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# Notes and Comments: U.P.I.A. In Maryland: Retroactive Application

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## U.P.I.A. IN MARYLAND: RETROACTIVE APPLICATION

*Adoption of the Uniform Principal and Income Act has greatly simplified the administrative duties of a trustee who must properly allocate corporate distributions between the income beneficiary and the remainderman. However, Maryland expressly prohibits retroactive application of the UPIA to trusts created prior to its adoption. The result is an inequitable application of obsolete rules of law which do not reflect the sophisticated accounting practices involved in modern corporate distributions.*

### I. INTRODUCTION

Corporate stock forms a large portion of the property held in trust. The stock represents investments which often yield distributions of income and capital appreciation. In a trust where the income is paid to one person for life or a period of years and the principal is paid to another, the respective rights of the income beneficiary and remainderman to corporate distributions are determined by the trustee, in a process usually called apportionment.

The trustee's primary duty is to apportion the distributions in accordance with the settlor's expressed or presumed intent. However, since the settlor does not always indicate how the corporate distributions are to be apportioned, the trustee must depend upon the prevailing rules of law for guidance. It is therefore important that the rules regarding apportionment of corporate distributions be both certain and fair.

An equitable application of the rules of law cannot be made in all cases, however, without an appreciation of the form which the corporate distribution takes. The nature of the distribution determines the extent to which the income beneficiary or the remainderman will receive the economic benefit of the corporate distribution. Consequently, in the apportionment process, it may make a significant difference whether the corporate distribution is in the form of cash or other property.<sup>1</sup>

There are three traditional types of corporate distributions: the cash dividend is a "distribution of cash by a corporation to its stockholders"<sup>2</sup> from either current or retained earnings; the stock dividend is a distribution of additional shares which requires a transfer on the corporate books, from retained earnings to the permanent capital

1. III A. SCOTT, THE LAW OF TRUSTS § 236 (3d ed. 1967).

2. W. MEIGS, A. MOSICH & C. JOHNSON, ACCOUNTING—THE BASIS FOR BUSINESS DECISIONS 500 (3d ed. 1972).

accounts, of an amount equal to the fair market value of the shares;<sup>3</sup> and the stock split is a distribution of shares of stock arising from the "multiplication of the number of shares issued with no corresponding effect on the corporate financial structure . . . ."<sup>4</sup>

In contrast to these prosaic distributions, there has been a proliferation of so-called "hybrid" stock distributions<sup>5</sup> since the end of World War II "forced by attempts to save taxes and to get wider public participation in stock ownership . . . ."<sup>6</sup> They are, for example: "(1) stock distributions supported by a transfer from earned surplus to stated capital in an amount equal to par or stated value of the new shares, but in an amount substantially less than the market or even book value of the new shares; (2) stock distributions accompanied by transfers, in whole or part, to or from capital surplus."<sup>7</sup>

This discussion will review the general rules of apportionment to provide a backdrop for the treatment in Maryland of such distributions and the problems that Maryland trustees must face in abiding by historical rules of law which fail to recognize modern developments in corporate accounting practice, and the consequent effect of this on shareholder distributions.

## II. RULES OF APPORTIONMENT

The general rule is that ordinary cash dividends are not apportionable because they are clearly income from invested capital. Accordingly, cash dividends are allocated to the income beneficiary.<sup>8</sup> Likewise, a corporate distribution in the form of a return of capital is clearly

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3. *Id.* 505. The earnings are "capitalized" rather than being actually distributed to the stockholders.

4. ATTORNEY'S HANDBOOK OF ACCOUNTING ch. 11, at 15 (rev. ed. H. Sellin 1971). This is not a generic class of distributions but rather an "all others" category used here for illustrative purposes. The minimum legal requirements for various kinds of corporate distributions often vary as do recommended standard accounting procedures. See 1 ABA-ALI MODEL BUS. CORP. ACT. ANN. 2D § 45 (1971), and MD. ANN. CODE art. 23, § 37 (1966) which provide that in the case of a stock dividend of a stock having a par value an amount shall be transferred to stated capital equal to the par value of the shares issued; and in the case of stock with no par value the amount transferred shall be fixed by the board of directors. The American Institute of Certified Public Accountants (A.I.C.P.A.) recommends that where stock dividends are small in comparison to the number of shares previously outstanding, an amount should be transferred from earned surplus to capital equaling the fair market value of the additional shares issued. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 43, at 51 (1961). In addition, the Pennsylvania courts have taken cognizance of this expression when they held that a 5-for-4 split-up by Sun Oil Company was a "hybrid" transaction. This type of distribution had not previously been recognized as an apportionable event under Pennsylvania law and, therefore, the stock distribution was not apportioned under the Pennsylvania Rule. *Pew Trust*, 398 Pa. 523, 530, 158 A.2d 552, 556 (1960).

