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Constitutionality of Non-Voting Stock

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LEGISLATION

CONSTITUTIONALITY OF NON-VOTING STOCK

During recent years, non-voting corporate stock has become a familiar instrument of corporation finance, used to induce the general public to invest without obtaining any of the rights or responsibilities of corporate administration, and thereby enabling those interested in the management of the corporation to retain control, through voting stock.[1] The validity of such stock has been recognized at common law,[2] and the statutes of many states, including West Virginia, expressly authorize its issuance. The West Virginia statute reads in part as follows:

> "Every corporation, other than a banking institution, shall have power to issue one or more classes of stock or one or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value, with such voting powers, full or limited, or without voting powers and in such series and with such designations, preferences and relative, participating optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the charter, or in any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors . . . ."[3]

The first statutory provision for the issuance of non-voting stock by West Virginia corporations was made in 1901.[4] That provision, providing for non-voting *preferred* stock only, remained on the books in the form in which adopted until the code revision of 1931.[5] At that time the Code Commission, recommending the retention of the old provision, expressed the view that non-voting stock is constitutional.[6]

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[1] The general subject of non-voting stock is well treated in DEWING, THE FINANCIAL POLICY OF CORPORATIONS (1926) 74-77; BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE (1928) 41 *et seq.*; BISHOP, FINANCING OF BUSINESS ENTERPRISES (1929) 138 *et seq.* The use of such stock has incited some criticism. BEARLE, *op. cit.*, 142 *et seq.*

[2] *Re* The Barrow Haematite Steel Co., Ltd., (1888) L. R. 39 Ch. Div. 582, 59 L. T. N. S. 500.

[3] W. VA. REV. CODE (1931) c. 31, art. 1, § 22; W. VA. CODE ANN. (Michie, 1932) § 3034.

[4] W. Va. Acts, 1901, c. 35, § 5. *Cf.* W. VA. CODE ANN. (Warth, 1900) c. 53, § 16.

[5] W. VA. CODE ANN. (Barnes, 1923) c. 53, § 16.

[6] REPORT OF CODE REVISORS OF W. VA., vol. 2, p. 10: ". . . . The weight of modern judicial opinion seems to hold such a provision unconstitutional, but these decisions, while well reasoned in many respects, seem to ignore the flexibility of a state constitution to meet changing public conditions, and

The legislature substituted for the old provision the much broader above quoted provision, taken *verbatim* from the corporation laws of Delaware.[7] Although the legislative note appended to this substituted section ignores any question of constitutionality, the history of non-voting stock in Illinois and Delaware indicates that the question discussed by the Code Commission might easily arise in West Virginia.

In the absence of contrary constitutional provisions, there seems to be no valid legal objection to depriving stockholders of the right to vote.[8] In Illinois and Delaware, however, non-voting stock has been held to be invalid under state constitutional provisions in one instance identical, and in the other similar, to section four of article eleven of the West Virginia Constitution, which provides as follows:

> "The Legislature shall provide by law that in all elections for directors or managers of incorporated companies, *every stockholder* (italics mine) shall have the right to vote, in person or by proxy, for the number of shares of stock owned

for this reason do not give as much weight as we think should be given the real purpose of the provision, which was to secure the right of cumulative voting. It is thought that if its true weight is given the purpose in mind, and the flexibility of state constitutions to meet changing conditions is not forgotten, that the provision respecting preferred stock is constitutional, especially where there has been a long existing legislative policy in harmony with this statute, which has induced many corporations to adopt its provision. Attention is also called to the fact that the constitutional provision referred to relates only to voting for directors, and does not relate to the right to vote on other corporate acts."

[7] W. VA. REV. CODE (1931) c. 31, art. 1, § 22, legislative note; W. VA. CODE ANN. (Michie, 1932) § 3034, legislative note. *Cf.* Del. Laws 1929, p. 371, § 5.

