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CUMULATIVE VOTING AND CLASSIFIED BOARDS: SOME REFLECTIONS ON WOLFSON v. AVERY

I

ORIGIN OF CUMULATIVE VOTING IN CORPORATE ELECTIONS

Cumulative voting in corporate elections was introduced into American law through a provision in the constitution of the State of Illinois that was adopted by the people in the year 1870. At the time that the delegates to the constitutional convention met, popular indignation at the excesses and frauds of various railroad managements was at fever pitch.¹ The Erie scandal was fresh in mind. Self-dealing by directors was as widespread as it was shameless. In Illinois, then a predominantly agricultural state, the popular dissatisfaction with railroads—in 1870 the principal type of publicly-owned corporations—and with their managements was expressed through the Grange move-

¹ For contemporary accounts of some of these frauds, especially the fabulous Erie swindle, see HICKS, *HIGH FINANCE IN THE SIXTIES* *passim* (1929), and MYERS, *HISTORY OF THE GREAT AMERICAN FORTUNES* *passim* (1936).

ment which was agitating for various financial reforms as the delegates began assembling. How to curb the power of the "rings" which ran the railroads and mulcted thousands of small investors was an issue that was raised on the floor of the convention almost as soon as the delegates took their seats.

Giving minority shareholders representation on corporate boards through the device of cumulative voting was the brain child of delegate Joseph Medill, publisher of the *Chicago Tribune* and a towering figure at the 1870 convention in Illinois. Medill had been won over to the principle of minority representation by the writings of John Stuart Mill who in 1861, in his *Representative Government*,² had stated:

. . . Because the majority ought to prevail over the minority, must the majority have all the votes, the minority none? Is it necessary that the minority should not even be heard? Nothing but habit and old association can reconcile any reasonable being to the needless injustice. In a really equal democracy, every or any section would be represented, not disproportionately, but proportionately. A majority of the electors would always have a majority of the representatives; but a minority of the electors would always have a minority of the representatives. Man for man, they would be as fully represented as the majority. Unless they are, there is not equal government, but a government of inequality and privilege: one part of the people rule over the rest: there is a part whose fair and equal share of influence in the representation is withheld from them; contrary to all just government, but above all, contrary to the principle of democracy, which professes equality as its very root and foundation.

Mill, of course, was speaking of minority representation in political matters. Medill and his group, however, saw the usefulness of the principle in corporate elections. Soon after the convention opened he introduced the cumulative

² Mill, *Representative Government*, in 170 THE WORLD'S CLASSICS 248-249 (1948).

voting provision for the election of corporate directors. After an illuminating debate,³ Medill's draft with certain insubstantial changes was adopted as the present article XI, section 3 of the constitution and read as follows:⁴

The general assembly shall provide, by law, that in all elections for directors or managers of incorporated companies, every stockholder shall have the right to vote, in person or by proxy, for the number of shares of stock owned by him, for as many persons as there are directors or managers to be elected, or to cumulate said shares, and give one candidate as many votes as the number of directors multiplied by the number of his shares of stock shall equal, or to distribute them on the same principle among as many candidates as he shall think fit; and such directors or managers shall not be elected in any other manner.

II

STRAIGHT AND CUMULATIVE VOTING DISTINGUISHED

At this point straight voting and cumulative voting should be distinguished. They proceed from altogether divergent concepts of stockholder representation and employ different mechanics.

In straight voting, the type employed in the majority of corporate elections, a shareholder votes the number of shares he owns for each candidate for office. If nine directors are to be elected and the shareholder owns 100 shares he may cast 100 votes for each of nine candidates. Under straight voting, shareholders owning a majority of 51 per cent or more of the shares can elect all nine directors; the minority elects none.

³ DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF ILLINOIS 1664-1667 (1870).

⁴ ILL. CONST. art. XI, § 3.

Under cumulative voting a shareholder is entitled to as many votes as he has shares multiplied by the number of directors who are to be elected. He may concentrate all of his votes on one candidate or distribute them among as many candidates as he sees fit. Under this method of voting, holders of 49 per cent of stock can elect four out of nine directors. The owners of 51 per cent of the shares, no matter how they marshal their votes, will be able to elect no more than five out of nine directors.⁵

Thus, with cumulative voting freely operating, shareholders can attain representation on corporate boards that is approximately proportionate to the number of shares they own.

III

PREVALENCE OF CUMULATIVE VOTING IN THE FORTY-EIGHT STATES

Following the lead of Illinois, cumulative voting in corporate elections has been made mandatory by constitutional provision in twelve other states⁶ and by statute in

⁵ The number of shares needed to elect a single director (X) under cumulative voting can be found by taking the total number of shares voting (Y) divided by one more than the number of directors to be elected (N plus 1) and adding one share to this quotient. Thus:

$$X = \frac{Y}{N \text{ plus } 1} \text{ plus } 1.$$

Using a nine-man board and percentage figures for the number of shares voting:

$$X = \frac{100\%}{9 \text{ plus } 1} \text{ plus } 1 = 10\% \text{ plus } 1 \text{ share.}$$

This formula is found in WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 41 (1951).

⁶ ARIZ. CONST. art. 14, § 10; IDAHO CONST. art. 11, § 4; KY. CONST. § 207; MISS. CONST. art. 7, § 194; MO. CONST. art. 11, § 6; MONT. CONST. art. XV, § 4; NEB. CONST. art. XII, § 5; N.D. CONST. art. VII, § 135; PA. CONST. art. 16, § 4; S.C. CONST. art. 9, § 11; S.D. CONST. art. XVII, § 5; W. VA. CONST. art. XI, § 4.

seven additional states.⁷

Statutes in twenty states⁸ make cumulative voting permissive. In the latter states cumulative voting must be provided for in the charter of the corporation if it is to be utilized at all.

