ALASKA LEGISLATURE COMMITTEE FILES 1993-1994 8672

8319 SENATE JUDICIARY

5784

Sponsored by: Jones

CITY OF SEWARD, ALASKA
RESOLUTION NO. 94-030

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF SEWARD, ALASKA, SUPPORTING SB 327, ESTABLISHING A DIFFERENT TAX LEVY ON RESIDUAL FUEL OIL USED IN AND ON WATERCRAFT

WHEREAS, residual fuel oil currently produced by Tesoro Alaska north of Kenai is sold as an export product due to the excessive tax on heavy fuels; and

WHEREAS, there is the potential for a market of these fuels in Alaska if the price of the fuel can be competitive with prices in Canada; and

WHEREAS, ninety cruise ships will visit the Port of Seward during the summer of 1994; and

WHEREAS, these cruise ships are currently purchasing their fuel oil in Canada and have indicated a desire to purchase fuel in Alaska; and

WHEREAS, the initial potential is for annual sales of $7,000,000 and employment for seven to ten Alaskans;

NOW, THEREFORE, BE IT RESOLVED BY THE CITY COUNCIL OF THE CITY OF SEWARD, ALASKA, that:

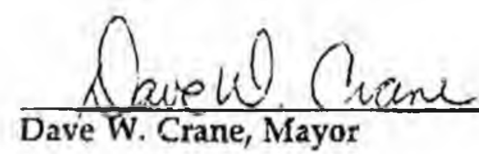
Section 1. The Seward City Council strongly urges the passage of SB 327, thereby reducing the tax on residual fuel oil used in and on watercraft of all descriptions to one cent per gallon.

Section 2. Copies of this resolution shall be sent to Governor Walter J. Hickel, Senator Suzanne Little and Representative Gary Davis.

Section 3. This resolution shall take effect immediately upon its adoption.

PASSED AND APPROVED by the City Council of the city of Seward, Alaska, this 14th day of March, 1994.

THE CITY OF SEWARD, ALASKA



Dave W. Crane, Mayor

MAR 21 '94 04:23PM CBS PUBLIC SERVICES P.2

City and Borough of Sitka

304 LAKE STREET. SITKA, ALASKA. 99835

March 21, 1994

The Honorable Bert M. Sharp, Chair
Senate Transportation Committee
Alaska State Senate
Room 514 State Capitol Building
Juneau, AK 99801-1182

RE: Senate Bill 327 C.S.

Dear Senator Sharp and Transportation Committee:

The City and Borough of Sitka strongly supports the passage of Senate Bill 327 to reduce the 5 cent per gallon State tax on marine bunker fuel. While the State receives very limited revenues from this tax, it has made bunker fuel uncompetitive for fueling of cruise ships, which are currently being fueled by vendors in Vancouver, British Columbia. If this tax were reduced to one cent per gallon, more bunker fuel could be sold, and Sitka and Seward would be able to provide cruise ship refueling services which would provide much-needed economic diversification for Sitka.

In response to concerns which have been expressed about Sitka asking for further capital funds to develop a fueling facility, this would not be the case. Alaska Pulp Corporation already has the necessary fuel storage tanks on site, and Pacific Northern Oil is interested in providing the services but is unwilling to proceed if the marine bunker fuel tax is not eliminated or substantially reduced.

If the Sitka fueling facility is developed, potable water and solid waste collection services would also be provided. In the long term, these services may result in longer cruise ship stays. The community may also become a change port with cruise ship passengers flying into Sitka for cruise ship connections, which would have major long-term economic impacts with increased airline service and passenger visits.

Your support for Senate Bill 327 is greatly needed to permit this project to proceed. Sitka can commit to not requesting any capital funding for the fueling facility if the legislation is approved. Please contact me at 747-3294 if you have any additional questions.

Sincerely,

Gary L. Paxton, Administrator

cc: Commissioner Paul Fuhs; Economic Development Director Chris Gates,
Alaska Dept. of Commerce and Economic Development

March 9, 1994

ALASKA TRUCKING ASSOCIATION POSITION PAPER

TO: Representative Gary Davis
and
Members of the Legislature

FROM: Frank J. Dillon, Executive Director Alaska Trucking Association, Inc.

RE: SUPPORT OF H.B. 453 AND S.B. 327

On behalf of the 300-member companies of Alaska Trucking Association, Inc. I ask your support for the passage of House Bill 453 and corresponding Senate Bill 327.

H.B. 453 entitled "An Act Amending Motor Fuel Tax To Establish A Different Levee on the Residual Fuel Oil Used In and On Water Craft and Providing For An Effective Date." What this bill basically does is reduce the tax on heavy bunker fuel from 5-cents a gallon to 1-cent a gallon.

The reason this legislation is needed is to bring the bunker fuel price down so that we can compete in selling fuel to cruise ships which visit Alaska ports. Currently, virtually all the fuel burned in Alaska's waters is purchased in British Columbia. Refiners, who as part of the refining process are left with the heavy bunker fuel currently have little or no market in Alaska for that fuel.

ATA feels that this is exactly the sort of business risk and economic endeavor the state of Alaska should be involved in. We recognize there are risks involved in the worse case scenario the state could lose revenue if fuel sales do not increase to offset the reduction in the tax rate. We believe this is a legitimate and reasonable business risk for the state of Alaska to take in order to expand Alaska's job base and economic activity.

In the trucking area alone we believe that the increased sales activity will result in 15-25 new and good paying jobs in Alaska's trucking industry.

Please move this bill. Please support this bill. It's a good piece of legislation.

GREATER SOLDOTNA CHAMBER OF COMMERCE
RESOLUTION NO. 94-3

A RESOLUTION SUPPORTING THE ADOPTON OF SENATE BILL NO. 327 "AN ACT AMENDING THE MOTOR FUEL TAX TO ESTABLISH A DIFFERENT TAX LEVY ON RESIDUAL FUEL OIL USED IN AND ON·WATERCRAFTS; AND PROVIDING FOR AN EFFECTIVE DATE."

WHEREAS, in 1970-72 heavy bunker fuel was sold, to a small market, for use instate; and

WHEREAS, in 1972, the present tax was placed on this fuel and all sales then ceased, and have remained non-existent since that date; and

WHEREAS, due to the excessive tax on heavy fuels if used instate, heavy fules have no instate sales/useage; and

WHEREAS, there is currently the potential for a market of these fuels in Alaska, if the price of the fuel can be competitive with prices in Canada; and

WHEREAS, Cruiselines have indicated a willingness to purchase Bunker fuel in Alaska if the marine fuel tax rate is lowered; and

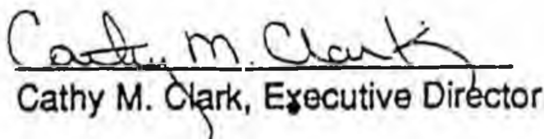
WHEREAS, the purchase of Bunker fuel by Cruiselines would have a positive economic impact to the State of Alaska and the Kenai Peninsula Borough,

NOW THEREFORE BE IT RESOLVED THAT THE GREATER SOLDOTNA CHAMBER OF COMMERCE urges the Alaska Legislature to adopt Senate Bill No. 327.

ADOPTED this 8th day of March, 1994 at Soldotna, Alaska.

Kurt Eriksson, Vice President

ATTEST:



Cathy M. Clark, Executive Director

A PROPOSAL
TO DEVELOP AN ALASKAN MARKET
FOR BUNKER FUEL

PREPARED MAY 1993

This is an economic development proposal which could result in the following benefits to the State of Alaska:

1. Creation of approximately eleven full-time jobs in Seward (eight seasonal drivers May through September, two dock watch operators, and one operations supervisor), plus three jobs in Kenai,

2. Increased commercial trucking activity at 60,000 metric tons or approximately 17,000,000 gallons equal 18 to 20 loads daily from May 15 until September 15,

3. Capital investment totalling $1.2 million at Seward, $50,000 at Kenai, plus $800,000 Weaver Brothers tank truck and trailers,

4. Development of an in-state market for Tesoro residual bunker fuel from the Kenai refinery. This will improve the economics over Tesoro's current Japanese export sales, and will assist consumers by stabilizing Tesoro refined products' cost. (This results from Tesoro being able to market residual oil domestically in place of exporting to foreign customers at a price significantly less than crude cost),

5. Provide the incentive for the cruise industry to fuel in Alaska as opposed to foreign ports, primarily Vancouver, B.C.

I. BACKGROUND

Cruise ships visiting Alaska utilize a very low grade of fuel oil for propulsion. This fuel is referred to as "bunker fuel," which can be handled most efficiently in the Alaskan climate during the summer months.

Currently, the Kenai Tesoro refinery exports its residual bunker fuel overseas to markets in Japan. There is currently no in-state market or use for bunker fuels.

The cruise industry has historically met its demands for bunker fuel by purchasing in Vancouver, B.C., and Seattle. Their prices are established off Seattle postings regardless of where they take physical delivery.

With the increase in cruise traffic to Southeast and South Central Alaska, Petro marine Services has undertaken a determined effort to develop a market in Alaska with the cruise industry utilizing the Tesoro bunker fuel, which otherwise would be shipped overseas.

This effort has resulted in serious negotiations with Princess Cruise Lines and other carriers.

II. ECONOMIC BENEFITS

If Princess or other cruise lines agree to purchase the bunker fuel in Alaska, this would result in capital development and construction investment amounting to about $2.1 million. (In Seward, it would mean $1.2 million and three jobs. In Kenai, it would mean $500,000 in capital improvements.

The product would be loaded on tanker trucks in Kenai and transported to Seward.

The volume for all vessels calling in Seward is in excess of 60,000 metric tons or approximately 17,000,000 gallons annually. This volume is expected to increase in future years and the trend is toward larger vessels carrying more people.

III. PROBLEM

The current Alaska state motor fuel tax of $0.05/gallon is a significant impediment to gaining the full potential of residual fuel oil volume available at Seward.

We feel that the bulk of the tour boat fuel business calling in Seward could be served from an Alaskan source if we can get our pricing within a competitive range versus Vancouver, B.C.

Current history is show in Exhibit 1. As you can see, on average, Seward is $0.0897/gallon out of line with the Vancouver alternate. Five cents per gallon of that difference is the Alaska State tax. Discussions with potential buyers have indicated that if we can get close to the Vancouver pricing, we will get the fuel business. Exhibit 2 graphs the fluctuations in that price differential.

Relief of the tax could bring in more than five times the volume as the Seward price is made competitive with Vancouver.

The vastly increased volume will mean economics of scale in:

- o product cost
- o freight
- o amortization of investment

This means the supplier can look at sharing those economies with the customer and get very close to Vancouver economies. We can sell the remaining difference with superior service and product quality. (See attached Exhibits 1, 2 and 3.)

"BUNKER FUEL" IS DISTINCT IN CHARACTER AND USAGE FROM MOTOR FUEL.

Bunker fuels are known in the refining industry as residual fuel oil. They are, just as the name implies, the residue of the refining process. When all of the desirable and profitable fuels, i.e., gasolines, jet fuel, diesel, and heating oil have been removed, that is what is left.

Crude oils vary in chemical make-up and the yield and quality of residual fuel may differ greatly from one to another. We have an excellent example right here in Alaska;

> Cook Inlet crude, of which there id very limited supply, will yield approximately 28.5% residual fuel oil with a sulphur content of 0.3%. It is a very desirable crude for this reason, but there is simply not enough available supply.
>
> North Slope crude, which is still available in great abundance, will yield 48% residual fuel oil with a sulphur content of 2.5%. Unfortunately, to have almost half of every barrel you refine ends up as a low quality fuel for which there traditionally has been no local market, is a tremendous economic detriment for any company to bear. Certainly Tesoro's earnings have reflected these economic realities since the mid 1980's when it switched to Alaska North Slope crude as its primary feed stock.

The question might be asked: Why is there no local market for this product? It is because the fuel is normally used in large scale applications which can afford to invest in the equipment to handle this viscous and "difficult to burn" material. Pumping and handling of bunker fuel will require the maintenance of tank and pipeline temperatures of at least 120 degrees F. Atomization for proper combustion will require approximately 200 degrees F.

Typically, the fuel is used in utilities for the production of steam to turn turbines and produce electricity. Other large applications are paper mills, steel mills, and chemical plants. We have little manufacturing base in the state and most of those that do exist are well served by convenient natural gas supplies.

THE ECONOMIC OPPORTUNITY

We have before us now a rare opportunity to develop a market for a product which is, currently, an economic liability to one of two major in-state refiners. While the volume is no quantum leap solution, it is a beginning to a market that clearly has the potential to expand.

If we are able to achieve price competitiveness, there is no reason that we cannot fuel the coal ships calling in Seward or the LNG and crude vessels at Kenai. This potential new business opportunity need not be limited to cruise vessels.

To summarize, bunker or residual fuel oil is not a motor fuel by industry definition. ASTM designation and "The Manual of Oil and Gas Terms" both define this product as heavy, high viscosity oil used primarily in industry, in large commercial buildings, and for the generation of electricity.

PETRO MARINE SERVICES
Petroleum Marketing to the Marine Industry

THIS PACKET IS INFORMATION THAT SUPPORTS
HOUSE BILL 453
AND
SENATE BILL 327

THE NEW LEVY WILL REDUCE THE TAX RATE
ON BUNKER FUEL AND HELP MAKE THE PRICE OF
BUNKER FUEL IN SEWARD COMPETITIVE WITH CANADA

3111 "C" Street, Suite 500

INFORMATION PACKET

0 • Fax (907) 561-6500

PORT OF SEWARD MARKET

THE SEWARD PROGRAM: IN THE SPRING OF 1993 PETRO MARINE INVESTED $509,500 IN A PUMPING/INLINE BLEND SYSTEM TO SELL SHIPS BUNKERS IN SEWARD. PETRO MARINE ESTABLISHED THIS FIRST OF ITS KIND FACILITY IN ALASKA AFTER PRINCESS CRUISE SIGNED A THREE YEAR CONTRACT TO BUY A SPECIFIED MINIMUM VOLUME. PRINCESS NEEDED BUNKERS FOR VESSEL STABILITY AND PETRO MARINE NEEDED A MINIMUM QUANTITY FOR ITS RETURN ON INVESTMENT. DURING THE 1993 SUMMER SEASON PETRO MARINE SOLD 4,106,876 GALLONS OF BUNKERS AND PAID $205,343.80 MARINE TAX.

