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Two Important Points About the ALASKA GENERAL STOCK OWNERSHIP CORPORATION

1. The AGSOC is not a "giveaway".

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

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

2. AGSOC is not State ownership.

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

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

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 chariman 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 thier 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.[illegible]).

.035. CORPORATE NAME. This section requires that a GSOC include in its corporate name the words "general stock ownership corporation" or an abbreviation thereof. In addition, the name may not be misleading or deceptively similar to the name of another corporation doing business in Alaska. (ABCA 10.05.021).

.040. RESERVATION OF CORPORATE NAME. This section allows a person or corporation to reserve a specific name for a general stock ownership corporation for a period of two years with a renewal period of one year. Reservation of a name might be used where an individual seeks to establish a GSOCs by initiative petition or where an existing GSOC seeks to change its name upon the approval of its shareholders. The name may be reserved by this section during the period in which the necessary activities are undertaken to make the name effective. (ABCA 10.05.024, .027, and .033).

.045. FOREIGN GENERAL STOCK OWNERSHIP CORPORATIONS. General stock ownership corporations chartered in another state and doing business in Alaska are subject to the rules of the Alaska Business Corporations Act (AS 10.05).

.050. REGISTERED OFFICE AND REGISTERED AGENT. The registered agent is the agent for the corporation upon whom legal papers may be served. This provision requires that the corporation maintain a registered office and agent within the state. (AS 10.05.045)

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

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

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

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

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

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

.085. PAYMENT FOR SHARES. Payment for shares may be made in cash, other property or services, but not in notes or future services. (AS 10.05.099).

.090. JUDGMENT OF BOARD OR SHAREHOLDER AS TO VALUE OF CONSIDERATION CONCLUSIVE. This section allows the directors or the shareholders to conclusively determine the value of payment for shares in the absence of fraud. (AS 10.05.102).

.095. EXPENSES OF ORGANIZATION, REORGANIZATION AND FINANCING. In sales of stock by a corporation shares entitled to the full protections of limited liability must be fully paid and nonassessable. This means that the full sales price for the stock has been received by the corporation. However, if the stock is sold through an underwriter the fees will come out of the sales proceeds before they are paid to the corporation. Likewise, the organizational expenses of the corporation may be paid out of stock sales before the proceeds are remitted to the corporation. This section clarifys that in such cases the shares are deemed to be fully paid. (AS 10.05.111).

.100. CERTIFICATES REPRESENTING SHARES. This provisions sets out the requirements as to form of stock certificates which must be signed by the corporate officers. (AS 10.05.114)

.105. INFORMATION REQUIRED TO BE STATED ON CERTIFICATE. The stock certificates or other evidences of ownership must include information regarding the person to whom they are issued, that they are no par value shares, and that the corporation is organized in Alaska. (AS 10.05.117).

.110. FULL PAYMENT REQUIRED FOR CERTIFICATE. If payment is required for shares they may not be issued until full payment is received. (AS 10.05.120).

.115. ISSUANCE OF FRACTIONAL SHARES. GSOCs may issue fractional shares of stock and these fractional shares hold dividend, voting and distribution rights equal to their fractional interest. It may be necessary for a GSOC to issue fractional shares in the situation where a shareholder leaves his stock to his heirs and there is more than one child beneficiary. (AS 10.05.123).

.120. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS. This section, adopted directly from ABCA, limits the liability of shareholders and those who have agreed to purchase share to the amount which they agreed to pay to the corporation for the shares. Subsequent holders of the stock are protected if they received the stock in good faith. (AS 10.05.126).

.125. BYLAWS. The board of directors adopts the initial bylaws of a GSOC subject to review and rejection by the legislature under section 335 of the bill. Subsequent bylaws may be adopted, amended or repealed by a vote of either the shareholders or directors.

.130. MEETINGS OF SHAREHOLDERS. The time and location of the annual shareholders meeting is established in the bylaws. The specific place is set by the board. Special shareholder meetings may be called by the president of the GSOC, the board or the holders of at least 1,000 shares. Shareholder meetings may be teleconferenced. (AS 10.05.138).

.135. NOTICE OF SHAREHOLDER'S MEETINGS. This section requires written notice of shareholder's meetings mailed to shareholders not less than 60 days before the meeting. In addition, notice of shareholders' rights to add ballot issues or nominate directors must be made by publication at least once a week for four weeks beginning at least 150 days before the meeting. (AS 10.05.141).

.140. CLOSING OF TRANSFER BOOKS AND FIXING RECORD DATE. To determine the shareholders of the corporation for purposes of a dividend distribution or voting rights the transfer books of the corporation may be closed prior to the date of the proposed activity or a "record date" may be established and the shareholders determined as of that date. Time limits are provided beyond which the transfer books may not be closed in order to protect shareholder voting rights and to allow interested parties to inspect the share records of the corporation prior to shareholders' meetings. (AS 10.05.144).

.145. VOTING LIST. The responsible officer of the corporation must make available at the registered office of the corporation beginning at least 60 days before any shareholders' meeting a list of the shareholders eligible to vote at the meeting and access to this list must be provided to all shareholders. (AS 10.05.147).

.150. QUORUM OF SHAREHOLDERS. 1/3 of the shares constitute a quorum for action by the shareholders and a majority vote of a quorum is sufficient to bind the shareholders in most cases. (AS 10.05.153).

.155. PROXY VOTING PROHIBITED. Because of the ballot mechanism whereby each shareholder is allowed to vote in person through his ballot proxies are unnecessary in general stock ownership corporations and are therefore prohibited.

.160. VOTING FOR DIRECTORS. Each shareholder may vote his shares for directors but cumulative voting is prohibited. This means that each share can cast only one vote for director in any contested election for a directorship position.

.165. VOTING OF SHARES IN THE NAME OF ANOTHER.

.170. VOTING OF PLEDGED SHARES.

These sections allow shares held by an administrator, executor or guardian to be voted by him without a transfer of the shares into his name. Shares held by a pledgee may be voted by the pledgor until transferred into the pledgee's name. (AS 10.05.165 and . 168).

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

Shareholders may, by petition of 1,000 or more, nominate directors and place issues on the corporate ballot. In addition, the directors may place issues and candidates on the ballot by a majority bote. 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 scats until the next shareholdler 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 incompetance of a board member. (AS 10.05.183).

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

.200. QUORUM OF DIRECTORS. A majority of the total number of directors fixed in the bylaws, articles or enabling legislation constitutes a quorum and action may be taken by a majority vote of a quorum. By allowing only ¼ 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.

Similarily, 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 1¼ 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 1¼ 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 10.0 5.222).

.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 germain 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 existance 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 attoreny 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. Voilations 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 existance. 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 minimun 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 broadcase 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 looses 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.

[illegible] 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 CERTIFCATE 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 section 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 looses 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 existance 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 existance 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 privisions 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.

ALASKA
GENERAL STOCK OWNERSHIP
CORPORATION

Sponsor Substitute for House Bill No. 240
Sponsor Substitute for Senate Bill No. 170

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HOW IT WORKS

THE ALASKA GENERAL STOCK OWNERSHIP CORPORATION

* A corporation is formed and each resident of Alaska is issued one chare of stock.

* The corporation borrows money to invest in profitable projects, having assured itself of the investment's soundness.

* Private lenders will be willing to provide loans because they can be secured by the assets of AGSOC and, if necessary subject to legislative approval, by a state guarantee.

* The loan proceeds will be invested in the project or projects, making AGSOC an owner and thus making each Alaskan (as a shareholder of AGSOC) an owner.

* Earnings from the project will be used to pay off the loan.

* Dividend payments can be made to AGSOC shareholders as soon as profits are made. Once the loan is paid off, all profits from the corporation's investments will be paid out to the shareholders.

EXPLANATION: FEDERAL GSOC PROVISIONS

Federal law provides income tax advantages to certain broadly owned corporations. These companies, known as General Stock Ownership Corporations (GSOCs), are exempt from corporate income tax. GSOCs are privately owned corporations designed to leverage the typical citizen into capital ownership. As such the stock is to be distributed free of charge and investments purchase entirely through borrowed funds. As the loans are paid down from investment earnings equity is built into the shareholders.

Charter Provisions

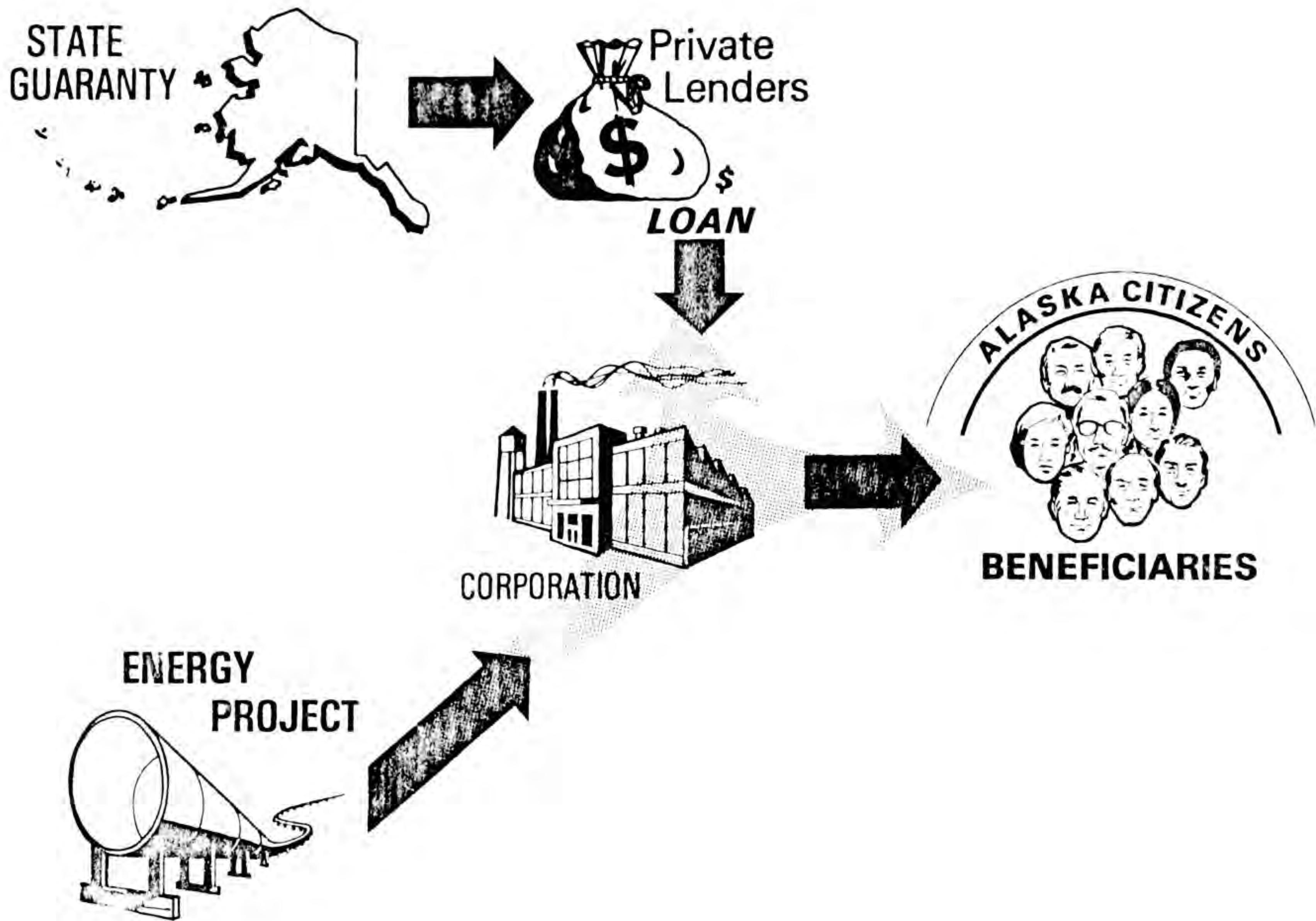
To qualify as a GSOC a corporation must be specially chartered by a state and have a single class of stock distributed to each qualified state resident. Transfers of stock must be limited to the earliest of five years from issue or the shareholder's death or emigration from the state. No shareholder may own or acquire more than 10 shares.

GSOC Taxation

The GSOC is exempt from corporate income taxes, but its shareholders must report their share of GSOC income personally. GSOC income is computed like that of other corporations with special treatment for tax credits. Audit adjustments are included in income of the corporation for the year during which they are finally determined. Net losses are subject to a 10 year carryover and investment credit and recapture is prorated to the shareholders.

Shareholder Taxation

GSOC shareholders are taxed on their share of GSOC income. If a shareholder disposes of his stock GSOC income will be prorated on a daily basis. The shareholder's stock basis will be increased by GSOC income attributed to him and reduced by cash distributions. Since GSOC shareholders are attributed GSOC income distributions from the GSOC are generally tax free. Distributions greater than attributed income are nontaxable to the extent of the shareholder's basis and the excess taxed as capital gains. To assure shareholders have cash for taxes on their share of GSOC income GSOCs must distribute 90% of taxable income by January 31. Noncompliance will subject the GSOC to a 20% tax on the distribution difficiency. To assure payment of taxes the GSOC must withhold 25% of each distribution. The amount withheld is a credit against shareholder income taxes. Individuals not required to pay taxes (because of insufficient income) may avoid withholding on GSOC distributions.



STATE
GUARANTY
Private
Lenders
$
$
LOAN
ALASKA CITIZENS
BENEFICIARIES
CORPORATION
ENERGY
PROJECT

TAX TREATMENT OF
GENERAL STOCK OWNERSHIP CORPORATIONS

THERE HAS BEEN CONFUSION OVER THE EXTENT TO WHICH GENERAL STOCK OWNERSHIP CORPORATIONS RECEIVE SPECIAL TAX TREATMENT. IN A GSOC THE CORPORATE INCOME TAX IS ELIMINATED AND THE INCOME OF THE CORPORATION IS TAXED DIRECTLY TO THE SHAREHOLDERS AT THEIR OWN PERSONAL RATES.

SIMILAR TAX TREATMENT HAS APPLIED TO SMALL CORPORATIONS FOR MANY YEARS. A CORPORATION WITH 10 OR FEWER SHAREHOLDERS MAY ELECT TO BE TREATED AS A "SUBCHAPTER S" CORPORATION. IT IS THEN EXEMPT FROM THE CORPORATE INCOME TAX AND THE CORPORATION'S INCOME IS TAXED TO THE SHAREHOLDERS IN MUCH THE SAME MANNER AS IN A GSOC. IN FACT, THE PROVISIONS OF INTERNAL REVENUE CODE "SUBCHAPTER S" WERE USED AS A MODEL IN DRAFTING THE GSOC TAX LAW.

THUS, THE GSOC TAX BENEFITS ARE NEW AS APPLIED TO CORPORATIONS WITH A LARGE NUMBER OF SHAREHOLDERS, BUT SIMILAR PROVISIONS HAVE BEEN IN EFFECT WITH RESPECT TO SMALL CORPORATIONS FOR SOME TIME.

TWO IMPORTANT POINTS ABOUT THE ALASKA GENERAL STOCK OWNERSHIP CORPORATION

1. THE AGSOC IS NOT A "GIVEAWAY".

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

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

2. AGSOC IS NOT STATE OWNERSHIP.

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

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

ALASKA

GENERAL STOCK OWNERSHIP CORPORATION

BILL SUMMARY

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

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

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

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

DETAILED EXPLANATION

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

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

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

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

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

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

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

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

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

ANALYSIS: SECTION 1

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

50.010. ALASKA GENERAL STOCK OWNERSHIP CORPORATION CREATED.

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

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

50.020. ARTICLES OF INCORPORATION.

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

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

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

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

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

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

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

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

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

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

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

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

.[illegible] BOARD OF DIRECTORS.

This section sets out the provisions for AGSOC directors which differ from those applicable under Alaska Statutes Title 10, Chapter 5. The nine incorporators serve as the original board of directors and are divided into three groups in accordance with AS 10.05.18[illegible], except that only one-third of the directors will stand for election at the first annual meeting, one-third at the second annual meeting and one-third at the third annual meeting. Thereafter each director will serve for a term of three years as provided in AS 10.05.186. None of the other provisions of the Alaska Business Corporations Act regarding directors is changed and the normal rules of Chapter 5 apply to the AGSOC.

50.040. NOTIFICATION OF ELIGIBLE SHAREHOLDERS.

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

50.050. CORPORATION NOT LIABLE TO SHAREHOLDERS.

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

50.060. LATE APPLICATION FOR SHARES.

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

50.070. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER.

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

50.080. DIVIDENDS OF THE CORPORATION.

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

50.090. EXEMPTION FROM AS 10.05

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

50.100. LOAN GUARANTEE FUND.

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

[illegible]. DEFINITIONS.

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

Introduced: 2/16/79
Referred: State Affairs and Finance

BY DUNCAN, COTTEN, HURLBERT, MCKINNON, MILES, MILLER, MUNSON, PARKER AND GARDINER

1 IN THE HOUSE

2 HOUSE BILL NO. 240

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 ELEVENTH LEGISLATURE - FIRST SESSION

5 A BILL

6 For an Act entitled: "An Act creating the Alaska General Stock Ownership
7 Corporation; and providing for an effective date."
8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:
9 * Section 1. AS 10 is amended by adding a new chapter to read:
10 CHAPTER 50. ALASKA GENERAL STOCK OWNERSHIP CORPORATION.
11 Sec. 10.50.010. ALASKA GENERAL STOCK OWNERSHIP CORPORATION
12 CREATED. (a) The governor shall appoint nine persons, at least five of
13 whom are residents of the state, to act as incorporators of the Alaska
14 General Stock Ownership Corporation.
15 (b) The corporation is a general stock ownership corporation and
16 shall be formed in accordance with subchapter U of the Internal Revenue
17 Code of 1954, as amended, (26 U.S.C. secs. 1391 - 1397), and with
18 AS 10.05. The corporation is subject to the provisions of AS 10.05,
19 except when inconsistent with this chapter.
20 (c) The corporation is not and may not be considered to be an
21 agency or political subdivision of the state for any purpose.
22 Sec. 10.50.020. ARTICLES OF INCORPORATION. The corporation's
23 articles of incorporation shall provide
24 (1) for the issuance of only one class of stock;
25 (2) that shares of stock may be issued only to individuals
26 who were residents of the state on December 31, 1978, and who continued
27 to be residents until the date of issuance of the stock;
28 (3) for the issuance of at least one share of stock to each
29 individual eligible under (2) of this section, unless that individual

elects within one year after the date of issuance not to receive the share;

(4) that no share of stock may be voluntarily or involuntarily transferred

(A) or encumbered by a shareholder, other than by will or under the laws relating to intestate succession, until five years after the date of issuance of the share, except if the shareholder ceases to be a resident of the state;

(B) to an individual other than one who is a resident on the date of transfer;

(C) to an individual who, after the transfer, would own more than 10 shares of stock of the corporation;

(D) by a shareholder under 18 years of age;

(5) that the corporation must maintain its status as a general stock ownership corporation under subchapter U of the Internal Revenue Code of 1954, as amended, (26 U.S.C. secs. 1391 - 1397);

(6) that the corporation may invest in properties other than those acquired by it, or for its benefit, through the right of eminent domain;

(7) that the corporation has the right of first refusal to purchase its shares of stock offered to be transferred by a shareholder within five years after the date of issuance of the shares; if the corporation exercises the right to purchase, shares purchased shall be considered treasury stock and not entitled to dividends, if any, or to voting privileges.

Sec. 10.50.030. BOARD OF DIRECTORS. (a) The corporation shall be governed by a board of directors. A majority of the members of the board of directors shall be residents of the state at all times during their terms of office. Except as provided in (b) of this section, the

term of office of each director is three years. A director, upon the expiration of his term, shall continue to hold office until his successor is elected and qualified.

(b) The initial board of directors shall consist of the incorporators of the corporation. The board shall be equally divided into three classes of directors. The initial class one directors shall serve one-year terms of office; the initial class two directors shall serve two-year terms of office; and the initial class three directors shall serve three-year terms of office.

(c) The number, terms of office, and classes of directors may be amended by a majority of the shareholders of the corporation.

Sec. 10.50.040. NOTIFICATION OF ELIGIBLE SHAREHOLDERS. At least 90 days before the issuance of any stock, the corporation shall at least weekly notify the public of its intention to issue stock and the method for qualifying and applying for shares. The notification shall be by publication in at least one newspaper of statewide circulation, by radio and television announcements, and by other means the corporation determines to be appropriate and reasonable, and shall be continued at least once each month for 11 months following the date of issuance of shares.

Sec. 10.50.050. CORPORATION NOT LIABLE TO SHAREHOLDERS. The corporation may not be held liable for

(1) any loss resulting directly or indirectly from the failure of an individual to apply for shares of the corporation;

(2) reimbursement of any individual who may incur tax liability from failure to apply for shares of the corporation; and

(3) payment of a declared or paid dividend to an individual who would have been entitled to receive the dividend had he been a shareholder at the time of declaration or payment.

Sec. 10.50.060. LATE APPLICATION FOR SHARES. An individual eli-

gible under AS 10.50.020(2) to receive shares of the corporation who failed to apply for the shares before their issuance may apply for and receive the shares at any time after the date of issuance if he is otherwise qualified to own stock of the corporation.

Sec. 10.50.070. SHARE OWNERSHIP RECORDS; TRANSFER AGENT. The corporation shall establish and maintain a system of share ownership records. The system shall be designed to make the issuance of stock certificates unnecessary and shall include the names and current addresses of all shareholders. The corporation may issue nonnegotiable evidences of ownership of shares of the corporation. The corporation shall act as its own transfer agent.

Sec. 10.50.080. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER. (a) The ownership interest in shares of the corporation's stock issued to an individual ineligible to receive the shares who has presented fraudulent or misleading information regarding his eligibility to own the shares, is voidable upon the issuance of an appropriate order by the superior court. The ineligible individual is also liable for the full amount of dividends, or other distribution to shareholders received by him plus interest from the date of distribution, and legal fees and costs of recovery incurred by the corporation. This section applies to an individual who has presented fraudulent or misleading information regarding the eligibility of another person for whom he acts in the capacity of legal guardian.

(b) An individual who obtains shares of the corporation, or in his capacity as legal guardian obtains shares of the corporation for another, through fraud, misrepresentation, or any deceitful or illegal means is guilty of a felony.

Sec. 10.50.090. DIVIDENDS OF THE CORPORATION. Dividends, or other distributions, may be declared and paid by the corporation at any time

and from any source to the extent considered necessary by the board in order to comply with the distribution requirements of subchapter U of the Internal Revenue Code of 1954, as amended, (26 U.S.C. secs. 1391 - 1397), except that no dividend or other distribution may be declared if the corporation is insolvent or if the declaration would cause the corporation to become insolvent.

Sec. 10.50.900. DEFINITIONS. In this chapter,

(1) "board" means the board of directors of the Alaska General Stock Ownership Corporation;

(2) "corporation" means the Alaska General Stock Ownership Corporation;

(3) "resident" means an individual who maintains a permanent place of abode in the state with the intention of making the state his permanent place of residence and who resides in the state continuously except for temporary purposes only and with the intent of returning; a person may not be considered to have gained a residence solely by reason of his presence and he may not lose it solely by reason of his absence while in the civil or military service of this state or of the United States or of his absence because of marriage to a person engaged in the civil or military service of this state or the United States; while a student at an institution of learning; while in an institution or asylum at public expense; while confined in public prison; while engaged in the navigation of waters of this state, of the United States, or of the high seas; or while residing upon an Indian or military reservation; a minor takes the residence of his parent or of his legal guardian; a married woman shall establish her own residence and does not presumptively take the residence of her husband.

* Sec. 2. AS 37.10.065(a) is amended by adding a new paragraph to read:

(9) secured loans to the Alaska General Stock Ownership

1 Corporation.

2 * Sec. 3. AS 37.10.070(a) is amended by adding a new paragraph to read:

3 (14) bonds or other forms of indebtedness of the Alaska

4 General Stock Ownership Corporation.

5 * Sec. 4. AS 45.55.140(a) is amended by adding a new paragraph to read:

6 (12) a security issued by the Alaska General Stock Ownership

7 Corporation.

8 * Sec. 5. AS 45.55.140(b) is amended by adding a new paragraph to read:

9 (18) a transaction of a security issued by the Alaska General

10 Stock Ownership Corporation.

11 * Sec. 6. Notwithstanding any other provision of law, a civil action to
12 contest the legality of this Act is barred unless the complaint is filed
13 within one year of the effective date of this Act. The purpose of this
14 limitation on suits is to insure that, after the expiration of a reasonable
15 period of time, the right, title, and interest of shareholders of the Alaska
16 General Stock Ownership Corporation will be vested with certainty and that
17 the corporation will be able to carry on its business activities with cer-
18 tainty.

19 * Sec. 7. Notwithstanding AS 01.10.030, the provisions of this Act are
20 nonseverable. If any provision of this Act, or the application of it to any
21 person or circumstance, is held invalid, this Act shall be void in its en-
22 tirety.

23 * Sec. 8. AS 10.50.080(b) is amended to read:

24 (b) An individual who obtains shares of the corporation, or in his
25 capacity as legal guardian obtains shares of the corporation for
26 another, through fraud, misrepresentation, or any deceitful or illegal
27 means is guilty of a <u>class C</u> felony.

28 * Sec. 9. Sections 1 - 7 of this Act take effect immediately in accor-
29 dance with AS 01.10.070(c).

1 * Sec. 10. Section 8 of this Act takes effect January 1, 1980.

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A Discussion of the Financial Foundation
for General Stock Ownership Plans*

by

Stephen A. Buser**
(April 1979)

*This paper was prepared in part from material gathered under a research project for the Ford Foundation and was submitted in support of oral testimony before the Alaska State Legislature in Juneau on March 20, 1979.

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I. Preface and Summary

A General Stock Ownership Corporation (GSOC) is not a magical money machine. In the absence of external support in some form, a GSOC cannot be expected to earn a net cash flow simply by borrowing from one group of capital owners in order to finance asset acquisitions from other capital owners. Inappropriate analogies are sometimes drawn between financed asset acquisitions that a GSOC might undertake and those that wealthy individuals and solvent firms undertake as a matter of routine. By definition, wealthy individuals and solvent firms have equity bases to cushion temporary or chronic operating deficits. In constrast, the financial condition of an unsubsidized GSOC, is similar to that of any other firm whose liabilities exceed its assets; it is insolvent. Like any other insolvent firm, a GSOC can be made to show an operating profit if given sufficient subsidies in the form of donated cash or assets, tax benefits, and/or credit assistance. However, since these subsidies would have earned a normal return if put to alternative uses, it is erroneous to attribute a GSOC "profit" to its leverage-acquisitions. Any such "profit" is simply a residual of the normal return on the subsidies invested in a GSOC, after the GSOC's own expenses have been deducted.

