Volume 63
Issue 3 *Dickinson Law Review - Volume 63, 1958-1959*

3-1-1959

Trusts-Apportionment of Stock Distributions Under the Pennsylvania Rule

COMMENTS

TRUSTS—APPORTIONMENT OF STOCK DISTRIBUTIONS UNDER THE PENNSYLVANIA RULE

Two recent decisions handed down by the Pennsylvania Supreme Court on January 12, 1959, *In re Estate of Edith B. Cunningham,*[1] and *Estate of R. Wistar Harvey,*[2] deal with the *Pennsylvania* or *American Rule* of apportionment of income between the income beneficiary and the remaindermen of a trust.[3] These two cases involve distributions of stock on similar stock held in the corpus. This is the first time that the Pennsylvania Supreme Court has been squarely faced with the difficult problem of treating distributions of stock, not only based on capitalized "earned surplus," but also "paid in surplus" or a readjustment of par or stated value of outstanding stock.[4]

Both of the trusts involved were created before the adoption of the Principal and Income Act in 1945;[5] thus there is no question that both would have been governed by the *Pennsylvania Rule* had the Supreme Court seen fit to apply it.[6] Both of the trusts held stock in the General Electric Corporation in 1954 when that corporation made the stock "change and conversion" in question. The Cunningham trust additionally owned stock in the Gulf Oil Corporation in 1951 when it declared its "stock dividend" also in question. The Harvey trust held stock in the Insurance Company of North America which raised a question not pertinent to this discussion.

The General Electric stock distribution took the form of issuance of three new shares of $5 par stock for each outstanding share of $6.25 stated value. The difference between the aggregate value of the three new shares and that of the old, $8.75, was made up by a capitalization from the "reinvested earnings"

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[1] Supreme Court of Pennsylvania Nos. 222, 223, 228 January Term, 1958.

[2] Supreme Court of Pennsylvania Nos. 209, 236, 240 January Term, 1958.

[3] For an extensive discussion of apportionment of stock dividends see: Brigham, *Pennsylvania Rules Governing the Allocation of Receipts Derived by Trustees from Shares of Stock,* 85 U. PA. L. REV. 358 (1937); Brigham, *Some Problems of Principal and Income,* 55 DICK. L. REV. 377 (1952); Cohan and Dean, *Legal, Tax and Accounting Aspects of Fiduciary Apportionment of Stock Proceeds: The Non-Statutory Pennsylvania Rules,* 106 U. PA. L. REV. 157 (1957).

[4] For lower court decisions see: *Fownes Trust,* 3 Pa. D.&C. 2d 637, 5 Fid. Rep. 239 (1955); *Cunningham Estate and Harvey Estate,* 13 Pa. D.&C. 63, 8 Fid. Rep. 71, 8 Fid. Rep. 84 (1957); *Pew Trust,* 8 Fid. Rep. 241 (1958); *Frick Estate,* 4 Pa. D.&C. 2d 247 (1955).

[5] PA. STAT. ANN, tit. 20, § 3471 (Purdon Supp. 1956).

[6] *Crawford's Estate,* 362 Pa. 458, 67 A. 2d 124 (1949); *Pew Trust,* 362 Pa. 468, 67 A. 2d 129 (1949); *Warden Trust,* 382 Pa. 311, 115 A. 2d 159 (1955).

(earned surplus) account. It was referred to by the corporation as a "change and conversion."

The Gulf Oil stock distribution took the form of an issuance of one new share of stock on each old share of $25 par stock outstanding. The new stock was supported by transferring about 75% of its value, $18.549, from earned surplus and the remaining 25%, $6.451, from paid in surplus to the capital stock account. Gulf called this a "stock dividend."

In both cases the lower court held that the part of the new stock representing capitalized earnings was apportionable between income and principal,[7] but in both cases the Supreme Court saw fit to reverse this holding. The effect of this reversal is to exclude from the class of "apportionable events" the situation where new stock is issued in the form of a stock dividend or a stock split supported partly by a capitalization of earned surplus and partly from either another surplus account not accumulated from earnings or a readjustment of par or stated value of previously outstanding stock.

