

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 86/2

891 SCOMM32: AK GENERAL STOCK OWNERSHIP CORP. 1979-80

plan, as described in this paragraph, shall be an individual retirement account, under Section 408(a), in all respects, except that -

- (i) the requirements of paragraphs (6) and (7) of Section 408(a) shall not be applicable;
- (ii) the taxes provided in Sections 408(f) and 4974 shall not be applicable;
- (iii) the total realized current income (excluding gains on the sale of the plan must be distributed, not later than sixty (60) days following the close of the taxable year in which such income is received by the plan, to that individual for whose benefit the plan is maintained; and
- (iv) the plan may only hold amounts which are attributable to distributions from an employee stock ownership plan.

PROPOSED AMENDMENT TO
INTERNAL REVENUE CODE
RELATING TO IRS "NO-ACTION" PROCEDURE
FOR ESOP TRANSACTIONS

The Internal Revenue Code of 1954 is hereby amended by adding the following new paragraph (7) at the end of subsection (f) of Section 4975 of Chapter 43:

(7) Procedure for advance opinions with respect to employee stock ownership plans - Upon application by an employee stock ownership plan, as defined in subsection (e)(7), the Secretary or his delegate shall, within sixty (60) days, issue an advance opinion as to whether a proposed transaction involving that employee stock ownership plan will satisfy all the requirements described in paragraphs (3) and (13) of subsection (d). Such opinion shall be binding upon the Secretary, and shall be deemed to be a determination with respect to qualification for purposes of Section 7476(a), relating to certain declaratory judgments of the Tax Court, except that administrative remedies shall be deemed to have been exhausted after sixty (60) days following application by the plan. The Secretary or his delegate shall, within ninety (90) days following the enactment of this paragraph, promulgate regulations and guidelines for the implementation of the procedure described in this paragraph.

PROPOSED AMENDMENT TO ERISA
CLARIFYING FIDUCIARY DUTIES APPLICABLE TO
ESOP TRANSACTIONS

The Employee Retirement Income Security Act of 1974 is hereby amended by adding the following new subsection (d) to Section 404 of Part 4 of Subtitle B of Title I:

(d) In the case of an employee stock ownership plan, as defined in Section 407(d)(6), the acquisition or holding of qualifying employer securities, or the incurring of acquisition indebtedness for the purchase thereof, shall satisfy the requirements of paragraph (a)(1), provided -

- (1) the requirements of subsections (b)(3) and (e) of Section 408 are satisfied with respect to any transaction between the plan and a party in interest; and
- (2) the same standards of prudence and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied.

PROPOSED AMENDMENTS TO
INTERNAL REVENUE CODE
RELATING TO DEFINITION OF ESOP

The Internal Revenue Code of 1954 is hereby amended by restating paragraph (7) of subsection (e) of Section 4975 of Chapter 43 to read as follows:

(7) Employee stock ownership plan - The term "employee stock ownership plan" satisfies the requirements of Section 401(a) and is designed -

- (A) to invest primarily in qualifying employer securities;
- (B) to meet general capital financing requirements of a corporation, including capital growth and transfers in the ownership of qualifying employer securities;
- (C) to build into employees beneficial ownership of qualifying employer securities, substantially in proportion to their relative compensation;
- (D) to receive loans or other extensions of credit to acquire qualifying employer securities, with such loans or credit secured primarily by a commitment by the employer to make future payments to the plan (which may include dividends on qualifying employer securities) in amounts sufficient to enable such loans (and interest thereon) to be repaid; and
- (E) to limit the liability of the plan (and its participants) for repayment of any such loan (including interest) to payments received from the employer (which may include dividends on qualifying employer securities) and to that portion of the qualifying employer securities acquired with the proceeds of such loan which represents that portion of the loan principal remaining unpaid.

(OVER)

The Secretary or his delegate may prescribe regulations further defining "employee stock ownership plan" consistent with the provisions of this paragraph. An employee stock ownership plan which satisfies the requirements of this paragraph shall also satisfy the definitions under Section 301(d)(2) of the Tax Reduction Act of 1975 and Section 407(d)(6) of the Employee Retirement Income Security Act of 1974.

The Internal Revenue Code of 1954 is hereby amended by inserting the following new subparagraph (C) after subparagraph (B) in paragraph (8) of subsection (e) of Section 4975 of Chapter 43:

- (C) For purposes of an employee stock ownership plan, as defined in paragraph (7), qualifying employer security means an employer security which is common stock or preferred stock convertible (at a reasonable conversion ratio) into common stock.

TWO IMPORTANT POINTS ABOUT THE ALASKA GENERAL STOCK OWNERSHIP CORPORATION

1. THE AGSOC IS NOT A "GIVEAWAY",

AGSOC stock would be issued to all citizens of Alaska. No cash investment is required of the shareholder because the AGSOC would borrow the funds necessary for profitable investments. The loan could be secured by the AGSOC assets and a state guarantee. As the loan is repaid the citizens' AGSOC equity increases.

This type of financing is not unique. The wealthy often borrow money on a nonrecourse basis for investment in profitable enterprises. They use their profits to repay the loans leaving themselves with an increased net worth. The AGSOC simply allows the rest of our citizens access to this type of financing.

2. AGSOC IS NOT STATE OWNERSHIP.

The stock of AGSOC will be held by the citizens of Alaska. They will vote this stock for a board of directors responsible for running the AGSOC in a profitable manner. AGSOC will be run in the same way as a typical business corporation. The only role for the State in AGSOC will be chartering the corporation and, if necessary, subject to legislative review, guaranteeing loans to the AGSOC.

In Alaska AGSOC may be an alternative to what would otherwise be State ownership of equity interests in some of Alaska's major energy projects. It was out of concern for this possibility that AGSOC was born.

John Misburns.

1. - There is no difference between Taxation of AGSoc & Subchapter S Corp.
2. - Wording in bill should be changed to determine what a Loan Guarantee fund is about.
Start up costs should be capitalized
Etc.

Joe Sonnenman -

1. Fallacy - that AGSoc is not ~~the~~ the same as a private Corporation.
2. When all people get ~~the~~ money the only thing that will happen is that prices go up.

AGSOP - is a nominal increase in wealth but is it a real increase in wealth

Duncan -

Q → Where does it say in the Regulation ~~that~~ for securing of future debt - that it would require a vote of the people?

Jim Thompson - Problem Areas

- 1) States Role?..
- 2) States credit Rating
- 3) Proving Solicitations under Fed. Law.
- 4) Provision for guardianship
- 5) - Selling of Stock Again

3/20/79 - Hewitt & Associate (Jeff Gate)
Concept of ESOP Been around for 30 yrs.
But Regulation has not been.

Ludwig - ESOP Council of America

AGSOP - ESOP

What are possibilities that AGSOC will
need no other Financial ASSISTANCE

~~AGSOP~~ X

- ① UCLA - ESOP - Survey
- ② Study on Productive - by Cal State
- ③ Prod. ESOP - Tannentann -
Mich. State U.

^{m + m.s.}
melt in your mouth
not in your hand

So Few

↓

For So Many

↓

For So Little

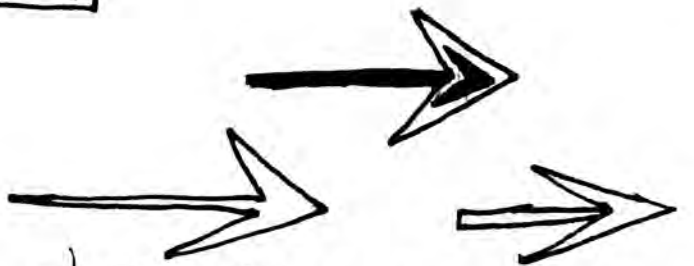
M + M + S

"Always have their foot
in their mouth"

Eric 459 - ~~at the house~~
~~your change~~

Mr. Stephen A. Bauer - 3/20/79

① Feel Key - really is a Subling for the NGOP



PF

PF

GSOC



Professor Kessler!!

- ① Enabling Leg.
- ② Articles of Inc.
- ③ Bylaws

- State Corp. Act -

1) 20% of Shareholders can call mtg.
How would you get agreement
between 20% -

Never been a corp. in the U.S.
with such a diffused management
structure!!

2) - Tremendous power vested in
9 Bd of Directors because of
Abuse + present legislation.

3) Reg. can not amend Articles
~~because~~ because it is a contract!!

Takes substantial amt of time
to change gov body of Corp - (Not
under influence of Gov.)

A) Believes Bd of Directors will become
Self-perpetuating

~~F~~essler's Proposals for changes in Legislation

1. Make Directors Accountable

^{add} A - Removable by Superior Court
Give Standing to court -
Top 10% S Holders
Priority 10% Shareholders etc. etc.
D.G. - ETC.

- B - Shareholder being "derivative suit"

SH may sue in name of corp. -
in certain instances - S/H

held harmless against his cost of

Litigation

Provide by Statute a Scheme
for bringing Suits - but not allow

abusing of suit as has happened

Damages from a Derivative
suit go to the Corp.

C - Removable By Shareholders.

"for cause" - at any time
when a majority of the Shares
will vote for removal of the
Director

or California law say removal
can be done simply because
we are dissatisfied!

D - Statute says Directors
must have knowledge of
certain tenets -

Butter
Say don't
want
derivative
if don't
if do
best provide
by statute

Presumably
have this
in court
Rule!

① Avoid Entrenchment

1) Bd ^{members} can't serve more than 1 term

2) Have proxies - appear on the General Election Ballot!

Necessary -

Clause that Says the Leg.
Has the right to change the
enabling Act from time to
time. -

Page 104 - yellow Book -

Creates 2 classes of Stock -
Because minor can't vote.

B. 105 -

★

By Laws - Can not be amended or
repealed by Shareholders!
Should be changed!!

Important that Shareholders
have the Right to amend the
By-Laws of the Corporation!!!
as well as the Bd of Directors!!

P.112 - About $\frac{1}{5}$ S/B $\frac{1}{10}$ by Law but practically lower

P.113 - 5 Days out of SH - Statute says 10 Days!! - ~~Law~~ Practically longer

P.115 -

P.116 - Needs Clarification
Disclosure device

P.117 - ~~S~~ Resignations

P.117 - Special Meetings.

P.120 $\rightarrow$ Transferrability
Prohibits Stock options

P.121 $\rightarrow$ Problem w/ 3
~~From~~ members of Comm.
Controlling - Actually
3 instead of 17

TO: Frances Ulmer, Director
Division of Policy
Development & Planning

DATE: March 19, 1979

FILE NO:

TELEPHONE NO:

FROM: AVRUM M. GROSS
ATTORNEY GENERAL

SUBJECT: Policy & Legal Issues
Surrounding AGSOC Legislation
(SSSB 170 and SSHB 240)

By: *Joseph K. Donohue*
Joseph K. Donohue
Assistant Attorney General

You have requested a brief outline of the various issues which the Administration should review in the context of the analysis of the AGSOC legislation presently before the legislature (SS for B 170 and SS for HB 240). The following is an outline of those issues from the Department of Law's perspective:

I. TAXATION

The Revenue Act of 1978 added Subchapter U to the Internal Revenue Code 1954, 26 U.S.C. §1391 through §1397. This legislation provides for the creation of a general stock ownership corporation (GSOC) and it authorizes special tax treatment for those corporations which qualify. The federal legislation requires that all GSOCs be chartered by an act of the State Legislature or by a referendum and further requires that each state charter provide as follows:

1. That the charter provide for the issuance of only one class of stock;
2. That the charter provide for the issuance of shares only to eligible individuals; "eligible individuals" are further defined as those who are residents of the State as of the date specified in the State's enabling legislation and who continue to be residents of the State as of the date of the issuance of the shares;
3. That the charter provide for the issuance of at least one share of stock for each eligible individual;

4. That the charter provide that no share of stock shall be transferred by the shareholder other than by will or by intestate succession, until after five years from the date of issuance (except where the shareholder ceases to be a resident); that no share of stock be transferred to a person other than a resident; and that no share of stock be transferred to any individual who would as a result of the transaction acquire more than ten shares of the GSOC.

In addition, the GSOC may not acquire more than twenty percent of the shares of any other existing corporation; the GSOC may not acquire property through the right of eminent domain; the GSOC's charter must mandate that it qualify as a GSOC under the Internal Revenue Code; and finally, the GSOC must be chartered and organized between December 31, 1978, and before January 1, 1984.

Thus, AGSOC (Alaska GSOC) as set out by Louis Kelso's proposal in SSSB 170 would create a corporation whose shareholders consisted of every resident of the State of Alaska as of the time the State charter goes into effect who remain a resident until the date of the first issuance of the AGSOC shares. The AGSOC is treated as a private corporation and not as a governmental unit for purposes of the Internal Revenue Code, except that a qualifying AGSOC is not subject to federal corporate income taxes. Instead, AGSOC's "taxable income" which is calculated in accordance with the Internal Revenue Code (with minor exceptions not relevant here) would be attributed directly to the shareholders in proportion to the number of shares held and would be taxed as individual income to those shareholders. This dividend income does not qualify for the exclusion from gross income normally associated with the first \$100.00 of dividend income. See 26 U.S.C. §116.

The AGSOC is required to distribute at least ninety percent of its "taxable income" for any tax year. 26 U.S.C. §1396(a). The failure of an electing AGSOC to make the required ninety percent distribution would subject it to a penalty of twenty percent of the excess amount required to be distributed over that amount actually distributed. The federal scheme is intended to give the AGSOC a significant competitive advantage since the corporation can operate free of corporate income taxes at the federal level. On the other hand, this ten percent maximum on retained earnings

Frances Ulmer, Director
DPDP

March 20, 1979
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may, indeed probably will, prohibit a corporation's expansion into major new investment areas on the basis of these earnings alone. New investment opportunities which arise in the future would require AGSOC to again obtain significant debt financing which may, in turn, require multiple state guarantees.

The first question which arises is whether or not the policy evidenced by the federal legislation (i.e., freedom from corporate income taxation) should be paralleled at the State level. The present SS for SB 170 would operate to exempt the AGSOC from the State's corporate income tax levied pursuant to AS 43.20. See AS 43.20.021, which incorporates by reference subchapter U of Chapter 1 of subtitle A of the Code. AS 43.20.021 provides for a delayed incorporation of tax exemptions. Those provisions of the Code adopted after 1975 "which change or modify exemptions from tax or credits against tax are not adopted by reference as a part of this chapter until the second January 1 following the effective date of the federal law". Here GSOC's exemption would go into effect at the State level on January 1, 1980. The AGSOC, however, would be subject to state severance taxes (AS 43.55), state oil and gas property taxes (AS 43.56), as well as the state's new oil and gas corporate income tax (AS 43.21.010) should the AGSOC invest in oil and gas production or pipeline transportation property. The investment opportunity presently recommended by Kelso's group is that the new AGSOC purchase BP's share of TAPS.

AGSOC's investment in the oil and gas arena would present several important policy questions which should be analyzed prior to the Administration's endorsement of the present legislation. By purporting to give each resident of the State a direct interest in the development of the State's natural resources, it would become an independent voice for more rapid exploitation of those resources. Because the dividends to the residents would, as presently proposed, be directly affected by the nature and extent of the State oil and gas tax policy, it would likely become a lobbying force for lower State taxes. Obviously, lots of tradeoffs are involved, but the political and economic issue reduces itself to the following: Would it be better to expedite resource development and lower State taxes in such a case in order to allow AGSOC's shareholders to benefit directly (albeit by only a marginal increase in their dividend) and at the same time deprive the State treasury of potentially enormous revenues which could be devoted to various social welfare programs? These programs would ultimately return greater proportionate benefits to those in the lower income brackets in the State and possibly lesser benefits (than AGSOC) to those in the upper income brackets.

However, they have also indicated that there was a significant probability (about 75%) that AGSOC would have to return to the Administration and to the legislature, and ultimately to the people at the polls, for approval of a major extension of State credit or guarantees to secure loans of sufficient size to enable AGSOC to invest in TAPS, construct a gas line, etc.

SSSB 170 presently contains only one financing device--AS 10.50.100. The bill proposes the creation of a loan guarantee fund which will be a special fund segregated from all other funds of the State. It purports to be a trust fund for the uses and purposes of this section, but no uses and purposes are set forth in that section. As proponents of the measure have stated that the sole purpose is to guarantee loans for startup or organizational costs of the corporation, they have agreed to both clarify the uses to which the monies can be put and to a statement of a definite limit on the appropriations into the fund (\$5,000,000.00). In addition, this section charges the Commissioner of Revenue with reviewing applications for loan guarantees (for the purpose of guarding against fraud and misrepresentation). It is suggested that the Commissioner of Revenue be given broader review powers such as the ability to disapprove a loan on the basis of its general inadvisability.

To accommodate these various concerns, the following substitute for AS 10.50.100 contained in SSSB 170 is submitted for consideration:

A) There is a special fund of the State known as the Alaska General Stock Ownership Corporation Loan Guarantee Fund, which shall not exceed \$5,000,000.00. and which shall be completely segregated from all other funds of the State. This fund is a trust for the uses and purposes of this section.

B) The Commissioner of Revenue shall use the fund to guarantee loans solely for startup costs (and not to include major investment financing) made to the corporation by lenders other than the State. In guaranteeing loans, the Commissioner of Revenue shall review the loans for the purpose of ascertaining the general soundness of the proposed loan and for the purpose of guarding against fraud

and misrepresentation. The guarantee of a loan may not be for an amount in excess of the unobligated balance in the fund at the time the guarantee is made.

Whereas the above minor technical changes can clarify or limit the general purpose of the loan guarantee fund as originally proposed, the manner in which AGSOC would approach the State and apply for an appropriation or legislation which would enable them to utilize the public credit of the State of Alaska to guarantee a major investment in the future is not treated in this bill. Senator Gravel has testified that such an extension of public credit would be in accordance with the procedures which pertain to the issuance of general obligation bonds which require the ratification of the voters at the polls. Thus, Senator Gravel has argued that no major extension of public credit would occur without the ultimate participation of all the voters of the State who would, of course, include most of the AGSOC shareholders.

Senator Gravel is basing his procedural argument on Article IX, §8, State Constitution, which states:

"No state debt shall be contracted unless authorized by law for Capital improvements and ratified by the majority of the qualified voters of the State who vote on the question."

Although the issue deserves further review by this department, it is suggested that this provision on its face does not apply to the type of guarantee contemplated by Senator Gravel and the proponents of the AGSOC, since the investment would not qualify as a capital improvement authorized by law under this section. See City of Juneau v. Hickson, 373 P2d 743 (Alaska 1962).

Rather, it would appear that Article IX, §6, applies in this context:

"No tax shall be levied, or appropriation of public money made, or public property transferred, nor shall the public credit be used, except for a public purpose."

Under this provision, all that would be required for an extension of credit to the AGSOC would be legislation appropriating a sufficient amount of money to guarantee AGSOC's commitment. Thus, it appears that something on the order of a loan guarantee fund on a vaster scale would in fact be required but such legislation would not be subject to voter ratification at a subsequent general election. Since Kelso's investment consultants have based their advice on the assumption that there could be a call on the general credit of the State without a significant appropriation to back up any guarantees, the ability of the State treasury to make such an appropriation and its fiscal impact on other State programs has never been carefully analyzed.

Thus, three questions need to be considered: (1) Whether there is any constitutional mechanism for extending the State's credit without the necessity of a large appropriation which may not be fiscally sound or economically feasible; if not, whether AGSOC's proponents who have assumed the availability of access to the State's credit have any alternative suggestions for the financing of the corporation which should be statutorily treated at this time; (2) Whether this statute should incorporate a statutory procedure or requirement for voter ratification of any major investment proposal, funded by direct appropriation into a guarantee loan fund; and (3) Whether a constitutional amendment would be required to allow the State to guarantee AGSOC's loans.

III. DEPOLITICIZING THE AGSOC

The proponents of the AGSOC have conceived of this entity as operating as a private corporation subject to the very few qualifications imposed on it by federal law. Thus, the corporation is subject to the standard provisions of the Alaska Business Corporation Act, AS 10.05, except where inconsistent with the state or federal enabling legislation. The proponents have argued that AGSOC stands the best chance of being a success, (i.e., operating at a profit which will be shared in by most Alaskan residents) if it is structured as a completely private corporation. However, it should be noted that there is nothing in the federal legislation which would preclude the AGSOC's establishment as a state agency or public corporation.

No matter how the AGSOC is ultimately designed, it would be foolhardy to believe that this entity would not quickly become highly politicized and ultimately, if it is successful, become an extremely powerful political force in

the State. Assuming it is established as a private corporation, it would present the following issues:

A) AGSOC: A Fourth Branch of Government

A successful AGSOC, representing as it would the residents of the State of Alaska would in essence, become a fourth branch of government. It will be a fourth forum in which State environmental, social, economic and tax questions will be vigorously debated. The Governor's control over this, corporation is limited to appointing the first board of directors. After that the corporation will, as presently designed, operate completely independent of any state agency, albeit it will be subject to all applicable state regulatory provisions. Given the composition of the corporation, it would become quickly susceptible to the pressures of any cohesive organized group of residents within the State, such as large labor unions, native corporations, etc. That is, any private organization containing a large number of resident votes could well form a block in the nature of a voters' trust, which could be used to gain control, or at least to form an influential minority on the board of directors.

The board, and indirectly management, would be subject to election by the same or a similar constituency as the Governor of the State. Thus, the chairman of the board could conceivably end up representing a larger number of Alaskan residents than the Governor of the State. The Governor would be put in the somewhat anomalous position of dealing with a more popular, albeit apolitical, leader representing the fourth estate, i.e., AGSOC.