Permissive cumulative voting has proven to be an ineffectual device. When a corporation is initially chartered it is highly unlikely that the organizing group will voluntarily provide for cumulative voting in the certificate of incorporation. They have little incentive to provide future shareholders with the means to unseat directors representing the controlling interest, *i.e.*, themselves. As time goes on it is also highly improbable that the stockholders in control of the corporation who can elect the entire board of directors will permit an amendment to the certificate of incorporation to be adopted which would allow the minority to gain representation through cumulative voting.

In short, if the principle of minority representation is a good one it requires implementation by mandatory law, either constitutional or statutory, and should not be left to the mercy of the majority shareholder group who are hardly ideal custodians of the rights of their dissatisfied brethren.⁹

⁷ ARK. STAT. ANN. § 64-224 (1947); CAL. CORP. CODE § 2235 (1953); KAN. GEN. STAT. ANN. § 17-3303 (1949); MICH. STAT. ANN. § 21.32 (1937); OHIO GEN. CODE ANN. § 1701.58 (1953); WASH. REV. CODE § 23.32.070 (1952); WYO. COMP. STAT. ANN. § 44-109 (1945).

⁸ COLO. REV. STAT. ANN. § 31-2-4 (1953); DEL. CODE ANN. tit. 8, § 214 (1953); FLA. STAT. ANN. § 608.10 (Supp. 1954); IND. STAT. ANN. § 25-207 (Burns 1955); LA. REV. STAT. § 12:32 (1950); MD. ANN. CODE art. 23, § 39(3) (1951); MINN. STAT. ANN. § 301.26(3) (1947); NEV. COMP. LAWS § 1629 (1929); N.H. REV. STAT. ANN. § 294:85 (1955); N.J. STAT. ANN. § 14:10-15 (1939); N.M. STAT. ANN. § 51-6-6 (1953); N.Y. STOCK CORP. LAW § 49; N.C. GEN. STAT. § 55-110 (1950); OKLA. STAT. ANN. tit. 18, § 1.68 (1951); ORE. REV. STAT. § 57.170(4) (1953); R.I. GEN. LAWS c. 116, § 23 (1938); TENN. CODE ANN. § 48-313 (1955); TEX. BUS. CORP. ACT art. 2.29 (1955); VT. REV. STAT. § 5784 (1947); VA. CODE ANN. § 13-203 (1950).

⁹ In a study of cumulative voting undertaken by Professor Williams of the Harvard Business School, it was found that in only "something more than 10% of the corporations chartered in those states which provide for permissive cumulative voting had the device been put into practice." Williams, *Cumulative Voting*, 33 HARV. BUS. REV. 109 (1955).

IV

THE EFFECT OF CLASSIFICATION OF
DIRECTORS ON CUMULATIVE VOTING

Cumulative voting, to paraphrase Chesterton's comment on Christianity, has not failed; it just hasn't been tried. In Illinois, two years after the adoption of the 1870 constitution, the state legislature passed the first of the so-called "classification statutes" which have done so much to devitalize cumulative voting in corporate elections. The Illinois act¹⁰ provided that the shareholders by resolution could divide the board of directors into three classes, the term of office of the first class to expire in one year, that of the second class in two years and that of the third class in three years. This provision continued until 1921 when the Illinois legislature provided that each class of directors elected annually must consist of at least three directors.¹¹ In 1933 the legislature added a further provision that made it possible to classify boards of directors without shareholder approval, *e.g.*, by director action alone.¹²

Of twenty states that have mandatory cumulative voting, eight permit boards to be classified.¹³ All of the twenty states which provide for permissive cumulative voting authorize staggered boards.¹⁴

The crippling effect that classified boards have on the cumulative voting right is simple to demonstrate. In a corporation with nine directors, all of whom stand for election at each annual meeting, shareholders owning 10

¹⁰ ILL. REV. STAT. c. 25, § 6 (1872).

¹¹ ILL. REV. STAT. c. 32, § 18 (1921).

¹² ILL. REV. STAT. c. 32, §§ 25, 34 (1933).

¹³ ILL. REV. STAT. c. 32, § 157.35 (1955); KY. REV. STAT. ANN. § 271.345(4) (Baldwin 1955); MO. REV. STAT. § 351.315 (1949); MONT. REV. CODES ANN. §§ 15-402, 15-403 (1947); NEB. REV. STAT. § 21-115 (1943); N.D. REV. CODE § 10-0508 (1943); PA. STAT. ANN. tit. 15, § 1074-403 (Purdon 1938); W. Va. CODE ANN. § 3028 (1955).

¹⁴ See note 8 *supra*.

per cent of the stock plus one share can elect one director. If the board is so classified that only three of the nine directors are elected each year, 25 per cent of the stock plus one share is required to elect a single director. Thus, through the device of staggering terms, 250 per cent more votes are necessary to gain one seat on the board than if all directors were elected simultaneously.

Classification can be carried to even greater extremes. If it is proper to elect classes of only three directors each year why not only two?¹⁵ Then persons owning up to 33 $\frac{1}{3}$ per cent of the shares would be unable to elect a single director. If only two directors of an 18-man board were elected annually, a minority group would have to have 33 $\frac{1}{3}$ per cent of the shares plus one share to elect a director, whereas if all directors were elected at once, a minority of 5.3 per cent could gain representation.

Furthermore, since the legislatures in the states where cumulative voting is made mandatory by constitutional provision are invariably under no compulsion to provide for annual elections or for terms of any specified duration, a classification statute could theoretically be passed which permits boards of directors with 18 or 27 members to have one-ninth of the membership elected each year for terms of nine years each. The election of a 27-man board could thus be spread over 27 years. In such a case instead of a minority with approximately 3.6 per cent of the shares being able to elect a director, it would take 25 per cent. Moreover, under such circumstances the owners of 75 per cent of the shares could not gain control of the board in less than 21 years. These examples are extreme but they illustrate one glaring fact about classified boards: once

¹⁵ The proponents of staggered terms concede, as indeed they must, that under cumulative voting it is improper to elect only one director a year since it is not possible to cumulate at all under such circumstances. The courts have so held. *Wright v. Central California Water Co.*, 67 Cal. 532, 8 Pac. 70 (1885); *Humphrys v. Winous Co.*, 125 N.E.2d 204 (Ohio App. 1955).

the principle of classification is held to be compatible with the constitutional right of cumulative voting the legislature has it within its power to reduce the right to practical impotence. It is no answer to say that the legislatures would not subject the right to such mutilation. Constitutions are enacted to relieve legislatures from any such temptation.

