

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672

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

EXECUTIVE SUMMARY

The Potential Problem

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

When Can It Occur

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

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

Shareholder Protection

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

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

Conclusion

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

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

THE POTENTIAL PROBLEM

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

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

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

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

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

WHEN CAN THE PROBLEM OCCUR

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

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

Non-deductible Expenditures

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

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

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

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

Taxable Income Without Cash Flow

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

Depreciation Recapture

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

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

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

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

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

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

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

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

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

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

Investment Tax Credit Recapture

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

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

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

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

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

Installment Sales

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

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

PROTECTION FOR SHAREHOLDERS

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

The Election

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

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

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

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

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

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

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

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

the special tax status subsequent to that date.

Management

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

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

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

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

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

Termination of Election

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

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

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

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

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

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

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

Revocation of Charter

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

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

CONCLUSION

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

ALASKA
GENERAL STOCK OWNERSHIP
CORPORATION

HOUSE STATE AFFAIRS COMMITTEE
Committee Action to April 27, 1979

BILL SUMMARY

ALASKA GENERAL STOCK OWNERSHIP CORPORATION

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

FORMATION OF THE AGSOC

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

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

AGSOC SHARES

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

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

SHAREHOLDER POWERS

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

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

DIRECTORS AND OFFICERS

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

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

OTHER PROVISIONS

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

SECTION BY SECTION ANALYSIS

This analysis of Committee action on the Alaska General Stock Ownership Corporation legislation describes the provisions of Section 1 of the Committee bill as of April 27, 1979. Since many of the provisions of the Committee Substitute are carried over wholly or in part from the Alaska Business Corporations Act (ABCA) there is included at the end of each section description a reference to the corresponding section of the ABCA, if any.

ARTICLE 1. SUBSTANTIVE PROVISIONS.

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

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

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

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

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

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

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

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

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

- .095. EXPENSES OF ORGANIZATION, REORGANIZATION AND FINANCING. In sales of stock by a corporation shares entitled to the full protections of limited liability must be fully paid and nonassessable. This means that the full sales price for the stock has been received by the corporation. However, if the stock is sold through an underwriter the fees will come out of the sales proceeds before they are paid to the corporation. Likewise, the organizational expenses of the corporation may be paid out of stock sales before the proceeds are remitted to the corporation. This section clarifys that in such cases the shares are deemed to be fully paid. (AS 10.05.111).
- .100. CERTIFICATES REPRESENTING SHARES. This provisions sets out the requirements as to form of stock certificates which must be signed by the corporate officers. (AS 10.05.114)
- .105. INFORMATION REQUIRED TO BE STATED ON CERTIFICATE. The stock certificates or other evidences of ownership must include information regarding the person to whom they are issued, that they are no par value shares, and that the corporation is organized in Alaska. (AS 10.05.117).
- .110. FULL PAYMENT REQUIRED FOR CERTIFICATE. If payment is required for shares they may not be issued until full payment is received. (AS 10.05.120).
- .115. ISSUANCE OF FRACTIONAL SHARES. GSOCs may issue fractional shares of stock and these fractional shares hold dividend, voting and distribution rights equal to their fractional interest. It may be necessary for a GSOC to issue fractional shares in the situation where a shareholder leaves his stock to his heirs and there is more than one child beneficiary. (AS 10.05.123).
- .120. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS. This section, adopted directly from ABCA, limits the liability of shareholders and those who have agreed to purchase share to the amount which they agreed to pay to the corporation for the shares. Subsequent holders of the stock are protected if they received the stock in good faith. (AS 10.05.126).
- .125. BYLAWS. The board of directors adopts the initial bylaws of a GSOC subject to review and rejection by the legislature under section 335 of the bill. Subsequent bylaws may be adopted, amended or repealed by a vote of either the shareholders or directors.
- .130. MEETINGS OF SHAREHOLDERS. The time and location of the annual shareholders meeting is established in the bylaws. The specific place is set by the board. Special shareholder meetings may be called by the president of the GSOC, the board or the holders of at least 1,000 shares. Shareholder meetings may be teleconferenced. (AS 10.05.138).

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

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

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

Shareholders may, by petition of 1,000 or more, nominate directors and place issues on the corporate ballot. In addition, the directors may place issues and candidates on the ballot by a majority vote. Information on board candidates and ballot issues is to be provided to the shareholders by the corporation and these materials will be filed with the Commissioner of Commerce and subject to the regulations and criminal penalties applicable thereto.

- .180. BOARD OF DIRECTORS. The board of directors is charged with management responsibility for the corporation and their compensation is to be fixed in the bylaws. The chairman and at least 3/4 of the board must be residents of Alaska insuring that outside directors may never constitute a quorum of directors except when meeting to fill vacancies in directors seats until the next shareholder meeting. Officers or employees of the corporation may not serve on the board of directors. (AS 10.05.174).

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

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

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

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

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

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

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

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

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

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

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

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

If the average pretax income plus interest expense for the two preceeding fiscal years is not at least equal to the average interest expense for those years the current assets must be at least $1\frac{1}{2}$ times current liabilities.

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

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

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

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

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

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

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

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

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

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

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

- .300. SHAREHOLDERS' DERIVATIVE ACTION. Shareholders may file suit on behalf of the corporation if those responsible inside the corporation fail to do so. Alaska Supreme Court Rule 23.1 provides for such an action, but does not specify treatment of security for expenses and other details. This section allows the court discretion to require security for expenses incurred in the prosecution of the suit. The court must approve of any settlement to insure that those prosecuting the suit are not simply bought off. The proceeds of any successful action or settlement must be accounted for to the court which may authorize reasonable expenses to the parties.
- .305. FRAUDULENT TRANSFERS OF SHARES. Transferring or obtaining shares of the corporation by fraud is a felony.
- .310. POLITICAL ACTIVITIES. GSOCs may not endorse candidates or ballot issues nor spend money in support or opposition of either. They are also prohibited from spending any monies to lobby the legislature. Violations are a misdemeanor punishable by a jail term and a \$10,000 fine.

ARTICLE 2. FORMATION OF CORPORATIONS.

- .315. INCORPORATORS. Incorporators are those persons who file the articles of incorporation to begin the corporation's existence. This must be done by at least three people over the age of 18. (AS 10.05.252).
- .320. ARTICLES OF INCORPORATION. This section sets out the minimum requirements of the articles of a GSOC including the provisions required by subchapter "U" of the Internal Revenue Code that the corporation have only one class of stock, issued only to individuals, with the right to elect not to receive a share, and subject to transfer restrictions for five years. Other provisions are carried over from the ABCA. (AS 10.05.255).
- .325. FILING OF ARTICLES OF INCORPORATION. Articles of incorporation are to be filed with the Commissioner of Commerce who shall certify the filing and return one original of the articles to the corporation. (AS 10.05.258).
- .330. EFFECT OF ISSUANCE OF CERTIFICATE OF INCORPORATION. Upon issuing the certificate corporate life begins. (AS 10.05.261).
- .335. ARTICLES OF INCORPORATION AND INITIAL BYLAWS. The articles and initial bylaws must be submitted to the legislature within 30 days of issuing the certificate of incorporation and, if not disapproved within 60 legislative days by concurrent resolution, they are approved. Legislative disapproval may not abrogate any contract obligations of the corporation and may be overridden by a shareholder vote.

- .340. ORGANIZATION MEETING OF DIRECTORS. The incorporators shall call an organizational meeting of directors in the state for the purpose of adopting bylaws, electing officers and conducting other business necessary to the organization of the corporation. (AS 10.05.267).

ARTICLE 3. APPLICATION FOR SHARES.

- .345. NOTIFICATION OF ELIGIBLE SHAREHOLDERS. Since stock is to be distributed free of charge initially all Alaska residents must be notified of its availability. This section sets out the minimum notice requirements of weekly broadcast and publication for at least three month before stock distribution and monthly broadcast and publication for eleven months after distribution. These are minimum requirements only and the board of directors may determine that the corporation should take other steps to identify and notify potential shareholders.
- .350. CORPORATION NOT LIABLE TO SHAREHOLDERS. Although GSOCs are required to take reasonable steps to notify potential shareholders of their right to stock the burden of applying for stock lies with the resident and the corporation is not liable for failure to notify or issue stock to a potential shareholder. If a resident makes application for stock after the distribution of one or more dividends he loses his right to those dividends and is entitled to receive only those dividends declared and paid after the date upon which his stock was issued to him.
- .355. LATE APPLICATION FOR SHARES. Any individual who is eligible to receive an initial distribution of shares but who fails to apply for issuance of stock may be issued a share without charge at any time within one year of the original issue. The one year period coincides with the period during which a shareholder may elect not to receive his stock and have his share cancelled. For one additional year a person who would have been eligible to receive an initial share but did not get one may purchase his share at book value. Original issue is cut off completely after the two year period.
- .360. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER. The superior court is given jurisdiction to void stock issued to an ineligible individual who obtained his shares by fraud and allows the corporation to recover any distributions paid to such a shareholder.

ARTICLE 4. AMENDMENT.

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

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

ARTICLE 5. SALE OF ASSETS.

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

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

ARTICLE 6. DISSOLUTION.