THE 1994 SEASON: THE FOUR MAJOR CRUISE LINES HAVE THE FOLLOWING REQUIREMNET EACH SUMMER SEASON. (ABOUT ONE HALF OF THE PRINCESS AND HOLLAND FLEET GO TO GLACIER BAY AND THEN RETURN SOUTH)

CRUISE LINE	SUMMER BUNKER CONSUMPTION TONS	GALLONS	
PRINCESS CRUISE	55,855	15,680,000	(PER LETTER)
HOLLAND AMERICA	55,000	15,070,000	(PER MEETING)
CROWN	6,030	1,680,000	(PER MEETING)
REGENCY	9,720	2,680,000	(PER LETTER)
	126,605	35,110,000	

SEWARD POTENTIAL VOLUME: OF THE 94 SAILINGS INTO SEWARD, 64 ARE BY THE ABOVE FOUR LINES. IF THE MOTOR FUEL TAX WAS REDUCED FROM 5 CENT PER GALLON TO 1.5 CENT PER GALLON, PETRO MARINE REALISTICALLY EXPECTS TO SELL IN EXCESS OF 12,000,000 GALLONS OF SHIPS BUNKER IN SEWARD DURING A SUMMER CRUISE SEASON. (NOTE: THE REDUCED TAX WOULD ONLY BE ON THE RESIDUAL PORTION (92%)OF THE BUNKER FUEL AND THE FULL 5 CENTS PER GALLON ON THE DIESEL. COMBINED TAX RATE WOULD BE 1.78 CENTS PER GALLON)

CRUISE LINE	IFO 380 TONS	GALLONS	
PRINCESS CRUISE	37,800	10,357,200	(CONTRACT MAXIMUM)
HOLLAND AMERICA	4,095	1,122,000	(ONE SHIP IN SEWARD)
CROWN	2,700	740,000	(ONE SHIP)
REGENCY	4,050	1,110,000	(TWO SHIPS)
	48,645	13,329,200	

PETRO MARINE WOULD PAY APPROXIMATELY $ 237,000.00 MARINE TAX TO THE STATE OF ALASKA IN 1994. ($31,657.20 OVER 1993)

SEWARD TOTAL VOLUME: WHEN THE SEWARD BUNKER PRICE IS ESTABLISHED AS A COMPETITIVE PRICE, YOU CAN BUILD A CASE THAT PETRO MARINE MAY BE ABLE TO ATTRACT ADDITIONAL VOLUME FROM THE FOUR MAJOR LINES AND OTHERS (IN OTHER WORDS BUNKER FOR THE ROUND TRIP). ONCE THE CRUISE INDUSTRY SEES SEWARD AS THEIR BUNKER PORT, THEN PETRO MARINE ALSO HAS AN OPPORTUNITY TO SELL STRAIGHT MARINE DIESEL AT THE FULL 5 CENT PER GALLON TAX (CURRENTLY PURCHASED IN CANADA). THE FULL POTENTIAL OF THE SEWARD SAILINGS (94) IS IN THE TABLE BELOW:

CRUISE LINE	IFO 380 TONS	MARINE DIESEL	GALLONS
PRINCESS CRUISE	37,800	NONE	10,357,200 (CONTRACT MAXIMUM)
HOLLAND AMERICA	16,380	1,260	4,875,000 (TWO SHIPS)
CROWN	5,400	630	1,673,000 (ONE SHIP)
REGENCY	8,100	1,620	2,717,000 (TWO SHIPS)
OTHER	7,000	3,520	3,000,000 (THREE SHIPS)
	74,600	7,030	22,622,200

PETRO MARINE WOULD PAY APPROXIMATLEY $472,600 MARINE TAX TO THE STATE OF ALASKA. ($267,252.20 OVER 1993)

UPDATE TO MAY 1993 "PROPOSAL TO DEVELOP AN ALASKAN MARKET FOR BUNKER FUEL":

- TESORO INVESTED $75,000 IN A TRUCK RACK LOADING SYSTEM FOR NO6 FUEL OIL
- PETRO MARINE INVESTED $509,500 ON A NEW PUMPING/INLINE BLENDING SYSTEM TO THE ALASKA RAILROAD DOCK.
- PETRO MARINE EMPLOYEED 2 DOCK WATCH OPERATORS.
- WEAVER BROTHERS TRUCKING PURCHASED TWO TRUCKS AND EMPLOYEED 4 DRIVERS
- TOTAL SALES FOR 1993 WAS 4,106,876 GALLONS, 356 TRUCK LOADS
- THE AVERAGE PRICE DIFFERENCE BETWEEN SEWARD AND VANCOUVER FOR SHIP BUNKERS IN 1993 WAS 6.08 CENTS PER GALLON

IF PETRO MARINE SETS A 1994 SALES OBJECTIVE OF 13,000,000 GALLONS:

- PETRO MARINE WILL HIRE 4 DOCK WATCH OPERATORS AND A OPERATIONS SUPERVISOR
- TESORO WILL UPGRADE THE TRUCK LOADING RATE AT THE REFINERY RACK
- WEAVER WILL BUY 5 ADDITIONAL TRUCKS AND EMPLOYEE 10 ADDITIONAL DRIVERS

WHAT IS SHIPS BUNKERS?

BUNKER OIL: FUEL FOR TANKER, CARGO OR CRUISE SHIPS DERIVED FROM THE BLEND OF RESIDUAL FUEL OIL AND DISTILLATE OILS. THE RESULTING BLEND IS DESCRIBED BY ITS VISCOSITY. ON BOARD A SHIP, THE BLEND MUST BE PRE-HEATED AT THE BURNER TO REDUCE THE VISCOSITY FURTHER FOR PROPER ATOMIZATION.

RESIDUAL FUEL OIL: GENERALLY A BLACK, THICK, VISCOUS, SEMIFLUID MATERIAL. IT IS THE RESIDUE FROM CRUDE OIL AFTER THE LIGHT OILS, GASOLINE, NAPHTHA, KEROSINE, AND MID- DISTILLATES ARE EXTRACTED IN THE REFINING PROCESS. IT IS ALSO CALLED REDUCED CRUDE AND NO6 FUEL OIL. RESIDUAL FUEL OIL IS LIMITED TO HEAVY COMMERCIAL AND INDUSTRIAL USE WHERE SUFFICIENT HEAT IS AVAILABLE TO FLUIDIZE FOR PUMPING AND COMBUSTION.

VISCOSITY: THE VISCOUS CONDITION OF RESIDUAL FUEL OIL IS BROKEN DOWN BY USING MID-DISTILLATES (NO2 DIESEL) OR OTHER VISCOSITY BREAKERS. THE BLEND IS MEASURED BY A SPECIFIC STANDARD THAT THE REFINING AND SHIPPING INDUSTRY HAS FOUND TO BE THE OPTIMUM FOR EFFICIENT COMBUSTION AND OPERATION. THE COMMON MARINE BLENDS ARE INTERMEDIATE FUEL OIL (IFO) 180 AND IFO 380. THE NUMBERS REFER TO THE SECONDS IT TAKES THE BLEND TO PASS THROUGH A MEASURING DEVISE.

ALASKA: TESORO IS THE ONLY ALASKA REFINER THAT MUST MARKET RESIDUAL FUEL OIL SINCE ALL OTHERS RE-INJECT RESIDUE BACK INTO THE ALYESKA PIPELINE. THE ONLY APPLICATIONS FOR RESIDUAL FUEL OIL IN ALASKA ARE ASPHALT AND SHIPS BUNKERS. OUTSIDE ALASKA IT CAN BE USED FOR REFINERY FEED STOCK (COKING) BOILER FEED FOR ELECTRIC GENERATION AND INDUSTRIAL HEATING.

TAX ON BUNKER FUEL: THE SALE OF THIS TYPE OF MARINE FUEL CAN EASLY BE EFFECTED BY TAXATION. THE STATE OF CALIFONIA WAS A MAJOR SUPPLIER OF SHIPS BUNKERS UNTIL THE STATE IMPOSED A 8.25% TAX. THE STATE HAS GONE FROM 3rd IN THE WORLD TO 22nd. BECAUSE OF THE CURRENT ALASKA TAX OF 5 CENTS PER GALLON, THIS FUEL IS ONLY SOLD IN ALASKA UNDER UNIQUE SITUATIONS. SEE THE ATTACHED ARTICLES

REASONS FOR BUYING BUNKERS IN ALASKA:

- VESSEL CHARTERED BY AN ALASKA COMPANY
- VESSEL REQUIRES BUNKER FOR RETURN VOYAGE (STABILITY)
- AN EMERGENCY
- ERROR AT DEPARTURE PORT

EXAMPLE OF TAX POLICY ON SHIPS BUNKER SALES

WESTCOAST: RESIDUAL FUEL OIL AND ANY BLENDED VARIETY SOLD AS SHIPS BUNKERS IS NOT SUBJECT TO ANY EXCISE TAX OUTSIDE OF ALASKA. CALIFORNIA IMPOSED A SALES TAX ON SHIPS BUNKERS AND THE MARKET "DRIED UP". THE STORY IS AN OUTSTANDING EXAMPLE OF HOW TAXING POLICY CAN IMPACT A MARKET.

SOURCE: OIL PRICE INFORMATION SERVICE (OPIS)
4 92-07-23 14:45:07 EDT
***MARINE FUEL BUSINESS 'DRYING UP' IN CALIFORNIA: JOC REPORTS

Today's Journal of Commerce, in a lead article, says that the marine fuel business in California is drying up.

In less than a year, sales of marine fuel in California have sunk from 4 million bbls monthly to 1 million bbls. The reason for the decline: the state sales tax on [bunker]-fuel purchases.

The 8.25 pct tax went into effect last July as a mechanism to help the state raise money to close a budget deficit. Instead, the tax has driven business away from California and is costing the state more than $3 million in lost payroll taxes and other fees, according to a study commissioned by the Pacific Merchant Shipping Association.

Los Angeles once ranked with Rotterdam and Singapore as one of the world's biggest marine fuel ports, reports the JOC. It wouldn't make the top 20 today.

5 92-09-28 14:43:57 EDT
***CALIFORNIA REPEALS [BUNKER] FUEL TAX

California Gov. Pete Wilson approved the repeal of a marine fuel sales tax that nearly devastated Southern California's [bunker] market by driving away business, the Journal of Commerce reports in today's issue.

The tax "placed California businesses at a competitive disadvantage with businesses in other states," the governor said in a statement announcing the repeal.

The repeal will take effect January 1, 1993. The 8.25tax on [bunker] fuel was imposed a little more than a year ago, as part of an effort to raise money to close a huge state budget deficit.

This particular tax ended up costing California [bunker] fuel business, as ships bunkered in areas with no taxes. Los Angeles sunk from being one of the top three [bunker] markets in the country to not even being in the top 30, the Journal of Commerce reports.

THE CALIFORNIA 8.25% DROVE BUSINESS AWAY. WITH THE ALASKA RATE OF 13%, BUNKER SALES IN-STATE ARE SPECIAL CIRCUMSTANCES ONLY. (I.E WEATHER EMERGENCIES, BALLAST NEEDS, IN-HOUSE REQUIREMENT) THERE IS NO "MARKET" PRESENTLY BUT THERE COULD BE IF THE ALASKA MARINE TAX ON HEAVY SHIPS BUNKERS WERE REDUCE TO 1 CENT PER GALLON. IN FACT THERE IS A GOOD "CASE" FOR TAX REVENUE GOING UP IF THE TAX WERE REDUCED.

SENATOR SUZANNE LITTLE

ALASKA STATE LEGISLATURE

Memorandum

TO: Senator Bert Sharp, Chairman
Senate Transportation Committee

FROM: Senator Suzanne Little SPL

DATE: March 9, 1994

RE: SB 327

SB 327 will amend the motor fuel tax to establish a different tax levy on residual fuel oil currently produced by Tesoro Alaska north of Kenai. Currently, the tax on this fuel, used mostly by cruise ships and other large vessels, is five cents per gallon. This bill will change the tax rate for residual fuel oil from the current rate of five cents per gallon to one cent per gallon. An economic incentive for cruise ships to purchase fuel in Seward would be created by this reduction. We anticipate that 10-20 jobs would be created on the peninsula by passage of this bill. Additionally, because of increased sales of bunker fuel, the state will break even or will have increased revenues to the treasury.

Residual fuel oil is the heavy refined hydrocarbon that is the residue from crude oil after refined petroleum products have been extracted by the refining process. Residual fuel may only be used when sufficient heat is provided to the oil to reduce its viscosity and to give it fluid properties sufficient for pumping and combustion. These residual fuels are excellent for use in the large cruise ships that travel to Alaska.

Because the current tax on the residual fuel is at five cents per gallon, companies such as Tesoro Alaska are forced to sell their residual fuel at a loss since there is no market for the fuel. By reducing the tax, a market is created with the cruise ships; more than 90 cruise ships will be coming into Seward this summer. The cruise ships that serve Seward now purchase fuel in Vancouver, British Columbia. According to the final report of the Governor's Task Force on Regulatory Reform, if the price for residual fuel can be competitive with prices in Canada, the initial potential is for annual sales of $7,000,000 and increased employment for Alaskan residents.

I urge the Senate Transportation Committee to support SB 327.

January-June: STATE CAPITOL / JUNEAU, AK 99801-1182 / (907) 465-2828 / Fax: (907) 465-4779
June-December: 34824 KALIFORNSKY BEACH ROAD, SOLDOTNA, AK 99669 / (907) 262-9420 / FAX (907) 262-1881
Seldovia • Homer • Anchor Point • Clam Gulch • Ninilchik • Kasilof • Soldotna • Sterling • Cooper Landing • Moose Pass • Seward

MEMBER
Senate Rules Committee
Senate Judiciary Committee
Senate Economic Task Force
Legislative Council

FINAL REPORT

OF THE

GOVERNOR'S TASK FORCE

ON

REGULATORY REFORM

MARCH 19, 1993

OIL

SI 9. Propose a statutory or regulatory change to make marketing of heavy fuels (heavy bunker oil) more economically competitive by eliminating or reducing the taxes. Statutory reference AS 43.40.1 - May be possible to do by regulation.

Due to the excessive tax on heavy fuels if used instate ($2.10), heavy fuels have no instate sales/useage. In 1970-72, heavy bunker fuel was sold, to a small market, for use instate, by such firms as Sealand. In 1972, the present tax was placed on this fuel. All sales then ceased, and have remained non-existent since that date. Currently, there is the potential for a market of these fuels in Alaska, if the price of the fuel can be competetive with prices in Canada (current fuel source). The initial potential is for annual sales of $7,000,000, and employment for 7-10 Alaskans. Refineries instate do produce the heavy bunker fuel, and then it sell as an exported product.

MINING

SI 10. Change the valid timeframe of an Exploration and Reclamation permit from one year to five years (DNR). 11 AAC 97.300

Currently permits are only good for one year, and require considerable effort and expense in preparation. Exploration and reclamation themselves are likely to span several years. Requiring firms to file anew each year is an unnecessary additional expense both for the business enterprise and the State, which does not contribute to either the applicant or ADNR.

If ADNR is seeking updated information on changes, then alter the regulations to require notification of any changes when and if changes occur from those in the original approved permit.

SI 11. Add a phrase to 18 AAC 80.020 so that it reads: "Toxic and Other Deleterious Organic and Inorganic Substances -Substances shall not exceed Alaska Drinking Water Standards (18 AAC 80) or EPA Quality Criteria for Water as applicable to substances *and use. i.e., if the water is not used as a public water system. 18 AAC 80.020 Source Protection is not the applicable use."*

This is recommended in order to get away from effective treated water at the source. As a result, "raw water" prior to treatment would not have to meet the same standards as water taken and treated for public consumption.

SB

332

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO: SB 332

Revision Date: ____

Title: Weight of Live Marijuana Plants

Sponsor: (S) JUD

Requestor: (S) JUD

Dept. Affected: Public Safety

BRU: Alaska State Troopers

Component: Detachments

COMPONENT SERIAL NO. 799

EXPENDITURES/REVENUES: (Thousands of Dollars) (inflation not included)

OPERATING	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-
CAPITAL EXPENDITURES	-0-	-0-	-0-	-0-	-0-	-0-
CHANGE IN REVENUES ( ) Revenue Code	-0-	-0-	-0-	-0-	-0-	-0-

FUNDING: (Thousands of Dollars)

	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1006 GF/MHTIA						
Other						
TOTAL	-0-	-0-	-0-	-0-	-0-	-0-

Estimate of current year (FY 94) impact: $ ____

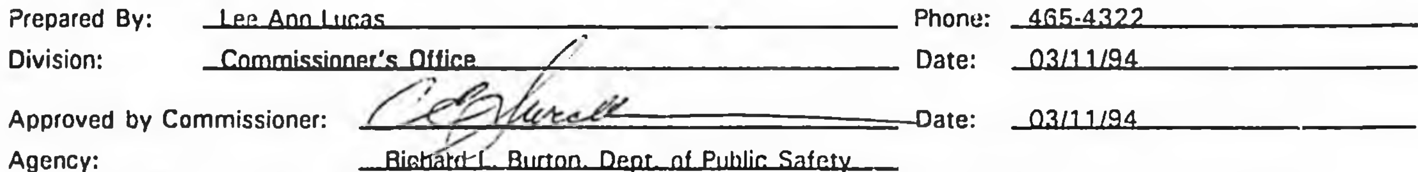
POSITIONS:

	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: (Attach a separate page if necessary.)
No significant impact is anticipated on the Department of Public Safety.

Prepared By: Lee Ann Lucas
Phone: 465-4322

Division: Commissioner's Office
Date: 03/11/94



Approved by Commissioner: ____
Date: 03/11/94

Agency: Richard L. Burton, Dept. of Public Safety

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Rev 01/94

March 10, 1994

To : MEMBERS OF THE SENATE JUDICIARY COMMITTEE

There are two problems which may be addressed via legislation. Current law mandates that when a large growing operation is taken down, that all of the plants be groomed to the point of the accepted market product. This entails many personnel hours harvesting, hanging, drying and then plucking the marijuana buds and leaves from the stems.