Therefore, despite optimistic claims by a few exhuberant supporters, a GSOC is more accurately described as an elaborate financial device for capturing and redistributing the federal taxes currently paid on privately owned assets. Since these tax payments can be sizable, the implicit federal subsidy represents a potentially valuable source of State revenue. However, under the federal "enabling" legislation a GSOC's tax liability is not forgiven but instead is passed through to (and borne fully by) the citizen shareholders of the GSOC. Technically, the federal tax "break" is limited distributions in excess of the

GSOC (pass through) tax liability. This provision carries important implications both for the financial viability of the GSOC and for the form of the distribution of the federal subsidy.

In terms of financial viability, the pass-through restriction, reduces the portion of the federal subsidy that a GSOC can use to cover its own overhead and debt-service expenses. Projected GSOC operating deficits (which any pure leverage investment company would run) must be funded from some other source. Most likely, State assistance will be required on a continuing basis and in an amount that is significant when measured against the after-tax benefits received by the citizens of the State.

In an attempt to lessen its own subsidy burden, a State might direct its GSOC to acquire assets that would generate a low (or even a zero) pass through tax liability. However, to the extent that such assets also generate low tax liabilities for existing owners, the federal subsidy is reduced as well. The "solution" that seems implicit in the federal legislation is for the GSOC to acquire assets that are eligible for tax credits and/or accelerated depreciation charges from owners who have already exhausted such benefits for themselves. Since nonsubsidized firms have a similar tax incentive for acquiring such assets, a GSOC must expect to pay prices above those that would otherwise prevail in the secondary market for depreciated assets. Sales at inflated prices would allow the selling firms to capitalize a greater portion of their scheduled tax payments to the federal government, reducing the portion of the subsidy captured by the GSOC.

GSOC advocates have suggested that careful investment analysis might eliminate such overpricing. However, the GSOC's investment team, will be virtually totally dependent on projections provided by the selling firms. Experi-

enced negotiators for selling firms also have been known to cite pressing cash needs or other smokescreens in an effort to convince buyers that the assets are actually offered below the prevailing market prices. Experienced buyers recognize, of course, that if such were in fact the case, a rational seller would always sell at the higher market price unless the sale at the lower price constituted an implicit payment for some past or future consideration. Such might be the case in a "pilot" program where a selling firm has a clear incentive to "prove" that the GSOC is viable in order to establish a future flow of subsidy benefits. In other cases, selling firms may simply rely on the observation that even at inflated prices, the GSOC will show a "profit" as long as the federal subsidy is less than fully capitalized by the seller.

Despite the apparent inevitability of the diversion of GSOC subsidies to selling firms, even GSOC directors with impeccable standards may be hard pressed to determine the true extent of these diversions. Efforts at extensive investment analysis might succeed in limiting the subsidies to selling firms but only by creating another type of subsidy diversion in its place since the required analysis is apt to be quite expensive, and these costs must be subsidized as well. Regrettably, it is unlikely that even an outside "watch dog" agent (perhaps established by the State legislature) could successfully monitor GSOC activities. On the contrary, the risk appears far greater that outside pressure will be exerted on the GSOC directors to use their considerable subsidy powers in support of particular firms or banks that might be deemed "essential" to the State or local economy. In fact, it might be argued by some that the GSOC has a "moral obligation" to provide such support as long as it can do so and still show an operating "profit." For example, subsidy diversions to the shareholders of particular firms might be regarded as necessary to continue employment for

workers who might otherwise face a loss of jobs. Unfortunately, the firms destined for subsidy diversions are capital intensive rather than labor intensive so that GSOC subsidy diversions are apt to be extremely inefficient (in terms of cost per worker) as a means of providing job security.

When the inherent disadvantages of the GSOC concept are measured against the ambiguous federal support for the program, a State may decide that the "price" it must pay for a GSOC is too high in relation to the potential benefits. Even if a State determines that GSOC benefits are "offered" at a bargain under the federal legislation , the State should be aware that the citizen-shareholders in a GSOC will share the federal and State subsidies with the GSOC bureaucracy and with the firms that sell assets or lend funds to the GSOC. While subsidy diversions in small amounts might be regarded as "normal" operating costs, the potential for large-scale subsidy diversions cannot be ignored. Such diversions are not necessarily "bad," but they defeat the expressed purpose of the GSOC concept by funnelling benefits to existing capital owners rather than to new capital owners. At present the "unintended beneficiaries" of a GSOC program appear to be the shareholders of capital intensive firms, as well as banks and other lending institutions that might win the favor of a particular board of GSOC directors. The federal immunity from personal income taxes on distribution in excess of the GSOC pass-through tax liability obviously benefits citizens in the highest tax brackets the most. Those who pay little or nothing in the way of taxes obviously receive little or no benefits from this tax "break." Those suffering the most from the proposed GSOC program would be firms that would have to compete with the GSOC, either in the market for credit or in the market for depreciated assets. In addition, despite the fact that the costs of the federal and State subsidies would be dispersed, every dollar of benefits distributed

by the GSOC will have to be made up, either in the form of additional tax revenues to replace those diverted or in the form of greater inflation if the lost tax revenues are not made up.

Economists note that asset transfers do not create new cash flows. In fact, transfer programs, no matter how socially desirable they might be, absorb rather than generate market value as new costs are merely grafted onto the existing economy. Thus economists place a heavy burden of proof on the proponents of particular plans to show that their plans are adequately funded (or subsidized) and that the benefits actually accrue to the targeted groups. Unfortunately, despite the force of a highly emotional call for action, the GSOC backers have not satisfied these basic requirements. "Faith" and "vision" are all that have been offered in support of the contention that a GSOC can achieve its intended goals and avoid becoming simply one more program that promises broad-based benefits but instead imposes broad-based costs and funnels the benefits to familiar recipients, the banks, the capital intensive industries, and of course, bureaucracy itself.

II. Financial Viability of a GSOC

Case 1: Viability without external support

To appreciate the limitations of the federal GSOC legislation, it is important to understand precisely how and why a GSOC is not financially viable without external support. To do so, let us reexamine a hypothetical example of financed capitalism found on p. 71 of the report submitted by Kelso & Co. to the Alaska State Legislature, "Design of an Alaskan General Stock Ownership Plan, Volume I" (February 15, 1979). In that example, a Mr. Adams borrows $200,000 and builds a fourplex which he rents out for a total of $24,000 per year. For simplicity, the drafters of the Kelso & Co. report abstract from vacancy risk, from taxes, from overhead expenses, and even from interest on the loan. Such simplifications might have served the narrow purposes of the commission issued by the State to Kelso & Co. They do little, however, to reassure a potential lender who is concerned with the financial viability of a GSOC. For example, with an interest rate of 10% (generous by today's standards), the annual debt service on a ten-year fully amortized loan is $32,500 rather than the $20,000 figure used in the interest-free example. Thus even if the $24,000 earnings figure is reinterpreted as net taxes and net of all expenses, the financed acquisition plan would fall considerably short of the goal of self-liquidation. Instead of an excess annual cash flow of $4,000 found in the zero-interest example, Mr. Adams would have to cover a short-fall of $8,500 per year over the life of the loan. The loan could be amortized over a longer period, thus reducing the annual debt service. However the interest alone amounts to $20,000 per year so that a self-liquidating the mortgage would have to be written with exceptionally long maturity. At an interest rate of 12% or better, the mortgage could never be paid off out of the projected rents alone.

Advocates for the concept of financed capitalism might observe that the rental rates chosen by the drafters of the Kelso & Co. report were arbitrary and just happened to be too low in order to make sense when representative charges are introduced. Therefore, it is important to recognize that even if the example were restructured so that Mr. Adams would have been able to arrange self-liquidating financing for his investment, that does not mean he would sell his fourplex to the GSOC at a price that (in the absence of external support) would allow the GSOC to finance the acquisition with a self-liquidating loan. On the contrary, rather than sell at such a price, Mr. Adams would simply refinance any outstanding mortgage against his fourplex, in order to raise the same amount of additional cash that the sale would have produced (after repaying the loan). Thus even though the financed capitalism concept might work for original investments, the model breaks down when it is applied to asset transfers. As long as asset sellers require full compensation for the stream of earnings they relinquish, the debt service on loans to provide such compensation must exhaust the full value of the asset's earning potential. Otherwise, the alternative of financed asset retention dominates the decision to sell the asset.

In reaching this general conclusion, it must be remembered that external factors, such as tax considerations, have not yet been introduced. Similarly, differences in borrowing capacities have not yet been considered. Thus the general conclusion is not contradicted by examples of asset acquisitions that are entirely financed via self-liquidating loans to individuals or firms who can secure the loan pledging more than just the asset's own earnings. Implicit in such arrangements is the very important premise that, if needed, the borrower can draw on other funds or resources. In contrast, a GSOC has no equity base to use

as supplemental collateral for loans. Thus in the absense of external su
GSOC would be unable to acquire assets via self liquidating loans even t
equity firms and some individuals might be able to do so. GOSC's are b
means unique in this regard. Extensive analysis of investment compan
(including mutual funds) confirms that these equity institutions would not be viable as pure-debt firms. I.e., they do not earn a rate of return equal to their risk-adjusted cost of capital.

Case 2: Viability under the federal legislation

The federal "enabling" legislation is not a legal requirement for the operation of a GSOC. It is merely an open admission that a GSOC is nc financially viable without external support of some form. On its own a GSOC would not earn leverage arbitrage profits, it would make leverage arbitrage losses as would any other pure-debt investment company. Without an equity base or an external subsidy to offset these losses no lender would extend funds to a GSOC. This observation, more than any other single factor, explains why pure-leverage investment companies have failed to materialize on their own despite promises of sure profits offered by advocates of financed capitalism.

Recent federal legislation grants qualifying GOSC's immunity from the federal corporate income tax. Had immunity been granted in an unrestricted form, a GSOC would have been able to use a greater portion of the pretax earnings on assets to cover GSOC overhead and to service the debt raised to finance asset acquisitions. Any excess subsidy would then have been available for distribution to citizen-shareholders or for accumulation as equity in the GSOC. To illustrate this point, let us return to the previous example. and assume that the pretax earnings on Mr. Adams' fourplex had been $40.000. of which he was required to pay $10,000 in federal taxes and another $6,000 in state

taxes, leaving $24,000 for expenses and debt service. Under federal (but not state) immunity, the GOSC would have the use of $34,000 per year, and thus, over some price range, could afford to offer Mr. Adams more for the asset than he would be able to raise via his own self-liquidating loan. At such a price, Mr. Adam's would capitalize all of the after-tax earnings plus a portion of the earnings stream otherwize lost to the federal government. In such a case, both Mr. Adams and the GSOC would benefit at the expense of the U.S. Treasury.

Apparently the U.S. Congress did not intend that the federal legislation reduce to merely a tax dodge (at least not so simply). Therefore, in granting GOSC's immunity, the "enabling" legislation also mandates that the equivalent tax liability be passed through to the citizen-shareholders without regard for the special tax status of the recipients. Had the GSOC been a viable-self-supporting firm, the pass-through restriction would not have been especially significant. A GSOC would simply pass through its own tax savings in order to cover the tax liability that it must also pass through. However, the GSOC requires these (or some other) funds to cover the amount by which its overhead and interest costs will exceed its (after-tax) earnings. Thus, as presently structured, the federal legislation does nothing to improve the financial condition of a GSOC. To qualify for the tax subsidy, the GSOC must accept an offsetting financial committment.

Despite this negative assessment, a GSOC would have the same opportunities for tax-arbitrage exchanges as any other firm would, and it might be able to make use of such opportunities to strengthen its financial base. Tax savings arise if the tax payments that would have been made by an existing owner (by Mr. Adams in the hypothetical example), are less than those that a GSOC would incur and this difference is less than fully capitalized in the sale of the asset to

the GSOC. The corresponding portion of the pre-tax earnings flow is, in effect, donated by the federal government rather than purchased from the previous asset owner. Such opportunities arise as a matter of routine because of federal tax laws that provide acquisition tax credits and/or accelerated depreciation charges which are renewable only if the qualified assets are transfered to new owners. Thus a GSOC might earn a tax-arbitrage profit by acquiring depreciable assets from owners that have already exhausted the liberal tax benefits for themselves. Unfortunately, these assets offer similar tax advantages for acquiring firms other than GSOC's. Thus GOSC's must bid against other firms for these assets, and this competition will allow the selling firms to capitalize even greater portions of their projected tax payments.

Since a GSOC cannot earn tax-arbitrage profits by acquiring assets from firms in lower tax brackets than the GSOC (based on the pass-through computation), the only way that a GSOC might be able to strengthen its own financial base is to divert a portion of the federal tax subsidy to the shareholders of large capital-intensive corporations seeking to unload some of their depreciable assets after the initial tax benefits have been gutted.

This description of the federal legislation is vastly different from the expressed intentions of the backers of the GSOC concept. So much so in fact, that it is difficult to imagine that the U.S. Congress had a similar goal in mind in settling on the form of this particular "enabling" legislation. It would be far easier to explain the federal "enabling" legislation as an attempt to provide large capital-intensive firms with additional relief from federal taxation.

Case 3: Viability under alternative forms of State assistance

At present, the extent of federal support for a GSOC appears anything but overwhelming. Kelso & Co. or some other source may be able to furnish a

description of the type of asset acquisitions that would recover enough of the federal subsidy to render a GSOC financial viability. As yet, however, no such encouragement has been provided. Nor is there any evidence for a legitimate reference to required State assistance as "start-up" costs. Surprisingly few of the proposed budget items are truely nonrecuring. On the contrary, virtually all of the GOSC's expenses contribute to the annual deficits that a GSOC must run in the absence of continuing financial assistance. These annual deficits are projected as substantial and must be supported from some external source. Moreover even after these deficits have been absorbed (by the State), the State must directly or indirectly provide for every dollar of benefits distributed by the GSOC (in excess of the GSOC tax liability). Recall the federal "contribution" is limited to forgiving the personal taxes that citizen-shareholders would otherwise owe on these excess disbtriubtions.

Although there are many forms that State assistance might take, any such assistance reduces to two basic dimensions, perpetual year-by-year maintenance, and/or an initial endowment. As a substitute for equity capital in a normal firm, an initial endowment of cash or earning assets would provide an income flow needed for an initial operating margin. To the extent that such an initial subsidy is insufficient, supplemental annual subsidies will be required as well. One obvious possibility for an annual maintenance subsidy is immunity from the State corporate income tax. In essence, the State could donate its own tax flow in support of the federal subsidy. Assuming that this benefit is less than fully capitalized in the sale prices of assets, the GSOC would then capture at least a part of the State subsidy (with the balance accuring to the seller of the asset as with the federal tax subsidy).

Credit assistance provides an alternative form of a maintenance subsidy. Instead of furnishing additional revenue, a credit subsidy is designed to reduce

borrowing costs and hence lower debt service claims against GSOC income. Agency status would provide the GSOC with direct access to the tax exempt borrowing market. Equivalently, the State could borrow (or divert funds from other uses) and lend to the GSOC at rates less than those charged in the fully taxable market. In either case, however, the State could have earned the higher (market) rate, on its funds and thus the State, should regard the difference in revenue as a subsidy to the GSOC.

Loan guarantees have been proposed as a low cost form of subisidy. Unfortunately, it is only the visibility of the cost that is low. In any insurance situation, such as a loan guarantee, it is not the visible or out-of-pocket expense that determines the true cost to the insurer. Far more important is the associated risk that must be borne. Without a highly diversified asset base to support precise accuarial assessments, the invisible costs of insurance are usually regarded as prohibitive rather than as negligible. If lenders (who are apt to be more highly diversified than the State) believed that these costs were negligible, they would not offer a substantial reduction in rates in exchange for a loan guarantee. The fact that lenders are willing to accept less interest in exchange for a loan guarantee indicates that they presume that the implicit risks are high. In effect, lenders are betting the difference in interest charges that even with massive federal and State subsidies, the GSOC may be overextended in relation to its financial committments. It is important to note that financial overextension can arise even if the asset portfolio of a firm is of the highest possible quality.

A normal firm that is overextended but otherwise sound is referred to as undercapitalized. In order to raise debt capital, such a firm may first have to raise additional equity capital. In the case of a GSOC, there is no initial equity capital, only a subsidy base. If this base is insufficient to assure an adequate

operating profit margin, the condition of the GSOC is analogous to that of the undercapitalized firm. Loan guarantees provide an additional subsidy, and eliminate the lender's risks. But, since there is no reason to presume that the State has any advantage over lenders in terms of bearing such risks, any apparent "profit" from selling loan guarantees (in exchange for lower borrowing costs) is purely illusory.

In terms of pure cost effectiveness, direct cash payments provide by far the most efficient form for subsidies since they are the least costly to administer . However, these payments are also the most visible and therefore they are often the least attractive from a political standpoint. Opting for less visible but also less efficient forms of subsidy makes it difficult, if not impossible, for the State to assess the extent of its own subsidy. (Just as it is already difficult to assess the extent of the subsidy implicit in the federal GSOC legislation.) For a State that is truely concerned about the extent of its own subsidy to the GSOC program, it is especially important to consider only the most cost-effective and visible subsidy program. It is difficult to imagine what is to be gained, other than short-run political expediency, by burying the unavoidable costs of a GSOC through a series of complex financial arrangements.

III. Distribution of the federal and State subsidies

A GSOC may useful as a device for capturing and redirecting federal tax revenues on earning assets. However, the GSOC's own budget,no matter spartan, can only draw from the subsidy pool. Moreover, even before the subsidies get to the GSOC, a portion will be diverted to asset sellers in the form of inflated market prices. An additional portion of the subsidies will be absorbed by banks and other lenders who earn more money from engaging in leverage-arbitrage of their own than they do by creating those opportunities for others.

This observation explains why the powerful bank lobby did not oppose the "enabling" federal legislation. That lobby would almost certainly have opposed any serious attempt at diffusing stock ownership since it is precisely this issue--disintermediation--that the banks have lobbied against for so many years. However, the GSOC lesgislation promises to cut banks in on the subsidy (at least those banks who win the favor of the GSOC directors).

Under scrupulous and cold-blooded financial management, it might be possible to hold the subsidy diversions to a minimum. But to do so, the GSOC's directors must turn a deaf ear to the pleas of special interest groups. It is to be expected, however, that the GSOC directors will be beseiged with requests for help from particular firms or industries that might be deemed essential to the State or local economy. Moreover, the subsidy diversion would be largely hidden in the sense that the GSOC still would be able to show a "profit" as long as it retains enough of the subsidy. Thus it may be difficult for GSOC directors to defend a decision to "support" some firms and some banks but not others. Such dilemma's always raise the possibility that political or other nonfinancial factors may influence the operating decisions of a GSOC.

In sum, while supporters may yet be able to show that GSOC benefits outweigh the additional costs that a State must bear under the federal "enabling"

legislation, thus far, little evidence has been offered in support of that contention. Instead, the case that has been presented is long on moral posturing, and long on railing against the sorry state of affairs that now exists, but painfully short in terms of sound economic reasoning that would lead one to believe that a GSOC offers any reasonable hope of achieving the expressed objectives. If left unattended, the existing biases in the federal legislation would funnel benefits to existing capitalists, as stockholders in banks and capital intensive firms, and to new GSOC bureaucrats, leaving an as yet undetermined fraction for (excess) distribution to citizen-shareholders. Even this distribution is regressive in the sense that the federal tax savings is greater for those in higher tax brackets. Since the same citizens must pay for the State subsidies (as well as their portion of the federal subsidy) either in the form of increased taxes or in the form of increased inflation (assuming that taxes are not raised), it is far from clear that the benefits outweigh the costs for any group of citizens. It should be clear, however, that the society as a whole loses since new costs are created but no new revenues are created to pay for those costs.

In the absence of "clarifying" analysis, the decision before the Alaska State Legislature appears to be one of whether or not to assist capital intensive firms in recovering part of the taxes they currently pay to the federal and State government. If so, a GSOC might be an appropriate vehicle, one that would also benefit selective banks and would create supporting jobs through its own bureaucracy. If sufficiently subsidized through tax benefits, loan guarantees, etc., a GSOC might even produce a modest excess cash flow to citizen-shareholders. However, if this is the ultimate goal, the State would be far better off to scrap the proposal for a costly administrative structure (the GSOC) and eliminate the subsidy diversions by simply distributing to its citizens the equivalent of the

proposed State subsidies to the GSOC. If it is deemed essential that checks be considered as "dividend" dispersements rather than as transfer payment (which they will be in either case), then the State might adopt a more ennobling title such as "the return on a citizen's share in State Wealth." It is doubtful that many citizens will feel all that different once they have cashed their checks. Only the banks and the capital intensive firms appear to have a strong financial incentive for favoring the more cumbersome and costly GSOC alternative.

Sec. 10.50.315. POLITICAL ACTIVITIES. (a) A corporation may not

(1) make contributions or expend money to influence the nomination or election of a candidate for office or the outcome of a ballot proposition or question;

(2) endorse a candidate for office or any side of a ballot proposition or question;

(3) make any expenditures, including reimbursement for travel and living expenses, or employ any person for the purpose of influencing legislative action.

(b) A corporation that knowingly violates this section or that knowingly causes, participates in, aids, abets, ratifies, or confirms any violation of this section is, upon conviction, punishable by a fine of not more than $10,000 for each offense.

(c) An individual who knowingly violates this section, whether acting for himself, on behalf of an employer, or in concert with other person, is, upon conviction, punishable by a fine of not more than $1,000, or by imprisonment for not more than one year, or by both.

(d) An individual who knowingly causes, participates in, aids, abets, ratifies or confirms any violation of this section is, upon conviction, punishable by a fine of not more than $1,000, or by imprisonment of for not more than one year or by both.

Sec. 10.50.220. DIVIDENDS PAID ON SHARES OWNED BY MINORS. The parent or guardian of a shareholder who is under 18 years of age shall, on a form provided by a corporation, designate a financial institution in the st ae to act as trustee for dividends of a corporation paid to such shareholder. If the parent or guardian faild to make the designation required under this section, the corporation shall do so and notify the shareholder. A financial institution acting as a trustee under this section shall pay interest on all funds held by it as trustee under this section and may charge against the funds held in trust a reasonable fee for its services as trustee. The trustee shall provide the shareholder with an annual statement showing the interest paid on and the charges made against the funds held in trust. All funds held in trust for a shareholder and an accounting of interest paid on the funds and charges deducted form the funds shall be paid to him within 30 days of his demand made after his 18th birthday.

James Allen were able to create and fund the Economic and Development Corporation, a separate Swiss company, and pay [illegible] to Dr. Hubert [illegible], a Swiss attorney, to stimulate West German jet sales without the knowledge of the board or, apparently, other senior executives.

At 3M, chairman Bert Cross and finances vice president Irwin Hansen ordered the company insurance department to pay out $500,000 for imaginary insurance and the bookkeeper to fraudulently record the payments as a "necessary and proper" business expense for tax purposes. Although the transactions lacked required documentation, they were approved by both departments and later "verified" by Haskins and Sells, the outside auditor.

Ashland Oil Corporation's chief executive officer, Orwin E. Atkins, involved at least eight executives in illegally generating and distributing $801,165 in domestic political contributions, also without question. Not only was the board not informed until the Special Prosecutor's Office and Internal Revenue Service compelled Atkins to dribble out details of the misappropriation of funds, but Ernst and Ernst, Ashland's accountants, did not effectively investigate any of half a dozen separate accounts it discovered that suggested Ashland's illegal course of action.

The Legal Basis of Management Power

The legal basis for such a consolidation of power in the hands of the corporation's chief executive is the proxy election. Annually the shareholders of each publicly held corporation are given the opportunity of either attending a meeting to nominate and elect directors or returning proxy cards to management or its challengers signing over their right to vote. Few shareholders personally attend meetings. Sylvan Silver, a Reuters correspondent who covers over 100 Wilmington annual meetings each year, described representative 1974 meetings in an interview: At Cities Service Company, the 77th largest industrial corporation with some 135,000 shareholders, 25 shareholders actually attended the meeting; El Paso Natural Gas with 125,000 shareholders had 30 shareholders; at Coca Cola, the 69th largest corporation with 70,000 shareholders, 25 shareholders attended the annual meeting; at Bristol Meyers with 60,000 shareholders a like 25 shareholders appeared. Even "Campaign GM," the most publicized shareholder challenge of the past two decades, attracted no more than 3,000 of General Motors' 1,400,000 shareholders, or roughly two-tenths of one percent.

Thus, corporate directors are almost invariably chosen by written proxies. Yet management so totally dominates the proxy machinery that corporate elections have come to resemble the Soviet Union's euphemistic "Communist ballot"—that is, a ballot which lists only one slate of candidates. Although federal and state laws require the annual performance of an elaborate series of rituals pretending there is "corporate democracy," in 1973, 99.7 percent of the directorial elections in our largest corporations were uncontested.

Of the 6,744 corporations required to file data with the Securities and Exchange Commission, incumbent management retained control in at least 6,734 companies, or [illegible] percent. In the 500 largest industrial corporations—corporations which account for some 66 percent of the sales of all industrial corporations in the United States—no incumbent management was even challenged in 1973. One-sided as these results are, they are entirely typical for the largest business corporations. During the 18 years for which data are available, 1956–73, management has won 99.9 percent of all proxy solicitations in 10 out of 18 years.

THE BEST DEMOCRACY MONEY CAN BUY

The key to management's hegemony is money. Effectively, only incumbent management can nominate directors—because it has a nearly unlimited power to use corporate funds to win board elections while opponents must prepare separate proxies and campaign literature entirely at their own expense.

There is first management's power to print and post written communications to shareholders. In a typical proxy contest, management will "follow up" its initial proxy solicitation with a bombardment of five to ten subsequent mailings. As attorneys Edward Aranow and Herb Einhorn explain in their treatise, *Proxy Contests for Corporate Control*:

SOURCE: TAMING THE GIANT CORPORATION
NADER, GREEN, AND SELIGMAN

Perhaps the most important aspect of the follow-up letter is its role in the all-important efforts of a soliciting group to secure the *latest-dated* proxy from a stockholder. It is characteristic of every proxy contest that a large number of stockholders will sign and return proxies to one faction and then change their minds and want to have their stock used for the opposing faction.

