

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 86 / 2

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

absorbed by the shareholder-readers of this report, not the management or the public relations firm which wrote it. These shareholder-readers were given absolutely no warning of what was coming, no opportunity to exert their prerogative to change management or to vote a more timely dissolution.

Nor can insurgent shareholders obtain much additional information from their own corporation when they prepare for a proxy challenge. They lack the legal tools to gain access to live interviews with corporate executives, board meetings, or memoranda which could document internal debate, management error, derogations of law, sloppy execution of policy, or even the content of management's policy formulations.

All of which is a bizarre commentary on the Securities and Exchange Commission. The federal security laws emphasize disclosure. The Commission has claimed that its Proxy Rules "represent an effective contribution to corporate democracy" because disclosure enables individual investors to exercise some measure of control over the management of their corporation. Although the Securities and Exchange Act of 1934 authorizes the SEC to require annual and quarterly reports, including the authority to prescribe "the items or details to be shown in the balance sheet and the earnings statement . . .," shareholders can not compel their corporation to give a product line or division accounting so as to uncover unprofitable operations. Specific management mistakes may thus be submerged in consolidated financial reports. Shareholders may wish to know whether executives are using expense accounts improperly or are being indemnified for certain civil or criminal liabilities. They cannot find out. They may wish to read minutes of the meetings of corporate directors—whom they elect—or reports of decisions by executives respecting corporate property—which shareholders own. Under federal securities laws, they have no legal rights to do so.

Under state statutory law, shareholders theoretically have broad rights to examine corporate records. State statutes typically authorize inspection of shareholder lists—without which a shareholder could not even begin a proxy solicitation—and "other books and records." But this access is circumscribed by legal restrictions

ments of "good faith," "proper purpose," and minimum share ownership, as well as ample opportunities for management to delay compliance with legitimate shareholder demands by forcing expensive court tests.

Almost invariably shareholders prevail in court battles to secure a shareholder list, for, as a leading Pennsylvania decision put it, ". . . the right to examine the stockholders' list is a basic privilege of every stockholder of a corporation and should be given the widest recognition as fundamental to corporate democracy." But the courts are reluctant to enforce shareholder demands for other information. Doctrinally, this has been rationalized as deterring excessive "stockholder agitation." The Supreme Court of Minnesota rather melodramatically explained why in the leading case of *State Ex rel. Pillsbury v. Honeywell*:

In terms of the corporate norm, inspection is merely the act of the concerned owner checking on what is in part his property. In the context of the large firm, inspection can be more akin to a weapon in corporate warfare. The effectiveness of the weapon is considerable: "considering the huge size of many modern corporations and the necessarily complicated nature of their bookkeeping, it is plain that to permit thousands of shareholders to roam at will through their records will render impossible not only any attempt to keep their records efficiently, but the proper carrying on of their business." . . . Because the power to inspect may be the power to destroy, it is important that only those with a bona fide interest in the corporation enjoy the power. . . .

Alarming as the specter of "thousands of shareholders roaming at will" through once efficient corporations may be, it can only be conjured up by courts so cunning as to overlook their inherent judicial power to restrict any shareholder access to corporate data to reasonable numbers of shareholders at reasonable times and reasonable places. Yet phantom or not, this rationale has been employed in recent decisions to deny one A&P shareholder access to the minutes of board meetings and information relevant to store closings; to deny Ralston Purina shareholders access to monthly profit analyses employed by management; and to deny shareholders of Gulf Sulphur Corporation information concerning a firm with which Gulf proposed to merge.

MANAGEMENT CONTROL OF THE LAW

Management power is further entrenched by three significant legal advantages.

First, in approximately 90 percent of all large industrial corporations, cumulative voting is not required. In these corporations, a minority of shareholders—even a minority as substantial as 49.9 percent—may be precluded from electing even one director to the board.

Under cumulative voting, each shareholder is entitled to votes equal to the number of his or her shares multiplied by the number of directors to be elected. The shareholder may cast all his or her votes for a single candidate or distribute them among two or more candidates as he or she sees fit. Cumulative voting, therefore, helps to protect the *financial* interest of minority shareholders by assuring them voice on the board of directors. And it protects the *political* interest of minority shareholders. For without cumulative voting, the tendency of large industrial corporations to perpetuate one-party rule is powerfully enhanced. As Professor Charles M. Williams demonstrated after analyzing proxy contests for the years 1943-1948, corporations with cumulative voting were more than twice as likely to have proxy contests as those without.

Because of these benefits, cumulative voting has enjoyed considerable popularity. From 1870, when Illinois became the first state to require cumulative voting, until 1955, 23 states had established absolute requirements for cumulative voting. Additionally, federal law requires cumulative voting for over 5,000 banks subject to the Federal Banking Act of 1933 (although the intent of this law has often been frustrated by bank holding company structures); and the Securities and Exchange Commission has consistently required cumulative voting for corporations subject to the Public Utility Holding Act of 1935 and corporations undergoing reorganization under Chapter X of the Bankruptcy Act. As an attorney snapped in 1950 in frustration at Wisconsin's refusal to enact cumulative voting, "Cumulative voting is so obviously in accord with our basic political philosophy of group representation and the party system that it is difficult to understand the legis-

ture's repeated rejection of it, except in terms of a response to the pressure of corporate management's interest."

Unfortunately, "the pressure of corporate management's interest" often does prevail in state corporation law. Between 1955 and 1972, five states dropped mandatory cumulative voting. In 1973, Michigan changed from mandatory to permissive cumulative voting; in 1974 both California and Ohio considered—but did not enact—similar legislation. Today, in Delaware, as well as 32 other states, cumulative voting is not required. True, in most of these states, cumulative voting is permitted. In practice, however, permissive cumulative voting offers little but an illusory right. Studies by Professor Williams in 1951 and the Conference Board in 1973 indicate that only about 15 percent of the corporations in states with permissive cumulative voting have provided for this right.

And even in those few corporations which voluntarily institute cumulative voting, most states provide ample devices to subvert it. Although cumulative voting aims to prevent a simple majority from maintaining absolute corporate control, Delaware permits a simple majority to amend the corporate charter to repeal cumulative voting. And Delaware and some 42 other jurisdictions allow the "classification" of the board of directors. This device reduces to one third or one half the number of directors required to stand for election annually and thus increases the minimum vote necessary to elect a director.

Management's second legal edge is its power to issue nonvoting stock or classes of stock with unequal voting rights. For example, prior to December 1, 1955, there were three classes of stock in Ford Motor Company: common, Class A, and Class B. Only the Class B shares (4.94 percent of total equity), all of which were owned by Ford family interests, were entitled to vote.

Only Illinois and a few other states forbid the issuance of classes or series of stock without voting rights. But the refusal of both the New York Stock Exchange and the American Stock Exchange to list corporations with nonvoting stock has substantially reduced the number of corporations which may totally eviscerate shareholder suffrage, although neither exchange actively enforces equal voting rights.

The third statutory device for impairing shareholder suffrage

rights is a provision common to the law of Delaware and apparently every other jurisdiction requiring the submission of proxy materials only to *shareholders of record*. This innocent sounding requirement effectively disenfranchises approximately 50 percent of the beneficial owners of corporate stock in the largest industrial corporations. For approximately 50 percent of the stock in the 1,800 companies traded on the New York Stock Exchange is held by mutual funds, life insurance or property and casualty insurance companies, private pension funds (usually administered through commercial bank trust departments), state and local pension funds, foundations, university endowment funds or other institutional investors. The result is a mockery of shareholder democracy: *Approximately 50 percent of the votes in our largest industrial corporations are cast by financial intermediaries—not the real owners.*

These institutional shareholders provide virtually no check to corporate management. Most financial institutions, according to the SEC's 1971 *Institutional Investor Study*, follow what is known as "The Wall Street Rule": An investment in a business corporation is considered an investment in that corporation's management; if the financial institution ceases to like what management is doing, the institution sells the stock. By examining the voting practices of 215 large institutions between January 1, 1967 and September 30, 1969, the SEC determined that approximately 30 percent of these institutions *always* voted for management (in elections other than votes for directors). For the remaining institutions, both voting against management and abstention were found "to be a relatively infrequent phenomenon." For example, in only 26 instances did any of the 215 institutions vote against an acquisition favored by management, "a miniscule fraction of such transactions."

The SEC conducted its study before the proliferation of shareholder proposals directed at social issues and precipitated by Campaign GM. In the past five years, some financial institutions have established formal procedures to consider shareholder public policy or ethical proposals. According to newsletters published by the Council on Economic Priorities and the Investor Responsibility Research Center, a small number of church-related funds, foundations, and universities have supported shareholder proposals respecting disclosure of political contributions; withdrawal from

South Africa, Rhodesia, or Namibia; opposition to military production; or review of corporate safety, environment, occupational discrimination, or community programs. Since most institutional shares are voted by banks, insurance companies, and mutual funds, and these financial institutions have shown only a negligibly greater willingness to oppose management, the overall pattern of institutional voting has changed little in the past five years.

MANAGEMENT CONTROL OF OTHER FUNDAMENTAL DECISION-MAKING

Historically, shareholders controlled the business corporation not only through the election of directors but also through shareholders' power to initiate and vote upon all fundamental changes in the character of the corporation. Management's ability to initiate change was carefully circumscribed by requiring two-thirds or three-fourths affirmative votes for charter amendments, bylaw changes, mergers, sales of assets, stock issuance, recapitalization, or dissolution and was further limited by shareholder appraisal and preemptive rights.

Under Delaware's General Corporation Law, shareholders have lost nearly all power to initiate corporate change. Only the board of directors may propose charter amendments, a merger, or a sale of assets. The SEC Proxy Rules complement Delaware's corporation law by denying shareholders opportunity to communicate opposition to management proposals or to suggest modifications in management's formal proxy proposals.

This rout has been substantially replicated in all other leading chartering states. Indeed, the trend of recent revisions to state corporation law has been to attempt to deny the shareholder any vote at all! Modern corporate draftsmen invariably write short, purely formal certificates of incorporation and then place most of a corporation's actual governing rules in its bylaws, which the certificate establishes can be revised by the corporation's directors without any shareholder vote. For example, when ITT reincorporated in Delaware in 1967, it did so by creating a Delaware corporation called the "DeLitt Corporation" and by then merging ITT, previously a Maryland corporation, into DeLitt. The certificate of incorporation of DeLitt was only 1½ pages long. It reads in toto:

CERTIFICATE OF INCORPORATION
OF
DELITT CORPORATION

Article 1

The name of the corporation is Delitt Corporation (hereinafter called the "Corporation"). The name and mailing address of its incorporators are as follows:

NAME	MAILING ADDRESS
John J. Navin	320 Park Avenue, New York, N.Y. 10022
William J. Donovan	320 Park Avenue, New York, N.Y. 10022
DeForest Billyou	320 Park Avenue, New York, N.Y. 10022

Article 2

The address of the registered office of the Corporation in the State of Delaware is No. 100 West Tenth Street, in the City of Wilmington, County of New Castle. The name of its registered agent at such address is The Corporation Trust Company.

Article 3

The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware.

Article 4

The total number of shares of stock which the Corporation has authority to issue is 100 shares of capital stock of the par value of \$100 per share.

Article 5

Whenever the vote of stockholders at a meeting thereof is required or permitted to be taken for or in connection with any corporate action by any provision of the General Corporation Law of Delaware, the meeting and vote of stockholders may be dispensed with if the holders of stock having not less than the minimum percentage of the vote required by statute for the proposed corporate action shall consent in writing to such corporate action being taken, provided that prompt notice must be given to all stockholders of the taking of such corporate action without a meeting and by less than unanimous written consent.

Article 6

In furtherance and not in limitation of the powers conferred by law, the Board of Directors is expressly authorized:

(a) To make, alter, amend or repeal the By-Laws of the Corporation.

(b) To direct and determine the use and disposition of any annual net profits or net assets in excess of capital; to set apart out of any of the funds of the Corporation available for dividends a reserve or reserves for any proper purpose; and to abolish any such reserve in the manner in which it was created.

(c) To establish bonus, profit-sharing, stock option, retirement or other types of incentive or compensation plans for the employees (including officers and directors) of the Corporation and to fix the amount of the profits to be distributed or shared and to determine the persons to participate in any such plans and the amounts of their respective participations.

(d) From time to time to determine whether and to what extent, and at what time and places and under what conditions and regulations, the accounts and books of the Corporation (other than the stock ledger), or any of them, shall be open to the inspection of the stockholders; and no stockholder shall have any right to inspect any account or book or document of the Corporation, except as conferred by statute or authorized by the Board of Directors or by a resolution of the stockholders.

(e) To authorize, and cause to be executed, mortgages and liens upon the real and personal property of the Corporation.

Article 7

The corporation reserves the right to amend, alter, change or repeal any provision contained in this Certificate of Incorporation, in the manner now or hereafter prescribed by statute, and all rights conferred upon stockholders herein are granted subject to this reservation.

The key sentence is contained in Article 6: "In furtherance and not in limitation of the powers conferred by law, the Board of Directors is expressly authorized: (a) To make, alter, amend or repeal the By-Laws of the corporation. . . ." What ITT tried to do, as so many other giant Delaware corporations have tried to do, was to totally shut shareholders out of the governing process except in those rare instances in which the Delaware General Corporation Law explicitly requires a shareholder vote—which is not very often.

True, technically, section 251(c) grants shareholders a vote on management merger proposals. But this, in fact, is a mere snare

for the dim-witted. Only a small minority of corporate fusion actually trigger this shareholder vote. The overwhelming majority employ one of three conventional loopholes (discussed in the Sources).

Similarly, section 271 limits shareholder suffrage in a sale, lease, or exchange of assets to transactions involving "all or substantially all" of a corporation's property and assets. Since most large industrial corporations are highly diversified, this provision effectively insures their shareholders will never vote. For example, General Motors could sell an automobile division such as Pontiac or Cadillac and not require a vote. It could liquidate hundred-million-dollar plants which manufacture refrigerators, diesel engines, and trucks or auction off all of its Detroit real estate and relocate in the Peoples Republic of China, and shareholders would have no choice in the matter. Only if GM sold *all* assets used to manufacture "automotive products" (about 75 percent of the corporation) would a sale of assets require a shareholder vote.

Moreover, section 271 is the only Delaware statute concerning corporate divisions. A Delaware corporation may create and fund new subsidiary corporations, regardless of size; liquidate these subsidiaries or comparable divisions and distribute assets to shareholders; or spin-off new corporations altogether without any shareholder vote. As business corporations have evolved these new forms, Delaware and other principal chartering states have deliberately not kept pace. Corporate executives have not hesitated to take advantage of this laxity. In the past three years many Delaware corporations have "gone private" and bought up minority shareholdings at bargain prices during a depressed stock market. This will allow favored shareholders or the firm itself to reap the profits when the company's stock price rises. Other senior managements have used the merger provisions to prevent take-over bids—which can benefit all shareholders—by requiring super-majorities, such as 75 or 90 percent, to consent to any consolidation or sale of the companies assets.

Whither/Wither the Board of Directors?

But does not the board of directors with its sweeping statutory mandate "to manage the business and affairs of every corporation"

provide an internal check on the power of corporate executives? No. Long ago the grandiloquent words of the statutes ceased to have any operative meaning. "Directors," William O. Douglas complained in 1934, "do not direct." "[T]here is one thing all boards have in common, regardless of their legal position," Peter Drucker has written. "*They do not function.*" In Robert Townsend's tart analysis, "[M]ost big companies have turned their boards of directors into nonboards. . . . In the years that I've spent on various boards I've never heard a single suggestion from a director (made as a director *at* a board meeting) that produced any result at all."

Recently these views were corroborated by Professor Myles Mace of the Harvard Business School, the nation's leading authority on the performance of boards of directors. In *Directors—Myth and Reality*, Mace summarized the results of hundreds of interviews with corporate officers and directors.

Directors do not establish the basic objectives, corporate strategies or broad policies of large and medium-sized corporations, Mace found. Management creates the policies. The board has a right of veto but rarely exercises it. As one executive said, "Nine hundred and ninety-nine times out of a thousand, the board goes along with management. . . ." Or another, "I can't think of a single time when the board has failed to support a proposed policy of management or failed to endorse the recommendation of management."

The board does not select the president or other chief executive officers. "What is perhaps the most common definition of a function of the board of directors—namely, to select the president—was found to be the greatest myth," reported Mace. "The board of directors in most companies, except in a crisis, does not select the president. The president usually chooses the man who succeeds him to that position, and the board complies with the legal amenities in endorsing and voting his election." A corporate president agreed: "The former company president tapped me to be president, and I assure you that I will select my successor when the time comes." Even seeming exceptions such as RCA's 1975 ouster of Robert Sarnoff frequently turn out to be at the instigation of senior operating executives rather than an aroused board.