However the Court does not stop there. It goes farther and specifically limits those events which it recognizes as apportionable to:

> "Liquidation of the corporation,[8] the distribution of a stock dividend,[9] the distribution of an extraordinary cash or scrip dividend,[10] sale of the stock itself,[11] the sale of the rights to subscribe to stock,[12] and the distribution of extraordinary stock dividends even though such dividends are paid in stock of another corporation." [13]

The Court frankly admits that in no prior case was it faced with a situation similar to the one raised here. However, in holding the present situation not apportionable they draw an analogy to their holding in *Jones Estate*.[14] That case involved the merger of the Union Trust Company of Pittsburgh and the Mellon National Bank and Trust Company. In concluding the merger the capital stock account of the new corporation was increased from $1,550,000 to $6,000,000 by capitalizing part of the earned surplus accounts of the two old banks. The court held that the new stock issued for the old and representing the $58,450,000 of

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[7] *Cunningham Estate and Harvey Estate,* 13 D.&C. 2d 63, 8 Fid. Rep. 71 and 8 Fid. Rep. 84 (1957).

[8] *Connolly's Estate* (No. 1), 198 Pa. 137, 47 Atl. 1125 (1901); *McKeown's Estate,* 263 Pa. 78, 106 Atl. 189 (1919).

[9] *Earp's Appeal,* 28 Pa. 368 (1857).

[10] *Nirdlinger's Estate* (No. 1), 327 Pa. 160, 193 Atl. 33 (1937); *Mandeville's Estate,* 286 Pa. 368, 133 Atl. 562 (1926); *Flaccus's Estate,* 283 Pa. 185, 129 Atl. 74 (1925).

[11] *McKeown's Estate,* 263 Pa. 78, 106 Atl. 189 (1919); *Nirdlinger's Estate,* 290 Pa. 457, 139 Atl. 200 (1927).

[12] *Hostetter's Trust,* 319 Pa. 572, 181 Atl. 567 (1935); *Jones v. Integrity Trust Company,* 292 Pa. 149, 140 Atl. 862 (1928).

[13] *Barnes Estate,* 338 Pa. 555, 12 A. 2d 912 (1940).

[14] 377 Pa. 473, 105 A. 2d 353 (1954).

capitalized earned surplus was not apportionable and the issuance of the stock did not constitute an apportionable event.

Apart from the fact that a stock distribution, such as the ones characterized by General Electric and Gulf Oil, has never been held to constitute an apportionable event in Pennsylvania, the Supreme Court indicates that it is trying to relieve some of the burden placed on the trustee by the Rule to analyze the corporate records of the issuing corporation in order to make his apportionment. The Court reasons that through the intricacies of modern corporate finance the *Pennsylvania Rule* has become unworkable, and that its unwieldiness outweighs its equitable solution by fostering excessive litigation. This problem was recognized by the Legislature and a similar policy was adopted when it enacted the *Principal and Income Act of 1945* [15] and a modified version thereof in 1947.[16] This the Court points out as a positive indication that public policy is *contra* the *Rule.* Therefore the Court rather than extend the *Rule* to the present situations, limits it to those cases in which it has already been applied.

THE CONCURRING AND DISSENTING OPINION

In a forty-three page opinion in which Justice Bell is joined by Justice Musmanno, the application of the *Pennsylvania Rule of Apportionment* is traced through the Pennsylvania decisions. The conclusion drawn from this extensive review is that the stock distribution of the General Electric Corporation was not an apportionable event because it was in the nature of a "stock split." The distribution of the Gulf Oil Corporation being of the nature of a "stock dividend" was an apportionable event.