The techniques of the Northern States Power Company in 1973 are illustrative. At that time, Northern States Power Company voluntarily employed cumulative voting, which meant that only 7.2 percent of outstanding shares was necessary to elect one director to Northern's 14-person board. Troubled by Northern's record on environmental and consumer issues, a broadly based coalition of public interest groups called the Citizens' Advocate for Public Utility Responsibility (CAPUR) nominated Ms. Alpha Smaby, a former Minnesota state legislator, to run for director. These groups then successfully solicited the votes of over 14 percent of all shareholders, or more than twice the votes necessary to elect her to the board.

Northern States then bought back the election. By soliciting proxies a second, and then a third time, the Power Company was able to persuade (or confuse) the shareholders of 71 percent of the 2.8 million shares cast for Ms. Smaby to change their votes.

Larger, more experienced corporations are usually less heavy-handed. Typically, they will begin a proxy campaign with a series of "build-up" letters preliminary to the first proxy solicitation. In Campaign GM, General Motors elevated this strategy to a new plateau by encasing the Project on Corporate Responsibility's single 100-word proxy solicitation within a 21-page booklet specifically rebutting each of the Project's charges. The Project, of course, could never afford to respond to GM's campaign. The postage costs of soliciting GM's 1,400,000 shareholders alone would have exceeded $[illegible]. The cost of printing a document comparable to GM's 21-page booklet, mailing it out, accompanied by a proxy statement, a proxy card, and a stamped return envelope to each shareholder might have run as high as $500,000.

Nor is it likely that the Project or any other outside share-holder could match GM's ability to hire "professional" pro[illegible]

tors such as Georgeson & Company, which can deploy up to 100 solicitors throughout the country to personally contact shareholders, give them a campaign speech, and urge them to return their proxies. By daily tabulation of returned proxies, professional solicitors are able to identify on a day-by-day basis the largest blocks of stock outstanding which have yet to return a favorable vote.

Management's "army" in a proxy contest will also include attorneys to prepare necessary documents for the SEC and distract the opposition with costly litigation; accountants and statisticians to prepare the most self-serving financial analysis allowable; and public relations advisors to prepare advertisements for trade journals and the financial section of major newspapers. In the past 25 years there have been no more than a dozen instances in which insurgents have been able to match management expenses in a major proxy fight. Over the past decade, only the MGM proxy contest of 1967 has seen insurgents match management expenses in a large corporation's proxy contest for control.

A second advantage—and one that no outsider can match—is management's ability to use corporate personnel on its own behalf. Clerical help and clerical facilities including printing presses, photocopying machines, and addressing machines are invariably employed. Salespersons skilled in talking to customers are frequently assigned to the telephones to answer inquiries and to supplement the professional proxy solicitors by making direct calls to shareholders. Moreover, senior executives can be assigned to telephone particularly important shareholders who may be impressed by the personal call of a top executive.

State corporations law has done nothing to correct this inequality of corporate resources. Although leading cases in Delaware and New York have engaged in much gnashing of teeth about [illegible] management expenditures to: (a) proxy contests involving a "policy" issue, (b) expenditures necessary to inform shareholders about the "policy" issue, and/or (c) "reasonable" expenses—no decision since 1907 in either jurisdiction has denied management the [illegible] to expend corporate funds or use corporate personnel ex[illegible] as management chooses. Even such seemingly "unreasonable"

expenditures as public relations counsel, "entertainments," chartered airlines, limousines, and the indirect cost to the corporation of using officers and employees on behalf of an incumbent director slate have survived judicial scrutiny. By contrast, state courts have firmly established the rule that insurgents, unlike management, are not entitled to reimbursement of any campaign expenses as a matter of right. Challengers must defray all their own expenses, with the single slim hope of later being reimbursed *if* they are successful and the stockholders approve.

MANAGEMENT CONTROL OF INFORMATION

Management's grip on corporate power is tightened by its authority to print and distribute annual, quarterly, and other reports to shareholders. Besides the formal proxy statement, these reports usually embody the only detailed information shareholders receive about their corporation.

Neither state nor federal law places any meaningful restrictions on the amount of money management may spend reporting to shareholders. SEC Proxy Rules *do* require certification of financial statements. The report, however, "may be in any form deemed suitable by the management" and is not subject to the same standards of truthfulness that the text of a proxy solicitation is subjected to. Consequently, though every word of an insurgent shareholder's communications with other shareholders may be challenged if it is arguably "false or misleading," most management reports are subject to no textual regulation whatever.

Unfortunately, management reports are frequently "false and misleading." They are often written in an upbeat public relations jargon which emphasizes "positive" aspects of the past business year while rationalizing or ignoring management mistakes, financial losses, corporate or executive criminal violations, or civil actions successfully prosecuted against the corporation. Frequently, as much as half of the text of an annual report is represented by oversized charts, colored illustrations, and kindred public relations gimmickry.

There is often little difference between the text of a fail[illegible] poration's annual report and a healthy corporation's report. [illegible]

ample, although subsequent congressional testimony made clear that Lockheed would have gone bankrupt unless it received an emergency loan guarantee from the federal government, Lockheed's 1969 annual report managed to ignore the prominent debate in Congress over whether the federal government should "bail out" the firm. Instead shareholders read the following:

> It is disappointing to have to record a net loss for the year. Yet setbacks like this are singularly possible in an industry so dependent upon government policy and the ebb and flow of domestic and international developments.
>
> We have experienced them before and in each case have emerged stronger than ever. We are confident this will be so again. We say this not out of easy optimism but from the knowledge that we have many broadly based defense and commercial programs with high business potential and that we are expending much technical effort to meet the nation's future needs.

The report then spent six pages suggesting that Lockheed's financial difficulties were primarily the result of contractual misunderstandings with the federal government. It strongly suggested that the federal government would compromise in these disputes. It was only *after* the Senate voted an Emergency Loan Guarantee by the razor-thin margin of 49–48 in August 1971 that Lockheed reported to its shareholders that without this congressional subsidy the corporation would have collapsed.

A similar lack of veracity appeared in the 1973 Annual Report of the Franklin New York Corporation, whose principal subsidiary was the Franklin National Bank, the largest state bank ever to fail in the United States. Just a few months before the Comptroller declared the Franklin National Bank insolvent, the corporation's management reported to its shareholders that "In 1973 Franklin crossed an important threshold so that it is now in a position to move forward in establishing itself as a major worldwide financial institution and a leading money center banking operation." Nowhere in the report was any mention made of the foreign currency [illegible] improvident real estate loans which four months [illegible] the bank's demise. This was a serious omission, for the [illegible] of financial loss caused by Franklin's collapse was

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

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

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

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

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

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

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

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

MANAGEMENT CONTROL OF THE LAW

Management power is further entrenched by three significant legal advantages.

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

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

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

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

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

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

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

The third statutory device for impairing shareholder suffrage

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

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

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

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

MANAGEMENT CONTROL OF OTHER FUNDAMENTAL DECISION-MAKING

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

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

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

CERTIFICATE OF INCORPORATION
OF
DELITT CORPORATION

Article 1

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

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

Article 2

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

Article 3

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

Article 4

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

Article 5

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

Article 6

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

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

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

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

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

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

Article 7

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

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

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

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

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

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

Whither / Wither the Board of Directors?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Q. As a member of that board, what else have you done?
A. *Oh, I have convened and talked.*
Q. You have convened and talked?
A. *And adjourned.*
Q. Well, you have convened and talked?
A. *And adjourned.*
Q. Well, what have you talked about?
A. *Statistics.*

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

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

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

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

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

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

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

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

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

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

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

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

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

The Limitations of Shareholder Litigation

STATE LAW: THE NON-DUTY OF CARE

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The consequence of *Lanza* and similar recent decisions has been to leave federal securities law in a crazy quilt pattern. The federal securities laws, for example, will not reach a deliberate though not self-enriching decision of corporate executives to engage in an unprofitable line of business unless there has been an accompanying failure of disclosure. Nor will they reach decisions which *do* enrich corporate officers unless they involve security transactions. Liability seems so haphazard and fortuitous that former SEC Chairman William Cary was moved to complain:

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

NULLIFY THE JUDGMENT: INDEMNIFICATION INSURANCE

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

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

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

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

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

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

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

Conflicts of Interests

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

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

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

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

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

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

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

Even beyond inadequate enforcement of its provisions, section 8 only forbids interlocks among competitive corporations. Interlocks among corporations which provide services, supplies, funding, or distribution for each other equally violate the fundamental law that no man can serve two masters. They are also far more numerous. In 1974, the Center for Science in the Public Interest analyzed interlocking directorates and advisory committee connections of the eighteen largest United States oil corporations. They found 460 interlocking connections in all, including 132 interlocks with banks, 31 interlocks with insurance companies, 12 interlocks with utilities, 15 interlocks with transportation corporations, and 224 interlocks with manufacturing and distribution corporations. Oil company ties with banks (which supply capital), insurance companies (which provide an underwriting service), distribution companies (which distribute oil company products), and utilities, transportation, and manufacturing corporations (which purchase oil products) inevitably diminish the arm's length atmosphere in which effective competition thrives.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Not only may corporate officers engage in such self-dealing but shareholders under Delaware law are nearly powerless to minimize the amount of corporate largess top executives pay themselves. Any contract or transaction between the corporation and an interested executive is permissible as long as it is "fair." But, in Delaware, fairness is presumed. Professor Ernest Folk, the leading commentator of Delaware's General Corporation Law, explains that "Given Delaware's presumption of sound business judgment with respect to board decisions, the courts will try to determine whether the decision can be attributed to any rational business purpose, and if so, there will be no judicial preemption of the decision."

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Remedies

REVAMPING THE BOARD

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

> The accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny. Were the federal constitution, therefore, really chargeable with this accumulation of power, or with a mixture of powers, having a dangerous tendency to such an accumulation, no further arguments would be necessary to inspire a universal reprobation of the system.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ELECTION OF THE BOARD

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

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

> Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporations whose consent must be sought. . . . Their interests are protected if financial information is made available, fraud and overreaching are prevented, and a market is maintained in which their shares may be sold. A priori, there is no reason for them to have any voice, direct or representational, in [corporate decision making]. They are no more affected than nonshareholding neighbors by these decisions. . . .
>
> A more spacious conception of 'membership,' and one closer to the facts of corporate life, would include all those having a relation of sufficient intimacy with the corporation or subject to its powers in a sufficiently specialized way. Their rightful share in decisions and the exercise of corporate power would be exercised through an institutional arrangement appropriately designed to represent the interests of a constituency of members having a significant common relation to the corporation and its power.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A NEW ROLE FOR SHAREHOLDERS

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

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

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

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

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

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

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

AFFECTED COMMUNITIES

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

Instead, upon finding of a public health hazard by three members of the board of directors or 3 percent of the shareholders, a corporate referendum should be held in the political jurisdiction affected by the health hazard. The referendum would be drafted by the unit triggering it—either the three board members or a designate of the shareholders. The affected citizens by majority vote will then decide whether the hazardous practice shall be allowed to continue. This form of direct democracy has obvious parallels to the initiative and referendum procedures familiar to many states—except that the election will be paid for by a business corporation and will not necessarily occur at a regular election.

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

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

Bill Summary

Alaska General Stock Ownership Corporation

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

FORMATION OF THE AGSOC

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

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

AGSOC SHARES

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

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

SHAREHOLDER POWERS

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

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

DIRECTORS AND OFFICERS

The board of directors has management responsibility for AGSOC. The chariman 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 thier actions on behalf of the corporation if they acted in good faith. Indemnification is disallowed in derivative suits where the defendant is guilty of negligence or misconduct in his duties unless the court determines the indemnification is proper. The corporation may purchase insurance on behalf of its directors and employees for claims against them arising out of their corporate positions. (ABCA 10.05.010).

.030. DEFENSE OF ULTRA VIRES. Meaning "beyond the power" an ultra vires act is one which the corporation did not have authority to perform. This section, carried over from the ABCA, provides that this lack of corporate power can be asserted by a shareholder, the corporation, or the attorney general. It may not, however, be asserted by another party to a transaction with the corporation as grounds for failing to perform. (ABCA 10.05.018).

.035. CORPORATE NAME. This section requires that a GSOC include in its corporate name the words "general stock ownership corporation" or an abbreviation thereof. In addition, the name may not be misleading or deceptively similar to the name of another corporation doing business in Alaska. (ABCA 10.05.021).

.040. RESERVATION OF CORPORATE NAME. This section allows a person or corporation to reserve a specific name for a general stock ownership corporation for a period of two years with a renewal period of one year. Reservation of a name might be used where an individual seeks to establish a GSOCs by initiative petition or where an existing GSOC seeks to change its name upon the approval of its shareholders. The name may be reserved by this section during the period in which the necessary activities are undertaken to make the name effective. (ABCA 10.05.024, .027, and .033).

.045. FOREIGN GENERAL STOCK OWNERSHIP CORPORATIONS. General stock ownership corporations chartered in another state and doing business in Alaska are subject to the rules of the Alaska Business Corporations Act (AS 10.05).

.050. REGISTERED OFFICE AND REGISTERED AGENT. The registered agent is the agent for the corporation upon whom legal papers may be served. This provision requires that the corporation maintain a registered office and agent within the state. (AS 10.05.045)

.055. FILING LIST OF REGISTERED CORPORATIONS WITH SUPERIOR COURT.
.060. CHANGE OF REGISTERED OFFICE OR AGENT.
.065. REGISTRATION OF REGISTERED AGENT.
These three sections set out the rules for registration of the registered agent with the Commissioner of Commerce, the listing of registered agents and offices with the superior courts throughout the state, and the method by which a registered agent may change the registered office or resign his position. These provisions are carried over intact from AS 10.05.048, .051, and .054 respectively.

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

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

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

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

.085. PAYMENT FOR SHARES. Payment for shares may be made in cash, other property or services, but not in notes or future services. (AS 10.05.099).

.090. JUDGMENT OF BOARD OR SHAREHOLDER AS TO VALUE OF CONSIDERATION CONCLUSIVE. This section allows the directors or the shareholders to conclusively determine the value of payment for shares in the absence of fraud. (AS 10.05.102).

.095. EXPENSES OF ORGANIZATION, REORGANIZATION AND FINANCING. In sales of stock by a corporation shares entitled to the full protections of limited liability must be fully paid and nonassessable. This means that the full sales price for the stock has been received by the corporation. However, if the stock is sold through an underwriter the fees will come out of the sales proceeds before they are paid to the corporation. Likewise, the organizational expenses of the corporation may be paid out of stock sales before the proceeds are remitted to the corporation. This section clarifys that in such cases the shares are deemed to be fully paid. (AS 10.05.111).

.100. CERTIFICATES REPRESENTING SHARES. This provisions sets out the requirements as to form of stock certificates which must be signed by the corporate officers. (AS 10.05.114)

.105. INFORMATION REQUIRED TO BE STATED ON CERTIFICATE. The stock certificates or other evidences of ownership must include information regarding the person to whom they are issued, that they are no par value shares, and that the corporation is organized in Alaska. (AS 10.05.117).

.110. FULL PAYMENT REQUIRED FOR CERTIFICATE. If payment is required for shares they may not be issued until full payment is received. (AS 10.05.120).

.115. ISSUANCE OF FRACTIONAL SHARES. GSOCs may issue fractional shares of stock and these fractional shares hold dividend, voting and distribution rights equal to their fractional interest. It may be necessary for a GSOC to issue fractional shares in the situation where a shareholder leaves his stock to his heirs and there is more than one child beneficiary. (AS 10.05.123).

.120. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS. This section, adopted directly from ABCA, limits the liability of shareholders and those who have agreed to purchase share to the amount which they agreed to pay to the corporation for the shares. Subsequent holders of the stock are protected if they received the stock in good faith. (AS 10.05.126).

.125. BYLAWS. The board of directors adopts the initial bylaws of a GSOC subject to review and rejection by the legislature under section 335 of the bill. Subsequent bylaws may be adopted, amended or repealed by a vote of either the shareholders or directors.

.130. MEETINGS OF SHAREHOLDERS. The time and location of the annual shareholders meeting is established in the bylaws. The specific place is set by the board. Special shareholder meetings may be called by the president of the GSOC, the board or the holders of at least 1,000 shares. Shareholder meetings may be teleconferenced. (AS 10.05.138).

.135. NOTICE OF SHAREHOLDER'S MEETINGS. This section requires written notice of shareholder's meetings mailed to shareholders not less than 60 days before the meeting. In addition, notice of shareholders' rights to add ballot issues or nominate directors must be made by publication at least once a week for four weeks beginning at least 150 days before the meeting. (AS 10.05.141).

.140. CLOSING OF TRANSFER BOOKS AND FIXING RECORD DATE. To determine the shareholders of the corporation for purposes of a dividend distribution or voting rights the transfer books of the corporation may be closed prior to the date of the proposed activity or a "record date" may be established and the shareholders determined as of that date. Time limits are provided beyond which the transfer books may not be closed in order to protect shareholder voting rights and to allow interested parties to inspect the share records of the corporation prior to shareholders' meetings. (AS 10.05.144).

.145. VOTING LIST. The responsible officer of the corporation must make available at the registered office of the corporation beginning at least 60 days before any shareholders' meeting a list of the shareholders eligible to vote at the meeting and access to this list must be provided to all shareholders. (AS 10.05.147).

.150. QUORUM OF SHAREHOLDERS. 1/3 of the shares constitute a quorum for action by the shareholders and a majority vote of a quorum is sufficient to bind the shareholders in most cases. (AS 10.05.153).

.155. PROXY VOTING PROHIBITED. Because of the ballot mechanism whereby each shareholder is allowed to vote in person through his ballot proxies are unnecessary in general stock ownership corporations and are therefore prohibited.

.160. VOTING FOR DIRECTORS. Each shareholder may vote his shares for directors but cumulative voting is prohibited. This means that each share can cast only one vote for director in any contested election for a directorship position.

.165. VOTING OF SHARES IN THE NAME OF ANOTHER.
.170. VOTING OF PLEDGED SHARES.
These sections allow shares held by an administrator, executor or guardian to be voted by him without a transfer of the shares into his name. Shares held by a pledgee may be voted by the pledgor until transferred into the pledgee's name. (AS 10.05.165 and . 168).

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

Shareholders may, by petition of 1,000 or more, nominate directors and place issues on the corporate ballot. In addition, the directors may place issues and candidates on the ballot by a majority bote. 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 shareholdler 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 incompetance of a board member. (AS 10.05.183).

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

.200. QUORUM OF DIRECTORS. A majority of the total number of directors fixed in the bylaws, articles or enabling legislation constitutes a quorum and action may be taken by a majority vote of a quorum. By allowing only ¼ 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.

Similarily, 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 1¼ 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 1½ 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 10.0 5.222).

.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 germain 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 existance 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 attoreny 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. Voilations 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 existance. 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 minimun 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 broadcase 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 looses 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 CERTIFCATE 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 section 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 AECA 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 looses 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 existance 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 existance 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 privisions and forms, and powers of the Commissioner of Commerce.

.630. FALSE STATEMENTS AFFECTING VALUE OF SHARES. An agent of a corporation who makes fraudulent statements regarding the value of shares is guilty of a misdemeanor.

.635. DIRECTOR MAKING UNLAWFUL DIVIDEND OR DISTRIBUTION OF ASSETS. A director who concurs in a distribution designed to deceive creditors or shareholders is guilty of a misdemeanor.

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

.645. DEFINITIONS. Many of the definitions in this section are carried over from ABCA and may also be found in AS 10.05.825. However, there are two significant new definitions:

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

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

QUESTIONS ON AGSOC FOR THE HOUSE STATE AFFAIRS COMMITTEE

1. How could AGSOC be structured so as not to create unnecessary conflicts between the public interest in business regulation and taxation and the shareholder's interest in higher dividends?

2. Would it be generally advisable to make attempts to depoliticize the AGSOC?

   Should the AGSOC be allowed to lobby, make political contributions or come out with endorsements for particular candidates?

3. Do normal state corporation statutes provide sufficient protection for minority shareholders?

   - Is it inevitable the AGSOC would become an urban dominated corporation, given the population of the state?

   - How would rural members be able to participate other than by proxy given the expenses involved in travelling to meetings?

   - Should the board be classified, i.e. only a subset of the board coming up for election at one time

   - Should cumulative voting be mandatory?

   - Should voting trusts be prohibited?

   - Who should have the authority to amend articles of incorporation and bylaws?

   - How should proxy fights and shareholder-management disputes be financed - should both incumbants and challengers be financed by corporation money?

4. Should exemption from federal income taxation be extended to state taxation in general?

5. What are the probabilities that AGSOC will need no other state assistance beyond start-up costs? Can AGSOC really operate as a purely private corporation?

   - Which particular investments would not require state financial aid?

   - Which particular investments would require state financial aid?

   * Ask Kelso representative to detail the mechanism whereby AGSOC requests state financial assistance.

   - What kind of impact on the state's credit rating would the potential access to state support and/or guarantees have? Is it fair that all residents bear the risk to the state's credit rating which benefits only the subset of residents who are shareholders?

6. What are the pros and cons of setting up the AGSOC up as a public corporation versus a private corporation, assuming it would be legal?

7. Is there further information which can be made available to the state which will help us to make a prudent decision on the AGSOC. Can such information be gathered before the end of this session?

   Possible questions to be answered:

   - Do Alaskan's want an AGSOC? Perhaps this issue needs an airing similar to that given to Alaska, Inc. via the Public Forum. Since AGSOC is to be a people's corporation, should the people deserve more involvement than has yet been provided?

   - What are the political implications of a corporation whose shareholders comprise the voting public? Are there any existing situations which are similar elsewhere, and from which lessons can be drawn?

   - What will be the impact on the state's credit rating if AGSOC requires different kinds of state financial assistance? If there is an impact, how much will non-shareholding residents be paying to benefit the shareholders?

   - If AGSOC had been incorporated five or ten years ago, how many residents would be shareholders today? Or conversely, how many shareholders would still be residents? What can we expect for the future? Taxpayer turnover data is available to answer this question.

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DAVIS, CALIFORNIA 95616

April 4, 1979

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

Dear Chairman Miller:

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

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

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

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

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

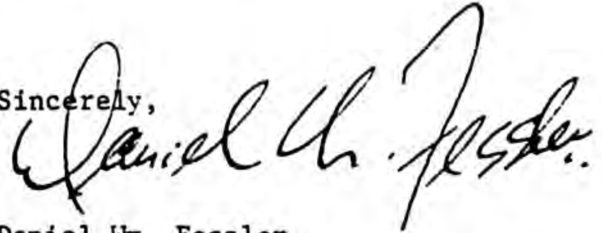
The Honorable Mike Miller
Chairman
State Affairs Committee

April 4, 1979

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

Best personal regards,

Sincerely,



Daniel Wm. Fessler
Professor of Law

DWF:hf

Enclosures

TO: THE STATE AFFAIRS COMMITTEE OF THE ALASKA HOUSE OF REPRESENTATIVES

FROM: Professor Daniel Wm. Fessler, King Hall, the Law School of the University of California at Davis

SUBJECT: Suggested Amendments to Sponsor Substitute for House Bill 240: "An Act Creating the Alaska General Stock Ownership Corporation; and providing for an effective date."

DATE: April 4, 1979

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

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

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

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

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

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

1 is with respect to the content of the statute. If you adopt the current
2 content of House Bill 240, you will hand these appointed individuals (only a
3 majority of whom need be Alaskans) a blank check to narrow their accountability
4 to all of the citizens of this state in their capacities as shareholders in the
5 GSOC. The express terms of SSHB 240 already give to this Board the strong
6 power position of "classification" meaning that the directors will serve three
7 year terms with the nine members segregated into three classes so that only one
8 third of the membership is up for election by the shareholders at each annual
9 meeting. (See, 10.50.030(a)(b), pp. 2-3 SSHB 240). There is a pragmatic
10 advantage in this proposed classification in that insures to the incumbent
11 board the continuity inherent in the fact that a working majority of the Board
12 will not be facing election. There is also a grave danger. Such a Board
13 could ignore the wishes of a majority of the shareholders and yet maintain
14 effective control and management over the corporation for two years. The
15 people in their role as shareholders would be powerless. This body in its
16 role as representative of the people would be equally powerless. True, it
17 could deny the GSOC cooperation to the extent that it was requesting the
18 legislature to call for an election to authorize a state guarantee of GSOC debt
19 instruments (although see the Memorandum of Attorney General Gross under date
20 of March 20, 1979, raising a question as to whether recourse to the people
21 would actually be required). Yet this is a very indirect way of attempting to
22 discipline the Board or correct the excesses of that body as viewed from the
23 perspective of the legislature. I do not wish to belabor the point: if the
24 members of this House feel that a different distribution of power as between
25 the shareholders and the board, and as between the GSOC and the government of
26 Alaska is desired . . . now is the time to act and the content of the enabling
27 legislation is the proper forum for that action.
28 ///////

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

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

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

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

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

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

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

1 granting standing only to one hundred or more shareholders?
2 YES ____ NO ____. Does the Committee favor granting standing
3 to the Attorney General of Alaska to initiate a removal suit?
4 YES ____ NO ____.
5
6 PROPOSAL NUMBER TWO: THAT ANY DIRECTOR OR THE ENTIRE BOARD MAY BE
7 REMOVED BY THE SHAREHOLDERS WITHOUT CAUSE.
8 I propose that at any annual meeting or a special
9 meeting properly noticed for the purpose at which a
10 quorum is present, a majority of the shares voting in
11 person or by proxy may remove the entire board and elect
12 replacement directors. I further propose that the share-
13 holders have power to remove less than the entire board
14 provided there are appropriate safeguards to minimize
15 the chance that an angry faction of shareholders could
16 oust a single director.
17 Explanation: Both California and Delaware have found it expedient to
18 pass recent legislation enabling shareholders who have lost confidence in
19 the Board of Directors to remove either the entire Board or individual
20 members at a meeting especially called and noticed to entertain such a
21 motion, and that such removal may be for any cause deemed sufficient by a
22 majority of the shares. In both California and Delaware, the statutes
23 grant the right of removal to an absolute majority of the shares (50% plus
24 1 share). Again, we must recognize that there may be individuals or
25 institutional shareholders who, though a handful in number, would command
26 an absolute majority of the outstanding shares. Such a potential
27 coalition of large shareholders is a strong check upon the Board of
28 Directors. Unfortunately, there will be no such potential shareholder

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

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

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

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

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

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

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

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

2 Explanation: One of the most important developments in the past half

3 century in seeking to hold directors and officers accountable for harm

4 they bring upon the corporation is the concept of the shareholders' action

5 or derivative suit. If you adopt the hypothesis that the Board or certain

6 of its members is guilty of action or inaction which has brought great

7 harm to the GSOC and which violates the duties of care or loyalty to the

8 corporation, it is unrealistic to assume that those very directors will

9 authorize or encourage corporate counsel to bring an action naming them as

10 defendants! For this reason it is necessary to give individual share-

11 holders the right to bring the litigation in the name of the corporation.

