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Shareholders--Chapter 1.6--Foreword

Thomas T. Moore

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SHAREHOLDERS

CHAPTER 1.6

THOMAS T. MOORE*

FOREWORD

The postponement of the effective date of the act until January 1, 1964, had a two-fold purpose; to give attorneys ample time to familiarize themselves and their clients with the provisions of the act and to give the legislature an opportunity to amend the act prior to the effective date thereof in the event that defects became apparent through the study of the act by the bar of the state. The purpose of this writing is to promote study and discussion of the chapter by pointing out some of the more controversial features and criticizing some of the apparent defects in the chapter.

The natural result of this approach is to create a highly critical atmosphere and to ignore the many good features of the chapter. Failure to comment upon a particular part of the chapter is not to be taken as a determination that it is unimportant but only that it is clear, not controversial and not subject to any criticism for the purposes of this article.

A. THE ACT AND THE CONSTITUTION

Many sections in this chapter use the qualifying phrase, "Shareholders entitled to vote" and in section 12-16.11 it is provided that the voting rights of preferred or special classes of shares may be limited by the articles of incorporation.

Article IX, Section 11 of the Constitution of South Carolina¹ and the present statutes² would appear to give to each share of stock, regardless of preference or class, the right to vote for directors.

Although it has been the practice in South Carolina to limit the voting rights of preferred stock—usually such stock can

*Member Robinson, McFadden & Moore, Columbia, S. C.

1. "The General Assembly shall provide by law for the election of directors, trustees or managers of all corporations so that *each stockholder* shall be allowed to cast, in person or by proxy, as many votes as the number of shares he owns multiplied by the number of directors, trustees or managers to be elected, the same to be cast for any one candidate or to be distributed among two or more candidates." (Emphasis added.)

2. S. C. CODE §12-253 (Supp. 1962).

vote for directors only upon default in the payment of the dividend for some specified time, and the question has never been decided by the Supreme Court—there is real doubt that the provisions of this act or action taken thereunder limiting the right of voting for directors would be upheld if challenged before the courts, and this doubt can only be resolved by repealing or modifying Article IX Section 11 of the Constitution.

B. CHAPTER 1.6—GENERAL

In drafting this chapter the committee was faced with a number of basic problems and in resolving them it was necessary to compromise in an effort to strike a balance between conflicting interests. It is only necessary to state some of these problems to point up the difficulty.

(a) The problem of drafting one law for both the large publicly-held corporation and the small closely-held partnership-or-family-type corporation;

(b) The problem of protecting the rights of the minority stockholder without making it possible for the minority stockholder to so harass the majority or the management as to render the corporate operation ineffectual;

(c) The problem of giving the directors of the corporation, who are the managers, the flexibility necessary to doing business under modernday conditions of constant change while reserving to the stockholders, who are the owners, the powers necessary to protect their investment in the enterprise.

These and other problems are discussed in their relationship to the various sections of this chapter.

C. THE MODERN TREND

The "modern trend" in corporate law as exemplified by this act, the American Bar Association Model Act and the acts of other states which have been recently revised is to shift power from the shareholders to the management and to rely on state and federal regulation to protect the shareholder against damaging acts on the part of the management. The justification of this shift is that corporate activity has become more complex and has speeded up to such an extent that the old procedures are now an intolerable burden and must be abandoned in favor of quicker action which is only possible if there

is a concentration of power in the directors who can meet and act on shorter notice and with less formality.

This line of reasoning is familiar and has had its greatest application in the attitude of the federal executive departments toward amending the Constitution of the United States. Aside from political philosophy its weakness in its relation here is that federal and state regulatory laws apply to relatively few business corporations and therefore the shareholders of corporations not required to register under the federal or state securities laws are without protection.

D. COMMENT BY SECTIONS

Section 12-16.1 makes little change in the present law³ insofar as contents of the by-laws are concerned, but it does provide that the initial by-laws may be adopted by the board of directors and it further provides directors shall have concurrent powers with the shareholders in amending, adopting or repealing by-laws, except that the shareholders may specify in a by-law adopted by them that it may not be amended or repealed by the directors and the articles of incorporation may reserve the power to adopt, amend or repeal by-laws to the shareholders or may require a greater than majority vote on the part of either the directors or shareholders to so adopt, amend or repeal.