The board's role as disciplinarian of the corporation is more apparent than real. As the business-supported Conference Board conceded, "One of the most glaring deficiencies attributed to the corporate board . . . is its failure to monitor and evaluate the performance of the chief executive in a concrete way." To cite a specific example, decisions on executive compensation are made by the president—with perfunctory board approval in most situations. In the vast majority of corporations, Professor Mace found, the compensation committee, and the board which approves the recommendations of the compensation committee, "are not decision-making bodies."

Directors do not even ask discerning questions. It is considered "discourteous," a breach of "corporate manners" for directors to "challenge" the president or other corporate officers. This can be a very expensive form of decorum, as the Penn Central's shareholders painfully discovered. At the time of its collapse in June 1970, Penn Central was the largest railroad in the country and the sixth largest industrial corporation overall. Within a two-year period, shareholders witnessed the decline of their shares from \$86.50 to \$2.75.

Why? "The board was definitely responsible for the trouble," recounted outside director E. Clayton Gengras. "They took their fees and they didn't do anything. Over a period of years, people just sat there. That poor man from the University of Pennsylvania [University President Gaylord P. Harnwell], he never opened his mouth. They didn't know the factual picture and they didn't try to find out." As the Penn Central rushed towards its monumental crack-up, the board routinely approved every proposal forwarded by management. Although Penn Central was desperate for capital, the directors paid out nearly \$100 million in dividends. The board never saw a capital expenditures budget. It never understood the inaccuracies published in Penn Central's annual reports. Just six hours before the corporation filed its bankruptcy petition, the board routinely approved new contracts for eight corporate executives, apparently unaware even then of the dimensions of the Penn Central's crisis. "All of this raises the serious question as to whether giant corporations affecting the everyday lives of our population . . . should continue to be governed in the traditional fashion

or whether a new system of corporate directorships should be devised," concluded the House Banking and Currency Committee.

Yet boards will continue to be dysfunctional as long as they remain the creature of the corporate chief executive. For it is the chief executive who, like the family owner-manager in a small corporation, selects new members of the board. And it is the chief executive who de-selects existing board members when nominations for the board are necessary for annual shareholders' meetings.

Our own survey of the boards of the 200 largest industrial corporations found that the average board had a total of 14.49 directors, including 7.93 "outsiders" (that is, directors who were not employees of the corporation) and 6.56 insiders (or employee directors). Some 69 percent of the outside directors were fellow corporate executives; 6 percent were investment bankers; 7 percent were lawyers. Only 2 percent were women; a lesser percentage were black. Hence over 90 percent of the directors of our largest corporations either worked for the corporate chief executive or were fellow corporate executives, corporate bankers, or corporate lawyers.

Most "outside" directors appear to be chosen because of their status. "Presidents and chairmen of large and respected companies," one corporate president observed, "enjoy the prestige of serving on similar large and respected company boards. They are identified with their peers. They find the experience socially satisfying. Outside directorships provide a few more lines in their *Who's Who*, and it is a little bit like being knighted to say 'I'm a director of General Motors, or General Electric, or AT&T.'" Frequently, the chief executive chooses his friends, or individuals known to be "sympathetic" or "congenial," to be directors. "You certainly don't want anyone on your board who even slightly might be a challenge on a question of your tenure, so you pick personal friends with prestige titles and names," a corporate president explained. Another executive agreed: "What would you do if you were president? You control the company and you control the board. You want to perpetuate this control. . . . You sure as hell are not going to ask Ralph Nader. . . ."

At its worst, the outside director system degenerates into a private club, as the president of a west coast company explained:

You've got to remember that the outside directors of large national and regional companies are members of a sort of club. To be considered for admission you must have the title as president or chairman of a respectable and respected organization. This is what some young people call the Establishment. But these are the people you do business with, travel around with, serve on community projects with—and it has to be a group the members of which get along together. Regionally each area has its elite. Sometimes many will in fact be members of the same golf or social club. Here in Los Angeles you will find a great number of directors with membership in the Los Angeles Country Club; in Cleveland the same is true of the Union Club—each city has its hard core members of the club group.

Exceptions to this pattern become news events. In reporting on General Motors' 1971 annual shareholders' meeting, the *Wall Street Journal* noted that, "The meeting's dramatic highlight was an impassioned and unprecedented speech by the Rev. Leon Sullivan, GM's recently appointed Negro director, supporting the Episcopal Church's efforts to get the company out of South Africa. It was the first time that a GM director had ever spoken against management at an annual meeting." Now Rev. Sullivan is an unusual outside director, being General Motors' first black director and only "public interest" director. But what makes Leon Sullivan most extraordinary is that he was the first director in any major American corporation to come out publicly against his own corporation when its operations tended to support apartheid.

Yet as lethargic as outside directors usually are, employee directors tend to be even less effective. The typical vice president/inside-director is in a very precarious position at a board meeting. Unwilling to say anything in disagreement with his boss, he usually sits quietly and waits until he is called upon to speak. Disagreements with other corporate executives are invariably resolved out of the board room. The effect is to present outsiders with a "united front": to make the corporate chief executive's decisions seem inevitable.

So staffed, board meetings in most large industrial corporations have become formalized into a monthly or bimonthly ritual, usually lasting about one to three hours. Much of this time is consumed by perhaps a 30-minute to an hour review of operations for the last period (month or quarter) by the president or vice president

of finance. This is followed by board approvals of capital appropriations and of the actions of the executive committee taken since the last meeting. The meeting often concludes after senior executives have described a new research development or a major operations program. Usually the entire meeting—which is closed to shareholders—is choreographed by the corporate chief executive. He chooses which officers shall speak. He writes the agenda. When he wants to be asked about a particular issue, he plants the relevant question.

The impossibility of so infrequent or so circumscribed meetings of the board enabling directors to effectively "manage" their corporation was sardonically illustrated by the congressional testimony of H. O. Havemeyer, a corporate chieftain of an earlier day:

Q. As a member of that board, what else have you done?

A. Oh, I have convened and talked.

Q. You have convened and talked?

A. And adjourned.

Q. Well, you have convened and talked?

A. And adjourned.

Q. Well, what have you talked about?

A. Statistics.

This testimony was given in 1887 when outside directors were typically the "tools" or "dummies" of the controlling corporate president or bank. A popular gag on Wall Street was that the role of an outside director was to receive his five-dollar gold piece at the start of each meeting and then obediently fall asleep. Directorial lassitude is not so obvious today. Yet considering that the size and complexity of corporate enterprise has significantly increased since 1887 while the frequency and length of directors' meetings has not, it is a fair assumption that the outsiders who obediently nod through ceremonial board meetings today are little better informed than their brethren who slept before them.

Certainly directors' sources of information remain as much subject to management control today as they did 90 years ago. After resigning from TWA's board, former United States Supreme Court Justice Arthur Goldberg had this complaint: "What the typical board of directors gets is a recommendation which seems mono-

lithic. . . . It's not like a court, where a judge can order a brief from both sides." Recently the quantity of preparatory information available to outside directors has significantly increased. Yet the thickened reports and whirlwind plant tours are still only what the corporate chief executive wants outsiders to see. "In many corporations," found Professor Melvin Eisenberg, "the executives go so far as to wholly deny the board—supposedly entrusted with supreme power over the corporation—access to certain categories of information." For instance, a 1971 survey found that only 17 percent of 474 industrial firms sent manufacturing data to directors prior to board meetings, only 21 percent sent marketing data, and 11 percent sent no data at all.

And outside directors have little personal incentive to doubt management. A 1973 survey of 378 manufacturing corporations with assets of \$50 million or more showed that outside directors received median annual fees of approximately \$5,900, while inside directors generally are not paid at all. On top of the \$100,000+ incomes typically earned by outside directors, who are corporate chief executives or vice presidents, leading investment bankers, or law firm partners, such annual retainers or meeting fees seem like peanuts. The result is counterproductive. Outside directors rationalize not doing very much by the fact they are not paid very much.

How, then, can one reconcile the grand imperative, "The business and affairs of every corporation . . . shall be managed by or under the direction of . . . a board of directors" with the reality of this "non decision-making body"? The fashionable response is that the board is a legal fiction. Management control has overwhelmed the rule of law.

This widely held view is only half right. Management has deposed the board of directors—but it has done so under color of law. No rule within the modern corporation statutes prohibits management from nominating and serving as directors. Corporation law has abrogated directional independence by omission. Moreover, even if the statutes provided structural safeguards to maintain the independence of the board, these could not undo the effect of two provisions found in most state corporation laws.

The first provision is exemplified by a Delaware Corporation Law section which provides that a director shall "be fully protected in relying in good faith upon . . . reports made to the corporation by any of its officers." The meaning of this provision is very simple. Directors have no duty to know. "Unless something occurs to put them on suspicion that something is wrong, directors are entitled to rely on the honesty and integrity of [management]," held the leading case of *Graham v. Allis-Chalmers Manufacturing Company*. Directors are not required to "put into effect a system of watchfulness." They need not anticipate problems nor verify the accuracy of reports upon which they rely.

A second provision of the Delaware General Corporation Law accomplishes the same result by allowing the board to formally delegate responsibility for most corporate business to a committee dominated by inside directors. Our survey of the 200 largest industrial corporations indicates that approximately two-thirds of the corporations had withdrawn directorial powers from the full board—typically a majority of whose members were outsiders—to an executive committee at least half of whose members were insiders.

A much smaller number of corporations accomplish a comparable result by delegating authority to an insider-dominated finance committee. In our survey of the 200 largest industrial corporations, we found that 16 corporations had delegated authority to a finance committee, half or more of whose members were insiders.

Examples of the delegation of the board's authority to either an insider-dominated executive or finance committee have been well described by attorney John A. McMullen:

At IBM—four directors, all top level officers of the corporation, control the all-important executive and finance committees; in addition, three of them are members of the powerful Corporate Office. At GM, four or five men, all inside directors of the company, dominate the executive and finance committees of the board as well as the administration committee comprised of key officers and directors. . . . DuPont's executive committee consists of the company's chairman of the board, president, and six senior vice presidents. Each of these men is entirely relieved of day-to-day functional responsibilities; each operates jointly with his fellow committee

members to set overall corporate policy, and acts only as an advisor to the operating department from which he originally derived his skills, training, and experience.

Yet, whether or not the board formally resolves to delegate operational authority to an executive committee between board meetings, the actuality is that employee directors or other senior executives invariably exercise the powers of initiation. It does not matter whether key corporate decisions are initiated by a single corporate autocrat or a board committee or a committee operating out of the office of the president. Senior executives call the shots. This is what Berle and Means meant by their insightful descriptions of "management control." This is why state corporation law is moribund. Not only is it written by corporate management's representatives, it is also hopelessly inaccurate. In appreciating the law of corporate governance, one rule above all others must be followed: *Concentrate on the omissions*. Where state law does not require directors to be, corporate executives inevitably are.

The Limitations of Shareholder Litigation

STATE LAW: THE NON-DUTY OF CARE

The erosion of shareholder authority within the corporation would be less serious if shareholders were able to oppose the abuses of corporate management in court. In theory, civil litigation remains the shareholder's ultimate check. The problem is that, except for certain limited claims under the federal securities laws, it rarely works. Long ago judicial doctrines reduced the state shareholder action to a trivial value.

Earliest was the judicial rejection of the principle of *ultra vires* action. In its classical form, the doctrine of *ultra vires* envisioned the corporate charter as a contract between the state, corporate management, and the shareholders. Corporations were prohibited from performing certain acts, not because they were illegal but because neither the state nor the shareholders had agreed to them. Shareholders could enjoin corporate officers and directors from engaging in actions "beyond their powers." Accordingly, in a leading 1867 case, a single shareholder blocked a railroad from extending

its railway to a more distant point than that specified in the charter because that was not the enterprise he had bargained for.

With the rise of the corporate enabling acts, the principle of *ultra vires* declined. Shareholder limitations were overridden through court discoveries of "implied" or "auxiliary" powers. In the 1896 case of *Jacksonville M. P. Ry. & Nav. Co. v. Hopper*, for example, the United States Supreme Court held that the Florida railway company might engage in leasing and running a resort hotel, on the curious logic that "to maintain cheap hotels or eating houses . . . would not be so plainly an act outside the powers of a railway company as to compel a court to sustain the defense of *ultra vires* . . ." By 1931, *Fletcher's Cyclopedia of Corporations* could proclaim, "the theory that a corporation can do no acts beyond its authority [has been] discarded by a majority of the courts in the country."

Paralleling the decline of *ultra vires* has been the universal refusal of state courts to hold corporate directors or officers liable for negligence. Because they are vested with great power over other people's property, the law has always nominally required, in the language of the present New York statute, that "Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions."

In practice, the typical judicial or statutory formulation of the duty of care is too vague to require much of anything. As Yale Law School's Professor Joseph Bishop concluded after an extensive review of the case law:

The search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack. Few are the cases in which the stockholders do not allege conflict of interest, still fewer those among them which achieve even such partial success as denial of the defendant's motion to dismiss the complaint.

In all, Professor Bishop was able to find only four recent cases in which a state court held that a shareholder had alleged a good cause of action for negligence uncomplicated by self-dealing. In only one

of these cases did a state court rule on the merits that a corporate officer was liable for negligence. And in that case, the word "negligence" had been used as a euphemism for dishonesty.

This result is primarily the fault of statutory draftsmen. They have refused to identify *how* a corporate officer meets his duty of care. They have never identified what specific actions he must perform; what specific responsibilities are his. In the absence of a clear standard from the legislature, state courts have refused to guess.

At most, state courts will hold corporate directors or executives liable for conduct involving obvious self-enrichment such as fraud, misapplication of funds, diversion of corporate business opportunities, or causing the corporation to make excessive payment for the purchase of their property. Yet even in these types of cases, where the actions of corporate officers amount to simple and obvious theft, the procedural rules of state corporation law have been skewed to discourage shareholder suits.

The most onerous bars to shareholder litigation are the so-called "security for expenses" provisions enacted by New York, New Jersey, Pennsylvania, Michigan, California, and 13 other states. These provisions require a complaining shareholder owning less than a stated amount of stock—typically 5 percent of the stock or shares worth less than \$50,000—to "give security for the reasonable expenses, including attorney's fees, which may be incurred" by both the corporation and the parties defendant in a shareholder action. Since the cost of defendants' legal fees may amount to hundreds of thousands of dollars, the security for expense provision, when enforced, presents a formidable barrier to shareholder action.

The rules respecting attorneys' fees pose a second procedural pitfall for shareholder actions. Nearly every jurisdiction provides that only shareholders whose suits are successful may be reimbursed by the corporation for attorneys' fees. This rule seeks to discourage attorneys from bringing nonmeritorious suits. Several states, however, further provide that attorneys' fees may be awarded only if a substantial monetary benefit is conferred upon the corporation. As a practical matter, this standard precludes shareholder litigation in all cases except those of overreaching where a monetary benefit—the amount taken—is readily apparent.

In all other cases it is normally cheaper to sell the stock than to compel the corporation to obey the law.

FEDERAL SECURITIES LAW: "TAKING OVER THE UNIVERSE GRADUALLY"?

To some extent, federal securities law—and federal court decisions—have compensated for the atrophy of state shareholder protection.

In 1968, the influential Second Circuit Court of Appeals handed down its celebrated *S.E.C. v. Texas Gulf Sulphur* decision which revolutionized the case law interpreting Rule 10b-5 under the 1934 Securities and Exchange Act. Rule 10b-5 provides that it is unlawful for any person to employ a fraudulent scheme, to make any untrue statement, or to fail to state a pertinent fact when purchasing or selling a security. *Texas Gulf* substantially broadened this antifraud rule by holding that corporate directors, officers, and employees violated 10b-5 when they purchased company stock knowing of a huge mineral strike before this fact was generally known or communicated to the public.

A federal district court, also in 1968, ruled in *Escott v. Bar Chris*—a decision some commentators initially believed would have even greater effect on directorial behavior than *Texas Gulf*. In *Bar Chris* security holders asserted that a bowling alley construction company that had sold them convertible debentures had filed a registration statement prior to the sale of the bonds which contained false statements and omissions. After concluding that the registration statement did, indeed, contain numerous inaccuracies, the district court stunned Wall Street by holding all nine directors who signed the prospectus—including two new to the board—liable. In summing up their liability, the court seemed to move far toward creating a federal duty of care, at least with respect to registration statements:

Section 11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property. In my opinion, a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole

reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case. To say that such minimal conduct measures up to the statutory standard would, to all intents and purposes, absolve new directors from responsibility merely because they are new. This is not a sensible construction of section 11, when one bears in mind its fundamental purpose of requiring full and truthful disclosure for the protection of investors.

The cumulative result of these and other federal securities law decisions led the *Wall Street Journal* to exclaim in early 1973, "[D]irectors of corporations now face more perils than Pauline ever did!" In a similar vein, Harvard Law School's securities expert, Professor Louis Loss, observed in 1969 that "the great Rule 10b-5," which had emerged as the principal basis of liability under the federal securities laws, "seems to be taking over the universe gradually."