12 Any recovery of money damages goes to the corporate treasury, not to the

13 litigating shareholder (save for reimbursing him/her for the costs of the

14 litigation).

15 Nearly every jurisdiction permits such actions and most regulate the

16 conduct of such litigation by statute. Alaska is one of the few juris-

17 dictions which permits but does not regulate by statute. Fortunately, the

18 Supreme Court has acted to fill this void by providing in Rule 23.1 of the

19 Civil Rules certain regulations for derivative actions by shareholders.

20 (Added by Supreme Court Order 258, November 16, 1976.) The Alaska rule is

21 predicated upon and nearly identical to Rule 23.1 of the Federal Rules of

22 Civil Procedure. In my opinion, it does not go far enough in policing

23 derivative actions by shareholders in the context of the General Stock

24 Ownership Corporation.

25 The matters which should be covered by statute include:

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

27 I suggest that standing be limited to a shareholder who held his or

28 her share at the time of the transaction of which complaint is made

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

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

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

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

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

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

* <u>Should the shareholder who has commenced a derivative action be allowed to compromise or "settle out of court"?</u>

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

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

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

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

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

28 / / / / /

DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor in principle the concept of permitting derivative actions by shareholders in the General Stock Ownership Corporation? YES ____ NO ____. If "yes," does the Committee favor regulating the derivative action by special provisions in the enabling act? YES ____ NO ____. If "yes," does the Committee favor:

* The suggested standing rules? YES ____ NO ____.
* The suggested provision on exhaustion of intra corporate remedies? YES ____ NO ____.
* The suggested provision on the posting of a security bond for the defendants' costs of litigation? YES ____ NO ____.
* The suggestion that there be no compromise or dismissal of such an action without court approval? YES ____ NO ____.
* The suggested provision that the litigating shareholder in all circumstances be forced to account to the corporation for any proceeds realized from such a derivative action? YES ____ NO ____.

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

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

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

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

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

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

25 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the
26 concept of a statutory right of shareholders in the General Stock
27 Ownership Corporation to inspect corporate books and records?
28 YES ____ NO ____. Should this sum be levied: (a) per

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

2

3 PROPOSAL NUMBER FIVE: THAT THE SHAREHOLDERS BE GIVEN THE POWER TO

4 INITIATE AMENDMENTS TO THE BYLAWS.

5 The current statutes in Alaska provide that the articles

6 may restrict the power to adopt, amend, and repeal bylaws to

7 the Board of Directors. The Kelso Report recommends articles

8 which do so restrict the power to the Board and it is likely

9 that this is what a Board would do. I propose that the

10 enabling act be amended to reserve a power of adoption,

11 amendment or repeal of the bylaws to the vote or written

12 assent of shareholders entitled to exercise a majority of the

13 voting power of the GSOC. I would also propose that the act

14 permit the Board to enjoy this power save for the fact that

15 the Board could not, on its own motion, repeal or amend a

16 bylaw which had been adopted by vote of the shareholders.

17 Explanation: As was dramatically illustrated by the content of the

18 Kelso Report, the document which is most likely to contain the crucial

19 provisions which govern the structure and operation of the General Stock

20 Ownership Corporation is the bylaws. A significant feature in what is, in

21 my opinion, the excessive grant of power to the Board in SSHB 240 is the

22 potential for vesting this power exclusively in the Board. The balance

23 can be redressed by simply amending the enabling act to provide for a

24 sharing of this power in the case of a General Stock Ownership Corporation.

25 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor

26 the concept of permitting the shareholders to adopt, amend or

27 repeal bylaws in the General Stock Ownership Corporation?

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

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

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

<u>PROPOSAL SIX</u>: THAT THE BOARD BE ENABLED TO TRANSACT BUSINESS BY USE OF A CONFERENCE TELEPHONE OR SIMILAR COMMUNICATIONS EQUIPMENT.

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

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

1 DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the
2 concept of permitting the directors to hold meetings via the use
3 of conference telephones or similar communications equipment with
4 participation in such a meeting constituting presence in person?
5 YES ____ NO ____.
6
7 PROPOSAL NUMBER SEVEN: THAT REGARDLESS OF COMMITTEE ASSIGNMENTS EVERY DIRECTOR
8 HAVE A RIGHT TO ATTEND THE MEETINGS OF ANY COMMITTEE AND BE PRIVY TO ALL BOOKS
9 AND RECORDS.
10 Current Alaska law permits the Board to divide itself into
11 committees including an executive committee and to delegate board
12 functions and authority. I have no quarrel with this concept but
13 do suggest that the enabling act be amended to make it clear that
14 regardless of committee assignments any director shall have the
15 right to attend (but not participate in) any meeting of any
16 committee and to have access to books and records pertaining to
17 the activities or responsibilities of such committees as may,
18 from time to time, be created.
19 Explanation: Again we illustrate what one jurist has termed the
20 "law of laws" . . . that every advantage is purchased at a price. The desire
21 to streamline and specialize the functions of directors is understandable but
22 the price is the exclusion of those directors who are not appointed to key
23 committees. Sometimes this problem assumes serious dimension as those
24 directors who are perceived by the majority as raising vexing questions and
25 airing dissenting views are simply shunted aside by exclusion from committee
26 assignments. The legislature can go some distance toward minimizing this harm
27 by providing by statute a right of each director to attend the meeting of any
28 committee and to have access to books and records.

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

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

KELSO & CO.

INCORPORATED

INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRA 'CO LOS ANGELES

April 1 , /9

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

Dear Representative Miller:

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

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

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

1. THE FIRST FULL PARAGRAPH ON PAGE 3

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

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

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

2. THE LAST FULL PARAGRAPH ON PAGE 3

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

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

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

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

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

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

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

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

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

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

In the first paragraph under this item is the statement that "it should be noted that there is nothing in the federal legislation which would preclude the AGSOC's establishment as a state agency or public corporation." We believe this is a misinterpretation of the federal law, which requires that a General Stock Ownership Plan be a private corporation even though its shareholders must include, at the outset, all residents of the State as of a date selected by the legislature and as of the date of the issuance of its stock.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

speculation.

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

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

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

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

7. PAGE 11, SECTION IV. CORPORATE DEMOCRACY

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

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

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

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

8. DESIRABILITY OF A HIGH FORUM REQUIREMENT

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

9. LESIGLATION ASSURING ADEQUATE NOTICE OF MEETINGS

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

10. THE CORPORATE BY-LAWS

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

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

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

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

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

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

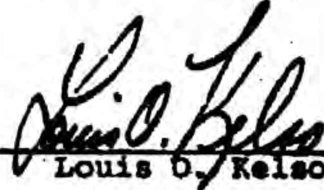
The "scenario" imagined by the author of the memorandum in the second paragraph on Page 15 is simply unrealistic. The preventative economic measures involved in establishing AGSOC that strike at the <u>cause</u> of poverty rather than merely at the <u>effects</u> of poverty hold more promise for eliminating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

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

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

Sincerely,

KELSO & CO., INCORPORATED



By ______________________
Louis O. Kelso

By ______________________
John A. Miskimen

LOK/JAM:ch

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

TAX CONSEQUENCES OF GSOCs

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

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

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

CASH AVAILABLE TO ALASKANS

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

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

ADDITIONAL STATE INCOME FROM MULTIPLIER

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

COMPARISONS

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

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

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

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

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

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

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

April 19, 1979
HB 240

GENERAL SUMMARY

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

Section 1: This section contains the provisions of the new chapter 50 of Alaska Statutes, Title X, and constitutes the core of the Committee bill. It contains six articles which deal with shareholder rights and internal operation of the corporations (Article I: Substantive Provisions), formation of general stock ownership corporations (Article 2: Formation of Corporations), amendment of articles of incorporation (Article 3: Amendment of Articles), sale of corporation assets outside the ordinary course of business (Article 4: Sale of Assets), voluntary and involuntary termination of the corporate existance (Article 5: Dissolution), and miscellaneous provisions such as filing fees, criminal penalties, and amendment of the legislation (Article 6: General Provisions).

Section 2: This section prohibits the Commissioner of Revenue from investing surplus state funds in securities of general stock ownership corporations.

Section 3: This section requires that all shareholder materials be filed with the Commissioner of Commerce at the time of distribution to the shareholders. In addition, the Commissioner is given authority to regulate concerning fairness, completeness and nondiscrimination of shareholder materials. The filing provisions coordinate with other sections of the Alaska securities laws making it a crime to file false or misleading materials with the Commissioner.

Section 4:
Section 5:
Section 6: These three sections amend the criminal penalties provisions of section 1 of the bill to conform to the new criminal code which becomes effective January 1, 1980. The provisions of section 1 are applicable upon signature by the governor and must therefor be amended as of January 1, 1980 to parallel the rest of the new criminal code.

Section 7: This section authorizes the governor to appoint nine persons to act as incorporators and the initial board of directors of the Alaska General Stock Ownership Corporation. This is the section which actually provides for the creation of a GSOC in Alaska. The section restricts share ownership of this corporation to Alaska residents and requires that shares be sold when a shareholder leaves the state or dies leaving his stock to an outsider. It also creates a special fund, not to exceed five million dollars, in the Dept. of Revenue to be used in guaranteeing private loans for the corporation's startup expenses.

Section 8: Section 1 of the bill amends Rule 23.1 of the Rules of Civil Procedure, dealing with derivative suits by shareholders of a general stock ownership corporation. Because it is amending a rule of the courts this provision must be approved by a 2/3 vote of each house. To allow separation of the vote section 8 amends the court rule.

Section 9: This section provides for an immediate effective date for the Committee bill.

Section 10: This section provides for a January 1, 1980 effective date for sections 4-6 which amend the criminal sanctions in the bill to parallel the treatment provided in the new criminal code which also becomes effective January 1, 1980.

SECTION BY SECTION ANALYSIS

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

ARTICLE 1. SUBSTANTIVE PROVISIONS.

.005. PURPOSES. This section makes it clear that, unless the enabling legislation for a GSOC provides otherwise, the corporation may engage in any legal business. (ABCA 10. 05.003).

.010. GENERAL STOCK OWNERSHIP CORPORATIONS. This section makes it clear that corporation organized under chapter 50, Title 10, are general stock ownership corporations subject to Internal Revenue Code Subchapter "U" and are not agencies of the state for any purpose.

.015. GENERAL POWER. This section grants to GSOCs the powers of normal corporations to conduct business. Two changes have been made in adapting the ABCA provisions to GSOCs.

1) There is a limitations in (4) preventing a GSOC from investing in property "acquired by it, or for its benefit, through the right of eminent domain . . . ." This limitation prevents GSOCs from acting in collusion with an agency or local government to acquire a going business from an unwilling seller. GSOCs are not prevented from investing in projects where some minor portion of the project is acquired through condemnation if the local government determines that the exercise of its condemnation power is appropriate.

2) The power to establish stock bonus plans is deleted from subsection (15) because of the special nature of GSOCs and the limitations on share ownership would make it difficult for a GSOC to adopt a qualified stock bonus plan for its employees. If the GSOC desires to have its employees benefit from growth in the value of GSOC stock the corporation could adopt a funded "phantom stock" program. (ABCA 10.05.009).

.020. INDEMNIFICATION OF OFFICERS, DIRECTORS, EMPLOYEES AND AGENTS; INSURANCE. This section is carried over unchanged from the ABCA and allows the corporation to indemnify its directors or employees for expenses and fines incurred as a result of thier 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 o whom they are issued, that they are no par value shares, and that the corporation is organized in Alaska. (AS 10.05.117).

.110. FULL PAYMENT REQUIRED FOR CERTIFICATE. If payment is required for shares they may not be issued until full payment is received. (AS 10.05.120).

.115. ISSUANCE OF FRACTIONAL SHARES. GSOCs may issue fractional shares of stock and these fractional shares hold dividend, voting and distribution rights equal to their fractional interest. It may be necessary for a GSOC to issue fractional shares in the situation where a shareholder leaves his stock to his heirs and there is more than one child beneficiary. (AS 10.05.123).

.120. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS. This section, adopted directly from ABCA, limits the liability of shareholders and those who have agreed to purchase share to the amount which they agreed to pay to the corporation for the shares. Subsequent holders of the stock are protected if they received the stock in good faith. (AS 10.05.126).

.125. BYLAWS. The board of directors adopts the initial bylaws of a GSOC subject to review and rejection by the legislature under section 330 of the draft bill. Subsequent bylaws may adopted, amended or repealed only by a vote of the shareholders.

.130. MEETINGS OF SHAREHOLDERS. The time and location of the annual shareholders meeting is to be established in the bylaws. The specific place for the meeting may be set by the board. Special meetings of the shareholders may be called by the president of the corporation, the board or the holders of at least 500 shares. Shareholder meetings may be teleconferenced. (AS 10.05.138).

.135. NOTICE OF SHAREHOLDER'S MEETINGS. This section requires written notice of shareholder's meetings mailed to shareholders not less than 60 days before the meeting. In addition, notice of shareholders' rights to add ballot issues or nominate directors must be made by publication at least once a week for four weeks beginning at least 150 days before the meeting. (AS 10.05.141).

.140. CLOSING OF TRANSFER BOOKS AND FIXING RECORD DATE. To determine the shareholders of the corporation for purposes of a dividend distribution or voting rights the transfer books of the corporation may be closed prior to the date of the proposed activity or a "record date" may be established and the shareholders determined as of that date. Time limits are provided beyond which the transfer books may not be closed in order to protect shareholder voting rights and to allow interested parties to inspect the share records of the corporation prior to shareholders' meetings. (AS 10.05.144).

.145. VOTING LIST. The responsible officer of the corporation must make available at the registered office of the corporation beginning at least 60 days before any shareholders' meeting a list of the shareholders eligible to vote at the meeting and access to this list must be provided to all shareholders. (AS 10.05.147).

.150. QUORUM OF SHAREHOLDERS. 1/3 of the shares constitute a quorum for action by the shareholders and a majority vote of a quorum is sufficient to bind the shareholders in most cases. (AS 10.05.153).

.155. PROXY VOTING PROHIBITED. Because of the ballot mechanism whereby each shareholder is allowed to vote in person through his ballot proxies are unnecessary in general stock ownership corporations and are therefore prohibited.

.160. VOTING FOR DIRECTORS. Each shareholder may vote his shares for directors but cumulative voting is prohibited. This means that each share can cast only one vote for director in any contested election for a directorship position.

.165. VOTING OF SHARES IN THE NAME OF ANOTHER.
.170. VOTING OF PLEDGED SHARES.
These sections allow shares held by an administrator, executor or guardian to be voted by him without a transfer of the shares into his name. Shares held by a pledgee may be voted by the pledgor until transferred into the pledgee's name. (AS 10.05.165 and . 168).

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

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

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

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

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

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

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

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

.200. QUORUM OF DIRECTORS. A majority of the total number of directors fixed in the bylaws, articles or enabling legislation constitutes a quorum and action may be taken by a majority vote of a quorum. By allowing only ¼ 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.

Similarily, 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 1¼ times its liabilities, <u>AND</u>

   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 1¼ 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 10.0 5.222).

.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 germain 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 existance 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 attoreny general to ask a court to remove a director for specific reasons. In order to have the court remove the director the shareholders or the attorney general bringing suit must still prove the director guilty of the offenses charged.

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

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

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

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

ARTICLE 2. FORMATION OF CORPORATIONS.

.310. INCORPORATORS. Incorporators are those persons who file the articles of incorporation to begin the corporation's existance. This must be done by at least three people over the age of 19. (AS 10.05.252).

.315. ARTICLES OF INCORPORATION. This section sets out the minimum requirements of the articles of incorporation for general stock ownership corporations. The article provisions required by subchapter "U" of the Internal Revenue Code are included in this section as requirements for GSOCs organized in Alaska. Other provisions are carried over from ABCA. (AS 10.05.255).

.320. FILING OF ARTICLES OF INCORPORATION. Articles of incorporation are to be filed with the Commissioner of Commerce who shall certify the filing and return one original of the articles to the corporation. (AS 10.05.258).

.325. EFFECT OF ISSUANCE OF CERTIFICATE OF INCORPORATION. Upon issuance of the certificate the corporate life begins. (AS 10.05.261).

.330. ARTICLES OF INCORPORATION AND INITIAL BYLAWS. This section provides for legislative review of the articles and initial bylaws. They must be submitted to the next session of the legislature and, if not disapproved within 60 days by concurrent resolution they are approved. Legislative disapproval may be overriden by a vote of the shareholders.

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

.340. NOTIFICATION OF ELIGIBLE SHAREHOLDERS. Since stock is to be distributed free of charge initially all Alaska residents must be notified of its availability. This section sets out the minimum notice requirements of weekly broadcast and publication for at least three month before stock distribution and monthly broadcase and publication for eleven months after distribution. These are minimum requirements only and the board of directors may determine that the corporation should take other steps to identify and notify potential shareholders.

.345. CORPORATION NOT LIABLE TO SHAREHOLDERS. Although GSOCs are required to take reasonable steps to notify potential shareholders of their right to stock the burden of applying for stock lies with the resident and the corporation is not liable for failure to notify or issue stock to a potential shareholder. If a resident makes application for stock after the distribution of one or more dividends he looses his right to those dividends and is entitled to receive only those dividends declared and paid after the date upon which his stock was issued to him.

.350. LATE APPLICATION FOR SHARES. Any individual who is eligible to receive an initial distribution of shares but who fails to apply for an issuance of stock may be issued a share at any time within one year of the original issue of stock upon application and payment of book value therefor. The one year period coincides with the period during which a shareholder may elect not to receive his stock and have his share cancelled. This cut off period protects the corporation and the other shareholders from those eligible reisents who are not identified and who fail to identify themselves hoping to see how the corporation fares before applying for their stock.

.355. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER. The superior court is given jurisdiction to void stock issued to an ineligible individual who obtained his shares by fraud and allows the corporation to recover any distributions paid to such a shareholder.

ARTICLE 3. AMENDMENT.

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

.365. PURPOSES FOR WHICH ARTICLES MAY BE AMENDED. This section lists some, but not all, of the legal purposes for which the articles may be amended. (AS 10.05.273).

.370. PROCEDURE TO AMEND ARTICLES OF INCORPORATION. The board of directors or the shareholders can propose amendments to the articles of incorporation, but the articles may only be amended upon a 2/3 majority vote of a quorum of shareholders.

.375. ARTICLES OF AMENDMENT.
.380. FILING OF ARTICLES OF AMENDMENT.
.385. EFFECT OF CERTIFCATE OF AMENDMENT.
These three sections provide that an amendment approved by the shareholders to the articles of incorporation must be filed with the Commissioner of Commerce in the same manner as the original articles of incorporation and once certified by the Commissioner the amendment becomes effective. These sections are adopted directly from AS 10.05.285, .288, and .291 respectively.

.390. RESTATED ARTICLES OF INCORPORATION.
.395. EXECUTION OF RESTATED ARTICLES OF INCORPORATION.
.400. CONTENTS OF RESTATED ARTICLES OF INCORPORATION.
.405. FILING OF RESTATED ARTICLES OF INCORPORATION.
.410. EFFECT OF ISSUANCE OF RESTATED CERTIFICATE OF INCORPORATION.
These five section deal with restated articles of incorporation. Restated articles of incorporation for purposes of GSOCs are simply a consolidation and updating of the articles of incorporation with current amendments. This allows the corporation to have on file with the Commissioner a current copy of the articles of incorporation incorporating all amendments. The provisions are adopted essentially from ABCA except that GSOCs are not allowed to amend the articles of incorporation through filing restated articles and for that reason are allowed to file restated articles upon motion of the board of directors. (AS 10.05.294, .297, .300, .303, and .306 respectively).

ARTICLE 4. SALE OF ASSETS.

.415. SALE OR MORTGAGE OF ASSETS IN REGULAR COURSE OF BUSINESS. The board of directors may sell or dispose of all the assets of the corporation if it is in the ordinary course of the corporation's business. (AS 10.05.435).

.420. SALE OR MORTGAGE OF ASSETS OTHER THAN IN REGULAR COURSE OF BUSINESS. Sale of all the assets of the corporation other than in the ordinary course of business requires a vote of the shareholders. (AS 10.05.438).

.425. APPROVAL OF PLAN BY SHAREHOLDERS. A 2/3 vote of the shareholders is required to approve a sale of all the assets of the corporation outside the ordinary course of business. (AS 10.05. 441).

.430. ABANDONMENT OF PLAN BY BOARD OF DIRECTORS. Even though a vote of the shareholders is required to approve a sale of all the assets the sale may be abandon by the board since such sales are unusual and may require quick decisions which cannot be effectively put to the shareholders. If the shareholders are unhappy about the abandonment they have the power to remove the board and it is to be expected that the board would not abandon such a sale without good cause. (AS 10.05.444).

.435. RIGHTS OF DISSENTING SHAREHOLDERS UPON SALE OR EXCHANGE OF ASSETS.
.440. NOTICE TO DISSENTING SHAREHOLDER.
.445. PAYMENT TO DISSENTING SHAREHOLDER AFTER AGREEMENT ON VALUE OF SHARES.
.450. ACTION BY DISSENTING SHAREHOLDER TO COMPEL PAYMENT UPON FAILURE TO AGREE ON VALUE.
.455. EFFECT OF ABANDONMENT OR REVOCATION OF SALE OR EXCHANGE ON SHAREHOLDER'S RIGHTS.
.460. STATUS OF SHARES ACQUIRED FROM DISSENTING SHAREHOLDER. These section deal with the shareholder who does not wish to be a part of the sale of substantially all the assets of the corporation in spite of the 2/3 majority vote of the shareholders. Such a shareholder can dissent from the sale and have the corporation purchase his shares. There are notice provisions and opportunity for the shareholder and the corporation to agree upon a purchase price for the shares. If the shareholder and the corporation cannot agree upon a price the matter can be decided by a court. If the sale is abandoned the dissenting shareholder looses his right to receive payment from the corporation for his share and he remains a shareholder. Shares acquired from a dissenting shareholder become treasury shares.

ARTICLE 5. DISSOLUTION.

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

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

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

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

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

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

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

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

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

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

ARTICLE 6. GENERAL PROVISIONS.

.620. AS 10.05 INCORPORATED BY REFERENCE. In order to reduce duplication this section incorporates by reference Sections .699 through .819 of ABCA (AS 10.05.699 - .819). These sections deal with requirements for annual reports to be filed with the Commissioner of Commerce, filing fees and charges, procedural privisions and forms, and powers of the Commissioner of Commerce.

.625. FALSE STATEMENTS AFFECTING VALUE OF SHARES. An agent of a corporation who makes fraudulent statements regarding the value of shares is guilty of a misdemeanor.

.630. DIRECTOR MAKING UNLAWFUL DIVIDEND OR DISTRIBUTION OF ASSETS. A director who concurs in a distribution designed to deceive creditors or shareholders is guilty of a misdemeanor.

.635. RESERVATION OF POWER. Amendments to this chapter apply to all existing and future corporations organized under it.

.640. DEFINITIONS. Many of the definitions in this section are carried over from ABCA and may also be found in AS 10.05.825. However, there are two significant new definitions:

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

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

DIVISION OF POLICY DEVELOPMENT AND PLANNING
OFFICE OF THE GOVERNOR

TO: Governor Jay S. Hammond

DATE: April 12, 1979

FILE NO:

TELEPHONE NO:

FROM: Frances A. Ulmer
Director

SUBJECT: AGSOC

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

First Level

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

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

   to provide dividends to supplement personal income.

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

   Examples; purchase of oil line share - tarrif question

   development of petrochemicals - royalty prices

   construction of gasline - oil recovery

   virtually any business - any regulation.

3. With respect to the above questions, can we expect AGSOC to become an important political force? Is it appropriate or possible (first amendment rights question) to prevent this?

4. Even with the amendments contemplated by either the House State Affairs Committee or the Administration regarding corporate governance, how likely is democratic control of AGSOC?

5. What is the likely extent of state subsidies to AGSOC? What will be the impact on the state's credit rating from passage of the bill? From actual extension of state financial aid?

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

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

6. Is it possible to resolve/avoid the "closed class" problem created by "old" residents being shareholders while "new" residents are not?

7. How will the Governor make decisions as to who shall constitute the first Board of Directors?

8. Does the Alaskan public want an AGSOC?

Second Level

1. What should be the procedures for electing the Board of Directors?

2. Should the state allow the federal corporate income tax exemption to pass through to state corporate income taxes?

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

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

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

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

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

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

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

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

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

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

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

House State Affairs Committee (tentative) desired amendments:

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

Administration working Group desired actions or amendments:

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

- Assessment of the definition of "resident" provided in the bill.

- Assessment of potential for tax liability on initial issue or otherwise to be greater than dividend.

- Criminal liability of directors in certain instances.

- Provision for cumulative voting.

- Limitation on voting trusts.

- Requirement that feasibility analysis and other information be provided to the Governor and the legislature in sufficient time before a decision is necessary on financial or other state aid.

- Details of shareholder meetings, i.e., notice, location, quorum.

- Limitation on assignment of dividend rights.

- Limitation on ability of corporation to acquire Treasury shares.

- Shareholders' ability to amend the number and terms of office of the Board of Directors.

- Directors subject to removal by Superior Court at suit of 100 or more shareholders or Attorney General for fraudulent or dishonest acts or gross abuse.

- Limitation of ownership to one share.

MEMORANDUM

To: MG

From: Jerry Gauche

Re: Marku. Issues for State Affairs

Date: 4/23/79

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1. Question of whether petition signed by 100 shareholders is too open to abuse and whether the number of signatures required for shareholder nominations or ballot issues should be some higher number like 500 or 1,000.

2. Directors should be able to suggest changes in bylaws to be voted on by the shareholders even though the shareholders prposed the bylaw. Currently the bill, at page 18, line 2, restricts the board from making such proposals for one year after the meeting at which a shareholder bylaw was proposed.

3. Could allow more outside directors and still assure Alaskan control by providing that a quorum of the board may not be constituted without a majority of Alaskan directors (instead of the current treatment of requiring that only 1/4 of the board be from outside). Bill at page 18 line 12.