To justify this position, Justice Bell first points out that the rule is designed to protect the interest of the life tenant in corporate earnings even though a dividend is paid in stock similar to that held in trust for him. But, he goes on to point out that the General Electric distribution was not a stock dividend, ordinary or extraordinary. The reasons for holding the latter not apportionable are similar to those given in the majority opinion; namely, (1) this type of distribution has never been held to be apportionable, (2) apportionability has been limited to certain specific situations, (3) public policy demands that the rule be limited, and (4) a contrary decision would repudiate the holding of the *Jones* case *supra.* He also points out that even the distributing corporation in referring to the distribution as a "change and conversion" did not intend to create a dividend though he recognizes that corporate labels are not binding on the court.

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[15] PA. STAT. ANN. tit. 20, § 3471 (Purdon Supp. 1958).

[16] PA. STAT. ANN. tit. 20, § 3470 (Purdon Supp. 1958).

In arguing that the stock distribution of the Gulf Oil Corporation did constitute an apportionable event, Justice Bell classifies it as an "extraordinary stock dividend" and for that reason it falls "within the spirit of the rule." He argues that the capitalizations of earned surplus and paid in surplus may be split apart and that the stock representing the capitalized earned surplus should be apportioned. "The fact that the two have been combined in this case, cannot alter their basic character, nor the legal effect which flows therefrom." [17]

Justice Bell then discusses the basis of measuring the intact value. He reviews the judicial decisions which have held that it is the market value of the stocks at the testator's death or when the trust was created, and also those decisions holding that book value is the proper measure of intact value. He arrives at the ultimate conclusion and would recommend a strong stand that the proper measure of the intact value is the book value of the stock at the creation of the trust. A similar conclusion is reached by the majority in ruling on the apportionment of the Insurance Company of North America stock held in the Harvey trust. Justice Bell contends that the application of the "book value" method of apportionment would resolve the problem of handling extraordinary stock dividends similar to that declared by Gulf Oil, by fixing the rule with such certainty that the trustee would encounter little or no trouble in arriving at his solution.

THE NEW YORK INTERPRETATION UNDER THE RULE

The only other state in which this matter has been litigated to any extent is New York. The *Pennsylvania Rule* was in effect in that State [18] until it was abolished by statute in 1926.[19] There has been much litigation on the particular issue raised by the *Cunningham* and *Harvey* cases. Contrary to the new Pennsylvania position, the New York Courts have consistently held that such events as illustrated by the stock distributions of Gulf Oil and General Electric are apportionable. This conclusion has been reached by recognizing that whenever stock is issued and supported by a capitalization of earnings, regardless of whether it is one hundred per cent of the value of the stock issued or less, that stock representing the capitalized earnings is in effect a stock dividend and is apportionable. The remainder is considered a stock split and is allocated to principal. This can be best illustrated by showing the treatment of one of the distributions in question.

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[17] Page 14a of the dissenting opinion.

[18] *Matter of Osborne*, 209 N.Y. 450, 103 N.E. 723, 50 L.R.A. N.S. 510 (1913).

[19] L 1926, Ch. 843 Personal Property Law § 17-a.

The case of *In re Fosdick's Trust*[20] involved a trust created in 1918, the corpus of which consisted partly of General Electric stock. The case concerned the treatment of that company's stock distribution of 1954. The court differentiated between a stock dividend and a stock split and awarded 7/12 of the new stock issued, or that representing the capitalized earnings, to the income beneficiary. On the appeal, the lower court was affirmed:

> It is the almost exceptionless holding of the later cases on this subject that the distribution of additional stock to shareholders in conjunction with the capitalization of earned surplus constitutes a stock dividend. It is established with equal clarity that in apportioning the amount of newly issued shares attributable to the new capital no reference is had to market—that proportion of the shares whose par or stated value is represented by the new capital constitutes the stock dividend . . .[21]

It is interesting to note the dissenting opinion by Judge Van Voorhis.[22] His main criticism of the apportionment is based on the application of the book value of the stock. He points out that the par or stated value of most stock today does not approach the market value and an apportionment on that basis gives the income beneficiary far more than just the earnings capitalized. He contends that since this particular stock distribution was considered by the financial world as a stock split, the settlor could not have intended (though no intent is expressed) the partial destruction of the trust corpus by a major stock division and apportionment using book value. For these reasons Judge Van Voorhis feels that the court ought to consider the entire distribution a stock split and therefore not apportionable.

