# INNOVATION AND THE ORGANIZATIONAL CONTRACT: LESSONS FROM INCOME TRUSTS

EDWARD M. IACOBUCCI*

*This Article investigates why North American businesses typically do not adopt the trust form, other than as a financing vehicle. It examines an episode in Canada in which the trust form became very popular amongst publicly traded businesses. Until 2006, there were significant tax advantages associated with adopting an "income trust" structure. Regardless of the tax motivations for the form, the income trust offered businesses greater flexibility in choosing their governance rules than that offered by the corporate form. Income trusts often took advantage of this flexibility, deviating from mandatory corporate law rules on a number of dimensions. This Article finds that there were positive market reactions to innovations in governance by income trusts. However, once the law changed to remove the tax advantages of income trusts, the form all but ceased to be adopted—despite relatively low costs of adoption. On balance, this Article suggests that innovative trust structures are not especially valuable from a pure governance perspective, though governance innovations may be valuable if combined with tax advantages.*

INTRODUCTION .......... 217
I. INCOME TRUSTS: THE BASICS .......... 220
II. WHY NOT BUSINESS TRUSTS? .......... 223
A. *The Value of Contractual Freedom* .......... 224
1. *The Governance Choices of Income Trusts* .......... 225
2. *The Value of Innovation Based on Evidence from Conversions* .......... 225
a. *Average Abnormal Returns* .......... 228
b. *Abnormal Returns and Governance Choices* .......... 230
3. *Post–Tax Reform Evidence of the Continued Use of the Trust Form* .......... 234
4. *Conclusions on the Value of Innovation* .......... 235
B. *Other Theories* .......... 237
CONCLUSION .......... 239

* Copyright © 2012 by Edward M. Iacobucci, Faculty of Law, University of Toronto. B.A. (Hons.); M.Phil.; LL.B. For helpful conversations and comments on earlier versions of this Article, thanks to Barry Adler, Ben Alarie, Anita Anand, Ian Caines, Andrew Green, Anthony Niblett, Sheryl Strother, Michael Trebilcock, Ralph Winter, Albert Yoon, and participants of the New York University School of Law–Columbia Law School Conference on Contractual Innovation, as well as participants of workshops at Yale and University of Illinois Law Schools. Thanks also for invaluable research assistance to Gord Houseman and Andrew Clark and for financial support to the Osler Chair in Business Law and the James Tory Fund for Studies in Business Law.

## Introduction

In recent years, following changes in practice, scholars have paid increased attention to business organizations other than corporations.[1] While some alternative organizational forms such as the limited liability company (LLC) have become very popular, the experience with the business trust has been mixed.[2] Two empirical phenomena relating to trusts help motivate this paper. First, there has been considerable growth in the value of assets owned and managed by trusts.[3] Second, in the United States, the assets owned and managed by business trusts tend to be financial claims on other assets.[4] While the trust form is used with increasing frequency, trusts have not been used as business entities themselves.

---

1 *See generally* Larry E. Ribstein, The Rise of the Uncorporation 10 (2010) (describing "the increasing importance of uncorporations in modern business").

2 Many scholars provide helpful discussions of the use of trusts for business purposes. *See* Henry Hansmann, *Corporation and Contract*, 8 Am. L. & Econ. Rev. 1, 3 (2006) [hereinafter Hansmann, *Corporation and Contract*] (describing the statutory business trust as one of "four newly established limited liability forms" that "permit creation of a full limited liability entity, without the remaining rigidities of the business corporation statutes"); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 Harv. L. Rev. 1333, 1384–86, 1397–99 (2006) (noting that entity shielding, which protects firm assets from owners' personal creditors, is one of the few statutory requirements of business trusts); Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. Rev. 434 (1998) (describing the evolution of trusts in English-inspired common-law jurisdictions and concluding that trusts add flexibility to corporate law); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165, 186 (1997) (describing how "commercial trust[s]" are "locked in a struggle for turf against competing modes of finance and competing modes of business organization, especially the corporation"); Paul B. Miller, *The Future for Business Trusts: A Comparative Analysis of Canadian and American Uniform Legislation*, 36 Queen's L.J. 443 (2011) (describing the history of business trusts and analyzing two proposed uniform trust statutes, the Canadian Uniform Income Trusts Act and the American Uniform Statutory Trust Entity Act); Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 Bus. Law. 559, 561 (2003) (comparing trusts with other forms of business organizations and concluding "that commercial trusts and corporations can be thought of as mirror-image entities that respond to different investor needs"); Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. Ill. L. Rev. 31, 35 (describing "a research agenda for the study of the trust—in particular, the statutory trust—as a mode of business organization").

3 *See, e.g.*, Langbein, *supra* note 2, at 178 (identifying that while "[t]he data available on the asset values of the various forms of trust has many shortcomings, . . . the drift is unmistakable"); Schwarcz, *supra* note 2, at 559 (estimating that the value of asset securitization trusts alone totals in the trillions of dollars); Sitkoff, *supra* note 2, at 34 (comparing the value of assets managed by trusts to total stock market capitalization).

4 *See* Schwarcz, *supra* note 2, at 559–60 (arguing that trusts have come to dominate certain types of modern business and financial transactions); Sitkoff, *supra* note 2, at 38–39 (noting that the statutory business trust is regularly used to organize mutual funds and facilitate asset securitizations).

The trust form offers the asset partitioning advantages of the corporation (especially the Delaware Statutory Business Trust, which treats the trust as a legal entity),[5] while also providing virtually unfettered discretion over the terms of the corporate contract.[6] Corporate law regimes, even liberal ones such as Delaware's,[7] contain mandatory rules that may not be optimal for particular corporations.[8] Adopting the trust form helps entities avoid potentially wealth-reducing restrictions on freedom of contract in corporate law while allowing them to maintain the advantages of legal personhood.

This Article investigates the apparent reluctance to adopt innovative organizational contracts by examining the Canadian experience with income trusts. The early years of this century saw widespread adoption of the "income trust" form in Canada, dramatically changing the business scene.[9] However, following the elimination of significant tax advantages associated with the form in 2006, virtually no new business trusts emerged. In this Article, I examine the rise and fall of the Canadian income trust in order to develop a better understanding of businesses' apparent hesitation to exploit the opportunities for contractual innovation that the trust form offers.

After explaining the basics of the income trust in Part I, I examine the insights that the empirical experience with income trusts can offer into adoption of the trust form generally in Part II. Part II.A focuses on the hypothesis that the trust form has not been adopted because trust-related contractual innovation is simply not valuable. This hypothesis could be true if the mandatory governance rules associated with the corporate form do not reduce value, or at least do not

[5] *See* DEL. CODE ANN. tit. 12, § 3801(g) (2007) (defining a "[s]tatutory trust" and establishing that such a trust is a "separate legal entity").

[6] *See, e.g.*, Hansmann, *Corporation and Contract*, *supra* note 2, at 3 (noting that the statutory business trust "offers virtually complete contractual freedom with respect to assignment of earnings, control, and even fiduciary duties").

[7] *See, e.g.*, Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahan & Kamar's* Price Discrimination in the Market for Corporate Law, 86 CORNELL L. REV. 1257, 1260 (2001) (observing that the "Delaware Model" of corporate law "is largely enabling and provides a wide realm for private ordering").