4. Add clause which insures that legislative disapproval

IF ARTICLES OR BYLAWS AND ANY LEGISLATIVE CHANGES TO THE GSOC CHAPTER WILL NOT AFFECT FINANCIAL COMMITMENTS OF THE CORPORATION. BILL SECTIONS 330 (PAGE 32) AND 635 (PAGE 57).

5. SUGGEST THAT TO LIMIT SHARE OWNERSHIP TO ALASKANS PROVIDE DURING FIRST YEAR ANYONE CAN GET SHARES FREE OF CHARGE, AFTER FIRST YEAR AND UP TO YEAR SIX MUST PAY BOOK VALUE. BILL SECTION 7, PAGE 60/61.

6. NEW PROVISIONS ON APPOINTMENT OF INCORPORATORS.

7. DISCUSS REMOVING THE LOBBYIEST SECTION FROM THE COMMITTEE AMENDMENT REGARDING POLITICAL ACTIVITIES.

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y · STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

M E M O R A N D U M June 18, 1979

SUBJECT: Meeting with Professor Fessler

TO: Representative Jim Duncan, Chairman
Legislative Budget and Audit Committee

Representative Mike Miller, Chairman
State Affairs Committee

FROM: Kenneth M. Rosenstein
Legislative Counsel

The meeting took place at the San Francisco airport on June 13, 1979. In attendance were: Professor Daniel Fessler, Representative Jim Duncan, Representative Mike Miller, Milt Barker and Ken Rosenstein.

The meeting began with Professor Fessler responding to Mr. Kelso's Comments on the bill (CSSSSB 170):

(1) Although the bill is fairly clear and unambiguous, Professor Fessler recommended the inclusion of a preemption provision suggested by Mr. Kelso in order that the issue be free from doubt.

(2) Regarding the problem with AS 10.50.215(b), Professor Fessler stated that treasury shares are not considered assets under prevailing accounting principles and that, therefore, they would not even considered under §215.

(3) Since a director is personally liable only for conscious "misfeasance in office," Professor Fessler felt that few qualified candidates for the board of directors would be dissuaded from serving on the board.

Professor Fessler had the following additional comments:

(1) The initial distribution scheme under which late applicants for shares would be required to pay book value for them may create a second class of shares. He suggests

seeking an opinion from the IRS and the SEC that such an interpretation would not be given.

(2) The limitation on the consideration paid for treasury shares in AS 10.50.080(b) is book value. This is a new standard. AS 10.05.096(c) permits the board of directors to fix the consideration for treasury shares.

(3) AS 10.50.105 should require that the transfer restrictions applicable to the shares should appear on the shares. This would protect potentially unlawful transferees.

(4) Shares owned in excess of the maximum permitted by federal law (10) should be subject to forfeiture.

(5) Directors should be prohibited from altering or repealing a by-law proposed by the shareholders. Professor Fessler did not give much weight to the argument that the board should have the power to change such by-laws in the name of business efficacy.

(6) The provisions relating to notice of shareholders' meetings need to be clarified as they relate to special meetings. There are conceivable situations where it would take almost 300 days between the call of the meeting and the meeting.

(7) AS 10.50.175(d) relating to information appearing on the ballot is too broad and without adequate control.

(8) The penalty contained in AS 10.50.275 should be assessed for each day that the wrongful refusal of inspection continues.

(9) The removal of a director by the shareholders should occur when a majority of the votes for removal exceed the number of votes that elected the director. Otherwise, a director could be removed by minority action.

(10) The prohibited political activities should be expressly declared as *ultra vires*.

(11) The intent of the requirement of legislative approval of the initial articles and by-laws is easily avoided.

(12) Under AS 10.50.475 it would be easier to dissolve the corporation than to amend the articles or rescind a proposed dissolution.

KMR:jdn

cc: Milt Barker
Jerry Gauche

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y · STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

M E M O R A N D U M

June 18, 1979

SUBJECT: Meeting with Kelso & Co., Inc.

TO: Representative Jim Duncan, Chairman
Legislative Budget and Audit Committee

Representative Mike Miller, Chairman
State Affairs Committee

FROM: Kenneth M. Rosenstein
Legislative Counsel

The meeting took place at Kelso's office in San Francisco on June 11, 1979. In attendance were: Louise Kelso, John Miskimmen, and Norma Johnson of Kelso & Co., Inc.; Representative Jim Duncan, Representative Mike Miller, Milt Barker and Ken Rosenstein.

Mr. Kelso began the meeting by stating that he had not yet had an opportunity to analyze the bill (CSSSSB 170) in detail, but had several comments and suggestions for changes:

(1) A provision should be included that makes clear that the Alaska Business Corporation Act (AS 10.05) is preempted by AS 10.50 insofar as it relates to general stock ownership corporations.

(2) Ownership of GSOC stock should be permitted by Alaska residents retiring to locations outside the state.

(3) Potential candidates for the board of directors may be eliminated due to the personal liability imposed on directors for certain acts and the risk of removal.

(4) Serious management problems could arise as a result of the prohibition on directors serving as officers. The suggestion was to add two directorships which would be filled by the president and highest financial officer of the GSOC.

(5) There was a problem perceived in AS 10.50.215(b) which was viewed as creating problems with the valuation of treasury shares. This problem was seen as possibly inhibiting the sale of those shares. It was explained that §215 merely established monetary limits on what a GSOC could distribute to shareholders and in that limited context treasury shares would not be considered.

In addition, Mr. Kelso outlined a proposal for his firm's continued work on the bill. The proposal included the following items:

(1) Study the feasibility of integrating the compilation of eligible shareholders with the federal census to be conducted next year. If it appears feasible, begin the negotiation of the details with the Bureau of Census.

(2) Prepare a detailed analysis of the bill.

(3) Prepare a catalog of the types of potential investments, without specifying particular investments, that would be available to the GSOC.

(4) Lobby the Congress for certain amendments to subchapter U of the Internal Revenue Code. Amendments would be sought to (A) allow the acquisition of capital assets without the payment of taxes on the earnings used to pay the principal for the asset; and (B) permit more than one class of GSOC shares in order for GSOC employees to create and employee stock ownership plan and to enable a nationally underwritten sale of stock to proceed.

cc: Milt Barker
Jerry Gauche

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

April 17, 1979

The Honorable Russell B. Long
United States Senator
217 Russell Senate Office Bldg.
Washington, D.C. 20510

RE: The Russell Long Study of ESOP Company Results

Dear Senator Long:

Results are in from 22 corporations out of our first pilot mailing to 30 corporations carefully selected to reflect a cross section of our ESOP company clients by sales volume, number of employees, and type of industry. We will be sending out a general mailing to the rest of our clients who have had plans installed and operating long enough to provide us with realistic results to add to the survey. This survey shows that your initial thoughts are correct: ESOPs are not a revenue drain on the Treasury -- they help offset deficits, they don't create them! Also, these plans have increased productivity in the companies surveyed and this is the best way to fight inflation. The ESOPs also created tax sheltered capital for these companies to use in increasing employment opportunity -- and this saves our government money and reduces transfer payments.

Key conclusions (average ESOP life 3.3 years):

1. Federal taxes paid (up $24,419,000) -- 112% increase.
2. Productivity per employee -- 38% increase.
3. Total sales -- 67% increase.
4. Corporate profits -- 125% increase.
5. Number of people employed -- 30% increase.

Average results (22 survey companies):

	Annual Sales	Employees	Productivity
Pre-ESOP	$20,858,000	333	$76,545
Post-ESOP	$34,597,000	433	$104,864
Increase	+67%	+30%	+38%

	Average Annual Pre-Tax/Pre-ESOP Income	Average Annual Taxes Paid
Pre-ESOP	$699,000	$300,000
Post-ESOP	$1,574,000	$636,000
Increase	+125%	+112%

The survey covered private companies which have had an ESOP for an average of 3.3 years and, in the aggregate, had annual sales prior to the ESOP installation of $458,880,000. Today's annual sales are $761,136,000. Most of these companies have been in business for over 30 years; four for over 50 years; one for over 80 years; six have been in business for 10 years or less. These companies employed 7,323 employees prior to the ESOP installation and now employ 9,529 people. The average annual sales per employee (productivity) were $76,545 prior to the ESOP installation and are $104,590 now. The companies had profits in the period prior to the ESOP installation of $50,775,000 compared to $114,314,000 since then and in the same period. They paid taxes in the period prior to the ESOP of $21,777,000 and $46,200,000 after.

These companies range in current sales from $4,174,000 to $157,000,000; from 35 employees to 1,500; from $152,500 annual profits to $10,033,000.

The companies represented in our pilot survey are in the following fields of endeavor:

Manufacturing	Retail/Wholesale	Other
Paper	Food	Media Sales
Telecommunications	Cameras	Construction
Graphic Arts	Furniture	Trucking
Furniture	Automobiles	Hospital
Sash and Doors	Home Building Supplies	Drilling Equipment
Mirrors		Wholesaler
Paint		General Wholesaler
Plastics		Appliance
Saws		Distributor
		Food Processor

The combined additional revenue to the Treasury from corporate taxes (and capital gains taxes paid by shareholders selling to the ESOP) was $24,423,000 -- an average of $1,110,000 per company over a period of 3.3 years -- and this doesn't include participants' taxes. However, the value of shares has been substantially enchanced due to the increased profitability and net worth created by corporate stock sales to the ESOP plus larger after-tax accumulated earnings.

The stockholders have a continuing market for their shares and all employees have a vested interest in maintaining and building stock values for their own self-interest. This obviously works for the mutual benefit of all shareholders -- ESOP participants and others.

We will have additional information to you soon on the amount of stock in the accounts of the 9,529 people who work for these 22 pilot

survey companies; the percent this constitutes of the total fair market value of the companies; the projected value of employee accounts; and the additional revenues this will provide our Treasury. Also, the average number of years these companies have been in business prior to the ESOP installation.

Thanks, again, for the leadership you have given the Employee Stock Ownership concept. At last count, there were over 3,000 companies that decided to spread their capital base. There are still thousands more companies in our country large and stable enough to adopt ESOPs. Your new proposed legislation will be helpful in encouraging the formation of new plans for these companies.

Cordially,

Dickson C. Buxton
Chairman of the Board

DCB:ch
Encls.

96th Congress } COMMITTEE PRINT
1st Session }

THE ROLE OF THE FEDERAL GOVERNMENT AND EMPLOYEE OWNERSHIP OF BUSINESS

SELECT COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

REVISED MARCH 20, 1979

Printed for the use of the Select Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
42-129 O WASHINGTON : 1979

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SUMMARY

In the last several years, there has been a growing trend for employees to own substantial equity in the companies for which they work. It has been estimated that there are between 1,000 and 3,000 employee stock ownership plans ("ESOPs") in the country, and in at least 90 cases, employees, through ESOPs or other means, have actually purchased a majority interest in their companies. In part, the popularity of ESOPs has been a result of special tax incentives enacted in the last five years; in part it stems from the belief on the part of many companies that ESOPs provide a unique means of financing growth and providing an employee benefit plan with the same dollars. Similarly, the trend towards employee acquisition of business has partly been encouraged by government loans, 13 of which have been made to date. On the other hand, roughly 70 percent of the employee owned companies have been formed in this decade, so government assistance had usually not been a factor. This report will review the information available on employee ownership of business, with particular emphasis on the role the government has played and might play in the future.

Employee ownership has been sold primarily as a means to increase worker motivation and productivity by giving employees a clearer stake in their companies. A comprehensive study by the University of Michigan's Survey Research Center has confirmed that this argument is valid. In a study of 98 firms, the study found that companies with employee ownership were 1.5 times as profitable as comparable conventional firms. They also found that employee and managerial satisfaction was higher, and that managers reported increased productivity. Other studies of the plywood industry and individual case studies have confirmed these findings, and the plywood studies showed, in addition, that wages were 25 percent higher in employee owned firms than non-employee owned firms. The higher wages were compensated for by 30 percent greater productivity in the worker owned companies. Finally, the Michigan study showed that the greater the amount of equity owned by employees, the greater the profits.

The most popular form of employee ownership is the employee stock ownership plan. In its typical form, a company establishes an ESOP and the ESOP includes an employee stock ownership trust. The trust secures a loan for company growth, with the company pledging to make whatever funds are necessary available to the ESOT to repay the loan. The ESOT uses the loan funds to purchase company stock, so that the company gets the money from the loan and the trust gets the stock. As the loan is repaid, the stock vests with employees. Contributions to the trust to repay the loan are tax deductible, so that the company can, in effect, deduct both the principal and interest on the loan, instead of the interest only. In addition to this tax benefit, companies making qualified investments can receive an additional 1 percent–1.5 percent credit if the investment is financed through an ESOP.

The benefits and disadvantages of ESOPs have been widely disputed. For the company, there are, in some cases, cheaper ways to borrow, and the issuance of new stock to an ESOT dilutes the value of existing stock. The employee, although he pays nothing for the ESOP (unless there is a contribution plan), may be asked by the company to rely on the ESOP as his employee benefit plan in lieu of something else. If the company succeeds, this will be to his benefit; if it fails, the benefit is worthless. For companies with good prospects without access to other sources of equity capital, however, ESOPs appear to be very useful for financing growth as well as being very beneficial for individual employees. Moreover, the ability to deduct both principal and interest payments on loans makes ESOPs uniquely suited to employee purchases of companies. There is no other means by which this could be accomplished as well in these situations. Finally, ESOPs offer special tax advantages to owners of nonpublic companies who wish to transfer ownership of their companies, either gradually or through an immediate sale, to their employees.

While ESOPs have gained in popularity as a tool for existing companies, employee purchases of companies have gained in popularity in cases where companies would otherwise close. In the last decade, perhaps 50 or 60 such purchases have occurred. In most cases, an ESOP is used, but a variety of other ownership forms, including producer cooperatives and simple direct purchases of companies through the sale of stock to employees and others, have also been used. The motivation for such purchases is generally to preserve jobs that would otherwise be lost when a company plans to close, relocate, or be purchased by an unrelated interest. Roughly 70 percent of the employee purchases since 1971, in fact, have been of conglomerate subsidiaries which were scheduled to close. Most of the rest appear to have been voluntary sales by owners of independent businesses to their employees when the owners were ready to retire. The companies that have been purchased in this way appear to have been very successful, in many cases transforming companies or subsidiaries with poor performance records into profitmakers. Despite their success, however, efforts by employees to purchase their businesses still face enormous obstacles in the areas of financing and simply organizing people around what is still an unconventional goal.

Government policy toward employee ownership has been mixed. On the one hand, the Congress has enacted special tax benefits for ESOPs, and the Small Business Administration, the Economic Development Administration and the Farmers Home Administration have all made loans to employee organizations which have purchased their businesses. The ESOP tax incentives, however, are limited primarily to capital intensive, large companies. Certain so-called incentives for ESOPs, in fact, actually only have the effect of equalizing the treatment of ESOPs with other employee benefit plans. Government loans have been made, but not frequently—SBA has made three, EDA nine, and FmHA only one. The SBA has expressed reluctance to make loans to employee organizations and will not make loans to companies or employee organizations through ESOPs, arguing that the employee stock ownership trust is not formally a small business and therefore does not qualify for a loan. EDA has made more loans, but their legislative mandate is such that they must give priority to companies suf-

fering from the effects of disasters, defense realignments, or government regulations. FmHA officials have expressed enthusiasm for the idea of employee ownership, but their loan program has not been seen, as yet, as a potential source of funding. Even if it were more broadly known that FmHA were favorable, however, only companies in places of less than 25,000 people would be eligible, and even then small business would be encouraged to go to SBA.

In the 95th Congress, a bill was introduced by Congressmen Kostmayer, Lundine and McHugh to create a special program in EDA, with $100 million in loan funds for employee or employee/community organizations seeking to purchase firms that would otherwise close, relocate, or be sold to outside interests. Loans would be granted only if feasibility studies confirmed that the company could make a profit when reorganized. The bill was not acted on, however, and will be reintroduced in the 96th Congress.

In the Senate, Senators Nelson and Long will introduce legislation to mandate that the SBA guarantee loans to ESOTs on a non-discriminatory basis, and that SBA guarantee loans to employee organizations seeking to purchase their businesses when they would otherwise close, relocate, or be sold to unrelated interests. These loans would also be granted on the basis of feasibility studies, without regard to the individual assets of employees, a criterion that, if in effect, would make it all but impossible for employee organizations to secure credit, Senator Nelson also plans to introduce legislation similar to the House bill mentioned above.

Given the lack of enthusiasm and regulatory policy of SBA and the legal limitations on EDA, legislation such as that proposed by Nelson, Long, Kostmayer, Lundine and McHugh is necessary if the government is to take a more active role in encouraging employee ownership. The alternative to this policy would be to allow the businesses to close and to make the variety of transfer payments that are involved when there is extended unemployment, such as occurs when a plant closes. Given the success of employee ownership, it seems much the wiser course for the government to make or guarantee loans, the large majority of which would almost certainly be repaid, then to spend money on various programs designed to ease the impact of unemployment. Of course, such loans should only be made to companies with reasonable prospects for success, and the government should not strive to make loans in every instance. Government encouragement of the concept and practice of employee ownership, however, could convince at least some conventional credit sources to treat it as just another way of organizing a business. That, it appears, would be a very positive development which could significantly increase the productivity, wealth, and job satisfaction of employees, as well as preserve and improve local businesses. Finally, it would accomplish these things within the framework of free enterprise rather than government regulation.

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THE ROLE OF THE FEDERAL GOVERNMENT AND EMPLOYEE OWNERSHIP OF BUSINESS

INTRODUCTION

In the last several years, there has been a growing trend for employees to own substantial equity in the companies for which they work. In a large number of cases, employees have actually purchased their firms. In some instances, employee ownership has been encouraged by government tax benefits or by direct or guaranteed loans, but in others it has been the result of purely private initiatives. Whatever the causes of the trend towards employee ownership may be, however, the results appear to be very positive: A broader distribution of equity and participation in the capitalist system, the preservation of businesses and jobs that would otherwise have been lost, greater profits, and higher levels of productivity, wages, and worker and management job satisfaction.

Problems have been encountered as well, of course, particularly in the area of transition to new management forms and preventing employee owned companies from being sold to other interests, but the apparent success of the experiment suggests that it merits serious attention by the government. If employee ownership as a concept is successful it could help provide a means of preventing unemployment, broadening economic opportunity, and increasing productivity. This report will evaluate employee ownership of business and the role the government currently plays in encouraging or discouraging it.

According to various estimates, there are approximately 1,000-3,000 employee stock ownership plans (ESOPs) in the United States, the vast majority of which provide employees with a minority of stock in a company. In addition, there are at least ninety companies in which a majority of the assets are owned by employees (both management and hourly—companies owned only by management employees are not considered in this figure). These companies range in size from several employees to several thousand. A list of the companies is included in the appendix. As the list shows, the companies are widely distributed around the country and represent a broad range of industries. 80 percent of these firms were formed since 1971 and 57 percent since 1975, and roughly 70 percent were the result of a corporate divestiture.[1] As later sections will make clear, these companies have been very successful. They have higher profits, wages, and productivity levels than comparable firms.

Two main arguments support the idea of employee ownership. One is that it would make possible a broader distribution of wealth in the United States.[2]

[1] From data gathered for a forthcoming study by Donna Sockell of Cornell University.
[2] For a detailed discussion of this issue and possible remedies, including employee ownership, see "Broadening the Ownership of New Capital: ESOPs and Other Alternatives," a staff study for the Joint Economic Committee, U.S. Congress, June 17, 1976.

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In 1972, for instance, 6 percent of the people in this country held 49.5 percent of all assets, including 72.2 percent of all stock, and had 52.4 percent of the total net worth.[3] A broader distribution of wealth, it is argued, would increase not only the material well-being of people, but also would give them a greater sense of participation in the economic system. This in turn would result in greater productivity.

The second argument is that employee ownership provides a means to save businesses and jobs when a company would otherwise close, be liquidated, or relocate, possibly abroad. Many companies close for reasons unrelated to profitability, such as the retirement of the owner or cash needs of a conglomerate; while others which were previously unprofitable can be made profitable when employees actually own the company. Employee ownership, in these cases, would provide a very desirable alternative to a program of government transfer payments for unemployed workers. This, of course, would also be a tremendous benefit to the community which would otherwise lose the business activity and have to be a contributor to the unemployed.

The Government policy on employee ownership has been mixed. The Small Business Administration, the Farmers Home Administration, and especially the Economic Development Administration have made loans to employee organizations who have purchased their firms, but the number of loans has been limited (13) and most employee takeovers have had to be accomplished through conventional financing means. At this point, financing employee ownership conventionally is extremely difficult. Government tax support for employee ownership has concentrated on ESOPs, giving substantial benefits to companies who can take advantage of these provisions.

The remainder of this report will develop these points in detail, with particular attention to companies actually owned by employees, as it is in this area that Congress will be considering new legislation next year.

I. Dimensions of Employee Ownership

As mentioned above, according to or estimate approximately 1,000–3,000 firms have ESOPs.[4] ESOPs are employee ownership plans in which employer contributions and/or the use of employee stock ownership trusts as leveraging devices are used to transfer stock ownership to employees over a period of time. Their operation will be discussed in detail below. There are, in addition, an undetermined, but probably small, number of companies whose assets are directly owned by employees, either through stock purchase or cooperative purchase of assets.

Roughly ninety firms have been identified in which a majority of the equity is owned by a majority of the employees. This list probably is fairly comprehensive for all but the smallest of businesses, since it excludes what is probably a large number of small producer cooperatives.

The characteristics of employee owned firms recently have been explored by the University of Michigan's Survey Research Center.

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[3] James D. Smith and Steven Franklin, "The Distribution of Wealth Among Individuals and Families," 1975.

[4] Employee Ownership: Report to the Economic Development Administration, Survey Research Center, Institute for Social Research, University of Michigan, estimated 1,100 in 1977, while the Employee Stock Ownership Council of America estimated 3,000 to committee staff in 1978.

In a survey of 100 employee owned firms, the Center found that 68 of 98 firms for which data was available were owned through ESOPs.[5] In a related study, about one-third of the firms were found to be small, using the Small Business Administration's criteria.[6] The ESOP firms tended to be larger than the non-ESOP firms.[7] Table 1 gives a detailed breakdown of the size characteristics of the surveyed firms.

TABLE 1.—SIZE CHARACTERISTICS OF EMPLOYEE OWNED FIRMS BY OWNERSHIP TYPE

[In percent]

	ESOP's (68)	Direct (30)	Total (98)
Number of employees:			
4 to 99	18	20	18
100 to 249	18	37	23
250 to 999	38	23	34
1,000 plus	26	20	25

Source: "Employee Ownership, op. cit."

The percentage of equity owned by employees varies considerably as well:

TABLE 2.—PERCENT OF EQUITY OWNED BY EMPLOYEES, BY EMPLOYEE TYPE, AND BY OWNERSHIP PLAN

[Percent owned by all workers/percent owned by hourly workers]

	Ownership plan					
	ESOP's		Direct		Total	
	All	Hourly	All	Hourly	All	Hourly
Percent of equity owned:						
0 to 9.9	4	50	4	16	4	40
10 to 49.9	18	43	18	20	18	36
50 to 100	78	7	78	64	78	24

Source: "Employee Ownership, op. cit."

The table shows that employees own a majority of the equity in a majority of the companies. This is probably misleading, however, if it is taken to be representative of all companies with some degree of employee ownership. The 100 companies identified for the survey are probably owned by employees more than the several hundred not identified, since the survey was not a random sampling, but simply a survey of all the companies the authors could find that were known to have employee ownership. Those with substantial employee ownership, being unusual, are probably better known and thus more likely to be included. Committee staff, for instance, has been able to find only 90 companies in the country in which a majority of the equity is owned by a majority of employees. It appears, therefore, that in most companies with employee ownership allow employees to own only a minority of the stock, and that the distribution of ownership is skewed towards management.

The table is more revealing with respect to the differences between direct and ESOP ownership. In directly owned companies, hourly workers are much more likely to own a majority of the equity (64 per-

[5] Employee Ownership, op. cit., p. 7.
[6] Sockell, op. cit.
[7] Employee Ownership, op. cit.

cent of the cases), whereas in ESOP companies hourly workers own considerably less (only 7 percent of the ESOP companies have hourly employees owning a majority of the equity). These companies concentrate ownership in managers, since most distribute stock according to salary to qualify for certain tax benefits. Overall, the study found that regardless of ownership form, firms of moderate size (100–250 workers) were most likely to be owned by hourly workers.[8]

The study found that companies chose to become partly or wholly owned by employees for a variety of reasons, but ESOP firms cited employee incentives most commonly, closely followed by the financial benefits to the firm of using ESOPs for capital acquisition. Directly owned companies cited saving jobs most frequently.[9] The reason for this is that ESOPs are generally set up by existing companies as employee benefit plans, while direct employee ownership is usually the result of employee efforts to keep a plant alive.

In the following sections, ESOP and direct ownership plans will be evaluated in greater detail. The overall performance of employee owned firms will then be evaluated, followed by a section on government support for the idea and one on pending legislation.

II. Employee Stock Ownership Plans

Employee Stock Ownership Plans are largely the effort of Louis Kelso, a San Francisco attorney who has argued that the success of the capitalist system will depend on broadening stock ownership. When a company sets up an ESOP it can now qualify for a number of tax benefits, a result of Congress's favorable position on the plans. Partly as a result of these benefits, ESOPs have been spreading widely in recent years.

Under an ESOP, a company establishes an employee stock ownership trust (ESOT). As Congress specified in the Employee Retirement Income Security Act of 1974, the trust, if properly established, qualifies as a stock bonus plan under section 401(a) of the Internal Revenue Code. The Trust then arranges a loan from a bank or other credit source to be used for company capital needs. The creditors will require that the company fully guarantee the ESOT borrowing, something the company is specifically allowed to do under the 1974 Pension Reform Act. The Trust uses the money it has received from the creditor to purchase company stock. The stock stays in the Trust: the company pledges to pay the Trust sufficient amounts to repay the principal and interest on the loan. Interest and principal are tax deductible, up to 15 percent of the covered payroll or 25 percent if the plan is being used as a retirement fund. The company benefits in that normally only interest payments are deductible on a loan. The entire contribution to the ESOT is thus in pretax dollars, so that a company in a 46-percent bracket will, in effect, be paying only 54 percent of the cost of both the program and the loan. The employees benefit because they will acquire the stock, which will vest with them as the loan is repaid. Vesting usually begins a few years after the loan is made. The employees receive their stock when they retire, died, or leave the company.

