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## Distribution of Extraordinary Dividends under a Trust

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legitimate and spurious, and add a new and substantial hazard to the many already confronting the manufacturer. As to the first of these objections the danger might be minimized by a policy of scrutinizing a plaintiff's case with a dubious eye and requiring clear proof of a material breach of warranty<sup>40</sup> As to the latter objection, each manufacturer could protect himself to a large extent by inspecting carefully and advertising cautiously<sup>41</sup>

It is submitted that the Washington court reached a desirable result, and one that is consistent both with common law principles and with modern business practice. J. B. SHOLLEY.

#### DISTRIBUTION OF EXTRAORDINARY DIVIDENDS UNDER A TRUST.

The distribution of extraordinary dividends between the life tenant and the remainderman under a trust created in corporate stock is a problem which has been extremely vexing to the courts with the result that three general rules have been developed. But, regardless of the rule followed, it is universally agreed that the intentions of the testator or trustor should be controlling.<sup>1</sup> The extraordinary dividend is most likely to arise under one of the following circumstances

1. Where an unusually large dividend is paid out of profits accumulated over a period of years.
2. In cases of total or part liquidation of the business and a distribution of the funds arising from the sale of the assets or of the business as a going concern.

Capital stock, unlike other property which may be the *corpus* of the trust, is possessed of a threefold value—par, market, and book value.<sup>2</sup> The stock is evidence of the stockholders' interest in the corporation. Hence, par value, which is merely that printed on the stock certificate, is clearly no evidence of the true interest which the owner may have, since the net worth of the company

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rules calculated to prevent fraud; to protect persons who are necessarily ignorant of the qualities of a commodity they purchase; and to make it the interest of manufacturers and those who sell, to furnish the best article that can be supplied." (5 Bing. 533, 543). And again: "The case is of great importance; because it will teach manufacturers that they must not aim at underselling each other by producing goods of inferior quality, and that the law will protect purchasers who are necessarily ignorant of the commodity sold." (5 Bing. 533, 546).

<sup>40</sup> The construction placed upon the wording of the advertisement gives the court an opportunity to exercise its discretion. See for examples of rather strict construction the cases of *Newhall v. Ward Baking Co.* and *Alpine v. Friend Bros., Inc.*, cited in note 6 *supra*.

<sup>41</sup> But there is always the danger that a chance defect will result in liability, as in the instant case. It is somewhat ironical that the Ford Motor Co., which has the reputation of being a very conservative advertiser, should be the defendant in this action. Yet the hazard is not as great as this case might lead one to believe, since the measure of damages in most cases would be the price of the defective article.

<sup>1</sup> *Gibbons v. Mahon*, 136 U. S. 549; 34 L. ed. 525, 10 Sup. Ct. Rep. 1057 (1890) *Carter v. Crehore*, 12 Haw. 309 (1900) *Thomas v. Gregg*, 78 Md. 549, 28 Atl. 565, 44 Am. St. Rep. 310 (1894) *Holbrook v. Holbrook*, 74 N. H. 201, 66 Atl. 124, 12 L. R. A. (n. s.) 768 (1907) *Irving v. Houstoun*, 4 Paton Sc. App. 521 (1803) *Bouch v. Sproule*, L. R. 12 App. Cas. 385 (1887).

<sup>2</sup> KESTER, *Accounting Theory and Practice* (1925 Ed.), Vol. II, 398.

may have increased or decreased, due to accumulated profits or losses. The market value, which is that placed on the stock in the market, depends principally on the present and prospective dividend producing capacity of the stock and may be affected by many collateral facts and opinions of investors. The book value is determined by taking the total assets less the total liabilities and dividing the difference, which is the net worth, by the number of shares of stock outstanding. Therefore, it is the only one which gives any consideration to the value of the corporation and, consequently, it is the only value which will truly represent the stockholders' interest. This, then, is the value at which the *corpus* should be appraised.

Assume a trust was created in corporate stock on March 1, 1932, the income to be paid to C for life and the stock to go to D or his heirs on the death of C. Suppose the company had not declared dividends since 1919, but had retained the profits in the business for the purpose of expansion. If the company declared a stock or cash dividend on December 31, 1925, what would be the result under each of the general rules?

