

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECTS 86/2

916 SCOMM32: AK GENERAL STOCK OWNERSHIP CORP. 1979-80 916

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

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

[Footnote continued]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

^{19/} §§ 10.50.155 & 175.

^{20/} § 10.50.160.

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

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

[Footnote continued on following page]

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

II. FEDERAL TAXATION OF AGSOC AND AGSOC SHAREHOLDERS

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

[Footnote continued]

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

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

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

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

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

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

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

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

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

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

Taxation of Shareholders
at the Time of Distribution

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

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

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

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

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

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

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

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

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

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

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

Tax Consequences After the
Initial Distribution of Shares

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

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

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

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

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

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

Summary of Points
To Be Discussed with the IRS

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

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

- (1) Confirmation of our understanding of how Subchapter U will work, including
 - (a) AGSOC obligations to the IRS;
 - (b) AGSOC shareholder obligations to the IRS;
 - (c) The general type of reports IRS will desire from GSOCs and the types of regulations contemplated to be issued for GSOCs.
- (2) Confirmation that AGSOC as proposed in S. 170 will be viewed in conformance with Subchapter U, including
 - (a) That S. 170 is a sufficiently detailed "charter" within the meaning of 26 U.S.C. § 1391(a);^{30/}
 - (b) That the definition of "eligible individuals" conforms to Subchapter U requirements;

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

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

III. CONSTITUTIONAL ISSUES

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

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

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

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

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

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

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

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

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

[Footnote continued on following page]

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

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

[Footnote continued]

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

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

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

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September 17, 1979

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

Dear Representative Duncan:

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

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

Sincerely,

Samuel A Stern
Samuel A. Stern

cc: Mr. Dale E. Staley

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COMMITTEE

WILMER, CUTLER & PICKERING
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September 14, 1979

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

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

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

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

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

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

I. SECURITIES REGULATION OF AGSOC

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

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

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

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

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

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

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

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

Provisions of the
Securities Act of 1933

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

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

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

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

^{6/} This section exempts from registration:

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

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

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

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

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

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

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

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

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

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

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

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

[Footnote continued]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

^{19/} §§ 10.50.155 & 175.

^{20/} § 10.50.160.

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

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

[Footnote continued on following page]

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

II. FEDERAL TAXATION OF AGSOC AND AGSOC SHAREHOLDERS

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

[Footnote continued]

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

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

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

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

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

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

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

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

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

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

Taxation of Shareholders
at the Time of Distribution

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

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

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

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

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

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

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

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

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

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

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

Tax Consequences After the
Initial Distribution of Shares

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

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

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

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

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

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

Summary of Points
To Be Discussed with the IRS

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

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

- (1) Confirmation of our understanding of how Subchapter U will work, including
 - (a) AGSOC obligations to the IRS;
 - (b) AGSOC shareholder obligations to the IRS;
 - (c) The general type of reports IRS will desire from GSOCs and the types of regulations contemplated to be issued for GSOCs.
- (2) Confirmation that AGSOC as proposed in S. 170 will be viewed in conformance with Subchapter U, including
 - (a) That S. 170 is a sufficiently detailed "charter" within the meaning of 26 U.S.C. § 1391(a);^{30/}
 - (b) That the definition of "eligible individuals" conforms to Subchapter U requirements;

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

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

III. CONSTITUTIONAL ISSUES

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

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

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

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

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

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

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

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

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

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

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

[Footnote continued]

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

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

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

Wilmer, Cutler & Pickering
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JUDITH BARRY WISH
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Mr. Dale E. Staley
Legislative Budget and
Audit Committee
Alaska Legislature
Pouch V
Juneau, Alaska 99811

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

Dear Dale:

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

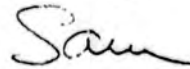
Also enclosed is a draft letter concerning these changes as well as a discussion of Alaska's law on conflict of interest which has been requested by the Staff. We ask you to clear these statutory changes and the draft letter in principle with the Committee. We will then forward the letter to the SEC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

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

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

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

Sincerely,

A handwritten signature in cursive script, appearing to read "Sam", written in dark ink.