This is an example of the shift of power from the shareholders to the directors and this is in an extremely important area since, in normal practice, the articles of incorporation and the initial by-laws will be drafted by those persons who will be directors but not necessarily the majority shareholders.

It is interesting to note in this connection that in the draft of this section the directors could not change a by-law adopted by the shareholders unless the by-law specifically gave them that right while in the section as enacted the directors may change the by-law unless they are specifically prohibited from doing so.

The effect of this section will be to give directors much greater control over large corporations than they now have and to necessitate an increased alertness on the part of shareholders since by-laws can be amended without notice to them.

3. S. C. CODE §12-101(6) (Supp. 1962).

Section 12-16.2 provides a framework within which corporations can continue to exist and operate in the event of a nuclear attack upon the United States, or a nuclear accident substantially affecting the State, by permitting the adoption of emergency by-laws to become automatically operative in such event.

Section 12-16.3 provides for the holding of annual meetings of shareholders for the purpose of electing directors and such other business as may come before the meeting and it further provides a remedy in the event that the meeting is not held on the proper date, or within 30 days thereafter or, in the event no meeting date is established by the by-laws, within thirteen months after the last annual meeting.

The section provides first that a substitute annual meeting may be called by any one of five enumerated persons, or classes of persons, and failing that, it provides that the courts, on application of any shareholder, may order a substitute annual meeting. The matter of quorum is not dealt with and presumably a substitute annual meeting called by one of the five enumerated persons, or classes of persons, would be subject to adjournment from time to time until a quorum was accomplished. In the event of a substitute annual meeting, ordered by a court, such an adjournment would require further order of the court, unless provided for in the original order, and it would appear that this section should be more specific on this point.

Section 12-16.4 provides for written notice of all meetings, with the purpose being stated in the notice of a special meeting, and provides that such notice shall be given not less than ten nor more than fifty days before the date of the meeting.

This section also provides for the giving of notice in the event of the calling of a substitute annual meeting under section 12-16.3. If the president or secretary fails to give notice of a substitute annual meeting upon proper request, the person or persons calling the meeting may themselves, after 15 days, give the notice, and there exists the possibility that more than one substitute annual meeting would thus be called. The possibility is admittedly remote but litigation would almost certainly result from the calling of more than one substitute annual meeting and such litigation could be prevented by clarifying this point.

Section 12-16.5 provides for the waiver of notice either before or after a meeting and is important in that it provides a means of perfecting a meeting, from a formal standpoint, if a question is raised as to the sufficiency of notice after the meeting is held.

Subsection (b) of this section provides that attendance at a meeting constitutes waiver of notice unless the shareholder or proxy protests the notice prior to the *conclusion* of the meeting and excepts from this the shareholder or proxy who attends "solely for the purpose of stating his objection, at the *beginning* of the meeting, to the transaction of business on the ground that the meeting was not lawfully called or convened." The equity of permitting one shareholder to sit through and participate in the meeting before objecting to his notice, while the other must state his objection in the beginning, is not apparent. It would be a better practice to make the shareholder elect, at the beginning of the meeting, or as soon as he has learned the purpose of the meeting, whether he will protest the validity of the notice and of the meeting, or whether he will waive notice and participate in the meeting.

Subsection (c) of this section is as follows:

(c) When a meeting is adjourned, for whatever reason, for 30 days or more, notice of the adjourned meeting shall be given as provided by this section. Notice of a meeting adjourned for less than thirty days need not be given if the time and place of the adjourned meeting are announced at the meeting at which the adjournment is taken, and at the adjourned meeting the corporation may transact any business which might have been transacted at the meeting at which the adjournment was taken.

There is an implication here that an adjourned meeting for which notice is required is not limited in the business which it may transact to business which may have been transacted at the meeting which was adjourned. This has the effect of making the adjourned meeting a new meeting and negates the theory that an adjourned meeting is a continuation of the meeting which was adjourned. This is important since shareholders generally are not aware of statutes and would probably see no significance in a motion to adjourn a meeting for thirty days or more, which, if carried, would have the effect

of terminating the meeting and calling a new meeting at the later date.

