The Need for Regulating Income Trusts:

A Bubble Theory

DIRK ZETZSCHE*

* Ph.D. (Heinrich-Heine-University, Düsseldorf, Germany); LL.M. (University of Toronto); Researcher at Bell University Laboratories at the Centre for Innovation Law and Policy, University of Toronto; and Habilitand (candidate for postdoctoral thesis) at the Professorship for Civil, Commercial and Business Law at the Faculty of Law, Heinrich-Heine-University, Düsseldorf.

Many thanks to Kathleen Grandy, Doug Harris, Ed Iacobucci, Ben Kinder, Jeff MacIntosh and commentators working in the securities industry who would prefer to stay anonymous, for their feedback on earlier drafts of this paper and their willingness to enter into fierce discussions with me pertaining to the issues of income trusts and bubbles. In addition, I thank the editorial and copy-editorial team of the Faculty of Law Review for their remarks and diligence, in particular Ryan T. Ashmead, Steve Doak, Noah J. Gellner, and Evan Thomas. Finally, I thank the holders of the copyrights for granting me permission to reprint the graphs in section IV.

This paper presents my personal views, rather than those of the commentators. Of course, failures and omissions are mine, as well. All online sources were last visited October 2004, unless otherwise mentioned.

Income trust units are some of the highest selling products in the Canadian securities industry, but they have been less successful beyond Canadian borders. The author discusses the remarkable profitability and proliferation of income trusts in Canada, but maintains that arguments in favour of income trusts as a sound investment are either overstated, inconsistent, or apt to mislead retail investors. Instead, the author argues that the Canadian income trust phenomenon is an irrational development in the Canadian capital market: a bubble. *The income trust boom exhibits characteristics typical to a bubble: story leverage, opportunistic support by interested parties, and overoptimistic retail investors. The author identifies striking similarities between the current market for income trusts and the Tech Bubble of 1999 and 2000, examining data relating to noise trading and limits on arbitrage in income trusts. The author counters arguments that the bubble risk in income trusts is low.*

Nevertheless, the author accepts that some firms may be structured effectively as income trusts. To mitigate the dangers of income trust investment, the author proposes five regulatory measures, four of which address idiosyncrasies of income trusts and one which addresses a fundamental issue of securities regulation. First, promulgators need to address the misallocation of capital by tax incentives for investments in low-growth business. Second, weak trust governance should be addressed by imposing default governance structures similar to those of shareholders and corporations. Third, investors should have some control over the distribution policy of the income trust. Fourth, there is an insufficient number of institutional investors in the market for income trusts and, consequently, promulgators should avoid any limit on institutional investment in income trusts. Last, regulators increasingly need to watch the conduct of broker-dealers and mutual fund managers, as a means of protecting retail investors from the marketing of investment products that fit some, but not all, investors. Mutual fund marketing needs to be monitored in order to avoid an over-supply of investment capital in narrow markets.

Les unités de fonds de titres à revenu fixe sont certains produits qui se vendent le mieux dans l'industrie canadienne en titres, mais elles n'ont pas eu une aussi bonne réussite au-delà des frontières canadiennes. L'auteur démontre la rentabilité remarquable et la prolifération des fonds de titres à revenu fixe au Canada, mais maintient que les arguments en faveur des fonds de titres à revenu fixe en tant que bon investissement sont soit surévalués, inconsistants ou disposés à tromper les investisseurs au détail. L'auteur argumente plutôt que le phénomène de fonds de titres à revenu fixe canadien est un développement irrationnel dans le marché *financier canadien : une* bulle. *Le boom des fonds de titres à revenu fixe démontre des caractéristiques typiques d'une bulle : un effet par étapes, un appui opportuniste par des parties intéressées et des investisseurs de détail trop optimistes. L'auteur identifie des similarités remarquables entre le marché actuel pour les fonds de titres à revenu fixe et la Bulle Tech de 1999 et 2000 en tenant compte les données liées au bruit de commerce et aux limites d'arbitrage dans les fonds de titres à revenu fixe. L'auteur réagit contre les arguments qui indiquent que le risque d'une bulle est minime dans les fonds de titres à revenu fixe.*

Néanmoins, l'auteur accepte que certains organismes peuvent être structurés efficacement en tant que fonds de titres à revenu fixe. Pour atténuer les dangers des investissements de fonds de titres à revenu fixe, l'auteur propose cinq mesures réglementaires, quatre d'entres elles au sujet des idiosyncrasies des fonds de titres à revenu fixe et une au sujet du problème fondamental dans le règlement des titres. Premièrement, les promulgateurs doivent adresser la mauvaise affectation du capital avec des incitatifs d'impôts pour des investissements dans une entreprise avec une croissance réduite. Deuxièmement, la faible gouvernance des titres devrait être adressée en imposant les structures de gouvernance par défaut semblables à celles des actionnaires et des sociétés. Troisièmement, les investisseurs devraient avoir plus de contrôle sur la politique de distribution des fonds de titres à revenu fixe. Quatrièmement, il n'y a pas suffisamment d'investisseurs institutionnels dans le marché pour les fonds de titres à revenu fixe et, en conséquence, des promulgateurs devraient éviter de limiter les investissements institutionnels des fonds de titres à revenu fixe. Dernièrement, les régulateurs ont besoin de surveiller de plus en plus la conduite des courtiers-concessionnaires et des directeurs de fonds mutuels de manière à protéger les épargnants du marketing de produits d'investissements qui s'applique qu'à certains des investisseurs. Le marketing de fonds mutuels doit être surveillé de manière à éviter un surplus de provisions de capitaux d'investissements dans des marchés étroits.

I INTRODUCTION

From 2002 through 2004, income trust units were top-selling products in the Canadian securities industry.[1] Beyond Canadian borders, in contrast, investors have not been as enthusiastic with respect to similar structures.[2] Instead, in August 2004, the high-profile initial public offering (IPO) of American Seafoods on the American Stock Exchange (AMEX) failed spectacularly. Similarly, in October 2004, B&G Foods could only raise US$261 million against a preliminary target of up to US$560 million.[3] In

1 As of September 2004, there were 168 income trusts with a market capitalization of more than Cdn$90 billion listed on Canadian stock exchanges; see "Full Listing of All Canadian Income Trusts", online: Investcom <http://www.investcom.com/incometrust/incometrust.htm>. In 2002, income trust offerings represented 94 per cent of total Canadian listings, decreasing to 80 per cent in the first six months of 2003 (study by PricewaterhouseCoopers, cited in *The Globe and Mail, Report on Business* (8 July 2003), cited in Paul Halpern & Oyvind Norli, "Old Wine in New Bottles?", online: Manulife <http://www.manulife.ca/canada/Investments.nsf/LookupFiles/DownloadableFileHeadlines-IncomeTrusts:OldWineinNewBottles/$File/PaulHalpern_CIR_FallIssue.pdf>). In 2003, income trusts represented 40 per cent of total equity issues by value; see data reported by BMO Nesbitt Burns, cited in Paul Halpern, Oyvind Norli & David Y. Timbrell, "Income Trusts: Viable Financial Instrument or Product of the Economic Environment?" (2004), [unpublished, Capital Markets Institute of the University of Toronto]. See also Michael R. King, "Income Trusts–Understanding the Issues" (Bank of Canada Working Paper 2003-25, September 2003), online: Bank of Canada <http://www.bank-banque-canada.ca/publications/working.papers/2003/wp03-25.pdf> at 2-3. For online databases on income trusts see the Canadian Association of Income Funds (CAIF), online: CAIF <http://www.caif.ca>; the Canadian Institute of Public and Private Real Estate Companies (CIPPREC)], online: CIPPREC <http://www.cipprec.ca>.

2 In general, the American capital market is well familiar with high income securities, which exhibit characteristics similar to income trusts, such as REIT units and certain forms of limited partnership units (*e.g.* Sunoco Logistics Partners, (see Sunoco Logistics Partners L.P., Annual Report for 2001, online: Sunoco Logistics <http://www.sunocologistics.com/docs/10k_2001.pdf>), which has been listed on the NYSE since 8 February 2002). Canadian investment banks, however, attempted introducing a functional equivalent to Canadian income trusts—so-called income deposit securities ("IDSs") or enhanced income securities ("EISs")—to American capital markets. IDSs are combinations of debt and equity, using joint-securitization of a debt security and a share, resulting in a slightly different formal structure than Canadian income trusts. The results have been, at best, mixed. As of October 2004, only two firms had succeeded in issuing IDSs (Volume Services America Holdings, Inc., Prospectus, EDGAR File Number: 333-103169, and B&G Foods Holdings Corp., Prospectus, online: B&G Foods <http://www.bgfoods.com>). This is in contrast to the optimistic estimates of the securities industry: in April 2004, Craig Farr, Citigroup's co-head of U.S. equity capital markets, predicted offerings of IDSs would raise US$15 billion in 2004. See Brett Cole & David Scanlan, "CIBC brings the Income Trust revolution to the U.S." *Financial Post* (5 April 2004) FP1. For further filings of IDSs and EISs, see American Seafoods Group, Prospectus, online: American Seafoods <http://www.americanseafoods.com> and FairPoint Communications, Inc., Prospectus, online: FairPoint Communications <http://www.fairpoint.com>.

3 See Andrew Willis, "Success of B&G Foods trust IPO is that it got done in the U.S." *The Globe and Mail* (15 October 2004) B12; and "U.S. investors have no appetite for American Seafoods IPO", *globeandmail.com* (19 August 2004) (noting that at least 18 more IDS issues were lined up behind the American Seafoods offering). For the prospectus, see American Seafoods online, *ibid*. (Willis offers a set of explanations, including an unfavourable overall market, the bad "new taste"

light of the hard times that income trust equivalents have experienced abroad, the remarkable success of income trusts in Canada raises several immediate questions and concerns. Why are income trust structures so successful in Canada? Are the existence and performance of income trusts a temporary phenomenon, or are they based on sound economic factors? Are they likely to remain merely a national phenomenon?

There are two popular and competing answers to these questions. First, some commentators believe that Canadian income trusts are a viable financial instrument whose success is based on factors idiosyncratic to Canadian corporate, trust, and tax law. Second, there are those who hold the view that the Canadian income trust phenomenon is an irrational development in the Canadian capital markets: a *bubble*.[4] The literature on income trusts has predominantly favoured the former position.[5] In contrast, this article suggests that the latter position is more likely to provide a sound explanation for the overwhelming success of income trusts in Canada. In order to overcome the bubble characteristics of income trusts, and hence allow them to remain viable in the long run, this article recommends five regulatory measures, four of which address idiosyncrasies of income trusts, and the last of which addresses an issue inherent in securities regulation. Promulgators need to address, first, the misallocation of capital motivated by tax incentives for investments in low-growth businesses; second, weak trust governance and uncertain unitholder rights; third, directors' discretion with respect to distributions; and fourth, an insufficient number of institutional investors in the market for income trusts. Furthermore, regulators should watch broker-dealers' and mutual fund managers' conduct more closely. Broker-dealers need to

---

of the IDS structure "in an income market that already features several flavours of high-yield offerings", and internal problems at American Seafoods.).

4 The tulip craze of the 17th century in the Netherlands and the South Sea Bubble in England in the 18th century are clear symbols of market frenzy; see Peter Garber, "Famous First Bubbles" (1990) 4:2 Journal of Economic Perspectives 35; on the "Tech Bubble" of 1999/2000, see also *infra* note 82.

5 Halpern, Norli & Timbrell, *supra* note 1 at 20; Paul D. Hayward, "Income Trusts: A 'Tax-Efficient' Product or the Product of Tax Inefficiency?" (2002) 50 Can. Tax J. 1529 at 1533ff; King, *supra* note 1 at 28; Avery Shenfeld, "The Economic Benefits of Income Trusts" (Paper written for CIBC World Markets: Economic Perspectives, 2003), online: CIBC World Markets <http://research.cibcwm.com/economic_public/download/incometrust.pdf>; Peter Beck & Simon Romano, *Canadian Income Funds: Your Complete Guide to Income Trusts, Royalty Trusts and Real Estate Investment Trusts* (Mississauga: John Wiley, 2004). More critical are Jack Mintz & Lalit Aggarwal, "Income Trusts and Shareholder Taxation: Getting It Right" (2003) [unpublished], online: CD Howe Institute <http://www.cdhowe.org/pdf/income_trusts.pdf> at 23ff (an earlier version of a paper published in (2004) 52 Can. Tax J. 3 at 793).

be monitored to protect retail investors from the marketing of investment products on a broad scale using arguments that respond to the needs of some, but not all, investors. Mutual funds need to be monitored in order to avoid an over-supply of investment capital in narrow markets.

The next section of this article provides a general overview of the income trust structure. Section III then considers the arguments in favour of an income trust investment, maintaining that these arguments are either overstated, inconsistent, or apt to mislead retail investors. Section IV shows that three characteristics of the American *tech bubble* in 1999 and 2000 also exist in the current income trust boom, and that arguments positing that bubble phenomena do not exist are based on conditions that the current trust boom does not meet. Some firms might nevertheless be more beneficial to investors and society if structured as income trusts, as compared to maintaining a corporate structure. In order to create a viable market in income trust units over the long run, section V therefore recommends the implementation of specific regulatory policies with respect to what I perceive to be the five core problems of the income trust market. Section VI concludes.