Samuel A. Stern

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

January 22, 1980

MEMORANDUM FOR THE ALASKA
LEGISLATIVE BUDGET AND AUDIT COMMITTEE

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

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

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

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

a) Conflict of Interest

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

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

^{*/} The term is defined in section 2(a)(3) of the ICA:

"'Affiliated person' of another person means

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

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

[Footnote continued on following page]

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

[Footnote continued]

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

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

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

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

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

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

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

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

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

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

[Footnote continued on following page]

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

[Footnote continued]

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

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

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

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

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

b) Indemnification

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

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

c) Miscellaneous

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

(i) Stock Options

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

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

(ii) Later Issues

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

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

(iii) Payment Other Than Cash

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

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

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

(iv) Interested Directors

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

DIRECTOR CONFLICTS OF INTEREST

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

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

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

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

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

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

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

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

(v) Replacing Directors

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

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

(vi) Disqualification

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

be added, to follow § 10.50.260:

" INELIGIBILITY OF CERTAIN AFFILIATED
PERSONS AND UNDERWRITERS

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

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

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

(vii) Public Utility Holding Company Act

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

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

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

Wilmer & Pickering
WILMER & PICKERING

ATTACHMENT A

DRAFT
January 22, 1980

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

Paul Royce, Esq.
Division of Investment Management

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

Re: Request for Exemption for Alaska
General Stock Ownership Corporation

Dear Sirs:

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

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

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

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

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

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

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

DIRECTOR CONFLICTS OF INTEREST

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

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

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

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

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

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

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

further assure that any transaction carrying the potential for abuse will be the subject of focus by a disinterested board.

Thus, persons associated with the AGSOC will have few opportunities to profit personally and even less chance to do so successfully. In light of these circumstances, we feel application of section 17 of the ICA is unnecessary in the case of the AGSOC.

* * * * *

After consultation with us, our client has agreed to make certain other changes in the state legislation to satisfy your concern that the protections offered by the ICA are adequately dealt with in the state AGSOC legislation. Below is a list of changes we propose to CSSS Senate Bill No. 170:

1. Add a new provision after § 10.50.015 as follows:

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

2. Act § 10.50.015(15) - Amend the section to read as follows:

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

3. Act § 10.50.020(f) - Delete.

4. Act § 10.50.080 - Amend the second sentence to read as follows:

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

5. Act § 10.50.085 - Amend the first sentence to read as follows:

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

6. Act § 10.50.195 - Amend so that the first sentence reads:

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

7. Add new provision after § 10.50.260, as follows:

" INELIGIBILITY OF CERTAIN AFFILIATED
PERSONS AND UNDERWRITERS

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

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

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

We hope this submission is helpful in your review of our exemption application. Please feel free to call on us should other questions arise.

Sincerely,

Samuel A. Stern

Appellant alleges that error was committed when evidence of the value of the property in dispute, supplied by the records and testimony of a tax assessor, was admitted.

It is pointed out by appellant, there is a difference of opinion among the various jurisdictions¹⁶ as to whether such evidence should be admitted. The testimony of the tax assessor was that the taxing district regularly assessed at 100 per cent of value based upon a record of comparable sales in the area within the preceding two years.

[9] Appellant has not shown how or why this testimony was unreliable with respect to the value of the property or how its admission prejudiced his case in any particular. The basis employed in arriving at the valuation was sound. The evidence had probative value and should have been admitted. No error was committed.

The trial court, over objection, permitted counsel for appellee to question appellant in detail concerning his military record, the nature of his discharge, wounds received while in the service, the degree of disability thereby created, the amount of a government pension received by appellant and appellee's inability to obtain employment because of his wounds and disability. Admission of this testimony is asserted as error.

Appellant's first objection was overruled, presently on the ground that appellee's physical ability to earn money was material to the determination of the issues. Second objection was overruled on the ground that the evidence was necessary to carry out the intent of the parties.

[10-11] We hold that no error was committed. The financial condition of the parties in a suit of this nature is a relevant factor to be considered.¹⁷ So also

may his physical ability to earn be relevant and material.