[8] *Cf.* Langbein, *supra* note 2, at 183–85 ("Transacting parties who employ the trust for commercial purposes appear to value the flexibility that trust law permits, both in matters of internal governance and in the creation of beneficial interests.").

[9] *See, e.g.*, Benjamin Alarie & Edward M. Iacobucci, *Tax Policy, Capital Structure and Income Trusts*, 45 CAN. BUS. L.J. 1, 1–2 (2007) (showing that the market capitalization of income trusts went from $18 billion in 2000 to $118.7 billion by the end of 2004); Tim Edgar, *The Trouble with Income Trusts*, 52 CAN. TAX J. 819 (2004) (arguing that the tax revenue losses associated with the growth of income trusts warrant tax reform).

reduce value sufficiently to justify organizational innovation.[10] The evidence on the value of innovation is mixed. On the one hand, trusts do depart systematically from corporate law on some governance dimensions[11] and stock price reactions suggest that the market views these departures favorably. On the other hand, there have been virtually no new business trusts formed in Canada after the 2006 tax reform despite low costs of conversion. Part II.A concludes that the gains from innovative governance per se are not especially valuable; any gains from innovation in the Canadian income trust experience must have been dependent on tax law in important ways.

Part II.B examines the evidence on other possible impediments to adoption of the trust form. For example, uncertainty about the governance impact of organizational change might deter innovation.[12] Also, legal uncertainty about a trust's limited liability status, as well as the possible conservatism of lawyers,[13] might impede adoption of the trust form. As Part II.B explains, however, the evidence from the Canadian income trust experience supports none of these alternative hypotheses.

The lesson of the income trust experience in Canada is that governance innovation away from the standard corporate form is not especially valuable. If there are tax advantages from the trust form, then innovation may be worthwhile, especially if these tax advantages interact with governance changes. Otherwise, there appears to be little to gain from using the trust form to support governance-related contractual innovation.

[10] For discussion about the potential irrelevance of restrictions on freedom of contract in corporate law, see, for example, Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989), and Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990). For discussion of the apparent lack of value in innovating by adopting the trust structure, see Hansmann, *Corporation and Contract*, *supra* note 2, at 5–8.

[11] Anita I. Anand & Edward M. Iacobucci, *An Empirical Examination of the Governance Choices of Income Trusts*, 8 J. EMPIRICAL LEGAL STUD. 147, 149, 155–66 (2011) (finding that trusts sometimes mimic, but sometimes deviate from, mandatory rules in the Canada Business Corporations Act).

[12] For a discussion of informational problems around nonstandard governance terms, see Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997).

[13] *See* Sitkoff, *supra* note 2, at 33 (discussing the problems associated with limited liability and with patchy judicial recognition of the common-law business trust).

## I
## Income Trusts: The Basics

While there are many variations on the basic structure, the essence of an income trust involves public investors (or unitholders) buying units in a trust, which in turn buys the equity and debt of an underlying business organization, what I will call the "operating corporation."[14] While the typical structure is much more complicated, this description captures the basic feature of the trust form that allows for the investigation in this Article: Public investors in the business own units in a trust, not shares in a corporation.

Prior to 2006, there were several tax advantages to the income trust form in Canada.[15] The trust is a flow-through vehicle for tax purposes and thus does not pay income tax as long as it distributes its income to unitholders. The operating corporation issues very high levels of debt to the trust, thus increasing the corporation's interest expenditures and reducing its taxable income, ideally to zero. Therefore, the income trust structure reduces entity-level taxes. Because personal and corporate income taxes are imperfectly integrated in Canada,[16] and because some investors (such as pension plans) are tax exempt,[17] the structure reduces the total tax burden of both investors and the business.

The income trust reduces entity-level taxes without creating agency costs of debt. The very high levels of debt adopted by the operating corporation would create serious agency costs of debt, including bankruptcy costs, if issued to third parties.[18] However, the debt is in

[14] The operating entity may actually be either a corporation or some kind of limited partnership. The nature of the operating entity has no meaningful effect on the empirical results set out below.

[15] *See* Alarie & Iacobucci, *supra* note 9, at 13–15 (arguing that the income trust's tax advantages rest on the bias in the tax system favoring interest on debt over dividends).

[16] *See, e.g.*, *id.* at 11 ("In Canada, the relief on dividend taxation—the dividend tax credit—has historically fallen short of complete integration [of corporate and personal income tax].").

[17] *See, e.g.*, Martin Przysuski, *Tax Leakage from Pension Fund Investment in Canadian Income Trusts*, 40 Tax Notes Int'l 467, 467 (2005) (discussing the Canadian government's focus on "the participation of pension funds in the business income trust marketplace" and considering "the tax-exempt nature of pension funds").

[18] Agency costs of debt result from a conflict of interest between shareholders and creditors: Shareholders realize most of the upside of risky investments, but share the downside significantly with creditors. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 334–37 (1976) (describing the agency costs associated with the existence of debt claims on the firm). As a consequence, shareholders may seek to induce boards of directors to opt for value-decreasing, risky investments. *Id.* at 334 n.39 (analogizing the incentive effect to "the way one would play poker on money borrowed at a fixed interest rate, with one's own liability limited to some very small stake").

essence held by the sole shareholder of the operating corporation, the trust. This mitigates the agency costs of debt since there is no point in enhancing shareholder value at the expense of creditors when the shareholders are also the creditors.

The trust has the added potential benefit of being governed by trust law, not by corporate law. This creates contractual freedom on a number of important dimensions. Rather than being bound by the many mandatory rules that govern corporations in Canada,[19] the trust relies on its Declaration of Trust (DOT) to establish its own rules without corporate law's constraints. To be sure, income trusts often have a corporation somewhere in the organizational chart, suggesting that some entities within the firm will be governed by corporate law. But the body at the top of the ownership chain that exerts control over the subsidiary corporations and the assets of the business is governed by trust law, not corporate law. This suggests that there is considerable scope for meaningful innovation on governance matters within the income trust.[20]

For example, something as fundamental as the fiduciary duties of the board of trustees can be defined in the DOT. Even if directors of subsidiary corporations are bound by corporate law, those ultimately in charge of the business may be permitted by the DOT to conduct themselves in a manner that would breach corporate law fiduciary duties.[21]

While income trust activity quickly ramped up to its peak levels in the middle of the last decade,[22] its decline arrived even more abruptly. Amendments to the Canadian Income Tax Act were

---

[19] There are fourteen Canadian corporate law statutes under which a business may incorporate. Each province and territory has a corporate statute; the federal government has one as well. The statutes closely resemble one another, however, and contain a number of mandatory rules. For greater discussion, see Anand & Iacobucci, *supra* note 11, at 155–61.

[20] *See, e.g.*, *id.* at 148–50 (predicting variation in income trust governance because "[i]f one size does not fit all, but only fits a few, then once firms are given the choice, a significant number of firms would opt out of the standard approach"); Martin Boyer et al., *Income Trusts Governance and Performance: Time for a Post-Mortem*, *in* STOCK RETURNS: CYCLICITY, PREDICTION AND ECONOMIC CONSEQUENCES 115, 120–21 (George I. Ellison ed., 2009) (reviewing the absence of a legal blueprint for trust formation that allows for variations in the structure and governance of income trusts).

