

HB

240

#2

THE FOLLOWING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

THE RELATIONSHIP
BETWEEN
CASH FLOW AND TAXABLE INCOME
IN
GENERAL STOCK OWNERSHIP CORPORATIONS

Senator Mike Gravel

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EXECUTIVE SUMMARY

The Potential Problem

The law governing GSOCs attributes GSOC taxable income to GSOC shareholders raising the possibility of shareholder tax liability on attributed GSOC income in excess of GSOC cash distributions. This could present hardships for the shareholders who might not have sufficient funds to pay the taxes due.

When Can It Occur

Shareholder tax liability in excess of cash available for distribution can occur when the corporation has (1) cash flow expenditures which are non-deductible for tax purposes or (2) items included in taxable income which do not represent cash flow income.

Examples of non-deductible cash flow expenditures include principal amortization on installment debt, some political and charitable contributions, the excess portion of unreasonably high salaries, illegal payments and contributions to non-qualified or disqualified retirement plans. Examples of items included in taxable income which do not represent cash flow income include depreciation and investment tax credit recapture income and income from installment sales with excessive down payments.

Shareholder Protection

The special tax treatment for GSOCs must be elected. If no election is filed the GSOC is taxed as a regular business corporation. To qualify for the election the corporation must meet the requirements of a GSOC which include limitations desirable in any state chartered broadly owned corporation.

GSOC management is the shareholders' first line of defense. Potential problems can be avoided with careful planning. However, since corporate management may err the law provides for termination of the special tax treatment voluntarily upon request of the corporation or involuntarily by operation of law. Termination closes off the attribution of corporate taxable income to the shareholders and the corporation is taxed as a normal business corporation. As a last resort the state legislature can revoke the GSOC corporate charter terminating its existence.

Conclusion

GSOC management has the tools to prevent shareholder tax liability in excess of GSOC distributions. Failing this the law allows the termination of special tax status in a number of ways closing off the attribution of income to the shareholders and protecting them regardless of management decisions.

The General Stock Ownership Corporation (GSOC) provisions of the Internal Revenue Code (Subchapter U, Sections 1391-1397) present an interesting question regarding the relationship between taxable income and cash flow of the corporation and distributions to its shareholders. Several witnesses before the State Affairs Committee have commented upon this issue during consideration of HB 240. This paper analyses the potential problem and the protections for the shareholders built into the statutes.

THE POTENTIAL PROBLEM

Subchapter U of the Internal Revenue Code (Code) provides that the taxable income of a GSOC is attributed annually to its shareholders. With minor exceptions taxable income of a GSOC is computed in a manner similar to other corporations. Shareholders must include in income for tax purposes their share of GSOC income for the year. The tax liability of a GSOC shareholder arising because of his share ownership is determined by multiplying the income attributed to him from the GSOC by his marginal tax rate. This tax is increased by the shareholder's portion of any net investment recapture tax and reduced by his share of any net investment credit.

To provide shareholders cash sufficient to meet the tax liability created by the attribution of GSOC income the Code requires a GSOC to distribute annually to its shareholders an amount equal to at least 90 percent of its taxable income. This distribution requirement applies irrespective of corporate

cash flow. However, if the GSOC fails to make the required distribution the only penalty is a 20 percent deficiency tax assessed against the corporation. Application of this tax does not absolve GSOC shareholders from the obligation to pay tax on the income attributed to them from the corporation.

Taxable income does not necessarily reflect cash flow available for distribution to shareholders. It is an artificial number arrived at in an effort to determine on an annual basis the average earnings of a company or individual over a lifetime. Some items such as depreciation on capital assets reduce taxable income without affecting cash flow while other items which are actual cash flow expenses, such as the repayment of debt principal, do not reduce taxable income. Thus, cash flow after expenses may be either more or less than taxable income.

Concerns have been expressed that GSOC cash flow could be insufficient to meet the distribution requirements and perhaps so low that no distributions occur at all. In such a case GSOC shareholders might have income tax liability as a result of income attributed to them from the GSOC and yet have no cash distributions from the corporation with which to pay the taxes. We shall attempt to analyse the risks presented by this scenario and the protections afforded the shareholders.

WHEN CAN THE PROBLEM OCCUR

Two general types of situations can cause taxable income to exceed cash flow. Taxable income can exceed cash flow where (1) cash flow expenditures are non-deductible for tax purposes

and (2) items of taxable income do not represent cash flow income. The first category of transactions includes the amortization of debt principal, illegal payments and unreasonably high salaries. The second category includes recapture of depreciation and investment tax credits and installment sales with excessive down payments.

Non-deductible Expenditures

Non-deductible expenditures reduce GSOC cash flow available for distribution to the shareholders without reducing taxable income attributed to shareholders for income tax purposes. Carried to an extreme these expenditures could eliminate all the cash in a corporation, but still not reduce the taxable income. The taxable income would be attributed to the shareholders who would incur tax liability based on the attributed income, but the corporation would have no cash to distribute and the shareholders would be required to finance the additional tax liability out of other income. This could work considerable hardship upon many shareholders.

There are many expenses which do not reduce taxable income. The more common of these include contributions to disqualified retirement plans, some charitable and political contributions and the excess portion of unreasonably high salaries. Amortization of debt principal is also a very common non-deductible cash flow expense. Although interest payments on a loan are deductible for Federal income tax purposes payments which reduce the principal amount due on the loan are not. In many cases the non-deductible principal portion of a loan payment may

represent the lion's share of the annual loan amortization cash flow. Since this principal amortization component of debt service requires cash payments from the corporation it is the type of non-deductible expenditure which could cause problems for the shareholders of a GSOC.

Other non-deductible corporate expenses can result in GSOC expenditures which do not reduce taxable income. Generally all ordinary and necessary business expenses are deductible in computing taxable income. However, some political and charitable contributions, the excess portion of unreasonably high salaries, illegal payments and contributions to non-qualified or disqualified retirement plans are not deductible. While this list of items is not exclusive these are the more common non-deductible corporate expenses. The common thread through all of these transactions is that they are avoidable with careful planning by management. There is no event which could involuntarily trigger large increases in taxable income without a corresponding increase in cash flow. The problem presented by loan amortization principal can be avoided through the installment purchase solely of depreciable assets with depreciation schedules carefully arranged to provide tax protection for principal amortization cash flow. This solution is workable because, over the life of an asset, depreciation and principal amortization will be the same. Thus, if a problem should occur in this area it will almost certainly be the result of bad management.

Taxable Income Without Cash Flow

The other situation in which cash flow available for distribution may not be adequate to cover the additional shareholder tax liability occurs where items which are included in taxable income do not represent cash flow income to the corporation. Generally, this occurs where a taxpayer has received cash flow income in the past which was non-taxable at the time of receipt. The inclusion of this cash flow in taxable income occurs at a later date when recognition for tax purposes is triggered by some event. The most common of this income type is recapture income. The law "recaptures" the tax on income which avoided tax at the time it was earned. This prevents the permanent deferral of tax on certain types of income. There are two major kinds of recapture income, depreciation recapture and recapture of investment credits.

Depreciation Recapture

Tax law allows the owner of a capital asset used in a trade or business to recover his initial investment tax free over the life of the asset. The mechanism used to provide this recovery of investment is depreciation. The depreciation deduction reduces taxable income sheltering income from tax. If a taxpayer holds a capital asset for its full useful life he is allowed depreciation deductions equal to its initial cost and can shelter that amount of income from tax.

Depreciation recapture may occur where a taxpayer elects to use accelerated depreciation. Accelerated depreciation

allows additional depreciation deductions protecting from tax income which would otherwise be taxed currently. Accelerated depreciation provides deductions larger in the early years than straight line depreciation. It allows rapid capital cost recovery on depreciable assets in an effort to encourage modernization of capital stocks.

To prevent additional income sheltered by accelerated depreciation from permanently escaping taxation when the asset is disposed of taxable income is increased by the amount by which accelerated depreciation on the asset exceeded straight line depreciation. When this occurs taxpayers may have taxable income without cash flow and other income will be required to pay off the tax liability. Planning can save taxpayers in these situations. Accelerated depreciation shelters cash flow from tax which would otherwise be taxable at the time of receipt. If the taxpayer sets aside this income or a portion of it into a fund for depreciation recapture taxes at the time the asset is disposed of he will have sufficient funds available to pay the tax generated by the recapture income. An example might help to clarify the operation of the depreciation recapture provisions.

John owns a rental apartment for which he paid \$100,000. The unit will last for 20 years. John takes a depreciation deduction each year equal to one-twentieth of his investment or \$5,000. This uniform annual depreciation deduction is known as straight line depreciation. After 20 years John will have taken depreciation deductions equal to the \$100,000 he paid for the apartment. He will have recovered his investment through income on which he paid no tax.

To encourage investment in rental housing the law allows John to recover his investment in a shorter period of time through accelerated depreciation. In some cases John can elect to take twice the normal depreciation deduction. If he takes a \$10,000 depreciation deduction in the first year he will shelter \$10,000 from tax. If he then sells the property

for \$100,000 he will have a capital gain of \$10,000 because he has been allowed to recover \$10,000 of his investment tax free. The \$10,000 depreciation deduction reduces his basis in the property for capital gains purposes resulting in a basis of \$90,000 at the time of the sale.

If John had taken straight line depreciation on the apartment he would have had a capital gain of only \$5,000 upon the sale because his basis would have been \$95,000 at the end of the first year due to depreciation deductions of \$5,000. The additional \$5,000 deduction in year one has sheltered from tax \$5,000 of additional income for John. However, as we have seen, this \$5,000 which is sheltered by accelerated depreciation appears upon the sale of the property as a capital gain receiving special favorable tax treatment.

Through accelerated depreciation John has converted ordinary income into capital gain income taxed at 40% of ordinary income rates. To prevent this conversion of ordinary income into capital gains, or the permanent sheltering of ordinary income, the depreciation recapture provisions step in and require that \$5,000 of John's \$10,000 gain on the sale be taxed as ordinary income.

This description of one transaction subject to the depreciation recapture rules is for illustration purposes only. These rules are complex and many of the ramifications of these provisions have been excluded from the example in the interests of simplicity.

Investment Tax Credit Recapture

The Code allows an investment tax credit equal to ten percent of the purchase price of certain types of new and used property. This ten percent credit reduces taxes rather than reducing gross income as does a deduction. The property eligible for the investment tax credit is generally depreciable tangible personal property, excluding buildings and structural components, used by an individual or corporation engaged in a trade or business and having a useful life of at least three years.

The investment tax credit may be taken for the year in which the taxpayer places the asset into use in his trade or business.

To prevent the sheltering of income through the investment tax credit Congress provided recapture provisions similar to the depreciation recapture rules. If a taxpayer disposes prematurely of an asset on which he has received an investment tax credit the disposition triggers the recognition of investment tax credit recapture income to the taxpayer in an amount designed to generate tax liability equal to the credit which he earlier received. This investment tax credit recapture income is included in income for the year of disposition and may increase the taxpayer's liability. The recapture income is income only in the tax sense and may or may not represent cash flow. It is an effort to recover tax on income which was earlier sheltered by the investment tax credit. Planning for investment tax credit recapture income involves steps similar to those followed in planning for depreciation recapture income. It can be avoided entirely by not disposing of the asset or it can be funded through a reserve set aside from the income sheltered by the credit

The law sets up special rules for the treatment of investment tax credits and investment credit recapture in GSOCs. The investment tax credit is not allowed to GSOCs. The investment tax credit to which a GSOC would be entitled if it were taxable flows through to the shareholders in much the same manner as income. The credit and any recapture of investment credit are netted at the corporate level. Thus, if a GSOC has both

investment credits and investment credit recapture income in the same year these items will be set off against each other and only the net credit or recapture will flow out to the shareholders. If there is a net investment tax credit, that amount will be prorated to the shareholders in the same manner as income. The credit will reduce the shareholders' tax liability. Net investment credit recapture is prorated to the shareholders and characterized as additional tax liability. Net investment credit recapture is not treated by the shareholders as additional taxable income, but as a direct addition to tax liability. It is different than depreciation recapture income which is treated as an addition to shareholder income. Investment credit recapture presents a more serious problem for the corporation and its shareholders because it increases tax liability rather than income. However, in nearly every case the generation of net investment credit recapture is avoidable or can be anticipated at the time the asset is acquired.

Installment Sales

The installment sale of an asset can generate taxable income without cash flow. The law allows a taxpayer to defer reporting income on an installment sale until the time payments are made. This allows the income from such a sale to be spread out over the life of the sales contract. However, if the seller receives more than 30 percent of the total contract price in the year of sale the entire gain is taxed as income in the year of sale ins pite of the fact that the seller did not receive

the full sales price at that time and may not do so for several years. this can mean that a seller has tax liability on gains from the sale in excess of the cash he received in the year of sale from the buyer. GSOCs, like other sellers, must operate within these rules.

PROTECTION FOR SHAREHOLDERS

GSOCs must elect to be subject to the flow through character and distribution requirements of subchapter U. Although the GSOC charter must provide "that such corporation shall qualify as a GSOC under the Internal Revenue Code," election of special tax treatment is not mandatory. If no election is filed a GSOC is taxed as a regular business corporation. GSOCs can qualify as such without making the election, however, in such a situation the primary advantage of GSOC status would be foregone.

The Election

There may be good reasons why a corporation might want to qualify as a GSOC and forego the election. If a corporation expected cash flow problems in the early years of operation or invested in projects with high reinvestment requirements it might desire to delay making the election until a more appropriate time. Comparable situations occur in closely held corporations where the owners may elect during loss years to be taxed under subchapter S, a provision allowing flow through of corporate losses and income to the shareholders of small corporations. But, when the corporation begins to turn a profit the election may be revoked and the income taxed to the corporation

rather than the shareholders. This is standard tax planning for high income shareholders of closely held corporations whose personal income tax rates may reach 70 percent. Since the maximum Federal corporate income tax rate is 46 percent, these individuals want losses to flow through to their personal returns and income to be taxed to the corporation. The subchapter S election allows such an outcome in certain cases.

Just as the subchapter S election provides flexibility in tax planning for high income shareholders of closely held corporations the subchapter U election provides flexibility for GSOC tax planning. The special tax treatment provided by subchapter U is not automatic. Election must be made by the GSOC or it will be treated as an ordinary business corporation subject to tax under the provisions of subchapter C, the general corporate tax provisions. The determination of whether or not to elect subchapter U treatment is one of the most important decisions to be made by the board of directors of a GSOC. The election need not be filed immediately upon formation of the corporation.

If the GSOC upon creation does not file an election one might ask why create a GSOC at all. Why not simply create a broadly owned conventional corporation not subject to the strictures of subchapter U? To answer this question we must separate those aspects of subchapter U required to qualify as a GSOC and those which flow from making the election. In so doing we find that the elements necessary to qualify as a GSOC are relatively innocuous. They include:

1. Chartered after 12/31/78 and before 1/1/84,

2. Chartered by legislation or initiative,
3. Charter providing-
 - Only one class of stock
 - Issuance of at least one share to each resident
 - Issuance of shares only to "eligible individuals"
 - Election to reject shares
 - Transfer restrictions
 - Intent to qualify as a GSOC
4. Limitations on use of state's condemnation powers, and
5. Affiliated group limitations.

Most of these limitations might be appropriate to any broadly owned corporation initiated by a state. The affiliated group limitation is applicable only at the time an election is filed and a defect here could be cured by a reduction in GSOC subsidiary share ownership below the 20 percent limit prior to filing.

The special tax and distribution provisions of subchapter U apply only to those corporations making the election. In some cases inadequate drafting left ambiguities in this regard which are being clarified by a bill, S.2275, currently pending in the United States Senate. Thus, a corporation can qualify as a GSOC and be taxed as a normal business corporation leaving open the option to be taxed under subchapter U if it becomes appropriate at a later date. However, if a corporation does not meet the requirements of a GSOC upon creation it will be difficult to cure the defect if, at some point, the special tax treatment becomes attractive. In fact, if the defect were not cured prior to January 1, 1984, it is likely that attempts to cure the defect and elect subchapter U status for tax purposes would fail. However, if the corporation qualifies as a GSOC prior to January 1, 1984, the statute does not preclude election of

the special tax status subsequent to that date.

Management

The first and most important protection for GSOC shareholders is good management. GSOCs are not foolproof. Like any corporation they can be successful only if carefully managed. This is true with respect to investment decisions and day to day operations as well as tax planning. Timing by GSOCs of an election for special tax status is an important management responsibility, but in order to analyze the protections for shareholders from tax liability in excess of cash distributions, we shall assume that the decision to be taxed under subchapter U has been made and a timely election filed.

GSOC management has a responsibility to protect the shareholders from tax liability on GSOC income in excess of distributions from the corporation. It would appear to be a violation of the shareholders' trust to allow any substantial amount of tax liability to befall them without providing distributions adequate, at least, to cover the liability for tax. If the management of a GSOC allowed such an event to occur without a vote of the shareholders it would seem appropriate for the shareholders to replace that management at the next opportunity.

Most of the events which could generate tax liability in excess of cash distributions involve discretionary acts by the corporation. Careful planning and attention to detail can avoid this undesirable result. In some cases the planning must occur at the time an asset is acquired to assure that principal amortization is accompanied by depreciation deductions to preclude

mandatory distributions and taxable income in excess of cash flow. So long as management carefully plans its acquisitions and views each transaction with an eye toward its tax consequences problems can be avoided.

It is difficult to visualize an instance where tax liability in excess of cash flow for distribution cannot be avoided by responsible management. Every situation in which such an event could occur would require either an intentional decisions or gross negligence by corporate management. There does not appear to be any involuntary event which could result in this undesirable outcome. Thus, the GSOC management is the shareholders' best protection. However, since negligent management does occur at times in corporations additional protections for the shareholders are built into subchapter U.

Termination of Election

If GSOC management should fail to protect the shareholders from tax liability in excess of cash distributions termination of the subchapter U election may be undertaken either voluntarily or involuntarily. Termination of the election should be used as a last resort since once terminated the special tax status may not be regained by subsequent election. Upon termination of the election the GSOC is treated as an ordinary business corporation for tax purposes. The flow through of taxable income to the shareholders is eliminated and the corporation becomes subject to the corporate income tax.

Voluntary termination may be undertaken with the consent of the Secretary of Treasury. This safety valve was designed to

be available in the very situations which are contemplated in this paper. The provision was included with the concurrence of the Department of Treasury which has no interest in audits involving all the shareholders of a GSOC and preferred a statutory escape clause in the situation where shareholders might be faced with large tax liability and insufficient cash flow. The voluntary termination is effective for the first year to which the Secretary consents. It is effective for the entire year and, if significant tax liability in excess of cash available for distribution is anticipated, the Secretary can be expected to make his consent effective for the year in which the problems arose, thereby protecting the shareholders. Even if management is so negligent that the problem is not discovered until after the close of the taxable year for which it exists the Secretary has authority to grant the revocation of election for any taxable year, even those which have gone by. Thus, the shareholders are protected even if the problem is not discovered until after the close of the corporation's taxable year.

Subchapter U elections may also be terminated without the consent of the Secretary of Treasury in a manner which we shall refer to here as an involuntary termination. The Secretary has no control over whether an involuntary termination occurs. Once certain events occur the corporation ceases to be a GSOC and is removed from the provisions of subchapter U by operation of law.

Involuntary terminations can occur by accident and management must plan carefully to assure that involuntary termination does not occur unintentionally. An involuntary termination occurs whenever an electing corporation fails to meet the

definition of a GSOC under subchapter U. Events which would trigger an involuntary termination of subchapter U status include revocation of the corporation's charter by the sponsoring state, acquisition of more than 20 percent of the stock of another corporation, and amendment of the corporation's charter permitting the issue of a second class of stock.

An involuntary termination of subchapter U status is retroactive to the beginning of the year during which it occurs. Thus, subchapter U status could be terminated involuntarily on the last day of the corporation's taxable year and the flow through of corporate taxable income to the shareholders would be terminated retroactively to the beginning of the corporation's taxable year, 364 days earlier. For the entire year the corporation would be taxed as an ordinary business corporation and the shareholders would have no liability beyond tax on dividends actually distributed by the corporation.

Revocation of Charter

If all of the protections which have been examined should fail the ultimate power over the corporation continues to lie with the legislature of the authorizing state. The corporate charter granted by the state can be revoked by the state. This revocation might be made retroactive to the date on which the legislation was introduced or earlier, perhaps as early as the date on which the GSOC was created. The revocation of the charter terminates the subchapter U status effective the first day of the year for which the revocation is effective. In a charter

revocation all existing contracts of the GSOC would have to be honored, but a receiver could be appointed to handle this task along with liquidation of the corporation. The important aspect of the revocation is that it cuts off the flow through of corporate income tax consequences to the shareholders. Revocation of the corporate charter and liquidation of the corporation is a drastic measure and, with careful management and the other protections afforded under subchapter U, should never be required to protect shareholders from tax liability due to GSOC taxable income in excess of cash distributed to the shareholders by the GSOC.

CONCLUSION

The possibility of GSOC taxable income attributed to the shareholders resulting in shareholder tax liability in excess of cash distributions from the corporation warrants careful consideration by the management of any GSOC. Without careful planning it can occur and could have serious consequences for the shareholders. However, it is the responsibility of the GSOC management to assure that the decisions which are made with respect to the operations of the corporation do not result in shareholder tax liability in excess of cash distributions. However, if the management of a GSOC fails to adequately protect the shareholders the law allows the termination of the subchapter U election in a number of ways in order to close off the flow through of corporate tax consequences to the shareholders. This assures that are protected regardless of management decisions.

THE PRECEDING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

BCRIC

1979 ANNUAL REPORT

BRITISH COLUMBIA RESOURCES INVESTMENT CORPORATION

British Columbia Resources Investment Corporation



INCORPORATED IN THE PROVINCE OF BRITISH COLUMBIA

B2197166

CUSIP 110721 10 7

BEARER SHARE CERTIFICATE

TWO HUNDRED THAT THE BEARER OF THIS CERTIFICATE IS THE HOLDER OF
 FULLY PAID AND NON-ASSESSABLE COMMON SHARES WITHOUT PAR VALUE IN THE CAPITAL OF
 BRITISH COLUMBIA RESOURCES INVESTMENT CORPORATION.

The bearer of this certificate, if qualified under the British Columbia Resources Investment Corporation Act, is entitled, on presentation at the offices in Vancouver, Calgary, Winnipeg, Toronto and Montreal, of Montreal Trust Company of the certificate together with suitable and share certificates of the Corporation representing (including this certificate) at least 100 common shares of the Corporation to have issued on exchange therefore a certificate for the appropriate number of such common shares in the name of the bearer, and to be registered in the appropriate register of the Corporation as such member holding such shares. The common shares represented by this certificate are transferable by delivery of this certificate.

In Witness Whereof the certificate is signed of its duly authorized with its common seal

Corporation has caused this by the first and only officer and to be sealed

DATED AUGUST 7 1979



John H. ...

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THE ANNUAL REPORT IN SUMMARY

- Consolidated net earnings were \$40,757,000 on total revenues of \$359,465,000 for 1979.
- Drilling on gas and oil lands resulted in the discovery of four gas wells and one oil well.
- Forest products performed reasonably well, and all three forestry companies have embarked on long-range strategic planning to improve their positions within the industry.
- The Company's short term investment portfolio, which consisted primarily of the \$487.5 million raised during the public share offering, benefited from high interest rates.
- BCRIC plans to participate actively in energy exploration and expects to commit \$170 million to this sector over the next five years. Other investment areas are also being closely examined.

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BCRIC has an estimated 2 million shareholders, of which 136,143 were registered shareholders at December 31, 1979. The geographical distribution of registered shareholders and the number of shares held was as follows:

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	Number of registered shareholders	Number of shares held
British Columbia	129,728	74,292,744
Alberta	3,600	2,437,206
Saskatchewan	287	132,860
Manitoba	295	790,344
Ontario	1,619	5,822,711
Quebec	412	570,837
New Brunswick	47	20,700
P.E.I.	6	6,900
Nova Scotia	54	28,945
Newfoundland	7	2,800
N.W.T. and Yukon	33	19,692
Other Canadians residing elsewhere	55	40,891
	136,143	84,166,630
Bearer shares		12,076,605
Total shares outstanding		96,243,235

ANNUAL GENERAL MEETING

The annual meeting will be held at the Orpheum theatre, Vancouver, B.C. at 10 a.m., March 27, 1980 unless adjourned automatically to the Pacific Coliseum, Exhibition Park, Vancouver, B.C. at 10 a.m., April 7, 1980.

FINANCIAL AND OTHER HIGHLIGHTS

		<u>1979</u>	<u>1978</u>
Consolidated net earnings		\$ 40,757,000	\$ 15,922,000
Consolidated financial position at year end:	short term investments	\$517,505,000	\$ 9,787,000
	working capital	559,719,000	77,822,000
	shareholders' equity	683,161,000	15,922,000
	total assets	940,720,000	425,068,000
Additional Company information:	cash from issue of common shares	\$487,459,000	—
	interest income from short term investments	\$ 32,511,000	\$ 155,000
	expenditure on petroleum and natural gas rights and exploration	\$ 7,527,000	\$ 63,000
	number of employees at year end	42	22
	Common share data:	price (August 7 to December 31, 1979):	
	HIGH	\$9.25	
	LOW	\$5.87	
	CLOSE	\$7.10	
	trading volume:	VANCOUVER	TORONTO
	number of shares	18,055,964	7,003,774
	dollar value	\$130,325,018	\$ 51,934,743

Certain 1978 comparative figures are not for a full year. See Note 10 to the financial statements for details.

These Highlights, the President's Letter and the Review of Operations and Activities constitute the Directors' Report to the shareholders for the year 1979.

TO OUR SHAREHOLDERS

1979 has been an exciting year for British Columbia Resources Investment Corporation. This, our first annual report as a public company, highlights the activities of 1979 and, where possible, indicates our direction for 1980. You should be aware that a real difficulty for us in this report is that the information as written is two months old by the time it is released, and two months is a long time in the short history of BCRIC.

At the start of 1979, BCRIC was a wholly government-owned corporation controlling some resource oriented activities with little resultant cash flow and relatively modest investment plans. As a result of the overwhelming desire of British Columbians to participate in direct ownership of BCRIC, the Company has been transformed during the year into a major Canadian public company with new share capital of \$487.5 million and a consequent requirement to completely reassess investment plans.

The response for shares by nearly 2,000,000 citizens who applied for their 5 free shares from the British Columbia Government and by the 200,000 who purchased additional shares from BCRIC, was far beyond any expectation. It clearly demonstrates the desire of most individuals to have a chance to share directly in the ownership of the present and future holdings of the Company by a method that was made as easy as possible for that participation. At the same time, that response vastly changed the horizons and possibilities for BCRIC and dictated the need for more time to develop strategic objectives in keeping with the new circumstances.

Establishing these objectives must be done thoroughly and it is not easily undertaken nor quickly accomplished. In fact, it has already taken longer than we had anticipated. This work is still in progress as we enter 1980 and we recognize that the delay might cause some shareholders to become impatient as they await major investment announcements from BCRIC. Compounding the difficulties is the fact that BCRIC has come into being at a time when more rapid and dramatic fluctuations than ever before are occurring in such important areas as interest rates, stock prices and commodity values. Furthermore, the outlooks for the economies of Canada and the United States are more uncertain than they have been for many years due to high inflation, recessionary influences and international political conflicts. Turbulent periods such as these are frequently followed by a period of hindsight when one is tempted to question the need for long term investment planning because short term trading gains might have appeared a more profitable objective. However attractive short term speculation may appear, it is our firm conviction that the long term interests of our shareholders will best be served by prudent deliberation in developing an effective, long term investment strategy. Shareholders must be convinced that their investment in this Company is not a short term proposition and be prepared to allow the Directors and management the necessary time to make prudent decisions for the future of the Company.

BCRIC has a number of general objectives upon which its investment strategy is being built. Foremost among these is our original objective to operate profitably and to maximize the value of BCRIC for the benefit of its shareholders, through growth in earnings and asset values.

The Company intends to achieve this growth through long term investment, primarily in the natural resource industries of Western Canada. Pending such long term investment, the Company's funds have been invested in quality short term money market securities which, in addition to very attractive interest returns, provide the Company with the liquidity necessary for long term investment activities.

In assessing various long term opportunities, the criteria against which investments are being measured include current income, potential future asset values, participation with partners who have expertise in a given field, use of BCRIC's own financial and other expertise, and the opportunity for a degree of participation sufficient for profits and cash to flow directly to BCRIC.

Within the framework of these objectives, the Company has been focusing attention on all natural resource areas, but because of our existing holdings in the gas and oil and forestry sectors we felt you would be particularly interested in our conclusions in those areas.

Following acquisition of the Licenced Lands as one of our founding assets, the initial strategy for BCRIC's gas and oil division was to obtain agreements with operating and drilling firms for exploration on these Lands and to pursue on its own a modest level of exploration expenditure and commitment. The program prior to the share offering was to acquire further land and undertake exploration totaling \$8 million for 1979 and \$55 million for the five year period ending in 1983.

After completion of the share offering, it was obvious that BCRIC had the capacity to increase its expenditures in the gas and oil sector. About the same time, the gas and oil division had achieved its initial objective of farming out virtually all of the Licenced Lands.

It also expanded programs to pursue exploration prospects through farmins with partners and through the purchase of additional lands to partially offset the dilution of the land inventory which resulted from farmout agreements on the Licenced Lands.

In mid October, the Board of Directors approved a \$30 million exploration budget for the gas and oil division for 1980. Accompanying this budget was a preliminary estimate that exploration expenditures for the five year period ending in 1984 would total \$170 million. The attainment of this five year estimate would result in a minimum total investment by BCRIC in the gas and oil sector of approximately \$220 million to the end of 1984. These expenditure levels were proposed in the context of the following strategy statement for the gas and oil division:

"To maximize expected return on investment by committing future investment into 'grass roots' exploration and development based upon acquisition of land, primarily wildcat acreage, and the expansion of in-house geological and geophysical skills and capacity in order to originate and manage plays on these lands."

It is a strategy which involves a high level of risk and deferred returns. The degree of success which may be achieved may not be measurable for several years and realized returns on funds committed most likely will not be significant for at least five years. This is a long term strategy which, once initiated, will involve additional expenditures over future years due to continuing participation commitments with partners and the desire to preserve full returns on our investment in successful ventures.

In the forestry sector, BCRIC already has substantial investments through its initial ownership positions in Canadian Cellulose, Kootenay Forest Products and Plateau Mills. In 1979, a major effort was made to encourage the development of long-range strategic planning within these subsidiary companies, so they can plot where they are going relative to their position within the British Columbia forest industry. The initial efforts are encouraging though the profit results may not be seen for several years and all three companies have been committing a high proportion of recent earnings to expenditures aimed at future benefits. Examples of this are the sawmill modernizations at both Kootenay and Plateau and the purchase by Canadian Cellulose of Price-Skeena Forest Products Ltd. which owns a sawmill in Terrace, B.C.

At CanCel, 81% owned by BCRIC, a number of organizational changes were made during the year and a number of senior employees added, which should considerably strengthen the management team.

At both Kootenay and Plateau, which are wholly owned, much more detailed assessments were undertaken of both management and general business and marketing practices. A number of changes were made and we are confident that both organizations are now better positioned and organized to capitalize on future opportunity.

In the broader forestry sector context, BCRIC has been assessing the optimum balance of a forest products position in terms of fibre supply, conversion facilities and markets. Some improvements are needed in our present balance and BCRIC will make additional investments in the forest products industry to achieve a stronger position.

Our investment plans concerning Westcoast Transmission Company Limited are still undetermined largely due to the uncertainty surrounding the 36% control block position held by Petro-Canada. Because of this we continue to regard this holding as part of our investment portfolio. The future outlook for Westcoast is good and we are pleased with the capital appreciation potential and dividend income received.

In any company, but particularly in a new and emerging company, the role of its employees is critical to its well-being. I want to pay tribute to our employees for their determination and effort in getting the Company successfully launched and into business.