In essence, police are being required to finish the illicit procedure of marijuana cultivation just to be able to charge the persons involved with the appropriate crime. Even then, if they stall the trial process, or even just waiting until the appeal process, the finished product has dried even beyond what would be a salable product on the streets and can be as much as half the weight loss of the original product.

In a smaller growing operation, this would come into play if the suspect were charged with Misconduct Involving a Controlled Substance in the Fourth Degree, which is a class C felony but requires a suspect to possess at least a pound of marijuana, AS 11.71.040(a)(3)(f). Depending on when the growing operation is taken down, the amount will vary. If the harvest has already been made, even a large operation may not yield a pound of processed and groomed marijuana. The other end of the spectrum is that we may interdict an operation just getting going with hundreds of starter plants which when combined would not amount to a pound.

It is a waste of enforcement time and resources to process marijuana and could be greatly simplified if the statute was changed to simply state that the weight of the cultivated marijuana will be calculated by weighing the plant after it has been severed from the root wad, at the time of seizure. This is the aggregate weight of the plant.

The other area of concern is that a Felony drug sale does not occur unless the product is more than an ounce. The drug dealers are aware of that and refuse to sell more than an ounce.

This can be addressed by adding a definition to the statute that the amount of marijuana weight as purported by the dealer will be the amount used to classify the offense. (If the dealer says it's an ounce and sells it as such, the dealer will be charged with selling an ounce.)

A two hundred mature marijuana plant growing operation took our narcotics enforcement team approximately 32 officer hours to process.

THE SOLUTION:

REPEAL: AS 11.71.080. AGGREGATE WEIGHT OF LIVE MARIJUANA PLANTS. For the purposes of calculating the aggregate weight of a live marijuana plant, the aggregate weight shall be the weight of the marijuana when reduced to its commonly used form.

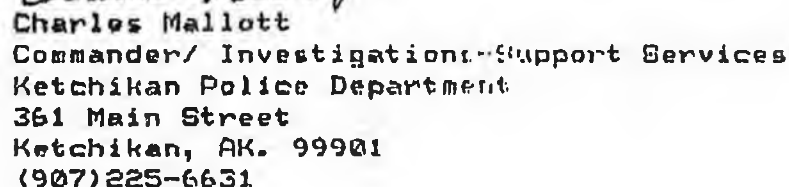
ENACT: AS 11.71.080. AGGREGATE WEIGHT OF LIVE MARIJUANA PLANTS. For the purposes of calculating the aggregate weight of a live marijuana plant, the aggregate weight shall be the weight of the entire plant, excluding the root wad and any growing media attached to it, at the time of harvest or seizure. OR

AS 11.71.080. PRESUMPTION OF POSSESSION WITH INTENT TO DELIVER. As it is now against the law to possess any amount of marijuana, for the purposes of prosecution, any person who is found to be in possession of or growing marijuana plants shall be presumed to be growing marijuana for illicit purposes. On a case by case screening, based on probable cause and in accordance with current law, the District Attorney's office in the appropriate jurisdiction, may chose to prosecute the possession case as an intent to distribute case.

ENACT: NEW STATUTE AS 11.71.090. WEIGHT OF MARIJUANA FOR SALE. For the purposes of classifying the level of offense in this statute, the purported weight of marijuana as stated, implied or represented by the person distributing the substance shall be the weight of classification, for purposes of charging.* For the purposes of prosecution weight if the amount exceeds the statutory requirement, the weight as determined by the Department of Public Safety Crime Detection Laboratory shall be the determined weight.**

*(If a dealer sells an ounce that is intentionally short in an effort by the dealer trying to avoid felony amounts, he may still be charged with dealing an ounce of marijuana.)

**(If an ounce and a half is weighed by the crime lab and then just prior to trial as long as six months to a year later the weight has decreased due to dehydration over time to weigh under an ounce, the original weight should still be used as the charging weight.)



Charles Mallott
Commander/ Investigations-Support Services
Ketchikan Police Department
361 Main Street
Ketchikan, AK. 99901
(907)225-6631

SB
333

ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit

P. O. Box 113300
Juneau, AK 99811-3300
(907) 465-3830
FAX (907) 465-2347

MEMORANDUM

TO: The Honorable Robin Taylor, Chairman
Senate Judiciary Committee

FROM: Randy S. Welker, Legislative Auditor

DATE: April 5, 1994

RE: Senate Bill 333

This memorandum is provided to briefly summarize the contents of Senate Bill 333. The bill was introduced by the Legislative Budget and Audit Committee in response to an audit released last year.

The impetus for the suggested changes comes primarily from our audit of the Department of Public Safety's Division of Fish and Wildlife Protection (FWP). However, the problem identified is not limited to only FWP. Other public officials with discretionary authority could also be placed in a conflict of interest position.

Section 1 of the bill establishes a requirement for disclosure of the formation or maintenance of a close economic association similar to that contained in the Legislative Ethics Act.

The bill also requires a public officer, if it appears feasible and in the best interests of the state, to refrain from taking or withholding official action in a matter that directly involves a person with whom the public officer has a close economic association. However, if taking or withholding official action is not avoidable, the public officer shall immediately disclose the action to the public officer's designated supervisor.

The bill requires a supervisor, to whom a public officer has made a disclosure, to make a written determination of whether the officer's involvement could constitute a conflict of interest. The supervisor could reassign duties to avoid the conflict or the supervisor may direct the divestiture or removal by the officer of the financial interest giving rise to the conflict.

Section 2 of the bill is a change to the nepotism prohibition in statute. As the result of an isolated circumstance we found at the Alaska Psychiatric Institute, we are recommending that the statute be expanded. Currently the only relationship that is prohibited is that a person may not be employed in the same department or agency if they are the spouse of, or related by blood to, the executive head of a principal state department or agency.

We are recommending that the statute be expanded to include all supervisory/subordinate relationships (not just a relationship to the commissioner) and that the definition of relationship be expanded to include a regular member of the officer's household.

I have attached a copy of the nepotism recommendation excerpted from our audit of the Alaska Psychiatric Institute. I have also provided a copy of the entire audit report on the Division of Fish and Wildlife Protection.

I appreciate the Committee's consideration of this legislation. If enacted, this legislation will help improve public perception and clarify the legislature's disapproval of close economic associations by public officials who have discretion in taking or withholding official action that may affect the public officer or a person with whom the public officer has an economic association.

Attachment

appropriate managerial response to committee recommendations, the long-term effectiveness of the committee process as well as overall hospital operations, will suffer.

Recommendation No. 2

The legislature should consider expanding the nepotism statute to prohibit supervisory/subordinate relationships of immediate family members.

Alaska Statute (AS) 39.90.020 prohibits nepotism and reads as follows:

> *It is unlawful for a person who is the spouse of or is related by blood within and including the second degree of kindred to the executive head of a principal state department or agency to be employed in that department or agency.*

First, we believe this statute should be expanded beyond just the executive head of principal state agencies to include all supervisory/subordinate relationships. Nepotism at any level can adversely impact the work environment.

Second, we believe this statute should address relationships beyond spousal and blood kindred to include immediate family members. In today's society, close relationships are more common in which an immediate family member is neither a spouse nor a blood relative. Nevertheless, any perceived favoritism shown this family member will likely affect employee morale.

This proposed expansion is not without statutory precedent. The legislature's Standards of Conduct, AS 24.60.090, state:

> *An individual who is related to a legislative employee may not be employed in a position over which the employee has supervisory authority. In this subsection, 'an individual who is related to' means a member of the legislator's or legislative employee's immediate family or a person who is a legislator's or legislative employee's spousal equivalent . . . . [emphasis added]*

Further, the Executive Branch Ethics Act, AS 39.52.960, defines an immediate family member as:

> *. . . a public officer's spouse, a relation by blood within and including the second degree of kindred, and a regular member of the officer's household. [emphasis added]*

In defining what constitutes improper influence over state grants and contracts, the Ethics Act states that an "immediate family member:"

. . . may not attempt to acquire, receive, apply for, be a party to, or have a personal or financial interest in a state grant, contract, lease, or loan if the public officer may take or withhold official action that affects the award, execution, or administration of the state grant contract, lease, or loan.

We see no reason for the State to apply a different standard for improper influence over grants and contracts than for nepotism. "A regular member of the officer's household" should be a standard for both.

During our review of personnel actions, we identified a situation where a public officer approved the appointment and promotion of an employee, when the public officer and employee were cohabitants. There was evidence in the personnel file that the relationship met the definition of an immediate family member as defined above under AS 39.52.960. A perceived act of relational favoritism within an agency, whether factual or not, can adversely affect an agency's efficiency and effectiveness. As this incident was brought to our attention by a number of API employees during audit interviews, we believe that it created significant morale problems at the hospital.

We recommend the legislature expand the current language of AS 39.90.020 to include regular members of an officer's household as part of the nepotism prohibition. Further, we recommend that all supervisory/subordinate relationships be addressed.

Recommendation No. 3

The Department of Health and Social Services (DHSS) should restructure the membership of the API governing body and consider establishing a board of governance.

API is required by JCAHO accreditation standards and state regulations to have a governing body with overall responsibility for the operations of the hospital. The governing body of API consists of the commissioner of DHSS, the director of the Division of Mental Health and Developmental Disabilities (DMHDD), and management of API; namely, the chief executive officer (CEO), the medical director, the hospital administrator, and the president of the medical staff.

The continuity within the governing body has been disrupted over the years because four of the six positions (DHSS commissioner, DMHDD director, API chief executive officer, and medical director) are political appointees and there has been a high turnover of management at API. In addition, the commissioner, division director, and medical director (prior to 1992 the medical director performed the CEO function) did not necessarily have experience in the management of a psychiatric hospital. Consequently, decisions may be deferred to a committee, delayed, or may not be the most efficient/effective option. Since 1988, there have been two commissioners, three division directors, two chief executive officers, five medical directors, five presidents of the medical staff, and three hospital administrators.

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. SB 333

Revision Date:
Title: An Act relating to disclosure of close economic associations..and to the prohibition against nepotism....
Sponsor: Senate Rules by request of Leg. Budget & Audit Committee
Requestor: (S) Sta

Department Affected: Administration
BRU: Personnel/OEEO
Component: Personnel/OEEO
COMPONENT SERIAL NO. 56

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
PERSONAL	6.5	0	0	0	0	0
TRAVEL	3.7					
CONTRACTUAL	15.6					
SUPPLIES						
EQUIPMENT						
LAND &						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	25.8	0	0	0	0	0
CAPITAL EXPENDITURES						
CHANGE IN REVENUES						

FUNDING SOURCE: (Thousands of Dollars)

	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
1002 Federal						
1003 GF Match						
1004 GF	25.8					
1005 GF/Program						
1006 GF/MHTIA						
OTHER						
TOTAL	25.8	0	0	0	0	0

Estimate of any current year (FY 94) cost: $ 0

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS: History tells us we can expect to receive a class action suit regarding the changes in the nepotism law from each of 11 bargaining units. The costs above are based on the assumption that 5 will go to hearing. Estimated total cost is 24.3. Costs for the Personnel Board to develop regulations and have necessary public hearings are calculated at 1.5. See attached breakdown for detail.

Prepared by: Kevin G. Ritchie, Director
Division: Personnel/OEEO
Phone: 465-4429
Date:

Approved by Commissioner: Nancy Bear Usera
Agency: Administration
Date: 3/14/94

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FISCAL NOTES

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Fiscal Note
Calculation Sheet

SB 333

Personal Services

5 class action hearings @ rg 21C	
3 days preparation	
2 days hearing	5,544.00
Personnel Board 1 hearing	
director & staff	
preparation time	1,000.00
	6,544.00

Travel

Airfare Juneau-Anchorage-Juneau	
444.00 x 6 trips	2,664.00
10 days per diem @ $100	1,000.00
	3,664.00

Contractual

5 days arbitrator @ $3120	15,600.00

TOTAL $ 25,808.00

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. SB 333

Revision Date: March 10, 1994
Title: "...disclosure of close economic associations by certain state employees...prohibition against nepotism..."
Sponsor: Senate Rules Committee By Request
Requestor: Senate State Affairs Committee

Department Affected: Department of Law
BRU: Legal Services
Component: Operations

COMPONENT SERIAL NO. 0093

EXPENDITURES/REVENUES:

OPERATING	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
PERSONAL						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND &						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-
CAPITAL						
REVENUE						
FUNDING:						
1002 [illegible]						
1003 [illegible]						
1004 GF						
1005 GF/Program						
1006 GF/MHTIA						
OTHER						
TOTAL	-0-	-0-	-0-	-0-	-0-	-0-
POSITIONS:						
FULL-TIME	-0-	-0-	-0-	-0-	-0-	-0-
PART-TIME						
TEMPORARY						

Estimate of current year (FY94) impact: -0-

ANALYSIS: (Attach a separate page if necessary.)
Please see the attached analysis.

Prepared by: Richard I. Peques, Director
Phone: 465-3672
Division: Administrative Services Division
Date: March 10, 1994

Approved by Commissioner: Bruce M. Botelho, Attorney General /FOR/
Agency: Department of Law
Date: March 10, 1994

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FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. S 333

ANALYSIS CONTINUATION:

This bill amends the Alaska Executive Branch Ethics Act, under AS 39.52, to add a new section that provides that a public officer in the executive branch must disclose a close economic association involving a substantial financial matter with a person who is likely to be affected by an official action taken or withheld by the public officer. Current law, under AS 34.52.120(b)(4) prohibits a public officer from taking or withholding official action in order to affect a matter in which the public officer has a personal or financial interest. However, the existing law does not include the requirements for prior disclosure of close financial associations that are contained in the bill.

The bill also amends the state's statute prohibiting nepotism, AS 39.90.020, to clearly define the supervisory position of a public officer in relationship to family members and those living regularly in a person's household to whom the prohibition applies.

It is not anticipated that either of these provisions would result in a level of violations that would cause a fiscal impact for the Department of Law.

FISCAL NOTE

STATE OF ALASKA
1994 LEGISLATIVE SESSION

BILL NO. SB 333

Revision Date:
Title: "An Acr relating to disclosure..."

Sponsor: Senate Rules Committee
Requestor: LB&A Committee

Department Affected: Office of the Governor
BRU: All BRUs
Component: All Components

COMPONENT SERIAL NO.

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0	0	0	0	0	0

CAPITAL EXPENDITURES						

CHANGE IN REVENUES ( )						

FUND SOURCE

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1006 GF/MHTIA						
OTHER						
TOTAL	0	0	0	0	0	0

POSITIONS

FULL-TIME						
PART-TIME						
TEMPORARY						

Estimate of any current year (FY94) cost: n/a

ANALYSIS: (Attach a separate page if necessary.)
No fiscal impact

Prepared by: Michael A. Nizich, Director
Division: Division of Administrative Services
Phone: 465-3976
Date: 3/8/94

Approved by Commissioner: Patrick P. Ryan, Chief of Staff
Agency: Office of the Governor
Date: 3/8/94

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SB 337

1/13/93

CURRENT ALASKA STATUTORY LAW RE
CORPORATE CUMULATIVE VOTING

AS 10.06.420(d) provides that each shareholder entitled to vote at an election of directors has a right to vote by cumulative voting, unless the articles of incorporation provide otherwise.

AS 10.06.460(a)(2) provides that a director may not be removed by the shareholders if the votes cast against removal would be sufficient to elect a director by cumulative voting, unless the articles of incorporation have eliminated cumulative voting.

AS 10.06.455(b) provides that an amendment of the articles of incorporation that would establish classification of the board may not be adopted by the shareholders if the votes cast against the amendment would be sufficient to elect a director by cumulative voting, unless the articles of incorporation have eliminated cumulative voting.

AS 10.06.504 -- 10.06.508, dealing with amendments of the articles, require approval by both the board and the outstanding shares, and imply that a simple majority is sufficient. (AS 10.06.508 speaks of the articles requiring a larger majority.) Former AS 10.05.276 required an amendment of the articles to be initiated by the board and approved by the two-thirds vote of the shares entitled to vote on the question.

AS 10.06.228 and 10.06.230, dealing with the adoption and amendment of bylaws, require approval by either the board or the

outstanding shares, and imply that a simple majority is sufficient (with certain exceptions).

Section 7, ch. 166, SLA 1988 sets a generally applicable effective date of July 1, 1989 for the new Corporations Code (AS 10.06), "[e]xcept as otherwise expressly provided." This section makes the new code generally applicable to corporations, including Alaska Native Claims Settlement Act corporations, existing on July 1, 1989.