Section 12-16.6 authorizes the board of directors to "fix in advance" a record date for the determination of the shareholders entitled to "notice of or to vote at any meeting of shareholders or any adjournment thereof, or entitled to receive payment of a dividend or other distribution or. . ." for any other purpose requiring such determination. Such record date may not be more than fifty nor less than ten days prior to the date upon which the action requiring the determination is to be taken.

This section also provides for the establishment of a record date in the event of several foreseeable contingencies and also permits, if the by-laws so provide, the closing of the transfer books as a means of establishing a cut-off date. Subsection (e) provides that the record date established for any meeting shall be applicable to any adjournment thereof "unless a new record date is fixed in accordance with subsection (a) of this section"; i.e., by the board of directors. This could give the directors the power to change the complexion of the meeting, and thus the results of the meeting, by the simple device of changing the record date between the meeting and the adjourned meeting and, since the adjourned meeting is a continuation of the meeting which was adjourned, any change in the shareholders entitled to vote at such meeting should be a matter for determination by the shareholders, not by the directors.

Section 12-16.7 provides that a list of shareholders entitled to vote at a meeting shall be prepared, and be available for inspection, from the date the notice of meeting is given until the date of the meeting, and in no event for less than ten days, at "the registered office of the corporation, or at its principal place of business or at the office of its transfer agent or registrar." It is further provided that the list shall be available at the time and place of the meeting and that, if this requirement is not complied with, any shareholder may demand, and be entitled to, an adjournment until it has been complied with, but in the absence of such demand the validity of the meeting is not affected. The use of the word "or" in listing the places of availability makes it necessary to add the words "within this state" at the beginning of the quoted phrase because otherwise the list could be filed in the office

of a transfer agent or registrar in a distant state, which would defeat the purpose of the requirement.

Section 12-16.8 establishes the requirements for a quorum of shareholders and is in line with the present laws in this state; i.e., a majority of the shares entitled to vote constitutes a quorum, except that the articles of incorporation may require a greater number to constitute a quorum. It is also provided in subsection (b) that a majority of the shares present may adjourn the meeting in the absence of a quorum.

Subsection (c) of section 12-16.8 makes an important change in what many lawyers regard to be the present law in this state regarding continuing quorums, in that it provides that a quorum, once established, continues through the meeting and any adjournment thereof. This codifies what is described by the textwriters as the "modern and better view"⁴ although it is contrary to parliamentary law generally applicable to legislative bodies, and may well take shareholders by surprise, especially when applied to an adjourned meeting.

Section 12-16.9 broadly defines the term "vote" and by inclusion in that term of "writings signed by shareholders in lieu of taking action at a meeting of shareholders" gives statutory sanction to unassembled meetings in an effort to deal with the practicalities of operating a closely-held corporation. The objection to unassembled meetings is that there is no interchange of ideas and the person obtaining the signatures of the shareholders separately is given great latitude in varying his approach to each shareholder so that no meeting of the minds is accomplished.

Section 12-16.10 requires no comment except to point out that a majority of the votes cast rather than the votes present is required.

Section 12-16.11 would appear to fly in the face of the constitution⁵ in permitting the articles of incorporation to "deny, limit or otherwise define the voting powers of any designated preferred or special class or classes of shares." This is a codification of the general practice of denying or limiting the voting power of preferred stock and of the more recent practice in this state of dividing capital stock into Class "A" and Class "B" shares, the entire voting power being given to the

4. 5 FLETCHER, CORPORATIONS 85 (1960); BALLENTINE, CORPORATIONS 395 (1946).

5. S. C. CONST. art. 9, §11; *supra* note 1.

Class "B" shares, which are retained by the promoters, while the non-voting Class "A" shares are offered to the public.

It should be noted that the grant of voting power to holders of debt securities can be accomplished only through the articles of incorporation.