In conclusion, it is most fitting to pay tribute to our founding shareholders for their support not only of BCRIC itself, but for the concept of BCRIC and the individual ownership that it represents. Our registered shareholders have increased from the original 128,346 to 136,143 and we continue to be delighted at the expressed interest of shareholders through telephone calls and letters. Testimony of that interest is that our Shareholder Information Service responded to 11,817 telephone enquiries between August 7 and December 31.

It is our commitment to make ownership in BCRIC both a profitable and proud experience.

Sincerely, and on behalf of the Board,



David L. Helliwell
President and
Chief Executive Officer

Vancouver, B.C.
January, 1980.

REVIEW OF OPERATIONS AND ACTIVITIES

Forest Products

BCRIC forest products holdings include: Canadian Cellulose Company, Limited, (CanCel) (81 per cent), which operates two kraft pulp mills, at Prince Rupert and Castlegar, B.C., and logging divisions and lumber mills in the northwest and southern interior of British Columbia; Kootenay Forest Products Ltd. (100 per cent), a lumber and plywood manufacturer at Nelson, B.C.; and Plateau Mills Ltd. (100 per cent), a lumber manufacturer near Vanderhoof, B.C.

The Company's forest products interests are an important component of its current holdings. In 1979, forest products consolidated earnings of BCRIC totalled \$21.8 million, representing 53.5 per cent of the Company's consolidated earnings for the year.

In 1979, CanCel had net earnings of \$15,832,000 on net sales of \$263,213,000 compared to \$6,774,000 and \$175,490,000, respectively, in 1978.

The significant improvement in earnings over 1978 largely reflects improved prices for bleached softwood kraft pulp, higher pulp sales volume and a higher foreign exchange premium on sales in U.S. dollars.

These factors were partially offset by inflationary cost increases, interest costs for a full 12 months for capital borrowed to finance the sulphite-to-kraft mill modification project completed late in 1978, and production lost at the Prince Rupert pulp mill as a result of labour disputes.

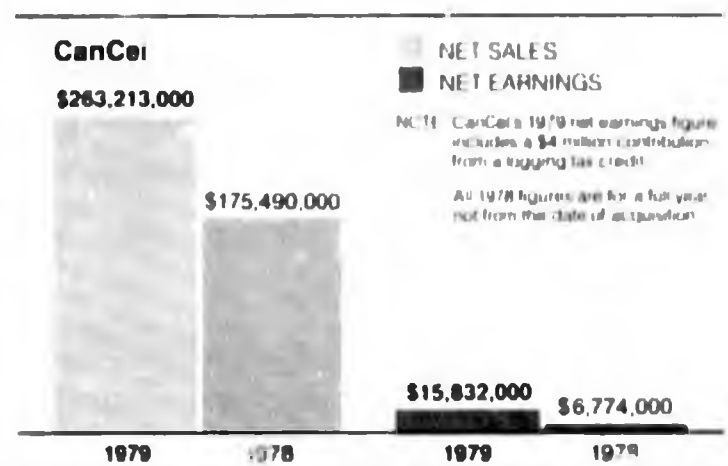
The price of bleached softwood kraft pulp continued to strengthen in 1979 from about the U.S. \$400 per tonne level prevailing in the first quarter of the year to U.S. \$465 per tonne in most markets by year end. On January 1, 1980, the price of kraft pulp was increased to U.S. \$490 per tonne. Lumber prices, on average, were also higher in 1979, notwithstanding a decline in the latter part of the year.

Capital spending by CanCel on property, plant and equipment totalled \$15.6 million in 1979. Early in the year the company completed the re-construction of its lumber facilities at Castlegar that were partially destroyed by fire in June, 1978.

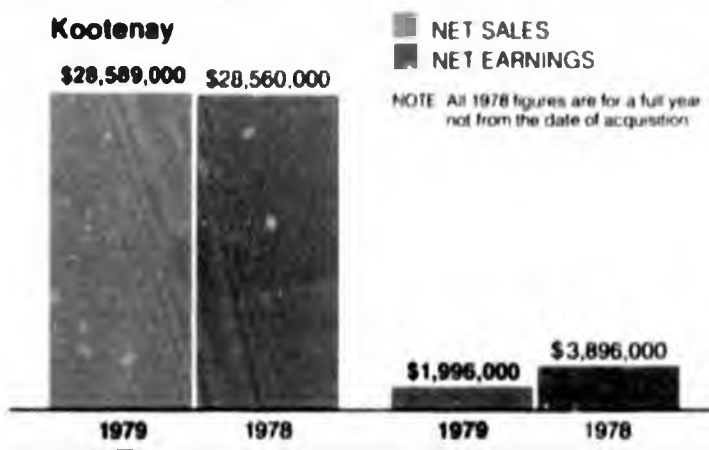
For 1980, CanCel plans significant capital expenditures for additions to property, plant and equipment, including approximately \$14 million for the purchase of Price-Skeena Forest Products Ltd. which owns a sawmill in Terrace, B.C. and holds related Crown timber rights.



CanCel's modified Prince Rupert, B.C. kraft pulp mill.



Kootenay Forest Products recorded net earnings of \$1,996,000 on net sales of \$28,589,000 in 1979 compared to \$3,896,000 and \$28,560,000, respectively, in 1978. 1979 earnings were lower than those of 1978 largely due to reduced shipments of lumber and plywood and higher manufacturing costs, partly offset by improved lumber prices. The lower volume of shipments resulted from lower product demand in the last half of the year. Lower production volume, inflationary cost increases and higher stumpage expenses contributed to the higher production costs.

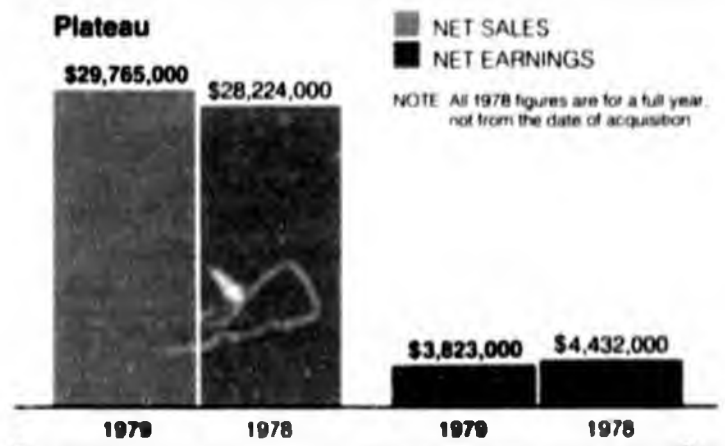


In 1979, capital spending by Kootenay totalled \$7.2 million, including \$5.7 million for the new log infeed and debarking systems for both the plywood mill and adjacent sawmill, and for major electrical upgrading. For 1980, Kootenay plans capital expenditures of approximately \$4 million for additions to property, plant and equipment, including \$1.2 million for the completion of the log infeed systems.

At Plateau, 1979 earnings amounted to \$3,823,000 on net sales of \$29,765,000 compared to \$4,432,000 and \$28,224,000, respectively, in 1978. The reduction from 1978 earnings largely

reflects lower production and sales volumes and higher manufacturing costs, offset, in part, by higher sales prices for lumber and a higher foreign exchange premium on U.S. sales. The lower production volume and higher manufacturing costs resulted from the protracted start-up difficulties of the new sawmill combined with inflationary cost increases and higher stumpage expenses.

Plateau completed a major expansion program during the year involving one of its two sawmills. In mid May, the older mill was shut down. Although the new mill encountered major start-up problems, the project has now enabled Plateau to improve timber utilization and productivity.

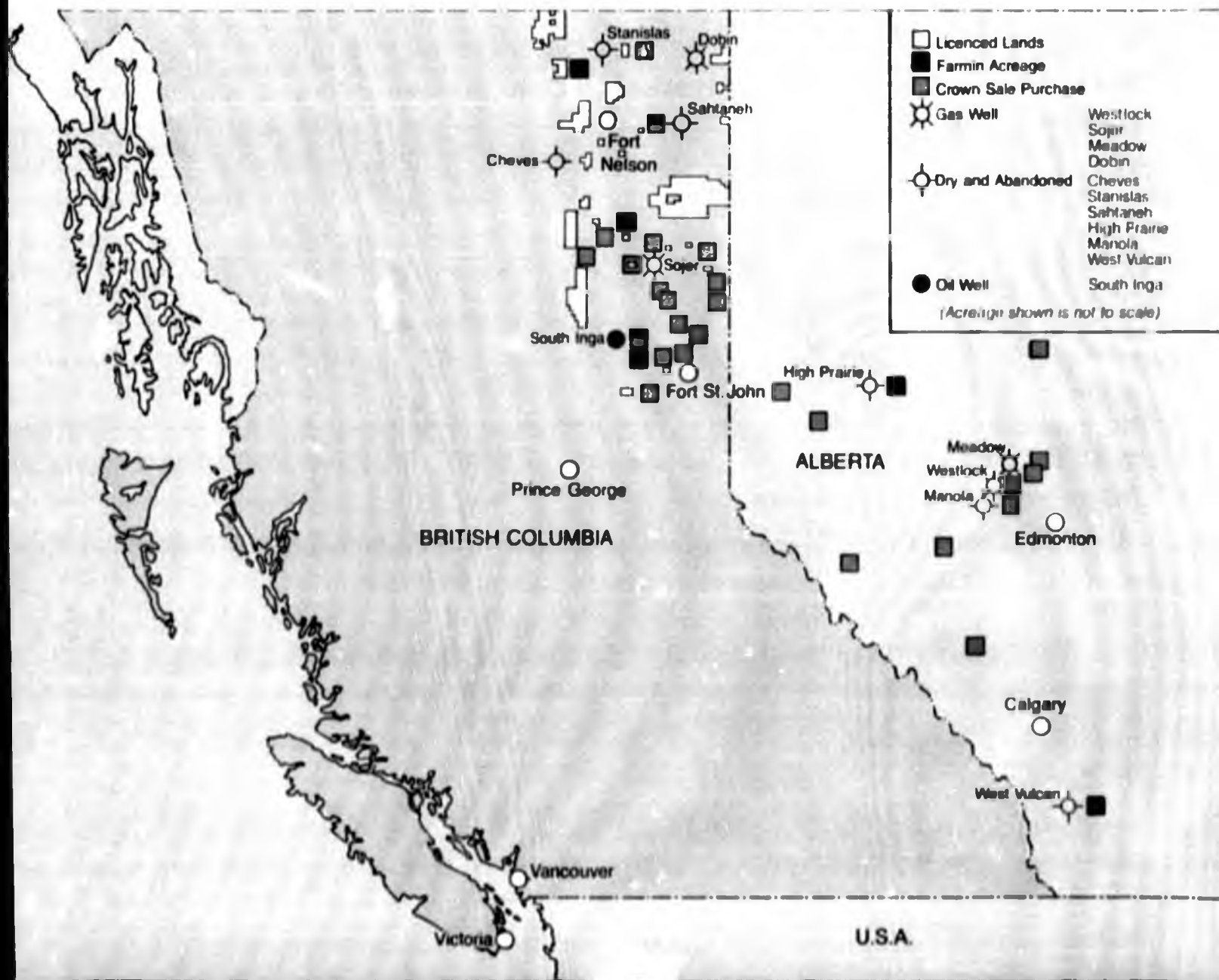


In 1980, Plateau plans to spend \$5 million on capital projects, including \$1.7 million for a new wastewood burner which would provide heat for all six lumber drying kilns and mill buildings. Some additional engineering improvements are required to the current pilot model before going ahead with this project. Pioneered by Plateau, the current pilot model has enabled the Company to significantly reduce natural gas purchases, thereby conserving hydrocarbon energy and reducing costs.

Gas and Oil

BCRIC's gas and oil interests include:
 Petroleum and natural gas licence to explore
 948,500 gross hectares (2.3 million gross acres) of
 Crown land in north-eastern British Columbia;
 other land holdings involving 43,635 gross hectares
 (13,577 net hectares) in British Columbia and
 21,412 gross hectares (7,686 net hectares) in Alberta.
 (1 hectare = 2.471 acres and 1 kilometre = 0.621 miles)

During 1979 BCRIC successfully entered
 into exploration agreements with a wide range
 of exploration companies on the original
 Licenced Lands acquired from the Province of
 British Columbia. Exploration consisted of
 2,147 kilometres (km) of seismic programs,
 purchasing and reprocessing 236 km of seismic
 data, a 400 km gravity survey program and
 8,564 metres of hole drilled. Of the four wells
 drilled on these lands during the 1978-1979



exploration program, there were two natural gas discoveries.

The extensive seismic programs completed in 1979 have provided a preliminary basis for determining the gas and oil potential of these Licenced Lands. Exploration commitments for 1980 include a possible 595 km of seismic programs and a concentration on drilling of prospects determined from the evaluations of the 1979 geophysical data. Twelve wells will be drilled on the Licenced Lands in 1980, triple that of 1979. Depending on the election of rights in 1980 of the exploration companies involved, 18 wells may be drilled on the Licenced Lands in 1981.



Energy exploration drilling in northeastern British Columbia

As a result of the Company's decision to expand its activities beyond the Licenced Lands beginning at a basic grass roots exploration level, BCRIC entered into a land acquisition program in 1979. This involved spending \$6.2 million at Crown land sales. Including farmin agreements with other companies, BCRIC acquired additional gas and oil rights totalling 13,577 net hectares in British Columbia and 7,686 net hectares in Alberta.

The exploration programs undertaken on these lands during 1979 amounted to \$1.3 million and consisted of 87 km of seismic surveys, 613 km of seismic data purchased and reprocessed and 10,590 metres drilled in one development well and six exploration wells. Of the seven wells drilled, two were gas wells, one was an oil well, and four proved unsuccessful. During 1980 the Company will be participating in the drilling of 15-20 wells on these lands and approximately 500 km of seismic work.

The total established reserves resulting from the discoveries to-date can only be determined through the drilling of additional delineation wells and further technical testing. Gas discoveries will not generate current revenue until sales contracts are concluded.

The gas and oil division has expanded its professional staff and budgeted \$30 million for an aggressive land acquisition and exploration program in 1980 on its own and in conjunction with partners. Such a program involves financial commitments over several years and BCRIC estimates that such exploration expenditures to the end of 1984 could approximate \$170 million.

Investments

At December 31, 1979, BCRIC's investments consisted of \$517 million placed in various short term money market securities and 3,471,375 common shares of Westcoast Transmission Company Limited.

The Company's strategy in managing the \$487.5 million in gross proceeds invested by its founding shareholders, as a result of the successful public issue completed in June, 1979, has been to achieve maximum short term returns. Consequently, BCRIC's interest income in 1979 on these and other funds totalled \$32,511,000. Cash dividends of \$2,777,000 were received in 1979 from Westcoast Transmission.

The short term investment policy established by the Company for its cash resources has been designed to ensure maximum returns and a high degree of liquidity so that funds are available when required for long term investments and projects. In keeping with this policy, BCRIC's short term investments at December 31, 1979 consisted of the following:

- \$12 million (2 per cent) Government of Canada and Crown corporation obligations.
- \$20 million (4 per cent) deposit securities of credit unions.
- \$149 million (29 per cent) deposit securities of Canadian chartered banks.
- \$336 million (65 per cent) short term notes of Canadian financial and industrial corporations.

The Company's short term investment transactions are executed in financial centres across Canada, with the majority taking place in Vancouver and Toronto.

With the rapid rise in interest rates in the latter half of 1979, the rate of return on the short term investment portfolio increased from about 11.1 per cent in June to 13.8 per cent in December as maturing investments were reinvested at higher rates. As a result, the Company achieved an over-all yield of 11.9 per cent on its short term investment portfolio over the period from June to December, 1979.

While short term interest rates remained at historically high levels at the end of 1979, the outlook for 1980 remains uncertain.



Westcoast Transmission pipeline is laid in northern British Columbia.

CONSOLIDATED STATEMENT OF EARNINGS

For the year ended December 31, 1979

(Comparative figures — see Note 10)

	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Revenue		
Sale of forest products	\$321,567	\$202,659
Interest on short term investments	33,114	303
Other (Note 8)	4,784	10,657
	<u>359,465</u>	<u>213,619</u>
Expenditure		
Cost of forest products sold	256,634	184,130
Selling and administration	16,023	9,603
Interest on long term debt	16,048	4,715
Other	3,215	1,694
	<u>291,920</u>	<u>200,142</u>
Earnings before the undernoted	67,545	13,477
Provision for income taxes (Note 9)	23,780	303
Earnings before minority interest and extraordinary item	43,765	13,174
Minority interest in earnings of a subsidiary	3,008	494
Earnings before extraordinary item	40,757	12,680
Recovery of logging taxes (net of minority interest of \$758,000)	—	3,242
Net earnings	<u>\$ 40,757</u>	<u>\$ 15,922</u>
Weighted average shares outstanding (Note 7)	59.2 million	
Net earnings per share	\$0.69	

See accompanying notes

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

For the year ended December 31, 1979

(Comparative figures — see Note 10)

	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Retained earnings at beginning of the year	\$ 15,922	\$ —
Net earnings	40,757	15,922
	<u>56,679</u>	<u>15,922</u>
Share issue expenses (net of \$9,320,000 income tax reduction)	12,510	—
Retained earnings at end of the year	<u>\$ 44,169</u>	<u>\$ 15,922</u>

See accompanying notes

CONSOLIDATED BALANCE SHEET

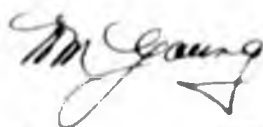
December 31 1979

(With prior year's figures for comparison)

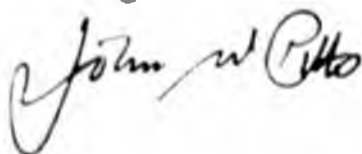
	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Assets		
Current		
Short term investments	\$517,505	\$ 9,787
Accounts receivable (Note 2)	39,641	52,040
Inventories (Note 3)	83,513	75,475
Other	1,387	1,328
	<u>642,046</u>	<u>138,630</u>
Investments and advances (Note 4)	41,877	41,067
Property, plant and equipment (Note 5)	252,981	239,732
Other	3,816	5,639
	<u>\$940,720</u>	<u>\$425,068</u>
Liabilities and Shareholders' Equity		
Current		
Bank demand loans	\$ 12,357	\$ 7,017
Accounts payable and accrued charges	59,006	14,507
Current portion of long term debt	8,264	9,284
Deferred income taxes	2,700	—
	<u>82,327</u>	<u>60,808</u>
Long term debt (Note 6)	132,591	168,247
Promissory note payable to the Province of British Columbia	—	151,533
Deferred income taxes	17,213	5,492
Minority interest in a subsidiary	25,428	23,066
	<u>257,559</u>	<u>409,146</u>
Shareholders' equity		
Share capital (Note 7)	638,992	—
Retained earnings	44,169	15,922
	<u>683,161</u>	<u>15,922</u>
	<u>\$940,720</u>	<u>\$425,068</u>

See accompanying notes

Approved by the Directors:



Director



Director

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

For the year ended December 31, 1979

(Comparative figures — see Note 10)

	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Source of funds		
From operations	\$ 76,217	\$ 24,552
Share subscriptions received	487,459	—
issue of shares on conversion of promissory note	151,533	—
Working capital of subsidiary companies acquired	—	51,551
Issue of long term debt	—	79,998
Recovery of logging taxes	—	4,000
Other	1,335	1,162
	<u>716,544</u>	<u>161,263</u>
Application of funds		
Conversion of promissory note to share capital	151,533	—
Additions to property, plant and equipment	27,694	77,606
Investment in petroleum and natural gas rights and exploration	7,527	63
Long term debt reduction	34,636	5,031
Share issue expenses (net of income tax reduction)	12,510	—
Other	747	741
	<u>234,647</u>	<u>83,441</u>
Increase in working capital	481,897	77,822
Working capital at beginning of the year	77,822	—
Working capital at end of the year	<u>\$559,719</u>	<u>\$ 77,822</u>

See accompanying notes

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS December 31, 1979

1. SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared within the framework of the accounting policies summarized below:

CONSOLIDATION

The consolidated financial statements include the accounts of the Corporation and its subsidiaries (see Note 13).

TRANSLATION OF FOREIGN CURRENCIES

Transactions in foreign currencies are translated at rates in effect on the dates of the transactions. Assets and liabilities, principally receivables and long term debt, carried at current prices are translated at the year end rate. Unrealized gains or losses are included in income except for those related to long term debt which are amortized over the remaining term of the debt.

INVENTORIES

Logs, wood chips and other raw materials are valued at the lower of average cost and replacement cost. Finished products (pulp, lumber and plywood) are valued at the lower of average cost and net realizable value.

INVESTMENTS AND ADVANCES

Investments and advances are stated at cost.

PROPERTY, PLANT AND EQUIPMENT

These assets are stated at cost less accumulated depreciation, amortization and depletion. Depreciation, amortization and depletion are computed as follows:

Asset	Rate and Method
Pulp mills	4% composite rate straight-line
Sawmills	4% to 6% composite rate straight-line on certain mills and 4% to 20% diminishing balance on others
Logging equipment	10% to 20% rate diminishing balance
Timber cutting rights, roads and related facilities	Unit of production method, using current log production as a percentage of estimated total log production available from such assets

Petroleum and natural gas properties are accounted for using a form of the full cost method of accounting whereby all acquisition, exploration and development costs are capitalized as incurred. Costs related to the petroleum and natural gas rights over 2.3 million gross acres, originally acquired under agreement with the Province of British Columbia, are being amortized over the periods during which exploration activity in each area of interest is expected to continue.

INCOME TAXES

Earnings are charged with income taxes at the effective rates applicable to the Company and its subsidiaries. Differences between this provision for income taxes and the amounts currently payable are reflected in deferred income taxes.

2. ACCOUNTS RECEIVABLE

	(Thousands)	
	1979	1978
Trade	\$33,823	\$40,700
Insurance claims	985	5,112
Other	4,833	6,228
	<u>\$39,641</u>	<u>\$52,040</u>

3. INVENTORIES

	(Thousands)	
	1979	1978
Logs, wood chips and other raw materials	\$55,151	\$48,877
Pulp, lumber and plywood	18,536	18,106
Supplies	9,826	8,492
	<u>\$83,513</u>	<u>\$75,475</u>

4. INVESTMENTS AND ADVANCES

	(Thousands)	
	1979	1978
Investment in Westcoast Transmission Company Limited (quoted market value of \$49,901,000 which does not necessarily reflect the realizable value of this investment)	\$37,364	\$37,364
Investment in an associated company, at cost plus equity in earnings less dividends received	3,101	2,117
Other	1,412	1,586
	<u>\$41,877</u>	<u>\$41,067</u>

5. PROPERTY, PLANT AND EQUIPMENT

	(Thousands)	
	1979	1978
Forest Products:		
Pulp mills	\$331,474	\$325,876
Sawmills	77,475	64,466
Timber cutting rights, roads and related facilities	65,120	58,722
Logging equipment and other facilities	21,097	21,369
	<u>495,166</u>	<u>470,433</u>
Less accumulated depreciation, amortization and depletion	290,465	272,956
	<u>204,701</u>	<u>197,477</u>
Land	1,260	1,296
	<u>205,981</u>	<u>198,773</u>
Petroleum and Natural Gas:		
Property rights	47,173	40,959
Exploration and development costs	1,313	—
	<u>48,486</u>	<u>40,959</u>
Less accumulated amortization	1,486	—
	<u>47,000</u>	<u>40,959</u>
	<u>\$252,981</u>	<u>\$239,732</u>

Depreciation, amortization and depletion charged to earnings during the year amounted to \$21,653,000 (1978: \$12,207,000). This amount has been reduced by \$2,735,000 (1978: \$2,300,000) for the amortization of the excess of the book value of net assets of Canadian Cellulose Company, Limited, Kootenay Forest Products Ltd., and Plateau Mills Ltd. over the consideration paid for these subsidiaries.

6. LONG TERM DEBT

	(Thousands)	
	1979	1978
Canadian Cellulose Company, Limited		
6 $\frac{1}{8}$ % Bonds due January 2, 1981 with annual principal payments (U.S. \$8,000,000)	\$ 9,372	\$ 14,202
5 $\frac{3}{8}$ % Bonds due July 1, 1985 with annual principal payments (U.S. \$20,000,000)	23,430	26,664
10 $\frac{1}{2}$ % Promissory notes due December 15, 1992 with annual principal payments commencing December 15, 1983 (U.S. \$50,000,000)	58,575	59,288
11 $\frac{1}{2}$ % Promissory notes due December 15, 1992 with annual principal payments commencing December 15, 1983	20,000	20,000
Bank loans on revolving credit facilities, with interest at various rates	25,000	50,000
Other	448	527
	<u>136,825</u>	<u>170,681</u>
Other Subsidiaries		
Term bank loan	—	2,200
Term loan with quarterly principal payments to 1986 with interest at bank prime plus $\frac{1}{2}$ %	4,030	4,650
	<u>140,855</u>	<u>177,531</u>
Less amounts due within one year	8,264	9,284
	<u>\$132,591</u>	<u>\$168,247</u>

Canadian Cellulose Company, Limited (CanCel) has bank lines of credit of \$45,000,000 on a revolving credit facility with any loans at June 30, 1981 converting into term loans, repayable over periods of up to nine years, in equal semi-annual or annual instalments, and, subject to certain restrictions, an additional \$20,000,000 on a revolving credit facility

repayable by December 15, 1980. At December 31, 1979 the outstanding loans under these facilities totalled \$25,000,000.

The bonds, promissory notes and bank loans on revolving credit facilities are unsecured. Certain assets have been pledged as collateral for the term loan.

CanCel's trust deed relating to its bonds and the agreements relating to its promissory notes, in general terms, restrict dividends and certain other payments by CanCel to a maximum of \$4,000,000 plus 50% of its net earnings after December 31, 1976.

The amount available for payment of dividends at December 31, 1979 was \$10,281,000.

Principal payments required on long term debt in each of the next five years, with the United States dollar component translated at the December 31, 1979 rate of exchange, are:

1980	\$ 8,264,000
1981	\$ 9,436,000
1982	\$ 7,512,000
1983	\$15,390,000
1984	\$15,390,000

7. SHARE CAPITAL

During the year the Company increased its authorized common shares without par value to 100,000,000. The Province of British Columbia received 15,000,000 common shares in exchange for the promissory note of \$151,532,930. In addition 81,243,230 common shares were issued at a price of \$6 per share for a total cash consideration of \$487,459,380, resulting in 96,243,235 shares outstanding at December 31, 1979 (1978: 5 shares).

The weighted average of shares outstanding was calculated on the basis of 15 million shares outstanding January 1, 1979, with the balance assumed to be outstanding on the dates the Company received the share subscriptions.

8. OTHER REVENUE

	(Thousands)	
	1979	1978
Insurance proceeds relating to loss of earnings due to a fire at the Castlegar sawmill ...	\$ 774	\$ 3,570
Income related to cancellation of a sales contract	—	3,370
Equity in earnings of an associated company	1,070	1,104
Dividends from Westcoast Transmission ...	2,777	2,394
Other	163	219
	<u>\$ 4,784</u>	<u>\$10,657</u>

9. INCOME TAXES

The Corporation and two of its subsidiaries were exempt from income taxes during 1978 and part of 1979 because not less than 90% of their outstanding shares were owned by the Province of British Columbia. Effective April 25, 1979 the companies became taxable and commenced providing for income taxes on earnings from that date.

The consolidated effective income tax rate for the year was 35.2%. A reconciliation between income taxes provided at that rate and at the basic rate of 51% for Canadian federal and provincial income taxes is as follows:

	(Thousands)
Tax on reported income at 51%	\$34,448
Less reduction in income taxes due to:	
Tax exempt period	(4,466)
Nontaxable dividends received	(1,416)
Manufacturing and processing credits and inventory allowances ..	(2,574)
Other	(2,212)
Deferred income taxes provided	<u>\$23,780</u>

CanCel has made fixed asset acquisitions qualifying for federal investment tax credits which will enable it to reduce income tax expense by approximately \$7,000,000 if sufficient income taxes become payable prior to December 31, 1984. The benefits will be recorded as and when they are realized.

AUDITORS' REPORT

10. COMPARATIVE FIGURES

The figures provided for comparison in the Consolidated Statement of Earnings, the Consolidated Statement of Retained Earnings and in the Consolidated Statement of Changes in Financial Position are those for the period from incorporation, February 22, 1978 to December 31, 1978.

11. COMMITMENTS

Rental obligations under long term leases amount to approximately \$3,500,000 in each of the years 1980 and 1981, \$2,800,000 in 1982, \$1,900,000 in 1983 and \$1,800,000 in 1984.

12. REMUNERATION OF DIRECTORS AND SENIOR OFFICERS

The aggregate direct remuneration paid or payable by the Company and its subsidiaries to directors and senior officers of the Company amounted to \$522,892 (1978: \$262,684).

13. SUBSIDIARY COMPANIES

Canadian Cellulose Company, Limited
(81% owned)

- Calum Lumber Limited
- Canadian Cellulose International S. A.
- Celgar Properties Limited
- Celtran Equipment Limited
- High Arrow Limited
- Pohle Lumber Co. Ltd.
- Twinriver Timber Limited

Kootenay Forest Products Ltd. (100% owned)

Plateau Mills Ltd. (100% owned)

- Plateau Timber Ltd.
- Nechako Valley Pulp Mill Ltd.

14. SUBSEQUENT EVENT

On January 10, 1980, CanCel agreed to purchase Price-Skeena Forest Products Ltd., which owns a sawmill in Terrace, British Columbia and holds related Crown timber rights, for approximately \$14,000,000.

TO THE SHAREHOLDERS OF BRITISH COLUMBIA RESOURCES INVESTMENT CORPORATION:

We have examined the consolidated balance sheet of British Columbia Resources Investment Corporation as at December 31, 1979 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Corporation as at December 31, 1979 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding period.

Vancouver, Canada
January 21, 1980

Clarkson Gordon
Chartered Accountants

CORPORATE INFORMATION

Board of Directors

John W. Pitts
Chairman, President and
Chief Executive Officer
Okanagan Helicopters Ltd.

* David L. Helliwell
President and Chief Executive Officer
British Columbia Resources Investment
Corporation

* Trevor W. Pilley
Chairman and Chief Executive Officer
Bank of British Columbia

John W. Poole
President and Chief Executive Officer
Daon Development Corporation

Charles N. W. Woodward
Chairman and Chief Executive Officer
Woodward Stores Limited

* W. Maurice Young
Chairman and Chief Executive Officer
Finning Tractor & Equipment
Company Limited

* Member of Audit Committee — Chairman, W. Maurice Young

Officers

Richard A. D. Commerford
Vice President

Robert G. S. Currie
Vice President, Gas and Oil Division

David L. Helliwell
President and Chief Executive Officer

G. Buchan McIntosh
Secretary

Michael G. McKibbin
Vice President

Dougal M. Meekison
Treasurer

David J. R. Petitpierre
Assistant Secretary

John W. Pitts
Chairman

John R. Redworth
Controller

Shareholder Information Service

WRITE: British Columbia Resources
Investment Corporation,
2600-1177 West Hastings Street,
Vancouver, B.C. V6E 3Y3

PHONE: Within Greater Vancouver area
669-4443. Outside Greater
Vancouver and within B.C. call
toll free (112) 800 663-9123. North
of Stewart and Wonowon, B.C.
call collect 669-4443.

Share Transfer Agent and Registrar

Montreal Trust Company, 466 Howe Street,
Vancouver, B.C. V6E 2A8
Telephone (604) 688-4411
Also in Calgary, Winnipeg, Toronto, Montreal.

Shares Listed

Vancouver Stock Exchange
The Toronto Stock Exchange

Duplicate Reports

While every effort is made to avoid sending more than one copy of the annual and interim reports to each shareholder, duplicate mailings will occur when shares are listed under different first names or initials. Shareholders who do receive more than one report are asked to contact Montreal Trust Company to have their shares registered under the exact same name to avoid the cost of duplicate mailings.

BCRIC

AGSOC proposal near collapse → Good

by Ray Tyson
Juneau Bureau

Juneau — U.S. Sen. Mike Gravel's proposed Alaska General Stock Ownership Corporation is on the brink of collapse in the Legislature.