Under the Massachusetts rule all cash dividends, however large, belong to the life tenant and all stock dividends belong to the remainderman.<sup>3</sup> Applying the rule to the supposititious case, the dividend would go to the remainderman if stock, and to the life tenant if it were cash. Since the dividend represented profits earned between the years of 1919 and 1925, the result would be to give to the remainderman profits earned after the creation of the trust, which rightly belong to the *cestui que* trust. If the dividend were cash the effect would be to reduce the book value of the stock, because assets are withdrawn from the corporation. Hence, insofar as this dividend reduced the book value below the figure as of the

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<sup>3</sup> *Minot v. Paine*, 99 Mass. 101 (1868). But a survey of subsequent Massachusetts cases reveals that the court does not apply the rule blindly but looks to the substance of the matter. See *Darland v. Williams*, 101 Mass. 571 (1869) holding a cash dividend with privilege of taking stock, was held merely done to comply with the law and the company intended capitalizing the earnings, belonged to the remainderman. *Leland v. Hayden*, 102 Mass. 542 (1869). Treasury stock purchased on the open market with earnings was held to be income. *Heard v. Eldridge*, 105 Mass. 258 (1872) holding a cash dividend paid out of proceeds of sale of real estate taken by eminent domain was a distribution of capital and belonged to the remainderman. *Davis v. Jackson*, 152 Mass. 58, 25 N. E. 21 (1890) Cash dividend with right to take out new stock or retain the cash, held that the cash dividend belonged to life tenant and proceeds from the sale of the stock rights belonged to the remainderman. The present tendency is to allow a more liberal treatment of the life tenant. *Gray v. Hemeway*, 212 Mass. 239, 98 N. E. 789 (1912) *Boston Safe Dep. & Trust Co. v. Adams*, 219 Mass. 175, 106 N. E. 590 (1914) The English rule established in *Brander v. Brander* 4 Ves. 800 (1799) and adopted by the House of Lords in *Irving v. Houstoun*, 4 Paton Sc. App. 521 (1803) but slightly modified and limited by *Bouch v. Sproule*, L. R. 12 App. Cas. 385 (1887) is practically the same as the Massachusetts rule. While the U. S. Supreme Court follows the Massachusetts rule it is interesting to note that Mr. Justice Gray who had previously been a member of the Supreme Judicial Court of Massachusetts, wrote the opinion. *Gibbons v. Mahon*, 136 U. S. 549, L. ed. 525, 10 Sup. Ct. Rep. 1057 (1890)

date of the creation of the trust, it would result in a distribution of the *corpus* to the life tenant.

The Kentucky rule<sup>4</sup> would give the dividend to the life tenant regardless of whether it was stock or cash, simply because the trust was in existence at the time the dividend was declared. Such a disposition of the profits being distributed would give the life tenant a part of the trust *res*. It is an elementary principle of trusts that the intent of the trustor control.<sup>5</sup> Therefore, inasmuch as the Kentucky and Massachusetts rules distribute *corpus* to the life tenant or income to the remainderman, they cannot be supported on recognized principles.

The Pennsylvania rule, sometimes referred to as the American rule, treats stock and cash dividends alike, and apportions the dividend according to the time when the profits were earned by the corporation. By its application the life tenant would be entitled to share in the dividend to the extent that the book value of the stock as of the date of creation of the trust was not impaired.<sup>6</sup> Beyond that point the cash or stock dividend would be held to belong to the remainderman. The result is that the *corpus* of the trust is maintained intact, the life tenant has received the income, and the expressed intentions of the trustor have been effected.

In situations involving liquidating dividends a survey of the cases shows that the courts which apply the apportionment rule refuse to consider the book value controlling, and give the entire dividend to the remainderman on the ground that it represents a distribution of the trust *res*.<sup>7</sup> In cases of a sale of the property at a profit the remainderman is held to be entitled to the entire dividend. The argument used to justify giving any increase in value of the assets to the remainderman is that, since he must bear any losses, he should be entitled to the increased value of the corporation's assets. It may also be explained on the theory of an analogy with a trust created in land. But where the trust *res* is realty it is the intent of the trustor that the remainderman take the land

<sup>4</sup> *Hite v. Hite*, 93 Ky. 253, 20 S. W. 778, 19 L. R. A. 173, 40 Am. St. 189 (1892). *Cox v. Baulbert's Trustees*, 148 Ky. 409, 147 S. W. 225 (1912). Kentucky is the only jurisdiction following this rule. For a thorough review of the early New York cases, which probably followed the Kentucky rule, see *In re Osborne*, 209 N. Y. 450, 103 N. E. 723, 50 L. R. A. (n.s.) 510 (1913), in which the court expressly adopted the Pennsylvania rule of apportionment.