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[8] *Employee Ownership, op. cit.*, pp. 14–5.
[9] *Employee Ownership, op. cit.*

Ten year income averaging, rollover into Independent Retirement Accounts, and capital gains treatment of the income, are the usual ways to avoid paying high taxes on the benefits. During their period of employment, however, the employees have paid nothing for the stock.

This added stake in the company, theoretically, will help the morale and motivation of the employees, resulting in greater productivity. The distribution of stock is usually made according to salary.[10] Plan participation is voluntary.

This description of ESOPs suggests that they allow a company to use the same dollars to repay a loan and to establish an employee benefit plan, while deducting much of the cost through tax writeoffs. As we shall see below, moreover, ESOPs have additional special tax benefits. There is, however, considerable disagreement about the actual benefits of ESOPs both for the company and for the worker.

ESOPS AND TAXES

The Tax Reduction Act of 1975 established an additional 1-percent investment tax credit for any company setting up a qualified ESOP. The essential new qualifications were that the stock had to be distributed accordingt o salary (ignoring amounts over $100,000), stock voting rights had to be passed through, and vesting had to be immediate. Until that time, ESOPs had been limited primarily to small, closely held companies which have used ESOPs as a means of creating a market for their stock, transferring ownership of stock to favored employees, or establishing an employee benefit plan. Use for financing growth was less common.[11] The 1-percent credit meant, however, that a company which was making investments, qualified under the investment credit provisions of the law, could receive from the government an amount equal to 1 percent of the cost of the investment if they established an ESOP. In other words, the government would make a contribution to the ESOP. The 1975 Act applied only to 1975 and 1976. In 1976, however, it was extended to 1980 and increased to 1.5 percent, provided the employees contributed .5 percent (otherwise the 1-percent credit applied). In 1978, the credit was further extended to 1983.

ESOPs established under this act (called TRASOPs) have been found primarily in large, capital intensive industries, for it is these companies who are making large enough investments and have few enough employees so that the 1- or 1.5-percent credit amounts to a significant amount per employee.[12] By contrast, for a large retailer, for instance, the benefit per employee would be less than $10.[13] Under these conditions, the cost of establishing the plan would exceed its benefits, especially since the plan requires that employees have voting rights. Even if a company had an ESOP, it might choose not to use the credit if it were small or labor intensive, due to the additional plan requirements stipulated by the act. Finally, a company cannot be sure that the credit will last beyond 1983, even though the ESOP obligation established under the bill would continue past that date.

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[10] *Employee Ownership, op. cit.*
[11] *ESOPs—An Analytical Report*, Hewitt Associates, 1977, p. 12.
[12] Broadening the Ownership of New Capital, op. cit., pp. 41–9.
[13] *Making New Capitalists—A Creative Response to Income Inequities*, Richard J. Smith, Department of State Executive Seminars, 1978, p. 18.

In addition to the limits of the tax advantage under the Tax Reduction Act, there is some debate over the usefulness of ESOPs to finance growth and employee benefit funds with pretax dollars. A company could borrow money from a creditor and make a stock contribution equal to the principal amount of the loan to an employee fund. The tax situation of the company would be precisely the same, since it could deduct the interest on the loan and the amount being contributed in stock to the fund.[14] While the difference between the two approaches would be negligible for the employer, except that he would not have to create an ESOT, the employee might notice a very important difference: under an ESOP, the entire amount of the loan is credited to the ESOT at the time the loan is made (in stock). In the alternative plan, stock accumulates only as the loan is repaid. The employee thus loses all the appreciation on the stock not credited to the fund over the life of the loan, an appreciation which could be substantial, especially during periods of inflation. Viewed conversely, if the employee must wait for installments of stock over a period of years, he is, in effect, having the value of the stock discounted by its anticipated appreciation, including the amount due to inflation.

In sum, the tax benefits for a company employing an ESOP are significant for some companies, but for most the tax laws simply put ESOPs on a similar footing with other employee benefit plans. The increase in their use, therefore, probably cannot be attributed to tax incentives per se. In fact, as of 1978, only 200 TRASOPs had been set up, but, altogether, there were at least five times as many ESOPs.[15] The spread of ESOPs, therefore, must be attributed to its other uses: a vehicle for financing, a genuine desire of employers to broaden stock ownership as a means to increase employee incentives, or as a means to transfer ownership of a company to employees. Data referred to above confirm this view. The following sections will explore these areas in greater specificity.

ESOP'S AS A FINANCING VEHICLE

The primary advantages of ESOPs as financing vehicles were listed at the outset of this chapter: The entire loan repayment (principal and interest) is deductible, there is a tax credit for some companies of 1 or 1.5 percent, a source is provided for buying out large stockholders or transferring stock to employees, and ESOP financing can be used simultaneously for a wide variety of financial needs and setting up an employee benefit plan with the same dollars. These advantages must be set against a number of disadvantages:

(1) A company could follow the example set forth on the preceding page and contribute stock to a fund as it repaid the loan. This would be less beneficial for employees, but the company would retain the stock, and thus any appreciation it might have, for a longer time.

(2) The issuance of new stock to the ESOT will mean a dilution of stock value for existing shareholders unless the new growth financed through the ESOP is large enough to offset the dilution. This can be of serious concern in a small, privately held company, especially if the plan carries voting rights with it.

[14] *Making New Capitalists*, op. cit., p. 19.
[15] *Making New Capitalists*, op. cit., p. 20.

(3) ESOPs must confrom to pension laws and, if a credit is sought, TRASOP provisions. The cost of compliance may be a significant barrier for some companies.[15a]

Of course, in any case, a company seeking to finance new growth must evaluate all the costs of whatever financing method it chooses—debt financing (eg; conventional loans), equity financing (eg; selling stock), or ESOP financing. One careful analysis of the costs of these approaches was made by Hewitt Associates. The study assumed that the company was in the highest tax bracket and thus could make full use of the principal and interest deduction features of ESOP, but did not assume the 1 percent credit was claimed. The study concluded that ESOP financing was better than debt financing by 15 percent over a 10-year period, but 15–20 percent worse than equity financing.[16] Of course, this example makes a number of important assumptions, but it does suggest that ESOPs should be more popular with closely held companies, since they would have difficulty with equity financing. Other than publicly held companies using the 1.5 percent credit of TRASOPs, this does seem to be true among ESOP companies.

The study also may be less applicable to small firms with lower corporate tax rates. For them, the ability to deduct the principal and interest portions of the payments to the Trust are less important than for more highly taxed firms.

As with the tax benefits for ESOPs, then, the financing benefits appear mixed and appropriate only to certain firms. A large or moderate sized company with a payroll large enough so that the borrowing it envisaged would be less than the 15 percent limit on deductibility would be ideally suited for ESOPs.

The previous two sections, however, have disaggregated the benefits of ESOPs and evaluated them separately. In fact, the primary advantage of an ESOP is that it can simultanelously be used for financing, for tax benefits in some cases, and for establishing an employee benefit plan, a plan which, by disbursing ownership, should increase motivation. While a company might be able to accomplish all these goals separately for the same money, ESOPs provide a convenient device to do all three which, at least for some companies, could provide important financial benefits.

ESOPs should not be evaluated only as a tool for the company, however, since they have important consequences for employees as well, as will be discussed below.

USING ESOP'S TO TRANSFER OWNERSHIP TO EMPLOYEES

Before turning to the effects of ESOPs on employees, however, one additional function of the plans needs to be considered their use to transfer a business to its employees. It is in this respect that ESOPs are particularly helpful. All analysts, including those critical of ESOPs, seem to agree that they provide a very advantageous approach for these situations.

There are two situations in which a company is sold—a divestiture from a parent company or a sale from an independent owner upon retirement, death, movement to a new position, etc.

[15a] For a comprehensive review of ESOP financing disadvantages see Jared Kaplan, "ESOP's Fable," *Taxes*, 1975, pp. 898–912.
[16] ESOP's—An Analytical Report, Hewitt Associates, 1977, pp. 34–5.

In the divestiture case, an ESOP would work as follows: The parent company creates a new company, which in turn creates an ESOP. The ESOP sets up an ESOT which secures a loan, which the new company (and sometimes the parent company) guarantees, using the assets of the company it is about to buy as collateral. The ESOT uses the money from the loan to buy the new company. The assets of the new company are exchanged for stock in the company (in effect, the ESOT gives the assets to the new company in return for an equivalent value in stock). The loan is repaid through the ESOT by the new company, which has pledged to make sufficient funds available to the ESOT for repayment. The payments through the ESOT, of course, are deductible up to the 15-percent or 25-percent limit.[17]

The company could accomplish the same thing by getting a bank loan and then setting up an employee benefit fund and making stock contributions equal to principal payments. This would amount to the same thing as an ESOP, except that the employees, who are now the owners of the company, would not get the full benefit of stock appreciation as the loan is being repaid. Since the employees now own the company, there would be no reason not to set up a plan in this manner.

Unless a government agency or the parent firm is backing up the loan to the ESOP, it is unlikely that a bank or other creditor would loan the money for the purchase of the company unless the individual employees could put forward a substantial amount of their own capital. The ESOP device, therefore, is not a magical tool for creating capital and credit where none existed before, but it is extremely useful in many circumstances.

The main benefit it offers is the creation of a market for the subsidiary. When a parent company decides to close or sell a subsidiary, other buyers may be reluctant to take the firm over. In many cases, the buyers simply may be other conglomerates only. ESOPs thus offer a way to sell a company so that new company is an independent, locally owned firm. Because the ESOP offers a means for purchasing the company in pretax dollars the new buyers are off to a better start than if they had to raise their capital on their own to buy the firm (in that case only the interest would be deductible). The result of all this is that the parent company has a buyer and the employees, rather than losing their jobs or being taken over by another conglomerate, can keep their jobs and have a stake in their new company.

ESOPs are also very useful when an owner wants to sell his company or his share in his company. Normally the sale of stock by an owner to his corporation is taxed as income, unless all or most of the stock is sold at one time, which an owner may not want to do as he plans to leave a company over a period of time. Under an ESOP, the owner simply makes contributions to an ESOT (straight contributions, not new borrowings), which the ESOT then uses to buy the stock. The IRS has held that this is not the same as a normal stock purchase and the sale of the stock is treated as a capital gain.[18]

In addition, of course, in any sale by an owner to his employees, the ESOP offers the same advantages as in the divestiture case: Creation of a market and the ability of employees to buy the company in pretax dollars.

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[17] "ESOP: Pluses and Minuses", Robert Reum and Sherry Milliken Reum, *Taxes*, July–August, 1976, p. 189.

[18] Neil Wassner, statement before the Joint Economic Committee, hearings on ESOPs, 1975.

Unlike the other aspects of ESOPs, then, their use in transferring ownership seems almost unequivocally beneficial, especially for the employee purchasers. Only in the case where a company desires to sell to another company through an exchange of stock (which would avoid capital gains taxes) would an ESOP purchase present a problem. This option only applies, however, in cases where a subsidiary is highly marketable and another conglomerate with desirable stock is interested.

ESOPS AND EMPLOYEES

ESOPs are clearly beneficial to employees seeking to buy their firms, but in ongoing concerns their benefits depend on the values of the employees.

ESOP proponents claim that ESOPs provide employees with stock at no cost to them. Thus, even if the company goes out of business and the stock becomes worthless, the employees have not lost anything. This, however, is an unrealistic view, since the ESOPs are likely to be viewed by the company as a form of employee compensation, thus reducing the need for other modes of compensation.

For the employee, in many cases, the choice is between an ESOP and some other form of employee benefit plan, such as profit sharing or, in some cases, a pension plan. Ownership of stock in the company is only beneficial, of course, inasmuch as the value of the stock increases. If the stock increases at rate faster than the loan rate, then the employees benefit more than had the money simply been returned through profitsharing.[19] If the stock declines, the employees lose, and if the plan represents their pension, they could face serious problems. Since most firms do eventually close, this is a problem that must be addressed.[20] In California, ESOP insurance at reasonable rates has started.[21] Employees can also be assured of gaining some equity when the company is sold or liquidated.

On the other hand, data will show later that employee owned firms do much better than non-employee owned firms. and the more equity employees own, the better the companies do. If a company succeeds, an employee, over the life of his participation, could accumulate considerable sums. ESOP proponents point to workers who have left ESOPs with hundreds of thousands of dollars. Finally, participation in ESOPs is voluntary, and employees could bargain for a choice of employees—ESOPs or a like contribution to another benefit plan.

Unions have generally opposed ESOPs due to the risks involved and due to a fear that worker-owners will be co-opted by management.[22] Where ESOPs are an employee benefit program, clearly the employees have the most to lose in relation to other alternatives. Employees must choose whether participation in their companies' possible success or failure is worth more than a more secure and conventional plan. The decision is not unlike deciding whether or not to buy stock or put money in the bank, except that the employee knows the stock better and can contribute to its value.

Where ESOPs are used to purchase or eventually transfer ownership to employees, however, the situation may be viewed differently.

[19] *Broadening the Ownership of Capital*, *op. cit.*, p. 37, and *ESOP's: An Analytical Report*, *op. cit.*, pp. 24–5.
[20] *Broadening the Ownership of Caiptal*, *op. cit.*, p. 36.
[21] Statement of Louis Kelso before JEC hearings, *op. cit.*
[22] *Broadening the Ownership of New Capital*, op. cit., p. 38.

Now the employees must choose between a simple wage and an opportunity to earn a wage and partake substantially in the company's direction and future. The risks are greater, but, since individual employees are not liable if a company does go bankrupt or suffer losses except inasmuch as salaries may decline, the risks are not as great as normal ownership. All of the psychic and financial opportunities are present, however.

These psychic rewards, of course, are one reason why ESOPs are established. Management hopes that employees will be stimulated to greater levels of productivity. Their hopes seem to be confirmed by the studies available (cited below in section VI), although it appears that ESOPs which provide only small amounts of stock to employees have little impact. Employee ownership of substantial equity, on the other hand, provides considerable incentives.

In sum, ESOPs present both risks and advantages for employers and employees, and each case must be evaluated individually. Nonetheless, ESOPs appear very useful for transferring ownership to employees and, in ongoing businesses, can often create substantial opportunities for businesses and employees. While not the financial miracle some proponents claim, they have important advantages, perhaps the most significant of which is the possibility for a new way of organizing American worklife by creating a much broader participation in the capitalist system.

III. Non-ESOP Modes of Ownership

While ESOPs have gained considerable popularity and constitute the bulk of employee ownership plans, there are alternatives to ESOPs. The most common of these alternatives are cooperative ownership, in which all or most employees purchase shares of a company and participate in its management, and direct ownership, in which employees purchase all or part of a company but retain traditional mangement forms. Both forms have advantages and disadvantages, but both require that individual employees put up a substantial amount of their own capital in order to purchase their companies, a process that requires not only considerable willingness to undertake risk on the part of employees, but also requires tremendous organization and leadership in order to assure that the employees will actually put forth the necessary capital in the limited time available to purchase the firm. While this obviously presents significant obstacles, using this procedure may make lenders and the company's prior owners more wiling to loan or sell than in an ESOP situation, where employees may not be risking any of their own assets.

COOPERATIVE OWNERSHIP

There are an unknown number of producer cooperatives in the United States, most of them small, non-conventional local businesses often motivated by concerns other than profit. While these businesses present an interesting alternative to traditional business forms, they will not be discussed in this report, which is, instead, focusing on uses of employee ownership in the more traditional sphere of business organized primarily for profit. The reader interested in these businesses

is referred to Daniel Zwerdling's excellent collection, *Democracy at Work.*[23]

Cooperatives have been used to organize more traditional businesses in at least a few industries, and case histories are available for those in agriculture, garbage collection, and plywood manufacturing. Of these, the most detailed information is available on plywood coops, and they present an important and illustrative example of the potential and problems of cooperative organization.

In the Pacific Northwest, there are currently about 16 cooperative plywood companies, about half the number that have been created at one time or another in the last 50 years. Most are of moderate size, and collectively they account for about one-eighth of the total Douglas Fir Plywod output.[24] The first of the cooperatives was formed in 1921 in the Seattle area, which had a large Scandinavian population with a cooperative tradition.[25] The company's success led to the formation of other plywood coops, sometimes at the instigation of promoters who took advantage of the workers.

The coops provided that each member would be allowed to buy only one share. In many companies, this could be done through a payroll deduction plan. Every shareholder is guaranteed a job. Wages are the same for all shareholders, but all the companies have non-owner general managers who are paid substantially more. Also, many companies hire non-owning workers, especially for temporary or less-desirable jobs, and most companies have incentive pay systems for unpleasant work. Shareholders elect a board of directors from among their ranks, and the directors meet periodically to make policy decisions. Day to day management is in the hands of the general manager. Directors, of course, continue at their jobs, and most usually serve for a limited time. Working shareholders are paid conventional wages, but at the end of the year are returned "surpluses" (the coop word for profits). Share values generally increase, and now are worth from $20,000 to $200,000.[26]

The subsequent resale of stock by retiring workers is limited to people who will or could become workers in the company (although it is not necessary to take a job immediately). Dividends are very limited so that benefits of ownership will accrue primarily to worker-owners. Shareholders can demand a job at any time when they are not working.[27]

Overall, the plywood coops have been successful. Some have made a great deal of money for their owners, while others have just survived and still others have failed. Given the often difficult conditions in the industry over the period of their existence, however, the companies have an admirable performance record. Workers, in addition to the share value they have accumulated, are paid about 25 percent more than in comparable plywood companies and are about 30 percent more productive.[28] Interestingly, Northwest plywood unions are uncomfor-

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[23] Daniel Zwerdling, *Democracy at Work* (Association for Self-Management, Washington, D.C., 1978).

[24] Bruce Stokes, "Worker Participation and the Quality of Worklife", (Worldwatch Institute, Washington, D.C., 1978), p. 28.

[25] Carl J. Bellas, *Industrial Democracy and the Worker Owned Firm*, (New York, Praeger Publishers, 1972), p. 17.

[26] For an excellent review of the plywood coops and their structure see Katrina Berman, *Worker Owned Plywood Companies* (Pullman, Washington State University Press, 1967).

[27] Berman, *op. cit.*

[28] Paul Bernstein, "Run Your Own Business", *Working Papers for a New Society*, v. 2, No. 2, summer, 1974.

table with the coops, since the role of the union is less important in the coops (most do have unions, but they are mostly concerned with relatively minor matters) and since coops will reduce worker pay when the company is not doing well.[29]

Management of the coops can present problems, since the workers are always tempted to reduce investment for the future in order to increase wages or surplus returns in the present. When financial problems arise, raising new capital becomes difficult, since it cannot be raised through stock-offerings and some creditors have been reluctant to make loans.[30] Nonetheless, most of the plywood coops have managed to overcome these problems.

In fact, of the plywood companies that have gone out of business, four did so because they were too successful. Share values increased so much that no new investors could be found who were willing to buy the shares. Those with enough money would not be interested in working in the company, with the result that in order to dispose of the shares and to raise new capital the companies were forced to sell to larger firms. Of course, in addition, the shareholders made substantial profits through the sale and generally urged that the sale be made.[31] Some other plywood coops only lasted a short time, as they were the creation of promoters trying to unload a dying business or simply to get rich quick by taking a substantial fee for their efforts.[32] According to Bernstein, only four of the coops simply failed once they had been established.[33]

One way to solve the problem of shares costing too much to attract new worker-owners would be for all companies to use a payroll deduction plan. Another approach would be to limit share value to a certain amount for the worker and have the company purchase the excess value, contributing the excess amount (a percentage of the actual share value) to a pension fund which would be recapturable by the employee only when he left the company.[34] The problem, although difficult, is capable of resolution, provided the coop plans ahead.

Coops do present one significant tax benefit to owners in that the IRS has ruled payments to shareholders could not be considered taxable corporate income, allowing the owners to transfer profits to themselves at lower tax rates than would be the case if they were retained as company profits. IRS rules require, however, that the coops show that the wages they pay are not in excess of reasonable labor costs. Since the coop workers have been more productive than their non-coop counterparts, the IRS has allowed the coops to pay substantially higher compensation to their employees.[35]

In sum, the coop experience in the plywood industry has been generally successful, demonstrating that workers can own their companies and manage them as well, and in so doing make high wages and a company "profit" (which they can keep for themselves). Although growth and management problems do arise, the problems have not been insurmountable. The rewards for the workers—a secure, high paying job in their own company—have been, it seems, well worth the efforts

[29] Berman, *op. cit.*, p. 127.
[30] Bellas, *op. cit.*, p. 97.
[31] Bernstein, *op. cit.*
[32] Berman, *op. cit.*
[33] Bernstein, *op. cit.*
[34] Bernstein, *op. cit.*
[35] Berman,, *op. cit.*, pp. 165 and 175.

to overcome obstacles. It appears, however, that few other cooperative ventures exist, and none are so widespread or well-developed as the plywood coops. Detailed information about them is not available. The most that can be said, then, is that the coop alternative shows considerable promise, but has been too uncommon to justify any firm conclusions about the precise role it might play in American business.

DIRECT WORKER OWNERSHIP OF BUSINESS

The phenomenon of workers buying their companies directly is a relatively recent one in this country. In this situation, when a company would otherwise close or relocate, workers, sometimes in cooperation with local community people, agree to raise the money needed to buy the firm themselves, generally through a purchase of stock issued by the new company. Of all forms of worker ownership, this is the most simple and direct as far as transition arrangements are concerned. It is not, however, easy to accomplish.

From the data gathered by the Survey Research Center and by committee staff, it appears that about one-fourth of the the employee owned firms (where employees own half the equity or more) are owned directly by employees or employee-community groups. The term direct ownership here is simply meant to distinguish between firms in which ownership is accomplished through an ESOP or through a cooperative and firms in which employees or employees and local people simply purchase the stock of a company on a normal stock offering basis (although stock may be limited to employees or local people, and ownership of more than a certain amount of shares may be prohibited). Unlike coops, owners can own more than one share.

The direct ownership concept is surely the simplest of the three arrangements discussed. When a plant is about to close, an organization is formed to sell stock in a new company which will buy the old plant from its previous owner. Generally, it appears that the stock offering is not limited to employees in order to facilitate raising the necessary capital, although some companies limit subsequent resale to the company or to employees. In some cases, the sale has been from former owners who have gradually transferred stock to employees over a period of time, while the company continued in operation, while in a few cases, employers have simply given the stock to their employees (most notably in International Group Plans of Washington, D.C.).

When a benevolent owner does not exist, raising the necessary capital in this manner can be extremely difficult. Employees may be asked to raise thousands of dollars in a few days or a few weeks. Banks may be very unwilling to loan money at this point, given the uncertainty of the endeavor at this early stage. Employees may end up owning worthless stock. Nonetheless, since their jobs are at stake, the investment risk may seem worthwhile. From the information available to the committee, it does not appear that any employees have lost their investments in the cases that follow this pattern that have occurred in this decade, when most of the employee takeovers have taken place.

Once the stock is owned by the company, and operating loans are secured, the company has a number of options concerning the role employees will play as owners. From the cases on which information is available, however, a common pattern seems to have emerged: Employees vote their stock, as would any owner, but the board of directors

rarely has substantial employee representation and worker participation in management is generally limited. The employees, in buying the company, are naturally primarily concerned with preserving their jobs, and give little thought to how the company will be run once it is saved. Moreover, it appears most companies do not plan for the transfer of stock from retiring employees to new employees, so that the idea of employee ownership may fade over time. Some companies do not even provide that stock must be sold back to the company, so that an outside interest can purchase a majority of company stock. This is precisely what happened in one of the best known cases of employee ownership, the Vermont Asbestos Group.[30]

The result of this lack of planning can be employee disenchantment after a few years. In this respect, ESOPs and cooperatives have clear advantages in that they specifically address questions of stock ownership and employee voting rights (although ESOPs, unlike coops, have no requirements for employee participation in management and many ESOP promoters oppose the idea). Nonetheless, this is not an inherent disadvantage for direct ownership. The problems of ownership transfer and employee participation can be resolved, but they must be addressed at an early stage, prior to the disappearance of a majority of the stock or the alienation of employee owners.

While direct ownership is the simplest way of transferring ownership to employees from a financial standpoint, it does not offer the tax benefits available to employee owners under an ESOP (the ability to deduct principal and interest repayments on the loans used to buy the company—employee owners in the direct ownership model can only deduct their interest, or nothing at all if they used their own savings) or coops (the ability to return profits to employees without having the company pay taxes on the profits). The value of these tax savings will vary from case to case, but certainly should be a consideration when employees purchase a company.

IV. Transfer of Ownership to Employees

The previous sections have explored the three basic modes of employee ownership and in so doing have discussed how each can be used to transfer ownership to employees. In this section, the reasons for transferring ownership to employees and the obstacles involved in doing it will be discussed.

Transfer of ownership occurs primarily under four conditions: (1) A company sets up an employee stock ownership plan as an employee benefit, usually either to provide an incentive to employees or to help finance expansion (or both), (2) a conglomerate decides to divest itself of a subsidiary, (3) an independent owner dies, retires, or leaves the business, and (4) an owner decides to give his company to his employees.

ESOPs have been discussed in detail above. This form of transfer is generally intiated by the employer and results in employees owning a minority of company stock, although there are cases, such as Hallmark Cards, in which employees will eventually own a majority of the stock. The use of an ESOP by management does not need further elaboration at this point, however.

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[30] Zwerdling is again insightful on this point. See Zwerdling, *op. cit.*, pp. 53–76.

A decision by an owner to give his company to his employees is, to the committee's knowledge, very rare, although a few cases have been documented.[37] The practice appears unusual enough, however, not to merit discussion here.

The other two cases are more common and more interesting, and both involve the actual sale of a company to its employees. As such, they provide potential for saving jobs and business activity in communities that would otherwise lose them, or for preventing independent or potentially independent businesses from being swallowed by conglomerates.

Sockell has concluded that almost all of the cases of employees purchasing a firm have occured in this decade, with the exception of the plywood companies.[38] Of these purchases, the large majority appear to be corporate divestitures.[39] Precise data are not available on all instances of known employee purchases, however, so estimates such as these are only approximate.

It may appear at first blush that a company that could not survive as a subsidiary of a conglomerate will also not survive as an employee owned firm. This, however, is often not the case. In many cases, a conglomerate sets certain rates of return (typically around 15 percent) it expects from its subsidiaries. If they do not achieve these rates, they are closed or sold. Employee owners, however, may well be satisfied with a lower, but still profitable, rate of return, since their jobs are at stake. In other cases, a conglomerate may simply find that a subsidiary does not fit into its current plans, or that it needs the cash that would result from a sale. Finally, conglomerates may mismanage firms, saddling them with substantial overhead costs or making inappropriate decisions. Even a subsidiary that is well run, moreover, might be better run by employee owners, since their new owners would presumably work harder than before.