Once the people of a state have determined that cumulative voting is of sufficient importance to provide for it in the basic law, is it likely that they intended the right to be subject to the limitations and restrictions mentioned above, or is it more probable that they intended that minority shareholders should have the opportunity to gain representation on the directorate proportional to their shareholdings? *Proportional* representation versus *any* representation at all thus becomes the pivotal issue in any analysis of the propriety of staggered boards in the context of a constitutionally protected right. For eighty-three years the question had not arisen in Illinois, and had received scant judicial attention elsewhere.¹⁶

Certain commentators, and principally Professor Charles M. Williams of the Harvard Business School, had called attention to the essential antagonism that existed between cumulative voting and classified boards. In his revealing monograph, *Cumulative Voting for Directors*, Williams states that:¹⁷

¹⁶ In an unreported decision, *Hepps v. Byers Co.*, No. 10, Court of Common Pleas, Allegheny Co. Pa., April, 1950, a Pennsylvania lower court denied a preliminary injunction on constitutional and other grounds on an application that challenged the constitutionality of the Pennsylvania classification statute. The Pennsylvania Supreme Court affirmed on the ground that a reviewing court will not upset a preliminary injunction if there are apparently reasonable grounds to support it. The court went on to say it would not further discuss the merits of the case. *Cohen v. Byers Co.*, 363 Pa. 618, 70 A.2d 837 (1950).

In another unreported case in Pennsylvania, a three-judge court in Allegheny County, had expressed doubt as to the constitutionality of the Pennsylvania classification statute. *Pittsburgh Steel Co. v. Walker*, 92 PTTs. LEGAL J. 464, 465 (1944).

¹⁷ WILLIAMS, *CUMULATIVE VOTING FOR DIRECTORS* 48-49 (1951).

Efforts to limit the impact of cumulative voting have taken the form of measures designed to prevent election of opposition candidates and of restrictions upon the influence of successful minority candidates as directors. Those who would like to curb the ambitions of minority groups have found classification of directors an effective limitation on the use of cumulative voting. Classified or staggered boards are usually established through enactment of a bylaw dividing the directors into, say, three classes. Customarily, at the first election under the classified provision, directors of one class are elected for, say, three-year terms, those of the second class for two, and of the third for one. Thereafter, each class is elected for full three-year terms, so that the directors of only one class come up for election each year.

.....

Hence, by reducing the number of candidates up for election each year, classification effectively limits the ability of minority groups to take advantage of cumulative voting. It does not eliminate the right in a technical sense; in a practical sense, nevertheless, it can make the right an empty one for all but very strong minority groups.

Considering the age of the constitutional provisions on cumulative voting and the obviously destructive effects of classification on the voting right, it seems odd that the issue of the constitutionality of staggered terms had not been squarely put to the courts long ago. *Wolfson v. Avery*,¹⁸ which involved the method of electing directors at Montgomery Ward & Company, an Illinois corporation, proved to be the first definitive case.

V

THE MONTGOMERY WARD CASE

In the year 1945, Montgomery Ward & Company had 13 directors, all of whom were elected to office annually.

¹⁸ 6 Ill. 2d 78, 126 N.E.2d 701 (1955).

That year a considerable amount of stockholder unrest and general dissatisfaction with management policies became evident. On March 2, 1945 the board of directors met and using its power to amend the by-laws without shareholder approval¹⁹ increased the number of directors from 13 to 15. Two months later, without any explanation to shareholders, the by-laws were again amended so as to provide, pursuant to the provisions of section 35 of the Illinois Business Corporation Act²⁰ for the election of 15 directors by classes, one-third of whom were to be elected annually for three-year terms.

In 1948 strong opposition to the management of Montgomery Ward developed on the board itself. The president of the company, every vice-president and two directors resigned.²¹ The board of directors promptly amended the by-laws again to reduce the board to 12 with four directors to be elected annually. In the following year the board was reduced to nine members with one-third of the membership to be elected each year. This was the minimum size the board could take under Illinois law if the mem-

¹⁹ Section 25 of the Illinois Business Corporation Act, ILL. REV. STAT. c. 32, § 157.25 (1955), gives such power to the board alone unless the charter reserves it to the shareholders which, in the case of Montgomery Ward, it did not.

²⁰ ILL. REV. STAT. c. 32, § 157.35 (1955). This section reads as follows:

"When the board of directors shall consist of nine or more members, in lieu of electing the whole number of directors annually, the by-laws may provide that the directors be divided into either two or three classes, each class to be as nearly equal in number as possible, the term of office of directors of the first class to expire at the first annual meeting of shareholders after their election, that of the second class to expire at the second annual meeting after their election, and that of the third class, if any, to expire at the third annual meeting after their election. At each annual meeting after such classification the number of directors equal to the number of the class whose term expires at the time of such meeting shall be elected to hold office until the second succeeding annual meeting, if there be two classes, or until the third succeeding annual meeting, if there be three classes."