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

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

A GSOC may be dissolved involuntarily by the Commissioner of Commerce with 60 days notice for failure to file reports or pay fees, failure to maintain a registered agent or office or change either without notice, and unfilled board vacancies continuing beyond the allowable time (.530). A corporation can be reinstated within two years upon remedy of the violation.

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

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

- 1) A shareholder where the board is deadlocked; the board is action in an illegal, oppressive, or fraudulent manner; the shareholders are deadlocked for two annual meetings; or, the corporation's assets are being misapplied (.545).
- 2) A creditor when the creditor's claim is unsatisfied and the corporation is insolvent (.550).
- 3) The corporation upon request to have a voluntary dissolution continued under court supervision (.555).
- 4) The Attorney General in conjunction with a suit for dissolution (.560).

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

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

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

ARTICLE 7. GENERAL PROVISIONS.

- .625. AS 10.05 INCORPORATED BY REFERENCE. In order to reduce duplication this section incorporates by reference Sections .699 through .819 of ABCA (AS 10.05.699 - .819). These sections deal with requirements for annual reports to be filed with the Commissioner of Commerce, filing fees and charges, procedural provisions and forms, and powers of the Commissioner of Commerce.
- .630. FALSE STATEMENTS AFFECTING VALUE OF SHARES. An agent of a corporation who makes fraudulent statements regarding the value of shares is guilty of a misdemeanor.
- .635. DIRECTOR MAKING UNLAWFUL DIVIDEND OR DISTRIBUTION OF ASSETS. A director who concurs in a distribution designed to deceive creditors or shareholders is guilty of a misdemeanor.
- .640. RESERVATION OF POWER. Amendments to this chapter apply to all existing and future corporations organized under it, but an amendment may not abrogate the contractual obligations of any corporation.
- .645. DEFINITIONS. Many of the definitions in this section are carried over from ABCA and may also be found in AS 10.05.825. However, there are two significant new definitions:
- Certificate as used in the context of "stock certificate" may mean something other than the actual certificate such as a receipt evidencing ownership. This definition has been broadened in order to allow for the possibility that the stock certificates themselves may never be issued, but that the stock records may be kept by the corporation itself as the evidence of ownership in a particular shareholder which ownership would be represented in the hands of the shareholder by a receipt. Such a receipt would be required to carry all the same information as is required on the certificate itself.
- Resident is defined as a person who lives in Alaska and intends to remain here permanently. The definition allows for temporary travel or employment outside without loss of residency. If a dispute arises over residency all of the facts and circumstances indicative of permanent residency must be considered.

AN ANALYSIS OF THE TWO-FACTOR
THEORY AS APPLIED TO ALASKA
IN PROPOSALS FOR AN ALASKA
GENERAL STOCK OWNERSHIP
CORPORATION

Prepared for the House Finance Committee
under contract with
The Division of Legislative Finance

by Mike Doogan

March 9, 1979

Introduction

Legislative proposals (SSSB170 and SSHB240) to establish an Alaska General Stock Ownership Corporation (AGSOC) are best understood if considered in two parts. First is the economic theory underlying the proposals; second is the mechanics of the proposals themselves. This report attempts to examine both parts.

Examination of the economic theory underlying the AGSOC proposals can help policy makers decide if an AGSOC ought to be created, while examination of the mechanics of the proposals can help them decide if an AGSOC can be created. Logic dictates that the theory be examined first, the mechanics second.

Part 1: Economic Theory Underlying The AGSOC

The Two-Factor Theory

There can be no argument that Louis Kelso holds patent to the economic theory that underlies proposals for the creation of an AGSOC. This theory is dubbed by Kelso the two-factor theory of economics.

Throughout his writings on capitalism¹, Kelso argues that the one-factor (labor) theory of economics² does not

¹ This analysis is based on a reading of Kelso's The New Capitalists and Design of an Alaskan General Stock Ownership Plan, Volume I.

² The one-factor theory holds that all wealth is created by labor. Its most rigid application is found in the writings of Karl Marx.

properly describe an industrialized economy. Instead, Kelso posits a two-factor theory, those factors being labor and capital.³ The gulf between the continuing belief in one-factor economics and the reality of two-factor economics, Kelso says, is responsible for a growing imbalance in the United States economy. To describe the situation in Kelso's own words:

"Two facts must be kept in mind. The first is that capital produces at least 90 percent of the gross national product in our economy; yet all but a small fraction of the capital instruments are owned (for the most part indirectly through share ownership) by 5 percent of the households of the economy. The second fact is that in spite of this concentration of apparent ownership, 70 percent of the income currently produced is distributed through labor."⁴

³ Throughout his analysis, Kelso uses the term capital to encompass capital investment (money diverted from the consumer economy to finance production), capital instruments (stocks, etc., purchased with capital investment), and capital goods (factors of actual production, excluding labor, purchased with capital investment through capital instruments). Simply put, capital is wealth devoted to productions rather than consumption.

⁴ The New Capitalists, by Louis O. Kelso and Mortimer J. Adler, Greenwood Press, Westport, Conn., 1961, p.5.

Kelso's two facts actually are three, and these three facts, Kelso argues, create an economic problem that must be solved.

Fact #1: Capital produces an increasing share of wealth

This is occurring, Kelso says, through technological change. Technology is both purchased with capital (capital investment and instruments) and a part of capital (capital goods). As machines perform more and men less, the proportionate share of wealth produced by labor is decreased. Thus, the value of labor declines.

This becomes a part of the economic problem because, as we shall see below, most Americans have only the value of their labor on which to subsist. This dictates that labor must be compensated at an artificial, pre-technological level.

Fact #2: Capital is concentrated

The ownership of capital is concentrated in the hands of a few, according to Kelso, because of a structural bias against risk.

Capital formation (the acquisition of capital investment to purchase capital goods) commonly occurs, he says, through borrowing. A borrower used debt to acquire a wealth-producer (a capital good, such as an expanded plant, a new business, etc.). The wealth produced is used to retire the debt, leaving the borrower to enjoy all the wealth produced after the debt is retired.

This process, Kelso argues, contains a structural bias against risk. Lenders want to be repaid regardless of the success of the wealth producer acquired with their money. So, lenders lend to those who already have enough wealth to repay even if the wealth producer acquired with the borrowed money goes belly up.

In short, it takes money to make money.⁵

Fact #3: Labor receives more wealth than it produces

As note above, Kelso argues that technological change is decreasing labor's share of wealth production. But, because capital is closely held, most Americans continue to gain their income only, or primarily, from their labor.

Thus, to avoid wide-spread poverty, labor must be compensated at a level above its level of wealth production. This is done, Kelso says, one of two ways.

First, labor increasingly is being compensated for its attendance at the scene of production, rather than its actual part in productions. Simply put, men are paid to show up and watch machines produce wealth.

Second, government transfers wealth from capital to labor. Government taxes capital-produced wealth and transfers that wealth to labor. These transfer payments, Kelso says, are made under a variety of guises: make-work

⁵Throughout his analysis, Kelso assumes that individual capital and corporate capital act the same way in the economy.

projects, social security payments, unemployment compensation, welfare payments, and so forth.⁶

Problems with the economy

These inter-related facts point to a fundamental problem in the United States economy: the economy is disfunctional because the means of acquiring real wealth are available to a few while the many subsist on artificial, transferred wealth.

The need to transfer wealth has changed the United States economic system from capitalism to a mixture of capitalism and socialism, Kelso argues. At the same time, Kelso says, the perception of the economy has not changed to match the facts.

Breaking this down further, we find what could be called the problem's symptoms.

First, the artificial compensation of labor is inefficient, making U.S. products non-competitive in world and domestic markets.

Second, although Kelso does not stress this, transfer payment distribution methods are inefficient, creating growing bureaucracies.⁷

⁶ Kelso's analysis does not directly address two other elements of taxation: the financing of so-called public goods and the compensation through transfer payments of existence as opposed to the compensation of labor.

⁷ These bureaucracies might themselves be considered make-work projects, thus becoming recipients as well as providers of transfer payments.

Third, those who are compensated beyond their labor's worth are degraded. This is caused, Kelso says, by the historical identification of a man's labor value with his personal value.

Finally, the United States is moving away from the fulfillment of the capitalist dream, instead of toward it.

The two-step solution

Solving these problems requires two steps be taken, Kelso asserts.

First, we must realize that the one-factor theory is wrong. If we were to do this, Kelso argues, we could see that full employment is not a proper economic goal. Rather, Kelso says, unemployment is a proper goal of an industrialized economy because labor is an inefficient method of wealth production.

Second, we must follow this realization with actions designed to transfer the income of the many from labor to capital. This will allow unemployment without poverty, eliminate the need for transfer payments and restore the economy to its capitalist beginnings.

This change from labor value to capital value is, Kelso argues, both morally and practically necessary if the United States economy is to survive and compete in the modern world.

Financed capitalism

Kelso simply asserts the necessity to change our view of the economy, but he creates the method of capitalist income transfer. He calls this method financed capitalism. Its goal, in Kelso's own frighteningly mechanistic phrase, is to build capital into more Americans.

