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## **Classification of Directors and Its Effect Upon Cumulative Voting in Corporate Elections**

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## CLASSIFICATION OF DIRECTORS AND ITS EFFECT UPON CUMULATIVE VOTING IN CORPORATE ELECTIONS

In keeping with our basic political philosophy of group representation and the party system which affords divergent views a chance to be heard, cumulative voting has been designed and serves the same purpose in bodies corporate. In practically all states a statutory authorization granting the right is in force.

Cumulative voting was designed as a measure whereby a minority interest of shareholders could obtain representation on the board of directors.<sup>1</sup> This enables them to obtain direct contact with the business of the corporation and to observe the action of the majority members and the officers appointed by them. The right of cumulative voting is sustained most often on the ground that not only does it insure the minority of representation, assuming they have the necessary voting strength, thereby enabling its views to be brought before the board; but of much more importance, that by virtue of such representation the minority is informed of what is really happening and thereby can notify the shareholders of any underhanded acts and commence proxy fights or litigation to stop the same. This minority representation is the severest blow which could be dealt to corporate mismanagement, for it makes secrecy of management as against shareholders substantially impossible, and prevents the swamping of the interest of the small shareholders.

Broadly speaking there are two classes of enactments dealing with the subject, namely, provisions that are mandatory in that they grant the privilege to all stockholders of corporations within its purview irrespective of the provisions of the charter or by-laws;<sup>2</sup> and those that are permissive in that the charter or by-laws grants the privilege at the option of the stockholders. Pennsylvania falls within the mandatory class. The privilege is granted by Constitutional provision<sup>3</sup> which provides; "In all elections for directors or managers of a corporation each member or shareholder may cast the whole number of votes for one candidate or distribute them upon two or more candidates as he may prefer." The option granted by this provision was aptly illustrated by the court in *Pierce v. Commonwealth*,<sup>4</sup> which calculated that at an election of six directors each share was worth six votes; and pointed out that at such an election the holder of that share "may cast those six votes for a single one of the candidates, or he may distribute them to two or more of such candidates as he may think proper. He may cast two ballots for each of the three of the proposed directors, three for two, or two for one and one each for four others, or finally, he may cast one vote for each of the six candidates." In other words, the formula is the number of shares held by a shareholder multiplied by the number of directors to be elected equals the total number of votes which

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<sup>1</sup> Commonwealth *ex rel.* O'Shea v. Flannery (1902) 203 Pa. 28, 52 Atl. 129.

<sup>2</sup> Maddock v. Verclone Corporation (1929) 17 Del. Ch. 39, 147 Atl. 255.

<sup>3</sup> CONSTITUTION OF 1874 Art. 16 § 4.

<sup>4</sup> 104 Pa. 150, 14 W.N.C. 97 (1883).

may be distributed in any manner. The constitutional provision is reiterated in § 505 of the B.C.L.<sup>5</sup> which provides:

*"Unless otherwise provided in the by-laws, elections for directors need not be by ballot, except upon demand made by a shareholder at the election and before the voting begins. In all elections for directors every shareholder entitled to vote shall have the right in person or by proxy to multiply the number of votes to which he may be entitled by the total number of directors of all classes to be elected by either the holders of the class or classes of shares and he may cast the whole number of such votes for one candidate, or he may distribute them among any two or more candidates. The candidates receiving the highest number of votes from each class or group of classes entitled to elect directors separately up to the number of directors to be elected by such class or group of classes shall be elected."*

So in Pennsylvania the privilege is granted by a Constitutional provision mandatory in effect, requiring no legislation to give it force, and also by a statutory grant. In neither case can the privilege be taken away except by authority equal in grade to that by which it was granted.

Whether or not the right of cumulative voting is desirable has been, as most reforms are, subject to much controversy. The proponents of the right base their case upon the safeguards set out above. The opponents base their arguments upon business, rather than legal grounds. Some of those advanced being:

1. The minority may somehow gain control.
2. Representation of the minority may result in deadlocks.
3. The representation will promote strife detrimental to efficient management.

Such arguments seem to those of a majority fearful of the disadvantage to themselves which may arise through a representative keeping in contact with their actions, rather than a majority interested in the welfare of all interests concerned. However this article is not concerned with the merits of the privilege, I merely wish to point out that the privilege is not subject to universal approval.