Section 12-16.12 provides for the voting of shares by corporations, fiduciaries and others who are not natural persons. A corporation is prohibited from voting shares issued by it, including treasury shares, and shares so disqualified from voting are not to be counted as outstanding shares. Subsection (b) provides for the voting of shares by a shareholder corporation by persons designated by the by-laws or, in the absence of applicable by-laws, by a person designated by the board of directors of the shareholder corporation or, "In the absence of any such designation, the chairman of the board, president, any vice-president, secretary and treasurer of the shareholder corporation *shall be presumed to possess, in that order, authority to vote such shares, unless prior to such vote it appears by a certified copy of the by-laws or other instrument of the shareholder corporation that such authority does not exist or is vested in some other officer or person.*" (Emphasis added)

The quoted portion of this subsection presents a number of problems: (a) the grading or ranking of corporate officers is new to statute law in South Carolina, the functions and duties of officers having been a matter for determination by the shareholders through the by-laws; (b) the likelihood that the shares will be voted by an unauthorized person is increased by the fact that the notice of the meeting will be directed to the shareholder corporation, and knowledge of the meeting may thus be limited to the person receiving such mail; (c) under the wording of the subsection, the presumption created may well be construed to be conclusive, in which case the shareholder corporation whose shares are voted without authority and against its interests may find itself without a remedy,⁶ or, on the other hand, if the presumption is not conclusive, the validity of action taken at the meeting may well remain undetermined until the authority of the corporate officer to vote the shareholder-corporation shares can be litigated.

6. See Annot., 75 A. L. R. 674 (1931), which discusses conclusiveness of presumption of fraud under the Bulk Sales Act.

It would seem to be preferable to require the person voting shares held of record by a shareholder corporation to present before, or at the meeting, a proxy, or other written authorization to vote, executed in the accepted manner for the execution of documents by a corporation, including the seal of the corporation; it should also be provided that, in the absence of such proxy or authorization, the shares of the shareholder corporation could not be counted as present at the meeting or allowed to vote.

Subsection (k) of section 12-16.12 should provide that no action of the issuing corporation could terminate the right to vote redeemable shares prior to the date of redemption established for such shares upon issuance.

Section 12-16.13 requires no comment except to point out that the shares may be divided for the purpose of voting if the joint owners are unable to agree.

Section 12-16.14 provides for the voting of shares by proxy and is of great importance in its entirety, but the discussion here will be limited to highlighting some of the provisions:

1. Proxies may be appointed by "telegram or cablegram appearing to have been transmitted by the shareholder."

2. No proxy shall be valid beyond eleven months from the date thereof unless specifically stated in the proxy.

3. A proxy is not revoked by the death or incapacity of the person giving it as in the case of ordinary agency but is valid unless written notice of the death or incapacity is given to the corporate officer in charge of the shareholder list.

4. Mere presence of the shareholder at a meeting does not revoke a proxy; notice of the intent to revoke is required.

5. A proxy carries the right of substitution unless otherwise specified.

6. Irrevocable proxies are authorized in five enumerated situations, each involving a degree of interest in the shares.

7. Irrevocable proxies are limited in term to ten years with a provision for the renewal thereof for an additional period of ten years.

8. A proxy may be revoked, although irrevocable, by a purchaser of the shares, without knowledge of the proxy, unless notice of the proxy and of its irrevocability plainly appears on the face or back of the certificate representing the shares.

No provision is made for the preservation of proxies by the corporation.

Section 12-16.15 authorizes agreements among shareholders respecting voting of shares. The purpose of this section is to settle the question of validity of agreements among shareholders to vote their shares in unison or in a particular manner on a particular subject matter which do not purport to give any shareholder an interest in the shares of another shareholder. This type of agreement was considered by the South Carolina Supreme Court in the case of *Johnson v. Spartanburg County Fair Ass'n*,⁷ with the result that the question of whether or not such agreements were against public policy was left unsettled. This will be settled by this section, but, because of the words "an otherwise valid agreement" at the beginning of the section, it is doubtful that agreements under it will escape the test of consideration as laid down in the *Johnson* case. This test is that the agreement must be supported by a consideration other than the mutual agreements of the stockholders. The question here is whether an agreement is "otherwise valid" where it is not supported by other consideration than the mutual agreements of the shareholders.

Section 12-16.16 provides for the creation and operation of voting trusts. Voting trusts were recognized in this state as permissible under common law by *Alderman v. Alderman*.⁸ This section, however, limits the duration of such trusts to ten years with provision for renewal for an additional ten year term and also provides that a voting trust of longer duration shall not be invalid but shall become inoperative after ten years.

Subsection (a) (2) provides that the shares, transferred to the trustees, may be retained by the trustees rather than transferred on the books of the corporation. This serves no useful purpose, and it should be eliminated. Proper operation of the voting trust, and of the corporation whose shares are the subject of the voting trust, require that the shares be re-issued in the name of the voting trustee, as such.