Sociologist William Whyte, who is heading a research project at Cornell University's School of Industrial and Labor Relations on this project, has cited these reasons and others as the explanation for the fact that, to the knowledge of researchers in the field, of the companies which have had employee takeovers in this decade, all are still in operation, and many have been turned from money losers into profit makers.[40] Given what many economists see as the over-acquisition of the sixties and seventies, there could be ample opportunities for employee ownership in the years ahead.[41] For employees and communities where conglomerates have erred, employee ownership may be the only way out of a desperate situation.

For independent owners who are retiring, leaving their company, or who have died, transfer to employees may be a very attractive alternative. An extensive survey of owners of wholesale distributing companies showed that few have given serious thought to this problem, and most had unrealistic expectations about prospects for their company's sale.[42] Although use of the techniques is still uncommon, its advan-

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[37] See Zwerdling, *op. cit.*, pp. 113–130.

[38] Sockell, *op. cit.*

[39] Sockell, *op. cit.*

[40] William Whyte, "In Support of the Voluntary Job Preservation and Community Stabilization Act", p. E3326 of the *Congressional Record* of June 19, 1978.

[41] "How To Buy Your Own Company", *Dun's Review*, November 1977.

[42] "Profile of the Perpetuation Crisis", National Association of Wholesale Distributors, 1975, p. 5.

tages—creating a market for the owner, preserving jobs for the employees, and providing an opportunity for the owner to see his company perpetuated as an independent business—suggest that it deserves much more serious consideration.

Despite the clear advantages of selling to employees, many conglomerates or individual owners are reluctant to do so. In some cases, an owner or conglomerate can sell a company to another company through an exchange of stock. Such exchanges are not taxed, whereas cash purchases are treated as capital gains. Using an ESOP can reduce some of the tax disadvantage in some situations, but not all. Many sellers simply do not take the idea of employee ownership seriously and refuse to negotiate with employees or fail to provide notice far enough in advance so that employees can organize. In some cases, a company can gain more through a liquidation sale and tax writeoff than it could through a sale, while in others a company is closing a subsidiary in one place to relocate elsewhere, and does not want anyone to own its former plant, since it would be a competitor.

Research on failures of employees to buy their firms is, unfortunately, very limited, but it appears that more important than any of the above reasons for failure is simply the inability of employees to raise the capital needed in a short enough time.[43] The problems in raising the money are obvious: employees must be organized quickly around a novel idea, cash must often be raised from low asset employees, and creditors must be convinced that an unconventional approach can work. Every case with which the committee is familar in which employees succeeded in making the purchase has involved something extraordinary: A benevolent owner, and exceptionally talented organizer, or government assistance—assistance almost always prompted by the intervention of a Senator or Congressman.

The problems of transition, of course, suggest a role for the federal government as a source of credit or credit guarantees. The idea has intuitive appeal: in any case in which a firm would otherwise close or relocate the government has, in effect, two choices. It can pay unemployment insurance and possibly food stamps and welfare to unemployed workers or it can loan the workers money for buying the plant and keeping their jobs. In the first case, the money is a permanent transfer; in the second, it is a loan and, presumably, most of the loans will be repaid. As the next section will indicate, however, government involvement in employee ownership has been spotty and generally reluctant.

V. Government Support for Employee Ownership

In this section, government support for employee ownership will be reviewed. As tax support for ESOPs has already been discussed, this section will focus on loan programs for employees who attempt to buy their businesses. There are four potential sources of funds: EDA's title IX program; SBA's 7a program, Farmers Home Business and Industrial Loans, and Loans to Producer Coops from the Cooperative Bank.

The Economic Development Administration, an agency of the Commerce Department, can grant and loan funds under its Title IX

[43] Robert Stern and Tove Helland Hammer, "Buying Your Job: Reconsiderations on Recent Experience", paper delivered at the 9th World Congress of Sociology, Uppsala, Sweden, Aug. 14–19, 1978.

program for business development in areas of high unemployment. EDA regulations require that assistance be given on a priority basis to areas affected by defense realignment, Environmental Protection Agency caused plant shutdowns, and disasters. All other assistance under this title receives lower priority. Nonetheless, to the committee's knowledge (records are not available with precise information) EDA has assisted nine employee organizations to purchase their companies, either through low-interest loans or grants to local agencies who in turn use the money to make loans to the employee organizations. In at least some of the cases, the assistance was a result of political pressure on the agency, but at least some of the agency's administrators have shown enthusiasm for the idea. Given the agency's required priorities, however, it is doubtful that EDA assistance can expand beyond its currently very limited scope without specific Congressional action. A proposal along these lines will be discussed later.

The Small Business Administration can make loans and guarantee loans under its 7a program. Direct loans are limited to $350,000 and guarantees to 90 percent of the loan for not more than $500,000. SBA has guaranteed three loans to employee organizations and appears to be about to guarantee a fourth. The SBA will not, however, make or guarantee loans to an ESOP. SBA regulations state that an ESOP is not a small business and that the advantages of an ESOP could be obtained in other ways.[45] While it is true that an ESOP or its trust is not formally a small business, it is simply a creation of a business, and its loans are formally guaranteed by the business. The distinction between the ESOP and the business is purely a paper distinction, and Senators Nelson and Long have expressed their disappointment and disagreement with the SBA position on this matter. Moreover, while it is true that in some cases a bsuiness could get the tax advantages of an ESOP without setting one up, as pointed out earlier, the employees benefit more if an ESOP is established than if an ESOP alternative is created. As was also pointed out, ESOPs are excellent tools for employee purchase of businesses, and there are on alternative methods of accomplishing the same tax purposes in this case. Since the SBA has stressed to the staff their concern with making loans to preserve or (in the case of a spinoff of a subsidiary) create independent small businesses, their refusal to make loans to ESOPs, which accomplish this extremely well, seems very contradictory and shortsighted.[46]

The loans SBA has guaranteed, then, have been in non-ESOP cases, but, even here, SBA officials have told staff that they do not see making loans to employee organizations as consistent with the primary purpose of the agency (as they see it), namely to assist individual entrepeneurs. Given SBA guidelines for making loans, which include sufficient collateral on the part of those receiving the loans, it is easy to understand why the SBA, at this time, is not likely to be a primary source of loans to employees. If SBA were to become an effective force in this area, its rules on ESOPs would have to be changed and its evaluation of loans to employee organizations would have to be based on an assessment of the future prospects of the company.

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[45] Letter from A. Vernon Weaver, Administrator, SBA, to the Honorable Russell Long, May 15, 1978.

[46] See Jan. 23, 1958, SBA memo reprinted in Opinion Digest, No. 56, Feb. 26, 1965 for SBA policy of encouraging the preservation and creation of small business.

The Farmers Home Administration also can make loan guarantees to employees and has done so in one instance (Bates Fabric in Maine). FmHA loans are not restricted by size of firm and can be as large as necessary, but must be made to businesses in places of 25,000 people or less. FmHA does, however, encourage small businesses even in these areas to approach SBA. Farmers Home officials have expressed enthusiasm about the idea of employee ownership to the staff, but said that they have not had many inquiries. For businesses in qualified areas, then, FmHA might be a logical place to seek credit.

Finally, the Cooperative Bank, created by the 95th Congress, can make loans to producer coops. There is a $10 million limit on these funds, since the bank was primarily intended for consumer coops. The program is just beginning, but could provide a modest source of capital for employee ownership.

Overall, then, government involvement has been limited—probably less than 15 or 20 percent of the cases of employee ownership known to the committee involved government assistance. As the next section will make clear, however, the government could stand to benefit itself and the country significantly by becoming more involved in employee ownership.

VI. Evaluating Employee Ownership

Employee ownership of companies has worked. The overwhelming preponderance of evidence shows that employee owned firms are both more profitable and productive than similar conventional firms and that employee ownership results in better working conditions for everyone. Most importantly, where employees have bought their companies, it results in the preservation of jobs that would otherwise be lost. This is not to say that there are not pitfalls in employee ownership—a program for the support of employee ownership could result in aiding shaky businesses to take advantage of their employees if not carefully administered, and even successful employee owned firms have had difficulty determining the role employees should play in management, but the overall record of employee ownership is very impressive.

In a study of the plywood industry, Paul Bernstein found that employee owned firms had 30 percent higher productivity and 25 percent higher wages than conventional firms.[46] In addition, of course, each employee owner has equity in the company. In the Survey Research Center study of 100 employee owned firms, profits were 1.5 times higher in employee owned firms than non-employee owned firms, and the greater the equity owned by employees, the higher the profits (the study included a variety of ownership arrangements, from a minority employee ownership arrangement to full ownership).[47] Managers surveyed in the study reported much higher levels of employee satisfaction with employee ownership compared to the prior conventional ownership of their companies.[48] They also contended that employee ownership improved productivity and work atmosphere.[49]

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[46] Paul Bernstein, "Worker-Owned Plywood Firms Steadily Outperform Industry," World of Work Report, June 24, 1977.
[47] *Employee Ownership, op. cit.*, p. 24.
[48] *Employee Ownership, op. cit.*, p. 30.
[49] *Employee Ownership, op. cit.*, p. 36.

The idea of employee ownership is also a popular one; a 1975 national poll by Hart Research showed that a margin of 66 percent to 25 percent would prefer to work in an employee owned firm.[50]

Perhaps the most important data, however, concerns the companies who would have gone out of business had employees not bought the company. Of the companies purchased by employees in the seventies, to the knowledge of the staff and researchers in the area, all are still in business, and many are succeeding where predecessors were failing. All told, perhaps 50,000 to 100,000 jobs have been saved. As a job creation program alone, employee ownership would compare very favorably to government funded public works jobs.

There are problems as well, however, Employee participation in management is often not planned, resulting in disenchantment of workers. According to the Survey Research Center, only about half the ESOP companies allow significant employee input into decisions and only 27 percent allow employees to vote their stock. By contrast, non-ESOP firms almost unanimously allow voting rights, and generally (77 percent of the firms) allow for employee input into major decisions.[51] Sockell's more detailed study of the issue showed that of 32 firms surveyed, only nine allowed direct participation in management by employees, although 23 allowed stock to be voted.[52]

Arguments can be made on either side of the issue of employee participation in management, but research conclusively shows that productivity increases with worker participation.[53]

Research by Zwerdling cited above showed that when such participation is not allowed, workers-owners become alienated. While still pleased to have their jobs, they feel their equity position should give them more of a say in company operations. At the very least then, companies contemplating employee ownership should give serious thought to worker participation and be prepared to allow as much participation as possible.

Finally, it is possible that employees could be sold a company that was dying or had poor prospects. This happened in a few cases in the plywood industry in the fifties, although there are no apparent cases of it in the wave of employee takeovers in the seventies. ESOP plans could be used to reduce employee compensation or to substitute stock in a weak company for a pension fund. At this point, however, these problems seem to have been very minor compared to the success of the idea of employee ownership. Moreover, there is no reason why employees are not capable of making sound financial decisions, nor is there any reason to believe that the government would be unable, when it makes loans to employee organizations, to avoid assisting weak companies take advantage of their employees. These dangers should be avoided, but they should not be allowed to prevent the government from encouraging what has been an extremely successful experiment.

VII. Case Studies

Some of the points made above can best be illustrated by specific examples. The following section will, therefore, briefly detail instances of employee takeovers of firms.

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[50] Quoted by Whyte in Whyte, *op. cit.*

[51] Employee Ownership, op. cit., p. 21.

[52] Sockell, *op. cit.*

[53] Paul Blumberg, *Industrial Democracy* (London: Constable, 1968), p. 123. Blumberg cites a number of studies to this effect.

SOUTH BEND LATHE

In 1975, Amsted Industries, a Chicago based conglomerate, decided to liquidate its South Bend Lathe subsidiary. The company employed 500 people and, although one of the few lathe manufacturers in the country, was just barely breaking even. SBL executives believed that with proper management, the company could make a profit, however, and decided to try to purchase it themselves. The executives joined with the union and city officials (South Bend was still recovering from the loss of Studebaker years before) and took their case to the EDA. EDA quickly agreed to grant $5 million to the city which in turn loaned the money to SBL's newly created ESOT. With this as a start, the company was able to secure another $4.5 million (roughly) and purchase the plant from Amsted. The employees in this arrangement put up none of their own money, but as the loan is repaid over 25 years will gradually build up equity in the company (the employees will have a percentage of the stock vested prior to the full 25 years, however). The loans are secured by the company's assets, which were worth at least the $10 million paid for the company.[54]

After the first year, the company had 20% higher productivity and 10% more pretax profits than the year before, and has continued profitably since. A typical employee at the plant accumulated about $2,000 in stock in his or her ESOP account.[55] While the reports of SBL's success have been glowing, there are reports that workers feel that the plant continues to operate as before as far as their role is concerned, and that greater employee participation is needed.[56]

VERMONT ASBESTOS GROUP

One of the most publicized employee ownership stories is that of the Vermont Asbestos Group. In late 1974 the GAF company decided that new EPA regulations and declining profits at its Vermont asbestos mine subsidiary made the mine no longer profitable and decided to close it. In Vermont's depressed Northern Kingdom, the closing of the mine meant that the almost 200 workers would have a difficult, if not impossible, time in finding new employment. Spurred by an aggressive former maintenance supervisor, the employees decided to try to buy the company. After a long and difficult process, employees were able to raise $100,000 and finally convince enough banks and the SBA to loan them enough money ($2.15 million) to buy the company from GAF. GAF agreed to sell the company for $400,000—a very good price. In the next year, the VAG, as the company was now called, installed all the needed pollution equipment.

In the next few years, fortuitous events in the world market made VAG a tremendously profitable company. Employee owners' wages went up substantially and the value of the stock, most of which was owned by employees, increased in value from $50 a share to $3,500 a share in 1976. Unfortunately, the company was not able to cope with success. Worker-owners were not pleased with the limited role they were playing in management, and disputes over how much money to

[54] *Newsweek*, Sept. 1, 1975, p. 49.
[55] *Time*, Oct. 4, 1976, p. 80.
[56] Zwerdling, *op. cit.*, 63–76.

reinvest and how much to redistribute were frequent. The originator of the employee ownership movement lost his leadership position in the company, and many employees sold their stock. Unofficial reports now say that a majority of the stock is owned by one local individual.[57]

The VAG experience shows the potential that employee ownership has for saving jobs, but it also shows the need for planning ways to keep stock in the hands of workers if the goal of employee ownership is to be maintained, and the need to come to grips with the fact that when employees become owners they may demand a greater role in management.

MOHAWK VALLEY CORP.

In early 1976 the Sperry Rand Company announced plans to close its Library Bureau division in Herkimer, New York. The Bureau had been making a small profit, but less than what Sperry expected from its subsidiaries. Library Bureau managers and employees were convinced that the company, which makes library furniture and has several hundred employees, could be profitable enough and has local ownership and organized an effort to purchase the company from Sperry. At first, Sperry was extremely reluctant to sell at all, since it could liquidate for more than the employees were willing to pay. Under intense pressure from Congressional representatives, however, Sperry agreed to sell for $6 million. The employees and members of the community raised $2 million through the sale of stock, with an initial pledge of $1,000 per employee in nonrefundable funds as a pledge to Sperry and to pay for legal and other costs. EDA arranged a $2 million loan and another $2 million was secured from local banks. The company has established an ESOP and the workers will eventually own all the stock in the company.

During its first year of operation the company made a profit, but during its second broke just about even. Company officials attribute that to the cost of the loans and expansion, plus a loss of business as a result of uncertainty on the part of customers during the transition period. Company officials are very optimistic about the future, however.

As in other companies, employees have a limited role in management, but, in this case, this is partly the result of the wishes of the employees, who have not actively sought a role in management decision.[58]

JONES AND PRESNELL

When the W. T. Grant Co. went bankrupt in 1976, one of its subsidiaries, Jones and Presnell, a firm specializing in color photographs of children, decided to try to survive on its own. The company set up an ESOT, which was able to secure a bank loan to buy the company from W. T. Grant. The loan was for $3.5 million, and another $1 million was raised from company capital and an existing profit sharing plan. During the first year of operation, company employees took voluntary salary cuts, but by the end of the year, the company has succeeded in stabilizing its business and, as of the time of the report on

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[57] Data for the above information comes from a report by Edgar May, "Mining for Jobs and Profit," Springfield, Vt., 1977. Reports of the end of worker ownership in VAG are from several people following the situation.

[58] Information on the Mohawk Valley Corp. is from conversations with company officials and staff and from testimony at a hearing in Jamestown, N.Y. on employee ownership held by Congressman Stanley Lundine, Nov. 20, 1978.

which this is based was published, seemed well on its way to financial stability.[59]

KASANOF'S BAKERY

In 1976 Fink Baking Co. of Brooklyn decided to close its subsidiary, Kasanof's Bakery, a profitable Boston bakery employing almost 300 people in the Roxbury section of the city. Although the company had been making a profit, labor problems and a long legal dispute over the noise levels of the bakery made future prospects very uncertain. The company had a good reputation and dedicated customers, however, and the employees, spurred by a local self-management group, made an effort to buy the firm. While this organization was getting started, the plant was closed and the workers went on unemployment. Despite that, and despite the fact that most were low income workers from the poor Roxbury area, they were able to raise $200,000 from funds owed them by the company for vacation pay and a smaller additional amount from their own savings, which were already depleted by their unemployment. The workers would use the $200,000 plus as a down payment and finance the acquisition of the company with a $1.8 million bank loan, hopefully guaranteed by EDA and/or SBA. The company's owners, however, insisted on an additional $20,000 per month to cover security and other costs of keeping the plant open. The workers would not be reimbursed any of this money, even if the deal failed. Unable to raise the $20,000 and unable to get a decision from the government agencies, the employees gave up and the plant closed.[60]

Of course, there are numerous other examples, but few have been documented very well—stories concerning the initial transition appear in newspapers, but followup stories are hard to find. Research at Cornell has confirmed the continued existence of most the companies, but little is known at this point about individual company performance. Related research at the Survey Research Center has provided information on the overall success and characteristics of the companies, but the individual cases on which that data are based are not available to the public. The cases here represent a sampling of some typical examples where information is available in some detail, but should not be taken as a basis for generalizations. For instance, in these examples, government involvement was much more significant than it usually is. All of the cases were medium sized firms, whereas, as previously pointed out, firm size varies from several to several thousand. What can be generalized is that in each case that succeeded jobs were saved and companies went on [illegible] profit. The comparison with the Kasanof case, where the government paid hundreds of workers months of unemployment, is instructive.

VIII. Legislation

In addition to tax legislation for ESOP discussed above, during the 95th Congress, Congressmen Kostmayer, Lundine, and McHugh introduced H.R. 11222, "The Voluntary Job Preservation and Community Stabilization Act". The bill would create a $100 million loan

[59] *Wall Street Journal*, "Jones and Presnell, a Grant Unit, Survives Via Leveraged Employee Ownership Plan," July 22, 1976, p. 6.
[60] Information in this section from *the Boston Phoenix*, Apr. 26, 1977.

fund in EDA to make loans to employees and employee organizations who are purchasing plants that would otherwise close or relocate. In approving the loan funds, the administrator of EDA would first require a feasibility study, for which EDA could also loan funds, which would have to include a plan for repayment of the loan, with provisions for employee payroll deductions if necessary. The bill allows for members of the community to participate in ownership as well. The bill attracted approximately 75 cosponsors, and will be reintroduced in the 96th Congress. Senator Nelson will introduce a similar, but not identical, bill in the Senate in that Congress.

Senators Nelson and Long will also introduce a bill in the Senate to require that the SBA include ESOTs as eligible for SBA loans and loan guarantees under all SBA programs. The bill will also encourage the SBA to make loans to employee organizations seeking to purchase their companies when they would otherwise close, relocate, or be purcased by a large business. Again, feasibility studies would be required, and loans could be made for this purpose. The bill would require, however, that the assessment of the soundness of the loan be based on the feasibility report for the company's prospects, and not on the individual assets of employees.

The advisability of such legislation most likely will be challenged on the basis of the risk the government is taking in making loans to employees or employee organizations. Even if individual employees were held liable for their portion of the loan, collecting the loan from individuals who have left the company, or from all the employees should the company fail, would be impractical and probably impossible. Moreover, this lack of direct liability could encourage some business owners to sell to their employees when their company is failing and other buyers cannot be interested.

These arguments have some merit but are not, on the whole, persuasive. Any loan to the employee organization, whether to an ESOT or to the company itself, would be secured by the assets of the company, so the government's liability would be limited to the difference between the worth of the assets and the amount of the loan or loan guarantee. In any loan guarantee, the pledge of the borrower's personal assets is more a test of good faith than a source of likely funds for repayment in the case of default.

Of course, with employees, this test of good faith may be lacking if there is no practical way to make individuals responsible. This presents two problems: (1) Cases where employee owners simply walk out on a firm; and (2) cases where employee owners are sold a bad company. In the first case, the problem is substantially alleviated by the fact that the employees stand to lose their jobs if the loan is not repaid, and there is likely to be considerable effort on their part, therefore, to make the company succeed at all costs. Data on employee owned firms confirm this argument. The threat of employees gullibly buying a company with poor prospects, figuring that they will not be liable if it fails, is more serious, but the agencies and the banks making the loan will have a feasibility report which should help them weed out such cases. Moreover, in most cases of employee ownership for which information is available, employees have put up some of their own money to buy the company, and even in ESOP arrangements where they do not, in the first few years, most employees accumulate

thousands of dollars worth of stock in the ESOT, which they will not get if the company fails.

What this suggests is that in making loans to employee organizations, the fact that individual employees may not be liable does introduce an element of risk not present when a conventional loan is made. This risk, for the reasons cited above, is small, however, and should be offset by the fact that employee owned firms are more successful than non-employee owned firms. In general, loans to employee owned firms should be more likely to be repaid, then, if these data are considered. All current loans to employee owned firms from the government (13) are being repaid.

Any decision to proceed with a government program should proceed on the basis of comparing alternatives, however. When a plant is closing or relocating, the government has a choice: it can make a loan, which will have a good chance of repayment, although one might argue whether the chance is as good as a conventional loan at this early date, or it cannot make a loan. If it does not make a loan, it will pay unemployment insurance and possibly food stamps, welfare, public works employment, or CETA money as well. Clearly, if there is a reasonable chance that the company could succeed as an employee owned firm, a loan to preserve the jobs would be vastly cheaper than the alternatives, as well as substantially more productive for the employees and the community.

In addition to these loan programs, it should be noted that Senator Long may introduce further legislation to encourage ESOPs through the tax system.

CONCLUSION

Employee ownership of business is still in its very early stages in this country, and government involvement in the process has been limited. Nonetheless, the experience with employee ownership so far has been very positive and encouraging. Employee ownership of business could provide a way to save jobs, save businesses, increase productivity, and spread the benefits of capitalism—goals the government has spent billions to achieve in the past. For much smaller sums, in the forms of loans and limited tax incentives, the government may be able to accomplish the same goals by supporting this promising form of free enterprise.

LIST OF EMPLOYEE OWNED FIRMS

1. A. C. Lawrence Leather Co., Paris, Maine.
2. Advance Micro Devices, Sunnyvale, Calif.
3. Algoma Plywood, Algoma, Wis.
4. Allied Plywood, Alexandria, Va.
5. American Cast Iron Pipe Co., Birmingham, Ala.
6. American Tube and Controls, West Warwick, R.I.
7. Arrow Lakes Dairy, Cranston, R.I.
8. Associated Freight Lines, Oakland, Calif.
9. Astoria Plywood, Astoria, Oreg.
10. Bates Fabrics Inc., Lewiston, Maine.
11. Beyda Stores.
12. Boston Consulting Group, Boston, Mass.
13. Brookings Plywood, Brookings, Oreg.

14. Brooks Camera, San Francisco, Calif.
15. Buffelin Woodworking, Tacoma, Wash.
16. Chicago and Northwestern Trans, Chicago, Ill.
17. Crosby Valve, Wrenthan, Mass.
18. Elma Plywood, Elma, Wash.
19. Everett Plywood and Door, Everett, Wash.
20. Fairbanks Daily News Miner, Fairbanks, Alaska.
21. Fort Vancouver Plywood Co., Vancouver, Wash.
22. Gladding Corp., Gladding, Maine.
23. Graybar Electric, New York, N.Y.
24. Great Western Inorganics, Golden, Colo.
25. Hardel Mutual Plywood, Olympia, Wash.
26. Hoguiam Plywood, Tacoma, Wash.
27. Huebner Publications, Solon, Ohio.
28. Infant's Specialty, San Francisco, Calif.
29. Independent Mining & Mfg., Connellsville, Pa.
30. International Group Plans, Washington, D.C.
31. International Poultry, Willamantic, Conn.
32. Jamestown Metal Products, Jamestown, N.Y.
33. Jones and Presnell Studios, Charlotte, N.C.
34. Kansas City Star, Kansas City, Mo.
35. Katz Agency, New York, N.Y.
36. Kreamo Bakers, Inc., South Bend, Ind.
37. Lacey Plywood, Lacey, Oreg.
38. Lionel D. Edie & Co., New York, N.Y.
39. Linton Plywood, Portland, Oreg.
40. Manalytics, San Francisco, Calif.
41. Marott Shoes Stores, Inc., Indianapolis, Ind.
42. Medford Veneer, White City, Oreg.
43. Merchant & Evans Co., Mt. Laurel, N.J.
44. Milwaukee Journal Co., Milwaukee, Wis.
45. Mohawk Valley Community Corp., Herkimer, N.Y.
46. Mt. Baker Plywood, Bellingham, Wash.
47. Mullach Steel, Bridgeville, Pa.
48. Multnomah Plywood, Portland, Oreg.
49. Muses (Menswear), Atlanta, Ga.
50. National School Studios, Bloomington, Minn.
51. North Pacific Plywood, Tacoma, Wash.
52. NWL Transformers, Bordentown, N.J.
53. Okonite Corp., Ramsey, N.J.
54. Operations Research, Inc., Silver Spring, Md.
55. Pacific Paperboard Products, Stockton, Calif.
56. Paine Lumber Co., Oshkosh, Wis.
57. Peninsula Newspaper, Palto Alto, Calif.
58. Puget Sound Plywood, Tacoma, Wash.
59. Radio Distributing Co., Inc., South Bend, Ind.
60. Rich-Sea Pak Corp., Brunswick, Ga.
61. Saski, Walker, Roberts & Ass., Sausalito, Calif.
62. Saratoga Knitting Mills, Saratoga, N.Y.
63. S-B Printers, Honolulu, Hawaii.
64. South Bend Lathe, South Bend, Ind.
65. Squire Heating Supply Co., Columbus, Ohio.
66. Stevenson CoPly, Washougal, Wash.

