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## Should Provinces Compete? The Case for a Competitive Corporate Law Market

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Critical reflection on Canadian corporate law, the author argues, has long been too focussed on the benefits and advantages of centralization and uniformity, and insufficiently sensitive to the potential benefits of inter-governmental diversity and competition. In contrast to this, the author puts forward a model of competitive corporate law production. After examining the possible problems of a diverse corporate and commercial legal system, the potential benefits of the competitive model are discussed. The impact of the *Canada Business Corporations Act* is then examined as a case study of the effect that competitive innovation can have in instigating effective reform and modernization of corporate law regimes. The impact of the *CBCA* is evaluated in light of American studies on the effect of competitive law formation. In the final sections of the article, the author critically assesses the intellectual and institutional factors which may inhibit the adoption of the competitive model in Canada.

L'analyse critique en matière de droit corporatif canadien s'attarde trop souvent sur les avantages de la centralisation et de l'uniformisation, alors que l'étude des avantages que peuvent procurer la concurrence et la diversité inter-gouvernementales demeure négligée. L'auteur propose donc un modèle concurrentiel du processus législatif sur le plan du droit corporatif et discute des avantages et inconvénients d'un tel système. Une étude de la *Loi sur les sociétés par actions* fédérale démontre l'influence positive de la concurrence entre les régimes législatifs de droit corporatif en ce qu'elle incite à la réforme et à la modernisation de ces régimes. La loi fédérale est aussi évaluée à la lumière d'études américaines portant sur l'impact de la concurrence législative. L'auteur analyse enfin les facteurs intellectuels et institutionnels qui pourraient faire obstacle à l'adoption du modèle concurrentiel au Canada.

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## Introduction

The optimal distribution of power in a federal state is an issue which has received considerable attention from Canadian academics.<sup>1</sup> Building from an "original state," Canadian academics have harnessed the tools and insights of a wide range of disciplines to devise elaborate methodologies for determining how power should be divided among various levels of government in a modern nation state.<sup>2</sup> These efforts have imbued policy makers with an enhanced ability to identify and measure the trade-offs implied by alternative institutional arrangements. Unfortunately, however, they have also deflected attention from

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<sup>1</sup>For example, thirteen volumes of the background studies commissioned by the Royal Commission on the Economic Union and Development Prospects for Canada (the "MacDonald Commission") were concerned with this issue. See the volumes under the general heading, "Federalism and the Economic Union," in M. Krasnick, K. Norrie & R. Simeon, Research Co-ordinators, *Studies Commissioned as Part of the Research Program of the Royal Commission on the Economic Union and Development Prospects for Canada*, [hereinafter *MacDonald Studies*] vols. 59-71 (Toronto: University of Toronto Press in cooperation with Supply and Services Canada, 1986). See also R. Simeon, ed., *Confrontation and Collaboration: Intergovernmental Relations in Canada Today* (Toronto: The Institute of Public Administration of Canada, 1979).

<sup>2</sup>See M.J. Trebilcock, "Federalism and the Canadian Economic Union" in H. Bakvis & W.M. Chandler, eds., *Federalism and the Role of the State* (Toronto: University of Toronto Press, 1987) 216; T.J. Courchene, "Analytical Perspectives on the Canadian Economic Union" in M.J. Trebilcock et al., eds., *Federalism and the Canadian Economic Union* (Toronto: Ontario Economic Council and University of Toronto Press, 1983) 51; J.R.S. Prichard with J. Benedickson, "Securing the Canadian Economic Union: Federalism and Internal Barriers to Trade" in M.J. Trebilcock et al., eds, *supra* 3; A. Breton, "Supplementary Statements" in *Report of the Royal Commission on the Economic Union and Development Prospects for Canada*, vol. 3 (Ottawa: Supply & Services Canada, 1985) 483 [hereinafter *MacDonald Report*]; A. Breton & A. Scott, *The Economic Constitution of Federal States* (Toronto: University of Toronto Press, 1978); E.G. West & S.L. Winer, "The Individual, Political Tension and Canada's Quest for a New Constitution" (1980) 6 Can. Pub. Policy 3.

determining how *existing* institutional arrangements can be used to produce superior policy outcomes.

The failure to work seriously within the constraints of the existing constitutional order is clearly manifest in the area of corporate and commercial law reform. A pervasive theme in the Canadian legal literature is the inability of provinces to produce optimal corporate and commercial legal outcomes.<sup>3</sup> In particular, the configuration of Canadian corporate and commercial law has been criticized for its excessive diversity. This diversity is viewed as a natural by-product of the pre-eminent role played by provinces in fashioning corporate and commercial law. Accordingly, there have been wistful and repeated calls for institutional re-ordering aimed at reducing the scope of provincial diversity. Generally, these proposals take the form of either increased centralization of power in the federal government or increased co-ordination of the legislative output of provincial governments.<sup>4</sup>

The argument for enhanced centralization or co-ordination in these areas overlooks, however, the capacity of highly decentralized, competitive institutional arrangements to produce optimal — albeit, in some cases, diverse — provincial laws. Moreover, when competitive processes are examined more closely, it can be demonstrated that they are capable of producing surprisingly uniform provincial laws. Indeed, it can be argued that the more vigorous the level of inter-governmental competition in a state, the greater the likelihood that uni-

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<sup>3</sup>See Note, "Company Law in Canada" (1927) 5 Can. Bar Rev. 733 at 733:

it seems to be reasonably clear ... that the whole trouble and difficulty [in respect of contemporary corporate law] has arisen from the framers of the B.N.A. Act having given to the Provinces jurisdiction to constitute companies for provincial objects instead of placing the whole subject of company law within the exclusive control of either the Dominion or the Provinces.

See also E.E. Palmer, "Federalism and Uniformity of Laws: The Canadian Experience" (1965) 30 Law and Contemp. Probs. 250; J.S. Ziegel, "Our Neglected Commercial Law" (1988) 13 Can. Bus. L.J. 385; P. Anisman & P.W. Hogg, "Constitutional Aspects of Federal Securities Legislation" in Anisman *et al.*, *Proposals for a Securities Market Law for Canada*, vol. 3 (Ottawa: Consumer & Corporate Affairs Canada, 1979) 135.

<sup>4</sup>As J. Willis ("Securing Uniformity of Law in a Federal System — Canada" (1943-44) 5 U.T.L.J. 352 at 352) has noted: "There is no secret about the key to uniformity of law. It is centralization, centralization in the making of law and centralization in the administration of law." See also Palmer, *ibid.* at 250 ("by placing the vast bulk of important legislative competence in the hands of the federal government, a relatively high degree of uniformity can be obtained"); Ziegel, *ibid.*; R.C.C. Cuming, Research Co-ordinator, *Perspectives on the Harmonization of Law in Canada*, *MacDonald Studies* vol. 55 (Toronto: University of Toronto Press with the cooperation of Supplies and Services Canada, 1985); J.S. Ziegel, "Harmonization of Provincial Laws, with Particular Reference to Commercial, Consumer and Corporate Law" in R.C.C. Cuming, Research Co-ordinator, *Harmonization of Business Law in Canada*, *MacDonald Studies* vol. 56 (Toronto: University of Toronto Press with the cooperation of Supplies and Services Canada, 1986) 1; P. Anisman, "The Regulation of the Securities Market and the Harmonization of Provincial Laws" in *Harmonization of Business Law in Canada*, *supra* 77.

form laws will be generated. Seen in this context, the finding that provincial laws are excessively diverse may, depending on the circumstances, implicate either insufficient competition, insufficient co-ordination, or insufficient centralization. In this respect, unless Canadian policy analysts evaluate the legal framework in a manner devoid of political and ideological preconceptions, they will fail to appreciate the potential gains to be realized from enhanced competition.

In this article, I consider seriously the capacity of multi-governmental competition to generate optimal corporate and commercial laws for Canada. I begin in Part I by enumerating and evaluating the concerns surrounding diversity of provincial laws. With some qualification, I find the widespread concern with diversity in the corporate and commercial area to be overstated. In Part II, I set out the virtues of the decentralized, competitive model of law production, and identify the prerequisites for its effective functioning. In Part III, I examine the production of corporate laws in Canada and the United States, and show that, in sharp contrast to the conventional wisdom, competition among provincial governments is clearly capable of generating responsive and, indeed, uniform laws. However, in contrast to the United States, the Canadian corporate law regime lacks several of the institutions that are perceived to play an important role in enhancing certainty. The absence of these factors implicates certain flaws in both the intellectual and institutional environment present in Canada. Accordingly, in the last section of the article, I enumerate and assess the impact of these factors on corporate law production in Canada.

## I. The Problem of Diversity

### A. Introduction

Canadian commentators have long been troubled by inter-provincial diversity in corporate and commercial legislation. As Hurlburt states:

[b]usiness is made less efficient if it has to conform to differing provincial laws and regulatory requirements. This argument ... is most strongly made in connection with such fields as securities regulation, corporation, personal property security law, and insurance law.<sup>5</sup>

Whereas critics have shown some ambivalence in assessing the merits of diversity in legislation designed to vindicate explicitly "social" and "political" goals, they have appeared far less equivocal in their condemnation of diversity in the

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<sup>5</sup>W.H. Hurlburt, "The Harmonization of Provincial Legislation in Canada: The Elusive Goal" (1987) 12 Can. Bus L.J. 387 at 396. In discussing the merits of uniformity of corporate laws, Ziegel assumes that uniformity is important for the "large corporation which operates from coast to coast and whose shares are publicly traded," but is more equivocal regarding the merits of uniformity for smaller, intra-provincial corporations (J.S. Ziegel, "The New Look in Canadian Corporation Laws" in J.S. Ziegel, ed., *Studies in Canadian Company Law*, vol. 2 (Toronto: Butterworths, 1973) 1 at 66).

corporate and commercial realm. Diversity in corporate and commercial laws is credited with impairing the realization of myriad national goals, including the promotion and maintenance of a vital economic union.<sup>6</sup> For the most part, responsibility for diverse legislative patterns is traced to the decentralized institutional arrangements contemplated by the property and civil rights clause of the *Constitution Act*,<sup>7</sup> which confers jurisdiction over a vast range of corporate and commercial matters on the provinces.

The difficulty, however, with most of the arguments made against diversity is that they fail to articulate clearly what it is that makes diversity an unqualified evil. Examination of the various arguments against diversity reveals that these arguments are often overstated and tend to obscure the benefits to be derived from diversity in certain circumstances.

### B. *The Effect of Diversity — A Cost-Benefit Analysis*

#### 1. The Costs of Diversity

##### a. *Erosion of National Identity*

A number of commentators see diversity as exerting a destructive force on the development and flourishing of a distinctive national identity.<sup>8</sup> Basically, diversity is believed to undermine the sense of commitment to national goals and objectives that derives from common standards and legislative schemes. As one commentator has observed:

Every time a citizen — or even, it may be asserted, a prospective citizen — of Canada notices a basic similarity between the laws and institutions of his or her part of Canada and those of another part, the notion of Canada is strengthened. Every time he or she notices a basic dissimilarity of laws or institutions which is not readily explainable on rational grounds, the notion of Canada is weakened.<sup>9</sup>

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<sup>6</sup>Jacob Ziegel, for instance, argues that whereas “[l]ocal initiative and experimentation, which may be a good reason for diversity in legislation of a social character, has little to contribute in the business law area” (Ziegel, *ibid.* at 66).

<sup>7</sup>*Constitution Act, 1982*, being Schedule B of the *Canada Act 1982* (U.K.), 1982, c. 11, s. 92 (13) [hereinafter *Constitution Act*].

<sup>8</sup>For a general discussion of the corrosive effect of diversity on the formation of a distinctive national identity, see J. Porter, *The Vertical Mosaic: An Analysis of Social Class and Power in Canada* (Toronto: University of Toronto Press, 1965). Porter argues that the strong emphasis in the Canadian value system on regionalism and ethnic differentiation has resulted in the fragmentation of Canadian society, especially at the political level, and has rendered Canada incapable of dealing with some of its major problems as an industrial society. In a similar vein, Gad Horowitz has argued that there is a need for an “overarching” English-Canadian national community to take root and to serve as the beacon for a national identity. He sees the mosaic ideal discussed by Porter as poisonous, an apology or rationalization for the absence of an identity. See G. Horowitz, “Creative Politics” (1965) 3:1 *Can. Dimensions* 14 and “Mosaics and Identity” (1966) 3:2 *Can. Dimensions* 17.

<sup>9</sup>Hurlburt, *supra*, note 5 at 395.

In this vein, coast-to-coast sameness is perceived to be the very essence of nationhood.

Arguments for uniformity tied to preservation of national identity are, however, extremely problematic. The very term "national identity" is highly amorphous, and is amenable to multiple meanings and interpretations. Just as some commentators regard "sameness" as the touchstone of national identity, others view diversity and tolerance in themselves as hallmarks of Canadian identity.<sup>10</sup> Accordingly, the creation and maintenance of an environment supportive of divergent aspirations, whether of a regional, cultural, or linguistic nature, is seen to fulfil one of the core objectives of the Canadian nation. Arguably, the validity of this set of objectives has been enhanced by the dramatic influx of immigrants into Canada since the Second World War.<sup>11</sup> Viewed from this perspective, a conception of Canadian identity founded on diversity attracts greater normative force than one tied to sameness, and, consequently, is unable to serve as a compelling rationale for expanded uniformity.<sup>12</sup> This means that the argument against diversity must be made on other grounds.

*b. Savings from Duplicate Legislation Production*

Another argument against diversity is based on the benefits realized from concentrating law production activities in a single government rather than having multiple governments incurring separate costs of production for the same basic legislative product. These savings are a function of the degree to which individual governments in an uncoordinated model are able to benefit from the law production activities of other governments. If, as is usually the case, successful legislation can be easily duplicated, then the cost savings from centralization or coordination will be trivial. Put simply, in the absence of centralization or coordination, governments will adopt the product of first movers,

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<sup>10</sup>R. Breton, "Multiculturalism and Canadian Nation-Building" in A. Cairns & C. Williams, Research Coordinators, *The Politics of Gender, Ethnicity and Language in Canada, MacDonald Studies*, vol. 34 (Toronto: University of Toronto Press in cooperation with Supply and Services Canada, 1986) 27; Ministry of the Attorney General, Ontario, *Sources for the Interpretation of Equality Rights under the Charter: A Background Paper* (January, 1985) at 91; P.E. Trudeau, "Statement on Multiculturalism" in H.D. Forbes, ed., *Canadian Political Thought* (Toronto: Oxford University Press, 1985) 349; P.E. Trudeau, *Conversation with Canadians* (Toronto: University of Toronto Press, 1972) at 32; R.L. Watts, *Multicultural Societies and Federalism: Studies of the Royal Commission on Bilingualism and Biculturalism*, vol. 8 (Ottawa: Information Canada, 1970).

<sup>11</sup>See Y. Péron & C. Strohmenger, *Demographic and Health Indicators: Presentation and Interpretation* (Ottawa: Statistics Canada, Minister of Supply & Services, 1985) at 68, for a useful summary of Canadian immigration patterns in the twentieth century.

<sup>12</sup>Admittedly, the distinction between "sameness" and "diversity" definitions of national identity is somewhat artificial. Both conceptions ultimately draw on elements of the other for support. For instance, development of a national environment conducive to diversity may require the creation of uniform standards to ensure that legislative outcomes that impinge on rights of minority expression, although formally diverse, are not adopted.

perhaps with slight modification,<sup>13</sup> thereby avoiding duplication of law production costs incurred elsewhere. While it is possible that another potential source of benefit, economies of scale,<sup>14</sup> may be realized from concentrated law production, as a practical matter these gains are likely to be small.

*c. Transactions Costs*

A stronger rationale for uniformity is found in its ability to reduce costs incurred by transactions executed across multiple jurisdictions. Under a regime characterized by incongruent legislation, individuals or corporations wishing to engage in economic activity in more than one provincial jurisdiction are confronted by search and compliance costs that constitute a barrier to mobility of factors and goods across the country. Search costs involve the costs of identifying and understanding the compliance requirements triggered by multi-jurisdictional activity. Obviously, the more complex the activity, and the more uncertain the content of the legal regime in the host jurisdiction, the higher the level of search costs triggered.

Presumably, for complex transactions, legal costs comprise a major component of search costs. These costs are magnified by provincial law society restrictions on the capacity of Canadian lawyers to render opinions on the law in extra-provincial jurisdictions.<sup>15</sup> This feature works, not surprisingly, to increase search costs because it prevents actors from availing themselves of the benefits of economies that would flow from dealing with one legal advisor.<sup>16</sup>

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<sup>13</sup>Consideration of the effects of free-riding on the incentive to innovate is dealt with in Part II.

<sup>14</sup>Economies of scale permit large manufacturers to produce and market their products at lower average cost per unit than relatively small producers. See, for instance, the discussion in F.M. Scherer, *Industrial Market Structure and Economic Performance*, 2d ed. (Chicago: Rand McNally, 1980), c. 4.

<sup>15</sup>A lawyer who has been called to the Bar in one province cannot give a formal legal "opinion" on the law in another province although, of course, such a lawyer can express a qualified "view" of the law. For instance, a member of the Ontario Bar could not *opine* that an entity had been validly incorporated in British Columbia. There are, however, provisions in each of the provinces for lawyers from other provinces to make "occasional" court appearances: see, e.g., *Law Society Act*, R.S.O. 1980, c. 233, s. 62(1) para. 24; *Law Society Act Regulations*, R.R.O. 1980, Reg. 573, s. 6. The purpose of such provisions is to enable lawyers to make one-time court appearances without having to write the provincial Bar examinations. In practice, however, these provisions can hardly be characterized as permissive; a great deal of discretion rests in the hands of the provincial Law Societies. Indeed, the process is viewed by some as so uncertain and arbitrary by some lawyers that writing the full range of bar exams necessary to qualify for practice in an extra-provincial jurisdiction is deemed to be the soundest option.

<sup>16</sup>Paraphrasing, it is worth noting that, owing to endemic information problems, search costs are unlikely to be susceptible to reduction by co-ordinated activity of similarly situated actors. These costs arise from a number of different sources. First, information on the legality of transactions in different jurisdictions is highly contingent on the underlying transaction. Slight variance in the form of the transaction may have a profound impact on its legal status. Also, given asymmetries in information, legal advisors are likely to exaggerate the meaning of these differences in an effort to increase artificially the demand for their services. Second, the contingency of legal

Assuming that actors are able to obtain a full understanding of host province law, they are then faced with multi-jurisdictional compliance costs. These costs may simply require the actor to incur relatively modest costs of duplicating, perhaps with slight modification, a standard compliance strategy across different jurisdictions. However, if the standards contained in the various provincial statutes diverge from one another to the point where compliance as mandated in one jurisdiction will bring the actor into conflict with the standards extant in another jurisdiction, additional investments in reconciliation activities must be incurred. These costs may be significant, and increase substantially the likelihood that individuals or corporations will simply refrain from engaging in multi-jurisdictional activity.<sup>17</sup>

The foregoing discussion on transactions costs is, however, subject to one very crucial caveat. That is, these costs are only significant when provinces respond to inter-provincial activity by actually attempting to regulate it. As the corporate law case study developed in Part III indicates, when provinces, whether because of judicial or self-imposed restraint, refrain from regulating activity within their borders that is already subject to regulation elsewhere, multi-jurisdictional compliance costs are dramatically reduced.

## 2. The Benefits of Diversity

The benefits of diversity are related to the increases in voter preference satisfaction that derive from having local (*i.e.*, within provincial boundaries) concentrations of values and beliefs reflected in legislation. In contrast, if jurisdiction over a certain subject area is conferred on the federal government, or if the provinces retain jurisdiction but agree to adopt uniform legislation, legislation will be much less responsive to local preferences. For the most part, this is related to the pre-eminent role of consensus processes in the formulation of uni-

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advice is exacerbated by its temporal nature. The content of the law is undoubtedly fluid, and, even if applied to exactly similar fact situations, it may, because of the passage of time, rapidly depreciate in value. At a minimum, legal advice must be updated to ensure that it is of a timely nature. Third, even assuming perfect symmetry in the form and timing of a transaction, actors may face insuperable difficulties in identifying partners for joint search activities. Because of the danger that competitors will exploit prior announcements of certain transactions to their own benefit, actors are unlikely to be willing to make contemplated transactions known in order to identify corporations that are "similarly situated."

<sup>17</sup>This problem has been a frequent source of complaint in the financial regulation realm. For instance, Canadian managers have long bemoaned the multi-jurisdictional compliance costs related to the multi-level regulation of securities activities. A comprehensive analysis of the impact of provincial regulation on the performance of this regime is found in Anisman, *supra*, note 4. Recently, the issue of multi-jurisdictional compliance has come to the fore in the financial institutions area. In particular, the adoption of the highly controversial Equals Approach by the Ontario government has imposed costs on extra-provincially incorporated loan and trust corporations wishing to carry on activity in Ontario. See R.J. Daniels, "Federalism and Regulation of Canadian Financial Institutions: A Prescription for an Ailing Patient" *Can. Bus. L.J.* (forthcoming, 1991).

form legislation. The issue is, then, whether via the unilateral action of the federal government or the co-ordinated action of the provinces, local concentrations of preferences are likely to be subordinated to the preferences of *ad hoc* national coalitions.<sup>18</sup>

Obviously, the benefit from allowing the provinces the scope to respond to local preferences in their pristine form is a function of the strength and homogeneity of local preferences, the correspondence of local concentrations of preferences with provincial geographical boundaries, and the degree of divergence in the strength and direction of preferences across different provinces. The widely held view that diversity is bereft of value in the corporate and commercial realm can be understood in these terms. Since corporate and commercial legislation is seen to be devoted to the realization of goals that are not believed to vary in intensity or content across provinces, a strong presumption against the value of diversity in this setting is seen to operate.