In retrospect, both views seem overstated. The basic reason the securities laws will neither "take over the universe" nor seriously "imperil outside directors" is that they are restricted to a discrete set of securities transactions. Although present securities laws do require corporate officers to file with the SEC accurate periodic financial reports and securities registration statements, not make false and misleading statements in proxies, nor defraud outsiders in connection with their own securities purchases or sales, the securities laws do not, emphasized the Supreme Court in 1971, reach transactions which otherwise involve "internal corporate mismanagement."

And in late 1973, the Second Circuit Court of Appeals held in *Lanza v. Drexel* that only corporate officers who recklessly or deliberately defrauded shareholders could be held liable for money damages under Rule 10b-5. In refusing to follow the reasoning of the district court in the *Escott v. Bar Chris* case, the appeals court made plain that an outside director who was "merely negligent" in his participation in a fraudulent securities transaction had little to fear.

The consequence of *Lanza* and similar recent decisions has been to leave federal securities law in a crazy quilt pattern. The federal securities laws, for example, will not reach a deliberate though not self-enriching decision of corporate executives to engage in an unprofitable line of business unless there has been an accom-

panying failure of disclosure. Nor will they reach decisions which *do* enrich corporate officers unless they involve security transactions. Liability seems so haphazard and fortuitous that former SEC Chairman William Cary was moved to complain:

There is no justification for a *federal* law disciplining or holding a tippee liable for misusing inside information concerning management decisions but not monitoring the misconduct of management itself. . . . It is absurd that a corporate transaction, clearly unfair though perhaps not fraudulent, should be subject to attack in the federal courts only upon the ground that it has not been disclosed to shareholders rather than because of its inherent inequity.

NULLIFY THE JUDGMENT: INDEMNIFICATION INSURANCE

Not only is it difficult for shareholders to successfully sue their companies, but even successful judgments often can be nullified. Seventeen states today permit corporations to purchase indemnification insurance for their directors and officers against, in the words of a typical policy, any "wrongful act [committed] . . . in their capacities as directors or officers." A 1974 survey of the Fortune 500 list found that 80 percent of these companies carried indemnification insurance. A similar sample of corporations listed on the New York Stock Exchange found that 76.1 percent carried such insurance. Since indemnification insurance was virtually unknown as recently as a dozen years ago, and most insurance policies were purchased within the past five to seven years, it is a fair assumption that nearly every large industrial corporation permitted by state law will carry indemnification insurance within a short time.*

* One reason for the enormous leap in the number of corporations carrying indemnification insurance has been the scare tactics employed by the insurance companies. The general tenor of their approach is illustrated by an advertisement on page six of the *Wall Street Journal*, March 21, 1968, featuring a composite photograph of a board of directors presided over by a stuffed duck and the explanatory text, "As a corporate officer or director, you may be a sitting duck for a shareholder or third party liability suit." A similar ad appears on page nine of the same issue wherein a sullen looking stockholder announces that he "might just sue every company director reading this newspaper," and reminds the presumably panicking directors that he is just one of "24 million potential enemies."

There is, to be sure, a persuasive case for indemnifying corporate directors against the costs of nonmeritorious legal claims. If innocent directors had to settle such suits because they lacked the resources to hire competent attorneys, responsible men and women would be discouraged from becoming directors. But current indemnity statutes are not limited to the purpose of protecting innocent officers from the costs of nonmeritorious suits. They also protect guilty officers from accountability for their wrongs and reduce incentives for lawful conduct.

Delaware's statute exemplifies this overbreadth. It allows a corporation

to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . . against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against any such liability under the provisions of this section.

As written, this provision permits the corporation to insulate its officers from *all* potential liabilities. Officers may be insured against any negligence, self-dealing, looting the corporation or embezzlement, all conflicts of interest, and deliberate statutory violations. They may be reimbursed for violations of federal safety, civil rights, environmental, tax, or antitrust laws. They may even be insured against the same judgments in derivative actions that an earlier provision of the same statute provided a corporation could not indemnify directly.

Delaware defends such insurance as a form of compensation, arguing that the corporation could make a larger compensation arrangement with the executive and let him pay for the insurance himself. But the question is not how much officers' compensation should be, but rather whether wrongful acts *should* be indemnified at all. Why should an executive of a drug company be indemnified for the costs of a criminal fine if he is convicted of allowing a harmful drug to injure several thousand people when the same act as a private individual would send him to jail? An untenable double standard has been created. The more powerful an executive becomes, the less likely he is to pay for an abuse of power.

Conflicts of Interests

In almost every primary economic relation of the industrial corporation—to competing corporations, to banks, to suppliers, to distributors, to investors—the law now permits (in many instances, encourages) the most blatant division of loyalties.

Most threatening is the anticompetitive practice of *interlocking directorates*. A philosophic cornerstone of American business is that vigorous competition will enable firms to have comparable access to capital, supplies, distributors, and markets, and thus an equal chance to succeed or fail on the merits. But if competing corporations place directors on each other's boards, there is opportunity to conspire on price or territory. If corporate officers sit on the boards of their banks or suppliers or distributors, there arises the obvious temptation to obtain preferential treatment based on favor and friendship. Then the race is not to the swift, but to the well-connected. Louis Brandeis saw the problem early in this century:

The practice of interlocking directorates is the root of many evils. It offends laws human and divine. Applied to rival corporations, it tends to the suppression of competition and to violation of the Sherman law. Applied to corporations which deal with each other, it tends to disloyalty and to violation of the fundamental law that no man can serve two masters. In either event it leads to inefficiency, for it removes incentive and destroys soundness of judgment. It is undemocratic, for it rejects the platform: "A fair field and no favors"—substituting the pull of privilege for the push of manhood.

With Brandeis as a major proponent, Congress in 1914 enacted the Clayton Act, section 8 of which expressly forbids any person from serving on the boards of two or more competing corporations. Until recently, however, section 8 had not been enforced. Through 1952, some 38 years after the enactment of the Clayton Act, the Department of Justice had not litigated a single case to a decision by a court. Through December 1975, the Department had instituted a total of 15 cases. The Federal Trade Commission, which has concurrent enforcement responsibilities, had filed only 13 complaints under section 8 of the Clayton Act through January 1965. Only one of these complaints resulted in a cease and desist order; the remainder were dismissed when the directors involved discon-

tinued the prohibited relationship. As Chairman Emanuel Celler's House Antitrust Subcommittee concluded in 1965 after a lengthy study of interlocks among competitors: enforcement had been neither "prompt nor vigorous."*

Shortly after Celler's study was released, economist Peter Dooley calculated that there were a total of 4,007 directorships held by the directors of the 200 largest nonfinancial corporations and the 50 largest financial corporations. "While most of these directors sat on a single board, 562 sat on two or more boards: Five men held six directorships each. In all, 1,404 directorships were held by multiple directors." Two hundred and thirty-three of the 250 corporations had at least one director who sat on the board of at least one other of the largest corporations. Most significantly, fully 297 interlocks involved companies which were competitors. "While illegal under the Clayton Act," observed Professor Dooley, "the law has not been effectively enforced, so that the institution of interlocking directorates continues to provide a vehicle for restricting competition. . . ."

Our own more recent survey of the boards of directors of the 50 largest industrial corporations identified eight apparent instances of illegal interlocks. John T. Connor, for example, is both a director of General Motors and Chairman of Allied Chemical, though Allied Chemical produces seat belts, shoulder harnesses, and airbags, all of which GM either presently manufactures or potentially could. Dean McGee is a director of General Electric and Chairman of Kerr-McGee, though both sell nuclear fuels. Henry S. Wingate is a director of both U.S. Steel and International Nickel Company of Canada, both of which mine nickel, iron ore, and other competing metals.

Even beyond inadequate enforcement of its provisions, section 8 only forbids interlocks among competitive corporations. Interlocks among corporations which provide services, supplies,

* In the past three years the Federal Trade Commission has begun to enforce the Act, bringing three major actions, the most important of which required seven directors common to the boards of 12 competing oil and gas corporations to resign. More recently the Justice Department awoke from its long slumber and brought an action in 1975 against the Bank of America holding company and certain insurance companies which allegedly competed in providing designated services.

funding, or distribution for each other equally violate the fundamental law that no man can serve two masters. They are also far more numerous. In 1974, the Center for Science in the Public Interest analyzed interlocking directorates and advisory committee connections of the eighteen largest United States oil corporations. They found 460 interlocking connections in all, including 132 interlocks with banks, 31 interlocks with insurance companies, 12 interlocks with utilities, 15 interlocks with transportation corporations, and 224 interlocks with manufacturing and distribution corporations. Oil company ties with banks (which supply capital), insurance companies (which provide an underwriting service), distribution companies (which distribute oil company products), and utilities, transportation, and manufacturing corporations (which purchase oil products) inevitably diminish the arm's length atmosphere in which effective competition thrives.

Such clubbishness, however, is typical of this nation's largest corporations. Our survey of the 50 largest industrial corporations and 10 largest commercial banks found that the 50 largest industrialists had 54 interlocks with the 10 leading commercial banks and 24 interlocks among themselves. Our survey also established that it has become a common practice for the leading commercial banks to bring together competitors on their boards of directors. For example, on its board Chase Manhattan unites directors from competing companies in four industries: industrial chemicals (Allied Chemical, Celanese, and Commercial Solvents Corporation); drugs (Pfizer and Squibb); paper goods (Celanese and International Paper); and oil (Exxon, Royal Dutch Petroleum, and Standard Oil of Indiana). Continental Illinois brings together leading agricultural equipment producers Caterpillar Tractor and International Harvester; food producers Esmark and Kraftco; and railroads Chicago-Milwaukee and Illinois Central.

When interlocks are viewed on a city-by-city basis, it becomes clear that there are substantial social costs as well—as in the case of Minneapolis-St. Paul. In January 1971, Richard Gibson, a methodical staff reporter for the *Minneapolis Star*, described the social structure of a major industrial city by examining the boards of the 20 or so leading Twin City industrial corporations and eight leading banks. What he found was a tight little net or what he

called swapping: Burlington Northern placed its executive on the board of General Mills, and General Mills reciprocated by placing an executive on the board of Burlington Northern. Honeywell, Pillsbury, 3M, and Dayton Hudson just placed executives everywhere, as did the leading banks.

But Gibson went beyond the statistics and examined the personalities involved. He found that the boards of the 30 leading corporations in a major metropolitan area of some two million people were dominated by 19 men. Eight served on three or more boards; five men served on four boards; six served on five boards or more. Crucially, these were the men that served as chairman or led the key committees. All but one of these men, Professor Walter Heller, was a corporate executive. Fourteen of the 19 were corporate chief executives. Examined in social terms, the economy of Minneapolis looks like an oligarchy.

Certainly no one would argue that all interlocks, whether among competitors, in financing, supply, or distribution relations, direct or indirect, lead to collusive behavior. But it is unnecessary that any interlock occur. There are sufficient directors available so that each board may be staffed by disinterested persons. The costs of interlocks—favoritism, joint price or output actions, discouragement of entrepreneurs—must be weighed against what are at best negligible advantages.

Conflict of interests can also occur when large industrial corporations invite their investment banker or outside counsel to serve on their boards. For the investment banker, especially, this creates a stark division of loyalty. In addition to underwriting security offerings and related corporate financial services, he typically does investment counseling, employs brokers, and administers mutual funds. He is just as likely to perceive his primary obligation to them as to his investment clients as to the shareholders of the corporation he directs. As one top executive explained, "As soon as you have an investment banker [on the board], you put yourself in a position where one group of shareholders might be favored at the expense of other shareholders."

A worse situation occurs when the investment banker is favored at the expense of *all* shareholders. J. M. Juran and J. Lou-

den, authors of the American Management Association's study, *The Corporate Director*, cited instances where investment bankers have been guilty of guiding the company into a poor acquisition to create a need for selling securities. Investment banker-directors have insisted on being involved—for a fee—when the corporation seeks to borrow money from an insurance company or other lender. And when a corporation has an investment banker on its board, it becomes very difficult to transact business with other investment bankers. "Having a senior partner of an investment banking firm on our board is notice to the world that we are his captive client," said one corporate president. "Of course this is the main reason investment bankers want to be on so many boards. They think of board membership as a very good way of assuring that the business of the company goes only to them. It's a sort of Operation Stakeout. It tags the company as belonging to one particular firm."

A similar division of loyalty occurs when corporate counsel serves on the board. Attorneys have a financial interest to increase the corporation's law bills, rather than economize for its shareholders. This inability of lawyer-directors to give disinterested counsel has led some law firms to discourage partners from serving on clients' boards. For example, New York City's Debevoise, Plimpton, Lyons and Gates will not permit a partner to go on a board without the approval of the firm as a whole. Skadden, Arps, Slate, Meagher and Flom, also of New York, flatly prohibits partners from becoming directors "except in extenuating cases." Nonetheless, an exhaustive 1971-72 study of some 12,000 companies, which filed information statements with the SEC, found that approximately one in six employs an attorney from the company's outside counsel as a director.

Aggravating the costs to shareholders of these structural conflicts of interest is the tolerance by modern corporate law of self-enriching executive conduct. As early as an 1846 Supreme Court opinion, the rule was well established that any contract between an interested director and his corporation was voidable at the mere insistence of the corporation or any of its shareholders regardless of the fairness or unfairness of the transaction. Professor Harold Marsh explained why:

Under this rule it mattered not the slightest that there was a majority of so-called disinterested directors who approved the contract. The courts stated that the corporation was entitled to the unprejudiced judgment and advice of all of its directors and therefore it did no good to say that the interested director did not participate in the making of the contract on behalf of the corporation . . .

By 1880, this principle "appeared to be impregnable. . . . It was stated in ringing terms by virtually every decided case, with arguments which seemed irrefutable, and it was sanctioned by age." One scholar termed this the "fundamental law of morals and of human nature" and identified its Biblical origin: "No man can serve two masters." "Fraud is too cunning and evasive," reasoned a New Jersey court, "for courts to establish a rule that invites its presence."

Today this principle is dead. The Delaware General Corporation Law not only tolerates interested conduct by corporate officers and directors; it has made self-dealing the norm.

Under current Delaware law, the chief executive of a corporation and other senior corporate executives may serve on the board of directors or compensation committee which: (1) sets executive salaries; (2) sells or purchases property from corporate executives; (3) loans money—on a secured or unsecured basis; with or without interest—to corporate executives; and (4) establishes pension plans, profit sharing plans, stock bonuses, retirement, benefit, incentive, and compensation plans (including "phantom stock"—a risk-free, cost-free stock option plan), trusts; health insurance; or deferred income plans for such corporate officers or their dependents.

Not only may corporate officers engage in such self-dealing but shareholders under Delaware law are nearly powerless to minimize the amount of corporate largess top executives pay themselves. Any contract or transaction between the corporation and an interested executive is permissible as long as it is "fair." But, in Delaware, fairness is presumed. Professor Ernest Folk, the leading commentator of Delaware's General Corporation Law, explains that "Given Delaware's presumption of sound business judgment with respect to board decisions, the courts will try to determine whether the decision can be attributed to any rational business pur-

pose, and if so, there will be no judicial preemption of the decision."

There seem to be few practical limits to this doctrine. For example, if a corporate chief executive were so graceless as to embezzle \$500,000, there is little question that even in Delaware he would be required to return the money and would be subject to criminal prosecution. Yet if that same corporate executive raised his salary \$500,000 and received the approval of a board of directors he selected, there is equally little question that a Delaware court would term this "fair"—so long as the chief executive could point to similar salary increases in his industry or received the \$500,000 through an "incentive bonus" or profit participation plan.

In the absence of judicial limitations, excessive remuneration has become the norm. In 1974 the executive compensation (salary, bonus, deferred income, and directors' fees) of the highest paid executive at the 50 largest industrial corporations was approximately \$400,000—or about as much in one year as many of their employees earn in a lifetime and two and one-half times the average executive compensation of \$145,000 earned by the highest paid executive at the 50 largest industrial corporations in 1963.

Contrary to the conventional wisdom, top executive salaries do not generally decrease in response to a decline in corporate sales or profits. In the recessionary years 1970–1973, Professor Wilbur Lowellen, a leading authority on executive compensation, found that the "mean" salary for the top executive at 50 large manufacturing corporations increased steadily from \$251,867 in 1970, to \$287,759 in 1971, \$323,802 in 1972, and \$389,277 in 1973.

But salary, bonus, and deferred income are only the most obvious benefits appropriated by corporate chieftains. Equally important is ownership income. Nearly every large industrial corporation offers its top executives stock options. These options allow executives to buy shares of stock in their corporation at a fixed price at any time or at specified times—often with the help of company-secured low interest loans or interest-free loans—and subsequently sell them.

From the shareholder's point of view, the result is a classic case of "heads we lose, tails you win." Over time, executives are

able to build up a substantial fortune in corporate stock without personal risk. The more they do so, the more they dilute the value of other stockholders' shares.