II STRUCTURE OF INCOME TRUSTS

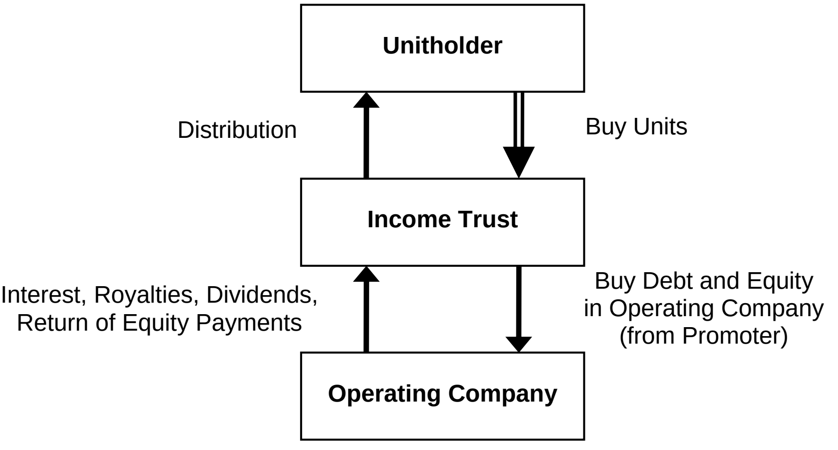
An income trust structure can be imposed upon interests in real property, interests in operating entities, or interests in any active businesses that are likely to produce reasonably predictable streams of cash flow. Income trust securities, usually in a form termed "units", represent a beneficial interest in the underlying business and entitle the unitholder to a share of the distributable cash flows that the business generates.[6] Over time, many variants of income securities have been developed, some predicated on trust law and others developed from the law governing limited partnerships. This article pertains to income securities associated with entities structured as trusts. Drastically simplified, these trusts adopt a three-layer structure, consisting of the operating firm, the trust, and the unitholders, as Figure 1 demonstrates.[7]

---

6 Part 1.2 of National Policy 41-201, "Income Trusts and Other Indirect Offerings", online: Ontario Securities Commission <http://www.osc.gov.on.ca> [NP 41-201]; Halpern, Norli & Timbrell, *supra* note 1 at 7, show that—on a median basis—income trusts pay out 87 per cent of their cash flow from operations, as compared to 7 per cent paid by comparable corporations (there is wide disparity between individual firms in each category).

7 King, *supra* note 1 at 10. In some income trusts, the management of the operating firm is delegated to a management company, which historically has consisted of the promoters or organizers (*i.e.*, past management) of the income trust (*e.g.* Inter Pipeline Fund adopted such a structure). For further modifications see Mark R. Gillen, "Income Trust Unitholder Liability: Risks and Legislative Response" (Paper prepared for the Capital Markets Institute, November

Figure 1: Income Trust Structure



Two contracts connect the three layers: a "declaration of trust" or "trust indenture" sets out the terms of the trust, and is applicable to all three layers; a "note indenture" sets out the terms of the debt and is an agreement between the trustee and the operating firm.[8] Together these documents set out a complex division of functions. The operating firm generates the distributable cash that is transferred to the trust as a combination of interest, dividends, lease interest or royalty payments, and return on equity payments. The trust is a special-purpose entity that is created to act as a fiduciary on behalf of the unitholders, and it is typically administered by multiple trustees, acting like a board of directors. In order to make trust units eligible investments for deferred income plans such as RRSPs, the trust is incorporated as a "mutual fund trust" under section 132 of the *Income Tax Act*.[9] The trust may fulfil five purposes: (1) bundling debt, royalties, and equity by securitization into a single "unit"; (2) issuing these units; (3) paying out the income generated by the operating firm to the unitholders on a monthly or quarterly basis; (4) exercising shareholder and creditor rights in the operating entity; and (5) owning the operating assets which were formerly owned by the firm. Through their direct investment in trust units, unitholders, who are for the most part public

---

2003) [unpublished], online: Capital Markets Institute <http://www.rotman.utoronto.ca/cmi/news/Gillen.pdf> at 4; Beck & Romano, *supra* note 5.

8 Gillen, *ibid.* at 4.

9 R.S.C. 1985 (5th Supp.), c.1, s. 132 [*ITA*].

investors, each hold a beneficial interest in the operating firm. An income trust unit represents a share in the combination of debt or royalty interests and equity in the entity owning or operating the business.

III ARGUMENTS FOR INCOME TRUST INVESTMENTS

Although a broad range of businesses, diverse in their organization and operation, have been structured as income trusts, the *sell side* (promoters, investment advisers, and underwriters)[10] predominantly develops its marketing efforts around five categories of arguments in favour of income trusts: identifying unitholders as secured debtholders, tax-based arguments, high-cash-return arguments, arguments pertaining to an alignment of interests between debtholders and equity holders, and the characterization of income trusts as conservative investments. Actual prospectuses do not expressly mention these arguments,[11] but they have become part of common public perceptions of income trusts. Nevertheless, these arguments either do not fit all investors, do not adequately address the complexity of the specific trust structure, or do not hold true when one looks at the underlying business of the trust.

Debt Security?

From a legal point of view, a trust unit represents an interest in both debt and equity. Nevertheless, the public seems to perceive income trust units primarily as bond-like.[12] Four factors might explain the public perception. First, income trust units are said to yield stable cash flows for investors. Second, Canadian income trusts and bond issuances are both governed by trust (common) law.[13] Thus there are similarities in the facial form of

[10] As defined in s. 1 of the *Securities Act*, R.S.O. 1990, c. S.5. Readers might perceive the following arguments as “straw man” arguments, meaning that I appear to be attributing statements about income trusts to the sell side for the purpose of critiquing them; of course, sell side representatives are likely to deny that they have ever raised some or all of the following marketing arguments. It must be considered, though, that these arguments are, in fact, out there and influence day-to-day investor decisions, which I try to indicate in the notes given in the following. It is likely that the sell side, at least, does not oppose the errors that investors make when investing in income trusts. Thus a clarification, for which this article strives, might be useful.

[11] Macquarie Power Fund, Prospectus (30 March 2004) at 83; Osprey Media Income Fund, Prospectus (5 March 2004) at 60; Holiday Income Fund, Prospectus (22 March 2003) at 65; Ag Growth Income Fund, Prospectus (29 March 2004) at 79; Richards Packaging Income Fund, Prospectus (5 March 2004) at 55; all available online: SEDAR <http://www.sedar.com/search/search_form_pc_en.htm>.

[12] Ontario Securities Commission (OSC), “The Ins and Outs of Income Trusts,” online: OSC <http://www.investored.ca/en/library/osc/ins_outs_of_income_trusts.htm>.

[13] In contrast, Delaware enacted the *Business Trust Act* in 1988, renamed the *Delaware Statutory Trust Act* in 2002, with the intention of increasing the utility of the statutory trust in modern

governing agreements, as well as common terminology. For example, written agreements called “indentures” or “deeds of trust” are used to structure both income trusts and the relationship between a borrower corporation and a trust company in a bond issuance (in which a corporation appoints a trust company to represent the bond-holders).[14] These commonalities in the form and description of agreements may confuse public investors, leading them to perceive income trust units as secured debt. Third, rating agencies rate the pay-out stability of many income trusts. Rating agencies usually evaluate bond ratings, but not equity investments,[15] thus giving uninformed investors the impression that income trust units are more akin to debt than to equity. Fourth, interest and royalty payments to a trust are considered to be a cost of doing business, and are thereby fully tax-deductible by the operating company. Because payments from a trust to unitholders are treated as debt payments for the narrow purposes of tax law, public investors may think trust units have debt rather than equity characteristics.[16]

Despite the legal form of the agreement between a trust and its related operating firm, an investment at the level of the unitholder does not necessarily constitute a debt investment. Instead, a regular debt investment differs from an income trust unit in four significant respects. First, the unitholders have a beneficial interest in both the debt *and the equity* of the underlying operating entity. Second, the level of debt owed to unitholders and the interest rates for this debt are not contingent on market mechanisms—that is, they do not directly result from the profits of operating activities but are deliberately fixed to accord with tax law restraints. Third, under a trust indenture, unitholders cannot enforce distribution promises. Even though trustees can enforce debt obligations owed to them by the operating company to fund distribution promises, the apparent reality is that trustees, acting in the best interests of unitholders, usually decide that enforcement is not appropriate. If trustees were to repeatedly enforce distributions in circumstances of financial difficulty,

---

financing transactions. Singapore plans to enact a statutory scheme for trusts as well; see Consultation Paper on Business Trusts Regulation (11 August, 2004), online <http://www.mas.gov.sg/masmcm/bin/pt1Reports_and_Consultation_Papers.htm>.

14 Stephen A. Ross, Randolph A. Westerfield & Jeffrey Jaffe, *Corporate Finance: International Edition*, 5th ed. (Boston: Irwin McGraw-Hill, 1999) at 319, 353, 526ff.

15 Halpern, Norli & Timbrell, *supra* note 1 at 22. As of September 2004, 75 trusts listed at the TSX were subject to ratings by Dominion Bond Rating Service and Standard & Poor’s. See Rob Carrick, “Stability ratings help spot bad tomatoes,” *The Globe and Mail* (4 September 2004), online: Globe Investor <http://www.globeinvestor.com>.

16 Ross, Westerfield & Jaffe, *supra* note 14 at 351.

the operating company might become insolvent, permanently harming the value of recovery to the unitholders. Fourth, many note indentures subordinate unitholders' claims in the operating company (the debt whose rights are administered by trustees) to all other third party debt. Unitholders, the last in line when the operating firm goes bankrupt, are effectively the residual claimants to the overall cash flow of the operating entity. In conclusion, for these four reasons, unit-investors, in substance, purchase an equity security.[17]

Among sophisticated investors, it is well known that corporations are very adept at creating hybrid securities that have the risk structure of equity but are legally characterized as and called debt in order to obtain beneficial tax deductions. Therefore, legally branding a security as debt should not be sufficient to obscure a sophisticated investor's view of the real nature of an investment. The situation is likely different with respect to retail investors, who are more likely to be confused by the name or form of a security.

Tax Advantages?

Under Canadian tax law, interest and royalty payments are tax deductible from the profits of a business.[18] For trusts, a return on equity is not taxed at the investor level at the time an investor receives cash flow from the investment. Therefore, income trusts might yield tax advantages. Income trust marketing focuses on these tax advantages by claiming that the overall tax burden of a unitholder is less than that of a shareholder or bondholder at the same level of investment.[19] The claim, however, is highly contested. Experts have fiercely debated whether there is an overall tax advantage to income trusts.[20] To evaluate the claim of income trust

---

[17] Halpern, Norli & Timbrell, *supra* note 1 at 6. Under some trust indentures, however, unitholders are ahead of trade creditors.

[18] American IDSs are unlikely to yield tax advantages. See *e.g.* the announcement on the AMEX website: "IDSs, in general, offer unique features and benefits: Designed to pay monthly income; Designed to distribute nearly all free cash flow; Designed for issuers with mature, relatively stable businesses." (online: AMEX <http://www.amex.com/?href=/equities/IDS_main.htm>). The US tax problems are summarized by Cleary Gottlieb LLP, "U.S. Federal Income Tax Issues Related to Income Deposit Securities" (2004), online: Cleary Gottlieb <http://www.cgsh.com/files/tbl_s5096AlertMemoranda/FileUpload5741/124/2-2004.pdf>.

[19] See *e.g.* K. K. Choong, "Income Trusts–A Betty Way To Produce Fixed Income", online: Investcom <http://www.investcom.com/incometrust/kkchoong.htm>; see also OSC, *supra* note 12 (particularly the sections titled "Why use an income trust rather than a conventional IPO?" and "Tax Treatment and Regulation").

[20] Four studies deal with the tax effects of income trust investments. Mintz & Aggarwal, *supra* note 5 at 4, hold that the tax gain of income trusts for investors might add up to between Cdn$500 and $700 million per year. HLB Decision Economics Inc., "Risk Analysis of Tax Revenue Implications of Income Trusts" (11 March 2004), online: CIPPREC <http://www.cipprec.ca/PDFs/HLB%20Final%20Report_Mar.11,2004.pdf> at 2-3 holds that income trust-related tax

marketers and assess it in light of this debate, a closer look at the tax structure is required.

Tax Efficiency at the Level of the Firm

Corporations are subject to income and capital taxation. Payments for the use of borrowed capital are tax deductible: debt financing charges and royalty payments are netted from gross income before the corporate tax rate is applied. In contrast, payments for the use of share capital or equity financing are not tax deductible at the level of the firm: dividends must be paid out from the corporation's after-tax earnings.[21] Thus, by structuring the capital supplied by a trust to an operating business in the legal form of debt, earnings that flow through as distributions to unitholders are tax deductible at the level of the business. As a result, there is support for the argument that investing in a business through an income trust as opposed to direct shareholdings reduces the total tax paid on the investment return.[22] If a trust pays out all taxable income received from its operating business to the trust's unitholders (as it typically does), then neither the operating business nor the trust pay taxes.[23] Consequently, income trusts are established to take advantage of single entity taxation at the unitholder level.[24]

Tax Efficiency at the Level of the Investor?

Income trusts declare distributions either as returns of capital, as interest, as income payments on units held by a unitholder, or as dividends. Redistributing part of an investor's capital (*return of capital*) results in a

---

losses to governments between 2002 and 2004 are most likely to total $217 million (with a 10 per cent range between +$72 million and –$560 million), taking into account taxes paid by unitholders for investments not held in tax shelters. Personal income tax on deferred income earned by unitholders is likely to add up to $268 million, which is roughly equal to what governments are forgoing in taxes today. The study was commissioned by CAIF and CIPPREC. For further estimates see Hayward, *supra* note 5 at 18 and Shenfeld, *supra* note 5 at 6.

21 *ITA*, *supra* note 9, s. 20(1)(c) (interest deductibility) and (e) (financing expenses).

22 Unless the operating firm holds significant capital, it also will not pay significant capital-stock taxes. Capital-stock taxes are usually assessed as a percentage of the par or assigned value of a firm's capital stock. However, capital-stock taxes are generally quite modest and do not constitute a core issue when considering the tax advantages associated with income trusts.

23 Otherwise, it will have to pay the highest personal income tax rate (see s. 104 (6) of the *ITA*, *supra* note 9), which is perceived as a "penalty". See Jack Mintz, "Looking for the best return", *The Globe and Mail* (30 March 2004) A15.