I believe, however, that the argument against diversity in the corporate and commercial area that is tied to preference satisfaction is overbroad. Preferences for corporate and commercial legislation are not necessarily uniform across the country, and can vary in accordance with economic or geographic factors. For instance, the content of commercial laws used to support an economy tied to resource extraction may differ from those required to support an economy devoted to agriculture or manufacturing.

Similarly, diversity in corporate and commercial laws may be found to be salutary if the constituencies (and preferences) that provinces are dedicated to are considered more expansively. It is possible that provinces may wish to "specialize" in legislation that satisfies the preferences of consumers residing in *another* provincial jurisdiction. This claim has been advanced by Baysinger and Butler in the context of American corporate law.<sup>19</sup> They argue that diversity in

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<sup>18</sup>This phenomenon is discussed in "public-choice" literature analyzing federalism. See, *e.g.*, Prichard with Benedickson, *supra*, note 2, where it is pointed out that interest groups that may be minorities nationally are more likely, mathematically, to become majorities locally.

<sup>19</sup>Barry Baysinger and Henry Butler ("The Role of Corporate Law in the Theory of the Firm" (1985) 28 J.L. & Econ. 179) contend that the corporate governance characteristics of a firm govern the firm's jurisdiction selection decision. Firms with dispersed share ownership will gravitate to "liberal" corporate law regimes, while firms with concentrated share ownership will migrate to "strict" corporate law regimes. "Liberal" regimes are characterized by minimal scope for direct controls by shareholders, while "strict" regimes afford relatively greater scope for shareholder activism. To substantiate their claim, the authors compare the share performance of firms in "strict" and "liberal" regimes, and find no detectable differences in performance. In a similar vein, Richard Posner and Kenneth Scott (*Economics of Corporation Law and Securities Regulation* (Boston: Little Brown and Co., 1980) at 111) posit a relationship between jurisdiction selection and corporate size. They suggest that Delaware has a commanding presence in the reincorporation market because of the amenability of its regime to large corporations. Roberta Romano ("Law as Product: Some Pieces of the Incorporation Puzzle" (1985) 1 J.L. Econ. & Org. 225) expresses reservation

the content of American corporate statutes can best be understood as an attempt to specialize in the regulation of different types of corporations and corporate conduct. In these terms, diversity in legislation is akin to diversity of products and services in private markets; in both cases, consumer welfare (in narrow economic terms) is augmented by producer specialization.

### 3. A Comparison of Costs and Benefits of Diversity

Ultimately, the case against diversity in the corporate and commercial realm is more complex than is generally acknowledged by its critics. To support a claim for generic uniformity, it is not sufficient merely to identify some costs from diversity. Rather, it is necessary to demonstrate that diversity's costs exceed its benefits. In contexts where there is no tangible benefit to be obtained from diversity, the calculus is straightforward and supports efforts to minimize the scope of such diversity. However, more commonly, there are both costs and benefits to be considered in the case against diversity. Yet, comparison of diversity's costs and benefits is fraught with uncertainty, and is likely biased in favour of rejecting diversity's utility in most settings. This is because the costs of diversity are relatively easy to enumerate, while the benefits are less susceptible to precise quantification. The inability of policy-makers to attach determinate values to the benefits of diversity drives a natural temptation to reject its overall value.

However, even if diversity is found to be normatively undesirable in a given isolated context, it is important to evaluate the case for reducing it in a *dynamic* framework. That is, in a highly competitive setting, it is possible that laws may at times be diverse, while at other times highly uniform. If diversity is only a temporary phenomenon, perhaps even a necessary antecedent to uniformity, then perhaps policy-makers should refrain from implementing enhanced co-ordination and centralization.

The concerns raised in this discussion cumulatively militate against the wholesale rejection of diversity in the corporate and commercial context. Although diversity in corporate and commercial legislation is, in many commercial settings, likely to generate more costs than benefits, it is important to be aware that there may be many exceptions to this rule. These exceptions can, of course, be identified only with fairly rigorous analysis.

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with the product differentiation argument on the basis of its inherent indeterminacy. Citing the work of Michael Spence ("Product Selection, Fixed Costs, and Monopolistic Competition" (1976) 43 Rev. Econ. Studies 217), she questions the capacity of product differentiation to generate a stable equilibrium for the charter market. She is also dubious of the implicit assumption in the product differentiation hypothesis that responsive states cannot accommodate the needs of diverse corporate constituencies within the same corporate regime. Finally, and most relevant to the concerns of Canadian critics, Romano posits that diversity in the context of the American charter market is simply a reflection of differential rates of adoption of corporate law innovations by states. Competition, in this respect, exerts a centripetal, not a centrifugal, effect on product diversity.

## II. Competitive, Centralized and Co-ordinated Models of Law Reform

Given the difficulties that confound relatively straightforward assessment of the merits of diversity in the corporate and commercial area, the prevalence of unequivocal support for institutional changes designed to diminish its scope is perplexing. Moreover, the changes most frequently called for to promote uniformity, greater centralization<sup>20</sup> or greater co-ordination,<sup>21</sup> are problematic because of their propensity to suppress market signals that can guide the formulation of legislation. This suppression confers a near-monopoly role on governmental bureaucrats in selecting the raw material for the law production process. As a consequence, the danger of mistaken or unresponsive legislative outcomes is increased. This includes the possibility that uniform legislation will be provided when diverse legislation is much more appropriate.

In contrast, in the competitive, decentralized model of law production, market forces are seen to play a pre-eminent role in the generation of legislation. Not unlike the allocation of resources in private economic markets, the production of laws in the decentralized model is seen to be guided by the "invisible hand" of consumer demand. In this model of law production, local governmental units are believed to compete against one another in the provision of legislative product. Those governmental units providing superior products will, like "winners" in economic markets, enjoy benefits from increased consumer patronage.<sup>22</sup> In this framework, the fact that gains in market share may accrue

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<sup>20</sup>That is to say, augmented federal power. See Anisman & Hogg, *supra*, note 3.

<sup>21</sup>Co-ordination of provincial outcomes can be achieved through a number of different mechanisms. In the simplest case, co-ordination is accomplished by the actions of a central agency that is expressly charged with the task of producing common legislation that will govern the same subject matter in all of the provinces. The Uniform Law Commission of Canada is the paradigmatic example of this type of agency. An alternative, less formal way of co-ordinating provincial government legislative output is through consultative activities. These activities may culminate in the conclusion of formal agreements (*e.g.*, memoranda of understanding) or informal commitments among the various governments.

<sup>22</sup>The claim that competitive provincial interaction is capable of producing superior laws owes much to Tiebout's model of local government. See C.M. Tiebout, "A Pure Theory of Public Expenditures" (1956) 64 J. Pol. Econ. 416. Tiebout designs his model of local government in an effort to show that the interaction of local governments and "consumer-voters" could overcome daunting revealed preference problems in the provision of public goods. Specifically, Tiebout posits that, under certain simplifying assumptions (*i.e.*, perfect information, negligible mobility costs, trivial external economies and diseconomies, and a large set of available destination jurisdictions), the migratory decisions of "consumer-voters" among local governmental jurisdictions can manifest honest revelations of individual preferences (*supra* at 420). The greater the number of choices (*i.e.*, local governmental units) that a "consumer-voter" can select from, the more likely that optimal matches between "consumer-voters" and local governments will result. If there is a hint of unreality about Tiebout's model, it is his assumption that local governments do not "adopt" the preferences of "consumer-voters"; rather, local governments are only "adopted" by "consumer-voters." The model of federalism developed in this article corrects for this deficiency, and anticipates that

to one province at the expense of another is both predictable and uncontroversial. Moreover, diversity in government output indicates either specialization of provincial activity or legal innovations introduced by competitive governments in an effort to gain market share. In any event, in this model, shifting market share, diversity of outcome, and rivalrous behaviour are indicators of optimal processes of law production.

In choosing among the various models, it is my submission that, provided that certain threshold criteria are satisfied, the competitive model is an unequivocally superior mechanism for supplying legislative product. The source of the competitive model's superiority can be identified through comparative examination of its supply and demand features.

A. *Demand and Supply Side Evaluation of the Competitive versus Centralized and Coordinated Models*

1. Demand Side

On the demand side, interested citizens in a competitive framework are able to signal their preferences to government more effectively and, once these preferences have been signalled, to monitor more effectively the way in which government responds to them, than can citizens whose legislation is derived from centralized or co-ordinated processes.<sup>23</sup> The ease in signalling is a function of the greater access of citizens to governments when the ambit of government jurisdiction is more circumscribed. Ease in signalling also reflects the heightened ability of citizens to register their preferences to government via voice and exit mechanisms.<sup>24</sup> Exit mechanisms, for instance, are very effective in the competitive model. If citizens (consumers) are dissatisfied with the legal product in a certain provincial jurisdiction, they can simply migrate to another jurisdiction offering a superior product. Because exit entails an immediate and possibly irreversible loss of citizen votes or revenue, it is effective in capturing the attention of government officials. Following the standard predictions of the public

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provinces will consciously modify their policy "bundles" so as to enhance the appeal of residency in their jurisdiction to mobile constituents.

<sup>23</sup>It can be argued that increased access by affected citizens to the legislation-making process is an *undesirable* feature of competitive models. That is, increased access raises the prospect of capture of the legislative process by special interest groups. Accordingly, the insulation from client demands implied by the co-ordinated model is seen to be conducive to the generation of optimal laws. Because, however, it is hard to construct a strategy that filters desirable from undesirable inputs, increased insulation will effectively attenuate the voice of all voters, irrespective of the breadth of their particular interests. As a consequence, the accountability of law-makers is reduced. The answer to capture by narrowly defined interest groups is not wholesale exclusion of all affected voters from the law-making process. Rather, it is the design and implementation of institutional safeguards that will ensure that all voters affected by contemplated legislation, including those beset by collective action problems, are properly represented in the law-making process.

<sup>24</sup>The terminology is from A.O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge: Harvard University Press, 1970).

choice model, any possible reduction in the size of "fiefdoms" is likely to impact adversely on the individual welfare of senior bureaucrats and politicians owing to their preoccupation with attaining enhanced prestige and power.<sup>25</sup> In contrast, co-ordinated and centralized models of law production render bureaucrats and politicians much less responsive to signalling via direct market pressures. In large part this is attributable to the lack of a credible exit option. When all of the provincial legislation is homogeneous, or when the federal government is the sole supplier of legislation, exit threats become less credible because inter-provincial migration does not enable a disaffected citizen to access superior legal products.<sup>26</sup> Indeed, in this setting, the only credible exit option available to disgruntled citizens is international migration. But, owing to a variety of restrictions on international mobility of goods and factors (in the form of immigration restrictions, investment constraints, etc.), such migration is much more difficult than inter-provincial migration. As a result, when the sole threat of exit is international in nature, the ability to demand favourable legislation through direct market pressure is attenuated.

In terms of the competitive versus the co-ordinated model, another demand-side strength of the former is the greater ease that citizens have in monitoring governmental responsiveness to preferences. With one level of government (and, in the normal case, one governmental department) responsible for the formulation of legislation, citizens will have no difficulty determining responsibility for tardy or misconceived legislation. In contrast, the linkage between legislative outcome and provincial responsibility is much more oblique in the co-ordinated model. Because, in this case, legislation is the by-product of a process involving the interaction of multiple provincial governments, final

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<sup>25</sup>See, for example, M.J. Trebilcock, L. Waverman & J.R.S. Prichard, "Markets for Regulation: Implications for Performance Standards and Institutional Design" in *Government Regulation: Issues and Alternatives* (Toronto: Ontario Economic Council, 1978). For a discussion of the role of bureaucratic behaviour in shaping federalist institutions, see A.C. Cairns, "The Governments and Societies of Canadian Federalism" (1977) 10 *Can. J. Pol. Sci.* 695.

<sup>26</sup>It is possible, however, that exit threats may be somewhat credible in the centralized or co-ordinated models if non-legal (*i.e.*, administrative) factors are an important component of legal products and the provinces have the discretion to differentiate their products along this axis. Competition for market share on the basis of non-legal attributes is predicted by organizational theory. For example, a co-ordinated legal regime can be likened to a cartel agreement among manufacturers governing the price of goods. Although there is a commitment to uniform price, cartel members regularly attempt to gain more than their allotted market share by competing on other product dimensions, such as product quality, support services, marketing, etc. Similarly, provinces that have committed to uniform legislation may compete for market share by offering more efficient administration of the legislation. Significant possibilities for this sort of differentiation exist in provincial Personal Property Security legislation, with regard to the Registration System. Different provinces may register secured properties with varying degrees of efficiency and detail, so that a printout of secured properties provided by the government pursuant to a PPSA search may provide very current and detailed information on the properties subject to security interests, or it may not be very helpful at all.

outcomes only weakly correlate with the action of particular provinces. As in other areas where output is achieved through team production, close scrutiny of outputs casts little or no light on the contribution of individual team members.<sup>27</sup> In this setting, each of the provinces can be expected to deflect blame for the generation of perverse decisions onto other members of the team. And, barring the existence of a highly transparent process, citizens will have no way of assessing actual responsibility.<sup>28</sup>

## 2. Supply Side

From a national perspective, the most salutary supply side characteristic of competitive law production is its encouragement of provincial experimentation. By encouraging the provinces to serve as "laboratories" for development, production, and adoption of innovative laws and policy, the risk of widespread adoption of flawed laws is reduced. In contrast, because both the centralized and co-ordinated models involve nation-wide adoption of novel legal products, the costs entailed by the adoption and correction of misconceived laws are increased. This point has been perceptively noted by Weiler in the labour law context:

The events of the 1970s have demonstrated the virtues of provincial jurisdiction and federal diversity ... Individual provinces can try out serious innovations. Each legislature responds to different characteristics of its industries; different complexion of the work force and its trade union allegiance; different political spectra. *If a statutory experiment proves successful, it can and is quickly emulated elsewhere in the country. If it proves a mistake, it can be quickly liquidated without widespread damage* (emphasis added).<sup>29</sup>

A second strength of the competitive model is based on the simplicity of its production function. Because of the more concentrated and homogeneous nature of preferences that are manifest in decentralized political units, government officials are able to produce legislation without having to devote excessive time and energy to the task of sorting, weighing, and reconciling diverse or competing preferences. In contrast, these activities constitute a central component of the task of legislation production in the centralized and co-ordinated

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<sup>27</sup>See, for example, the discussion in A. Alchian & H. Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 *Amer. Econ. Rev.* 777.

<sup>28</sup>In such cases, the only recourse left for citizens aggrieved by the production of perverse laws is to attempt to influence all of the provincial representatives involved in a given legislative initiative. Obviously, however, lobbying all of the officials involved in the production of co-ordinated laws is expensive. It is also less certain, for it is not at all clear that governmental officials from "foreign" provinces will be receptive to claims brought by citizens outside their provinces.

<sup>29</sup>P. Weiler, "The Virtues of Federalism in Canadian Labour Law" in F. Bairstow *et al.*, eds, *The Direction of Labour Policy in Canada, 25th Annual Conference, 1977* (Montreal: Industrial Relations Centre, McGill University, 1977) 58 at 59. See also Breton, "Supplementary Statements," *supra*, note 2; Breton & Scott, *supra*, note 2; A. Breton, "The Growth of Competitive Governments" (1989) 22 *Can. J. Econ.* 717.

models. Indeed, in the case of the co-ordinated model, this task is rendered especially complex owing to endemic collective action problems.<sup>30</sup> That is, if, as is conventionally the case, a rule of unanimity is relied upon as a way of ensuring that the preferences of all provinces are enshrined in legislation, the process of legislation production is likely to be inhospitable to the production of timely, bold, and innovative legislation. If provinces possess divergent views on the ideal form of legislation, considerable compromise, with attendant delay, will be required in order to secure agreement on joint outcomes. Moreover, in an effort to reach elusive consensus, outcomes are likely to be drawn to the lowest common denominator, thereby diluting the strength with which deeply held preferences are reflected in legislation. These problems are magnified considerably if provinces act opportunistically by cynically exploiting differential interests in and commitments to the production of joint outcomes by various group members.<sup>31</sup>

### 3. Conclusion

Comparison of competitive, centralized, and co-ordinated models of legislation production demonstrates the superiority of competitive models. Simply put, in an environment characterized by decentralized, competitive interaction, government officials are forced to respond to citizen preferences, not as a matter of grace, but as a matter of compelling necessity. Moreover, the greater provincial autonomy and accountability contemplated by this model enhances the ability of provinces to reflect these preferences in their pristine form. In contrast, the centralized and co-ordinated models are less able to effectively satisfy citizen preferences because of demand and supply-side defects.

#### *B. The Conditions Necessary for Optimal Production of Laws in a Competitive Framework*

In view of the superior capacity of competitive law production processes to generate optimal laws, I now consider the factors that determine the vitality of this model across a wide range of subject areas. The literature on the economics of federalism indicates that four basic factors are necessary for optimal leg-

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<sup>30</sup>“Public-choice” theorists stress the problems which arise with rules of unanimity. A leading work in this area is M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge: Harvard University Press, 1965). At 41 he points out, “Whenever unanimous participation is required, any single holdout has extraordinary bargaining power; he may be able to demand for himself most of the gain that would come from any group-oriented action .... This incentive to holdouts makes any group-oriented action less likely than it would otherwise be.” See also J.M. Buchanan & G. Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962), c. 8 at 96.

<sup>31</sup>For instance, a province with a marginal interest in a contemplated initiative may “hold-up” the entire production process in order to wrest concessions from “large-stake” provinces. This type of behaviour threatens the conceptual coherence of the entire process, and increases the likelihood of generating a legal product that is punctuated by a series of unprincipled, *ad hoc* compromises.

islative outcomes to be generated in the competitive model: (i) a high degree of mobility of people and resources; (ii) a large number of destination jurisdictions; (iii) jurisdictional latitude in the selection of laws; and (iv) no spillover effects.<sup>32</sup> Each of these will be discussed in turn.

### 1. Jurisdictional Mobility

For exit threats to be credible in the competitive model, citizens must enjoy a high degree of inter-jurisdictional mobility. There are, however, a wide range of barriers that impede inter-jurisdictional migration. The most onerous barriers to mobility are suffered when physical relocation in the destination jurisdiction is a prerequisite to the consumption of superior legal products. Barring physical relocation, it would simply be impossible for an Ontario citizen to consume Saskatchewan's social welfare or labour laws. However, physical relocation is seldom accomplished without cost. At one level, these costs are derived from explicit governmental policies. By physically relocating in another jurisdiction, citizens may sustain significant reductions in wealth. For instance, the "home" jurisdiction may impose restrictions on the transportability of certain employment benefits, while "destination" jurisdictions may impose certain qualification tests on entrants that limit their ability to work or access benefits.<sup>33</sup> At another level, physical relocation costs emanate from non-governmental or natural sources. These include: tangible relocation costs (*e.g.*, search costs entailed in finding a new home or job, miscellaneous moving costs, etc.), losses in human specific capital, and psychic losses resulting from the disruption or severance of community ties.

Another barrier that powerfully limits inter-jurisdictional mobility when physical relocation is a prerequisite to consumption is the "bundling" of legal products.<sup>34</sup> Tied consumption bundles raise the possibility that, regardless of the

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<sup>32</sup>See Tiebout, *supra*, note 22 and F.H. Easterbrook, "Antitrust and the Economics of Federalism" (1983) 26 J.L. & Econ. 23 at 34.

<sup>33</sup>See, *e.g.*, M.J. Trebilcock, M. Chandler & R. Howse, *Adjusting to Trade: A Comparative Perspective* (Ottawa: Economic Council of Canada, 1988). In this study at 227, the authors point out that under Canada's Unemployment Insurance system, regional differentiations in the level and duration of benefits reinforce the concentration of temporary and unstable jobs in high unemployment and low wage regions. See also J.M. Cousineau, "Unemployment Insurance and Labour Market Adjustments" in F. Vaillancourt, Research Co-ordinator, *Income Distribution and Economic Security in Canada, MacDonald Studies*, vol. 1 (Toronto: University of Toronto Press in cooperation with Supply and Services Canada, 1985) at 187; T.J. Courchene, *Social Policy in the 1990s: Agenda for Reform* (Toronto: C.D. Howe Institute, 1987).

<sup>34</sup>In antitrust parlance, this bundling is referred to as a "tied sale" or a "tying arrangement." The presumption underlying the prohibition of such arrangements is that consumers are prevented from making optimal consumption choices. It should be noted, however, that a vociferous group of antitrust scholars feels that the prohibition on tying arrangements — and the "leverage theory" which is invoked to justify the prohibition — cannot be supported on logical, principled grounds. See R.H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (New York: Basic Books, 1978) at 365; R.A. Posner, *Economic Analysis of Law*, 2nd ed. (Boston: Little, Brown, 1977) at 226; W.S.

unequivocal superiority of certain laws, consumers will not move to take advantage of them because of the forced consumption of other, less optimal laws. For instance, while a potential destination province's corporate and commercial laws may be valued by a consumer, its broad social laws may be viewed by that same consumer as being antiquated and unresponsive. The lack of utility that is occasioned by the latter may indeed eclipse any utility realized by consumption of the former, leading the consumer to refrain from migrating. These problems are predictably exacerbated by the inclusion of non-legal (economic, cultural, climatic, geographic) considerations into the jurisdiction selection calculus.

Many of these problems are, of course, mitigated when physical relocation is not a precondition to consumption of legislation offered by another jurisdiction. However, there are relatively few species of legislation that are conducive to consumption without physical relocation of citizen-consumers. And indeed, even for the relatively few situations where this is possible, such as corporate law, inevitable and non-trivial adjustment costs will be sustained that may militate against migration.<sup>35</sup> In any event, the foregoing discussion suggests that consumers are unlikely to be highly responsive to relatively marginal changes in the legal product of a potential destination jurisdiction. Rather, in order for migration to occur, the benefits of legislation offered by a competitor jurisdiction must exceed non-trivial relocation costs.