Although one could argue that AGOSC violates the fundamental political theory of the State Constitution which established only three branches of government, this objection is more of a philosophical one than a legal one, and it is not anticipated that any such challenge could be successfully formulated and presented to the State courts. Finally, under this general category of concerns relating to its impact on the present institutional balance of power as contemplated by the State Constitution, it should be noted that

management of the corporation, members of the board of directors of the corporation, could, and very well might, utilize their position as a forum for criticism of the Administration's economic policies and ultimately as a launching pad for State elective office.

B) Specific Constraints: Lobbying and Political Contributions. Since AGSOC will purport to represent the people of the State of Alaska, it could be argued that since that function is also served by the Governor of the State and by the legislature in the political arena, AGSOC should be prohibited from participating in that same arena, or at least be made subject to stringent restrictions. It is suggested that AGSOC should be prohibited from lobbying, from making political contributions to candidates for State offices, and that strict proxy review mechanisms should be added to the bill to ensure that the board of directors act in a politically neutral fashion. For instance, AGSOC's board, in its annual report, would be allowed to analyze the impact of State taxes on its percapita dividends. However, the board would not be able to affirmatively encourage the shareholders to write their legislators and call for a lower rate of taxation. The shareholders would have to draw their own conclusions. Obviously, the shareholders would then be allowed to contact their legislators and express their opinion on the subject.

Furthermore, a AGSOC endorsement of a political candidate would obviously be a cherished one. Even though AGSOC's proponents at present claim that this corporation is merely another private corporate entity, we have absolutely no guarantees that management in future years will not take full advantage of its position as representative of the residents of Alaska and try to see its political and economic policy preferences implemented by vigorous participation in the political arena. AGSOC endorsements and political contributions might therefore best be prohibited.

C) Litigation With The State. AGSOC, just like any other major corporate entity, would become subject to various State regulatory laws, and the

possibility for confrontation is obvious. For instance, should AGSOC become the vehicle for financing the gas line, AGSOC would have a corporate interest in raising the tariff on the pipeline which would be assessed against the State, and the State as producer and shipper would have an interest in lowering the tariff in order to maximize State royalty and severance tax revenues to the treasury.

In addition, the proponents of AGSOC have stated on several occasions that in order for it to result in tangible benefits to the individual Alaskan shareholder, it must invest in vast development projects which will involve vast returns (hopefully). Thus, there is every likelihood that AGSOC would become a major force for concentration of economic power in the State and might ultimately develop or acquire monopoly control over one or more economic sectors. This, in turn, would present anti-trust problems, both under state and federal law, and the following scenarios are possible: 1) Since AGSOC is not a State agency, it would not enjoy the "state action" exemption from the federal anti-trust laws and it would likewise be subject to treble damage actions for any economic injuries arising out of violations of the Sherman or Clayton Anti-Trust Acts, 15 U.S.C., §1, et seq., and (2) The State could find itself litigating at great expense against AGSOC in order to require it to divest itself of various interests, or to require it to cease and desist from some specific anti-competitive practice.

The anti-trust example is one of many. It could occur in the environmental sector, the banking and securities area, the tax area, or in any other area of commercial endeavor. The State and AGSOC, if engaged in litigation with each other, would be drawing on resources which ultimately affect the same individuals, i.e., the taxpayers versus the shareholders. Should the State prevail and obtain a fine, such a fine would, itself, seem counterproductive.

Some suggestions for mitigating the underlying irony of the State litigating against the people of the State, i.e., AGSOC, and the potential for enormous waste of common resources which is inherent in any extensive litigation such as a protest of a pipeline tariff, might be as follows:

1) When a dispute arises between the State and AGSOC, the matter could be held in abeyance until the next legislature to allow the latter to determine by legislation the proper resolution of the matter; or the matter could be submitted to an arbitration panel established by statute.

2) Other means of controlling litigation between AGSOC and the State would be to create a disincentive to any litigation. One such disincentive would be a modification of the court rules relating to the award of costs and attorney's fees to provide that the State would always be entitled to receive its actual costs and attorney's fees incurred in the litigation of any action involving AGSOC. In addition, AGSOC's right to costs and attorney's fees would arise only in those cases where the court makes an express finding that the State's prosecution or defense was frivolous or lacking in good faith.

IV. CORPORATE DEMOCRACY

One of the most important policy questions which must be addressed in any analysis of AGSOC is whether or not resident shareholders' right to participate in and to influence corporate decision making is adequately protected or assured by the normal corporate procedures set forth in AS 10.05. The following is a list of specific issues which the administration and the legislature should address in its analysis of the AGSOC legislation:

1) Classified Directors. The present sponsor substitute provides for a board of directors consisting of nine members divided into three classes of three members each. Three directors will therefore be eligible for an election during any one year. See AS 10.50.030. A highly classified

board of directors such as this would limit the ability of minorities within the State to obtain representation on the board of directors. Every shareholder has one vote, and if all nine directors were elected at the same time, there is a greater opportunity for minorities such as native organizations, etc., to elect at least one board member. A highly classified board would tend to heavily favor urbanized Alaska.

2) Cumulative Voting. AS 10.05.162 presently provides that shareholders may, at an election for directors, cumulate their votes by giving one candidate as many votes as the number of directors to be elected, multiplied by the number of that shareholder's shares. However, a corporation may provide in its bylaws (modified by board of directors' resolutions) that shareholders cannot cumulate their votes but must vote shares held by them on an election-by-election basis. Cumulative voting is another device to help ensure minority representation on the board of directors. By leaving it optional, as stated in AS 10.05.162, the board of directors could amend the bylaws to prohibit cumulative voting. It is suggested that it might be desirable for the AGSOC legislation to expressly state that cumulative voting cannot be prohibited by shareholder or by director action.

3) Voting Trusts. In accordance with AS 10.05.171, voting trusts may be created by any number of shareholders who wish to confer upon a trustee the right to vote or otherwise represent the shareholders for a period not exceeding ten years. The existence or toleration of voting trusts within the AGSOC context is a question which should be carefully analyzed. At this point in time, it is suggested that their prohibition might be advisable or at least a limitation imposed on the number of years that they can remain in existence. For instance, AGSOC proponents indicate that the original AGSOC will be coming back to the legislature for each major investment proposal. Thus, within a ten-year period, two or three major investment schemes may have been considered and acted upon, and a ten-year voting trust would allow a trustee undue amount of influence over any of these decisions.

4) Amendment of The Articles of Incorporation. AS 10.05.276 presently provides that the board of directors shall adopt a resolution setting out a proposed amendment directing that it be submitted to a vote at the annual or special meeting of the shareholders. Thus, it appears that the initiative to amend the articles must come from the board, and it may be desirable to provide for an amendment which would allow the shareholders to propose amendments to the articles of incorporation that can be taken up and voted on at annual meetings:

5) Quorum of Shareholders. AS 10.05.153 presently provides that, unless otherwise provided in the articles of incorporation, the majority of the shares entitled to vote constitutes a quorum in a meeting of shareholders. (The section provides for a minimum of one-third of the shares.) The quorum requirement is something that the legislature may wish to mandate by statute. Here, of course, the higher the quorum requirement, the greater the difficulty the corporation will have in holding an annual meeting. However, a high quorum requirement would necessitate vigorous promotional and educational programs to ensure the presence of the quorum at each annual meeting and might indirectly spur the corporation to greater efforts to include or request the participation of all shareholders of the State in corporate decision making.

6) Notice of Meetings of Shareholders. AS 10.05.138 presently provides that meetings of shareholders may be held at the place (either inside or outside the State) as may be provided in the bylaws. In addition, an annual meeting of the shareholders shall be held at the time provided in the bylaws. Special meetings of the shareholders may be called by the president, the board of directors, and holders of not less than one-tenth of all the shares entitled to vote at the meeting.

AS 10.05.141 in addition requires written or printed notice of all meetings, such notice shall be delivered not less than ten nor more than fifty days before the date of the meeting, either personally or by mail.

Obviously, together these rules operate to favor incumbent management. Annual meetings could

be rescheduled by a change in the bylaws which requires a vote of the board of directors. The board could, on short notice, i.e., as little as ten days, present the shareholders with any major issue it chose, such as the election of new directors or consideration of a major investment proposal.

The legislature might well wish to consider statutory safeguards which would ensure adequate notice of the time, place and purpose of any meeting which would preclude manipulation of the timing of any meeting to the advantage of the incumbents.

7) Bylaws. AS 10.05.135 presently provides that the board of directors shall have the power to alter, amend or repeal the bylaws unless it is reserved to the shareholders by the articles of incorporation. Again, it is suggested that the amendment of the bylaws might be a power which should be reserved to the shareholders in order to ensure adequate public review of any change in the management's approach to the conduct of the corporation's business.

8) Financing of Proxy Fights, Access to Voting Lists and Mailing Machinery. Several commentaries concerning modern corporate battles note the inherent advantage which incumbent management has through its control of the corporate machinery for sending out mailings, soliciting support, and arguing its cause before the shareholders. This is done at corporate expense, whereas opposing or dissenting shareholders frequently have to finance such efforts from private sources. Amendments might well be considered which would allow shareholders who can obtain a certain number of qualified signatures to utilize the corporation's mailing machinery at the corporation's expense. This procedure should be especially encouraged in the context of elections for the board of directors. Candidates who can either obtain a nomination by the board of directors or the support of a predetermined percentage of the shareholders should be entitled to publish information concerning themselves, their experience, their policy preferences and their criticisms of existing management at the corporation's expense.

V. PRIVATE CORPORATION: CLOSED CLASS OF
SHAREHOLDERS

Two other constitutional issues should be mentioned briefly in this context. First, the federal legislation authorizing the creation of GSOC mandates that the shareholder group be made up of a closed class (i.e., those residents who satisfy the eligibility requirements imposed by state law as of the date of the state charter, and who remain residents as of the date of the issuance of the shares). Thus, future residents would be ineligible for one of the free shares of AGSOC. Under Kelso's present plan, AGSOC shareholders who leave the state and become nonresidents would be entitled to retain their dividends and voting rights in AGSOC. Persons leaving the state who wish to sell their shares could, of course, sell to new residents who wish to participate in the AGSOC. In addition, oldtime residents could acquire as many as ten shares in AGSOC through purchase or inheritance.

These two factors, when combined, could lead to the following scenario: The initial one hundred percent of the AGSOC shares could be concentrated in as few as ten percent of the original shareholders. Those shareholders, in turn, could become residents of other states, and thus it is theoretically possible that ten or twenty years from the original issuance, AGSOC shareholders could be composed of a select group of resident Alaskans and nonresident former Alaskans. Ironically, it may be at this very time that the state may be called upon to honor its guarantee, and thus the state's credit rating and ability to issue bonds at favorable interest rates would be adversely affected, and the people who would be called upon to bear the burden of AGSOC adventures would be the taxpaying class of Alaskans at that time. This potential for a sharp dichotomy between the shareholder class of AGSOC and the resident population of the state deserves closer analysis. Kelso's report contains no estimates of the transiency rates of the Alaskan population and no projections as to the future composition of its AGSOC.

The legal issue which overlaps this general policy question is whether or not the closed class nature of the AGSOC offends the equal protection provisions of the state or federal constitutions. Wilmer, Cutler & Pickering, in their memorandum of December 15, 1978, on the constitutional issues, felt that such a provision might be successfully

defended against a federal constitutional challenge. A closer question is presented under the state constitutional provision which has been interpreted somewhat more stringently than its federal counterpart. See Isakson v. Richey, 550 P2d 359 (Alaska 1976). Under this provision, a substantial question is raised as to whether or not the AGSOC arbitrarily discriminates against future residents of the state.

Secondly, a derivative issue is whether or not the use of the public credit for the direct benefit of a private corporation whose shareholders will, over time, form a distinct class within the state (possibly a minority class) qualifies under the "public purpose" requirement of Article IX, §6 of the Alaska State Constitution.

MEMORANDUM

TO: Rep. Jim Duncan
FROM: Jerry Gauche
RE: Policy & Legal Issues Surrounding AGSOC
DATE: April 4, 1979

Following is a discussion of some political and legal issues raised by a memorandum dated March 19, 1979 from Avrum Gross, Attorney General, to Frances Ulmer, Director, Division of Policy Development & Planning, regarding the Alaska General Stock Ownership Corporation legislation, SSHB 240.

I. TAXATION

The current sponsor substitute for HB 240 fulfills the requirements of Subchapter U of the Internal Revenue Code for tax qualification as a general stock ownership corporation and a corporation organized under its terms would be entitled to special tax treatment. The tax advantages available to GSOCs are presently available to all corporation with 15 or fewer shareholders. The Internal Revenue Code permits small business corporations to avoid corporate income taxes in much the same manner as a general stock ownership corporation. But, for the first time this concept of "integration" of the corporate and personal income tax has been extended to a large corporation through the GSOC.

A. State Income Tax.

Alaska law incorporates federal income tax changes unless the legislature acts. Tax benefits provided GSOCs could be denied to AGSOC by the Alaska legislature. However, for Alaska to take special steps to tax AGSOC as a typical corporation would reduce its ability to benefit its shareholders. In addition, the tax treatment provided GSOCs might well generate more income to the state per dollar of corporate earnings than the corporate income tax. In any event, no one has suggested that Alaska deny the tax benefits provided by federal law.

B. Other State Taxes.

AGSOC is subject to all state taxes including severance, property and, if certain investments are undertaken, the oil and gas corporate income tax. There has been no discussion of exempting AGSOC from these taxes and the Department of Revenue understandably opposes any exemption of AGSOC from the oil and gas corporate income tax. Such exemption could harm the state's case in litigation over that tax.

If AGSOC investments subject it to the oil and gas corporate income tax no special problems appear to be presented. The tax reaches income sheltered by multistate and multinational corporations through accelerated deductions, expenses, and shifting of income. AGSOC has no capacity to shift income out of Alaska nor the incentive to shelter income. The flow through of tax liability and high distribution requirements enable the AGSOC to function comfortably under the oil and gas corporate income tax if the tax should apply.

C. Potential Investments.

Several investments have been mentioned as possibilities for AGSOC. However, the concept of a general stock ownership corporation is to make investment decisions at the corporate level based on the good business judgement of professional managers following careful investigation of the alternatives. Selection of investments is designed to be made outside the political process. It is therefore impossible to suggest at this time which project or projects the AGSOC might find appropriate for investment. Because of this freedom of investment selection it would also be unwise to attempt to tailor the taxation of AGSOC through exemption from special taxes such as the oil and gas corporate income tax.

D. Policy Questions.

1. Pressure for Development.

Oil and gas development is one of many possible investments which may be explored by AGSOC. According to the Attorney General such an investment would encourage rapid exploitation of these resources because Alaskans would benefit directly. This suggests that if the people of Alaska benefit directly from development they will act irresponsibly with respect to Alaska's

resources. The status quo avoids any push for exploitation because Alaskans benefit only from taxes on the development earnings of outside corporations.

AGSOC provides an alternative to this status quo if one is willing to believe that Alaskans are capable of making proper decisions regarding their own economic destiny. For the first time, through AGSOC, development earnings will flow to Alaskans instead of the non-Alaskans who have, until now, controlled development in our state. Alaskans will continue to benefit from state ownership and control of the resources. In addition, they will have the opportunity to benefit from extraction and delivery as well.

There is no reason to believe that AGSOC will ravage Alaska in the name of ever higher profits. It is likely that the corporation will become a voice for more responsible development in Alaska. For the first time the people of the state will control a major corporation doing business in Alaska. AGSOC will be an exemplary corporate citizen because its activities will directly affect the quality of its shareholders' lives. Alaskans can be expected to demand responsible actions by the corporation. Unlike many developers here, if AGSOC dumps its garbage in Alaska it will be dumping it in the back yards of its shareholders.

2. State Revenues vs. AGSOC Income.

Will AGSOC become a lobbying force for lower state taxes? Every taxpayer in Alaska has some interest in lowering taxes. The real issue is whether AGSOC will change the balance between Alaskans' desire for more government services and lower taxes. Is there reason to believe that AGSOC shareholders will act differently with respect to taxes on AGSOC income than they do with respect to taxes on their other income?

The political and economic issues of state revenues versus disposable personal income are not new to Alaska or the nation. AGSOC does not significantly alter the trade off. The issue cannot be reduced to the simplistic choice between AGSOC dividends or social welfare programs. AGSOC will become only one relatively small component in the complex mix of taxes, government programs, and taxpayer perceptions. Increases in AGSOC dividends from lower taxes will not take food out of the mouths of the poor. AGSOC dividends may well benefit the poor as much, if not more than, the same amount of money doled out by the government as transfer payments.

In any event, there is no reason to presume that the AGSOC will lobby strongly for tax reduction. Alaskans already pay a significant share of their income in state taxes, but there has been no irresponsible drive to eliminate the personal income tax. Those same Alaskans will control the AGSOC. There is no reason to believe that the possibility of some additional dividend income will cause them to raid the state's treasury. The entire discussion of the trade off between state revenues and AGSOC income is mute if we assume that the people of Alaska and their elected representatives will continue to act responsibly in defining the relationship between state revenues and Alaskans' personal income.

II. "DEPOLITICIZING" AGSOC

"Depoliticize" is a polite word for the elimination of political rights. Proposals to limit the political and legal rights of AGSOC imply that Alaskans cannot be trusted to distinguish between their roles as citizens and shareholders. Therefore, the citizens must be protected from making unfortunate economic decisions by denying the political and legal rights of their corporation. Underlying is the implication that Alaskans should not have the power, independently of the state government, to determine their own economic future.

To suggest that AGSOC will become a "fourth branch of government" is an insult to the integrity of the governor, the legislature and the voters of the state. The proposed abrogation of political rights seems designed to protect the legislature from the influence of a corporation owned by its own people. It seems the legislature needs protection from AGSOC, a corporation owned by Alaskans, more than from other powerful corporate influences in the state.

Attempts to "depoliticize" AGSOC require limitations on the political rights of the corporation. This limits the ability of the corporation to protect the interests of its shareholders. Such limitations suggest that AGSOC shareholders are either less deserving of full political rights than the shareholders of other corporations or so powerful that they do not need the political protections afforded the shareholders of other corporations.

Government is one of the most significant forces affecting the conduct of modern corporate business. Taxes, licencing, and regulation of environmental pollution, securities transactions, transportation, health and safety and many other governmental activities affect the profitability and continued existence of the corporation. In order to protect itself and its shareholders from arbitrary or ill considered actions by the government the corporation must be able to exercise its political rights.

A. Specific Limitations.

Several specific limitations on the political and legal rights of the AGSOC are suggested. It is appropriate to question whether any of these limitations would be constitutional as applied only to AGSOC? These proposals may well be the start of an attempt to limit the political and legal rights of all corporations chartered or doing business in Alaska. If they are appropriate for AGSOC why not for other Alaska corporations as well?

The right to make political contributions is already limited to \$1,000 per year per candidate. AS 15.13.070. The right to lobby is restricted by the existing disclosure provisions of Alaska law. The Attorney General suggests that AGSOC be denied the right to lobby, make political contributions, endorse candidates and reserve comment on state activities affecting the interests of its shareholders. In other words, if the state acts irresponsibly with respect to AGSOC the corporation cannot tell anyone or do anything to change the state's position. It must stand passively by while its shareholders suffer.

The justification for denying AGSOC political rights appears to be that it might have too much influence. Regarding the right to endorse candidates the Attorney General says, "[W]e have absolutely no guarantees that management . . . will not take full advantage of its position as representative of the residents of Alaska and try to see its political and economic preferences implemented by vigorous participation in the political arena." We do not deny the political rights of other groups and corporations simply because they seek to implement their political and economic preferences, that is the essence of our system, why should we limit the AGSOC?

There are three points raised by the Attorney General which warrant consideration:

1. Block Voting.

Block voting of AGSOC stock by influential Alaska groups such as natives or labor unions is a possibility. To the extent that the corporation is made more responsive to its shareholders block voting is facilitated. However, we should ask why it is inappropriate for these important Alaskan groups to have an influence on AGSOC? Why is their influence within AGSOC more to be feared than their existing influence within the economic or political arena?

2. Political Popularity.

The Attorney General points out that the governor could be in the "anomalous position of dealing with a more popular, albeit apolitical, leader representing" the AGSOC. This issue may present a political problem for the governor, but certainly is not grounds for denying the people of Alaska the benefits of a general stock ownership corporation.

3. The Springboard.

The suggestion is made that the AGSOC board members might use their positions as springboards to political office. It is not uncommon for individuals who have served in important posts within the state, both in government and the private sector, to subsequently run for political office. To protect against such an eventuality only in the case of the AGSOC would be to discriminate unfairly against that corporation. To deny the people an AGSOC because the directors might "utilize their position as a forum for criticism of the Administration's economic policies and ultimately as a launching pad for State elective office" seems narrow minded indeed.

B. Litigation with the State.

The Attorney General finds an "underlying irony" in the state litigating against the people of the state. This observation reflects again the confusion between the citizens of Alaska and the shareholders of AGSOC.

The Attorney General would not hesitate to sue a corporation owned by a few Alaskans. Why are these suits not a "waste of common resources" when, apparently, a suit against the AGSOC would be? The difference seems to be that damages from other corporations would burden only a few Alaskans while damages levied against AGSOC would cause many Alaskans to suffer.