5. *Niles, Fosdick, Cunningham and Chaos*, 98 TRUSTS & ESTATES 924 (1959).

6. *Id.*

7. *Id.*

8. III A. SCOTT, *supra* note 1, § 236.2.

property as evidenced by the stock certificates held by the trustee, and should be credited to the corpus.<sup>9</sup> There is, however, no unanimity as to stock distributions,<sup>10</sup> proceeds on liquidation,<sup>11</sup> or extraordinary cash dividends.<sup>12</sup> Excepting the Six Percent Rule<sup>13</sup> and the Kentucky Rule,<sup>14</sup> the most widely used methods of apportionment of corporate distributions are by application of the Massachusetts and Pennsylvania Rules.<sup>15</sup>

The Massachusetts Rule, a rule of administrative convenience, allocates distributions in the form of cash to the income beneficiary, while distributions in the form of stock are allocated to the principal held in trust.<sup>16</sup> By comparison, the Pennsylvania Rule of apportionment provides that, in the case of distribution of corporate earnings in the form of stock or extraordinary cash dividends, "[a] life tenant is entitled to receive the earned net income of a corporation which has accumulated since the stock was acquired, except where it is necessary to preserve the intact value of the principal . . . ."<sup>17</sup> This rule, however, requires "a detailed analysis of corporate accounting practices, and has consequently proved unwieldy."<sup>18</sup>

The rules of apportionment for trusts in states where "uniform"

9. *Id.* § 236.14.

10. *Id.* § 236.7.

11. *Id.* § 236.10.

12. *Id.* § 236.5.

13. Comment, *Principal and Income Allocation of Stock Distribution—The Six-Per Cent Rule*, 64 MICH. L. REV. 856 (1966).

14. The Kentucky Rule apportions to the income beneficiary all extraordinary corporate dividends without regard to their identity as a stock or cash dividend, or whether the income earned by the corporation was earned before or after the creation of the trust. The rule was overturned by *Bowles v. Stiller's Ex'r*, 267 S.W.2d 707 (Ky. 1954), because (1) the rule was not followed in any other jurisdictions, and (2) it fostered inequities and usually ignored the settlor's intent.

15. G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 842 (2d ed. 1962).

16. Annot., 44 A.L.R.2d 1287 (1955).

17. *Cunningham Estate*, 395 Pa. 1, 13, 149 A.2d 72, 79 (1959).

18. Comment, *supra* note 13, at 856. The awkward nature of the Pennsylvania Rule was pointed out in a concurring opinion in the *Cunningham* case:

For example, in *Cunningham Estate*, three Judges of the Orphans' Court of Philadelphia County reached one conclusion, one Judge reached a different conclusion, another Judge reached a still different conclusion; and the learned Judge . . . of the Orphans' Court of Allegheny County applied a different yardstick and reached still another conclusion in his comprehensive 94 page opinion in the very recent case of *Trimble Estate*. Moreover, the auditing Judge in *Harvey Estate*, using only book value as a base, laid down a simple formula for determining distribution of a stock dividend. After exceptions, he changed and (still based on book value) laid down a different and complex formula. Based solely on book value, counsel have suggested 6 different solutions (which they called mathematical formulas) for apportioning an extraordinary dividend. If market value, or a combination of book and market value are used, the possible solutions which can be urged will be more than doubled. . . . Furthermore, attorneys who specialize in trust estates, and trust companies throughout the State, very frequently and widely disagree among themselves as to the application of the Apportionment Rule."