Lawmakers are looking on AGSOC with increasing skepticism and it faces constitutional questions.

House Speaker Terry Gardiner, Ketchikan, an original sponsor of the AGSOC House bill, and other key legislators now question whether the plan can stand on its own without massive state financial commitments.

Senate President Clem Tillion, K-Baraboo Cove, has his suspicions, too.



GRAVEL

"The bill needs some changes," Tillion said. "Unless the House makes the changes, why should the Senate bleed?"

Sen. Bettye Fahrenkamp, D-Fairbanks, a major backer of an initiative drive



TILLION

to place AGSOC on the ballot in November should it fail in the Legislature, agrees the proposal has little chance of making it through the Legislature this year.

"That's the reason I worked as hard as I did last summer," Sen. Fahrenkamp said. "I knew the leadership was against it and I wanted to get it to the people for a vote."

The lieutenant governor's office Monday certified the AGSOC initiative, sponsored by Gravel, for the November ballot.

But even if it is approved by voters, AGSOC might face trouble in the Legislature when it comes back for appropriation of startup money.

And it could be shot down in court on issues of constitutionality.

on the Legislature if the voters approved it (the initiative), but it still has the constitutional question," Gardiner said.

Identical AGSOC bills are locked in committees in both houses, although the House State Affairs Committee is expected to decide Friday whether to move the bill out.

AGSOC is billed by its advocates as a private corporation that would invest in major development projects on behalf of all Alaskans, who in turn would receive dividend checks.

Its major feature is that it would be separated from state government, although proponents are asking for a \$5 million state loan for startup costs.

Rep. Mike Miller, D-Juneau, chairman of the State Affairs Committee, said economists testifying before his panel question "whether AGSOC can get 100 percent private financing (for projects) unless it gets state guarantees."

As Gardiner put it: "Then it becomes a whole different beast, if the government winds up owning it."

One proposal is that AGSOC could buy into the trans-Alaska oil pipeline.

"There's no doubt it would take a vote of the public if not a constitutional amendment to permit the state to invest in AGSOC," Gardiner said.



FAHRENKAMP

State law prohibits the state from indebting itself without a vote of the people. Bonds can only be used to finance capital improvement projects.

It is doubtful whether AGSOC constitutes a capital improvement project, the attorney general's office says.

"There's no question there are serious constitutional questions," said Rod Pegues, an assistant attorney general. "A loan guarantee is a conditional debt. And the state cannot have a constitutional debt except for capital improvement projects."

AGSOC would have to stand on its own financially. "There's no hint in the plan that the state would finance AGSOC. If the AGSOC portfolio could not stand in the bond market, naturally the bonds wouldn't sell."



GARDINER

Even if the bill moves out of Miller's committee, it would face tough sledding in the House Finance Committee, said Rep. Russ Meekins Jr., D-Anchorage, the committee chairman.

If AGSOC makes it to the House floor, Gardiner said, it doesn't stand

much chance of passing "unless Gravel starts strong-arming people."

Gardiner questions Gravel's motives regarding the proposal. "The Legislature gave him every consideration, and when the Legislature didn't do what he wanted he got an initiative" to put on the ballot. "A lot of legislators feel abused."

Gardiner said Gravel, who is up for re-election this year, is using AGSOC as a campaign tool. "I don't really think he cares about the issue."

Yukon Territory is expected to become Canada's 11th province by '83.

3/1/80 Notes

Now here's another grandiose scheme to "get something for nothing". Why? Well, first each Alaskan gets a "free" share of stock in AGSOC, and second AGSOC's profits and bonds are both tax free (Wow!), and third a \$5 million State "loan" (non-repayable?) is required for startup costs, and fourth AGSOC's borrowing will probably require State guarantees (which means if AGSOC can't pay it's debts, the State must—and who's going to oppose that with every Alaskan a stockholder) and fifth grandstander Gravel desperately needs a give-a-way proposal to soothe the voters — Right?

With a tax-free, State backed set up like that, how can private enterprise (the large corporations who put the daily bread on our table), co-exist in Alaska with a monster like AGSOC? Well, the majority of free-loading Alaskans will probably approve it by referendum anyway, while they're in the present mood to "get all you can for nothing", but I hope our state Supreme Court has the good sense to shoot it down afterward.

Cheers from the richest, greediest, and most socialist State in the Union.

Charlie Parker

Charlie Parker, Box 349, Soldotna, Ak.

O.C. to others to use as they see fit.

THE FOLLOWING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

*file
AGSOC*

Dear Fellow Legislator:

Attached is some information that I have put together regarding the issue of AGSOC. I think you will find it both interesting and pertinent.

Regards,



Dick Randolph

Alaska State Legislature

Libertarian
Representative
RICHARD (DICK) L. RANDOLPH
1105 Cushman St.
Fairbanks, Alaska, 99701



While in Juneau
POUCH V
Juneau, Alaska
99801

House of Representatives

Dear concerned Alaskans,

Senator Gravel is energetically promoting his AGSOC proposal. In typical Gravel fashion he is employing every technique of professional "con-ism" available. Please do not swallow his big lie. AGSOC is not free enterprise! It is not capitalism of any kind! It is complete and total collectivism and it must be stopped!! I can appreciate the appeal of something-for-nothing "professtations," but it's full of holes, it won't work, and it will commit at least one and maybe many generations of Alaskans to its cruel hoax.

Gravel's altar-ego, Louis O. Kelso, has been promoting this "economic idiocy" for over 20 years and in Gravel he has finally found a politician who is politically oriented enough to promote it. It is a scheme completely void of any redeeming values to a free society.

I appreciate that this is a harsh indictment, but one which is completely defensible. I will, between now and however long it takes to expose and defeat this sham, provide information and leadership to those who agree with this indictment.

To begin with, it is important that we understand Kelso's so-called "economic theories" from which AGSOC is derived. Toward that understanding I have enclosed two critiques of his book, The New Capitalists.

The first critique was recently produced by Robert Shelley, a life-long Alaskan, attorney, and presently my administrative aide in Juneau. Bob does an excellent job of tying Kelso, Gravel and AGSOC together and pointing out their fallacies.

Percy L. Greaves, a free-market economist, in his critical analysis of this work comments: "This small book contains more economic fallacies than it does pages. The basic assumptions upon which it is built cannot withstand the light of careful scrutiny. Furthermore, the alleged facts are not documented and the logic employed is extremely loose. Its strong effect on the casual reader rests largely upon the repeated assertion of seemingly plausible statements

AGSOC
Page 2

which, upon close analysis turn out to mean almost the exact opposite of what they first seemed to say.

Any attempt to put the book's proposals into effect would immediately reduce the incentive to produce and result in a rapid paring down of the American standard of living. At the same time, it would set up an economic dictatorship which would select the management of the nation's industries and determine all production goals. In short, it is an unwitting blueprint for the establishment of a Socialist America."

Please carefully read both, and then compare the AGSOC proposal in detail against this background. I am convinced that anyone who understands and believes in true free enterprise and capitalism will agree that this sham does not qualify in any aspect!

I would not dignify this proposal with a response if it were not apparent that many fine and normally right-thinking Alaskans are being drawn in by the insidious lure of this bankrupt proposal.'

It is my commitment to provide a well studied, articulate defense of the free market as opposed to this vicious, fraudulent misrepresentation of the facts! I am absolutely convinced that the adoption of the AGSOC proposal would have the most negative economic and social impact on the traditional Alaskan lifestyle conceivable.

I sincerely and emphatically request that you study the enclosed material and the other information which I will provide you from time to time. If you agree and want to help, let me know. Together we can expose and defeat this fraud and save 450,000 Alaskans from inadvertently creating a socialist Alaska!!

Freedom is the issue,



Dick Randolph
Alaska's Libertarian Legislator

AGSOC -- A FOOL'S PARADISE

prepared for

Representative Dick Randolph (L)

by

Robert Reed Shelley

AGSOC - A FOOL'S PARADISE
by
Robert Reed Shelley

In order to understand the meaning of the Alaska General Stock Ownership proposal presently before the legislature and the people of Alaska, it is necessary to become more familiar with the philosophy of its creator and to test some of the premises upon which its foundation is built.

Certainly any discriminating thinker who has encountered the AGSOC concept has realized that there must be more to the proposal than meets the eye. This is primarily because rarely in human experience does one get something for nothing. Try to picture Senator Gravel performing his political song and dance version of Jiminy Cricket's "Oh the World Owes Me a Living" on the Gong Show. Then compare The Sound of Music in which Julie Andrews sings, "Nothing comes from nothing, nothing ever could." Which one would you believe?

The creator of this attractive sounding 'horn of plenty' is a man named Louis O. Kelso who, along with myself, has combined the two professions of which the discriminating thinker is most skeptical, Economist and Lawyer, to form his background. From that point on, however, Mr. Kelso and I seem to diverge in our approach to human nature and the application of human nature to the economics of man.

Among Mr. Kelso's publications are two books with rather deceiving titles. The first in order is one entitled The Capitalist Manifesto, and its sequel is one called The New Captalists. This paper is primarily con-

cerned with The New Capitalists, with references made therein to The Capitalist Manifesto. It's the inclusion of the term 'capitalist' which makes these titles so deceiving. Upon close scrutiny it is clear that Mr. Kelso is to capitalism what Benedict Arnold was to the American revolution.

Webster's Dictionary (1979 Ed) defines 'capitalism' as: "the form of economic, industrial, and social organization of society involving ownership, control, and direction of production by privately owned business organizations" (as opposed to the government). In other words, capitalism means free enterprise without government interference in the economy. Mr. Kelso, on the other hand, has the audacity to try to pawn off his plan for governmental direction of the economy to unsuspecting readers as 'capitalism.' If he and Senator Gravel (Kelso's political promoter) are successful, they should be named the flim-flam men of the century.

Basically, Mr. Kelso sees only two factors in production: 1) Physical labor and 2) Capital goods (those goods which produce other goods). It is his contention that capital produces 90 percent of the gross national product in our economy, and that all but a small fraction of the capital instruments are owned by 5 percent of the households of the economy. In addition, he claims that despite this "concentration of ownership of capital, "70 percent of income produced is distributed through labor.

It is important to critically examine these contentions because they are the basic assumptions upon which his entire theory rests.

Any reasonably astute person knows that the initial factor in any kind of production is an 'idea.' While ideas are not exactly physical labor, they are essential to production. When physical labor and capital are added

to ideas, we may have production. Mr. Kelso seems to practically ignore ideas as the factor of production which is uniquely human. Instead, he classifies the factors of production into physical labor (his "human" factor) and capital (his "nonhuman" factor). One might wonder how capital can be termed "nonhuman" since it is only by human conception, creation, and operation that capital exists.

At any rate, contrary to Kelso's views, each factor of production is not mutually exclusive. Neither ideas, physical labor, nor capital can produce anything by itself. It is ludicrous to attempt to determine what percentage of any finished product was the result of the idea, the physical labor, or the capital goods used to produce it. We could argue forever as to how much of the production of the Wright Brothers' first plane at Kitty Hawk was the result of their idea, their physical labor, or their capital. For each item of capital produced, it takes ideas and labor to put it together, to operate it and to maintain it. Then, once the capital produces something, it takes ideas and labor to distribute and market the product. Mr. Kelso has conveniently determined, in an effort to support his theories, that 'capital' is responsible for 90% of all production. So much for the first of Mr. Kelso's premises.

Next, Mr. Kelso claims that this 'capital' is almost totally owned by only 5% of the households in America. While it is undoubtedly true that some Americans own more capital than others, Mr. Kelso's estimate is obviously misleading. The number of stockholders of publicly held corporations listed on the New York Stock Exchange now exceeds 20 million, or one out of every six adults in the United States. In addition, Kelso seems to ignore the multitude of privately owned closed corporations, partnerships, sole proprietorships, house ownership, real

estate holdings, life insurance and other forms of capital. The most important point to make is that a large extent of what capital concentration does exist in the United States is the result of government control of the economy, which results in political rather than economic allocation of available resources. In other words, through subsidies, regulation, and huge government spending, government, through politics, helps some wealthy people to unjustly remain wealthy and even become wealthier. In any case, it is the divergence in wealth between people in a free society that has given the world its highest standard of living and which makes life interesting. It is the opportunity to better one's well-being that stimulates all production. The extent of that opportunity should not be limited. Variance in wealth should not be disdained in itself as Mr. Kelso seems to do.

The third 'statistic' which Mr. Kelso uses to further his plans is that 70% of all income produced is distributed through labor. While one might be able to come up with such an estimate, careful thinking would certainly question the accuracy of such a figure. For instance, is the board member of a large corporation really earning \$500,000 worth of labor in his salary, or is this a payment in lieu of dividends which could be taxed as high as 70%, whereas earned income has a 50% maximum tax rate? Even assuming Kelso's 70% of all income being distributed through labor, one could argue that this refutes his previous assumption

that capital produces 90% of all production, since one would assume that each factor would be rewarded in relation to its worth. Kelso, however, argues that this disparity between 10% of production being caused by labor and 70% of income being distributed to it proves that American labor is composed of primarily lazy people who just take up space and time but don't really produce anything. Kelso says that unemployment in a capitalist system is both desirable and inevitable. He supposes that soon machinery will do everything and humans will do nothing. This concept is so naive that it barely rates refuting. While it is true that capital equipment may eventually produce more products which were produced previously by labor, so far no machine can replace man's unique ability to reason and create new ideas. In addition, it will always take human physical labor to get the resources, to build the new capital equipment, to operate it, to maintain it and to distribute the product which it produces. In addition, it will be a long time before machines totally replace humans in the service industries. Perhaps technology has allowed mankind to concentrate on mental labor rather than physical labor, but even physical labor will never be totally eliminated. Kelso says his plan would cast out the irrational doctrine of full employment, indicating the people wouldn't have to work. As he says, "unemployment is natural and desirable in a technically advanced economy." Until human needs are totally satisfied, there will always be a demand for new and better products at a lower price, and this will keep most of us employed (if we so choose) through the next major evolution of man.

From these "statistics" as to production and the distribution of income, Mr. Kelso comes up with some incredible conclusions and recommendations.

One such conclusion is that the rich get richer and the poor get poorer. Mr. Kelso reasons that since "labor is being replaced by capital as the total factor of production," soon those who currently own capital will be the only ones who will survive economically. He further argues that it's nearly impossible to accumulate capital unless you already have capital. This, he says, is causing an increasing concentration of wealth in the country. Then Kelso wonders what these wealthy capitalists do with all of their extra capital. He comes to the conclusion that they just make themselves wealthier by re-investing it, with no benefit to anyone else. This is a distorted conclusion indeed. Because when that 'extra' capital is reinvested, many people become employed, and we can assume that somebody's need will be fulfilled if the product sells. On top of that, it is true capitalist economic theory to believe that because of the increased supply of products on the market, the added competition by the new business venture, and the added growth to the wealth of the economy, both the particular price of that product and the general price level of the economy would fall to some extent. In turn, this lowering of prices and increased availability of goods on the market make almost everyone else in the economy better off (wealthier). It is clear, then, that Mr. Kelso's conclusion should have been that the rich get richer (assuming they make productive investments) and so do the poor. Everyone is made better off by the reinvestment of the capital which the wealthy man did not consume himself.

What's wrong with some rich people getting richer in relation to some poor people? In my view, nothing. In Mr. Kelso's view, however, it is somehow unfair, and he claims it will soon lead to socialism since the relatively less rich will use government to control the economy, and redistribute the wealth. The incredible inconsistency

in Mr. Kelso's thinking occurs when in the next breath he suggests the creation of a new governmental agency that would virtually take over the banking system and control the entire economy. This he calls the Capital Diffusion Insurance Corporation (CDIC).

Although Kelso doesn't like his plan to be associated with the redistribution of wealth, he believes that the government needs to take an active role in redistributing wealth so that there are many little "capitalists" rather than just a few. It shows his lack of understanding of capitalism that he should use the concepts of redistribution of wealth and capitalism in the same breath. In addition, Kelso defines a capitalist as "a member of a household which derives not less than half the amount the household spends on consumption from the ownership of capital." Under this definition, Leonid Breznev would be one of the biggest capitalists in the world (although he steals it) and an average American with a business, a house, a retirement system, and a small portfolio of common stock probably would not qualify (although he probably earned it honestly). Of course, when this average American retires and lives off the return on his investment rather than labor related income, he can suddenly call himself a capitalist even though he might do virtually nothing.

Kelso says government's objective should be to make sure that technological unemployment falls on those who can afford it (the wealthy). Does he actually advocate government retirement of successful people so that others can take their place?

The Capital Diffusion Insurance Corporation (CDIC) is the governmental mechanism by which Kelso plans to "create" lots of little "capitalists" out of nothing. In Kelso's view, the only thing that is preventing more

little "capitalists" from popping up is the present free market system of capital formation financing. Under the current system, someone who doesn't own capital can only get it in one of two ways: 1) forego consumption and accumulate savings (capital), or 2) find someone who will lend you money (capital) so that you can reinvest it and make a higher return. Kelso argues that most people can't afford to forego consumption so as to accumulate capital, and that this wouldn't be good anyway because it would cause a decrease in the demand for consumer goods and the economy would collapse. Again, Kelso fails to see that as the economy expands because of capital investment, the entire populace benefits due to more and better products at lower prices. If the average American of today was compared to the average American of 100 years ago, there is little doubt that today's subject is much better off economically than yesterday's. As the man of today rises higher and higher above a subsistence living, he ends up having more wealth to spend on both consumption and capital investment, thereby both keeping up the demand in the economy and giving himself more opportunity to own capital. Again, Kelso leaves out the Human idea factor of production. He almost assumes that an investment is just an investment. The truth is that a man with a big idea and little capital can make more wealth than a man with a small idea and lots of capital. Therefore, Kelso's view that there is no upward mobility in our society and that one can only acquire capital if he already has capital, is not entirely correct.

Kelso astutely observes that those lending capital to others want some insurance that they will be repaid. Under the current system of financing, this means that the lender will want collateral in the form of a claim upon the currently held assets of the borrower. Kelso claims those without currently held capital will then not

be able to get a loan to acquire their own capital. He fails to see that at some point all of us must forego some consumption (save) in order to borrow to accumulate capital. (Unless it's given to us, of course.)

In order to provide those who lack collateral with capital-producing potential, Kelso's CDIC would guarantee, in the name of the government, loans by commercial banks to borrowers who would otherwise be poor credit risks. These loans would not even provide for the personal liability of the borrower. Responsibility is totally removed for the borrower. Kelso compares his plan to the federal FHA program, which is noted for its bankrupt failings.

By the government becoming involved in capital financing, all of us, including those who make successful investments, would be paying for the mistakes of those who didn't deserve a guarantee in the first place and who would go belly up in their investment. There are only two ways the government could pay off such guarantees. 1) raise taxes on everyone else; or 2) start up the printing presses and pay the claims off in phony dollars thereby feeding fuel to inflation. Neither method is fair or honest.

But the fact that such a government program is not fair because it would force innocent people to pay for others' mistakes is only a small part of the real evils that such a scheme would create. In describing CDIC still further, Kelso discusses what 'policy' factors should go into the manner in which CDIC decides who should get the guarantee and in what business ventures these borrowers should be able to invest.

Included in these proposed policies are the following:

1. Anti-Monopoly Policy: This would be left to the political whim of bureaucrats who would likely insure through government power that the rich and powerful were well protected. Still Kelso calls

- his plan capitalism.
2. Promotion of technological improvement policy: There could be no more detrimental effect on technological change than to misallocate resources for such change by political (government) means rather than by the free market. Leave it to competition! Still Kelso writes of capitalism?
 3. Increase the number of capital owning households policy: This basically means redistribution of wealth by transferring opportunity and risk from those who deserve it to those who don't. The New Capitalists?
 4. Investment preferences for new capital estates policy: Another form of the redistribution of wealth. Capitalist?
 5. Prevention of speculation in stocks policy: Let's say goodbye to the New York Stock Exchange. Kelso fails to see that stock speculation is the incentive for persons to first put money into a proposed development. He still refers to his plan as capitalist!
 6. Coordination of consumer demand and new capital formation policy: This is plain and simply a planned economy proposal. Kelso the capitalist?
 7. Inflation control and reduction of consumer credit policy: There are several reasons why Kelso's plan would in fact be inflationary. First, the misallocation of resources from the free market to borrowers with a poor credit risk will adversely affect economic expansion while the money supply either remains constant or expands. Second, it is likely that the government would honor guarantees made by CDIC by printing dollars (a hidden tax) rather than by raising actual taxes.

Additionally, once the government, through CDIC has guaranteed a major portion of outstanding loans

in the economy, it will have even a more vested interest in promoting inflation as a way to make the loans easier to repay.

8. Personal aptitudes and education requirements policy:

This is perhaps the most appalling of the powers Kelso wants to place in government hands. Under this policy, a bureaucrat would direct the economy by giving preferences on loans to only those with a particular level of education or background. This would be a very hard part of Kelso's planned economy to swallow. I can just see a father telling his son that he must become an artist in order to get started in the world because that's what the CDIC decided he should be.

It is inconceivable to me that any reasonable person after reading Kelso's proposed policies could not see his plan as pure socialism -- governmental control of the means of production. This is definitely not capitalism.

A good rule of thumb is that any government policy means government control -- unless that government policy is freedom. Kelso's "new capitalism" is in fact a blueprint for a totally socialist society. The most incredible thing is that he claims to propose his plan to avoid socialism.

The CDIC would have to make countless arbitrary rules about who was eligible for the program and who wasn't. By Kelso's own description, bankers would basically become government agents interpreting regulations and helping to operate a government program. Their decisions would be based on political governmental edict rather than good solid business factors.

Only a fool would believe that CDIC guaranteed loans would not soon permeate the capital market, drying up available capital to non-government approved enterprise. Eventually, anyone not qualifying for the CDIC program would be at a tremendous competitive disadvantage to those using

the program. Why should anyone strive for financial well being if government programs will eventually discriminate against them?

Creating the CDIC would substitute a political economy for a free market economy. It would open the whole system up to graft and corruption both in terms of bureaucrats wielding undeserved power and in terms of crafty entrepreneurs ripping off a shoddily run government program.

Eventually, the government, through CDIC, will literally be controlling the economy by deciding who's going to get loans, and for what purpose. No better plan could be conceived to destroy free enterprise and substitute socialism in the name of "capitalism."

Even beyond Kelso's CDIC blueprint for socialism, he advocates several changes in free market corporate operations. For instance, Kelso wants some kind of legal requirement that all earnings of corporations be paid out in dividends rather than allow investment for future expansion. This goes right along with his plans to eliminate speculation on resale of stock certificates. He wants an end to consumer credit so that people will be forced to become capitalists by foregoing consumption. (This is despite his fear that less consumption will hurt the economy.) Even if all corporate earnings were paid out in dividends, there is no assurance that people would spend the money on capital investment rather than consumption. The fact is that the government would get a larger part of it since dividends are taxed as non-earned income, and the sale of speculated stock is taxed at capital gains rates.

As an additional tool for the redistribution of wealth (which Kelso claims he does not advocate) he suggests major increases in inheritance tax rates. This proposal would give even less incentive for a man to build up his capital estate.

So as to not let Mr. Kelso off the hook too easily, let's look at some additional inconsistent remarks made by him which indicate a lack of understanding about capitalism and the free market.

At one point Kelso remarks that in Russia, industrialization is achieved at the cost of totalitarianism. Actually, industrialization isn't achieved very well in Russia, and even then only by almost completely foregoing consumption. In addition, Kelso is promoting totalitarianism here by creating an economy based on politics rather than the free market.

Kelso also claims that "conventional business financing falls far short of satisfying the basic principles of economic justice." The truth is that the free market finance system is the only one which does create economic justice. Justice means no more nor less than one deserves. Kelso's plan would, through government intervention, give some more than they deserve at the expense of others. At another point, Kelso says wealth should be distributed to those who produce, yet he comes up with plans like CDIC, and increased inheritance taxes.

Consistent with Kelso's something for nothing theory, he attempts to create capital wealth for those who he thinks don't have it by bookkeeping entries brought about by government guarantees without any abstaining from consumption. This is economically ridiculous and amounts to government increasing the money supply without additional wealth, thereby fueling inflation.

Placing his personal value judgment on everyone else, Kelso states that "society's first economic duty to its citizens is to enable them to be or become productive." True capitalism, meaning economic freedom, is the only way that individuals will have the opportunity to be or become productive. "Society" is a group of individuals, and individuals should have no duty to anyone other than

those they choose to contract with. It is individual freedom that sparks economic growth even for less productive people. Kelso's meddling in the economy is nothing but anti-productive.

Elsewhere, Kelso states that we "need even more intensive efforts by government and government supported power blocs to divert the wealth produced by capital to those who do not own capital." If this isn't a proposal for the redistribution of wealth and socialism, then neither was the Communist Manifesto.

Later Kelso states "every major increase in new capital formation that is not accompanied by an increase in the number of new 'capitalists' is a leap in the direction of socialism." Not only is this an untrue statement in itself, but if there is any leap to socialism, it would be to adopt Kelso's proposals.

While Kelso indicates that it's impossible for those without capital to become capitalists, he complains that "today owners of a hotel suddenly become owners of a chain of hotels" and says the same about restaurants and warehouses. This only points out the fallacy of his theory. If someone has a good idea, and foregoes a little consumption, then there's no reason why he couldn't become a wealthy capitalist. If someone doesn't do that, it's primarily because they don't have the qualities necessary to be capitalists. One of the most dangerous aspects of Kelso's theory is that he wants to make the government the insurer for people who probably don't have the qualities to be capitalists, are poor credit risks, and don't deserve loans.

At another point, while speaking woefully about inevitable socialism if we don't adopt his plan, Kelso states "socialist methods of new capital formation are more efficient and quicker than traditional methods of business finance now employed by the free world." This

is called talking out of both sides of your mouth.

Kelso virtually ignores that there is a skill involved in choosing good capital investment which should be rewarded. Instead, he figures that by putting capital into anyone's hands, benefit will result.

In short, Kelso's theory closely follows that of another economist who advocated, 'from each according to his ability, to each according to his need.' Kelso further admits the failure of his theory by stating that, with it in effect, "the government would wield considerable power."

It is unfortunate indeed that so many pages of words need to be produced describing Kelso's illogical economic theory, but when the legislature and the people of Alaska are asked to swallow the demagogic AGSOC proposal of Senator Gravel, they should know what the ultimate theory is behind the AGSOC plan. After examining Kelso's inconsistent and illogical reasoning, it would be incredible that any legislator could lend their support to AGSOC. Let's look at how the AGSOC proposal fits into Kelso's overall plan, and why certain parts of Kelso's plan are conveniently being left out at the initial stages of AGSOC.

In brief, AGSOC would hand out shares of stock "free" to most every Alaskan. The corporation would be formed by the initial appropriation of millions of your tax dollars by the government, with no guarantee or liability by the state or the stockholders (at least for the time being). One indicator of the deception built into AGSOC is that while its initiative literature only mentions initial government aid to the project, the Alaska House State Affairs Committee and Senate Finance Committee plans call for the likely guaranteeing of loans to AGSOC by the state. Ownership of the "free" shares would have all kinds of restrictions including the number of shares, how and when they could be sold, and who could own them. Then, this paper corporation would supposedly be able to

to borrow all kinds of capital to invest in money-making projects that would make us all wealthy since it would be required to pay all hoped-for earnings out in dividends without investing in itself. Even though there is talk of AGSOC buying various companies, one might wonder at the viability of such companies if they're willing to sell to AGSOC.

Comparing such a plan to Kelso's theory, it's easy to see what essential feature of Kelso's plan is missing from AGSOC. That missing piece is CDIC and the government guarantee of any part of the operation.

The question might be asked how could such a plan work when even Kelso admitted that some kind of a guarantee or collateral is absolutely essential to the formation and acquisition of capital? The answer is that it won't.

For AGSOC to go begging to a lender for money would be ridiculous. Can you imagine yourself, or any other intelligent person, readily lending huge amounts of capital to some immature youngster with no experience, no well-formed ideas, no collateral, no guarantee, and no strong sense of direction? Of course not. And this is exactly what AGSOC will be when it attempts to get a loan.

The only reason anyone would lend money to such a scheme would be if there were some hidden factors involved. I can immediately see at least one possibility of such a hidden factor.

The most dangerous of such hidden factors would be the unwritten assumption that based on political experience, the government, (State of Alaska) would eventually step in and guarantee, loan, or subsidize to AGSOC if it should ever find itself in bad finances (which it is doomed to from the outset). Any astute political observer (such as Senator Gravel) knows very well that if the state had already invested millions into AGSOC's start-up costs, had

perhaps lent money to AGSOC, if powerful legislative political figures had supported the AGSOC concept, and if politically appointed 'leading citizens' had been appointed to its directorship -- then the State of Alaska would politically be forced into saving the sinking ship of AGSOC before it went totally under. Such a bail-out of AGSOC by the state would be inevitable, and would complete Kelso's blueprint for socialism. There is no way that those demagogic promoters of AGSOC would allow AGSOC to go under, and if there's one attribute which politicians like to maintain, it's the characteristic of infallibility. Senator Gravel's primary concern is getting re-elected in 1980. The AGSOC 'something for nothing' appeal might get him over that hurdle and set him up for another six years, by which time he would find another distraction with which to attempt to fool the voters.

It would be this unwritten, but politically sound assumption of bail-out by the wealthy state of Alaska that might actually find someone willing to 'risk' a loan to AGSOC. An analogous situation would be a child's (AGSOC's) first loan, with the father (politicians) winking in the background that he will actually guarantee the loan even though it's not on paper. Such a risky loan would particularly be possible by the application of political pressure or offer of political gain by a powerful promoter of AGSOC to some government protected holder of extra capital which could be loaned to AGSOC (political payoff).

The next question to ask is, why wouldn't the AGSOC proposal include government subsidy, loans, and guarantees right from the beginning? The answer is simple. It would be easier for Kelso and Gravel to hold AGSOC up as "capitalistic" and not socialistic if they can minimize the aspect of government involvement. They may also be clever enough to realize that it wouldn't be necessary to include government guarantees at the outset. If they just feed

AGSOC to the people a little at a time, they'll be hooked by the time it's too late to do anything about it. Promoters of AGSOC would know that once the corporation was created on paper, and stock was issued to all Alaskans, it will be easy to get the missing government guarantees and subsidies worked into the picture later on. When those subsidies and bail-outs occur later on, individual owners of AGSOC shares may not be personally liable as stockholders, but they would certainly be liable as taxpayers.

In addition to the possible devious scheme behind AGSOC, there are many other aspects of it which make it undesirable. For instance, promoters claim that the fact that AGSOC would not be subject to taxes on its earnings (even though shareholders would be on their dividends) will make it attractive enough for investors to lend to it. That not only points out the ridiculous level to which taxation has risen in this country, but it should be obvious to the observer that by exempting AGSOC from taxation, the government is actually subsidizing it, since all of us will probably have to make up the revenue lost by tax exemption.

Another aspect of AGSOC is its political control from the outset. Politicians would be appointed to its board of directors at the beginning, and because of its diversified ownership, those directors would be nearly impossible to dislodge. These political directors would have AGSOC competing with other businesses in the Alaskan economy with the competitive edge of no taxation and no capital requirements. Through a slow process, this politician's boondoggle would begin to control and affect more and more of the Alaskan economy, with government's help.

Since AGSOC would be prohibited from retaining earnings for reinvestment, it couldn't help itself grow even when reinvestment might be economically feasible.

Even if the claimed purpose of AGSOC is to somehow return wealth to the people, there is no question that there are many better ways to do so. The people of Alaska are already in a dangerous situation with a state government holding billions of dollars of surplus funds while individual Alaskans go without. The simplest, most reasonable, and most consistently capitalistic way to solve the problem is to take that dangerous surplus away from the government and give it to each individual to choose for himself whether to consume or invest with it. This can be achieved through the elimination of taxes, among other means. We must assume that each person knows his own happiness better than the government does.

I have laid out my observations about the theories promoted by Mr. Kelso and Senator Gravel. If you have been concerned enough to stay with me to this point, you may ask yourself, "What can I do?"