An analysis of AGSOC legal rights must be founded on a proper understanding of the state's role as litigant. The state litigates for the purpose of enforcing reasonable rules established for the benefit of its citizens. If some of its citizens, acting through a corporation, violate its reasonable rules, the state should reprimand them. On the other hand, if the state's rules are unreasonable, the right to litigate protects the citizens. The state's relationship to AGSOC and its shareholders should be the same for purposes of litigation as its relationship to other corporations. It is proper for the state to litigate against even a majority of its citizens to enforce reasonable laws and regulations and it is reasonable for those citizens to defend in order to assure that their rights are not violated by the state.

The Attorney General offers two suggestions for resolving legal conflicts between the state and AGSOC. One suggestion is to throw any such dispute into the political arena where, if other Attorney General proposals are adopted, the AGSOC would have no access. This would politicize the AGSOC to the extreme and make of the legislature a court before which the issue would be tried without the procedural protections of the law. Resolution of legal disputes would be based on political influence.

The suggestion to arbitrate conflicts approaches more closely existing law and would, hopefully, assure the parties' legal rights. However, arbitration can be nearly as costly and time consuming as a law suit. In the final analysis one must ask what is wrong with the existing system for settling legal conflicts between the state and corporations as applied to the AGSOC?

The existing system of laws was designed to protect the rights of the parties while arriving at a proper decision of the issues. It is sometimes costly, but we have yet to develop an alternative which arrives at

REVENUE ACT OF 1973

Report of the Committee on Finance

United States Senate

H.R. 13511

J. General Stock Ownership Corporations

(Sec. 201 of the bill)

Present law

Under present law, there are no special provisions relating to the establishment of a private corporation for the benefit of the residents of a State.

Reasons for change

The committee believes that many citizens should have a greater ownership stake in the private enterprise system, and that this would lead to better understanding of the system and would encourage individuals to invest in other business enterprises. Also, in the case of individuals now receiving various forms of transfer payments from Federal, State, or local governments, the receipt of dividend income from a General Stock Ownership Corporation (GSOC) would, to some extent, reduce the need for such payments. The committee believes that an experimental program permitting States to form such private corporations for the benefit of their citizens may enable the Congress to study a method of replacing transfer payments with dividend income.

Explanation of provisions

General.—Under the committee bill, a State would be authorized to establish a GSOC for the benefit of its citizens. It is anticipated that the GSOC would be authorized to borrow money to acquire business enterprises. The cash flow from the operation of the business would be used to pay the loan, and the corporate revenues would be distributed to the GSOC shareholders (i.e., the citizens of the State).

Definition of GSOC.—The bill provides that a corporation must meet certain statutory tests in order to be treated as a GSOC. First, the corporation must be chartered by an official act of the State legislature or by a State-wide referendum. Second, the GSOC's corporate charter must provide for the issuance of all authorized shares to eligible individuals provided that at least one share is issued to each eligible individual, and such eligible individual does not elect within one year after the date of issuance not to receive such share, and provides for certain restrictions on the transferability of the share. The transfer restriction must provide that the share cannot be transferred until the earliest to occur of (1) the expiration of 5 years from issuance (2) death or (3) failure to meet the State's residency requirements. In no event may shares of stock of a GSOC be transferred to nonresidents. Also, an individual may not acquire more than 9 shares by purchase. Third, the charter must provide that the GSOC is empowered to invest in properties (not including properties acquired by it or for its benefit through the right of eminent domain). Fourth, the GSOC may not be affiliated with any other corporation. Fifth, the GSOC must be organized after December 31, 1978, and before January 1, 1984. An eligible individual is any individual who is a resident of the chartering State as of the date specified in the corporate charter. A State may define a resident for purposes of its GSOC so long as such definition is consistent with constitutional principles.

Election.—A GSOC must make an election to obtain the special statutory treatment provided for by the amendment. The election is effective for the taxable year for which it is made on a timely filed tax return. The manner in which the election is to be made would be determined by regulations. The election once made is irrevocable unless terminated with the consent of the Secretary of the Treasury.

Effect of election.—The effect of the election would be to exempt the corporation from Federal income taxation. Instead, the shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

Treated as a private corporation.—A GSOC would be treated as a private corporation.

Computation of GSOC income.—The GSOC would compute its taxable income in the same manner as a regular corporation with certain modifications. The GSOC would not be eligible for a dividends received deduction nor any tax credits.

Net operating loss deduction.—The shareholders of a GSOC would not be eligible to report any portion of a GSOC net operating loss on their individual income tax return. Instead, the GSOC would be entitled to a 10-year carryover of any net operating losses.

Investment tax credit and recapture of investment tax credit.—Under the bill, shareholders of the GSOC would be entitled to their pro-rata share of the GSOC's investment tax credit. The shareholders would also be personally responsible for any recapture of such investment tax credit. Neither the corporation nor its shareholders would be entitled to the foreign tax credit.

Taxation of shareholders.—Under the bill, each shareholder would include in his gross income his daily prorated portion of the GSOC's taxable income. Such income would be included in the shareholder's gross income for the taxable year in which or with which the GSOC's taxable year ends. The income in the hands of the shareholder would be treated as ordinary income and would not be eligible for either the partial dividend exclusion (sec. 116) or the maximum tax of earned income.

Shareholders would increase the tax basis of shares of stock in the GSOC to the extent they reported income from the GSOC. Distributions from the GSOC out of such previously taxed income would decrease the tax basis of such shares.

Taxation of GSOC distribution.—Under the bill, distributions from a GSOC's taxable income previously taxed to a shareholder would be treated as a tax-free distribution. Any distribution in excess of such previously taxed income would be taxed in the same manner as a distribution from a regular corporation (sec. 301(c)).

Audit adjustments and amended tax returns.—Any audit adjustment resulting from an Internal Revenue Service determination would be reflected in the GSOC's taxable year in which such adjustment is made (and not the taxable year to which it relates). The amount of such adjustment would be subject to an interest charge in an amount computed as though the income had been taxed to a nonexempting corporation.

Reporting requirements.—Under the bill, a GSOC would be required to file a Federal income tax return and a computer-coded data showing information reported to each of its shareholders. The corporate tax return would be required to meet the same timing requirements as a regular corporation. In addition, a GSOC would be required to give each shareholder a Form 1099. The Form 1099 would report (1) the shareholder's pro rata income for the taxable year, (2) tax-free distributions for the year, (3) the tax treatment of other distributions, and (4) the amount of any investment tax credit and recapture thereof for such year, and (5) any amounts withheld for Federal income tax purposes.

Distribution requirements.—A GSOC would be required to distribute 90 percent of its taxable income to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the deficiency (i.e., the difference between the required distribution and the actual distribution) would be imposed on the GSOC. The amount of such tax would be allowed as a deduction to the GSOC for the year in which it is paid.

Withholding requirements.—The bill requires the GSOC to withhold an amount equal to 25 percent of every distribution made to its shareholders. The amount of such withholding would be allowed as a refundable credit to the shareholder. The Treasury would be authorized to issue regulations providing a certification procedure for individuals who are nontaxpayers under which they may be exempted from the withholding requirement.

Studies.—It is expected that a study would be made of the effect GSOC's have on competition with regular private corporations. It is also anticipated that a study would be made of the GSOC as a form of full corporate integration.

Taxable year end of GSOC.—The bill requires a GSOC to adopt a taxable year end of October 31. It is anticipated that most GSOC's would elect an October 31 year end. This would enable them to close their books and meet their shareholder reporting requirements by January 31 of the next succeeding year.

Effective date

The provision applies to corporations chartered and organized after December 31, 1978.

Revenue effect

The revenue cost of the proposal is expected to be negligible during the next few years. However, the long-run cost could be substantial.



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Senate

GENERAL STOCKOWNERSHIP PLANS

Mr. GRAVEL. Mr. President, I would like to take a moment to compliment the Senate on one provision of this bill. This tax bill goes far toward stimulating the much needed growth of capital in our economy. But, there is one provision in this bill, a provision which I am proud to say was added by the Senate, which addresses the question of who will own this new capital.

The Joint Economic Committee estimated in 1974 that 1 percent of our population owned 25 percent of our wealth and more than 50 percent of all corporate stock. Studies indicate that these concentrations of wealth have not changed significantly in 50 years despite all our efforts at income redistribution and amelioration of poverty. The amendment regarding general stockownership plans in this bill is a significant step toward broadening the ownership of American wealth.

Leadership on the issue of broadening capital ownership has long and ably been carried by my colleague and friend, the chairman of the Finance Committee. His work in the area of employee stock ownership plans has laid the foundation for Federal policy on expanded capital ownership. Following in his footsteps I sought to extend the concept of broadened capital ownership beyond the employer-employee relationship. The general stock ownership plan legislation contained in this bill is an important step in that direction. I would like to thank Chairman Long for his help in seeing these provisions adopted and to thank

my fellow Finance Committee members who were supportive of my efforts.

There are a number of questions which my colleagues have put to me over the past few months and I would like to include some explanation of these issues for the RECORD.

First. What is a general stockownership corporation and how is it organized?

A general stockownership corporation would be formed either by act of a State legislature or by statewide referendum and each resident would be issued a share of stock. The residents would not be charged for their stock and would receive it free and clear. The corporation would borrow money to invest in profit-making ventures with the loan secured by the assets and, if necessary, by a State guarantee. Through this method the citizens of a State would become owners of capital. The earnings from the GSOP investments would be used to retire the loan and the balance distributed to the shareholders.

Second. What sort of technical requirements must be met in order to establish a general stock ownership corporation?

The bill authorizes States to establish privately owned GSOC's for the benefit of their citizens. A GSOC is a private corporation chartered by an act of a State legislature or by statewide referendum with a charter providing for first, the issuance of at least one share of stock to each eligible individual who does not elect within 1 year from the date of issuance not to receive such share; second, restrictions on transferability of shares (a) to nonresidents, (b) to an individual owning more than 9 shares or (c) until the earliest to occur

...to meet the State residency requirements. The GSOC must be chartered after December 31, 1978 and before January 1, 1983 and may not own more than 20 percent of any subsidiary corporation. GSOC investments are not limited, but a GSOC may not acquire a business from an unwilling seller through the State's power of eminent domain. This limitation does not apply to the State's power to acquire a right-of-way for a particular project, but precludes the involuntary sale of a business to the GSOC.

Third. What does the legislation mean when it refers to stock being distributed to "eligible individuals?"

An eligible individual is any individual who is a resident of the chartering State as defined in the State's enabling legislation so long as the definition is consistent with constitutional principles.

Fourth. GSOC's are entitled to taxation in a unique manner. What is the special tax treatment of these corporations?

GSOC's may elect to be exempt from Federal income taxation. The shareholders of an electing GSOC will report their proportionate share of the GSOC's taxable income on their Federal individual income tax returns. The election, made in a manner to be determined by regulation, is effective for the taxable year for which made on a timely filed return. The election may be terminated with the consent of the Secretary of Treasury. It would be appropriate for the Secretary to consent to revocation for a taxable year where the tax liability of GSOC shareholders significantly exceeds cash distributions. Once the election is terminated the GSOC is subject to the normal Federal income tax and may not re-elect. The taxable year of an electing GSOC shall end October 31, unless the Secretary of Treasury consents to a different taxable year.

A GSOC will compute its taxable income in the same manner as other corporations, but is not eligible for a dividends received deduction nor any tax credits. The GSOC is entitled to a 10-year carryover of any net operating losses. An audit adjustment resulting from an Internal Revenue Service final determination will be reflected in the

...year in which such adjustment is made and not the taxable year to which it relates. The amount of such adjustment will be subject to an interest charge in an amount computed as though the income had been taxed to a nonselecting corporation.

Fifth. The corporation itself does not pay Federal income tax, but the income of the corporation is taxed to the shareholders?

Yes, each shareholder will include in his gross income his daily prorated share of the GSOC's taxable income. The shareholder will also be entitled to his pro-rata share of the GSOC investment credit and liable for any recapture computed at the corporate level. Income, credits and recapture will be included in the shareholder's gross income and reported on his return for the taxable year in which or with which the GSOC's taxable year ends. The income will be treated as ordinary income to the shareholders and will not be eligible for either the partial dividend exclusion—section 116—or the maximum tax on earned income. The shareholders of the GSOC will not be eligible to report any portion of a GSOC net operating loss on their returns and neither the corporation nor the shareholders will be entitled to the foreign tax credit on taxes paid by the GSOC.

Sixth. What about the shareholder's basis in his stock?

Shareholders will increase the tax basis of shares of GSOC stock to the extent they report income from the GSOC. Shareholders not required to file returns will increase the tax basis of shares to the extent they were attributed income from the GSOC. Distributions from the GSOC out of previously taxed income will decrease the tax basis of such shares.

Seventh. What about distributions of the stock? Will the shareholder be taxed upon receipt of the stock and will he receive a dividend in his share at the time of receipt?

If the shares are distributed before any investment has been made by the GSOC, the shares will be treated as having a zero value at the date of receipt. Therefore, no income would accrue to the shareholder at receipt and no tax

valuing would be a disaster. Investments have been made, the valuation of the shares should be made on a net asset basis so that if the GSOC investment were 100 percent leveraged, the shares distributed would have zero value and no income would accrue. If the shareholder receives his shares free of tax, he would have a zero basis in his stock at the time of receipt.

Eight. If the GSOC shareholders are taxed on the income of the corporation, how do they receive this income and what is the treatment of distributions?

Distributions from a GSOC's taxable income previously taxed to a shareholder will be treated as a tax-free distribution. Any distribution in excess of such previously taxed income will be taxed in the same manner as a distribution from a regular corporation—section 301(c). Such distributions will first be treated as a tax-free reduction in basis to the extent thereof with any distribution in excess of basis treated as income from the sale or exchange of a capital asset. A GSOC will be required to distribute 90 percent of its taxable income to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the difference between the required distribution and the actual distribution is imposed on the GSOC. The amount of such tax is allowed as a deduction to the GSOC for the year in which it is paid.

Ninth. Are there any special filing requirements for GSOC's?

GSOC's are required to file Federal income tax returns meeting the timing requirements of regular corporate returns and showing information reported to each shareholder. GSOC's are also required to provide each shareholder a form 1099 showing the shareholder's—first, pro-rata income from the taxable year; second, tax-free distributions for the year; third, tax treatment of other distributions; fourth, amount of any investment credit or recapture for such year; and fifth, amount withheld for Federal income tax purposes. Regulations implementing the reporting requirements and other provisions of subchapter S should be given priority in light of the limited time within which

GSOC's may be chartered.

Tenth. If the GSOC distributes all of the shareholder's portion of the GSOC earnings, what is to prevent the shareholder from spending this money prior to tax time and being left with a tax liability and no cash?

GSOC's must withhold an amount equal to 25 percent of every distribution made to their shareholder except shareholders who, under regulations issued by the Treasury, certify that they are non-taxpayers. The amount of such withholding will be allowed as a refundable credit to the shareholders.

Eleventh. Will the GSOC really be a breakthrough in the battle to broaden capital ownership. If so how will we know?

GSOC's are required to file annual reports with the Treasury summarizing their operations for each year. As the primary sponsor of the GSOC provisions I intend that these reports include studies of the effect of the GSOC on distribution of income and wealth, the level of transfer payments made or required, the social and demographic profiles of GSOC shareholders, the level of economic understanding of GSOC shareholders, and possible beneficial revisions to the GSOC legislation. The bill also requires the staff of the Joint Committee on Taxation to undertake a study of the operation and effect of GSOC's on capital formation, income and capital distribution, competing businesses, integration of the corporate and personal income tax, and the workability of the dividend withholding system. Through these studies I hope we can quantify the effect of GSOC's on expanding capital ownership. I would also like to see the Joint Committee address the broader question of capital ownership in our society and suggest to the Congress a system for annual measurement of our progress in broadening the ownership of capital in America.

THURSDAY, DECEMBER 14, 1978
PART III



SECURITIES AND EXCHANGE COMMISSION

SHAREHOLDER COMMUNICATIONS

Shareholder Participation in the
Corporate Electoral Process and
Corporate Governance Generally

[8010-01-M]

Title 17—Commodity and Securities
ExchangesCHAPTER II—SECURITIES AND
EXCHANGE COMMISSION

[Release Nos. 34-15384; IC-10510]

SHAREHOLDER COMMUNICATIONS,
SHAREHOLDER PARTICIPATION IN
THE CORPORATE ELECTORAL
PROCESS AND CORPORATE GOV-
ERNANCE GENERALLYAGENCY: Securities and Exchange
Commission.

ACTION: Final rules.

SUMMARY: The Commission today issued a release announcing the adoption of proposed rule, form and schedule amendments intended to provide shareholders with information to assist their more informed assessment of the structure, composition and functioning of issuers' boards of directors. The Commission also is adopting rules which afford shareholder-proponents an opportunity to review the accuracy of management statements in opposition to shareholder proposals prior to the mailing of issuers' proxy soliciting materials and which provide information about the terms of settlement of proxy contests.

EFFECTIVE DATES: The amendments to regulation 14A and schedule 14A are effective for fiscal years ending on or after December 25, 1978 for initial filings on or after January 15, 1979. The amendments to forms 8-K, 10-Q and N-1Q are effective for all issuers for filings made on or after January 15, 1979 for periods ending on or after December 25, 1978.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today issued a release announcing the adoption of amendments to regulation 14A (17 CFR 240.14a-1 et seq.) and schedule 14A (17 CFR 240.14a-101) under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq., as amended by Pub. L. No. 94-29 (June 4, 1975)), as well as related amendments to forms 8-K (17 CFR 249.308) and 10-Q (17 CFR 249.308a) thereunder and to form N-1Q (17 CFR 274.106) under the Investment Company Act of 1940 (15 U.S.C. 80a et seq.). These amendments are intended to improve the in-

formation available to shareholders regarding (1) the structure, composition and functioning of issuers' boards of directors; (2) resignations of directors; (3) attendance at board and committee meetings; and (4) the terms of settlements of proxy contests. A rule which provides shareholder-proponents with an opportunity to review the accuracy of management statements in opposition to shareholder proposals prior to the mailing of issuers' proxy soliciting materials also has been adopted. A related proposal, which would have required disclosure of the voting policies and procedures of institutions subject to the Commission's proxy rules, which exercise voting rights with respect to equity securities held for their own accounts or for the accounts of others, has been withdrawn.

I. BACKGROUND

In April of 1977, the Commission authorized its staff to institute a broad re-examination of its rules relating to shareholder communications, shareholder participation in the corporate electoral process and corporate governance generally. As explained in Securities Exchange Act Release No. 13482 (April 28, 1977), 42 FR 23901 (May 11, 1977), the decision to undertake the study was based, in large part, on expressions of concern about the efficacy of existing mechanisms of corporate accountability, including proxy solicitations and the corporate electoral process. Preparatory to holding public hearings, written comments were solicited on a number of questions relating to: (1) the adequacy of existing avenues of communication between shareholders and corporations, and, particularly, whether shareholders should be provided with more information than is now available with respect to socially significant matters affecting their corporations; (2) whether Rule 14a-8, regarding shareholder proposals, should be amended to further facilitate the presentation of shareholder views and concerns in the corporate proxy materials; (3) the role of shareholders in the corporate electoral process; and whether the Commission should amend its proxy rules to provide shareholders access to corporate proxy materials for the purpose of nominating persons of their choice to serve on boards of directors; and (4) whether additional disclosure relevant to an assessment of the quality and integrity of management should be required. The Commission also raised general inquiries concerning the need for Federal minimum standards or Federal chartering legislation, the role of the self-regulatory organizations in improving corporate

governance, and the costs and benefits associated with various regulatory approaches.

In the fall of 1977, the Commission held public hearings on these and related issues¹ in Washington, D.C., Los Angeles, New York and Chicago. More than 300 individuals and organizations testified or submitted written comments on a large number of issues ranging from narrow technical questions arising under existing proxy rules to broad, philosophical inquiries concerning means by which corporations can be made more responsive to shareholders and the public at large.

As discussed in greater detail in Securities Exchange Act Release No. 14970 (July 18, 1978), 43 FR 31000 (July 24, 1978), the participants in the public comment and hearing phase of this proceeding expressed diverse opinions with respect to the scope of existing problems in corporate governance and corporate accountability and the means by which reform could best be achieved. There was, however, general support for the proposition that a strong board of directors, able to exercise independent judgment, is a critical element of corporate accountability. Various means of promoting more effective boards of directors were suggested, including promulgation by the Commission of disclosure requirements which would provide shareholders with better information concerning the composition, structure and functions of corporate boards, and thus indirectly encourage the adoption of more effective corporate governance mechanisms.

Based on its review of the comment and testimony submitted in this proceeding, as well as its experience in administering and enforcing the Federal securities laws, the Commission determined that shareholders may need additional information about the structure, composition and functions of corporate boards of directors and, therefore, on July 18, 1978, proposed for public comment the rule proposals discussed herein. In announcing this publication, the Commission indicated that the proposals represented the first stage of the Commission's response to the issues raised in its ongoing corporate governance study and would be followed by publication of a staff report on other important questions then under consideration, possibly

¹ Securities Exchange Act Release No. 13901 (August 28, 1977) contains a statement of the issues on which testimony and comments were requested. The identification of these issues was based, in part, on the public comments received in response to its prior release. Transcripts of the hearings and comment letters submitted during the hearing phase of the proceeding are available for inspection at the Commission's Public Reference Room, 1100 L Street, N.W., Washington, D.C. (File No. S7-693).

² See Securities Exchange Act Release No. 15385, also published today.

ble additional rule-making proposals and/or legislative recommendations.

The proposals evoked an enormous public response. In total, almost 600 individuals and organizations submitted letters in response to the Commission's request for public comments. Many of the thoughtful and comprehensive views expressed provided the Commission with helpful insights in its further consideration of the proposals.