[8] Note (1922) 21 A. L. R. 643. Courts usually reach this result on the ground that non-voting provisions are agreements between classes of stockholders, binding as such between the shareholders, and of no concern to the public. Hamlin v. Toledo, *etc.*, R. Co., 78 Fed. 664, 671, 36 L. R. A. 826 (C. C. A. 6th, 1897); People v. Koenig, 113 App. Div. 756, 118 N. Y. Supp. 136 (1909); Miller v. Ratterman, 47 Ohio St., 141, 157, 24 N. E. 496 (1890). But should such agreements be binding on a third party, as, for example, a secretary of state requested to issue non-voting stock?

In the light of the broad provision of the present West Virginia statute, it is noteworthy that, apparently, all cases dealing with the validity of non-voting stock involve only preferred stock, and that the provisions are usually spoken of as agreements between preferred and common stockholders. See Note (1922) 21 A. L. R. 643, and cases cited *supra*. There would be no difficulty, however, in construing them as agreements between a voting class and a non-voting class. *Cf.*: Macintosh v. Flint, *etc.*, R. Co., 34 Fed. 582 (C. C. E. D. Mich. 1888); Gen. Inv. Co. v. Bethlehem Steel Corp., 87 N. J. Eq. 234, 100 Atl. 347 (1917).

Some courts have intimated that non-voting provisions are of doubtful public policy. Hamlin v. Toledo R. Co., *supra*. Others have expressly taken the opposite stand. St. Regis Candies Co. v. Hovas, 117 Tex. 313, 3 S. W. (2d) 429 (1928).

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."

The fate of non-voting stock in Illinois is of peculiar interest in West Virginia, due to the fact that the constitutional provision[9] there in force is identical, in phraseology, to the West Virginia provision. In *People v. Emmerson*,[10] decided in 1922, the Illinois Court held that that provision conferred upon *all* stockholders the right of one vote for each share of stock owned, and that there could be no deprivation of that voting right. The court placed its decision upon the "ordinary and natural meaning" of the language used in the provision, holding that the provision's "unambiguous" wording prevented a consideration of extrinsic matters, such as the constitutional debates, to discover the purpose for which it was drafted. It is noteworthy that Illinois has no statute authorizing non-voting stock, such as is found in the West Virginia Code, and that legislative construction of a constitution has considerable weight as to constitutional questions.[11] The Delaware Supreme Court, however, refused to allow the presence of such a statute to deprive a constitutional provision of its fullest effect.[12]

Delaware's first provision for non-voting stock, enacted in 1899,[13] was evidently copied after the corporation laws of New Jersey,[14] in which state there was no constitutional provision affecting the validity of such a statute. At the time of the adoption of the Delaware statute, however, the Delaware constitution provided,

"In all elections for directors and managers of statutory corporations, each shareholder shall be entitled to one vote for each share of stock he may hold.'"[15]

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[9] Ill. Const. 1870, art. 11, § 3.
[10] 302 Ill. 300, 134 N. E. 707, 21 A. L. R. 636 (1922).
[11] State v. Harden, 62 W. Va. 313, 58 S. E. 715 (1907). See State v. Rocke, 91 W. Va. 423, 113 S. E. 647 (1922).
[12] Brooks v. State, 3 Boyce 1, 79 Atl. 790 (Del. 1911).
[13] Del. Laws 1899, c. 273.
[14] Brooks v. State, *supra* n. 12.
[15] Del. Const. 1897, art. 9, § 6.

In *Brooks v. State*,[16] decided in 1911, the Delaware Supreme Court, in construing this constitutional provision, held the statute depriving stockholders of their right to vote unconstitutional and all issues of non-voting stock thereunder invalid. In 1903, however, prior to this decision Delaware had repealed the constitutional provision in question,[17] the effect of the *Brooks* case applying only to non-voting stock issued prior to the repeal. Thus the way was cleared, in Delaware, for the unquestioned validity of non-voting corporate stock. The broad provision subsequently adopted by the West Virginia Legislature was first put on the Delaware statute books in 1929.[18]

In *State v. Swanger*,[19] decided in 1905, the Missouri Supreme Court held that the purpose of a provision of the Missouri Constitution[20] similar to the West Virginia provision was only *to guarantee to those shareholders having the right to vote* the right of cumulative voting, and that non-voting provisions were agreements between the two classes of stockholders, of no concern to the public, and not affected by the constitutional provision. Although the *Swanger* case has been distinguished by the Illinois Court,[21] as involving a constitutional provision different in wording and meaning from the Illinois provision, which, as has been pointed out, is identical to that of West Virginia, the Missouri result appears to be clearly contrary to those reached in Illinois and Delaware.