## 2. Large Number of Destination Jurisdictions

The second requirement for the production of optimal laws in the competitive model is a large number of destination jurisdictions. Unless a range of destination jurisdictions is available, it is unlikely that citizens will have the product choice necessary to make meaningful migratory decisions. Partly, this reflects a belief that a multiplicity of choices is necessary in order to satisfy the full range of consumer preferences. Partly, it reflects concern with the prospect of anti-competitive cartels forming when the number of destination jurisdictions is small. That is, the likelihood that cartels will form and persist is greater the smaller the number of goods suppliers.<sup>36</sup> Anti-competitive activity in the case of

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Bowman, Jr., "Tying Arrangements and the Leverage Problem" (1957) 67 Yale L.J. 19. For an article supporting leverage theory, see L. Kaplow, "Extension of Monopoly Power through Leverage" (1985) 85 Col. L. Rev. 515. A critical discussion of this issue in a Canadian context is in B. Dunlop, D. McQueen & M.J. Trebilcock, *Canadian Competition Policy: A Legal and Economic Analysis* (Toronto: Canada Law Books, 1987) at 253.

<sup>35</sup>This point is discussed by Romano, *supra*, note 19 at 246.

<sup>36</sup>Scherer looks at price-fixing and collusive agreements and the studies done on them: One prominent feature is the typically small number of sellers and the high degree of seller concentration in the relevant product or geographic market. Evidently, agreement is easier to achieve when the number of sellers is modest — *e.g.*, ten or fewer ... (*supra*, note 14 at 175).

legislation production may take the form of a collusive agreement among governments to refrain from legislative innovation in an effort to maintain stable market shares.<sup>37</sup>

Related to the multiple destination condition is the requirement of perfect information. That is, if the costs of obtaining and assimilating information respecting legislative differences are prohibitively high, then citizens will be unable to avail themselves of the information's benefits. Accordingly, to the extent that nuances in laws among jurisdictions are disseminated in a timely and accessible manner, the benefits from legislative diversity are enhanced. Interpretation and assimilation barriers are less easily redressed. The value of a novel legislative initiative may not be immediately apparent to all citizens interested in it. A costly learning process, whereby more risk-averse citizens studiously examine the effects of novel legislation on those first subject to it, may be inevitable.

### 3. Jurisdictional Latitude in the Selection of Laws

The third requirement, jurisdictional latitude in the selection of laws, means that jurisdictions must not be subject to external constraint in the production of laws. If governments are constrained in their capacity to respond to market forces, owing to constitutional or quasi-constitutional restrictions, then their scope for autonomous competitive action is reduced.

### 4. Internalization of Benefits and Costs

The fourth requirement of a vigorous competitive model is the full internalization of the costs and benefits of laws onto their direct suppliers and consumers.<sup>38</sup> Less than complete internalization of the effects of legislation, as in the case of other conventional goods, will perversely distort optimal production and consumption decisions. In the realm of legal product manufacture, the most serious externality results from the inability of innovating jurisdictions to limit

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See also G.A. Hay & D. Kelley, "An Empirical Survey of Price-Fixing Conspiracies" (1974) 17 *J.L. & Econ.* 13 at 21; A.G. Fraas & D.F. Greer, "Market Structures and Price Collusion: An Empirical Analysis" (1977) 26 *J. Indust. Econ.* 21.

<sup>37</sup>This argument has been made by H.N. Butler & J.R. Macey, "The Myth of Competition in the Dual Banking System" (1988) 73 *Cornell L. Rev.* 677, in the context of the dual banking system in the United States. They suggest that there is little competition among states and the federal government for market share in banking regulation because of tacit collusive agreement.

<sup>38</sup>Internalization of costs and benefits and "externalities" are discussed in Posner, *supra*, note 34 at 51, 139, & 293 and in R. Cooter & T. Ulen, *Law and Economics* (Glenview: Scott, Foresman, 1988) at 45 & 169. At 170, the authors point out that

[t]he essence of the problem created by externalities is that they make the utility-maximizing actions of consumers and the profit-maximizing actions of firms inefficient .... Efficiency can be restored by getting the externality-generator to *internalize* these external effects. Thus, one of the important economic aspects of property law is to try to induce this cost internalization when property rights are not separable.

competitor jurisdictions from duplicating successful innovations. In large part, this is due to the lack of appropriate and enforceable intellectual property rights in this area.<sup>39</sup> Lacking a robust intellectual property regime, successful legal innovation can be costlessly and quickly adopted by “free-riding” jurisdictions. As a consequence, many of the expected gains from successful legal products, in terms of enhanced market share, are denied to innovating states.<sup>40</sup>

This phenomenon poses a serious problem for the competitive model. Essentially, the risks of innovative laws are borne asymmetrically: the benefits of successful legal innovations are shared with non-innovating, free-riding states, whereas the consequences of failed innovation (sunk research and development costs, migration of constituents out of the jurisdiction, and diminished reputation and goodwill) are shouldered by the innovating state alone.<sup>41</sup> This feature of law-making in a federal state has led Rose-Ackerman to conclude that

[w]hile some policy improvements are possible, low-level governments remain flawed mechanisms to rely on in the search for new ideas ... If state and local governments are supposed to be “laboratories,” then my model predicts that few useful experiments will be carried out in them.<sup>42</sup>

Rose-Ackerman’s criticism of the competitive model is predicated on the assumption that mere duplication of legislation will enable a free-riding government to appropriate much of the benefit derived from the innovation. However, if innovative legislation confers reputational benefits on the innovating jurisdiction, this may confer an advantage on the innovating jurisdiction that is not easily emulated by other states. For instance, a province that consistently introduces innovative and successful legislation in a certain area will develop a reputation for expertise in that area. To some extent, reputational effects may simply be evidence of other non-duplicatable, extra-legal attributes enjoyed by

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<sup>39</sup>See Posner, *ibid.* at 54 & 84; Cooter & Ulen’s comments on property rights in information and public goods are worth noting in this context:

It is extremely hard for anyone who has devoted resources to the production of information to appropriate its value through the sale of that information. This is because the instant the producer sells the information to one consumer, that consumer becomes a potential competitor of the original producer, owing to the low cost of transmitting information. Consumers desire to become “free riders” for information, paying no more than the cost of transmission for the commodity.... In short, information has one of the attributes of a public good, namely, that it is costly to prevent non-paying beneficiaries from consuming the commodity (*ibid.* at 112).

Of course, the same can be said for legislative product innovations.

<sup>40</sup>That is, there is no reason to incur the costs of relocation to another jurisdiction if the government of the present jurisdiction adopts the innovation produced elsewhere.

<sup>41</sup>The consequences of failed policy include the direct research and development costs of the innovation, and the indirect costs arising from migration of constituents out of the jurisdiction (and attendant losses in revenue) and the costs from diminished reputation and goodwill.

<sup>42</sup>S. Rose-Ackerman, “Risk Taking and Reelection: Does Federalism Promote Innovation?” (1980) 9 J. Leg. Stud. 593 at 594.

an innovating regime. As will be discussed in Part III, these attributes constitute a central part of Delaware's leading role in the American corporate law regime.

### III. Corporate Law and the Competitive Model

As the following case study demonstrates, competitive, decentralized law production has historically played an important role in the provision of corporate law in the United States, and, more recently, in Canada. Although the impact of competition on the production of corporate law has received considerable attention from American academics, the subject has attracted only fleeting attention in Canada. The inattention of Canadian commentators to competitive processes reflects both normative and positive beliefs. In terms of the former, the desirability of co-ordinated and centralized law production in the corporate law area enjoys widespread support among practising and academic lawyers.<sup>43</sup> In terms of the latter, it is generally assumed that competition among provinces is not an important feature of the Canadian legal landscape. The following comment is indicative of this general view:

"Province shopping" has never been in vogue in Canada. Partly this may be because until recently the differences among the provincial Acts and between the provincial and federal Acts were not as pronounced as were those among the various state laws in the U.S. Probably an even more important reason is the greater conservatism of Canadian corporation lawyers and counsel's unwillingness to expose his client to an unfamiliar corporate law regime.<sup>44</sup>

The following case study, however, challenges these beliefs. It is my submission that not only is decentralized competition among provinces a laudable normative goal, but that these processes have played a *recent* and important role in shaping Canadian corporate law. Although competitive processes are not as intense, nor have they generated a corporate law infrastructure as elaborate as in the United States, it can be demonstrated that competitive forces were largely responsible for the eradication of one of the most anachronistic and perplexing features of the Canadian corporate law regime: the maintenance of two wholly dissimilar corporate law systems within Canada — the letters patent and the memorandum systems.

#### A. *The Unification and Modernization of Corporate Law in Canada*

##### 1. Corporate Law Diversity and Reform Efforts

Historically, corporate law scholarship in Canada has sounded two recurrent themes: the lack of uniformity among the corporate law statutes adopted by the provinces and the federal government, and the glacial pace of corporate law

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<sup>43</sup>See above, note 3.

<sup>44</sup>S.M. Beck *et al.*, *Cases and Materials on Partnerships and Canadian Business Corporations* (Toronto: Carswell, 1983) at 152.

innovation.<sup>45</sup> In large part, these problems can be traced to the existence of two distinctive corporate law systems in the same country: the letters patent and memorandum systems. According to one commentator, the emergence of these two systems was the result of an "historical and geographic accident."<sup>46</sup> Although the nomenclature by which the two systems are identified suggests that the difference between them is rooted solely in incorporation method, as Ziegel has astutely observed, the "differences between the two ... went well beyond the method of incorporation, since the form of incorporation also brought in its train important conceptual differences ..."<sup>47</sup> The rise and persistence of two corporate law systems was criticized as early as 1910 and endured repeated criticism for well over half a century.<sup>48</sup>

Interestingly, despite sustained criticism and repeated calls for co-ordinated resolution of the problem, it was not until the mid-1980s that a modern and highly uniform corporate law regime emerged in Canada. What is, of course, significant is that the emergence of this new regime occurred relatively quickly and without reliance on extensive governmental co-ordination. Rather, the triumph of this new regime resulted from the unilateral action of the federal government when, in 1975, it introduced its new corporate statute, the *Canada Business Corporations Act*.<sup>49</sup> This innovation sparked an intense competitive reaction on the part of the provinces, causing them to engage in a flurry of legislative activity. With the notable exception of British Columbia, the result of this activity was the rapid adoption of the core features of the *CBCA*. Commencing with Manitoba in 1975, and concluding with Newfoundland in 1986, the *CBCA*, in the words of one commentator, "swept the country."<sup>50</sup> So dramatic was the success of the *CBCA* that the oft-repeated calls for enhanced uniformity and modernization by Canadian corporate law scholars have mysteriously subsided in this particular area.

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<sup>45</sup>See "Company Law in Canada" *supra*, note 3; A. Smith, "Uniform Company Law in Canada" (1938) 16 Can. Bar Rev. 701; Ziegel, *supra*, note 5 at 62.

<sup>46</sup>B. Welling, *Corporate Law in Canada: The Governing Principles* (Toronto: Butterworths, 1984) at 45.

<sup>47</sup>Ziegel, "Harmonization of Provincial Laws," *supra*, note 4 at 33.

<sup>48</sup>See Smith, *supra*, note 45 at 701. For a history of initiatives designed to rectify the lack of uniformity among Canadian provincial corporate laws, see C.S. Richardson, "Company Law: 1923-1947" (1948) 26 Can. Bar Rev. 185; Ziegel, *supra*, note 5 at 62.

<sup>49</sup>R.S.C. 1985, c. C-44 [hereinafter *CBCA*]. In discussions I had with several officials involved in the adoption of the *CBCA*, I was told that the federal government initially tried to enlist the support and involvement of all the provinces in the development of the new legislation. However, since many of the provinces were reluctant to participate in an enterprise conducted by the federal government, co-ordinated production of the *CBCA* was doomed from the start and, as a consequence, the federal government decided to eschew a co-ordinated approach and proceed unilaterally.

<sup>50</sup>Welling, *supra*, note 46 at 48.

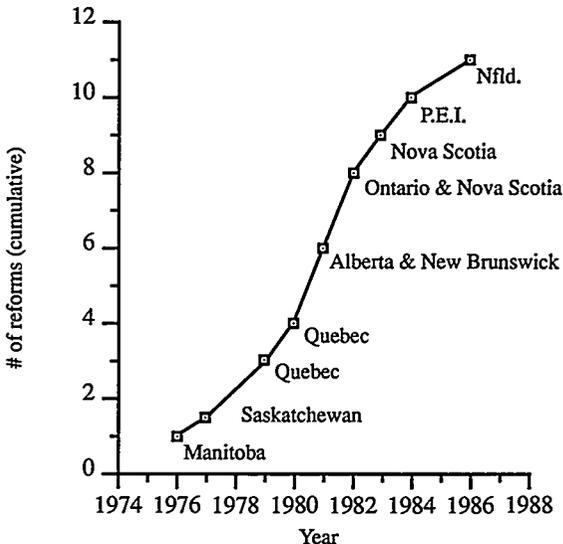
## 2. The Diffusion of the *CBCA* Model

To appreciate the alacrity with which the *CBCA* model was adopted across Canada, I have constructed Graph 1 and Table 1. In Graph 1, I depict the incidence of major corporate law reforms undertaken by the provinces following the adoption of the *CBCA*. As can be observed from the Graph, some provinces, *e.g.*, Alberta and Quebec, undertook more than one reform initiative during this period, whereas other provinces only introduced one major reform — which, in most cases, was the adoption of a comprehensive new statute modelled after the *CBCA*. In Table 1, the substantive nature of the reforms adopted by the provinces can be observed. In particular, I show the rate of adoption of ten core reforms that were ushered in by the *CBCA*:

- (i) non-discretionary incorporation by articles,
- (ii) the ability to operate one-director corporations,
- (iii) specific provision for the adoption of pre-incorporation contracts,
- (iv) the eradication of the *ultra vires* doctrine by endowing the corporation with the power of natural persons,
- (v) the ability of the corporation to repurchase its issued and outstanding shares,
- (vi) simplified director removal provisions,
- (vii) codified general standards of conduct for directors and officers,
- (viii) provisions for shareholder requisition of special meetings,
- (ix) the capacity of directors to convene meetings by telephone, and
- (x) the introduction of the oppression remedy.<sup>51</sup>

### Graph 1

Adoption (cumulative) of Major Corporate Law Reforms by Canadian Provinces



<sup>51</sup>Most of these reforms were identified and discussed by Ziegel, *supra*, note 5.

<u>Year</u>	<u>Province</u>	<u>Legislative Reform</u>
1976	Manitoba	S.M. 1976, c. 40
1977	Saskatchewan	S.S. 1976-77, c. 10
1979	Quebec	S.Q. 1979, c. 31
1980	Quebec	S.Q. 1980, c. 28
1981	Alberta	S.A. 1981, c. B-15
	New Brunswick	S.N.B. 1981, c. B-9.1
1982	Nova Scotia	S.N.S. 1982, c. 17
	Ontario	S.O. 1982, c. 4
1983	Nova Scotia	S.N.S. 1983, c. 19
1984	P.E.I.	S.P.E.I. 1984, c. 14
1986	Newfoundland	S.N. 1986, c. 12

**Table 1**  
**DATE OF ADOPTION OF TEN KEY CBCA REFORMS**

Province	Articles of Incorp.	One D/O	Adoption Pre-Incorp. Oontracts	Natural Persons	Co. Share Repurchase	Simplified D. Removal	Codified Gen. Dir./ Off. Shdrs.	5% Shdr Initiation of meeting	Telephone Direct Meetings	Oppression Remedy
<b>B.C.</b> *E* refers to S.B.C. 1973, c.18	—	E: (130)	—	E: (23 (1))	E: D (256-258)	E: D (153(3))	E: (141)	E: (170)	—	E: (221)
<b>ALTA.</b> *C.13* refers to S.A. 1977, c.13 *Novr* refers to S.A. 1981, c.B-15	Novr: S (6,7,8)	Novr: VS (97(2))	Novr: S (14)	Novr: VS (15(1))	C.13: S (41) Novr: VS (32)	Novr: VS(104)	Novr: VS (117)	E: D (134) Novr: VS (137)	Novr: VS (109(9))	Novr: VS (234)
<b>SASK.</b> *E* refers to R.S.S. 1965, c.131 *Novr* refers to R.S.S. 1978, c.B-10	Novr: S (6, 7, 8, 225)	Novr: VS (97 (2))	Novr: VS (14)	Novr: VS (15)	Novr: VS (32)	E: D (110) Novr: VS(104)	Novr: VS (117)	E: VS (175) Novr: VS(137)	Novr: VS (109(9))	Novr: VS (234)
<b>MAN.</b> *E* refers to 1970 R.S.M., c.160 and amend. *Novr* refers to S.M. 1976, c.40	Novr: VS (6, 7, 8)	Novr: VS (97(2))	Novr: VS (14)	E: (160) Novr: VS (15(1))	E: D (33, 34, 35) Novr: VS (32)	E: D (79) Novr: VS (104(1))	E: D (83) Novr: VS (117 (1))	E: D (184) Novr: VS (137)	Novr: VS (109(9))	Novr: VS (234)
<b>ONTARIO</b> *E* refers to R.S.O. 1970, c.53 *Novr* refers to S.O. 1982, c.4	E: D (4, 5) then Amended: VS (S.O. 1979, c.36, s.3) Novr: VS (5, 6)	E: 122(2) Novr: VS(115)	E: (20) Novr: VS (21)	Novr: (15)	E: (S.O. 1972 O.138, s.60) Novr: VS (30)	E: (140) Novr: VS(122)	E: (144) Novr: VS (134(1))	E: (109) Novr: VS(105)	E: (S.O. 1972, c148, s.33 (2)) Novr: VS (126 (13))	Novr: (247)

*Chart continued on following page*

Table 1 (cont'd)

Province	Articles of Incorp.	One D/O	Adoption Pre-Incorp. Contracts	Natural Persons	Co. Share Repurchase	Simplified D. Removal	Codified Gen. Dir/ Off. Shdrs.	5% Shdr Initiation of meeting	Telephone Direct Meetings	Oppression Remedy
QUEBEC "C.31" refers to S.O. 1979, c.31 "C.28" refers to S.O. 1980, c.28	C.31: VS (120(.7)-(.9))	C.31: VS (120-33)	0.28: S (123.7-.8)	C.31: S (120-24)	C.28: S (123.52-.57)	C.31: VS (120-38)	—	E: S (96)	C.31: VS (86-2)	—
N.B. "E" refers to R.S.N.B. 1973, c.13 "Now" refers to S.N.B. 1981, c.B-9.1	Novr. VS (4,5,6)	Novr. VS (60)	Novr. VS (12)	Novr. (13) (1)	Novr. VS (31)	Novr. VS (67(1))	Novr. VS (79(1))	E: VD (102-(.13)) Novr. S(96)	Novr. VS (72(8))	Novr. VS (166)
N.S. "E" refers to R.S.N.S. 1967, c.42 "C.17" refers to S.N.S. 1982, c.17 "C.19" refers to S.N.S. 1983, c.19	—	0.17: S (s.13) Novr: 79	—	C.17: VS (5, 7) Novr: (24(5B))	C.17: S (10)	—	E: D (139)	E: D (72)	—	—
Nfld. "Novr" refers to S.H. 1966, c.12	Novr. VS (15-18)	Novr. VS(164)	Novr. VS (29)	Novr. VS (30 (1))	Novr. VS (62)	Novr. VS(175)	Novr. VS(199)	Novr. VS(237)	Novr. VS(184)	Novr. VS(366)
P.E.I. "E" refers to R.S.P.E.I. 1974, c.15 "Novr" refers to S.P.E.I. 1984, c.14	Novr. D (2-11)	Novr. VS (7)	—	—	—	—	—	E: VD (30)	—	—

E = provision similar to or identical to one contained in *CBCA* at time of *CBCA* adoption.

VS = provision very similar to *CBCA* provision.

S = provision similar to *CBCA* provision.

D = provision deals with same subject matter as *CBCA* provision but in a *different* manner.

\* This Chart allows the reader to determine the year in which a provision similar in nature to the ten *CBCA* provisions was *first* adopted by one of the provincial legislatures. The letter "E" indicates that the province had in place a provision similar to the one introduced by the *CBCA* but before the *CBCA* was adopted. For example, the Chart indicates that several of the *CBCA* reforms were adopted by British Columbia and Ontario prior to the adoption of the *CBCA*. Conversely, the Chart indicates that a number of provinces, e.g., Alberta, Saskatchewan, Manitoba, Quebec, and Newfoundland, adopted major *CBCA* inspired reforms after the adoption of the *CBCA*.

Review of this table shows the considerable similarity that now exists among the corporate law statutes of the various provinces. For instance, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick, and Newfoundland all have corporate statutes that have incorporated most of the crucial innovations contained in the *CBCA*.<sup>52</sup> Although the corporate legislation of Nova Scotia and Prince Edward Island adopted reforms that resulted in corporate statutes less faithful to the *CBCA* model, the timing of their adoption suggests that the *CBCA* figured importantly in the decision to innovate. Moreover, the dearth of codified minority shareholder protections and director removal provisions suggests that these provinces may have been explicitly trying to capture a share of the national incorporation market by passing legislation more lenient than the *CBCA* and its progeny. British Columbia, as discussed previously, did not

<sup>52</sup>In the case of Ontario, it should be noted that many of these reforms were adopted prior to the adoption of the *CBCA*. Indeed, Ontario's *Business Corporations Act, 1982*, S.O. 1982, c. 4 [hereinafter *OCBA*] inspired many of the reforms eventually embraced by the framers of the *CBCA*.

undertake explicit reform in response to the *CBCA*, but its statute contains many of the reforms contained in the *CBCA*.