Inequitable results may arise from the exercise of the right. For example through the use of strategic devices, the minority in several cases have gained control of the board of directors. In one case,<sup>6</sup> at an election of six directors 7,000 shares were outstanding, of these 6,433 were voted, 3,396 by the majority faction, 3,037 by the minority. The minority kept secret the fact that they were going to vote cumulatively and the result of the election was as indicated below:

	Total Shares	Total Votes	A	B	C	D	E	F	G	H	I	J
Maj. group	3,396	20,376	3,396	3,396	3,396	3,396	3,396	3,396				
Min. group	3,037	18,222							4,557	4,556	4,555	4,552
Totals	6,433	38,598	3,396	3,396	3,396	3,396	3,396	3,396	4,557	4,556	4,555	4,552

<sup>5</sup> Act of 1933 § 505, 15 P.S. § 2853-505; Act of '51, Act 366, eff. 9-26-51 added the matter in italics.

<sup>6</sup> *Pierce v. Commonwealth* 104 Pa. 150, 14 W.N.C. 97 (1883).

It is apparent that in this case the majority group lost control of the board because they failed to vote their stock cumulatively; while the minority took advantage of the privilege. Also apparent is that the majority could have remained in control had they exercised the privilege and cumulated their votes upon four of the candidates. They thereby could have limited the minority representation to two. This inequitable situation was the result of elections in two other cases.<sup>7</sup>

Such results have caused several states to insert a provision in their corporation law requiring the stockholder to give advance notice if his intention is to cumulate his votes;<sup>8</sup> generally twenty-four hours is the required time. If after this warning, the majority is too indifferent to preserve its control, it will have shown by such indifference that it is unfit to manage and deserves to be replaced. If the majority group is alert and judicious they will remain in control regardless of concerted minority voting. However the minority group, if substantial, will be able to secure representation on the board, and thus be in the coveted position to observe and voice opinions. In Pennsylvania no advance notice of the intention of the stockholder is required, for it is the exercise of a constitutional privilege not requiring such notice. Although a stockholder desiring to cumulate his votes must clearly indicate that intention on his ballot.<sup>9</sup>

This privilege however was not intended as a method whereby the minority could gain control; a result which was aptly called an "evil" by the court in *Pierce v. Commonwealth*.<sup>10</sup> That such a situation could arise did not occur to the framers of the Constitution.<sup>11</sup> A few courts have erroneously referred to the right of the majority to elect the directors as a vested one. Judge Gordon in *Hays v. Commonwealth ex rel. McCutcheon*<sup>12</sup> said, "But if it be not a vested right in these who own the majority part of the stock to elect, if they see proper, every member of the board of trustees, then I would like to know what a vested right is." Said another court, ". . . the right to administer the affairs of the corporation is with justice, vested in those who have the larger financial interest therein."<sup>13</sup> Perhaps prior to the Constitutional provision the right of the majority to elect all was considered a vested one, but such an interpretation today is clearly erroneous in light of Article 16 § 4.

Other devices have been used by the minority shareholders to elect a majority of the board but obviously such results are seldom encountered for the usual election finds both factions, if they are organized, judiciously alert and eager, the majority to continue its reign, and the minority to gain representation, and the outcome is usually just, with the minority, if substantial, finding itself with a spokesman. However if the results of the balloting find the minority without

<sup>7</sup> Chicago Macaroni Mfg. Co. v. Bogganio (1900), 61 Ohio St. 497, 56 N.E. 201.

<sup>8</sup> Ohio General Code Page's 1938, § 8623-50; Minnesota, M.S.A. § 301.26(3).

<sup>9</sup> Commonwealth v. Stager 20 D.R. 650 (1911).

<sup>10</sup> 104 Pa. 150, 14 W.N.C. 97 (1883).

<sup>11</sup> 5 Del. Const. Con. 118, 758, 761, 762, 765.

<sup>12</sup> 82 Pa. 518, 3 W.N.C. 549 (1876).

<sup>13</sup> Commonwealth ex rel. Hanrahan v. Smith 19 D.R. 638 (1910).

its expected voice, there is little they can do for the right of cumulative voting does not pretend to assure to the minority a representation in any event; the effectiveness of the exercise of the right is dependent upon several factors. The idea was aptly expressed by the court in *Maddock v. Verclone Corporation*:<sup>14</sup>

"While the right of cumulative voting has for its purpose the affording to a minority of the voting stock an opportunity to elect one or more of the directors, the scheme does not pretend to assure to a minority a representation in any event. The enjoyment of the right is a thing incident to each share of stock; it belongs to no one group as such. If its exercise results in the election of a director it is only because enough individual shares have banded together to achieve that result; the end obtained is in consequence of the individual voting power of shares of stock no matter by whom owned. It is not a result which particular individuals in the corporation are entitled to achieve in the sense that one group of stockholders are entitled under the corporate compact to have a director representative on the board and another group to have so many other representatives."