Section 9, ch. 166, SLA 1988 provides that AS 10.06.208 and 10.06.210, pertaining to the contents of the articles of incorporation, do not apply to corporations existing on July 1, 1989 until either (a) the corporation adopts an amendment of its articles stating that the corporation elects to be governed by all provisions of AS 10.06, or (b) July 1, 1994, whichever occurs first.

Section 10(a), ch. 166, SLA 1988 provides that former AS 10.05.276's requirement of a two-thirds majority for an amendment of the articles remains in effect for corporations existing before July 1, 1989. Subsection (b) allows such a corporation to elect to be governed by the new statutes on amending the articles. Subsection (c) (added by sec. 57, ch. 50, SLA 1989) states an exception dealing with director liability in ANCSA corporations.

Section 58, ch. 82, SLA 1989 provides that, if a corporation organized under former AS 10.05 has a bylaw (existing immediately before July 1, 1989) that prohibits cumulative voting, the corporation may continue to operate without cumulative voting until July 1, 1994.

##########

LAW OFFICES

DILLON & FINDLEY

A PROFESSIONAL CORPORATION

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January 13, 1993

The Honorable Jim Duncan
Alaska State Senate
State Capitol, Room 119
Juneau, Alaska 99801-1182

Re: Your draft bill regarding voting of shares in Native corporations

Dear Jim:

Your assistant, Dale Staley, has asked Tom Findley and me to review your November 2, 1992 draft bill entitled "An Act relating to the voting of shares in Native corporations." We have done so, and our comments follow.

Dale mentioned that your basic purpose is to keep things as flexible as possible with regard to cumulative voting. The bill appears to do that, although the second part of your first section leaves open a couple of important (but easily answered) questions.

While non-cumulative voting more closely tracks the "one man, one vote" concept, cumulative voting helps assure that a minority of shareholders will have <u>some</u> representation on a board of directors. The current law preserves both options. Your draft bill makes the non-cumulative-voting option easier.

The three sections of your bill deal with two aspects of corporate voting: (1) cumulative voting, and (2) voting by a government agency. The latter point, addressed in your sec. 1's proposed AS 10.06.960(<u>k</u>), appears to be the simplest, and we will address it first.

<u>Voting By Government Agency</u>

Proposed AS 10.06.960(k) appears to be aimed at situations where a government agency, such as the Department of Health and Social Services in connection with the <u>A.K. v. Ahtna, Inc.</u> case, becomes a trustee or other holder of shares. Also, under existing

sh/art/duncan.let

AS 10.06.210(1)(H), a corporation's articles of incorporation may include a provision conferring upon the "holder of an evidence of indebtedness" of the corporation the right to vote in an election of directors and on any other matters on which shareholders may vote. A state agency could be a "holder of an evidence of indebtedness."

Whatever the reason the state has come to hold ANCSA corporation shares, your amendment would appear to succeed in prohibiting the voting of those shares. Your amendment, however, leaves open the two questions of whether those shares may be counted to establish a quorum (see AS 10.06.415) and whether the government agency may grant a proxy to another person (i.e., an ANCSA corporation shareholder) for voting purposes. I express no opinion on those issues, although AS 10.06.418(a) suggests that the answer to this second question is no. Your new subsec. (k) could easily address these two points and remove any doubt. Presumably, you would want to state that the answer is no to both questions.

Cumulative Voting

The cumulative voting provisions of the current law are more complex. A brief outline of them is attached. Essentially, the 1989 revision of Alaska's corporation law (the new Corporations Code [AS 10.06]) changed the prior law with regard to cumulative voting by providing that, instead of the corporate bylaws eliminating cumulative voting, such a limitation must be in the articles of incorporation. Under the current law, a corporation, including an ANCSA corporation, may eliminate the statutorily provided cumulative voting by stating that elimination in its articles.

Section 58, ch. 82, SLA 1989 provides that, if a corporation organized under former AS 10.05 has a pre-July 1, 1989 bylaw that eliminates cumulative voting, the corporation may continue to operate without cumulative voting until July 1, 1994. By your sec. 1's proposed AS 10.06.960(j), a corporation organized under the former law, with a bylaw provision eliminating cumulative voting, may permanently retain that bylaw and continue to operate without cumulative voting. In other words, your amendment would simply remove the July 1, 1994 deadline for relocating such a bylaw provision to the articles of incorporation.

The significance of the difference, of course, lies in the difference between the method for amending bylaws as opposed to the method for amending the articles of incorporation. Amending bylaws

is easier, because it may be done by either a majority of the board of directors or a majority of the outstanding shares. On the other hand, an amendment of the articles must be approved by a majority of the board and a majority of the outstanding shares. Please see the attached summary of the current statutes.

If it is your intent simply to achieve a greater ease of adoption and amendment in connection with the provision on cumulative voting, then it appears that your sec. 1 accomplishes your intent. If your concern was simply the preservation of the non-cumulative-voting option, then the amendment is not necessary.

Your sec. 2, adding a subsec. (d) to sec. 10, ch. 166, SLA 1988, provides another facilitating feature. Under that subsection, an ANCSA corporation that was incorporated under former AS 10.05 may amend its articles of incorporation to prohibit cumulative voting, by the affirmative vote of a majority of the shares represented at a regular or special meeting at which a quorum is present. Currently, AS 10.06.504(a)(2) requires that an amendment of the articles of incorporation be approved by the board of directors and the outstanding shares. Section 2 removes the requirement of board approval, and changes the base for determining the majority. Thus, with your amendments, an ANCSA corporation could fairly easily put the non-cumulative-voting provision in either its bylaws or its articles.

Your sec. 3 appears to be simply a compatibility amendment, to assure that existing sec. 58, ch. 82, SLA 1989 is not in conflict with your proposed AS 10.06.960(j) (in sec. 1 of the bill). I detect no problem with it.

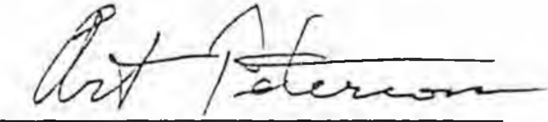
Having reviewed AS 10.06, and the relevant provisions of temporary or special law in ch. 166, SLA 1988, ch. 50, SLA 1989, and ch. 82, SLA 1989, I spot no other provisions that would need amendment in order to achieve what I understand to be your purpose.

The second paragraph of the sheet that Dale gave us regarding your bill that was introduced in the last legislature (which we have not reviewed) contains an error. The concluding clause of its second paragraph, "at which time all corporations will be required to utilize cumulative voting," is not correct. The new Corporations Code provides for cumulative voting and allows its elimination, but merely says that such an eliminating provision must be in the articles of incorporation rather than in the bylaws (as under the former law).

We hope that these comments are helpful to you. If you are planning to prepare an explanation sheet, such as the one for your bill in the last legislature, we would be happy to review it.

Yours truly,

Dillon & Findley

By: 
Arthur H. Peterson

AHP/sh
Enclosure

The new Alaska Corporation Code was adopted in 1988. AS 10.06.420 (d) provided that shareholders would have the right to vote for the election of directors by the cumulative voting method.(If three directors were to be elected the shareholder would be entitiled to cast the number of shares owned times three in any manner the shareholder desired- i.e. 100,100, or 100; 150 or 150 or 300- by voting for three, two or one director.)

Section 58, Ch. 82, SLA 1989 provides that notwithstanding AS 10.06.420 (d) and AS 10.06.460(a)(2) if a corporation provided for non-cumulative voting in conformance with prior statutory provisions the corporation could continue non-cumulative voting until July 1, 1994 at which time all corporation would be required to utilize cumulative voting.

There are some native corporations that utilize non-cumulative voting as provided by their corporate documents and wish to continue using this method of voting.

The proposed legislation applies only to Alaska Native Corporations-ANSCA corporations and is written so that corporations have the option as to whether they elect cumulative or non-cumulative voting.

The non-cumulative method of voting represents a true form of one man one vote. The cumulative method allows a shareholder to vote all cumulated votes to only one director or to divide the number of votes in any manner the voter so elects among the candidates. The cumulative voting method thereby allows a few people to accumulate votes in a manner that does not really represent the one man one vote method.

The proposed amendment as written allows each native corporation the opportunity to consider which form of voting they want to use and secondly to clarify Section 58, Ch. 82, SLA 1989 as to the application of cumulative and non-cumulative voting for corporation after 1994..

ATTORNEYS AT LAW

BAXTER, BRUCE & BRAND

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CHRYSTAL SOMMERS BRAND
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JEFFREY F. SAUER
LINDA T. McKINNEY

February 14, 1994

Senator Tim Kelly
The Capitol Building, Room 101
Juneau, Alaska 99801

Re: Proposed Technical Amendment to the Corporations Code
Our File No. 0001-020

Dear Senator Kelly:

I thank you for taking the time to meet with me this afternoon concerning a proposed technical amendment to the Alaska Corporations Code.

I represent Huna Totem Corporation, which is an Alaska Native Claims Settlement Act corporation located in Hoonah, Alaska.

Before the Alaska Legislature adopted the new Alaska Corporations Code in 1988, Huna Totem Corporation amended its bylaws with shareholder approval to provide for noncumulative voting. The new Corporations Code provides that a corporation using noncumulative voting by its shareholders may continue to operate without cumulative voting only until July 1, 1994.

Huna Totem Corporation wishes to continue to use the noncumulative method of voting by its shareholders. The corporation believes that this form of corporate shareholder voting truly is representative of the one-person-one-vote system, and does not provide management with any inherent advantages. During Huna Totem Corporation's past annual shareholder meeting, independent candidates were able to defeat all three of the management slate by the noncumulative voting method.

The second technical amendment included in the proposed legislation is the provision that a governmental agency or entity may not exercise the voting privileges of the stock of a corporation organized under the Act.

The proposed legislation is supported by AFN, the Aleut Corporation, Sealaska Corporation, Huna Totem Corporation and numerous other village corporations which currently use the noncumulative method of shareholder voting.

Your assistance in introducing this proposed legislation is very much appreciated. If I can provide any assistance to you concerning this proposed legislation, please give me a call. Thank you.

Very truly yours,

BAXTER, BRUCE & BRAND

- Fred J. Baxter

FJB/pc
cc: George D. Cooper, CEO
Huna Totem Corporation
Mr. Larry Kimball, AFN

January 25, 1993

Honorable Bill Williams, Representative
Alaska State Capitol
Room 128
Juneau, Alaska 99801

Dear Bill:

At a recent board meeting, I reported on our proposed bill to allow non-cumulative voting rights to survive the sunset provision now written into statutes, as an option for those ANCSA corporations that have non-cumulative provisions in their Articles of Incorporation and Bylaws.

Senator Jim Duncan has worked with us in the past, and has a proposed bill for submittal to this legislature - copy attached.

As I recall from the last legislature, Senator Fred Zharoff also strongly supports this issue.

The board members of HTC suggested I contact you, as a member of the House Majority Caucus, to see if you would assist us in presenting the proposed bill, or similar, to accomplish our goal.

If you or your staff would like to discuss this issue further, I can be reached by telephone at 206-387-1553, or contact Fred Baxter, our counsel who has worked with Senator Duncan on this amendment, at Juneau 789-3166.

Thanks Bill, and good luck at this session.

Respectfully Submitted,

HUNA TOTEM CORPORATION

George D. Cooper /e.s.

George D. Cooper
Chief Executive Officer

Enclosure

cc: HTC Board of Directors
Fred Baxter
Senator Jim Duncan ✓

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NAIC NEWS SUPPLEMENT

January 1994 Vol. XI, No. 1 Official Newsletter of the National Association of Insurance Commissioners

Questions and Answers

RECEIVED
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DEPARTMENT OF COMME
& ECONOMIC DEVELOPME
DIVISION OF INSURANCE

Risk-Based Capital Requirements Property/Casualty Insurance Companies

Q: What is the purpose of a capital and surplus requirement for insurers?

A: A capital and surplus requirement is designed to provide an adequate cushion for unexpected increases in liabilities, unexpected decreases in asset values, inadequate rates, cash flow timing problems, and catastrophes.

Q: Do states now have capital requirements for insurers?

A: Yes. State laws generally require insurers to maintain minimum levels of capital and surplus. Historically, insurers' capital and surplus requirements have been established by law at a fixed amount for each major line of insurance. For example, now, a state might have a $1,000,000 minimum capital standard for all companies in the state that write property/casualty insurance, regardless of the size of the company or the differing degrees of risk to which different companies are exposed.

Q: What are the limitations of fixed capital standards?

A: Fixed capital requirements are unrelated to the risk posed by a particular insurer's business practices. As a result, they are too low for many insurers, particularly those that engage in business practices that pose a relatively high risk for consumers. Furthermore, they often provide an insufficient basis for timely regulatory action involving inadequately capitalized insurers.

Q: What is a risk-based capital requirement?

A: When a law requires that the minimum level of required capital be maintained with reference to the specific risks faced by institutions, it is known as a risk-based capital requirement.

Q: Why are state insurance regulators changing to a risk-based capital system for insurers?

A: In recent years insurers' business practices — particularly as they relate to exposure to risk — have become more diverse. While some insurers remain conservative in both their investments and their underwriting practices, others have become less conservative. Companies that assume a more aggressive, risk-taking approach must assure that their consumers are protected from the financial hazards created by that risk-taking through the establishment of higher capital standards.

Q: What are the objectives of a risk-based capital requirement?

A: A risk-based capital requirement establishes a standard of capital adequacy that is related to risk. Furthermore, it raises the safety net to protect consumers from the potential for capital inadequacy of insurers. Finally, such a requirement would provide insurance regulators with the regulatory authority to take action when a company's actual capital falls below the risk-based capital standard.

Q: What process has the NAIC gone through to develop risk-based capital requirements?

A: In 1990, the NAIC decided that risk-based capital requirements were superior to fixed standards and established two working groups to develop such standards. One group was charged with the development of the standards for life and health insurers, while the other group was charged with doing the same for property and casualty companies.

Since that time, the property/casualty working group has sought wide input from insurance regulators, experts, academics, industry associations and insurers. Additionally, the NAIC has conducted extensive research and testing designed to help develop the formula, evaluate the reasonableness of the formula results for insurers, assess the industrywide impact of the formula, and refine the formula. The testing has involved industry and company results, the allocation of risk-based capital charges by risk, individual insurer "case analyses," comparisons with rating agency results and results from the NAIC's Insurance Regulatory Information System (IRIS), a sensitivity analysis, a failed insurer analysis, simulation and scenario testing, and special surveys of insurer data.

Q: What types of risks will be factored into a company's risk-based capital requirement?

A: Under the present version of the formula, four types of risk — asset risk, underwriting risk, credit risk and off-balance sheet risk — go into the calculation of a property/casualty insurer's risk-based capital requirement.

Q: What is an asset risk?

A: Asset risk is the risk of asset default for fixed assets and loss in market value for equity assets. In other words, asset risk is the risk that a long-term mortgage or bond held by an insurer may go into default, or that the value of a real estate property will fall.

Q: How did the working group derive the factors for asset risk?

A: The formulas developed by the Life Risk-Based Capital Working Group were used as a starting point. Adjustments to those factors were made based upon the differences in valuation reporting for property/casualty insurers as well as other distinctions.

Q: How is the asset risk calculated?

A: The formula establishes a risk-based capital level for each of a number of asset categories. For example, there are six categories of bonds, reflecting the differing levels of risk posed by different quality obligations. The reported value of the assets in each asset category is multiplied by a risk factor that reflects the asset category's relative risk. For example, a bond rated NAIC 3 (the equivalent of a BB rating by Standard and Poor's) has a risk factor of 0.02, twice the risk factor of a less risky bond rated NAIC 2 (the equivalent of a BBB bond). Additionally, the asset portion of risk-based capital is increased in the event of high concentrations in single exposures.

Q: What is the credit risk?

A: Credit risk is the risk of losses from unrecoverable reinsurance and the inability of insurers to collect agents' balances and other receivables.

Q: **How is the credit risk calculated?**

A: A factor of 10 percent is charged for reinsurance recoverables from non-affiliated reinsurers and affiliated non-U.S. reinsurers, less the reinsurance penalty already taken on the annual statement under the so-called "90-day rule." Miscellaneous receivables require a 5 percent capital charge.