[12] Appellant's allegation of error committed in admitting certain exhibits is not briefed sufficiently to be readily understandable and will not be considered.

The findings of fact, conclusions of law and judgment are set aside and the case remanded for retrial.



ALVEST, INC., Appellant,

v.

SUPERIOR OIL CORPORATION, Appellee.

No. 503.

Supreme Court of Alaska.

Jan. 21, 1965.

Proceeding on appeal from a judgment of the Superior Court, Third Judicial District, Ralph E. Moody, J., affirming decision of state division of lands cancelling award to corporation which had been awarded first priority at noncompetitive oil and gas lease drawing. The Supreme Court, Dimond, J., held that fact that two officers of corporation filed applications for themselves in non-competitive oil and gas lease drawing conducted by state division of lands when corporation itself had filed application violated administrative regulation providing that each applicant shall have only one chance in any one drawing, and division of lands properly cancelled award to corporation which had been awarded first priority at drawing.

Judgment affirmed.

¹⁶ See 5 Wigmore, Evidence § 1640 (3d ed. 1940) for a discussion of the subject and tabulations of the holding of the various jurisdictions.

¹⁷ *Emmons v. Emmons*, 217 Miss. 504, 64 So.2d 753, 755 (1953).

1. Corporations ⇨307

Corporate officer or director stands in fiduciary relationship to his corporation.

2. Corporations ⇨310(1)

Out of fiduciary relationship between corporate officer or director and corporation arises duty of reasonably protecting interests of corporation.

3. Corporations ⇨315

It is inconsistent with and breach of duty of corporate officer to reasonably protect interests of corporation for officer or director to take advantage of business opportunity for his own personal profit when, applying ethical standards of what is fair and equitable in particular situation, opportunity should belong to corporation.

4. Corporations ⇨315

Where business opportunity is one in which corporation has legitimate interest, officer or director may not take opportunity for himself, and if he does, he will hold all resulting benefit and profit in his fiduciary capacity for use and benefit of corporation.

5. Corporations ⇨315

Whether business opportunity is corporate one or one within legitimate scope of individual interests of officer or director depends on facts and circumstances of each case.

6. Mines and Minerals ⇨5

Fact that two officers of corporation filed applications for themselves in non-competitive oil and gas lease drawing conducted by state division of lands when corporation itself had filed application violated administrative regulation providing that each applicant shall have only one chance in any one drawing, and division of lands properly cancelled award to corporation which had been awarded first priority at drawing.

7. Mines and Minerals ⇨5

Administrative regulation providing that each applicant in noncompetitive oil and gas lease drawing should have only one chance in any one drawing would not have precluded corporation from making success-

ful claim for lease or its benefits against corporate officers who filed applications for themselves had either been successful at drawing.

8. Corporations ⇨315

In absence of shareholder approval, business opportunity involving application by corporate officers, as individuals and for themselves, in noncompetitive oil and gas lease drawing conducted by state division of lands was not within legitimate scope of individual interests of officers where corporation itself had filed application.

9. Corporations ⇨315

Showing of bad faith is not essential to establish duty on part of officers or directors of corporation in connection with business opportunities which they wish to acquire for themselves, and fact that business opportunity is of such nature that under particular circumstances it should fairly belong to corporation is sufficient to establish duty on part of officer or director to acquire opportunity for corporation.

Clifford J. Groh and Ronald G. Benkert, Groh & Benkert, Anchorage, for appellant.

Paul F. Robison, Robison, McCaskey & Lewis, Anchorage, for appellee.

Before NESBETT, C. J., and DIMOND and AREND, JJ.

DIMOND, Justice.

Appellant was awarded first priority for an oil and gas lease at a non-competitive lease drawing conducted by the state Division of Lands. Appellee was given second priority. Later the Division of Lands cancelled the award to appellant and gave it to appellee for the reason that two of appellant's officers and directors, White and Mueller, had filed applications for themselves in the same drawing. The Division of Lands held that this action on the part of White and Mueller gave appellant more than one chance at the drawing in violation

of an administrative regulation provided:

"Each drawing shall be such a manner as to determine only one

The superior court of the Division of Lands allowed.