By far the most controversial portion of the proposals was proposed item 6(a)(6) of schedule 14A, which would have required that directors be identified as "management," "affiliated nonmanagement" and "independent." The use of the term "independent," in juxtaposition with statements in the release concerning the Commission's views about the importance of a strong board of directors capable of exercising independent judgment, and the desirability of key standing committees composed entirely of persons independent of management, provoked considerable controversy. Commentators asserted that the term "independent" conveyed a value judgment on the part of the Commission that persons meeting the Commission's definition of "independent" not only are preferable to "management" or "affiliated nonmanagement" directors but are, in fact, the only persons who are capable of exercising disinterested oversight and independent judgment. Further, a large number of commentators, on the erroneous assumption that certain of the proposals were designed primarily to influence corporate conduct rather than to provide useful information to shareholders, contended that these proposals were beyond the Commission's statutory authority.

The Commission believes that the rules adopted today will facilitate informed voting decisions and promote fair corporate suffrage and are an appropriate exercise of its rulemaking authority under section 14(a) of the Securities Exchange Act. The rules do not, as some commentators thought, constitute a regulatory effort by the Commission to prescribe or determine board composition or corporate governance mechanisms. The legislative history of the federal securities laws reflects a recognition that disclosure, by providing corporate owners with meaningful information about the way in which their corporations are managed, may promote the accountability of corporate managers.³ Thus, while

the federal securities laws generally embody a disclosure approach, it has long been recognized that disclosure may have beneficial effects on corporate behavior.⁴ Accordingly, although the Commission's objective in adopting these rules is to provide additional information relevant to an informed voting decision, it recognizes that disclosure may, depending on determinations made by a company's management, directors and shareholders, influence corporate conduct. This sort of impact is clearly consistent with the basic philosophy of the disclosure provisions of the federal security laws.

After careful analysis of the comments which were submitted, the Commission has concluded that the rules adopted today will provide useful information to shareholders. In some respects it appears that certain of the rule proposals might have raised inferences unintended by the Commission. The Commission has, therefore, revised the proposals in several respects as discussed below.

II. DISCLOSURE OF BOARD COMPOSITION—ITEM 6(B)⁵

Item 6(a)(6), as proposed, would have required issuers, other than investment companies registered under the Investment Company Act of 1940, to identify each nominee and each director whose term of office as a director will continue after the annual meeting as an "independent," "affiliated nonmanagement" or "management" director, as those terms were defined in an instruction accompanying the item. In the case of an "affiliated nonmanagement director," issuers would have been required to describe the nature of the relationship by reason of which the nominee was so deemed.

As defined in the instruction to proposed item 6(a)(6), the term "management director" included, in addition to an officer or employee of the issuer, an officer or employee of any parent, subsidiary or other affiliate of the issuer. The term "affiliated nonmanagement director" referred to persons having certain specified economic and

personal relationships to the issuer and its management. An "independent director" was defined as an individual who is neither a "management director" nor an "affiliated nonmanagement director." However, the instruction indicated that designation of a nominee as an "independent director" would be inappropriate if the issuer is aware of relationships between the nominee and the issuer which, under the circumstances, reasonably could be viewed as interfering with the nominee's exercise of independent judgment.

In the release announcing publication of this proposed item, the Commission expressed its view that "the interests of shareholders are best served by a board of directors which is able to exercise independent judgment, ask probing questions of management and bring to the company a broader perspective than that of management." The Commission further expressed its belief that board composition is of such importance that shareholders whose proxies are solicited with respect to an election of directors should be provided with information concerning the affiliations of board members and nominees with management. Additionally, the Commission stated that the terms "independent" and "affiliated nonmanagement," as defined in proposed item 6(a)(6), were intended to distinguish between nonmanagement directors who are completely unaffiliated with the issuer and its management and those having certain business or personal relationships. The Commission recognized that the terminology it proposed to express this distinction might not be ideal and, therefore, specifically solicited suggestions for alternative terms.

Almost all of the comment letters contained an assessment of proposed item 6(a)(6) and, in fact, many commentators dealt only with this issue. Many believed that the proposal would place too much emphasis on disclosure concerning independence, to the exclusion of information regarding other attributes which are desirable for directors to possess, and a large number of commentators questioned whether the independence of a director can be ascertained solely from a description of his affiliations with the issuer. Nevertheless, there was substantial support for the proposition that shareholders should receive information on the proxy statement concerning the business and personal relationships of directors to the issuer. Commentators' views concerning the desirability of additional disclosure varied greatly. On the one hand, many commentators who acknowledged the usefulness of such information to shareholders in exercising their franchise asserted that current disclosure

³Under section 14(a), the Commission is charged with the responsibility of regulating the proxy soliciting process in order to assure "fair corporate suffrage" for every security holder, and to assure that each "stockholder (has) adequate knowledge as to the manner in which his interests are being served." H.R. No. 1383, 73d Cong. 2d

Sess. 13 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934). In section 14(a), the Congress granted the Commission the authority to promulgate "such rules and regulations . . . necessary or appropriate in the public interest or for the protection of investors."

⁴See, e.g., S. Rep. No. 47, 73 Cong., 1st Sess. 7 (1933); Brandels, "Other People's Money" 92 (1932 ed.); Frankfurter, "The Federal Securities Act II," *Fortune* Mag. 53, 55 (Aug. 1933); Anderson, "The Disclosure Process in Federal Securities Regulation: A Brief Review," 25 *Hastings L. J.* 311, 318, 330 (1974). See generally, "Laurenzano v. Einbender," 264 F. Supp. 356 (E.D.N.Y. 1968).

⁵Item 6(b) corresponds to proposed item 6(a)(6)(i) and would apply to issuers other than registered investment companies.

requirements, specifically items 6 and 7 of schedule 14A,⁸ provide sufficient information concerning director affiliations and conflicts of interest for shareholders to make reasonable judgments concerning the independence of directors. On the other hand, a large number of commentators stated that additional information regarding the business and personal relationships of nominees would be useful to shareholders.

Virtually all of the commentators expressed opposition to the proposed requirement that nonmanagement directors be identified in the proxy materials as "independent" or "affiliated." These commentators asserted that the use of these categories would provide no additional useful information to, and would, in fact, mislead or confuse, shareholders because the term "independent" attempts to reflect a state of mind which is not susceptible of measurement by reference to the existence or non-existence of certain relationships. Some commentators asserted that directors identified as other than "independent" would be perceived as incapable of exercising independent judgment and as a result corporations would be encouraged, in nominating persons to serve as directors, to select candidates on the basis of their lack of certain defined relationships with the issuer rather than their expertise or experience. Similarly, it was argued that otherwise well-qualified persons who would be designated as "affiliated" or "management" directors would be unwilling to serve. Without necessarily agreeing with all of these assertions, on balance the Commission has determined that a requirement that directors be categorized should not be adopted at this time.

The Commission recognizes the fact that the nonexistence of a particular economic or personal relationship with the issuer does not determine the quality of a nominee's performance on the board. The extent to which nominees possess other intangible attributes such as strength of character and good business judgment is also important. While an individual's capacity to render independent judgment is, in the final analysis, a qualitative matter, the nature and scope of a director's relationship with the issuer and its management certainly bears upon his independence, and, in the Commission's view, information respecting such relationships should be provided to shareholders when they exercise their franchise.

Thus, as adopted, item 6(b) requires a brief description, in tabular form to the extent possible, of any of certain significant economic and personal re-

lationships which exist between the director and the issuer. These relationships are similar to those by virtue of which a director would have been deemed an "affiliated nonmanagement director" under proposed item 6(a)(6), but with several modifications.⁹

A. FORMER OFFICERS AND EMPLOYEES

As proposed, the term "affiliated nonmanagement director" would have included any person who, within the last five years, had been an officer or employee of the issuer or any of its parents, subsidiaries or other affiliates.⁷ Information concerning the principal occupations and employment of a nominee during the past five years, including the name and principal business of any organizations in which those occupations are carried on, is currently required to be disclosed pursuant to item 3(e) of Regulation S-K. Paragraph (1) of item 6(b) as adopted requires that if the organization is a parent, subsidiary or affiliate of the issuer that fact be disclosed as well.

B. RELATIVES OF OFFICERS

As proposed, the term "affiliated nonmanagement director" would have included a person who is related to an officer of the issuer, or any of its parents, subsidiaries or other affiliates by blood, marriage or adoption (except relationships more remote than first cousin). The few commentators who addressed this issue opined that disclosure should cover relationships to "executive officers" only, consistent with the new proxy disclosure requirements adopted by the Commission subsequent to the publication of the subject proposals,⁹ because family relationships to officers who are not in policy making positions would not be of sufficient significance to warrant disclosure. The Commission agrees in part,

⁸While the rules adopted herein do not retain the director categories proposed in our July release, for convenience, those categories have been employed in the text of this release solely for the purpose of explaining our responses to comments on those proposals and discussing the affirmative disclosure requirements which are adopted herein.

⁷An "affiliate" of a specified person is defined as a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. Securities Exchange Act rule 12b-2, 17 CFR 240.12b-2.

⁹The term "executive officer" is defined in the instructions to item 3(b) of regulation S-K to mean the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administration or finance) and any other person who performs similar policy making functions for the registrant.

⁹See Securities Exchange Act Release No. 15006 (July 28, 1978), 43 FR 34402.

and therefore, as adopted, paragraph (2) of item 6(b) requires disclosure only of relationships to executive officers of the issuer, any of its parents, subsidiaries or other affiliates. However, because of the control relationship between an issuer and its affiliates, the Commission believes it appropriate to require disclosure of relationships between the nominee and executive officers of the issuer's affiliates.

C. OFFICER, DIRECTOR, EMPLOYEE AND OWNER OF A SIGNIFICANT SUPPLIER OR CUSTOMER

(1) Persons Included

Proposed item 6(a)(6) would have included within the definition of "affiliated nonmanagement director" any person who is or has within the last two years been an officer, director, employee or owner of an interest in excess of one percent of the equity of an entity which, as customer or supplier of the issuer, had or will have business transactions of a specified magnitude with the issuer.

Many commentators expressed a preference for the approach taken in item 4(f) of regulation S-K¹⁰ which, as a general matter, would not require the disclosure of certain transactions between the issuer and another entity in which the director has an interest if that interest arises solely from the directorship of, or ownership of less than ten percent of, the other entity. These commentators asserted that information concerning less significant relationships to the issuer would not facilitate a meaningful assessment of potential conflicts. A small number of commentators also objected to the inclusion of any employee of the other entity, arguing that employees, other than executive officers, may have no influence over the other entity or stand to benefit from its business transactions with the issuer.

The Commission disagrees with these comments. As adopted, paragraph (3) of item 6(b) would require a description of economic relationship of the same persons referred to in proposed item 6(a)(6). In the Commission's view, if there is a significant amount of business between the issuer and the other entity, the interest of a owner of a one percent equity interest or an officer, director or an employee of that entity in maintaining the business relationship is sufficiently great that the relationships should be disclosed. Shareholders would then be able to reach their own conclusions as to the extent to which such interest may conflict with those of the issuer or may impact upon that person's performance as a director of the issuer. For purposes of clarification (1)

⁸See discussion of coordination with regulation S-K, *infra*.

¹⁰See discussion of coordination with regulation S-K, *infra*.

phrase "in excess of one percent equity interest in" has been substituted for the phrase "in excess of one percent of the equity of."

(2) Amount of Business Between the Issuer and its Customers or Suppliers

The types and size of business relationships the existence of which would render a director "affiliated" were covered by subparagraphs (A), (B), (D) and (E) of instruction 3(iii) to proposed item 6(a)(6). Subparagraphs (A) and (B) referred to customers of the issuer which made payments during the issuer's last fiscal year or proposed to make payments during the issuer's next fiscal year in an amount in excess of one percent of the issuer's gross revenues for its last fiscal year or \$1,000,000, whichever is less. Subparagraphs (D) and (E) referred to suppliers to the issuer to which the issuer made payments during such entity's last fiscal year or proposed to make payments during such entity's next fiscal year in an amount in excess of one percent of such entity's gross revenues for its last fiscal year or \$1,000,000, whichever is less.

Many commentators who addressed this issue opposed retention of the \$1,000,000 threshold on the theory that \$1,000,000 represents such an insignificant portion of the revenues of large corporations that it would be unreasonable to draw any inference from the existence of such an inconsequential relationship. Others noted that large corporations, because of the relative insignificance to them of transactions aggregating \$1,000,000 and the complexity of their operations, would find it virtually impossible to maintain and examine the records necessary to determine whether they had done business in that amount with a particular entity.

The Commission is persuaded that the concerns expressed with respect to the \$1,000,000 threshold may be valid and has determined that an economic test of significance expressed in terms of a percentage of revenues may be more workable. Therefore, subparagraph 3(i), (ii), (iv) and (v) of the item 6(b), as adopted, contains an economic standard based on one percent of consolidated gross revenues.

Additionally, in adopting these subparagraphs in final form, the Commission has incorporated the suggestions made by several commentators that certain kinds of transactions be excepted from the calculation of the magnitude of business between the issuer and the other entity. Thus, in view of the absence of normal competitive factors in transactions involving the rendering of services as a public utility at rates or charges fixed in conformity with law or governmental authority, subparagraph 3(vii) excepts from the

calculation of payments for property or services payments made in such transactions as well as payments representing rates or charges which are determined by competitive bids. Further, in accordance with the Commission's general intent to have included in the calculation payments arising from commercial rather than ordinary investment transactions, subparagraph 3(vii) also contains an exception for non-preferential dividends and other payments arising solely from the ownership of securities.

(3) Creditor Relationships

Under the instruction to proposed item 6(a)(6), a person who is an officer, director or one percent equity owner of certain creditors of the issuer would have been deemed to be an "affiliated nonmanagement director." Subparagraph (C) of paragraph 3(iii) of the instruction to proposed item 6(a)(6) would have included within the class of affected creditors an entity to which the issuer was indebted at any time during the issuer's last fiscal year in an aggregate amount in excess of one percent of the issuer's total assets at the end of such fiscal year, or \$1,000,000, whichever is less. A substantial number of commentators questioned the appropriateness of this test, asserting that an outstanding loan of \$1,000,000 would not be of significance to most large banks. Deletion of the dollar threshold was recommended.

The Commission recognizes that a loan of \$1,000,000 may represent an insignificant percentage of the total loan portfolio of most large financial institutions. The Commission is concerned, however, that the inherent nature of a debtor-creditor relationship and the potential conflicts between the interests of creditors and shareholders make it appropriate to retain a dollar threshold. In an effort to balance these competing concerns, subparagraph 3(iii) of item 6(b), as adopted, requires disclosure of loans which exceed one percent of the issuer's consolidated total assets, or \$5,000,000, whichever is less. Additionally, a new subparagraph (viii) has been added which permits debt securities which have been publicly offered or which are listed on a national securities exchange or quoted on the automated quotation system of a registered securities association to be excluded from the calculation of aggregate indebtedness.

(4) Technical Amendments Contained in Subparagraph 3(i)-(v) of Item 6(b)

Proposed item 6(a)(6) referred to payments made during the last fiscal year of the issuer or other entity and those proposed to be made during the next fiscal year. A number of commen-

tators expressed confusion concerning whether the term "next fiscal year" referred to the current fiscal year and, if not, whether payments for the current fiscal year were inadvertently omitted. As adopted, subparagraphs 3(i)-(v) have been revised to require disclosure concerning payments for the last fiscal year and for the current fiscal year. Consistent with the approach taken in Securities Exchange Act Release No. 14970, payments which are "proposed" to be made during the current fiscal year would include payments which are the subject of a formal agreement or are reasonably expected to be made pursuant to any understanding or course of conduct between the issuer and the other entity.

In addition, proposed item 6(a)(6) referred to payments made by or to the "issuer." It was clear from the context in which the term "issuer" was being used, however, that it referred to payments made by or to the issuer and its subsidiaries, and the commentators apparently so understood its use. A technical amendment clarifies this reference. A further technical amendment adds the word "consolidated" to modify the term "gross revenues." Subparagraph 3(iii), as adopted, also reflects a technical amendment which adds the word "consolidated" to modify the term "assets."

(5) Recipient of \$25,000 from the Issuer

As proposed, the definition of "affiliated nonmanagement director" would have included a person (as owner of an equity interest in any entity or otherwise) to whom the issuer directly or indirectly had made payments in the last fiscal year or to whom the issuer proposed to make payments in the next fiscal year, for property or services, in excess of \$25,000 (other than fees as a director or retirement allowances). Most commentators who addressed this definition expressed confusion as to its meaning and asserted that the \$25,000 threshold figures was unrealistically low. The Commission has determined that this proposal probably would provide little additional information of significance to shareholders since, in most cases, transactions involving payments to a director of \$40,000 or more already are reportable under item 4(f) of regulation S-K. Accordingly, item 6(b) as adopted does not require such disclosure.

(6) Attorneys and Investment Bankers

The instruction to proposed item 6(a)(6) would have included within the definition of "affiliated nonmanagement director" any person who is a member or employee of, or is associated with, a law firm which the issuer has retained in the last two years or

proposes to retain in the next year and any person who is a director, partner, officer or employee of any investment banking firm which has performed services for the issuer in the last two years or which the issuer proposes to have perform services in the next year. While few commentators disagreed, in principle, with the concept that the relationship of lawyers and investment bankers with the issuer differs from that of other suppliers of goods and services, and that the significance of their affiliation to the issuer should be measured by a different standard, many felt that some threshold economic standard should be applied. These commentators stated that it is inappropriate to deem "affiliated" a partner of a law firm retained for a minor matter or an investment banking firm which merely participates in an underwriting group.

Despite the objections of the commentators to the absence of an economic standard with respect to lawyers, the Commission has determined to require disclosure of the relationships as proposed. In view of the inherent conflicts faced by lawyers who serve both as directors and as counsel to corporations, the Commission is reluctant to limit disclosure of such relationships solely on the basis of an economic test.

With respect to disclosure of investment banking relationships, however, the Commission has determined that information concerning a director or nominee's relationship with a firm which has performed services for the issuer only as a participating underwriter in an underwriting syndicate is not sufficiently significant to warrant disclosure. Paragraph (5) of Item 6(b), as adopted, has been revised accordingly and would require disclosure of a director or nominee's relationship to an investment banking firm which has performed services for the issuer other than as a participating underwriter in an underwriting syndicate.

(7) Control Persons

The proposed definition of "affiliated nonmanagement director" would have included any person who is a control person of the issuer (other than as a director of the issuer). This paragraph was the subject of little commentary. As adopted, paragraph 6 of item 6(b) requires disclosure of this relationship.

D. DISCLOSURE OF OTHER RELATIONSHIPS WHICH ARE SUBSTANTIALLY SIMILAR IN NATURE AND SCOPE

Proposed item 6(a)(6) would have provided for the characterization as "independent" of directors who were neither "management" nor "affiliated nonmanagement," as defined in the proposed item. In recognition of the

difficulties inherent in any rigid definition of independence, an instruction to the proposed item indicated that it would be inappropriate to designate a nominee as independent if the issuer were aware of relationships between the nominee and the issuer which, under the circumstances, reasonably could be viewed as interfering with the nominee's exercise of independent judgment.

As indicated above, the Commission has determined not to require that directors be characterized in proxy statements but has adopted a requirement that certain business and personal relationships, discussed in detail above, be disclosed.

It is the Commission's intent, in adopting item 6(b), to provide shareholders with information necessary to an evaluation of a nominee's relationships to the issuer and the potential conflicts of interest with which he or she may be confronted. Because of the multiplicity of possible relationships which are similar to those as to which disclosure is specifically required and the Commission's concern that issuers not elevate form over substance in complying with this disclosure requirement, a new paragraph (7) has been included in item 6(b) which states that if the issuer is aware that the nominee has relationships substantially similar in nature and scope to those which are enumerated in paragraphs (1) through (7) of that item, disclosure of such relationships should also be included.

E. USE OF MISLEADING TERMINOLOGY IN PROXY STATEMENTS

As discussed above, the Commission has determined that a requirement that directors be categorized in proxy statements should not be adopted at this time. The Commission is concerned, however, that a variety of director "labels" are currently being used in a number of different contexts and in publications which reach shareholders. The use of such terms may not be comparable and may be confusing and susceptible to misunderstanding. These labels often obfuscate important distinctions between nonmanagement directors. For example, the

"This problem is illustrated by a comparison of the findings of two recent surveys on the board composition of major U.S. corporations. One was conducted by Heidrick and Struggles, Inc., an executive recruiting firm. This study, which surveyed 1,000 of the largest companies as ranked by "Fortune", concluded that "[t]he average percentage of outside directors on a board is 59.8 in 1978." "The Changing Board Update 1978," Heidrick & Struggles, Inc. The other survey, conducted by Spencer Stuart & Associates, Inc., a management consulting firm, examined 100 of the largest companies as ranked by "Fortune" for 1978. This survey studied, in addition to "inside" and "outside" directors, the number of "quasi-insiders," a term which included lawyers, commercial bank-

term "independent" often is employed to refer to all nonmanagement directors despite the fact that some such directors may have significant business or personal relationships with the issuer or its management.