In subsection (d) the holder of a voting trust certificate is given the rights of a stockholder with respect to the inspection of the books and records of the corporation and subsec-

7. 210 S. C. 56, 41 S. E. 2d 599 (1947).

8. 178 S. C. 9, 181 S. E. 897 (1935).

tion (g) gives such holder the rights of a shareholder in respect to the right to dissent to proposed corporate action and to be paid the fair value of his shares if such action is effected.⁹ The latter subsection, (g), creates an anomaly in that the voting trust certificate holder is not a "shareholder entitled to notice" and therefore failure of the corporation to give him notice would not relieve him of the duty to protest the action prior to or at the meeting and, further, the shares represented by the voting trust certificate are voted by the voting trustee and are thus not under the control of the certificate holder to the extent necessary to keep them from being voted in favor of the action which he is protesting. The subsection does not make the certificate holder's position clear in either of these situations and so the rights granted by section 12-16.16(g) may be taken away by section 12-16.27 (b) and (c).

Section 12-16.17 provides for the appointment of voting inspectors by the board of directors of a corporation in advance of a shareholders' meeting or, absent such appointment, by the presiding officer at the meeting, upon the request of any shareholder entitled to vote. The inspectors, so appointed, have complete control of the voting at the meeting and any questions in connection with votes or voting rights are determined by them. The report or certificate of the inspectors is *prima facie* evidence of the facts stated therein. No provision is made for the preservation of ballots or other written evidence upon which such reports or certificates are based.

Section 12-16.18 validates informal or irregular action by shareholders provided there is unanimity. This section requires no comment except to point out that it validates un-assembled meetings.¹⁰

Section 12-16.19 provides for judicial review of the election of directors and the appointment of officers. Such review may be had on the petition of any director or any shareholder. No provision is made for the initiation of proceedings by officers or defeated candidates for director. The court is given broad power to correct whatever situation it finds to exist, if correction is necessary, including the power to order a new election and determine who shall occupy the contested office pending the new election.

9. See section 6.27, *infra*.

10. See comments on §6.9 *supra*. at 7.

Section 12-16.20 provides for cumulative voting for directors by each holder of *shares entitled to vote for directors*.¹¹ Subsection (b) of this section requires notice of the intent to vote cumulatively, such notice to be given, in writing, not less than 48 hours before the meeting to an officer of the corporation, or announced at the meeting, in which case any shareholder shall be entitled to a two hour adjournment upon demand. The purpose of the provision for notice is to give all other shareholders an opportunity to determine whether or not they will vote cumulatively or to determine how best to cast their votes to offset the noticed cumulative voting. As the subsection is written, each shareholder, in order to be permitted to vote cumulatively, must give the required notice and this obviously would result in unending delay if a shareholder demanded an adjournment for two hours after each notice of intent to vote cumulatively. The purposes of the notice would be better served if it were provided that, upon the giving of notice of intent to vote cumulatively by one shareholder, all other shareholders would also be entitled to vote cumulatively. Also in this connection, since notice to "the president or other officer" is not notice to the shareholders, and it is only to the shareholders that the notice has any value, the provision of notice to the president or other officer should be eliminated.

Section 12-16.21 defines pre-emptive rights and, "except to the extent the articles of incorporation shall otherwise provide," delineates their applicability in several situations including a list of nine corporate actions to which pre-emptive rights do not apply.

Subsection (b) (3) contains matter which is apparently intended to be applicable generally and should be paragraphed in a manner to remove this general matter from the subparagraph. Among other things it provides, "The price to each holder shall be no less favorable than the price at which such shares, securities, options or rights are to be offered to other holders." (Emphasis added). This would enable a management to establish a price to holders in exercise of their pre-emptive rights which would be substantially higher than the price at which the shares, etc., were to be offered to an outsider, or to the public generally, and thus to defeat the purpose of this section. The price to each holder should be no

11. See S. C. CONST. art. 9, §11.

less favorable than the price to other holders or any other purchaser to whom the shares are to be offered. Subsection (d) (9) may accomplish this effect but it would lessen confusion to spell it out in subsection (b) which grants the right rather than in subsection (d) which denies it in enumerated situations.