The thing that must be done is for all of us as individuals or in groups to oppose AGSOC now, before it's too late.

The most effective group to begin this effort is the hard-working, self-sufficient businessmen and businesswomen of Alaska. They are the ones who keep this economy limping along despite government interference, and they are among those who would be affected most adversely by the adoption of the AGSOC foolishness.

If Kelso's scheme is allowed to happen, capital accumulation, the source of our high American standard of living, would soon begin to dry up. Men do not save and invest when they know it will be confiscated from them.

Schemes like AGSOC would set up an economic dictatorship which, through the political application of capital, would select and manage the economy's industries and determine production goals. There is no more devious a plan for a socialist economy.

THE NEW CAPITALISTS

by

Louis O. Kelso and
Mortimer J. Adler

A CRITICAL ANALYSIS

by

Percy L. Greaves, Jr.

This small book contains more economic fallacies than it does pages. The basic assumptions upon which it is built cannot withstand the light of careful scrutiny. Furthermore, the alleged facts are not documented and the logic employed is extremely loose. Its strong effect on the casual reader rests largely upon the repeated assertion of seemingly plausible statements which, upon close analysis, turn out to mean almost the exact opposite of what they first seemed to say.

Any attempt to put the book's proposals into effect would immediately reduce the incentive to produce and result in a rapid paring down of the American standard of living. At the same time, it would set up an economic dictatorship which, through the political allocation of capital, would select the management of the nation's industries and determine all production goals. In short, it is an unwitting blueprint for the establishment of a Soviet America.

A complete analysis of all the book's fallacies would necessitate a theoretical treatise of several large volumes. However, the following brief analysis of seven of the book's basic fallacies should be helpful in indicating why the book is unworthy of serious consideration. These seven basic fallacies are:

- I. Capital produces at least 90 percent of the gross national product. (pp. 5, 6, 38-40, et al.)
- II. A progressive concentration of the ownership of capital exists; the great bulk of capital is owned by 3 or 4 percent of the households (pp. 14-15, 28-37, et al.)
- III. Savings are not required for capital accumulation. (pp. 53, 55, 59, et al.)
- IV. No real shortages of labor and resources exist in Western nations. (pp. 4, 41, 46, 86, 101, 104 et al.)
- V. Government redistribution of income is now necessary. (pp. 6, 31, 32, 41, 45, et al, ad infinitum.)
- VI. Bank credit expansion can create wealth. (pp. 17-18, 55-56, 58-59, 60-63, 100-102, et al.)
- VII. Proposals provide for a free society. (Implicit throughout and stated in conclusion, pp 108-109.)

I. Capital produces at least 90 percent of the gross national product.

The early classical economists and Karl Marx believed that human labor produced all economic values. Today, most labor union leaders, as well as those who write our laws, believe that human labor is responsible for producing almost all economic values and that employees, as employees, are entitled to all increases in production.

The authors of this book believe that capital is responsible for the production of almost all economic values and that the share attributable to capital is ever increasing with each addition to available capital. They assume that this is an apparent fact and make no attempt to document it or defend it logically. They apparently assume that because the increasing use of capital results in higher physical volume of goods, all the increased human satisfaction resulting from such increased quantities must be attributed to capital.

This neo-capital theory of value is just as indefensible as the labor or neo-labor theory of value. They both ignore the essential factors of time and abstinence as well as the factor of profit and loss which results from the uncertainty of future demand at the time businessmen commit their capital to the time-consuming process of producing particular goods. Attributing 90 percent or more of all production to any one essential factor and belittling the contributions of the other factors as insignificant and no longer needed is a little like attributing all football victories to the backs who score the touchdowns and thus implying that the linemen are no longer necessary. Attention is concentrated on the sensational at the expense of other very essential contributions. No football game can be won without linemen. Similarly, no economic production can take place without human foresight and the combination of capital and labor over a period of time. Each of the four factors is both important and essential.

Capital is always the result of human action. To obtain capital, men must first save, i.e., consume less than they produce. Only such savings can give them the time and ability needed to produce capital goods. Human ideas and foresight of future needs must also precede the introduction of every new capitalistic method. Then men must not only produce the capital goods but also direct and manage their use in production of other goods. Without the human factor, there would be no production, capitalistic or otherwise. Capital alone is incapable of producing anything.

Men do not value all labor or all capital. Men only value the specific units of labor or capital which they are considering in connection with a specific situation. Men think in terms of the value to them of one more, or one less, unit, that is the marginal unit. If they are buying, they compare the value to them of one more unit of labor or capital of a specific type and the price they must pay for it. They then buy until one more unit is no longer worth its market price to them. When they consider selling, they compare the value to them of one less specific unit with the value to them of the sum of money they receive in return for it. The market values of all types and units of both labor and capital are traceable to the values consumers are expected to place on their final products.

In the market place all identical units sold at the same time and place are sold at the same price. The market process thus tends to allocate every available unit of capital and labor to the production of those products which are expected to bring the highest prices from consumers. This means that each additional unit of capital tends to be used to produce something considered less valuable than what was produced with previously available capital. Otherwise, the previously available units of capital would have been used to make those products.

So, with any given population, each additional unit of capital is not only worth less than the units of the previously existing supply of capital units, but it also reduces the value of every other existing capital unit with which it competes. Thus, with any given population, every increase in the amount of available capital reduces the importance of every existing unit of capital. Man can then have more of the things he wants but the additional things are not as important to him as the things he desired when less capital was available. So more capital makes capital less important (valuable), rather than more important (valuable) to man.

Let us attack the problem in another way. As man is constituted, his desires are insatiable. As soon as some desires are satisfied, other unsatisfied desires arise to take their place. If they did not, man would stop eating and all his other actions. He would, in fact, lie down and die.

As long as man lives, he has unsatisfied desires. This means there is always a demand for more of what labor can produce with available resources. There are always ores that are not mined, land that is not planted, waters that are not fished, and goods that are not made because there is an insufficiency of labor. Labor, a necessary factor of all economic production, is the limiting factor in almost all areas of production. Every new person born on this earth brings his own unsatisfied demands for more things than can be produced with available supplies of labor. There is no such thing as a sufficiency of all kinds of labor.

Some types of labor are always in short supply. The economic problem is how to use available supplies of labor so as to produce the highest valued possible products, that is, how to prevent the waste of available supplies in idleness or producing less valuable products than such types of labor are capable of producing. All men have a point at which they prefer rest or leisure to the results of more labor, but up to that point men desire more of the goods and services that they can obtain only by more of their own labor or by spending money they are paid for contributing more of their labor.

Millions are unemployed today because political conditions either make them unemployable or create a situation in which they prefer to be unemployed, even though there is a great unsatisfied demand for the things they could help to produce. These political conditions are the laws and customs which hinder or prohibit the employment of persons where they could be most productive in terms of what consumers want more of most. These laws and customs include those that permit unions

to raise wages above free market rates, thus reducing the number employable in unionized industries; minimum wage laws, which prohibit the employment of those for whose products consumers will not pay the equivalent of the minimum wage; unemployment benefits, which encourage men to remain unemployed; and employment taxes, including social security taxes, progressive income tax rates and higher rates for overtime, all of which increase the costs of labor to employers and thus to the ultimate consumers.

It must be remembered that businessmen are merely middlemen between the workers and consumers. They will always hire every possible person they can afford to pay, up to wage rates that raise costs above what they can expect to recover from consumers. If they can make a penny by hiring one man more and selling his product, they will do so. Businessmen constantly strive to hire all who are willing to work at the free market wages which are set at the point which it is expected can be recouped from the ultimate consumer. Laws and customs which interfere with such free market wages also interfere with employment. They either cause unemployment or shift men into poorer paid jobs where they compete with less skilled persons who are driven further down the economic ladder, some of them being pushed below the minimum wage and thus into compulsory unemployment. These interventions have produced mass unemployment but in a free market society there can be no surplus of labor as long as men have unsatisfied desires which the employment of labor could satisfy. As mentioned above, such unsatisfied desires are a fact of human life.

One of the values of owning capital is that it saves men time. If we have the capital, we do not have to take the time and trouble to produce it. The payment for capital is thus a payment for time saved as well as for the labor needed to produce it. The payment for time is called interest. The rate of interest is determined by man's time preference, that is, by how much he prefers to have some things now rather than a year from now. Businessmen devote time and labor to the production of specific types of capital goods when they foresee that the cost of producing such capital goods will be less than their expected market value at the time of their completion. Not even the best businessman can always foresee future market conditions perfectly. This imperfection of human foresight is responsible for the factor of profit and loss. A period of time must elapse between the time businessmen decide what to produce and its later availability for sale. Those who turn out to have been relatively the most proficient in foreseeing correctly future demands make a profit. Those who do not suffer a loss.

In this connection, it should be remembered that profits are the amounts they receive over and above their labor costs, expenses for supplies and raw materials, and interest charges on necessary capital for the necessary period of time. When businessmen recover only their expenses for labor, supplies and raw materials and do not recover sufficient funds to pay the interest rate they could have obtained by lending their capital funds, they have suffered a loss. No one goes into business without the hope of earning more than he could by lending his money out or putting it in a savings account. On the other hand, profit or loss is merely the relative difference in expected market values between the time production is started and when it is completed, that is the time when the producer can transfer its ownership to another who then assumes the responsibility for future changes in its value.

For the fallacy of this book, all this means that the contributions of capital to production must be traced back to the contributions of the four essential factors that are necessary for the creation of capital. These four factors are human foresight, scarce goods consumed (savings) human labor and time. The scarce goods consumed in producing capital are the tools, supplies, and raw materials which, in turn, represent savings produced by human labor over a preceding time period.

The more capital savings there are available, the more apt we are to undertake projects which take a long time to produce to the point of operation and which will last a long time before their value is fully consumed. This means that interest payments are likely to be a larger factor in the costs of such enterprises. Any profits above the basic interest rate will attract competition which will pare down and finally eliminate the profit item. However, with the passage of time and changes in consumer preferences, new opportunities constantly arise for the re-emergence of new profits and losses.

As men are constituted, human foresight in deciding what to produce is imperfect and always will be. Likewise, our time, labor and capital are in short supply and always will be. The competition of a free market will allocate available supplies so that in the long run they will be combined to produce the highest possible values known to mankind. Should any investment temporarily obtain profits over and above labor, material and interest charges, competition, if not politically prevented, will soon tend to eliminate the profits. All profits are at best only fleeting in character and must be re-earned if they are to reappear.

In this connection, it should be pointed out that every increase in capital permits the production of goods and services not previously produced. Each new addition to capital goes to work by bidding up wages and the prices of raw materials before it can obtain the factors needed to go into production. Then, the newly produced goods must compete with existing goods and services and offer consumers a better buy before the contributor of the capital can receive a cent back on his investment. Further, the capital goods and the products they make must continue to compete for their originally estimated life if the capitalist is to get back his full investment with interest and possibly a net profit.

Another popular fallacy, inherent in the logic of the book's authors, is that it is thought that if corporate income taxes are reduced or repealed, the present profits before taxes would continue to be about what they are now and that this would be a windfall for the owners of capital. This is a gross error.

As long as a market economy exists, competition will determine the allocation of the reduced taxes among the various market participants as each specific condition dictates. This means that the repeal of 50 percent corporate income taxes would not double available corporate income as the authors seem to think when they estimate the share of production they attribute to capital. Actually, market competition would rapidly force the sharing of the tax savings in lower prices, increased production and higher wages. No doubt such an event would affect interest rates (time preferences). It would also change the

pattern of goods and services produced and thus those on which the highest profits of the future would be made. However, these changes in the allocation of produced income would be determined by the existing market forces and not by corporations trying to maintain the same wages, prices and production pattern as prevailed before the reduction in corporate income taxes.

Corporate income taxes are indirect taxes levied on market operation. Such taxes tend to hide the real burden of government spending from the general public which in the long run must bear the full burden. Unfortunately, many high and low income people, as well as the authors of this book, tend to think that it is the capital stock holders who now bear the full burden of corporate income taxes. This is just not so. Investors still earn the market rate of interest plus profits or less losses, depending on the foresight of each company's management, under existing conditions, in supplying what consumers want most as shown by how they spend their money.

In the long run, those who accumulate capital by consuming less than they produce must receive interest on their savings. If they did not, they would not invest their savings in capitalistic production. No law short of a complete dictatorship can force a man to save and invest without payment of interest. Nor can any law eliminate the uncertainties of the future. Any attempt to reduce or eliminate profits from business enterprise would only result in reducing the efforts of business to provide more efficiently for the uncertain human wants of an unknowable future.

While laws can and do reduce the return on capital, they cannot do so without at the same time reducing real wages and increasing the costs of the goods and services people want. Every government tax, rule or regulation which is not for the purpose of protecting or defending life, health, property or the activities of the market place must be a burden on all market participants. What is more, it is the market and not the government that allocates that burden and it does not spare those with low incomes. Except for their proposal to remove all corporate income taxes, the proposals of this book would increase the present burdens of every American. Its authors have no real concept of how a capitalistic society functions and how the benefits from the increased use of capital are shared by all market participants.

II. A progressive concentration of the ownership of capital exists; the great bulk of capital is owned by 3 or 4 percent of the households.

There is a slight plausibility to this argument. However, such plausibility is entirely due to political interferences rather than free market operations. One little known result of the political interventions before, during and since the New Deal is that they have tended to protect the positions of those already at the top of the business heap by making it considerably more difficult for new and struggling new competitors to replace them.

This is particularly true of the tax laws. Under present tax laws, it would be impossible for any man or family to duplicate the contributions to society of Henry Ford. He raised wages and benefited millions by making autos available for a few hundred dollars because he was able to

plow back his profits into expansion of his original small plant. This process could not be duplicated on a similar scale today. In this connection, it should be further stressed that the benefits of his increased capital investment did not all go to him or his family. The market compelled him to share his gains with his workers, his suppliers and his customers.

Other laws also help to protect those who have arrived from the competition of newcomers. This is most apparent in the labor area where union members can keep the unemployed from competing for the highest paid jobs. This unfortunately is the underlying cause of the economic distress and unrest among American negroes. However, all interventionary laws have this effect. It is quite evident where permits or licenses are required for the sole purpose of limiting competition. Laws which prevent the use of new materials or more economic methods or protect featherbedding are other instances. So also are the farm laws which curb the most efficient use of land. So also are oil import quotas, export licenses, interstate commerce regulations, certain food and drug regulations and many many more types of government owned and operated activities.

However, it is not such intrenchment of established business that the authors of this book have in mind. Nonetheless, it is the results of such interventions that opened the door to their approach. They build heavily on the results of government directed expansion of bank credit and the progressive income tax. They constantly stress the point that much present day capital accumulation is amassed by corporations plowing back their earnings rather than paying them out in dividends. They even admit that personal income taxes at higher rates than those on capital gains are a major factor.

However, they neglect to mention another contributing factor---that interest payments on corporate bonds entirely escape corporate income taxes. This fact, plus the effects of inflation, encourages the accumulation of capital in the form of corporate debts and capital gains upon the retirement of the bonds. They do not seem to realize that many of the conditions they deplore could be eliminated by simply removing the double taxation now levied on corporate dividends and levying the same tax rate on all personal and corporate income.

Unfortunately, the error in their reasoning is still greater. They assume that because a great part of capital accumulation takes place within existing corporations that almost all of it does and then as they proceed they not only assume that all capital accumulation happens in this manner but also that the owners of capital stock always remain the same persons. Actually, where corporations accumulate capital in order to provide their owners with capital gains rather than dividends, the stockholders must sell some of their holdings in order to realize their capital gains. The authors ought to visit the stock market some day, or at least read the figures on the turnover of stock ownership every business day. It runs into millions of shares.

While the authors with ever increasing emphasis proclaim the ever narrowing number of the nation's stockholders, the actual figures belie them. On June 24, 1965, the New York Times and Wall Street Journal

published figures of the New York Stock Exchange reporting that the number of stockholders of publicly held corporations has increased with every count made since 1952. The total figure now exceeds 20 millions and includes one out of every six adults in the United States. This is a far cry from the claim of the authors and this is only for the publicly owned corporations.

Many of our wealthiest men are owners of closely held privately owned corporations. So are many of our middle class citizens, including millions who place their savings in their own businesses with which they are more familiar than with the affairs and management of publicly owned corporations. The facts indicate that over the years the ownership of capital has become ever wider as has the resulting benefits to workers and consumers who use the many products made possible by the increase in capital. Many more than the Ford family are now benefiting from the existence of the Ford Motor Car Company. And so it is with every large corporation that earns profits.

The authors completely overlook the huge savings of the masses in many areas, including home ownership and other real estate. Take life insurance for example. There are now more than 120 million individual policy-holders insured with legal reserve life insurance companies holding more than \$141 billions in assets. In 1960, 89 percent of all family heads were insured, including 71 percent of those with annual incomes under \$3000. In 1963, American families received from life insurance companies payments amounting to 10 billion dollars. Such payments as well as the assets held by life insurance companies for their policy-holders are increasing with every passing year.

By the end of 1964, insured deposits in mutual savings banks had risen to more than 42 billion dollars, compared with only 10 billions at the end of 1945. This quadrupling was not done by any 3 or 4 percent of the nation's households. In the same period the savings capital of the savings and loan associations had increased from less than 8 billion dollars to almost 102 billion dollars. This is not where a few enormously wealthy capitalists are concentrating their savings. Individuals also now hold more than 49 billion dollars worth of the national government's baby bonds. This figure is up by more than 6 billion dollars since the end of World War II.

There is absolutely no evidence that there is a progressive concentration of capital in the United States. In fact, all the available evidence points in the opposite direction. Unfortunately, too much of the increasing savings have gone into forms that are hard hit by the inflationary policies of our national government.

There are two lesser points that should also be mentioned. First, the authors consider depreciation, amortization and depletion, along with withheld earnings, as "internally generated funds" which contribute "today almost three-fourths of new capital formation." Such funds are merely a replacement of capital consumed in production. While they may represent a demand for new capital goods, they are not an increase in capital, but merely a maintenance of prior capital accumulations.

Second, the book makes no mention of the effects of inflation on corporate earnings as figured by tax authorities, in general, a part of what is considered "taxable profits" is in fact only illusory profits. Under the tax laws, taxpayers are allowed to amortize or depreciate only the original costs and not the eventual replacement costs. Thus, when inflation increases the dollar costs for replacements, the government is actually taxing as a profit what is in fact a loss, or technically a consumption or depletion of previously accumulated capital assets. So the authors actually consider the mere replacement of such consumed capital as further evidence of their imagined concentration of the ownership of capital.

III. Savings are not required for capital accumulation.

This is one of the most idiotic ideas on which the entire book is based. The authors bluntly assume that capital can be created from scratch and without any abstinence by the application of the future earnings from capital created by the mere bookkeeping addition of sums to bank deposits. The only basis furnished for such illogical reasoning is a study that Harold G. Moulton made some thirty years ago. That study indicated that historically capital accumulations have on certain occasions increased most rapidly during periods of "high-level consumption."

Dr. Moulton made this study for Brookings Institution early in the New Deal. It was part of a four volume series in which each succeeding volume pyramided its own fallacies on top of those of the preceding volumes. However, Dr. Moulton and his Brookings associates, including Dr. Edwin G. Nourse, later, 1946-49, Chairman of President Truman's Council of Economic Advisors, are not to blame for the extreme interpretation placed on their findings by the authors of the book under review. In boom times, particularly those induced by expansion of bank credit, there are more dollars for both consumption and investment.

The fact remains: all capital accumulation must be the result of savings on the part of someone. Capital can only be amassed by abstaining from consuming all that is produced and available. Before goods can exist, they must be produced. Those who consume all that they produce have no savings or capital. Those who consume less than they produce have some savings. These savings are their capital. It is as simple as that.

Unfortunately, the authors of this book have been fooled, as have many others, by the illusion that the granting of bank loans by bookkeeping processes is a wealth creating process. This illusion will be dealt with under VI. Here, it is sufficient to state that physical capital goods, the only kind that can be used in production, can not be created by accounting manipulations. Capital accumulation requires abstinence on the part of the owners of wealth. They must first live on less wealth than they, their ancestors or other benefactors have produced.

In the market economy, people are paid in money for their contributions to the market. When they do not spend all their money income for consumption of goods and services, there must remain in the economy a portion of their contribution to society which is available as capital. They can use that capital themselves or transfer title to it by lending or investing that part of their money income. When one lends his savings, he merely transfers title temporarily to existing wealth.

This, of course, assumes no theft or manipulation of the money supply such as the authors of this book endorse when they propose making their proposed capital-creating bank loans redeemable in newly created Federal Reserve Notes. When one borrows or spends artificially created bank credit, one merely exercises a claim on previously existing wealth---wealth which in a free and moral society would be allocated to someone spending funds that were received in return for a contribution to society.

Capital cannot be created out of thin air or by the bookkeeping opening of a bank credit. The authors believe that capital can be so created. All that they ask is that the bank borrower pay an insurance premium to a government agency which will insure the bank against any entrepreneurial error by the user of such accounting-created-capital. They expect that such accounting created capital will earn sufficient profits and interest to pay off the original loan with interest. This is pure nonsense. Yet the entire plan of the book is based on it.

IV. No real shortage of labor and resources exist in Western nations.

If this were so, there would be no economic problem. A prime factor of life here on earth is that the things men want and can produce are in short supply. Where they are not in short supply they are free goods and there is no economic problem.

The top shortage is labor. As mentioned under number I, many resources are not fully developed to the extent of present technological knowledge because there is a shortage of labor. The usual expression is that labor costs would be too high, or that it would be uneconomic or simply that it would not pay. All of which means that there are better uses available for the labor on hand. Unfortunately, governments are not always guided by such economic logic. The present development of atomic power for peaceful uses is still uneconomic. The labor and capital so consumed could produce higher values if there were no government interference with market processes. This is true of almost every government activity except those of defense and the peaceful settlement of disputes. If this were not so, men would find it profitable to undertake such activities in a free market.

Nothing can have value in the market place unless the supply is less than the demand for it as a means for satisfying some human need or want.

It goes without saying that there are many resources around the world that men could and would exploit if governments did not hinder or prohibit such exploitation. However, there is a real shortage of labor and resources in the form that men find them useful and there always will be.

V. Government redistribution of income is now necessary.

The only justification for such a belief is that of Marx and Engels in the Communist Manifesto, where they state that every government intervention makes matters worse and creates a demand for further intervention until the point is reached where the whole capitalistic system is overthrown and replaced by a dictatorship of the proletariat.

A good argument might be made that because government spending, taxing and inflation policies have destroyed considerable private savings and potential private savings the government now has an obligation to those it has impoverished. However, that is not the argument of the book. The authors imply that all present deplorable conditions are the natural result of a free and unhampered capitalistic system which must be reformed by governmental action. They thus offer their plan for the political creation of capital with the promise that Congress will vote to give every person his fair share of the capital created by bank loans. The owners of such capital will then somehow be entitled to receive 90 percent or more of all production.

It is true, of course, that there are people in this country who are in need of financial help. That this number is now large is due primarily to political interferences with the operations of a free market as well as uneconomic fiscal and monetary policies. However, it is still likely that private charity could and would take care of all cases of real need, particularly if political restraints on employment were lifted.

Present day political programs only serve to encourage and sustain poverty and unemployment by dampening the spirit and ability of people to find self supporting jobs where they could contribute to society as they improve their own lot in life. Present programs lead people to believe that they are entitled to a living without any contribution on their part. In fact, they are even encouraged to think they are contributing when they are living on and distributing largesse obtained through taxes collected from the more successful citizens. The illusion that the burden of such taxes fall entirely on the well-to-do is encouraged at every opportunity. It is popularly considered a form of economic justice. Actually, as explained previously, the market allocates the tax burden on every citizen of the land, even those with the least to spend.

This book encourages the popular fallacy that only a few own capital and if the government did not intervene, these few would receive 90 percent of the nation's production. This is pure nonsense. Market processes, if left free from government interferences, allocate all production to those responsible for its production. Everyone is then free to choose the most attractive opportunity open to him. Every worker is assured of the market value of his wages before those advancing his wages can get back a cent. The market processes thus see to it that the capitalists are the last to receive any of the gains from their contribution. This book encourages its readers to think otherwise. They declare that every person is entitled to become owners of capital without any contribution or sacrifice on their part, except for the

payment of a small insurance fee to a government agency. Their plan is a plan for the redistribution of 90 percent of total production. It would rapidly reduce total wealth to the point where many would starve. They simply do not understand that every honest and moral person would attain his maximum possible income in a free and unhampered market economy.

VI. Bank credit can create wealth.

It would take a volume to present fully the monetary explanation of the trade cycle as expounded by Ludwig von Mises. However, Mises has clearly demonstrated that modern recession and depression problems are basically the result of political attempts to stimulate economic activity by the expansion of the money supply through the creation of circulating bank credit. Should the holders of such bank credit desire to convert their artificially created bank accounts into cash, the central banks, in our case the Federal Reserve Banks, are empowered to print legal tender paper money against evidences of debt owed to banks. In the United States, such printed money is in the form of Federal Reserve Notes.

The authors of this book would extend this disastrous principle still further. They propose the printing and issuance of Federal Reserve Notes against bank loans with no security except government insurance and the hope that the sum created will be put to work as capital in such a way that it will before too long repay the loan with interest. They blithely assume that such government insurance can be sold for a mere trifle just as the National Government now insures mortgages on real property.

Actually, banks perform a useful social function when they operate as middlemen between savers who want to lend money and borrowers who need and want funds they expect to be able to repay with interest at the maturity of the loan. Such loans are merely temporary transfers of monetary savings (purchasing power) from one person to another. They do not increase the available amount of spendable money in the economy. What the borrower can now spend, the lender can no longer spend. Such voluntary loans help all parties concerned, whether made through a bank or not.

However, when a bank makes a loan merely by adding the sum to the checking account of the borrower, it is not transferring to the borrower the title to someone's actual monetary savings (purchasing power). The bank is merely adding this sum to the available amount of spendable money in the economy. This addition to the money supply empowers the borrower to go out and buy something, leaving less available for all previous owners of money. Thus, those who have obtained their money in payment for their contributions to society find that they cannot buy as much as they could have bought if the bank had not issued an artificially created claim to its borrower. Such bank loans merely transfer a part of the existing wealth from those who helped create it to the borrower from the bank. Such bank loans add no wealth to that previously existing. They merely transfer titles to existing wealth at the expense of all those who have earned or saved their dollars which will now buy less.

Needless to say, such expansions of bank credit cannot create any useful capital goods. All that such bank credit, as these authors propose and endorse, can do is to transfer ownership of existing capital goods from their rightful owners to those receiving the proceeds of the bank loan. It is done by a process that probably not one in a million can detect, for each loan reduces each person's purchasing power only infinitesimally. However, over a period of time such loans have a tremendous effect. Any expansion on the scale proposed by these authors would quickly depreciate the already shaky value of the dollar.

The authors propose that their plan will make everyone a capitalist merely by the creation of such bank credits. They believe that future earnings from the capital so created will pay off the loans with interest and that thereafter the borrowers will be entitled to all further earnings for evermore. Such income is then supposed to make it possible to sustain millions without any further effort on their part.

Such a program is absolute nonsense. It could not work once people realized what it meant. It would certainly not encourage an increase in real savings, the only kind businessmen can use. The greatest incentive for the increase of capital is for people to believe that their savings are safe from either direct or indirect confiscation. The scheme proposed is an indirect confiscation of the wealth of others. It could not and would not increase wealth in any useful form. It would merely dilute titles to existing wealth until the point was reached when people no longer found it profitable to invest their savings in capitalistic production. They would then put their savings in gems, jewelry and precious metals that they could hide and quickly move should the authorities become too nosy.

VII. Proposals provide for a free society.

The first fifty or more pages of the book make no mention of the government controls involved. However, starting on about page 55, such controls are mentioned on almost every succeeding page. In short, the scheme provides that a governmental agency would insure all lending banks against all future human errors of their borrowers in investing their loans so they can be repaid by earnings without any further claim on the sum lent or what was bought with the sum so lent. A government agency would thus be forced to determine all future investments as well as the amounts banks might lend for the purpose of creating capitalists out of bank borrowers. By such a fantastic scheme of government controls of the very life-blood of business we would "start the process of industrialization without resort to past savings." (Pg. 55)

To get the plan started, they would force present corporations to pay out all earnings in dividends. To keep it going and put an end to uncontrolled investments, they would enact inheritance taxes which equalize the dividend income of the entire population, or so they think. They would prohibit those owning a certain amount of income from capital from working and thus competing for jobs. The government could control all monopolies by shutting off capital and creating competitors. The government would, of course, prevent all malinvestment.

"Each loan would be made in accordance with policies established by Congress and administered by the Federal Reserve System" or some other agency "as Congress might determine." (Pg. 61) If the politicians would decide which industries and which managements could have capital, pray tell where would any free enterprise exist??

On page 75 we learn that the government would impose "high standards for demonstrating feasibility of new enterprises or new expansions before their securities could qualify for CDIC-insured loans." Shades of Thomas A. Edison !!! Could he have gotten the capital for his inventions?

On page 69 we learn that American political history has been characterized by changes "required to increase its efficiency in the face of its large-scale tasks by eliminating much of its original decentralization." Shades of Adolf Hitler!!!

They do admit, "there is no doubt that government would exercise considerable power." However, they do not admit that it would exercise totalitarian power over the access to capital, without which no business could even exist. If men were not free in the economic realm, they would soon find that they had lost all that freedom had ever meant. Who could print books and papers? Those the politicians selected and allocated the needed capital. Who could build churches and schools? Those the politicians selected and allocated the needed capital. Who could work? Those the politicians decided were eligible.

One could go on and on but the reader who has read this far should easily see that it is merely another scheme for milking those who have produced, saved and invested wealth for the benefit of those who will keep the politicians in office. The book's authors would make everybody a capitalist by giving them a share of the wealth already produced by others.

If such a scheme were ever attempted, capital accumulation, the source of the ever higher American standard of living, would soon dry up. Men do not save and invest when they know their savings will be despoiled or confiscated. Workers and consumers alike are heavily indebted to those who have saved in the past. Without such additions to capital by every succeeding generation, our standard of living would have stood still. If the capital so carefully accumulated over the decades should be dissipated by any such illogical wild scheme as this proposal, Americans would be compelled to return to the living standard of the Indians. Our population would also have to shrink to that of a century or more ago.

THE PRECEDING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

K-40 MRS. 107

WARNING

A person who signs a name other than his own on the petition, or who knowingly signs his name more than once for the same proposition at one election or who signs the petition knowing he or she is not a qualified voter, upon conviction is punishable by a fine of not more than \$1,000 or by imprisonment for not more than one year, or by both. (AS 15.45.100)

SUMMARY OF THE INITIATIVE

The proposed law will create a new private corporation, the Alaska General Stock Ownership Corporation (AGSOC), owned by Alaskans. AGSOC will invest in major projects within the state. It is required to distribute annually to its shareholders at least ninety percent of its income. The law creates a fund not to exceed \$5 million subject to legislative appropriation to guarantee loans to AGSOC for startup expenses, but provides no other state support for the corporation.

One share of AGSOC stock will be distributed free of charge to each Alaskan who is a resident at the time of the law's effective date. Only individual Alaskans may own AGSOC shares, and no one may own more than ten shares. The public must be notified of stock availability, and residents may elect not to receive stock. Residents have one year in which to receive a share without charge and an additional year during which they may purchase their share at book value. The stock may not be sold for five years unless the shareholder permanently leaves the state, in which case he must sell his stock to the AGSOC at book value.

Each share of stock may be voted at annual shareholder meetings with one-third required for a quorum. A corporate ballot and shareholder pamphlet will be prepared by the AGSOC, under regulations insuring fairness, and mailed to each shareholder. Shareholders vote their ballot by mail. Shareholders may (1) amend the bylaws and articles of the AGSOC, (2) nominate directors and place issues on the ballot by petition, (3) remove the entire board or any director at any time, (4) sue to remove a director for fraud or abuse of authority and, (5) in limited circumstances sue on behalf of the AGSOC.