Conceding however, that in the ordinary case, the minority group by exercising its privilege and voting cumulatively will be able to elect its representative, is there any way the effect of that right can be lessened or taken away altogether? Since the privilege exists in Pennsylvania irrespective of the provisions of the charter or by-laws such method must exist by authority equal in grade to that by which it was granted. Naturally a majority group finding itself faced with the prospect of losing its control or sharing its board with a minority representative will seek measures of correcting the situation. I have been unable to find any cases in which this remedial method was tried but it seems as though § 403 of the B.C.L. offers a method whereby the effect of § 505 can be lessened and in cases taken away altogether. § 403 provides:

"If the articles or by-laws of a corporation so provide the directors of the corporation may be classified in respect to the time for which they shall severally hold office, *except that the first directors shall serve only until the first annual meeting*. In such cases each class shall be as nearly equal in number as possible, the term of office of at least one class shall expire in each year and the members of a class shall not be elected for the shorter period than one year or for a longer period than four years."<sup>15</sup>

So under this provision there may be no less than one, and no more than four, classes in Pennsylvania.

To illustrate the effect of classification I will take a hypothetical situation; Corporation X has 10,000 shares outstanding, of these, 7,600 is owned by the majority faction and 2,400 by the minority faction. The articles of the corporation provide for a nine man board to serve annually. The results of an election for these nine directors, each faction voting as a block and cumulating their votes would be in every case seven directors for the one group, and two for the other.

<sup>14</sup> 17 Del. Ch. 39, 147 Atl. 2nd. 255 (1929).

<sup>15</sup> 15 P.S. § 2852-403 amended by A. 532 Laws of 1949 eff. 5-23-49 which added the matter in italics.

	Total Shares	Total Votes	A	B	C	D	E	F	G	H	I	J	K
Maj. group ...	7,600	68,400	7,604	7,603	7,602	7,601	7,600	7,599	7,598	7,597	7,596		
Min. group ...	2,400	21,600										10,801	10,799
Totals ...	10,000	90,000	7,604	7,603	7,602	7,601	7,600	7,599	7,598	7,597	7,596	10,801	10,799

There is no way by which the majority could keep the minority from electing two directors to the board; if they (majority) distributed their votes over eight men each would receive a total of 8,500+, so the minority candidates would still have more than enough votes for their two men, distributed over seven men each would have only 9,000+. So in every case the minority can elect two men to the board, but no more. The minority could not distribute their votes over three men and elect even one because the number of votes each man would receive would be less than the majority nominees receive; realizing this they judiciously will vote only for two men. Now however by taking advantage of the privilege granted by § 403, that of classifying, the majority will be able to change the result.

Taking the same corporation with the nine man board, the by-laws can be amended as provided for in § 302(11) B.C.L., to permit classification. The amended by-laws would provide, "the business and affairs of the corporation are to be controlled and managed by a board of nine directors divided into three classes of three each. The directors shall be elected at the annual meeting of the stockholders; at the annual meeting in the year 1952 the three nominees receiving the highest number of votes shall be elected directors of the class to serve for a term of three years. The three nominees receiving the next three highest number of votes shall be elected directors of the class to serve for a term of two years, and the three nominees receiving the next three highest number of votes shall be elected directors of the class to serve for a term of one year, and until in each case their successors are elected and have qualified. At each annual meeting thereafter three directors shall be elected for the term of three years, and until their successors are elected and have qualified, to succeed those of a class whose terms then expire." In such a case the majority will naturally want to control the classes serving two and three years which they will be able to do on the first ballot by cumulating their votes on six nominees giving each one 11,000 plus votes. If the minority wants a man in the two or three year class they will have to put all their votes on one man giving him a total of 21,600. This would place him in the three year class with two majority nominees, the two year class then would be made up of all majority nominees and the other majority nominee would be in the one year class with two existing vacancies. The majority would be able to fill these vacancies by again voting cumulatively for two men, giving one 3,900 votes and the other 3,700. When vacancies exist on a board the right of cumulative voting extends to the election of the nominees for those vacancies. If the majority should err and distribute their votes over all nine of their nominees the minority could cumulate their votes and distribute them among two candidates and thus elect two directors to the three year class as illustrated in the preceding graph.

