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# DIVIDENDS

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## DIVIDENDS.

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The term, dividends, while equally applicable to a distribution of the capital of a corporation among its stockholders, more commonly relates to its declared and divisible earnings. As such, it is the purpose of this article to consider them with reference to the manner in which, and by whom, they are to be properly ascertained and declared; the rights of creditors of the corporation, as thereby affected; their ownership as between stockholders and their vendees and between life-tenants and remaindermen; with some consideration of the peculiar interests of the guaranteed, or preferred, stockholders of a corporation.

It is fundamental that dividends are payable only from the profits of the corporation, and that they cannot be paid from any portion of the capital stock, from compensation for property taken under the power of eminent domain, from a penalty recovered from a contractor for a failure to complete his work, or from the sale of forfeited stock.<sup>a</sup> Indeed, in some of the States, *e. g.*, New York, the statutes declare a director making a dividend withdrawing any portion of the capital stock, guilty of a misdemeanor. The capital represents the property of a corporation and must remain as security to the creditors until their claims are satisfied. When this security is diminished by its division among the shareholders, in whatever form it may be undertaken, their rights are violated and they are entitled, not only to enjoin such a distribution when made in the nature of dividends, but, as we shall presently see, may follow such a division in the hands of the stockholders participating therein.

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<sup>a</sup> Curran *v.* State of Arkansas, 15 How. 307; Chicago, etc. R. R. Co., *v.* Howard, 7 Wall. 392; Wood *v.* Dummer, 3 Mason 308; Union Nat. Bank *v.* Douglass, 1 McCray 86; National Trust Co. *v.* Miller, 33 N. J. Eq. 155; Bartlett *v.* Drew, 57 N. Y. 589; *Re* National Funds Ass. Co., L. R., 10 Ch. Div. 118; Heard *v.* Eldridge, 109 Mass. 258; Bloxam *v.* Metropolitan R. R. Co., L. R. 3 Ch. App. Cases 337; Gratz *v.* Redd, 4 B. Mon. 187.

While the ascertainment of the net earnings of a corporation is, perhaps, more a matter of business policy, governed by a sound and conservative judgment, exercised on the one hand so as to preserve the permanent interests of its creditors and stockholders, represented by its certificates of indebtedness and capital, and, on the other, to fairly distribute among its shareholders the earned accretions upon their holdings, yet, the courts have not hesitated to lay down rules under which dividends are to be ascertained and declared. They are clearly stated in *Belfast Railroad Co. v. City of Belfast*, where the Supreme Court of Maine, said :

“ In a general sense, net earnings are the gross receipts less the expenses of operating the road to earn such receipts. But several kinds of charges must first come out of net earnings before dividends are declared. The creditor comes in for consideration before the stockholder. The property of a corporation is a trust fund pledged for the payment of its debts. Therefore, if there is a bonded, funded, permanent, or standing debt, the interest on it must be reckoned out of net earnings. If there is a floating debt, which it is not wise and prudent to place in the form of a funded debt, or to postpone for later payment, that should also be paid. If the financial situation of the company is such as to render it expedient to commence or continue the scheme of a sinking fund for the extinguishment of the company's indebtedness some day or other, an annual contribution out of the net earnings for that purpose would be reasonable. These deductions made from the net earnings, the balance will be the profits of the company distributable among stockholders.” *δ*

There seems to be some variance of custom among corporations in charging improvements, or betterments, to construction or to expense account. That the latter is the best and most conservative course, at least with reference to the use of a portion of the earnings, has received judicial approval in *Union Pacific R. R. Co. v. United States*, 99 U. S. 402, where Mr. Justice Bradley observed :

“ With regard to the last-mentioned class of expenditures, however, namely, those which are incurred in enlarging and improving the works, a difference of practice prevails among railroad companies. Some charge to construction account every item of expense and every part and portion of every item which goes to make the road or any of its appurtenances or equipment better than they were before ; while others charge to ordinary expense account, and against earnings, whatever is taken for these purposes from the earnings, and is not raised upon bonds or issues of stock. The latter method is deemed the most conservative and beneficial for the company, and operates as a