24 Halpern, Norli & Timbrell, *supra* note 1 at 5.

tax deferral: return of capital does not accrue to computable income at the time that it is received by an investor.[25] Instead, a return of capital reduces, on paper (for tax purposes), a purchaser's original cost (*adjusted capital cost*) of acquiring ownership. Because taxable capital gains are equivalent to the proceeds of selling a security minus this adjusted cost base, a decrease in the cost base from a return of capital leads to an increase in an investor's taxable capital gain on the eventual sale of the securities. Although it is uncontested that some tax savings exist with the preferential treatment of capital gains (through a lower inclusion rate), the additional and often-claimed tax deferral benefit is contestable. Due to the time value of money, tax deferrals can be advantageous, but whether a tax deferral is always advantageous really depends on the specific investor. Two examples explain this contention. First: investor A is 60 years old, and will retire in a few years. He has reached his highest annual income in his life. Lower income in retirement is likely to cause lower marginal tax rates to apply to him. Deferring income is preferable to A, since this income will be taxed at a lower overall rate in the future. Second: investor B is 40 years old. She is likely to reach her highest annual income at the age of 60. Unless invested in a Registered Retirement Savings Plan (RRSP), which benefits from an income tax credit, deferring income might not be advantageous to investor B. If received today, the income will be subject to lower marginal tax rates than it would were it received in the future, assuming that investor B is progressively earning more income in subsequent years. These very simple examples do not take into account many other factors, such as the costs of maintaining the liquidity of some assets to prepare for unexpected expenses, family, and cross-relationships with other investments. They do, however, demonstrate that tax deferral is not a universally applicable argument in marketing income trust units.

An indirect benefit to investors may be associated with the tax characterization of income trusts: because a trust's operating firm benefits from lower taxation compared to ordinary corporations with direct shareholders and higher equity-to-debt ratios, there is comparatively more liquidity in the operating firm, which should result in relatively higher security or unit prices. A price increase based on having more cash in the firm is, however, unlikely, because income trusts are designed to pay out to unitholders all available cash at the level of the operating firm and the trust. Despite this, such a price increase could theoretically result from a split between cash flow and profits, as is the case with depreciation.[26] If,

---

[25] King, *supra* note 1 at 12-13.

[26] When a firm invests in a good, the cash payment might differ from the depreciation rate, with an effect on profits as follows: assume that a firm buys real estate for $100, and finances the purchase from its cash flow. In its books, however, the real estate might be depreciated for the next twenty

however, all assets are owned by a trust, as in Real Estate Investment Trusts (REITs), there is nothing to depreciate in the operating firm. Thus, such a price increase is unlikely to materialize in practice.

Distributions in the legal form of interest and income payments to unitholders can either be compared with interest payments to bondholders or with dividends paid to ordinary shareholders. Compared with bonds, there is no tax advantage. However, it has been argued that income trust units are substantively equity, and must therefore be compared with dividends. As a means of providing equal levels of taxation for dividends and interests or royalty payments, section 121 of the *ITA* provides a tax credit for dividends.[27] The provisions of the *ITA* dealing with the taxation of dividends are intended to avoid the incidence of double taxation, at least to some degree. Thus, the taxation of a dividend at the investor level is designed to take into account the fact that the corporation which is paying the dividend has already paid tax on that money. Integration under the *ITA*, however, is incomplete in most cases. This is due to the fact that the tax credit is based on the small business corporate income tax rate of about 23 per cent. Most corporations pay higher income taxes of, on average, 45 per cent. Without being structured as an income trust, an operating firm would have to pay higher taxes on its dividends than can be regained by investors through their tax credits, leaving a net loss to the investors. By avoiding tax at the level of the operating business, Canadian income trusts can eliminate the increased tax burden that results from an incomplete integration of corporate and personal income taxes.[28]

Do these tax advantages for tax-exempt entities, however, create overall value for investors? The average underwriters' and legal fees for *corporate* IPOs in Canada in the years 1997 through 1999 was 11.78 per cent, and the weighted average, which measures IPOs proportionally to the size of the offering, was 7.19 per cent. The average total direct cost of an IPO in 1997 through 1999 was 7.28 per cent for large issues (Cdn$100 to

---

years at five per cent per annum. In year one, the profit will be reduced by $5, although the cash is reduced by $100. In the following years, the investment will reduce profit by $5, but the cash will not be reduced any more. Thus, the income trust may pay out a higher amount of cash to investors than profits would allow for. The same effect is possible in the other direction, *e.g.* a good might be depreciated to 100 per cent in the year of investment, and financed over, say, five years. Contingent on investment policy, a separation of cash flow from profits might therefore account for a higher or lower payout by the firm.

27 *Supra* note 9.

28 Mintz & Aggarwal, *supra* note 5 at 3.

$200 million) and 15.98 per cent for small issues (Cdn$1 to $10 million).[29] Data on underwriters' and legal fees for *income trust issues* have not been published, but the figures are likely to be a little higher for income trust issues than for corporate IPOs, since income trust issues require a complicated restructuring in advance of an offering. Thus, underwriters' and legal fees for income trust issues are likely to add up to approximately seven to ten per cent of an overall issue. In 2003, income trust issues raised a total of approximately Cdn$13.5 billion in capital,[30] which, according to my estimates, would add up to consultant fees of about Cdn$0.95 to $1.35 billion.[31] In contrast, previous studies analysing the tax effects of income trusts have assumed a median positive tax effect, at the level of investors, of between Cdn$500 and 700 million.[32] In order to calculate the net value of tax savings realized by an individual investing in income trusts, one cannot simply subtract the latter figures from the former, because the tax effect includes institutional and retail investors. Furthermore, corporations, though more seldom than income trusts, also require external financing from capital markets, and thus will also pay some consultant fees. The figures indicate, however, that tax effects must be significant in magnitude to offset the general cost effects that the complex structure of income trusts imposes on investors' money.

Long Term Investment Argument?

If there is ultimately some tax advantage to investing in income trusts, investing on the basis of that tax advantage in the long term will be risky. If an investment concept is *really* tax effective, governments may change tax laws for the very same reason, as a government will act to protect its revenues and adhere to the principle of equitable taxation. If an *overall* tax leakage were likely, one would assume that the government would fill the tax loophole by, for example, qualifying distributions paid to unitholders as dividends.[33] In fact, the Canadian federal government did attempt to stop some tax leakage from income trusts when it put forward a proposal to limit the overall amount of income trust units that were permitted to be

---

29 Cécile Carpentier *et al.*, "Initial Public Offerings: Status, Flaws and Dysfunction" (Paper prepared for Industry Canada, April 2003) [unpublished], online: Strategies.gc.ca <http://www.strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/vwapj/PrimaryIssues_e.pdf/$FILE/PrimaryIssues_e.pdf> at 27.

30 Andrew Willis & Elizabeth Church, "Trust mania spurs quality concerns" *The Globe and Mail* (2 February 2004) B1.

31 The expenses for continuous listings, which is likely to add up to about Cdn$0.5 million per trust, are excluded.

32 See Mintz & Aggarwal, *supra* note 5.

33 From a tax perspective, all distributions would then be treated as dividends. This handling is likely under s. 42 of the German Abgabenordnung (BGBI. I, S. 613; 1977 I, S.269) (the German taxation statute).

held by an institutional tax-exempt entity, such as a pension plan.[34] The proposal, however, was subsequently withdrawn. It is noteworthy that the federal budget proposal did not cap RRSP investments in income trusts, but it is unlikely that the different treatment of institutional and individual investors results from greater likelihood of tax leakage at the level of the institutional investor. Rather, political considerations come into play: retail investors are a strong constituency in federal elections. The core point that I have raised in this section, however, which is that tax efficiency is not a good investment argument for long term investments, is still valid because tax law has been, and will always remain, subject to abrupt legislative, administrative and political changes.

Intermediate Results

The argument that income trusts are not advantageous to investors for tax reasons, as compared to shares and bonds, is not true with respect to all investors. Instead, tax exempt institutional investors and investors in RRSPs do indeed realize net tax savings. Generally, no tax on an operating corporation's distributable earnings will be paid at the corporate level, and no tax will be paid at the investor level either. In contrast, corporate earnings received in the form of dividends will be taxed at the corporate level. As explained above, the tax advantage in income trusts results from the inadequate integration of corporate and personal income taxes. Whether this will be true in the future, and whether these advantages presently offset the additional costs of restructuring businesses into income trusts, is unclear. Actual income trust prospectuses seem to refrain from utilizing tax arguments to promote the income trust.[35] On the other hand, the prospectuses also seem to lack a comparison of the tax consequences of investing in shares or bonds with those of investing in income trust units. In a recent opinion issued to the Canadian Securities

---

[34] In the Federal budget proposal of 23 March 2004, a pension plan is prohibited from owning more than one per cent of the book value of its assets as business trusts and from owning more than five per cent of any single business trust. There is no cap on pension-plan holdings in real estate investments or royalty trusts. See Mintz, *supra* note 23. The retreat came shortly before the federal elections. See Heather Scoffield & Elizabeth Church, "Goodale backtracks on trust cap move" *The Globe and Mail* (14 May 2004) B1. See also James Pierlot, "Federal Government Retreats on Income Trusts," Canadian Employment Benefits and Pension Guide no. 523 (June 2004) at 1-3.

[35] Macquarie Power Fund, Prospectus (30 March 2004) at 83; Osprey Media Income Fund, Prospectus (5 March 2004) at 60; Holiday Income Fund, Prospectus (22 March 2003) at 65; Ag Growth Income Fund, Prospectus (29 March 2004) at 79; Richards Packaging Income Fund, Prospectus (5 March 2004) at 55; all *supra* note 11.

Administrators (CSA), the Canadian Association of Income Funds (CAIF) did not support this kind of disclosure.[36]

As with the characterization of income trust units as debt-like, the characterization of tax treatment as advantageous is not necessarily wrong, but the tax arguments are unlikely to fit *all* investors. While sophisticated investors are likely capable of sorting the various claims and assessing the real value of tax effects, the marketing of income trusts as tax-saving investments might mislead retail investors.

High Cash Returns?

The Paradox of High and Stable Cash Flows

With the yields for government bonds at or close to their all time low,[37] income trust units seem to be an appealing alternative that—as the sell side states—generates a stable and high yield.[38] According to the *efficient market hypothesis*, there is no 'free lunch at the markets'.[39] As long as there are efficient capital markets, security prices reflect all available information about the underlying value of the business and its risk exposure.[40] An extraordinary return relative to a broad market index will therefore either be immediately consumed by higher unit prices, or explained as reflecting the particular risk of an investment. To the same

---

36 CAIF, Press Release, "The Canadian Association of Income Funds Announces Comments and Support for National Instrument 41-201 Issued on October 24th by the Canadian Securities Administrators" (27 November 2003), online: CAIF <http://www.caif.ca/content/CAIF_PressRelease3_031127.htm> at comments 2.5 and 5.1.

37 Jeffrey Rubin, "Why feds clamped down on income trusts" *The Globe and Mail* (29 March 2004) B7.

38 The average pre-tax overall return of cash distributions from income trusts in 2002 was between 9.5 per cent and 21.4 per cent.; See King, *supra* note 1 at 14. On the sell side, see Integrated Corporate Relations, Inc., "White Paper on IDS" (2003), online: Integrated Corporate Relations <http://www.icr-online.com/images/ICR_WHITE_PAPER_ON_IDS.pdf> [ICR, "White Paper"] at 5 ("To counter the disappointing returns of the broader market and in response to the higher importance placed on cash generation of late, issuers are able to emphasize predictability and distribution merits."). See also Investcom, "Income Trusts," online: Investcom <http://www.investcom.com/incometrust/whatis.htm> ("The projected life of distributions and the sustainability of distribution levels tend to vary with the nature of the business underlying the income trust. Earnings from the business are distributed to investors each month or quarter, with yield ranging anything from 6 to 20 per cent a year. (The higher the yield, the riskier the trust.)"); Choong, *supra* note 19 ("If you want fixed income but you are not happy with the recent low return generated by investment such as bonds, T-bills and money market, then you may want to consider investing in an Income Trust.").

39 Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance: International Version*, 6th ed. (Boston: Irwin McGraw-Hill, 2000) at 354-376; Ross, Westerfield & Jaffe, *supra* note 14 at 319ff.

40 This is independent of the form or the hypothesis (weak, semi-strong, or strong form) one maintains. See *ibid*. Exceptions might result from irrational investor behaviour; see "Overoptimistic, Retail-Driven Market", below at 87.

extent that the risk increases, the predictability of cash returns decreases. The obvious solution (to the sophisticated investor) to the marketing paradox is twofold. Either there are no efficient markets, or there are no *extraordinarily* stable and high-yield cash flows.[41]

Debt as Discipline?

Another way of understanding the marketing of income trusts as 'high and stable cash flows' is to see the cash flow as high and stable *when compared to corporations*. In the income trust structure, an operating firm typically has comparatively more debt than does an ordinary business with a similarly sized capital stock. This heavier debt load (owing to the trust) obligates corporate management to consistently generate higher cash flows than would be necessary for an ordinary corporation in order to make substantial and regular interest payments.[42] Notwithstanding taxes and managerial agency costs, under the efficient market hypothesis it should not matter whether a firm accumulates and reinvests profits or whether it pays out the cash to investors, as long as the firm has sufficient investment opportunities with positive net present value. The advantage of income trusts is then merely the 'service' they provide to the investor. While corporations accumulate a large amount of their returns within the firm and investors must sell their shares in order to realize these returns, income trust investors receive their returns regularly. One might perceive this as a more comfortable scenario and, hence, as a valid reason to invest. However, this 'pay-out service' by income trusts is not provided for free, since payments generate transaction costs that are likely to increase as the number of transactions (namely pay-outs) increases. Thus, benefits of the pay-out service, such as a reduction in agency costs through a disciplinary effect on management or a regular return of cash into the hands of security holders, must be weighed against the high transaction costs incurred to provide this service. The remainder of this section deals with the question of whether managerial agency cost considerations can justify an income trust investment.