In re Sanford's Estate[23] cites the *Fosdick* case as controlling and similarly holds that the new stock received on the old General Electric stock was apportionable, again by differentiating the stock representing a stock split from that purporting to be a stock dividend on the basis of capitalized earnings.

With a few notable exceptions, the New York Courts have consistently found that when there has been a distribution similar to that made by the Gulf Oil Corporation, the stock representing the capitalized earnings is apportionable while that representing a capitalization of some other surplus is retained in principal under the *Pennsylvania Rule*.[24] However in a case involving the particular Gulf Oil stock distribution with which we are concerned, the court

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[20] 4 N.Y. 2d 646, 176 N.Y.S. 2d 966 (1958).

[21] *Id.* at 653, 176 N.Y.S. 2d at 971.

[22] *Id.* at 656, 176 N.Y.S. 2d at 973.

[23] 161 N.Y.S. 2d 507 (1957).

[24] *In re Hogan's Estate,* 138 N.Y.S. 2d 864, 869 (1954); *In re Lissberger's Estate,* 189 Misc. 277, 71 N.Y.S. 2d 585 (1947); *In re Muller's Estate,* 5 Misc. 83, 158 N.Y.S. 2d 417 (1956); *In re Sanford's Estate,* 4 Misc. 83, 158 N.Y.S. 2d 417 (1956).

awarded all of the stock distributed to income under a direction in the trust that all "stock dividends" be considered income.[25] Some recent cases, nevertheless, have held that even in the absence of such a direction, the income beneficiary is entitled to that stock representing capitalized earned surplus and capital surplus, if the particular capital surplus is legally available for dividends and has accumulated after the creation of the trust or purchase of the stock.[26]

Some Criticisms of the New Interpretation

One of the reasons to which the court gives a great amount of emphasis in making their decision is that current public policy is against the *Pennsylvania Rule* and its application. This was indicated by the adoption of the Principal and Income Acts of 1945 and 1947.[27] The court feels that its decision is in line with the new trend. However, what the court fails to take cognizance of is that the effect of their decision might do something which they determined was unconstitutional and forbade the Legislature to do in 1945. That was to apply the act retroactively so that it destroyed the value of a vested property right of the income beneficiary in the trust by providing that stock dividends were no longer subject to apportionment but automatically became part of the principal.

This was the holding of *Crawford Estate*,[28] which involved a trust created in 1935 of stock on which was subsequently issued certain stock dividends which the life tenant claimed as income. Under the Principal and Income Act of 1945 the dividends clearly belonged to the principal, however, the court said:

> A gift of an equitable life estate in "income" is a grant of *a vested property interest.* The Legislature may not thereafter qualify or extinguish it. Where part of the trust corpus consisted of corporate stock, this Court possessed the power, in the absence of then existing Legislative enactment to *define and measure* what constituted or was included in the term "income." In so defining and measuring such "income," we decided what cash or property passed to the life tenant and at what time. Such "income" thus defined became a *vested* property interest. In so adjudicating the right to income between the life tenant and remainderman, this Court was exercising an inherent judicial power and function. It was deciding and declaring legal principles governing the ownership and possession of property.[29]

The question arises as to what the court is doing in these two recent cases. It is merely exercising its adjudicative power to determine what is "income" or

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[25] *In re Lawrie's Estate*, 119 N.Y.S. 2d 906 (1953).

[26] *Blakes Estate*, 177 N.Y.S. 2d 255 (1958); *In re Thom's Trust*, 3 Misc. 2d 784, 152 N.Y.S. 2d 939 (1956).

[27] See notes 15 and 16, *supra.*

[28] 362 Pa. 458, 67 A. 2d 124 (1949).

[29] *Id.* at 463, 67 A. 2d at 125.

is it going beyond that and "qualifying or extinguishing" a vested property interest? The problem was not mentioned in the decision.