[21] *See, e.g.*, Anand & Iacobucci, *supra* note 11, at 148 (noting that the basic governance of the trust is the result of the Declaration of Trust (DOT), rather than of corporate law). More broadly, "the notion that parties can contract out of default trust law obligations (including their fiduciary duties) has taken hold in common-law jurisdictions, including Canada." *Id.* (citation omitted). For further discussion of the interplay between contract and fiduciary law, see Anthony Duggan, *Solicitors' Conflict of Interest and the Wider Fiduciary Question*, 45 CAN. BUS. L.J. 414 (2007).

[22] Alarie & Iacobucci, *supra* note 9, at 1–2.

announced on October 31, 2006.[23] The amendments, which exempted real estate investment trusts (REITs) and were formally passed in June 2007 with retroactive effect to October 31, 2006, eliminated the tax advantages of the income trust form for any new income trust and nullified such advantages for existing income trusts as of January 1, 2011.[24] As a result of the amendments, the only remaining tax advantage of the income trust form is for businesses that earn income with foreign operations: Income from these operations is not subject to tax at the trust level.[25] Other than REITs, only three income trusts have gone public since 2006. These three expressly did so because they could minimize trust-level taxes, since their income was largely earned abroad.[26] Given the frenzy to convert to income trusts immediately before October 31, 2006, this halt was strikingly sudden.

Scholars have studied a number of issues concerning income trusts. In findings that would be unsurprising to practitioners, studies

---

[23] This came to be known as the "Halloween massacre." *See, e.g.*, Shirley Won, *Income Trust Funds Putting on a New Face*, GLOBE & MAIL (Toronto), Mar. 12, 2010, at B13 ("Income trust funds are undergoing a makeover as the deadline from the 2006 Halloween massacre edges closer.").

[24] Section 104(6)(b)(iv), a 2006 addition to the Income Tax Act, generally prevents a specified investment flow-through trust (SIFT Trust) from deducting from income "non-portfolio earnings" that it has made payable to a beneficiary under section 104(6). *See* Income Tax Act, R.S.C. 1985, c. 1, § 104(6)(b)(iv) (5th Supp.) (Can.). Real estate investment trusts that meet certain qualifying conditions are explicitly excluded from the definition of a SIFT trust and thus are not affected by section 104(6)(b)(iv). *Id.* § 122.1.

[25] Income from foreign operations is not subject to tax at the trust level because a SIFT trust is defined as a trust "resident in Canada" that "holds one or more non-portfolio properties" at any point during the taxation year. *Id.* § 122.1. Canadian real or resource property, or property that the trust uses in the course of carrying out business in Canada, may constitute non-portfolio property. *Id.* However, a non-resident person or partnership may be deemed a "subject entity" under section 122.1 if its "principal source of income [derives from] one or any combination of sources in Canada." *Id.*

[26] The trusts are: Eagle Energy Trust, which issued its prospectus in November 2010; Parallel Energy Trust, which went public in 2011; and Argent Energy Trust, which had its IPO in August 2012. *See* Press Release, Eagle Energy Trust, Eagle Energy Trust Files Final Prospectus for $150 Million Initial Public Offering (Nov. 16, 2010), *available at* http://www.eagleenergytrust.com/PublicDocuments/News/eetpr-2010.11.16-2.pdf (discussing the favorable impact of the trust structure on the Eagle Energy Trust's tax position); *Parallel Energy Trust Files Final Prospectus for $342,000,000 Initial Public Offering*, PARALLEL ENERGY TRUST (Apr.21, 2011, 2:11 PM), http://redir.parallelenergy.ca/index.php?option=com_content&view=article&id=17:parallel-energy-trust-completes-342000000-initial-public-offering&catid=1:news-releases&Itemid=6 (discussing the completion of the initial public offering and its designation as a "mutual fund trust" as defined under the Income Tax Act); Mary Teresa Bitti, *Foreign Assets Let Trusts Make a Comeback*, NAT'L POST (Can.), Sept. 19, 2012, at FP12 (covering the IPO of Argent Energy Trust, a "cross-border income trust[ ]"). For discussion of whether these trusts might spark a boom in foreign-asset income trusts, see David Parkinson, *Why an Income Trust Breakthrough Could Become an Oil Patch Betamax*, GLOBE & MAIL (Toronto), Apr. 7, 2012, at B9.

show that trusts' tax savings are empirically significant.[27] But scholars have paid considerably less attention to trust governance. In an earlier Article, Professor Anita Anand and I compared income trust governance choices to a variety of mandatory corporate law rules.[28] While the trusts' DOTs mimic corporate statutes on some matters (e.g., fiduciary duties), they depart significantly on others (e.g., derivative actions).[29] Part II discusses these results in greater detail.

The news media has treated novel governance arrangements in the trust context as causes of inferior governance. The *Globe and Mail* concluded that governance of income trusts was like the "Wild West"[30] given the absence of mandatory rules and oversight, resulting in "minor league[ ]" governance.[31] Similarly, one scholarly study assumed that governance of income trusts was inferior, concluding that, since observed returns at trusts were not higher than those at corporations, they did not adequately compensate investors for inferior governance.[32] This Article does not assume a negative relationship between value and governance innovation, but rather examines market reactions to innovation to determine the nature of the relationship, if any.

## II
## Why Not Business Trusts?

This Part relies on evidence from the income trust experience to examine the general reluctance of businesses to become trusts. In Part II.A, I test one main hypothesis: that business trusts are not more prominent because the governance freedom that the trust provides is not especially valuable. In Part II.B, I consider several other hypotheses.

---

[27] *See, e.g.*, Ben Amoako-Adu & Brian F. Smith, *Valuation Effects of Recent Corporate Dividend and Income Trust Distribution Tax Changes*, 25 Can. J. Admin. Sci. 55, 66 (2008) (indicating that the elimination of the tax advantage led to a significant shift in the valuation of income trust listings); Lawrence Kryzanowski & Ying Lu, *In Government We Trust: Rise and Fall of Canadian Business Income Trust Conversions*, 35 Managerial Fin. 784, 786 (2009) (finding that abnormal returns "are positively and strongly related to the tax-saving motivation for conversions to business income trusts" and supporting the hypothesis that limited liability companies are motivated by tax savings to convert into income trusts).

[28] Anand & Iacobucci, *supra* note 11, at 155–61 (examining provisions in four categories: directors and officers, shareholder rights, transactions, and shareholder remedies).

[29] *See infra* Part II.A.2 (discussing similarities and differences between mandatory corporate law rules and trust governance options).

[30] Elizabeth Church & Janet McFarland, *Income Trust Boards: The New "Wild West*," Globe & Mail (Toronto), Oct. 25, 2006, at B1.

[31] Andy Hoffman, *Under the Spotlight's Glare, Trusts Slowly Embrace Reform*, Globe & Mail (Toronto), Oct. 19, 2005, at B7.

[32] Boyer et al., *supra* note 20, at 129.

To test these hypotheses, I rely on the following data. In a previously published study, Anand and I compiled a list of 187 income trusts that: (1) either went public in an initial public offering (IPO) or converted to the trust form from a publicly-held corporation over the period from 1997 to 2005; (2) were listed on the Toronto Stock Exchange; and (3) made significant documents, such as the Declaration of Trust, available on SEDAR (the Canadian equivalent of EDGAR).[33] We compare the governance choices of those trusts to twenty-five provisions of mandatory Canadian corporate law, as found in the Canada Business Corporations Act (CBCA).[34] For this Article, I used our previously-gathered data and I also gathered governance information on income trusts formed in 2006.