In light of those concerns which commentators raised in opposition to Commission-mandated "labeling," as well as the confusing nature of "labels" as currently used, the Commission urges issuers not to "label" their directors until such a time as a system of director categorization which better serves the disclosure purposes of the federal securities laws is developed. A note to item 6(b) indicates that any issuer which, in a proxy statement, nevertheless chooses to categorize its directors should do so only after having considered both the existence or nonexistence of business and personal relationships between each director and the issuer or its management and the inherent inadequacy of "labels" currently in use. Where significant relationships do exist—including, but not limited to, those as to which disclosure would be required pursuant to item 6(b)—characterization of a director or nominee by any "label" connoting a lack of relationship to the issuer and its management may be materially misleading."

F. INTERESTED PERSONS OF INVESTMENT COMPANIES

Proposed item 6(a)(6)(ii) would have required investment companies registered under the Investment Company Act of 1940 to identify in their proxy statements which nominees and other directors whose term of office will continue after the annual meeting are "interested persons" as the term is defined in that act. The item also would have required, with respect to any person so identified, a brief description of the relationship by reason of which the person is deemed to be an "interested person." Relatively few commentators addressed this part of the proposals. Some commentators expressed reservations about the use of the term "interested," pointing out that while some investment companies presently disclose which of their directors are "interested," others prefer to

ers, investment bankers, retired officers and persons with family relationships to corporate management, but did not include directors who may be affiliated with significant customers or suppliers of the issuer. The study did not determine whether persons identified as "quasi-insiders" had a business relationship with the issuer. The figures provided by the Spencer Stuart study indicate that, if "quasi-insiders" are excluded, the average percentage of outsider directors on corporate boards is 41.5 percent. See also, "The Boardroom is Becoming a Different Scene," *Fortune* Mag. (May 8, 1978).

"See "TSC Industries, Inc. v. Northway, Inc.," 426 U.S. 438 (1976).

designate only those persons who are "not interested" as such determination is easier to make. The Commission believes that because the term "interested person" is defined statutorily in the Investment Company Act and such persons are identified in prospectuses filed by registered investment companies, it is appropriate to require the identification of those persons in proxy statements. As adopted, item 6(c) requires the issuer to identify by an asterisk any nominee or director who is an "interested person" within the meaning of Section 2(a)(19) of the Act, and to briefly describe the nature of the relationship which renders him "interested."

III. COMMITTEE DISCLOSURE—PROPOSED ITEM 6(d)

As proposed, item 6(d) would have required disclosure of whether or not the issuer has a standing audit, compensation or nominating committee of its board of directors. If the issuer had such committees, it would have been required to identify each committee member and indicate whether he or she was a "management director," "unaffiliated nonmanagement director" or "independent director" as those terms were defined in proposed item 6(a)(6). Issuers that had a nominating committee also would have been required to state whether that committee would consider nominees suggested by shareholders and, if so, to indicate the procedure the shareholders should follow in submitting recommendations. Additionally, a note to the item indicated that a statement that the issuer had any of the named committees connoted that its committees perform certain functions customarily performed by such committees. Those functions were identified in the note. If the issuer disclosed the existence of a committee which, in fact, did not perform the enumerated customary functions, it would have been required to identify those customary functions which its committee did not perform.¹³

Although a majority of commentators favored disclosure of the existence of standing audit, nominating and compensation committees and of their membership, a substantial number objected to the requirement that the nonexistence of any of these committees also be disclosed.¹⁴ This was particularly true with respect to nominating committees, which are less

prevalent than other key standing committees. These objections were based on assertions that the disclosure of the nonexistence of committees was intended to encourage companies to establish the named committees, rather than to provide useful information to shareholders.

While the Commission recognizes that the adoption of this disclosure requirement in some instances may indirectly stimulate the establishment of audit, nominating and compensation committees, the Commission believes that disclosure of the nonexistence of the named committees serves a valid informational purpose. In particular, whether or not an issuer has an audit committee and, if so, information concerning its functioning would help the issuer's shareholders to assess the effectiveness of the board's oversight of the company's accounting functions. The recent enactment of the Foreign Corrupt Practices Act of 1977 has underscored the importance of effectively functioning audit committees.¹⁵ Similarly, the Commission believes that disclosure of whether or not an issuer has a nominating committee and the functions performed by the committee would be material information to shareholders and could improve the director selection process by increasing the range of candidates under consideration while intensifying the scrutiny given to their qualifications. Finally, the Commission believes that similar disclosure concerning an issuer's compensation committee would permit investors to better assess the process by which management and director compensation is determined.¹⁶

In light of the importance of strong committee systems and their impact on the oversight capabilities of the board of directors, shareholders who are being asked to make voting decisions with respect to the election of directors are entitled to know whether or not these important committees exist. Accordingly, the Commission

has determined to adopt the requirements in item 6(d) that the issuer state whether or not it has a standing audit, nominating or compensation committee, however designated, and, if so, identify each committee member. If the issuer is a registered investment company and has such committees, it would be required, pursuant to item 6(d), to identify by an asterisk which committee members are "interested" as defined in section 2(a)(19) of the Investment Company Act of 1940. However, under item 6(d) as adopted, information concerning compensation committees is not required of registered investment companies whose management functions are performed by external managers.

While the Commission has determined that there is a need for disclosure of meaningful information about committee functions, it is persuaded that adoption of a negative disclosure requirement—which would provide information to shareholders only of any customary functions not performed by an issuer's committee—is not appropriate at this time. In this regard, many commentators challenged the proposition that the indicated "customary" committee functions are accepted and stated that a definition of functions customarily performed by audit, nominating and compensation committees would not allow for needed flexibility. Similarly, some were concerned that a "laundry list" approach would set a ceiling or lowest common denominator and discourage committees from performing different functions, thus tending to deter the evolution of committee functions and limit experimentation. Others incorrectly asserted that negative disclosure serves no legitimate informational purpose and is intended solely to influence conduct.

The use of a negative disclosure approach in providing information concerning committee functioning was intended to shorten the required disclosures and to assure that boilerplate disclosures are avoided. It was not the Commission's intent, as some critics have suggested, to establish a comprehensive, rigid model for all committee operations. Thus, while the Commission believes that the statement of customary functions which was contained in the note to proposed item 6(d)¹⁷ provides a convenient initial ref-

¹³With respect to audit committees, the functions included engaging and discharging the independent auditors (or recommending such actions), directing and supervising special investigations, reviewing with the independent auditors the plan and results of the auditing engagement, reviewing the scope and results of the issuer's procedures for internal auditing, approving each professional service provided by the independent auditors prior to the performance of such services, reviewing the independence of the independent auditors, considering the

Footnotes continued on next page

¹³As proposed, the item would also have required disclosure of the number of meetings held by each named committee. See discussion of Board Meetings and Attendance, *infra*.

¹⁴Item 8(c) of schedule 14A currently requires an issuer to state whether or not it has an audit or similar committee of the board of directors and, if so, to name the members of the committee.

¹⁵Pub. L. No. 95-213, Tit. I, § 102-103 (Dec. 19, 1977). See also "SEC v. Falstaff Brewing Co.," Civ. Action No. 77-994 *supra*, where the court found that the statement in the 1977 proxy statement regarding the existence of an audit committee of Falstaff's board of directors was materially false and misleading, in that the audit committee never met, or functioned. The proxy statement, thus, falsely conveyed to Falstaff's shareholders the impression that effective oversight of their company's accounting functions was being exercised by the board of directors.

¹⁶It should be noted that rule 10b-3, 17 CFR 240.10b-3, which provides an exemption from section 16(b) of the Securities Exchange Act for certain acquisitions of securities by officers, directors and principal stockholders, requires that discretionary allocations of such securities be made by, or only in accordance with the recommendation of a committee of disinterested persons, as defined therein.

erence for companies subject to the proxy rules, in light of the evolving nature of corporate committee systems and the varying characteristics and needs of different issuers, the Commission has concluded that a compendium of customary functions should not be set forth in a Commission rule at this time. The Commission is concerned, however, that disclosure of the existence of any of the committees named above would not be meaningful, absent some indication of the functions performed by the committees. Therefore, as adopted, the item has been revised to require, as was suggested by many commentators, a brief description of the functions actually performed by issuers' committees.¹⁹

IV. ATTENDANCE AND NUMBER OF MEETINGS

A. DISCLOSURE OF THE NUMBER OF BOARD AND COMMITTEE MEETINGS HELD

Proposed item 6(d) would have required disclosure of the number of meetings held by an issuer's standing audit, nominating and compensation committees since the date of the most recent annual meeting of shareholders. Similarly, proposed item 6(e)(1) would have required disclosure of the total number of meetings of the board of directors held since the date of the most recent annual meeting.

Some commentators argued that the number of meetings held is not a meaningful indication of the effectiveness of committee and board functioning and noted that in certain circumstances such disclosure may be misleading because the frequency and length of meetings must necessarily vary, depending on the specific circumstances and corporate entity involved. The Commission recognizes that the quality of the performance of a committee or a board is not necessarily a function of the quantity of time spent by its members. However, the Commission believes that the number

of board and committee meetings held is a relevant factor which may be helpful to shareholders in evaluating the performance of their committees or boards and has therefore determined that adoption of the items is appropriate. If the issuer believes that particular circumstances make the number of meetings held susceptible to misinterpretations, it may, of course, include an appropriate explanation.

As a technical matter, several commentators noted that the proposed rule as originally drafted would not elicit disclosure of the total number of board or committee meetings held annually since it would require disclosure only of those meetings held since the date of the last annual meeting. Disclosure of the total number of board and committee meetings held annually would, of course, provide more meaningful information to shareholders. Accordingly, items 6(d) and (e) have been revised to require disclosure of the number of meetings held during the issuer's last fiscal year.

B. DISCLOSURE OF DIRECTOR ATTENDANCE—ITEM 6(e)

Proposed item 6(e)(1) would have required identification of each incumbent director who has attended less than 75 percent of the board meetings held. Similarly, proposed item 6(e)(2) would have required identification of any director who has failed to attend at least 75 percent of the total number of meetings held by all committees on which he sits.

Commentators who opposed the proposal indicated that, in their view, the fact that a director has attended less than 75 percent of the meetings of the board or of the relevant committees would not be a meaningful indication of the quality of his contribution to the board. Some were concerned that the disclosure would discourage highly qualified nonmanagement directors from serving on boards. Others observed that it might influence boards to reduce or increase the number of meetings to help directors meet the 75 percent threshold.

Another objection to the proposal was the belief of some commentators that the 75 percent figure was too high. In this regard, it was noted that special board or committee meetings may be scheduled on short notice and some committees may meet infrequently. Further, commentators opined that a failure to attain the 75 percent attendance record would invariably result in some proxy statement explanation and that a threshold that is too high would lead to a proliferation of explanations in the proxy materials. Several of these commentators urged the Commission to apply the 75 percent test in the aggregate.

Others suggested that the percentage be lowered.

The Commission recognizes that in particular instances directors may provide the board with valuable insight and expertise without actually attending formal meetings on more than an intermittent basis. However, we believe that these occasions are likely to be the exception and that, in general, attendance is an indication of effective board and committee functioning and is relevant to an evaluation of directors for election purposes. In addition, the Commission is not persuaded that the contemplated disclosure would deter responsible boards from holding meetings when it is appropriate to do so.

Nevertheless, the Commission believes that the threshold is problematic in certain respects. In particular, board committees may not, on the average, meet frequently enough to assure that an attendance threshold based only on committee meetings will be meaningful. Accordingly, item 6(e) has been adopted in revised form to require disclosure only in the event that a director attends fewer than 75 percent of the aggregate number of meetings of the board and of the committees on which he sits. The item has also been revised to require disclosure with respect to meetings held during the "last fiscal year," rather than meetings held since the "date of the last annual meeting." As indicated above, this technical amendment is necessary to make the time period cover a full 12 months.

V. RESIGNATIONS OF REGISTRANT'S DIRECTORS—ITEM 6 OF FORM 8-K; ITEM 6(f) OF SCHEDULE 14A

As proposed, item 6 of form 8-K¹⁹ and item 6(f) of schedule 14A would have required that if a director resigned or declined to stand for re-election because of a disagreement on matters involving business operations, policies, or practices, the issuer would be required to report the disagreement on form 8-K as well as in its proxy statement. Before filing its preliminary proxy materials with the Commission, the issuer would be required to furnish the director with a copy of its proposed statement. If the director disagreed with the issuer's characterization of the disagreement, he would be permitted to include in the proxy materials a brief statement presenting his views, provided he submitted his statement to the issuer within ten business days after receiving the issuer's statement.

Some commentators who opposed adoption of the proposal were concerned that this disclosure would dis-

¹⁹This item was originally proposed as item 5 but as adopted has been redesignated item 6.

Footnotes continued from last page
range of audit and nonaudit fees and reviewing the adequacy of the issuer's system of internal accounting controls. With respect to nominating committees, the functions included selecting or recommending to the full board nominees for election as directors and consideration of the performance of incumbent directors in determining whether to nominate them for re-election. The functions of compensation committees included approval (or recommendation to the full board) of the remuneration arrangements for senior management and directors, adoption of compensation plans in which officers and directors are eligible to participate and granting of options or other benefits under any such plans.

¹⁹In the interest of contributing to the ongoing evolution of committee functions, the Commission has instructed its Division of Corporation Finance to monitor proxy statement disclosures made in response to this item.

courage the evolution of stronger boards by increasing divisiveness among board members. Others noted that the proposal might make it more difficult to attract and retain directors with divergent viewpoints. In addition, a number of commentators questioned the appropriateness of relying on an event, rather than the materiality of the underlying facts, to trigger disclosure. It was noted by some that under existing rules disagreements involving material information would already be required to be disclosed.

The Commission believes that disclosure of director resignations or declinations to stand for re-election would provide useful information to investors in assessing the quality of management, consistent with the increasing emphasis on the monitoring function of corporate boards. A director who wishes to make a public record of the disagreement which prompted his resignation from the board should have the opportunity to do so in a manner which will most likely come to the attention of the shareholders who elected him.

In proposing this disclosure requirement, the Commission had determined that the issuer should be required to provide the disclosure because it was concerned that if the requirement were to be premised only on an affirmative request by the director, the dynamics of most situations would be such that a director would feel pressure to refrain from "rocking the boat." However, after considering the commentary, the Commission believes that, on balance, it is more appropriate to require disclosure only upon the request of the director. If disclosure is triggered by director request, the director will have a forum if he chooses to use it, and the issuer will be relieved of any obligation to document and characterize what it believes are the reasons for director resignations.

Accordingly, item 6 of form 8-K and item 6(f) of schedule 14A have been revised to require disclosure of a director's resignation only if the director has furnished the registrant with a letter describing the disagreement relating to the registrant's operations, policies or practices and requesting that the matter be disclosed. If the issuer believes the description provided by the director is inaccurate or incomplete, it may, of course, include a statement of its views of the disagreement. The items, as adopted, include an express statement to that effect. The Commission believes that, as revised, the items will be less likely to create compliance problems and yet will still assure that directors who have resigned or declined to stand for re-election will be able to disclose this information in a manner which is most likely to reach shareholders.

VI. SHAREHOLDER-PROPONENT CONSIDERATION OF MANAGEMENT'S STATEMENT IN OPPOSITION—RULE 14a-8(c)

As proposed, rule 14a-8(c) would have required an issuer to transmit to a shareholder-proponent ten business days before the filing of its preliminary proxy material any statement in opposition to the shareholder's resolution that the issuer intends to include in the proxy material.

The purpose of this proposal was to provide a shareholder-proponent with the opportunity to bring materially inaccurate statements contained in opposing statements to the attention of management and the Commission before the proxy materials are mailed to shareholders. As noted in the Commission's release announcing the proposed rule, a number of witnesses during the hearings indicated that under the present system a proponent does not have a practical means of curing any misstatements which are made in the discussion of his proposal. A recent federal court decision has raised questions as to the availability of judicial review for materially false statements made by management in connection with precatory shareholder proposals.²⁰ Further, witnesses at the hearings had noted that even if judicial review is available it is questionable in some instances whether it can provide a workable remedy. The deliberate pace of a court action may not be well suited to these types of problems since, unless a temporary restraining order or injunction has been granted, appropriate relief may not be available before the meeting.

A number of commentators opposed adoption of the proposal because they believed it would result in delay and is unnecessary in light of the lack of demonstrated abuses in this area and the legal remedies which are already available to shareholder-proponents. Nevertheless, the Commission believes it is appropriate to adopt proposed rule 14a-8(c) on an experimental basis. First, it simply would be more equitable if shareholder-proponents were permitted to see management's opposing statement before it is mailed to shareholders. Second, in light of the problems associated with a total reliance on judicial remedies and the limited Commission resources available for review of proxy materials, it appears appropriate for an effective ad-

ministration of the proxy rules that a shareholder-proponent be given the opportunity to examine management's opposing statement for accuracy. Finally, it would appear to be in the best interests of all parties that questions concerning the factual accuracy of the opposing statements be resolved during the comment process.

Commentators also were concerned that the proposal would cause additional difficulties in complying with the already tight time deadlines characteristic of proxy season. A number of commentators suggested alternative means of avoiding extended delays. For example, it was suggested that "10 business days" be changed to "10 calendar days." It was also noted that, even though advice may be received from the staff 20 days before the filing date, the advice is often that management may exclude the proponent's proposal unless the proponent amends the proposal within a reasonable time. It was argued that it would be impossible in such cases to prepare a response to the shareholder 10 days before filing preliminary materials with the Commission. Some recommended that procedures similar to rule 14a-8(d) be adopted so that management would be provided a copy of the proponent's communication to the staff and would, as a result, be in a better position to respond promptly to staff inquiries.

The Commission agrees that timing problems could have arisen under the rule as proposed, particularly in instances where the staff has advised an issuer that the proposal may be omitted unless the proponent amends it in certain respects. Therefore, rule 14a-8(c) has been revised to provide that in those cases the issuer need not forward the statement in opposition until five calendar days after it has received an appropriately revised proposal. In other instances, issuers generally will know no later than 20 days before filing their preliminary proxy materials whether a proposal will be included and therefore would have at least 10 days to draft and mail to a shareholder-proponent any statement in opposition which it intends to include in the proxy statement.²¹

Additionally, commentators had expressed concern that the rule as initially drafted might provide a forum for further debate on the merits of the proposal. It was noted that the rule has the potential for drawing the staff into debate over social and political

²⁰"*Sisters of the Precious Blood v. Bristol-Myers Co.*," Fed. Sec. L. Rep. ¶96,047 (1977), appeal dismissed, C. A. 2, 77-7229 (Jan. 11, 1978). In that case, the district court in effect held that there is no judicial remedy under section 14(a) for materially inaccurate statements made by management in connection with precatory shareholder proposals, i.e., proposals that request, rather than require, that management take certain actions.

²¹Where includability of a shareholder proposal is contested, in order to take advantage of the staff's no-action procedures, an issuer must file its objections with the Commission at least 50 days prior to filing its preliminary proxy materials (rule 14a-8(d)). As a general rule, the staff's no-action position is communicated within 30 days of receipt of the issuer's objections.

issues. Nevertheless, a number of commentators concluded that this problem could be adequately remedied by revising the rule to clarify that a proponent's review is solely for the purpose of exposing possible violations of rule 14a-9. Rule 14a-8(e), as adopted, includes an additional sentence which states that if the proponent believes the statement in opposition contains a materially inaccurate statement, and wishes to bring this to the attention of the Commission, the proponent should provide the staff with a statement setting forth the reasons for this view and, at the same time, forward a copy of the statement to management. It is anticipated that any questions raised by proponents would be handled in connection with the staff's comments on the issuer's proxy material. This statement would clarify the procedure to be followed in administering the rule and also would help to assure that the issuer is able to promptly advise the staff of any appropriate supporting factual material. Further, the Commission believes this explicit statement will help to clarify that the rule is intended to elicit a proponent's views only to the extent that these views relate to material misstatements or omissions of a factual nature.

In adopting rule 14a-8(c), the Commission emphasizes that it is adopted on an experimental basis. The Commission intends to monitor closely the effect of the rule on the proxy review process, particularly with respect to timing, and will re-examine the rule at some later date.

VII. DISCLOSURE OF TERMS OF SETTLEMENT OF ELECTION CONTESTS—ITEM 3(b)(6) OF SCHEDULE 14A; ITEM 7(d) OF FORM 10-Q

Proposed items 3(b)(6) of schedule 14A and 7(d) of form 10-Q would have required that an issuer disclose the terms of settlement of an election contest, including the anticipated cost to the issuer. Commentators who responded to the proposed items generally either favored or did not oppose the proposed disclosure. The Commission believes that a discussion of the terms on which election contests are settled would provide shareholders with important information useful in making voting decisions and has therefore determined that adoption of the proposals is appropriate.²²

The release proposing these items stated that the Commission did not intend that issuers be required to file an amended proxy statement solely to disclose the terms of settlement, if such amended proxy statement was

not otherwise necessary, for example, because management's slate of nominees had changed. The release also indicated that if the proxy statement relating to the contest is not amended, the disclosure should be included in the proxy statement for the following year as well as in the quarterly report on form 10-Q. It should be noted that, contrary to the description contained in the release proposing the items, item 3(b)(6) would not require that the disclosure be provided in the proxy statement for the following year. Subsequent disclosure would be required only in the next quarterly report on form 10-Q (pursuant to paragraph (d) of item 7 of form 10-Q.) If the settlement has already been disclosed in proxy soliciting materials furnished to shareholders, instruction 5 to item 7 of form 10-Q provides that paragraph (d) of item 7 may be answered by reference to the information contained in such material.

VIII. COORDINATION WITH REGULATION S-K

On July 28, 1978, as part of its efforts to standardize and integrate existing disclosure requirements, the Commission added four new disclosure items to regulation S-K, 17 CFR 229.20, including new item 3 which is captioned "Directors and Executive Officers." At the same time, certain of the Commission's forms and regulations were amended to require that information which had been standardized in these new items be disclosed in accordance with the appropriate item of regulation S-K.