²¹ For an interesting commentary on this period of Montgomery Ward's corporate life, see AMERICAN INSTITUTE OF MANAGEMENT, *The Corporate Director*, in 4 BACKGROUND STUDIES IN MANAGEMENT ACTION, MONTGOMERY WARD & Co. (1954).

bers were to be elected for staggered terms.²²

The effect of the foregoing amendments on the cumulative voting rights of Montgomery Ward shareholders was devastating. In 1945, with 15 directors being elected annually, shareholders with $6\frac{2}{3}$ per cent of the shares could have cumulated their votes and elected one director. But in 1949 with the board staggered and reduced to nine members, the percentage of votes necessary to gain a single seat had been increased to 25 per cent. Thus the effect of the by-law changes was to make it 250 per cent more difficult in 1949 for the minority to elect a director than it had been in 1945. All this had been accomplished, it is worth repeating, without any shareholder approval. Moreover, had the shareholders of Montgomery Ward wished to abolish the staggered board because of its enfeebling effect on their cumulative voting rights they could not have done so without first getting the approval of the incumbent board of directors—the very group who had an interest in preserving staggered terms! The reason for this strange state of affairs lay, of course, in the power to amend the by-laws. This was lodged in the directors. So long as it continued there the staggered board could not be eliminated. But to take the power to amend the by-laws away from the directors and give it to the shareholders required an amendment to the certificate of incorporation. This could not be accomplished under Illinois law unless the board of directors first passed a resolution recommending such an amendment to the shareholders.²³

Thus the cumulative voting right, hailed as a great innovation in corporate democracy in 1870, had in the state of its birth reached a stage of dreary desuetude. In a huge industrial enterprise like Montgomery Ward with approximately 68,000 shareholders and 6,700,000 shares of stock

²² ILL. REV. STAT. c. 32, § 157.35 (1955).

²³ ILL. REV. STAT. c. 32, § 157.53 (1955).

outstanding, the replacement of an existing board of directors had in the words of one jurist become "virtually impossible."²⁴

In August of 1954 an insurgent group of shareholders led by Louis E. Wolfson announced that they were launching a proxy contest for control of Montgomery Ward. On October 11, 1954 Mr. Wolfson wrote to the directors of the company and demanded that the directors: (1) repeal the by-law of the company which provided for staggered terms, and (2) announce forthwith to the shareholders that all directors would stand for election at the annual meeting of shareholders to be held on April 22, 1955. Counsel for the company replied and stated, in effect, that the management declined to follow Mr. Wolfson's recommendations. An action was promptly commenced in the Circuit Court of Cook County, Illinois by Mr. Wolfson against the directors of Montgomery Ward²⁵ in which a declaratory judgment was sought adjudging that section 35 of the Illinois Business Corporation Act and the by-law of Montgomery Ward providing for staggered terms for directors were invalid and unconstitutional since they contravened article XI, section 3 of the Illinois constitution.

The defendants' answer did not place any material fact in issue. Only legal questions were before the court. Plaintiff accordingly moved for judgment on the pleadings.

The ultimate legal question before the trial court and later the Supreme Court of Illinois²⁶ was, of course, the meaning to be ascribed to the constitutional language. This, in turn, according to traditional canons of constitutional interpretation, depended on the intention of the

²⁴ Judge Harry Fisher of the Circuit Court of Cook County, Illinois, the trial judge in *Wolfson v. Avery*.

²⁵ The company was also joined as a party.

²⁶ Since a constitutional issue was involved, an appeal lay directly from the trial court to the Supreme Court of Illinois.

adopters who voted in favor of the 1870 constitution.²⁷ Although each side contended that the constitutional language was clear and supported its respective position, neither was willing to rest its case on the language point alone. Since there were no reported judicial decisions that bore upon the precise question before the court, the legal argument necessarily turned to historical data (including the constitutional debates and contemporaneous comments in the public press), the long years (83) of legislative construction that the constitutional provision had experienced, the practical effect of staggered boards on the cumulative voting right, the experience of other states with cumulative voting and classified boards, the widespread use of classified boards in corporate life and the supposed upheaval that would result if classification should be held to be unconstitutional.

The critical wording in the constitutional section provided that in all elections for directors, ". . . every stockholder shall have the right to vote . . . for as many persons as there are directors or managers to be elected, or to cumulate [his] . . . shares, and give one candidate as many votes as the number of directors multiplied by the number of his shares. . . ."²⁸

The defendants contended that the phrase "directors or managers to be elected" contemplated the possibility that less than the whole number of directors can be elected at any particular meeting of shareholders; hence classification was admissible. The plaintiff countered with the argument that the phrase "directors . . . to be elected," standing alone, is neutral in its implications and is consistent with either of the alternatives of electing the entire board or a part of it at any given time. To speak of "directors . . . to be elected," said plaintiff, is merely to describe a future

²⁷ *Graham v. Dye*, 308 Ill. 283, 139 N.E. 390, 391 (1923); *City of Beardstown v. City of Virginia*, 76 Ill. 34, 41 (1875).

²⁸ ILL. CONST. art. XI, § 3.

event. It is natural to refer to "Congressmen to be elected" or "automobiles to be manufactured" without implying that less than all are being mentioned. Moreover, since corporate boards may vary in size, the phrase "to be elected" provides the flexibility necessary for such variations. Arguing that the constitutional provision must be read as a whole, the plaintiff contended that when the mechanics of cumulative voting are described it is provided that a shareholder may multiply the number of his shares by "the number of directors." The latter phrase, argued the plaintiff, meant the whole number of directors.²⁹ Thus, it was the whole number who were "to be elected." The defendants argued that it was more logical to read "number of directors" as having reference to the earlier phrase "directors or managers to be elected"; therefore, the election of the entire board at one time was not required.

In such a slippery problem of constitutional construction resort must obviously be had to aids other than the conventional canons. Each side found considerable support for its position in historical fact.

The constitutional debates in Illinois in 1869-1870 gave support to a principal contention of plaintiff that the cumulative voting provision was intended to give minority shareholders representation on boards of directors *proportionate* to their voting strength. If this proposition could be sustained, it would follow that all directors would have to be elected simultaneously, since proportional representation is not attainable at any election in which only part of the board stands for office.³⁰

²⁹ The plaintiff further contended that since "number of shares" clearly refers to all shares owned by the shareholder, "number of directors" can hardly mean less than all.

³⁰ Whether all or a portion of the board is being elected, cumulative voting operates to give the minority its approximate proportion of the number of seats being contested. The crucial question thus became whether the Illinois constitutional provision guaranteed minority shareholders their proportion of the whole board or merely a part of it.