All that financed capitalism really requires is allowing more Americans access to borrowing for capital formation. Kelso has created a variety of methods to allow this access, all dependent on risk pooling and tax advantages. In short, Kelso doesn't really want to change the basic system of capital formation; he merely wants to adapt it to serve more Americans.

Kelso's specific proposal for Alaska, the AGSOC, will be discussed in detail in Part 2 of this report.

Some Alaskan questions

The basic question is how well Kelso's theory applies to Alaska. Specifically:

Is capital producing an increasing share of wealth in Alaska?

Is capital concentrated in Alaska?

Is labor receiving more wealth than it produces?

Answers to the first and third questions require the performance of extensive statistical analysis on Alaska's economy. Without such analysis policy makers can only assume that, since

the Alaska economy is a part of the larger national economy, the answers is "yes" to both questions.

Common sense tells us that a partial answer to the second question is "yes", too. Some Alaskans are wealthier than others.

But such an answer ignores real questions about the continued existence of entrepreneurs in Alaska, long after entrepreneurs have ceased to be a major force in the rest of the U.S. economy. This, too, needs to be properly analyzed.

Finally, a blanket "yes" answer to these questions ignores the singular peculiarity of the Alaska economy: the existence of vast amounts of public capital.

This capital is in the form of resources, held by the state for its citizens.⁸ Traditionally, this capital has been rented to the private sector for development. The private sector used its own capital, acquired much as Kelso describes, to develop the resource.

The rent paid is in two forms. The first, which fits the Kelso analysis, is taxes, paid to the state as a government. Resource taxation is no different than any other form of taxation in its philosophical bases.

⁸ A full explanation of this phenomenon would require a book. Suffice it to say that the peculiar circumstances of Alaska at the time it became a state have led to this peculiarity in Alaska's economy.

But, the second form of rent is vastly different. This is the rent paid to the state as an owner of the resource: bonus, royalty, least rental, etc. To emphasize the point: this second form of rent is paid to the state as though it were being paid to all Alaskans.

Both morally and practically, Alaskans already own vast amounts of capital. The Alaska question is not how to make capitalists of the state's citizens, to which the AGSOC may or may not be the answer. Rather, the Alaska question is how to grant control of existing capital to its real owners.⁹

Because of this Alaska peculiarity, the state's residents don't really need the transfer benefits¹⁰ of the AGSOC. Without these benefits, the AGSOC becomes one of a number of potential distribution methods, ranging from the state budget to dividing the resources into equal shares and giving them to Alaska residents.

Thus, Part 2 of this report will consider the AGSOC simply as a method of distributing capital already owned by Alaskans.

⁹ Actually, there are two, inter-related questions: how do we maximize the return (rent) for our capital (resources) and how do we most efficiently distribute that return to its real owners.

¹⁰ These benefits are mainly tax advantages. In this sense, the AGSOC offers additional capital, since it would take capital from the federal government as well as from the state government. It should be remembered, however, that this capital is only borrowed. Tax liability falls on the individual at the time he receives dividends.

Part 2: The mechanics of AGSOC

To Alaskans, the AGSOC proposed in SSSB170 and SSHB240 is simply the latest in a series of plans to distribute public capital to its real owners. These plans include Gov. Jay Hammond's ill-fated Alaska, Inc., various other proposals for the Alaska Permanent Fund, income tax rebates and so forth.

As a distribution method, AGSOC is much like the Alaska Permanent Fund: it is financed by segregating a sum of public capital. Like some permanent fund proposals, the AGSOC is established as a quasi-governmental entity. And, like other permanent fund proposals, the AGSOC would make direct payments to Alaska residents. Once the AGSOC is established and the money segregated, however, the AGSOC becomes a completely private operation. No other proposal, permanent fund or otherwise, removes the distribution function so completely from existing government.

SSSB 170 and SSHB 240

The AGSOC begins with the appointment by the governor of nine incorporators, the majority of whom must be state residents (page 1, line 11-14).¹¹

Initially, these incorporators serve as the board of directors, with provision for electing new directors (page 2, line 27 to page 3, line 10).

The corporation then notifies Alaskans that it will issue stock (page 3, line 11-19).

¹¹All page and line references are to either SSSB 170 or SSHB 240, since they are identical.

The stock is issued, one share to each resident applicant as defined in the bill (page 1, line 23 to page 2, line 3).

The corporation is not liable for those who fail to apply for a share (page 3, lines 20-28), but it may award a share to a late applicant (page 3, line 29 to page 4, line 5).

Those who attempt to obtain a share illegally are subject to penalties (page 4, lines 6-21 and page 7, lines 2-6).

During the first five years of the corporation's existence, no share may be transferred unless a shareholder dies or ceases to be a resident (page 2, lines 4-9). Shares transferred in the first five years must first be offered to the AGSOC (page 2, lines 21-26).

After five years shares may be transferred, although not to non-residents, minors or anyone already owning 10 shares (page 2, lines 10-15).

The corporation must remain an AGSOC and cannot use eminent domain to acquire property (page 2, lines 16-20).

The corporation must distribute at least 90 per cent of its taxable income each year, unless such distribution would make the corporation insolvent (page 4, lines 22-29).

The corporation is not an instrumentality of the state (page 1, lines 20-22).

State financial assistance to the AGSOC consists of a special loan guarantee fund (page 5, lines 4-14).

Policy considerations in SSSB 170 and SSHB 240

The AGSOC created by the two bills raises a number of policy considerations.

First, the AGSOC would belong to a special class of citizens. As currently structured, stock would go only to those people "who were residents of the state on the effective date of this Act,¹² and who continued to be residents until the date of issuance of the shares;". This means those who arrive in the state or are born in the state the day after the act takes effect are not entitled to AGSOC shares. Likewise, anyone who leaves the state before the stock is issued will not be entitled to a share.

Constitutional problems may be avoided if the period between the effective date and stock issuance is sufficiently short. But, like any arbitrary qualification, this residency requirement raises a question of equity.

Kelso has addressed this problem, saying that those who don't qualify for the first AGSOC could qualify for the next. Even assuming that there is a next AGSOC, this does not fully answer the equity questions. The requirements for structuring any AGSOC dictate there will be some time lag. Thus, two children born one day apart would be members of different classes

¹²The act takes effect immediately upon passage.

for some time.

Second, while the return would go to a special class, the risk would be shared by all. It is assumed that the loan guarantee made by the state would be made for the term of the loan.¹³ During that term the state as a whole, including residents who are not AGSOC shareholders, would be liable if the AGSOC failed to repay.

Third, the AGSOC would change the criteria for making decisions about using public capital. Those who say the state should be run like a business generally mean that the methods be businesslike, not the goals. But the AGSOC, like other corporations, is most likely to make its decisions on strict profit-and-loss criteria. For the public money involved, social goals would disappear. The single goal would be profit. Thus, not only would there be no direct benefit to non-shareholder residents but also there would be no indirect benefit in the form of services.

Fourth, the AGSOC is likely to limit, rather than expand, decision-making power. There are two considerations here:

a. The likelihood that corporate decisions will actually be controlled by each and every stockholder is remote. Generally, the management of a corporation makes the decisions and there is nothing the the AGSOC proposal that would change this.

¹³ It is unlikely that the term of a loan would be less than 20 years.

b. By allowing one resident to hold 10 shares of stock, the AGSOC proposals allow 10 per cent of the stockholders to hold 100 per cent of the stock.

Fifth, the AGSOC directors can commit the use of state funds without regard to elected representatives of the people. By allowing an unconditional loan guarantee, the proposals allow the AGSOC directors to commit the state to contingent liabilities over which it has no control. The provision that loans to be guaranteed be approved by the commissioner of revenue does not alter the fact that those who can constitutionally appropriate funds are left out of the decision-making process.

Sixth, a large amount of public capital must be committed for even small individual dividends. In order to provide just \$10 a month to 400,000 shareholders, the AGSOC must earn \$48 million a year. With a profit-to-worth ratio as high as 15 per cent, the business acquired by the AGSOC must be worth about \$320 million.¹⁴

Seventh, tax benefits accre to this corporation, not the shareholders. AGSOC earnings become taxable as personal income when they are paid as dividends to the shareholders. Although the corporation's tax exempt status makes it attractive

¹⁴ Actually, this figure would be higher, since the AGSOC is required to distribute only 90 per cent of its taxable income.

to lenders, it is no more attractive than any other corporation to shareholders except that initial shares are free. In this regard, tax rebates are more beneficial to many, if not all, Alaskans than taxable dividends from the AGSOC.

Eighth, the AGSOC and the state are likely to clash.

Assuming the AGSOC purchases an in-state firm or firms, it is likely to be subject to state regulation. This will, in effect, set the citizen-as-shareholder against the citizen-as-citizen; that is, the citizen against himself in regulatory matters. The impact on politics cannot be predicted.

Conclusion

As a distribution method, the AGSOC presents many problems that are not solved in current proposals. Unless there is clear evidence that the AGSOC is something more than a distribution method, policy makers would be wise to measure it against all other suggested distribution methods. Only then will they be able to determine if the benefits outweigh the costs.