In the release announcing adoption of the new items of regulation S-K, it was noted that the amendments to item 6 of schedule 14A which are being adopted today had been published for comment and were then outstanding. The release indicated that, if adopted, the proposals would be adopted as amendments to item 3 of regulation S-K, which contains the type of disclosure requirements previously set forth under item 6. However, if adopted as part of item 3 of regulation S-K, which is required disclosure for a number of Commission forms, an express limitation would be necessary in order to limit their applicability to proxy statements. Moreover, the purpose of regulation S-K is to set forth standardized disclosure items which are common to several Commission forms. Therefore, the Commission believes it would be more appropriate to

adopt the proposals as amendments to item 6 of schedule 14A. Accordingly, item 6 has been amended to designate the information required by item 3 of regulation S-K as paragraph (a) of the item. Proposed item 6(a)(6) has been adopted as paragraphs (b) and (c);²³ the remaining rule proposals are adopted under the same designations as proposed.

Additionally, it should be noted that, since the disclosure previously required by item 7(f) of schedule 14A is currently required under item 4(f) of regulation S-K, references to "item 7(f)" have been revised to read "item 4(f) of regulation S-K, 17 CFR 229.20" in item 6(b).

IX. ITEM 8 OF SCHEDULE 14A

Item 8(e) of schedule 14A, 17 CFR 240.101, currently requires disclosure of whether or not an issuer has an audit committee and, if so, of the names of the individual members of the audit committee. As item 6(d), which is adopted today and which requires information concerning audit, nominating and compensation committees, includes an identical requirement, paragraph (e) of item 8 has been deleted.

X. CERTAIN FINDINGS

As requested by section 230(a)(2) of the Exchange Act, the Commission has specifically considered the impact which the amendments adopted herein would have on competition and has concluded that they impose no significant burden on competition. In any event, the Commission has determined that any possible burden will be outweighed by, and is necessary and appropriate to achieve the benefits of these amendments to investors and registrants.

TEXT OF AMENDMENTS

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

17 CFR Parts 240 and 242 are amended as follows:

1. Section 240.14a-8 is amended by adding paragraph (c) as follows:

§ 240.14a-8. Proposals of security holders.

(c) If the management intends to include in the proxy statement a statement in opposition to a proposal received from a proponent, it shall, not later than ten calendar days prior to the date the preliminary copies of the proxy statement and form of proxy

²²Paragraph (b) corresponds to proposed item 6(a)(6). Paragraph (c) corresponds to proposed item 6(a)(6)(ii).

²³Since certain investment companies registered under the Investment Company Act of 1940 file their quarterly reports on Form N-1Q (17 CFR 273.104), a conforming amendment to that form has been adopted.

²⁴Securities Exchange Act Release No. 15006 (July 28, 1978), 43 FR 31102. Regulation S-K was adopted in order to establish uniform disclosure requirements which may be used in preparing similar disclosures which were required by a number of Commission forms and regulations. See Securities Exchange Act Release No. 5883 (Dec. 23, 1977), 42 FR 65554.

are filed pursuant to rule 14a-6(a), or, in the event that the proposal must be revised to be includable, not later than five calendar days after receipt by the issuer of the revised proposal, promptly forward to the proponent a copy of the statement in opposition to the proposal.

In the event the proponent believes that the statement in opposition contains materially false or misleading statements within the meaning of § 240.14a-9 and the proponent wishes to bring this matter to the attention of the Commission, the proponent should promptly provide the staff with a letter setting forth the reasons for this view and at the same time promptly provide management with a copy of such letter.

11. Section 240.14a-101 is amended by adding paragraph 6 to Item 3(b); revising Item 6, deleting old paragraph (c) of Item 8 and redesignating paragraph (f) of that item as follows:

§ 240.14a-101. Schedule 14A. Information required in proxy statement.

Item 3. Persons Making the Solicitation.

(b) ***
(5) If any such solicitation is terminated pursuant to a settlement between the issuer and any other participant in such solicitation, describe the terms of such settlement, including the cost or anticipated cost thereof to the issuer.

Instructions

1. With respect to solicitations subject to § 240.14a-11 (rule 14A-11), costs and expenditures within the meaning of this Item 3 shall include fees for attorneys, accountants, public relations or financial analysts, solicitors, advertising, printing, transportation, litigation and other costs incidental to the solicitation, except that the issuer may exclude the amount of such costs represented by the amount normally expended for a solicitation for an election of directors in the absence of a contest, and costs represented by salaries and wages of regular employees and officers, provided a statement to the effect is included in the proxy statement.

2. The information required pursuant to paragraph (5) of Item 3(b) should be included in any solicited or unsolicited proxy statement or other solicitation material relating to the same meeting or sale of stock furnished to security holders by the issuer subsequent to the date of settlement.

Item 6. Directors and executive officers.

If action is to be taken with respect to election of directors, furnish the following information, in tabular form to the extent practicable, with respect to each person nominated for election as a director and each person whose term of office will continue after the meeting. However, if the solicitation is made on behalf of persons other

than management, the information required need be furnished only as to nominees of the persons making the solicitation.

(a) The information required by Item 3 of regulation S-K, 17 CFR 229.20;

(b) With respect to issuers other than investment companies registered under the Investment Company Act of 1940, describe any of the following relationships which exist:

(1) If the nominee or director has during the past five years had a principal occupation or employment with any of the issuer's parents, subsidiaries or other affiliates.

(2) If the nominee or director is related to an executive officer of any of the issuer's parents, subsidiaries or other affiliates by blood, marriage or adoption (except relationships more remote than first cousin);

(3) If the nominee or director is, or has within the last two full fiscal years been, an officer, director or employee of, or owns, or has within the last two full fiscal years owned, directly or indirectly, in excess of 1 percent equity interest in any firm, corporation or other business or professional entity;

(4) Which has made payments to the issuer or its subsidiaries for property or services during the issuer's last full fiscal year in excess of 1 percent of the issuer's consolidated gross revenues for its last full fiscal year;

(5) Which proposes to make payments to the issuer or its subsidiaries for property or services during the current fiscal year in excess of 1 percent of the issuer's consolidated gross revenues for its last full fiscal year;

(6) To which the issuer or its subsidiaries was indebted at any time during the issuer's last fiscal year in an aggregate amount in excess of 1 percent of the issuer's total consolidated assets at the end of such fiscal year, or \$5,000,000, whichever is less.

(7) To which the issuer or its subsidiaries has made payments for property or services during such entity's last fiscal year in excess of 1 percent of such entity's consolidated gross revenues for its last full fiscal year;

(8) To which the issuer or its subsidiaries proposed to make payments for property or services during such entity's current fiscal year in excess of 1 percent of such entity's consolidated gross revenues for its last full fiscal year;

(9) In order to determine whether payments made or proposed to be made exceed 1 percent of the consolidated gross revenues of any entity other than the issuer for such entity's last full fiscal year, it is appropriate to rely on information provided by the nominee or director.

(10) In calculating payments for property and services the following may be excluded:

(A) Payments where the rates or charges involved in the transaction are determined by competitive bids, or the transaction involves the rendering of services as a public utility at rates or charges fixed in conformity with law or governmental authority;

(B) Payments which arise solely from the ownership of securities of the issuer and no extra or special benefit not shared on a pro rata basis by all holders of the class of securities is received;

(C) In calculating indebtedness for purposes of subparagraph (6) above, debt securities which have been publicly offered, admitted to trading on a national securities exchange, or quoted on the automated quotation system of a registered securities association may be excluded.

(4) That the nominee or director is a member or employee of, or is associated with, a law firm which the issuer has retained in the last two full fiscal years or proposes to retain in the current fiscal year;

(5) That the nominee or director is a director, partner, officer or employee of any investment banking firm which has performed services for the issuer other than as a participating underwriter in a syndicate in the last two full fiscal years or which the issuer proposes to have perform services in the current year; or

(6) That the nominee or director is a control person of the issuer (other than solely as a director of the issuer).

(7) In addition, the issuer should disclose any other relationships it is aware of between the director or nominee and issuer or its management which are substantially similar in nature and scope to those relationships listed above.

NOTE--In the Commission's view, where significant business or personal relationships exist between the director or nominee and the issuer or its management, including, but not limited to, those as to which disclosure would be required pursuant to Item 6(b), characterization of a director or nominee by any "label" constituting a lack of relationship to the issuer and its management may be materially misleading.

(c) With respect to investment companies registered under the Investment Company Act of 1940, indicate by an asterisk any nominee or director who is or would be an "interested person" within the meaning of section 2(a)(19) of the Investment Company Act of 1940 and briefly describe the relationship, by reason of which such person is deemed an "interested person."

(d) State whether or not the issuer has standing audit, nominating and compensation committees of the Board of Directors, or committees performing similar functions. If the issuer has such committees, however designated, identify each committee manager, state the number of committee meetings held by each such committee during the last fiscal year and describe briefly the functions performed by such committees. In the case of investment companies registered under the Investment Company Act of 1940, indicate by an asterisk whether that member is an "interested person" as defined in section 2(a)(19) of that Act. Information concerning compensation committees is not required of registered investment companies whose management functions are performed by external managers.

(2) If the issuer has a nominating or similar committee, state whether the committee will consider nominees recommended by shareholders and, if so, describe the procedures to be followed by shareholders in submitting such recommendations.

(c) State the total number of meetings of the board of directors (including regularly scheduled and special meetings) which were held during the last full fiscal year. Name each incumbent director who during the last full fiscal year attended fewer than 75 percent of the aggregate of (1) the total number of meetings of the board of directors held during the period for which he has been a director and (2) the total number of meetings held by all committees of the board on which he served (during the period that he served).

(f) If a director has resigned or declined to stand for re-election to the board of directors since the date of the last annual meeting of shareholders because of a disagreement with the issuer on any matter relating to the issuer's operations, policies or practices, and if the director has furnished the issuer with a letter describing such disagreement and requesting that the matter be disclosed, the issuer shall state the date of resignation or declination to stand for re-election and summarize the director's description of the disagreement.

If the issuer believes that the description provided by the director is incorrect or incomplete, it may include a brief statement presenting its views of the disagreement.

Item 8. Relationship with independent public accountants.

Old paragraph (c) is deleted.

(c) [No change from current paragraph (f).]

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

III. Section 249.303 is amended by revising instruction 6 to item 2; adding a new item 6; renumbering old item 6; and adding paragraph 4 to that item.

§ 249.308 Form 8-K, for current reports.

Item 2. Acquisition or Disposition of Assets

Instructions.

6. Attention is directed to the requirements in item 7 of the form with respect to the filing of financial statements for business acquired and to the filing of copies of the plans of acquisition or disposition as exhibits to the report.

Item 6. Resignations of Registrant's Directors

(a) If a director has resigned or declined to stand for re-election to the board of directors since the date of the last annual meeting of shareholders because of a disagreement with the registrant on any matter relating to the registrant's operations, policies or practices, and if the director has furnished the registrant with a

letter describing such disagreement and requesting that the matter be disclosed, the registrant shall state the date of such resignation or declination to stand for re-election and summarize the director's description of the disagreement.

(b) If the registrant believes that the description provided by the director is incorrect or incomplete, it may include a brief statement presenting its views of the disagreement.

(c) The registrant shall file a copy of the director's letter as an exhibit with all copies of the form 8-K required to be filed pursuant to general instruction E.

Item 7. Financial Statements and Exhibits

[No change from present item 6 except to add paragraph (b)(4) as follows:]

4. Letters from directors furnished pursuant to item 6.

IV. Section 249.308a is amended by adding paragraph (d) to item 7; by adding a new instruction 5; and by renumbering old instruction 5.

§ 249.308a Form 10-Q, for quarterly reports under section 13 or 15(d) of the Securities Exchange Act of 1934.

Item 7. Submission of Matters to a Vote of Security Holders.

(d) Describe the terms of any settlement between the registrant and any other participant (as defined in rule 14a-11 of regulation 144 under the Act) terminating any solicitation subject to rule 14a-11, including the cost or anticipated cost to the registrant.

Instructions.

5. If the registrant has furnished to its security holders proxy soliciting material containing the information called for by paragraph (d), the paragraph may be answered by reference to the information contained in such material.

6. [No change from current instruction 5.]

Item 9. Exhibits and Reports on Form 8-K.

(a) ***

4. Copies of any published reports furnished in response to item 7 (See item 7, instruction 6.).

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

V. Section 274.106 is amended by adding paragraph (d) to item 2 and by adding a new instruction 4.

§ 274.106 Form N-1Q, for quarterly reports of registered management investment company.

Item 2. Submission of Matters to a Vote of Security Holders.

(d) Describe the terms of any settlement between the registrant and any other participant (as defined in rule 14a-11 of regulation 144 under that Act) terminating any solicitation subject to rule 14a-11, including the cost or anticipated cost to the registrant.

Instructions.

4. If the registrant has furnished to its security holders proxy soliciting material containing the information called for by paragraph (d), the paragraph may be answered by reference to the information contained in such material.

[Sec. 12, 13, 14, 15(d), 20(a), 40 Stat. 892, 894, 895, 901 secs. 1, 3, 8, 49 Stat. 1375, 1377, 1379; sec. 203(a) 49 Stat. 794; sec. 202, 68 Stat. 656, secs. 3, 4, 5, 6, 75 Stat. 545, 548, 569, 570-574; secs. 1, 2, 3, 42 Stat. 454, 455; secs. 28(a), 1, 2, 3-5, 61 Stat. 1100, 1497; secs. 10, 18, 82 Stat. 119, 155; sec. 360(b), 90 Stat. 57; sec. 294, 91 Stat. 1500; 15 U.S.C. 78, 78m, 78n, 78o(d), 78w(a).]

The Commission finds that any changes in the amended rules and schedules adopted from those published in Securities Exchange Act Release No. 14970 have already been generally subject to comment and are either technical in nature or less burdensome than previous requirements so that further notice and rulemaking procedures pursuant to the Administrative Procedure Act (5 U.S.C. 553) are not necessary.

By the Commission.

GEORGE A. FRYZIMMONS,
Secretary.

DECEMBER 6, 1978.

[FR Doc. 78-34774 Filed 12-13-78; 8:45 am]

FEDERAL REGISTER, VOL. 43, NO. 241—THURSDAY, DECEMBER 14, 1978

PROPOSED RULES

In consideration of the foregoing, the proposal concerning institutional voting published in the FEDERAL REGISTER (43 FR 31945) on July 24, 1978, and circulated as Securities Exchange Act Release No. 14970 is hereby withdrawn.

By the Commission.

GEORGE A. FITZSIMMONS,
Secretary.

DECEMBER 6, 1978.

[FR Doc. 78-34775 Filed 12-13-78; 8:45 am]

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BILL SUMMARY

ALASKA GENERAL STOCK OWNERSHIP CORPORATION

The general stock ownership corporation (GSOC) bill provides for the creation of a GSOC in Alaska and a new chapter of Alaska Statutes to regulate it. The AGSOC, taking advantage of new federal law, will be exempt from corporate income taxes. Income will be distributed to the shareholders and they will pay tax at their personal rates. The shareholders will be all the residents of Alaska as of the bill's effective date and stock will be distributed to them free of charge. The AGSOC will borrow funds to finance investments.

FORMATION OF THE AGSOC

The Alaska General Stock Ownership Corporation is formed by three incorporators appointed one each by the Speaker, Senate President and Governor. The incorporators will select nine people to serve as the initial board of directors subject to disapproval within 15 days by two of the three state officials mentioned. The incorporators will prepare and file the articles of incorporation to begin the AGSOC. The articles will include technical requirements of federal law restricting transfer of shares for five years and mandating issue of stock to all Alaska residents.

The directors, appointed by the incorporators, adopt bylaws, hire officers and begin the process of shareholder identification. The initial board serves only until the first shareholder meeting when the appointed directors must stand for election. The initial articles and bylaws of the corporation must be submitted to the legislature within 30 days of adoption and the legislature has 60 legislative days within which to disapprove of any provision by concurrent resolution.

AGSOC SHARES

One share of stock will be distributed free of charge to each Alaskans resident who was a resident on the effective date of the bill. Resident means a person who lives in Alaska and intends to remain here permanently. Only individuals may own AGSOC shares and no one may own more than ten. Each week for three months before issuance of stock the AGSOC must by newspaper, radio and television notify residents of their eligibility to receive stock. A resident who does not wish to receive stock may decline. For one year after the initial stock issue a qualified resident may receive his share of stock without charge and for an additional year may purchase his share for book value.

Federal law requires GSOCs to have a charter providing for the issuance of "at least one share (of stock) to each eligible individual." To fulfill this requirement the first share of GSOC stock must be issued without charge to the shareholders. However, there is no restriction upon subsequent sales of GSOC stock. Thus, provision is made for the subsequent sale of AGSOC stock if the shareholders approve.

SHAREHOLDER POWERS

Each share of stock may be voted at shareholder meetings with 1/3 of the shares required for a quorum. Proxies are prohibited and in their place a corporate ballot and shareholder's pamphlet will be prepared, under regulations insuring fairness, and mailed to each shareholder. Shareholders vote their ballot by mail and cumulative voting is prohibited. The shareholders may nominate directors and place issues on the corporate ballot by petition of 1,000 shareholders. Notice of the right to nominate directors and place issues on the corporation ballot must be made by publication at least 150 days before the shareholder meeting and the meeting notice and ballot must be mailed at least 60 days before the meeting.

AGSOC is required to keep complete books and records available for shareholder inspection and any corporate agent wrongfully refusing shareholder access may be fined \$1,000 per day. Shareholders have the right to remove the entire board by a majority vote or any single director by a vote at least as large as that which elected him. The attorney general or 100 shareholders may file suit to remove a director for fraudulent or dishonest acts or gross abuse of authority. Any shareholder may file a derivative suit on behalf of the corporation if those responsible inside the AGSOC fail to do so. The shareholders have the right to amend the bylaws and with a 2/3 vote the articles of incorporation.

DIRECTORS AND OFFICERS

The board of directors has management responsibility for AGSOC. The chairman and at least 3/4 of the board must be Alaskans. Board meetings must be held in the state, but members may participate by conference telephone. Outside directors can never constitute a quorum except when meeting to fill vacancies in the board. AGSOC will have nine directors although the number may be changed in the bylaws. The entire appointed initial board will stand for election at the first annual meeting. Thereafter, members serve for two years with half the board elected each year. Criminal misdemeanor penalties are provided for directors making distributions designed to deceive creditors or shareholders of AGSOC and any agent of AGSOC who makes fraudulent statements regarding the value of shares.

Officers of the AGSOC are appointed by the board of directors and serve at their pleasure. The board establishes the duties of the officers and may replace them at any time.

OTHER PROVISIONS

AGSOC is prevented from making endorsements of political candidates or ballot issues and may not spend money for lobbying of the legislature. Many of the other provisions of the Committee bill have been carried over substantially from existing Alaska corporate law. The provisions regarding sales of assets outside the ordinary course of business, dissolution of the corporation, restatement of the articles of incorporation, requirements for annual reports to the Dept. of Commerce, filing fees and charges, procedural provisions and forms, and power of the Commissioner of Commerce are all basically the same provisions which apply to existing Alaska corporations. The bill does retain the right in the legislature to change the law with respect to AGSOC at any time so long as the creditors of the corporation are protected.

STATE OF ALASKA

OFFICE OF THE GOVERNOR

DIVISION OF POLICY DEVELOPMENT AND PLANNING

JAY S. HAMMOND
GOVERNOR

POUCH AD-JUNEAU 99811
PHONE 465-3577

April 19, 1979

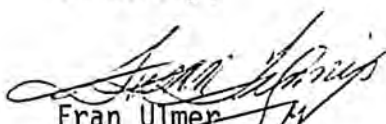
The Honorable Mike Miller
Chairman
House State Affairs Committee
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

Dear Mike:

Attached is a briefing memo prepared for the Governor's conference call with Senator Gravel last Friday. We offer it to your committee as a source of ideas for additional amendments to HB 240. In particular, the items on pages two through four include a number of points raised by Professor Fessler and others which have not yet been incorporated into the committee substitute. The most important of these are circled. If your committee decides to pursue any of these items, Administration staff will be available to provide assistance upon your request. One point not discussed in the memo which should be mentioned is the level of state financial assistance to AGSOC. The Governor recommended and and Senator Gravel agreed that the AGSOC should not be allowed to request or receive any state financial assistance (by appropriation, guarantee, or any other method).

While the Governor has not yet resolved all of the "First Level" questions for himself, he wants to share the ideas in this memo with your committee and to provide staff assistance, so that the best possible AGSOC bill might be developed.

Sincerely,


Fran Ulmer
Director

Enclosures

MEMORANDUM

DIVISION OF POLICY DEVELOPMENT AND PLANNING
OFFICE OF THE GOVERNOR

TO: [

DATE: April 12, 1979

Governor Jay S. Hammond

FILE NO:

TELEPHONE NO:

FROM: Frances A. Ulmer
Director

SUBJECT: AGSOC

The following questions still remain concerning SB 170/HB 240, the Alaska General Stock Ownership Corporation bill. There are really two levels of questions. The first are the more basic philosophical questions which defy technical resolution. They must be answered intuitively. The second level involve more tangible questions which can, to a greater or lesser degree, be resolved via amendment to the bill. However, consideration of second level questions assumes that the first level questions are resolved in favor of the basic AGSOC concept and a decision is made to develop the best possible bill.