Q: **What is the underwriting risk?**

A: Underwriting risk is the risk of errors in pricing and reserves.

Q: **How is the underwriting risk calculated?**

A: The factors are based partially on the industry's worst accident year loss reserve development and accident year loss ratio over a 10-year period. The industry worst-case factors are modified to limit the disparities between lines of insurance. Furthermore, the factors are adjusted for individual company experience and the time value of money.

Q: **What are the off-balance sheet risks?**

A: The primary off-balance sheet risk is the risk created by excessive growth. Rapidly growing companies have a greater propensity to encounter financial difficulty.

Q: **How is growth risk calculated?**

A: The growth risk-based capital formula uses an average growth in gross premiums written and reserves over the previous three years as a baseline. Insurers with growth exceeding 10 percent receive a charge to premiums and reserves.

Q: **Will the results of the risk-based capital formula calculations be made public?**

A: Yes, both the calculation of each company's risk-based capital requirement and its total adjusted capital will be reported on the Annual Statement filed by the company. However, the NAIC has cautioned that the formula has not been designed to rate or rank adequately capitalized companies and should not be used for that purpose.

Q: **Once a company has calculated its risk-based capital requirement and has reported it on the annual statement, what does the regulator do with that information?**

A: The regulator compares the company's total adjusted capital against the risk-based capital requirement to determine if regulatory action is called for. That question is answered by the Risk-Based Capital for Insurers Model Act.

Q: **What does the model law do that is not accomplished by the formula itself?**

A: The formula provides a mechanism for the calculation of an insurance company's Authorized Control Level Risk-Based Capital and its total adjusted capital. The model law sets forth the points at which a commissioner is authorized and expected to take regulatory action.

Q: **What are the various levels of risk-based capital established by the model law?**

A: The first level is known as the Company Action Level RBC, which is set at twice the Authorized Control Level RBC. The second level is the Regulatory Action Level RBC, at 1.5 times the Authorized Control Level RBC. The third is the Authorized Control Level RBC, and the fourth is the Mandatory Control Level RBC, set at 70 percent of the Authorized Control Level RBC. (See table)

Risk-Based Capital Levels	
Name of RBC Level	**Percentage of Authorized Control Level RBC**
Company Action Level RBC	200 Percent
Regulatory Action Level RBC	150 Percent
Authorized Control Level RBC	100 Percent
Mandatory Control Level RBC	70 Percent

Q: What happens when a company's total adjusted capital falls below the Company Action Level RBC?

A: If a company files a risk-based capital report (RBC report) which indicates that, while the total adjusted capital is higher than the Regulatory Action Level RBC, it is lower than the Company Action Level RBC, the insurer must submit to the insurance commissioner a comprehensive financial plan. That plan must identify the conditions in the insurer that contribute to the company's financial condition, contain proposals to correct the financial problems of the company, and provide projections of the company's financial condition, both with and without the proposed corrections. The plan must also list the key assumptions underlying the projections, and identify the quality of, and problems associated with, the insurer's business.

Q: What if the company's total adjusted capital falls below the Regulatory Action Level RBC?

A: If a company's capital falls between the Regulatory Action Level RBC and the Authorized Control Level RBC, or if the company fails to file an RBC plan when required, the Commissioner shall perform such examination or analysis as he or she deems necessary of the insurer's business and operations and issue any appropriate corrective orders to address the company's financial problems.

Q: What happens if the company's total adjusted capital falls below the Authorized Control Level RBC?

A: In addition to those actions available to the Commissioner for less serious financial problems, the Commissioner may place the insurer under regulatory control.

Q: What if the company's total adjusted capital falls below the Mandatory Control Level RBC? What happens then?

A: In that case, the Commissioner will be required to place the insurer under regulatory control

Q: When will the risk-based capital requirements for property/casualty insurers become effective?

A: The risk-based capital formula will take effect with the Annual Statement for the calendar year ending December 31, 1994, which will be filed by insurers in the spring of 1995. The model law prescribing regulatory actions accompanying the results of the formula will take effect on a state-by-state basis upon each state's adoption of the law.

Q: Will the Model Act be made a part of the Financial Regulation Standards of the NAIC and, therefore, be required for certification by the NAIC?

A: That has yet to be formally determined by the NAIC. The NAIC added the Life Risk Based Capital Model Act to the standards in the fall of 1993 and will not take up consideration of the addition of the property/casualty amendments to the standards until 1994 at the earliest.

National Association of Insurance Commissioners

Risk-Based Capital Requirements for Insurers

A New Solvency Tool for Consumer Protection

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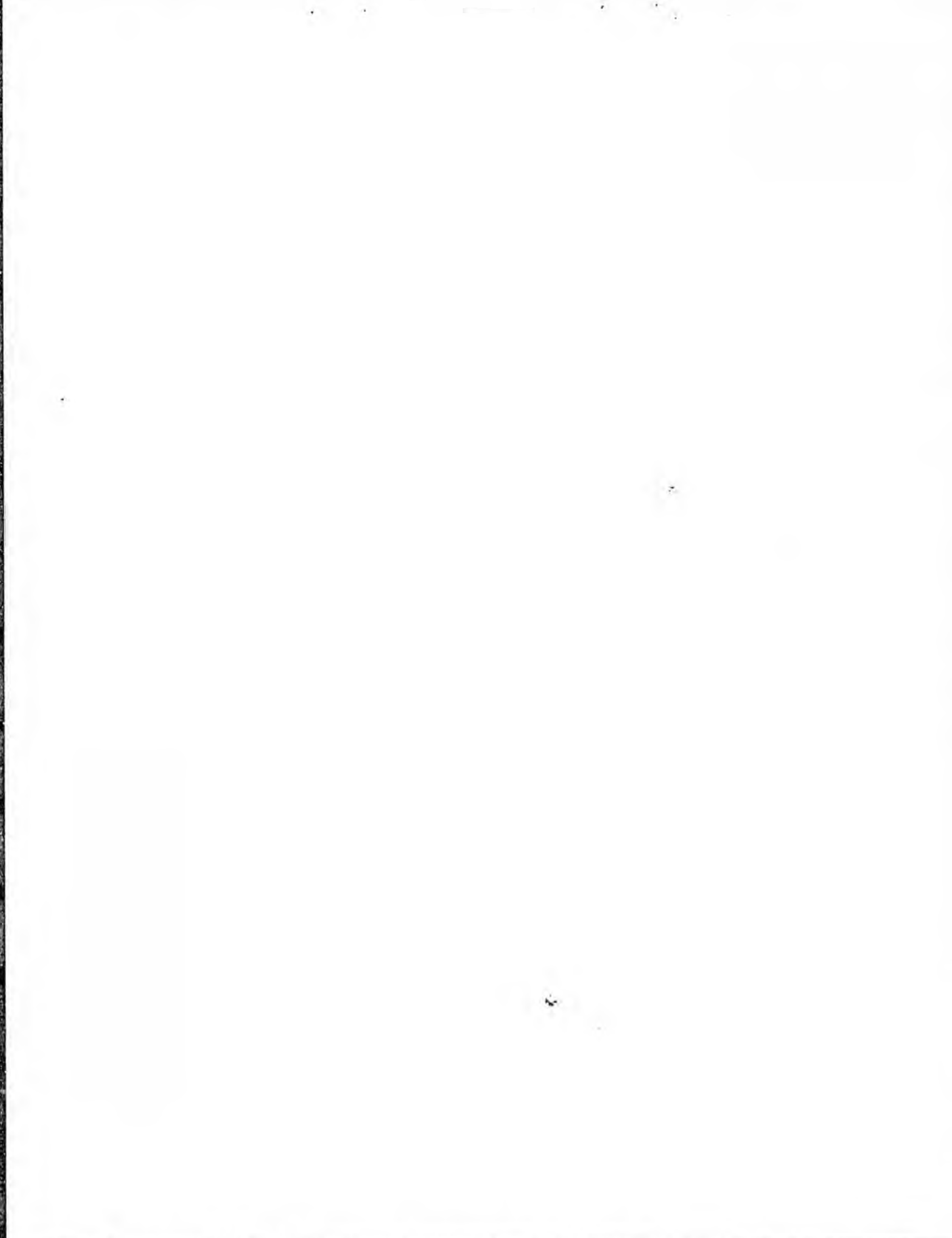

Introduction

State laws generally require insurers to maintain minimum levels of capital or surplus. Historically, state laws have established insurers' capital and surplus requirements at a fixed amount for each major line of insurance. For example, a state might have a $1,000,000 minimum capital standard for all companies in the state that write life insurance, regardless or the size of the company or of the differing degrees of risk to which different companies are exposed.

In recent years insurers' business practices—particularly as they relate to exposure to risk—have become more diverse. While some insurers remain conservative in both their investments and their underwriting practices, others have become less conservative. These less conservative practices by some insurers ran headlong into the economic troubles of the late 1980s and created an increase in the failure of insurance companies, to the detriment of policyholders and taxpayers.

In 1990, the NAIC examined both the existing capital requirements and this growing diversity in insurer business practices and concluded that consumers should be protected by subjecting companies that assume a more aggressive, risk-taking approach to higher capital requirements. This conclusion led to the formation of two working groups charged with the development of risk-based capital requirements for insurers. After extensive research and expert advice, the NAIC adopted life/health risk-based capital requirements in December 1992 and adopted property/casualty risk-based capital-requirements in December 1993.

It is helpful to think of each of the NAIC's risk-based capital proposals as consisting of two parts:

- The formula and reporting requirement, under which each insurer calculates and reports to regulators its capital requirement and total adjusted capital.

There are two formulas, one for life/health companies and one for property/casualty companies.

- The Risk-Based Capital (RBC) for Insurers Model Act, which establishes duties for both the company and insurance regulators based upon the figures generated by the formulas. There is one model law that covers both life/health and property/casualty risk-based capital requirements.

This booklet describes the life/health formula, the property/casualty formula, and the RBC for Insurers Model Act.

The Life/Health Formula

The Calculation of the Risk-Based Capital Requirement

Four types of risk—asset risk, insurance risk, interest risk and business risk—go into the calculation of a life insurer's risk-based capital requirement.

Asset risk is the risk of asset default for debt assets and loss in market value for equity assets. In other words, asset risk is the risk that a long-term mortgage or bond held by an insurer may go into default, or that the value of a real estate property will fall.

The formula establishes a risk-based capital charge for each of a number of asset categories. For example, there are six categories of bonds, reflecting the differing levels of risk posed by different quality obligations. The reported value of the assets in each asset category is multiplied by a risk factor that reflects the asset category's relative risk. Bond factors are adjusted up or down based on the number of issuers. Additionally, the asset portion of the risk-based capital requirement is increased if an insurer's assets are highly concentrated in single exposures.

Insurance risk is the risk that claims might exceed expectations, both from random fluctuations and from not making adequate provision in the pricing for unexpected risks. The factors chosen represent surplus needed to provide for excess claims over expected. For example, the risk factor for life insurance risk is based upon the net amount at risk. Companies with larger net amounts at risk have lower factors since the larger the amount, the greater its predictability.

The interest rate risk is the risk of losses due to changes in interest rate levels. The impact of interest rate changes is greatest on those products where the guarantees are most in favor of the policyholders and where the policyholder is most likely to be responsive to changes in interest rates by withdrawing funds from the insurer

Therefore, risk categories vary by the withdrawal provision (i.e., whether there is a substantial penalty for withdrawal).

Like all companies, insurers face a wide range of general business risks. However, the characteristics of these risks are difficult to quantify in a general way for all companies. One risk that is somewhat quantifiable, and therefore serves as the basis for the calculation of general business risk, is the risk that, because of the failure of other insurers, the insurer in question would be charged a guaranty fund assessment. Under the current system of guaranty associations, a financial crisis in the industry would likely trigger payments by the surviving insurers through the guaranty funds. A company's exposure to this risk is based upon the total volume of business written by the insurer in a given year, as measured by premium income.

These four types of risks are combined in a formula that produces the company's Authorized Control Level Risk-Based Capital, which then serves as a standard for regulatory action. The purpose of the formula is to estimate the capital levels required to deal with losses that may be caused by a catastrophic financial event. However, because it is unlikely (indeed, impossible) that all such possible losses will occur at once, a "covariance adjustment" is made to the formula. The adjustment operates on the assumption that asset risk and interest rate risk are correlated, while insurance risk is independent of the other two.

While risk-based capital requirements are intended to be used only as a regulatory tool, each company's Authorized Control Level Risk-Based Capital requirement and its Total Adjusted Capital will be reported on the annual statement filed by the company, and, therefore, will be available to insurance consumers. However, the NAIC has cautioned that the formula has not been designed to rate or rank adequately capitalized companies and should not be used for that purpose.

The Calculation of Total Adjusted Capital

Regulators will use a company's risk-based capital requirement as a baseline standard against which to compare that company's Total Adjusted Capital. The Total Adjusted Capital is the sum of a company's capital and surplus, Asset Valuation Reserve[1], voluntary investment reserves, 50 percent of its dividend liability, and its subsidiary company amounts.[2]

[1] The Asset Valuation Reserve is described in greater detail in the NAIC publication. *The Valuation of Insurer Assets and the NAIC Securities Valuation Office*

[2] The subsidiary company amounts are the sum of the subsidiaries' Asset Valuation Reserve, voluntary investment reserves, and half the dividend liability times the insurer's percent ownership.

The Property/Casualty Formula

The Calculation of the Risk-Based Capital Requirement

There are four broad types of risks included in the calculation of the property/casualty risk-based capital requirement:

1. Asset Risk—the risk of default and decline in market value of assets.
2. Credit Risk—the risk that premiums and reinsurance recoverables may not be collected.
3. Underwriting Risk—includes the risk that prices and/or reserves are not adequate.
4. Off-Balance Sheet Risk—includes excessive premium growth and potential liabilities not reported in the annual statement.

Asset Risk

The capital requirements to support the invested asset risk is based on the capital charges established by the Life Risk-Based Capital Working Group. The life/health formula factors were then adjusted due to differences in valuation reporting and other differences between life/health and property/casualty companies. The property/casualty formula requires, as does the life/health formula, an adjustment for bond diversification and asset concentration, in order to add risk-based capital for insurers with more concentrated portfolios.

Credit Risk

Credit risk is the risk of losses from unrecoverable reinsurance and other receivables, such as due and accrued income from interest; dividends from real estate; and recoverables from parents, subsidiaries, and affiliates, among others.

Underwriting Risk

Underwriting risk is primarily the risk of pricing and reserving errors. Since reserves are difficult to estimate with high degrees of accuracy, the question remains as to how much capital is necessary to support any given reserve level. Because reserves for the various types of business possess rather different frequency and severity characteristics and are, therefore, not homogeneous, it is appropriate to make that determination by line of business. The approach that the NAIC adopted is to consider the calendar year reserve developments, by line of business, for the industry as a whole over the last 10 years and to base the capital charges on those developments, selecting the worst year of development as the base for the risk based capital requirement.

However, the formula makes two modifications to this deficiency factor. The first adjustment considers each individual company's reserving experience. Companies with reserve developments that are better than the industry average are given a credit in the formula while those exhibiting worse reserve developments are surcharged. The second adjustment is for the time value of money. The reserves and the capital requirement are discounted at 5% interest using payment patterns established at the Internal Revenue Service for each line of business.

The capital to support the other underwriting risk, that is, the risk that current premiums charged are not sufficient to pay future losses, is calculated in much the same way as the reserve risk. Here the formula uses the worst industrywide loss ratio over the past 10 years modified by the company's experience and again discounted for the time value of money. The resultant factor is applied to the previous years written premium. Thus, the formula establishes a capital standard that requires the industry as a whole to have sufficient capital to survive a repeat of the worse underwriting year in recent history.

The worst case scenario factors for reserves and premiums are modified to increase the RBC required for lines with relatively favorable historical experience and to lower the RBC required for lines with relatively adverse historical experience. This recognizes that particularly favorable or unfavorable historical experience will not necessarily repeat itself in the future.

Off-Balance Sheet Risk

Off-balance sheet risk is comprised of four factors: non-controlled assets, guarantees for affiliates, contingent liabilities, and premium and reserve growth risk.

Non-controlled assets are the amount of all assets not exclusively under the control of the company, or assets that have been sold or transferred subject to a put option contraction currently in force.