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*δ* *Belfast R. R. Co. v. City of Belfast*, 77 Me. 445. See also *St. John v. Erie Ry. Co.*, 22 Wall. 136 ; *New York, etc. R. R. Co. v. Nickals*, 119 U. S. 296 ; *Barry v. Merchant's Exch.*, 1 Sandf. Ch. 307 ; *Williams v. Western Union Tel. Co.*, 93 N. Y. 162 ; *Park v. Grant Locomotive Works*, 40 N. J. Eq. 114 ; *Culver v. Reno Real Estate Co.*, 91 Pa. St. 367 ; *Stringer's Case L. R.*, 4 Ch. App. Cases 475.

restraint against injudicious dividends and an accumulation of a heavy indebtedness. The temptation is, to make expenses appear as small as possible, so as to have a large apparent surplus to divide. But it is not regarded as the wisest and most prudent method. The question is one of policy, which is usually left to the discretion of the directors. There is but little danger that any board will cause a very large or undue portion of their earnings to be absorbed in permanent improvements. The practice will only extend to those which may be required from time to time by the gradual increase of the company's traffic, the despatch of business, the public accommodation, and the general permanency and completeness of the work. When any important improvement is needed, such as an additional track, or any other matter which involves a large outlay of money, the owners of the road will hardly forego the entire suspension of dividends in order to raise the requisite funds for those purposes; but will rather take the ordinary course of issuing bonds or additional stock. But for making all ordinary improvements as well as repairs, it is better for the stockholders and all those who are interested in the prosperity of the enterprise, that a portion of the earnings should be employed."

Again, some corporations devote a portion of their earnings, annually, to a reduction of their original construction account, or, in other words, the cost of their plant. With manufacturing, railroad, and other companies employing a large portion of their capital in buildings, machinery, roadbeds, rolling stock, and the like, where their use must, of necessity, cause deterioration, it would seem only prudent to create a surplus from annual earnings, out of which the property, thus depreciated, can be replaced. It is done by annually crediting construction account with a percentage of its cost and retaining the earnings, thus reserved, as a surplus fund. If the deterioration is constantly being mended such a course might not be necessary, but, in companies, like those engaged in manufacturing, where their plants necessarily are wearing out without the need of immediate replacement, such a course would not only be wise, but should always be adopted.

A corporation is not denied the privilege of paying dividends, when earned, even if largely indebted, provided such indebtedness is taken into consideration in determining what are the net earnings to be distributed, and an English case has gone so far as to hold it to be not improper to borrow money for the purpose of paying a dividend, provided a surplus remains after deducting the capital and indebtedness of the company from a fair valuation of its assets.<sup>c</sup> But no American case has been found warranting such a course.

Mr. Morawetz, in his work on Private Corporations (2d Ed. §§440, 441), says, that in ascertaining if a dividend has been

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<sup>c</sup> Stringer's Case, L. R. 4 Ch. App. Cases 475.

earned, the property of a corporation may be valued at cost, even if it could not be sold again except at a loss, provided such depreciation has not been caused by design, accident, or wear and tear in using the property, or from losses incurred in carrying on its business. In most cases these exceptions would eat out the heart of the rule.

The directors, being the agents of the corporation, alone have the power to determine the amount and to declare a dividend from its earnings—a power resting in their honest discretion, uncontrollable by the courts, when not exercised illegally, wantonly or oppressively. A prosperous corporation, with provision for its indebtedness and its future prosperity, must divide a reasonable proportion of its earnings among its stockholders, though the right to reserve a portion to increase its surplus and enlarge its business, or to replace its property deteriorating from use, cannot be denied. While courts will interfere with the discretion of the directors with great reluctance, and only in rare and exceptional instances, yet, when they are acting in bad faith, or from a wilful abuse of their discretion, equity will grant relief to a stockholder and decree a proper distribution of the earnings among the shareholders of the corporation; but an action at law will not lie, nor is *mandamus* the proper remedy. It is evident, however, that each case must be governed by its own circumstances, the question being largely controlled by the use to which the capital is put, and the intention of the charter of the corporation. *d*