The history of non-voting stock would seem to indicate what must have been the intended purpose of the Delaware and Illinois constitutional provisions. At common law each shareholder had but one vote, despite the number of shares he might hold,[22] a voting method which was obviously unfair. This method eventually gave way, in most jurisdictions, at least, to the so-called, modern

[16] *Supra* n. 12. This case reverses State v. Brooks, 74 Atl. 37 (Del. Sup'r. Ct. 1909), a case frequently cited for the proposition that the benefit of the constitutional provision could be waived by the stockholders.

[17] Del. Laws 1903, c. 1, pp. 3, 4, and c. 254, p. 543; Notes to Const., DEL. REV. CODE (1915) p. lxxvi.

[18] Del. Laws 1929, p. 371, § 5.

[19] 190 Mo. 561, 89 S. W. 872, 4 Ann. Cas. 563 (1905).

[20] Mo. Const., 1875, art. 12, § 6: "In all elections for directors or managers of any incorporated company, each shareholder shall have the right to cast as many votes in the aggregate as shall equal the number of shares so held by him in said company, multiplied by the number of directors or managers to be elected at such election; and each shareholder may cast the whole number of votes, either in person or by proxy, for one candidate . . . ."

[21] The People v. Emmerson, *supra* n. 10.

[22] BISHOP, *op. cit. supra* n. 1, at 139; Taylor v. Griswold, 2 Green 22 (N. J. L. 1834).

"statutory" method, under which each shareholder has the right to cast one vote for each share of stock he holds.[23] The Delaware constitutional provision could reasonably be interpreted as being merely a guarantee of the "statutory" method of voting to shareholders having the right to vote. Likewise, the Illinois provision, adopted early in the development of cumulative voting, which followed the adoption of the "statutory" method could be interpreted as intended merely to secure to minority stockholders having the right to vote a representation in the management of the corporation.[24]

Section four of article eleven of the West Virginia Constitution was adopted as a part of the Constitution of 1872. Its wording warrants the opinion that it was taken from the Illinois Constitution, adopted but two years before. Available records of the constitutional convention indicate that it passed through the committee of the whole and was adopted by the convention, without recorded consideration, in the form in which submitted by the committee on corporations,[25] so that its real purpose seems to be nowhere set out.[26]

Should the constitutionality of non-voting stock arise in West Virginia, the Missouri case would seem to be good precedent for construing section four of article eleven of the constitution as being merely a guarantee of cumulative voting,[27] for the benefit of those stockholders entitled to vote,[28] especially in the light of the legislative and executive interpretation which has been placed on the provision.

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[23] BISHOP, *op. cit. supra* n. 1, at 139-140.

[24] *Cf.* (1922) 17 ILL. L. REV. 138.

[25] The records of the constitutional convention indicate no consideration of section four although other sections of article eleven received considerable attention. See JOURNAL OF THE CONSTITUTIONAL CONVENTION, 243-255.

[26] The West Virginia court has apparently considered it but once, at that time holding that it gives railroad corporation shareholders the right to cumulate their vote in the election of directors. Cross v. W. Va. Ry. Co., 35 W. Va. 174, 12 S. E. 1071 (1891).

[27] The "statutory" method, one vote for each share, had previously been a concern of the West Virginia Code. W. VA. CODE (1870) c. 53, § 44.

[28] The section of the West Virginia Code providing for cumulative voting provides that shareholders shall have one vote for each share *entitled to vote.* W. VA. REV. CODE (1931) c. 31, art. 1, § 66; W. VA. CODE ANN. (Michie, 1932) § 3078.