AGSOC will be organized by three people appointed one each by the Governor, Speaker of the Alaska House of Representatives, and President of the Alaska Senate. These three people will select nine people as the original board of directors, subject to disapproval by two of the three state officials named above. The directors form the governing board of AGSOC. The initial appointed directors serve only until the first shareholders meeting, when they must stand for election. The organizational documents of the AGSOC must be submitted to the legislature, which may disapprove any provision. Legislative disapproval may be overridden by a shareholder vote.

The directors have management responsibility for AGSOC. The chairman and at least three-fourths of the nine member board must be Alaskans. Members will serve for two years with half the board elected each year. Officers of the AGSOC are appointed by the board which also defines their duties.

AGSOC may not endorse political candidates or ballot issues nor lobby the legislature. The legislature may amend the AGSOC law so long as the creditors of AGSOC are protected. Carried over substantially intact from existing Alaska law are provisions regarding sales of assets, dissolution of AGSOC, restatement of articles, annual reports, filing fees, procedural provisions, and regulatory authority of the Commissioner of Commerce.

IT'S TIME TO TAKE STOCK IN ALASKA

ALASKA GENERAL STOCK OWNERSHIP CORPORATION



**Everything You Always
Wanted To Know
About AGSOC...***

***...But Were Afraid To Ask.**

1. Q. What is AGSOC?

A. AGSOC stands for "Alaska General Stock Ownership Corporation." It would be a private owning and operating enterprise in Alaska. Every resident of Alaska as of the date of incorporation would be given a share of stock in the AGSOC, and its profits would be distributed to them as dividends.

2. Q. Does AGSOC exist now?

A. No. It must be created through law by the State Legislature or by popular vote.

3. Q. Why should we create an AGSOC?

A. There are five main benefits:

A) AGSOC gives all Alaskans a second income. This second income derives from production and development in the state. So:

B) It helps promote economic activity in Alaska. And just as important:

C) It keeps the profits from that activity in Alaska, rather than enriching outside companies. Also:

D) It puts the profit directly into the hands of Alaskans, without passing it through the state government and its costly bureaucracy. And:

E) It can give a preference for local hire, despite recent court decisions, by establishing a corporation policy to hire shareholders first.

AGSOC gives Alaskans a real stake in the free enterprise system because it allows them to participate in that system, as owners of capital.

4. Q. How does AGSOC work?

A. There are six steps:

A) AGSOC is created by the State.

B) Each resident of the state on the date of incorporation gets one share in AGSOC. There is no cost to get the share.

C) AGSOC management looks for sound investments in Alaska.

D) Having decided on an investment, AGSOC borrows money and makes the investment.

E) AGSOC operates the enterprise it has invested in, and this produces earnings for the AGSOC.

F) The earnings are used to pay off the loan and to pay dividends to shareholders.

5. Q. What kinds of investment would AGSOC make?

A. AGSOC would probably look for large and relatively low-risk projects. One possibility would be to purchase a part ownership of the trans-Alaska pipeline, which would produce earnings immediately. Other energy or resource projects, communications, or similar large industries would be appropriate for AGSOC investment.

6. Q. How do we know this will work?

A. It has the same chance, or better, as any sizable corporation dealing in sound investments. In fact, it has an extra safety value—since it will operate entirely with borrowed money, it will benefit from the judgment of the lenders as to the soundness of its investments.

7. Q. How much will shareholders get?

A. That depends on how much is invested and on the rate of return from each investment. As an example, AGSOC could purchase British Petroleum's share of TAPS. Last year, B.P.'s pre-tax profit from TAPS was \$127.2 million. Divided among 405,000 Alaskans, that would come to \$314 per person (\$1,256 per family of four). This is an indication of the kind of opportunities that are available, although it should not be taken as a precise indication of what an AGSOC share would earn. Generally, AGSOC would aim at a 20 percent annual return on investment, as other corporations do. The more AGSOC invested, assuming sound investment, the more each share would eventually earn.

8. Q. Isn't this something for nothing, like a government handout?

A. No, it isn't. What the AGSOC does is use a credit device, debt financing, to acquire capital tools to produce wealth. It's the capital tool itself that produces the wealth to pay for its cost. When that debt is satisfied or being satisfied the balance of the money, the profit, goes to the owner of the capital tool. This plan is to spread out the ownership of new productive wealth to more people, without taking one dime from the rich to give to the poor. The gift, and there is one, is from the genius of man in developing productive technology in our industrial society.

9. **Q.** If an investment turns sour, what liability do Alaskans have?
A. The individual shareho'ler has no liability. That's an important reason for forming any corporation.
10. **Q.** Why would anybody lend money to the AGSOC if the shareholders are not responsible for the debt?
A. Because the loan is made on the strength of the productive investments. This is not unlike the mortgage on a building. The loan is made on the value and productive capacity, rental income, of the building. Often they are 100% financed.
11. **Q.** Has anybody tried this before?
A. Not exactly. People have formed corporations before, of course. But this is a new idea for a state to form a private corporation on behalf of its citizens. It is made possible by a federal tax law written by Senator Mike Gravel and passed by Congress last year.
12. **Q.** Isn't this like socialism?
A. Not at all—in fact, just the opposite. AGSOC would be a private corporation owned by private individuals, like General Motors or U.S. Steel or any other large American corporation. Under Socialism, corporations like these are run by the government. Socialism is a concentration of power by the state. AGSOC would operate completely independently of the state, just like U.S. corporations that are involved in Alaska or the rest of the country today.
13. **Q.** But doesn't the state set up AGSOC?
A. Yes. But it's like the Alaska Native Regional Corporations. They were set up by the government. All of Alaska's natives were named by the government as shareholders. But then the corporations embarked on their own independent courses. They're not run by the government—they're private companies, a part of the normal free enterprise system. AGSOC would be the same: created by the State, but then cut loose to operate independently in the private market.
14. **Q.** But wouldn't there be a conflict of interests? The same people who would be voting in Alaska on state policy would be owners of the AGSOC?
A. Yes, there would be a conflict. It is a conflict which already exists between private enterprise and the State. And it already affects individual Alaskans like those who own Native Corporation stock, or those who own General Motors or Alaska Airlines stock or any other stock in corporations operating in Alaska who also vote on State policy. When all Alaskans see that they have a stake in the private market, through their ownership of AGSOC stock, they will probably consider much more thoughtfully the implications of state regulation and other state policies toward private business. So yes, this conflict will exist—just as it already exists. And that will be good, because it will give a stronger constituency to the needs of private enterprise, and it will make for better considered state policies.
15. **Q.** Since the AGSOC is statewide, won't a position on the board of directors be used as a stepping stone to higher political office?
A. No more so than other positions like the head of a statewide bank, an owner of hotels or the president of a statewide communications company. The test of those positions and that of being an AGSOC board member is success, competence and skill. There's nothing wrong with proving one's self in that manner. It's the best criteria for political and private leadership.

AGSOC: OPERATION AND SUPERVISION

16. **Q.** Would AGSOC get money from the state?
A. No. AGSOC would get a relatively small loan guarantee from the state for start-up costs, probably about \$5 million. But there would not be a transfer of money to AGSOC like there was under the Native Claims Settlement Act.
17. **Q.** Where does AGSOC get its money?
A. AGSOC would borrow money to make its investments in Alaskan enterprises. This would be done by

selling bonds, the same way other corporations do. The bonds would be purchased by traditional large lenders like banks and insurance companies.

18. Q. Why would they be willing to lend to AGSOC?

A. *Mostly on the strength of the investment to be made. An investment in the Trans-Alaskan pipeline, for example, would be looked at as a secure investment. In the first years, state guarantees of AGSOC loans might be desirable. Eventually the overall financial strength of the AGSOC would also help secure its borrowing.*

19. Q. Who would be running AGSOC?

A. *It would be run by a regular management team: President, Vice-presidents in charge of various areas, investment specialists and so on. The management would be accountable to the Board of Directors, and the Directors would be accountable to the shareholders (Alaska residents).*

20. Q. Who appoints the directors?

A. *At first, the nine directors would be appointed by a board which was selected by the Governor, the President of the State Senate and the Speaker of the State House of Representatives. But this appointed Board of Directors would stand for election by the shareholders at AGSOC's first annual meeting. And all directors would subsequently be elected by shareholders. The directors' terms would be staggered so that three seats would be up for election each year. The important point is that the directors are elected by the shareholders. The directors can be challenged and removed from the board by vote of the shareholders. This is the same as other corporations.*

21. Q. What's to keep the directors or the management from making a killing on the money they handle?

A. *The same laws which protect shareholders in other corporations: securities laws as well as state and federal laws on fraud, embezzlement, mismanagement and so on. In addition, the AGSOC cannot have retained earnings to reinvest or manipulate. All the money that comes in must be paid out by serving debt and paying dividends to shareholders except a small percentage of up to 10% to be used for paying the cost of operating the corporation.*

22. Q. Who monitors AGSOC?

A. *Again like other corporations: the Securities and Exchange Commission, the IRS, the State's Department of Commerce and most important, the shareholders themselves. In addition, several committees of the Congress will have a special interest in AGSOC.*

23. Q. Who decides what investments AGSOC will make?

A. *The management, subject to the approval of the Board of Directors, and ultimately a majority of the shareholders.*

24. Q. Who hires AGSOC's staff?

A. *The Board of Directors would appoint the corporation's officers, the officers would be responsible for hiring the rest of the AGSOC staff.*

25. Q. How big would AGSOC's staff be?

A. *AGSOC's start-up staff is estimated at about 25, from officers to secretaries. The number of AGSOC employees eventually depends on AGSOC's investments.*

26. Q. What would AGSOC's budget be?

A. *The budget for running AGSOC during the start-up period, 18 months to two years, has been estimated very roughly at about \$5 million.*

27. Q. What controls do Alaskans have over AGSOC?

A. *As shareholders, they control the corporation. They elect the Board of Directors, and they can remove a director by vote at any time. At annual meetings, shareholders can place issues and candidates on the corporation ballot. They can vote to dissolve the corporation. Individual shareholders can sue the directors on behalf of the corporation. A majority of the Board of Directors must always be Alaskans.*

28. **Q.** What kind of reports will AGSOC make to the people?
A. An annual report will go to each shareholder, detailing the operations and financial situation of the AGSOC. Semi-annual or quarterly reports will also be issued.
29. **Q.** Will AGSOC financial records be available to the public?
A. Yes.
30. **Q.** What controls do the Governor and the legislature have over AGSOC?
A. The same control they have over all other corporations chartered in Alaska.

AGSOC STOCK OWNERSHIP

31. **Q.** Who is qualified to own AGSOC stock?
A. Only residents of Alaska.
32. **Q.** Who is going to be given shares of AGSOC stock?
A. All those who are residents of Alaska as of a date set by law—in the case of the initiative petition, all those who are residents on the day 60 days after passage of the proposition.
33. **Q.** What if an AGSOC shareholder moves out of Alaska?
A. He or she must sell the stock to the AGSOC. The price of the stock would be set according to the book value of the AGSOC, as determined by independent accountants for the first five years.
34. **Q.** What about people who move into the state (or who are born) after AGSOC is formed?
A. They can buy the stock, or it can be bought for them, as it becomes available from AGSOC—first come, first-served. The price, again, would be based on book value. After five years, a market would probably develop in Alaska for the stock and people would be free to sell or buy as long as they are Alaskans. To take care of new births and new residents, additional AGSOC's could be formed or with a change in federal law, different classes of stock could be issued for different time frames or different investment portfolios.
35. **Q.** What about share-holders who die?
A. They can will their AGSOC stock to a qualified Alaskan, or it will be purchased at book value by the corporation for the first five years. Later, it could be sold for fair market value by the shareholders' estate to any Alaskan.
36. **Q.** How many shares can one person own?
A. No more than ten.
37. **Q.** How often will dividends be paid?
A. At least yearly.
38. **Q.** Will dividends be taxed?
A. Yes, like any other personal income.
39. **Q.** Can an AGSOC shareholder sell his stock?
A. During the first five years, it can be sold only to the AGSOC itself, at book value. After five years, the stock can be sold to any Alaskan so long as he doesn't end up with more than ten shares.
40. **Q.** What about minors?
A. A parent cannot sell his child's stock. Only the child can sell his or her stock upon reaching majority assuming the first five years have elapsed. Until majority, the dividends are paid to the parents.

AGSOC HISTORY

41. **Q.** Where did the idea of AGSOC get started?

A. You could say it started with Adam Smith, since his name and his *Wealth of Nations*, published in 1776, is often associated with the beginnings of a theory of the modern free-enterprise system. More to the point, though, it grew out of the nation's recent success with ESOPs (Employee Stock Ownership Plans). And it was made possible in 1978 when Congress adopted an amendment to the tax code outlined by Senator Mike Gravel.

42. Q. What is ESOP?

A. ESOP is a tax-assisted means for employees to buy the company they work for. In the words of ESOP organizer Louis Kelso, it's a way to "take everyone a capitalist." If the employees of a company also own the company, they have a bigger stake in how well the company performs. They get the rewards (i.e., the profits) when the company performs well, and they have a real stake in the free enterprise system. Many companies in Alaska are ESOPs now, including Yukon Office Supply, the Fairbanks Daily News-Miner, Alaska Northwest Publishing and Alaska Bank of the North.

43 Q. How would AGSOC be like ESOPs?

A. First, AGSOC has the same purpose: to make more people the owners of capital. As shareholders of AGSOC, each Alaskan would be part owner of a capital instrument, a corporation, that produces a profit for its owners. The ownership of capital is what constitutes wealth, because capital is what produces an income. So the main purpose of AGSOC, like that of ESOPs, is to gradually spread America's wealth among all the people.

Second, AGSOC is given tax assistance, as ESOPs are, in order to help achieve that goal.

44. Q. What kind of tax assistance does AGSOC get?

A. It does not pay corporation tax. It can therefore use all its earnings to pay back its lenders and to pay dividends to its shareholders, without having to pay the government first. Other corporations usually face taxes of about 45 percent.

45. Q. Why should AGSOC get special tax treatment?

A. Because the goal of spreading capital ownership is worth it. AGSOC will operate even more than most corporations on borrowed funds. The exemption from corporate tax is what makes it possible for AGSOC to pay its lenders and pay dividends at the same time.

46. Q. Does the shareholder pay tax on his dividend income?

A. Yes, it would be part of his or her personal income and would be taxed the same as other personal income.

47. Q. Isn't wealth already pretty well spread among Americans?

A. No. The income we earn for our work is spread more equally, but wealth, which is ownership of capital, is not. About 5 percent of Americans own some 50 percent of the nation's wealth. In fact, only 1 percent own about 25 percent of the wealth. And that has been the case since the beginning of this century. Without a deliberate effort to spread new wealth more fairly, it will remain concentrated in this way.

48. Q. Is AGSOC taking money away from somebody to "spread capital ownership"?

A. No. AGSOC would be a new corporation. Its profits would represent newly-created wealth, just as any corporation creates wealth through its successful enterprises. It's this newly-created wealth that is being distributed more fairly among a larger number of people by means of AGSOC and other general stock ownership corporations.

49. Q. Is this the same as Governor Hammond's Alaska Inc.?

A. No. Under Alaska Inc., the state would be in charge. It would decide how to distribute the wealth that was produced from Alaska's resources. Some of this money would inevitably be "creamed off" to pay for a growing state bureaucracy. AGSOC, on the other hand, is separate from the state. All its profits would go directly to its Alaskan shareholders.

50. Q. I'm confused as to who owns this wealth of Alaska now.

A. The Alaska state government owns the oil, gas and minerals. They are leased to permit these exploitations. The state receives royalties and taxes. That is the wealth that Hammond's Alaska Inc. would distribute.

The taxes that exploit Alaska's resources like pipelines, refineries and communications systems, are generally owned by large outside companies. Gravel's AGSOC is a device to acquire ownership of some of those tools for Alaskans so that the profit from the productive capability of those tools will go to Alaskans. In other words, its getting hold of wealth we don't already have as opposed to passing out the wealth in the state treasury.

51. Q. If AGSOC is such a good idea, why aren't other states starting their own general stock ownership corporations?

A. *Other states are looking into GSOPs, just as Alaska is. But Alaska has many unusual advantages: investment possibilities that appear well-suited to AGSOC, a small population, the experience of a somewhat similar enterprise in the regional Native corporations and the fact that an Alaskan Senator, Mike Gravel, thought up the whole idea.*

52. Q. Does Senator Gravel stand to benefit financially if AGSOC passes?

A. *He and his family stand to get one share each in AGSOC just like other Alaskans.*

THE PETITION

53. Q. What does this petition do?

A. *It requires the state to submit to the voters the question of whether AGSOC should be formed. The question would be put on the November, 1980, ballot. If AGSOC were created by the legislature next year, the question would not be put on the ballot.*

54. Q. Why is the petition needed?

A. *There's a limited time during which AGSOC can be formed, under the tax amendment passed by Congress last year. Alaska has until 1983. The state Legislature failed to pass AGSOC legislation during the 1979 session, although a bill was created. The petition ensures that Alaskans will have the opportunity to create AGSOC if they want to, even if the Legislature fails to create it or the Governor vetoes it.*

55. Q. If I sign the petition, do I have to vote for AGSOC?

A. *No. Signing the petition only means you're in favor of giving Alaskans the opportunity to decide for themselves about AGSOC.*

56. Q. Won't placing the issue on the ballot in 1980 discourage the legislature from action next session, passing the buck to the '80 elections?

A. *No, the legislature is sensitive to the decreasing time available to create an AGSOC. The House committee chaired by Representative Miller has done excellent work on a bill which will surely be brought to the full legislature.*

57. Q. Again, why do we need the petition?

A. *As a safety net—just in case. Also it's an educational device to inform all Alaskans on the proposition. Your signature, though not a vote, does show interest in the undertaking and serves to encourage the legislature.*

58. Q. Who supports the petition?

A. *Here are some legislators who have signed the petition. In the order they signed it: Jim Duncan (Juneau), Senator Bettye Fahrenkamp (Fairbanks), Senator Frank Ferguson (Kotzebue), Senator Mike Colletta (Anchorage), Senator Jalmar Kerttula (Palmer), Representative Oral Freeman (Ketchikan), Representative Al Osterback (Sand Point), Representative Dick Eliason (Sitka), Representative Leo P. Schaeffer (Kotzebue), Representative Vern Hurlbert (Sleetmute), Representative Terry Martin (Fairbanks), Representative Mike Belme (Anchorage), Representative Joe McKinnon (Anchorage), Representative Sally Smith (Fairbanks), Senator Clem Tillion (Hallbut Cove), Representative Pappy Moss (Delta Junction), Representative Fred Zharoff (Kodiak), Senator George Hohman (Bethel), Senator Bill Sumner (Anchorage), Representative Nels Anderson (Dillingham), Senator Terry Stimson (Anchorage), Representative Joyce Munson (Anchorage), Senator Pete Meland (Sitka).*

AGSOC
file

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C.

SAN FRANCISCO

LOS ANGELES

January 2, 1980

RECEIVED
JAN 07 1980
BUDGET/AUDIT
COMMITTEE

Hon. James Duncan
Chairman
Legislative Budget and
Audit Committee
State of Alaska
Pouch V
Juneau, Alaska 99811

Report 4
AGSOC Study

Dear Jim:

In this report we will update our report on TAPS, summarize our research into the potential of AGSOC engaging in the leasing business and report on the results of our research into other potential AGSOC investments.

TAPS

During this past month we have reviewed the past year's performance of TAPS and the current status of the FERC hearings on TAPS rates. In addition, we have updated our files on the BP ownership interest in TAPS.

The FERC hearings are proceeding at a slow pace with current interim rates in effect at the operators' requested levels. However, there is still the possibility that carriers may have to refund revenues if permanent rates are set by FERC at a level lower than the current rates. It is expected that final rate determination will be made by mid 1980.

Although no new oil has been discovered and total proven reserves are still 9.1 billion barrels, expansion of TAPS capacity is under way. Current flow capacity has been raised to 1.36 million barrels per day (up from the initial capacity of 1.16 million barrels per day) and should reach 1.42 million barrels per day by the end of 1980. Most of the higher flow capacity has been achieved through use of a special chemical additive, without construction of new pump stations, although new pump stations are being completed.

To date, only Arco, Exxon, and BP are participating in the capital expansions and BP's share should increase to a 16.8% ownership of TAPS by the end of 1980. Other revenue and expense items are in line with past projections except for the high cost of the additive. However, profitable operations exist with the interim rates in effect.

Hon. James Duncan, Chairman
Legislative Budget and Audit Committee
State of Alaska
January 2, 1980
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LEASING

As we mentioned in our last report, leveraged leasing could offer some favorable tax advantages for AGSOC. Additionally, an AGSOC leasing program could stimulate many segments of the Alaskan economy which are currently restricted by lack of capital.

Although leasing is an alternative source of financing capital equipment, it offers advantages to both sides of the relationship. Both have some tax advantages, and although the leasing company assumes more risk, the lessee grants compensation for its diminished risk in higher rental payments.

There are many variables in the structure of a lease so that a single financial model would not cover all cases. However, for illustrative purposes, the following example shows the advantages to AGSOC:

Suppose a company were to lease a \$1,000,000 piece of equipment through AGSOC. If this equipment had a 20 year life, possible lease payments (under today's high interest rates) might be as high as \$175,000 per year or higher if a short term lease were executed. On the other hand, AGSOC's principal and interest payment could be under \$150,000 per year. Thus AGSOC could achieve a cash flow spread of at least 2-1/2% of the equipment value per year and under certain conditions this could be as much as 5%. However, the significant tax factors which would benefit AGSOC and its stockholders would be the investment tax credit and depreciation. In the first year of the investment, 10% of the value of the equipment could be claimed as a tax credit. Under the Federal legislation, Subchapter U to the Internal Revenue Code, this would be passed through directly to AGSOC's shareholders. The distribution of profits could be controlled by the depreciation schedule used so that up to the full value of the positive cash flow could be retained by AGSOC without tax penalty. This reserve could be used to offset future cash requirements or for new investment.

A major attractiveness of leasing for AGSOC is that it could borrow nearly 100% of the purchase price of certain investments. Our recent discussions with major banks, indicate that the banks would loan to AGSOC at favorable rates assuming a reasonable AGSOC capitalization. Additionally, for large investments, most institutions will provide necessary expertise in structuring the lease and managing the asset through the lease term.

Leasing is a competitive business. Initially, we investigated AGSOC leasing aircraft to Alaska Air Lines, for example. However, Alaska Air Lines has multiple proposals for such leases and at much more favorable rates than could be offered by AGSOC. The reasons for strong competition, especially in aircraft, are the favorable tax advantages (increasing for those in higher than 50% tax brackets) and high resale residual values for aircraft after the initial lease terms. Many lessors will therefore sacrifice short term cash flow for current tax benefits and long term profits. The best

Hon. James Duncan, Chairman
Legislative Budget and Audit Committee
State of Alaska
January 2, 1980
Page 3

opportunities for AGSOC would seem to be areas of leasing where lease competition is not so high, e.g., for leasing to start-up business ventures, and in other situations where financing sources are difficult to obtain.

We have reviewed the component parts of the Alaskan economy outlined in our October 2, report and have identified some possible areas where leasing opportunities may be found. We will summarize these findings here.

MOTEL AND HOTEL

We are currently reviewing opportunities in sale and leasebacks of hotel/motel sites and structures. This industry offers more favorable opportunities for AGSOC leasing since there are more favorable tax credits available in motel/hotel leasing than for other forms of commercial real estate.

FISHING

Currently, there are investment opportunities in Alaska for both processing vessels and on-shore processing plants. The vessels offer good opportunities since interim financing during construction would not be as big a handicap as construction of new plants. Leasing of fishing vessels, or sale and leasebacks of converted fishing vessels, also offer opportunities in the fishing industry. We are continuing to investigate these possibilities.

HARD ROCK MINERALS

There seems to be a potential for leasing mining equipment. We will investigate further.

OIL AND GAS

In gas pipeline construction, leasing opportunities exist in rolling stock used during construction. There also are opportunities for leasing drilling rigs or LNG storage tanks. The high value of storage tanks is attractive for an AGSOC investment.

PETROCHEMICALS

The development of a petrochemical industry using Alaskan resources has stimulated much interest in parts of Alaska. Construction financing is not an attractive leasing opportunity, but certain installed equipment may offer attractive opportunities.

AGRICULTURE

Agricultural equipment offers some lease opportunities although AGSOC might not want to compete in the financing for the leasing of relatively low value equipment.

Hon. James Duncan, Chairman
Legislative Budget and Audit Committee
State of Alaska
January 2, 1980
Page 4

ELECTRIC POWER

Potential for the leasing of prefabricated plants exists in Alaska. Major users of electric power or new hydroelectric plants may have financing difficulties. AGSOC may be able to lease a full plant to potential operators.

ALASKA RAILROAD

While we are studying the actual purchase of the ARR, there is also a potential lease opportunity in freight cars, locomotives and other equipment. As in the airline industry, rail car leasing is competitive with many players. We will analyze this further in our study of the Alaska Railroad.

TRANSPORTATION

We are currently investigating other surface transportation opportunities within which areas leasing potential is generally good.

FURTHER CANADIAN MOVES TO BROADEN OWNERSHIP OF INDUSTRY


The Federal Progressive Conservative Government of Canada has announced that if it is reelected in the forthcoming Federal election, it would offer five free shares in the \$3.3 billion integrated petroleum corporation, Petro-Canada, to every Canadian adult and to young Canadians upon their becoming eighteen years of age. Individuals and institutions in Canada would be permitted to purchase up to a maximum of 3% of Petro-Canada shares, but one-third of the equity would be retained by the Federal Government.

This is further evidence that Canada is moving in the direction of encouraging broad ownership of basic industry and resources by Canadians.

Very truly yours,

KELSO & CO. INCORPORATED

By



Louis O. Kelso
Chairman of the Board

Alaska State Legislature

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REPRESENTATIVE
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HAINES
JUNEAU-DOUGLAS
KLUKWAN
SEADWAY
CHAIRMAN
BUDGET & AUDIT COMMITTEE
MEMBER
FINANCE COMMITTEE

House of Representatives

MEMORANDUM

TO: ALL REPRESENTATIVES

FROM: Rep. Jim Duncan

SUBJECT: General Stock Ownership Corp.

DATE: March 6, 1979

Attached herewith is a copy of the General Stock Ownership Corporation bill summary for your reference.

I hope this helps you in your considerations for House Bill No. 240.

JD:jp
Attachment

ALASKA
GENERAL STOCK OWNERSHIP CORPORATION

BILL SUMMARY

Federal law requires state authorization of general stock ownership corporations receiving special tax treatment under Subchapter "U" of the Internal Revenue Code. The bill creates the Alaska General Stock Ownership Corporation (AGSOC). This corporation is a completely private for profit corporation which will operate under the Alaska Business Corporations Act to the extent consistent with the AGSOC act. The shares of the AGSOC will be owned and voted by the citizens of Alaska with each resident holding a share of stock.

The bill directs the Governor to appoint incorporators to form the AGSOC and sets forth the following:

- 1) Board membership limitations assuring Alaskan control;
- 2) Federal requirements for corporate articles;
- 3) Stock distribution to all Alaska residents;
- 4) Penalties for fraudulent acquisition of AGSOC stock.
- 5) One year statute of limitations on AGSOC challenges;
- 6) Financing for AGSOC startup costs; and,
- 7) Technical amendments required to Alaska statutes.

The corporation is designed to have as its shareholders existing Alaskan residents. Stock will be distributed to eligible individuals without cost. Investments by the AGSOC will be made through the use of borrowed funds and the earnings from those investments used to retire the loan and distribute dividends to the shareholders. Except for minor exemptions the AGSOC will be subject to the same rules as all other Alaska corporations.

DETAILED EXPLANATION

The bill creates a new Chapter 50, entitled "Alaska General Stock Ownership Corporation", within Title 10, the Corporations and Associations title, of Alaska Statutes. The act contains nine sections which may be summarized as follows:

Section 1 sets forth those areas where the AGSOC differs from a typical Alaska business corporation organized under Chapter 5 of Title 10. To the extent that these provisions do not conflict with the provisions of Chapter 5, the Alaska Business Corporations Act, Chapter 5 will apply;

Section 2 includes the corporation among those organizations eligible to receive secured loans from the Permanent Fund;

Section 3 allows the investment of surplus state funds in bonds of the AGSOC;

Section 4 exempts the AGSOC from registration under the Alaska securities laws while providing protection from fraud;

Section 5 creates a one year statute of limitations on suits brought to challenge legality of the AGSOC;

Section 6 makes the provisions regarding eligibility for stock ownership "nonseverable" in order to assure that if this fundamental section is found unconstitutional the entire law will be voided;

Section 7 makes fraud or misrepresentation in obtaining or selling shares of the AGSOC a Class C felony; and,

Sections 8 and 9 provide effective dates immediately following the Governor's signature for most of the legislation.

ANALYSIS: SECTION 1

Section 1 of the bill constitutes the primary legislative section. It creates a new chapter, Chapter 50, of the Alaska Statutes, Title 10, setting forth technical requirements for the Alaska General Stock Ownership Corporation. The Chapter is divided into nine sections dealing with creation of the AGSOC, federally required charter limitations, board of directors, notification of shareholders' eligibility, limitations on corporate liability, restrictions on application for shares, fraud penalties, corporate dividends and definitions. A section by section analysis of Chapter 50 follows.

50.010. ALASKA GENERAL STOCK OWNERSHIP CORPORATION CREATED.

This section directs the Governor to appoint nine people as the incorporators and initial board members of the Alaska General Stock Ownership Corporation. These nine people, a majority of whom must be Alaskans, will adopt corporate articles and by-laws and file with the state to create the corporation as required under the Alaska Business Corporations Act. The bill allows the appointment of some non-Alaskan directors to provide flexibility in obtaining special expertise.

The status of the general stock ownership corporation is made clear by this section. AGSOC is not and may not be considered to be an agency, instrumentality or political subdivision of the State of Alaska. This parallels the federal statute which provides that a GSOC shall be treated as a private corporation and not as a governmental unit. The section also clarifies AGSOC status in relation to other statutes by requiring that it comply with the provisions of Subchapter U of the Internal Revenue Code and the Alaska Business Corporations Act. To the extent that the AGSOC authorizing legislation is not inconsistent with Chapter 5 of Alaska Statutes Title 10, AGSOC will be subject to all the rules applicable to any other Alaska business corporation.

50.020. ARTICLES OF INCORPORATION.

Federal law requires certain charter provisions for general stock ownership corporations and these are set out as requirements for the articles of incorporation of the Alaska General Stock Ownership Corporation. Each of the subsections in .020 set forth a different requirement which must be included in the AGSOC articles.

Subsection 1 provides that the AGSOC may issue only one class of stock which impliedly must be voting common stock.

Subsection 2 provides that stock may be issued only to a certain class of individuals. The group to whom stock may be issued, a closed class of original issue shareholders, are those people who fulfill two tests:

- a) They were residents of Alaska, as defined by the definition Section .900, as of the effective date of the legislation which, under Section 8 of the bill, will be the day following the Governor's signing; and,
- b) They remain residents of Alaska until the shares are issued.

50.000 defines resident as a person who lives in Alaska and intends to remain here permanently. The definition allows for temporary travel or employment outside without loss of residency. If a dispute arises over residency all of the facts and circumstances indicative of permanent residency must be considered.

Subsection 3 provides that at least one share of stock must be issued to each eligible resident unless that person elects within one year not to receive the stock. The legislation contemplates issuance of shares to eligible individuals free of charge with corporate investments financed entirely with borrowed funds. The one year period allows shareholders who do not wish to receive stock for whatever reason to reject their share, but this election not to receive stock is irrevocable and once made may not be changed.

Subsection 4 provides for limitations on the transferrability of the stock so that shares may not be sold or used as security for a loan during the first five years unless the shareholder dies or moves out of the state. Shares may only be transferred to another Alaska resident and then only if that person would not own more than ten shares of AGSOC stock after the transfer. Corporations and other artificial persons may not be shareholders. Finally, in order to protect minors, shares may not be transferred until the shareholder reaches 18.

Subsection 5 provides that the corporation shall qualify as a general stock ownership corporation subject to the special tax provisions of Subchapter U of the Internal Revenue Code.