Income trusts are designed to distribute nearly all of a business's free cash flow to investors on a monthly or quarterly basis. An operating firm signals its intention to pay out by issuing high-yield bonds to the trust, or

41 The OSC holds that the common perception is different. OSC, *supra* note 12 ("Despite a common perception to the contrary, Income Trusts are not fixed-income investments and returns are not assured. They are not suitable investments for everyone.").

42 Halpern, Norli & Timbrell, *supra* note 1 at 7, show that trusts pay out 87 per cent of their cash flow from operations, as compared to 7 per cent for corporations (there is wide disparity between individual firms in each category).

by signing contracts with the trustees that secure an equivalent effect on its cash flow. Management thereby theoretically gives up the discretion that it has with respect to dividends. At first glance, it thus seems probable that income trusts increase spending discipline and diminish managerial agency costs at the level of the firm,[43] which commonly occur either as managerial *stealing* or *shirking*.[44] At second glance, however, it is unlikely that managers of an operating firm would be *extraordinarily disciplined* by the formal obligation to pay out high cash flows to investors for three reasons: first, the bankruptcy threat is implausible; second, there is only weak direct investor influence; and, finally, there exists only periodical market control.

Implausible Bankruptcy Threat

In the context of Leveraged Buy Outs (LBOs), Michael Jensen contends that high leverage could increase managerial efforts to the benefit of all shareholders.[45] The argument of 'debt as discipline' is based on the assumption that managers are afraid of a creditor's commencement of a bankruptcy proceeding since bankruptcy is particularly costly to managers, due to a lack of diversification. A large portion of the personal financial welfare of managers is generally tied to the success of their firms, and they stand to lose these amounts in bankruptcy. One could assume that the same is true with respect to income trust structures, because, formally, the operating firms within the structure are highly leveraged. As Jensen's argument evinces, however, debt will only be likely to effectively discipline managers if the bankruptcy threat from creditors is credible. Otherwise, managers will have the same leeway as they do in other corporations.

Thus, the analogy to the 'debt as discipline' argument will only be valid if a bankruptcy threat imposed by unitholders is credible. This is, however, unlikely because of legal hurdles and unitholders' incentives. First, although the legal form (debt) might generally signal enforceability,

---

43 Halpern, Norli & Timbrell, *supra* note 1 at 11. More generally with respect to debt as discipline, see Brealey & Myers, *supra* note 39 at 528; George G. Triantis & Ronald J. Daniels, "The Role of Debt in Interactive Corporate Governance" (1995) 83 Cal. L.R. 1073.

44 Edward M. Iacobucci, "A *Wise* Decision? An Analysis of the Relationship between Corporate Ownership Structure and Directors' and Officers' Duties" (2002) 36 Can. Bus. L.J. 337 at 343-346; see also Mark J. Roe, "Corporate Law's Limits" (2002) 31 J. Legal Stud. 233 at 234-235.

45 Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers" (1986) 76:2 American Economic Review 323 [Jensen, "Agency Costs"]; Michael C. Jensen, "Active Investors, LBOs, and the Privatization of Bankruptcy" (1989) 2:1 Journal of Applied Corporate Finance 35; Michael C. Jensen, "The Eclipse of the Public Corporation" *Harvard Business Review*. (September-October 1989), revised 1997 [revision unpublished], revision online: SSRN Electronic Library <http://ssrn.com/abstract=146149>.

the trust indentures do not contain a guarantee of high distributions.[46] Thus, unitholders have no legal basis for enforcing the promise of high distributions.[47] In addition, even if unitholders are able to enforce the distribution estimate, they would have lower incentives to commence a bankruptcy proceeding, as compared to (other) creditors, since shareholder and (subordinated) debt-holder rights are combined in the income trust units. While a creditor might receive a portion of its investment back when commencing a bankruptcy proceeding, it would be unlikely to obtain any payment from the liquidation of a firm that has paid out all of its available cash. Consequently, unitholders are unlikely to institute bankruptcy proceedings.

One could argue that these observations do not constitute a serious concern, given that in the context of corporations, equity holders, to whom I compared unitholders, generally refrain from instituting bankruptcy proceedings. In income trusts, as in corporations, the bankruptcy threat may be exercised by third parties. However, an operating firm is unlikely to default on the payment of third party debt, since it has a protective layer of subordinated debt owed to the trust on which it can fail without risk. The operating firm is thus even less exposed to bankruptcy risk than is an ordinary corporation.

Possibly Weak Direct Investor Influence

Both trustees and operating firm managers act as agents on behalf of unitholders, and the danger of misconduct is inherent in every principal-agent relationship.[48] Investor influence could substitute for the bankruptcy threat to discipline the agents—since, at least in a corporation, directors and officers risk losing their jobs as a response to shareholder pressure. In

---

46 Macquarie Power Fund, Cover Page: “Although the Fund intends to make distributions of its available cash to Unitholders, these cash distributions are not assured.” Identical quotes are found in each of the following, unless otherwise indicated: Osprey Media Income Fund, Cover Page (with concrete amount of distributions); Holiday Income Fund, Cover Page; Ag Growth Income Fund, Cover Page (distributions “to the maximum extent possible” and printed in bold); Richards Packaging Income Fund, Cover Page (distributions “to the maximum extent possible” and printed in bold); all *supra* note 11.

47 They also lack the standing to make such a claim, since the power to enforce contractual rights is vested with the trustees.

48 This is particularly true with respect to trusts. See Robert H Sitkoff, “Trust Law, Corporate Law, and Capital Market Efficiency” (2003) 28 J. Corp. L. 565. A short overview of agency theory is provided by Ronald J. Daniels, “Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance” 1995 Can. Bus. L.J. 229 at 237-241; William A. Klein & John C. Coffee Jr., *Business Organization and Finance: Legal and Economic Principles*, 8th ed. (New York: Foundation Press, 2002) at 17-27. For a basic discussion of agency problems see Michael C. Jensen & William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3 Journal of Financial Economics 305.

income trusts, however, it could be argued that trust law enables income trusts to be structured according to what sponsors find beneficial to themselves. This can result in a situation in which management is neither directly controlled by unitholders, nor by trustees, as the following section demonstrates.

Trust indentures delegate shareholder and creditor rights to trustees who, in many cases, are also managers of the operating firm or who may instead elect the management. In the latter case, they constitute a functional equivalent to boards of directors in corporations. Because the legal owner of a trust is the trustee (or trustee firm), unitholders have only the rights that the trust indenture vests in them. Pursuant to many trust indentures, an operating firm requires the approval of its *unitholders* only for fundamental changes, such as an amendment to its articles or memorandum, amalgamation of the operating corporation, and the sale, lease, or exchange of corporate assets.[49] In rare cases, some trust indentures even vest these rights with the trustees.[50] Furthermore, unitholders are usually empowered to select or remove some or all of the trustees, to approve amendments to the trust instrument, and to terminate the trust.

Trust law does not require that investors possess the capacity to control trustees, nor does it mandate the independence of trustees.[51] Instead, in many cases, the interests of the trustee and the management are intertwined, to the detriment of investors. For example, trustees may delegate most, if not all, of their responsibilities and powers to the management of the operating firm in order to avoid potential liability.[52] Managers of the operating firm would be trustees of the income trust, and as trustees they might be individually indemnified by the trust with respect to the discharge of their duties. In this setting, the "market for trustees"[53] does not discipline trustees, because trustees of income trusts do not participate in that market. They participate instead in the managerial labour market, which is influenced by different considerations. One may

---

49 King, *supra* note 1 at 22.

50 See the overview provided by Gillen, *supra* note 7 at 34-35. For example, the management of Inter Pipeline Fund, an income fund structured as a limited partnership, decided upon an acquisition of a firm that reflected more than 70 per cent of Inter's market capitalization without the participation of its investors. See Derek DeCloet, "Inter investors have no say: would you sign up for a deal like this?" *The Globe and Mail* (17 September 2004), online: Globe Investor <http://www.globeinvestor.com>.

51 However, the Canadian "Proposed Multilateral Policy 58-101: Disclosure of Corporate Governance Practices" (16 January 2004) does mandate the independence of trustees with respect to audit committee candidates.

52 King, *supra* note 1 at 22-23. Experts, however, hold that this strategy is unlikely to work.

53 See Triantis & Daniels, *supra* note 43 at 1090ff.

argue that the position of trustees does not differ from that of inside directors of a corporation.

Compared to a shareholder, the position of a unitholder is weaker, for two reasons.[54] First, the exercise of the unitholder's power can have only an indirect effect, in that it needs to be enforced by the trustee. While directors of a corporation might be subject to shareholder suits, unitholders of income trusts cannot pursue directors of the operating entity that are not at the same time trustees. In this structure, the trust shields the operating entity from unitholder activity. Second, as compared to corporate statutes, the trust indenture and the management agreement rarely, if ever, provide for effective minority rights. For example, there is no equivalent to the oppression remedy in the income trust context.

The above does not suggest that all trusts have governance problems. However, the discretion which trust law allows over the choice of income trust governance might result in structures that are detrimental to investors.[55] This is particularly problematic given that income trusts are marketed as a product for retail investors who might not understand the implications that trust law provides for them.

Periodic Market Control

Market forces could, theoretically, substitute for direct investor influence. A decision by managers to reduce distributions is likely to be met with a unit price decline in the secondary market, which in turn can have a major disciplining effect on managers.[56] Because all generated cash, save maintenance expenditures, is to be paid to unitholders, one could argue that income trust structures heighten the underlying firm's need to raise

---

54 In this respect I do not follow Hayward, *supra* note 5 at 1545, who states:

> The units have attributes similar to those of ordinary common shares (each carries a right to vote, a right to receive distributions of income in the nature of a dividend, and a right to receive a pro rata share of the net assets of the issuer in the event of the issuer's termination or winding up). Annual meetings of unitholders must be held at which trustees are elected, auditors appointed, and other matters ordinarily associated with annual meetings of shareholders voted on. The trustees have rights and obligations that explicitly parallel the rights and obligations of directors under corporate statutes.

55 See also the statement by the long-term chairman (and saviour) of Penn West Petroleum that he did caution that income trust structures "can be abused", which the press interpreted as a "cryptic comment suggesting there could be a number of trusts whose sins are being hidden by the current lofty price environment." See Deborah Yedlin, "Penn West's conversion to trust marks end of an era" *The Globe and Mail* (23 August 2004), online: Globe Investor <http://www.globeinvestor.com>.

56 Those who are most severely hit by this disciplining tool are investors who do not sell fast enough when the information becomes public that a trust has reduced its distributions. It is likely that a significant number of retail investors will belong to the group that is punished, while the sponsors who have sold the product to the market will not be harmed immediately.

capital in public markets, which in turn results in greater market oversight and more discipline of managers.[57] "Every time the firm goes to the capital market to issue new units," as Halpern *et al.* have noted, "it faces more intense scrutiny and the expectation of this scrutiny will reduce current cash flow waste."[58] In recent years, however, the consistently high demand for income trust units relative to supply suggests that there is no such intense scrutiny of management decisions, and that unit pricing is unresponsive with respect to management distribution decisions; thus the proposition that market forces could substitute for direct investor influence is cast into doubt.[59] Even if market scrutiny does indeed yield a positive effect, a minor positive factor would be insufficient to explain the demand. In order to justify the high costs associated with the repeated use of the capital market, the *overall* governance of an income trust must be *better* than *corporate* governance.[60]

In corporations, the takeover market imposes disciplining constraints on managers. As compared to directors of (other) corporations, managers of an income trust operating firm are relatively invulnerable, for two reasons. First, since there are no excess financial resources (*slack*) in the firm, an acquirer cannot use the firm's assets to pay the relatively high takeover costs. Second, if the trust indenture vests the power to appoint trustees with institutions other than unitholders—something that was more common in past, rather than in recent, issues—the fact that an acquirer buys relatively powerless trust units, as compared to voting stock, renders takeovers unlikely.[61] Consequently, while *future* projects might indeed force managers to the market more often, as compared to (other) corporations, the disciplining forces on *current* projects are reduced.

Information Content of Distributions

Another argument supporting the existence of increased managerial discipline in income trusts could focus on the information contained in the distributions: since one can assume that the old owners do not leave a dime on the table, and trust units are evaluated on the basis of expected

57 The argument is based on Frank H. Easterbrook, "Two Agency Cost Explanations of Dividends" (1984) 74 American Economic Review 650.

58 Halpern, Norli & Timbrell, *supra* note 1 at 11.

59 Willis & Church, *supra* note 30, state that the fund industry collects Cdn$1.2 billion *per month*, much of which is "earmarked for trusts". Willis and Church expect a supply of $2 billion worth of trust offerings in the first quarter of 2004, with $3 billion or more in trust financings in the previous three quarters.

60 Since one can assume that the expenses for an issue of about 10 per cent of the invested money are partly offset by tax advantages, the efficiency gain must reach significant levels within one business cycle.

61 See "Possibly Weak Direct Investor Influence", above at 64.

future pay outs, the prospectus is likely to promise the highest cash distribution that the underlying business can yield. Thus, ongoing distributions might signal that the business is progressing in accordance with the (positive) business plan. Investors thereby receive a credible signal without incurring monitoring expenses. This could increase the overall return on their investments. One could further assume that good managers can signal their quality by promising (even) higher distributions, thereby subjecting themselves to the greater discipline of having to meet the promised obligation.[62]

Ongoing distributions are likely to reduce investors' monitoring costs. However, as compared to ordinary corporations with the usual debt-to-equity capital structure, the argument relying on the information content of distributions is inconsistent in two respects. First, as long as a firm pays out, the argument disregards that not only the operating business, but also third party debt, generates cash flows. At least for a short time, the trust and the firm may be able to fill the hole that develops from the incidence of insufficient returns of the operating firm through external financing. For corporations, accounting rules usually require transparent disclosure to public investors about the source of cash flows, whereas for income trusts the source of cash flows may not be so readily represented and easily determinable. Due to the unclear supervisory structure between trusts and their operating firms, commentators predict a deficiency in the disclosure and transparency of income trusts relative to corporate entities.[63] Income trust disclosure focuses on the term "distributable cash-flow"—a term that is not (yet) defined by General Accepted Accounting Principles (GAAP). Furthermore, in the marketing of income trusts a correlation between price and expected distributions is used to determine and account for unit prices. Thus "any increase in distributable cash is considered to be good,"[64] wherever it may come from at the very moment that it is paid out. In general, promulgators have not clarified the answer to the question of which disclosure rules apply to income trusts and to what extent. The new National Policy on Income Trusts and Other Direct Offerings[65] prescribes reconciliation to the GAAP, a measure that might help clarify the issue. However, the National Policy has not yet been universally adopted. Furthermore, uncertainty is likely to remain among retail investors, given the incomparability of different figures provided by different issuers.