We examined the stock holdings of the highest paid executives at the 50 largest industrial corporations to get some indication of the extent of executive stock holdings. From the start, we eliminated from consideration the seven highest paid chief executives whose stock holdings were either largely inherited or largely "founder's shares": Henry Ford II (Ford Motors), Robert Sarnoff (RCA), Brooks McCormick (International Harvester), Willard Rockwell (Rockwell International), Armand Hammer (Occidental Petroleum), Sanford McDonnell (McDonnell Douglas) and J. P. Grace (W. P. Grace). The 43 remaining chief executives were "employee" executives. Yet each owned an average of \$1,566,009 of his corporation's stock, according to the most recent proxy statements filed with the SEC and the closing stock prices of October 1, 1975.*

This crude figure illustrates three points. First, primarily at shareholder expense, the top executives of our largest corporations can, and often do, build up million-dollar fortunes in corporate stock on top of their substantial cash and deferred compensation. Second, the income of top executives is significantly increased each year by dividends from their corporate stock. Using our 43 top executives as an example again, each received an average of \$60,382 in dividend income in 1974 above and beyond a \$400,000 salary. Third, each top executive will further be enriched by increases in the price of the stock. Professor Lewellen has determined that a similar list of chief executives at the fifty largest industrial corporations (after deleting "extreme values" such as inherited or founder's stockholdings) averaged \$220,087 per year in capital gains income for the four years 1960-63.

* This figure is admittedly a very crude approximation of ownership income. On the one hand, it does not distinguish the shares the executives purchase with their own money from those the company gave them through stock options, stock bonuses, or loan arrangements. On the other hand, it understates the amount of ownership income of these executives by making no allowance for the fact that corporate chief executives frequently sell stock they own in their own corporation and put their money in other investments.

Additionally, pension or retirement benefits have swollen. McKinsey and Company's 1975 Executive Compensation Survey found that all but one of 577 major U.S. corporations studied had a pension or profit-sharing retirement plan to pay former executives a fixed income each year after they retire. Almost half of the companies provide either a thrift or savings plan or a profit-sharing plan in addition to the pension plan. Our own survey found that the 21 chief executives of the 50 largest corporations who disclosed their estimated annual retirement benefits anticipated an income of \$133,910 per year after they retire. And corporate executives also enjoy other benefits such as life and medical insurance; free medical service; educational grants for their children; indemnification insurance; company apartments; country club membership; luncheon or dinner club membership; chauffeur-driven cars; free legal and tax counseling; personal financial counseling; expense accounts; and other amenities. This myriad of stock bonus, insurance, and benefit programs increases the income of corporate chiefs by approximately 50-75 percent above their \$400,000 direct remuneration to an actual income of approximately \$600,000 to \$700,000 per year.

Yet if excessive remuneration were a conflict of interest confined to the corporate chief executive, it would seem small once it was divided by the total number of shares in most large industrial corporations. What makes the executive compensation conflict truly expensive is that the corporate chief executive not only sets his own salary but also determines the remuneration of other executives all the way down the line. It is clearly in the corporate chief executive's personal interest to seek the greatest possible rewards for his subordinates as well as himself. For a corporate chief who can "deliver" high salaries increases the personal loyalty of his subordinates. And the higher his subordinates' income, the higher the chief executive's income must be.

A good illustration of this is General Electric, where in 1974 Reginald Jones, the chairman, received a compensation of \$501,200. Walter Dance, Jack Parker, and Herman Weiss, the next three highest paid executives, received \$400,750; \$400,500; and \$400,000, respectively. The next 107 highest paid officers averaged direct compensation of \$121,240. Aggregate figures for "executive groups" at the other 50 largest industrial corporations were approx-

imately the same. In the average corporation, the 31 or so officers ranked immediately below the five highest paid executives received an average of \$99,256 in direct remuneration, which would equal approximately \$150,000 imputing the present value of stock bonus programs, retirement benefits, insurance, and other perquisites.

A compensation system is obviously askew when a private business corporation must pay a chief executive compensation and benefits of over \$600,000 when this is 15 times the \$40,000 or so the United States government must pay its highest ranking general, regulator, or Senator. Or when it must pay its next 20-100 senior executives an average of \$150,000 each when the federal government expends a maximum of \$38,000 per year to hire its highest ranking civil servants, and California, this nation's largest state, pays its governor \$49,000.

This is not to deny that the entrepreneur or corporate founder who, at substantial risk, introduces a new or better good or service should not be given a substantial incentive to make an unusual personal contribution to society. But we are concerned here with the administrators of large industrial corporations who, at minimal personal risk, serve as the bureaucrats of private industry. These individuals receive their staggeringly large salaries and stock options by rising through executive ranks—in exactly the same way that government's civil servants rise through civil service ranks—and by then exploiting the laxity of state corporate laws that their predecessors helped write.

Remedies

REVAMPING THE BOARD

The modern corporation is akin to a political state in which all powers are held by a single clique. The senior executives of a large firm are essentially not accountable to any other officials within the firm. These are precisely the circumstances that, in a democratic political state, require a separation of powers into different branches of authority. As James Madison explained in the *Federalist* No. 47:

The accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few or many, and whether hereditary,

self-appointed, or elective, may justly be pronounced the very definition of tyranny. Were the federal constitution, therefore, really chargeable with this accumulation of power, or with a mixture of powers, having a dangerous tendency to such an accumulation, no further arguments would be necessary to inspire a universal reprobation of the system.

A similar concern over the unaccountability of business executives historically led to the elevation of a board of directors to review and check the actions of operating management. As a practical matter, if corporate governance is to be reformed, it must begin by returning the board to this historical role. The board should serve as an internal auditor of the corporation, responsible for constraining executive management from violations of law and breach of trust. Like a rival branch of government, the board's function must be defined as separate from operating management. Rather than pretending directors can "manage" the corporation, the board's role as disciplinarian should be clearly described. Specifically, the board of directors should:

- establish and monitor procedures that assure that operating executives are informed of and obey applicable federal, state, and local laws;
- approve or veto all important executive management business proposals such as corporate by-laws, mergers, or dividend decisions;
- hire and dismiss the chief executive officer and be able to disapprove the hiring and firing of the principal executives of the corporation; and
- report to the public and the shareholders how well the corporation has obeyed the law and protected the shareholders' investment.

It is not enough, however, to specify what the board should do. State corporations statutes have long provided that "the business and affairs of a corporation shall be managed by a board of directors," yet it has been over a century since the boards of the largest corporations have actually performed this role. To reform the corporation, a federal chartering law must also specify the manner in which the board performs its primary duties.

First, to insure that the corporation obeys federal and state laws, the board should designate executives responsible for compliance with these laws and require periodic signed reports describing the effectiveness of compliance procedures. Mechanisms to administer spot checks on compliance with the principal statutes should be created. Similar mechanisms can insure that corporate "whistle blowers" and nonemployee sources may communicate to the board—in private and without fear of retaliation—knowledge of violations of law.

Second, the board should actively review important executive business proposals to determine their full compliance with law, to preclude conflicts of interest, and to assure that executive decisions are rational and informed of all foreseeable risks and costs. But even though the board's responsibility here is limited to approval or veto of executive initiatives, it should proceed in as well-informed a manner as practicable. To demonstrate rational business judgment, the directorate should require management "to prove its case." It should review the studies upon which management relied to make a decision, require management to justify its decision in terms of costs or rebutting dissenting views, and, when necessary, request that outside experts provide an independent business analysis.

Only with respect to two types of business decisions should the board exceed this limited review role. The determination of salary, expense, and benefit schedules inherently possesses such obvious conflicts of interest for executives that only the board should make these decisions. And since the relocation of principal manufacturing facilities tends to have a greater effect on local communities than any other type of business decision, the board should require management to prepare a "community impact statement." This public report would be similar to the environmental impact statements presently required by the National Environmental Policy Act. It would require the corporation to state the purpose of a relocation decision; to compare feasible alternative means; to quantify the costs to the local community; and to consider methods to mitigate these costs. Although it would not prevent a corporation from making a profit-maximizing decision, it would require the corporation to minimize the costs of relocation decisions to local communities.

To accomplish this restructuring of the board requires the institutionalization of a new profession: the full-time "professional" director. Corporate scholar frequently identify William O. Douglas' 1940 proposal for "salaried, professional experts [who] would bring a new responsibility and authority to directorates and a new safety to stockholders" as the origin of the professional director idea. More recently, corporations including Westinghouse and Texas Instruments have established slots on their boards to be filled by full-time directors. Individuals such as Harvard Business School's Myles Mace and former Federal Reserve Board chairman William McChesney Martin consider their own thoroughgoing approach to boardroom responsibilities to be that of a "professional" director.

To succeed, professional directors must put in the substantial time necessary to get the job done. One cannot monitor the performance of Chrysler's or Gulf's management at a once-a-month meeting; those firms' activities are too sweeping and complicated for such ritual oversight. The obvious minimum here is an adequate salary to attract competent persons to work as full-time directors and to maintain the independence of the board from executive management.

The board must also be sufficiently staffed. A few board members alone cannot oversee the activities of thousands of executives. To be able to appraise operating management, the board needs a trim group of attorneys, economists, and labor and consumer advisors who can analyze complex business proposals, investigate complaints, spot-check accountability, and frame pertinent inquiries.

The board also needs timely access to relevant corporate data. To insure this, the board should be empowered to nominate the corporate financial auditor, select the corporation's counsel, compel the forwarding and preservation of corporate records, require all corporate executives or representatives to answer fully all board questions respecting corporate operations, and dismiss any executive or representative who fails to do so.

This proposed redesign for corporate democracy attempts to make executive management accountable to the law and shareholders without diminishing its operating efficiency. Like a judi-

ciary within the corporation, the board has ultimate powers to judge and sanction. Like a legislature, it oversees executive activity. Yet executive management substantially retains its powers to initiate and administer business operations. The chief executive officer retains control over the organization of the executive hierarchy and the allocation of the corporate budget. The directors are given ultimate control over a narrow jurisdiction: Does the corporation obey the law, avoid exploiting consumers or communities, and protect the shareholders' investment? The executive contingent retains general authority for all corporate operations.

No doubt there will be objections that this structure is too expensive or that it will disturb the "harmony" of executive management. But it is unclear that there would be any increased cost in adopting an effective board. The true cost to the corporation could only be determined by comparing the expense of a fully paid and staffed board with the savings resulting from the elimination of conflicts of interest and corporate waste. In addition, if this should result in a slightly increased corporate expense, the appropriateness must be assessed within a broader social context: should federal and state governments or the corporations themselves bear the primary expense of keeping corporations honest? In our view, this cost should be placed on the corporations as far as reasonably possible.

It is true that an effective board will reduce the "harmony" of executive management in the sense that the power of the chief executive or senior executives will be subject to knowledgeable review. But a board which monitors rather than rubber-stamps management is exactly what is necessary to diminish the unfettered authority of the corporate chief executive or ruling clique. The autocratic power these individuals presently possess has proven unacceptably dangerous: it has led to recurring violations of law, conflicts of interest, productive inefficiency, and pervasive harm to consumers, workers, and the community environment. Under normal circumstances there should be a healthy friction between operating executives and the board to assure that the wisest possible use is made of corporate resources. When corporate executives are breaking the law, there should be no "harmony" whatsoever.

ELECTION OF THE BOARD

Restructuring the board is hardly likely to succeed if boards remain as homogeneously white, male, and narrowly oriented as they are today. Dissatisfaction with current selection of directors is so intense that analysts of corporate governance, including Harvard Law School's Abram Chayes, Yale political scientist Robert Dahl, and University of Southern California Law School Professor Christopher Stone, have each separately urged that the starting point of corporate reform should be to change the way in which the board is elected.

Professor Chayes, echoing John Locke's principle that "no authority is legitimate except that granted 'the consent of the governed,'" argues that employees and other groups substantially affected by corporate operations should have a say in its governance:

Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporations whose consent must be sought. . . . Their interests are protected if financial information is made available, fraud and overreaching are prevented, and a market is maintained in which their shares may be sold. A priori, there is no reason for them to have any voice, direct or representational, in [corporate decision making]. They are no more affected than nonshareholding neighbors by these decisions. . . .

A more spacious conception of 'membership,' and one closer to the facts of corporate life, would include all those having a relation of sufficient intimacy with the corporation or subject to its powers in a sufficiently specialized way. Their rightful share in decisions and the exercise of corporate power would be exercised through an institutional arrangement appropriately designed to represent the interests of a constituency of members having a significant common relation to the corporation and its power.

Professor Dahl holds a similar view: "[W]hy should people who own shares be given the privileges of citizenship in the government of the firm when citizenship is denied to other people who also make vital contributions to the firm?" he asks rhetorically. "The people I have in mind are, of course, employees and customers, without whom the firm could not exist, and the general

public, without whose support for (or acquiescence in) the myriad protections and services of the state the firm would instantly disappear. . . ." Yet Dahl finds proposals for interest group representation less desirable than those for worker self-management. He also suggests consideration of codetermination statutes such as those enacted by West Germany and ten other European and South American countries under which shareholders and employees separately elect designated portions of the board.

From a different perspective, Professor Stone has recommended that a federal agency appoint "general public directors" to serve on the boards of all the largest industrial and financial firms. In certain extreme cases such as where a corporation repeatedly violates the law, Stone recommends that the federal courts appoint "special public directors" to prevent further delinquency.

There are substantial problems with each of these proposals. It seems impossible to design a general "interest group" formula which will assure that all affected constituencies of large industrial corporations will be represented and that all constituencies will be given appropriate weight. Even if such a formula could be designed, however, there is the danger that consumer or community or minority or franchisee representatives would become only special pleaders for their constituents and otherwise lack the loyalty or interest to direct generally. This defect has emerged in West Germany under codetermination. Labor representatives apparently are indifferent to most problems of corporate management that do not directly affect labor. They seem as deferential to operating executive management as present American directors are. Alternatively, federally appointed public directors might be frozen out of critical decision-making by a majority of "privately" elected directors, or the appointing agency itself might be biased.

Nonetheless, the essence of the Chayes-Dahl-Stone argument is well taken. The boards of directors of most major corporations are, as CBS's Dan Rather criticized the original Nixon cabinet, too much like "twelve grey-haired guys named George." The quiescence of the board has resulted in important public and, for that matter, shareholder concerns being ignored.

An important answer is structural. The homogeneity of the board can only be ended by giving to each director, in addition to:

general duty to see that the corporation is profitably administered, a separate oversight responsibility, a separate expertise, and a separate constituency so that each important public concern would be guaranteed at least one informed representative on the board. There might be nine corporate directors, each of whom is elected to a board position with one of the following oversight responsibilities:

1. Employee welfare
2. Consumer protection
3. Environmental protection and community relations
4. Shareholder rights
5. Compliance with law
6. Finances
7. Purchasing and marketing
8. Management efficiency
9. Planning and research

By requiring each director to balance responsibility for representing a particular social concern against responsibility for the overall health of the enterprise, the problem of isolated "public" directors would be avoided. No individual director is likely to be "frozen out" of collegial decision-making because all directors would be of the same character. Each director would spend the greater part of his or her time developing expertise in a different area; each director would have a motivation to insist that a different aspect of a business decision be considered. Yet each would simultaneously be responsible for participating in all board decisions, as directors now are. So the specialized area of each director would supplement but not supplant the director's general duties.

Although not a symmetrical analogy, the most successful precedent for dividing the representative responsibilities and constituencies is, of course, the Constitution of the United States. There, too, a basic question was one of motivation: How to design a political administration which would retain an equal respect for the rights of all of its citizens. Only by arranging "ambition . . . to counteract ambition" did the Federalists believe such respect would endure. By granting the President, the two houses of Congress, and the judiciary different geographic constituencies, different

terms, and different duties, the various factions of the nation's citizens were most likely to be insured some representation within the government. "Hence a double security arises to the rights of the people. The different governments will control each other, at the same time that each will be controlled by itself," explained Madison in *Federalist No. 51*.

In recent years, some business corporations have also perceived the advantages of creating constituent voices within the structure of the firm. Reverend Leon Sullivan, the only black director on General Motors' board, has made plain that he considers it his special responsibility to advance the interests of GM's black employees and dealers. His representation, among other things, has led to an increase in the number of blacks being trained to be GM executives. Gillette's Vice President for Product Integrity, Robert Giovacchini, is said to perform a similar role. Although not a member of the board, Mr. Giovacchini has been given the authority to recall any Gillette product, quash any advertising claim, or order any packaging change he feels is necessary to protect the company's consumers.

Only by institutionalizing the duties and power that individuals like Reverend Sullivan and Robert Giovacchini hold can responsible corporate government be brought to each large firm.

For in most giant corporations, no specific executive official or board member is responsible for protecting the interests of employees, consumers, the environment, or local communities. No one outside of senior management reviews the most important business decisions to assure their compliance with law, financial integrity, efficiency, or long-term corporate goals. Because these concerns become everybody's general interest, they become nobody's particular interest—and often go unattended.