It is interesting to compare the diffusion of the *CBCA* model with the diffusion of corporate law innovations across states in the United States.<sup>53</sup> Romano, in a comprehensive study of the structure of the American corporate law regime, studied the vigour of state competition by examining the pace of statutory innovation.<sup>54</sup> Romano examined the diffusion of four "successful" corporate law reforms that were adopted in Delaware's 1967 Corporate Code.<sup>55</sup> She found that the indemnification provision was adopted by 43 states within 22 years, the merger vote exemption by 22 states within 18 years, the appraisal rights exemption by 26 states within 14 years, and the anti-takeover statute by 37 states within 13 years.<sup>56</sup> In mapping the actual frequency of the adoption against years since introduction, Romano was able to observe an "S shaped" cumulative distribution pattern, which has been found in other legal innovation contexts.<sup>57</sup>

What is striking about Romano's results, which are used by her in support of a claim in favour of the competitive vitality of the American corporate law regime, is the very similar pace of diffusion of legislative innovation observed in Canada in relation to the adoption of the *CBCA* model. Within a decade, nine out of ten provinces felt compelled to respond to the unilateral initiative of the federal government. Moreover, of special relevance to the Canadian case, examination of the content of the reforms shows that inter-governmental competition exerted a *harmonizing* rather than divisive impact on the Canadian corporate law regime. That is, the mere adoption and marketing of an unequivocally supe-

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<sup>53</sup>In the United States, the states are vested with authority over the incorporation and regulation of corporations. The situation is somewhat different from Canada in that the American federal government is only empowered to incorporate corporations when "necessary and proper to such express powers as the fiscal, war, interstate commerce, territorial, and seat of government (District of Columbia) powers." H.G. Henn & J.R. Alexander, *Laws of Corporations and Other Business Enterprises*, 3rd ed. (St. Paul, Minn.: West Publishing Co., 1983) at 25.

<sup>54</sup>See Romano, *supra*, note 19. Her study was motivated by a desire to understand the impact that Delaware, the leading supplier of corporate laws in the United States, was having on the quality of American corporate laws.

<sup>55</sup>General Corporation Law of the state of Delaware, Del. Code Ann. tit. 8 (Cum. Supp. 1968). These reforms were: (i) the explicit elaboration of a standard for director and officer indemnification; (ii) the exemption from stockholder vote of mergers involving a specified percentage of the corporation's stock; (iii) the elimination of appraisal rights in corporations whose shares trade on a national exchange; and (iv) anti-takeover statutes.

<sup>56</sup>See Romano, *supra*, note 19 at 234, Figure 1.

<sup>57</sup>See Romano, *ibid.* at 233. For a discussion of patterns of policy innovation in other contexts, see J. Walker, "The Diffusion of Innovations Among American States" (1969) 63 Am. Pol. Sci. Rev. 880; V. Gray, "Innovation in the States: A Diffusion Study" (1973) 67 Am. Pol. Sci. Rev. 1174; J. Walker, "Comment: Problems in Research on the Diffusion of Policy Innovations" (1973) 67 Am. Pol. Sci. Rev. 1186.

rior corporate law product by the federal government unleashed a wave of reform that achieved nationalist objectives without the contentious and debilitating negotiation that frequently characterizes other Canadian law reform initiatives that rely on co-ordinated processes.

### 3. Shareholder Mobility in Canada

Although the rapid diffusion of the *CBCA* model throughout the country furnishes strong evidence of the role of competitive forces in shaping Canadian corporate law, a complete picture of the impact that these forces have had on the structure of Canadian corporate law requires close scrutiny of the mobility decisions of shareholders (at the time of initial incorporation) and firms (at the time of reincorporation). That is, to the extent that shareholders consistently favour certain jurisdictions in their incorporation and reincorporation decisions, and to the extent that these decisions are not made merely on the basis of where the economic activity of the firm will be concentrated, then the case for competition is established. The difficulty in Canada, however, is that comprehensive data which would rigorously document the nature of the jurisdiction selection decisions made by Canadian shareholders when incorporating and reincorporating companies are not available. For example, documents filed with provincial and federal corporate law officials at the time of incorporation do not include information on the location(s) of actual economic activity or the residence of all shareholders.<sup>58</sup> And, for reincorporation, *i.e.*, continuance in another jurisdiction, the ability to document the pattern of these decisions is impaired by the different statutory treatment accorded migration of established corporations depending on the jurisdiction of initial incorporation.<sup>59</sup>

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<sup>58</sup>Although jurisdictions may require the initial incorporators and directors of a company to indicate their residence addresses, on the articles of incorporation, see, for example, *OCBA*, Form 1, where there is no requirement that the names and addresses of those individuals acquiring shares after the incorporation of the company be filed with corporate regulators.

<sup>59</sup>Nine provinces contain explicit provisions dealing with both continuance and discontinuance in the province, but Quebec only has explicit provisions dealing with continuance (see *infra*, note 111). Moreover, the differential rate of adoption of *CBCA* reforms means that a comprehensive and consistent data set for the past decade cannot be generated. This is because many jurisdictions adopted continuance provisions only recently, and so a consistent continuance trend can only be generated for those jurisdictions having operative continuance provisions during the better part of the decade. As a consequence, shareholders seeking to migrate to or from Quebec are required to incorporate a new entity in the destination jurisdiction and then to arrange a sale of assets. However, an asset purchase, because unreported and because not always a vehicle for reincorporation, is not an effective proxy for reincorporation. One source of data that has proven particularly valuable in American studies of charter market is the Moody's manual (R.P. Hanson, ed., *Moody's International Manual* (New York: Moody's Investor Service, 1987) at 503). I reviewed the descriptions of over 800 Canadian companies listed in Moody's 1987 International Manual to identify instances where companies changed their incorporation jurisdiction. Unfortunately, I was able to find only fifteen companies that had changed domicile during their life. Although the data are seriously incomplete (only large, surviving Canadian companies are included in the manual and the data may be incomplete and inaccurate), the information obtained showed that as a reincorporation

Despite the lack of an ideal information set, it is possible to obtain some appreciation of the demand-side characteristics of the incorporation market in Canada through examination of other data. To begin with, Table 2 exhibits the number of incorporations<sup>60</sup> (expressed in absolute terms and as a percentage of total annual incorporations) for all of the provinces and the federal government for the period 1975 to 1988.<sup>61</sup> Review of the table shows that the general trend in total incorporation activity is upward. From 1975 to 1988, the volume of incorporations increased by 80,111 — an increase of 139%. However, the upward trend was not consistent throughout the period. In 1982, the number of incorporations dropped from 108,181 (in 1981) to 89,416 — a 17.3% decrease in total incorporation activity. Moreover, as these data indicate, the pace and direction of change in incorporation activity was not identical for different provinces and the federal government. For instance, during the 14 year period covered in the table, the market shares of the provinces and the federal government fluctuated considerably. For the years 1975, 1979, and 1988, the market shares of the Federal Government, British Columbia, Alberta, Ontario and Quebec were as follows:

	1975	1979	1988
Federal Government:	6.2%	19.5%	8.7%
British Columbia:	17.8%	17.6%	14.1%
Alberta:	17.3%	20.4%	10.8%
Ontario:	28.9%	25.9%	40.4%
Quebec:	16.3%	4.7%	17.8%

destination, the federal government dominates the provinces. Of fifteen migrating companies, eleven moved to the federal government, eight of them after the adoption of the new *CBCA*. Of these eight, one came from British Columbia, two from Alberta, two from Manitoba, and three from Ontario. However, because the migration of four of the eight companies to the federal government occurred *after CBCA* inspired reforms had been adopted in the home jurisdiction, support for the competitive model from these data is equivocal.

<sup>60</sup>It is unfortunate that robust reincorporation data could not be obtained. By focusing only on initial incorporation data, there is a danger that the depiction of shareholder mobility that is gleaned may be incomplete. It can be argued that the charter market in Canada is really segmented into two distinct markets: the incorporation and the reincorporation markets. Although shareholders in both markets are likely to be sensitive to changes in legal product, differences in the size, sophistication, and wealth of shareholders will be reflected in differences in the nature of the demand function of the participants in each market. Whereas shareholders in the incorporation market will most frequently be forming closely held start up ventures, shareholders in the reincorporation market are more likely to be associated with more established and successful enterprises. The former, owing to their innate ability to contract out of the terms of the standard form contract specified in incorporation statutes, will be less sensitive to the content of legal product and more sensitive to the price level of that product and to the process by which corporate status is obtained. The latter, especially if they are shareholders in a public corporation, will be less sensitive to the price and the process by which corporate status is obtained and more sensitive to the content of legal product.

<sup>61</sup>These data were derived from annual reports of the various ministries responsible for corporations across the country and were collected principally by the Canadian Federation of Independent Business.

**Table 2**  
**INCORPORATIONS BY JURISDICTION OF INCORPORATION\***  
**FOR FISCAL YEARS 1975 TO 1988<sup>†</sup>**  
*(Total Number/Percentage of Total (in Brackets))*

Prov.	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
FED.	3570 (6.2)	5581 (8.2)	8736 (11.8)	13574 (15.9)	19528 (19.5)	19332 (17.9)	16628 (15.4)	18510 (20.7)	19728 (20.3)	19297 (18.6)	15137 (13.3)	11652 (9.4)	12187 (8.9)	11962 (8.7)
B.C.	10267 (17.8)	12355 (18.2)	13209 (17.8)	15215 (17.8)	17616 (17.6)	21380 (19.8)	23368 (21.6)	11965 (13.4)	13915 (14.3)	14085 (13.6)	16180 (14.2)	17395 (14.0)	18648 (13.7)	19494 (14.1)
Alta.	9984 (17.3)	12811 (18.9)	14391 (19.4)	18045 (21.04)	20395 (20.4)	22530 (20.8)	21769 (20.1)	10691 (12.0)	12302 (12.7)	15902 (15.4)	15965 (14.0)	17425 (14.0)	16712 (12.3)	14890 (10.8)
Sask.	2256 (3.9)	2486 (3.7)	2450 (3.3)	3346 (3.9)	3629 (3.6)	3639 (3.4)	3454 (3.2)	3120 (3.5)	3159 (3.2)	3128 (3.0)	3208 (2.8)	3661 (2.9)	3205 (2.4)	2416 (1.8)
Man.	1729 (3.0)	2316 (3.4)	2398 (3.2)	2747 (3.2)	3195 (3.2)	2546 (2.4)	2921 (2.7)	2886 (2.9)	2785 (2.6)	2625 (2.5)	2986 (2.6)	3005 (2.4)	3246 (2.4)	2450 (1.8)
Dnt.	16682 (28.9)	18556 (27.4)	20847 (28.1)	20929 (24.5)	25871 (25.9)	26586 (24.6)	27099 (25.1)	28451 (31.8)	29173 (30.0)	32409 (31.3)	38233 (33.5)	43940 (35.3)	51824 (38.0)	55657 (40.4)
Que.	9433 (16.3)	9746 (14.4)	7917 (10.7)	6919 (8.1)	4718 (4.7)	6585 (6.1)	8014 (7.4)	8708 (9.7)	10398 (10.7)	10807 (10.4)	17078 (15.0)	21768 (17.5)	24455 (17.8)	24521 (17.8)
N.S.	1579 (2.7)	1450 (2.1)	1490 (2.0)	1778 (2.1)	1724 (1.7)	1740 (1.6)	1642 (1.5)	1513 (1.7)	1815 (1.9)	1921 (1.9)	2026 (1.8)	2256 (1.8)	1319 (1.7)	2190 (1.6)
N.B.	1155 (2.0)	1409 (2.1)	1550 (2.1)	1624 (1.9)	1834 (1.8)	2135 (2.0)	1866 (1.7)	2347 (2.6)	2555 (2.6)	1880 (1.8)	1870 (1.6)	1723 (1.4)	1936 (1.4)	2012 (1.4)
Nfld.	812 (1.4)	824 (1.2)	908 (1.2)	972 (1.1)	1147 (1.2)	1335 (1.2)	1128 (1.0)	1034 (1.2)	1101 (1.1)	1209 (1.2)	1180 (1.0)	1241 (1.0)	1515 (1.1)	1611 (1.3)
P.E.I.	280 (.5)	276 (.4)	294 (.4)	330 (.4)	343 (.3)	299 (.3)	292 (.3)	191 (.2)	272 (.3)	248 (.2)	336 (.3)	320 (.3)	322 (.2)	432 (.3)
	57724 (100)	67812 (100)	74190 (99.94)	85479 (99.94)	100000 (99.9)	108107 (100.1)	108181 (100)	89416 (100)	97203 (100)	103491 (100.1)	114199 (100.1)	124386 (100)	136369 (100)	137835 (100)

\* Data derived from Canadian Federation of Independent Business files and from annual reports of Ministries.

<sup>†</sup> Fiscal year is April 1<sup>st</sup> to March 31<sup>st</sup>, inclusive.

One possible explanation for discernible changes in jurisdictional incorporation activity is macro-economic in nature. Specifically, incorporation activity can be expected to crudely track changes in the economic conditions prevailing in each of the provinces. During times of robust economic growth, the level of provincial incorporation activity should increase as citizens residing in the province create new enterprises in an effort to exploit new opportunities for economic gain. Correspondingly, when a province's economy slows, the incorporation rate for the province can be expected to slow because the climate is less conducive to new ventures.<sup>62</sup> In this vein, alleging a correlation between provincial incorporation activity and provincial economic conditions is supportive of the traditional vision of the Canadian charter market: shareholders mechanistically incorporate in the jurisdiction in which shareholders plan to concentrate

<sup>62</sup>The correlation between incorporation levels and provincial economic activity is not perfect. Incorporation applications may lag behind increases in economic activity during a recovery, while declines in economic activity may be accompanied by slight increases in incorporation activity reflecting initiation and incorporation of private ventures by workers suffering job losses.

their economic activity, and, as a consequence, changes in incorporation levels are a function of exogenous economic factors and are wholly unrelated to endogenous price and quality attributes of the various provincial corporate law regimes.

Attributing changes in incorporation levels solely to changes in economic conditions is, however, problematic. Although economic conditions could explain variation in *provincial* incorporation levels, it is difficult to explain trends in federal government incorporations in these terms. Why, for example, did federal government incorporations increase dramatically in the period 1975 to 1979, and decline just as dramatically in the period 1979 to 1988? Although the country endured a serious economic recession in the early part of the 1980s, by the latter half of the decade the country in general was experiencing buoyant economic growth, and one would have predicted, *a fortiori*, that federal government incorporations would have increased commensurately.

#### 4. Incorporation Activity and Economic Growth Factors

To explore further the correlation between economic activity levels and incorporation trends, I assembled annual real gross domestic product data for each of the provinces for the period 1975 to 1988. In Table 3, these data, expressed in both absolute and relative terms, are exhibited. Although comparison with the data in Table 2 should cast light on the correspondence between incorporation and income patterns of each of the jurisdictions, the comparability of the tables is confounded by problems in comparing the incorporation and income experience of the federal government. Although the federal government's incorporation data is, like those of the provinces, expressed as a *share* of the total incorporation market, the only income measurement for the federal government, national GDP, is the *summation* of the income figures of all the provinces. As such, the statistic is not uniquely related to the federal government, and so cannot be used for effective comparison with the incorporation data. Nevertheless, despite their shortcomings, the data in Table 3 do at least yield some information on the trend in provincial income levels and on the relative income shares of the provinces over the fourteen year period.<sup>63</sup>

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<sup>63</sup>It should be noted that the data in Table 3 are shown for fiscal years (April 1 to March 31), not calendar years. Accordingly, the data shown for 1975 are for the period April 1, 1975 to March 31, 1976. The fiscal year was chosen to allow easier comparison to the incorporation data exhibited in Table 2, which are denominated by fiscal rather than calendar years.

Table 3

**GROSS DOMESTIC PRODUCT BY PROVINCE FOR  
FISCAL YEARS 1975 TO 1988<sup>†</sup>**

*(Total amount in millions of \$ 1981/percentage of total for all provinces (in bracket))\**

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
BC	29802.5 (10.8)	32048.3 (11.0)	32879.8 (11.2)	34428.3 (11.5)	36214.3 (11.7)	38357.5 (12.3)	38544.8 (12.2)	36234.8 (11.9)	37910 (11.8)	39282.3 (11.5)	40712 (11.5)	41383.5 (11.3)	43932.5 (11.4)	46432 (11.5)
AL	40812 (14.8)	41371 (14.4)	41843 (14.3)	41746 (13.9)	45557 (14.7)	44078.8 (14.2)	45278 (14.3)	43851 (14.4)	43846 (13.6)	45946.5 (13.5)	47395 (13.3)	45958.3 (12.6)	48435.5 (12.6)	51306.3 (12.8)
SK	11770 (4.3)	12425.3 (4.3)	12420.5 (4.2)	12357.3 (4.1)	12292.8 (4.0)	12438 (4.0)	12960 (4.1)	13222.3 (4.3)	13532.8 (4.2)	13660 (4.0)	14035.5 (4.0)	14967.3 (4.1)	14760.8 (3.8)	14073.8 (3.5)
MB	11434.5 (4.2)	11977.8 (4.2)	12075 (4.1)	12204.8 (4.1)	12218.8 (4.0)	12082.8 (3.9)	12391.3 (3.9)	12103.5 (4.0)	12565.3 (3.9)	13593 (4.0)	14378.8 (4.0)	14937.8 (4.1)	15148.3 (3.9)	15265.3 (3.8)
ON	101417.3 (36.9)	106393.5 (37.0)	108659.8 (37.1)	111370.8 (37.1)	113243.3 (36.6)	113907.8 (36.6)	116361 (36.8)	112709.5 (36.9)	121385 (37.8)	131366.5 (38.6)	138212.3 (39.0)	145307.5 (39.8)	153925.3 (39.9)	161394.5 (40.1)
PQ	62819.8 (22.8)	66006.3 (22.9)	67255 (23.0)	68971.8 (23.0)	70724.5 (22.9)	71359.8 (22.9)	71749.5 (22.7)	67935.8 (22.6)	71547.3 (22.3)	75110.5 (22.1)	77718.5 (21.9)	79782.8 (21.9)	85269 (22.1)	89012.5 (22.1)
NS	6747 (2.5)	6896.5 (2.4)	7183.5 (2.5)	7436 (2.5)	7555 (2.4)	7665.8 (2.4)	7673 (2.4)	7712.8 (2.5)	8220.3 (2.6)	8704.3 (2.6)	9304 (2.6)	9508.3 (2.6)	9770 (2.5)	10093.5 (2.5)
NB	5456 (2.0)	5719.8 (2.0)	5762.5 (2.0)	6094.8 (2.0)	6057 (2.0)	5966.8 (1.9)	6046.3 (2.0)	6085.8 (2.1)	6590.3 (2.1)	6813 (2.0)	7023.5 (2.0)	7291.5 (2.1)	7640.3 (2.0)	8000.8 (2.0)
NO	3963 (1.4)	4192.3 (1.5)	4203.5 (1.4)	4322.8 (1.4)	4642.3 (1.5)	4511.5 (1.5)	4555.5 (1.4)	4428 (1.4)	4608.3 (1.4)	4783.3 (1.4)	4988.5 (1.4)	4911 (1.3)	5239.5 (1.4)	5392 (1.3)
PEI	839 (.3)	682.5 (.3)	896.25 (.3)	957 (.3)	957.5 (.3)	958.3 (.3)	972 (.3)	997.3 (.3)	1031.8 (.3)	1079.5 (.3)	1117.8 (.3)	1175.8 (.3)	1216 (.3)	1203.5 (.3)
	274880.6	287913.3	293178.9	299799.3	309479.5	311327.1	316331.4	305260.8	321287.1	340288.4	354785.9	365203.8	385337.2	402164.2

<sup>†</sup> Fiscal year is April 1<sup>st</sup> to March 31<sup>st</sup>, inclusive.

\* Data derived from Conference Board of Canada Provincial Forecasting Model.

Comparison of the data in Table 2 and Table 3 yields an interesting insight: the income shares for each of the provinces are far more stable than the corresponding incorporation shares for the period under examination. If, for example, the income shares of the provinces in 1975 and 1988 are compared, only modest change can be detected. In the case of British Columbia, Saskatchewan, Manitoba, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland, a less than 1 percentage point income-share difference is observed, although the difference in market shares for Alberta (-2 percentage points), Ontario (-3.2 percentage points), and Quebec (+1.5 percentage points) is slightly larger.<sup>64</sup> In contrast, comparison of the difference in the incorporation market shares for the same two years discloses much larger variation. For example, save for the three provinces having the smallest market share (*i.e.*, New Brunswick, Newfoundland, and Prince Edward Island), the differences in incorporation shares for the

<sup>64</sup>That is to say, the overall market share increased or decreased by less than 1% in absolute terms. In the case of Quebec, for instance, the province's income share was 22.8% in 1975 and 22.1% in 1988 — the difference in market shares amounting to a .7% decrease.

remaining provinces all exceed 1 percentage point. In several cases, the difference is quite large: for example, Alberta's share decreased by 6.5 percentage points, while Ontario's share increased by 11.5 percentage points.

Of course, forming conclusions as to the strength of the association between income factors and incorporation levels solely on the basis of two single point observations (*i.e.*, the income and incorporation shares of the provinces in 1975 and 1988) is not as convincing as conclusions predicated on analysis of the *trends* operating during the entire period. In Table 4, the annual changes in income shares and incorporation levels are shown for the various provinces for the entire period 1975 to 1988. Scrutiny of this table shows that, for most of the provinces, incorporation levels do move in the same *direction* as economic growth indices, but not with the same magnitude.<sup>65</sup> For instance, when, in 1982, real income declined in five provinces from the levels recorded in 1981, incorporation levels in four of the provinces also declined.<sup>66</sup> A simple linear regression which tests the correlation between changes in gross domestic product and incorporation levels confirms the lack of a strong association between the variables. The correlation is statistically significant for only three provinces, British Columbia, Manitoba, and Nova Scotia, with P-values of .004, .02, and .006, respectively.<sup>67</sup> To better appreciate the trend in these changes, in Graph 2 the data in Table 4 is plotted for the four provinces with the largest number of incorporations: Alberta, British Columbia, Ontario, and Quebec. The important puzzle for proponents of the association between income and incorporation is, of course, the experience of the Province of Quebec. As the data in Graph 2(d) indicate, during the period 1975 to 1979, provincial income levels increased steadily each year (almost a 13% increase), although provincial incorporation levels declined dramatically (by almost 50%). Equally perplexing are the changes in income and incorporations occurring in the period 1979 to 1988, wherein provincial income increased by 26% and provincial incorporations increased by 420%. These data do not support the association between income and incorporations, and furnish strong evidence that price or quality factors endogenous to the corporate law regimes are at least partially implicated as a causal force in incorporation levels.