Subsection 6 provides for a limitation on investments which the corporation may purchase. The corporation may not invest in assets acquired by it or for its benefit through the power of eminent domain. This is not to imply that the AGSOC has the power of condemnation since that power may be exercised only by the government. The limitation is designed to prevent the AGSOC from acting in collusion with an agency or local government to acquire a going business from an unwilling seller. It is not intended to prevent the purchase at arm's length of a business where a portion of the seller's assets may have been acquired by condemnation. The AGSOC would not be prevented from investing in a project where some minor portion of the assets must be acquired through eminent domain if the State or local government determines that the exercise of its condemnation power is appropriate. Such a situation might occur should the AGSOC become involved in the construction of a major pipeline.

Subsection 7 provides the AGSOC with a right of first option to purchase, at a price not less than book value, any stock offered for sale during the first five years of the corporation. The terms and conditions for exercise of this right will be set forth in detail in the corporate bylaws and a notice of the restriction will appear on the stock certificates or receipts.

The five year period for the right of first option parallels the time during which shareholders are prohibited from selling their stock. Only a limited number of shares will become available for sale during this period of time and it is unlikely that an organized market for AGSOC stock will develop during this period. Discretion is left with the corporation to pay prices higher than book value for the stock, but it is likely that the directors will determine that book value is the appropriate price.

Since shareholders who become non-residents during the five year period of transfer restrictions may be able to sell their stock at a high price in an uncontrolled market emigration might be encouraged. The option by the corporation provides a controlled market during the transfer restriction period and allows time to structure the full public market which will develop after the transfer restrictions lapse.

50.030. BOARD OF DIRECTORS.

This section sets out the provisions for AGSOC directors which differ from those applicable under Alaska Statutes Title 10, Chapter 5. The nine incorporators serve as the original board of directors and are divided into three groups in accordance with AS 10.05.186, except that only one-third of the directors will stand for election at the first annual meeting, one-third at the second annual meeting and one-third at the third annual meeting. Thereafter each director will serve for a term of three years as provided in AS 10.05.186. None of the other provisions of the Alaska Business Corporations Act regarding directors are changed and the normal rules of Chapter 5 apply to the AGSOC.

50.040. NOTIFICATION OF ELIGIBLE SHAREHOLDERS.

Since stock is to be distributed free of charge all Alaska residents must be notified of its availability. This section sets out the minimum notice requirements of weekly broadcast and publication for at least three months before stock distribution and monthly broadcast and publication for eleven months after distribution. These are minimum requirements only and the board of directors may determine that the corporation should take other steps to identify and notify potential shareholders. The AGSOC might want to compile mailing lists from various sources to develop a list of potential shareholders while in the bush it might be appropriate for it to hire census personal to locate and identify eligible Alaskans.

50.050. CORPORATION NOT LIABLE TO SHAREHOLDERS.

This section makes it clear that although the AGSOC is required to take reasonable steps to notify potential shareholders of their right to stock the burden of applying for stock lies with the resident and the corporation is not liable for failure to notify or issue stock to a potential shareholder. If a resident makes application for stock after the distribution of one or more dividends he loses his right to those dividends and is entitled to receive only those dividends declared and paid after the date upon which his stock was issued to him.

50.060. LATE APPLICATION FOR SHARES.

The legislation provides that stock is to be issued to all qualifying residents and the corporation directed to use reasonable efforts to identify potential shareholders. The burden of application is upon the resident. Those residents who are identified or who identify themselves will have one year in which to elect not to receive stock. To protect against those eligible residents who are not identified and fail to identify themselves hoping to see how the corporation fares before applying for their stock, a final cutoff date is provided after which distributions of stock will be made only upon payment to the corporation of book value.

50.070. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER.

This section provides a civil right of action against individuals who obtain stock through fraud or misrepresentation and who sell stock on the same basis. It allows the stock to be voided, dividends to be recovered with interest and costs of the suit to be paid by the defendant.

50.080. DIVIDENDS OF THE CORPORATION.

Under the rules of the Alaska Business Corporations Act a corporation may pay dividends only out of earned surplus, the retained earnings of the corporation. Since the AGSOC is required by federal law to distribute 90% of its taxable income to its shareholders on an annual basis it may be necessary to distribute a dividend in excess of earned surplus. Such a situation can arise because accounting for tax purposes and for purposes of the corporation's books may not and are not required to be the same. For this reason an exception to the general rule of Chapter 5, Title 10, is required allowing the AGSOC to distribute dividends as required to meet the terms of Internal Revenue Code Subchapter U except where such distribution would cause the corporation to become bankrupt or when the corporation is already bankrupt. Bankruptcy in this situation means when the corporation is unable to meet its current obligations.

50.090. EXEMPTION FROM AS 10.05

This section exempts the AGSOC from the provisions of the Alaska Business Corporations Act which requires \$1,000 of paid in capital before operation of the corporation commences.

50.100. LOAN GUARANTEE FUND.

This section establishes a fund within the Department of Revenue which is to be used to guarantee loans to the AGSOC by private lenders. This fund is intended to provide security for private credit to be used by the AGSOC for its startup expenses such as the costs of stock issue and the investigation of potential investments.

50.300. DEFINITIONS.

This section defines the terms used in Chapter 50. Especially important is the definition of resident since that definition will determine who is eligible to receive AGSOC stock without charge.

KELSO & CO.

INCORPORATED

INVESTMENT BANKERS

GREENSBORO, N.C.

SAN FRANCISCO

LOS ANGELES

July 24, 1979

The Honorable Jim Duncan
Chairman
Legislative Budget & Audit
Committee
State of Alaska
State Capitol
Pouch WF
Juneau, Alaska 99811

SUBJECT: Modification of Our Proposal to the Budget & Audit Committee
of the State of Alaska dated June 12, 1979

Dear Mr. Chairman:

In conversations that have taken place between you and several of your colleagues and officers of this firm since our proposal letter to you of June 12, 1979, (the "Interim Work Proposal"), you have indicated to us that the budgetary funds available for interim work on the AGSOC project are of a smaller magnitude than those contemplated by our Interim Work Proposal; that the Budget & Audit Committee wishes to see the scope of our work limited to the three basic areas mentioned below, and that the Committee would like a more detailed description of the scope of work envisaged in each of these three specific areas. A reduction in our charges for the diminished scope of work would, of course, follow.

ALLOCATION OF SPECIFIC COST ESTIMATES TO SPECIFIC ITEMS IN THE WORK
PROJECT

In our Interim Work Proposal, at Pages 9 and 10, we stated:

"In our preliminary discussion of this proposal with members of the Alaskan Legislature and staff members on June 11-13, 1979, it was emphasized that it would be desirable for us to suggest separate fee amounts for each of the work items in the proposal. We think that this is not feasible because of the nature of the work proposed.

None of the tasks specified herein is a finitely-bounded work project. Rather, each is in the nature of bridge work to connect the primary work done so far with the more advanced status of the project that can be presented to the next session of the Alaska Legislature. It is momentum-maintaining work; it is work that advances necessary preparations to the launching of AGSOC if the

The Honorable Jim Duncan, Chairman
Legislative Budget & Audit Committee
State of Alaska
July 24, 1979
Page Two

pending legislation becomes law and by its very nature can save many times its cost in avoiding future AGSOC start-up delays."

On careful reexamination and discussion of this problem among the senior officers of our firm, we are still of the opinion that there is no way to identify particular steps in any of the areas of work proposed and to affix fee estimates to those steps. Rather, we propose controls in the nature of bi-weekly progress reports to the appropriate representative of the Alaska Legislature and its Budget & Audit Committee, with our commitment to respond to any suggested changes in direction or emphasis of the work, and, of course, implicitly the right of the Committee's representative to terminate our work on any payment date if it appears unsatisfactory.

We still believe these controls to be the only realistic ones that can be designed for the type of work involved. We could bill the Legislature retrospectively, following each bi-weekly report, but this would render the entire project excessively speculative, preventing our employing subcontractors or consultants, and placing burdens on our working capital which we are not prepared to assume.

We hope that the quality of our work under our previous contract has given the Legislature and the Budget & Audit Committee some measure of confidence in our integrity.

✓ ADDITIONAL DETAILS -- ANALYSIS, CATALOGING AND EVALUATION OF FINANCING SOURCES

The research under this category must be correlated to the research under the category of "DEVELOPMENT OF TYPES OF POTENTIAL INVESTMENT OPPORTUNITIES TO AGSOC". For each type of potential investment, we would expect to identify the potential financing sources, to evaluate the feasibility of success in obtaining financing, or portions of the financing, from each such source, and to analyze the implications of reliance upon such financing sources.

We would include within the scope of our analysis each potential financing source and our estimate of the limits of funding available from each source for each particular type of investment. Political and economic side-effects of the use of each particular financing source would be studied and the conclusions and relevant observations would be included in our report.

All known conventional sources, including banks, insurance companies, and other private suppliers, as well as all public sources, both within and without the State of Alaska would be studied. Each of these would be analyzed in the light of potentially available collateral or security or guarantee arrangements, and the effects upon interest costs would be estimated.

The Honorable Jim Duncan, Chairman
Legislative Budget & Audit Committee
State of Alaska
July 24, 1979
Page Three

Unless objected to by the Committee or its representative, we would explore the levels of resistance which might be encountered in seeking unprecedented sources for financing, such as arranging, through legislative changes if necessary, for the discount of AGSOC loan paper with the Federal Reserve Bank.

All tactical information developed in the course of these studies would be carefully cataloged for use by AGSOC at such time as it needs financing.

FURTHER DETAILS -- LAYING THE FOUNDATION FOR WORKING WITH THE 1980 FEDERAL CENSUS IN ORDER TO DEVELOP A STOCKHOLDER CONSTITUENCY DATA BASE

Because the printing of questionnaire forms for use in the 1980 United States census has already begun, this is an area of great urgency. Preliminary conversations with census officials indicate little precedent for enlarging the activities of census workers to include what will be basically State-oriented data. Nevertheless, a willingness to explore the administrative rulings and procedures necessary to enable the collection of data which would be vital to AGSOC in building its stockholder identification base has been evidenced. All relevant legislation, administrative regulations, and judicial precedents will of necessity be reviewed simultaneously with the carrying on of conferences both at the regional and national levels of the Bureau of the Census.

It is clear that the data for AGSOC purposes must be of a higher order than that required for census purposes, since a flow of funds and allocation of liabilities between AGSOC and its stockholder constituencies will be involved, whereas no such relationships arise out of the national census as such.

Only the initiation and diligent prosecution of this work can throw light on more of the details that will be encountered.

FURTHER DETAILS -- DEVELOPMENT OF TYPES OF POTENTIAL INVESTMENT OPPORTUNITIES FOR AGSOC

This work will involve not only an analysis of the Alaskan economy and its total range of potential investment opportunities, but interviews with those whose long involvement in the Alaskan economy has given them a familiarity with facets of the economic structure unique to them or beyond the range of imagination of the analyst lacking such particularized experience. Certainly numerous repositories of information bearing on identification of the types of potential investment opportunities for AGSOC exist throughout departments and agencies of the State Government, the Federal Government in Alaska, and State and private universities and research centers. We will undertake, to the extent that the time available permits, to ferret out every type of such investment opportunity and evaluate it in terms of its priority and its implications for the orderly economic development of Alaska.

The Honorable Jim Duncan, Chairman
Legislative Budget & Audit Committee
State of Alaska
July 24, 1979
Page Four

SPECIAL NOTE CONCERNING CONFERENCES WITH THE SECURITIES AND EXCHANGE COMMISSION

On Pages 8 and 9 of our Interim Work Proposal of June 12, 1979, we outlined our basis for believing that we should develop a working relationship for AGSOC with the Securities and Exchange Commission. The Committee proposes that this be one of the subjects eliminated from the presently proposed contract. In earlier discussions, someone mentioned the possibility that the Washington law firm of Wilmer, Cutler & Pickering might be employed, possibly by the Budget & Audit Committee, to discuss AGSOC with the Securities and Exchange Commission. That firm, because of its previous research on this subject for the Commissioner of the Department of Revenue, would, of course, be eminently qualified to negotiate the anticipated status of AGSOC's securities under the Federal securities laws.

We would like to reemphasize, however, that the theory of capitalism appears, for whatever reason, to be extremely difficult for lawyers and economists steeped in the conventional wisdom to totally master. We would, as a matter of precaution, rest easier if we participated, to whatever degree necessary, in such negotiations to make certain that the nature of AGSOC is fully understood by the representatives of the Securities and Exchange Commission. The decision on this, of course, lies with your Committee.

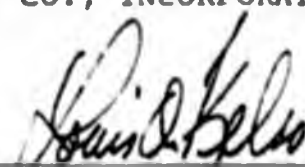
Since the scope of the work has been reduced, it is elementary that the overall fee should be reduced. To give us sufficient funding to enable us to make a significant contribution to foreshortening the time and work required upon passage of the AGSOC legislation before AGSOC can become an active force, we hope that the overall fee will not be reduced below \$150,000. If that funding were available, we would suggest that the payment pattern set forth in our original proposal of June 12, 1979, be modified -- both because of the reduction in the fee and the passage of time -- into a retainer of \$25,000 on the first day of August, 1979, and a like amount on the first day of each of the ensuing five months during the term of the contract.

Please do not hesitate to call the undersigned or Mr. John Miskimen of this firm should there be further questions.

Yours truly,

KELSO & CO., INCORPORATED

By



Louis O. Kelso, President and
Chief Executive Officer

LOK:cae

KELSO & CO.

INCORPORATED

INVESTMENT BANKERS

GREENSBORO, N.C.

SAN FRANCISCO

LOS ANGELES

June 19, 1979

The Honorable Jim Duncan, Chairman
Legislative Budget and Audit Committee
State of Alaska
Capitol Building
Pouch W F
Juneau, Alaska 99811

Dear Mr. Chairman:

RE: PROPOSAL TO UNDERTAKE AND EXECUTE SUPPLEMENTARY INTERIM WORK RELATING TO THE PROPOSED ALASKA GENERAL STOCK OWNERSHIP CORPORATION (THE CREATION OF WHICH IS THE SUBJECT OF S.B. NO. 170 AND H.B. NO. 240 IN THE STATE OF ALASKA ELEVENTH LEGISLATURE-- FIRST SESSION) RELATING TO SEEKING CONGRESSIONAL IMPROVEMENT OF THE TAX POSITION OF CITIZEN-STOCKHOLDERS OF AGSOC UNDER FEDERAL PERSONAL INCOME TAX LAWS; DESIGNING AND DEVELOPING A PROPOSED MANAGEMENT STRUCTURE AND MANAGEMENT PROCEDURES FOR AGSOC; SEEKING CLARIFICATION AND FAVORABLE TREATMENT OF THE ULTIMATE SECURITIES ACTIVITIES OF AGSOC BY THE SECURITIES AND EXCHANGE COMMISSION; EVALUATING FOR THE BUDGET AND AUDIT COMMITTEE OF THE HOUSE OF REPRESENTATIVES OF THE STATE OF ALASKA THE DESIRABILITY OF CONGRESSIONAL AMENDMENT OF SUBCHAPTER U OF THE INTERNAL REVENUE CODE SO AS TO PERMIT MULTIPLE CLASSES OF STOCK TO BE ISSUED BY A GENERAL STOCK OWNERSHIP CORPORATION IN ORDER PERIODICALLY TO EXTEND ITS STOCKHOLDER BENEFITS TO NEW CATEGORIES OF RESIDENTS, TO HAVE STOCK THAT WOULD BE ELIGIBLE FOR AN EMPLOYEE STOCK OWNERSHIP PLAN, AND IF A FAVORABLE DECISION THEREON RESULTS, UNDERTAKING TO PERSUADE CONGRESS TO INITIATE AND ADOPT SUCH AMENDMENT; INITIATING LIAISON WITH THE UNITED STATES BUREAU OF CENSUS IN ORDER TO TAKE MAXIMUM ADVANTAGE OF ITS ACTIVITIES PRELIMINARY TO THE 1980 FEDERAL CENSUS TO INITIATE BUILDING THE DATA BANK OF RESIDENTS OF ALASKA QUALIFIED TO BECOME STOCKHOLDER CONSTITUENTS OF AGSOC AND TO PROGRESS THE BUILDING OF SUCH DATA BANK, ON THE BASIS OF THE DEFINITIONS OF "QUALIFIED RESIDENT" IN SAID

PENDING STATE LEGISLATION; CONDUCTING A BROAD INVESTIGATION OF POTENTIAL TYPES OF INVESTMENT OF AGSOC AND PREPARING A CATALOG THEREOF; AND INITIATING AND COMPLETING A DEFINITIVE ANALYSIS OF THE DETAILS OF THE PENDING STATE LEGISLATION AND MAKING SUCH RECOMMENDATIONS THEREON AS MAY SEEM JUSTIFIED.

From information we have gathered in the course of our work pursuant to our now completed contract with the Legislature of the State of Alaska and our continued close liaison with representatives of the Legislature of the State of Alaska and the office of the Attorney General of Alaska, we think it safe to venture the assertion that no legislation ever to come under consideration by the Legislature has received more intensive and broad-gauge analysis and scrutiny than the legislation dealing with AGSOC. This is entirely fitting in view of the enormous potential significance of AGSOC to the economic and political wellbeing of the citizens of the State of Alaska. Nor can such meticulous care and consideration fail to benefit others beyond Alaska who, it seems probable, will seek to follow in the pioneering footsteps of the Alaskan Legislature.

Much has been accomplished through the study by legislators, by their staffs, by the sizable group of witnesses who have appeared before various Committee hearings, and by consultants in responding with analytical efforts and with proposed modifications to the pending legislation in the course of a year's thoughtful consideration of the AGSOC legislation.

However, the vast work done to date has raised almost as many questions as it has provided answers, and unremitting and painstaking work must continue to be done if the Legislature of the State of Alaska, upon convening its next session in January, 1980 is to have before it an AGSOC bill upon which it can act with confidence and with a minimum of doubts that any critical areas have been left unexplored.

In this proposal, we urge the State of Alaska to employ our firm, together with such subcontractors and consultants as we may, with the approval of the designated representative of the Budget and Audit Committee of the State of Alaska, employ to undertake and complete, (or complete so far as possible), a number of activities aimed at answering these unanswered questions and providing the Legislature with the basic analytical material to resolve most of the unresolved doubts.

The Hon. Jim Duncan
Legislative Budget and Audit Committee
June 19, 1979
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Many trends in the economy of Alaska, of the United States, and in the field of international economic relations have developed during recent months that suggest greater urgency in avoiding loss of momentum in the AGSOC project. The importance of the energy resources of the State of Alaska have gained an even more awesome significance to the future of America. Regulatory confusion in the energy field has increased in complexity. The precariousness of the continued viability of the U. S. economy, as it is presently structured, has become more doubtful. The pace of nation-debilitating inflation has quickened. The willingness of Federal leadership to use further inflation-creating stimuli to cut unemployment meets rising opposition in the form of taxpayers' revolts. The needs for economic leadership and to clarify economic policy considerations--to which the Legislature of the State of Alaska can make major contributions with the launching of a carefully designed AGSOC--has risen to preeminence in the minds of many Americans.

The 95th Congress of the United States, in enacting Subchapter U of the Revenue Code of 1954, as amended, went further in recognizing the need for a new economic policy built upon broader ownership of capital than anyone with historical perspective could have confidently anticipated. Nevertheless, Subchapter U in its present form accomplishes only part of the necessary changes in our basic approach to financing business enterprise and facilitating individual acquisition of capital ownership that are necessary in order to construct a rational economic policy. While it is feasible, in certain highly productive investments, to so design financing structures that stockholders, or beneficial stockholders can buy productive capital and pay for it, both principal and interest, in after-personal-income-tax dollars, it is not in the interest of either State or Federal governments, nor certainly in the interest of accelerating the virtually dormant economic growth rate of our economy, for them to do so. The proof of this lies in the great success of ESOP financing. In that technique, which, like the AGSOC, is based upon the theory of capitalism, or two-factor economics, the employee has access to credit through which we can buy stock representing productive capital and pay for it, both principal and interest, in pre-corporate-income tax dollars from the return on invested net worth of the shares purchased, and defer personal taxation, normally to his retirement date. Clearly what is needed is to recognize that the purchase of capital under arrangements that make it possible to pay for it out of what that capital produces is, in reality, not an income transaction at all. Thus, it is of major importance to persuade

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Congress to eliminate personal income tax liability upon stockholders of a General Stock Ownership Corporation as to all yield of the underlying capital applied to amortization of the purchase price, both principal and interest, and to do so permanently. The sooner the ownership of productive capital can begin producing added income for the new stockholder, the faster the income tax base grows, both for the Federal and State governments.

SUMMARY OF PRINCIPAL COMPONENTS OF WORK CONTEMPLATED BY THIS INTERIM PROPOSAL FOR THE LEGISLATURE OF THE STATE OF ALASKA DURING THE PERIOD JUNE 15 THROUGH DECEMBER 15, 1979

While our work on the AGSOC project for the State of Alaska has continued, at reduced speed, since the completion of that agreement upon delivery of our final report thereunder in January, 1979, we propose herein that the Legislature of the State of Alaska employ us to marshall the necessary manpower and talents to accomplish, between June 15, 1979 and December 15, 1979, under the direction of such representative of the Legislature of the State of Alaska as the joint Budget and Audit Committee of the State may designate, the following work projects for the purpose of supplementing and extending the preparatory work accomplished by the Eleventh Legislature of the State of Alaska, First Session, and by its consultants, including ourselves, towards establishing the Alaskan General Stock Ownership Corporation and in due course, if the legislation becomes law, enabling it to acquire significant productive capital ownership.

Analysis. Cataloging and Evaluation Of Financing Sources

In the debates and discussions that took place during the Eleventh Legislature, First Session, both within the Legislature and between the Legislature and the Office of the Governor, the sources for financing the acquisition of capital assets for AGSOC of such magnitude as to be significant to the State's economy, were a major subject. In modifying the initial AGSOC bill, as first introduced, several restrictions were imposed upon the economic resources and power of the State itself and of its agencies.

It is critical now that realistic sources and methods for financing the acquisition of major capital assets by AGSOC be identified, and that the means by which such financing sources can be induced to participate be determined. We would undertake to analyze and catalog these sources, to evaluate them, and to generate strategic and tactical approaches with respect to each of them.

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Page Five

Laying the Foundation for Working With the 1980 Federal Census in
Order to Develop a Stockholder Constitutency Data Base

Preparations for the 1980 United States census are already well advanced. Failure to develop, in connection with the appropriate agencies of the State of Alaska, a working relationship that will enable Alaska to take advantage of the experience and major manpower expenditures of the Federal government in accomplishing the census in Alaska would be to miss a vital opportunity to accelerate the establishment of AGSOC if the Legislature adopts the necessary legislation during the forthcoming Session. The end result would force AGSOC into making duplicating expenditures that would waste its start-up funds. Maximizing the availability of the Federal census facilities and resulting data to the building of the list of residents qualified to become stockholders of AGSOC would, if the representative of the Legislature concurs with our views on this, be given the highest priority.

Development of Types of Potential Investment Opportunities for AGSOC

From our work in connection with AGSOC to date, we are well aware that it would be counterproductive, until AGSOC becomes an operating and functional reality, to investigate, evaluate, or initiate probing activities with respect of any particular investment opportunity for AGSOC.

At the same time, it is clear that a careful review of the types of investment opportunities that will be open to AGSOC is indispensable to a consideration of the feasibility and an estimate of the time that will be required to activate AGSOC once it is brought into existence. Our study would take into consideration all aspects of particular types of available investments that will be relevant and of interest to those who ultimately make and implement investment decisions for AGSOC.

Educational Efforts Directed at the Appropriate Committees of Congress
and Their Individual Members, and at the United States Treasury
Department and the Appropriate Officials Therein

The office of the Hon. Russell B. Long, Chairman of the United States Senate Finance Committee, estimates that there are approximately 3,000 Employee Stock Ownership Plans operating in the United States. The overwhelming evidence is that these financing techniques bring about spectacular improvements in the productivity, profits, sales, increase in net worth, and even income tax payments of the companies that adopt them. The ESOP is a double tax shield: it gives employees access, through

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credit, to the pre-corporate-income tax return on net worth of the shares that the employees have purchased through their ESOP in order to pay principal and interest on the debt incurred to make such acquisition. At the same time, the ESOP is a tax shield against current, year-to-year taxation of employees while they are accumulating viable capital estates. Federal tax law, however, is still flawed with respect to ESOPs: it taxes the employee when his portfolio (or its cash equivalent) is removed from the ESOP trust. This is simply evidence of the historical confusion resulting from the use, pioneered by our firm, of "deferred compensation" legislation for purely financing purposes, i.e., the purchase of capital assets and the payment of the purchase price out of the income thus produced. Legislation to correct that defect was introduced into the 54th Congress by U. S. Congressman William Frenzel (from Minnesota) and its introduction, we are informed, is planned again in the current Congress by Senator Long. Opposition to the last mentioned tax aspect, namely the elimination of personal income taxation upon taking possession of the capital accumulation as it is released from the trust, has been presented by the United States Treasury on the ground that it would cause an excessive loss of revenue to the Federal government. We have accumulated a great deal of evidence to the contrary, however, demonstrating that the Federal Government derives a net benefit from raising the productiveness and incomes of consumer units by equipping them with productive capital.

Virtually all of the estimated 3,000 or so ESOPs now in existence have been adopted since 1970 when the firm of Kelso & Co., Incorporated was organized. The ESOP functions by giving employee-participants (who become, through the ESOP trust, beneficial stockholders of their employer) access to the corporate pre-tax return on invested net worth of the shares which are allocated to their accounts to pay for the stock which they have bought. Furthermore, the ESOP defers (usually until the participant's retirement) taxation on the sums applied to amortization of acquisition debt. Thus the value of the stock received from the ESOP trust is partly taxable as ordinary income and partly at capital gain rates. Even this "deferred taxation" is the result of an historical accident. In seeking to apply the theory of capitalism to the practical financing problems of a business corporation in such manner as to build the ownership of newly formed capital, or newly acquired capital assets, into employees as those assets pay for themselves in pre-corporate-income tax dollars, it was expedient to use Section 401(a) of the Internal Revenue Code as a financing device, even though it was originally

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intended only to provide "deferred compensation." Thus, the theory of capitalism, as applied to employee stock ownership plans, is not yet perfected to its ultimate efficiency, and will not be so until an employee, upon retirement, can take his portfolio of stock (or its cash equivalent) out of the ESOP trust without tax consequences, so long as he keeps it invested in productive capital which will help to make him a better income tax payer, and a better customer for business.

This same logic is applicable to the General Stock Ownership Corporation legislation set forth in Subchapter U of the Internal Revenue Code, as the result of amendments adopted in the Revenue Act of 1978. However, the citizen-stockholder of a general stock ownership corporation is not yet as well off as an employee beneficial stockholder under an ESOP: for this latter has what is allegedly his "income" applied to the amortization of debt incurred to finance stock acquisition deferred, whereas the citizen-taxpayer under a general stock ownership corporation is taxed currently on that part of the corporation's income applied to the retirement of principal of debt incurred in acquiring capital investments.

Clearly, it is of the greatest urgency that the appropriate committees of Congress and their respective members, as well as the Department of Treasury and its appropriate officials, be educated to understand the logic of two-factor economics in order that the impact of AGSOC, once it is activated, not be slowed for years by the stretch-out of debt retirement resulting from the intervention of personal income taxes while the citizen taxpayer is purchasing his AGSOC stock.

We would concentrate our attention during the period covered by this proposal, either on bringing about the amendment of the GSOC legislation, or laying the foundation for its early amendment in the next session of this Congress. The end result, if we are successful, as we are confident we can be, will be a vast advance in the time when AGSOC can become income-significant to the people of Alaska, as well as to the tax collectors in governments at all levels.

Development of Organizational Structure and Procedures for AGSOC

It has appeared to us that many of the questions raised about the future operations of AGSOC have resulted from the fact that little attention has been, or up to this point could be, devoted to developing and defining concretely a proposed rational

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management structure for AGSOC and operations procedures to enable it to accomplish the various tasks which it is expected to accomplish by the pending legislation. Under this proposal, working with management consultants approved by the representative of the Legislature, we would seek to define and design and appropriate management structure for AGSOC and operations procedures that can be readily adapted to it or adopted by its management to facilitate its accomplishing its various functions, including building its data-base, its identification and evaluation of investments, and its arranging for the financing of their acquisition; its establishment of escrow accounts for each of its stockholders; its organization of a trust department (or in the alternative its employment of a professional trustee) for the handling of its stockholder accounts, its dividends, its notifications to stockholders; its calling of meetings of its board and of its stockholders, etc.

Establishing an Acceptable Working Arrangement With the Securities and Exchange Commission With Respect to Reporting of Activities; Avoiding or Simplifying Registration, Etc.

AGSOC will, in all probability, be the first general stock ownership corporation to make its appearance on the American financial stage. The securities laws of the United States were not designed to cope with such a corporation, even though it is defined by law as a private for-profit corporation, because its stock, through the proposed legislation, will be under many controls and restraints which do not apply to ordinary business corporations or their securities.

We would undertake as part of our work assignment during the forthcoming six-month period, under close liaison with the representative of the Legislature and with the Budget and Audit Committee and any other agencies of the State or consultants of the Legislature whom the Budget and Audit Committee may deem appropriate, the initiation and progressing of a dialogue with the regulatory and enforcement divisions of the Securities and Exchange Commission, looking toward the evolution of procedures to assure that the interests guarded by the securities laws will be protected, while avoiding unnecessary bureaucratic procedures that are not appropriate to a general stock ownership corporation.

The end result of this effort should enable AGSOC to fully live up to the expectations of the Securities and Exchange Commission from the moment that it becomes operational, and at the same time should enable the Securities and Exchange Commission to understand and to know what to expect from a general stock ownership corporation such as AGSOC. Many months of delays in the future, when such

The Hon. Jim Duncan
Legislative Budget and Audit Committee
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delays could be extremely costly, can, we are confident, be avoided by these efforts during the intervening months before the next session of the Eleventh Legislature of Alaska is convened.

Time of Performance

Our work under this proposal would, if agreeable to the designated representative of the Legislature, commence promptly upon the granting of a contract between this firm and the Budget and Audit Committee of the Legislature, and final reports would be delivered to the Legislature on or before December 15, 1979. We would, of course, as we have during the past five and one-half months of 1979, although our work under our previous agreement was concluded at the end of 1978, be prepared to explain, execute refinements of our work, and to cooperate with the needs of the Legislature in going forward with the Alaska legislation.

Our Proposed Fee for Services

We would propose that upon the granting of a contract pursuant to this proposal, we be paid a retainer fee of \$35,000, and that we be paid on or before the 15th day of each month during the contract period, beginning with July 15 and concluding with December 15, 1979 a similar sum, for an aggregate payment of \$245,000. This fee would cover not only the services of our own personnel, but our out-of-pocket travel, computer time, and miscellaneous expense (which we estimate at approximately \$3,000 per month) and the fees and expenses of subcontractors and consultants employed with the consent and approval of the representative of the Budget and Audit Committee for the purpose of executing in full the work program contemplated by the proposal.

In our preliminary discussion of this proposal with members of the Alaskan Legislature and staff members on June 11-13, 1979, it was emphasized that it would be desirable for us to suggest separate fee amounts for each of the work items in the proposal. We think that this is not feasible because of the nature of the work proposed.

None of the tasks specified herein is a finitely-bounded work project. Rather, each is in the nature of bridge work to connect the primary work done so far with the more advance status of the project that can be presented to the next session of the Alaska legislature. It is momentum-maintaining work; it is work

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June 19, 1979
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that advances necessary preparations to the launching of AGSOC if the pending legislation becomes law and by its very nature can save many times its cost in avoiding future AGSOC start-up delays.

We propose to deliver progress reports at 15-day intervals to the representative of the Legislature and its Budget and Audit Committee designated as our liaison if our proposal is accepted. If, as a result of these reports, it is desired that the emphasis we are giving to each portion of the work be changed, we will respond accordingly upon request.