Two-Factor Theory And ESOP Financing

Why, In An Advanced Industrial Economy,
Substantial Income-Producing Capital
Must Be Owned By Corporate Employees

And

How--With Very Slight Changes In Basic
Business Strategy--This Can Be
Effectively Accomplished Through Employee
Stock Ownership Plan (ESOP) Financing:

- °The Most Potent Instrument For The Purpose
- °The Most Advantageous To The Corporation
- °The Most Beneficial To Employees

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Investment Bankers
Specialists in ESOP Financing
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Although two-factor economics is a new and fundamental concept, it is simple and straightforward. The reasoning runs as follows:

1. While it is true that people, participating in the economy through the performance of their various tasks, are a basic source of productive input, they are not the only source of productive input.
2. Non-human things, such as land, structures and machines, also make productive input into the economy.
3. The division of the input sources into two types is both necessary and adequate, because the ownership of labor power cannot be concentrated, while the ownership of non-human things can easily be concentrated. It is, after all, an individual's property in an input factor that entitles him to receive what it produces.
4. Under the logic and morality of a market economy, productive input into the economy is the basis for the individual's right to receive income from it. Economic outtake is conditioned on economic input. To accountants and businessmen, this relationship is simply double-entry bookkeeping. To economists, it is "Say's Law" or "Say's Identity". To moralists, it is the Puritan Ethic, or simply the principle of economic justice defined by Aristotle. To lawyers, it is the principle of private property, under which the owners of capital and the individual owners of labor power are accorded the income equivalent of what each privately-owned input factor contributed to production.

Figure 1:

SAY'S LAW: THE BASIC LAW OF TWO-FACTOR ECONOMICS

For every dollar spent, somebody gets a dollar in economic value. Say's Law is simply a prose statement of the principle of double-entry bookkeeping, which is the logic of a private property, market economy.

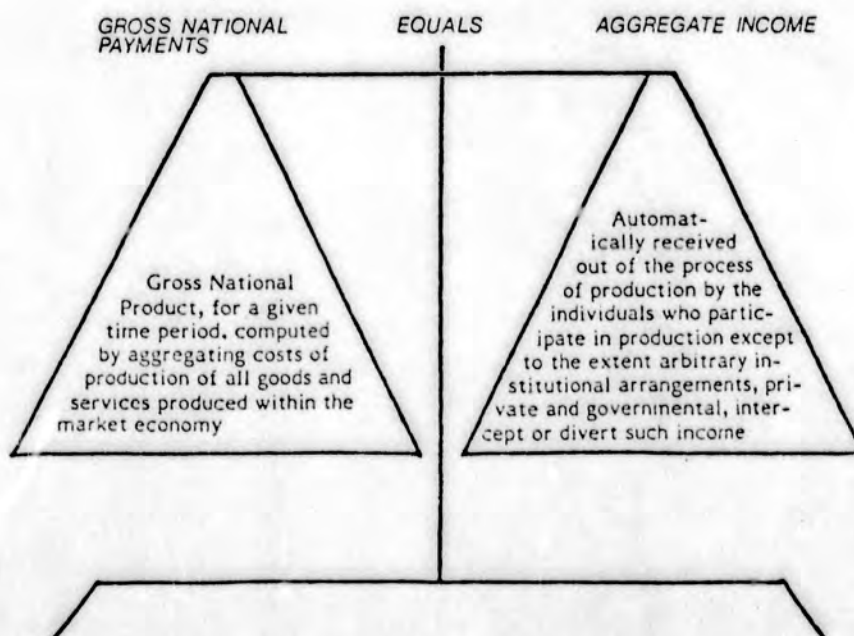
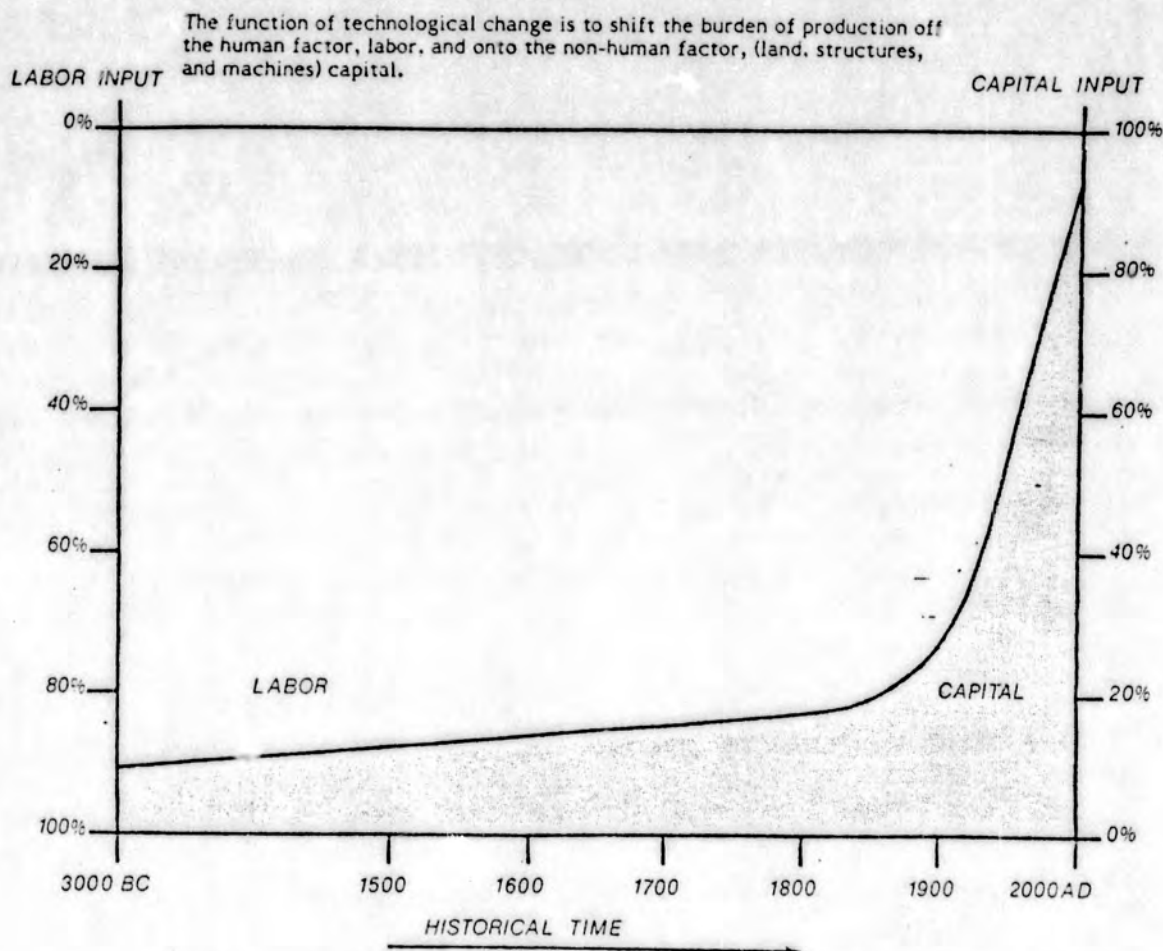


Figure 2: SAY'S LAW ILLUSTRATED ON THE BASIS OF 1973 STATISTICS (IN BILLIONS)

<u>Gross National Product</u>		<u>Pre-tax Income</u>	
Less adjustments for capital consumption allowances, indirect business tax and non-tax liability, business transfer payments and other minor adjustments.		Pre-tax Income Automatically Arising out of Production and Received by the Participants in Production	
CONSUMER COSTS OF:		INCOME OF PARTICIPANTS IN:	
Agriculture, forestry, and fisheries	\$ 37.8	Agriculture, forestry, and fisheries	\$ 37.8
Mining	9.7	Mining	9.7
Contract construction	57.5	Contract construction	57.5
Manufacturing	291.9	Manufacturing	291.9
Transportation	39.3	Transportation	39.3
Communications	21.7	Communications	21.7
Electric, gas, and sanitary services	19.8	Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5	Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9	Finance, insurance, and real estate	118.9
Services	133.6	Services	133.6
Government and government enterprises	162.9	Government and government enterprises	162.9
Foreign trade and transactions	9.6	Foreign trade and transactions	9.6
	\$1,054.3		\$1,054.3

5. Technological advance, which is the phenomenon responsible for the Industrial Revolution, as well as our own automation revolution, and all of the intermediate revolutions brought about by science and technology, changes, and is intended to change, the input mix. It shifts the burden of production off labor (the human factor) and onto capital (the non-human factor). Technological change does not operate directly on labor. It cannot increase the productiveness of an individual worker. It increases the productiveness of machines, tools, structures, land and processes. The economic productiveness of human workers--what they can accomplish with their unaided muscles or minds has not changed during the course of history, if the value of that productiveness is determined objectively and competitively by the free operation of the law of supply and demand.