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<sup>65</sup>For instance, data from Table 3 show that the income share of British Columbia, Alberta, Ontario, and Quebec (the provinces with the most dramatic shifts in incorporation share identified above), rarely differed by more than .75 of one percentage point from year to year. For the four provinces, there were only five occasions where the change in provincial income from one year to the next exceeded .75 percentage points. In contrast, the incorporation share of the provinces varied much more frequently and to a greater extent. Over the fourteen year period documented in Table 3, there were close to 30 occasions in which the year to year change in incorporation share exceeded 1.5 percentage points.

<sup>66</sup>The provinces in which income declined were: British Columbia, Alberta, Manitoba, Ontario, and Quebec. With the exception of Ontario, incorporation levels in all of the other provinces registered a decline.

<sup>67</sup>The regression study was undertaken by Professor Robert Tibshirani of the Department of Preventative Medicine and Biostatistics, University of Toronto.

Table 4

**PERCENTAGE CHANGE (FROM PREVIOUS YEAR) IN LEVELS OF PROVINCIAL  
GROSS DOMESTIC PRODUCT AND TOTAL INCORPORATIONS  
FOR FISCAL YEARS<sup>1</sup> 1976 TO 1988\***

*(GDP Change/Incorporation Change (in brackets))*

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
B.C.	7.5 (20.3)	2.6 (6.9)	4.7 (15.2)	5.2 (15.8)	5.9 (21.4)	.5 (9.3)	-6.0 (-48.8)	4.6 (16.3)	3.6 (11.1)	3.6 (15.0)	1.6 (7.5)	6.2 (7.2)	5.7 (4.5)
ALT.	1.36 (28.6)	1.1 (12.3)	-.2 (25.4)	9.1 (13.0)	-3.2 (10.5)	2.7 (-3.4)	-3.1 (-50.9)	-.01 (15.1)	4.8 (29.3)	3.1 (.4)	-3.0 (9.1)	5.4 (-4.1)	5.9 (-10.9)
SASK.	5.6 (10.2)	.04 (-1.5)	.5 (36.6)	-.5 (8.5)	1.2 (2.8)	4.2 (-5.1)	2.0 (-9.7)	2.4 (1.3)	.9 (1.0)	2.7 (2.6)	6.6 (14.1)	-1.4 (-12.5)	-4.7 (-2.5)
MAN.	4.8 (34.0)	.8 (3.5)	1.1 (14.6)	1.1 (16.3)	.01 (-20.3)	2.6 (14.7)	-2.3 (-1.2)	3.8 (-3.5)	8.2 (-5.7)	5.8 (13.8)	3.9 (6.4)	1.4 (8.0)	-8.0 (-24.5)
ONT.	4.9 (11.2)	2.1 (12.4)	2.5 (.4)	1.7 (23.6)	5.9 (-2.8)	2.1 (1.9)	-3.1 (5.0)	7.7 (2.5)	8.2 (11.1)	5.2 (18.0)	5.1 (14.9)	5.9 (17.9)	4.8 (7.4)
QUE.	5.4 (3.3)	1.9 (-18.8)	2.6 (-12.6)	2.5 (-31.8)	.9 (39.6)	.6 (21.7)	-9.5 (8.6)	5.3 (19.4)	4.9 (3.9)	3.5 (58.0)	2.7 (27.5)	6.9 (12.3)	4.4 (.3)
N.S.	2.2 (-.8)	4.2 (2.7)	3.5 (19.3)	1.6 (-3.0)	1.5 (1.)	.1 (-5.6)	.5 (-7.8)	6.6 (20.)	5.9 (5.8)	6.9 (3.5)	2.2 (11.4)	2.8 (2.8)	2.4 (-5.6)
N.B.	4.8 (22)	.8 (10)	4.2 (4.8)	.9 (12.9)	-1.5 (16.4)	1.3 (-12.6)	.3 (25.8)	8.6 (8.9)	3.4 (-26.4)	3.1 (-5)	3.8 (-7.9)	4.8 (12.4)	4.7 (3.9)
NFLD.	5.8 (1.5)	.3 (10.2)	2.8 (7.0)	7.4 (18.0)	-2.8 (16.4)	1.0 (-15.5)	2.8 (-9.1)	4.1 (6.5)	2.7 (9.8)	3.3 (-2.4)	.5 (5.2)	6.7 (22)	2.9 (19.5)
P.E.I.	5.2 (-1.4)	1.6 (6.5)	6.8 (12.2)	1.9 (3.9)	-1.7 (-12.8)	1.5 (-2.3)	2.6 (-34.6)	3.4 (42.4)	4.7 (-8.8)	3.5 (35.5)	5.2 (-4.8)	3.5 (.6)	5.6 (34.2)
CAN.	4.8	1.8	2.3	3.2	.6	1.6	-3.5	5.3	5.9	4.3	2.9	5.5	4.4

<sup>1</sup> Fiscal year is April 1<sup>st</sup> to March 31<sup>st</sup>, inclusive.

\* Data derived from data presented in Tables 2 and 3

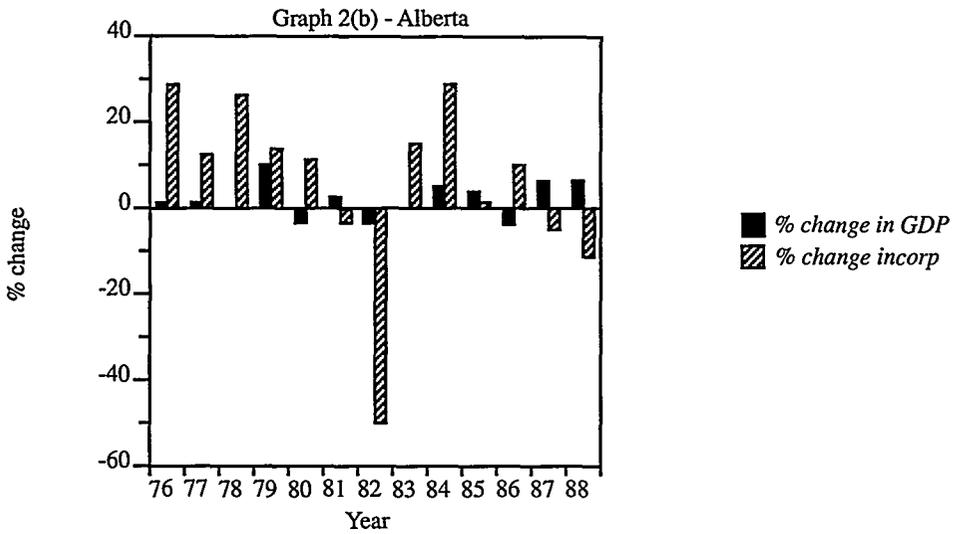
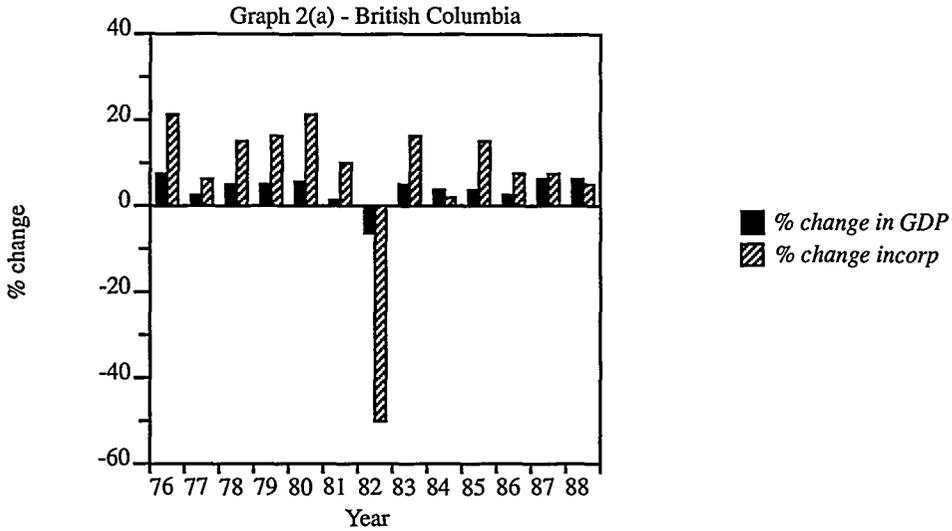
## 5. Endogenous Factors Driving Incorporation Trends

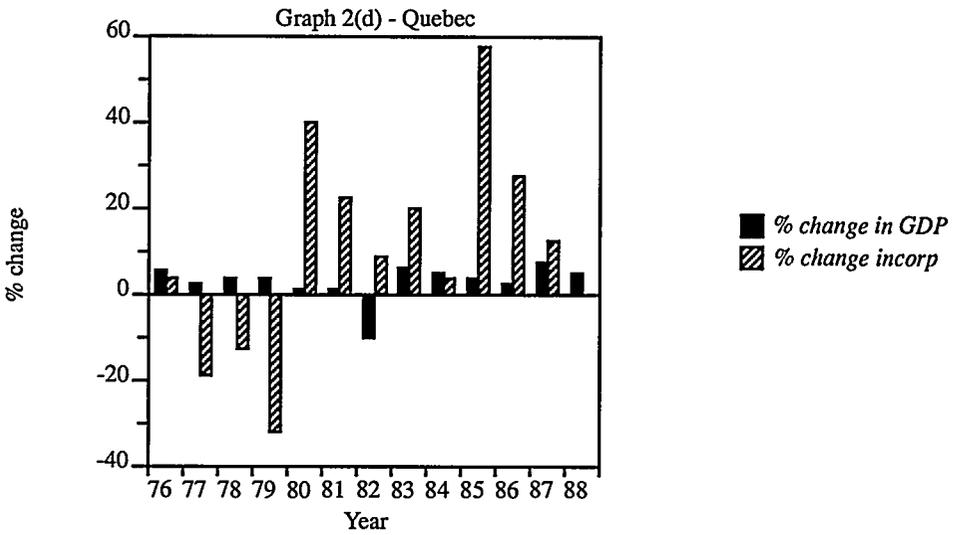
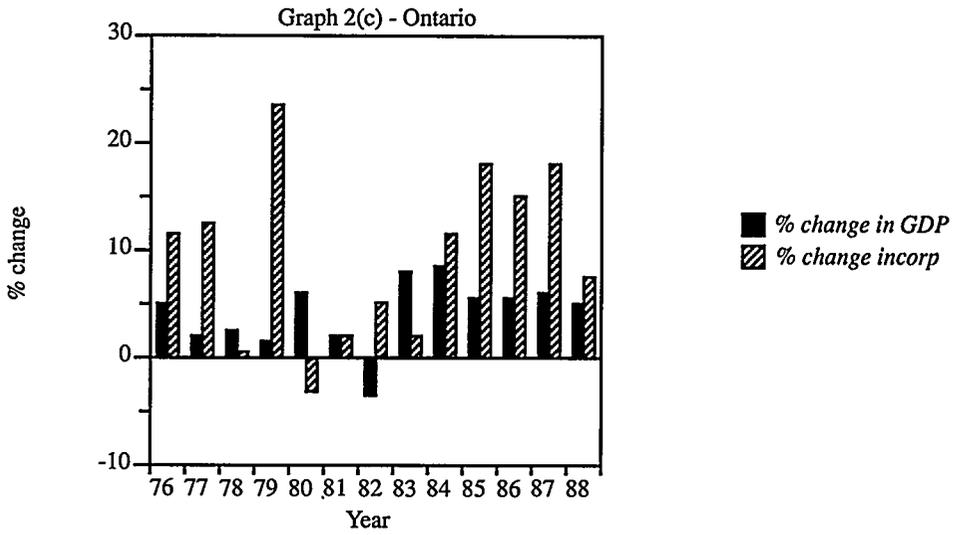
Confirmation for the role of endogenous characteristics of the corporate law regime in driving incorporation levels is obtained by exploring further the case of Quebec. One of the most striking features of Table 2 is the fact that the number of annual incorporations registered by Quebec and the federal government appear to closely complement each other. Although, in the period 1976 to 1979, the number of incorporations in Quebec declined by 5,030, the number of federal government incorporations leaped by 13,947. Thereafter, in the period 1979 to 1988, the number of Quebec incorporations increased by 19,803, while the number of federal incorporations declined by 7,566.<sup>68</sup> Are these changes linked?

<sup>68</sup>Although the magnitude of the changes observed in Quebec and the federal government is not perfectly complementary, given the role of macro-economic factors in increasing the aggregate stock of incorporations, the dynamic that emerges is not zero-sum, and, consequently, the number of incorporations in "favoured" jurisdictions should eclipse the losses sustained in "less favoured" jurisdictions.

Graph 2

Comparison of Annual Changes in GDP and Incorporation for Four Provinces





In Table 5, data supplied by the Corporations Branch of Consumer and Corporate Affairs provides strong evidence for the existence of such a linkage. These data identify the location (by province) of federally incorporated companies formed in the period 1980 to 1987.<sup>69</sup> Commencing in 1980, 14,964 out of 18,444 incorporations — 81.1% of total federal incorporations — originated from Quebec. In contrast, only 2,340 incorporations, or 12.7% of the total, were derived from Ontario. By 1987, the number of incorporations originating from Quebec contracted by 6,082 (or 40.6% from the 1980 level), yielding a 71.8% share of total federal incorporations.<sup>70</sup>

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<sup>69</sup>One interesting feature of the data on federal incorporations is that the trends in initial incorporations do not parallel the trends in reincorporations. This observation is significant because of the tendency by American commentators to equate reincorporation trends with initial incorporation trends. I reviewed data derived from the federal government on the jurisdiction of origination of companies continuing (reincorporating) under the *CBCA*. These data show that the distribution of companies, by province, that *continue* under the *CBCA* differs from the distribution of companies, by province, that *incorporate* under the *CBCA*. For instance, 54.2% of the 299 companies that continued under the *CBCA* in 1986 were located in Ontario, while only 18.4% of the companies incorporating under the *CBCA* in that same year were from Ontario. An even greater disparity is exhibited in Quebec's case: in 1986, 72% of incorporating *CBCA* companies originated from Quebec, while only 0.3% of continuing companies originated from that province. This disparity is puzzling — why should the patterns of reincorporation differ so dramatically from incorporation? One implication that follows from this disparity is that it may be appropriate to consider the charter market in Canada as segmented into two constituent markets: the incorporation and reincorporation markets. In these terms, the demand side factors that fuel the incorporation market may be quite different. At incorporation, shareholders may focus on attributes such as price, stability, and chartering ease. On reincorporation, more specific attention may be paid to nuances in the content of specific statutory sections of a jurisdiction's corporate law. This is because shareholders may reincorporate only when certain transactions are contemplated that increase the risk of shareholder litigation. Indeed, this search for a legal environment conducive to certain transactions was found by Romano, *supra*, note 19, to be an important motive for reincorporation to Delaware.

<sup>70</sup>Parenthetically, it should be noted that overall federal incorporations declined by 6,079 or 33% in the same period.

**Table 5**  
**FEDERAL INCORPORATIONS – BREAKDOWN BY JURISDICTION**  
**OF INCORPORATION\***  
*(Total number of incorporations/percentage of total incorporations (in brackets))*  
**(CALENDAR YEAR)**

	NFLD.	P.E.I.	N.S.	N.B.	QUEBEC	ONT.	MAN.	SASK.	ALTA.	B.C.	TOTAL
1980	12 (.06)	18 (.1)	116 (.6)	42 (.2)	14,964 (81.3)	2,340 (12.7)	216 (1.2)	47 (.3)	505 (2.7)	184 (1.0)	18,444
1981	20 (.1)	24 (.13)	160 (.9)	57 (.3)	13,950 (75.8)	2,977 (16.2)	319 (1.7)	57 (.3)	621 (3.4)	219 (1.2)	18,484
1982	16 (.1)	33 (.2)	149 (1.0)	59 (.4)	11,108 (74.3)	2,796 (18.7)	136 (.9)	37 (.2)	451 (3.0)	168 (1.1)	14,953
1983	32 (.2)	57 (.3)	284 (1.0)	43 (.2)	15,262 (75.5)	3,546 (17.5)	184 (.9)	81 (.4)	577 (2.9)	225 (1.1)	20,211
1984	33 (.2)	33 (.2)	228 (1.2)	65 (.3)	14,176 (75.2)	3,155 (16.7)	170 (.9)	63 (.3)	620 (3.3)	298 (1.6)	18,841
1985	22 (.1)	39 (.2)	160 (.9)	53 (.3)	13,222 (75.4)	2,827 (16.1)	161 (.9)	53 (.3)	717 (4.1)	311 (1.8)	17,545
1986	16 (.1)	19 (.2)	88 (.8)	35 (.3)	7,970 (71.9)	2,042 (18.4)	117 (1.0)	04 (.6)	480 (4.3)	255 (2.3)	11,088
1987	10 (.1)	23 (.2)	81 (.6)	37 (.3)	8,882 (71.8)	2,269 (18.4)	128 (1.0)	65 (.5)	570 (4.6)	300 (2.4)	12,365

\* Source: Corporations Branch, Consumer and Corporate Affairs, Canada.

In conjunction, the trends observed in the Quebec case can be interpreted to support the simple but powerful claim that shareholders residing in Quebec did not mechanically incorporate in Quebec whenever they wished to establish a limited company.<sup>71</sup> And, since shifts in the pattern of incorporation decisions made by shareholders residing in a *given* jurisdiction are not easily correlated with macro-economic factors, the movement of Quebec shareholders out of and into Quebec must reflect the innate price and quality characteristics of Quebec's corporate law regime. In these terms, the corporate law regimes of Quebec and the federal government can be viewed as relatively close substitutes for one another;<sup>72</sup> as one jurisdiction's corporate law product became relatively more attractive, shareholders responded by increasing their consumption of that product at the expense of the other.

<sup>71</sup>The two most important observations in this regard are: (i) the fact that contractions in the absolute number of Quebec incorporations coincided almost perfectly with expansion in the absolute number of federal government incorporations, and vice versa; and (ii) for the period in which data are available, federal government incorporations were overwhelmingly dominated by Quebec and that, concurrent with the decrease in federal government incorporations and increase in Quebec incorporations, there was a corresponding decrease in the proportion of federal government incorporations originating from Quebec.

<sup>72</sup>In economic terms, the cross-elasticity of demand for the Quebec and federal government corporate law regimes was relatively high.

What accounts for the shifting attractiveness of each jurisdiction's corporate law product? Following Romano, it is clear that the factors considered by shareholders in making incorporation decisions extend well beyond the content of a given jurisdiction's legislation.<sup>73</sup> By studying the *reincorporation* patterns of American corporations, Romano found that Delaware's continued preeminence in the American corporate law market was a function of: the legislative responsiveness of the state, the development of a large and stable body of judicial precedent, the expertise of the Delaware judiciary in corporate law matters, the familiarity of American corporate lawyers with the statutory regime extant in Delaware, and the establishment of formalized consultative apparatus between the state legislature and the corporate community. The benefits realized by reincorporation were sufficiently high as to overshadow the costs entailed by incorporation arising from shareholder notice and approval obligations.<sup>74</sup>

In explaining the shifting preference of Quebec shareholders in the choice between Quebec and the federal government incorporation, both narrow legal and broad institutional factors are implicated. In terms of the former, the fact that, until the amendments of 1979 and 1980, the Quebec *Companies Act*<sup>75</sup> lacked many of the central ingredients of the *CBCA*, provides a reasonably persuasive explanation for the declining share of the total incorporation market enjoyed by the province of Quebec in the period 1975 to 1979 (from 16.3% to 4.7%). However, commencing in 1980, Quebec's market share steadily began to increase, so that by 1988, it came to enjoy a 17.8% market share. Although the gradual growth of Quebec's market share can be construed as undermining the significance of the 1979 and 1980 statutory amendments (because there was not a dramatic increase in incorporation share following the adoption of these amendments), it is arguable that the gradual increase in market share is consistent with the process by which awareness and understanding of the *CBCA*-inspired amendments was transmitted. That is, as shareholders and their legal advisers became cognizant of the improvements effected by the adoption of the legislative amendments, shareholders began, once again, to favour Quebec as an incorporation jurisdiction.

What extra-legal or broad institutional factors accounted for the shifting preference for Quebec and federal government incorporation by Quebec shareholders? One possibility is that the election of the Parti Québécois on November 15, 1976, may have precipitated the movement of shareholders to federal government jurisdiction because of the party's commitment to national independence and socialist objectives. By incorporating under the federal government,

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<sup>73</sup>See Romano, *supra*, note 19 at 273-79.

<sup>74</sup>Romano reports that the costs of reincorporation (*e.g.*, legal fees, proxy statement preparation fees, fees related to shareholder meetings and filing fees) may, in some cases, exceed \$1 million. On average, Romano found that these costs were \$40,000 (*ibid.* at 246).

<sup>75</sup>R.S.Q. 1977, c. C-38.

Quebec shareholders may have sought to immunize themselves from the instability that accompanies dramatic political and economic transitions. When, in December, 1985, the Liberal government was elected to the National Assembly, the value of federal incorporation as an economic and political sanctuary was attenuated, and, consequently, Quebec shareholders were less motivated to obtain federal incorporation.<sup>76</sup> This explanation is consistent with the data.