First Level

1. What are the basic goals of AGSOC? Is AGSOC the best mechanism for achieving those goals?

Basic goals: to provide broad capital ownership by Alaskans of either existing assets or new assets involved in resource development

to provide dividends to supplement personal income.

2. Is there any way to avoid or resolve the basic conflict of interest between residents as taxpayers and citizens, and residents as shareholders?

Examples; purchase of oil line share - tariff question

development of petrochemicals - royalty prices

construction of gasline - oil recovery

virtually any business - any regulation.

3. With respect to the above questions, can we expect AGSOC to become an important political force? Is it appropriate or possible (first amendment rights question) to prevent this?
4. Even with the amendments contemplated by either the House State Affairs Committee or the Administration regarding corporate governance, how likely is democratic control of AGSOC?
5. What is the likely extent of state subsidies to AGSOC? What will be the impact on the state's credit rating from passage of the bill? From actual extension of state financial aid?

Should procedures and/or conditions for extending such aid be included in the bill?

NOTE: The House State Affairs Committee has requested drafting of amendments to provide for a referendum for any state financial assistance to AGSOC. No legislative approval would be required for AGSOC investment not requiring state financial assistance.

6. Is it possible to resolve/avoid the "closed class" problem created by "old" residents being shareholders while "new" residents are not?
7. How will the Governor make decisions as to who shall constitute the first Board of Directors?
8. Does the Alaskan public want an AGSOC?

Second Level

1. What should be the procedures for electing the Board of Directors?
2. Should the state allow the federal corporate income tax exemption to pass through to state corporate income taxes?

NOTE: The House State Affairs Committee has agreed to pass through the tax exemption.

3. Should there be one AGSOC per investment or project, or should there be only one AGSOC which could invest in a variety of projects?

NOTE: Senator Colletta supports the former approach; House leaders support the latter.

4. Should people who leave the state be able to take their shares with them?

NOTE: The House State Affairs Committee has decided to mandate that people who cease to be residents transfer their shares either to a resident or to the corporation.

5. Is AS 10.05 of the Alaska Business Corporation Act the appropriate "regulatory umbrella" for AGSOC, or do we need a new chapter specifically designed for AGSOC?

NOTE: The House State Affairs Committee has requested drafting of a new "GSOC" chapter.

6. Should there be a limitation on, or incentives against, litigation between AGSOC and the state (because the same people bear the costs)?

Does AGSOC possess unfair competitive advantages which could lead to anti-trust problems?

7. What are the implications for AGSOC of SEC regulations?

8. What other changes to the bill, Articles of Incorporation, or Bylaws are desired by the Governor or the legislature?

House State Affairs Committee (tentative) desired amendments:

- (-) Chairman of the Board must be Alaska resident.
- Nine member board, seven residents, two outsiders.
- No classified board; all directors elected every two years (mechanics, i.e., proxy issues, undecided).
- Directors removable by shareholders without cause.
- Statutory provision for derivative suits.
- Require legislative approval by resolution of articles and bylaws.
- Give shareholder the ability to amend bylaws.
- Allow board business to be conducted via telecommunications.
- Every director has right to attend all board committee meetings.
- Liability for officers' refusal to allow shareholder access to corporation books and records.
- Loan guarantee fund limited to start-up costs not to exceed \$5 million.
- Delete Sections 2 and 3 regarding investments of GF surplus or permanent fund in AGSOC securities. Consider amendment to AS 37.10.070 to prohibit use of subsection 6 for investment of GF surplus in AGSOC. Also delete Sec. 4 which would exempt AGSOC securities from registration under the Alaska Securities Act of 1959 and from filing of sales and advertising literature.
- (-) Prohibit officers and employees of corporation from serving on board.

Administration working Group desired actions or amendments:

- (-) Statutory reservation by the legislature of the right to amend the statute - impairment of contracts issue.
- Development of election procedures for the Board, including financing of proxy fights, access to voting lists and mailing machinery, and consideration of a regionalized board.
- Solution of "single class of stock" issue created by the voting rights of shares held by minors.

- Assessment of the definition of "resident" provided in the bill.
- ⊖ Assessment of potential for tax liability on initial issue or otherwise to be greater than dividend.
- Criminal liability of directors in certain instances.
- ⊖ Provision for cumulative voting.
- ⊖ Limitation on voting trusts.
- ⊖ Requirement that feasibility analysis and other information be provided to the Governor and the legislature in sufficient time before a decision is necessary on financial or other state aid.
- Details of shareholder meetings, i.e., notice, location, quorum.
- ⊖ Limitation on assignment of dividend rights.
- ⊖ Limitation on ability of corporation to acquire Treasury shares.
- Shareholders' ability to amend the number and terms of office of the Board of Directors.
- Directors subject to removal by Superior Court at suit of 100 or more shareholders or Attorney General for fraudulent or dishonest acts or gross abuse.
- ⊖ Limitation of ownership to one share.

GENERAL SUMMARY

The proposed Committee substitute creates a new chapter 50, Title X, of Alaska Statutes entitled "General Stock Ownership Corporations." This chapter governs the creation, operation and termination of all general stock ownership corporations organized in Alaska. Many of the provisions have been carried over or adapted from existing Alaska corporate law. The bill is divided into 10 sections.

- Section 1: This section contains the provisions of the new chapter 50 of Alaska Statutes, Title X, and constitutes the core of the Committee bill. It contains six articles which deal with shareholder rights and internal operation of the corporations (Article 1: Substantive Provisions), formation of general stock ownership corporations (Article 2: Formation of Corporations), amendment of articles of incorporation (Article 3: Amendment of Articles), sale of corporation assets outside the ordinary course of business (Article 4: Sale of Assets), voluntary and involuntary termination of the corporate existence (Article 5: Dissolution), and miscellaneous provisions such as filing fees, criminal penalties, and amendment of the legislation (Article 6: General Provisions).
- Section 2: This section prohibits the Commissioner of Revenue from investing surplus state funds in securities of general stock ownership corporations.
- Section 3: This section requires that all shareholder materials be filed with the Commissioner of Commerce at the time of distribution to the shareholders. In addition, the Commissioner is given authority to regulate concerning fairness, completeness and nondiscrimination of shareholder materials. The filing provisions coordinate with other sections of the Alaska securities laws making it a crime to file false or misleading materials with the Commissioner.
- Section 4: These three sections amend the criminal
Section 5: penalties provisions of section 1 of the bill
Section 6: to conform to the new criminal code which becomes effective January 1, 1980. The provisions of section 1 are applicable upon signature by the governor and must therefor be amended as of January 1, 1980 to parallel the rest of the new criminal code.

- Section 7: This section authorizes the governor to appoint nine persons to act as incorporators and the initial board of directors of the Alaska General Stock Ownership Corporation. This is the section which actually provides for the creation of a GSOC in Alaska. The section restricts share ownership of this corporation to Alaska residents and requires that shares be sold when a shareholder leaves the state or dies leaving his stock to an outsider. It also creates a special fund, not to exceed five million dollars, in the Dept. of Revenue to be used in guaranteeing private loans for the corporation's startup expenses.
- Section 8: Section 1 of the bill amends Rule 23.1 of the Rules of Civil Procedure, dealing with derivative suits by shareholders of a general stock ownership corporation. Because it is amending a rule of the courts this provision must be approved by a 2/3 vote of each house. To allow separation of the vote section 8 amends the court rule.
- Section 9: This section provides for an immediate effective date for the Committee bill.
- Section 10: This section provides for a January 1, 1980 effective date for sections 4-6 which amend the criminal sanctions in the bill to parallel the treatment provided in the new criminal code which also becomes effective January 1, 1980.

SECTION BY SECTION ANALYSIS

This analysis of House State Affairs Committee action on the Alaska General Stock Ownership Corporation legislation describes the provisions of Section 1 of the Committee draft as of April 19, 1979. Since many of the provisions of the draft are carried over wholly or in part from the Alaska Business Corporations Act (ABCA) there is included at the end of each section description a reference to the corresponding section of the ABCA, if any.

ARTICLE 1. SUBSTANTIVE PROVISIONS.

- .005. PURPOSES. This section makes it clear that, unless the enabling legislation for a GSOC provides otherwise, the corporation may engage in any legal business. (ABCA 10.05.003).
- .010. GENERAL STOCK OWNERSHIP CORPORATIONS. This section makes it clear that corporation organized under chapter 50, Title 10, are general stock ownership corporations subject to Internal Revenue Code Subchapter "U" and are not agencies of the state for any purpose.
- .015. GENERAL POWER. This section grants to GSOCs the powers of normal corporations to conduct business. Two changes have been made in adapting the ABCA provisions to GSOCs.
 - 1) There is a limitations in (4) preventing a GSOC from investing in property "acquired by it, or for its benefit, through the right of eminent domain" This limitation prevents GSOCs from acting in collusion with an agency or local government to acquire a going business from an unwilling seller. GSOCs are not prevented from investing in projects where some minor portion of the project is acquired through condemnation if the local government determines that the exercise of its condemnation power is appropriate.
 - 2) The power to establish stock bonus plans is deleted from subsection (15) because of the special nature of GSOCs and the limitations on share ownership would make it difficult for a GSOC to adopt a qualified stock bonus plan for its employees. If the GSOC desires to have its employees benefit from growth in the value of GSOC stock the corporation could adopt a funded "phantom stock" program. (ABCA 10.05.009).

- .020. INDEMNIFICATION OF OFFICERS, DIRECTORS, EMPLOYEES AND AGENTS; INSURANCE. This section is carried over unchanged from the ABCA and allows the corporation to indemnify its directors or employees for expenses and fines incurred as a result of their actions on behalf of the corporation if they acted in good faith. Indemnification is disallowed in derivative suits where the defendant is guilty of negligence or misconduct in his duties unless the court determines the indemnification is proper. The corporation may purchase insurance on behalf of its directors and employees for claims against them arising out of their corporate positions. (ABCA 10.05.010).
- .030. DEFENSE OF ULTRA VIRES. Meaning "beyond the power" an ultra vires act is one which the corporation did not have authority to perform. This section, carried over from the ABCA, provides that this lack of corporate power can be asserted by a shareholder, the corporation, or the attorney general. It may not, however, be asserted by another party to a transaction with the corporation as grounds for failing to perform. (ABCA 10.05.018).
- .035. CORPORATE NAME. This section requires that a GSOC include in its corporate name the words "general stock ownership corporation" or an abbreviation thereof. In addition, the name may not be misleading or deceptively similar to the name of another corporation doing business in Alaska. (ABCA 10.05.021).
- .040. RESERVATION OF CORPORATE NAME. This section allows a person or corporation to reserve a specific name for a general stock ownership corporation for a period of two years with a renewal period of one year. Reservation of a name might be used where an individual seeks to establish a GSOCs by initiative petition or where an existing GSOC seeks to change its name upon the approval of its shareholders. The name may be reserved by this section during the period in which the necessary activities are undertaken to make the name effective. (ABCA 10.05.024, .027, and .033).
- .045. FOREIGN GENERAL STOCK OWNERSHIP CORPORATIONS. General stock ownership corporations chartered in another state and doing business in Alaska are subject to the rules of the Alaska Business Corporations Act (AS 10.05).
- .050. REGISTERED OFFICE AND REGISTERED AGENT. The registered agent is the agent for the corporation upon whom legal papers may be served. This provision requires that the corporation maintain a registered office and agent within the state. (AS 10.05.045)

- .055. FILING LIST OF REGISTERED CORPORATIONS WITH SUPERIOR COURT.
- .060. CHANGE OF REGISTERED OFFICE OR AGENT.
- .065. REGISTRATION OF REGISTERED AGENT.

These three sections set out the rules for registration of the registered agent with the Commissioner of Commerce, the listing of registered agents and offices with the superior courts throughout the state, and the method by which a registered agent may change the registered office or resign his position. These provisions are carried over intact from AS 10.05.048, .051, and .054 respectively.

- .070. SERVICE OF PROCESS ON CORPORATION. In addition to designating the registered agent as agent for service of legal papers on the corporation this section allows the Commissioner of Commerce to be served on behalf of the corporation when the registered agent cannot be found. (AS 10.05.057).

- .075. CREATION AND ISSUANCE OF SHARES. This section allows the corporation to create and issue shares of no par value stock. The total number of shares available for issue must be stated in the articles of incorporation. GSOCs are prohibited from issuing "par value" stock since that concept, developed for the protection of shareholders, has no application in a corporation such as the GSOC where shares are to be distributed initially without payment by the shareholders.

- .080. CONSIDERATION FOR SHARES. The federal GSOC legislation requires that a GSOC have a charter providing for the issuance of "at least one share (of stock) to each eligible individual." In order to fulfill this requirement it appears that the first share of GSOC stock must be issued without charge to the shareholders. However, there does not appear to be any restriction in the federal legislation upon subsequent sales of stock by GSOCs except for the general limitations upon share ownership. In keeping with the Committee's desire for a generally applicable GSOC chapter provision is made for the subsequent sale of stock by GSOCs. Thus, this section allows the GSOC to issue shares without consideration or for a payment fixed in advance by a vote of the shareholders.

Sales of corporation stock by the corporation may not be made at a price in excess of book value if the shares sold are treasury shares, that is shares which have been issued and repurchased by the corporation. (AS 10.05.096).

- .085. PAYMENT FOR SHARES. Payment for shares may be made in cash, other property or services, but not in notes or future services. (AS 10.05.099).
- .090. JUDGMENT OF BOARD OR SHAREHOLDER AS TO VALUE OF CONSIDERATION CONCLUSIVE. This section allows the directors or the shareholders to conclusively determine the value of payment for shares in the absence of fraud. (AS 10.05.102).

- .095. EXPENSES OF ORGANIZATION, REORGANIZATION AND FINANCING. In sales of stock by a corporation shares entitled to the full protections of limited liability must be fully paid and nonassessable. This means that the full sales price for the stock has been received by the corporation. However, if the stock is sold through an underwriter the fees will come out of the sales proceeds before they are paid to the corporation. Likewise, the organizational expenses of the corporation may be paid out of stock sales before the proceeds are remitted to the corporation. This section clarifys that in such cases the shares are deemed to be fully paid. (AS 10.05.111).
- .100. CERTIFICATES REPRESENTING SHARES. This provisions sets out the requirements as to form of stock certificates which must be signed by the corporate officers. (AS 10.05.114)
- .105. INFORMATION REQUIRED TO BE STATED ON CERTIFICATE. The stock certificates or other evidences of ownership must include information regarding the person to whom they are issued, that they are no par value shares, and that the corporation is organized in Alaska. (AS 10.05.117).
- .110. FULL PAYMENT REQUIRED FOR CERTIFICATE. If payment is required for shares they may not be issued until full payment is received. (AS 10.05.120).
- .115. ISSUANCE OF FRACTIONAL SHARES. GSOCs may issue fractional shares of stock and these fractional shares hold dividend, voting and distribution rights equal to their fractional interest. It may be necessary for a GSOC to issue fractional shares in the situation where a shareholder leaves his stock to his heirs and there is more than one child beneficiary. (AS 10.05.123).
- .120. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS. This section, adopted directly from ABCA, limits the liability of shareholders and those who have agreed to purchase share to the amount which they agreed to pay to the corporation for the shares. Subsequent holders of the stock are protected if they received the stock in good faith. (AS 10.05.126).
- .125. BYLAWS. The board of directors adopts the initial bylaws of a GSOC subject to review and rejection by the legislature under section 330 of the draft bill. Subsequent bylaws may adopted, amended or repealed only by a vote of the shareholders.
- .130. MEETINGS OF SHAREHOLDERS. The time and location of the annual shareholders meeting is to be established in the bylaws. The specific place for the meeting may be set by the board. Special meetings of the shareholders may be called by the president of the corporation, the board or the holders of at least 500 shares. Shareholder meetings may be teleconferenced. (AS 10.05.138).

- .135. NOTICE OF SHAREHOLDER'S MEETINGS. This section requires written notice of shareholder's meetings mailed to shareholders not less than 60 days before the meeting. In addition, notice of shareholders' rights to add ballot issues or nominate directors must be made by publication at least once a week for four weeks beginning at least 150 days before the meeting. (AS 10.05.141).
- .140. CLOSING OF TRANSFER BOOKS AND FIXING RECORD DATE. To determine the shareholders of the corporation for purposes of a dividend distribution or voting rights the transfer books of the corporation may be closed prior to the date of the proposed activity or a "record date" may be established and the shareholders determined as of that date. Time limits are provided beyond which the transfer books may not be closed in order to protect shareholder voting rights and to allow interested parties to inspect the share records of the corporation prior to shareholders' meetings. (AS 10.05.144).
- .145. VOTING LIST. The responsible officer of the corporation must make available at the registered office of the corporation beginning at least 60 days before any shareholders' meeting a list of the shareholders eligible to vote at the meeting and access to this list must be provided to all shareholders. (AS 10.05.147).
- .150. QUORUM OF SHAREHOLDERS. 1/3 of the shares constitute a quorum for action by the shareholders and a majority vote of a quorum is sufficient to bind the shareholders in most cases. (AS 10.05.153).
- .155. PROXY VOTING PROHIBITED. Because of the ballot mechanism whereby each shareholder is allowed to vote in person through his ballot proxies are unnecessary in general stock ownership corporations and are therefore prohibited.
- .160. VOTING FOR DIRECTORS. Each shareholder may vote his shares for directors but cumulative voting is prohibited. This means that each share can cast only one vote for director in any contested election for a directorship position.
- .165. VOTING OF SHARES IN THE NAME OF ANOTHER.
- .170. VOTING OF PLEDGED SHARES.
These sections allow shares held by an administrator, executor or guardian to be voted by him without a transfer of the shares into his name. Shares held by a pledgee may be voted by the pledgor until transferred into the pledgee's name. (AS 10.05.165 and . 168).

- .175. CORPORATION BALLOT. Voting at meetings of shareholders will be by ballot rather than through the normal corporate vehicle of proxies. The ballot will be prepared by the corporation subject to review for fairness by the Commissioner of Commerce. It will be mailed to each shareholder with the notice of the shareholders' meeting and voted by mailing it back to the corporation before the date of the meeting.

Shareholders may, by petition of 100 or more, nominate directors and place issues on the corporate ballot. In addition, the directors may place issues and candidates on the ballot by a majority vote. Shareholder information on board candidates and ballot issues is to be provided to the shareholders by the corporation and these materials will be filed with the Commissioner of Commerce and subject to the regulations and criminal penalties applicable thereto.

The directors may not propose to amend any proposal sponsored and approved by the shareholders within one year of the meeting at which the proposal was approved.

- .180. BOARD OF DIRECTORS. The board of directors is charged with management responsibility for the corporation and their compensation is to be fixed in the bylaws. At least 3/4 of the board must be residents of Alaska insuring that outside directors may never constitute a quorum of directors except when meeting to fill vacancies in directors seats until the next annual meeting of shareholders. (AS 10.05.174).

- .185. NUMBER OF DIRECTORS. The minimum number of directors is three and the number is to be fixed in the bylaws except that the original number is fixed by the enabling legislation. If the bylaws are silent the number fixed in the enabling legislation is the proper number. The number of directors can be changed through a bylaw amendment.

The board members serve for two year terms and they are to be divided into classes with only half the board standing for election at any one annual meeting. This staggering of the board members' terms provides for some continuity of management on the board of directors. (AS 10.05.177).

- .190. ELECTION OF DIRECTORS. Directors are to be elected at the annual meetings and each director hold office until his successor is elected and qualified. This prevents gaps in board membership except upon death or incompetance of a board member. (AS 10.05.183).

- .195. VACANCIES. Vacancies in the board caused by death, resignation or incompetance may be filled by a majority vote of the remaining directors. Directors elected by the board to fill a vacancy must stand for election by the shareholders at the next shareholders' meeting and are elected to fill the remaining portion of the directors position originally filled by vote of the board. No vacancy may continue for more than 6 months or until the next shareholders' meeting. (AS 10.05.189).

- .200. QUORUM OF DIRECTORS. A majority of the total number of directors fixed in the bylaws, articles or enabling legislation constitutes a quorum and action may be taken by a majority vote of a quorum. By allowing only $\frac{1}{4}$ of the board to be outsiders Alaskan control of the board is assured. One-quarter of the board can never constitute a majority of a quorum except in the event of a vacancy in which case the board must act to fill the vacancy. (AS 10.05.192).
- .205. PLACE AND NOTICE OF DIRECTORS' MEETINGS. Directors meetings may be held only in Alaska and regular meetings of the board may be held without notice. Special board meetings require notice specifying the purpose of the meeting. (AS 10.05.198).
- .210. PARTICIPATION BY TELEPHONE. Directors may participate in directors meetings by telephone if all the participants may hear and be heard by each other. (AS 10.05.199).
- .215. DISTRIBUTIONS. Some restrictions on corporate distributions are necessary because the limited liability feature of corporations prohibits creditors from levying against shareholders if the corporation distributes its way to insolvency. The traditional restraints which have been used to protect creditors of corporations are the devices of stated capital, capital surplus, earned surplus and retained earnings. Through these devices corporations are required to keep at least something in the till for creditors.

However, the traditional restraints never ensured that cash would be on hand for creditors and they have been eroded by numerous exceptions allowing the corporation to designate capital surplus and create surplus by reduction of capital. As a result corporations have been able to make distributions beyond the point where liabilities to third parties were protected.