Guarantees for affiliates include guarantees for the benefit of an affiliate that result in a material contingent exposure of the company's assets to liability.

The property/casualty RBC working group found that rapidly growing companies have a greater propensity to encounter financial difficulty. To reflect that

additional risk, insurers with growth exceeding an average of 10% per year over the three previous years receive a charge to premiums and reserves.

Like the life/health formula, the property/casualty formula addresses the presumption that not all that could happen will happen all at once through a covariance adjustment.

The Calculation of Total Adjusted Capital

Like the life/health RBC instructions, the property/casualty RBC instructions provide for a modification to the insurer's statutory capital and surplus in the calculation of total adjusted capital, the figure that is compared with the Authorized Control Level RBC to determine appropriate regulatory action. All non-tabular discounts are to be subtracted from statutory surplus with a five-year phase-in—20% the first year, with 20% added every year after until it is 100%.

The Model Act

A state insurance regulator compares the company's total adjusted capital against the risk-based capital requirement to determine if regulatory action is called for. That question is answered by the Risk-Based Capital for Insurers Model Act. The formula provides a mechanism for the calculation of an insurance company's Authorized Control Level Risk-Based Capital and its total adjusted capital. The model law sets the points at which a commissioner is authorized and expected to take regulatory action.

The first level is known as the Company Action Level RBC, which is set at twice the Authorized Control Level RBC. The second level is the Regulatory Action Level RBC, at 1.5 times the Authorized Control Level RBC. The third is the Authorized Control Level RBC, and the fourth is the Mandatory Control Level RBC, set at 70 percent of the Authorized Control Level RBC. (See table)

Risk-Based Capital Levels	
Name of RBC Level	**Percentage of Authorized Control Level RBC**
Company Action Level RBC	200 Percent
Regulatory Action Level RBC	150 Percent
Authorized Control Level RBC	100 Percent
Mandatory Control Level RBC	70 Percent

If a company files a risk-based capital report (RBC report) indicating that, while the total adjusted capital is higher than the Regulatory Action Level RBC, it is lower than the Company Action Level RBC, the insurer must submit to the insurance commissioner a comprehensive financial plan. That plan must identify the conditions in the insurer that contribute to the company's financial condition, contain proposals to correct the company's financial problems, and provide projections of the company's financial condition, both with and without the proposed corrections. The plan also must list the key assumptions underlying the projections and identify the quality of, and problems associated with, the insurer's business.

If the company's total adjusted capital falls between the Regulatory Action Level RBC and the Authorized Control Level RBC, or if the company fails to file an RBC plan when required, the commissioner will perform such examination or analysis as he or she deems necessary of the insurer's business and operations and issue any appropriate corrective orders to address the company's financial problems.

If the company's total adjusted capital falls below the Authorized Control Level RBC, in addition to those actions available to the commissioner for less serious financial problems, the commissioner may place the insurer under regulatory control. Finally, if the company's total adjusted capital falls below the Mandatory Control Level RBC, the commissioner will be required to place the insurer under regulatory control.

As of February 1994, five states (California, Illinois, Missouri, Nebraska and New York) have adopted the NAIC RBC model act as it applies to life/health insurers.

Conclusion

In January 1994, the NAIC established a standing task force, the Risk-Based Capital (EX4) Task Force, to evaluate and recommend appropriate refinements to capital requirements for all types of insurers. That task force will continue to research and refine the life/health and property/casualty risk-based capital systems. In addition, the task force will oversee the NAIC's next step in protecting consumers through risk-based capital standards, the development of an RBC for health organizations.

In 1993, the NAIC created the Health Organizations Risk-Based Capital Working Group. That working group is developing a separate risk-based capital formula for health insurance including traditional health insurers, health maintenance organizations (HMOs), Blue Cross/Blue Shield (BCBS) plans, and health service plans. The working group will expand the provisions in the current life/health formula to better measure risk in various health organizations.

For example, insurance companies invest extensively in marketable securities, and the risk-based capital factors are set accordingly. However, some health organizations have substantial assets in ventures—such as hospitals—that are used directly in providing services and, therefore, contribute directly to the health organization's ability to control quantity and cost of services. Also, some have suggested that health organizations transfer risk differently than do health insurers, with the former using such devices as negotiated fee schedules, budgets, and capitation rate agreements, and the latter focusing on reinsurance and stop-loss coverage.

The working group is addressing all these issues, along with many others. The NAIC's goal is to develop a seamless system of risk-based capital requirements that will be appropriate for the existing environment and accommodate future evolution as well. This should facilitate an even playing field for health insurers

BCBS plans, HMOs, and others, while not stifling the development of innovations.

Other Related NAIC Publications

The following NAIC publications deal with issues related to solvency regulation:

Insurers' Distribution of Assets

Insurers' Long-Term Mortgage Loans and Real Estate Investments

Insurers' Medium- and Lower-Quality Bond Holdings

Issues Concerning Insurance Guaranty Funds

Profitability by Line by State

The Financial Regulation Standards and Accreditation Program of the NAIC

The Valuation of Insurer Assets and the NAIC Securities Valuation Office

Persons interested in obtaining any of these publications or a catalog of all the NAIC's publications may do so by calling the NAIC Publications Department at (816) 374-7259.

II. Insolvency Risk and Risk-Based Capital

A. Property/Casualty Insurer Insolvency Risk

From an economic perspective, an insurer is insolvent if the economic (market) value of its assets is less than the economic (discounted) value of its liabilities, i.e., if the economic value of its net worth is negative. Because shareholders have limited liability, the shortfall will result in some combination of losses to policyholders and guaranty fund assessments on other insurers.

The immediate cause of insolvency can be reductions in asset values, (for example, defaults on bond investments or reductions in the market value of investments), or increases in liabilities for claims, (for example, large natural catastrophes, such as hurricanes and earthquakes or from unexpected increases in the frequency and severity of tort claims). Economic net worth may also become negative as a result of changes in interest rates, if increases in interest rates cause the market value of assets to fall much more than the discounted value of liabilities. However, property/casualty insurers are not subject to product disintermediation as are commercial banks and some life insurance products.

The underlying causes of insurer failures include bad luck and insufficient incentives for safety. While some insolvencies will occur even with substantial incentives for safety, inadequate or misguided incentives can result in excessive risk, including deliberate under-pricing of policies to generate cash prior to insolvency. The point at which "economic" insolvency occurs cannot always be determined with precision. "Accounting" net worth may differ substantially from economic net worth, due to differences that arise from conventional accounting practices or managerial efforts to manipulate reported net worth by overstating asset values and understating liabilities. A major problem in valuing property/casualty insurer net worth is that the liability for claims is not known with certainty for some lines of insurance until long after policies are sold. Regulators that believe an insurer is near insolvency may sometimes find it difficult to meet required standards of legal proof to remove the insurer from the market.

Although studies of insurer insolvencies during the late 1960's and early 1970's identified fraud and mismanagement as the primary causes of insurer insolvencies, the situation has changed since these studies were conducted. A recent study of property/casualty insurer insolvencies over the period 1969–1990 by the A.M. Best Company (1991) identified deficient loss reserves and/or inadequate prices as the most common "cause" of insolvency (results of the report are illustrated in Table 1). The table shows that rapid growth, which can sometimes indicate inadequate prices, also has been frequently associated with failure. Less common "causes" of failures include overstated assets, fraud, failure of reinsurance, and catastrophes.[1] Although the study found that the most important problem is inadequate prices, it is not clear whether prices were inadequate at the time business was sold, as opposed to being inadequate after the fact (i.e., after unexpectedly high claims have occurred).[2] The evidence of rapid growth suggests that underpricing up front has been important in some insolvencies, as one way insurers can grow rapidly is by cutting prices.

Table 1
PRIMARY CAUSES OF PROPERTY/LIABILITY INSURER INSOLVENCIES, 1969–1990

PRIMARY CAUSES	NUMBER OF COMPANIES	PERCENT OF TOTAL
Deficient loss reserves (inadequate pricing)	86	28%
Rapid growth	64	21
Alleged fraud	30	10
Overstated assets	30	10
Significant change in business	26	9
Reinsurance failure	21	7
Catastrophe losses	17	6
Miscellaneous	28	9
Total	302	100

Source: A.M. Best Company (1991).

The A.M. Best study found that 63 percent of property/casualty insolvencies during the period 1969–1990 occurred among small insurers, 34 percent among medium insurers, and only 3 percent among larger insurers. Insolvency rates (number of failures divided by number of companies) were much higher for small and medium size insurers than for large insurers and largest among medium sized insurers. However, it would clearly be a mistake to conclude from these statistics that the solvency regulation system should focus primarily on small and medium size companies. The potential for significant insolvency costs is much higher among larger companies even though the failure frequency for this group is lower. For example, 40 percent of property/casualty guaranty fund assessments since 1969 have been generated by five failures and 80 percent by only 25 failures.

More fundamentally, insolvency risk depends on potential volatility in asset returns and claim costs and on the incentives of insurers to reduce insolvency risk by holding more capital, investing in safer assets, reducing interest rate risk, purchasing high quality reinsurance, and diversifying across lines of insurance. Because these risk management methods are costly, safer insurance generally will be more expensive than risky insurance. Apart from any regulatory monitoring, incentives for safety in turn depend on several factors including the demand for safety by policyholders, the cost and ability of policyholders to identify and monitor safe insurers, and whether insurer insolvency will result in significant costs to insurer owners and/or managers.

Potential costs to insurance company owners from insolvency include the loss of future income arising from previous investments made by the insurer in building a reputation and a book of business. The possible loss of this "franchise value" will provide a significant incentive for many insurers to avoid insolvency.[3] This is true even if policyholders are unable to readily identify and monitor safe insurers -- or if policyholders are less concerned with safety because of guaranty fund protection. However, large reductions in net worth due to factors such as large, unexpected increases in claim costs can substantially increase the risk of insolvency and alter insurer incentives. Beyond some point, reductions in net worth may lead an insurer to "go for broke," i.e., to pursue very high risk strategies with the hope of delaying or preventing insolvency.

Costly monitoring of insolvency risk by policyholders, reduced incentives for policyholder monitoring because of guaranty funds, and the possibility of "go for broke" behavior provide the major rationales for regulatory monitoring of

solvency risk and other forms of solvency regulation. Regulation can reduce the cost of insolvency by monitoring insurers, by constraining excessively risky behavior, and by closing down as promptly as possible companies that have become insolvent.

The objective of solvency regulation should be to duplicate as closely as possible the outcome of a competitive market in which all parties have efficient access to all of the information needed for rational decisions. This means that solvency regulation should not attempt to prevent all insurer failures. Market exit through failure and voluntary withdrawal is a normal outcome in a competitive market. However, failed firms should not be permitted to place a significant burden on healthy firms and policyholders through guaranty fund assessments and delayed or incomplete payment of claims. Thus, the objective should be to facilitate where possible the rehabilitation of weak insurers and to bring about the orderly exit of unsuccessful companies as closely as possible to the point where the economic value of assets falls below the economic value of liabilities.

B. Theoretical Basis for Risk-Based Capital Requirements

In theory, risk-based capital refers to a system in which insurers would be required to meet or exceed a minimum capital requirement tied to specific characteristics of the company that are presumably related to the risk of insolvency. Under a risk-based capital system, if an insurer's reported capital (surplus) failed to exceed its required risk-based capital (or some percentage of risk-based capital), it would be subject to regulatory action. Possible regulatory responses that could be specified in a risk-based capital system might include increased monitoring, restrictions on growth, requiring the insurer to add more capital to avoid being placed in receivership, and/or placing the insurer in receivership or conservatorship. A well-designed risk-based capital system should help regulators identify financially weak companies while there is still time for rehabilitation and remove unsalvageable companies from the market before they incur significant deficits that would place a burden on healthy insurers. Such a system should also motivate insurers which otherwise would have inadequate incentives for safety to hold more capital and otherwise manage their operations to reduce their risk of insolvency in order to avoid increased attention or intervention from regulators.

Risk-based capital would differ fundamentally from the current system of minimum dollar capital (and surplus) requirements, which are identical for all insurers (or broad classes of insurers, such as stocks or mutuals). Existing minimum

capital requirements typically are less than or equal to $2 million. These requirements probably deter entry by some insurers that would otherwise be inadequately capitalized and likely to fail and facilitate regulatory action against small insurers that are experiencing financial difficulty. Existing minimum capital requirements, however, have little or no impact on insurers beyond some very small size. An advantage of this feature is that they do not constrain behavior and increase costs (and thus prices) for financially sound insurers. A disadvantage is that little or no guidance is provided to regulators about the adequacy of capital for all but the smallest insurers. Existing requirements also are of little value to regulators in providing a legal basis for intervening in the operations of all but the smallest insurers. In addition, a weak insurer's reported (statutory) capital may not fall below the legal minimum until the market value of its assets fall far below its true liabilities. Of course, regulators have already developed a variety of tools to monitor insurer capital relative to risk, including the Insurance Regulatory Information System (IRIS), less formal analyses of insurer premiums and liabilities relative to capital, and the assessments developed by private rating agencies.

A formal risk-based capital system offers several possible advantages compared to the existing systems of minimum capital requirements and regulatory monitoring of capital relative to risk. These advantages have the potential to achieve an efficient reduction in the expected cost of insolvencies. As noted, a well-designed risk-based capital system should encourage greater safety for insurers for which market incentives for safety are inadequate. A genuinely well-designed risk-based capital system will also provide guidance and assistance to regulators. It will provide information to help identify weak companies and to facilitate regulatory intervention either before an insurer becomes insolvent or at a minimal level of deficit.

A risk-based capital system will give regulators legal authority to intervene if reported capital falls below risk-based capital requirements (or some percentage of risk-based capital). This authority will be valuable in cases where it might otherwise have been difficult for intervention to be upheld by the court system. In some instances, a risk-based capital system may force regulators to take some action rather than delay intervention due to pressure from the troubled company or the hope that things will get better without having to declare an insurer insolvent or to significantly restrict its activities.

At the same time, there are possible systems besides risk-based capital that could encourage insurer safety and facilitate regulatory monitoring and prompt regulatory attention to weak

insurers. For example, a system of financial ratio analysis in which regulatory action would be required under specified circumstances in principle could help achieve these goals.[4] This type of system could in effect create implicit capital requirements for insurers in order to avoid increased regulatory attention. The theoretical advantages of risk-based capital over a ratio based system include greater ability to reflect and aggregate the major aspects of insurer risk and the creation of an explicit linkage between insurer risk and required capital.[5]

On the other hand, risk-based capital requirements have a number of serious potential limitations. It is infeasible for a risk-based capital system to duplicate precisely the capital levels and incentives for safety that would exist in a dynamic, competitive environment in which both consumers and insurers have adequate incentives for safety. Insolvency risk depends on numerous factors that are difficult to quantify, and the insurance market is characterized by substantial diversity across insurers in types of business written, characteristics of customers, and methods of operation. It is impossible to specify the "right" amount of capital for most insurers through a formula. Unavoidable imperfections in any meaningful risk-based capital system will likely distort some insurer decisions in undesirable and unintended ways. As we discuss further below, overly stringent risk-based capital requirements would produce significant market dislocations to the detriment of many insurers and consumers. Thus, the desire to achieve the objectives of a risk based capital system must be tempered by the reality that any such system will be imperfect and that the inevitable imperfections have the potential to impose significant costs on healthy insurers.

In addition, risk-based capital requirements by themselves will do little or nothing to help regulators determine whether an insurer's reported net worth is overstated. The great difficulty in determining whether an insurer's reported losses and loss reserves are significantly understated, especially for long-tailed lines of business subject to large volatility in costs, limits the ability of risk-based capital to encourage weak insurers to hold more capital and to assist regulators. In fact, poorly designed risk-based capital requirements could increase incentives for some insurers to under-report loss reserves in order to show lower required risk-based capital, higher capital relative to required risk-based capital, or both. In general, some insurers will try to manage their required level of risk-based capital through means that do not reduce risk or increase economic net worth. Thus, risk-based capital is not a substitute for regulatory monitoring of prices, reserves, and other financial variables.