Dividends must be declared alike upon the same class of stock, but the time and place of payment, within reasonable limits, can be fixed by the directors, and, when determined, each stockholder must claim and take his share *sub modo*. The right of a stockholder, at law, to a share of the profits does not arise until a dividend has been declared, although, as we have seen, he may, under some circumstances, obtain the assistance of equity to enforce the declaration of a dividend. But when a dividend has been declared and the time of payment has arrived, the stockholder, after demand made, may sue the corporation in *indebitatus assumpsit* for his share of such dividends; all community of interest in relation thereto, as between the stockholders themselves and between

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*d*New York, etc., R. R. Co. v. Nickals, 119 U. S. 296; King v. Paterson R. R. Co., 29 N. J. Law 88; Park v. Grant Locomotive Works, 40 N. J. Eq. 114; Boardman v. Lake Shore R. R. Co., 84 N. Y. 157; Williams v. Western Union Tel. Co., 93 N. Y. 162; Chaffee v. Rutland R. R. Co., 55 Vt. 110; Beers v. Bridgeport Spring Co., 42 Conn. 17; Brown v. Railway Co., 13 Beav. 32; Rex v. Bank England, 2 Barn. & Ald. 620.

the stockholders and the corporation, is at an end ; his right is a separate and independent one ; the true principle being that when a dividend is declared, *eo instanti* a debt is thereby created against the corporation in favor of each stockholder for his proportionate share of the dividend : the right of each stockholder to his dividend becomes individualized and therefrom arises an implied promise to pay it on demand, enforceable by action. *e* It has also been held that equity will enforce the payment of a declared dividend, and also that mandamus will not lie. *f*

Stock dividends may be declared by the directors of a corporation, but they cannot be declared unless the directors have power under its charter to issue new shares, and there are legal profits to distribute ; governed also by the requirement of a proper exercise of their discretionary power to withhold cash dividends, and, by the issue of such new stock, thereby retain these profits for the future use of the corporation. *g* A stock dividend may also practically be made by issuing stock at par, although the stock so issued is worth much more than par. This is entirely proper, under such circumstances, and is of very common occurrence. Each stockholder, however, is entitled to take or purchase the new stock in the proportion his former holdings have to the new issue, and, in general, new stock cannot be offered to others until the stockholders have first been given the option to purchase.

When the dividend has been declared it is irrevocable, and the stockholders may claim his share even if the corporation has suffered losses, or has become insolvent between the time the dividend was declared, if properly declared, and the time of payment. This is upon the principle, already stated, that a proper dividend, when declared, instantly puts the stockholder, with relation thereto, on the footing of a creditor of the corporation. Nor can the creditors of a corporation recover such dividends from the shareholders, or from the directors, where they have been declared and paid in good faith, although after the dividends were declared and paid, the corporation became insolvent. *h* But when the

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*e* King *v.* Paterson R. R. Co., 29 N. J. Law 82 ; West Chester R. R. Co. *v.* Jackson, 77 Pa. St. 321 ; Granger *v.* Bassett, 98 Mass. 462 ; Jermain *v.* Lake Shore R. R. Co., 91 N. Y. 483 ; State *v.* Balto. & Ohio R. R. Co., 6 Gill (Md.) 363 ; City *v.* Cleveland R. R. Co., 6 Ohio 490.

*f* Beers *v.* Bridgeport Spring Co., 42 Conn. 17 ; Leroy *v.* Globe Ins. Co., 2 Edw. Ch. 657 ; Van Norman *v.* Central Car Co., 41 Mich. 166.

*g* Rand *v.* Hubbell, 115 Mass. 461 ; Com. *v.* Pittsburgh, etc. Ry. Co., 74 Pa. St. 83 ; Terry *v.* Eagle Lock Co., 47 Conn. 141.

*h* Le Roy *v.* Globe Ins. Co., 2 Edw. Ch. 657 ; *In Re* Le Blanc, 14 Hun. 8 ; Reid *v.* Eatontown Mfg. Co., 40 Ga. 98.