Joseph Medill, the leading advocate of cumulative voting for both corporate and political elections, had stated to the convention:

Suppose a company with a capital stock of \$100,000, elect ten directors. At present, under the ordinary method of electing directors, stockholders holding five hundred and one shares elect the entire board, and those holding four hundred and ninety shares cannot elect a man to represent their interests. After these ten directors are thus elected, they can proceed to create an "executive committee", to run the institution, the members of which may not represent a quarter or a fifth of the stock. Thus we have the whole interests of the company controlled by \$25,000 or \$30,000 of stock.

On the plan here proposed the holders of \$49,000 by clubbing their votes together could elect four of the ten directors, and if shares to the amount of \$10,000 were held by one stockholder he could elect one director to protect his interests. . . .³¹

Another delegate of prominence, Mr. Coolbaugh, told the assembly:

The principle is precisely this: If I am an individual owner of one third of this capital stock of an incorporation organized for pecuniary profit, it would enable me to have representation in the board of directors equal to my interest in the stock of that corporation. For instance, if a company is organized with a capital stock of \$100,000, with nine directors, and I am the owner of one third of the aggregate capital of that company, I will have the privilege of electing three of those directors, and have an influence on that board of directors equal to my interest in the company. . . .³²

On May 14, 1870, an editorial in the *Chicago Tribune*,³³ which was published by Medill, had this to say about the

³¹ DEBATES AND PROCEEDINGS OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF ILLINOIS 1666 (1870).

³² *Id.* at 1667.

³³ *Chicago Tribune*, May 14, 1870.

cumulative voting provision:

In all incorporated companies every stockholder shall have the privilege of voting as heretofore, for as many Directors as are to be elected, or of casting the whole number of his shares, *multiplied by the whole number of Directors*, for any one person, or to otherwise distribute them as he pleases. (Emphasis added.)

On June 25, 1870, a week before the people voted on the new constitution, another editorial in the *Chicago Tribune*³⁴ stated:

By the adoption of the section in question, the minority will always be able, by concentrating their votes, to elect as many Directors as their proportion of shares would fairly entitle them to. Thus if a company with a capital of \$1,300,000 elects a board of thirteen Directors, the minority, if they control \$600,000 of the stock, can elect six of the thirteen Directors. If they control but \$100,000 they can still elect one Director to look after their interests in the management of the affairs of the company. The selfishness, rapacity, and mismanagement of corporate bodies and the secrecy, intrigue, and corruption in the proceedings of their officers will receive a healthy and salutary check.

Two days before ratification, the *Chicago Tribune*³⁵ editorialized on the Erie Railroad scandal in these words:

The third clause [of Article XI of the new constitution] on "Corporations" will forever prevent the confiscations of the rights of stockholders by Directors, of which the Erie Railway is a conspicuous and infamous example. . . . Now, if the four-ninths of Erie stock actually held by the opponents of Fisk and Gould, prior to the fraudulent over-issues, had been allowed its fair representation in the Board of Directors, as provided by our new Illinois Constitution, the Gould-Fisk party, instead of electing the whole board, would only have elected five-ninths of them, while the other party would have had immediately four-ninths of them in the Board of Directors, and a minority in the Execu-

³⁴ *Id.* June 25, 1870.

³⁵ *Id.* June 30, 1870.

tive Committee. . . . This will, at all times, enable the holders of any given minority of the stock to elect a number of Directors proportionate to their number of shares of stock. . . .

Another Illinois newspaper,³⁶ prior to the vote, spoke of the cumulative voting provision as making it possible for minority shareholders to always "elect a minority of directors proportioned to its strength." Still another journal³⁷ contrasted "monopoly representation" with "proportional or minority representation" as provided in the new constitution. On July 6, 1870, the Bloomington *Pantagraph* commented that cumulative voting ". . . is right in principle; for minorities are entitled to representation in proportion to their numbers. . . ."³⁸

The plaintiff argued that the foregoing excerpts from the debates and from the contemporaneous press, as well as others published immediately prior to adoption of the constitution, were proper for the court to consider, citing, among authorities, *Cohens v. Virginia*,³⁹ which spoke of the great weight courts had always attached to the *Federalist* writings of Madison, Hamilton and Jay in which the merits of the new federal constitution were expounded.

The defendants, for their part, pointed to the fact that staggered boards had been used extensively in Illinois corporations prior to 1870;⁴⁰ that in 1872 the first legislature that met after the adoption of the constitution had adopted a statute permitting staggered boards;⁴¹ and that

³⁶ Edwardsville Intelligencer, June 9, 1870.

³⁷ Chicago Evening Post, June 22, 1870.

³⁸ Bloomington Pantagraph, July 6, 1870.

³⁹ 19 U.S. (6 Wheat.) 264, 418-19 (1820).

⁴⁰ Most of the corporations in which classifications had been employed in Illinois prior to 1870 were non-stock companies. All were incorporated by special legislative act.

⁴¹ ILL. REV. STAT. c. 25, § 6 (1872). The Illinois legislature in the first classification statute placed no limitation, however, on the size of the classes of directors. Thus, it was theoretically possible for a class to be composed of one person — a practice that would completely nullify cumulative voting.

13 members of the 1872 legislature had been members of the constitutional convention. The defendants placed heavy reliance on such "contemporaneous construction," as the most persuasive evidence of what was intended by the constitutional language.⁴²

Defendants further observed that in numerous states besides Illinois, cumulative voting and classification of directors are permitted to co-exist.⁴³ Moreover, defendants pointed out, Congress has provided for cumulative voting and classified boards for Federal Reserve Banks, Federal Savings and Loan Associations, and National Farm Loan Associations. Additionally, The Model Business Corporation Act prepared by the Commissioners on Uniform State Laws contains similar provisions.

The defendants also called the court's attention to the fact that out of approximately 1000 corporations whose shares are listed on the New York Stock Exchange, 142 corporations elect their directors by classes, and of these, 61, or 43 per cent, employ cumulative voting in the election of directors.

Thus, argued defendants, a very large and respectable body of legislative and professional opinion in this country believes that no inherent inconsistency exists between cumulative voting and classified boards.