To determine the association between firm value and governance choices, I frequently focus in this Part on the subset of trusts that originated in conversions, rather than in IPOs. Only the former group is amenable to an event study of stock price movements when the trust governance terms were publicly announced. Over the period from 1996 to 2006, there were fifty-four trusts that listed on the Toronto Stock Exchange, converted from public company status, and had stock prices available on at least the day on which the proposed governance choices of the trust were made public.

### *A. The Value of Contractual Freedom*

This Part focuses on three hypotheses regarding the ways in which Canada's experience with income trusts sheds light on the value of innovation in the governance structures of publicly traded businesses. First, if governance innovation were valuable, trusts would deviate from mandatory corporate law rules. Second, if exercising the freedom to innovate created value, one would expect positive stock price reactions to such innovation. Third, if the trust form provides valuable governance benefits, one would expect adoption of the form regardless of tax benefits, unless the costs of adopting the form were significant. The evidence relating to the first two hypotheses suggests that trust-related governance innovation is beneficial, but the evidence relating to the third indicates that innovation is not valuable.

---

[33] Anand & Iacobucci, *supra* note 11, at 154. EDGAR is the U.S. Securities and Exchange Commission's publicly accessible online filing system.

[34] *Id.* at 154–55; *see also* Canada Business Corporations Act, R.S.C. 1985, c. C-44.

### 1. *The Governance Choices of Income Trusts*

Anand and I previously studied the governance choices of income trusts extensively.[35] With a fuller explanation left to that Article, there are some provisions of the CBCA that trusts adopt and many other provisions that they avoid. On some matters, especially involving rules governing major transactions such as mergers, trusts almost uniformly adopt existing corporate law rules.[36] On other matters, especially those relating to shareholder remedies such as the derivative action, trusts almost uniformly decline to adopt corporate law rules.[37] Experience is mixed on rules governing directors and officers[38] as well as shareholder rights.[39] Given that income trusts systematically depart from conventional corporate law rules, especially in some key areas of governance such as shareholder remedies, it is reasonable to infer *prima facie* that governance innovation may be valuable, at least for some firms that choose to adopt the income trust form.[40]

### 2. *The Value of Innovation Based on Evidence from Conversions*

In this Part, I explore whether adoption of unconventional governance rules increased market value of trusts formed through conversions of public companies. Given that the firms that would benefit most from innovative governance are most likely to convert to the trust form, there is a clear selection bias in the data. Still, if value increases with unconventional governance, it would demonstrate that innovation is valuable for at least some public companies.

---

[35] *See* Anand & Iacobucci, *supra* note 11, at 155–61 (examining whether governance provisions regarding directors and officers, shareholder rights, transactions, and shareholder remedies mimic the CBCA).

[36] *Id.* at 159 (noting that trusts often adopt provisions on approval for sales and acquisitions that are similar to those found in the CBCA).

[37] Not a single trust in the Anand and Iacobucci sample adopted a derivative action procedure, for example. *Id.* at 159–60.

[38] For example, some DOTs allow trustees to be corporations, while corporate law requires directors to be individuals. *Id.* at 156. On the other hand, trusts and corporations both require annual elections of their trustees. *Id.* at 158.

[39] For example, some DOTs are consistent with corporate law and allow unitholders with five percent of the votes to requisition a unitholder meeting, while others adopt a higher (typically ten percent) ownership threshold. *Id*.

[40] Space may exist for managers to propose suboptimal, but self-interested, innovative governance because of their expectation that shareholders support the conversion for tax reasons. But Anand and I do not find statistically significant differences in governance choices between IPOs and conversions. *See id.* at 168. Since managers largely internalize the value of governance choices in IPOs, innovation is likely valuable, not self interested. *See* Jensen & Meckling, *supra* note 18, at 325 (concluding that owner-managers reap the benefits of a commitment not to engage in self-interested behavior when selling shares into an efficient market).

To investigate the effects of trust conversion on company value, I examine the abnormal returns to a listed corporation's stock around the date on which the governance provisions for the proposed income trust were made publicly available.[41] The description of the trust's governance provisions is available in the firm's Management Information Circular, which describes in detail the proposed plan of arrangement involving a conversion to an income trust. More specifically, I examine the window around the date on which the circular containing the details of the plan of arrangement was posted on SEDAR.[42] The basic empirical strategy is to conduct an event study of abnormal returns around the time of the announcement of governance details and then regress these abnormal returns on governance choices to determine if the effects of deviations from the CBCA are positive or negative.

A few caveats are worth noting. Because anticipated governance changes would already be reflected in the stock price given the prior announcement of the conversion,[43] observed abnormal returns may be close to zero even if governance changes have a large impact on value. For there to be significant results in the event study, there must be some surprises in the proposed governance arrangements in the circular. Moreover, the importance of anticipation means that I can only make inferences about the directional impact of governance choices on value, and not about the magnitude of these effects.[44]

Another caveat is that, with respect to many governance choices, there was little variation across trusts, which precludes some inferences about value. It could be that there are very large gains (or losses) from governance innovations, but these arise largely because

---

[41] Event study analysis focuses on abnormal returns for two reasons. First, stocks are generally expected to have positive returns, and second, their prices may be influenced by general economic news, not firm-specific news. The measure of abnormal returns accounts for the relationship between the individual stock price and the market, and thus focuses on unexplained returns during the relevant period. For more on measuring abnormal returns, see JOHN Y. CAMPBELL, ANDREW W. LO & A. CRAIG MACKINLAY, THE ECONOMETRICS OF FINANCIAL MARKETS 157–63 (1997).

[42] While there is often a one business day lag between filing with SEDAR and the posting of the document on SEDAR's public website, there are private services that will provide investors with same-day delivery of the relevant documents. I assume, therefore, that the documents are made public, and that the market price will react, on the same day as filing with SEDAR. However, I also test longer event windows to be sure that this is the case.

[43] It is worth noting that the stock price reactions to the initial conversion announcements were positive, although they reflected both anticipated governance changes (which may or may not be positive, as I explore in this Part) and tax effects (which are positive and significant).

[44] In addition, if the costs of the conversion have already been anticipated, the observed directional effect is not net of the costs of conversion.

of uniform deviations from the CBCA (e.g., no trust adopts a derivative action procedure). Such effects of deviation from the CBCA are not detectable in the present study. The study provides evidence on value only for deviations from the CBCA that were not uniform across all trusts studied.[45]

A third caveat is that it is possible that other information, such as new financial information in the circular, may affect the relationship between abnormal returns and the governance choices found in the circular. Such new information is unlikely to undermine the central aim of this Article. The key objectives here are to determine whether average abnormal returns on the event date depend on governance choices and whether deviations from mandatory corporate law rules are associated with positive or negative abnormal returns. That circulars may contain other value-relevant information potentially muddies the association between market reactions and governance details, but should not introduce a bias. There would be concern about the noise introduced by the new information unrelated to governance in the circular only if the governance choices were related to the new information—and even in this case, the relationship between governance and value would be interesting because some element of the governance innovation would complement an increase in value.