C. Goals and Objectives of Risk-Based Capital

The overall goal of risk-based capital should be to minimize the expected cost of insolvency, including both direct and indirect costs. The direct costs of insolvency include the regulatory monitoring and prevention which are ultimately borne by insurance buyers. The most important indirect costs are market dislocations and distortions caused by the inevitable inaccuracies that will be imbedded in any practical risk-based capital system. These costs encompass unintended adverse effects on insurance pricing and availability as well as penalties to owners of sound insurance companies resulting from inaccurate signals from the risk-based capital system. In other words, the potential benefits of risk-based capital must be balanced against the costs that arise because of the infeasibility of duplicating the outcome of an efficient competitive market. A well-designed risk-based capital system must achieve an appropriate balance among a number of specific objectives related to risk measurement and market responses to risk-based capital requirements:[6]

1. **The risk-based capital formula should provide incentives for weak companies to hold more capital and/or reduce their exposure to risk without significantly distorting the decisions of financially sound insurers.**

A major goal of a risk-based capital system should be to improve the incentives of insurers to reduce the expected cost of insolvency in efficient ways. Because market incentives for safety are inadequate in some cases, some insurers may pose too great a threat of insolvency. Risk-based capital should encourage insurers for which market incentives for safety are inadequate to hold more capital and/or take other actions to reduce risk. It should be emphasized that these actions generally will lead to higher premium rates for these insurers.

When attempting to affect the behavior of weak insurers, risk-based capital requirements must confront a basic tradeoff: increases in the amount of required risk-based capital may likely reduce the frequency and severity of insolvencies, but they will also lead to more and greater distortions in the decisions of financially sound companies. If risk-based capital requirements are set too low, they will have little effect on insolvencies. However, if they are set too high, they will create costs that exceed the benefits of lower insolvency costs. As we discuss further below, adverse consequences include that the price of coverage would become higher than necessary.

2. **The risk-based capital formula should reflect the major types of risk that affect insurers and how these risks differ across insurers.**

It is important that all major types of risk be reflected in the formula. To the extent possible, the types of risk incorporated in the formula should be related to the underlying theory of insurer insolvency risk and the empirical evidence on the causes of insolvencies. Subject to practical considerations, the major types of risks should be measured as accurately as possible. This will reduce the extent of undesirable distortions on decisions and make it more difficult for insurers to increase risk in ways that are not constrained by the system. It also will make it less likely that certain segments of the industry will be unfairly and inefficiently disadvantaged by application of the formula. For example, the formula should not have differential effects on stocks vs. mutuals, agency companies vs. direct writers, or small vs. large companies unless there is clear evidence of significant differences in risk between the groups that can be measured with reasonable precision.[7]

3. **The risk-based capital charges (or weights) for each major type of risk should be proportional to their impact on overall risk of insolvency.**

Differences in risk-based capital charges for the major types of risk should be consistent with their importance in explaining prior insolvencies based on both theoretical and empirical analysis. For example, since both theory and evidence suggest that a large proportion of property/casualty insurer insolvencies were associated with inadequate prices and loss reserves rather than reductions in asset values, the formula should produce results that are broadly consistent with these findings.

4. **The risk-based capital system should focus on identifying insurers that are likely to impose the highest costs of insolvency.**

Although most insurers that fail are small and insolvency frequency rates are higher among small insurers than for larger insurers, a relatively small number of insurance failures have also imposed substantial insolvency costs on the guaranty fund system. Although about 200 insurer insolvencies have resulted in guaranty fund assessments since 1969, five failures account for 40 percent of the assessments and twenty-five account for 80 percent (A.M. Best Company, 1991). Clearly, the objective of reducing total insolvency costs can best be achieved by focusing resources on the identification of those companies that

have the greatest risk of imposing high costs in the event of financial distress.

5. **The formula and/or the measurement of actual capital should reflect economic values of assets and liabilities whenever practicable.**

Net worth calculated according to either statutory or generally accepted accounting principles can differ significantly from the economic value of net worth. For example, loss reserves generally are not discounted and bonds are carried at amortized value rather than market value (or estimated market value). Ignoring potentially large differences between accounting and economic values would reduce the ability of a risk-based capital system to assist regulators and encourage greater safety for weak companies.

6. **To the extent that is possible, the risk-based capital system should discourage under-reporting of loss reserves and other forms of manipulation by insurers.**

As noted, poorly-designed risk-based capital requirements might increase incentives for insurers to under-report loss reserves. They also might be subject to other forms of manipulation by insurers through the presentation of their financial results. The formula should be designed to reflect and control these possibilities to the extent that is practically feasible.

7. **The formula should avoid complexity that is of questionable value in increasing accuracy of risk-measurement.**

Increased complexity will likely be subject to diminishing returns in increasing accuracy. Giving up potentially minor (or questionable) increases in accuracy to reduce complexity will make the system easier to explain, understand, and use. Increases in complexity will make it more difficult for insurers to discern the implications of their decisions on required risk-based capital, and it may lead some users to mistakenly believe that the system is more precise than actually is the case. Additional complexity could increase the likelihood of significant unintended consequences, because of the additional difficulty in considering all of the possible effects of risk-based capital on the market. As a practical matter the benefits and costs of any additional data reporting under a system of risk-based capital also will need to be considered carefully.

FISCAL NOTE

1

STATE OF ALASKA
1994 LEGISLATIVE SESSION

Bill Version: SB 342
(S) Publish Date: 3-18-94

Revision Date:
Title: Risk Based Capital For Insurers
Sponsor: Labor & Commerce Committee
Requestor:

Department Affected: Commerce and Economic Development
BRU: Insurance
Component: Operations
COMPONENT SERIAL NO. 354

Expenditures/Revenues:

OPERATING EXPENDITURES	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LAND & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
TOTAL OPERATING	0	0	0	0	0	0
CAPITAL EXPENDITURES	0	0	0	0	0	0
CHANGE IN REVENUES ( )	0	0	0	0	0	0

FUND SOURCE

	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
1002 Federal Receipts	0	0	0	0	0	0
1003 GF Match	0	0	0	0	0	0
1004 GF	0	0	0	0	0	0
1005 GF/Program Receipts	0	0	0	0	0	0
1006 GF/MHTIA	0	0	0	0	0	0
Other	0	0	0	0	0	0
TOTAL	0	0	0	0	0	0

Estimate of current year (FY 94) cost: $ 0

POSITIONS

	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00
FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: (Attach a separate page if necessary.)

No fiscal impact.

Changes in CSSB 342 (L&C) have no fiscal impact. This fiscal note is appropriate.
3/16/94 date — JPF Comme Aide (initial)

Prepared by: Joan Brown, Administrative Officer
Division: Insurance
Phone: 465-2597
Date: 3/10/94

Approved by Commissioner: Paul Fuhs
Agency: Commerce and Economic Development
Date:

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The Many Advantages Of a Hybrid Company

BYLINE: By Jan M. Rosen

BODY

NEW YORK and New Jersey are expected to enact legislation soon allowing privately owned businesses and partnerships to organize as limited liability companies, which combine the tax advantages of a partnership with the legal protection of incorporation.

California and a dozen other states are considering similar proposals, and 31 states already recognize limited liability companies -- so named because liability for such things as legal judgments against a company or bankruptcy are limited to the entity's assets like a corporation. These businesses do not put their owners' personal assets at risk beyond their original investment.

"It's the wave of the future; it provides more flexibility with protection from liability," said Assemblywoman Harriet Derman, Republican of Metuchen, who is sponsoring the measure in New Jersey and expects passage this month.

Accounting firms, for example, are eager to avoid a repeat of "the fiasco when Laventhol & Horwath went under," and partners were personally liable for millions of dollars owed by the partnership, she said. That bankruptcy, which led to a snarl of litigation, caused some managers of other firms to voice doubts about accepting partnerships, if offered.

Kenneth J. Norcross, a partner in Pitney, Hardin, Kipp & Szuch in Morristown, N.J., said that limited liability companies could be useful for "everything from new ventures at A.T.& T. down to the corner deli."

With partnerships, income and losses flow directly to the partners, avoiding corporate taxation, but partners' personal assets can be at risk for their firm's liabilities.
To protect themselves from liability, business owners can incorporate. But they will face Federal corporate taxation unless the business meets the rigorous requirements for an S corporation: no more than 35 partners, no foreign partners and only one class of stock.

Family businesses often want two classes of stock, voting shares for the family members active in the business and nonvoting for those who are not. Thus, they are precluded from a S corporation, but they could set up a limited liability company.

- ARTICLES ON LIMITED LIABILITY COMPANIES

Most existing corporations are not likely to want to convert, Mr. Norcross said, because they would face "an exit tax" for dissolving their current incorporation.

He predicts, however, that when the legislation passes in New York, New Jersey and California -- all important states for business -- there will be a rush to adopt the new form, which is already permitted in other big business states, including Illinois, Texas, Florida and Delaware.

Brian L. Schorr, a partner in Paul, Weiss, Rifkind, Wharton & Garrison, and co-chairman of a drafting committee for the measure pending in Albany, said, "I think it has broad application in real estate, joint ventures, atrical investments, high technology and venture capital," as well as oil and gas, replacing both actively managed partnerships and passive investment partnerships. However, attention should be given the state tax treatment of limited liability companies, Mr. Schorr said.

The measures pending in New York and New Jersey, like the one recently adopted in Delaware, are flexible, allowing businesses to tailor their limited liability companies for their own purposes, Mr. Schorr pointed out. But to qualify for the same tax breaks as partnerships, he cautioned, the limited liability companies must comply with Internal Revenue Service requirements.

SUBJECT: CORPORATIONS; PARTNERSHIPS

NAME: ROSEN, JAN M

GEOGRAPHIC: NEW YORK STATE; NEW JERSEY

WALL STREET JOURNAL TUESDAY, MAY 14, 1991 ....

ENTERPRISE

Partnership, Corporation Aren't Only Ways to Start Out

Forming as a Limited Liability Company Offers Best of Both Worlds

By JEFFREY A. TANNENBAUM
Staff Reporter of THE WALL STREET JOURNAL

Robert H. Kane's start-up enterprise is a mouthful: Octagon Communications Limited Liability Co.

The name doesn't exactly have a ring to it. It's rather awkward on stationery and business cards. It even fails to convey the company's intended business: investments in rural cellular-telephone companies.

But loud and clear, the name conveys something else: a new form of ownership that Mr. Kane and his seven partners expect will serve them well. Their enterprise—to be based in Denver—is neither a traditional partnership nor a traditional corporation. Rather, under Colorado law, it is a "limited liability company," or LLC.

Growing Interest

Mr. Kane and his partners expect to enjoy the best of both worlds: the tax advantages of a partnership and the legal safeguards of a corporation. Yet they face none of the drawbacks associated with forming a so-called subchapter S corporation, which also is taxed much like a partnership. For example, S corporations can't have corporate shareholders, but LLCs can. "If some corporation ever wants to offer me jillions of dollars for my interest, I'll be able to sell it," Mr. Kane says.

Not yet worth jillions, Octagon doesn't even have an office. But it is in the forefront of a movement toward the LLC as a form of ownership for small U.S. businesses and joint ventures. "Interest in the LLC concept is growing remarkably fast," says John R. Maxfield, a Denver lawyer who helped write the LLC law there.

Fast, anyway, by the slow-paced standards of lawmaking. In 1977, Wyoming became the first state to authorize LLCs, but it took until 1988 for the Internal Revenue Service to confirm that the new Wyoming entities would be treated as partnerships for federal tax purposes.

To date, only five other states—Colorado, Florida, Kansas, Virginia and, most recently, Utah—have followed Wyoming in authorizing their own LLCs, according to an American Bar Association survey. But lawyers in many other states report growing interest because of the IRS ruling. Two ABA panels are studying the topic, as is the National Conference of Commissioners on Uniform State Laws, a group allied with the ABA. Meantime, moves are afoot to introduce LLC statutes in Arizona, Illinois, Maryland, Michigan, Nevada, Ohio, Oklahoma and Texas, the ABA survey found.

"I'm stunned by the amount of excitement generated by these entities," says Barbara C. Spudis, a Chicago attorney and the head of one ABA panel on LLCs.

Flexibility of a Partnership

One appeal of LLCs is that, as with partnerships, any income flows through untaxed to the individual owners. Such owners don't avoid personal taxes, but they do avoid corporate taxes. Regular corporations face higher maximum taxes in the first place. And if the corporations pay dividends, owners are taxed again.

Of course, S corporations avoid double taxation—but they don't enjoy all the advantages of partnerships when it comes to juggling income and deductions. For example, the 20%-owner of an S corporation normally must pay taxes on 20% of any income. By contrast, partnership members are free to divvy up any income and tax liability as they see fit. Thus, equal partners might change the allocations of profit or loss year to year to fit their individual tax needs. LLCs offer the same freedom.

With LLCs, as with regular corporations, only the company's assets, and not the owners' personal assets, are at risk in business-related lawsuits. In partnerships, so-called limited partners enjoy such protection, but general partners don't. And limited partners face restrictions on how active they can be in the business. LLCs are designed to protect all partners while imposing no limits on their activity.

Not surprisingly, lawyers in a few states say LLCs are an easy sell. Since Colorado's LLC statute went into effect in April 1990, 250 LLCs have been organized there, an official says. Forming an LLC usually costs $1,000 to $5,000 in attorney and filing fees, depending on complexity, says Mr. Maxfield, the Denver lawyer.

But some state programs have drawbacks. Florida LLCs are exempt from federal corporate taxes but subject to the state's 5.5% corporate-income tax. Since Florida has no personal income tax affecting partnership income, "that 5.5% is enough to scare people off," says Jose M. Sariego, a Miami lawyer.

Moreover, the IRS has yet to give its imprimatur to any state LLC program except Wyoming's, though a few LLCs elsewhere have gotten favorable private-letter rulings. And lawyers say it's unclear how enterprises treated as LLCs in their home states will be treated in states without LLC laws. Of the states without LLCs, Indiana alone explicitly recognizes LLCs organized elsewhere. "There has been no litigation on LLCs," says Robert R. Keatinge, a Colorado lawyer who heads the other ABA panel on LLCs. "And nobody wants to be the test case."

Benefit for Foreigners

Still, proponents say the LLC raises little risk for enterprises operating only in their home state or outside the U.S. And it's ideal for foreign investors—normally barred from S corporations.

LLCs don't limit the number or type of owners, as S corporations do, except for a two-owner minimum. But because of other restrictions, only closely held enterprises are suited to be LLCs. For example, if any owner leaves, the others must all formally agree to keep the enterprise going. "If you have 200 members, it's hard to get everybody to sign off on anything," Mr. Keatinge says.

But even closely held companies face uncertainties on a number of technical and procedural issues, such as whether the conversion of a partnership into an LLC amounts to a "termination" under tax law, which might increase tax liability. IRS rulings are still awaited. In the meantime, warns Ms. Spudis, the Chicago lawyer, many LLC investors are entering uncharted territory.

INTRODUCING THE

Limited Liability Companies: Gaining *Momentum*

By Thomas Earl Geu

The limited liability company (LLC), a unique and relatively new form of unincorporated business organization, is available by statute in 24 states and is being considered to some extent in almost every other jurisdiction. An LLC is a hybrid form of business created by combining the organizational and tax attributes of partnerships and corporations in a unique mix.

In many respects the LLC resembles its organizational cousin, the limited partnership, because it may qualify for partnership "flow through" federal income taxation while retaining limited liability for its members. Unlike a limited partnership, however, an LLC is not required to have a general partner with "unlimited" liability. In that regard the LLC more closely resembles the S corporation, which also approximates the "flow through" income taxation. Conceptually, therefore, the LLC may be analogized under existing law to a combination entity consisting of a limited partnership with an S corporation general partner. The LLC, however, carries much less tax and organizational baggage and complexity than a *combination* entity. In short, the LLC seems to be an efficient and flexible form of business that allows its members both limited liability and partnership federal income tax treatment.

Origins: The Limitada Model

LLCs are also similar, and owe their origin, to other types of recognized business organizations. For example, the legislative history of the seminal 1977 Wyoming LLC act expressly compared the LLC to the partnership association adopted in Pennsylvania in 1874, in Michigan in 1877 and in several other states. The LLC is also similar to "limitada," a Latin American business form that in turn is similar to the German GmbH.

Partnership associations largely became extinct as viable business entities because they generally placed a cap on the maximum number of members; suffered from the lack of widespread availability of enabling or registration provisions to facilitate interstate business; and, after the advent of the federal income tax, suffered from uncertain tax treatment.