Another possible explanation for the shifting preferences of Quebec shareholders resides in the costs of incorporation. Although the costs of incorporating a company are not nearly as large as the costs of reincorporating,<sup>77</sup> filing fees and corporate-based taxes can influence the incorporation decision. In Table 6, I have assembled data on the structure and magnitude of incorporation filing fees for each of the provinces and the federal government for the period 1975 to 1987.<sup>78</sup> These data show that the method for calculating incorporation fees has changed dramatically during the period. Originally, with the exception of British Columbia and the federal government, incorporation fees were calculated in relation to the size of authorized capital, but by the end of the decade, save for Quebec, all Canadian jurisdictions used flat-based fees. Table 6 reveals that, by 1987, the fees charged by the provinces converged into a fairly narrow range: from \$100 to \$220.<sup>79</sup> However, the federal government's incorporation fee was considerably higher: \$500. Interestingly, the federal government's adoption of a higher fee appears to have accelerated the trend of Quebec shareholders to prefer Quebec rather than federal government incorporation. The federal fee increase was adopted on June 1, 1985 and, almost immediately, incorporation numbers dropped precipitously: from 19,297 in 1984 to 11,652 in 1986. It

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<sup>76</sup>On the PQ election, see Maclean's (15 November 1976) 20. On the elements of socialism in the PQ platform, see "Separatism May Scare Businessmen, But It's the Socialism that Terrifies" Maclean's (29 November 1976) 71; P. Vallières, "The Left and the P.Q." Quebec-Presse, 3:51 (19 December 1971); P. Vallières, "The FLQ and the Lessons of the October Crisis" Can. Forum (Jan./Feb. 1972) 12, originally published as "'L'urgence de choisir' Pourquoi le FLQ n'a plus de raison d'être aujourd'hui" *Le Devoir [de Montréal]* (13 December 1971) 5 & (14 December 1971) 5.

<sup>77</sup>The costs of incorporation are considerably less than the costs of reincorporation. Because initial incorporations seldom require the assent of more than a handful of individuals, the costs of shareholder notice and approval that are entailed by reincorporation can be avoided. Not surprisingly, these costs can be quite large for reincorporation of publicly-held corporations.

<sup>78</sup>The corporate tax regime in Canada appears to render jurisdiction of incorporation irrelevant. That is, corporate taxes are levied on the basis of the locus of economic activity (measured in terms of assets and income generated in a given province). Corporations must pay tax on the income earned in the province(s) where they had a permanent establishment. Where a corporation is incorporated in one province but carries on business in others, little if any income would be attributed to the head office and no tax would be payable. Therefore, changes in income or capital tax rates are unlikely to influence the choice of incorporation jurisdiction. The location in which a company incorporates does not entail any particular tax consequence: *Income Tax Regulations*, C.R.C., 1978, c. 945, ss. 400(2), 402.

<sup>79</sup>This range excludes Quebec because its fees were calculated on a graduated, rather than flat based, scale.

is, of course, interesting to speculate on the forces motivating the federal government to adopt a fee increase which, in retrospect, had the effect of undermining severely its market position. One particularly intriguing explanation is that the federal government acquiesced to the demands of Quebec politicians who were concerned with the inability of Quebec to regain its market share by way of legislative amendment alone.<sup>80</sup> If accurate, the explanation underscores the limited capacity of legislative innovation alone to capture market share. It also highlights the stake that politicians have in securing a sizeable share of the incorporation market.

Table 6

## Incorporation Fees (for provinces and the federal government)

	1975	1977	1979	1981	1983	1985	1987
Canada	\$200 f	\$200 f	\$200 f	\$200 f	\$200 f	\$500 f	\$500 f
B.C.	\$125 f	\$125 f	\$125 g	\$175 f	\$175 f	\$175 f	\$175 f
Alta.		\$55 g (\$20,000)	\$58 f	\$58 f	\$200 f	\$200 f	\$200 f
Sask.	\$40 g (\$20,000)	\$75 g (\$75,000)	\$75 g (\$75,000)	\$75 f	\$75 f	\$100 f	\$100 f
Man.	\$45 g (\$40,000)	\$135 g (\$40,000)	\$135 g (\$40,000)	\$200 g (\$40,000)	\$200 f	\$200 f	\$200 f
Ont.		\$125 g (\$40,000)	\$200 f	\$200 f	\$200 f	\$220 f	\$220 f
Que.		\$100 g (\$40,000)	\$125 g (\$40,000)	\$200 g (\$40,000)	\$200 g (\$40,000)	\$200 f (\$40,000)	\$300 g (\$40,000)
N.S.	\$50 g (\$5,000)	\$125 g (\$5,000)	\$125 g (\$40,000)	\$125 g (\$40,000)	\$125 g (\$40,000)	\$200 f	\$200 f
N.B.		\$50 g (\$5,000)	\$50 g (\$40,000)	\$100 g (\$5,000)	\$100 g (\$5,000)	\$200 f	\$200 f
Nfld.		\$10 g (\$40,000)	\$10 g (\$40,000)	\$100 g (\$5,000)	\$200 f	\$200 f	\$200 f
P.E.I.		\$50 g (\$5,000)	\$50 g (\$5,000)	\$100 g (\$5,000)	\$100 g (\$5,000)	\$150 f	\$150 f

f = flat based fee      g = graduated scale fee where the fee level depends on amount of authorized capital. The ceiling on authorized capital for the minimum fee is noted in brackets.

Source: Provincial data derived from: *Provincial and Municipal Finances*, (Biannual publication of the Canadian Tax Foundation). Federal data derived from: Corporations Branch, Department of Consumer and Corporate Affairs.

### *B. Is Legislative Product Enough? The Structure of the Canadian Corporate Law Regime in Relation to the United States*

In combination, the examination of incorporation trends and legal and extra-legal factors affecting the corporate law regimes of the federal government and Quebec is supportive of the suggested role of competitive factors in shaping Canadian corporate law product, especially in relation to the triumph of

<sup>80</sup>Telephone conversation with John Howard, former Deputy Minister, Department of Consumer and Corporate Affairs.

the *CBCA*. Yet, despite evidence of shareholder mobility and legislative responsiveness to market share targets, it is clear that competition in a Canadian setting has not nurtured the development of the institutions that have played a central role in the American corporate law regime. For instance, there is no Canadian jurisdiction that possesses the specialized court system, the highly developed body of corporate law precedent, and the formalized consultative mechanisms that are the hallmarks of the Delaware regime. To some extent, the failure of Canadian governments to adopt these institutions could be reflective of a rejection of the intellectual case for the competitive model in the corporate law area that is rooted in traditional concerns surrounding managerial opportunism. Perhaps, at another level, the failure of these institutions to flourish in a Canadian setting is reflective of an institutional environment that is less hospitable to the operation of competitive forces. I will explore each of these possibilities in turn.

### 1. The Shareholder Exploitation Hypothesis and Competitive Corporate Law Provision

It can be posited that one of the major reasons that an elaborate corporate law market has not developed in Canada is the discomfort that Canadian commentators have had with inter-governmental competition in the corporate law area because of its perceived incompatibility with the goal of shareholder welfare maximization.<sup>81</sup> The hostility of Canadian policy-makers to competition in the corporate law field is reminiscent of the position held by certain American legal academics in the debate over the role of Delaware in shaping the American corporate law regime.<sup>82</sup> These scholars, of whom William Cary is the most prominent, are critical of the effect that Delaware has had on the content of American corporate laws. Delaware, according to Cary, is the source of a nation-wide "race to laxity"<sup>83</sup> in corporate law norms. This erosion in norms is the result of a process by which states devoted to the protection of shareholder wealth through strengthened fiduciary duties found themselves unable to resist

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<sup>81</sup>In numerous interviews I had with both federal and provincial corporate law administrators, the claim that inter-governmental competition would result in a "race to the bottom" was made.

<sup>82</sup>William Cary's criticism of Delaware is found in a seminal article, "Federalism and Corporate Law: Reflections upon Delaware" (1974) 83 *Yale L.J.* 663. Other American scholars critical of the American charter market and, in particular, the role of Delaware, include R. Nader, M. Green, & J. Seligman, *Taming the Giant Corporation* (New York: Norton, 1976); R.W. Jennings, "Federalization of Corporation Law: Part Way or All the Way" (1976) 31 *Bus. Law* 991; S.A. Kaplan, "Fiduciary Responsibility in the Management of the Corporation" (1976) 31 *Bus. Law* 883; G.G. Young, "Federal Corporate Law, Federalism, and the Federal Courts" (1977) 41:3 *Law & Contemp. Probs.* 146.

<sup>83</sup>This evocative metaphor traces its lineage to Justice Brandeis' judgment in *Liggett Co. v. Lee* 288 U.S. 517 (1933) at 558-59, where he stated that "Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. ... The race was not one of diligence but of laxity."

the demands of their corporate residents for more lenient legislation.<sup>84</sup> This vulnerability to corporate pressure emanated from the threat of the dramatic losses in tax revenue that were anticipated to result from shareholder migration.<sup>85</sup> Fearing the loss of rents, both direct (incorporation and franchise fees)<sup>86</sup> and indirect (legal fees, corporate service fees), states, of which Delaware was the most prominent, responded to threatened migration by developing corporate codes that facilitated the diversion of wealth from shareholders to managers.<sup>87</sup> Of course, the calculus driving one state legislature to increase the attractiveness of its corporate law regime by passing legislation inimical to shareholders could just as easily apply to all states that fancied revenue from chartering activity.<sup>88</sup>

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<sup>84</sup>In these terms, the production of stringent fiduciary duties suffers from many of the defects that beset collective action in other contexts. Although, in Cary's world, all states would prefer to promulgate rigorous fiduciary duties, the fact that there are gains to states from defecting on commitments made to other states makes it difficult to enforce high fiduciary duties. As such, the production of stringent fiduciary duties resembles the classic prisoner's dilemma problem. For a definition and discussion of the prisoner's dilemma, see Scherer, *supra*, note 14 at 162-64; T.C. Schelling, *The Strategy of Conflict* (Cambridge: Harvard University Press, 1960), c. 5; R.D. Luce & H. Raiffa, *Games and Decisions: Introduction and Critical Survey* (New York: Wiley, 1957) at 94-102.

<sup>85</sup>According to Cary, so potent was the corrupting influence of corporate franchise revenue that, in Delaware's case, its allure even managed to cast a malignant shadow across the shoals of the Delaware judiciary:

In general, the judicial decisions [of the Delaware judiciary] can best be reconciled on the basis of desire to foster incorporation in Delaware. It is not clear, however, that the revenue thermometer should replace the chancellor's foot (*supra*, note 82 at 670).

<sup>86</sup>Romano, *supra*, note 19 at 240-42 found that 15.8% of Delaware's fiscal revenue was derived from corporate franchise fees.

<sup>87</sup>J.R. Macey & G.P. Miller, "Toward an Interest-Group Theory of Delaware Corporate Law" (1987) 65 *Texas L. Rev.* 469 develop an analysis of Delaware corporate law that is predicated on the self-serving role of special interest groups within Delaware. These groups, of which, not surprisingly, the legal profession is the most important, seek to increase the magnitude of the *indirect* benefits accruing to themselves, at the expense of those direct benefits accruing to the state at large. Ultimately, according to the authors, the corporate law regime that is produced in Delaware reflects tradeoffs between the various interest groups endeavouring to influence the production of corporate law. Because the legal profession has a stake in increasing the complexity, and hence undermining the certainty of Delaware law, the authors explicitly recognize the potential for outcomes destructive of shareholder wealth to be generated. The prospect of such outcomes is increased when managers share the preferences for such legislation.

<sup>88</sup>Interestingly, Cary did not confine his criticism to the Delaware legislature. He also argued that the Delaware judiciary were willing accomplices in the effort to increase the state's share of the charter market. According to Cary, the Delaware courts have "contributed to shrinking the concept of fiduciary responsibility and fairness, and indeed have followed the lead of the Delaware legislature in watering down shareholders' rights" (*supra*, note 82 at 696). Cary argued that the Delaware judiciary were amenable to the erosion of shareholder rights because they shared common views and goals with the Wilmington Bar from which they are traditionally drawn. In contrast, Cary found federal judges to be far more sensitive to shareholder rights.

The role of the Delaware judiciary has once again become a matter of debate. Following a series of cases decided by the Delaware Chancery Court which had the effect of limiting the circumstances in which the management of firms subject to a takeover could engage in defensive tactics, the

To safeguard or, indeed, increase one's share of the charter market, state legislatures were required to increase the permissiveness of their corporate law regime. The predictable effect of this situation was the destruction or unravelling of a responsible national corporate law regime as states competed in offering greater laxity in order to attract managerial patronage. In the tradition of other centralists, Cary's antidote for this destructive competition was simple: vest exclusive power over the chartering and regulation of corporations in the national government.<sup>89</sup>

Despite the considerable surface appeal of Cary's criticism, his argument against the role of Delaware did not go unchallenged. In a thoughtful and creative argument, Ralph Winter<sup>90</sup> invoked economic insights to support his claim that competition among states in their corporate law product would work to ensure the production of laws that were distinguished not merely by their innovative and responsive nature, but also by their capacity to enhance shareholder welfare.<sup>91</sup> Winter's faith in the capacity of state competition to produce optimal laws was based on a fundamentally different vision of the severity of the conflict between shareholder expectations and managerial performance. Whereas Cary's criticism is tethered to a conception of the modern corporate law regime

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Delaware Supreme Court in *Paramount Communications Inc. v. Time Inc.* Fed. Sec. L. Rep. (CCH) ¶94,938 (Del. Sup. Ct. Feb. 26, 1990) aff'g ¶94,514 (Del. Ch. July 14, 1989) cut back considerably the effect of judicial constraints on defensive activity. A number of commentators have argued that the change in direction of the Delaware Supreme Court was motivated by a memo circulated by prominent takeover defense attorney Martin Lipton to a number of the largest Delaware corporations. The memo suggested that, in view of the growing unwillingness of Delaware courts to accord sufficient deference to managerial actions in response to a takeover, clients should reconsider reincorporation in states like Pennsylvania, Ohio, and New Jersey which were seen to have greater sympathy for target management. See L.P. Cohen, "Lipton Tells Clients That Delaware May Not Be a Place to Incorporate" *Wall Street Journal* (11 November 1988) B7; T. Smart, "For Managers, Delaware Isn't the Haven It Used to Be" *Business Week* (19 December 1988) 33.

<sup>89</sup>The claim that exclusive federal government control over incorporation activity will produce legislation that overcomes many of the defects of state legislation is contentious. R. Romano ("The Future of Hostile Takeovers: Legislation and Public Opinion" (1988) 57 U. Cincinnati L. Rev. 457) argues that, in the case of anti-takeover legislation, there is no reason to expect that regulation at the federal level will differ from regulation produced at the state level. This is because of the asymmetrical bargaining power of affected interest groups at the federal level. Romano suspects that managers and unions are better equipped than shareholders to organize themselves at the federal level, thereby enabling them to wrest more favourable concessions from Congress.

<sup>90</sup>See R.K. Winter, Jr., "State Law, Shareholder Protection, and the Theory of the Corporation" (1977) 6 J. Leg. Stud. 251.

<sup>91</sup>As Fischel states, "Delaware's preeminence, in short, is in all probability attributable to success in a 'climb to the top' rather than to victory in a 'race to the bottom'" (D.R. Fischel, "The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law" (1982) 76 Nw. U.L. Rev. 913 at 920).

that is, in the tradition of Berle and Means,<sup>92</sup> predicated on endemic and uncontrollable managerial opportunism, Winter's response is based on the supposition that the gale of various market forces — the product, capital, labour and takeover markets<sup>93</sup> — operates to constrain considerably the danger of unaccountable managerial action. Absent the problem of unconstrained managerial conduct (the externality upon which Cary's rejection of decentralized competition is based), the vitality of decentralized corporate law production is redeemed. For if, as Winter argues, the scope for managerial diversion is in general much more limited than Cary envisages, there is no reason to expect that shareholders or their market proxies will be incapable of identifying and penalizing opportunistic reincorporations by managers.

Distilled to its bare essentials, the debate over Delaware and the role of decentralized corporate law provision turns on the impact of reincorporation on shareholder wealth. Seen in this light, resolution of the debate appears to be amenable to resolution through empirical investigation. In other words, by making the plausible and widely accepted assumption that shareholder welfare is embodied in share prices and, further, that market prices are the best estimation of the intrinsic value of a company's share value,<sup>94</sup> financial economists are able

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<sup>92</sup>See A.A. Berle & G.C. Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932). Berle and Means' thesis is discussed in "Corporations and Private Property: A Conference Sponsored by the Hoover Institution" (1983) 26 J.L. Econ. 235.

<sup>93</sup>J.S. Ziegel *et al.*, *Cases and Materials on Partnerships and Canadian Business Corporations*, 2d ed., vol. 1 (Toronto: Carswell, 1989) at 372-76. The authors define the product market as the market in which the corporation's goods are bought and sold. The success or failure of a company's goods on the product market is governed by the price, quality, and service characteristics of the corporation's products (*supra* at 374).

The capital market

is comprised of numerous bond and equity markets that are located in countries throughout the world .... Capital markets can ... play a role in detecting and signalling unanticipated opportunism by managers when it occurs, thereby allowing shareholders to discipline such conduct via their voting rights (*supra* at 373).

The labour market, or managerial market "is the market where the services of corporate managers are traded. It is the threat of having to compete in the managerial market that encourages managers to act in their principals' best interests" (*supra* at 375). The takeover market, also known as the market for corporate control, "operates by transferring control of mismanaged corporations (*i.e.*, corporations beset by high levels of agency costs) to owners more willing or able to discipline self-serving managers" (*supra* at 376).

<sup>94</sup>This is known in the parlance of corporate finance as the Efficient Capital Markets Hypothesis (ECMH), for which there is a vast literature. Good discussions of ECMH can be found in R.J. Gilson & R.H. Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Virginia L. Rev. 549; J.N. Gordon & L.A. Kornhauser, "Efficient Markets, Costly Information, and Securities Research" (1985) 60 New York U.L. Rev. 761; C.P. Saari, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry" (1976-77) 29 Stan. L. Rev. 1031; R.J. Shiller, "Fashions, Fads and Bubbles in Financial Markets" in J.C. Coffee, Jr., L. Lowenstein & S. Rose-Ackerman, eds., *Knights, Raiders and Targets: The Impact of the Hostile Takeover* (New York: Oxford University Press, 1988) 56; Posner & Scott, *supra*, note 19, c. 7.

to posit what the level of share prices would have been in the absence of some major transaction, and then to compare this hypothetical price to the actual price of the share on a given day. If *actual* share prices are in excess of *predicted* share prices over a given period, then the transaction can be deemed to be one that augments shareholder wealth. Conversely, if *actual* share prices are below predicted values, then the transaction can be viewed as jeopardizing shareholder welfare.<sup>95</sup> A strong *a priori* case for the suitability of invoking these techniques to evaluate the efficacy of the charter market reflects the ease in identifying accurate announcement dates for proposed reincorporations and the presumed capacity of capital markets to accurately assess the impact of reincorporations on firm wealth.<sup>96</sup>

Dodd and Leftwich, in one of the earliest econometric studies of reincorporation, examined the share performance of 140 New York Stock Exchange firms that changed domicile jurisdiction in the period from 1927 to 1977, and found that shareholders of reincorporating companies earned persistently abnormal returns of an average of 30.25% in the twenty five months prior to, and including, the month of the switch.<sup>97</sup> Interestingly, the researchers found that over 80% of the abnormal performance over the two year period could be traced to one price observation of each firm. Dodd and Leftwich construed this evidence as being "consistent with the hypothesis that the decision to reincorporate is motivated by the desire to minimize the costs of the new set of activities."<sup>98</sup>

Romano also investigated the share performance of reincorporating firms, but refined Dodd and Leftwich's methodology by sorting firms by reincorporation motive. She found that the abnormal returns accruing to shareholders varied with reincorporation motive. Romano examined the performance of share prices 99 days before and after a "reincorporation event."<sup>99</sup> She found that cumulative average residuals ranged from 0.6% for tax-motivated reincorporations to 8.6% for firms engaging in mergers and acquisitions activity, with an overall average for all firms of 4.1%.<sup>100</sup> Significantly, Romano determined that cumulative aver-

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<sup>95</sup>This method, known as the Cumulative Abnormal Returns (CAR) technique, is discussed at length in R.J. Gilson, *The Law and Finance of Corporate Acquisitions* (Mineola: Foundation Press, 1986) at 213-38.

<sup>96</sup>Because information respecting the relative merits of myriad state legal regimes is easily gathered and analyzed, the impact of migration (*i.e.*, a decision to substitute one legal regime for another) on firm wealth should not, *ceteris paribus*, be difficult to predict.

<sup>97</sup>See P. Dodd & R. Leftwich, "The Market for Corporate Charters: 'Unhealthy Competition' versus Federal Regulation" (1980) 53 J. Bus. 259.

<sup>98</sup>*Ibid.* at 281.

<sup>99</sup>Romano used the earliest of the following events as event dates: date of directors' approval of reincorporation, incorporation of a shell successor company, signing of merger agreement, proxy mailing, the shareholders' meeting, the effective date of reincorporation, or an article in the Wall Street Journal (Romano, *supra*, note 19 at 268).