To maintain the independence of the board from the operating management it reviews also requires that each federally chartered corporation shall be directed by a purely "outside" board. No executive, attorney, representative, or agent of a corporation should be allowed to serve simultaneously as a director of that same corporation. Directorial and executive loyalty should be furthered by an

absolute prohibition of interlocks. No director, executive, general counsel, or company agent should be allowed to serve more than one corporation subject to the Federal Corporate Chartering Act.

Several objections may be raised. First, how can we be sure that completely outside boards will be competent? As elaborated subsequently, corporate campaign rules will be redesigned to emphasize qualifications. This will allow shareholder voters to make rational decisions based on information clearly presented to them. It is also a fair assumption that shareholders, given an actual choice and role in corporate governance, will want to elect the men and women most likely to safeguard their investments.

A second objection is that once all interlocks are prescribed and a full-time outside board required, there will not be enough qualified directors to staff all major firms. This complaint springs from that corporate mentality which, accustomed to 60-year-old white male bankers and businessmen as directors, makes the norm a virtue. In fact, if we loosen the reins on our imagination, America has a large, rich, and diverse pool of possible directorial talent from academics and public administrators and community leaders to corporate and public interest lawyers.

But directors should be limited to four two-year terms so that boards do not become stale. And no director should be allowed to serve on more than one board at any one time. Although simultaneous service on two or three boards might allow key directors to "pollinize" directorates by comparing their different experiences, this would reduce their loyalty to any one board, jeopardize their ability to fully perform their new directorial responsibilities, and undermine the goal of opening up major boardrooms to as varied a new membership as is reasonable.

The shareholder electoral process should be made more democratic as well. Any shareholder or allied shareholder group which owns .1 percent of the common voting stock in the corporation or comprises 100 or more individuals and does not include a present executive of the corporation, nor act for a present executive, may nominate up to three persons to serve as directors. This will exclude executive management from the nomination process. It also increases the likelihood of a diverse board by preventing any one or

two sources from proposing all nominees. To prevent frivolous use of the nominating power, this proposal establishes a minimum shareownership condition.

Six weeks prior to the shareholders' meeting to elect directors, each shareholder should receive a ballot and a written statement on which each candidate for the board sets forth his or her qualifications to hold office and purposes for seeking office. All campaign costs would be borne by the corporation. These strict campaign and funding rules will assure that all nominees will have an equal opportunity to be judged by the shareholders. By preventing directorates from being bought, these provisions will require board elections to be conducted solely on the merit of the candidates.

Only the actual or "beneficial" owners of stock should be eligible to vote. Financial intermediaries shall be required to "pass through" voting rights in approximately the same manner that present New York and American Stock Exchange rules require broker-dealers to "pass through" proxies and corporate reports to shareholders owning stock in street name accounts. Already a number of major firms, including Sears, Roebuck, General Motors, McDonnell Douglas, and United States Steel, "pass through" voting rights to hundreds of thousands of employees holding stock in joint pension funds.

Finally, additional provisions will require cumulative voting and forbid "staggered" board elections. Thus any shareholder faction capable of jointly voting approximately 10 percent of the total number of shares cast may elect a director.

A NEW ROLE FOR SHAREHOLDERS

The difficulty with this proposal is the one that troubled Juvenal two millennia ago: *Quis custodiet ipsos custodes*, or, Who shall watch the watchmen? Without a full-time body to discipline the board, it would be so easy for the board of directors and executive management to become friends. Active vigilance could become routinized into an uncritical partnership. The same board theoretically elected to protect shareholder equity and internalize law might instead become management's lobbyist.

Relying on shareholders to discipline directors may strike many as a dubious approach. Historically, the record of share-

holder participation in corporate governance has been an abysmal one. The monumental indifference of most shareholders is worse than that of sheep; sheep at least have some sense of what manner of ram they follow. But taken together, the earlier proposals—an outside, full-time board, nominated by rival shareholder groups and voted on by beneficial owners—will increase involvement by shareholders. And cumulative voting insures that an aroused minority of shareholders—even one as small as 9 or 10 percent of all shareholders—shall have the opportunity to elect at least one member of the board.

But that alone is hardly sufficient. At a corporation the size of General Motors, an aggregation of 10 percent of all voting stock might require the allied action of over 200,000 individuals—which probably could occur no more than once in a generation. To keep directors responsive to law and legitimate public concerns requires surer and more immediate mechanisms. In a word, it requires arming the victims of corporate abuses with the powers to swiftly respond to them. For only those employees, consumers, racial or sex minorities, and local communities harmed by corporate depredations can be depended upon to speedily complain. By allowing any victim to become a shareholder and by permitting any shareholder to have an effective voice, there will be the greatest likelihood of continuing scrutiny of the corporation's directorate. Shareholder involvement can be further enhanced by the disclosures discussed in the next chapter, by the opportunity to attend periodically scheduled directors' meetings to ask questions or present grievances, and by reform of the shareholder derivative action so that any investor who identifies a corporate violation of law may bring lawsuit without risk of financial loss.

For the purpose of motivating the board to perform its intended role, however, it is appropriate to inject shareholders further into corporate governance wherever they have a financial or other incentive to perform effectively.

Six weeks before a vote on any fundamental transaction—which can be defined as executive proposals involving the purchase, sale, lease, merger, consolidation, financing, refinancing, dissolution, or liquidation of assets equal to, say, 10 percent of the corporation's total assets or over \$100 million, or the authorization

of corporate securities in any amount—the board should forward a written statement to the shareholders explaining the transaction, the vote by which the transaction was approved by the board, the reasons why members of the board approved the transaction, the reasons why other members opposed it, and the foreseeable costs and risks of implementing the proposal. This provision would provide for shareholder votes on all business decisions above a certain minimum size, however named. By requiring directors to publicly elaborate their reasoning—reasoning which may be judged not only during this vote but also during subsequent board elections or mismanagement suits—there would be a powerful incentive for directors to police themselves.

A complementary provision should allow any shareholder or allied shareholder group holding stock equal to a minimum of one percent of all outstanding stock to simultaneously publish a dissenting view or, at any time, to propose amendments to the corporate charter or bylaws.

AFFECTED COMMUNITIES

Shareholders are not the only ones with an incentive to review decisions of corporate management; nor, as Professors Chayes and Dahl argue, are shareholders the only persons who should be accorded corporate voting rights. The increasing use by American corporations of technologies and materials that pose direct and serious threats to the health of communities surrounding their plants requires the creation of a new form of corporate voting right. When a federally chartered corporation engages, for example, in production or distribution of nuclear fuels or the emission of toxic air, water, or solid waste pollutants, citizens whose health is endangered should not be left, at best, with receiving money damages after a time-consuming trial to compensate them for damaged property, impaired health, or even death.

Instead, upon finding of a public health hazard by three members of the board of directors or 3 percent of the shareholders, a corporate referendum should be held in the political jurisdiction affected by the health hazard. The referendum would be drafted by the unit triggering it—either the three board members or a designate of the shareholders. The affected citizens by majority vote

will then decide whether the hazardous practice shall be allowed to continue. This form of direct democracy has obvious parallels to the initiative and referendum procedures familiar to many states—except that the election will be paid for by a business corporation and will not necessarily occur at a regular election.

What would happen to the local community if it voted to close a dangerous plant? Three answers seem reasonable. First, the board of directors should have the opportunity to modify the local plant to reduce the health hazard. If the board chooses to do so, it should be allowed to submit its modification plan as a subsequent referendum for community approval. Second, if the corporation chooses to leave after the vote, it should be required to immediately repay the local community for all damages to its health and property by the outlawed activity. This valuation proceeding should occur in federal district court. If the corporation chooses to leave before the referendum vote, it should additionally be required to pay its local employees salaries for a reasonable interim period. Third, the referendum voting procedure should be flexible. Local communities should be given the opportunity to vote upon an initiative calling for the corporation to remedy a specific health hazard by a designated date as an alternative to one calling for immediate closing of a plant. Similarly, the board should be given the opportunity to submit a plan of modification simultaneously with the initial referendum vote.

This type of election procedure is necessary to give enduring meaning to the democratic concept of "consent of the governed." To be sure, this proposal goes beyond the traditional assumption that the only affected or relevant constituents of the corporation are the shareholders. But no longer can we accept the Faustian bargain that the continued toleration of corporate destruction of local health and property is the cost to the public of doing business. In an equitable system of governance, the perpetrators should answer to their victims.

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.

SECTION BY SECTION ANALYSIS

This analysis of Committee action on the Alaska General Stock Ownership Corporation legislation describes the provisions of Section 1 of the Committee bill as of April 27, 1979. Since many of the provisions of the Committee Substitute 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 335 of the bill. Subsequent bylaws may be adopted, amended or repealed by a vote of either the shareholders or directors.
- .130. MEETINGS OF SHAREHOLDERS. The time and location of the annual shareholders meeting is established in the bylaws. The specific place is set by the board. Special shareholder meetings may be called by the president of the GSOC, the board or the holders of at least 1,000 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 1,000 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. 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.
- .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. The chairman and 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 shareholder meeting. Officers or employees of the corporation may not serve on the board of directors. (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 incompetence of a board member. (AS 10.05.183).
- .195. VACANCIES. Vacancies in the board caused by death, resignation or incompetence 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 $\frac{1}{2}$ 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 $1\frac{1}{2}$ 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 $1\frac{1}{2}$ 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. Shareholders may file suit 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 treatment of security for expenses and other details. This section allows the court discretion to require security for expenses incurred in the prosecution of the suit. The court must approve of any settlement to insure that those prosecuting the suit are not simply bought off. The proceeds of any successful action or settlement must be accounted for to the court which may authorize reasonable expenses to the parties.
- .305. FRAUDULENT TRANSFERS OF SHARES. Transferring or obtaining shares of the corporation by fraud is a felony.
- .310. POLITICAL ACTIVITIES. GSOCs may not endorse candidates or ballot issues nor spend money in support or opposition of either. They are also prohibited from spending any monies to lobby the legislature. Violations are a misdemeanor punishable by a jail term and a \$10,000 fine.

ARTICLE 2. FORMATION OF CORPORATIONS.

- .315. 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 18. (AS 10.05.252).
- .320. ARTICLES OF INCORPORATION. This section sets out the minimum requirements of the articles of a GSOC including the provisions required by subchapter "U" of the Internal Revenue Code that the corporation have only one class of stock, issued only to individuals, with the right to elect not to receive a share, and subject to transfer restrictions for five years. Other provisions are carried over from the ABCA. (AS 10.05.255).
- .325. 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).
- .330. EFFECT OF ISSUANCE OF CERTIFICATE OF INCORPORATION. Upon issuing the certificate corporate life begins. (AS 10.05.261).
- .335. ARTICLES OF INCORPORATION AND INITIAL BYLAWS. The articles and initial bylaws must be submitted to the legislature within 30 days of issuing the certificate of incorporation and, if not disapproved within 60 legislative days by concurrent resolution, they are approved. Legislative disapproval may not abrogate any contract obligations of the corporation and may be overridden by a shareholder vote.

- .340. 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).

ARTICLE 3. APPLICATION FOR SHARES.

- .345. 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.
- .350. 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.
- .355. LATE APPLICATION FOR SHARES. Any individual who is eligible to receive an initial distribution of shares but who fails to apply for issuance of stock may be issued a share without charge at any time within one year of the original issue. The one year period coincides with the period during which a shareholder may elect not to receive his stock and have his share cancelled. For one additional year a person who would have been eligible to receive an initial share but did not get one may purchase his share at book value. Original issue is cut off completely after the two year period.
- .360. 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 4. AMENDMENT.

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

- .370. 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).
- .375. 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.
- .380. ARTICLES OF AMENDMENT.
- .385. FILING OF ARTICLES OF AMENDMENT.
- .390. 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.
- .395. RESTATED ARTICLES OF INCORPORATION.
- .400. EXECUTION OF RESTATED ARTICLES OF INCORPORATION.
- .405. CONTENTS OF RESTATED ARTICLES OF INCORPORATION.
- .410. FILING OF RESTATED ARTICLES OF INCORPORATION.
- .415. 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 5. SALE OF ASSETS.

- .420. 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).
- .425. 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).

- .430. 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).
- .435. 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).
- .440. RIGHTS OF DISSENTING SHAREHOLDERS UPON SALE OR EXCHANGE OF ASSETS.
- .445. NOTICE TO DISSENTING SHAREHOLDER.
- .450. PAYMENT TO DISSENTING SHAREHOLDER AFTER AGREEMENT ON VALUE OF SHARES.
- .455. ACTION BY DISSENTING SHAREHOLDER TO COMPEL PAYMENT UPON FAILURE TO AGREE ON VALUE.
- .460. EFFECT OF ABANDONMENT OR REVOCATION OF SALE OR EXCHANGE ON SHAREHOLDER'S RIGHTS.
- .465. 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 6. DISSOLUTION.

GSOCs may be dissolved voluntarily by a 2/3 vote of a quorum of shareholders (.475) or by the Commissioner of Commerce (.530). In a voluntary dissolution the question may be put to the shareholders upon action of the board or a petition of 1,000 shareholders (.475). On affirmative vote of the shareholders a statement of intent to dissolve signed by corporate officers (.480) is filed with the commissioner of Commerce (.485). When the statement is officially filed by the Commissioner the corporation must cease doing business and wind up its operations (.470). However, the corporate existence continues while the corporation notifies creditors,

collects and liquidates assets and pays off its obligations (.490)(.495). When the business of the corporation has been wound up articles of dissolution (.515) are filed with the Commissioner (.520) and when certified the corporate existence ceases (.525). Voluntary dissolutions may be revoked at any time by a 2/3 vote of the shareholders (.500) in which case the corporation files a statement of revocation (.505) and the dissolution process is terminated (.510).

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 (.530). A corporation can be reinstated within two years upon remedy of the violation.

The superior court may dissolve a GSOC (.530) and has jurisdiction to liquidate the corporation's assets (.540). The Attorney General may bring suit to dissolve the corporation where there was fraudulent incorporation or continual abuse of corporate authority (.530).

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 (.545).
- 2) A creditor when the creditor's claim is unsatisfied and the corporation is insolvent (.550).
- 3) The corporation upon request to have a voluntary dissolution continued under court supervision(.555).
- 4) The Attorney General in conjunction with a suit for dissolution (.560).

The shareholders need not be a party to the action for liquidation (.565). The court has authority to appoint a qualified receiver (.605) for the corporation with power defined by the court (.585) to collect and sell its assets (.570)(.575). Proceeds are to be used to pay expenses allowed by the court (.590) and debts of the corporation with the remainder distributed to the shareholders (.580).

The receiver may sue and be sued (.595) and all claims against the corporation must be filed in a timely manner with the court or the receiver (.610). Liquidation may be terminated by the court (.615) but upon completion the court must enter a decree of dissolution (.620).

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

ARTICLE 7. GENERAL PROVISIONS.

- .625. 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.
- .630. 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.
- .635. 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.
- .640. RESERVATION OF POWER. Amendments to this chapter apply to all existing and future corporations organized under it, but an amendment may not abrogate the contractual obligations of any corporation.
- .645. 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.

QUESTIONS ON AGSOC FOR THE HOUSE STATE AFFAIRS COMMITTEE

1. How could AGSOC be structured so as not to create unnecessary conflicts between the public interest in business regulation and taxation and the shareholder's interest in higher dividends?
2. Would it be generally advisable to make attempts to depoliticize the AGSOC?
Should the AGSOC be allowed to lobby, make political contributions or come out with endorsements for particular candidates?
3. Do normal state corporation statutes provide sufficient protection for minority shareholders?
 - Is it inevitable the AGSOC would become an urban dominated corporation, given the population of the state?
 - How would rural members be able to participate other than by proxy given the expenses involved in travelling to meetings?
 - Should the board be classified, i.e. only a subset of the board coming up for election at one time
 - Should cumulative voting be mandatory?
 - Should voting trusts be prohibited?
 - Who should have the authority to amend articles of incorporation and bylaws?
 - How should proxy fights and shareholder-management disputes be financed - should both incumbents and challengers be financed by corporation money?
4. Should exemption from federal income taxation be extended to state taxation in general?
5. What are the probabilities that AGSOC will need no other state assistance beyond start-up costs? Can AGSOC really operate as a purely private corporation?
 - Which particular investments would not require state financial aid?
 - Which particular investments would require state financial aid?
 - * Ask Kelso representative to detail the mechanism whereby AGSOC requests state financial assistance.
 - What kind of impact on the state's credit rating would the potential access to state support and/or guarantees have? Is it fair that all residents bear the risk to the state's credit rating which benefits only the subset of residents who are shareholders?

6. What are the pros and cons of setting up the AGSOC up as a public corporation versus a private corporation, assuming it would be legal?
7. Is there further information which can be made available to the state which will help us to make a prudent decision on the AGSOC. Can such information be gathered before the end of this session?

