CONstitutional CONcepts

Number 3

A series of condensations of the scholars' research papers prepared by the Illinois Constitutional Research Committee which was appointed by Governor Richard B. Ogilvie to furnish background material for delegates to the Constitutional Convention.

LEGISLATING BY THE CONSTITUTION: CORPORATIONS

David S. Ruder

Does the present State Constitution drive corporations from Illinois?

Should the legislature be prevented from making special laws for corporations?

Does business regulation belong in a constitution?

These and other questions were discussed in the paper "Business Regulation: Corporations," written by David S. Ruder, Professor of Law, Northwestern University School of Law. Commissioned for the Governor's Constitution Research Group, this will be background material for use by Constitutional Convention delegates.

This is a summary of the original ten-page report and does not purport to contain all the detail of the original. (See the back page for further information.)

The Illinois Constitution of 1870 contains several sections relating to the internal affairs of corporations. Article IV, Section 22, prohibits special laws granting to any corporation a special or exclusive privilege, immunity or franchise. Article XI, Section 1, prohibits creation of corporations by special law and revokes special charters under which no organization has taken place. Article XI, Section 3, makes cumulative voting mandatory for election of corporate directors. The purpose of this paper is to examine the desirability of including such provisions in a revised Illinois constitution.

This paper will reach three conclusions: first, that provisions prohibiting special franchises, charters or legislation for private corporations should be continued in the Illinois Constitution; second, that the provision requiring cumulative voting for directors should be omitted; and third, that no additional provisions regulating internal affairs of private corporations should be included in the constitution.

Special Franchises and Privileges

Prior to the adoption of the 1870 Constitution, private corporations in Illinois were created by special legislation granting individual charters together with special privileges, including monopoly powers. Campaign contributions and outright payments were made to legislators for the purpose of inducing granting of such charters. Such practices not only led to wholesale corruption of

legislators, but caused the legislature to devote immense amounts of time to the problems of granting special charters.

A related problem arose when the holders of the special charters either sold them outright or used the monopoly privileges contained in them to block economic development by other corporations. Large numbers of these unused charters were held as speculations by their owners.

Elimination of all special legislation was one of the primary purposes of the Constitutional Convention of 1869-70. Special privileges for corporations were eliminated primarily by two sections. Article XI, Section 1, and Article IV, Section 22.

Not only did the 1870 Convention decide to forbid further special charters and privileges and to substitute a general corporation law, but it determined to revoke all special charters and privileges not then exercised. After considerable debate concerning federal constitutional prohibitions against the taking of property without due compensation, the convention adopted Article XI, Section 2, cutting off charters and privileges after a ten-day grace period.

The practice of prohibiting special charters and privileges for private corporations and substituting general incorporation laws has received universal recognition by the states. The retention in a new Illinois Constitution of prohibitions against special charters, franchises and privileges will thus be consistent with both present practices and strong Illinois constitutional history. The present language of the 1870 Constitution is satisfactory to continue the prohibition of special charters.

Although the Section 2 revoking charters or grants of special or exclusive privileges to corporations which had not been organized or which were not in operation within ten days from the time the 1870 Constitution took effect may be obsolete, omission of the revocation provision may raise the question whether previously revoked charters have somehow been revived. This problem was met in Pennsylvania in 1966 by adoption of a special clause in its revised constitution; which, when put in Illinois terms, would be something like the following:

> All charters or grants of special or exclusive privileges, under which organization had not taken place or which had not been in operation within ten days from the time the Constitution of 1870 took effect, shall thereafter have no validity or effect whatever.

If it is deemed desirable to retain the language revoking special charters in a special section concerning corporations, then it may also be advisable to include the section prohibiting special charters, franchises and privileges in a separate corporate section, rather than including it in a section prohibiting special laws generally. The result would be a corporate section limiting the powers of the legislature. This result would also be consistent with the action taken by the Constitutional Convention which produced the proposed constitution which was defeated in 1922. That proposed constitution did not contain a corporate article, but did contain a provision prohibiting the legislature from granting "any special or exclusive privilege, immunity or franchise" or from granting or changing "any corporate powers except those of educational, charitable, reformatory or penal corporations, under the patronage and control of the state."

Cumulative Voting

In corporations, a system of cumulative voting is one in which in an election for directors, each shareholder is entitled to votes equal to the number of his shares multiplied by the number of directors to be elected. He may cast all of his votes for a single director, or distribute them among the candidates as he sees fit. The cumulative voting system is designed to allow a shareholder to secure representation on his corporation's board of directors even though he owns less than 50% of the corporation's shares.