The limitada, by contrast, was viable in foreign jurisdictions when Wyoming adopted its LLC act in 1977; and its viability continues today. The attributes of the limitada generally include management by an "administrator"; limited liability; and continuous life for at least 20 years without limitation by death, separation or dissociation of its members.

The limitada was, in fact, the genesis for the original Wyoming legislation, which was prompted by the request of an oil company to make the benefits of the limitada available in this country. The limitada was also important in Florida's enactment of the second LLC act. The Florida legislative committee examining the act heard testimony that the LLC would encourage international investment from Central and South America by giving investors from that region a familiar investment vehicle in the United States. Thus the LLC, at least in a sense, evolved from the old partnership association in the United States, and its development was encouraged by the success of limitadas and similar organizations in the western hemisphere and in other civil law nations such as France, Germany, Greece and Saudi Arabia.

Neither Wyoming nor Florida LLCs were immediately popular with business planners. Only two Florida LLCs were formed in the first year after enactment of enabling legislation. Wyoming LLCs formed at an average rate of only three a year between 1978 and 1988. In 1988, however, the IRS issued Rev. Rul. 88-76, which classified a Wyoming LLC as a partnership for federal tax purposes. Since the issuance of Rev. Rul. 88-76, neither the IRS nor state legislatures have looked back. Two states adopted LLC acts in 1990, four in 1991, 10 in 1992, and legislation has been introduced in more than 20 states in 1993. The increase in the number of states

> "Thus the LLC, at least in a sense, evolved from the old partnership association in the United States, and its development was encouraged by the success of limitadas and similar organizations in the western hemisphere and in other civil law nations such as France, Germany, Greece and Saudi Arabia."

adopting LLC legislation led the National Conference of Commissioners on Uniform State Laws (NCCUSL) to appoint a committee to draft a uniform LLC law, which could be approved as early as August 1994.

Federal Income Tax Classification

One way to understand the LLC is to look at the criteria that distinguish an organization taxed as a partnership from an organization taxed as a corporation (an "association" in tax classification parlance). In addition to an aid in understanding the LLC, tax classification is a critical factor in entity choice.

The primary source for determining whether a business organization will be taxed as a partnership or a corporation is Treas. Reg. § 301.7701, which lists six basic characteristics usually found in corporations: (1) associates (members), (2) an objective to carry on business and to divide the gains therefrom, (3) continuity of life, (4) centralized management, (5) liability for debts limited to corporate property and (6) free transferability of interests. The first two "major characteristics" are common to both partnerships and corporations and are ignored in distinguishing the two entities.

To be classified as a corporation for federal income tax purposes, an organization must have at least three of the last four characteristics. To be classified as a partnership, therefore, the LLC must *fail* at least two of the four tests for corporations.

• **Continuity of life.** An organization lacks continuity of life, according to Treas. Reg. § 301.7701-2(b), if the death, insanity, retirement, resignation or expulsion of any member of a general partnership, or of the general partner of a limited partnership, causes a dissolution. The fact that the remaining members may agree to continue the partnership does not necessarily mean that the organization possesses continuity of life. The continuity of life standard was applied to a Wyoming LLC in Rev. Rul. 88-76 and the IRS ruled that the LLC lacked continuity of life.

The Wyoming LLC statute provided that the LLC dissolved at the death, retirement, resignation, bankruptcy, expulsion, dissolution or any other event terminating a member's membership unless *all* remaining members consented to continue the business under a right to do so stated in the organizational documents. Newly proposed tax regulations, however, would allow a majority (rather than all) of the remaining general or limited partners in a limited partnership to continue business after a dissolution event involving a general partner without that organization being deemed to have continuity of life. Presumably the same rule would apply to an LLC classified as a partnership for tax purposes.

• **Free transferability of interests.** Federal regulations provide that free transferability of interests exists if substantially all of the complete interests in the partnership, including governance and economic rights, can be transferred "without the consent of other members." The regulatory language does not require all other members to consent to the transfer. As a result the IRS informally has ruled in PLR 9210019 that a Texas LLC requiring only the majority vote of the other members to transfer a "complete interest" lacked free transferability.

• **Centralized management.** Centralized management exists if a group that does not include all members has the exclusive authority to make management decisions on behalf of all members. The Wyoming LLC in Rev. Rul. 88-76 vested management in three of 25 members. Therefore the IRS ruled that the LLC had centralized management.

Recent LLC rulings help to define the parameters of centralized management. In Rev. Rul. 93-6 (Colorado), the IRS ruled that centralized management existed in a five member LLC, where all five members were elected managers. The IRS reasoned that the act vested management authority in managers rather than members and, thus, that membership alone did not permit management authority. Therefore, the five "managers" constituted centralized management even though the "managers" were also the only members of the LLC. Further, in Rev. Rul. 93-5 (Virginia) the IRS stated that centralized management could result from the use of various techniques

that concentrate power in fewer than all members. The ruling identified the use of proxies as among the several techniques that can result in centralized management.

• **Limited liability.** Almost by definition, and in almost all cases by express design, an LLC will possess limited liability. In most cases limited liability is one of the reasons for organizing an entity as a limited liability company. The regulations state that an organization possesses limited liability if no member is personally liable for debts or claims against the LLC.

Based on these four "major characteristics," it is relatively easy to obtain partnership classification of an LLC for federal income tax purposes. The importance of the tax factors to the LLC form of business has led to a variety of approaches to drafting statutes. These approaches are usually labeled either "bulletproof" or "flexible." Bulletproof statutes *mandate* failure of at least two of the four major corporate tax attributes, most commonly continuity of life and free transferability.

Flexible statutes, by contrast, allow the members to pick and choose which tax classification characteristics they want the LLC to fail. Thus, LLCs organized in compliance with flexible statutes grant the members discretion in structuring the LLC. LLCs organized under flexible statutes, however, will not "automatically" meet the partnership classification requirements. Nonetheless, even flexible statutes provide "default" provisions that will govern in the absence of agreement to the contrary. These default provisions *usually* result in partnership classification. Obviously, planners in states that have flexible statutes must be very careful to structure the LLC so that it qualifies as a partnership for federal income tax purposes if such treatment is important to the members of the LLC.

Partnership Taxation Advantages

Although a comparison of S corporation taxation and partnership taxation is beyond the scope of this article, a basic understanding of a few of the tax differences is necessary to understand when to use an LLC instead of an S corporation. Two of the big advantages of partnership taxation when compared to S corporations are eligibility and special allocations.

The S corporation eligibility requirements are very specific and severely limit the businesses that may avail themselves of S status. The most important of these eligibility requirements are the requirements that only domestic corporations (those formed in the United States) qualify for S status, that S corporations have no more than 35 shareholders, that each shareholder be an individual or a limited type of trust (a qualifying trust), that none of the shareholders is a nonresident alien, that the corporation have only one class of stock, and that the corporation timely elect and file to be taxed as an S corporation.

Although perfection of the election might seem perfunctory, complications may arise because the statute governs both when and by whom the election must be made. S status terminates whenever any of the eligibility requirements cease to be met. This could occur, for example, when the 35 member limitation bumps into a second or third generation estate plan, when a decedent fails to craft a trust as a qualifying trust or when it is necessary to seek more equity capital for a growing concern. Limitations exist on the percentage amount of passive revenue that may be received by an S corporation before risking termination. Limited liability companies do not suffer from these limitations when they are taxed as partnerships.

Another major advantage of partnership taxation, compared to S corporation taxation, is that income and loss my be specially allocated to different partners (within statutory parameters). S corporation shareholders must receive their pro rata share of the corporation's income and loss. The availability of the special allocation is probably most important in capital intensive organizations, including real estate transactions, where pass-through loss treatment may be an important factor in the investment decision.

Other differences between the federal income taxation of S corporations and partnerships include different tax treatment on liquidation and basis treatment of a member's or shareholder's debt.

Unfortunately, tax questions arise when an LLC is classified as a partnership, in part because several tax issues turn on the distinction between general and limited partners. The distinction between general and limited partners creates interpretive questions because an LLC member is neither a limited nor a general partner. There are also unresolved tax issues concerning accounting method, passive loss limitations, at-risk limitations, the unified audit rules, and self-employment taxes. Even so, the combination of partnership tax treatment and organizational flexibility are generally viewed as advantages of the LLC compared to the S corporation, and in many instances these more sophisticated tax issues will not be determinative of entity choice.

Estate and gift tax valuation issues also may be important in the selection of an entity for a closely held (especially family) business. The troublesome valuation issues that arise in the use of other organizations also exist for LLC use. One of the valuation pressure points, for example, is IRC § 2704(b), a successor to the old anti-freeze § 2036(c). Section 2704(b) imposes valuation limitations in the family business setting when there are greater liquidation restrictions by agreement than according to state law. This places a premium on the careful crafting of the LLC. Further, administrative rulings like Rev. Rul. 93-12, which deals with minority discount, would apply by analogy to the LLC.

Finally, state tax treatment of LLCs may be important in entity selection. Indeed, state revenue loss projections because of LLCs have been hotly contested in many state legislatures. Revenue projections may vary widely, depending on the assumptions used

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concerning which entities will choose or convert to the LLC form. A lack of uniformity characterizes the state tax treatment of LLCs. Several states simply mirror the federal income tax scheme and classify LLCs as partnerships for state tax purposes. Delaware, Minnesota and other states require LLCs to pay a minimum annual filing fee or tax. Florida and Texas tax LLCs essentially as corporations under their income or business franchise taxes. In other states, like Illinois, the taxing structure is more complicated and somewhat ambiguous.

Multi-State LLC Operations

One problem with the use of LLCs is their "extra-territorial" use in multistate business. Fortunately, this problem is becoming less important as more states adopt LLC legislation that provides for registration of foreign LLCs. When an LLC does business in a state that does not statutorily recognize LLCs, a risk exists that the forum (non-adopting) state will not recognize the limited liability of the LLC granted by the adopting state.

"Comity," as a general matter, requires the forum state to recognize and admit the operation of the laws of the domiciliary state (the state of organization) when those laws are not contrary to its own public policy. Matters of comity, therefore, often involve difficult policy issues unique to the forum state. Two lines of reasoning exist to resolve the problem:

- The forum state may recognize the limited liability of the LLC because it already recognizes by statute the limited liability of corporations and limited partnerships.
- The forum state may reason that the public policy of the state is to grant limited liability only by express statute and, in the absence of statute, that the forum state does not recognize the limited liability of LLCs. Ultimate resolution of this "comity" issue also may involve general conflicts of laws, full faith and credit, due process and the commerce clause.

State Operating Provisions and Choice of Entity

The various state LLC acts address the same organizational issues addressed by statutes governing other business organizations. LLC statutes, for example, address formation, contributions, filing, agency powers of members, governance rights of members, liability of members, organizational record and information requirements, sharing and allocation of profits and losses, the identification of dissolution events, effect of occurrence of dissolution events, and rights on liquidation. Because of the present lack of uniformity in state LLC acts, it is not possible to state general principles that apply in every state. However, a common statutory LLC pattern does exist:

1. Almost all state acts provide for two organizational documents, usually identified as the "articles of organization" and the "operating agreement." The authoritative weight given these documents is consistent with flexibility, one of the hallmarks of the LLC. As a result, many matters may be agreed on by the members. A trend may be developing that the operating agreement serves as the basic organizational document (like the limited partnership agreement) and the articles serve only a notice function (like the certificate of limited partnership). Several states more closely follow the corporate model, however, under which the articles play a far greater role in the hierarchy of authority than that just described.

2. Except in a few states, governance and agency authority is vested in the members unless otherwise provided in the organizational documents. The documents usually may vest governance in either "managers" or in "members."

3. The statutes provide for dissolution on the happening of specified events and at the end of a term of years (usually 30). Whether the parties may continue the business after dissolution or may avoid dissolution altogether is uniquely a matter of the particular state law and also has federal income tax implications.

4. Upon dissolution or withdrawal of a member, the statutes provide for a "buy-out" or "put" of that membership interest, much like that afforded by the Revised Uniform Limited Partnership Act.

5. States have treated voting and profit sharing either on the basis of membership (one person/one vote, per capita) or on the ratio of the

member's original contribution or capital account to the total original contribution or the total capital accounts of all members (pro rata). Again, the voting and profit sharing arrangements may vary in the LLC documents.

6. One of the most important state law LLC attributes is the limited liability of members. Particularly in LLCs with a small membership, however, there are several ways this advantage may be nullified in the normal course of business, much as limited liability is subject to nullification in the close corporation context. Tort liability, for example, will accrue to any individual member who has personal responsibility in the commission of the tort. Contract liability for the debts of the organization is often dealt with contractually by using guarantees and similar arrangements. "Piercing the veil" issues, although generally an open question for LLCs, also may be addressed by courts. Finally, creditors and others might attempt to assert the law of agency in an attempt to find personal liability.

Rules of thumb for LLC use are difficult to state because of the flexible LLC structure. Nonetheless, commentators have suggested the LLC be used for real estate investment, receivables financing, corporate joint ventures and entrepreneurial and family businesses. Most states also allow professionals to organize as, and use, LLCs subject to the state's professional corporation act.

Foreign investors may favor LLCs over unfamiliar forms of business such as the corporation. The comfort level of foreign investors may play an increasingly important role, given the current status of the North American Free Trade Treaty. Finally, many knowledgeable lawyers believe that the LLC choice is most appropriate to organizations that otherwise would choose a different flow-through tax entity such as a partnership, limited partnership or S corporation.

Conclusion

The limited liability company is an important organizational development for business planners. It offers many advantages over other business organizations. It is, however, only an additional arrow in the business planner's quiver of available organizations and clearly not a panacea. Indeed, the demise of other business forms due to the LLC is probably greatly exaggerated, because most LLCs will suffer the disadvantages of lack of free transferability of interests and lack of perpetual life. As a result, many, perhaps most, entities choosing to operate as C corporations before the advent of LLCs probably will continue to choose C corporation status. Moreover, federal income tax classification as a partnership brings the LLC under the same package of "tax shelter" rules designed to combat abusive limited partnerships. These rules include, for example, the publicly traded limited partnership rules, the passive activity loss limitations and the at-risk rules.

The primary advantage of the LLC may be its efficiency in accomplishing business planning goals that already can be accomplished by using a combination of other organizations.

Although the LLC form of business is an extremely important addition to the existing menu of business entities, the LLC is neither the first nor the last business form to evolve through time. LLC use must be matched carefully to client needs, just as the use of more familiar organizations must be matched to client needs.

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MEMORANDUM

HUGHES THORSNESS
GANTZ POWELL & BRUNDIN
ATTORNEYS AT LAW

TO: Senator Tim Kelly
Senate Labor & Commerce Committee
ATTN: Josh Fink (Via Fax 465-3756)

FROM: Robert L. Manley
Chairman, Working Group on Limited Liability Companies
Composed of Members of the Tax Law and Business Law
Sections of the Alaska Bar Association

RE: Senate Bill 347
Limited Liability Companies

DATE: March 22, 1994

I am writing to provide you with some additional information on limited liability companies. LLC's are a relatively new form of business entity in the United States. At the present time, 37 states have enacted LLC legislation and legislation is pending in a number of other states. Enclosed for your reference is a brief bibliography on the subject.

LLC is a business entity which combines the best features of a corporation and a partnership. Like corporate shareholder, LLC owners are not responsible for company liabilities beyond their investment. Like a partnership, there is no corporate double taxation. Rather, owners (like partners) incur federal income taxation at the individual level based on the profits and losses allocated to them.

The proposed legislation is drawn largely from a prototype act drafted by a working group of the Business Law Section of the American Bar Association with input from the Alaska Department of Labor & Commerce. The Alaska working group has modified various provisions to conform with Alaska procedure and additional developments in the law.

At this point, the lack of LLC legislation puts Alaska at a competitive disadvantage in attracting investment from outside. This is particularly so with foreign investors who are familiar with the limited liability company format because it is commonly used in European, Asian and South American countries.

An LLC can provide investors with conduit tax treatment, limited liability for investors, and freedom from many of the restrictions imposed on S-corporations and limited partnerships. As indicated LLC legislation is particular important to facilitate foreign investment. At the present time, non-resident aliens may not be S-corporation shareholders. Thus, in order for those investors to secure limited liability, they must operate as C-corporation shareholders (subject to double taxation) or as limited partners in a limited partnership (giving up operational control).

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