Should the aggregate funding for this project be less than suggested herein, we would suggest that the seven installments be equally reduced to stay within the available budgeted goals as we can, within such budgetary restraints. Needless to say, we are open to your suggestions on all aspects of the matters covered by this letter.

We will, of course, be pleased to respond to any and all questions relating to this proposal. If you decide to proceed with the contract proposal herein outlined, please provide authorization hereof through signatures by officers authorized to obligate the state, and by delivery to us of a retainer check in the sum of \$35,000.

There is no task that we look forward to with greater pleasure than that of assisting the Alaskan General Stock Ownership Corporation not only to become a reality, but to be an enterprise that is prepared and has been so thoroughly equipped in advance to cope with its challenges that it will set a performance record that will not soon be broken.

KELSO & CO., INCORPORATED

By Louis O. Kelso
Louis O. Kelso, President
and Chief Executive Officer

10502
Alaska State Legislature

House of Representatives



MEMBER
FINANCE COMMITTEE

REPRESENTATIVE JIM DUNCAN
CHAIRMAN
BUDGET & AUDIT COMMITTEE

STATE CAPITOL
POUCH V
JUNEAU, ALASKA 99811
465-3818

HOME ADDRESS
RR 4 BOX 4316
JUNEAU, ALASKA 99803
789-9792

August 14, 1979

The Honorable Mike Gravel
United States Senate
3131 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear ~~Senator~~ *Mike* Gravel:

I am taking this opportunity to inform you of our interim AGSOC work. Currently, we have two contracts in effect. The first of these is with Wilmer, Cutler & Pickering. The scope of their work is as follows:

1. Review federal securities law problems that would be raised by the proposed AGSOC legislation and initiate discussion with the federal Securities and Exchange Commission in accordance with recommendations set forth in Wilmer, Cutler & Pickering memorandum dated November 2, 1978.
2. Review federal tax problems that might arise in implementing the proposed AGSOC legislation including any federal tax problems that might occur upon initial distribution of shares. Initiate appropriate discussions with the Treasury Department and/or Internal Revenue Service and submit a federal tax ruling request if necessary to confirm the federal tax consequences of the AGSOC proposed legislation.

Our second contract is with Louis Kelso, who will provide the following services:

1. Development of potential investment opportunities for AGSOC. Analyze the Alaska economy and its total range of potential investment opportunities and evaluate those investment opportunities for their relative significance to the State's

District 4

HAINES

JUNEAU · DOUGLAS

KLUKWAN

SKAGWAY

Hon. Mike Gravel

-2-

August 14, 1979

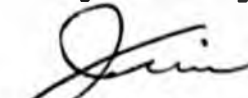
economy against a criterion of maximum return to stockholders.

2. Analysis, cataloging and evaluation of financing sources. Correlate with each of the findings of Task I (Development of Potential Investment Opportunities for AGSOC) the potential financing sources and estimate the limits of funding available from each source, considering potentially available collateral or security and/or guarantee arrangement and estimate the effects upon interest costs.

We anticipate either extending one or both of these or contracting for further AGSOC research.

Please call if you have any questions or suggestions concerning this interim project.

Respectfully,



Jim Duncan

JD:jp

File of AGSOC

(bring up at 1st
S.A. meeting) on AGSOC,
however, we should
consider these changes?

Rep. Miller

WILMER, CUTLER & PICKERING

1666 K STREET, N. W.

WASHINGTON, D. C. 20006

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 ANN O. WILLIAMS
 ROBERT S. WILSON
 JUDITH BABY WISE
 ROGER S. WITTEB

September 17, 1979

Representative James Duncan
 Chairman, Legislative Budget
 and Audit Committee
 Alaska Legislature
 Pouch V
 Juneau, Alaska 99811

Dear Representative Duncan:

I enclose a memorandum for your Committee on the federal tax and securities law issues raised by Senate Bill No. 170. The memorandum suggests several possible changes in S. 170 in order to facilitate the necessary federal action. Consistent with our contract with you of June 1, 1979, we have focused mainly on the securities and tax issues and have not attempted a review from the standpoint of constitutional questions or corporate law. However we have, in Section III of the memorandum, questioned the desirability on constitutional grounds, of the waiting period for eligibility under S. 170 and suggested an alternative.

Finally the memorandum outlines the approaches we recommend to the IRS and SEC. We would be grateful for your reaction to the memorandum and authorization to begin preliminary discussions with appropriate IRS and SEC officials. In the interest of time, we have begun drafting submissions to the two agencies along the lines proposed in our memorandum.

Sincerely,

Samuel A. Stern
 Samuel A. Stern

cc: Mr. Dale E. Staley

RECEIVED
 SEP 21 1979
 BUDGET/AUDIT
 COMMITTEE

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D. C. 20006

September 14, 1979

MEMORANDUM FOR THE LEGISLATIVE
BUDGET AND AUDIT COMMITTEE, STATE OF ALASKA

Subject: Proposed CSSS Senate Bill No. 170:
Federal Tax and Securities Laws Issues
and Suggested Approaches

You have asked us to review pending legisla-
tion ^{1/} permitting the establishment of an Alaskan General
Stock Ownership Corporation ("AGSOC") in conformance with
the recently enacted Subchapter U of the Internal Revenue
Code. ^{2/} We have considered issues which may arise under
the federal tax and securities laws in connection with
this legislation, having previously, in our memorandum of
November 2, 1978, for the Alaska Commissioner of Revenue,
treated the securities law issues. This memorandum sum-
marizes those issues, identifies optional approaches to
resolution of certain problems, and identifies sections
of S. 170 which you may wish to consider revising in order
to facilitate regulatory approvals. We also propose an

1/ CSSS Senate Bill No. 170, introduced as amended
April 27, 1979. (Hereafter "S. 170").

2/ 26 U.S.C. §§ 1391-97, eff. November 6, 1978.

approach for our presentations to the Internal Revenue Service ("IRS"), and the Securities and Exchange Commission ("SEC") to facilitate the creation and operation of AGSOC in conformity with the federal regulatory provisions administered by those agencies.

I. SECURITIES REGULATION OF AGSOC

Our firm's Securities Law Memorandum of November 2, 1978, indicated that AGSOC will potentially be subject to provisions of three of the federal securities laws: the registration provisions of the Securities and Exchange Act of 1933 (the "1933 Act"); the registration, reporting, and proxy rules of the Securities Exchange Act of 1934 (the "1934 Act"), and the registration, conduct regulation and disclosure requirements of the Investment Company Act of 1940 (the "1940 Act").

S. 170 poses no securities regulation problems beyond those raised in our earlier memorandum.^{3/} Because the statute is an adaptation of general corporation law,

^{3/} However, we do recommend herein minor modifications to S. 170 to facilitate conformance with the intrastate exemption to the 1933 Act.

it does not deal with most of the subject areas which are likely to concern the SEC: particularly disclosure of risks to potential shareholders, periodic reports on financial condition, the administration of the "ballot" mechanisms, and fiduciary duties of officers and directors. Moreover, our initial approach to the SEC will be made at a time when the final form of the AGSOC has not yet been determined. For example, the question of the appropriate basis for exemption from the registration requirements of the 1933 Act must await a final decision as to whether payment of consideration will be required of Alaska citizens who wish to acquire AGSOC shares.^{4/}

4/ We presume that an initial free issuance is preferred if we are able to obtain a ruling from the IRS that a tax will not be imposed upon citizens who receive shares. However, AGSOCA provides in Section 10.50.080 that

"Shares may be issued without consideration or for consideration fixed by the shareholders before issuance. Consideration for shares shall be fixed by a vote of a majority of the shares voting on the issue."

This provision appears to suggest that AGSOC may charge consideration for shares only after the initial distribution as no shareholders will exist until then to fix the consideration. This point should be clarified if an initial charge for shares is contemplated. If you wish to leave the option open, Section 10.50.075 could be amended to read: "Shares may be issued without consideration or for consideration fixed by the Board of Directors before issuance."

We propose to present to the SEC a briefing memorandum describing the proposed AGSOC as set out in the S. 170 draft offered April 27, 1979, formally requesting a 1933 Act exemption, and requesting the commencement of negotiations to develop a modified form of 1934 Act regulation and a waiver of the 1940 Act's requirements during the first five years of AGSOC existence. We plan a preliminary presentation and discussions with the SEC prior to making detailed requests for rulings on the latter points so that we may involve them in establishing a creative approach to GSOC regulation. We hope to have received preliminary feedback from the SEC before S. 170 is passed in final form.

Provision of the
Securities Act of 1933

We believe, as we indicated in our Securities Memorandum, that AGSOC should not be subject to the registration requirements of the 1933 Act, either on the basis that an initial distribution of shares is not a "disposition . . . for value" within the meaning of Section 2(3) of the 1933 Act, or on the basis of the "intrastate exemption" provided by Section 3(a)(11) of

the same Act. We propose to argue both points to the SEC.^{5/}

Even if the AGSOC shares are sold for consideration or if the SEC deems the disposition otherwise to be for value, we anticipate that we will be able to prevail on the theory that its shares are exempt from registration under the 1933 Act by virtue of the intrastate exemption in section 3(a)(11).^{6/} The characteristics of offerings the SEC will deem as falling within

^{5/} Of course, even if the initial distribution of shares is free of charge and thus falls within a "not for value" exemption to the Securities Act of 1933, any additional issuances which are for value would fall within the registration requirement unless they are otherwise exempt. This would include exchanges of shares for property or services as provided for in S. 170 § 10.50.085.

^{6/} This section exempts from registration:

"Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

Section 3(a)(11) are described in non-exclusive Rule 147 (17 C.F.R. § 230.147).^{7/} The rule requires that both the purchasers of the securities and the issuer have certain characteristics to ensure that both are truly residents of the state and that sales and resales are restricted to state residents. We believe that several minor changes in S. 170 are advisable in that they will bring the AGSOC within Rule 147 and thus simplify our task if the intrastate exemption need be relied on (either for the initial or any later issues).

AGSOC will be an Alaska corporation as required by Rule 147. Its principal place of business will probably be located in Alaska (Rule 147(c)(1)(i) and (2)(iv)), although the latter is not required by S. 170.^{8/} We suggest that the legislature consider

^{7/} Issuers may avail themselves of the intrastate exemption even if they do not satisfy all the provisions of this rule. 17 C.F.R. § 230.147 (Preliminary Notes, p. 1). If an issue satisfies all of Rule 147's provisions, however, the intrastate exemption will apply.

^{8/} S. 170 § 10.50.050 requires only that the corporation maintain a "registered office" within the state.

requiring AGSOC to have its principal place of business in Alaska as this would clarify this aspect of compliance with Rule 147.

Rule 147 restrictions on sales and resales to state residents are clearly satisfied by AGSOC.^{9/} The basic purpose of Rule 147's limitations on resale is to ensure that securities do not enter the interstate marketplace. It does not appear that the fact that a few shares pass by descent after five years to out-of-state holders or that former residents may retain their AGSOC shares if they leave the state after five years is so inconsistent with those principles as to upset application of the exemption.

Rule 147 also requires that the issuer's business be conducted predominantly within the state in which the securities are distributed.^{10/} The gross revenues and

^{9/} Subchapter U and S. 170 provide that shares may only be transferred voluntarily or involuntarily to persons who are residents of the state. 26 U.S.C. § 1391(4)(D)(ii); S. 170 §§ 10.50.320(a)(6) & 8(B). The general prohibition against transfers except by descent for five years also helps to meet the Rule 147 requirement that resales in a nine-month period after the initial distribution be restricted to state residents. S. 170 also provides that if the shareholder leaves the state or shares pass by operation of law to a non-resident, the corporation shall repurchase them at book value. S.170, Section 4(c).

^{10/} The issuer must derive at least 80 percent of its gross revenues from within the State and have at least
[Footnote continued on following page]

asset provisions of the rule will only be applicable to the initial GSOC distribution if AGSOC becomes operational before its shares are distributed.^{11/}

The use of proceeds provision will only apply if AGSOC charges for the shares, and it may be satisfied easily by segregating issue proceeds to ensure that they are spent within Alaska. If AGSOC is to acquire an asset prior to share distribution we must know what the asset is to formulate arguments that the asset and its income are "within" the State within the meaning of Rule 147 and section 3(a)(11). AGSOC will presumably be acquiring a minority participation in a joint venture as an asset. If majority control of that venture is in the hands of non-Alaskans, it is arguably not an Alaska asset. Also, income may or may not be deemed derived from within the state -- e.g., sales of oil to out-of-state corporations may be deemed non-Alaska income. Even if the initial

[Footnote continued]

80 percent of its assets within the State. Rule 147 (c)(2)(i) and (ii). It must also intend to use 30 percent of the net proceeds from sales of the issues in question within the State.

11/ Rule 147 provides that if gross revenues for the most recent twelve-month period are less than \$5,000, the proceeds provision is not applicable.

distribution is of shares in a shell company, it will be necessary to examine whether AGSOC revenues can be deemed to arise from the "operation of a business or of real property within the state," with regard to subsequent issues of shares. The legislature may wish to consider so restricting the corporation in its enabling legislation.

S. 170 does not now specifically provide for procedures required by Rule 147 to ensure that the reality comports with the intent of the issuer.^{12/} We recommend that the legislature amend S. 170 to provide for adequate legends on share certificates;^{13/} and that

^{12/} A legend on the share certificates must identify the limitations on resale and warn of the lack of registration, stop transfer instructions must be given to the transfer agent, and purchasers must be required to make written representations as to their residence. Rule 147 (b)(1). The issuer must also restrict sales of shares which are part of the same issue and make appropriate disclosures. *Id.* § (f)(2) and (3). S. 170 does require that eligible individuals apply for shares and that their interest will become void if it is determined that they misrepresented their eligibility. § 10.50.345-360. The SEC may wish to make rules in this regard or examine AGSOC procedures for establishing residency prior to authorizing sale or distribution without registration.

^{13/} S. 170 § 10.50.105 provides for extremely limited information to be contained on the certificate. We recommend that the legislature amend this section to require disclosure on the certificate of all the restraints on transfer, including the fact that shares are not transferable to non-residents.

the AGSOC provide for the application and stop transfer requirements in the articles of incorporation or the by-laws.

The Securities Exchange Act of 1934
and The Investment Company Act of 1940

As was indicated in our firm's Securities Memorandum, AGSOC does not fall within any statutory exemptions to either the 1934 or the 1940 Acts, and without special provision by the SEC, it will be required to register its securities, to file periodic reports, to comply with proxy rules, to comply with disclosure and trading rules under the 1934 Act and to file under and comply with the fiduciary standards of the 1940 Act.

The primary goals of the 1934 Act are to ensure that shareholders have adequate information concerning the financing and operations of registered companies to permit informed investment decisions, to ensure that shareholders have similar information when they are called upon to vote on corporate matters, and finally to ensure that sales and exchanges of shares occur in a free and open fair market exchange. The 1940 Act has similar goals although it additionally imposes certain fiduciary standards upon the management of investment companies because of the risks that it might usurp control of shareholder assets.

S. 170 permits the AGSOC to be run as a fairly conventional private corporation. It is primarily subject to control by the legislature in its initial stages^{14/} and it is thereafter subject to governance by shareholders^{15/} and the board of directors.^{16/} It is unique in other respects: (1) its shareholders, constituting a cross-section of the state's citizens, will be in large measure unsophisticated in the exercise of shareholder rights and investment decisions;^{17/} (2) shareholders will have little or no initial equity investment in AGSOC; (3) they will be subject to severe limitations on sales or transfers of their shares, particularly during the first five years

^{14/} The legislature must amend the enabling legislation pursuant to § 10.50.640 to control it thereafter.

^{15/} A vote of shareholders is required to amend the articles of incorporation, § 10.50.375, and to approve certain asset sales.

^{16/} The directors may create and amend the bylaws, § 10.50.125, and have other standard management powers of corporate directors.

^{17/} Many shareholders will be minors or other legal incompetents.

after distribution; ^{18/} (4) ownership of shares will remain unconcentrated by statutory mandate; (5) bars to proxy

18/ In conformance with Subchapter U, S. 170 provides many restrictions which will make it extremely difficult for a trading market in AGSOC shares to develop. For example, shares may not be transferred, voluntarily or involuntarily, within the first five years after issuance, and they may thereafter only be transferred to "resident individuals of the chartering State." It will not be possible for security brokers or dealers to make a market in AGSOC shares if this section is interpreted to mean such entities cannot hold AGSOC shares. Also, since no individual can own more than ten shares, it may not be feasible to create a trading market funded through transfer fees in a manner comparable to those which exist for other private corporate securities. The legislature should, as we previously recommended, give serious consideration to empowering AGSOC to be its own transfer agent or to the creation of a transfer mechanism for bringing together willing buyers and sellers.

Another potential problem is presented by the involuntary transferor. The AGSOC legislation provides at several points that redemption of shares shall be at book value. It is possible that there will be no or negative book value for the shares at stages during the operation of the corporation, when the carrying value of assets approximates the unamortized acquisition debt. This means that shareholders who leave the state or whose shares pass by operation of law to non-residents during the first five years after issuance may end up being forced to "sell" for far less than what would otherwise be market value. The legislature may wish to consider enabling AGSOC to pay a "fair market value" rather than book value to avoid unfairness.

usage^{19/} and cumulative voting^{20/} will limit shareholder power (while simultaneously barring usurpation of it by certain groups) and (6) AGSOC equity will be primarily supplied by loans from large financial institutions in reliance upon state guarantees. The existence of a diffuse, unsophisticated, and passive shareholder population together with a sophisticated and concerned set of creditors provides potential for abuses. S. 170 does not contain provisions which are adequate substitutes for most of the investor protections of the 1934 and 1940 Acts.^{21/}

^{19/} §§ 10.50.155 & 175.

^{20/} § 10.50.160.

^{21/} For example, because of the large shareholder population involved and the large sums of money which will be sought from financial institutions, this entity may have major impact upon financial markets. The SEC will probably be quite concerned about the contents of disclosures made to potential shareholders because of the lack of sophistication of this group of people compared with other investors in corporate securities. Particular care should be given to disclosure of the rights of minors and incompetents, who will probably compose a significant portion of shareholders. We propose to represent to the SEC that the notices to Alaska residents, the prospectus or other offering circulars, and other explanations of AGSOC made available to the public will contain full disclosure of the risks to shareholders.

In addition, S. 170 has no provision imposing fiduciary duties on officers or directors, other than requirements that loans not be made to officers or directors and

[Footnote continued on following page]

Our briefing memorandum prepared for the SEC will suggest that a modified form of 1934 Act regulation will be adequate to meet these problems during the five years after the initial distribution and that 1940 Act regulation would be unnecessarily burdensome. However, we anticipate that some modifications to S. 170 may be requested by the SEC during the course of these discussions because of the possibilities for abuse.

II. FEDERAL TAXATION OF AGSOC AND AGSOC SHAREHOLDERS

Subchapter U permits the creation of GSOCs by states and generally provides that a GSOC set up in conformance with its requirements will be exempt from federal taxation. 26 U.S.C. § 1392.^{22/} Taxation of the income of such corporations occurs at the shareholder level. § 1393. Shareholders also receive investment

[Footnote continued]

that distributions not be made unless there are adequate resources in the corporation. § 10.50.230. It provides for no periodic reports but only that shareholders may receive the most recent financial statements of the corporation upon written request. § 10.50.285.

^{22/} See generally Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 (H.R. 13511, 95th Cong.; P.L. 95-600) (Joint Committee Print, March 12, 1979, pp. 321-24).

tax credits which would otherwise accrue to the corporation. § 1393(b). The corporation, rather than its shareholders, utilizes net operating losses which it may incur, and these may be carried forward for a ten-year period. § 172(b)(1)(H). The GSOC is required by Subchapter U to distribute 90 percent of its annual taxable income to shareholders,^{23/} (§ 1396), but to withhold 25 percent of such distributions for the IRS on behalf of shareholders. § 3402(r). AGSOC must file an informational tax return that identifies all shareholders and the distributions they have received. § 6039B.

Subchapter U permits a state to establish a GSOC between December 31, 1978 and January 1, 1984 by a charter enacted by the state legislature or a state-wide referendum. §§ 1391(a)(2) and (3). For the GSOC to qualify for the benefits of the Subchapter,

^{23/} These distributions must be made by January 31 of the year following the taxable year in question. A GSOC must maintain a segregated shareholder income account for purposes of accounting for such distributions. § 1394. At certain points, S. 170 refers to "dividends" rather than distributions. See, e.g., §§ 10.50.115(b), 10.50.140(a) and (b), 10.50.350, and 10.50.360; cf. § 10.50.215. These provisions should be conformed to the Subchapter U language.

its charter must provide for the issuance of only one class of stock, for the issuance of the stock only to "eligible individuals,"^{24/} for the issuance of at least one share of stock to each "eligible individual" unless such individual elects not to receive a share, and for certain restrictions on the transfer of shares. Id. § 1391(a)(4).^{25/} GSOCs may not own more than 20 percent of another company, (§ 1391(a), 1504), and may not obtain investment properties through the exercise of the state's power of eminent domain. § 1391(a)(5).

S. 170 contains the obligatory provisions required by Subchapter U^{26/} and generally appears to conform to the statutory standards. However, there are a few respects in which modifications to S. 170 may facilitate conformance of AGSOC with Subchapter U.

24/ Eligible individuals are defined as individuals who are residents of the chartering state during a period between "a date specified in the State's enabling legislation . . . and the date of issuance" of shares. § 1391(c).

25/ Shares may not be transferred for five years except by reason of death or if the shareholder ceases to reside in the state. Thereafter they may only be transferred to individual state residents who may not acquire more than 10 shares. Id. § 1391(a)(4)(D).

26/ See § 10.50.320(a), which requires AGSOC to set forth in its articles of incorporation Subchapter U's limitations on classes of shares, issuance, and restraints on alienation. S. 170 also requires that AGSOC must qualify under Subchapter U. § 10.50.320(9).

Taxation of Shareholders
at the Time of Distribution

Section 102 of the Internal Revenue Code provides that "gross income does not include the value of property acquired by gift" A gift has been defined as a voluntary transfer of property by one to another without any consideration or compensation therefor. Gray v. Barton, 55 N.Y. 68. The recipients of the shares are not required to do anything in order to be entitled to participate in AGSOC. They need only be residents of Alaska which they already are and will be. It cannot reasonably be argued that the possibility of becoming a shareholder will induce anyone to move to, or remain in Alaska. The recipients only have to be in Alaska to share in the disinterested generosity on the part of the donor. See Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278 (1960).

It must be recognized that the IRS may resist treating the share distribution as a gift. For example, there is precedent for treating amounts as income where the recipient has done little or nothing to acquire the property. See Rev. Rul. 53-61, 1953-1 C.B. 17, holding treasure trove to be income to the finder. See also Cesarini v. United States, 428 F.2d 812 (6th Cir. 1970),

where a taxpayer was required to include in income currency discovered in a used piano bought at auction. The IRS has also held that payments under the Soil Bank Act, 7 U.S.C. § 1801, for refraining from planting crops constitute income. Rev. Rul. 60-32, 1960 C.B. 23. These precedents, which involve some minimal taxpayer activity, or induced inactivity, may be distinguishable in the mind of IRS. They do indicate, however, that there may be some reluctance on the part of IRS to exclude amounts from income, for example, where there is a transfer of property outside the normal family situation.

An alternative argument should also be considered. The receipt of shares by Alaska residents is comparable to a non-taxable transfer payment by a government. Support for the transfer payment analogy is found in the legislative history of Subchapter U.^{27/}

In general, the IRS has taken the position that transfer payments such as social welfare payments are not non-taxable, although no statutory authority for it to do so exists. United States v. Kaiser, 363 U.S. 299, 305-14 & App. (1960) (concurring opinion of Mr.

^{27/} Senator Gravel emphasized the hope that GSOC Income could ultimately become a substitute for welfare.

Justice Frankfurter); see, e.g., I.T. 3230, 1938-2 C.B. 136 (unemployment benefits); I.T. 3447, 1941-1 C.B. 191 (social security payments); Rev. Rul. 57-102, 1957-1 C.B. 26 (aid to the blind); Rev. Rul. 72-340, 1972-2 C.B. 31 (job training); Rev. Rul. 36-395, 1976-2 C.B. 16 (home rehabilitation grants).

Rev. Rul. 76-131, 1976-1 C.B. 16, holding that benefit payments under the Alaska Longevity Bonus Act are taxable appears readily distinguishable. Those payments are available to all Alaskans "to provide an incentive to continue uninterrupted residence in the State and under no circumstances is to be considered a form . . . of public relief." The payments by Alaska under this Act must have been sufficient in amount to provide a realistic inducement for persons to remain in the State and are comparable to the Soil Bank Act payments in Rev. Rul. 60-92, supra.

It will, of course, be helpful to a favorable determination by IRS that the value of these shares of AGSOC will be readily perceived to be negligible, or possibly zero. The cost basis for gain on a future sale of the shares by the donee shareholder will be the same as the cost to the donor, i.e., negligible or possibly zero. 26 U.S.C. § 1015. Accordingly, the IRS may

recognize the administrative convenience of not taxing the initial distribution but instead deferring the tax until eventual sale when the entire proceeds will be subject to tax.

Finally, in the event that IRS is unwilling to rule favorably on the tax treatment of the initial stock distribution, consideration may be given to obtaining the opinion of two reputable appraisers, if it can reasonably be anticipated that a conclusion of zero value will be reached. In view of the apparent negligible revenue loss involved, if any, it would be highly unlikely that such appraisal would not be accepted as conclusive of the issue.

Tax Consequences After the
Initial Distribution of Shares

Under federal law, AGSOC will become eligible for Subchapter U treatment once it qualifies and so elects. 26 U.S.C. 1392(a). It may revoke its election for a year or more with the consent of the Secretary of the Treasury. Id. § 1392(f). S. 170 provides that AGSOC shall be formed in conformance with Subchapter U, (§ 10.50.010), and that its Articles of Incorporation shall set out that it "must qualify" as a GSOC under Subchapter U. § 10.50.320(9). The Articles may be

amended in conformance with Section 10.50.365 et seq. but only if as amended the Articles "contain provisions which would be lawfully contained in original articles of incorporation at the time the amendment is made."

While the matter is not free from doubt, we believe the state legislation is thus more restrictive than Subchapter U,^{28/} and requires AGSOC to maintain its election as a Subchapter U entity. We believe it would be preferable to permit a maximum flexibility by allowing the Articles to be amended to drop Subchapter U status under the usual procedure whereby the Board of Directors (or 1000 shareholders) proposes an amendment subject to shareholder approval. § 10.50.375. To accomplish this end, we believe § 10.50.320(9) should be modified^{29/} and that the possibility of such a change should be added to the list in § 10.50.370.

28/ AGSOC may also lose its Subchapter U status under federal law by "ceasing to be" a GSOC, 26 U.S.C. § 1392(f), but it would appear that this can only occur by such affirmative actions as passing amendments which do not conform to § 1391(a)(4), acquiring assets through exercise of the power of eminent domain, or becoming a member of an affiliated group (i.e., obtaining a greater than 20% investment in another group).

29/ The phrase "unless any election to so qualify is terminated under section 1392(f) of such Subchapter" would be added to the section.

Tax consequences to individuals holding AGSOC shares are set forth in Subchapter U, and nothing in S. 170 raises questions in this regard. The Internal Revenue Code provides that the IRS may by rule provide for a certification procedure by which AGSOC could be exempt, as to non-taxpayers, from the requirement of section 3402(r) that the GSOC reserve 25 percent of distributions as withheld taxes on behalf of shareholders as if it were their employer. 26 U.S.C. 3402(r). We propose to explore the feasibility of establishing such a procedure with the IRS. While such a procedure is desirable from a social welfare perspective (permitting these individuals to receive full distribution value as soon as possible and removing the burden of filing a federal tax return), a technique will have to be established to minimize administrative burdens upon AGSOC which would have to determine and keep a record of which of its anticipated 400,000 shareholders were taxpayers in any given year.

**Summary of Points
To Be Discussed with the IRS**

We propose to present a brief memorandum describing AGSOC and S. 170 to officials of the IRS.

The focal point of our discussions will be the tax consequences of the initial distribution of shares. We propose to request a revenue ruling on this point on behalf of the citizen shareholders of the State of Alaska. Consideration should also be given to discussing the following matters with IRS:

- (1) Confirmation of our understanding of how Subchapter U will work, including
 - (a) AGSOC obligations to the IRS;
 - (b) AGSOC shareholder obligations to the IRS;
 - (c) The general type of reports IRS will desire from GSOCS and the types of regulations contemplated to be issued for GSOCS.

- (2) Confirmation that AGSOC as proposed in S. 170 will be viewed in conformance with Subchapter U, including
 - (a) That S. 170 is a sufficiently detailed "charter" within the meaning of 26 U.S.C. § 1391(a);^{30/}
 - (b) That the definition of "eligible individuals" conforms to Subchapter U requirements;

^{30/} It could be argued that such a charter must contain details of AGSOC governance as currently planned for the Articles of Incorporation.

- (c) That charging consideration for shares will not defeat Subchapter U status;
- (d) That S. 170 provisions requiring eligible individuals to apply for shares are compatible with Subchapter U status;^{31/}
- (e) That secondary issuances of shares will not be considered different classes of stocks in conflict with 26 U.S.C. § 1391(a)(4)(A).

III. CONSTITUTIONAL ISSUES

For purposes of determining who is an "eligible individual, the drafters of S. 170 would begin the mandatory period of state residency on the effective date of the enabling legislation. § 10.50.320(6). Persons who are entitled to receive shares thus must remain residents of Alaska for the entire period from the effective date of S. 170 until the date of issuance of shares.^{32/} As now defined, the class of eligible individuals is permanently fixed and any later issuances of shares by AGSOC apparently

^{31/} The federal legislation states that the GSOC shall provide for the "issuance of at least one share to each eligible individual," 26 U.S.C. § 1391(f)(4)(C). S. 170 makes clear that receipt of a share is dependent upon application by residents in response to state-wide notification procedures. § 10.50.345-360. We will attempt to clarify that the IRS does not deem GSOCs as under a duty to seek out and issue shares to all eligible individuals. Such a view could be fatal to AGSOC's tax-free status.

^{32/} These individuals are referred to herein as "charter residents."

may only be made to charter residents. We again call to your attention our reasons for questioning this approach, although it appears acceptable under Subchapter U.

First, this restriction of eligible individuals to members of a closed class of persons resident within the state at a fixed point in time may pose significant constitutional problems. See Wilmer, Cutler & Pickering, Memorandum for the Commissioner of Revenue, State of Alaska: Federal Constitutional Issues Presented by Alaska's GSOC (December 15, 1978).^{33/} S. 170 exaggerates some of the problems we have previously raised because it also provides that within five years of issuance, shares must be sold back to the corporation if charter residents leave the state or die leaving their shares to nonresidents. This means that the pool of AGSOC shareholders will include only those charter residents who stay within the state for five years (and the small group who move into the state within this period and inherit shares from a charter resident). After five years, right to AGSOC shares seemingly vests in charter residents and their heirs may retain

^{33/} (Hereinafter "Constitutional Memorandum"). As we indicated there, such limited eligibility for a government benefit must at least be based upon significant state interests as recited in legislative findings.

AGSOC shares even if they do not reside in Alaska. Establishing a fixed class which excludes Alaska citizens who are born in or move to Alaska after S. 170's effective date from AGSOC share issuances may then appear particularly inequitable in view of the fact that these non-Alaskan heirs will hold shares and receive AGSOC income. Even if later arriving residents may acquire shares from charter residents after the five-year period, there can be no assurance that a market in such shares will exist.

The possible constitutional problems are exacerbated by the fact the residency period to qualify as a charter resident could be lengthy, as AG OC must be organized and become sufficiently operational to issue shares.^{34/} The longer the eligibility period the more difficult it will be to verify compliance with residency requirements. A long residency period will also reduce

^{34/} Incorporators must be selected, and an initial slate of directors chosen. The latter are subject to disapproval within 15 days of their nominations which could cause delay. S. 170 § 4(b). The directors must prepare articles of incorporation and bylaws, and there is at least a 60-90 day period after they have been drafted and filed during which the legislature has the authority to disapprove any of their provisions. § 10.50.335. Activities before share issuance but after finalization of the articles and bylaws, including preparation of offering materials and procedures for share distribution, will also take considerable time,
[Footnote continued on following page]

the pool of eligible individuals and increase the number of Alaska citizens who will be resident within the state on the date of issuance or before distribution but ineligible to receive AGSOC shares. The latter will increase the potential for challenges to the constitutionality of AGSOC, and may undercut the political acceptability of AGSOC as well.