Figure 3: THE FUNCTION OF TECHNOLOGICAL CHANGE



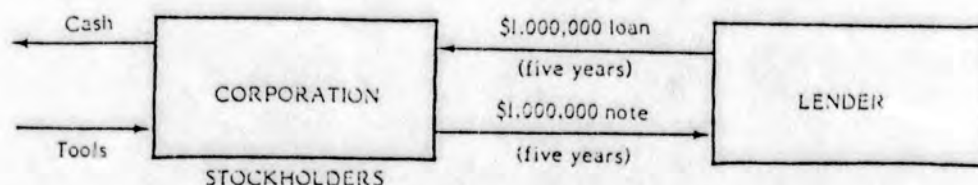
6. In the United States economy, the world's most advanced, the process of technological change has gone so far that most of the goods and services today are produced by capital instruments; only a minor portion of the productive input is made by people. With rare exceptions, it is capital that produces affluence. Labor, in a free labor market, can normally produce only subsistence. The relative distribution of aggregate personal income between workers (roughly 3/4ths) and the owners of capital (1/4th) does not reflect the relatively higher productive input by capital because our governmental economic policy (the Employment Act of 1946), and implementing legislation, attempts to repeal the law of supply and demand as it applies to the value of labor. This is the purpose of minimum wage laws, coercive fixing of wages, vast governmental make-work programs, government subsidies to industry and other government entities to "create" jobs, etc.

The costs of all such efforts enter into the costs of production, directly or indirectly, and thus are inflationary precisely because they are not reflected in the increased production of goods and services by labor. Such costs, neither representing increased labor input nor labor shortages, are, in fact, disguised welfare. They are injected into the costs of the same quantities of goods and services that, prior to the coerces increases, would have been produced at lower costs. These attempts to overvalue labor constitute the monetization of welfare.

7. The shifting of the input mix from labor to capital would cause no economic problem, even under competitive labor markets, if the declining productiveness of labor were offset by increasing capital ownership, i.e., if, as technology diminished the productive role of the human factor, workers simultaneously acquired ownership of enough productive capital to compensate for their loss, or even better, enough capital to provide what few labor-dependent persons have ever achieved, a truly affluent standard of living.
8. Unfortunately, traditional techniques of finance do exactly the reverse of what the situation logically requires. They insure that all newly-formed capital will be automatically owned by those who own all existing capital. Under these techniques, the \$100 billion-plus of new capital formation that comes into existence each year in the U.S. economy becomes owned by a tiny proprietary class--5% of consumer units at most. If averaged over the past 15 years, about 98% of new capital formation in the corporate sector (which produces more than 85% of total private sector goods and services) is financed out of direct cash flow or borrowings repaid out of cash flow.

Figure 4: CONVENTIONAL CORPORATE FINANCE

Including internal cash flow, borrowings repaid from after-tax cash flow, accelerated depreciation, depletion, and investment tax credit, but excluding sale of new stock to the public for cash

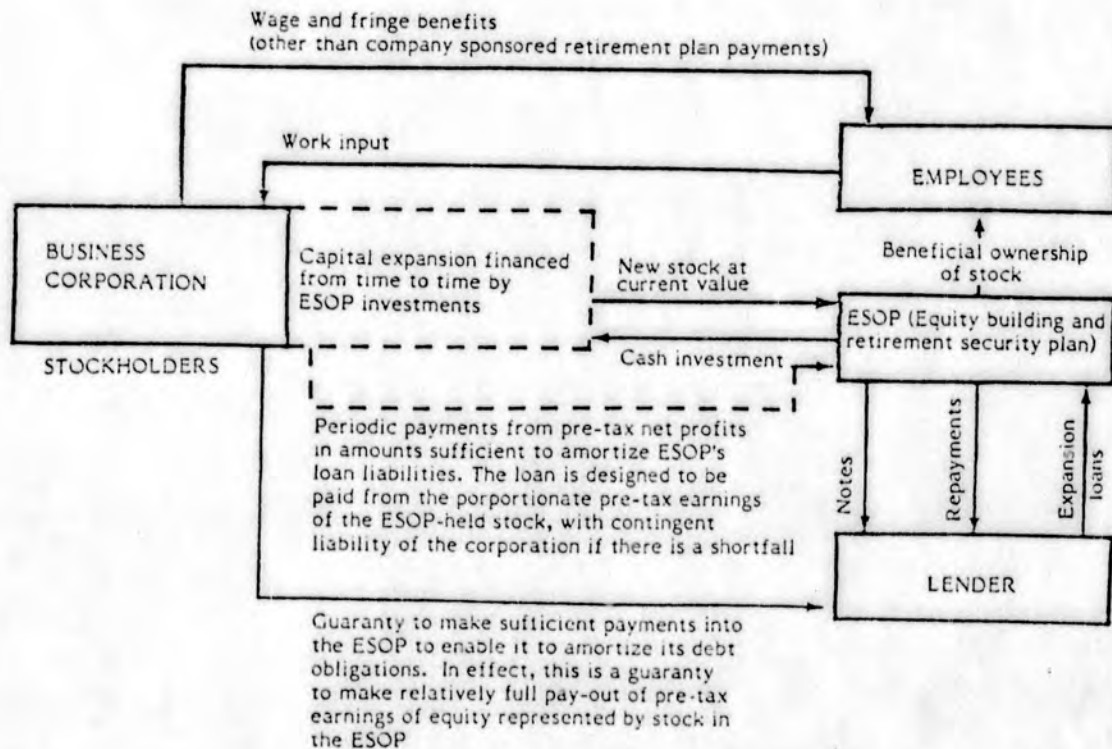


These methods of financing new capital formation have one common characteristic: they do not create a single new stockholder. The portion of new capital formation (about 2%) financed by sale of equity stock to the public does not alter this propensity. Every qualitative study of stock ownership to date shows that ownership of virtually all individually-owned productive capital is lodged in the top 5% of consumer units. These are the families who have excess funds to buy newly-issued stock. Conventional finance has created this monopoly.

9. The logic of business finance is to invest in productive capital that will pay for itself within a reasonably short space of time, normally three to five years, and then go on throwing off wealth indefinitely, its productive power being replenished through depreciation funds set aside out of gross income before net income is computed. Two-factor financing techniques, of which the most widely used today is the Employee Stock Ownership Plan or ESOP, makes this logic available to employees.

Figure 5: BUSINESS CORPORATION FINANCED BY A PROPERLY DESIGNED ESOP

Intended to simultaneously (1) finance growth of the corporation, and provide second incomes for the employees (if the stock is dividend paying and, after shares are paid for, the dividends pass through the ESOP currently to the employees) and (2) to build retirement security in the form of equity capital ownership.

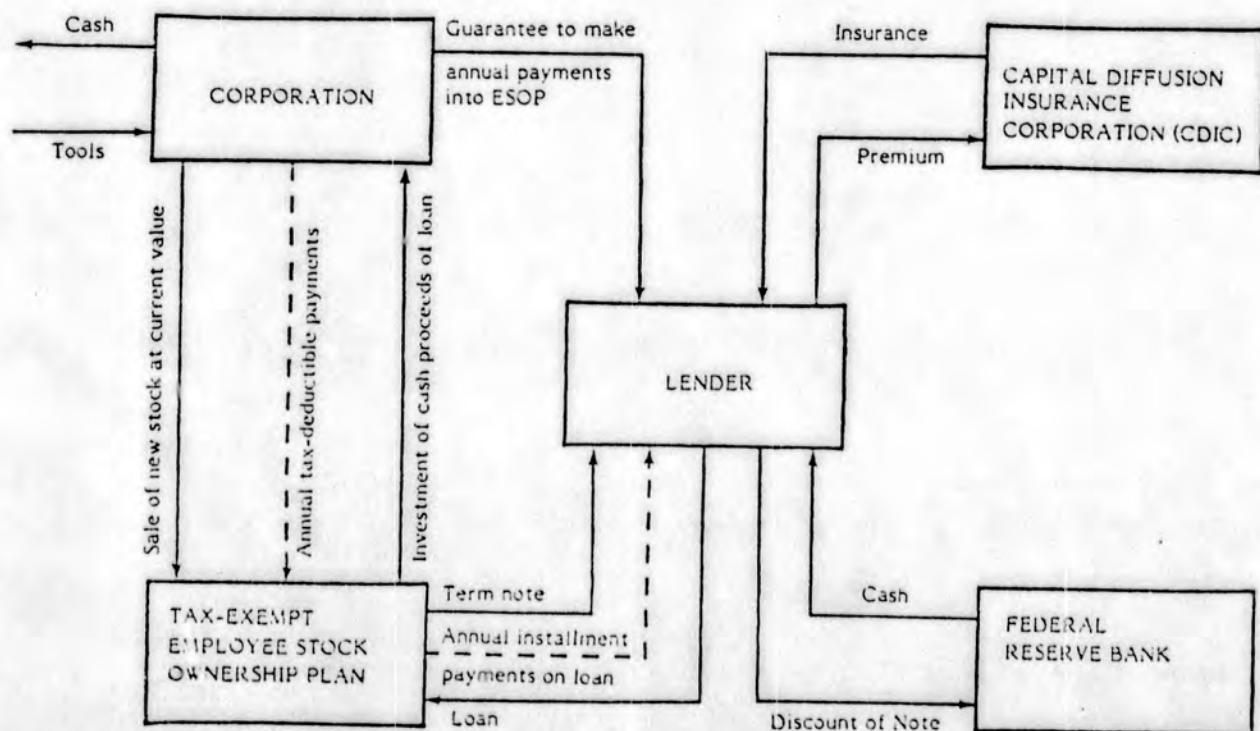


10. ESOP financing, on the one hand, provides low cost capital, through the use of pre-corporate-tax funds, to finance corporate growth, and on the other hand, builds ownership into workers without diminishing their take-home pay or calling upon their small or nonexistent savings.
11. With minor legislative changes to provide capital diffusion insurance (modeled after FHA insurance) for lenders that make sound ownership broadening loans and to make the financing paper held by lenders discountable at a rate not in excess of the administrative costs of the Federal Reserve Bank, two factor techniques provide means for financing unlimited growth, while building market power, economic security, and growing current second incomes from capital* into the masses of workers; thus the market power of potential consumers rises in step with the productive output of the economy.