As the argument proceeded it became apparent that the transcendent issue in the case was whether the constitutional provision was intended to afford minority shareholders *proportional* representation on corporate boards or merely *some* representation. The defendants vigorously urged upon both courts the proposition that the constitutional mandate was satisfied if shareholders could get a

⁴² Plaintiff argued that the 1872 legislature has shown itself not to be particularly sure-footed in corporate matters by adopting a statute which permitted directors to fill vacancies on corporate boards, a practice ruled unconstitutional fifty-eight years later in *People ex rel. Weber v. Cohn*, 339 Ill. 121, 171 N.E. 159 (1930).

⁴³ See notes 13 and 14 *supra*.

single "watch-dog" director on a board. Such representation, it was said, would have curbed the excesses and rapacity of the "rings" which had so agitated the people in 1870, and would have adequately protected the minority interest. Proportional representation, in defendant's view, was never intended since the size of corporate boards was left to the discretion of the legislature. If the legislature had the power to provide that all corporations shall have three directors, (thus requiring a vote of 25 per cent plus 1 share to elect a single director) it could with equal logic, permit three directors out of nine to be elected annually. Moreover, the argument ran, the legislature could constitutionally provide that corporate elections need be held only once every three years. If the legislature adopted such a statute, a minority of 25 per cent plus 1 share would have to wait three years to elect a director. Why, therefore, should such a minority be heard to complain that it can elect only one director to a nine-man board if it can ultimately elect three directors (more than its fair proportion) by voting in three successive annual meetings?

The plaintiff's rebuttal to the foregoing points — it must be conceded that they were not without persuasiveness — was that a three-man board and a nine-man board are not the same thing. If a corporation such as Montgomery Ward because of its size and complexity believes it needs nine directors to run its affairs efficiently, the minority is entitled to its fair share of the nine. The corporation should not be permitted to function with a board of nine but for purposes of cumulative voting "make believe" it has a board of three. As for the contention that minority shareholders with at least 25 per cent of the shares may gain proportionate (or even greater) representation by voting in three successive elections, the plaintiff argued that representation *in futuro* is not what the constitution contemplated but rather representation *now*. If a situation exists within management which a minority group is dis-

satisfied with, it hardly satisfies their grievance to tell them that if they wait patiently for three years they may ultimately be able to make their voices heard.

The lower court granted plaintiff's motion for judgment on the pleadings and declared section 35 of the Illinois Business Corporation Act and the by-law of the company which provided for a classified board both to be invalid and in conflict with the constitutional right. On direct appeal the Supreme Court of Illinois affirmed, with six justices joining in the majority opinion and one dissenting.

The court squarely faced the problems of interpretation involved in the constitutional language. The phrase "... directors . . . to be elected . . ."⁴⁴ was not intended, in the court's view, to imply that less than the whole board could be elected at one time. On the contrary, the language of the second clause of the constitutional section which gives a stockholder as many votes as "... the number of directors multiplied by the number of his shares of stock . . ."⁴⁵ requires the election of all directors at once. Given their normal and natural meaning the words "number of directors" mean the whole number. If the constitutional convention meant anything less it should have used qualifying language.

The appellants and various amici curiae⁴⁶ had urged in argument that since staggered boards were not expressly prohibited by the constitution they should be deemed to be allowed under the familiar doctrine that the legislature is the repository of all power not placed elsewhere by the constitution. The court reacted to this argument with the observation that the constitutional guaranty of minority representation prohibits any legislative act which *in effect*

⁴⁴ ILL. CONST. art. XI, § 3.

⁴⁵ *Ibid.*

⁴⁶ Several Illinois corporations whose classified boards would be affected

nullifies or defeats the constitutional right. The court pointed out that the constitutional language does not expressly forbid the filling of vacancies by directors, or the issuance of non-voting stock, yet statutes authorizing such practices have been held invalid in Illinois.⁴⁷ The greatly increased percentage of stock necessary to obtain any representation on a board which results from classification is, in effect, an impairment of the constitutional right and hence prohibited by necessary implication.

The court seems to have been strongly influenced by the explanation of the constitutional provision given by its sponsors at the constitutional convention and by the exposition that the section received in the press in 1870. The excesses of corporate managements in the 1860's, the mood of public indignation that hung over the convention, and the obvious good sense of judging the scope of the reform in terms of the mischief sought to be remedied, led the court to the conclusion that the people intended that minority shareholders should have representation that is proportionate to their voting strength.

The court was not impressed with the arguments that since classified boards had existed in Illinois for eighty-three years they should be tenderly regarded. It pointed to several other practices which had been struck down in the past and which had had the sanction of history,⁴⁸ and remarked that "age . . . does not immunize a statute from constitutional attack."⁴⁹

Nor was the court greatly influenced by the fact that the

by the ruling in the instant case were allowed to file amicus briefs.

⁴⁷ *People ex rel. Weber v. Cohn*, 339 Ill. 121, 171 N.E. 159 (1930); *People ex rel. Watseka Telephone Co. v. Emerson*, 302 Ill. 300, 134 N.E. 707 (1922).

⁴⁸ *People v. Bruner*, 343 Ill. 146, 175 N.E. 400 (1931), holding invalid a statute enacted in 1827 making jurors the judges of the law as well as of the facts in criminal cases; *People ex rel. Weber v. Cohn*, 339 Ill. 121, 171 N.E. 159 (1930), invalidating the practice of directors filling vacancies on corporate boards; *Grasse v. Dealers Transport Co.*, 412 Ill. 179, 106 N.E.2d 124 (1952), holding invalid a forty-year old section of the Workmen's Compensation Act.

⁴⁹ *Wolfson v. Avery*, 6 Ill. 2d 78, 126 N.E.2d 701, 711 (1955).