[1-4] A corporation stands in a fiduciary relationship to its shareholders. The duty of a corporation to its shareholders is to protect their interests of the corporation with and a business opportunity for the corporation when, applying ethical standards of what is fair and equitable in particular situation, the opportunity should belong to the corporation. Where one in which the corporation has a legitimate interest, the officer or director may not take the opportunity for himself, and if he does, he will hold all resulting benefit and profit in his fiduciary capacity for use and benefit of the corporation.

[5, 6] Where a corporation has a legitimate interest in a business opportunity, the officer or director may not take the opportunity for himself, and if he does, he will hold all resulting benefit and profit in his fiduciary capacity for use and benefit of the corporation.

1. 11 Alaska
2. Diedrick v. N.W. 2d 91 (1948); L. v. Loft, Inc. 510 (1939) U.S.App.D. (1935).

of an administrative regulation which provided:

"Each drawing shall be conducted in such a manner as the Director shall determine and each applicant shall have only one chance in any one drawing."¹

The superior court affirmed the decision of the Division of Lands and this appeal followed.

[1-4] A corporate officer or director stands in a fiduciary relationship to his corporation. Out of this relationship arises the duty of reasonably protecting the interests of the corporation. It is inconsistent with and a breach of such duty for an officer or director to take advantage of a business opportunity for his own personal profit when, applying ethical standards of what is fair and equitable in a particular situation, the opportunity should belong to the corporation. Where a business opportunity is one in which the corporation has a legitimate interest, the officer or director may not take the opportunity for himself. If he does, he will hold all resulting benefit and profit in his fiduciary capacity for the use and benefit of the corporation.²

[5, 6] Whether a business opportunity is a corporate one or one within the legitimate scope of the individual interests of the officer or director depends upon the facts and circumstances of each case.³ Here appellant's chance to be the successful applicant at the lease drawing was a business opportunity in which appellant had expressed a definite interest. That interest was a legitimate one because appellant had made similar applications in previous drawings, and the leasing of oil and gas lands was

within the scope of appellant's corporate activities. This was a corporate opportunity which appellant's officers and directors, White and Mueller, had no right to seek for themselves. If either had been the successful applicant at the drawing he would have held the lease in a fiduciary capacity for the use and benefit of appellant. This means that appellant did not have only one chance at the drawing, but three—its own, represented by the corporate application filed on its behalf, plus two additional chances, represented by White's and Mueller's individual applications. Since appellant had more than one chance in the drawing, it was not a qualified applicant under section 507.31 of the administrative regulations. The Division of Lands was correct in holding that appellant was not entitled to the lease.

[7] Appellant argues that it had only one chance at the drawing, because the regulation would have precluded appellant from making a successful claim for the lease or its benefits against White or Mueller had either been successful at the drawing. This argument is untenable. The regulation deals with the element of chance. When a lease drawing has been concluded and the successful applicant known, the element of chance is gone. What had been chance has now become something certain. The regulation pertains only to the situation which exists while the element of chance is present, and not afterwards. The regulation would have no pertinency in an action by a corporation claiming that one of its officers or directors held a lease as constructive trustee for the corporation. What the rights would be as between those parties

1. 11 Alaska Adm. Code § 507.31 (1964).

2. *Diedrick v. Helm*, 217 Minn. 483, 14 N.W.2d 913, 919, 153 A.L.R. 649 (1944); *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 80 N.E.2d 522, 527, 529 (1948); *Lutherland, Inc. v. Dahlen*, 357 Pa. 143, 53 A.2d 143, 147 (1947); *Guth v. Loft, Inc.*, 23 Del.Ch. 255, 5 A.2d 503, 510 (1939); *McKay v. Wahlenmaier*, 96 U.S.App.D.C. 313, 220 F.2d 35, 45-46 (1955).