67. Sullair, Michigan City, Ind.
68. Spartan Motors Inc., Lansing, N.C.
69. Vermont Asbestos Group, Eden, Vt.
70. Washington Plywood, Tacoma, Wash.
71. Webb's City, St. Petersburg, Fla.
72. Western States Plywood, Port Orford, Oreg.
73. Woodland Mobile Homes, Mountain View, Calif.
74. Luna Beverage Distributors, North Babylon, N.Y.

POTENTIAL WORKER-OWNED FIRMS [1]

1. Abrogast Bastion, Allentown, Pa.
2. Bearing Specialty, San Francisco, Calif.
3. Natural Beers Inc., Yonkers, N.Y.
4. Crows Publications, Portland, Oreg.
5. Steiger Tractor, Fargo, N. Dak.
6. SWA Group, Sausalito, Calif.
7. Summers Electric, Dallas, Tex.
8. Resistance Corp., Bremen, Ind.
9. Gray Tool, Kansas City, Mo.
10. Hallmark Cards, Kansas City, Mo.
11. Hatfield Packing, Hatfield, Pa.
12. Construction City.
13. Devor Nursery, Pleasanton, Calif.
14. First Bank Shares, Boca Raton, Fla.
15. W. H. Newholds Son Corp., Philadelphia, Pa.
16. O'Conner Lumber Co., Mass.
17. San Mateo Times, San Mateo, Calif.

In addition, Western Bank and Trust of California has apparently sold 41 of its units to employees.

ADDENDUM

Since the first printing of this study there have been a number of developments. On February 8, 1979, Senators Nelson, Stewart, Hatch, Weicker and Pressler introduced S. 388, the Small Business Employee Ownership Act. This bill would authorize the Small Business Administration to guarantee loans to ESOTs and to employee organizations seeking to purchase their businesses when they would otherwise close or relocate. A companion bill, H.R. 2480, was introduced on February 28 in the House by Congressmen Baldus, Kostmayer, Bedell and Daschle. On February 27, 1979 the Senate Small Business Committee held hearings on S. 388, and a majority of the committee is now committed to the bill. The Small Business Administration, in the meantime, has revised its stance on employee ownership, and has said that it would reconsider the issue. In addition, the SBA, with some reservations, gave its support to S. 388.

[1] Firms with plans to become employee-owned in the next several years.

Congressmen Kostmayer, Lundine and McHugh reintroduced the Voluntary Job Preservation and Community Stabilization Act in the House, and a similar bill will be introduced in the Senate in mid-March by Senators Gravel, Nelson, Heinz, and Hatfield. Senator Williams will be introducing legislation also containing employee ownership provisions, along with provisions requiring pre-notification of plant closings providing for certain employee protections when a plant closes.

The Farmers Home Administration continues its policy of placing a high priority on employee ownership, and the Department of Housing and Urban Development is considering ways to use its urban development action grant program to encourage employee ownership. The Carter administration is drafting legislation to create a national development bank within the Economic Development Administration, and has asked staff members of the offices involved in the employee ownership concept to assist in drafting provisions in that legislation.

ALASKA

GENERAL STOCK OWNERSHIP

CORPORATION

Sponsor Substitute for House Bill No. 240
Sponsor Substitute for Senate Bill No. 170

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EXPLANATION: FEDERAL GSOC PROVISIONS

Federal law provides income tax advantages to certain broadly owned corporations. These companies, known as General Stock Ownership Corporations (GSOCs), are exempt from corporate income tax. GSOCs are privately owned corporations designed to leverage the typical citizen into capital ownership. As such the stock is to be distributed free of charge and investments purchase entirely through borrowed funds. As the loans are paid down from investment earnings equity is built into the shareholders.

Charter Provisions

To qualify as a GSOC a corporation must be specially chartered by a state and have a single class of stock distributed to each qualified state resident. Transfers of stock must be limited to the earliest of five years from issue or the shareholder's death or emigration from the state. No shareholder may own or acquire more than 10 shares.

GSOC Taxation

The GSOC is exempt from corporate income taxes, but its shareholders must report their share of GSOC income personally. GSOC income is computed like that of other corporations with special treatment for tax credits. Audit adjustments are included in income of the corporation for the year during which they are finally determined. Net losses are subject to a 10 year carryover and investment credit and recapture is prorated to the shareholders.

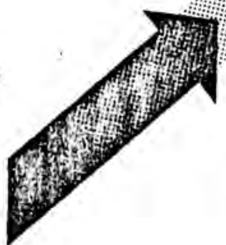
Shareholder Taxation

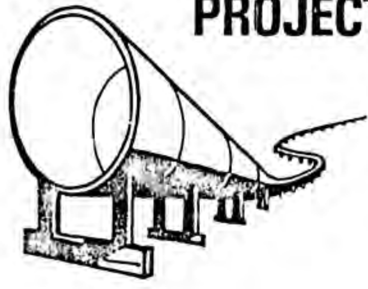
GSOC shareholders are taxed on their share of GSOC income. If a shareholder disposes of his stock GSOC income will be prorated on a daily basis. The shareholder's stock basis will be increased by GSOC income attributed to him and reduced by cash distributions. Since GSOC shareholders are attributed GSOC income distributions from the GSOC are generally tax free. Distributions greater than attributed income are nontaxable to the extent of the shareholder's basis and the excess taxed as capital gains. To assure shareholders have cash for taxes on their share of GSOC income GSOCs must distribute 90% of taxable income by January 31. Noncompliance will subject the GSOC to a 20% tax on the distribution difficiency. To assure payment of taxes the GSOC must withhold 25% of each distribution. The amount withheld is a credit against shareholder income taxes. Individuals not required to pay taxes (because of insufficient income) may avoid withholding on GSOC distributions.

BENEFICIARIES

CORPORATION

ENERGY
PROJECT





ALASKA

GENERAL STOCK OWNERSHIP CORPORATION

BILL SUMMARY

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

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

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

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

DETAILED EXPLANATION

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

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

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

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

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

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

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

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

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

ANALYSIS: SECTION 1

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

50.010. ALASKA GENERAL STOCK OWNERSHIP CORPORATION CREATED.

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

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

50.020. ARTICLES OF INCORPORATION.

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

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

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

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

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

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

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

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

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

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

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

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

50.030. BOARD OF DIRECTORS.

This section sets out the provisions for AGSOC directors which differ from those applicable under Alaska Statutes Title 10, Chapter 5. The nine incorporators serve as the original board of directors and are divided into three groups in accordance with AS 10.05.186, except that only one-third of the directors will stand for election at the first annual meeting, one-third at the second annual meeting and one-third that the third annual meeting. Thereafter each director will serve for a term of three years as provided in AS 10..5.186. None of the other provisions of the Alaska Business Corporations Act regarding directors are changed and the normal rules of Chapter 5 apply to the AGSOC.

50.040. NOTIFICATION OF ELIGIBLE SHAREHOLDERS.

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

50.050. CORPORATION NOT LIABLE TO SHAREHOLDERS.

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

50.060. LATE APPLICATION FOR SHARES.

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

50.070. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER.

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

50.080. DIVIDENDS OF THE CORPORATION.

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

50.090. EXEMPTION FROM AS 10.05

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

50.100. LOAN GUARANTEE FUND.

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

50.900. DEFINITIONS.

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

Introduced: 3/6/79
Referred: Commerce

IN THE SENATE BY COLLETTA, STIMSON AND FAHRENKAMP

SPONSOR SUBSTITUTE FOR SENATE BILL NO. 170

IN THE LEGISLATURE OF THE STATE OF ALASKA

ELEVENTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act creating the Alaska General Stock Ownership Corporation; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 10 is amended by adding a new chapter to read:

CHAPTER 50. ALASKA GENERAL STOCK OWNERSHIP CORPORATION.

Sec. 10.50.010. ALASKA GENERAL STOCK OWNERSHIP CORPORATION CREATED. (a) The governor shall appoint nine persons, at least five of whom are residents of the state, to act as incorporators of the Alaska General Stock Ownership Corporation.

(b) The corporation is a general stock ownership corporation and shall be formed in accordance with subchapter U of the Internal Revenue Code of 1954, as amended, (26 U.S.C. secs. 1391 - 1397), and with AS 10.05. The corporation is subject to the provisions of AS 10.05, except when inconsistent with this chapter or 26 U.S.C. sec. 1391(a).

(c) The corporation is not and may not be considered to be an agency, instrumentality, or political subdivision of the state for any purpose.

Sec. 10.50.020. ARTICLES OF INCORPORATION. The corporation's articles of incorporation shall provide

(1) for the issuance of only one class of stock,

(2) that shares of stock may be issued only to individuals who were residents of the state on the effective date of this Act, and who continued to be residents until the date of issuance of the shares;

(3) for the issuance of at least one share of stock to each

individual eligible under (2) of this section, unless that individual elects within one year after the date of issuance not to receive the share;

(4) that no share of stock may be voluntarily or involuntarily transferred

(A) or encumbered by a shareholder, other than by will or under the laws relating to intestate succession, until five years after the date of issuance of the share, except if the shareholder ceases to be a resident of the state;

(B) to an individual other than one who is a resident on the date of transfer;

(C) to an individual who, after the transfer, would own more than 10 shares of stock of the corporation;

(D) or encumbered by a shareholder under 18 years of age or encumbered by that shareholder's parent or legal guardian;

(5) that the corporation must qualify as a general stock ownership corporation under subchapter U of the Internal Revenue Code of 1954, as amended, (26 U.S.C. secs. 1391 - 1397);

(6) that the corporation may not invest in properties acquired by it, or for its benefit, through the right of eminent domain;

(7) that the corporation has a first option to purchase, at book value, its shares of stock offered to be transferred by a shareholder within five years after the date of issuance of the shares; if the corporation exercises the right to purchase, shares purchased shall be considered treasury stock and not entitled to dividends, if any, or to voting privileges.

Sec. 10.50.030. BOARD OF DIRECTORS. (a) The corporation shall be governed by a board of directors. A majority of the members of the board of directors shall be residents of the state at all times during

their terms of office. Except as provided in (b) of this section, the term of office of each director is three years. A director, upon the expiration of his term, shall continue to hold office until his successor is elected and qualified.

(b) The initial board of directors shall consist of the incorporators of the corporation. The board shall, as nearly as possible, be equally divided into three classes of directors. The initial class one directors shall serve one-year terms of office; the initial class two directors shall serve two-year terms of office; and the initial class three directors shall serve three-year terms of office.

Sec. 10.50.040. NOTIFICATION OF ELIGIBLE SHAREHOLDERS. Beginning not less than 90 days before the issuance of any stock, the corporation shall at least weekly notify the public of its intention to issue stock and the method for qualifying and applying for shares. The notice shall be by publication in at least one newspaper of statewide circulation, by radio and television announcements, and by other means the corporation determines to be appropriate and reasonable, and shall be continued at least once each month for 11 months following the date of issuance of shares.

Sec. 10.50.050. CORPORATION NOT LIABLE TO SHAREHOLDERS. Registration as a shareholder of the corporation is a responsibility solely of an individual eligible under AS 10.50.020(2) to receive shares of the corporation. The corporation may not be held liable for

(1) any loss resulting directly or indirectly from the failure of an individual to apply for shares of the corporation; or

(2) payment of a declared or paid dividend to an individual who would have been entitled to receive the dividend had he been a shareholder at the time of declaration or payment.

Sec. 10.50.060. LATE APPLICATION FOR SHARES. An individual eli-

gible under AS 10.50.020(2) to receive shares of the corporation who failed to apply for the shares before their issuance may apply for and receive the shares any time within one year after the date of issuance if he is otherwise qualified to own stock of the corporation and upon the payment of the book value of the shares.

Sec. 10.50.070. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER. (a) The ownership interest in shares of the corporation's stock issued to an individual ineligible to receive the shares who has presented fraudulent or misleading information regarding his eligibility to own the shares, is void upon the issuance of an appropriate order by the superior court. The ineligible individual is also liable for the full amount of dividends, or other distributions to shareholders received by him plus interest from the date of distribution, and legal fees and costs of recovery incurred by the corporation. This section applies to an individual who has presented fraudulent or misleading information regarding the eligibility of another person for whom he acts in the capacity of legal guardian.

(b) An individual who transfers or obtains shares of the corporation, or in his capacity as legal guardian obtains shares of the corporation for another, through fraud, misrepresentation, or any deceitful or illegal means is guilty of a felony.

Sec. 10.50.080. DIVIDENDS OF THE CORPORATION. Dividends, or other distributions, may be declared and paid by the corporation at any time and from any source to the extent considered necessary by the board in order to comply with the distribution requirements of subchapter U of the Internal Revenue Code of 1954, as amended, (26 U.S.C. secs. 1391 - 1397), except that no dividend or other distribution may be declared if the corporation is insolvent or if the declaration would cause the corporation to become insolvent.

1 Sec. 10.50.090. EXEMPTION FROM AS 10.05. The corporation is
2 exempt from the requirements of AS 10.05.012, 10.05.216(e), 10.05.255(7),
3 and 10.05.264.
4 Sec. 10.50.100. LOAN GUARANTEE FUND. (a) There is a special fund
5 of the state known as the "Alaska General Stock Ownership Corporation
6 loan guarantee fund" which shall be completely segregated from all other
7 funds of the state, and which is a trust fund for the uses and purposes
8 of this section.
9 (b) The commissioner of revenue shall use the fund to guarantee
10 loans made to the corporation by lenders other than the state. In
11 guaranteeing loans the commissioner of revenue shall review the loans
12 for the purpose of guarding against fraud and misrepresentation. A
13 guarantee of a loan may not be for an amount in excess of the un-
14 obligated balance of the fund at the time the guarantee is made.
15 Sec. 10.50.900. DEFINITIONS. In this chapter,
16 (1) "board" means the board of directors of the Alaska
17 General Stock Ownership Corporation;
18 (2) "corporation" means the Alaska General Stock Ownership
19 Corporation;
20 (3) "fund" means the Alaska General Stock Ownership Corpora-
21 tion loan guarantee fund;
22 (4) "resident" means an individual who maintains a permanent
23 place of abode in the state with the intention of making the state his
24 permanent place of residence and who resides in the state continuously
25 except for temporary purposes only and with the intent of returning; a
26 person may not be considered to have gained a residence solely by reason
27 of his presence and he may not lose it solely by reason of his absence
28 while in the civil or military service of this state or of the United
29 States or of his absence because of marriage to a person engaged in the

civil or military service of this state or the United States; while a student at an institution of learning; while in an institution or asylum at public expense; while confined in public prison; while engaged in the navigation of waters of this state, of the United States, or of the high seas; or while residing upon an Indian or military reservation; a minor takes the residence of his parent or of his legal guardian; a married woman may establish her own residence and does not presumptively take the residence of her husband.

* Sec. 2. AS 37.10.065(a) is amended by adding a new paragraph to read:

(9) secured loans to the Alaska General Stock Ownership Corporation.

* Sec. 3. AS 37.10.070(a) is amended by adding a new paragraph to read:

(14) bonds or other forms of indebtedness of the Alaska General Stock Ownership Corporation.

* Sec. 4. AS 45.55.140(a) is amended by adding a new paragraph to read:

(12) a security issued by the Alaska General Stock Ownership Corporation.

* Sec. 5. Notwithstanding any other provision of law, a civil action to contest the legality of this Act is barred unless the complaint is filed within one year of the effective date of this Act. The purpose of this limitation on suits is to insure that, after the expiration of a reasonable period of time, the right, title, and interest of shareholders of the Alaska General Stock Ownership Corporation will be vested with certainty and that the corporation will be able to carry on its business activities with certainty.

* Sec. 6. Notwithstanding AS 01.10.030, the requirements of this Act for eligibility to receive original issue shares of the Alaska General Stock Ownership Corporation are not severable. If those requirements, or the application of them to any person or circumstance, are held invalid, this Act

is void in its entirety.

* Sec. 7. AS 10.50.070(b) is amended to read:

(b) An individual who transfers or obtains shares of the corporation, or in his capacity as legal guardian obtains shares of the corporation for another, through fraud, misrepresentation, or any deceitful or illegal means is guilty of a class C felony.

* Sec. 8. Sections 1 - 6 of this Act take effect immediately in accordance with AS 01.10.070(c).

* Sec. 9. Section 7 of this Act takes effect January 1, 1980.

GSOC FINANCIAL PROJECTIONS

Assumptions: Purchase of 15.85% interest in TAPS line
Interest rate on financing of 7%
Current annual flow of 1.2 million barrels per day
Tarrif of $5.50 per barrel uninflated
Cost of acquisition $1.3 billion
Inflation of operating costs by 7% per annum

Based on these assumptions the GSOC could distribute $286.00 in dividends to each shareholder during its first full year of operations while paying off its loan.

NET INCOME

($000)

YEAR	DELIVERY VOLUMES (000 BBLS)	TARIFF	REVENUES	OPERATING EXPENSES	INTEREST	DEPRECIATION AND AMORTIZATION	INCOME TAX	NET INCOME	CITIZEN SHAREHOLDER INCOME
		$	$	$	$	$	$	$	ACTUAL $
1979	64062	5.50	352341	78400	91000	54167	0	128774	286
1980	64062	5.50	352341	83888	87200	54167	0	127070	282
1981	64062	5.50	352341	89760	83417	54167	0	124997	277
1982	64062	5.50	352341	96043	79625	54167	0	122506	272
1983	64062	5.50	352341	102766	75833	54167	0	119575	265
1984	64062	5.50	352341	109960	72042	54167	0	116172	258
1985	64062	5.50	352341	117658	68250	54167	0	112266	249
1986	64062	5.50	352341	125894	64458	54167	0	107822	239
1987	64062	5.50	352341	134707	60666	54167	0	102801	228
1988	64062	5.50	352341	144137	56075	54167	0	97162	215
1989	64062	5.50	352341	154226	53083	54167	0	90865	201
1990	64062	5.50	352341	165022	49291	54167	0	83861	186
1991	64062	5.50	352341	176573	45500	54167	0	76101	169
1992	64062	5.50	352341	188933	41708	54167	0	67533	150
1993	64062	5.50	352341	202158	37916	54167	0	58100	129
1994	64062	5.50	352341	216309	34125	54167	0	47740	106
1995	64062	5.50	352341	231451	30333	54167	0	36390	80
1996	64062	5.50	352341	247652	26541	54167	0	23981	53
1997	64062	5.50	352341	264987	22750	54167	0	10437	23
1998	64062	5.50	352341	283537	18958	54167	0	-4321	0
1999	64062	5.50	352341	303384	15166	54167	0	-20376	0
2000	64062	5.50	352341	324621	11375	54167	0	-37822	0
2001	64062	5.50	352341	347345	7583	54167	0	-56754	0
2002	64062	5.50	352341	371659	3791	54167	0	-77276	0

ALASKA GSOP

CASH FLOW

($000)

YEAR	REVENUES	NET INCOME	TOTAL SHAREHOLDER DISTRIBUTION	DEPRECIATION AND AMORTIZATION	DISMANTLING RESERVE	PRINCIPAL PAYMENTS	NET CASH FLOW	CUMULATIVE CASH FLOW
	$	$	$	$	$	$	$	$
1979	352341	128774	115897	54167	7400	54167	20277	20277
1980	352341	127078	114370	54167	7918	54167	20626	40903
1981	352341	124997	112497	54167	8472	54167	20972	61875
1982	352341	122506	110255	54167	9065	54167	21316	83191
1983	352341	119575	107618	54167	9700	54167	21657	104848
1984	352341	116172	104555	54167	10379	54167	21996	126844
1985	352341	112266	101039	54167	11106	54167	22333	149177
1986	352341	107822	97040	54167	11883	54167	22665	171842
1987	352341	102801	92521	54167	12715	54167	22995	194837
1988	352341	97162	87446	54167	13605	54167	23321	218158
1989	352341	90865	81779	54167	14557	54167	23643	241801
1990	352341	83861	75475	54167	15576	54167	23962	265763
1991	352341	76101	68491	54167	16666	54167	24276	290039
1992	352341	67533	60780	54167	17833	54167	24586	314625
1993	352341	58100	52290	54167	19081	54167	24891	339516
1994	352341	47740	42966	54167	20417	54167	25191	364707
1995	352341	36390	32751	54167	21846	54167	25485	390192
1996	352341	23981	21583	54167	23375	54167	25773	415965
1997	352341	10437	9393	54167	25011	54167	26055	442020
1998	352341	-4321	0	54167	26762	54167	22441	464461
1999	352341	-20376	0	54167	28635	54167	8259	472720
2000	352341	-37822	0	54167	30639	54167	-7183	465537
2001	352341	-56754	0	54167	32784	54167	-23970	441567
2002	352341	-77276	0	54167	35079	54167	-42197	399370

INTEREST RATE: 700 TAX RATE: 0 INFLATION RATE: 070

PIPELINE VALUE: 1300000 POPULATION RATE: 000 POPULATION: 405

ALYESKA EXPENSE: 64700 DIRECT EXPENSE: 6300

MEMORANDUM

TO: Representative Jim Duncan, Chairman
Budget and Audit Committee
Alaska State Legislature

FROM: Arlon R. Tussing

RE: Questions about an Alaska General Stock Ownership Corporation (GSOC)

I am submitting these preliminary comments at the request of Mr. Milt Barker of the Division of Legislative Finance. They are based upon my review of the following materials:

1. Louis O. Kelso, et al, Design of an Alaskan General Stock Ownership Plan, Volume I. (February 15, 1979);

2. Kelso & Co., (untitled) documents on British Petroleum's interest in TAPS (December 7, 1978);

3. Alaska House of Representatives, Sponsor Substitute for House Bill No. 240 (March 6, 1979);

4. Wilmer, Cutler & Pickering, Federal Constitutional Issues Presented by Alaska's GSOC (December 15, 1978);

5. Senator Mike Gravel, various speeches, Congressional Record citations on GSOCs (1978 & 1979).

I regret that I was not able to present these comments in person to the House State Affairs Committee on March 20, 1979, but I hope that they will be of use to you. Please let me know if you have any further questions.

QUESTIONS ABOUT AN ALASKA GENERAL STOCK
OWNERSHIP CORPORATION

1. GSOCs in General. Louis Kelso's concept of the General Stock Ownership Corporation (GSOC) has much in common with socialist and welfare state programs for redistributing wealth.* Instead of directly expropriating or taxing away property for redistribution, however, Kelso's approach would use the government's credit to finance specially created corporations, whose shares would be dealt out to eligible citizens. The individual shareholder in GSOC thus could regard any dividends he received as earnings from his ownership of private capital rather than as a government handout.

Like confiscation or condemnation, GSOCs would create no new wealth for society. The money used to create the GSOC would have to be bid away from private investors who did not have the same access to the government's power to tax (or, in the case of a federally-sponsored GSOC, to print money) in order to make good on their obligations. Because

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* Kelso's accusations against present-day capitalism could well have come from a handbook of revolutionary Marxism. His program, it appears, is a remedy for "endemic poverty . . . misuse of technology, resource waste, despoilation of the environment, declining personal freedom, increasing lawlessness and civil disorder, the waning of liberal education, the civil rights impasse, the youth revolt, urban concentration, rising public and private debt, public loss of confidence in leadership and the seemingly irreversible advance toward a totalitarian society." [Kelso, et al, p. 16].

the "losers" would be widely scattered and impossible to identify individually, however, we could expect this kind of property redistribution to be less painful and less socially disruptive than more traditional socialist schemes.

There is nothing novel or radical in this aspect of the GSOC. Private individuals and corporations already benefit from a wide variety of federal and state loan and guarantee programs: each of them reallocates resources and redistributes wealth as surely (if not as visibly) as would taxation or government ownership of industry. GSOCs would no more revolutionize or redeem the capitalist system than do the existing programs of government credit for housing, agriculture, shipbuilding, rural electrification or education. The value of the GSOC concept to Alaska must be judged not by the sweeping claims of its inventors, but rather by whether specific proposals are properly tailored to the state's specific problems.

2. GSOCs in Alaska. The GSOC concept (like that of "Alaska, Inc.") appeals to legislators and other Alaskans because it may be a Constitutional way to use the state's petroleum revenue to increase the wealth of present resident Alaskans without permanently swelling the size of state government or attracting a host of immigrants to share in the windfall. In my opinion, something like a GSOC as contemplated in H.B. 240 may indeed be the best way to give

Alaskans a personal stake in the state's natural resource income. But the GSOC concept is still a very rough one, and there are a number of reservations and cautions even apart from technical legal issues, that I would like to raise here. As the Legislature deliberates further on the GSOC concept, I would expect to raise other problems and perhaps to offer some suggestions for improving the pending legislation.

3. Widely distributed ownership vs. broad-based control. GSOCs may very well be a means of widening ownership in Alaska industry, but widely distributed ownership is not the same thing as broadly-based control. It is a truism that corporations with widely dispersed share ownership are the easiest for small groups of insiders to control. They are practically immune both to stockholder revolts and to hostile takeover attempts (which are often the only way in which an ineffective management can be replaced).

Small shareholders normally do not take an interest in corporate affairs, and it is usually not worth their time to do so. Most shareholders express any dissatisfaction with management by selling their stock, not by becoming active in corporate politics. Otherwise, they routinely give their proxies to management, or simply decline to vote at the annual meeting. This experience in ordinary business corporations is duplicated in "non-profit" economic enterprises

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with widely spread ownership, such as cooperatives, credit unions, savings and loan associations, and mutual insurance companies.

By limiting any person's interest to ten shares of GSOC stock, the proposed legislation assures that shareholders generally will not have a large enough stake to warrant their taking an active part in the corporation's affairs on the basis of economic self-interest. This limitation on individual share ownership, the absence of cumulative voting and the staggered terms of office for directors, almost guarantee a self-perpetuating management.

In this setting, the alternative of vigorous controversy among the shareholders is hardly more attractive, however. Any activists, apart from the insider group itself, are likely to be more concerned with personalities and politics then with prudent business management. Alaska can already offer a few prominent examples of broadly-based corporations with such a malady.

4. Motivations of the Directors. Since the officers and directors of a GSOC will not be selected on the basis of a substantial ownership position, and may not obtain such a position, the legislature should consider in advance just what kind of people will constitute this self-perpetuating insider group, and what their motivations are likely to be. Such a group is more likely to be moved by considerations

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