395 Pa. at 23 n.\*\*; 149 A.2d at 84 n.9.

legislation is applicable are determined by the Uniform Principal and Income Act of 1931,<sup>19</sup> effective in twenty-two states, and by the revised Uniform Principal and Income Act of 1962,<sup>20</sup> effective in eight states. The uniform legislation jurisdictions have, in effect, codified the Massachusetts Rule of apportionment.<sup>21</sup> The UPIA of 1931 provides that dividends payable in shares of the corporation are deemed principal, while all other dividends are considered income.<sup>22</sup> The UPIA of 1962 continues the codification of the Massachusetts Rule, together with the major statutory exceptions which provide for allocation to trust corpus of corporate distributions pursuant to calls of shares,

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19. UNIFORM PRINCIPAL AND INCOME ACT OF 1931, 98 U.L.A. (1966) [the Act of 1931 is hereinafter cited as UPIA (1931)].
  20. UNIFORM PRINCIPAL AND INCOME ACT OF 1962, 98 U.L.A. (1966) [the Act of 1962 is hereinafter cited as UPIA (1962)].
  21. H. HENN, *THE LAW OF CORPORATIONS* 680 (2d ed. 1970).
  22. UPIA (1931) § 5 provides:

§ 5. Corporate Dividends and Share Rights.—(1) All dividends on shares of a corporation forming a part of the principal which are payable in the shares of the corporation shall be deemed principal. Subject to the provisions of this section, all dividends payable otherwise than in the shares of the corporation itself, including ordinary and extraordinary dividends and dividends payable in shares or other securities or obligations of corporations other than the declaring corporation, shall be deemed income. Where the trustee shall have the option of receiving a dividend either in cash or in the shares of the declaring corporation, it shall be considered as a cash dividend and deemed income, irrespective of the choice made by the trustee.

(2) All rights to subscribe to the shares or other securities or obligations of a corporation accruing on account of the ownership of shares or other securities in such corporation, and the proceeds of any sale of such rights, shall be deemed principal. All rights to subscribe to the shares or other securities or obligations of a corporation accruing on account of the ownership of shares or other securities in another corporation, and the proceeds of any sale of such rights, shall be deemed income.

(3) Where the assets of a corporation are liquidated, amounts paid upon corporate shares as cash dividends declared before such liquidation occurred or as arrears of preferred or guaranteed dividends shall be deemed income; all other amounts paid upon corporate shares on disbursement of the corporate assets to the stockholders shall be deemed principal. All disbursements of corporate assets to the stockholders, whenever made, which are designated by the corporation as a return of capital or division of corporate property shall be deemed principal.

(4) Where a corporation succeeds another by merger, consolidation or reorganization or otherwise acquires its assets, and the corporate shares of the succeeding corporation are issued to the shareholders of the original corporation in like proportion to, or in substitution for, their shares of the original corporation, the two corporations shall be considered a single corporation in applying the provisions of this section. But two corporations shall not be considered a single corporation under this section merely because one owns corporate shares of or otherwise controls or directs the other.

(5) In applying this section the date when a dividend accrues to the person who is entitled to it shall be held to be the date specified by the corporation as the one on which the stockholders entitled thereto are determined, or in default thereof the date of declaration of the dividend.

This basic section is found with minor modification in Law of May 3, 1939, ch. 580, § 1, [1939] Laws of MD. 1160, 1162, repealed by Law of May 4, 1965, ch. 877, § 2 [1965] Laws of Md. 1442, 1443.

organic corporate acts, capital gains, depreciation and depletion from regulated investment companies and real estate investment trusts.<sup>2 3</sup>

The UPIA has been hailed as "one of the most successful accomplishments of the National Conference on Uniform State Laws,"<sup>2 4</sup> and its success is evidenced by the lack of significant litigation in the thirty states adopting its provisions,<sup>2 5</sup> as well as its apparent ease of application. Consequently, several states have applied the UPIA provisions retroactively to trusts created prior to the enactment of the UPIA in that state.<sup>2 6</sup> The failure of other states to apply the UPIA retroactively was probably encouraged by a leading Pennsylvania case<sup>2 7</sup> which held retroactive application to be an unconstitutional deprivation of a vested property interest. This case,

23. UPIA (1962) § 6 provides:

§ 6. [Corporate Distributions].—(a) Corporate distributions of shares of the distributing corporation, including distributions in the form of a stock split or stock dividend, are principal. A right to subscribe to shares or other securities issued by the distributing corporation accruing to stockholders on account of their stock ownership and the proceeds of any sale of the right are principal.