Nevertheless, to minimize possible concerns about extraneous influences on returns, I conducted the study with two different samples. The first includes all fifty-four conversions, while the other includes only the forty-four conversions that did not involve new financial information in the circular. I present below the results from the sample of forty-four firms, but note that the results are not qualitatively different when the analysis relies on the sample of fifty-four firms (except that the significance of some coefficients drops to some extent, as one would expect with the introduction of noise).

Ideally these regression analyses would include controls for other new information, such as announcements of debt recapitalizations associated with the conversion,[46] as well as other known factors that may interact with governance choices to affect value (e.g., firm size or

---

[45] Optimal governance choices may vary with the firm's assets. *See, e.g.*, Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 554–57 (2007) (noting that governance choices, such as the place of incorporation or existence of takeover defenses, may depend on the nature of the assets in question). As such, a cross-sectional analysis may not reveal an association between governance and value, even if there were such an association for any given firm. But if such a cross-sectional association existed, it would be sufficient to conclude that governance choices matter for at least some public companies.

[46] Thirteen of the forty-four converting firms announced in their circulars that they were paying down external debt.

industry).[47] Unfortunately, adding variables to the right-hand side of the regressions to control for such factors quickly overwhelms the dataset of only forty-four observations. While the data reveal statistically significant associations, the inability to add controls implies that the results are better understood as suggestive of a positive relationship between innovative governance and firm value, even if not definitive.[48]

The central empirical goal is to detect the extent to which specific governance choices may drive variation in abnormal returns. Therefore, I run regressions of abnormal returns (and standardized abnormal returns) on governance. Anand and I took two approaches to measuring an income trust's governance choices. First, we constructed a measure of governance by choosing twenty-five CBCA provisions and counting how many of these provisions were adopted by a given income trust.[49] I will refer to this as the "Anand and Iacobucci index." Second, we categorized the twenty-five provisions into four categories, relating to: (a) directors and officers (eight provisions), (b) shareholder rights (eleven provisions), (c) shareholder remedies (four provisions), and (d) transactions (two provisions).[50] I next examine the association between abnormal returns and governance choices as reflected by these indices.[51]

a. Average Abnormal Returns

This Part discusses results from the event study of forty-four trust conversions, examining abnormal returns around the day on which the circular containing the new trust's governance details was made public. To calculate abnormal returns, I estimated the market model, $R_i = \alpha + \beta R_m$, where $R_i$ is the daily return of each firm and $R_m$ is the

[47] *See* Anand & Iacobucci, *supra* note 11, at 170 (noting that industry, location, timing, and firm size can affect governance choices, but that these factors had no noticeable relationship with aggregated choices).

[48] In unreported regressions I added a control for whether there was a debt buyback associated with the arrangement. This did not affect the association between innovation and value. Paying down debt itself had a negative relationship with abnormal returns, but this result was not robust across specifications. Another variable that I included as a right-hand side variable in robustness checks was the timing of the conversion as measured by the number of months from the beginning of the sample. It may be that market reactions evolved over time such that abnormal returns would vary systematically with timing. The interaction of timing and governance variables was not significant.

[49] *See* Anand & Iacobucci, *supra* note 11, at 154–55 (discussing the approach taken to compare the twenty-five CBCA provisions with the income trust provisions).

[50] *Id.* at 156 tbl.2.

[51] Ideally, I would also consider regressions relying on individual provisions with dummy variables set to one if the provision resembles the CBCA. But with a sample size of forty-four and twenty-five individual provisions, such a regression yields nothing of significance.

daily market return. To calculate firm returns for most trusts, I used data from Bloomberg; however, for the four trusts for which the Bloomberg database had gaps, I relied on the Canadian Financial Markets Research Centre database. I derived the market return from the S&P/TSX Composite Daily Total Return index. To estimate the market model, I used daily return data from the five months before the conversion, where possible. All firms in the sample had return data for the event date, but some did not have data for the days following the event date: This explains why "N" varies depending on the size of the window.

TABLE 1

| *Income Trusts, Date of Posting of Circular to SEDAR* | *Average Daily Abnormal Returns (z-statistic)* |
|---|---|
| *1-day window*<br>*N = 44* | –0.50%*<br>(–1.84) |
| *2-day window*<br>*N = 42* | –0.28%<br>(–0.99) |
| *3-day window*<br>*N = 41* | –0.28%<br>(–0.97) |

*p*-values in parentheses.
*** Significant at the 0.01 level.
** Significant at the 0.05 level.
* Significant at the 0.1 level.

There is some evidence that on average the market was disappointed with governance choices. If there were such disappointment, this might support a hypothesis that corporate managers relied on the tax advantages of the income trust form even more than the market anticipated to ensure shareholder support for a conversion that would bring about undesirable governance changes. The statistical significance is marginal, however, and disappears over event windows longer than one day. Moreover, managers have stronger incentives to adopt efficient governance provisions in IPOs than in conversions, given that they internalize the impact of inferior governance through smaller proceeds from the sale of securities in an IPO. Yet Anand and I do not discern systematic differences between IPO and conversion choices on governance.[52] Our result, combined with the weak statistical significance of the negative returns, casts doubt on the managerial self-interest theory.

[52] *See* Anand & Iacobucci, *supra* note 11, at 168; *see also supra* note 40 (discussing the Anand and Iacobucci analysis).

b. Abnormal Returns and Governance Choices

This Part seeks to determine whether abnormal returns are associated with governance choices by regressing abnormal returns on governance choices. I use two alternative left-hand side variables in the regressions—each firm's abnormal returns and each firm's standardized abnormal returns. Regressions with the former allow for intuitive interpretation of the coefficients, while regressions with the latter better control for high variance around the estimate of abnormal returns.

I begin by examining whether the Anand and Iacobucci index of overall resemblance to the CBCA is associated with abnormal returns. The results are listed in Table 2, with alternative left-hand side variables in the top row, the right-hand side variables in the first column, and *p*-values in parentheses.

TABLE 2

| | *1-day abnormal return N = 44* | *1-day standardized abnormal return N = 44* | *2-day average daily abnormal return N = 42* | *2-day standardized average daily abnormal return N = 42* | *3-day average daily abnormal return N = 41* | *3-day standardized average daily abnormal return N = 41* |
|---|---|---|---|---|---|---|
| Intercept | 0.023 (0.113) | 9.108 (0.050) | 0.016 (0.037) | 6.939 (0.042) | 0.014 (0.092) | 4.866 (0.117) |
| CBCA Index | -0.002* (0.051) | -0.850** (0.018) | -0.001** (0.014) | -0.616** (0.019) | -0.001** (0.039) | -0.454* (0.057) |
| *R*-squared | 0.088 | 0.127 | 0.142 | 0.130 | 0.104 | 0.090 |
| Adjusted *R*-squared | 0.066 | 0.106 | 0.121 | 0.108 | 0.081 | 0.066 |

*p*-values in parentheses.
*** Significant at the 0.01 level.
** Significant at the 0.05 level.
* Significant at the 0.1 level.