In justifying its restriction of the *Pennsylvania Rule,* the Court expresses the hope that it will reduce the hazard of litigation and save the trustee the burden of analyzing the corporate records of the issuing corporation. There is little doubt that this is a desirable end, but it is questionable whether or not the Court has avoided a difficult situation or merely become more involved. They say that when there is a capital reorganization simultaneously with a capitalization, or where there is an issuance of stock based on a capitalization of earnings and some other surplus account, the stock so received by the trustee is not apportionable. However, they also hold that *ordinary* or *extraordinary stock dividends* are apportionable without giving any definitions of those terms.

The case of *Nirdlinger's Estate* defined *extraordinary dividends* as:

> . . . unusual in amount or form as to require an investigation into their source and apportionment according to equitable principles rather than an application of the common law rule that a dividend belongs to the party entitled to it at the date of its declaration. In other words, the unusual character of the dividend requires form and convenience to give way to substance and equity.[30]

Under such general language it is not difficult to fit the "dividend" declared by Gulf Oil into this category as did Justice Bell, and with but little stretch of the imagination the General Electric distribution could also be included even though it was called a "change and conversion." However the dissent calls the latter a stock split.

What then distinguished a stock dividend from a stock split? The New York Courts have adopted the following:

> The essential difference between a stock dividend and a stock split is that in the former there is a capitalization of earnings or profits together with a distribution of the added shares which evidence the assets transferred to capital, while in the latter there is a mere increase in the number of shares which evidence ownership without altering the amount of capital or surplus.[31]

According to this definition, the General Electric "change and conversion" is not really a stock split but rather a sort of hybrid between a split and a dividend. As was noted before, the New York Courts handle this hybrid situation by dividing the stock issued into two parts, allocating that representing a stock split to principal and apportioning that representing capitalized earnings as a stock dividend.

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[30] 327 Pa. 160, 168, 193 Atl. 33, 37 (1937).

[31] *In re Lawrie's Estate,* 119 N.Y.S. 2d 906 (1953).

However the Pennsylvania Court does not seem to subscribe to the above definition. They imply that to have a stock dividend there must be, at the very outset, 100% capitalization of all the stock issued. The capitalization must also be made from earnings which were intentionally set aside "solely for eventual distribution to the shareholders" [32] and those earnings must be derived from the operation of the business since the creation of the trust.[33] The Court says that they are not going to make the trustee determine what portion of the capitalized surplus was made up of these earnings, but they are imposing the duty on the trustee to be certain that it is 100%. All else would be a "stock split" or some hybrid if that is recognized and not apportionable.

If that is the definition applicable, then why should not the distribution made by the General Electric Corporation be considered a dividend as between income and principal since the only account capitalized was earnings? Should the right of an income beneficiary to earnings be destroyed because a corporation merely readjusts its capital structure in conjunction with a capitalization of earnings? It must be kept in mind that the question is not between the corporation and the shareholder, but rather between the income beneficiary and the remaindermen, and that we are dealing with the former's vested property right which should not be cut off by a decision which is arbitrary so far as he is concerned.

CONCLUSION

Unfortunately the future of this complex problem uncovered by *Cunningham Estate* and *Harvey Estate* grows blacker as our society develops a more and more complex economic system. Perhaps the problem will die as those trusts created prior to 1945 pass out of existence and lawyers try to avoid the issue by making adequate provisions in the trust instruments. What the immediate result will be in the light of these decisions limiting the *Pennsylvania Rule* lies in the hands of the courts as it is more clearly defined in future litigation. In the interim it would seem advisable that the perplexed trustee guard himself against personal liability by seeking court approval of any proposed apportionment involving "stock dividends" or "stock splits."

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[32] Page 11, Majority opinion, Estate of Edith B. Cunningham, Supreme Ct. of Pennsylvania, Nos. 222, 223, 228 January Term, 1958.

[33] *Waterhouse's Estate*, 308 Pa. 422, 428, 162 Atl. 295, 296 (1932); *Chauncey's Estate*, 303 Pa. 441, 448, 154 Atl. 814, 816 (1931).