(b) Except to the extent that the corporation indicates that some part of a corporate distribution is a settlement of preferred or guaranteed dividends accrued since the trustee became a stockholder or is in lieu of an ordinary cash dividend, a corporate distribution is principal if the distribution is pursuant to

(1) a call of shares;

(2) a merger, consolidation, reorganization, or other plan by which assets of the corporation are acquired by another corporation; or

(3) a total or partial liquidation of the corporation, including any distribution which the corporation indicates is a distribution in total or partial liquidation or any distribution of assets, other than cash, pursuant to a court decree or final administrative order by a government agency ordering distribution of the particular assets.

(c) Distributions made from ordinary income by a regulated investment company or by a trust qualifying and electing to be taxed under federal law as a real estate investment trust are income. All other distributions made by the company or trust, including distributions from capital gains, depreciation, or depletion, whether in the form of cash or an option to take new stock or cash or an option to purchase additional shares, are principal.

(d) Except as provided in subsections (a), (b), and (c), all corporate distributions are income, including cash dividends, distributions of or rights to subscribe to shares or securities or obligations of corporations other than the distributing corporation, and the proceeds of the rights or property distributions. Except as provided in subsections (b) and (c), if the distributing corporation gives a stockholder an option to receive a distribution either in cash or in its own shares, the distribution chosen is income.

(e) The trustee may rely upon any statement of the distributing corporation as to any fact relevant under any provision of this Act concerning the source or character of dividends or distributions of corporate assets.

This statute, with modification, is found in MD. ANN. CODE art. 75B § 6 (1965). See note 29 *infra*.

24. Machen, *The Apportionment of Stock Distributions in Trust Accounting Practice*, 20 MD. L. REV. 89, 105 (1960). This article is a good summary and critique of the historical development of the application of the Pennsylvania Rule in Maryland.

25. See Annot., 9B U.L.A. 365 (1957); Annot., 9B U.L.A. 203 (Supp. 1965).

26. States presently applying the UPIA retroactively include Kentucky, Mississippi, New Jersey, Pennsylvania, South Carolina and Vermont.

27. *Crawford Estate*, 362 Pa. 458, 67 A.2d 124 (1949).

however, was later overruled,<sup>28</sup> thereby creating a precedent for retroactive application of the UPIA in other states.

There is an obstacle to retroactive application in Maryland even without the constitutional bar: the UPIA, as adopted, is expressly restricted to trusts created after its effective date, unless the governing instrument indicates otherwise.<sup>29</sup> Maryland is the only state which restricts retroactive application by express statutory terms.

### III. NON-RETROACTIVE APPLICATION IN MARYLAND

Maryland has three basic sets of rules governing the apportionment of corporate distribution:<sup>30</sup> the Pennsylvania Rule, for trusts created prior to June 1, 1939; the original UPIA of 1931 rule, for trusts created between June 1, 1939 and June 1, 1965; and the revised UPIA of 1962 rule, for trusts created on or after June 1, 1965. The apparently successful application of the two versions of the UPIA eliminates the necessity for a detailed consideration of post-UPIA trusts; however, the application of the Pennsylvania Rule to pre-UPIA trusts remains a problem area.<sup>31</sup>

The Pennsylvania Rule was established in the 1857 case of *Earp's Appeal*.<sup>32</sup> In that case, the testator created a testamentary trust which contained 540 shares of stock of a corporation with a market value of \$80.00 per share. In 1857 the market value of a corporate stock was

28. *Catherwood Trust*, 405 Pa. 61, 173 A.2d 86 (1961). The argument for unconstitutionality was as follows: The Pennsylvania Rule of apportionment gave the income beneficiary an income interest in corporate distributions to the trustee. Since the Pennsylvania Rule was a part of the case law prior to the enactment of the UPIA, the interest of the income beneficiary was a vested property right. Application of the UPIA to trusts created prior to the enactment of the UPIA would deprive the income beneficiary of this vested property right thus contravening the fourteenth amendment. "[I]f by a decision of the Supreme Court of Pennsylvania a property interest is held to be *vested*, no subsequent act of the Legislature may *divest* it." *Crawford Estate*, 362 Pa. 458, 464, 67 A.2d 124, 127 (1949). The Supreme Court of Pennsylvania undercut this argument twelve years later holding that "[t]here is no vested property rights in a court-made rule of apportionment." *Catherwood Trust*, *supra* at 77, 173 A.2d at 93.