<sup>100</sup>Romano suggests that, in comparison to Dodd and Leftwich, her lower cumulative average residuals may be attributed to temporal factors. Since the data were generated in different time frames, global changes in the market trends may explain the disparity.

age residuals for shareholders in firms whose reincorporation was motivated by the benefits of anti-takeover legislation amounted to 1.3%. These data, according to Romano, were consistent with a transactions cost explanation for the role of Delaware: because of the superior institutional attributes of Delaware's corporate law regime, the state was able to reduce the costs to migrating corporations of executing certain transactions and was also able to provide corporations with greater litigation certainty.<sup>101</sup>

Yet despite the finding that reincorporations were, depending on underlying motive, either positive or zero net present value decisions, Romano did not construe her results as an unequivocal vindication of the Winter thesis. The source of Romano's ambivalence was the perplexing case of state anti-takeover statutes.<sup>102</sup> That is, whereas there is no *a priori* reason to expect that reincorporations triggered by the forthcoming implementation of a mergers and acquisition program or the pursuit of favourable tax benefits should reduce shareholder values, there is, in contrast, very considerable consensus in the mainstream law and economics literature that providing judicial or legislative scope for defensive measures in response to a takeover bid is deeply inimical to shareholder

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<sup>101</sup>See text accompanying notes 73-74 *supra* on the extra-legal attributes of the Delaware regime.

<sup>102</sup>These statutes are designed to supplement the federal securities law regime that governs takeovers (the "Williams Act," 15 U.S.C. §§ 78g, 78l-78n, 78s (1976)). The "first generation" takeover statutes adopted by the states were found, however, to encroach on the federal government's securities law powers related to regulation of interstate commerce (*Edgar v. MITE Corp.* 457 U.S. 624 (1982)). In order to avoid being subject to attack on the basis of constitutional infirmities, the "second generation" statutes regulated transactions on the basis of incorporation domicile, not mere presence of investors as in the earlier legislation. Generally, these second generation statutes fall into three distinct patterns. First, Control Share Acquisition laws: These statutory provisions require a majority of disinterested shareholders to sanction the acquisition of control (defined on the basis of some statutory threshold) by any person or group of associated persons. Second, Fair Price laws: These laws require that any business combination between a firm and a shareholder with some specified minimum amount of stock be subject to supermajority shareholder approval (for instance, 80% of outstanding shares and 2/3 of the disinterested shareholders). There are a series of exemptions that may operate to allow the combination to proceed without the vote (*e.g.*, payment of a fair price, approval of disinterested board, etc.). And third, Redemption Rights laws: These laws provide that upon some share acquisition event, *e.g.* acquisition of 30% of firm's stock, all remaining shareholders are entitled to an immediate cash payment for their shares equal to the fair value of the stock. Recently, these statutes have become more complex, with provision being made for target board responsibilities to non-shareholder constituencies (Indiana) disgorgement of gains on disposition of stock after a failed control bid (Pennsylvania) and staggered boards (Massachusetts). In any event, all of these provisions have the clear effect of increasing the costs of acquiring control, thereby increasing the ability of target management to subvert a takeover bid. See F.H. Easterbrook & D.R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harv. L. Rev. 1161; G.A. Jarrell, J.A. Brickley & J.M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980" (1988) 2:1 J. Econ. Perspectives 49. For a very recent popular account of the proliferation of state anti-takeover provisions, see "Private Property! Keep Out! American States Raise Barriers Against Hostile Takeovers" TIME (14 May 1990) 80.

welfare.<sup>103</sup> Accordingly, legislation aimed at increasing the ability of target management to defend against a hostile takeover bid should, *ceteris paribus*, reduce the value of a corporation's equity. Viewed from this perspective, reincorporations motivated by a desire to take advantage of state anti-takeover legislation should have generated negative, not positive, returns.

Obviously, one way of resolving the incompatibility of the empirical data on reincorporations motivated by anti-takeover measures with the thesis predicting gains from state competition is to modify or reject the "strong form"<sup>104</sup> assertions of the law and economics community respecting the desirability of defensive tactics from a shareholder welfare perspective.<sup>105</sup> This line of argu-

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<sup>103</sup>See Jarrell, Brickley & Netter, *ibid.*; R.J. Gilson, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers" (1981) 33 *Stan. L. Rev.* 819; Gilson, "The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept" (1982) 34 *Stan. L. Rev.* 775; M.C. Jensen & R.S. Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11 *J. Fin. Econ.* 5; G.A. Jarrell & A.B. Poulsen, "Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980" (1987) 19 *J. Fin. Econ.* 127; F.H. Easterbrook & G.A. Jarrell, "Do Targets Gain from Defeating Tender Offers?" (1984) 59 *New York U. L. Rev.* 277.

<sup>104</sup>For definitions of "weak form," "semi-strong form" and "strong form" assertions of market efficiency, see Gilson & Kraakman, *supra*, note 94 at 554-65. The terms were coined in Eugene Fama's seminal study, "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 *J. Fin.* 383. A market is weak-form efficient if it impounds all historical information; it is semi-strong form efficient if it impounds historical and current publicly available information; finally, it is strong-form efficient if it impounds not only historical and publicly available information, but also information that is "available only to particular groups of privileged investors" (Gilson & Kraakman, *supra* at 555-56).

<sup>105</sup>It is interesting that the debate over the role of Delaware has recently focused so closely on the perplexing case of anti-takeover inspired reincorporations. Underlying the debate is the assumption that anti-takeover inspired reincorporations are qualitatively different in terms of their potentially negative impact on shareholder wealth. My own view is that virtually all transaction-inspired reincorporations pose opportunities for managers to divert wealth from shareholders. Since many of the cost savings experienced by firms from a shift to Delaware involve the suppression of shareholder voice, it seems that the move to Delaware enlarges the domain for present or future opportunistic behaviour by managers. The fact that reincorporations to Delaware were either positive or zero net present value events is not inconsistent with this finding. By considering the effects of reincorporation as the byproduct of two distinct decisions — the decision to engage in a certain transaction and the decision to reincorporate in Delaware — it is possible to imagine that, although aggregating to a positive or zero sum event, the *direction* (positive or negative) of each of the constituent components may be different. If an event study based on a similar sample of transactions as those studied by Romano could be undertaken, but confined to firms not undergoing reincorporation, it would be interesting to compare the share price effects. Stated simply, the fact that reincorporations are entangled with certain motivating transactions raises, at least, the prospect that Delaware reincorporations may lower the level of benefits accruing to shareholders from certain transactions. Of course, even with this caveat in mind, the case for state competition can still be made; for even if Delaware reincorporation may impair shareholder interests in some circumstances, it is possible that, but for reincorporation to that state, the transaction would not have been consummated. Viewed from this perspective, reincorporation to Delaware may, in some circumstances, be a "bribe" that shareholders must pay in order for their managers to agree to engage in

ment has been pursued recently by a number of corporate theorists.<sup>106</sup> Romano too has argued for the possibility that some forms of state anti-takeover legislation, *i.e.*, fair price provisions, can increase the welfare of shareholders because they reduce the transactions costs of adopting provisions that would have been adopted through shareholder voting in the absence of legislation.<sup>107</sup> These provisions are valued by shareholders because of their desirable distributional effects.<sup>108</sup> Nevertheless, empirical support for her thesis is equivocal, and Romano was unable to discount the possibility that reincorporations motivated by the benefits of anti-takeover protections were designed to vindicate managerial rather than shareholder welfare objectives. This finding has led Romano to adopt a "middle ground" between Cary and Winter insofar as the welfare effects of state competition are concerned. According to her, "such a view recognizes that, on occasion, (state) competition may well produce laws that shareholders

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positive net present value decisions. This argument is consistent with the work of those scholars who argue that because of implicit forms of regulation, managers are systematically undercompensated (M. Jensen & K. Murphy, "Performance Pay and Top Management Incentives" Harvard Business School Working Paper No. 88-059, May 1988). Accordingly, other, less obvious mechanisms for motivating managers to overcome their innate risk aversion, so that they seek out and execute positive net present value decisions for the corporation, must be devised. In this respect, allowing reincorporation to Delaware may be viewed as a form of gain sharing. (The virtues of gain sharing are discussed by F.H. Easterbrook and D.R. Fischel in "Corporate Control Transactions" (1982) 91 Yale L.J. 698.)

<sup>106</sup>See, for instance, R.A. Booth, "The Promise of State Takeover Statutes" (1988) 86 Mich. L. Rev. 1635. Booth argues that state anti-takeover laws can limit the scope for coercive tactics that exists under federal legislation. An alternative analysis has been advanced by Macey and Miller, *supra*, note 87. Invoking the insights of public choice theory, they argue that most outcomes produced through state provision of corporate law are conducive to shareholder welfare maximization, but allow for some outcomes, *e.g.*, anti-takeover legislation, to be generated which are corrosive of shareholder welfare. See also E. Berkovitch & N. Khanna, "How Target Shareholders Benefit from Value-Reducing Defensive Strategies in Takeovers" (1990) 45 J. Fin. 137.

<sup>107</sup>See R. Romano, "The State Competition Debate in Corporate Law" (1987) 8 Cardozo L. Rev. 709; "The Political Economy of Takeover Statutes" (1987) 73 Virg. L. Rev. 111; and "The Future of Hostile Takeovers: Legislation and Public Opinion," *supra*, note 89. Romano's view is consistent with the vision of corporate law as standard form contract that has been espoused by a number of law and economics scholars. See, for instance, the papers collected in "Contractual Freedom in Corporate Law" (1989) 89 Columbia L. Rev. 1395. For a critical assessment of this framework, see V. Brudeney, "Corporate Governance, Agency Costs, and the Rhetoric of Contract" (1985) 85 Columbia L. Rev. 1403.

<sup>108</sup>Her argument is that fair price provisions can ensure that the gains from a control transaction do not accrue disproportionately to institutional investors. Romano argues that, in the context of a two tiered bid, smaller investors are less able to sell their shares to an acquiror in the pre-bid period, and, owing to informational difficulties, are more likely to experience the lower bid prices often offered in the second tier of a two tier bid. Fair price provisions have the effect of levelling the prices offered in multi-tiered bids, and, therefore, can be viewed as protecting smaller shareholders from having their pro-rata share of the control premia compromised. See Romano, "The Political Economy of Takeover Statutes" *ibid.* at 145-89.

in some firms would not choose to adopt voluntarily."<sup>109</sup>

Given the difficulties in assembling unequivocal empirical support for the competitive model from the American corporate law experience, should, on the grounds of shareholder welfare, the competitive model of law reform be rejected for Canada? Despite the difficulties in providing plausible first principles efficiency rationales for *all* of the outcomes generated by state competition in the United States, my view is that, on balance, the gains from competitive law production in terms of its innovative and dynamic outcomes, are likely to outweigh the costs generated by externalities, such as those arising from shareholders' inability to control managerial conduct. This position reflects my belief that, although managerial opportunism is by no means a trivial problem, a variety of both legal and market instruments clearly limit the scope for it in Canada. And although some of the mechanisms deployed in Canada to control managerial opportunism may not be as vigorous as those in the United States — owing to the existence of certain defects in the Canadian corporate control, product, managerial and capital markets — the deleterious impact of these defects on shareholder welfare are likely balanced or even eclipsed by other distinctive features of the Canadian regime.<sup>110</sup> These features include the various statutory devices triggered by continuance to another jurisdiction — appraisal rights and shareholder approval requirements — that increase the strength of shareholder voice and exit instruments at the time that a domicile change is proposed.<sup>111</sup>

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<sup>109</sup>Romano, "The State Competition Debate in Corporate Law," *supra*, note 107 at 752. It should, however, be noted that Romano has declared, at 753, her position to be closer to Winter than to Cary.

<sup>110</sup>The distinctive features of Canadian capital markets and their impact on corporate and securities regulation are canvassed in R.J. Daniels & J. MacIntosh, "Toward A Distinctive Canadian Corporate and Securities Law Regime" (unpublished manuscript on file with the author).

<sup>111</sup>These provisions permit corporations to continue in another Canadian jurisdiction provided certain conditions are fulfilled. These statutory continuance provisions require migrating corporations to secure supra-majority shareholder approval, to obtain a certificate from a corporate law administrator, and to give dissenting shareholders the right to tender their shares to the corporation for "fair value" before a domicile shift out of the originating jurisdiction is permitted to take effect. Currently, ten Canadian jurisdictions have adopted statutory continuance and discontinuance devices into their corporate law statutes (Quebec is the exception, lacking a discontinuance device; instead it requires a voluntary dissolution). See *CBCA*, ss. 187-188; *OCBA*, ss. 179-180; *Company Act*, R.S.B.C. 1979, c. 59, ss. 36-37; *Business Corporations Act*, S.A. 1981, c. B-15, ss. 181-182; *The Business Corporations Act*, R.S.S. 1978, c. B-10, ss. 181-182; *Corporations Act*, R.S.M. 1987, c. C-225, ss. 181-182; *Companies Act*, *supra*, note 75, as am. S.Q. 1980, c. 28, ss. 123.131-123.133; *Business Corporations Act*, S.N.B. 1981, c. B-9.1, ss. 126-127; *Companies Act*, R.S.N.S. 1967, c. 42, as am. S.N.S. 1978-79, c. 12, s. 119B; *Companies Act*, R.S.P.E.I. 1974, c. C-15, as am. S.P.E.I. 1984, c. 14, ss. 84-84.1; *The Corporations Act*, S.N. 1986, c. 12, ss. 295-296. In contrast, domicile changes in the United States are usually effected by a reverse triangular merger that requires only bare majority shareholder approval without any accompanying discretionary administrative approval. See Romano, "Law as Product," *supra*, note 19 at 248. The reverse triangular merger is described by R.C. Clark, *Corporate Law* (Boston: Little, Brown, 1986) at 426-33. See also L. Loss & J. Seligman, *Securities Regulation*, 3d ed. (Boston: Little, Brown,

Also important in this respect is the much higher level of share ownership concentration in Canada that enables Canadian shareholders to overcome endemic collective action problems, thereby reducing significantly the problems wrought by the separation of ownership and control.<sup>112</sup> In these terms, the spectre of opportunistic management cynically exploiting competition between Canadian governments for their own ends is diminished. Intergovernmental competition should be lauded, rather than condemned, by Canadian commentators.

## 2. Structural Features of the Canadian Corporate Law Regime Undermining the Competitive Model

Apart from the dubious case against the competitive model on grounds of shareholder welfare, there are a variety of distinctive structural features of the

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1989) at 1255-56; E.-L. Folk, III, R. Word, Jr. & E.P. Welch, *Folk on the Delaware General Corporation Law*, 2d ed. (Boston: Little, Brown, 1989), ss. 251.2.1, 251.2.5. It is essentially a "dressed up" variation on the standard stock for stock merger. In the transaction, a shell company is interposed between the existing corporation and a corporation incorporated in the destination jurisdiction. Through a series of transactions, the shares of the existing corporation are transferred to the new corporation via the shell company in exchange for shares in the new corporation. For most states, 50% approval is sufficient to support migration. A pivotal development in these transactions occurred in 1969, when amendments to Delaware's Corporation Law dropped the 2/3 approval requirement for mergers of this sort to a bare majority. Another consideration in structuring these transactions in the United States is federal securities law. SEC Rule 145 extends the disclosure requirements of the 1933 Act to mergers and acquisitions; however, Rule 145(a)(2) exempts mergers effected solely to change corporate domicile. See 2 Fox & Fox, *Corporate Acquisitions and Mergers*, § 28.06 [1][b][ii].

<sup>112</sup>D.A. Demott, "Comparative Dimensions of Takeover Regulation" (1987) 65 Wash. U. L.Q. 69 at 74: "Unlike publicly traded companies in the United States, a majority of large, publicly traded Canadian corporations are legally or effectively controlled by an identifiable shareholder or group of shareholders." Demott gives the following breakdown, derived from the Standard and Poor's Index and the TSE 300 Composite Index, respectively at 73 n. 12 and 74 n. 13:

	<i>Number of American Companies</i>	<i>Percentage of American Companies</i>
Shareholder with legal control (50% or more)	6	1.2
Shareholder with effective control (20%-49.9%)	68	13.16
Widely held shares	<u>426</u>	<u>85.2</u>
Total	500	100 % [sic]
	<i>Number of Canadian Companies</i>	<i>Percentage of Canadian Companies</i>
Shareholder with legal control (50% or more)	137	48.4
Shareholder with effective control (20%-49.9%)	85	30.0
Widely held shares	<u>61</u>	<u>21.6</u>
Total	283	100 %

Canadian regime which may have impeded the rise of a competitive and comprehensive corporate law regime. The role of each of these features will be assessed in turn.

*a. Inability to Realize Minimum Efficient Scale in Institutions*

The lack of a well-developed corporate law infrastructure could reflect the relatively fragmented state of the Canadian corporate law market. Owing to the multiplicity of jurisdictions offering corporate law product and the relatively small size of the Canadian market, it can be argued that no one jurisdiction will be able to capture a share of the total corporate law market necessary to justify the start-up investment in corporate law infrastructure. This argument assumes that governments will be unable to overcome minimum efficient size constraints and will refrain from expending effort in the development of an infrastructure necessary for effective competition. This argument is flawed by its failure to delineate between initial and end states. While it is possible, though unlikely, that the *existing* level of incorporations may not allow any one of the eleven jurisdictions to earn a positive return on its investment, there is no reason to expect that a jurisdiction making institution-based investments will not enjoy a shift in the demand for its corporate law product. Assuming that the demand for corporate law product is downward sloping, it is reasonable to predict increases in the *future* volume and price of supplied product from a shift in demand. Such increases should enable the innovating jurisdiction to earn an economic rate of return on its investment. Is it reasonable to predict demand increases for corporate law innovation? On the basis of the *CBCA* case study above, it is fair to assume that even relatively limited corporate law reforms can induce quite significant demand-side effects. And, as the stellar success of Delaware in the United States demonstrates, it is possible even for a jurisdiction lacking any particular natural endowments, other than physical proximity to a major financial centre, to obtain a dominant market position through the provision of a desired product. In sum, there is no reason to doubt the capacity of at least one Canadian jurisdiction to capture more than its "natural" share of the corporate law market by offering a superior product. Consequently, economies of scale must be rejected as a reason for stunted institutional development in Canada.

*b. The Enhanced Prospect of Coordinated Behaviour*

An alternative explanation for the failure of an elaborate institutional framework to evolve in Canada lies in the greater scope for co-ordinated behaviour by government competitors that is aimed at limiting competition in the provision of corporate law product.<sup>113</sup> The scope for such behaviour emanates from the smaller number of jurisdictions offering corporate law product in Canada

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<sup>113</sup>See Breton, "Supplementary Statements," *supra*, note 2.

(11)<sup>114</sup> in comparison to the United States (50). The consequence of having fewer suppliers is that the costs of negotiating, executing and enforcing anti-competitive agreements or understandings<sup>115</sup> is reduced, thereby facilitating the consummation and maintenance of such commitments, even in the face of strong incentives to defect.<sup>116</sup>

Why would Canadian governments prefer not to compete on the basis of corporate law product? Two principal explanations may be advanced. First, agreements restricting competition may be perceived as producing outcomes that are compatible with widely held views of regional or inter-provincial fairness. Because constrained competition minimizes the gains from "charter shopping," the ability of any one province to capture more than its pro-rata share of the total market is fettered. Since the distribution of outcomes is equalized across all jurisdictions by this process, it may be loosely supported on grounds

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<sup>114</sup>Indeed, in view of the relatively small number of Canadian governments that are seriously committed to establishing a reputation in the corporate law field, the actual number of competitor jurisdictions may be even smaller, perhaps only 5 (the federal government, Ontario, Quebec, Alberta, and British Columbia).

<sup>115</sup>These agreements or understandings need not be explicit. As the industrial organizations literature has shown, co-ordinated behaviour among rivals can occur even in the absence of actual contact. See Scherer, *supra*, note 14 at 155-56. Scherer cites E.H. Chamberlin, "Duopoly: Value Where Sellers Are Few" (1929) 43 Q.J. Econ. 63, later incorporated with revisions in *The Theory of Monopolistic Competition* (Cambridge: Harvard University Press, 1933), c. 3. Chamberlin argued that when the number of sellers is small and products are standardized, oligopolists can scarcely avoid full recognition of their interdependence. The result follows from the structure of the market — no formal collusion or agreement is necessary. "For the inopoly price to emerge, it is essential only that the firms recognize their mutual interdependence and their mutual interest in a high price" (Scherer, *supra* at 155). The problem of "conscious parallelism" in oligopolistic industries is also discussed in Dunlop, McQueen & Trebilcock, *supra*, note 34 at 119-21. The authors examine the validity of the premise that firms in oligopolistic markets will find it rational to resist competitive pricing behaviour. See also D.F. Turner, "The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal" (1962) 75 Harv. L. Rev. 655; R.A. Posner, "Oligopoly and the Antitrust Laws: A Suggested Approach" (1969) 21 Stan. L. Rev. 1562; D.R. Kamerschen, "An Economic Approach to the Detection and Proof of Collusion" (1979) 17 Am. Bus. L.J. 193.

<sup>116</sup>Public-choice theorists tend to argue that the ability to maintain and enforce welfare-enhancing agreements increases as the number of players decreases. See Olson, *supra*, note 30 at 29-36; D.C. Mueller, *Public Choice II* (Cambridge: Cambridge University Press, 1989) at 13-15. Mueller maintains that

one can expect the voluntary provision of public goods and cooperative behavioural constraints to be greater in small, stable communities of homogeneous behaviour patterns (*supra* at 13).

In contrast, "[l]arger, more impersonal communities must typically establish formal penalties against asocial behaviour (like stealing), levy taxes to provide for public goods, and employ a police force to ensure compliance" (*supra* at 14) and "[r]eliance on voluntary compliance in large communities or groups leads to free riding and the under or non-provision of the public good" (*supra* at 13). See also R.H. Coase, "The Problem of Social Cost" (1960) 3 J.L. Econ. 1; J.M. Buchanan, "Ethical Rules, Expected Values, and Large Numbers" (1965) 76 Ethics 1.

of horizontal equity. However, it is not clear that equality of *outcome* is the only, or in fact the most, important concept of fairness embedded in the compact underlying Canadian federalism. Arguably, equality of *opportunity*, subject to some minimum level of common services, is just as, if not more, compatible with that compact. Of course, assuming that all provinces have an equal capacity to win a disproportionate share of the corporate law market, under the latter vision of equality there is no basis in principle for restricting competition.