Under the ABCA dividends may generally be declared only out of earned surplus. (AS 10.05.204). There are several exceptions to this rule. Dividends may be paid in cash out of depletion reserves by natural resource companies and in stock out of capital surplus. (AS 10.05.204). However, a dividend may not be declared if the corporation would thereby be rendered insolvent. (AS 10.05.201). These restrictions provide some protection to creditors in that at least 75% of the amount received for shares must be allocated to stated capital, but the remaining 25% may be allocated to capital surplus available for distribution under certain circumstances.

Similarly, the ABCA provides that a corporation may acquire shares issued by it only from earned surplus except in special situations. (AS 10.05.012). This distinction between the sources from which shares may be purchased and those from which dividends may be paid does not make much sense since a purchase of shares on a prorata basis has the same effect as a dividend with regard to the protection of creditors.

To protect the creditors and shareholders of general stock ownership corporations and to rationalize restrictions upon the payment of dividends and repurchase of shares, this section provides restrictions on shareholder distributions based upon the current financial condition of the corporation. This section, adapted from a 1977 California amendment to the California Corporations Code, eliminates the concepts of stated capital and capital surplus in favor of a simple balance sheet test.

Under this section the corporation may always make the distribution required by subchapter "U" of the Internal Revenue Code. Thus, the corporation may always distribute to its shareholders an amount equal to 90% of its taxable income.

For distributions in excess of 90% of taxable income the corporation must fulfill either of two tests:

- 1) The corporation may make a distribution out of retained earnings.
- 2) If there are no retained earnings the corporation may make a distribution only if it meets a two pronged test:
 - a) The assets of the corporation, after the distribution are at least equal to $1\frac{1}{4}$ times its liabilities, AND
 - b) The current assets, after the distribution, are at least equal to the current liabilities (a "liquidity test").

If the average pretax income plus interest expense for the two preceeding fiscal years is not at least equal to the average interest expense for those years the current assets must be at least $1\frac{1}{4}$ times current liabilities.

If the corporation does not classify its assets into current and fixed in accordance with generally accepted accounting principles the current assets or liquidity test does not apply.

- .220. DISTRIBUTIONS IN PARTIAL LIQUIDATION. Distributions in partial liquidation are special distributions which reduce the capital value of the corporation. They are distributions out of capital rather than earnings. These distributions may be made only upon a 2/3 vote of the shareholders and must be identified as distributions in partial liquidation. (AS 10.05.207).
- .225. CERTAIN LOANS PROHIBITED. Loans by the corporation to its officers or directors are prohibited. (AS 10.05.213).

- .230. LIABILITY OF DIRECTORS IN CERTAIN CASES. This section carried over from ABCA makes directors personally liable for distributions and stock purchases by the corporation in violation of the distribution limitations. (AS 10.05.216).
- .235. EFFECT OF GOOD FAITH RELIANCE ON FINANCIAL STATEMENTS OR BOOK VALUE. Directors are not liable under the preceeding section if they relied upon financial statements of the corporation represented to him to be correct. (AS 10.05.219).
- .240. PRESUMPTION OF CONSENT OF DIRECTOR AND FILING OF DISSENT. A director present at a meeting is presumed to consent to the action taken by the board at such a meeting unless he files a dissent in accordance with this section. (AS 10.05.222).
- .245. DIRECTOR'S RIGHT TO CONTRIBUTION. A director sued for violation of the distribution rules is entitled to contribution (a sharing of the damages) from all directors assenting to or voting for the action. (AS 10.05.225).
- .250. OFFICERS. Officers of the corporation are elected by the board of directors and serve at their pleasure. (AS 10.05.228).
- .255. DUTIES OF OFFICERS. The board and the bylaws establish the duties of the corporate officers. (AS 10.05.231).
- .260. REMOVAL OF OFFICERS. Officers may be removed by the board but removal does not prejudice contract rights. (AS 10.05.234).
- .265. BOOKS AND RECORDS. GSOCs are required to keep complete books and records and make them available for inspection by shareholders and the Dept. of Commerce at the principal place of corporate business or the registered office. (AS 10.05.237).
- .270. SHAREHOLDER'S RIGHT TO EXAMINE BOOKS AND RECORDS. Shareholders have the right to examine books of the corporation at a reasonable time upon written demand. Access to the books of the corporation can be denied if sought for an "improper" purpose. The proper purpose restriction is a carryover from common law where the restriction insured that the examination was for an honest purpose and not to gratify curiosity or for speculative or vexatious purposes. It was designed to make certain that the purpose of the shareholder desiring to make examinations must be germane to his interests as a shareholder, that it was proper and lawful in character, and that it was not inimical to the interests of the corporation.

To clarify the applicability of this common law doctrine a number of states, including Alaska, have adopted into their corporation codes an inspection of records provision requiring the proper purpose. Under these provisions the shareholder is presumed to have the right of inspection and the lack of a proper purpose can only be asserted as a defense to a claim of wrongful denial of inspection. There is no comprehensive definition of what constitutes a proper purpose since there are innumerable valid reasons for a shareholder to inspect the books of his corporation. However, case law has indicated many such purposes a partial list of which would include:

- 1) To ascertain the value of a shareholder's stock.
- 2) To acquire knowledge to enable him to vote understandingly at a shareholder's meeting.
- 3) To investigate into consideration actually paid for stock and the failure to distribute dividends.
- 4) To investigate irregularities resulting in secret profits to officers of the corporation.
- 5) To determine correctness of financial statements and the existence of collateral for notes.
- 6) To determine whether a shareholder is being discriminated against in relation to his shares. (AS 10.05.237).

.275. LIABILITY FOR REFUSAL OF EXAMINATION. Any agent of the corporation wrongfully refusing shareholder access to the books and records of the corporation is subject to a fine of \$1,000 per day for each day of wrongful refusal. (AS 10.05.243).

.280. COURT MAY COMPEL INSPECTION. Courts have the power to compel inspection of the corporations books. (AS 10.05.249).

.285. SHAREHOLDERS' RIGHT TO FINANCIAL STATEMENT. The corporation must provide the shareholders with a financial statement upon request. (AS 10.05.249).

.290. REMOVAL OF DIRECTORS BY SUPERIOR COURT. This new provision allows a court, upon the suit of the attorney general or 100 shareholders 18 or older, to remove a director for fraudulent or dishonest acts or gross abuse of authority and bar such director from reelection.

This provision is not a simple removal clause, but gives standing to the shareholders and the attorney general to ask a court to remove a director for specific reasons. In order to have the court remove the director the shareholders or the attorney general bringing suit must still prove the director guilty of the offenses charged.

.295. SHAREHOLDER REMOVAL OF DIRECTORS. This section allows the shareholders to remove the entire board by a majority vote or any single director by a vote at least as large as that which elected him at his last election.

- .300. SHAREHOLDERS' DERIVATIVE ACTION. This section allows shareholders to file an action on behalf of the corporation if those responsible inside the corporation fail to do so. Alaska Supreme Court Rule 23.1 provides for such an action, but does not specify the treatment of security for expenses or accounting of settlements. Because this section would amend a rule of court a 2/3 vote is required for passage and the provision is set forth separately in Section 8 of the bill.

This section allows the courts discretion to require security for expenses incurred in the prosecution of the derivative action. It requires court approval of any out of court settlement to insure that those prosecuting the suit may not simply be bought off. The proceeds of any successful action or settlement of a derivative suit must be accounted for to the court and the court is then authorized to award reasonable expenses to the parties.

- .305. FRAUDULENT TRANSFERS OF SHARES. Transferring or obtaining shares of the corporation by fraud is a felony.

ARTICLE 2. FORMATION OF CORPORATIONS.

- .310. INCORPORATORS. Incorporators are those persons who file the articles of incorporation to begin the corporation's existence. This must be done by at least three people over the age of 19. (AS 10.05.252).
- .315. ARTICLES OF INCORPORATION. This section sets out the minimum requirements of the articles of incorporation for general stock ownership corporations. The article provisions required by subchapter "U" of the Internal Revenue Code are included in this section as requirements for GSOCs organized in Alaska. Other provisions are carried over from ABCA. (AS 10.05.255).
- .320. FILING OF ARTICLES OF INCORPORATION. Articles of incorporation are to be filed with the Commissioner of Commerce who shall certify the filing and return one original of the articles to the corporation. (AS 10.05.258).
- .325. EFFECT OF ISSUANCE OF CERTIFICATE OF INCORPORATION. Upon issuance of the certificate the corporate life begins. (AS 10.05.261).
- .330. ARTICLES OF INCORPORATION AND INITIAL BYLAWS. This section provides for legislative review of the articles and initial bylaws. They must be submitted to the next session of the legislature and, if not disapproved within 60 days by concurrent resolution they are approved. Legislative disapproval may be overridden by a vote of the shareholders.

- .335. ORGANIZATION MEETING OF DIRECTORS. The incorporators shall call an organizational meeting of directors in the state for the purpose of adopting bylaws, electing officers and conducting other business necessary to the organization of the corporation. (AS 10.05.267).
- .340. NOTIFICATION OF ELIGIBLE SHAREHOLDERS. Since stock is to be distributed free of charge initially 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 month 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.
- .345. CORPORATION NOT LIABLE TO SHAREHOLDERS. Although GSOCs are 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.
- .350. LATE APPLICATION FOR SHARES. Any individual who is eligible to receive an initial distribution of shares but who fails to apply for an issuance of stock may be issued a share at any time within one year of the original issue of stock upon application and payment of book value therefor. The one year period coincides with the period during which a shareholder may elect not to receive his stock and have his share cancelled. This cut off period protects the corporation and the other shareholders from those eligible residents who are not identified and who fail to identify themselves hoping to see how the corporation fares before applying for their stock.
- .355. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER. The superior court is given jurisdiction to void stock issued to an ineligible individual who obtained his shares by fraud and allows the corporation to recover any distributions paid to such a shareholder.

ARTICLE 3. AMENDMENT.

- .360. RIGHT TO AMEND ARTICLES OF INCORPORATION. The articles of the corporation may be amended to include any legal provision. (AS 10.05.270).

- .365. PURPOSES FOR WHICH ARTICLES MAY BE AMENDED. This section lists some, but not all, of the legal purposes for which the articles may be amended. (AS 10.05.273).
- .370. PROCEDURE TO AMEND ARTICLES OF INCORPORATION. The board of directors or the shareholders can propose amendments to the articles of incorporation, but the articles may only be amended upon a 2/3 majority vote of a quorum of shareholders.
- .375. ARTICLES OF AMENDMENT.
- .380. FILING OF ARTICLES OF AMENDMENT.
- .385. EFFECT OF CERTIFICATE OF AMENDMENT.
These three sections provide that an amendment approved by the shareholders to the articles of incorporation must be filed with the Commissioner of Commerce in the same manner as the original articles of incorporation and once certified by the Commissioner the amendment becomes effective. These sections are adopted directly from AS 10.05.285, .288, and .291 respectively.
- .390. RESTATED ARTICLES OF INCORPORATION.
- .395. EXECUTION OF RESTATED ARTICLES OF INCORPORATION.
- .400. CONTENTS OF RESTATED ARTICLES OF INCORPORATION.
- .405. FILING OF RESTATED ARTICLES OF INCORPORATION.
- .410. EFFECT OF ISSUANCE OF RESTATED CERTIFICATE OF INCORPORATION.
These five sections deal with restated articles of incorporation. Restated articles of incorporation for purposes of GSOCs are simply a consolidation and updating of the articles of incorporation with current amendments. This allows the corporation to have on file with the Commissioner a current copy of the articles of incorporation incorporating all amendments. The provisions are adopted essentially from ABCA except that GSOCs are not allowed to amend the articles of incorporation through filing restated articles and for that reason are allowed to file restated articles upon motion of the board of directors. (AS 10.05.294, .297, .300, .303, and .306 respectively).

ARTICLE 4. SALE OF ASSETS.

- .415. SALE OR MORTGAGE OF ASSETS IN REGULAR COURSE OF BUSINESS.
The board of directors may sell or dispose of all the assets of the corporation if it is in the ordinary course of the corporation's business. (AS 10.05.435).
- .420. SALE OR MORTGAGE OF ASSETS OTHER THAN IN REGULAR COURSE OF BUSINESS. Sale of all the assets of the corporation other than in the ordinary course of business requires a vote of the shareholders. (AS 10.05.438).

- .425. APPROVAL OF PLAN BY SHAREHOLDERS. A 2/3 vote of the shareholders is required to approve a sale of all the assets of the corporation outside the ordinary course of business. (AS 10.05. 441).
- .430. ABANDONMENT OF PLAN BY BOARD OF DIRECTORS. Even though a vote of the shareholders is required to approve a sale of all the assets the sale may be abandon by the board since such sales are unusual and may require quick decisions which cannot be effectively put to the shareholders. If the shareholders are unhappy about the abandonment they have the power to remove the board and it is to be expected that the board would not abandon such a sale without good cause. (AS 10.05.444).
- .435. RIGHTS OF DISSENTING SHAREHOLDERS UPON SALE OR EXCHANGE OF ASSETS.
- .440. NOTICE TO DISSENTING SHAREHOLDER.
- .445. PAYMENT TO DISSENTING SHAREHOLDER AFTER AGREEMENT ON VALUE OF SHARES.
- .450. ACTION BY DISSENTING SHAREHOLDER TO COMPEL PAYMENT UPON FAILURE TO AGREE ON VALUE.
- .455. EFFECT OF ABANDONMENT OR REVOCATION OF SALE OR EXCHANGE ON SHAREHOLDER'S RIGHTS.
- .460. STATUS OF SHARES ACQUIRED FROM DISSENTING SHAREHOLDER. These section deal with the shareholder who does not wish to be a part of the sale of substantially all the assets of the corporation in spite of the 2/3 majority vote of the shareholders. Such a shareholder can dissent from the sale and have the corporation purchase his shares. There are notice provisions and opportunity for the shareholder and the corporation to agree upon a purchase price for the shares. If the shareholder and the corporation cannot agree upon a price the matter can be decided by a court. If the sale is abandoned the dissenting shareholder loses his right to receive payment from the corporation for his share and he remains a shareholder. Shares acquired from a dissenting shareholder become treasury shares.

ARTICLE 5. DISSOLUTION.

GSOCs may be dissolved voluntarily by a 2/3 vote of a quorum of shareholders (.470) or by the Commissioner of Commerce (.525).

In a voluntary dissolution the question may be put to the shareholders upon action of the board or a petition of 100 shareholders (.470). Upon affirmative vote of the shareholders a statement of intent to dissolve signed by corporate officers (.475) is filed with the Commissioner of Commerce (.480). When the statement is officially filed by the Commissioner the corporation must cease doing business and wind up its operations (.465). However, the corporate existence continues while the corporation notifies creditors,

collects and liquidates assets and pays off its obligations (.485)(.490). When the business of the corporation has been wound up articles of dissolution (.510) are filed with the Commissioner (.515) and when certified the corporate existence ceases (.520). Voluntary dissolutions may be revoked at any time by a 2/3 vote of the shareholders (.495) in which case the corporation files a statement of revocation (.500) and the dissolution process is terminated (.505).

A GSOC may be dissolved involuntarily by the Commissioner of Commerce with 60 days notice for failure to file reports or pay fees, failure to maintain a registered agent or office or change either without notice, and unfilled board vacancies continuing beyond the allowable time (.525). A corporation can be reinstated within two years upon remedy of the violation.

The superior court may dissolve a GSOC (.53) and has jurisdiction to liquidate the corporation's assets (.535). The Attorney General may bring suit to dissolve the corporation where there was fraudulent incorporation or continual abuse of corporate authority (.525).

In addition a suit for liquidation of the corporations assets may be brought by:

- 1) A shareholder where the board is deadlocked; the board is action in an illegal, oppressive, or fraudulent manner; the shareholders are deadlocked for two annual meetings; or, the corporation's assets are being misapplied (.540).
- 2) A creditor when the creditor's claim is unsatisfied and the corporation is insolvent (.545).
- 3) The corporation upon request to have a voluntary dissolution continued under court supervision(.550).
- 4) The Attorney General in conjunction with a suit for dissolution (.555).

The shareholders need not be a party to the action for liquidation (.560). The court has authority to appoint a qualified receiver (.600) for the corporation with power defined by the court (.580) to collect and sell its assets (.565)(.570). Proceeds are to be used to pay expenses allowed by the court (.585) and debts of the corporation with the remainder distributed to the shareholders (.575).

The receiver may sue and be sued (.590) and all claims against the corporation must be filed in a timely manner with the court or the receiver (.605). Liquidation may be terminated by the court (.610) but upon completion the court must enter a decree of dissolution (.615).

The article on dissolution is carried over substantially intact from ABCA (AS 10.05.465 - .594).

ARTICLE 6. GENERAL PROVISIONS.

- .620. AS 10.05 INCORPORATED BY REFERENCE. In order to reduce duplication this section incorporates by reference Sections .699 through .819 of ABCA (AS 10.05.699 - .819). These sections deal with requirements for annual reports to be filed with the Commissioner of Commerce, filing fees and charges, procedural provisions and forms, and powers of the Commissioner of Commerce.
- .625. FALSE STATEMENTS AFFECTING VALUE OF SHARES. An agent of a corporation who makes fraudulent statements regarding the value of shares is guilty of a misdemeanor.
- .630. DIRECTOR MAKING UNLAWFUL DIVIDEND OR DISTRIBUTION OF ASSETS. A director who concurs in a distribution designed to deceive creditors or shareholders is guilty of a misdemeanor.
- .635. RESERVATION OF POWER. Amendments to this chapter apply to all existing and future corporations organized under it.
- .640. DEFINITIONS. Many of the definitions in this section are carried over from ABCA and may also be found in AS 10.05.825. However, there are two significant new definitions:

Certificate as used in the context of "stock certificate" may mean something other than the actual certificate such as a receipt evidencing ownership. This definition has been broadened in order to allow for the possibility that the stock certificates themselves may never be issued, but that the stock records may be kept by the corporation itself as the evidence of ownership in a particular shareholder which ownership would be represented in the hands of the shareholder by a receipt. Such a receipt would be required to carry all the same information as is required on the certificate itself.

Resident is defined 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.

TAX CONSEQUENCES OF GSOCs

The figures used in this example assume on the one hand ownership of a 15.84% interest in the TAPS line by a private corporation wholly owned by non-residents and on the other hand a similar interest owned by an Alaska general stock ownership corporation. An effort is made here to illustrate the effect of these different forms of ownership upon the tax revenues of the state of Alaska.

	<u>NON-RESIDENT CORP.</u>	<u>GSOC</u>
Taxable Income ¹	\$131,548,000	\$131,548,000
Alaska Corporate Tax (9.4%)	12,366,000	-0-
Cash for distribution	\$119,182,000	\$131,548,000
Distributions to Alaskans	-0-	\$131,548,000
Alaskans subject to tax on ² their distribution	-0-	51.85%
Distributions taxed by Ak.	-0-	\$68,208,000
Average rate on distributions ³ taxed by Alaska		5.5%
Income to State of Alaska	\$12,366,000	3,751,000

The second step in the analysis is to determine how much additional income will accrue to Alaskans from this type of corporation. Once that is determined we can apply a multiplier to that income and determine the tax consequences of later transactions in which the additional income is spent and becomes income to someone else.

CASH AVAILABLE TO ALASKANS

Income to Alaskans after state income tax	-0-	\$127,797,000
Alaskans subject to federal ⁴ income tax on distribution		<u>51.85%</u>
Distributions taxed by the federal government		66,263,000
Average federal rate on ⁵ distributions		<u>27.5%</u>
Federal taxes paid on distributions		18,222,000
Cash, after income taxes, available to Alaskans		
Total distribution to Alaskans		\$131,548,000
Less Alaska income taxes		\$3,751,000
Less federal income taxes		18,222,000
Total cash, after income taxes, available to Alaskans		<u>\$109,575,000</u>

From this total cash available to Alaskans figure we can determine the secondary tax consequences of this addition to personal income in Alaska. The MAP econometric model of the Institute of Social and Economic Research in Anchorage uses a multiplier of 2 to determine the tax effect of additions to personal income in Alaska. Since the income has already been taxed once by Alaska in our calculations the model tells us that an additional 5.5% can be expected in state taxes, most of which would be realized within 18 months of the distribution.

ADDITIONAL STATE INCOME FROM MULTIPLIER

Portion of distribution taxed in Alaska ⁶	\$ 68,208,000
Additional 5.5% from taxes on income generated by spending of the additional disposable income	<u>5.5%</u>
Tax revenues to state from multiplier	\$ 3,751,000

COMPARISONS

Income to Alaskans (pre federal income tax)	\$ -0-	\$124,046,000
Income to State	12,366,000	7,502,000
Total income to Alaska	<u>\$12,366,000</u>	<u>\$131,548,000</u>

¹Derived from Arthur Anderson & Co. study "Prudhoe Bay Field and Trans-Alaska Pipeline System - Comparative State Tax Burden Study" Feb. 1979.

²The Department of Revenue estimates that approximately 210,000 Alaskan individuals pay income taxes out of a total population of 405,000. Thus, approximately 51.85% of Alaskans pay taxes to the state.

³The average rate of state income tax on the last dollar of income received by Alaskans who pay state income taxes is estimated by the Department of Revenue to be approximately 5.5%. Since any GSOC dividend would constitute additional income to the shareholders they would be taxed on this income at their marginal rate.

⁴This figure is approximately the same as those Alaskans subject to state income tax.

⁵Department of Revenue estimates that the average rate of federal income tax on the last dollar of income of those who pay federal taxes in Alaska lies between 25% and 30%. For purposes of this example these estimates are averaged to arrive at a rate of 27.5%.

⁶This is the same amount as found above on the line below footnote #2 and represents the amount received by those Alaskans subject to state income tax.