3. *American Inv. Co. v. Lichtenstein*, 134 F.Supp. 857, 861 (E.D.Mo.1955); *Industrial Indem. Co. v. Golden State Co.*, 117 Cal.App.2d 519, 256 P.2d 677, 686-687 (Dist.Ct.App.1953); *Johnston v. Greene*, 35 Del.Ch. 479, 121 A.2d 919, 923 (1956); *Guth v. Loft, Inc.*, 23 Del.Ch. 255, 5 A.2d 503, 511-515 (1939); *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 80 N.E.2d 522, 528-529 (1948); *Henn, Corporations* § 228, at 372 (1961).

would not be governed by the regulation. The regulation would be relevant after a drawing had been concluded only insofar as it was established that before the drawing took place an applicant had had more than one chance to be successful. If that is established, then the regulation can be invoked to disqualify such an applicant from securing the lease. That is what was done here.

[8] Appellant contends that it could not have claimed the benefits of the lease had it been awarded to White or Mueller, because a full disclosure of their actions in filing their individual applications had been made to the corporation, and because the filing of applications by appellant's officers and directors was consistent with corporate policy. There was evidence that the members of appellant's board of directors had generally approved the appropriateness of officers and directors filing on the same land that the corporation had filed on, although it was not established that this in fact had ever been done prior to the filings in this case. But there was no evidence that the shareholders of the corporation had consented to such a policy generally, or that in this particular instance they had approved White's and Mueller's actions in filing in competition with appellant. In the absence of such approval by the shareholders, the business opportunity in this case was not within the legitimate scope of the individual interests of appellant's officers and directors.⁴

[9] Appellant states that White and Mueller had at all times been open and above board and had acted in good faith in all their dealings here. That is apparently true. But it has no bearing on the decision of the issues in this case. A showing of bad faith is not essential to establish a duty on the part of officers or directors in connection with business opportunities which they wish to acquire for themselves.

4. In re Lerch's Estate, 390 Pa. 59, 159 A.2d 506, 513 (1960); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App.2d 405, 241 P.2d 66, 74-75 (1952).

The fact that a business opportunity is of such a nature that under the particular circumstances of the case it should fairly belong to the corporation is sufficient to establish a duty on the part of an officer or director to acquire the opportunity for the corporation.⁵

The judgment is affirmed.



WRIGHT TRUCK AND TRACTOR
SERVICE, INC., Appellant,

v.

STATE of Alaska, Appellee.
No. 525.

Supreme Court of Alaska.
Jan. 21, 1965.

Action on construction contract against the state. The Superior Court, First Judicial District, James A. von der Heydt, J., entered judgment for contractor for \$285,933.17 plus costs but disallowed claim for interest between date when sums became due and date of formal entry of judgment, and contractor appealed. The Supreme Court, Nesbitt, C. J., held that state was not liable for interest between date sums became due and date of entry of judgment, under statute providing in effect that judgment entered for plaintiff against state shall be for legal amount found due with interest only from date of judgment.

Affirmed.

1. States $\Rightarrow$ 171

Legislature intended to preclude interest on all claims, not just tort claims, against state prior to judgment. Laws 1957,

5. Rosenblum v. Judson Engineering Corp., 99 N.H. 267, 109 A.2d 558, 563 (1954).

c. 170, § 1 c
c: seq.; AS

2. States $\Rightarrow$

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Michael M.
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Phone Conversation w/

10-15

Sam Stern W+P 202-872-6000 2:45

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Contract - they are subject entirely to our direction

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EZEKIEL G. STODDARD
DONALD F. TURNER
COUNSEL

January 22, 1980

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

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

Dear Dale:

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

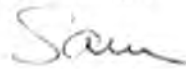
Also enclosed is a draft letter concerning these changes as well as a discussion of Alaska's law on conflict of interest which has been requested by the Staff. We ask you to clear these statutory changes and the draft letter in principle with the Committee. We will then forward the letter to the SEC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

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

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

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

Sincerely,



Samuel A. Stern

cc: Mr. Jerry Gauche
Mr. Jay Hogan

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

January 22, 1980

MEMORANDUM FOR THE ALASKA
LEGISLATIVE BUDGET AND AUDIT COMMITTEE

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

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

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