Given that the index increases with the number of CBCA provisions that an income trust proposes to adopt, Table 2 suggests that the more CBCA provisions a firm adopts, the *lower* the value of the firm. This result is robust across event windows and across standardized and raw abnormal returns. The coefficient for raw abnormal returns indicates the magnitude of the effect: Each additional CBCA provision adopted out of twenty-five is associated with a drop in abnormal returns of 0.1 to 0.2% (the largest number of CBCA provisions adopted by a firm was seventeen, and the smallest was nine). It is essential when interpreting this association to appreciate that the change in returns reflects only the market's surprise. If markets were good at anticipating governance choices, the observed change in returns may understate significantly the association between governance and abnormal returns.

The next stage of the investigation is to probe deeper into the particular kinds of provisions that reduce value by testing for an association with the four sub-indices in the Anand and Iacobucci index. The results are displayed in Table 3.

TABLE 3

| | *1-day abnormal return N = 44* | *1-day standardized abnormal return N = 44* | *2-day average daily abnormal return N = 42* | *2-day standardized average daily abnormal return N = 42* | *3-day average daily abnormal return N = 41* | *3-day standardized average daily abnormal return N = 41* |
|---|---|---|---|---|---|---|
| Intercept | -0.022 (0.468) | -0.201 (0.983) | -0.023 (0.479) | -4.792 (0.479) | -0.039 (0.040) | -10.168 (0.176) |
| Directors / Officers | -0.002** (0.037) | -0.833** (0.020) | -0.002*** (0.000) | -0.855*** (0.001) | -0.002*** (0.002) | -0.658*** (0.008) |
| Shareholder Rights | 0.001 (0.848) | -1.069 (0.255) | 0.002 (0.242) | 0.271 (0.700) | 0.040* (0.057) | 0.905 (0.275) |
| Transactions | 0.010 (0.145) | 4.952** (0.020) | 0.006* (0.060) | 1.898 (0.193) | 0.004 (0.243) | 1.701 (0.218) |
| Shareholder Remedies | 0.008 (0.470) | 1.840 (0.580) | 0.011** (0.031) | 5.513** (0.024) | 0.011* (0.061) | 4.377* (0.061) |
| *R*-squared | 0.188 | 0.287 | 0.428 | 0.354 | 0.347 | 0.284 |
| Adjusted *R*-squared | 0.104 | 0.214 | 0.366 | 0.285 | 0.274 | 0.205 |

*p*-values in parentheses.
*** Significant at the 0.01 level.
** Significant at the 0.05 level.
* Significant at the 0.1 level.

There is a robust, statistically significant association between abnormal returns and one sub-index: the directors and officers index. The market responded more positively the less that the income trust resembled a corporation with respect to board governance. There is less robust evidence of a positive reaction to conformity with shareholder remedies. While income trusts almost uniformly deviated from CBCA remedies, three trusts did include the appraisal remedy, and this provision appears to be associated with higher returns.

The sub-index testing revealed that the market particularly seemed to welcome deviations from CBCA provisions on directors and officers. The numbers cannot reveal the reasons for such reactions, but one particular set of innovations in this area is especially likely to have an effect on value. Rather than requiring directors to be individuals, as does the CBCA,[53] twenty-seven of forty-four DOTs allowed for trustees that were themselves corporations. Also, the

[53] *See* Canada Business Corporations Act, R.S.C. 1985, c. C-44, § 105(1)(c) ("The following persons are disqualified from being a director of a corporation: . . . a person who is not an individual . . . .").

same twenty-seven DOTs allowed for a sole trustee, something that is not possible for public companies under section 102 of the CBCA.[54]

The restriction found in the CBCA and similar statutes on the nature of directors could have a significant effect on value. Income trusts with a single corporate trustee typically appoint trust companies to serve as trustee. In the pure debt context, these companies are known for their passivity.[55] An income trust with a corporate trustee is more likely to have a board that will focus only on collecting cash from the operating corporation and passing that cash to unitholders. In contrast, an income trust with individual trustees is more likely to have an active board that would exercise its own business judgment in a manner similar to boards of holding companies. A corporate board structure could therefore lead to both costs and benefits.

In terms of potential costs, there is a danger that management of the operating corporation may function with relatively little oversight from the board. This could exacerbate agency costs. On the other hand, the same feature, trustee passivity, could conceivably provide benefits. As noted above, the operating corporation owes the trust a significant amount of debt. But this debt is not at arm's length since the equity of the operating corporation is also owned by the trust. The contractual commitment to pay out cash from the operating corporation to the trust is relatively weak since the trust and corporation are not at arm's length and can renegotiate the debt payments between themselves. Where the board of the operating corporation includes the members of the board of trustees of the trust, it is obviously very easy to renegotiate the debt. It may be more difficult, in contrast, to renegotiate debt with passive, arm's length corporate trustees. If corporate trustees are reluctant to take an active role in governance, they may resist managerial efforts to renegotiate lower debt payments. It may be, therefore, that the unconventional corporate trustee structure better commits the income trust to cash distribution than a conventional board of individual trustees. To the extent that cash payments mitigate agency problems, the corporate trustee may improve governance relative to a board of individual trustees.[56]

---

[54] *See id.* § 102(2) ("[A] distributing corporation . . . shall have not fewer than three directors . . . .").

[55] *See* Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 Stan. L. Rev. 447, 473 (1999) (noting that indenture trustees have no legal or contractual obligation to monitor the company's finances actively).

[56] Ribstein observes that a key element of governance in what he calls "uncorporations"—partnerships, LLCs, and the like—is reliance on cash distributions, which is consistent with the theory here. Ribstein, *supra* note 1, at 209–12.

For these reasons, altering the board's governance structure to allow sole corporate trustees has a plausible impact on value. Moreover, this decision is much more likely to matter than either the other governance matters reflected in the directors and officers sub-index[57] or the one provision that varies in the remedies category, the appraisal remedy, which would presumably be significant only in unusual circumstances.[58]

While there is a logical reason to suppose that innovative governance creates value by increasing a commitment to pay out cash, there are alternative, though not mutually exclusive, explanations of the association between value and innovation. For example, signaling might help explain the association. Suppose that innovative governance improves value by increasing the commitment to distribute cash. Suppose further that unitholders are very likely for tax reasons to support a conversion to an income trust even if managers propose inferior governance that is good for managers. If these conditions hold, the decision by managers in a conversion to opt for innovative governance would not only be useful in its own right, but would also signal managerial commitment to value.[59] The observed positive relationship

---

[57] Among the sections in which there was considerable variation across trusts, sections 108(1) and 108(2) concern the resignation of trustees and when trustees cease to hold office, neither of which appears to be of fundamental importance. *See* Canada Business Corporations Act §§ 108(1)–(2). Section 109 concerns the threshold for removing sitting directors by vote. *Id.* § 109. This provision would only affect the possibility of a proxy contest outside a regular annual meeting because there are annual elections by majority vote for the trusts in this sample. Given the rarity of successful proxy contests generally and the presumably small effect of not being able to launch a removal campaign mid-year, it seems unlikely that section 109 would have a profound effect on value. The common deviation from section 120 was to be more permissive of self-dealing transactions than the CBCA provision, in part because of the presence of a single, corporate trustee that would prevent disinterested voting by the board on any self-dealing transaction. *See id.* § 120 (requiring directors or officers of a corporation, in certain instances, to disclose any interest they have in a material contract or transaction). It is possible that this would have a significant impact on firm value, but it would depend on the frequency of self-dealing and the advantages of the more permissive rules. The existing rules, which rely on disinterested voting, do not seem particularly onerous, which makes it less plausible that deviations are likely to have a significant impact on value.