---

62 This argument is based on Jensen, "Agency Costs", *supra* note 45 at 324.

63 S.I. Erlichman, "Income Trusts: Some Legal Considerations" (Speech delivered to the National Summit on Income Trusts, Toronto, 25-26 November 2002) cited in King, *supra* note 1 at 22; see also King, *supra* note 1 at 23.

64 Halpern, Norli & Timbrell, *supra* note 1 at 10.

65 NP 41-201, *supra* note 6 at 2.5.

Although Alberta has made changes to its *Securities Act* to harmonize the rules pertaining to trust disclosure with corporate disclosure,[66] there is arguably a lack of policy or regulation for the transparent disclosure of cash flow sources in income trusts. This might disadvantage public investors and outweigh the benefit that distributions may provide in monitoring management and reducing agency costs.

Second, if a firm reduces its distributions, the argument about distribution information disciplining management will be even less convincing: it does not logically follow from the premise of management reducing distributions that the present management is deficient. As in every business, *idiosyncratic risks* might cause a reduced cash flow.[67] Once the cash flow is reduced, investors lose their monitoring signal, at least in the short term. As well, if distributions are not subsequently reset to previous higher levels, investors lose a valuable information signal in the future.

Compared to corporations, a distributions regime results in a deficiency of information about management activity. Investors do not receive the forward-looking information that is contained in dividend announcements. Corporate managers tend to adopt dividend-smoothing behaviour, since they assume that a variable dividend stream will result in reduced share prices. Several commentators have noted that dividend changes provide information about the management's belief concerning the future prospects of the firm: for example, an increase in dividends is a signal from the management of a firm to the market that the firm is expected to do well.[68] For income trusts, a policy to distribute all free cash in the operating company to unitholders means that the carrying forward

---

66 Typically in an income trust structure it is the trust units, rather than the shares of the underlying operating entity, that are listed for trading on an exchange. As operating entities are usually not reporting issuers, there is no requirement to maintain a public disclosure record regarding their business and financial affairs. NP 41-201, *ibid.*, addresses this issue, but has not been adopted. Further, its provisions are not mandatory requirements. Thus, Bill 34, the Alberta *Income Trusts Liability Act*, S.A. 2004, c. I-1.5 (Royal Assent, 19 May 2004) clarifies that an underlying operating entity in which an income trust holds an interest will be considered to be an affiliate of the income trust for the purposes of complying with required continuous disclosure obligations. Furthermore, insiders of the underlying operating entity of an income trust, including external persons contracted to manage an operating entity, are deemed insiders of the reporting income trust issuer.

67 Although the high transaction costs might prevent management from pursuing some projects, *new investments* are not valid reasons for a reduction of distributions, since the management should go to the capital market, if there are projects with positive Net Present Value, rather than relying on internal financing.

68 Merton H. Miller & Kevin Rock, "Dividend Policy under Asymmetric Information" (1985) 40 The Journal of Finance 1031 at 1038ff; Ross, Westerfield & Jaffe, *supra* note 14 at 478-483. For empirical testing of the information content of dividends see Adam S. Koch & Amy X. Sun, "Dividend Changes and the Persistence of Past Earnings Changes" (2004) 59 The Journal of Finance 2093 (including references to further studies).

of profits and smoothing of dividends at the corporate level is unlikely. Consequently, changes in distribution policy by income trusts can be deemed to focus on the short term, rather than the long term, perspective. Thus, income trust investors exchange possibly better information about the present state of the business for worse information about the future. This is a particularly precarious position for investors, since the expectation of future earnings motivates the average investor to a greater extent than does the present economic reality.[69]

There is no simple determination of whether the overall informational set with respect to income trusts as opposed to ordinary corporations is more or less effective in disciplining management. It generally depends on the quality of information that investors can acquire with respect to a specific trust, its operating firm, affiliates and relationships to third parties, and sophisticated analyses of the disclosure. Retail investors are unlikely to invest the time and money required for this sophisticated examination.

Aligned Interests of Debt and Equity Holders?

Shareholders have an incentive to gamble their firm's assets when the firm is in the vicinity of bankruptcy: to the extent that equity value has declined, "shareholders in financially distressed companies will be inclined to engage in risky behaviour in order to increase the option value of their equity."[70] In other words, in the vicinity of bankruptcy, equity holders are likely to make risky gambles at the expense of creditor interests by maximizing the uppermost profit potential of the firm's assets while planning to walk away from the businesses if the gamble fails. If the gamble does succeed, the shareholders will benefit. If it fails, the firm will go bankrupt and the creditors will pay the costs, by way of a reduced pay-back as a consequence of both the bad gamble and the bankruptcy costs. This conflict of interest between debt- and equity-holders is unlikely to emerge if shareholders are also holders of a significant part of the corporate debt.[71] Income trust structures might signal to third-party creditors that the equity-holders are unlikely to support excessively risky business strategies and hence might decrease financing costs. However, income trusts do not meet the prerequisites of the alignment-of-interests argument, since the debt held by a trust is subordinated to all other debt.

69 Anders Johansen & Didier Sornette "The Nasdaq crash of April 2000: Yet Another Example of Log-Periodicity in a Speculative Bubble Ending in a Crash" (2000) 17 European Physical Journal B 319 at 324.

70 Daniels, *supra* note 48 at 552-553; Merton H. Miller, "The Wealth Transfers of Bankruptcy: Some Illustrative Examples" (1977) 41 Law & Contemp. Probs. 39 at 40-41; Triantis & Daniels, *supra* note 43 at 1100; Brealey & Myers, *supra* note 39 at 517 ("Risk Shifting: The First Game").

71 Jensen, "Agency Costs", *supra* note 45 at 325-326.

As noted at the beginning of this article, unitholders are in effect residual claimants.[72]

Conservative Investment?

Income trusts are said to be structures for stable, relatively mature issuers,[73] with "healthy business fundamentals".[74] In the aftermath of the tech bubble of 1999 and 2000, income trust promoters emphasize characteristics of conservative, low risk investments. From a legal point of view, sellers benefit from the fact that *maturity* and other associated attributes are not legally defined; otherwise, potential purchasers might ask about which characteristics these attributes are founded upon in particular cases.[75]

Assuming that income trusts are indeed founded upon low risk businesses, unitholders bear three structural risks, which may render the label 'conservative investment' a poor fit. First, if an operating corporation faces no immediate bankruptcy threat, all available cash is distributed. A lack of retained earnings and common equity—the typical safety layer in ordinary corporations—jeopardizes the operating corporation's ability to adjust to sudden market changes in the future. New issuances of trust units, raising cash to deal with market shocks, are expensive, and in a bust market such issuances might result in substantial dilution of the old units.

Second, some income trust issuances seem to be part of a high-risk debt-to-equity swap.[76] A *debt-to-equity* swap involves raising cash from an issuance of equity securities in order to finance a repurchase of debt that usually has unfavourable terms or requires unaffordable servicing charges. Investors are well advised to agree on a swap when the risk structure of the debt is close to the risk structure of the equity (*high-risk debt*) and when the probability of default on the debt has increased since the debt was first acquired. This advice follows from the fact that the swap will decrease

---

72 See "Debt Security?", above at 53.

73 Choong, *supra* note 19; Hayward, *supra* note 5 at 1549.

74 ICR, "White Paper", *supra* note 38 at 5.

75 FairPoint Communications, Prospectus, *supra* note 2, is the 16th largest phone company in the US. Although network effects might support the business model, one might doubt whether a firm of that size is likely to stand the technology change and increasing competition in the communication business. MTS announced that it eventually abstained from restructuring into an income trust for that very reason. See MTS, press release (1 April 2004), online: MTS <http://www.mts.mb.ca/news/nr_2004_TSXSupportsMTS.html>. Many investors, however, question whether this reason is true. Another income trust leverages the position of the "largest iron ore producer in Canada and among 5 largest in the world." The fund, however, holds only a 7 per cent gross overriding royalty and a 15.1 per cent equity stake in the iron producer.

76 *E.g.* in August 2003 Standard & Poor's rating for the $219 million secured bank loan of FairPoint Communications was BB. FairPoint Communications, Prospectus, *supra* note 2.

investors' risk of a total loss (by improving the debtor's debt-to-equity-ratio), while at the same time increasing their chances of benefiting from a positive turnaround in the business. In the particular market and business circumstances of each capital restructuring, however, evaluating the adequacy of the conditions of a debt-to-equity swap demands a sophisticated analysis of the underlying business.

Third, income trusts require businesses with low growth and high returns. According to a matrix developed by the Boston Consulting Group, low-growth high-return businesses are either in the *cash cow* or in the *dog* period.[77] While the latter is the final stage of a business cycle before liquidation or new investment, the former might allow many years of successful business. Considering the incidence of asymmetric information, and assuming that those with the most information are apt to make the best decisions,[78] managers and long-term investors are likely to make the best estimates of (1) whether the firm is in the cash cow or the dog period and (2) if the firm is in the cash cow period, how long the period will last. Income trust offerings are sales by incumbent investors in the underlying business entity. Prospective purchasers in an income trust offering, and thus prospective investors in the underlying business entity, attempt to interpret sales by incumbents as information about the value of the firm. Market analysts have recognized that with respect to young businesses, typically not within an income trust structure, sales by incumbents are perceived as noisy negative signals about the prospects of the business.[79] Likewise, but for different reasons, with respect to income trusts, sales by incumbents should be perceived as a noisy negative signal: it is not transparent to prospective investors, especially unsophisticated retail investors, what sales by incumbents indicate about the value of the underlying business entity—whether it is in the *cash cow* or the *dog* period.

Creating a higher risk security is not necessarily a negative scenario. Income trust promoters might tailor the attributes of their securities to the different needs of different classes of purchasers. Thus, by filling a niche,

---

77 Carl W. Stern & George Stalk, eds., *Perspectives on Strategy from The Boston Consulting Group* (New York: John Wiley & Sons, 1998) at 35, 43, 195ff.

78 For details, see Dirk Zetzsche, "Aktionärsinformation in der börsennotierten Aktiengesellschaft" ("Shareholder Information in Public Corporations") [forthcoming in 2005], at s. 1.

79 Price-pressure effects were first denied by M. Scholes, "The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices" (1972) 45:2 Journal of Business 179. Later studies, *e.g.* Donald B. Keim & Ananth Madhavan, "The Upstairs Market for Large-Block Transactions: Analysis and Measurement of Price Effects" (1996) 9 Review of Financial Studies 1 at 21 (and citing further studies at 1-2), however, demonstrate a rebound effect caused by distressed sales of approximately 1.86 per cent for large block trades. Newer studies seem to indicate some exceptions: see James Scott & Peter Xu, "Some Insider Sales Are Positive Signals" (2004) 60:3 Financial Analysts Journal 44.

income trusts might augment the allocative efficiency of capital markets. At the same time, the clear risk structure might increase overall demand, through the "advantage of unbundling".[80] If broker-dealers, however, rely on low-risk attributes while selling high-risk securities to retail investors, they do not further the allocative efficiency of capital markets. Instead, they mislead unsophisticated investors. Consequently, an intensified regulatory scrutiny with respect to broker-dealers' marketing behaviour is justified.

Conclusion

This section has shown that the marketing of income trusts relies on five relatively simple considerations: debt security, tax advantages, high cash returns, aligned interests, and conservative investment. At a second glance, however, these keywords either do not fit all investors, do not adequately address the complexity of the specific trust structure, or do not hold true when one looks at the underlying business of a trust. While sophisticated investors are likely to untie the complicated bundle of arguments, the marketing of income trust units is apt to blur the view of retail investors on the fundamentals of the underlying business. In light of the complexity of income trust units, neutral or good advice by the sell side of the securities industry is especially required in order to avoid misunderstandings by retail investors.

IV TECH BUBBLE CHARACTERISTICS OF THE INCOME TRUST BOOM

The complexity of income trust units raises the question of why income trusts have become so successful in the retail market, where investors may find it difficult to see through the intricate structures and assess the fundamental value of the underlying business. One possible explanation could be a partial inefficiency of the capital markets,[81] as markets

---

80 Klein & Coffee, *supra* note 48 at 339-340.

81 See Ronald J. Gilson & Reinier Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Va. L. Rev. 549 [Gilson & Kraakman, "MOME"], reviewed in a recent set of articles in the Journal of Corporate Law: see Ronald J. Gilson & Reinier Kraakman, "The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias" (2003) 28 J. Corp. L. 715 [Gilson & Kraakman, "MOME – the Hindsight Bias"]; Howell E. Jackson, "To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns" (2003) 28 J. Corp. L. 671; Lynn A Stout, "The Mechanisms of Market Inefficiency: An Introduction to the New Finance" (2003) 28 J. Corp. L. 635. See also Joseph E. Stiglitz, "Symposium on Bubbles" (1990) 4:2 Journal of Economic Perspectives 13; symposium articles include Garber, "First Bubbles", *supra* note 4; Robert P. Flood & Robert J. Hodrick, "On Testing for Speculative Bubbles" at 85; Robert J. Shiller, "Speculative Prices and

experienced, for example, during the tech bubble of 1999 and 2000.[82] This section compares the income trust boom and the tech bubble, thereby revealing some provocative insights.