I say the minority could distribute their votes upon two *candidates* rather than nominees for § 505 B.C.L., after confirming the right to vote cumulatively for directors, further provides, that, "the *candidates* receiving the highest number of votes up to the number of directors to be elected shall be elected." A candidate is one who is seeking office. Webster defines a candidate as, "one who offers himself, or is put forward by others as a suitable person or an aspirant or contestant for an office, privilege, or honor." The term candidate embraces a much larger class than the term nominees, therefore one does not need to be nominated to be elected a director. This interesting method was presented in the case of *Commonwealth ex rel. Laughlin v. Green*.<sup>16</sup> The minority successfully elected their candidate after the corporation by-laws were amended to provide for classification of directors by voting cumulatively for one not a nominee. The majority objected and the court held as stated above.

The minority will be able to gain representation in the three year class, electing either one or two depending upon how the majority votes. This cannot be prevented. The voice of the minority though obnoxious must be tolerated, if they are in the three year class, for three years; they had better speak loudly and frequently for at the end of that three year period their representation is through. If the representation is in the class of one or two years their enjoyment of the position will not last even that long, one and two years respectively.

The minority's representation is finished at the end of that period when the term of office of the three year class terminates, for the by-laws, in conformity with § 403, provides for an annual election of three directors to succeed those of a class whose terms have expired. So in the election for the succeeding directors the minority in the corporation who control 2,400 shares, will only be able to place 7,200 votes upon their nominee, while the majority owning 7,600 shares may distribute their votes upon their three nominees in this manner, 7,601, 7,600, 7,599. Since these three will have the highest number of votes they will be elected. This will be the result of every annual election, and the minority faction will not be heard to complain for as was pointed out in the case of *Maddock v. Verclone Corporation*,<sup>17</sup> the right to representation is not assured to any group as such, it is an incident to the voting power of stock.

There is this limitation however on the power of the majority to defeat representation by the other faction. § 401 of the B.C.L. provides, "the business and affairs of every corporation shall be managed by a board of at least three directors . . ." I interpret this section as meaning there must be three directors serving at the same time for the same term. Since that is the provision, the majority must control 76% of the stock in order to keep the minority off of the three man board elected annually. If they do not control that percentage, there is the possibility it may be acquired through soliciting proxies.

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<sup>16</sup> 351 Pa. 170, 40 Atl. 2nd. 492 (1945).

<sup>17</sup> 17 Del. Ch. 39, 147 Atl. 2nd. 255 (1929).

Today, due to increase in size and the geographical dispersion of corporate membership, the use of proxies is a necessary development. Without the device the inability of shareholders to attend might make action impossible for failure to gain the necessary quorum.

While the device is needed, there is no doubt that its use has aided the group of shareholders in control, enabling them to securely entrench themselves by soliciting proxies which are almost automatically given to them by trusting shareholders. Rohrlich in his book *Law and Practice in Corporate Control* says,

"With the notice of annual meeting, a request for the execution and return of an enclosed proxy by stockholders 'unable to attend' is transmitted. The proxy ordinarily runs in favor of one or more persons selected by the board of directors. The return is almost automatic."

As a general rule the average stockholder is interested mainly in the dividends issued and as long as he receives them regularly or those in control provide a good reason for their absence he is prone to trust the management. Those in control are also in the best position to carry out an effective campaign by preparing the necessary literature and charging the expenses to the corporate treasury.

However the right of the management to solicit proxies is controlled by the Securities Exchange Act of 1934,<sup>18</sup> which gave the Securities Exchange Commission power to regulate the solicitation of proxies from holders of securities traded on a national securities exchange. Under such authority the Commission has promulgated rules requiring the solicitation to set forth all pertinent facts relating to the issue to be voted upon in a full, frank and fair manner. Regulations Rule X-14A-4 provides:

"The form of proxy (1) shall indicate in bold face type whether or not the proxy is solicited on behalf of the management, and, (2) shall identify clearly and impartially each matter or group of related matters intended to be acted upon whether proposed by the management or by security holders."

Therefore, under this rule the minority security holders can have any of their proposals presented in the proxy. So under this act if proxies are solicited, unbiased information must be furnished. However the effect of this is doubtful. In all probability, the return in the managements favor will continue to be as automatic as before. So if the majority can acquire its 76% they will be able to deprive the minority of the representatives it is entitled to have, by virtue of the voting power of its 24%, on the nine man board, by using the device of classification. This opportunity may arise in only a few cases but when it does, the right of cumulative voting may as well be non-existent for the exercise of the right by the group it was intended to benefit will be inefficacious.

Since the privilege is granted, its effect should be the same in all cases, rather than subject to the dictates of the majority.

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<sup>18</sup> Title One, Pub. No. 291, 73rd. Cong., § 14, 15 U.S.C.A. 78(N).