Section 12-16.22 provides a framework within which the shareholders of a closely held corporation can, by written agreement, establish a partnership-type management with the shareholders participating directly in the management, as shareholders rather than as directors. This, of course, requires the shifting of the duties and liabilities of directors to the shareholders as provided in subsection (e). This section does not limit the corporations to which it is made applicable by size or number of stockholders but it makes such agreements invalid if the shares of the corporation are traded either on a national stock exchange or in the over-the-counter market by one or more broker dealers. It further limits the binding effect of the agreement to transferees of shares who have actual notice of the agreement, such actual notice being "deemed" if the text of the agreement is set forth in the articles of incorporation. Since the agreement will be of substantial importance to the transferee of shares, and since the articles of incorporation are rarely examined by the purchaser of corporate shares, it would be well to require that actual notice to the transferee be given by the person responsible for transferring the shares on the books of the corporation.

Section 12-16.23 limits the liability of a holder or subscriber of shares to the amount remaining due to the corporation on the shares or subscription and further provides that such liability may be enforced "by the corporation or by any shareholder suing derivatively on behalf of the corporation and by a receiver, liquidator or trustee in bankruptcy of the corporation." Insolvency, under this section, is not required to mature the liability as is the case under present law.¹²

Section 12-16.24 defines the liability of a shareholder receiving improper distributions. Such distributions, to be improper, must render the corporation insolvent or the shareholder must know or have reason to know that the distribution is contrary to this act or the articles of incorporation.

12. S. C. Code §12-72 (Supp. 1962).

Section 12-16.25 provides for the keeping of books and records by the corporation and for the inspection thereof by shareholders and in subsection (e) provides a penalty for the refusal of a corporation, upon request, to furnish to a shareholder a current balance sheet and profit and loss statement or to permit an inspection as provided.

Section 12-16.26 defines the rights of shareholders to inspect corporate records. A corporation is permitted to deny inspection rights to an otherwise eligible shareholder who refuses to "furnish an affidavit that the inspection is not sought for a purpose which is in the interest of a business or object other than the business of the corporation, that he has not within five years preceding the date of the affidavit sold or offered for sale and does not now intend to sell or offer for sale any list or (of) shareholders of the corporation or of any corporation and that he has not aided or abetted any other person in procuring any list of shareholders for such purpose."

Section 12-16.27 provides a method by which a dissenting stockholder, having the right to be paid the fair value for his shares, may be so paid. The fair value is to be determined as of the day prior to the date on which the vote was taken approving the corporate action to which dissent is filed and the fair value shall be determined "excluding any appreciation or depreciation of shares in anticipation of such corporate action." The latter may prove difficult to determine, especially with actively traded shares, since it is practically impossible to determine what factors may have influenced the price, and to what extent, on any given date.

The shareholder may file written objection to the proposed corporate action before the vote on it is taken and must not vote in favor of it.¹³ He must then file a demand for payment within 20 days after the date on which the vote was taken. This 20-day period (demand period) is only one of many periods and these periods are listed here to give the attorney some ideas of the watchfulness required:

- a—Demand period—20 days after vote.
- b—Within 20 days after demand certificates must be surrendered for stamping or noting demand thereon.
- c—Within later of ten days after expiration of demand period, or ten days after corporate action is effected,

13. See comments on §6.16, Voting Trusts.

corporation must make offer to purchase shares on which demand is filed.

d—(1) If within later of 30 days after corporate action is effected, or 30 days after demand period expires, agreement has been reached on price, payment shall be made within 90 days after corporate action effected.

(2) If agreement is not reached as to price as above, then corporation shall institute action, within 30 days thereafter, for determination of fair value.

e—If corporation fails to institute action within the thirty days specified then dissenting shareholder may institute action within the next succeeding thirty days.

It should be noted that the corporation is required, either in an action by it or in an action against it by a dissenting stockholder, to make all dissenting shareholders parties.

CONCLUSION

In conclusion, it must be said that the Joint Committee has done a splendid job in drafting this chapter. The criticisms herein are considered justifiable but some points of controversy and some unforeseen results are a necessary and understandable part of such a monumental undertaking. It is not the purpose here to detract in any way from these accomplishments but rather to help them achieve a more perfect result.