<sup>5</sup> See note 1 *supra*.

<sup>6</sup> *Earp's Appeal*, 28 Pa. St. 368 (1857). *Holbrook v. Holbrook*, 74 N. H. 201, 6 Atl. 124, 12 L. R. A. (n.s.) 768 (1907). *Lord v. Brooks*, 52 N. H. 72 (1872). *In re Osborne*, 209 N. Y. 450, 103 N. E. 723, 50 L. R. A. (n.s.) 510 (1913). *Nirdlinger's Estate*, 290 Pa. 457, 139 Atl. 200 (1927). *Jones v. Integrity Trust Co.*, 292 Pa. 149, 140 Atl. 862 (1928). *Re Oliver's Estate*, 136 Pa. 43, 9 L. R. A. 421, 20 Am. St. Rep. 894 (1890). See 77 U. Pa. L. Rev. 981, 23 Col. L. Rev. 569.

<sup>7</sup> *Gifford v. Thompson*, 115 Mass. 478 (1874). *Second Universalist Church v. Colegrove*, 74 Conn. 79, 49 Atl. 902 (1901). *Wheeler v. Perry*, 18 N. H. 307 (1846). *Re Stevens*, 111 App. Div. 773, 98 N. Y. S. 28 (1906). *Mercer v. Buchanan*, 132 Fed. 501 (1904). *Connoly's Estate*, 98 Pa. 137, 47 Atl. 1125 (1901). *Eisner's Estate*, 175 Pa. St. 145, 34 Atl. 577 (1896). *Walker v. Walker*, 68 N. H. 407, 39 Atl. 432 (1896). *Re Skillman*, 2 Connoly 161, 9 N. Y. S. 469 (1890). *Vinton's Appeal*, 99 Pa. 434, 44 Am. Rep. 116 (1882).

in fee, and, therefore, to hold that the remainderman realizes on the increase in value of the land is merely giving effect to the intent of the trustor.

It may be admitted that the book value test does not take into consideration intangibles which are not shown on the books. Goodwill is a striking example. Conservative accounting and finance requires that goodwill be included on the balance sheet or carried on the books only at such times as it has been realized on and the value actually determined. But problems of intangible values will only arise when the business has been sold as a going concern. At that time the goodwill has been given a definite value. This value may be added to the net worth and the sum divided by the number of outstanding shares of stock, thus definitely establishing a value for the trust *res*. The fact that the remainderman may sustain some loss should not be controlling. He is a donee at the most and the possibility that a loss in value of the *corpus* may result is a circumstance over which no control may be exercised. It is, therefore, submitted that the book value test should be followed in cases of liquidating dividends as well as cases involving a distribution of accumulated profits.

The Massachusetts and Kentucky rules were adopted at an early period when accounting systems had not developed to the extent they are today. The common practice of the corporations today is to keep a complete accounting record and to take statements from the books at regular intervals. The book value may be determined from the balance sheet, hence the difficulty of application of the Pennsylvania rule which may once have existed has been eliminated. Jurisdictions following the Massachusetts rule have rejected the Pennsylvania rule solely on the ground of difficulty of application.<sup>8</sup>

What is meant by "income"? Mr. Kester, in his book *Accounting Theory and Practice Vol. I.*, in classifying income says "Other sources of income are (1) the sale of assets other than stock in trade, such as securities, machinery, land, etc., for more than the values at which they appear in the records." If such is the meaning of the word in business circles, are we not forced to conclude that the same meaning was intended by the trustor?

The application of the Pennsylvania rule to cases involving liquidating dividends would not, because of modern accounting practice of business organizations, present greater difficulties than in situations involving the distribution of accumulated surplus derived from the operation of the business. It would give full effect to the intentions of the trustor. Therefore, it would seem that this rule should be applied in all cases of extraordinary dividends, regardless of whether the dividends were derived from operation or liquidation of the corporation.