A possible solution to these problems would be to revise S. 170 to provide that the eligibility period will commence on a fixed date prior to the date of share issuance -- ^{35/} e.g., three to six months before issue. This approach has the advantage that if there is an issuance of shares subsequent to the initial distribution, later arriving residents could be included as long as they had

[Footnote continued]

for example, section 10.50.345 provides for notice to allow for application for shares of at least 90 days before the date of issuance. Litigation by opponents of some aspect of the program could cause indefinite delay. It appears extremely likely that the total period involved may exceed six months and could create constitutional problems under both the federal and State of Alaska constitutions. As we have mentioned previously, Alaska courts have taken a particularly strong stance against durational residency requirements. Constitutional Memorandum at 1, n.1, 34, n.38.

35/ The pivotal "date of issuance of shares" of S. 170 §§ 10.50.345 and 355 may not be effectual, since the bill appears to contemplate sporadic issue. Perhaps, the standard "the date of initial notification to the public of its intention to issue shares" would better carry out the purpose.

been and remained residents for the applicable period to the later issuance. This approach would, of course, exclude charter residents who leave the state prior to any secondary issuance.

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RICHARD W. CASE
WILLIAM A. COLBERT, JR.
A. STEPHEN RYAN, JR.
DAVID S. JOHNSON
JOHN ROUBINAVILLE, JR.
ROBERT M. MYTREN

JUDITH BAILEY
DAVID M. BECKER
EMILIA BRADY
RUBEN LOW BLOCH
ALAN B. BRAVERMAN
VITO BRIGMAN
WILLIAM D. BRINTON
JAMES L. COLLIER, JR.
BRUCE E. COLLINGS
JOHN F. COONEY
MARY CAROLYN COE
JANETTE A. COOPER
JANE TUCKER BANA
SEYMOUR A. DAVIDSON
NORMAN S. DOLANS
PATRICIA B. DOUGLASS
STEPHEN R. DOLLE
DANIEL W. DORR
CAROL A. FISHER
NANCY L. GERBER
RICHARD R. GORRETT
JOSEPH A. GRUNBERG
EDWARD T. HARRIS
ALLEN H. HARRISON, JR.
JOHN H. HARRISON, III
DAVID M. HELLES
LAUREN B. HODER
SHERYL L. KATI
CAMELIA F. KERR
STEPHEN M. KIBBE
JAMES T. KILGORE, III
JOSEPH E. KILGORE, JR.
WALTER A. KOPPEL
CAROL B. LAMORE
GERALD A. LANGRISH

HENRY B. LEVINE
CHRISTOPHER S. LIPSEY
ROBERT A. MAJOR, JR.
BRUCE MARINOV
JOHN B. MARSHALL, III
MAURIT J. MEEHANIC
LOWELL S. MILLER
FRANK MADDOX ROBINSON
JOHN MATTSON
WILLIAM A. PERLSTEIN
JOHN S. ROBERTS
CLAUDIA RIBET
WILLIAM S. RICHARDSON, JR.
ANTHONY TIBBO BALLEW
MICHAEL B. SCODOLER
DAVID R. SCHULZ
JAMES ROBERT SCHWARTZ
LESLIE E. SEEMAN
ELIZABETH A. SHYER
ARTHUR S. SPITZER
LYMAN S. SPITZER
ALAN S. STERNSTEIN
THOMAS A. STUBBIE
TIMOTHY S. TAYLOR, JR.
ANDREW W. VOLLMER
ARVID S. WEISSMAN
ARTHUR B. WEISSMAN
BARBARA B. WELLSLEY
DAVID WESTIN
THOMAS W. WHITE
ANDREW B. WILLIAMS
ROBERT D. WILSON
JUDITH BARRI WYON
GEORGE B. WOLFE

CERIEL B. STODARD
DONALD F. TURNER
COUNSEL

Mr. Dale E. Staley
Legislative Budget and
Audit Committee
Alaska Legislature
Pouch V
Juneau, Alaska 99811

Re: Exemption of the Alaska General Stock Ownership
Corporation from the Investment Company Act of
1940.

Dear Dale:

I enclose a memorandum to the Budget and Audit Committee recommending several specific changes in the Alaska GSOC enabling legislation which have suggested themselves in the course of our consultations with the Staff of the SEC. We believe that representations to the Staff that these changes will be made would be most helpful in securing Staff support before the Commission for our request for a total exemption from the Investment Company Act for the first five years.

Also enclosed is a draft letter concerning these changes as well as a discussion of Alaska's law on conflict of interest which has been requested by the Staff. We ask you to clear these statutory changes and the draft letter in principle with the Committee. We will then forward the letter to the SEC Staff and ask that they recommend to the Commission that the requested exemption be granted if the Alaska legislation is amended along these lines. When and if we receive informal assurances, we will suggest that you proceed with the revisions.

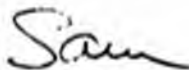
- 2 -

The Staff has also requested more information as to the nature of the investments which are planned for the AGSOC. We have told them that we do not believe portfolio securities will be among the investments to be made, but rather that the AGSOC will seek to become a joint venturer with other large enterprises in the development of various natural resources. We have been specifically asked whether it is contemplated that the AGSOC will own in excess of 25 percent of each entity in which it invests. Please clear with the Committee a representation whether ownership of this magnitude is or is not contemplated. Any additional information you could provide as to contemplated investments would be most helpful.

Your prompt response on these matters is appreciated. On the whole we have been encouraged by the Staff's receptivity to the GSOC concept.

On the IRS front, we understand that IRS, at the urging of a representative of the Treasury, will reconsider its initial unwillingness to rule. We will of course keep you posted.

Sincerely,



Samuel A. Stern

WILMER & PICKERING
1666 K STREET, N. W.
WASHINGTON, D. C. 20006

January 22, 1980

MEMORANDUM FOR THE ALASKA
LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Re: Exemption of the Alaska General Stock Ownership Corporation from the Investment Company Act of 1940.

We have submitted to the staff of the Securities and Exchange Commission ("SEC") our memorandum of December 5, 1979, and discussed the submission with the staff on several occasions. As a result of our discussions, we believe certain steps are necessary and appropriate to secure total exemption for five years for the Alaska General Stock Ownership Corporation ("AGSOC") from operation of the Investment Company Act of 1940 ("ICA"). We have been given informal assurances that if the Division of Investment Management (the section of the SEC which regulates registered investment companies) will recommend granting the AGSOC total exemption for five years from operation of the ICA, SEC personnel will also recommend approval of our application for partial and temporary exemptions from operation of the Securities Act of 1933 and the Securities and Exchange Act of 1934.

We suggest that certain specific changes set forth below be made to the enabling legislation before its passage in its current form to maximize our chances of

persuading the Division of Investment Management that the AGSOC should be exempt from operation of the ICA. All of these suggested changes have been prompted by specific comments of the staff. The alternative will be at best a partial exemption and some measure of SEC regulation of the AGSOC.

a) Conflict of Interest

The SEC's primary concern is whether granting an exemption from operation of those provisions of the ICA which outlaw certain transactions which could involve conflicts of interest or self-dealing will result in a failure to protect AGSOC shareholders.

Section 17 of the ICA makes unlawful (absent an exemption by Commission order) certain transactions between an investment company and "affiliated persons," broadly defined.^{*/} Under section 17(a) it is unlawful for an

^{*/} The term is defined in section 2(a)(j) of the ICA:

"'Affiliated person' of another person means

"(i.) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person;

"(B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;

[Footnote continued on following page]

"affiliated" person to sell or buy property or most securities to or from the investment company or to enter into joint ventures with or borrow money from the company.*/

[Footnote continued]

"(C) any person directly or indirectly controlling, controlled by, or under common control with, such other person;

"(D) any officer, director, partner, copartner, or employee of such other person;

"(E) if such other person is an investment company, any investment advisor thereof or any member of an advisory board thereof; and

"(F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

*/ Section 17(a) makes it unlawful for an "affiliated" person:

"(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely

"(A) securities of which the buyer is the issuer,

"(B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or

"(C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

"(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or any other property (except securities of which the seller is the issuer); or

[Footnote continued on following page]

The SEC staff has pointed out: that various sections of the proposed AGSOC enabling legislation^{*/} could give rise to the kind of transactions which would be prohibited under section 17. For example, the Act (§§ 10.50.015(4), (5) and (7)) permits the AGSOC to buy and sell property and securities; the ICA, if applicable, would prohibit it from engaging in such a transaction with, for example, a person who is a director of the GSOC (or with a company on whose board their director also sits). The ICA might also prohibit the AGSOC from becoming a joint venturer with such a company, as contemplated in Act § 10.50.015(17), in certain circumstances.^{**/} Similarly, the Act § 10.50.015(6) permits

[Footnote continued]

"(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender)"

*/ References to "Act §" refer to section 1 of CSSS Senate Bill No. 170, introduced as amended April 27, 1979.

**/ Section 17(d) makes it "unlawful for any affiliated person of . . . a registered investment company . . . or any affiliated person of such a person . . . acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person . . . for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant."

the AGSOC to lend money to its employees; since the ICA defines employees as "affiliated persons," such a loan would constitute a violation.

One option -- an option invited by the staff -- is to argue to the Commission why existing Alaska law on conflicts of interest adequately protects the public and why therefore there is no need for section 17 of the ICA to apply to AGSOC. Attached hereto as Attachment A is a draft of a letter we propose to send to the staff for its informal reaction. If we are not successful with this approach, it may be necessary to formulate certain modifications of the enabling legislation to include explicit prohibitions of transactions with persons who may have a conflict of interest.

b) Indemnification

The staff also commented on the scope of the AGSOC's power to indemnify provided by section 10.50.020 of the enabling legislation. The staff has indicated that these standards are acceptable to them as consistent with section 17(h) of the ICA, with the exception of the open-ended power granted in Act § 10.50.020(f), which widens the scope of possible indemnity to allow any corporate

choice. Although we realize that the provision was based on the American Bar Foundation's Model Business Corporation Act, it goes further than the ICA. We suggest strongly that Act § 10.50.020(f) be deleted from the legislation.

c) Miscellaneous

Below we discuss a series of miscellaneous changes to the legislation which have been suggested by our conversations with the staff. We request that you clear each of these changes in principle so that we may represent to the staff that they will be implemented if our exemption request is granted.

(i) Stock Options

The AGSOC is given the power to establish pension plans and other incentive plans for its directors, officers and employees. Act § 10.50.015(15). The staff has pointed out that section 18(d) of the ICA prohibits an investment company from granting stock options to its employees. We recommend that stock options be specifically excepted from Act § 10.50.015(15). The new section would read:

"(15) pay pensions and establish pension plans, pension trusts, profit-sharing plans, and other incentive plans for its directors, officers and employees, except that such pensions or plans shall not include the issuance of stock options;"

(ii) Later Issues

Under Act § 10.50.080, the AGSOC shareholders are permitted to set the price of shares to be sold in later issuances. The staff has pointed out that section 23(b) of the ICA requires that shares not be sold at an amount below the current net asset value of each share without the consent of a majority of the investment company's shareholders. Under Act § 10.50.150, one third of the AGSOC shareholders constitutes a quorum and, thus, one vote more than one sixth could set the price at less than net asset value. We recommend that you tighten the restriction in the AGSOC legislation to match the ICA. The second sentence of section 10.50.080 would be amended to read:

"The decision to issue shares without consideration or for consideration if that consideration is less than the current net asset value of such shares shall be made by the vote of a majority of the shareholders."

(iii) Payment Other Than Cash

The staff has also noted that Act § 10.50.085 allows payments for shares to be by transfer of property other than cash or in exchange for services. The ICA does not allow payment other than in cash (section 23(a)). We suggest conformance to the ICA in this minor matter. The

first sentence of Act § 10.50.085 would be amended to read:

"Consideration for the issuance of shares if required shall be paid in cash."

(iv) Interested Directors

Section 10(a) of the ICA provides that no investment company may have more than 60 percent of its Board of Directors be "interested persons". The ICA's definition of "interested" persons includes all affiliated persons and many others.^{*/} There is currently no similar restriction on who may serve on the Board of Directors of the AGSOC. In lieu of incorporating some sort of restriction along the lines of the ICA into the AGSOC legislation, we suggest that a provision along the lines of section 41 of the Model Business Corporation Act be added to the legislation. That section provides:

DIRECTOR CONFLICTS OF INTEREST

No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are

^{*/} "Interested person", as defined in section 2(a)(19) of the ICA, includes (unless exempted by Commission order) members or the immediate family of affiliated persons, affiliates or other interested persons of the company's investment adviser, legal counsel for the company or any partner or employee of such counsel, and any registered broker or dealer or an affiliate of such a broker or dealer.

directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:

(a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or

(b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or

(c) the contract or transaction is fair and reasonable to the corporation.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction.

We suggest the new provision follow Act § 10.50.200. This new provision will also strengthen our position with the SEC concerning the need for application of section 17 of the ICA to the AGSOC. See Attachment A.

(v) Replacing Directors

The ICA requires (section 16) that when a vacancy occurs in the Board of Directors of an investment company it may be filled only if after it is filled, two thirds of the Board has been elected by the shareholders. No such restriction exists in Act § 10.50.195, and we recommend adding such a provision. The first sentence of § 10.50.195 would then read:

"A vacancy occurring in the board of directors may be fulfilled by the affirmative vote of a majority of the remaining directors if immediately after filling any such vacancy at least two thirds of the directors then holding office shall have been elected by the shareholders at a shareholders' meeting."

(vi) Disqualification

The ICA places certain restrictions on who may serve as an officer, director, or employee of an investment company, forbidding (unless an exception is granted) persons convicted within 10 years of a securities related crime or subject to an injunction arising from past securities laws violations (section 9). The staff has indicated, and our research has confirmed, that this provision of the ICA is one for which exceptions are only very infrequently given. The enabling legislation contains no equivalent, and we suggest that a provision such as the following

be added, to follow § 10.50.260:

" INELIGIBILITY OF CERTAIN AFFILIATED
PERSONS AND UNDERWRITERS

"It shall be unlawful for any of the following persons to serve or act in the capacity of employee, officer, or director of a corporation:

"(1) any person who within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company; or

"(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security."

(vii) Public Utility Holding Company Act

Finally, as we have advised previously, the Public Utility Holding Company Act places very severe restrictions on a company owning in excess of 10 percent of (or otherwise controlling) a "public utility" as that term is defined in the Act. The staff has indicated that it

would be useful if a mechanism were worked into the legislation so that the directors would be advised of the possibility that an investment would fall within the terms of the Public Utility Holding Company Act, and either seek specific exemption from the SEC as permitted under section 3 of that Act, or comply with the Act's extremely rigid requirements. For this reason, we suggest a new section be added to follow Act § 10.50.015:

PROHIBITION. A corporation may not own, control or hold with power to vote ten percent or more of the outstanding voting securities of a public utility company or a public utility holding company (as those terms are defined in the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 et seq.), without first taking steps to come within the requirements of that Act, or seeking exemption from the Act's coverage from the Securities and Exchange Commission.

Wilmer & Pickering

WILMER & PICKERING

ATTACHMENT A

DRAFT
January 22, 1980

Houghton R. Hallock, Jr., Esq.
Division of Investment Management

Paul Roye, Esq.
Division of Investment Management

Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Re: Request for Exemption for Alaska
General Stock Ownership Corporation

Dear Sirs:

You have asked us to amplify our opinion as to why exemption of the AGSOC from the conflict of interest provisions of the Investment Company Act ("ICA") would not work to the detriment of the investing public. In addition, this letter responds to several other concerns you have expressed to us.

As we have stated previously (Memorandum to the Staff of the Securities and Exchange Commission, dated December 5, 1979), the AGSOC, while it may technically fit within the definition of an investment company, is not at all the sort of entity typically regulated under the ICA. It will not invest in portfolio securities, will not use traditional investment advisors or underwriters, and will not engage in more than occasional purchases or sales of securities. Thus, the traditional

abuses which section 17 of the ICA was created to outlaw -- such as conflicts of interest on the part of investment advisors, mutual backscratching and other self-dealing -- will not take place. Moreover, one obvious potential for abuse -- loans to AGSOC officers and directors -- is strictly forbidden by the Alaska legislation. (Act § 10.50.225).

The AGSOC is in many ways a political entity; its few investments and loan transactions will be highly visible and a subject of widespread public comment and debate. This scrutiny alone provides a strong disincentive for self-dealing. Certain provisions of the Alaska enabling legislation provide additional "sunshine" protections against conflict of interest situations. For example, shareholders have the right to examine AGSOC books and records (Act § 10.50.270), and the AGSOC must file an annual report to the Secretary of the Treasury. 24 U.S.C. § 6039B. Extensive publicity will undoubtedly surround the appointment of officers and directors. As for deterrence, these persons are subject to court-ordered removal for fraudulent or dishonest acts and criminal penalties for defrauding shareholders or creditors or making misleading statements. (Act §§ 10.50.290, 10.50.635, 10.50.630).

In addition, Alaska law creates strict fiduciary duties owed every corporation by its officers and directors.

Although we have discovered no Alaska statutes specifically dealing with conflicts of interest, the most complete statement of Alaska law on this subject is contained in the Supreme Court of Alaska's opinion in Alvest, Inc. v. Superior Oil Corp., 398 P.2d 213 (1965), a copy of which is attached hereto. Under the rule of law set forth in this case, corporate officers or directors are fiduciaries and cannot personally profit from a corporate opportunity even with the concurrence of the company's Board of Directors. (Op. at 216). Any such conflict could only be waived by the shareholders (id.), and it is not necessary to allege bad faith by an officer or director in an action against him for dereliction of his fiduciary duties and recovery of the opportunity diverted.

We have also secured agreement from our client that a new provision modeled on section 41 of the Model Business Corporation Act will be added to the proposed Alaska legislation. The new section will provide:

DIRECTOR CONFLICTS OF INTEREST

No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are

directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:

(a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or

(b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or

(c) the contract or transaction is fair and reasonable to the corporation.

Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction.

We believe that such a provision is more suited to the AGSOC than are the complex "interested person" restrictions of section 10(a) of the ICA, and that this provision will

further assure that any transaction carrying the potential for abuse will be the subject of focus by a disinterested board.

Thus, persons associated with the AGSOC will have few opportunities to profit personally and even less chance to do so successfully. In light of these circumstances, we feel application of section 17 of the ICA is unnecessary in the case of the AGSOC.

* * * * *

After consultation with us, our client has agreed to make certain other changes in the state legislation to satisfy your concern that the protections offered by the ICA are adequately dealt with in the state AGSOC legislation. Below is a list of changes we propose to CSSS Senate Bill No. 170:

1. Add a new provision after § 10.50.015 as follows:

PROHIBITION. A corporation may not own, control or hold with power to vote ten percent or more of the outstanding voting securities of a public utility company or a public utility holding company (as those terms are defined in the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 et seq.), without first taking steps to come within the requirements of that Act, or seeking exemption from the Act's coverage from the Securities and Exchange Commission.

2. Act § 10.50.015(15) - Amend the section to read as follows:

"(15) pay pensions and establish pension plans, pension trusts, profit-sharing plans, and other incentive plans for its directors, officers and employees, except that such pensions or plans shall not include the issuance of stock options;"

3. Act § 10.50.020(f) - Delete.

4. Act § 10.50.080 - Amend the second sentence to read as follows:

"The decision to issue shares without consideration or for consideration if that consideration is less than the current net asset value of such shares shall be made by the vote of a majority of the shareholders."

5. Act § 10.50.085 - Amend the first sentence to read as follows:

"Consideration for the issuance of shares if required shall be paid in cash."

6. Act § 10.50.195 - Amend so that the first sentence reads:

"A vacancy occurring in the board of directors may be fulfilled by the affirmative vote of a majority of the remaining directors if immediate, after filling any such vacancy at least two thirds of the directors then holding office shall have been elected by the shareholders at a shareholders' meeting."

7. Add new provision after § 10.50.260, as follows:

" INELIGIBILITY OF CERTAIN AFFILIATED
PERSONS AND UNDERWRITERS

"It shall be unlawful for any of the following persons to serve or act in the capacity of employee, officer, or director of a corporation:

"(1) any person who within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company; or

"(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security."

We hope this submission is helpful in your review of our exemption application. Please feel free to call on us should other questions arise.

Sincerely,

Samuel A. Stern

Appellant alleges that error was committed when evidence of the value of the property in dispute, supplied by the records and testimony of a tax assessor, was admitted.

As is pointed out by appellant, there is a difference of opinion among the various jurisdictions¹⁶ as to whether such evidence should be admitted. The testimony of the tax assessor was that the taxing district regularly assessed at 100 per cent of value based upon a record of comparable sales in the area within the preceding two years.

[9] Appellant has not shown how or why this testimony was unreliable with respect to the value of the property or how its admission prejudiced his case in any particular. The basis employed in arriving at the valuation was sound. The evidence had relative value and should have been admitted. No error was committed.

The trial court, over objection, permitted counsel for appellee to question appellant in detail concerning his military record, the nature of his discharge, wounds received while in the service, the degree of disability thereby created, the amount of government pension received by appellant and appellee's inability to obtain employment because of his wounds and disability. Admission of this testimony is asserted as error.

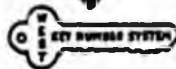
Appellant's first objection was overruled, apparently on the ground that appellee's physical ability to earn money was material to the determination of the issues. Appellant's second objection was overruled on the ground that the evidence was necessary to carry out the intent of the parties.

[11] We hold that no error was committed. The financial condition of the parties in a suit of this nature is a relevant factor to be considered.¹⁷ So also

may his physical ability to earn be relevant and material.

[12] Appellant's allegation of error committed in admitting certain exhibits is not briefed sufficiently to be readily understandable and will not be considered.

The findings of fact, conclusions of law and judgment are set aside and the case remanded for retrial.



ALVEST, INC., Appellant,
v.
SUPERIOR OIL CORPORATION, Appellee.
No. 503.

Supreme Court of Alaska.
Jan. 21, 1965.

Proceeding on appeal from a judgment of the Superior Court, Third Judicial District, Ralph E. Moody, J., affirming decision of state division of lands cancelling award to corporation which had been awarded first priority at noncompetitive oil and gas lease drawing. The Supreme Court, Dimond, J., held that fact that two officers of corporation filed applications for themselves in non-competitive oil and gas lease drawing conducted by state division of lands when corporation itself had filed application violated administrative regulation providing that each applicant shall have only one chance in any one drawing, and division of lands properly cancelled award to corporation which had been awarded first priority at drawing.

Judgment affirmed.

¹⁶ See 5 Wigmore, Evidence § 1640 (3d ed. 1940) for a discussion of the subject and citations of the holding of the various jurisdictions.

¹⁷ Finmons v. Finmons, 217 Miss. 504, 64 So.2d 755, 753 (1953).

1. Corporations ⇨307

Corporate officer or director stands in fiduciary relationship to his corporation.

2. Corporations ⇨310(1)

Out of fiduciary relationship between corporate officer or director and corporation arises duty of reasonably protecting interests of corporation.

3. Corporations ⇨315

It is inconsistent with and breach of duty of corporate officer to reasonably protect interests of corporation for officer or director to take advantage of business opportunity for his own personal profit when, applying ethical standards of what is fair and equitable in particular situation, opportunity should belong to corporation.

4. Corporations ⇨315

Where business opportunity is one in which corporation has legitimate interest, officer or director may not take opportunity for himself, and if he does, he will hold all resulting benefit and profit in his fiduciary capacity for use and benefit of corporation.

5. Corporations ⇨315

Whether business opportunity is corporate one or one within legitimate scope of individual interests of officer or director depends on facts and circumstances of each case.

6. Mines and Minerals ⇨5

Fact that two officers of corporation filed applications for themselves in non-competitive oil and gas lease drawing conducted by state division of lands when corporation itself had filed application violated administrative regulation providing that each applicant shall have only one chance in any one drawing, and division of lands properly cancelled award to corporation which had been awarded first priority at drawing.

7. Mines and Minerals ⇨5

Administrative regulation providing that each applicant in noncompetitive oil and gas lease drawing should have only one chance in any one drawing would not have precluded corporation from making success-

ful claim for lease or its benefits against corporate officers who filed applications for themselves had either been successful at drawing.

8. Corporations ⇨315

In absence of shareholder approval, business opportunity involving application by corporate officers, as individuals and for themselves, in noncompetitive oil and gas lease drawing conducted by state division of lands was not within legitimate scope of individual interests of officers where corporation itself had filed application.

9. Corporations ⇨315

Showing of bad faith is not essential to establish duty on part of officers or directors of corporation in connection with business opportunities which they wish to acquire for themselves, and fact that business opportunity is of such nature that under particular circumstances it should fairly belong to corporation is sufficient to establish duty on part of officer or director to acquire opportunity for corporation.

Clifford J. Groh and Ronald G. Benkert, Groh. - Benkert, Anchorage, for appellant.
Paul F. Robison, Robison, McCaskey & Lewis, Anchorage, for appellee.

Before NESBETT, C. J., and DIMOND and AREND, JJ.

DIMOND, Justice.

Appellant was awarded first priority for an oil and gas lease at a non-competitive lease drawing conducted by the state Division of Lands. Appellee was given second priority. Later the Division of Lands cancelled the award to appellant and gave it to appellee for the reason that two of appellant's officers and directors, White and Mueller, had filed applications for themselves in the same drawing. The Division of Lands held that this action on the part of White and Mueller gave appellant more than one chance at the drawing in violation

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1. 11 Alaska
2. *Diedrick v. N.W.2d 012*
Durfee v. Mass. 257
(1948); *L. Pa. 143, 53*
v. Loft, Inc. 310 (1939)
U.S.App.D.C. (1955).

of an administrative regulation which provided:

"Each drawing shall be conducted in such a manner as the Director shall determine and each applicant shall have only one chance in any one drawing."¹

The superior court affirmed the decision of the Division of Lands and this appeal followed.

[1-4] A corporate officer or director stands in a fiduciary relationship to his corporation. Out of this relationship arises the duty of reasonably protecting the interests of the corporation. It is inconsistent with and a breach of such duty for an officer or director to take advantage of a business opportunity for his own personal profit when, applying ethical standards of what is fair and equitable in a particular situation, the opportunity should belong to the corporation. Where a business opportunity is one in which the corporation has a legitimate interest, the officer or director may not take the opportunity for himself. If he does, he will hold all resulting benefit and profit in his fiduciary capacity for the use and benefit of the corporation.²

[5,6] Whether a business opportunity is a corporate one or one within the legitimate scope of the individual interests of an officer or director depends upon the facts and circumstances of each case.³ Here appellant's chance to be the successful applicant at the lease drawing was a business opportunity in which appellant had expressed a definite interest. That interest was a legitimate one because appellant had made similar applications in previous drawings, and the leasing of oil and gas lands was

within the scope of appellant's corporate activities. This was a corporate opportunity which appellant's officers and directors, White and Mueller, had no right to seek for themselves. If either had been the successful applicant at the drawing he would have held the lease in a fiduciary capacity for the use and benefit of appellant. This means that appellant did not have only one chance at the drawing, but three—its own, represented by the corporate application filed on its behalf, plus two additional chances, represented by White's and Mueller's individual applications. Since appellant had more than one chance in the drawing, it was not a qualified applicant under section 507.31 of the administrative regulations. The Division of Lands was correct in holding that appellant was not entitled to the lease.

[7] Appellant argues that it had only one chance at the drawing, because the regulation would have precluded appellant from making a successful claim for the lease or its benefits against White or Mueller had either been successful at the drawing. This argument is untenable. The regulation deals with the element of chance. When a lease drawing has been concluded and the successful applicant known, the element of chance is gone. What had been chance has now become something certain. The regulation pertains only to the situation which exists while the element of chance is present, and not afterwards. The regulation would have no pertinency in an action by a corporation claiming that one of its officers or directors held a lease as constructive trustee for the corporation. What the rights would be as between those parties

1. 11 Alaska Adm. Code § 507.31 (1964).
2. *Diedrick v. Helm*, 217 Minn. 463, 14 N.W.2d 913, 919, 153 A.L.R. 646 (1944); *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 80 N.E.2d 522, 527, 529 (1948); *Lutherland, Inc. v. Dublin*, 357 Pa. 143, 53 A.2d 143, 147 (1947); *Guth v. Loft, Inc.*, 23 Del.Ch. 235, 5 A.2d 503, 510 (1939); *McKay v. Wahlenmaier*, 96 U.S.App.D.C. 313, 220 F.2d 35, 45-46 (1955).

3. *American Inv. Co. v. Lichtenstein*, 134 F.Supp. 557, 861 (E.D.No.1055); *Industrial Indem. Co. v. Golden State Co.*, 117 Cal.App.2d 519, 256 P.2d 577, 636-657 (Dist.Ct.App.1953); *Johnson v. Green*, 35 Del.Ch. 479, 121 A.2d 919, 923 (1954); *Guth v. Loft, Inc.*, 23 Del.Ch. 235, 5 A.2d 503, 511-515 (1939); *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 80 N.E.2d 522, 529-529 (1948); *Beau, Corporations* § 233, at 372 (1961).

would not be governed by the regulation. The regulation would be relevant after a drawing had been concluded only insofar as it was established that before the drawing took place an applicant had had more than one chance to be successful. If that is established, then the regulation can be invoked to disqualify such an applicant from securing the lease. That is what was done here.

[8] Appellant contends that it could not have claimed the benefits of the lease had it been awarded to White or Mueller, because a full disclosure of their actions in filing their individual applications had been made to the corporation, and because the filing of applications by appellant's officers and directors was consistent with corporate policy. There was evidence that the members of appellant's board of directors had generally approved the appropriateness of officers and directors filing on the same land that the corporation had filed on, although it was not established that this in fact had ever been done prior to the filings in this case. But there was no evidence that the shareholders of the corporation had consented to such a policy generally, or that in this particular instance they had approved White's and Mueller's actions in filing in competition with appellant. In the absence of such approval by the shareholders, the business opportunity in this case was not within the legitimate scope of the individual interests of appellant's officers and directors.⁴

[9] Appellant states that White and Mueller had at all times been open and above board and had acted in good faith in all their dealings here. That is apparently true. But it has no bearing on the decision of the issues in this case. A showing of bad faith is not essential to establish a duty on the part of officers or directors in connection with business opportunities which they wish to acquire for themselves.

4. In re Lerch's Estate, 300 Pa. 80, 189 A.2d 508, 513 (1960); Remillard Brick Co. v. Remillard-Dandiel Co., 100 Cal. App.2d 403, 241 P.2d 68, 74-75 (1952).

The fact that a business opportunity is of such a nature that under the particular circumstances of the case it should fairly belong to the corporation is sufficient to establish a duty on the part of an officer or director to acquire the opportunity for the corporation.⁵

The judgment is affirmed.



WRIGHT TRUCK AND TRACTOR
SERVICE, INC., Appellant,

v.

STATE of Alaska, Appellee.
No. 525.

Supreme Court of Alaska.
Jan. 21, 1965.

Action on construction contract against the state. The Superior Court, First Judicial District, James A. von der Heydt, J., entered judgment for contractor for \$285,933.17 plus costs but disallowed claim for interest between date when sums became due and date of formal entry of judgment, and contractor appealed. The Supreme Court, Nesbett, C. J., held that state was not liable for interest between date sums became due and date of entry of judgment, under statute providing in effect that judgment entered for plaintiff against state shall be for legal amount found due with interest only from date of judgment.

Affirmed.

1. States C-171

Legislature intended to preclude interest on all claims, not just tort claims, against state prior to judgment. Laws 1957,

5. Rosenblum v. Judson Engineering Corp., 99 N.H. 267, 100 A.2d 858, 863 (1954).

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