29. MD. ANN. CODE art. 75B, § 6 (a) (1965), provides:

(a) Corporate distributions of shares of the distributing corporation (whether or not of the same class), including distributions in the form of a stock split or stock dividend, are principal but the provisions of this subsection shall not apply to successive estates or interests in existence prior to June 1, 1965, in which the life tenant is entitled to stock dividends representing earnings during the life tenancy. A right to subscribe to shares or other securities issued by the distributing corporation accruing to stockholders on account of their stock ownership and the proceeds of any sale of the right are principal.

The UPIA of 1931 adopted in Maryland in 1939 had a similar clause restricting application to trusts created prior to June 1, 1939. See Law of May 3, 1939, ch. 580, § 1, [1939] Laws of Md. 1160, 1162, repealed by Law of May 4, 1965, ch. 877, § 2, [1965] Laws of Md. 1442, 1443.

30. See generally Machen, *supra* note 24.

31. Niles, *supra* note 5.

32. *Earp's Appeal*, 28 Pa. 368 (1857).

synonymous with book value.<sup>33</sup> In this case, the market value consisted of \$50 par value per share and noncurrent surplus profits of \$30 per share. Part of this surplus profit was earned before the creation of the trust. In apportioning stock distributed to the trust as a result of capitalization of surplus profits at par value, the court ordered retained as trust principal as many shares of stock issued as would equal in market value the market value of the number of shares held by the trustees at the testator's death.<sup>34</sup> This decision seems sound for two reasons. First, since there was an identity of book and market values in 1857, an investor would pay no more for a share of stock (*i.e.* the market price) than its book value (*i.e.* the value of the corporate assets divided by the number of shares). Therefore retention of earnings by the corporation would effect a proportionate increase in the value of the stock. Second, there is a fundamental sense of equity to a rule which allocates income, earned by a corporation after the creation of the trust, to the income beneficiary *provided* that the value of the original trust is maintained.

This rule of *Earp's Appeal*, the Pennsylvania Rule, has been developed in Maryland into three tests which are applied independently, with the income beneficiary getting the fewest shares under the most restrictive of three applications. First, "[t]he life tenant may receive no more than those shares which represent the proportion of the earnings capitalized." Second, "[t]he life tenant may receive no more than those shares which represent earnings capitalized and earned during the holding period of the stock by the trustee." Third, "[t]he life tenant may receive no more than those shares which would leave intact the book value of the investment in the hands of the trustees reckoned as of its acquisition date."<sup>35</sup>

#### IV. COMPARISON OF THE UPIA AND PENNSYLVANIA RULES

One of the difficulties of comparing the UPIA with the Pennsylvania Rule is that on first glance the UPIA seems arbitrary, while the Pennsylvania Rule appears to be an energetic attempt to balance the interests of the income beneficiary and the remainderman. However, upon close inspection, these rules indicate their true merit.

It is difficult to criticize the UPIA rule because it seems to be working so well. Additionally, the rule provides positive benefit to the trustee, *qua* portfolio manager, in carrying out his investment functions. By contrast: (1) the basic theory of the Pennsylvania Rule is probably obsolete; (2) the application of the Rule can effect an unjustifiably bad result; and (3) the corporate technique and

33. *Cf.* note 5 *supra*.

34. 28 Pa. at 373.

35. Machen, *supra* note 24, at 110 (emphasis added).

motivation for contemporary stock distributions and the accompanying balance sheet changes are irrelevant to the question of ascertaining the amount of corporate "income" distributed to the stockholders. These factors are also irrelevant to the trustee's problem of apportioning the corporate distribution fairly among the income beneficiary and remainderman in accordance with the settlor's presumed intent.