The question of the distribution of extraordinary dividends is still an open one in Washington. In the case of *Bothwell, Trustee v. Estep et al.*<sup>9</sup>, the court set forth the various rules but was not

<sup>8</sup> See notes 3 and 4, *supra*.

<sup>9</sup> *James Bothwell as Trustee, Pl. v. Ezra Estep, et al., App., The Girls Club of Seattle, et al., Resp.*, 166 Wash. 420, 6 P (2d) 1108 (1932).

compelled to adopt any one, since they found the dividend involved a distribution of the *corpus*. The facts of the case show that the fund for distribution arose through the sale of a subsidiary of the company in whose stock a trust had been created. The branch was sold as a going business and any amount realized over and above the net worth may rightly be considered as goodwill. If the court had applied the book value test the same result would have been reached. The opinion quotes at length from *Holbrook v. Holbrook*,<sup>10</sup> the leading case on the Pennsylvania rule. If the extensive quotations are indications of the court's inclination, it may be assumed that, when the question is squarely presented, Washington will adopt the only reasonable and fair rule, the Pennsylvania rule, which has the support of reason and the numerical weight of authority

R. W. MAXWELL.

## RECENT CASES

MASTER AND SERVANT — WORKMEN'S COMPENSATION — RIGHT TO SUE FOR MALPRACTICE OF PHYSICIAN. The interesting question of an employee's right of action against a physician for malpractice suffered in the treatment of injuries received in the course of his employment, when the employment is covered by the Workmen's Compensation Act is discussed in the recent case of *Williams v. Dale*, — Ore — 8 P. (2d) 578 (1932). There the workman received final compensation from the Industrial Commission over a year after the original accident. The injury in the meantime had been aggravated by the malpractice of the attending physician, but no report of the malpractice was at any time made to the commission. A majority of a department of the Oregon Supreme Court held that the final award must have completely covered the workman's situation as of that time and therefore must have compensated him both for the main injury and for any aggravation; that therefore the workman could not sue the physician and in effect recover double damages. One judge, dissenting, felt, because the malpractice was not reported to the commission, that the workman had not actually been paid for it and that this action should lie.

The rule seems well established that a workman may recover compensation for an aggravation of the original injury which is due to malpractice. This was true at common law. *Hunt v. Boston Terminal Co.*, 212 Mass. 99, 98 N. E. 786, 48 L. R. A. (n. s.) 116 (1912) and is the law under the Workmen's Compensation Acts, in most jurisdictions. *Yarrough v. Hines*, 112 Wash. 310, 192 P. 886 (1920) 8 A. L. R. 503; 39 A. L. R. 1276. The contrary rule is less frequent. *Ruth v. Witherspoon-Englar Co.*, 98 Kan. 179, 157 P. 403, L. R. A. 1916E, 1201 (1916) *Smith v. Golden State Hospital*, 111 Cal. App. 667, 296 P. 127 (1931) and cf. *Viita v. Fleming*, 132 Minn. 128, 155 N. W. 1077, L. R. A. 1916D, 644 (1916).

But whether the workman may himself sue the physician for the malpractice is a disputed and variously determined controversy on which the cases are not at all in accord. The general trend of the courts in interpreting the various statutes seems to allow the workman an election. He may either look to the Industrial Commission for an award covering both injury and aggravation, or he may ask for compensation for the original accident only, retaining a separate remedy against the attending physician for the damages resulting from the latter's malpractice. *Powlak v. Hays*, 162 Wis. 503, 156 N. W. 464, L. R. A. 1917A, 392 (1916) *Lakeside Bridge & Steel Co. v. Pugh*, 206 Wis. 62, 238 N. W. 872 (1931) and see *Polucha v. Landes*, 60 N. D. 159, 233 N. W. 264 (1930).

Assuming this choice of remedies, a question arises as to the manner in which it should be exercised. Must the workman make his election clearly and unequivocally, or may he do so impliedly? In the principal case, *Williams v. Dale*, *supra*, mere failure to report the aggravation to the commission was not considered an election to sue the physician; there

<sup>10</sup> See note 1, *supra*.