[58] The appraisal remedy is available only when there is a fundamental change, such as a merger, which will be infrequent. Moreover, the remedy will only have value if the appraised value of the shares before the fundamental change deviates from the value, as found by a court, after the change.

[59] Several other sources discuss the signaling implications of governance choices. *See* Edward M. Iacobucci, *Toward a Signaling Explanation of the Private Choice of Corporate Law*, 6 AM. L. & ECON. REV. 319 (2004) (examining how the choice of a governance rule may signal quality to investors); Michal Barzuza, *Lemon-Signaling in Cross-Listing* (Univ. of Va. Sch. of Law, Working Paper No. 2012–03, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1022282 (discussing the signaling effects of cross-listing); Lucian Arye Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* (Harvard Law Sch., John M. Olin Ctr. for Law, Econ., & Bus., Discussion

between innovation and value might rest only partially on the actual effect on governance; it might rest also on the signal of managerial fidelity to value.

There is a different signaling hypothesis that is consistent with a positive observed relationship between innovative governance choices and firm value, despite *inferior* governance. According to this theory, the choice of novel governance terms inefficiently increases uncertainty, which increases the expected costs of future litigation should governance disputes arise. If litigation is less likely at firms anticipating strong performance, and if managers are loyal to shareholders, then adopting novel governance terms and accepting uncertainty could be a positive signal: "Good" firms have less to fear from uncertainty because they face a lower probability of future disputes that could lead to litigation.[60]

In summary, there is a positive association between value and innovative governance. Such a result is consistent with improved governance resulting from a greater commitment to cash distribution. However, it is also consistent with signaling that may or may not be associated with improved governance. The results, although not definitive, tend to support the conclusion that innovative governance of income trusts improves governance and enhances value.

### 3. *Post–Tax Reform Evidence of the Continued Use of the Trust Form*

On October 31, 2006, the Canadian federal government announced that it was eliminating the tax advantages of the income trust structure for new trusts, while phasing out the benefits for existing trusts by 2011. As one would expect, this had a profound impact on existing income trust value. What was less clear at that time, however, was whether the trust form would continue to thrive despite the tax changes. Today, the evidence is unambiguous: Since the announcement, the only new trust vehicles created have been those that were unaffected by tax reform—REITs and three foreign asset income trusts.

How can one reconcile the post-2006 experience with evidence that governance innovation was rewarded by the market? One possibility is that the costs of converting to a trust exceed the governance benefits. This would indicate that when tax and governance benefits

Paper No. 398, 2002), *available at* http://papers.ssrn.com/abstract_id=327842 (discussing how, because of signaling concerns, founders may not always choose the most efficient corporate governance structure).

[60] *Cf.* Iacobucci, *supra* note 59, at 324 (noting that the "expected costs from litigation are lower for good firms than for bad").

are both available, the benefits of conversion exceed the costs. However, when only governance advantages are available, the benefits of innovation do not justify the costs of conversion.

The entities' circulars contain information about the costs of the arrangement leading to a conversion. In the sample of forty-four firms, the costs of a conversion to an income trust vary considerably, ranging from a low of $200,000 to a high of $110,000,000. Moreover, the costs of the arrangement as a percentage of total market capitalization ranged from a low of 0.02% to a high of 6.9%. The high was very clearly an outlier, however, as only six conversions were more costly than 1% of equity, and only two were more than 3%. The median cost of conversion as a percentage of market capitalization was only 0.4%.

The costs of converting to a trust are not large, but appear to have been sufficiently high to deter conversions after 2006. Given that the costs of conversion for income trusts are as low as 0.02% of market capitalization, and yet no business trusts have converted in the absence of a tax advantage for doing so, there is doubt about the economic value of innovative governance structures.

### 4. *Conclusions on the Value of Innovation*

Evidence is mixed on the value of governance innovation permitted by the trust structure. On the one hand, trusts clearly took advantage of contractual freedom to adopt innovative governance rules, and the market reacted favorably to such innovations. On the other hand, converting to an income trust is not especially costly, and yet only three businesses, all of which continued to enjoy tax advantages from their reliance on foreign assets, have adopted the trust form since the announcement of the 2006 tax reforms. This casts doubt on the value of the innovation that trusts allow.

How can one reconcile these mixed results? The most plausible explanations rest on the premise that the pre-2006 tax system and the valuable governance innovations were related. There are two different ways in which these elements might have been related.

The first, and most straightforward, interpretation of the data is that while governance innovation was valuable when a conversion was already taking place for tax reasons, it was not sufficiently valuable on its own to justify the costs of conversion. Gains from innovation were merely incidental to the tax motivations for adopting the income trust structure. If this explanation holds, the inference is that governance innovation is not particularly valuable.

The second possibility is that governance innovation was indeed a significant source of gains for income trusts, but that these gains

depended on the tax context that existed at the time. As discussed in Part II.A.2.b, corporate trustees may have enhanced the credibility of the commitment to distribute free cash flow to investors. But tax law was also creating incentives for the income trust to avoid restructuring the operating corporation's debt obligations.[61] Had the debt been renegotiated and reduced, perhaps to allow managers greater discretion over cash, the organization would have paid more taxes because of smaller deductions for paid interest. It is possible, therefore, that both the governance innovation of corporate trustees and tax law operated in tandem to strengthen the trust's commitment to pay out free cash.[62]

There is another way of looking at the tax-governance relationship. The pre-2006 tax rules created incentives for trusts to pay out cash. As a result, there was less of a need to rely on other methods, such as independent, active monitors on the board, to discipline corporate managers. Once the tax reforms were introduced, the tax advantages of maintaining large intra-organizational debt disappeared. This may have shifted the optimal board composition from a passive one, relying on cash distributions as a discipline mechanism for management, to an active one, requiring scrutiny of management. This would suggest that one of the key governance innovations of the income trust form—the passive corporate trustee—became less valuable after tax reform. This would also explain the post–tax reform decline in trust structure adoption.

The Canadian experience with income trusts suggests that the governance innovation permitted by the trust form may be valuable; however, it also reveals that such value is either insufficient on its own to justify conversions to the trust form or is contingent on a particular tax structure. Governance innovation per se, which adopting the trust form would allow, does not appear to be especially valuable, either in its own right or as a signal. If this is so, the limited adoption of the

---

[61] *See, e.g.*, Alarie & Iacobucci, *supra* note 9, at 17 ("Differential tax treatment of the income trust has the consequence of allowing a business to commit better to paying out cash than an announced policy of paying high dividends.").

[62] Ribstein discusses the relationship between tax law and governance choices, noting that certain tax laws encourage distributions of cash. For example, partnerships are taxed whether they distribute cash or not, which encourages cash distributions. *See, e.g.*, RIBSTEIN, *supra* note 1, at 210 (discussing mechanisms through which cash distributions are encouraged). In the partnership example, the size of cash distributions does not affect the total amount of taxes that the partnership pays; therefore, the extent to which the tax law encourages distributions depends on liquidity problems for individual partners in the absence of distributions. The incentive to distribute cash in the income trust context is even stronger since a cut in distributions increases the combined tax bill of investors and of the organization.

business trust in North America, despite the scope of innovation that trusts permit, is not surprising.