*Where the stock in the ESOP pays a dividend, the plan often provides that, after each particular share of stock is paid for, the dividends on it shall currently pass through the trust into the workers' pockets.

Figure 6: FINANCING ECONOMIC GROWTH

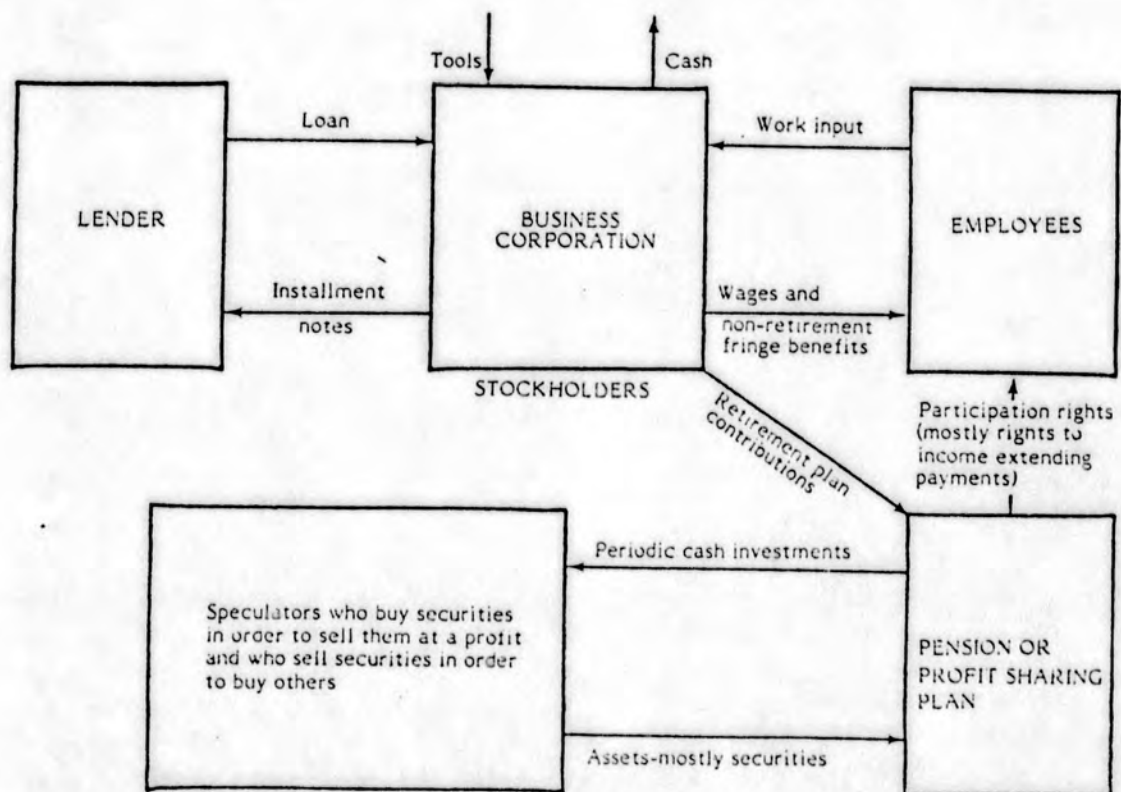
Financing economic growth by monetizing productive capital while building market power into consumers through ESOP financing



12. Inflation is eliminated. Institutional barriers, such as lack of "money" to finance solid, self-liquidating economic growth are eliminated; legitimate leisure, built upon the ownership of a holding of productive capital that will enable a man or woman to produce a viable income, becomes possible over a reasonable working lifetime; and the burden of public taxes imposed upon producers to support the non-productive and under-productive can ultimately be virtually eliminated. Fully productive households and individuals do not need to be subsidized.
13. The ESOP is an enormous cost-saver for the corporation which--sooner or later--can substitute it for a fixed-benefit pension plan, or any other pension plan or conventional profit-sharing plan. All payments by the corporation into these conventional plans are pure cost.

Figure 7: CONVENTIONAL FINANCING OF A BUSINESS CORPORATION

Conventional financing of a business corporation, other than by sale of new stock to the public for cash, with conventional pension or profit sharing plans invested wholly in assets purchased from sources other than the employer-corporation.

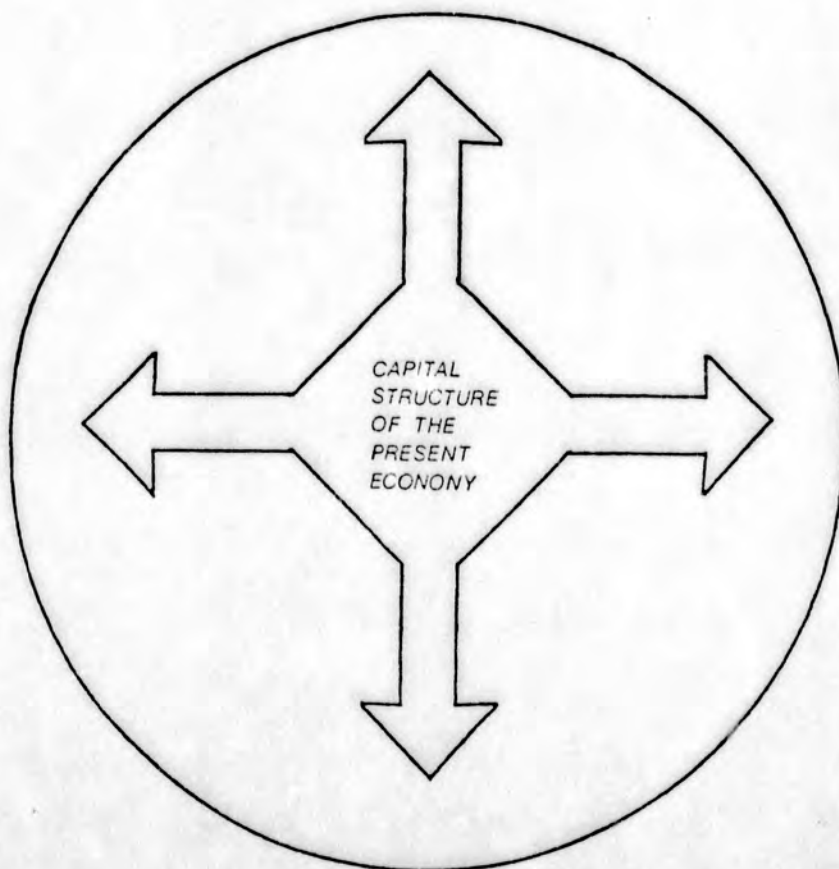


Compared with the ESOP (see Figure 5), not only does the identical dollar paid by the corporation to build stock ownership into employees also finance corporate growth, but corporate growth can be accomplished on pre-tax dollars. By comparing the ESOP (Figure 5) with conventional economic security-building plans (Figure 7), you will see that the ESOP enables the corporation to gain \$3 of advantage for each dollar spent. And it conforms to the sound economic goal of enabling employees, who work hard and well over a reasonable working lifetime, to retire singularly well off.

14. Finally, because the economic goal implicit in Two-Factor Theory is to expand the U.S. economy (and any other economy that adopts it) sufficiently to enable all consumers to live well--general affluence--while also producing the technology to protect the environment, a change to a two-factor policy by business and government could give us twenty-five years or more of legitimate full employment. This would be time enough for society to adjust to a world in which each person will spend less time in economic work and more time in the work of civilization.

Figure 8: OBJECTIVE OF TWO-FACTOR ECONOMICS

Capital structure of the present economy, owned by 5% of consumers, expands ten-fold to create the SECOND ECONOMY, owned primarily by the 95% of consumers who now own no capital



SUGGESTED READING ON TWO-FACTOR ECONOMICS

Books

THE CAPITALIST MANIFESTO by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1958. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

THE NEW CAPITALISTS by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1961. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

TWO-FACTOR THEORY: THE ECONOMICS OF REALITY by Louis O. Kelso and Patricia Hetter (Random House, New York, 1967; Paperback Edition, Vintage Press, 1968)

Testimony

Testimony by Louis O. Kelso before the Joint Economic Committee, U.S. Congress, December 11-12, 1975, on "Employee Stock Ownership Plan Financing and Other Financing Concepts Based on Two-Factor Economics"

Testimony by Louis O. Kelso, Norman G. Kurland and Patricia Hetter before the Senate Finance Committee, U.S. Congress, March 31, 1976, on "Major Tax Revisions and Extension of Expiring Tax Cut Provisions"

Reports and Publications

"ESOPS: An Analytical Report" prepared for the Profit Sharing Council of America, Chicago, Illinois, by Hewitt Associates, Deerfield, Illinois

"Employee Stock Ownership Plans" prepared by The Committee of Publicly Owned Companies, New York, New York

"A Symposium on Employee Stock Ownership Plans", The American University Law Review, Spring 1977, Volume 26, No. 3, prepared by The Washington College of Law, American University, Washington, D.C.