A provision on cumulative voting was inserted in the 1870 Constitution at the urging of those who believed that once majority stockholders obtained control of a company, they were likely to keep corporate information from minority stockholders, plunder the property of the corporation, and otherwise abuse their positions of trust. Although there was no substantial opposition to the adoption of the corporate cumulative voting provision, objection was made that it contained matter which was legislative in nature and therefore should not be included in a constitution. Inclusion of legislative matters in constitutions is counter to current thinking regarding modern constitutions.

Justification for cumulative voting by corporate shareholders even as a legislative matter, is not entirely clear at this time. The legal literature is replete with arguments on both sides. Nevertheless, the arguments against cumulative voting are at least substantial enough to justify legislative, rather than constitutional treatment. The right to cumulative voting is not of such clear importance as to raise the provision to constitutional status.

Practices in other states also point towards elimination of cumulative voting from the constitution and a similar provision appears in only eleven other state constitutions. The modern trend is to treat cumulative voting as a legislative matter, and even then to make adoption of cumulative voting optional for each corporation.

Partly as a result of the cumulative voting provision, many businesses which might normally incorporate in Illinois have chosen to incorporate in other states, notably Delaware. Incorporation of an Illinois business in another state means that Illinois may be unable to protect its citizens who are shareholders of that business, since the law of the other state, rather than that of Illinois, will regulate the relationship between the managers of the corporation and its shareholders.

There are several constitutional restrictions which cause business to avoid incorporating in Illinois. First, as a result of language stating that each stockholder must have the right to vote for the number of shares of stock owned by him, and adding that such directors or managers shall not be elected in any other manner, Illinois corporations may not issue non-voting stock and directors may not be removed or replaced by the board of directors.

Additionally, the language guaranteeing the right to vote in a cumulative manner prevents Illinois corporations from classifying directors as eligible for either two

or three-year terms in order to assure continuity of management. The constitutional prohibition against classified boards, like that against non-voting stock, operates as a significant limitation on Illinois corporations desiring to achieve sophisticated management and financing.

Another potential difficulty for operation of businesses incorporated in Illinois exists by reason of statements by the Illinois Supreme Court that the Illinois Constitution guarantees representation in proportion to stock ownership. If the concept of proportional representation is applied strictly, many flexible devices normal to the operation of a modern corporation will be unavailable. Such devices include classified boards, appointed directors, limitations on the number of directors, non-voting stock, bondholder voting arrangements, issuance of large numbers of low priced shares, executive committees, voting agreements, and voting trusts.

If the legislature were relieved of constitutional restrictions in its regulation of corporations, it could permit the use of flexible modern corporate practices while still protecting the right to vote cumulatively. For instance, it could provide that a director may not be removed from office if the number of shares voted against the resolution for his removal exceeds the number which would have elected him. A similar provision would be possible with regard to reduction of the number of directors.

Finally, even if the constitutional provision dealing with cumulative voting is removed, the Illinois Business Corporation Act contains a mandatory cumulative voting provision guaranteeing the right to every shareholder to cumulate his shares and to distribute his votes among candidates as he sees fit. This statute will remain in effect unless affirmative legislative action is taken to remove or change it. Thus, the question for the delegates is not whether to have corporate cumulative voting in Illinois, but whether to have it in the Constitution.

Elimination of the cumulative voting provision in a new Illinois constitution would be based upon the sound theory that the legislature can be counted upon to provide adequate protections to stockholders while permitting flexibility for corporate operation. More generally, corporate regulation is not a proper subject for constitutional treatment. Although limitations on granting special corporate charters and privileges should be continued, no additional provisions regulating the internal affairs of private corporations should be included.

UNION LEAGUE CLUB OF CHICAGO

WHY these DIGESTS?

Preparing for a constitutional convention requires advance background and research. Accordingly, Governor Richard B. Ogilvie called upon a group of scholars to prepare research papers for the use of delegates and appointed Dr. Samuel K. Gove, director of the Institute of Government and Public Affairs of the University of Illinois as project director. Sixteen papers on various aspects of state government are being assembled. These will be issued in condensed form in continuing issues of Constitutional Concepts. A sincere attempt has been made to retain the concepts and ideas of the writers whose papers run from up to 80 pages or more. Any errors which result from the condensations clearly are not those of the scholars originating the research.

As no public funds were available to the Constitution Research Group, the Union League Club of Chicago made an initial grant of $10,000 to the group so the work might proceed. The Club took no part in the selection of the scholars nor the topics to be researched; made no effort to influence either research or conclusion; and did not, in any manner, direct the group. Nor does the Club necessarily endorse any suggestions, proposals or ideas expressed by the scholars.

This is one of a series of condensed research papers, prepared and published as a public service by the Public Affairs Committee of the Union League Club of Chicago.

Union League Club of Chicago
65 W. Jackson Blvd.
Chicago, Ill. 60604

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