Possible questions to be answered:

- Do Alaskan's want an AGSOC? Perhaps this issue needs an airing similar to that given to Alaska, Inc. via the Public Forum. Since AGSOC is to be a people's corporation, should the people deserve more involvement than has yet been provided?
- What are the political implications of a corporation whose shareholders comprise the voting public? Are there any existing situations which are similar elsewhere, and from which lessons can be drawn?
- What will be the impact on the state's credit rating if AGSOC requires different kinds of state financial assistance? If there is an impact, how much will non-shareholding residents be paying to benefit the shareholders?
- If AGSOC had been incorporated five or ten years ago, how many residents would be shareholders today? Or conversely, how many shareholders would still be residents? What can we expect for the future? Taxpayer turnover data is available to answer this question.

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SCHOOL OF LAW

DAVIS, CALIFORNIA 95616

April 4, 1979

The Honorable Mike Miller
Chairman
State Affairs Committee
Alaska State House of Representatives
Pouch "V" State Capitol Building
Juneau, Alaska 99811

Dear Chairman Miller:

I am enclosing the promised specific, suggested amendments to SSHB 240 which are addressed to the questions of accountability of the Board, the rights of shareholders, and procedures for Board and Board Committee meetings. In each instance I have attempted to describe the content of the proposed amendment and to offer an explanation of why I hold the view that such an amendment would be desirable. I have then attempted to break the amendment down into its component ideas and to give the Committee an opportunity to vote them up or down. My further function in this regard is then to draft statutory language which carries into effect the decisions of your Committee.

A number of critical questions concerning SSHB 240 are not addressed in this transmission. We have yet to discuss the regulation of proxies, their content and the vexing issue of how they will be financed. If the legislature desires to influence these thorny problems, now is the only opportunity. Another unfinished item is the future political activities of the GSOC. We can anticipate substantial first amendment problems if we embark on a project to muzzle the directors in their individual capacities. If the directors can speak to the public, the limitation on the "corporation's political activities" is, at best, theoretical. Working on this problem should present quite a challenge.

Finally, there are the proposals I advanced on the first evening of my testimony regarding criminal liability of directors in certain instances. I will work on these in the course of the next week.

If I may offer a suggestion: As I spend more and more time with SSHB 240 and the Alaska Business Corporations Act the more I become convinced that the better course is not to amend the existing corporations code to make room for the GSOC, but to begin anew and design a fully developed Code to regulate the GSOC, a set of laws designed with the special attributes of a general stock ownership corporation in mind and not as an afterthought. This project sounds bigger than it will turn out to be. I sincerely believe that working with your staff people it could be accomplished in a matter of weeks, although I would prefer to have the summer months to fine-tune the statute but, in the final analysis, having come this far with you, I am the servant of the Committee.

I hope that this material proves of use to the Committee. When you have reached your decisions simply mail them back to me and I will sit down and draft the content of suggested legislation.

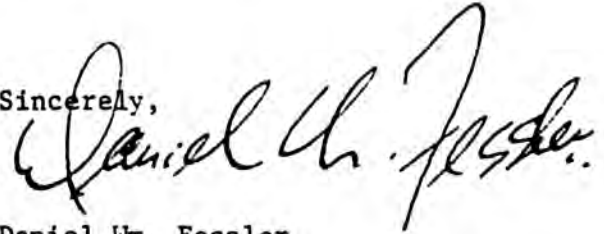
The Honorable Mike Miller
Chairman
State Affairs Committee

April 4, 1979

May I take this opportunity to thank you, the other members of the Committee, the various nonmembers who sat in on our discussions and the staff people for a splendid experience. People here have remarked that they have never seen me so energetic. One student commented that I seem to be following the "North Star." In any event, it has been an experience beyond the imagination of the scriptwriters for the "Paper Chase." I thank you all.

Best personal regards,

Sincerely,

A handwritten signature in cursive script, reading "Daniel Wm. Fessler". The signature is written in dark ink and is positioned to the right of the word "Sincerely,".

Daniel Wm. Fessler
Professor of Law

DWF:hf

Enclosures

1 TO: THE STATE AFFAIRS COMMITTEE OF THE ALASKA HOUSE OF
2 REPRESENTATIVES
3 FROM: Professor Daniel Wm. Fessler, King Hall, the Law School of the
4 University of California at Davis
5 SUBJECT: Suggested Amendments to Sponsor Substitute for House Bill 240:
6 "An Act Creating the Alaska General Stock Ownership Corporation;
7 and providing for an effective date."
8 DATE: April 4, 1979

8 Preliminary statement: At the conclusion of my appearance before the
9 Committee last week I agreed with the members to prepare a series of written
10 proposals for your consideration. Depending upon the sentiment of this body I
11 will be directed in the drafting of amendments to the Sponsor's Substitute for
12 House Bill No. 240. As will quickly become evident, it is time for the
13 Committee to make some basic choices concerning the nature of the General Stock
14 Ownership Corporation which it may wish to pass to the floor for consideration
15 in the whole House. The suggestions which follow represent nothing beyond the
16 scope of our discussion last week unless specifically indicated as "NEW." In
17 each instance I will set forth the proposal and a brief statement illustrating
18 specifically what it is that I am suggesting be accomplished if you elect to
19 follow my recommendation.

20
21 I. SUGGESTIONS DESIGNED TO MAKE THE BOARD OF DIRECTORS MORE RESPONSIVE TO THE
22 DESIRES OF SHAREHOLDERS OF THE GENERAL STOCK OWNERSHIP CORPORATION:
23

24 My perception of the need for revision: The pending proposal is that the
25 legislature create the AGSOC as a "private" corporation essentially regulated
26 under the terms of Chapter 05 of the Alaska Statutes (The Alaska Business
27 Corporation Act). As I indicated in my testimony, this general statute is a
28 bare bones version of the "Model Act" which is, in turn, fashioned after the

1 Illinois Business Corporation Act. Its essential feature is to give a corpora-
2 tion a license to create a very strong board of directors, a board which is
3 effectively insulated from shareholder pressure during its tenure in office.

4 This is a crucial assertion. Once this corporation is created and
5 deemed "private" the legislature will part with its major chance to have an
6 effective voice in the behavior of such an instrumentality. If the GSOC is a
7 successful economic venture the power of that unchecked body will rise
8 dramatically and its ability to pursue conduct which subsequent legislatures
9 may deplore is a real danger which ought to concern this present body.

10 Why is the board of directors of a corporation organized under a
11 statutory framework such as the Model Act virtually unchecked in these circum-
12 stances? To begin our assessment we should think in terms of the content of
13 three documents: the statutory framework, the articles of incorporation, and
14 the bylaws. It is no accident that the Kelso Report presents this legislature
15 with a package containing a recommended content for each of these essential
16 documents. Here is a point the Kelso Report does not stress: the legislature
17 has control only over the statutory framework (the enabling legislation now
18 before the Committee). Once the GSOP is formed by this legislation, the
19 incorporators (See, Sec. 10.50.010(a), p. 1 SSHB 240) will adopt the articles
20 of incorporation and it will then be beyond the powers of this or subsequent
21 legislatures to interfere with the content of that fundamental document. Once
22 the incorporators have elected themselves as the initial board of directors
23 (See, Sec. 10.50.030(b), p. 3 SSHB 240), they will act in that capacity to
24 adopt the content of the bylaws. Again, it will be too late for the legisla-
25 ture to exert its will. Thus unless changes are made you will have surrendered
26 to these nine appointed individuals sole determination over the content of the
27 documents which will become the framework in which the corporation will
28 actually be structured and function. Your only chance for effective influence

1 is with respect to the content of the statute. If you adopt the current
2 content of House Bill 240, you will hand these appointed individuals (only a
3 majority of whom need be Alaskans) a blank check to narrow their accountability
4 to all of the citizens of this state in their capacities as shareholders in the
5 GSOC. The express terms of SSHB 240 already give to this Board the strong
6 power position of "classification" meaning that the directors will serve three
7 year terms with the nine members segregated into three classes so that only one
8 third of the membership is up for election by the shareholders at each annual
9 meeting. (See, 10.50.030(a)(b), pp. 2-3 SSHB 240). There is a pragmatic
10 advantage in this proposed classification in that insures to the incumbent
11 board the continuity inherent in the fact that a working majority of the Board
12 will not be facing election. There is also a grave danger. Such a Board
13 could ignore the wishes of a majority of the shareholders and yet maintain
14 effective control and management over the corporation for two years. The
15 people in their role as shareholders would be powerless. This body in its
16 role as representative of the people would be equally powerless. True, it
17 could deny the GSOC cooperation to the extent that it was requesting the
18 legislature to call for an election to authorize a state guarantee of GSOC debt
19 instruments (although see the Memorandum of Attorney General Gross under date
20 of March 20, 1979, raising a question as to whether recourse to the people
21 would actually be required). Yet this is a very indirect way of attempting to
22 discipline the Board or correct the excesses of that body as viewed from the
23 perspective of the legislature. I do not wish to belabor the point: if the
24 members of this House feel that a different distribution of power as between
25 the shareholders and the board, and as between the GSOC and the government of
26 Alaska is desired . . . now is the time to act and the content of the enabling
27 legislation is the proper forum for that action.

28 //

1 PROPOSALS DESIGNED TO INCREASE THE ACCOUNTABILITY OF INDIVIDUAL DIRECTORS AND
2 THE BOARD AS AN ENTITY:

3

4 PROPOSAL NUMBER ONE: THAT DIRECTORS BE SUBJECT TO REMOVAL BY ORDER OF A
5 SUPERIOR COURT UPON SUIT BY 100 OR MORE SHAREHOLDERS OF THE GENERAL STOCK
6 OWNERSHIP CORPORATION.

7 I propose that the enabling legislation be amended to
8 provide that a superior court may, at the suit of 100 share-
9 holders or more or upon petition of the attorney general,
10 remove from office any director in case of fraudulent or
11 dishonest acts or gross abuse of authority or discretion
12 with reference to the corporation and may bar from reelection
13 any director so removed for a period prescribed by the court.
14 In any such proceeding the corporation should be made a
15 party to the action.

16 Explanation: This proposal is based upon Section 304 of the 1977
17 California Act with two important modifications: first, I propose that
18 you alter the "standing requirement" from California's [" . . . share-
19 holders holding at least 10 percent of the number of outstanding
20 shares. . . ."] to one hundred shareholders. To follow the California
21 percentage would be most unreal given the total diffusion of share-
22 holdings in the GSOC (one share per resident). It would require a
23 petition of 40,000 Alaskans or more! In any other private corporation it
24 is perfectly possible for a single shareholder to own 10% or more of the
25 outstanding shares and thus have standing under the California Act.
26 Requiring one hundred Alaskans to join in this suit should ensure that a
27 single angry shareholder could not inaugurate a vexatious complaint. The
28 second modification is to specially grant to the Attorney General standing

1 to initiate this removal litigation. I do this because while the attorney
2 general may well have personal standing as a resident of Alaska to join in
3 such a suit we must recognize that litigation may be costly and that
4 frequently only the office of the attorney general may have the human and
5 financial resources to prosecute a removal suit upon which may depend the
6 welfare of the corporation (and with that, welfare and interests of
7 Alaskans).

8 Now it must be immediately evident that this type of removal can only
9 be for the most gross violations of the fiduciary responsibilities assumed
10 by a director and that the statute only grants standing to potential
11 litigants and subject matter jurisdiction to the superior courts.
12 Naturally, the plaintiffs would have to prove the allegations of their
13 complaint by a preponderance of the evidence before the superior court
14 would be warranted in exercising the power vested in it by this statute.
15 I should add that it is quite possible that if the legislature does not
16 act to provide for removal of directors in circumstances such as are
17 covered by this proposal, a superior court might entertain such suits on
18 a theory that such a grave matter is within the court's inherent juris-
19 diction. There is precedent. See, California Fruit Growers' Assn. v.
20 Superior Court, 8 Cal.App. 711, 97 Pac. 769 (1908). In my opinion, this
21 is not a desirable alternative because the legislature would be without
22 control over the vital questions of who had standing to initiate the
23 litigation and what would be deemed sufficient grounds for this grave
24 remedy.

25 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor
26 in principle the concept of having directors subject to
27 removal by order of a superior court? YES ____ NO ____ . If
28 "yes," is the Committee in favor of the proposed formula

1 granting standing only to one hundred or more shareholders?

2 YES ____ NO _____. Does the Committee favor granting standing
3 to the Attorney General of Alaska to initiate a removal suit?

4 YES ____ NO _____.
5

6 PROPOSAL NUMBER TWO: THAT ANY DIRECTOR OR THE ENTIRE BOARD MAY BE
7 REMOVED BY THE SHAREHOLDERS WITHOUT CAUSE.

8 I propose that at any annual meeting or a special
9 meeting properly noticed for the purpose at which a
10 quorum is present, a majority of the shares voting in
11 person or by proxy may remove the entire board and elect
12 replacement directors. I further propose that the share-
13 holders have power to remove less than the entire board
14 provided there are appropriate safeguards to minimize
15 the chance that an angry faction of shareholders could
16 oust a single director.

17 Explanation: Both California and Delaware have found it expedient to
18 pass recent legislation enabling shareholders who have lost confidence in
19 the Board of Directors to remove either the entire Board or individual
20 members at a meeting especially called and noticed to entertain such a
21 motion, and that such removal may be for any cause deemed sufficient by a
22 majority of the shares. In both California and Delaware, the statutes
23 grant the right of removal to an absolute majority of the shares (50% plus
24 1 share). Again, we must recognize that there may be individuals or
25 institutional shareholders who, though a handful in number, would command
26 an absolute majority of the outstanding shares. Such a potential
27 coalition of large shareholders is a strong check upon the Board of
28 Directors. Unfortunately, there will be no such potential shareholder

1 coalition in the GSOC. We must deal with the fundamental characteristic
2 of a corporate entity, the shares of which are held in lots of one . . .
3 and by more than 400,000 individuals.

4 The Kelso Report recognizes the problem of human inertia inherent in
5 such diffuse shareholdings when it proposes to set a quorum for share-
6 holder attendance at annual and special meetings at one-third of the
7 shares voting either in person or by proxy (an absentee ballot). At any
8 meeting at which such a quorum is ascertained to be present, a vote of a
9 majority of that quorum is sufficient to elect directors. Simple arith-
10 metic will reveal that a simple majority of one-third is one-sixth of the
11 shares plus one. Such a scheme is permitted by Sec. 10.05.153 of the
12 Alaska Business Corporation Act if the articles of incorporation are so
13 drafted. I favor this aspect of the proposed articles contained in the
14 Kelso Report because I fear that setting a higher quorum requirement might
15 preclude the shareholders from effectively meeting. How then does this
16 guide us as to the machinery for removal of directors by shareholder vote?
17 I propose that the entire board might be removed for any reason either at
18 an annual or special meeting of shareholders for which notice of such a
19 proposal had been given (as provided in Sec. 10.05.141) upon the vote of a
20 majority of a quorum of the shares present in person or by proxy.

21 If the shareholders desire to remove less than the entire board, we
22 have a different problem. Here is a danger that a special interest group
23 or other faction might attempt to gang up on a single director for his or
24 her policies and seek to accomplish this at a special meeting which may
25 well be attended by fewer shares than were present at the annual meeting
26 which elected the targeted director. We can guard against this possibility
27 by drafting the statute to provide that in the event that there is an
28 attempt to remove less than the entire board, the resolution shall fail

1 unless the number of shares cast for removal exceeds the number of shares
2 which originally elected the director. Thus if he was elected by a
3 majority of 261,000 shares at an annual meeting, a special meeting noticed
4 to entertain a removal resolution would not accomplish that objective
5 unless 261,001 shares voted "yes" (in person or by proxy) on that question.
6 If the director was appointed (as in the case of the initial Board), or
7 elected by the Board to fill a vacancy arising by death, incapacity, or
8 resignation mid-term. I would propose that a simple majority of a quorum
9 would be sufficient to remove that director.

10 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor
11 in principle the concept of having directors susceptible of
12 removal by vote of the shareholders? YES ____ NO _____. If
13 so, is the Committee content with the suggested formula for
14 that removal? YES ____ NO _____.
15

16 PROPOSAL NUMBER THREE: THAT THE ENABLING ACT REGULATE THE STANDING OF
17 SHAREHOLDERS TO INAUGURATE ACTIONS AGAINST DIRECTORS OR OFFICERS BROUGHT
18 FOR THE BENEFIT OF THE CORPORATION (SHAREHOLDER'S DERIVATIVE ACTIONS).

19 I propose that the enabling act be amended to regulate
20 the standing of shareholders to inaugurate actions seeking
21 declaratory relief or money damages as against officers and
22 directors of the GSOC for the benefit of the corporation
23 (shareholder's derivative actions); lodge discretion in the
24 superior court respecting whether and in what amount a security
25 bond for expenses of litigation should be required of such a
26 plaintiff; preclude non-judicially approved out-of-court
27 settlements of such actions; and, provide for an accounting
28 to the corporation of any proceeds received by the litigating

1 shareholder(s) whether by judgment, settlement, or compromise.