During the tech bubble period, the relative pricing of internet stocks diverged from the broad market as a whole.[83] This divergence developed in three major steps. First, a sound economic story was abstracted from the businesses on which it was first based. Second, an alignment of interested parties supported the abstraction of the story from the underlying businesses. Third, an overoptimistic, retail-driven market induced a steep rise in stock prices.

Story-Leverage

Innovative Story

First, a bubble requires a compelling story about the extraordinary profitability of an investment. This story can be based on a specific invention or discovery (the South Sea provides a historical example), a product (like tulips), an industry (such as the internet), or other concepts.[84]

The story for the tech bubble was based on the internet. Investors focused on firms that were young and inexperienced, but innovative in their use of computers, the internet, and related high technologies. Therefore, firms needed to demonstrate three characteristics: (1) internet-related, (2) young, and (3) no cash return. As a consequence, firms went public at an unprecedented early stage. While in recent years, investment

---

Popular Models” at 55; Andrei Shleifer & Lawrence H. Summers, “The Noise Trader Approach to Finance” at 19; Eugene N. White, “The Stock Market Boom and Crash of 1929 Revisited” at 67.

82 Thomas Hellmann & Manju Puri, “On the Fundamental Role of Venture Capital” (2002) 87:4 Economic Review of the Federal Reserve Bank of Atlanta 19; Robert J. Hendershott, “Net Value: Wealth Creation (and destruction) during the Internet Boom” (2004) 10:2 Journal of Corporate Finance 281; Debra Howcroft, “After the Goldrush: Deconstructing the Myths of the Dot.com Market” (2001) 16 Journal of Information Technology 195; Johansen & Sornette, *supra* note 69; Martin Lipton, “The Millennium Bubble and Its Aftermath: Reforming Corporate America and Getting Back To Business” (2003) [unpublished], online: SSRN Electronic Library <papers.ssrn.com/sol3/ papers.cfm?abstract_id=417503>; Eli Ofek & Matthew Richardson, “DotCom Mania: The Rise and Fall of Internet Stock Prices” (2003) 58 The Journal of Finance 1113 [Ofek & Richardson, “DotCom Mania”]; Jay Ritter & Ivo Welch, “A Review of IPO Activity, Pricing, and Allocations” (2002) 57 The Journal of Finance 1795.

83 Eli Ofek & Matthew Richardson, “The Valuation and Market Rationality of Internet Stock Prices” (2002) 18 Oxford Review of Economic Policy 265.

84 Bubbles can occur in all publicly traded assets. Compare the articles in William C. Hunter, George G. Kaufman & Michael Pomerleano, eds., *Asset Price Bubbles: The Implications for Monetary, Regulatory, and International Policies* (Cambridge, MA: MIT Press, 2003), at parts II and III.

bankers hesitated to issue shares of firms that did not make any kind of profit, in the tech bubble, firms went public that were unlikely to make profits for at least two years following the IPO.[85] Public investors were convinced of the extraordinary profitability of businesses sharing certain characteristics, justifying high levels of investment. This was triggered by a very limited number of spectacular public offerings, giving rise to the perception that the story was indeed founded on sound economic reasoning. The triggering event of the tech bubble was the overwhelming success of Netscape and other early entrants into the internet boom. These firms exhibited high rates of return to investors in the years immediately following their IPOs.[86]

The income trust boom story relies on the presence of three new characters, namely reduced taxes, old and stable businesses, and high cash returns. It is thereby a reflex to the tech bubble. While the securitization of oil, gas and other natural resources is a traditional phenomenon in (not just Canadian) capital markets,[87] the adoption of trust structures by other businesses is a relatively new phenomenon. The most publicly noticed trust offering—and as yet one of the most successful businesses organized as an income trust—was the Yellow Pages business trust offering in the summer of 2003, which raised close to Cdn$1 billion. In the aftermath of the Yellow Pages offering, many other income trusts sold units to investors.[88] Yellow Pages was thus likely the trigger for the current income trust boom.

Supporting Economic Arguments

Precipitating a bubble, investors are assumed to arrive at their decisions rationally. Consequently, a bubble, defined as a period in which prices are overoptimistic and dissolved from the underlying fundamentals of real business activity, cannot develop without creditable economic arguments. The extraordinary success of the trigger can then give rise to the assumption that the supporting arguments are consistent. 'Bubble

---

85 Lisa DiCarlo, "Five Reasons to Love the Tech Bubble", (12 April 2001), online: Forbes.com <http://www.forbes.com/2001/12/04/1204bubble.html >: "During the heyday of the bubble, words like profit, sales, and even business plan, lost their relevance. People invested their life savings in stocks that had no business plans and no profits in sight."

86 Hendershott, *supra* note 82 at 292, shows that the market-adjusted return-on-equity invested ranges from 36.5 per cent to 94.7 per cent for a sample of dot-coms of the years 1995-1997, until the end of 2001.

87 Compare Charles E. Harrell, James L. Rice III & W. Robert Shearer, "Securitization of Oil, Gas, and other Natural Resource Assets: Emerging Financing Techniques" (1997) 52 Bus. Law. 885.

88 According to Willis & Church, *supra* note 30, 107 income trusts tapped the market in 2003 (22 new offerings, and 85 incumbents). In the fourth quarter of 2003, investors purchased trust units for more than Cdn$6 billion.

arguments' have the characteristics of good advertising; for instance, the sales pitch can be reduced to as few as three selling features that are easily disseminated and appealingly coherent.[89]

The tech bubble had a striking logic. First, it relied on the economies of scale that the internet technology would allow. The sudden and extraordinary price increases of internet-related firms reflected the market's enthusiasm for the "seemingly endless possibilities for growth that the Internet represented."[90] What mattered was not profitability but rather the scope of operations: the volume of sales, or if not sales, then simply the volume of website traffic. Many market participants thus held that the future potential of internet-related companies could not be measured with traditional, fundamental valuation methods based on quantified accounting variables such as revenues and cash flows. Second, in order to reach the necessary size to exploit the economies of scale, a firm needed the dynamics of youthful, visionary managers and employees. Third, concerns about managerial slack seemed to be unjustified, since the common opinion was that managerial waste in high growth businesses would be restrained by a business's permanent need for cash in order to grow its operations.[91]

The logic of the income trust boom leverages on the tech bubble experience as a reflex. First, cash returns are now predominant, because pay-outs discipline managers by imposing liquidity restraints. The tech bubble has demonstrated that the opposite—high cash retention and burn rates—is not true. Second, established firms are preferable since the tech bubble indicated that young firms cannot handle money effectively. Third, a business relying on innovation is a business without secured yields for investors. It is thus assumed to be better to rely on stated guaranteed returns; specifically, predictable tax benefits.[92]

Leverage by Other Businesses

The success of a market story eventually raises public interest and stimulates investment in businesses having characteristics similar to those

89 They follow the "KISS" concept: "Keep It Smart and Simple". Some commentators would say "Keep It Simple, Stupid".

90 Lipton, *supra* note 82 at 3.

91 For "rational" and "irrational" arguments of the tech bubble, see Steven N. Kaplan, "Valuation and New Economy Firms" in Hunter, Kaufman & Pomerleano, *Asset Price Bubbles*, *supra* note 84 at 391ff.

92 The comparison highlights another weakness of income trusts. To the same extent that, during the tech bubble, overly immature firms were brought to the capital markets (see, for example, Kaplan, *ibid.* at 397), the income trust boom might result in issues by outdated businesses that lack the vigour and innovation to withstand competitive pressures over the long term.

of the triggering business(es), which in turn motivates other firms to attempt to leverage on the story by re-organizing to adopt or imitate those characteristics. The fact that the story is sound for the triggering firm, however, does not mean that it also fits every other firm in the same industry. Furthermore, other entities that are operating different types of businesses will also try to leverage on the success of the trigger. By recycling the story over and over, the story eventually becomes abstracted from the triggering firm and its underlying fundamentals.

Due to Netscape's soaring share prices, other businesses leveraged on Netscape's internet story.[93] Nearly every firm that had an internet-related story profited from the boom. At the peak of the tech bubble, firms only needed an internet-related name. This could be achieved by simply adding '.com' to the end of their name, trademarks, or brands: no internet business was required in order to leverage on the internet effect.[94] Investors seemed to forget that there are always winners and losers: not all dot-coms could succeed.

The same effect is currently happening with respect to income trusts. While some businesses, in particular energy-based royalty and real estate trusts, restructure into income trusts for sound economic reasons, other businesses which the income trust structure does not fit have been restructuring into income trusts as well.[95] If these firms restructure into income trusts, they leverage on income trust characteristics, mirroring the actions of firms that emerged during the tech bubble by simply changing their names into dot-coms without developing an internet-based business. If investors merely rely on the income trust 'brand', they neglect the different economic structures of the underlying businesses to the same extent as tech bubble investors who relied on dot-com names: most established royalty trusts are *wasting businesses*, insofar as cash distributions have a significant return of capital element and the underlying asset is depleted. REIT businesses are similar: a trust owns real estate, the value of which is depleted by time, according to the estimated time of use. The risk of both businesses is focused on finding customers (in marketing activities) and achieving beneficial sale prices for the

---

93 Compare Hendershott, *supra* note 82 at 282, for data on the return on equity of 441 dot-coms; see also Ofek & Richardson, "DotCom Mania", *supra* note 82 at 1115-1116 (including data on 400 internet-related companies).

94 See Michael J. Cooper, Orlin Dimitrov & P. Raghavendra Rau, "A Rose.com by Any Other Name" (2001) 56 The Journal of Finance 2371. See also P. Raghavendra Rau *et al.*, "Managerial Actions in Response to a Market Downturn: Valuation Effects of Name Changes in the dot.com Decline" Journal of Corporate Finance [forthcoming in 2005].

95 "[O]il and gas and real estate trusts…were the original prototypes for Income Trusts….But in recent years the trust market has evolved well beyond those sectoral boundaries, becoming in many ways a general asset class with representation from all walks of the economy." Jeffrey Rubin, "Why feds clamped down on income trusts" *The Globe and Mail* (29 March 2004) B7.

product, although different factors might influence the sales prices.[96] Distributions are a good indicator for sales success. Efficient monitoring in these businesses is thus relatively inexpensive.

In contrast, other businesses with low growth and steady earnings that restructure as income or business trusts bear all kinds of risk, with possibly two exceptions. First, research and development risks in business trusts will be low if these businesses do not develop new products. Second, marketing risks for business trusts are relatively low because these firms are often solidly established in the relevant product market. But the same risk structure is also associated with corporations that sell established products. With respect to risk structure, income trust units are not different from any other kind of security insofar as their risk relies on the underlying business.[97] If firms nevertheless restructure into income trusts, they free-ride on investor confidence in the income trust structure, rather than relying on the strength of their business. The analogy to the dot-com boom is obvious.

During the tech bubble, only a minority of businesses leveraging on the boom characteristics could benefit from the boom in the long run: businesses whose operations were well-positioned to enable practical integration of the characteristics, like a genuine internet company with a sound business plan.[98] The same is likely to be true with respect to the income trust boom. Some businesses would be better off, given the nature of their operations, structured as ordinary corporations rather than as income trusts. It follows that in the long run these businesses will probably fail under the pressure of competition in the product markets.

Alignment of Interested Parties

The second characteristic of the tech bubble was the fact that the interests of Private Equity Investors (PEIs), the securities industry, managers, and politicians, all of whom benefited from the boom, were remarkably well-aligned with each other. This convergence of interests offset the market's inherent check mechanisms on overoptimistic pricing. The potential for a similar alignment in the current income trust boom could presumably illuminate the possible obstacles and opportunities on the horizon.

---

[96] For example, overall economic changes affect REITs differently than energy trusts. See Halpern, Norli & Timbrell, *supra* note 1.

[97] OSC, *supra* note 12, subsection "Risk and Returns".

[98] Hendershott, *supra* note 82 at 293.

Private Equity Investors [PEI]

The issuing behaviour of firms significantly varies in *hot* and *cold* securities markets. If investors are overoptimistic, firms respond by issuing equity in a "window of opportunity".[99] If investors are too pessimistic, on the other hand, firms avoid external equity financing. Firms do not file for IPOs without the consent of pre-issue investors. Thus, the phenomenon that firms take advantage of hot issue markets is likely to be grounded in the support of PEIs who are interested in high evaluations of the shares of companies that they sell to public investors.

In the tech bubble, the influence of pre-issue investors was mitigated by venture capitalists (VCs). Developing in young tech firms the maturity necessary for capital market listings requires the input of experienced venture capital managers. Although the value-added activities conducted by VCs are dependent on their contexts,[100] VCs basically offer four kinds of value-added services in addition to a broad network: financial expertise, strategic and management advice, administrative advice, and marketing expertise. Australian data suggests that investors in VC funds place the highest value on financial expertise and on strategic and management expertise.[101] The necessary expertise, however, is very costly to attain. In order to become a good venture capital manager, a professional would need long years of management experience as well as training on the job. VCs are "repositories of useful institutional knowledge".[102] Obviously, VCs demand payment for their services that reflects the high value that they contribute to a young firm's development. Venture capital partners receive not only hefty management fees, typically between 2 and 2.5 per cent of the funds committed, but also a profit share (*carry*) of about 20 per cent.[103] At the same time, investors have basically no access to *good* information about the portfolio firm[104] nor accurate perceptions of the efforts or luck of venture capital managers before a fund is terminated,

---

99 Jay Ritter, "The Long-Run Performance of Initial Public Offerings" (1991) 46 The Journal of Finance 1 at 3-27; Ritter & Welch, *supra* note 82 at 1799; this trend is also true with respect to Canada, see Carpentier *et al.*, *supra* note 29 at 15ff.