dividends are paid from the capital, which is thereby deteriorated and consequent loss ensues to its creditors, both the stockholders and directors may be proceeded against, at law or in equity, and compelled to repay the amounts improperly paid. It is well settled doctrine, that the capital stock and property of every corporation constitute a trust fund for the benefit of the general creditors of the corporation, on which such creditors have a lien and the right to priority of payment over any stockholder ; if the capital is, in whole or in part, diverted to dividends, the creditors may follow it into the hands of the stockholders and recover it back; the stockholders being affected with notice of the trust character of the capital stock, and cannot be considered to be in the position of *bona fide* holders. But the action cannot be maintained until the creditor has first obtained a valid judgment against the corporation, and, by proper process, exhausted its remaining assets.<sup>i</sup> Nice questions might arise if directors, who had improperly declared and paid a dividend, should seek to recover contribution from the stockholders for their proportion of the amounts, which the directors, as such, had been compelled to refund to defrauded stockholders. If, however, the stockholders were ignorant of the fraud, and had been led to believe by the directors that the dividends had been declared from divisible earnings, it would seem, on principle, that the action could not be maintained.

Dividends are payable to the stockholders of record on the books of the company at the date of their declaration, and its officers are justified in so paying them, unless notified of the rights of equitable assignees ; and the rule applies equally to dividends payable before or after a transfer is made.<sup>j</sup> As between the vendor and purchaser of stock, their agreement, of course, will determine the one to whom the dividends are to be paid : but, in the absence of such an agreement, it is settled that the purchaser is entitled to all dividends subsequently declared, without reference to the time they were earned, on the ground that he takes the stock with all its incidents, and is substituted, in all respects, to the position of the vendor ; and, also, that the dividends due on stock follow the ownership thereof. It is also equally clear that the vendor is entitled to the dividend declared and payable at the

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<sup>i</sup> *County of Morgan v. Allen*, 103 U. S. 498 ; *Hastings v. Drew*, 76 N. Y. 9 ; *Williams v. Boice*, 38 N. J. Eq. 364 ; *Sturges v. Vanderbilt*, 73 N. Y. 384.

<sup>j</sup> *Brisbane v. Delaware, etc., R. R. Co.*, 94 N. Y. 204 ; *Cleveland, etc., R. R. Co. v. Robbins*, 35 Ohio 483.

time of the sale. *k* Where, however, the dividend was declared before the sale but is not payable until afterwards, the rule is not so well settled: in fact the only two reported decisions, where this question is distinctly raised and adjudicated, differ in opinion; the one awarding the dividend to the purchaser and the other to the vendor. In *Burroughs v. North Carolina R. R. Co.* (67 N. C. 376; 12 Am. Rep. 611) decided in 1873, the facts were as follows: Burroughs, the plaintiff, was the owner of stock in the company defendant, on which a dividend was declared February 16, 1870, payable, one half April 1, 1870, and one half July 1, 1870. On February 17, 1870, the plaintiff sold and transferred his stock to one Wiley. Burroughs made demand for this dividend and, upon refusal, brought suit and recovered judgment against the company in the court below: on error to the Supreme Court this judgment was reversed, and the dividend was held to have been properly paid to Wiley, the vendee. The opinion seems to be based upon the principle, that the directors intended to make the dividend payable to the person owning the stock at the date when the dividend was to be paid, although there was nothing in the language of the resolution in that case to indicate such an intention. Reasoning by analogy, the court seemed also to base its opinion upon the principle that the incident passes with the principal, and, therefore, that the sale of the stock carried with it future dividends. The other case is that of *Bright v. Lord* (51 Indiana 272; 19 Am. Rep. 732), decided ten years later. There, Lord gave to Bright on April 1, 1873, an option to purchase certain stock on or before July 16, 1873, on which date the option was exercised and the stock transferred to Bright, the vendee. On July 3, 1873, a dividend on this stock was declared payable August 1, 1873, and Bright sought to restrain its payment to Lord, the vendor. The appellate court, affirming the finding of the lower courts and of the General Term, held that the vendor was entitled to the dividend, on the ground that it ceased to be an incident to the stock after its declaration, and this, notwithstanding the outstanding option to purchase the stock. It seems clear, after a careful study of these cases, that the decision in Indiana can be better supported on principle than the one of the courts of North Carolina, and, in the absence of an agreement, that a dividend declared before the sale, but payable afterwards, must belong to

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*k* *March v. Eastern R. R. Co.*, 43 N. H. 515; *Central R. R. Co. v. Papot*, 59 Ga. 342; *Goodwin v. Hardy*, 57 Me. 143; *Jermain v. Lake Shore R. R. Co.*, 91 N. Y. 483; *Gifford v. Thompson*, 115 Mass. 478.