### *B. Other Theories*

This Part considers and rejects four alternative theories for the limited adoption of innovative governance through the trust structure: imperfect information about the governance impact of innovation, managerial agency costs, adviser conservatism, and uncertainty about the impact of the trust form on limited liability.

Imperfect information about the governance impact of novel organizational forms may deter innovation. For example, uncertainty may increase the cost of future governance disputes since parties would be more likely to differ on their predictions of what the law requires in a given setting. If imperfect information were a problem for Canadian businesses seeking to adopt the trust form, it is plausible that there would have been positive network externalities: Businesses contemplating the form would have better information about the governance impact of becoming a trust once other businesses had adopted the form.[63] The prediction would be, therefore, that adoption of the form would promote further adoption of the form. There is evidence consistent with this prediction, as illustrated by Figure 1, which displays the pattern of adoption of the trust form in the Anand and Iacobucci sample of 187 trusts created in the 1996–2005 period.[64]

But other evidence casts doubt on the importance of imperfect information as a deterrent of innovation. If uncertainty deters innovation in governance, one would expect adoption of unconventional rules to follow a similar pattern to that of trusts themselves: Innovations would help resolve uncertainty and promote further innovation. As Anand and I reported previously, however, as time passed, income trusts were *more* likely to adopt conventional corporate terms, holding constant a variety of factors, including industry, size, headquarter location, nature of the legal adviser, and nature of the underwriter.[65] The pattern of adherence to the CBCA indicates that

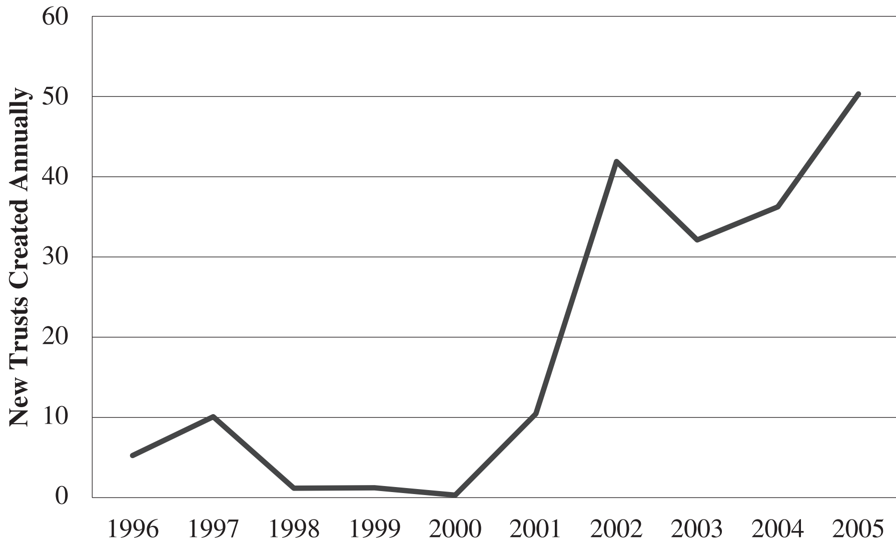
---

[63] *See, e.g.*, Kahan & Klausner, *supra* note 12, at 730–33 (discussing how learning benefits accrue to firms who adopt the trust form later in time).

[64] *See* Anand & Iacobucci, *supra* note 11, at 154 (describing the sample).

[65] To investigate potential causes of variation in governance terms, Anand and I regressed our measure of similarity to the CBCA on a number of factors. *See id.* at 161–66 (discussing controls for certain trust characteristics, such as jurisdiction, law firm experience, underwriter experience, transaction by which the income trust was formed, timing, presence of a controlling shareholder, quoted market value, and industry). Notably, the timing variable was significant and positive: Trusts increased resemblance to corporations over time, all things equal. *Id.* at 168.

FIGURE 1




uncertainty did not deter innovation. Moreover, as discussed earlier, the market appeared to welcome innovation, not fear it.

Another explanation for reluctance in adopting the trust form turns on managerial agency costs: Managers may resist the improved governance of income trusts. But even if managerial agency problems in existing companies were impeding adoption of the trust, this would not explain the extreme rarity of trust IPOs after the 2006 tax reform.[66]

Another problem might arise between businesses and their advisers. Advisers, such as lawyers, may have avoided suggesting the trust form to their clients because of self-interested conservatism resulting from their own lack of human capital in the area.[67] But the Canadian experience with income trusts casts significant doubt on this hypothesis. By 2006, at least some advisers had become experts in income trusts and would have been happy to continue their practice in this area. Despite this, only three businesses have adopted the form since 2006.

A final theory that may explain the reluctance of businesses to adopt the trust form relates to uncertainty about the impact of the

[66] Managers are more likely to internalize the costs of suboptimal governance in IPOs than in trust conversions. *See supra* note 40 (noting Jensen and Meckling's conclusion that owner-managers benefit from committing to avoid self-interested behavior).

[67] *See, e.g.*, Sitkoff, *supra* note 2, at 46 (discussing how a lawyer can have a "significant impact" on the decision to use a trust or corporation).

trust form on limited liability.[68] First, the basis for such a concern would be weak given the role of limited liability entities such as corporations within the income trust structure. Second, even if there had been such a concern, it was largely eliminated before 2006 with the passage of a number of provincial statutes establishing that unitholders in an income trust would not be liable for the debts of the trust.[69] Yet once the tax law changed, income trusts largely disappeared, even though concerns about limited liability had effectively been eliminated. Thus, uncertainty about limited liability is also not a plausible explanation for businesses' hesitation to adopt the trust form.

## Conclusion

The income trust experience provides insight into the apparent reluctance of businesses to adopt the trust form. Uncertainty does not appear to present an obstacle given that innovation away from corporate law norms was more common early in the income trust boom and was rewarded by the market throughout. The best answer appears to be that innovation per se is not particularly valuable given the virtual absence of new trusts following tax reform. While governance and tax law seem to interact in a way that created value in the income trust context, deviation from corporate law norms did not itself appear to generate significant gains. The questionable association between innovative governance and value in the income trust experience helps make sense of the dearth of business trusts generally.

---

[68] *See, e.g.*, *id.* at 36–37 (noting that a further problem with trust adoption was the lack of statutory recognition of limited liability for investors).

[69] For example, Alberta, British Columbia, Manitoba, Ontario, Québec, and Saskatchewan, the provinces in which almost all income trusts are domiciled, have statutes that explicitly provide for unitholder limited liability. *See* Income Trusts Liability Act, S.A. 2004, c. I-1.5, § 2(1) (Can. Alta.); Income Trust Liability Act, S.B.C. 2006, c. 14, § 2 (Can. B.C.); Investment Trust Unitholders' Protection Act, S.M. 2005, c. 36, § 2 (Can. Man.); Trust Beneficiaries' Liability Act, 2004, S.O. 2004, c. 29, sched. A, § 1(1) (Can. Ont.); Civil Code of Québec, S.Q. 1991, c. 64, § 1322 (Can.); Income Trust Liability Act, S.S. 2006, c. I-2.02, § 3(1) (Can. Sask.).