100 Douglas Cumming & Jeffrey G. MacIntosh, "Venture Capital Finance and Litigation over the Boom and Bust Cycle" (paper written for the Willamette Conference on Venture Capital in Portland, 2003) [unpublished].

101 Douglas Cumming, Grant Fleming & Jo-Ann Suchard, "Venture Capitalist Value-Added Activities, Fundraising and Drawdowns" Journal of Banking & Finance [forthcoming in 2005].

102 William A. Sahlman, "The Structure and Governance of Venture-Capital Organizations" (1990) 27 Journal of Financial Economics 473 at 500.

103 Hellmann & Puri, *supra* note 82 at 22; see also Sahlman, *ibid.* at 491, who reports that in 88% of the funds surveyed the funds are entitled to 20% of the realized gains; the remainder entitle the VC to 15 per cent to 30 per cent.

104 Sahlman, *supra* note 102 at 492. Ongoing reporting used to be inaccurate, due to the problem of evaluating strong growth firms with prospects for future value, but scarce assets in the present.

which tempers any active monitoring of VCs by investors. PEIs therefore need to trust in the quality and luck of VC fund managers, as suggested by their previous failures and successes.

Eventually, during the tech bubble, the PEIs' investment in venture capital funds did not result in immediate returns as soon as firms went public. Rather, until 2002, investments were subject to escrow agreements, which prevented old shareholders from selling shares between 6 and 24 months after an IPO.[105] At the expiry date of the escrow, many VCs would transfer shares of the investee firm to the investors of the venture capital fund as a means of avoiding price effects on the listed shares.[106] There is evidence, however, that IPO shares during the tech bubble reached their peak shortly after the IPO and generally tumbled around the expiration date of the *lock up* period mandated by the escrow agreement.[107]

As compared to the tech bubble, the current income trust boom yields three advantages for PEIs. First, PEIs yield returns by selling old, existing businesses to the market. Thus, PEIs do not need to take on long-lasting and highly risky venture capital investments. Furthermore, PEIs do not need to pay venture capitalist rates for the development of their firms. Less spectacular returns, as compared to 'home runs' during the tech bubble,[108] might, however, offset the cost advantage. Second, PEIs can sell their shares in income trusts in indirect secondary offerings: "[i]nstead of offering their securities directly to the public, the vendors sell their interests in the operating entity of units to the public. The income trust purchases those interests with proceeds that it raises through its offering of units to the public."[109] Therefore, income trust offerings avoid risky and

105 National Policy 46-201, "Escrow for Initial Public Offerings", online: Ontario Securities Commission <http://www.osc.gov.on.ca> [NP 46-201], prescribes a standard form for escrow agreements (56-x201F1). Pursuant to TSX company manual Pt. III, E, section 1400-419, and the TSX Escrow Policy Statement, in TSX company manual, Appendix C, section 1450-051, II, the national policy generally applies to all IPOs. Effective 3 October 2002, the Toronto Stock Exchange implemented a new escrow policy, exempting issuers that have a market capitalization of at least $100 million after concluding an IPO. Companies subject to escrow will have shares released as follows: 25 per cent at the listing date; one third of the remaining shares issued after six months; half of the remaining shares after a year; and 18 months after the listing date, the remaining escrow securities are distributed.

106 Alon Brav & Paul A. Gompers, "Insider Trading subsequent to Initial Public Offerings: Evidence from Expirations of Lock-Up Provisions" (Working Paper, Harvard University, 2002) [unpublished], online: SSRN Electronic Library <papers.ssrn.com/sol3/papers.cfm?abstract_id=204094>.

107 Ofek & Richardson, "DotCom Mania", *supra* note 82 at 1131ff. hold that the expiration of the lock up period may have caused the bubble to burst.

108 Hendershott, *supra* note 82 at 292, has listed the return of equity of 441 VC-backed dot-com investments from the vintage years 1995 through 1997. In December 2001, at the lowest point of dot-com valuations in the aftermath of the bubble, VC-backed firms continued to provide returns of capital between 35 per cent and 85 per cent.

109 NP 41-201, *supra* note 6, section 1.5.

negative effects that could result from information that might influence unit prices in the aftermath of an IPO. In addition, small issues (with market capitalization of less than Cdn$100 million after concluding the IPO) avoid the escrow period to which issues typically are subject.[110] Third, trust law enables PEIs who want to keep their stakes in the firm to tailor the governance structure of the income trust in a manner that furthers their private interests. The PEIs' discretion is limited only by the fiduciary duties of the trustees, which may, however, be shaped in the trust indenture. Because the vendors sell trust units primarily to retail investors, PEIs are more likely to get away with a structure from which they personally benefit than they would in a market in which institutional investors, more knowledgeable and sophisticated, prevail. Finally, income trust offerings provide PEIs with opportunities to restructure debt as securities with an equity-like risk structure. Debt-to-equity swaps usually require a significant discount on the share price as compared to the bond's nominal value, because shareholders accept higher risks than bondholders. In income trusts, however, investors do not seem to discount the value of the overall business when former debt is swapped for quasi-equity and is issued as an income trust unit. There might be a coherent explanation for this phenomenon. If the risk structure of former debt is similar to the risk structure of equity then financial inducement in the form of a discount on the equity price is not necessary to compensate for differential risks. That will be true if the debt is subordinated or has the characteristic of junk bonds. Some income trusts have indeed been heavily indebted before their debt-to-equity swap.[111]

Consequently, PEIs are likely to benefit from the current income trust boom even more than from the tech bubble.

The Wall Street / Bay Street Industry

Scholars have just begun to analyze the role of financial consultants during the tech bubble.[112] However, research has yielded some conspicuous results: in order to bring internet-related companies to public markets and to cash in the virtually guaranteed profits that *hot* IPOs presented, underwriters chose both legal and illegal means. Financial and legal

110 NP 46-201, *supra* note 105.
111 Compare the proposed transaction with respect to FairPoint Communications, *supra* note 75.
112 See *e.g.* Daniel J. Bradley, Bradford D. Jordan, and Jay R. Ritter, "The Quiet Period Goes Out with a Bang" (2003) 58 The Journal of Finance 1; John C. Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid" (2002) 57 Bus. Law. 1403; Cumming & MacIntosh, *supra* note 100.

consultants are likely to have influenced the pricing of many IPOs,[113] IPO allocations,[114] and after-IPO support.[115]

First, it must be emphasized that there is no evidence that Bay Street currently benefits from illegal activities in income trusts. However, the incentive structure is apt to facilitate activities that may harm investors. It is argued by some that Bay Street benefits from hot issue markets simply by conducting more business:

> Underwriters encourage more firms to go public when public valuations turn out to be higher than expected and…underwriters discourage firms from filing or proceeding with an offering when public allocations turn out to be lower than expected.[116]

The income financial consultants receive for particular deals is generally contingent on the size of the issue. The income consists of a fixed percentage fee, as well as the profit from exercising *green shoe* options.[117] Legal consultants bill by the hour, and hence are unlikely to profit directly from an overoptimistic pricing of a share issue. They can indirectly profit from a boom, however, since there is simply more work to do.

Two characteristics of income trusts render the current income trust boom even more favourable to the financial industry than the tech bubble. First, income trusts are much more complicated structures than are corporations. Consultants are likely to benefit from the complexity of the

---

113 Ritter & Welch, *supra* note 82 at 1803ff. See especially 1810.

114 Ekkehart Boehmer & Raymond P.H. Fishe, "Who Receives IPO Allocations? An Analysis of 'Regular' Investors" (2004) [unpublished], online: SSRN Electronic Library <papers.ssrn.com/ sol3/papers.cfm?abstract_id=517302>. Cumming & MacIntosh, *supra* note 100 at 10-11. A famous example is Credit Suisse First Boston's "Friends of Frank" list of clients preferred in IPO allocations. See SEC, Litigation Release 17327 (22 January 2002), online: U.S. Securities and Exchange Commission <http://www.sec.gov./litigation/litreleases/lr17327.htm>. At the peak of the tech bubble, a leading investment banker of CSFB used IPO shares as currency to bribe some of the venture capitalists, institutional investors, and corporate officers into providing business to his department.

115 Bradley *et al.*, *supra* note 112; Stephen J. Choi & Adam C. Pritchard, "Should Issuers be on the Hook for Laddering? An Empirical Analysis of the IPO Market Manipulation Litigation" U. Cin. L. Rev. [forthcoming in 2005], online: SSRN Electronic Library <papers.ssrn.com/sol3/ papers.cfm?abstract_id=527684>; Lipton, *supra* note 82 at 3; Ritter & Welch, *supra* note 82 at 1815, report a "booster shot" at the end of the quiet period.

116 Ritter & Welch, *ibid.* at 1800.

117 The "Green Shoe" provision in underwriting contracts, named after Green Shoe Corp., the first firm to allow this provision, gives the members of the underwriting group the option to purchase additional shares at the offering price. Thus, underwriters may cover excess demand and oversubscription, at terms limited in time (up to 30 days) and limited in the quantity of shares the underwriters may buy (up to 15 per cent of the newly issued shares). The Green Shoe option is a benefit to underwriting syndicates and a cost to issuers. For details, see Ross, Westerfield & Jaffe, *supra* note 14 at 501-502 and 507.

structure.[118] One can interpret an income trust offering as asset securitization of a specialized business, formerly held by PEIs. Asset securitizations use trust structures that are comparable to income trusts. Measured in high fixed transaction costs, asset securitization is a more expensive form of raising capital.[119] Up-front costs include legal fees, asset review costs, and rating agency fees, while ongoing costs include credit enhancement cost, administrative fees, trustee fees, issuing fees, and agent fees. The same cost structure applies to income trusts. Second, as the main market-maker in an issue, a lead underwriter can acquire a significant amount of money in trading fees in the first weeks following an IPO.[120] As a general trading pattern, institutional investors are likely to continue holding their shares, whereas if they had not received any shares in the first place they would have been unlikely to buy them in a hot aftermarket at higher prices.[121] Traders in the first days are for the main part retailers who flip the shares allocated to them in an IPO. The fact that there are many more retail investors investing in income trust offerings, as compared to share offerings,[122] is thus favourable to underwriters because it means higher trading fees.

From Bay Street's point of view, it is preferable to sell income trust units, rather than stocks, in a hot issues market. The characteristics associated with a hot market make it less likely that 'reputational intermediaries', who are supposed to keep the gates closed for bad products,[123] will deny support to issues of businesses that are not as large, old, or mature as the businesses that triggered the income trust story in the first place.

Entrepreneurs and Managers

During the tech bubble, many VCs replaced founders and initial CEOs of firms, either in an early stage or, at the latest, when the firm was brought

---

118 A presentation by Blake, Cassels & Graydon LLP on income funds discussed even more complicated variations: notwithstanding the "simple" 'Flow through Entity structure', which is the basis of the analysis, there are the 'Leveraged Income Fund Structure' and the 'Exchangeable Unit Structure', online: Blake, Cassels & Graydon LLP <http://www.blakes.ca>.

119 Edward M. Iacobucci & Ralph A. Winter, "Asset Securitization and Asymmetric Information" (Paper written for the Northwestern University School of Law and Economics Colloquium Series, 2003) [unpublished], online: Northwestern University School of Law <http://www.law.northwestern.edu/colloquium/law_economics/Iacobucci.pdf> at 11; Steven L. Schwarcz, "The Alchemy of Asset Securitization" (1994) 1 Stan. J. L. Bus. & Fin. 133 at 138-139.

120 Ritter & Welch, *supra* note 82 at 1814.

121 *Ibid.* at 1813.

122 Mintz & Aggarwal, *supra* note 5 at 20.

123 See Gilson & Kraakman, "MOME", *supra* note 81 at 604-605 and 619-621.

to the capital markets.[124] Thus, VCs had stronger influence over the young firms, since entrepreneurs tend to be obstinate. With respect to income trusts, these measures are usually unnecessary, because these businesses tend to be older businesses in which the influence of the founder has been absorbed, due to the size of the firm or its long history.[125] These businesses are, therefore, primarily in the hands of external managers, though generalizations are not justified.[126]

External managers are risk-averse due to a lack of diversification. Investors can reduce managerial agency costs by incentive compensation schemes and reputation,[127] which will be particularly important if ownership and control are separated.[128] Historically, external managers of tech companies were often experienced, but IPOs offered young managers selected by VCs the opportunity to develop their reputations as CEOs or CFOs of successful tech firms.[129] If a manager was unsuccessful, a replacement could add new spirit to the firm. The incentive structure generally provided to managers in income trust businesses is slightly different. In order to demonstrate the maturity of a business, income trusts are often managed by managers who already have significant experience and solid reputations in the managerial market. The loss of this intangible asset, as well as the fact that sophisticated managers are likely to negotiate favourable contracts for themselves, makes a replacement of these managers costly to the firm.

Both in tech firms and in income trust businesses, financial incentives should seek to align the interests of managers and investors. In addition to salaries, managers during the tech bubble often participated in the equity

---

124 Hellmann & Puri, *supra* note 82 at 21. While entrepreneurs rarely survive in the first line of management, their influence in the second line of business, as chief of technology and operations, or other creative positions, generally remains quite strong. After the exit of a VC, entrepreneurs can become strong monitors, due to their knowledge of the business and significant shareholdings.

125 Many businesses which are later restructured as income trusts are bought by PEIs from the former owners, in most cases the families and close associates of the entrepreneur, or other conglomerates seeking to sell segments of their businesses. For example, Osprey Media Income Fund has been structured out of 27 Hollinger newspapers through Management Buy Outs.

126 The former CEO and director of Atlas Cold Storage Income Trust, Patrick Gouveia, who resigned in November 2003, is the firm's second largest shareholder after TD Capital, the private equity subsidiary of Toronto Dominion Bank. See John Partridge, "New Atlas results paint cold reality" *The Globe and Mail, Report on Business* (2 February 2003) B11.

127 Jensen & Meckling, *supra* note 48 at 312ff.

128 See Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property*, revised ed. (New York: Harcourt, Brace & World, 1991) at 112ff.