the vendor. The rule invoked in *Burroughs v. North Carolina R. R. Co.*, that the dividend is an incident to the stock and therefore belongs to the purchaser, would be correct in its application were the dividend in the case in hand an incident to the stock ; but, when it is declared, it is supposed to be placed to the credit of the stockholder, who, as we have before seen, then becomes, to that extent, a creditor of the corporation; and the dividend is thereby so separated and disjointed from the principal as to cease to be an incident to the stock and therefore does not follow it. The authorities bear out this position. <sup>1</sup>

As between life-tenants and remaindermen, the proper application of dividends has caused numerous adjudications, not always harmonious. The questions have arisen when, by deed or will, there has been granted to one person, for life or for a term of years, the "income," or the "dividends," or the "dividends and profits," or the "dividends, interest and profits," or the "interest, dividends, profits and proceeds,"—all held to be phrases identical in effect—with remainder over to another at the termination of the life or particular estate. These questions arise concerning (a) cash dividends, and (b) stock dividends.

Ordinary or regular dividends declared from the earnings of the company, and payable in cash, are universally held to belong to the life-tenant; and this irrespective of the time they were earned, whether before or after the creation of the life estate; the doctrine being that dividends, declared in the regular and usual course of business, were intended to be included within a grant of the use, income or profits of shares. <sup>m</sup> In *Read v. Head*, a case where the business of the company was to improve certain land in which its capital had been invested, and, afterwards, to sell the land at a profit, the Supreme Court of Massachusetts held the life-tenant to be entitled to dividends, declared during his life tenancy, although paid out of the proceeds of the land purchased with the capital of the company. This decision seems to be based

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<sup>1</sup> *City of Ohio v. Cleveland, etc.*, R. R. Co., 6 Ohio 489; *Jones v. Terre Haute, etc.*, R. R. Co., 29 Barb. 353; *Spear v. Hart*, 3 Robt. (N. Y.) 420; *Brundage v. Brundage* 65 Barb. 397; *March v. Eastern R. R. Co.*, 43 N. H. 515; *De Gendre v. Kent*, 4 Equity Cases 283. *In re Kernochan*, 104 N. Y. 618.

<sup>m</sup> *Jermain v. Lake Shore, etc. R. R. Co.*, 91 N. Y. 483; *Richardson v. Richardson*, 75 Me. 570; *Bates v. McKinley*, 31 Beav. 281; *Barclay v. Wainwright*, 14 Vesey 66; *Price v. Anderson*, 15 Sim. 473; *Hoopes v. Rossiter*, 1 McLean (C. C.) 527.

upon the fact that the nature, as well as the charter, of the corporation contemplated earnings in that manner. *n*

Where the dividends are extraordinary or unusual, and in the nature of a distribution of accumulated earnings, the rule is not so well settled. The earlier English cases appropriated such dividends to the *corpus* of the trust, but the courts, both of England and the United States, now seem generally to agree that such dividends are payable to the *cestui que trust*, if they were earned during the existence of the life tenancy, and, unless a contrary intent may be inferred from the terms of the resolution declaring the dividend, or from attending circumstances, that it will be presumed it was the intention of the corporation to make the distribution as income and not as capital; some of the cases going so far as to hold that the bonus, or accumulated earnings, will be taken to have been earned during the life tenancy. *o* In Maine, even a stronger rule has been adopted, for there it seems to have been held that all cash dividends of earnings to the life-tenant, are payable irrespective of the time when earned. In *Richardson v. Richardson* (75 Me. 570) the Supreme Court of that State said :

“But we are well convinced that the general rule, deducible from the latest and wisest decisions, declares all money dividends to be profits and income, belonging to the tenant for life, including not only the usual annual dividend, but all extra dividends or bonuses payable in cash from the earnings of the company. We are satisfied that this can be the only safe, sound, just and practical rule, and that any attempt to engraft refined and nice distinctions upon such rule will be productive of much more evil than any good which can come from it.”