"Making New Capitalists -- A Creative Response to Income Inequities" prepared by the 1977-78 Twentieth Session, Executive Seminar in National and International Affairs, Department of State

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EMPLOYEE OWNERSHIP

Report to
the Economic Development Administration
United States Department of Commerce
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SURVEY RESEARCH CENTER
INSTITUTE FOR SOCIAL RESEARCH
UNIVERSITY OF MICHIGAN

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Broad access to property is fundamental to the American economic system. Throughout our history, there has been a steady growth of institutions especially designed to help the average citizen acquire and safeguard property of one sort or another. The early Homestead Acts, Federal Deposit Insurance Corporation, credit unions, cooperatives, aid to small business, and more recently minority enterprise ownership assistance are just a few examples of broadening the property base of "expanding ownership."

One of the most recent variations to emerge is the Employee Stock Ownership Plan, or ESOP, which permits employees to acquire up to 100 percent of the equity of the firm for which they work. This plan not only affords a real increase in property ownership for the workers as individuals, but also serves as an instrument for new corporate capital formation.

The transfer of ownership is accomplished by an ESOT (Employee Stock Ownership Trust), a separate entity designed to receive the stock, or give it to the employees, repay such loans as have been made to acquire the stock, and to act as agent for the corporation.

The ESOP/ESOT may have any number of objectives apart from stock transfer and management. It can raise new capital, enhance current pension trusts, develop second incomes for stockholder-workers, or pursue any other set of legitimate corporate objectives. The ESOP principle finds both interest and support among a wide variety of disciplines, from investment bankers to social scientists. Many students of the quality of working life perceive positive correlations between worker participation and productivity, between job satisfaction and the sharing of decision-making responsibilities.

Despite growing interest in expanded ownership in general, and ESOPs in particular, little organized research has been done. There are several success stories, to be sure, but appearances do not define causality.

EDA is the Federal agency most directly responsible for economic development in areas which suffer unemployment, underemployment, or sudden economic downturn. The Public Works and Economic Development Act of 1965, as amended, authorizes the use of various economic stimulants — public works assistance, business development and loan guarantees, research and development, technical assistance, and other special impact forms of aid.

The question has arisen whether newer forms of employee ownership, such as the ESOP-ESOT models, are reliable tools for redevelopment. Can failing business firms be saved? Will areas which have resisted other forms of development incentives be stimulated into growth and new work opportunities by expanded ownership devices?

EDA put these and other related questions to the Institute for Social Research of the University of Michigan. This report is their response and represents, we believe, a pioneer effort. The study is divided into two parts. The first is a general overview and analysis of a variety of employee participation expanded ownership programs — including many ESOPs. The second part is a study of one specific ESOP, 100 percent of whose stock is owned by the employees.

The overall findings are necessarily tentative, particularly in the case of ESOPs included in the sample, whose history is too short for absolute conclusions to be drawn. Nevertheless, it appears that optimism would not be inappropriate, and that further study of long-term performance is warranted.

Office of Technical Assistance
Economic Development Administration

I. Employee Ownership

This section concerns firms that have adopted a plan of employee ownership. Employees at all levels in these firms own stock varying from a very small percent of the company's equity in some cases to as much as 100 percent in other cases. We have located 472 such firms. Ninety-eight were identified through information in newspapers, magazines, and professional journals, as well as through information provided by persons who are familiar with employee owned companies. In some of these companies employees own stock through an employee stock ownership trust (ESOT); in others employees own stock directly. The remaining 374 firms were identified through information provided by the Internal Revenue Service from applications by these firms for ESOT status.

We have collected detailed information in the first 98 of the above firms, including such information as industry type, number of employees, magnitude of sales volume, the percent of employees who participate in the ownership plan, the percent of equity owned by non-managerial as well as managerial persons, whether ownership is direct or through a trust, whether ownership implies voting rights and whether employee representatives are on the board of directors. We also measured the attitudes of managers toward the ownership plan and their judgment about the effect of the plan on productivity and profit. In thirty of the companies we were able to obtain actual data about profit, and we therefore analyzed for this sub set of companies the relationship between profit and some of the above aspects of ownership.

The data that we have collected along with the analyses that we have performed offer preliminary evidence concerning the possible impact of expanded ownership on the economic viability of firms and on their ability to save jobs.

Summary of Findings¹

We estimate that more than a thousand firms in this country have some form of employee ownership plan (not including profit sharing and pension trusts), although in most of these firms the percent of equity owned by employees, particularly by non-managerial employees is small. We were able to identify and to collect data from 68 firms in which at least 50 percent of the equity is owned by employees. In 20 of these firms, non-managerial employees themselves own at least 50 percent of the equity either directly or through an employee stock ownership trust.

Managers offer a number of reasons for having established an employee ownership plan. The incentive that it provides to employees and the tax advantages that it affords the company were among the prominent reasons given by managers in firms with employee stock ownership trusts. Reasons that are related to the creation or maintenance of employment were also mentioned by some of the managers of ESOT firms, but these employment-related reasons were offered more frequently by managers of firms in which employees own stock directly.

Managers in both types of firms are in general very supportive of the ownership plan and they see the plan as contributing to the productivity and profit of the firm. In fact, the thirty firms in our sample for which data about profit are available do show a higher level of profit than do similar conventional firms in their industry, although it is not possible to assert on the basis of this comparison that employee owned firms in general are more profitable than conventional firms, since the firms in our sample may be select with respect to profit. It is clear, nonetheless, that employee

¹This section of the report was prepared by Michael Conte and Arnold Tannenbaum.

owned firms can function efficiently and profitably. Furthermore, analyses concerning the possible determinants of profitability of these thirty companies indicate that the single most important correlate of profitability among the aspects of ownership that we measured is the percent of the company's equity owned by non-managerial employees. The greater this percent, the greater the profitability of the firm.

Introduction

Examples of expanded ownership can be found throughout the history of the United States. An unpublished survey, for example, has found that 389 firms in which a large proportion of the stock is directly owned by employees were established in this country between 1791 and 1940.¹

Employee ownership can take two forms: direct, in which employees own shares in the company as would any shareholder in a joint-stock company; or "beneficial," in which employees own shares through a trust. Since the passage of the Employee Retirement and Income Security Act of 1975 (ERISA), the only type of trust which may legally accommodate large amounts of investment by employees in their company's stock is the Employee Stock Ownership Trust (ESOT).

Contributions to an Employee Stock Ownership Trust are governed by an Employee Stock Ownership Plan (ESOP) which requires that the trust invest primarily in employer securities, unlike a normal pension trust or profit-sharing trust which must diversify its holdings. The plan may leave the method of contribution entirely to the discretion of a single party or parties or it may specify one of several methods of contribution. Contributions may be made on the basis of a profit-sharing principle (whereby some fixed percentage of company profits is annually transferred to the trust), a cost principle (whereby a fixed percentage of labor costs is annually transferred to the ESOT), or a fixed contribution principle (whereby a fixed dollar amount is transferred to the trust). The central requirement, however, is that the ESOT invest "primarily" in employer securities, and that disbursements from

¹ Jones, D. The economics and industrial relations of producer cooperatives in the United States, 1790-1940, n.d.

the ESOT be made in employer securities. Dividends that may be declared are not usually distributed immediately to employees but rather are held in trust. Nonetheless, the financial well-being of the "beneficiaries" of stock in the ESOT is tied to the success of the company.

We include in this study data from both these types of plans but not from other types of stock ownership trust, such as profit-sharing and pension trusts. Under present law these latter trusts are not permitted to hold large blocks of employer's securities.¹

Method of Selecting Companies for Study

We compiled a list of 148 companies in the United States and Canada that we thought might have some degree of employee ownership. This list was culled from articles in newspapers, magazines and professional journals, from conversations with colleagues, and finally, from references given by persons in employee-owned companies whom we contacted. A letter was written to the president of each of these companies, asking permission to conduct a fifteen to twenty minute telephone interview. These persons were generally willing to participate in our survey, although many of them delegated responsibility for the interview to another officer, usually a financial officer. Interviews were finally conducted in 132 companies, of which 98 actually proved to have some component of worker ownership. These 98 cases, seven of which are in Canada, serve as the main basis for the analysis of this section.

In addition to information about the above 98 companies, we obtained copies of recent applications to the Internal Revenue Service from 374 firms for ESOT status. These applications represent the work in progress in the 13 IRS key districts at the time of our request to the IRS. Some of the information included in the IRS records overlaps with information obtained through interviews with the 98 firms and a limited comparison can therefore be made between the

¹For an analysis of some firms that have substantial profit sharing programs, see Profit sharing in 38 large companies, piece of action for 1,000,000 participants. Vols. 1 and 2. Evanston, Ill.: Profit Sharing Research Foundation.

two sets of firms. For example, 41 percent of the employees in the average firm of the IRS set participate in the ownership plan compared to 77 percent of the employees in the average firm of our first set. Our initial selection procedures, which were designed to locate firms with "substantial" employee ownership have understandably led to firms that have a higher participation rate for employees in ownership than the norm. The plants in this set, however, are comparable in size to those of the IRS set, the average number of employees in the former case being 1,448 compared to 1,334 in the latter.