2 Explanation: One of the most important developments in the past half
3 century in seeking to hold directors and officers accountable for harm
4 they bring upon the corporation is the concept of the shareholders' action
5 or derivative suit. If you adopt the hypothesis that the Board or certain
6 of its members is guilty of action or inaction which has brought great
7 harm to the GSOC and which violates the duties of care or loyalty to the
8 corporation, it is unrealistic to assume that those very directors will
9 authorize or encourage corporate counsel to bring an action naming them as
10 defendants! For this reason it is necessary to give individual share-
11 holders the right to bring the litigation in the name of the corporation.
12 Any recovery of money damages goes to the corporate treasury, not to the
13 litigating shareholder (save for reimbursing him/her for the costs of the
14 litigation).

15 Nearly every jurisdiction permits such actions and most regulate the
16 conduct of such litigation by statute. Alaska is one of the few juris-
17 dictions which permits but does not regulate by statute. Fortunately, the
18 Supreme Court has acted to fill this void by providing in Rule 23.1 of the
19 Civil Rules certain regulations for derivative actions by shareholders.
20 (Added by Supreme Court Order 258, November 16, 1976.) The Alaska rule is
21 predicated upon and nearly identical to Rule 23.1 of the Federal Rules of
22 Civil Procedure. In my opinion, it does not go far enough in policing
23 derivative actions by shareholders in the context of the General Stock
24 Ownership Corporation.

25 The matters which should be covered by statute include:

26 * Who among the shareholders may bring such an action?

27 I suggest that standing be limited to a shareholder who held his or
28 her share at the time of the transaction of which complaint is made

1 else an unscrupulous shareholder might merely "buy a lawsuit." And
2 standing should be limited to a shareholder or shareholders with
3 sufficient resources to be able to vigorously prosecute the action
4 since a judgment will bind all of the other shareholders by its
5 result.

6 * Should the shareholder be required to exhaust intra-corporate
7 remedies (e.g., make a demand upon the Board that it bring the
8 action) as a precondition to commencing the action?

9 Modern statutes do not require the shareholder to make demands upon
10 the Board if that would be a futile act (e.g., if the directors are
11 named as the defendants it is unlikely that they would respond to the
12 demand by directing suit against themselves). Thus I would propose
13 that the shareholder be required to make demand upon the Board for
14 corrective action or to allege in his complaint before the superior
15 court the reasons why he deems such a demand to be a futile gesture.

16 * Should the shareholder be required to post a bond as a
17 precondition to maintaining any derivative action?

18 Defending a derivative action is time consuming and expensive and
19 there is always a danger that a shareholder will bring an ill-
20 founded or vexatious action simply to harass management or in the
21 hope that he will be "bought off" with an out-of-court settlement.
22 To minimize the instance of such "strike suits," many states in the
23 1940's adopted the practice of requiring a litigating shareholder to
24 post a bond as a precondition to maintaining the action, a bond which
25 would hold the defendants harmless against their costs of litigation
26 (including attorney's fees) in the event the shareholder should fail
27 to prevail. There is no current Alaska law on this point. Rule 23.1
28 is silent. My suggestion is that the Committee borrow the best

1 features of modern California and New York statutes on striking a
2 balance on this vital question. Section 800 of the California Act
3 leaves the trial court with substantial discretion to entertain a
4 timely motion from defendants for the posting of such security. Thus
5 the court could consider the nature of the plaintiff's allegations
6 and project the likelihood of success. It would then exercise sound
7 discretion in requiring that a bond be posted or in denying the
8 request of the defendants. If a bond is required the court has
9 further discretion to determine the amount of the bond. California
10 presently limits the bond to a sum not more than \$50,000. This
11 ceiling is viewed as posing some protection against a judge who would
12 simply price the plaintiff out of court with a bond requirement
13 substantially beyond reasonable means. Again, the California Act
14 provides that the amount of the bond may be raised or lowered (subject
15 to the \$50,000 ceiling) at any time during the course of the litigation
16 upon the motion of either party or upon the court's own
17 initiative as it seems the interests of fairness to require.

18 * Should the shareholder who has commenced a derivative action be
19 allowed to compromise or "settle out of court"?

20 No, not in my opinion. This is very dangerous and tolerates "strike
21 suits"--actions commenced with no solid ground but with the hope that
22 management will tire of the time and expense of defending the litigation
23 and "buy plaintiff off." New York is far ahead of other jurisdictions
24 in warding off this danger. No action in the nature of a
25 derivative suit may be settled or compromised without the approval of
26 the court in which it was commenced and without notice to the other
27 shareholders. This last feature is essential to protect the interests
28 of both the court and the other shareholders. The court is protected

1 for a judicially approved settlement precludes any shareholder from
2 attempting to relitigate the same questions. The notice requirement
3 permits other shareholders to come forward and object either to the
4 terms of the proposed settlement or to offer to take up the suit and
5 carry it forward in the event of an afterarising unwillingness of the
6 original litigant.

7 * Should the litigating shareholder in all circumstances be forced
8 to account to the corporation for any proceeds realized from such
9 an action?

10 Yes. In all jurisdictions this is mandatory if the court returns a
11 judgment against the defendant officers or directors. All proceeds
12 of the judgment are paid into the corporate treasury on the theory
13 that the action has vindicated harm done to the corporation and not
14 the litigating shareholder. The shareholder receives an allowance
15 from these funds sufficient to cover the costs of the litigation.
16 But what if the resolution is by way of an informal settlement? This
17 is the dark side of this type of litigation. Frequently shareholders
18 are offered a tidy sum (e.g., \$20,000) if they will dismiss their
19 suit. They keep the money and none of the other shareholders are the
20 wiser. New York simply prevents this. There can be no informal
21 settlement. Any dismissal predicated upon a compromise must be pre-
22 sented to the court, its terms noticed to the other shareholders, and
23 any proceeds paid into the corporate treasury.

24 If all of these features are incorporated into the enabling act, I am
25 of the view that Alaska will have the best of all possible positions with
26 the virtue of derivative actions and none of the vices inherent in strike
27 litigation.

28 / / / / /

1 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor in
2 principle the concept of permitting derivative actions by share-
3 holders in the General Stock Ownership Corporation? YES ____ NO ____.

4 If "yes," does the Committee favor regulating the derivative action
5 by special provisions in the enabling act? YES ____ NO _____. If
6 "yes," does the Committee favor:

7 * The suggested standing rules? YES ____ NO ____.

8 * The suggested provision on exhaustion of intra corporate
9 remedies? YES ____ NO ____.

10 * The suggested provision on the posting of a security bond
11 for the defendants' costs of litigation? YES ____ NO ____.

12 * The suggestion that there be no compromise or dismissal of
13 such an action without court approval? YES ____ NO ____.

14 * The suggested provision that the litigating shareholder in
15 all circumstances be forced to account to the corporation
16 for any proceeds realized from such a derivative action?
17 YES ____ NO ____.

18
19 II. PROPOSALS DESIGNED TO INCREASE THE INFORMATION AVAILABLE TO AND THE
20 POTENTIAL ROLE OF SHAREHOLDERS IN THE GENERAL STOCK OWNERSHIP CORPORATION.

21
22 PROPOSAL NUMBER FOUR: THAT THE ENABLING ACT BE AMENDED TO PROVIDE
23 LIABILITY FOR AN OFFICER OR AGENT WHO WRONGFULLY REFUSES TO ALLOW A SHARE-
24 HOLDER, OR A SHAREHOLDER'S AGENT OR ATTORNEY, TO EXAMINE AND MAKE
25 EXTRACTS FROM CORPORATE BOOKS AND RECORDS.

26 I propose that an officer or agent who refuses to allow
27 a shareholder or the agent or attorney of a shareholder to
28 examine and make extracts from corporate books and records

1 of account, minutes, and record of shareholders, for a
2 proper purpose be made liable to the aggrieved shareholder
3 for the penal sum of \$1,000 in addition to other damages or
4 remedy given such shareholder by law.

5 Explanation: Currently Sec. 10.05.240 of the Alaska Business
6 Corporations Act confers upon shareholders a right to examine books and
7 records. Section 10.05.243 provides a penalty for any officer or agent
8 of the corporation who refuses to permit this inspection. Unfortunately,
9 the penalty there provided (10% of the value of the shares owned by the
10 aggrieved shareholder), is not much of a sanction in the context of the
11 GSOC. In other contexts it may be very effective for it is obvious that
12 the larger the number of shares owned by the aggrieved shareholder the
13 more substantial are the consequences of denying the right of inspection.
14 But a shareholder in the GSOC can never own more than 10 shares. Thus I
15 propose to follow the current content of Alaska law in all particulars
16 save for suggesting that a flat penal sum of \$1,000 be established as the
17 sanction.

18 The effective use of any of the shareholder checks upon management
19 which are set forth in Suggestions One, Two and Three depend upon an
20 effective ability to gain information as to the conduct of corporate
21 affairs by the officers and the Board. Thus an effective right of
22 inspection is essential. Indeed, the Committee might desire to see the
23 penal sum imposed for each day there is a wrongful denial of the statutory
24 right of inspection conferred by Sec. 10.05. 240.

25 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the
26 concept of a statutory right of shareholders in the General Stock
27 Ownership Corporation to inspect corporate books and records?

28 YES ____ NO ____ . Should this sum be levied: (a) per

1 refusal ____; or, for each day of a refusal ____?

2
3 PROPOSAL NUMBER FIVE: THAT THE SHAREHOLDERS BE GIVEN THE POWER TO
4 INITIATE AMENDMENTS TO THE BYLAWS.

5 The current statutes in Alaska provide that the articles
6 may restrict the power to adopt, amend, and repeal bylaws to
7 the Board of Directors. The Kelso Report recommends articles
8 which do so restrict the power to the Board and it is likely
9 that this is what a Board would do. I propose that the
10 enabling act be amended to reserve a power of adoption,
11 amendment or repeal of the bylaws to the vote or written
12 assent of shareholders entitled to exercise a majority of the
13 voting power of the GSOC. I would also propose that the act
14 permit the Board to enjoy this power save for the fact that
15 the Board could not, on its own motion, repeal or amend a
16 bylaw which had been adopted by vote of the shareholders.

17 Explanation: As was dramatically illustrated by the content of the
18 Kelso Report, the document which is most likely to contain the crucial
19 provisions which govern the structure and operation of the General Stock
20 Ownership Corporation is the bylaws. A significant feature in what is, in
21 my opinion, the excessive grant of power to the Board in SSB 240 is the
22 potential for vesting this power exclusively in the Board. The balance
23 can be redressed by simply amending the enabling act to provide for a
24 sharing of this power in the case of a General Stock Ownership Corporation.

25 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor
26 the concept of permitting the shareholders to adopt, amend or
27 repeal bylaws in the General Stock Ownership Corporation?

28 YES ____ NO ____ If "yes," does the Committee favor the

1 suggestion that this power be vested by statute in both the
2 shareholders and the Board? YES ____ NO ____.

3
4 III. PROPOSALS DESIGNED TO IMPROVE THE QUALITY OF BOARD DECISION MAKING.

5
6 PROPOSAL SIX: THAT THE BOARD BE ENABLED TO TRANSACT BUSINESS BY USE OF
7 A CONFERENCE TELEPHONE OR SIMILAR COMMUNICATIONS EQUIPMENT.

8 Given the significant distances as barriers to travel within the
9 State of Alaska plus the strong likelihood that a minority of the
10 directors will be non-Alaskans, I propose that the enabling act be
11 amended to authorize the board to transact business by use of a
12 conference telephone or similar communications equipment so long as
13 all members participating in such a meeting can hear one another.

14 Explanation: One of the difficulties inherent in a body of nine members
15 is to physically gather them in the same place at the same time for the trans-
16 action of Board business. In large corporate entities this is frequently
17 difficult. The result has been a tendency to permit the Board to divide
18 itself into smaller working committees or an "executive committee" to which is
19 delegated most of the Board's function and authority. There is a price paid
20 for such a solution. Decisions are made without the participation of the full
21 membership. Yet a non-classical solution is at hand, and from my personal
22 observation, a very familiar aspect of life in Alaska--the use of modern
23 communications equipment to hold board meetings notwithstanding the fact that
24 the members are not in the same place at the same time. Both California and
25 Delaware now permit this and the reported experience is very satisfactory. I
26 would suggest that such a provision be made a permanent amendment to Sec.
27 10.05.198 for all corporations formed in Alaska. It certainly merits adoption
28 in the special case of the GSOC.

1 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the
2 concept of permitting the directors to hold meetings via the use
3 of conference telephones or similar communications equipment with
4 participation in such a meeting constituting presence in person?

5 YES ____ NO ____.

6
7 PROPOSAL NUMBER SEVEN: THAT REGARDLESS OF COMMITTEE ASSIGNMENTS EVERY DIRECTOR
8 HAVE A RIGHT TO ATTEND THE MEETINGS OF ANY COMMITTEE AND BE PRIVY TO ALL BOOKS
9 AND RECORDS.

10 Current Alaska law permits the Board to divide itself into
11 committees including an executive committee and to delegate board
12 functions and authority. I have no quarrel with this concept but
13 do suggest that the enabling act be amended to make it clear that
14 regardless of committee assignments any director shall have the
15 right to attend (but not participate in) any meeting of any
16 committee and to have access to books and records pertaining to
17 the activities or responsibilities of such committees as may,
18 from time to time, be created.

19 Explanation: Again we illustrate what one jurist has termed the
20 "law of laws" . . . that every advantage is purchased at a price. The desire
21 to streamline and specialize the functions of directors is understandable but
22 the price is the exclusion of those directors who are not appointed to key
23 committees. Sometimes this problem assumes serious dimension as those
24 directors who are perceived by the majority as raising vexing questions and
25 airing dissenting views are simply shunted aside by exclusion from committee
26 assignments. The legislature can go some distance toward minimizing this harm
27 by providing by statute a right of each director to attend the meeting of any
28 committee and to have access to books and records.

1 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor
2 the concept of granting directors a statutory right to attend
3 the meetings of any Board committee and to have access to minutes
4 and records? YES ____ NO ____.

5
6 END OF THIS TRANSMISSION -- SEPARATE LETTER BEING TRANSMITTED NEXT.

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C.

SAN FRANCISCO

LOS ANGELES

April 10, 1979

**The Honorable Mike Miller
Chairman, State Affairs Committee
Alaska State House of Representatives
Pouch V
State Capitol Bldg.
Juneau, Alaska 99811**

Dear Representative Miller:

We are writing you to comment upon the principal items covered by the memorandum from The Honorable Avrum M. Gross, Attorney General (by Mr. Joseph K. Donohue, Assistant Attorney General), to The Honorable Frances Ulmer, Director of the Division of Policy Development & Planning, under date of March 19, 1979. We understand this memorandum has been considered by both State Senate and State Assembly Committees, but is presently before the State Affairs Committee. The subject of the memorandum is "Policy & Legal Issues Surrounding AGSOC Legislation (SSSB 170 and SSHB 240)". The memorandum states that it is in response to a request from The Honorable Frances Ulmer for a brief outline of the various issues which the Administration should review in the context of the analysis of the AGSOC legislation presently pending before the legislature.

The memorandum itself, the care and astuteness used in its preparation, and the wisdom of Miss Ulmer in requesting it, all attest the high degree of responsibility and thoroughness with which the legislature is studying the AGSOC legislation. We hope that our comments on certain of the provisions of the memorandum will prove of use to your Committee, and to others to whom you may wish to distribute copies.

For simplicity of reference, we will initiate each of our comments with a reference to the paragraph or paragraphs and to the page number in the memorandum of March 19th or 20th (March 20th being the date used on its separate pages). We will also number our paragraphs for easy reference in case you wish to ask questions or comment on this letter.

1. THE FIRST FULL PARAGRAPH ON PAGE 3

The question of whether the State should follow the policy of the federal legislation and exempt AGSOC from State corporate income tax and from certain other State level taxes which might otherwise be imposed on the corporation are, of course, precisely the kinds of questions that only the legislature can answer. There is one erroneous statement at the end of the paragraph, however, and that is that

The Honorable Mike Miller
Chairman, State Affairs Committee
April 10, 1979
Page Two

our firm, as investment bankers, is presently recommending "the new AGSOC purchase BP's share of TAPS." We, in our instructions from the legislature, were expressly requested to avoid recommendations as to AGSOC's investments, although, basically to illustrate feasibility, we believe, we were asked to do a feasibility study of that particular purchase.

In general, it will be obvious to your Committee that the taxes imposed on AGSOC at the corporate level would simply slowdown the rate at which AGSOC could amortize its debt incurred in acquiring productive investments from time to time, and thus slowdown the rate at which AGSOC is effective in building capital ownership into each Alaskan resident.