As we shall see, when discussing stock dividends in this connection, the Supreme Court of Massachusetts has adopted a similar rule. A careful study of all the cases will result in establishing, we think, the rule first suggested, viz : that unusual cash dividends belong to the life-tenant as income, unless a contrary intent can be shown, or reasonably inferred, from the action of the directors, and that the presumptions are in his favor. In New Jersey a rule has been adopted which seems to do justice between the parties. The percentage of accumulated profits to each share is ascertained as of the time the life estate was created, and also at the com-

*n* *Read v. Head*, 6 Allen 174. See also *Bulch v. Hallet*, 10 Gray 402; *Harvard College v. Amory*, 9 Pick. 446. *Oliver's estate*, 136 Pa. St. 43.

*o* *In Re Kernochan*, 104 N. Y. 618; *Lord v. Brooks*, 52 N. H. 72; *Millen v. Guenard* (Georgia) 21 Am. L. Reg. 381; *Ashurst v. Field*, 11 C. E. Greene 1; *Price v. Anderson*, 15 Sim. 473; *Johnson v. Johnson*, 15 Jur. 714; *Bates v. McKinley*, 31 Beav. 280; *In Re Barton's Trust*, L. R., 5 Eq. 238.

ment of the action ; if the latter is equal to or greater than the former, the life-tenant has all the bonus ; if it be less, a deduction is made from the bonus to equalize the amounts, and the balance is awarded as income, the deduction being deemed capital. *p* A similar plan seems to have been adopted in New Hampshire. *q* The rule in Pennsylvania is like that in New Jersey, except that the later valuation is as of the time the bonus is issued rather than of the commencement of the action. *r* Whenever it is possible to ascertain these values, it would seem as if the rule adopted in these States is entirely just and equitable, both to the owner of the income and the holder of the stock.

Where a corporation had disposed of all its property and franchises, and was about to dissolve its corporate existence, and made distribution of such sales, including a large amount of earnings accumulated during the existence of a life tenancy, it was held, in Massachusetts, that it was the intention of the corporation to distribute the profits as capital, while in New Hampshire, it was held to be income and payable to the *cestui que trust*. *s* Following out the principle laid down in other cases in Massachusetts, that all cash dividends are income, the decision cited would not seem to be entirely in harmony with those cases. In those States where the tendency seems to be to give the life-tenant, at least, the benefit of all dividends earned during his term, it would undoubtedly be held, as it was in New Hampshire, that he was entitled to so much of the distribution as represented profits acquired by the company during his life tenancy. Such a decision would seem to be only fair and equitable.

While, as we have seen, the authorities are not entirely harmonious as to cash dividends of accumulated earnings, there is still more contrariety among those relating to stock dividends, so much, indeed, that it is quite difficult to state a general rule. In England, a recent decision of the House of Lords (*Bauch v. Sproule*, 12 App. Cases 385, reversing S. C. 29 Ch. Div. 635), settles the law there, by holding that such dividends are capital and that the life-tenant is not permitted to share in them. None of the English cases indicate that any investigation was made to ascertain if the dividend were declared out of profits earned before or after the commencement of the life estate. If the latter were

*p* *Van Doren v. Olden*, 19 N. J. Eq. 176.

*q* *Lord v. Brooks*, 52 N. H. 72.

*r* *Earp's Appeal*, 23 Pa. St. 368 ; *Moss's Appeal*, 83 Pa. St. 264 ; *Smith's Estate*, 140 Pa. St. 344.

*s* *Gifford v. Thompson*, 115 Mass. 478 ; *Lord v. Brooks*, 52 N. H. 72.

shown to be true, the decisions of the English courts might be more in harmony with the majority of the leading American cases. † In Massachusetts, the English rule is not only followed, but its courts have held that a distribution of earnings, made after the testator's death, by stock dividends, must be preserved as capital irrespective of the time when earned. This makes the rule in that State very easy of application to the cases of life-tenants and remaindermen, with reference to all dividends, as those in cash, however great and irrespective of the time of their accretion, are awarded to the *cestuis que trust*, and stock dividends, in every instance, to the remainderman. ‡ This rule has also been followed in Maine. § The convenience of the rule is apparent, but its justice has been seriously questioned by other courts. On the other hand, the courts of New York, New Jersey and New Hampshire have gone to the other extreme, and hold that the life-tenant is entitled to all the dividends, cash or stock, declared from the earnings of the corporation. ¶ In Pennsylvania a happy medium between the two extremes has been reached. The courts of that State apply equitable principles to the question, and thereby award to the life-tenant so much of the stock dividend as represents earnings after the creation of his estate, leaving those earned before the death of the settlor or testator, and thus capitalized, to be kept for the remainderman. †† The language of Mr. Justice Gordon in Vinton's Appeal, so clearly states the justice of this position that it is worthy of repetition:

"It is, indeed, true, as said by Mr. Chief Justice Chapman in *Minot v. Paine*, 99 Mass. 101, that the rule which regards cash dividends, however large, as income, and stock dividends, however made, as capital, is a very simple and convenient one, and may relieve trustees and courts of much trouble, but it is certainly not one that commends itself for its justice and equity, neither does it at all regard the facts of a case like that of *Earp's Appeal*, or like the case in hand. To us, it seems like a bungling rule of law that, at one time, would give what is indisputably income to the remainderman, and, at another, what is as clearly capital to the life-tenant. It is however, enough for us that our own authorities repudiate such a rule. In the case last referred to, it was held, that dividends from a corporate surplus fund, accumulated before the testator's death, must be regarded as part of the stock forming the

† *Price v. Anderson*, 15 Sim. 473; *Bates v. McKinley*, 31 Beav. 281; *Barton's Trust*, L. R. 5 Eq. 238.

‡ *Minot v. Paine*, 99 Mass. 101; *Leland v. Hayden*, 102 Mass. 542; *Rand v. Hubbell*, 115 Mass. 461.

§ *Richardson v. Richardson*, 75 Me. 573.

¶ *Earp's Appeal*, 28 Pa. St. 368; *Wiltbank's Appeal*, 64 Pa. St. 286; *Moss's Appeal*, 83 Pa. St. 204; *Vinton's Appeal*, 99 Pa. St. 434; *Smith's Estate*, 140 Pa. St. 344.

trust fund, whilst after-accumulations, though distributed in the shape of stock, must be treated as income, and go to the life-tenant. In like manner it was held, in *Wiltbank's Appeal*, that earnings, or profits, of the stock of a decedent, made after his death, were income, though put into the form of capital by the issue of new stock, and it was there said, that 'equity, seeking the substance of things, found that the new stock was but a product, and was, therefore, income.' So may we say in this case; equity seeking, not mere convenience, but the substance of things, finds the dividend, in controversy, to be part of the actual capital of the company; money raised by a sale of part of its original franchise and realty; that which its stock most specifically and directly represents, hence, it awards the product to him in whom the stock is finally to vest. Assume the contrary doctrine, and that which we have already pointed out may at any time occur; on a sale of the entire franchise and property of the company, with a like order by its directors for a distribution of the money so raised, the dividends must go, regardless of the equities of the parties, to the life-tenant, and nothing whatever be left for the remainderman. This might be very convenient for trustees and courts, for, as it would definitely close out the trust, there would be no farther trouble about it; nevertheless, the justice of such a disposition of the trust would be more than doubtful. Again, this same doctrine, which makes cash dividends income, and stock dividends capital, would often work with equal harshness upon the interest of the life-tenant. For corporate earnings might be retained for an indefinite length of time, and then be distributed in the shape of stock shares, which the rule contended for would at once pronounce to be capital, and thus would the beneficiary be deprived of his income. Than this, far better is our Pennsylvania doctrine, admirably stated by our brother, Mr. Justice Paxson, in *Moss's Appeal*, as follows: 'But where a corporation, having actually made profits, proceeds to distribute such profits amongst the stockholders, the tenant for life would be entitled to receive them, and this without regard to the form of the transaction. Equity, which disregards the form and grasps the substance, would award the thing distributed, whether stock or moneys, to whomsoever was entitled to the profits.'