The trustee, *qua* portfolio manager, must select investments to carry out his duty to give the income beneficiary reasonable income while achieving reasonable corpus appreciation for the remainderman. Assuming the wide range of available investment securities, and noting the recent trend toward the hybrid stock distribution,<sup>36</sup> the strict UPIA rule eliminates for the trustee the possibility that the anticipated income and corpus appreciation of the trust's portfolio will be distorted by the manner in which a corporation capitalizes stock distributed to the trust. When the Pennsylvania Rule is applicable, the trustee will not only have to examine the corporation's dividend policies and growth potential, but the trustee must be able to predict the balance sheet changes supporting any stock distribution—a formidable task in view of the trustee's duty to diversify by holding a variety of securities.

The probable obsolescence of the Pennsylvania Rule is rooted in *Earp's Appeal*, where one of the premises of the holding was the identity of the market and book values of the stock. While the Pennsylvania Rule may be relevant to distributions from closely held corporations, the Rule is not relevant to distributions from large, publicly held corporations where there is a conceptual difference between market and book value. Book value is related to the total of paid-in capital plus retained earnings,<sup>37</sup> while market value is today a function of future earnings. A second premise of *Earp's Appeal* is that, but for the retention of earnings, the accumulated surplus corporate income would have been distributed as income to the income beneficiary of the trust. In modern practice the retention and accumulation of earnings is a method of replacing capital equipment, thus assuring future corporate earnings rather than serving as a depository for funds distributable to the stockholders.<sup>38</sup> Consequently, the corporate accounting practices which justified the rule in 1857 would lead to a different result today.

Although it is difficult to form an objective test to determine whether the Pennsylvania Rule or the UPIA Rule yields the better result in a given distribution, we can recognize patently unfair results. For example, in 1954, General Electric Company made a three-for-one stock distribution of its no-par common stock.<sup>39</sup> In *Mercantile-Safe*

36. Niles, *supra* note 5, at 924.

37. MEIGS, *supra* note 2, at 510.

38. Cohan & Dean, *Legal, Tax and Accounting Aspects of Fiduciary Apportionment of Stock Proceeds: The Non-Statutory Pennsylvania Rules*, 106 U. Pa. L. Rev. 157, 205 (1957).

39. General Electric indicated that this was a "change and conversion" rather than a stock dividend or split. In exchange for each share of the stock having a stated value of

*Deposit and Trust Co. v. Apponyi*,<sup>40</sup> the Court of Appeals of Maryland affirmed a decision awarding 1750 of the 2000 General Electric Co. common stock shares distributed to the income beneficiary and 250 shares to the trust corpus for the remainderman. In this case, the original value of the General Electric shares held by the trust was \$8,575.97. At the time of the three-for-one distribution the value of the original shares adjusted by the changes in the consumer price index was \$19,335.80. The market value<sup>41</sup> of the shares deemed to be corpus was \$47,343.75. The market value of the shares allocated to the income beneficiary was \$66,281.25. Thus the income beneficiary not only received the income from all of the General Electric common stock, but he had all of the incidents of ownership over more than half of the stock. If the stock distribution would have been apportioned according to the then-existing but not applicable UPIA Rule, the income beneficiary still would have had the income benefit of all of the General Electric stock, but the remainderman ultimately would have been entitled to all of the General Electric stock upon termination of the trust. Such a result would appear to be more in keeping with the presumed intent of the settlor.

A third premise of *Earp's Appeal* is the theory that the capitalization of earned surplus and the distribution of the capitalized stock is a method of distributing income. However, the decision of corporate management to do so rather than to distribute the income in the form of a cash dividend is governed by other factors. Management might be prompted to capitalize current or surplus profits and distribute stock in an effort to retain a cash reserve or to provide a hedge against inflation,<sup>42</sup> or perhaps to cut off threatened stockholder's suits complaining of unreasonable corporate profits without any distribution of cash dividends.<sup>43</sup> They might also decide that the price of the stock is above the "optimum" price range for stock in their industry. To reduce the price of the stock from \$100 per share to \$80 per share, the corporate management might use a simple five-for-four stock split, which would have no effect on the corporate financial structure. If, however, the decision was made to use a hybrid stock distribution, the market price of the stock could be reduced together with several favorable side effects. For example, if the stock distribution is based upon a transfer from retained earnings to the common stock portion of the capital account, some of the components of the capitalization

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\$6.25, the shareholder would receive three shares of stock with a par value of \$5.00. Thus the stated value was written down from \$6.25 to \$5.00 leaving \$1.25 per share. The two shares distributed, par value of \$5.00 each, were supported by the \$1.25 "written down" and \$8.75 transferred from earned surplus to capital. *Mercantile Safe Deposit & Trust Co. v. Apponyi*, 220 Md. 275, 152 A.2d 188 (1959).