1872 legislature, only two years after the constitutional convention, had adopted a classification statute. While such legislative construction was entitled to "some weight," in this instance, said the court, "it must yield to the evidence supplied by the constitutional debates and the contemporary accounts in the press."⁵⁰

The appellants and certain of the amici curiae had predicted alarming results in our corporate life if classified boards should be held invalid. The integrity of commercial transactions and the rights of innocent third parties dealing with the corporation would be placed in serious jeopardy, it was said. Such fears, the court held, were unwarranted, since directors exercising the function of their office under color and claim of an election are *de facto* directors whose acts, so far as third parties are concerned, are as binding upon the corporation as if the directors were *de jure*.⁵¹

VI

THE EFFECT OF THE MONTGOMERY WARD DECISION IN OTHER JURISDICTIONS

What effect, if any, the decision in *Wolfson v. Avery* will have in other jurisdictions will depend on the degree of protection that is given corporate cumulative voting in any given state. In those states in which cumulative voting is made mandatory or permissive *by statute* and classified boards are permissive, the decision should have no judicial repercussions at all.⁵² In such states the legislatures have seen fit to give shareholders a right that is conditioned at its birth by the classification device. Since shareholders in those states had no right to vote their shares cumulative-

⁵⁰ *Ibid.*

⁵¹ *Id.* at 711-712.

⁵² See notes 7 and 8 *supra*.

ly before the legislature acted, they cannot now complain that the right they have received does not permit them to secure proportional representation. What the legislature can give the legislature can water down.

For those states⁵³ in which the cumulative voting right is constitutionally protected and classification is permitted, the Montgomery Ward decision has obviously greater relevance. Here, of course, the constitutional language must be carefully scrutinized. The cumulative voting provisions in Montana,⁵⁴ Nebraska⁵⁵ and West Virginia⁵⁶ are substantially the same as the Illinois⁵⁷ provision. The wording of the Kentucky,⁵⁸ Missouri,⁵⁹ North Dakota,⁶⁰ South Dakota⁶¹ and Pennsylvania⁶² provisions is different from Illinois in certain respects that could be material. The Missouri constitution, for instance, provides that each shareholder shall have the right to cast "... as many votes in the aggregate as shall equal the number of shares held by him, multiplied by the number of directors or managers to be elected. . . ."⁶³ Does the insertion of the phrase "to be elected" after "number of directors"⁶⁴ have any controlling significance? It is submitted that it should not.⁶⁵ It

⁵³ See note 6 *supra*.

⁵⁴ MONT. CONST. art. XV, § 4.

⁵⁵ NEB. CONST. art. XII, § 5.

⁵⁶ W. VA. CONST. art. XI, § 4.

⁵⁷ ILL. CONST. art. XI, § 3.

⁵⁸ KY. CONST. § 207.

⁵⁹ MO. CONST. art. 11, § 6.

⁶⁰ N.D. CONST. art. VII, § 135

⁶¹ S.D. CONST. art. XVII, § 5.

⁶² PA. CONST. art. 16, § 4.

⁶³ See note 59 *supra*.

⁶⁴ It will be remembered that this, in effect, was the way the defendants in the Montgomery Ward litigation asked the courts to construe the Illinois constitutional provision.

⁶⁵ Many of the comments that have appeared to date in the law journals on *Wolfson v. Avery* have shown an intense preoccupation with the constitutional language, and especially with the phrase "directors or managers to be elected" occurring in the first part of the constitutional section. For analyses which, to the writer, place more stress on semantics than on the purposes of the constitutional reform, see: 69 HARV. L. REV. 380 (1955); 50 NW. U. L. REV. 112 (1955); 30 ST. JOHN'S L. REV. 83 (1955); 11 THE BUSINESS LAWYER 31, 36 (1955); 22 U. CHI. L. REV. 751 (1955); 1955 U. ILL. FORUM 323.

seems highly fanciful to contend that the people of a state in adopting such a provision 80 years ago when corporate law was in its infancy had in mind the possibility of staggered director terms or the effect which they would have on the cumulative voting right. The probability is that staggering never occurred to them nor to the persons who drafted the provision. In such a situation, the task that confronts a court is not so much that of determining what the framers and adopters intended, but what they would have intended had they thought of the problem.

Constitutional provisions are to be interpreted "... in a broad and liberal spirit."⁶⁶ They are drawn to be intelligible to the average citizen not merely to corporation lawyers. The cumulative voting provision in Illinois was plainly intended to give minorities the opportunity for representation on corporate boards. It has no other purpose. It presupposes a body of stockholder opinion that disagrees with the way an incumbent board of directors is conducting the business. It believes that the presence of minority directors will have a corrective and salutary influence on corporate practices. These were the thoughts, if the history of the times is to be believed, which were uppermost in the minds of the framers and adopters of the constitutional provision. The right was thought important enough to put it beyond the reach of the legislature.

If we assume, therefore, a strong public policy in favor of minority representation in corporate matters (otherwise why express it in a constitution?) the question logically occurs whether such a policy is furthered or impeded by classification of directors. If shareholders owning 49 per cent of the stock have serious disagreement with the management, is the public policy in favor of minority representation given its due if the 49 per cent can elect only one director out of nine? Let us suppose there are

⁶⁶ *People v. Lewis*, 375 Ill. 330, 31 N.E.2d 795, 796 (1940).

two minority groups each with approximately 20 per cent of the shares? Is it rational or just to deny them any representation whatever on a board of nine and at the same time permit the 60 per cent majority to elect the entire directorate? It should be kept firmly in mind that once the principle of proportional representation is rejected no group can be under-represented without another group being over-represented.

Whether the doctrine of *Wolfson v. Avery* will be followed in the other "constitutional" states will ultimately depend upon the inherent importance that courts attach to minority representation. With precedent so sparse, with the constitutional language often flexible enough to permit a court to define the cumulative voting right either sympathetically or hostilely, with historical factors often evenly balanced, the decisions will inevitably turn upon policy considerations of the broadest and most philosophic kind.

Once the right of the minority to *any* representation is acknowledged, it would seem to follow logically that it is entitled to representation commensurate with its holdings, unless there is some strong, overriding public policy that makes this result socially undesirable. This leads one to inquire about the social usefulness of classified boards.