Mr. Morawetz (in his invaluable work on "Private Corporations" 2d Ed. §§ 468-471) in discussing stock dividends with relation to the rights of life-tenants and remaindermen, after saying that the weight of reason and authority appears to be against the Massachusetts rule, continues:

"While the payment of a stock dividend is not an actual distribution of profits, it does materially affect the rights of the shareholders in respect of the accumulated profits. The effect of a stock dividend is to capitalize the accumulated profits permanently. The profits on account of which a stock dividend is declared can never afterwards be distributed among the shareholders as dividends, and, after the new shares have been issued, the right of the corporation to pay further dividends, and the right of the shareholders to demand them, must be considered with reference to the increased nominal capital. The payment of a stock dividend is not merely an increase of the nominal amount of the shares, leaving the rights of the shareholders unchanged. In substance and effect, it amounts to a distribution of profits among the shareholders in cash, and a subsequent purchase of new shares in the company with

the sums distributed. \* \* \* \* It is difficult to follow the reasoning by which these (Massachusetts) conclusions and distinctions were reached. Reasoning based upon legal technicalities can clearly be of no service in ascertaining the intentions of a grantor. The rule in *Minot's* case undoubtedly has the merit of being simple and of easy application. But that does not prove it would carry out the intentions of the grantor of a trust of this kind. Indeed, it seems almost self evident that a simple grant of the income of shares is not in fact intended as a grant of all cash dividends and of no stock dividends ; and if the general purpose of a grant of this description is considered, it becomes evident that such a construction would in many cases defeat the intentions of the grantor rather than carry them out."

We think, then, that viewing the question from the standpoint of equity and justice, a fair consensus of the rule as to the division of the earnings of a corporation, between life-tenants and remaindermen, may be thus stated : The life-tenant shall have all the regular cash dividends of earnings during the existence of his estate, irrespective of the time they were earned, and shall also have the extraordinary cash dividends, unless earned before the creation of the life tenancy, the presumption being that they were earned during that time. He shall also have the stock dividends of earnings accumulated during his term, the presumptions being against him, in the absence of evidence that they were earned during that time.

It has been held that the value of an option to subscribe for new stock at par, belongs to the capital, unless the value of such option is due to an enhanced value growing out of accumulated earnings during the life tenancy, when it belongs to the income. *x* It is also held, that when the life-tenant dies between dividend dates no apportionment can generally be made, although in England it is required by statute. *y*

It is not uncommon for a corporation, when properly authorized, to issue "preferred" or "guaranteed" stock; those words, in this connection, being considered synonymous. This is distinguished from the other stock of the company, which is ordinarily designated as "common" or "deferred." The usual preference in such stock is as to the payments of dividends, although, if expressly so provided in the charter, it may relate, as well, to a preference in a division of the assets upon the dissolution or winding up of the corporation. Preferred stock may also be "cumulative;" the distinction being, that in the former the

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*x* *Wiltbank's Appeal*, 64 Pa. St. 286 ; *Moss's Appeal*, 83 Pa. St. 204 ; *Biddle's Appeal*, 99 Pa. St. 278.

*y* *Earp's Appeal*, 28 Pa. St. 368 ; *Clapp v. Astor*, 2 Ed. Ch. (N. Y.) 319 ; *In Re Maxwell's Trust*, 1 H. & M. Ch. 610.

arrears of the preferred rate must be made up out of the profits subsequently earned, irrespective of the dividend year in which they were earned, and before any distribution is made to the other stockholders ; while non-cumulative preferred stock is entitled to a preference in dividends only from the profits of each year. Unless expressly provided otherwise, preferred stock is held to be non-cumulative.

Dividends upon the preferred, like those upon the common stock, are payable only out of the earnings and require their declaration by the board of directors before they can be demanded. *z*

We have already seen, that a holder of the general stock of a corporation is entitled to relief, in equity, to compel the directors to declare dividends of accumulated profits, rightfully applicable to that purpose. This right extends equally to its preferred stockholders, to whom it applies with greater strictness if their holdings are non-cumulative, as they can with more justice demand the payment of that for which their stock seems to call, the annual distribution of a fixed rate.

The large increase in corporate holdings in this country during the past decade, and the reasonable certainty of their continued expansion, warrants the belief that the subject we have discussed will be of interest to the legal profession, and, it is hoped, of some value to those whom it chiefly concerns—the stockholders of the many American corporations, whose hopes for increasing dividends are evidenced by their willingness to risk their capital in new ventures, developing the wealth and industries of our country.

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*z* New York, etc. R. R. Co. *v.* Nickals, 119 U. S. 296.