40. *Id.*

41. General Electric common stock had a value of High—39 ⅓, Low—38 ⅓, Mean—38 ⅓ on June 11, 1954, the date of the stock split. Record Extract at E.53, *Mercantile-Safe Deposit & Trust Co. v. Apponyi*, 220 Md. 275, 152 A.2d 188 (1959).

42. Zang & Thompson, *Why Stock Dividends are Declared*, 27 TAXES 883, 885 (1949).

43. Machen, *supra* note 24, at 97.

ratios<sup>44</sup> are reduced. This change in the various capitalization ratios can enhance the corporation's credit rating by giving the appearance of viability evidenced by stockholder contribution.

The distribution of a stock dividend is not an actual distribution of property as is a cash dividend, but is rather a watering down of the stockholder's interest per share. Corporate management can therefore please the stockholders by giving them something both tangible and convertible into cash to show for their investment which represents no cost to the company other than the cost of printing and distributing the certificates. On this issue, a large corporation has indicated:

Our experience seems to indicate that the per share value of the stock does not permanently suffer the full proportionate decrease in its interest following the payment of a small stock dividend. To the extent this is so, the aggregate value of the greater number of shares outstanding, after payment of a small stock dividend, will be greater than the aggregate value of the shares outstanding prior to such payment.<sup>45</sup>

Although the stock distribution is usually beneficial to the individual stockholder, application of the Pennsylvania Rule in the process of apportioning the stock dividend has an opposite effect with respect to the disparate interests of income beneficiary and remainderman. Unlike the individual stockholder who suffers no change in his proportionate interest in the corporation as the result of a stock dividend, the trust corpus suffers a *pro tanto* invasion of corpus to the extent the Pennsylvania Rule requires that stock be given to the income beneficiary. The trustee's, and ultimately the remainderman's, proportionate interests in the corporation are actually reduced.

## V. RECOMMENDATIONS

In view of the problems involved with applying the Pennsylvania Rule to stock distributions and the apparent success of the UPIA Rules, the legislature should extend the application of the UPIA to all trusts, as has successfully been done by judicial interpretation in other states.

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44. Capitalization ratios are the comparisons of the various elements of the long-term liability and the stockholders' equity accounts. The comparison of these various elements is a tool used by financial analysts. Typical of these capitalization ratios are that of debt to equity, debt to total capitalization, *i.e.* the value of the bonds, preferred stock, common stock, capital surplus, and retained earnings, and equity to total capitalization. Also of importance is the alteration of other components of the balance sheet, that is, the contributed capital and retained earnings. Admittedly, the same goals could have been attained by the use of the traditional twenty percent stock dividend, but capitalization at fair market value rather than a low par value also would have resulted in a depletion of retained earnings.

45. Zang, *supra* note 42.

It seems to have been settled that diminution of any interest that the income beneficiary or remainderman might have under the Pennsylvania Rule is not violative of the due process clause of the fourteenth amendment.

In absence of energetic action by the legislature, the Maryland Court of Appeals can soften the impact of the Pennsylvania Rule in one of two ways. First, the *Apponyi* case<sup>4 6</sup> could be overruled to permit the tying of the intact value of the stock to the Consumer Price Index, so that a settlor's original investment is not reduced by inflation (thus benefiting the income beneficiary to the extent of the inflation in the apportionment of stock distributions). Second, the Court of Appeals could follow the A.I.C.P.A. recommendation by analogy and restrict the amount of stock distributed to the income beneficiary to the amount of stock which could have been purchased on the open market with the value of the earnings capitalized.<sup>4 7</sup>

In the absence of any activity to curtail the operation of the Pennsylvania Rule in Maryland, it will continue to be applied—presumably until 21 years after the deaths of persons in being on July 1, 1939.

*Richard A. Spirko*

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46. 220 Md. 275, 152 A.2d 188 (1959).

47. See Niles, *supra* note 5.