VII

THE MERITS OF CLASSIFIED BOARDS

The usual justification for classified boards is that they promote "continuity of management." If this phrase means anything, it must mean that by electing directors to staggered terms it makes it impossible for the shareholders to turn the entire board out of office at any one election. Hence, no matter how great the upheaval, there will al-

ways be some persons on the board from the year before. Being familiar with the operations of the business, they supply the "continuity of management." In assaying this argument let us pass the point that perhaps shareholders who want a wholly new board of directors should be able to have one. Let us also forget, for the moment, that classification, whether accompanied by straight or cumulative voting, makes it prohibitively expensive for almost any dissatisfied group of shareholders ever to challenge the management since at least two annual proxy contests are required for a majority to gain control. We may also, for the moment, ignore the obvious point that "continuity of management" may mean continuity of poor management as well as good.

The "continuity of management" argument still lacks substance in the context of corporate elections with cumulative voting. If all directors are elected at once under *straight* voting, it is true that shareholders owning 51 per cent of the votes can elect an entirely new (and perhaps inexperienced) board at any given annual election. But, except in the rarest of cases, this is precisely what does *not* happen with *cumulative voting* freely operating. The insurgents may marshal enough votes to become the majority but some of the incumbents will then comprise the minority. Each of the rival groups will gain representation proportionate to its strength. Some person or persons from the prior board of directors will be continued in office unless (assuming a board of nine members) the dissident majority owns more than 90 per cent of the shares.⁶⁷ Thus, "continuity of management" in the best sense of the term is promoted by cumulative voting unhampered by the classification device.

The only other justification heard for classification of

⁶⁷ If they do, why should they not elect the whole board? Put otherwise: why should a 10 per cent minority be able to block the 90 per cent majority from control for two years?

directors is that the device makes it more difficult for "outsiders" to gain control of a corporation for their own selfish interests.

One prominent member of the bar put the matter as follows in an address to the American Bar Association last summer:

While the advantages of continuity of management must be given weight, the advantages or disadvantages of a classified board will be judged primarily on the basis of one's views as to whether it should be made harder or easier for persons seeking to obtain control of management to do so. Cumulative voting is favored by many because it permits a minority to obtain *representation* on a board of directors. Classification of directors makes it harder to obtain such representation because it takes more stock to elect one director out of three than to elect one out of nine. However, the more important question, I think, is whether the path of those seeking to oust a management should be made smoother. I have included "Corporate Democracy" in the title of this discussion because I do not believe that public policy requires, for the protection of stockholders' interests, proportionate representation for minorities, or that public policy should forbid reasonable limitations on stockholders' rights to overthrow a management or even to obtain representation on a board.⁶⁸

The foregoing passage, admirable in its frankness, lays bare the fundamental issue. That issue is not the compatibility of staggered boards and cumulative voting. It is rather whether minority representation is per se a good or bad thing. There are those who contend that in most instances cumulative voting is used by a dissident group of shareholders who aspire to a seat on a corporate board merely to "raid" the corporation or to "rock the boat" or for some other base purpose. If the major premise is that cumulative voting produces more evil than good, it follows that any device such as classification which cuts

⁶⁸ Address by Leonard D. Adkins, *Corporate Democracy and Classified Boards*, ABA Annual Meeting, August, 1955.

down its effectiveness should have judicial sanction. Whatever else may be said of the philosophy of keeping the "ins" in and the "outs" out one thing is certain: it was not the philosophy that animated the people who wrote the cumulative voting right into the state constitutions some eighty years ago.

Who, it may be asked, is to be the judge of the motives of two rival shareholder groups? It is suggested that if the shareholder's vote is to have any meaning, the resolution of any such controversy must be left to him, fallible and unsophisticated though he may be. Democratic procedures whether in corporate or political matters often produce abuses and injustices but no system has ever been found to protect the voter from his own weaknesses which has not ultimately destroyed his freedom. Classification may sometimes prevent the unscrupulous from being elected to corporate office. But it may more often keep an incompetent in office. Fundamentally, it is a wall built to protect the directors from the shareholders and to protect shareholders from themselves. Its social value is minimal and hardly outweighs the plain justice of proportional representation.

VIII

CONCLUSION

Cumulative voting was intended to give representation to minority shareholders on corporate boards of directors. When given constitutional protection it reflects a strong public policy in favor of the right and a disinclination to leave its fate to legislative hands. Classification, as the court found in *Wolfson v. Avery*, so weakens and vitiates cumulative voting that it is unreasonable to suppose that the framers and adopters of the constitutional provision intended to permit it.

The constitutional debates in Illinois and the contemporary comments in the press make it clear that cumulative voting was intended to promote proportional representation on corporate boards. The language of the Illinois constitutional provision, while not entirely free from ambiguity, should be read in the light of such contemporaneous exposition and of the evil sought to be remedied. In states where the cumulative voting right is protected only by statute and where classification is permitted, *Wolfson v. Avery* should have little precedential effect. In states other than Illinois where cumulative voting has constitutional sanction the legality of classification will depend in large degree upon the social usefulness which the courts attach to minority representation. In such jurisdictions, the decision in *Wolfson v. Avery* may have far-reaching effects. Since Illinois was the progenitor of cumulative voting in corporate elections, the historical factors which the court found determinative in arriving at the intention of the framers and adopters should have important influences elsewhere.

Cumulative voting, uninhibited by the classification device, results in proportionate representation for both minority and majority groups and promotes "continuity of management" in the classic sense of the term. Classification, when coupled with cumulative voting, tends to perpetuate present management and, in practical effect, deprives minority interests of any representation whatever.

For several decades the voting rights of shareholders have been subjected to a continuous process of erosion to the point where "corporate democracy" has become an almost meaningless shibboleth. Non-voting stock, voting trusts, classified boards, management's iron control of the proxy machinery, the prohibitive cost of election contests, the holding of annual meetings at inaccessible places —

these and comparable developments have all but reduced the shareholder to an innocuous figurehead. The decision in *Wolfson v. Avery*, in some degree at least, narrows the heretofore constantly widening gap between ownership and control.

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