Description of the Companies

Data from the IRS records. Table 1 presents data from the IRS applications that describe several features of ESOPs and that illustrate how ownership through an ESOT may differ from direct ownership. The vesting period is one such feature. Stock that is held in trust but is not yet vested to an employee may be forfeited if the employee leaves the company for reasons other than sickness or death. This condition, which applies to ESOPs, does not apply to direct ownership and, as the first two columns of Table 1 show, the vesting period in the average ESOT begins about three years after the employee has joined the plan and is completed seven years later. Large firms, however, may commence and complete the vesting process faster than small firms. (In some companies, the vesting period may be as long as 20 years.)

A second feature of ESOPs concerns the right of employees to sell their shares, which right they do not have until the shares have been "distributed" to the employees. Column 3 of Table 1 indicates that in 72 percent of the firms in the IRS "sample" distribution does not occur until after the employee leaves the company. This prevailing feature of ESOPs may not differ in principle from that in cases of direct ownership, where ownership of stock is a condition of employment.

Column 4 of Table 1 provides information about the basis upon which stock is allocated to employees. In 82 percent of the cases the amount of stock an employee receives is proportional to the employee's wage or salary, although the allocation formula need not be linear, and it may take into account other considerations, such as seniority.

Column 5 indicates that in some ESOP firms employees themselves must make a contribution toward the purchase of their stock, but this feature occurs in only seven percent of the ESOP firms in the IRS set. It may be somewhat more frequent in larger than in smaller firms.

Column 6 presents information concerning the percent of employees in each firm who participate in the plan. A larger proportion of employees participate in small firms compared to large ones.

Data from telephone interviews. Of the 98 companies where we interviewed a managerial representative, 68 have ESOPs and 30 have direct ownership. The firms differ a good deal from one another in number of employees, as shown in Table 2, although in general they are relatively large by conventional standards. Furthermore, ESOP firms in this set are larger than directly owned firms, even though both types include a broad distribution of size.

Size as measured by sales is presented in Table 3. Forty-five percent of the firms in our set had sales of at least \$25,000,000.

Table 4 indicates that as many as 50 percent of the ESOP firms in our set are wholly owned by employees including managers while only 19 percent of the directly owned firms are wholly owned by employees. However, in 78 percent of the directly owned firms at least half of the equity is owned by employees. Table 5 shows the percent of equity owned by the ESOT. The percent of stock owned by workers themselves is, of course, lower than the above figures, as Table 6 indicates.

Table 1

Some Characteristics of ESOP Firms in the IRS Set

Size of Firm: (number of employees)	Average number years till vest- ing begins	Average number years till fully vested	% cases where "distribution" not allowed be- fore termination of employment	% cases where allocations are made on basis of total compensation	% cases where employees must contribute	Average % of employees participating in ESOP
14-74 * (N=100)	3.5	10.8	75	86	0	77
75-149 (N=79)	3.2	10.2	71	90	2	68
150-424 (N=101)	3.2	10.2	81	82	2	58
425-46842 (N=94)	2.2	7.6	60	72	25	49
All (N=374)	3.0	9.7	72	82	7	62

* Number of cases

Table 2

Number of Employees in ESOP and Directly Owned Firms

Number of Employees	Percent of Firms		
	ESOP (N=68)	Direct Ownership (N=30)	All Firms (N=98)
4-99	18%	20%	18%
100-249	18	37	23
250-999	38	23	34
≥ 1000	26	20	25
Total	100%	100%	100%

Table 3

Sales Volume of ESOP and Directly Owned Firms

Sales (in millions of dollars)	Percent of Firms		
	<u>ESOP (N=68)</u>	<u>Direct Ownership (N=31)</u>	<u>All Firms (N=97)</u>
less than 1	6%	10%	8%
1-10	22	24	22
10-25	20	35	24
25-100	32	17	28
>100	20	14	18
Total	100%	100%	100%

Table 4

Distribution of Percent Total Equity Owned by Employees (including Managers)

Percent Total Equity Owned by Employees	Percent of Firms		
	ESOP (N=60)	Direct Ownership (N=27)	All firms (N=87)
< 9.9%	4%	4%	4%
10-49.9%	18	18	18
50-99.9%	28	59	38
100.0%	50	19	40
Total*	100%	100%	100%

* Eleven firms did not provide sufficient data to determine the percent of equity owned internally. They are eliminated from this table.

Table 5

Percent of the Firm's Equity Owned by the Employee Stock Ownership Trust

	<u>N</u>	<u>Percent of Firms</u>
Percent of equity owned by trust:		
0-9.9%	15	26%
10-24.9%	20	34
25-49.9%	11	19
50-100%	12	21
Total*	58	100%

*Ten firms did not provide data on the percent of equity owned by the trust.

Table 6

Percent Total Equity Owned by Workers

Percent Total Equity Owned by Workers	Percent of Firms		
	<u>ESOP (N=58)</u>	<u>Direct Ownership (N=25)</u>	<u>All firms (N=83)</u>
less than 3%	34%	8%	27%
3-9.9%	16	8	13
10-49.9%	43	20	36
50-100.0%	7	64	24
Total*	100%	100%	100%

* Fifteen firms did not provide data relevant to the percent of equity owned by workers. They are eliminated from this table.

A measure of equity owned by workers in each ESOP firm was obtained by multiplying the percent of the company's equity owned by the ESOT times the percent of the ESOT's equity owned by the workers. Because of the way records are kept in most of the ESOP firms, we found it necessary to rely on the distinction between salaried and non-salaried personnel as the basis for distinguishing rank-and-file workers from managers in these firms. Furthermore, while all of the respondents in the directly owned firms were able to provide information about the allocation of ownership between managers and non-managerial personnel, only about half of the respondents in the ESOT firms were able to provide precise information concerning the allocation of stock within the ESOT. In these firms, 54 percent of the ESOT stock on the average is owned by non-salaried employees and we assume that this average defines the amount of stock belonging to workers within each ESOT of the remaining cases.¹ The percent of total equity owned by workers in these remaining cases, as we estimate it, is therefore directly proportional to (i.e., 54 percent times) the percent of the company's equity in the ESOT itself.

Table 7, based on the above assumptions, provides information about the amount of equity owned by workers in firms of different size. Substantial ownership by workers occurs predominantly in firms of moderate size rather than in the very small or the very large ones. For example, workers own at least half of the equity in 42 percent of the firms having between 100 and 249 employees. By way of contrast, workers own this much equity in only 12 percent of the

¹The definition of "worker" implicit in the above procedure differs somewhat in the two types of firms. "Worker" may include foremen and salaried clerical workers in some directly owned firms, but not in the ESOP firms. Table 6 may, therefore, overstate the difference in worker ownership between ESOP and directly owned firms, although we do not believe that the definitional inconsistency accounts for the entire difference shown in the table. Furthermore, we "control" for this variation in definition in the regression analyses shown below.

Table 7

Distribution of Percent Total Equity Owned by Workers in Firms of Different Size

Number Employees	Percent Equity Owned by Workers				<u>Total</u>
	<u>0-2.9%</u>	<u>3-9.9%</u>	<u>10-49.9%</u>	<u>50-99.9%</u>	
4-99	31%	13	44	12	100%
100-249	24%	15	29	42	100%
250-999	22%	19	37	22	100%
1000-18000	31%	16	37	16	100%
Total	27%	13	36	24	100%

firms of under 100 employees and in 16 percent of the firms of over 1,000 employees.

Reasons for Adopting Employee Ownership

Respondents were asked their reasons for adopting an employee ownership plan. Answers were classified as follows:

- Incentive: e.g., "Ownership provides an incentive for employees to work harder" or Employees will be "more conscientious about their work."
- Financial: e.g., "ESOP provides us with a tax advantage" or "ESOP permitted our company to raise needed capital."
- Moral: e.g., "Employees should own part of the company that they work in."
- Employment: e.g., "The company would have closed down if the employees had not bought it" or "It [employee ownership] is a good way to start a business."

Miscellaneous

Each respondent was permitted to indicate three reasons and Table 8 gives the percent who mentioned each of the above categories as one of their responses. While the "incentive" and "financial" motives appear to be the more prominent ones among the ESOP firms, "employment" stands out as a reason for the creation of the direct ownership plans.

The relative importance attached to financial reasons for the adoption of an ESOP undoubtedly reflects the tax incentives associated with ESOPs as well as other features of an ESOP that might prove advantageous under some circumstances. For example, the principal owners of a business may wish to divest themselves of their holdings while retaining control of the business. The owners can accomplish this through an ESOP in two ways: by passage of nonvoting stock to the ESOP or by passage of voting stock but not permitting "pass through" voting. In the latter case, the trustee of the ESOT, who may be accountable to the board of directors of the company rather than to the