The second, and less principled, basis for governments attempting to limit competitive interaction relates once again to concerns over non-recoverable investments in highly specific institutional assets. Assuming that migration between jurisdictions is relatively rapid and inexpensive, an innovating government will fear that its investment in corporate law institutions is vulnerable to massive outflows of corporate residents in response to relatively minor innovations introduced by competitor governments. If all jurisdictions believe that asset-specific investments are vulnerable to shifts in consumer preferences, they will refrain from investing in institutions supportive of its corporate law. However, this situation has prisoner's dilemma properties; each government will fear that its pro-rata share of the market may be prone to contraction in the event of innovation elsewhere.<sup>117</sup> An obvious solution to the concern over innovation elsewhere is to conclude "hands tying" understandings by which potential competitors agree not to introduce innovations which will upset existing market shares. These understandings mitigate the risk of a first mover jurisdiction being saddled with non-recoverable investments. The difficulty, however, with this rationale is its dependence on a view of corporate law market that has been powerfully discredited by Romano's work. Romano's results indicate that a variety of factors (*e.g.*, transactions costs, jurisdiction-specific investments by corporate managers and their lawyers, and the widespread desire for business certainty) impede the mobility of corporations and protect innovating jurisdictions from precipitous declines in their corporate base. Because the presence of mobility rigidities in the corporate law market reduces the vulnerability of jurisdictions undertaking innovative investments, the suitability of competition-suppressing agreements is rendered highly suspect.

Together, these arguments suggest that the normative desirability and the actual likelihood of provinces engaging in co-ordinated behaviour in an effort to protect market share is limited. Indeed, the rapid diffusion of the *CBCA* model suggests that the source of competitive restraints must reside elsewhere.

### *c. Overlapping Legal Products*

The overlap between Canadian corporate and securities law is a subject that has received considerable attention by corporate law scholars.<sup>118</sup> As the

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<sup>117</sup>On the prisoner's dilemma, see above, note 84.

<sup>118</sup>See P. Anisman, "The Commission as Protector of Minority Shareholders" in *Securities Law in the Modern Financial Marketplace, Law Society of Upper Canada Special Lectures* [hereinafter *LSUC Lectures*] (Toronto: De Boo, 1989) 451; S.M. Beck, "Minority Shareholders' Rights in the

recent *Canadian Tire* case so vividly demonstrates,<sup>119</sup> Canadian securities regulators have frequently encroached on the domain of the courts in deciding corporate governance disputes.<sup>120</sup> The existence of overlapping securities and corporate laws in Canada means that the benefits of a province's corporate law regime may be undermined by the operation of provincial securities law administrators located in the incorporating province or, more significantly, in other provinces. The prospect of intervention by extra-provincial securities administrators is facilitated by the fact that securities law jurisdiction is not based on location of corporate domicile (as in the corporate law case), but on the basis of investor residence.<sup>121</sup> As a consequence, a firm with investors dispersed throughout the country may find that the putative benefits of a shift in corporate law domicile are jeopardized by the role of securities administrators located in the originating jurisdiction or elsewhere in the country. For instance, a public corporation contemplating "going private,"<sup>122</sup> may find that the benefits of migration (in terms of more lenient or certain fiduciary duties in the destination

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1980s" in *Corporate Law in the 80s, LSUC Lectures* (Don Mills, Ont.: De Boo, 1982) 311 at 342-47; J.C. Baillie, "Shareholders' Remedies" in *New Developments in the Law of Remedies, LSUC Lectures* (Don Mills, Ont.: De Boo, 1981) 21 at 26-34.

<sup>119</sup>In *Re Canadian Tire Corp.* (1987), 10 O.S.C.B. 857, 35 B.L.R. 56 (O.S.C.), aff'd (1987), 10 O.S.C.B. 1771, 35 B.L.R. 117 (*sub nom. C.T.C. Dealer Holdings Ltd. v. Ontario (Ont. Securities Comm.)*) 59 O.R. (2d) 79, 37 D.L.R. (4th) 94 (Ont. Div. Ct.), leave to appeal denied (1987), 35 B.L.R. xx (Ont. C.A.), the Ontario Securities Commission relied on its "public interest" powers to impose quasi-fiduciary obligations on majority shareholders (*Securities Act*, R.S.O. 1980, c. 466, s. 123). *Per Beck*, Chairman, at B.L.R. 105-106:

A transaction such as is proposed here is bound to have an effect on public confidence in the integrity of our capital markets and on public confidence in those who are the controllers of our major corporations. If abusive transactions such as the one in issue here, and this is as grossly abusive a transaction as the Commission has had before it in recent years, are allowed to proceed, confidence in our capital markets will inevitably suffer and individuals will be less willing to place funds in the equity markets. That can only have a deleterious effect on our capital markets and, in that sense, it is in the public interest that this Offer be cease-traded...

Such quasi-fiduciary obligations as were found here are, of course, part of the traditional domain of corporate law.

<sup>120</sup>In large part, overlap is indicative of the normative difficulties inherent in constructing watertight boundaries between corporate and securities laws. Investor protection — the oft-cited central objective of securities law — and managerial and shareholder accountability — the oft-cited central objective of corporate law — are, to say the least, very closely related. With closely related, if not similar, objectives governing both bodies of law, the prospect of overlap in application of laws is not surprising.

<sup>121</sup>See Anisman & Hogg, *supra*, note 3, c. III.

<sup>122</sup>In a "going private" transaction, the public shareholders are forced out of the company, with the result that a small group of persons (or corporations) ends up owning all the equity of the firm. Its shares cease to trade on public markets. A going private transaction can be effected in a number of ways. These include (but are not limited to) the following: freezeout (or squeezeout) amalgamation; compulsory acquisition; reverse stock split (or "consolidation freezeout"); sale of assets; redemption flip-flop; arrangement (*e.g.*, under *CBCA*, s. 192); statutory going private provisions (*e.g.*, *OBCA*, s. 189).

jurisdiction's corporate law) are eroded by substantive security legislation such as Policy 9.1 of the Ontario Securities Commission which requires regulators to comply with a comprehensive investor protection regime.<sup>123</sup> To the extent that securities regulators are able to impinge on the scope traditionally accorded corporate law, the integrity of each government's corporate law product is compromised. Seen in this light, the parallel operation of the securities law regime is likely to undermine competitive activity in the corporate law market.

*d. Legal Market Failure*

Some analysts have argued that the lack of competition in the provision of Canadian corporate law reflects the innate conservatism of Canadian lawyers and the "unwillingness [of counsel] to expose his client to an unfamiliar corporate law regime."<sup>124</sup> Why would Canadian lawyers fail to advise their clients to move jurisdictions? An obvious reason centers on the risk of losing clients to competitor law firms located in the destination jurisdiction. Although a lawyer residing in one provincial jurisdiction may be familiar with the content of another jurisdiction's corporate law statute, provincial law society practise codes restrict the capacity of non-resident lawyers to render opinions on the state of the law in that jurisdiction. For a firm contemplating a domicile change that may give rise to future litigation, law firms in the originating jurisdiction will foresee losses in future service revenue owing to their inability to render further advice on the transaction. And, to the extent that there are economies in having all of the migrating firm's legal matters handled by one firm, law firms in the originating jurisdiction will fear losing the entire account on migration. Finally, even if the law firm in the originating jurisdiction were given some scope to act in the destination jurisdiction,<sup>125</sup> these firms would be required to make additional investments in their human capital so that they could become proficient in the destination jurisdiction's corporate law regime.

Despite the surface plausibility of these arguments, there are a number of reasons for suspecting that the legal market failure explanation for lacklustre corporate law competition is greatly overstated. The elaborate network of national law firm associations that has grown up over the last five years reduces considerably the danger that revenue losses will be sustained by member firms from domicile changes by corporate clients. Even for those firms not associated with one of the national partnerships, it is still possible to retain corporate clients after migration by referring the client to agent law firms in the destination jurisdiction. Given that these firms may be involved in long term relationships with the firm in the originating jurisdiction, there will be little incentive to "cheat" the law firm in the originating jurisdiction by trying to secure all of the

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<sup>123</sup>O.S.C. Policies, s. 9.1 — Going Private Transactions, Issuer Bids, and Insider Bids.

<sup>124</sup>Beck *et al.*, *supra*, note 44 at 152.

<sup>125</sup>See *supra*, note 15.

reincorporating firm's legal work.<sup>126</sup> The fact that reincorporation need not threaten traditional relationships between law firms and their corporate clients means that firms can counsel clients to reincorporate elsewhere in Canada without fearing revenue consequences.

Even if the claim that law firms can counsel reincorporation without fear of compromising traditional client relationships rings hollow, there is a further reason to doubt that lawyers are responsible for less vibrant corporate law competition in Canada. Simply, the claim that lawyers are responsible for lackluster corporate law competition is tethered to the assumption that the market for legal services is plagued by serious failures; otherwise, it is difficult to explain the ability of legal service suppliers to withhold value-maximizing advice from clients without suffering the discipline of the market. Examination of the structure of the legal market yields little evidence of structural characteristics consonant with high levels of supplier concentration.<sup>127</sup> Indeed, it can be argued that in a number of different segments, the legal market appears to be a highly competitive industry. Absent the possession of significant market power, it is unlikely that firms would be able to exploit corporate consumers indefinitely without inviting entry from competitors willing to offer more responsible legal advice.<sup>128</sup> This entry can be expected to occur even in the face of the informational asymmetries that inhere in the lawyer-client relationship.<sup>129</sup> After all, by publicizing the failure of a corporation's current advisors to render value-maximizing advice to their clients, an entrant could be expected to be rewarded by increased patronage. The prospect of just desserts can be expected to increase the propen-

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<sup>126</sup>See O.E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York: Free Press, 1985), c. 3, 7 & 8, where the author discusses the use of bonding mechanisms in a contractual context to deter cheating on long-term relationships.

<sup>127</sup>See S. Colvin *et al.*, *The Market for Legal Services, Working Paper No. 10 Prepared for the Professional Organizations Committee* (Toronto: Ministry of the Attorney General of Ontario, 1978), c. 5 & 7. The authors found that "despite the apparent lack of similarity of service characteristics among firms of different sizes, there is sufficient overlap to ensure a low level of concentration and a large number of suppliers in most segments" (*supra* at 168). In particular, the authors found the Ontario market "highly unconcentrated" (*supra* at 169).

<sup>128</sup>In these terms, the denial of value-maximizing legal advice is akin to the appropriation of supra-competitive rents. In the absence of effective barriers to entry, it is unlikely that a firm or group of firms could enjoy these rents for long. Classic micro-economic theory posits that new entrants will offer a more attractive product — either in price or quality terms — that will dissipate the economic rents. For representative literature on barriers to entry, see A. MacMillan, *Microeconomics: The Canadian Context* (Scarborough, Ont.: Prentice-Hall, 1980) at 242-43; C.C. v. Weiszacker, *Barriers to Entry: A Theoretical Treatment* (Berlin: Springer-Verlag, 1980); M.J. Trebilcock & J. Quinn, "The Canadian Antidumping Act: A Reaction to Professor Slayton" (1979) 2 *Can.-U.S. L.J.* 101 at 105-106.

<sup>129</sup>On these information problems, see M.J. Trebilcock, C.J. Tuohy & A.D. Wolfson, *Professional Regulation: A Staff Study of Accountancy, Architecture, Engineering and Law in Ontario Prepared for the Professional Organizations Committee* (Toronto: Ministry of the Attorney General for Ontario, 1979) at 50-56.

sity of competitors to generate and distribute information that will reduce the importance of asymmetries in this area.

*e. The Geographic Monopoly of Central Canadian Governments*

Another variable that can be advanced to explain the lack of vigorous corporate law competition in Canada turns on the proximity of central Canadian governments to the locus of commercial and corporate activity in the country. According to this argument, this geographic proximity confers monopoly powers on these governments, and impairs the ability of more remote governments to compete effectively for corporate patronage. Whereas in the United States, the concentration of corporate/commercial activity in the eastern seaboard allows any of a number of states to capture a dominant market share, the concentration of commercial and corporate activity in central Canada limits the set of alternative domiciles that shareholders desirous of reincorporating could choose. According to this argument, it is difficult to imagine corporate executives and their lawyers willing to incur the time and cost of having to commute to locations distant from the industrial and financial heartland of the country in the event of a dispute arising under corporate law. Therefore, shareholders and their managers face two principal incorporation domiciles in Canada — either Ontario or Canada.

There are several reasons for rejecting this argument. First, Delaware's success shows that a jurisdiction can capture a dominant market position, even though it is not a centre of financial or corporate/commercial activity. Second, the availability of low cost communications devices, *e.g.*, facsimile machines, video-conferencing and designated computer lines, diminishes the importance of a corporation having its centre of operations located in the same place as its legal head office. These new forms of technology permit corporate executives and their lawyers to make decisions without having to meet face to face. Finally, to the extent that proximity to underlying financial and commercial activity is important, the rise of a number of regional centres of economic activity in Canada, *e.g.*, Vancouver, Calgary, Montreal and Halifax, means that there is an infrastructure that supports the attractiveness of these cities as corporate domiciles.

*f. Role of the Supreme Court in Impairing the Integrity of Provincial Courts*

Similar to the challenges to the integrity of a province's corporate law regime that are posed by overlapping securities regulation, the structure of judicial review in Canada may also contribute to enervated levels of competition. Because of the Supreme Court of Canada's exercising judicial review over decisions made by provincial appeal courts, the ability of a province to craft a dis-

tinctive approach to corporate law adjudication may be impaired.<sup>130</sup> This feature of the institutional context may explain the failure of provincial governments to respond positively to calls for a specialized corporate-commercial court that have been frequently made in Canada.<sup>131</sup> The reality, however, is that the Supreme Court has paid less and less attention over the last decade to corporate/commercial matters, in effect allowing provincial appellate courts to have the final say in interpreting contentious statutory provisions.<sup>132</sup> The relatively marginal role of the Supreme Court in corporate/commercial disputes can be traced to two factors: (i) the removal in 1974 of an automatic right of appeal to the Supreme Court for cases in which the value of the matter in controversy exceeds \$10,000,<sup>133</sup> and (ii) the growing "constitutionalization" of the Court's docket ever since the adoption of the *Canadian Charter of Rights and Freedoms*<sup>134</sup> in 1982.<sup>135</sup> In tandem, these two factors mean that the scope for nettlesome interference in lower court corporate/commercial decisions by the Court is fairly small indeed.

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<sup>130</sup>In contrast, the appellate jurisdiction of the U.S. Supreme Court over decisions made by the Delaware Supreme Court is extremely circumscribed. Decisions made by the Delaware Court can only be appealed to the U.S. Supreme Court in the following circumstances: (1) cases arising under the Constitution, U.S. laws and treaties; (2) cases affecting ambassadors, consuls, etc.; (3) cases involving admiralty jurisdiction; (4) cases to which the U.S. is a party; and (5) cases arising between two or more states, or between a state and a citizen of another state, or between citizens of different states, or between a state (or citizens thereof) and foreign states, citizens, etc. See U.S. Const., art. III, §§ 1 & 2. The basic appellate principle is: "Of cases originating in the course of the states, only those presenting questions of federal law — statutory, constitutional or otherwise — may be considered by the [U.S.] Supreme Court. Its consideration of such a case is limited to the federal issues involved" (D.W. Louisell, G.C. Hazard, Jr. & C.C. Tait, *Cases and Materials on Pleading and Procedure*, 5th ed. (Mineola, N.Y.: Foundation Press, 1983) at 17). A key limiting provision on the U.S. Supreme Court's appellate jurisdiction over state court decisions is s. 25 of the *Judiciary Act of 1789* (1 Stat. 73, 85), limiting Supreme Court review of state courts to final judgments or decrees in the higher court in which the suit could be had. See P.M. Bator *et al.*, *Hart and Wechsler's The Federal Courts and the Federal System*, 3d ed. (Westbury, N.Y.: Foundation Press, 1988), c. 5. Note the rule in *Fox Film Corp. v. Muller* 296 U.S. 207 (1935): the Supreme Court's jurisdiction to review a federal question fails if the state court's judgment also rested on a non-federal ground that is itself independent of the federal ground and adequate to support the judgment.

<sup>131</sup>See Ontario, *Interim Report of the Select Committee on Company Law* (Toronto: Queen's Printer, 1967) at 115-16.

<sup>132</sup>For instance, of the 304 cases heard by the Supreme Court in the period 1986-89, only 14 were classified by the Court as dealing with corporate/commercial matters. Supreme Court of Canada Annual Report 1988-89.

<sup>133</sup>The automatic appeal was repealed by S.C. 1974-75-76, c. 18, s. 3. Presently, a matter may only be appealed to the Supreme Court with leave pursuant to the public importance test set out in s. 40 of the *Supreme Court Act*, R.S.C. 1985, c. S-26.

<sup>134</sup>Part I of the *Constitution Act*.

<sup>135</sup>See Panel Discussion, "The Future of the Supreme Court of Canada as the Final Appellate Tribunal in Private Law Litigation" (1982-83) 7 Can. Bus. L.J. 389, especially the results of the docket study at 449.

In sum, this discussion suggests that, save for the problems occasioned by overlapping legal products and, to a lesser extent, the centralizing role of the Supreme Court, there is no institutional constraint in Canada on the generation of a comprehensive corporate law regime. Consequently, the failure of this regime to evolve can be largely credited to intellectual discomfort with the case for competitive provision of legal product in Canada which, as I have argued, is without foundation.

### C. Conclusion

In this article, I have attempted to develop an argument in favour of greater reliance on competitive production of laws and supporting institutions in the realm of Canadian commercial and corporate law. As the corporate law case study shows, these processes are capable of serving a catalytic role in encouraging Canadian governments to adopt laws and institutions that are highly responsive and innovative in nature. It is ironic that the competitive model is generally eschewed by Canadian commentators in favour of the centralized model, given the particularly decentralized nature of the Canadian federation. Arguably, the former model is more compatible with the powerful role played by regional and local interests in Canada. In these terms, apart from the model's value in producing superior laws, it can be further defended for its role in fostering workable approaches to Canadian federalism.

A second and less obvious implication of this article is the light it casts on the role of the federal government in the competitive model. Typically, commentators advocating heavier reliance on competitive, decentralized models of law production focus exclusively on the virtues of lower level governments, thereby relegating national governments to a relatively marginal position of importance. Given the expansive terrain shared between federal and provincial governments under the *Constitution Act*, this indifference or, in some cases, antipathy to federal government activity is especially perplexing in the Canadian case. But the corporate law case study developed in this article offers some insight into both the rationale for and the ambit of higher government activity. First, it is clear that the corporate law market in both the United States and Canada would not have been able to develop as effectively as it has in the absence of rules that conferred on incorporating jurisdictions the power to have their statutory regime govern all corporate governance disputes, irrespective of the location of the disputing parties. Had the courts failed to impose this rule (as the Privy Council did in the *Bonanza Creek* case<sup>136</sup>), the only remaining way to implement such a rule would have been by way of shared agreement. Because of endemic collective action problems, the provinces may not be able to reach this agreement themselves. An obvious candidate for leading and supporting initiatives aimed at developing the institutional infrastructure necessary for

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<sup>136</sup>*Bonanza Creek Gold Mining Co. v. The King*, [1916] 1 A.C. 566, 26 D.L.R. 273 (P.C.).

effective competition is the federal government. For instance, to the extent that overlapping legal products and Supreme Court appellate jurisdiction impair the flourishing of competitive processes of corporate law production, some co-ordinated activity is necessary to correct these problems, and should be led by the federal government. In this respect, it is important to acknowledge the intimate relationship between competitive and co-ordinated forms of law production; in order to promote efficient competition, some threshold level of co-ordination will be necessary.

A second teaching of the corporate law case study for the federal government concerns the capacity of the competitive model to vindicate goals and values cherished by federal politicians and bureaucrats. In the corporate law case, the federal government was able to create a modern national corporate law regime with little of the acrimony and antagonism that tends to characterize other federal initiatives involving co-ordinated processes. Why was the federal government so successful? At one level, the corporate law market in Canada possesses many of the underlying features that are necessary for efficient competition.<sup>137</sup> But this only explains the greater likelihood of success of competition, not the success of any particular competing government. However, when the Canadian corporate law market is examined closely, it is clear that the federal government possesses a comparative advantage in determining or, at least, influencing outcomes produced in this setting. Among other factors, the fact that shareholders believe that the federal government incorporations are more prestigious than provincial incorporations or that migration to the federal government in no way severs lawyer-client relationships (because provincial law society practise codes do not restrict the capacity of resident lawyers to render opinions on federal statutes and regulations<sup>138</sup>) means that the federal government will be favoured as a destination jurisdiction.

In the past few years, the corporate community and the legal profession have grown increasingly disenchanted with the federal government's treatment of the *CBCA*. What was a few short years ago one of the shining jewels in the federal government's policy chest is today tarnished by neglect and abuse suffered through sporadic and incoherent enforcement, relatively undeveloped institutional linkages between policymakers and their constituents, and glacial legislative reform. Like Dorothy in Oz, the sooner the federal government awakens to the power and the possibilities of its slippers — competitive law production in general and the corporate law instrument in particular — the more rational and effective will its own policy-making agenda become. Moreover, by

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<sup>137</sup>See the discussion above, in Part II, on the four conditions for efficient competitive model outcomes: jurisdictional mobility, large number of destination jurisdictions, jurisdictional latitude in selection of laws, and internalization of benefits and costs.

<sup>138</sup>For example, a member of the Newfoundland Bar can opine on federal law because that law is, in the eyes of the Law Society, "Newfoundland law" as well.

assuming a leadership mantle in championing institutional modifications designed to engender competitive activity, the core objective of the federal government — the maintenance and promotion of a harmonious and lively federation — will be realized.

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