefore is not taxable as income under the Federal Income Tax.

The reasoning in favor of the Massachusetts rule found in *Gibbons v. Mahan*, *supra*, commends itself at first glance as logically sound, but on close examination appears somewhat casuistic.

Though, as the Court truly says, after a declaration of a stock dividend a shareholder's proportional interest remains the same in the corporate funds, yet those funds, if the dividend is rightfully declared out of profits, have increased to the amount of such dividend, and if the shareholder sell his new shares, by such sale the original investment evidenced by the old shares has not been depleted an iota. How, then, can such additional shares be termed anything but income?

The Court says: "The question whether a distribution of earnings among stockholders is an apportionment of additional stock or a division of profits, and income *depends on the substance and intent of the action of the corporation.*" This, then, is the gist of the matter—the corporation rather than the courts becomes the judge of the rights of life tenant and remainderman through an arbitrary ruling that the intention of the testator will thus be effectuated.

It is universally admitted that directors of a corporation, acting for the best interests of the corporation, may declare cash dividends, stock dividends, or no dividends at all, but it does not follow logically that once the dividend is declared, the corporation rather than the law should determine whether it be corpus or income in the dispute between the parties themselves.

It is amusing to observe the conflict between the two theories in the viewpoint of the judges. Take, for example, this language from a

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<sup>15</sup> *Towne v. Eisner*, 62 U. S. L. Ed. 183.

decision which upholds the Pennsylvania doctrine,<sup>16</sup> though, as is apparent, with reluctance:

“As a matter of logic, it is difficult to resist the reasoning leading to the conclusion that stock dividends are, in fact, principal; for the life tenant, as is usually held, is not, in the absence of fraud, or improper conduct, entitled to the earnings until they are distributed. They are not, in fact, distributed, but on the contrary, put permanently into capital account when new stock is, without any money equivalent, allotted to the whole body of stockholders.”

In contrast we find this expression from a Court following the Massachusetts rule and in reference to it: “It was not pretended that this rule \* \* \* was the ideal rule of reason; nor have the Courts which have given their approval of it ever claimed it to be such, or one which would accomplish exact justice under all circumstances.”<sup>17</sup>

The reason given over and over again for the application of the Massachusetts rule is, that by its certainty and ease of application it is more productive of justice in the long run than is a search behind a dividend to discover the equitable demands of each case.

Were the Massachusetts rule always simple to apply and the Pennsylvania rule invariably complex, a sound argument for the former would exist despite its purely arbitrary character, though even this is denied indirectly by the opinion in *Goodwin v. McGaughey* in this phrase: “It may be that it is not always easy to determine when the fund was earned, but that fact alone is not sufficient for refusing to apply the (Pennsylvania) rule.”<sup>18</sup>

But it is by no means so simple as it first appears. All Courts following this (Massachusetts) rule hold:

I. That the discretion of the corporation in declaring the dividend will not be binding if done in fraud or bad faith.<sup>19</sup>

II. That the Court will look into a dividend to ascertain whether it is declared out of capital or profits.

III. That the Court will examine a so-called stock or cash dividend to ascertain its true nature and distribute it accordingly, or in other words, “in determining what is a cash

<sup>16</sup> *Ballantine v. Young*, 79 N. J. Eq. 70.

<sup>17</sup> *Smith v. Dana*, 77 Conn. 543.

<sup>18</sup> *Goodwin v. McGaughey*, 108 Minn. 248.

<sup>19</sup> *Gibbons v. Mahan*, *supra*.

dividend and what is a stock dividend, substance and not form is regarded and often it is difficult to decide to which class a particular dividend belongs."<sup>20</sup>

If we stop to consider that the Courts will investigate a dividend's good faith, its source in earnings or capital, and its subsequent nature, there seems small ground for their criticism of the apportionment rule, *i. e.*, that the insuperable difficulty of investigating corporate accounts renders such task uncertain and hence unfair. Since Massachusetts Courts look into the matters hitherto enumerated, they could with equal propriety inquire as to the time in which a dividend was earned.

Another matter to consider in this connection is one frequently overlooked—only in cases involving a *dispute* as to the time of earning does the apportionment rule become complex and unwieldy of application. In any other case the corporation's books alone furnish the requisite information.

The Pennsylvania rule does substantial justice to both parties. Under it, a corporation, even for legitimate business reasons, cannot, by the accumulation of profits before the vesting of the life estate, and the declaration of a cash dividend thereafter, strip the remainderman of all claim thereto. Neither can it turn over the entire income earned during a life tenancy to the remainderman by deciding to keep the profits for further corporate use and issuing for that purpose stock instead of cash dividends.

The interests of both parties are guarded under the Pennsylvania rule and are not dependent on the varying exigencies of business conditions as evidenced by the issue of cash or stock. The principle is occasionally as difficult and unsatisfactory in its application as its opponents allege; but it is based on an equitable attempt at fairness and is theoretically perfect, though, as we know, no rule of law accomplishes perfect justice in every case in which it is applied. Still, the failure of such an equitable test in a few cases would not justify the substitution therefore of an arbitrary rule for purposes of convenience, the results of which may be, and frequently are, more unfair than a faulty apportionment.

The Pennsylvania rule, in fact, to do perfect justice, should go farther and apply the time-of-earning test to the termination of the life tenancy and the beginning of the remainderman's estate. The present rule, by the great weight of authority under all methods of determining the rights of the parties at the close of the life tenancy, is to give to the

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<sup>20</sup> Lyman v. Pratt, 13 Mass. 58.

remainderman, as though it were an ordinary dividend, any extraordinary dividend declared after the vesting of his estate, regardless of whether it was earned before such period or subsequent to it.

The concluding argument for the Pennsylvania rule is a matter of human experience. It is a reasonable supposition when a testator, in creating a trust, gives "income for life" without mentioning extraordinary dividends, that he regards his entire corporate holdings at the time of his death as principal. The most natural thought to one making such a will would be that his death fixes the rights of the parties and that "income" would consequently refer to profits made after his death.

For these reasons the Pennsylvania rule (amended to extend the apportionment test to the end as well as the beginning of the life tenancy), seems better than the others now existing, both to effectuate the intention of the testator and to form a standard for doing substantial justice in the adjudication of the conflicting claims of life tenant and remainderman.<sup>21</sup>

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<sup>21</sup> This question has not been adjudicated in Missouri, though a dictum in the case of *Knapp v. George Knapp & Company*, 127 Mo. 53, favors Massachusetts.

\*This article was awarded, in 1918, the prize offered each year for the best thesis submitted by a member of the Senior Class. The article is reproduced without addition or correction.—Eds.