2. THE LAST FULL PARAGRAPH ON PAGE 3

In the last paragraph at the bottom of Page 3 (erroneously reproduced in our copy at the top of Page 4), it is postulated that by purporting to give each resident of the State a direct interest in the development of the State's natural resources, AGSOC would become an independent voice for more rapid exploitation of those resources, and that because the AGSOC is required to pay out substantially all of its net income to residents of the State, it "would likely" become a lobbying force for lower State taxes. We do not believe that these conclusions are by any means obvious or sound. It apparently has been overlooked that while AGSOC, as a corporation in which every resident owns an interest, is intended to build capital ownership in each such resident each resident also has other and independent interests. He has an interest in the overall tax impact on him. Thus if reducing the taxes on AGSOC raised his personal income tax, or his property tax, he would certainly take both into consideration and either of these events would undoubtedly have a far greater individual effect than lowering State taxes of the corporation of which he is a shareholder. It is inconceivable that AGSOC would become a lobbying force contrary to other basic interests of the residents of Alaska, simply because its stockholders would have ultimate control over AGSOC.

To be sure, as independent and privately owned capital is built into Alaskan residents, there will be less need for welfare and redistribution of income within the State of Alaska. The very theory upon which AGSOC is structured asserts that by enabling each resident to become, to whatever degree possible, economically autonomous and independent, such resident will be freed from the indignity of seeking welfare and other taxpayers will be freed from the unpleasant task of being forced to support strangers through taxation used for welfare purposes. These are "trade-offs" of a political and economic nature, but the underlying theory of AGSOC is that economic self-sufficiency through the ownership of income producing capital is preferable to welfare for some and redistributive taxes for others. We believe that this point should be clearly and thoroughly debated by the legislature and the question of whether the legislature prefers the prin-

ciple of capitalism or the principle of socialism should be determined.

3. THE SEVERAL PARAGRAPHS BEGINNING AT THE BOTTOM OF PAGE 4
UNDER SECTION II. FINANCING

It is represented in the memorandum that Louis Kelso testified before the Joint Committee and has stated to various Administration officials that AGSOC will be able to obtain financing on the private market without recourse to State guarantees or State credit. This is not, we believe, an accurate summary of my personal testimony and statements to various Committees and to various individuals in the legislature.

I have pointed out that in addition to start-up funding in order to make AGSOC an operating reality, it should then seek the best sources of funding available. Some investments, it is possible, can be acquired through collateral financing, or other conventional types of corporate finance. On the other hand, some investments may require support by the State or by some appropriate or appropriately created State agency. The important point to be focused upon in this area is that conventional corporate and business finance tends specifically to make the rich richer and to fail to make the poor richer. We do not see how it can be considered objectionable for the people of the State to use their collective power to assist the individual residents -- all residents at the outset and new residents as these grow in significant numbers -- by amendments to the State and federal legislation, or by the Alaskan State Legislature's specifically incorporating future AGSOCs -- AGSOC-I, AGSOC-II, etc.

The points made in the remainder of Section II should, of course, be considered by the legislature in the light of the existing Constitutional provisions and the existing State machinery for backing up an enterprise -- AGSOC -- that is a private corporation but whose activities will address themselves to the solution of a public problem. AGSOC is a device to carry into practice preventative economic measures to avoid future poverty and to improve future affluence for Alaskan residents as a whole. We submit that these are noble public purposes and that in considering the use of the power of the State to support investments made by AGSOC, all of the income of which is commanded to be distributed to the stockholders of AGSOC, the legislature should not impose administrative barriers that would prevent AGSOC from competing effectively with giant corporations for investments. Investments of AGSOC will benefit all the residents of Alaska whereas investments of the traditional giant corporations primarily benefit the pinnacle wealth owners, a few of whom may be Alaskan residents, but most of whom will be non-residents and perhaps even non-U.S. citizens.

For our part, it would seem that the wisdom of the legislature in appropriating particular funds that can be used as guaranty funds is adequate assurance of careful review by the legislature on behalf of the people as a whole.

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4. SECTION III. DEPOLITICIZING THE AGSOC BEGINNING ON PAGE 7

In general, it appears to us that the discussion here is made-up not of legal analysis primarily, but rather of political concerns.

In the first paragraph under this item is the statement that "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." We believe this is a misinterpretation of the federal law, which requires that a General Stock Ownership Plan be a private corporation even though its shareholders must include, at the outset, all residents of the State as of a date selected by the legislature and as of the date of the issuance of its stock.

We disagree with the unwarranted conclusion drawn in the paragraphs at the bottom of Page 7 and on Page 8, et seq. that, if successful, AGSOC would quickly become highly politicized and an extremely powerful force -- in fact a Fourth Branch of Government. If AGSOC were permitted to accumulate its net income and thus develop a vast reservoir of funds which it could spend as its Board of Directors saw fit, then these comments might be justified. But that is precisely what AGSOC is designed to avoid. Its income is promptly translated into the income of its broad base of stockholders. It is not designed to be a powerful entity for anyone except the people of the State as a whole. As the shareholders gain power, their power to control AGSOC, through election of directors and through the power, under general law, to initiate a suit to have questioned in court a misuse of funds by AGSOC, is, it would seem to us, an ironclad guaranty that AGSOC would never become a branch of government in any form.

Because of its very size, and its potential economic importance to the enormously broad base of Alaska residents, we do not believe the speculation that ultimately one-tenth of the residents could wind-up owning all of AGSOC. One very simple reason for this belief is that if the residents do not tenaciously hold on to their AGSOC stock, the legislature is free to incorporate successive new AGSOCs and to add assurances that they do keep their individual economic power and independence.

Thus we regard it as simply improbable and unfounded speculation that any "power blocks" of residents could be established or that, if established, they could not be controlled quite easily by stockholders' derivative litigation.

With the absolute necessity that for many if not most of its investments AGSOC will look to the economic power of the State, as determined by the legislature, to give it access to federal or private credit, we think that there is no basis for imagining that AGSOC could develop a constituency over which it has no control whatsoever. We also believe that since AGSOC must pay its income to its stockholders, and has no duty except to develop and produce wealth and to distribute

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it to those citizens, that the Board of Directors or the management of AGSOC could not become a political center or political leader of any kind whatsoever.

The last paragraph on Page 8 speculates that "Although one could argue that AGSOC violates the fundamental political theory of the State Constitution which established only three branches of government****. As noted above, AGSOC is not, and could never be under the proposed legislation, a branch of government of any kind whatsoever. It is an instrumentality created by the State, just as the State creates the laws under which business corporations in general can be established, but upon which the governments, State and Federal, have imposed limitations to assure that it will work for all residents -- all stockholders -- rather than for one, or a few, as present corporate giants do. Having made a false assumption that AGSOC could be a "Fourth Branch of Government", it is natural to speculate on all the dangers that would flow from this impossible situation. The recommendation for bureaucratic regulation appears to us to be totally unwarranted and would impede the potential efficiency of AGSOC to improve the economic status -- legitimately -- of all residents of Alaska. There is no virtue in bureaucratic regulation as such. The stockholders would annually vote on directors and upon all issues put to them by the Board or by stockholder initiative. A broader and more diversified base for AGSOC could hardly be conceived. The power of AGSOC is in its stockholders, not in its Board of Directors or its management.

Sight seems to have been lost of the fact that AGSOC is meticulously designed as the new method of financing economic growth and development for the purposes of attacking the cause rather than merely the effects of poverty. This is precisely what it is designed to do and precisely what it must do under its structural regulations. That is its purpose. Since AGSOC must pay out substantially all of its earnings to its shareholders, its sole function is to connect each resident with capital ownership and income. Could a more desirable goal be conceived?

5. BEGINNING AT THE BOTTOM OF PAGE 8 AND CONTINUING ONTO PAGE 9 OF THE MEMORANDUM

The problem is raised that members of the Board of Directors of AGSOC could use their position as a forum for criticizing the Administration's economic policies and ultimately as a launching pad for State elective office.

This is not a very real concern because the only official obligation of the members of the Board of Directors of AGSOC is to develop and produce Alaskan wealth for ownership by every Alaskan resident. When members of the Board of Directors periodically run for election as such, if they are incumbents, they do so on their performance record, as does any elected official, public or private.

The freedom of particular directors and/or officers of AGSOC to criticize the State's economic policies is nothing but the Constitutional right of all U.S. citizens to free speech. Precisely the reverse exists as well. The Governor, or any Committee of the legislature, is free to criticize the investments of AGSOC. It would appear to us that the absolute dependence from time to time of AGSOC upon specific legislative provision of economic support for its investments assures that any free speech that passes between the Board of Directors of AGSOC and any branch of the State Government will be tempered with these realities in mind.

Any activity within or without the State of Alaska could theoretically be a "launching pad" for public office. But AGSOC as an entity that makes every resident more affluent will increase the possible opportunities of every resident to run for State office, and to participate in local State and community affairs. This is a more democratic basis for the State than where only a few people can afford to run for office. Does Alaska want more or less democracy?

In the first full paragraph on Page 9 of the memorandum, it is suggested that AGSOC be prohibited from lobbying and from making political contributions to candidates for State offices. We would think it entirely proper that AGSOC be prevented from making political contributions out of its funds to candidates for State office. Indeed, since it must periodically come under the scrutiny of the entire legislature and the Governor, we find it difficult to imagine that such prohibition would not be voluntarily imposed upon itself. But nothing would be lost by including such limitations in the legislation.

However, we have grave reservations about "strict proxy review mechanisms" that would cause the directors to act in "a politically neutral fashion". AGSOC is not designed to act in a politically biased fashion, nor does its design so permit. It has one function: to make each resident wealthier and to deliver that wealth to him periodically and dependably. Nothing more. What the residents of Alaska do with their wealth would seem to us to be their business.

On general legal principles, it would appear to us that any stockholder of AGSOC could institute legal action to restrain AGSOC's Board from using the potential income belonging to the residents as stockholders for the benefit -- any benefit -- of the Board of Directors.

Only totalitarian states adopt edicts to shield bureaucrats from speaking freely, but AGSOC's single purpose assures the ease of its stockholders in holding it to the performance of its sole purpose.

6. CAN AGSOC BECOME A CENTER OF CONCENTRATED ECONOMIC POWER?

This question is raised at the bottom of Page 9 and on Page 10 of the memorandum. We believe that this is random and unrealistic

speculation.

It is quite true that because of the vastness of its stockholder constituency, AGSOC should seek to invest in massive and highly productive economic developments and activities. But it is not true that this can lead to its becoming a "major force for concentration of economic power in the State***". The design of AGSOC specifically makes this impossible for the very simple reason that it is required to pay out all of its income to its shareholders. That its shareholders will become more affluent, less dependent on redistribution of wealth, less dependent on welfare, and more powerful, is elementary. But this is the same as saying that its shareholders are the ones who have the power to scrutinize, correct, and contain any potential concentration of economic power in AGSOC.

The same is true of the risk that AGSOC may violate the Federal anti-trust laws. We have seen no lack of ability on the part of the Federal Anti-Trust Division to watch over this area of business activity. The periodic supervision by the legislature at the time it grants added support for any further investment by AGSOC assures that the State legislature itself can consider the question of whether any anti-trust monopoly action is involved. Certainly the absolute inability of AGSOC to accumulate internal funds defeats its power of ever exercising the main means by which business corporations violate anti-trust laws, namely by withholding the "wages of capital" from the owners of capital (the stockholders) and accumulating those funds to buy monopolistic power. Again, AGSOC is designed to make this impossible. We cannot conceive of the slightest need for any added limitations in this area.

We submit that the last sentence in the last paragraph on Page 10 of the memorandum, in itself, recognizes the improbability of the speculation involved in the preceding paragraphs. The fact that the stockholders of AGSOC and the people of the State are, and at all times will be identical, merely shows that AGSOC is, by its design, constrained through its broad ownership, and through the right of the legislature to launch any number of additional AGSOCs and to dry up its source of funding, designed to avoid any of the conflicts thus imagined.

Since the type of conflicts imagined in Pages 9 and 10 of the memorandum are unrealistic and cannot occur, the remedies proposed on Page 11 for this non-existent danger would seem to be entirely unnecessary. AGSOC's designed trust obligation -- to develop and produce wealth for all Alaskans -- assures that any wasteful or improper use of its resources could be enjoined by any of its stockholders under general principles of corporate law. The imagined problems simply do not and cannot exist, and if they did, they could be quickly restrained under these generally applicable legal principles.

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7. PAGE 11, SECTION IV. CORPORATE DEMOCRACY

That the existence of classification of directors would limit the ability of minorities within the State to obtain representation on the Board of Directors of AGSOC is, in our opinion, without foundation in fact. Board classification is desirable to promote stable policies in corporate matters. The possibility of an entirely new Board being elected each year would be highly undesirable. Board membership will be in a corporation charged with a trust to represent all the people of the State of Alaska.

On the question of cumulative voting, we do not see, in a corporation with a stockholder base as vast as that proposed for AGSOC, that there would be any advantage in insuring cumulative voting. On the other hand, we see no disadvantage in assuring that cumulative voting must exist.

On the question of limiting the duration of any voting trusts, made in the paragraph at the bottom of Page 12, it would appear to us that this suggestion is a good one.

Similarly, providing for shareholders to initiate amendments to the Articles of Incorporation would be desirable where a substantial shareholder initiative, say 10%, or even 5%, of the registered shareholders' signatures would be required. It would not be desirable to permit a tiny handful of stockholders to upset the efficiency of the corporation in making its day-to-day decisions.

8. DESIRABILITY OF A HIGH FORUM REQUIREMENT

This would seem to us to simply impose clumsy procedures on the State's prime weapon in building preventative economic power into its citizens, i.e., measures to prevent future poverty from arising. AGSOC will be under a constant obligation to educate its stockholder constituency about the economics of capitalism and will, of necessity, become a source of economic education because it will enable, for the first time in history, every Alaskan to become a capital owner. To go further than this would seem to be probably wasteful in terms of paperwork and a pointless waste of time.

9. LESIGLATION ASSURING ADEQUATE NOTICE OF MEETINGS

In the second paragraph on Page 14 of the memorandum, suggestions with respect to this are made. We would think this entirely proper if the restriction does not obstruct reasonably efficient governance of the corporation.

10. THE CORPORATE BY-LAWS

The memorandum suggests that the power to amend the By-Laws should be reserved to the shareholders "in order to ensure adequate public review." We believe that such a provision would be too expen-

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sive and too restrictive in terms of efficient governance of the corporation, and excessively wasteful of time.

11. AGSOC'S FINANCING OF PROXY FIGHTS, ACCESS TO VOTING LISTS AND VOTING MACHINERY

We believe that the suggestion made in Paragraph 8 on Page 14 would be salutary if the signatures of 10% or more of shareholders were required. Otherwise, the corporation could waste time dealing with mere adventurers.

12. SECTION V. PRIVATE CORPORATION: CLOSED CLASS OF SHAREHOLDERS

In this matter, covered on Pages 15 and 16 of the memorandum, we believe that the first paragraph on Page 15 is in error in stating that federal legislation mandates that the shareholder group in AGSOC be made up of a "closed class" in any realistic sense, for the simple reason that it imposes no limitation upon the number of AGSOCs which the Alaskan Legislature could authorize. Thus a longtime resident might well wind-up holding shares in ten or fifteen different AGSOCs, while those who depart the State would only own shares in those AGSOCs whose stock ownership qualifications they had previously met.

The "scenario" imagined by the author of the memorandum in the second paragraph on Page 15 is simply unrealistic. The preventative economic measures involved in establishing AGSOC that strike at the cause of poverty rather than merely at the effects of poverty hold more promise for eliminating poverty than all past measures, State and Federal, dealing with this subject, for those measures merely apply band-aids to the effects of poverty.

The problems imagined here are under year-to-year control by the legislature since AGSOC must be created by a separate act of the legislature. Other AGSOCs can be created at will by the legislature. Changes in the law concerning transferability of its stock can be made by the legislature if experience proves that such changes are warranted. It is contemplated that the full thrust of AGSOC's educational stockholder relations program will induce most stockholders to hold onto their shares as their dearest economic possessions.

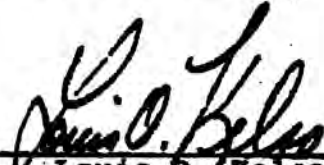
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We hope that the foregoing comments will be of use to your Committee in its deliberations. We would be pleased to respond to any requests for elaboration or to any questions.

Sincerely,

KELSO & CO., INCORPORATED

By


Louis O. Kelso

By


John A. Miskimen

LOK/JAM:ch

cc: The Honorable John G. Fuller,
Vice Chairman, State Affairs Committee
The Honorable Terry Gardiner,
State Affairs Committee
The Honorable Bill Parker
State Affairs Committee
The Honorable Terry Martin,
State Affairs Committee
The Honorable Ray H. Metcalfe,
State Affairs Committee
The Honorable Richard Eliason,
State Affairs Committee
Frances Ulmer, Director, Division
of Policy Development & Planning

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>

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

² The 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.

³ The 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.

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

⁵ Department 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%.

⁶ This 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.

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 therefore be amended as of January 1, 1980 to parallel the rest of the new criminal code.