129 These reputational gains could offset the chilling effects on managerial efforts resulting from other restrictions imposed on managers by the size of the firm, the liquidity constraints resulting from growth, and market monitoring, especially by larger institutional investors and the entrepreneur. See, with respect to the concept of reputation as managerial incentive, Eugene F. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 The Journal of Political Economy 288 at 293ff.

of the IPO firm, either directly by holding shares or indirectly via stock options and other performance-related incentive structures.[130] Accordingly, managers had strong incentives to go public in the first place, and to induce soaring stock prices afterwards. This aligned shareholders' and managers' interests since investors were supposed to receive their returns by selling shares rather than by dividend payouts. Income trust prospectuses now reveal that managers are tending to participate in distributions.[131] Thus, investors' and managers' incentives are supposed to be aligned once again.

The general weakness of incentive payments is the abuse of incentives for personal interests. To the same extent that soaring share prices might not reflect persistence of shareholder value,[132] high distributions in the short run might not reflect solid cash flows in the long run. Furthermore, while in tech bubble IPOs the escrow period and negative market reaction prevented insider sales, many managers and entrepreneurs are now selling portions of their holdings in income trust issues without negative price effects, thereby reducing risks within their personal portfolio. Investor monitoring thus remains important.

At first glance, though, the same aspect sounds less enthusiastic from the director's perspective: the more efficient the investor monitoring, the less directors can lean back in the swivel chair. However, as scandals in the aftermath of the tech bubble have demonstrated, investor monitoring through the capital markets is ineffective in boom periods. Notwithstanding this general point, this article has held that neither high distributions nor trust law guarantee investor protection through explicit means to the same extent as do corporate law regimes.[133] Two idiosyncratic features add to the impression that income trusts will allow for more managerial leeway than will the corporate form. First, income trusts are a retail product. Unlike institutional investors who can separately wield considerable influence over management through the control of large numbers of units, each retail investor acting separately and controlling relatively few units can exert very little influence over management. This often precipitates severe free-rider and collective action

---

130 Lipton, *supra* note 82 at 5.

131 Macquarie Power Fund at 53 ("incentive fee" for management company); Osprey Media Income Fund at 7 and "Long-Term Incentive Plan" at 29; Holiday Income Fund at 11 (management hold 4.5 per cent in the Fund) and 33 ("Long-Term Incentive Plan"); Ag Growth Income Fund at 51 ("Long-Term Incentive Plan" with minimum holding requirements for managers); Richards Packaging Income Fund at 27 ("Management Equity Incentive Plan") and 54, especially profitable for CEOs; all *supra* note 11.

132 Robert Franks *et al.,* "Scandal Scorecard: Executives on Trial" *Wall Street Journal* (3 October 2003).

133 See "High Cash Returns?", above at 61.

problems.[134] Consequently, there is a good argument that the higher the proportion of retail investors, the lower the monitoring intensity of management. Second, takeovers become more risky for acquirers because the behaviour of atomistic retail investors is hard to predict.[135] Managers are not as easy to oust in widely held retail investments as they are in investments with significant institutional shares. For these reasons, one can infer that managers and entrepreneurs prefer income trust offerings even to corporate IPOs.

Politicians and Regulators

Politicians and regulators are the official watchdogs of the public interest in capital markets. It can be surmised that both benefit from a strong economy because that usually results in high public approval of their monitoring and policy decisions. A booming capital market also bolsters the economy as a whole; the politicians and regulators could therefore be said to have an interest in preserving a boom. Under pressure to get elected, appointed, or re-appointed, politicians and regulators thus have strong incentives to avoid activity that could be blamed for causing a deflation in capital markets. For these reasons, they tend to refrain from talking negatively about the income trust boom. Politicians and regulators are thus unlikely to act in a way that could cause the bubble to burst.

The former assumption is supported by the behaviour of American public watchdogs with respect to the tech bubble. It might have been observed that as long as tech stocks boomed, regulators were relatively passive. Although the overpricing and overstating was open and notorious during the tech bubble, the SEC did little to warn the public of the bubble dangers. Congress and the White House were similarly silent. Martin Lipton blames them for not providing sufficient funding to intervene in the market abuses.[136] Despite sparse and unclear warnings, the Federal Reserve Bank did little to temper the capital markets. Regulators and legislators thus "stood idly by as the tech bubble grew".[137] This behaviour did not change until the tech bubble eventually burst.[138]

The same patterns of behaviour might occur with respect to income trusts in Canada. Provincial capital market regulators have not made any

---

[134] Frank H. Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991) at 77.

[135] Ritter & Welch, *supra* note 82 at 1812. This, of course, may also increase management's difficulties, as it cannot negotiate effectively with (institutional) investors.

[136] Lipton, *supra* note 82 at 4.

[137] *Ibid*.

[138] The regulatory mania is associated with the *Sarbanes-Oxley Act*, 15 U.S.C. § 7201 (2002), reforms of the SEC rules, and the NYSE and NASDAQ-Listing standards. See Lipton, *ibid.* at 7ff.

serious efforts to prevent the use of marketing campaigns focused on tax advantages. The governments of Ontario and Alberta, which are the provinces with the most income trusts, have only acted to limit unitholder liability—an obstacle to institutional investors' investments—rather than thinking of, and improving, direct investor control over income trusts. Finally, securities regulators have not yet agreed on a national policy. Under the Chretien Liberal majority, the federal government was mostly passive with respect to income trusts, narrowly focusing on tax leakages. It did not proactively attempt to curtail marketing that tends to lead to public misperceptions about the advantages of income trusts, which could have been accomplished by regulating the treatment of merely formal debt owed to the trust structure as equity. Presumably, in an election year, the federal government did not want to reduce the perceived benefits of income trust units to taxpayers. Overall, there is a cogent argument that politicians and regulators, ostensibly as watchdogs of capital markets, have in fact been complacent with respect to the potential harms that could result from the income trust boom. To some extent, it might be suggested that they have even facilitated the boom.

Overoptimistic, Retail Driven Market

Bubble Theory

According to research in the behavioural finance field, a bubble can develop as a consequence of overoptimistic, uninformed "noise trading",[139] often proxied by retail investors, or as a consequence of limits on arbitrage.[140]

1) **Noise Trading**. If institutional investors generally abstain from trading in one specific class of securities, two effects occur. First, the fewer interested institutional investors who participate in the market, the less effective is the book-building procedure, since there are no investors disclosing their 'fair' valuation of securities

[139] Shleifer & Summers, *supra* note 81 at 24ff. I do not address whether the optimistic beliefs are "irrational beliefs" about future cash flows or whether there is a rational ground for investors acting in a bubble, for example as provided by the "greater fool" theory; see Olivier Blanchard & Mark Watson, "Bubbles, Rational Expectations and Financial Markets" in Paul Wachtel, ed., *Crises in the Economic and Financial Structure* (Lexington, MA: Lexington Books, 1982); Kenneth Froot & Maurice Obstfeld, "Intrinsic Bubbles: The Case of Stock Prices" (1991) 81 American Economic Review 1189; Jose Scheinkman & Wei Xiong, "Overconfidence, Short-Sale Constraints and Bubbles" (Working Paper, University of Wisconsin-Madison, Department of Economics, 2002) [unpublished], online: The Social Science Computing Cooperative <http://www.ssc.wisc.edu/~manuelli/879/OverconfidenceBubbles_Scheinkman.pdf>.

[140] Gilson & Kraakman, "MOME – the Hindsight Bias", *supra* note 81 at 734-735.

to the underwriter. The effect might be that the old owners and the underwriters can raise unit prices above fair-market value. This creates inefficiencies in the primary market and affects the relative pricing of this security class. Second, recent studies[141] have found that the market will be "more prone to the types of behavioural biases that lead to overly optimistic beliefs" and overconfidence.[142] In turn, the market tends to be overpriced. Inefficiencies then occur in the secondary market.

2) **Limits on Arbitrage**. In its business, an arbitrageur needs to find a lender for the securities that it will sell. Then the arbitrageur transfers collateral to the lender in the amount of 102 per cent of the value of the borrowed securities, before the arbitrageur can use the lender's securities for, in essence, a bet on rising (*long position*) or declining (*short position*) prices of the security. Active arbitrage business thus requires a demand (arbitrageur) and a supply (lender) side. If there is either insufficient demand or insufficient supply, arbitrage business will not be made. On the demand side, arbitrageurs are generally institutional investors. Some institutional investors, particularly mutual funds, usually do not participate in trades on short positions with respect to stocks.[143] There is also some evidence that hedge funds avoid short positions in highly volatile settings such as bubbles.[144] The

---

141 Brad Barber & Terence Odean, "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors" (2000) 55 The Journal of Finance 773; Brad Barber & Terence Odean, "Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment" (2001) 116 Quarterly Journal of Economics 261; John Pound & Robert Shiller "Survey Evidence on Diffusion of Interest and Information Among Investors" (1989) 12 Journal of Behavior and Organization 47.

142 Ofek & Richardson, "DotCom Mania", *supra* note 82 at 1121.

143 Joseph Chen, Harrison Hong & Jeremy C. Stein, "Breadth of Ownership and Stock Returns" (2002) 66 Journal of Financial Economics 171. According to the American Securities and Exchange Commission, only 43 per cent of mutual funds are authorized by their charters to sell short and only 2.5 per cent of the registered investment companies in the U.S. are actually engaged in short selling; see Staff Report No. 41 to the US SEC, "Implications of the Growth of Hedge Funds" (Sept. 2003) at 108, online: American Securities and Exchange Commission <http://www.sec.gov/news/studies/ hedgefunds0903.pdf>. Further, the Canadian National Instrument 81-102 *Mutual Funds* restricts mutual funds from certain short sales, though exemptions may be granted. Finally, the management of mutual funds benefits from rising unit prices through the management fee. Should they refrain from collecting money in order to facilitate a better but uncertain development of the fund in the future, if there is certain money on the table in the present? Thus, the incentive structure of fund managers induces neither hedging nor refraining from investment. There is, in fact, an analogy to the incentive structure by which VCs were induced to bring more and more firms to the market in the tech bubble despite the fact that these firms were immature.

144 See Andrei Shleifer & Robert W. Vishny, "The Limits of Arbitrage" (1997) 52 The Journal of Finance 35. For empirical studies on hedge fund trading behavior in volatile settings see Markus

supply side of arbitrage comprises large, long-term investors, such as pension funds, insurance companies, and index investors. If fewer of these shareholders are in the market for a security, proportionately less arbitrage business will be made.[145]

3) **Collusion**. The presence of noise traders in the market is insufficient, on its own, to explain bubbles, since the trading of optimistic noise traders is offset by pessimistic noise traders. Rather, the biases of noise traders must be consistent. Even then, "under perfect capital markets, fully informed traders with unlimited access to capital immediately pounce on incorrectly priced securities. If arbitrageurs were available to trade against the noise traders, then their action would suffice to return prices to efficient levels."[146]

Neither perfect capital markets nor fully informed traders with unlimited capital, however, exist. Reality consists of limited access to information and capital and thus limits the incidence of arbitrage. Furthermore, arbitrageurs, as opportunistic rather than altruistic market participants, act for profit, not for the promotion of efficient capital markets. An arbitrageur might profit from the valuation error of noise traders by taking either long or short positions in the anticipated future direction. If the prices are anticipated to rise, an arbitrageur might drive up the price of already overvalued stocks and thereby prolong and increase the overpricing.[147]

In sum, relatively efficient markets can tip towards inefficiency under three conditions: if many investors are not rational in their investment decision; if there are observable cognitive biases directing the market towards overpricing; and if significant barriers prevent arbitrageurs from correcting the mistakes made by less-than-rational investors.[148]

K. Brunnermeier & Stefan Nagel, "Hedge Funds and the Technology Bubble" (2004) 59 The Journal of Finance 2013 (including a list of further references).

145 For details, see Gene D'Avolio, "The Market for Borrowing Stock" (2002) 66 Journal of Financial Economics 271.

146 Gilson & Kraakman, "MOME – the Hindsight Bias", *supra* note 81 at 720-721.

147 J. Bradford DeLong *et al.*, "Positive Feedback Investment Strategies and Destabilizing Rational Speculation" (1990) 45 The Journal of Finance 379; Jeremy Bulow & Paul D. Klemperer, "Rational Frenzies and Crashes" (1994) 102 Journal of Political Economy 1.

148 Lawrence A. Cunningham, "Behavioral Finance and Investor Governance" (2002) 59 Wash. & Lee L. Rev. 767 at 774-780; Gilson & Kraakman, "MOME – the Hindsight Bias", *supra* note 81 at 720-721; Donald C. Langevoort, "Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation" (2002) 97 Nw. U.L. Rev. 135 at 148-152.

The Bubble of 1999 and 2000

Though it is unclear whether noise trading or limits on arbitrage finally triggered the bubble, the tech bubble of 1999 and 2000 eventually showed both characteristics. Many observable trends suggested a level of arbitrage that was likely too low to correct inefficient pricing caused by irrational, overoptimistic investors. For instance, the sharp increase in IPOs corresponded to an increase in directors, officers, and shareholders subject to escrow agreements that prevented them from arbitrage business in tech stocks. Of greater significance is the data indicating that the tech bubble was primarily a retail-driven market. Accordingly, the market likely experienced trading by many investors with cognitive biases and there was probably a deficient level of arbitrage. A smaller constituency of large, long-term institutional investors in tech stocks implies a shortage of lending for arbitrage activity. It also implies that less-sophisticated traders moved market prices.

In absolute terms, internet stock-holdings by institutional investors remain extensive, but measured in relative figures, these holdings are significantly lower, on average, than those in other stocks. Although internet stocks in the aggregate market were 4.38 per cent measured by total market capitalization, pension funds hold only 2.32 per cent of their total invested capital in tech stocks. In March 2000, the median holding of institutions for internet stocks measured by value was only 25.9 per cent, compared to 40.2 per cent for non-internet stocks. Though the difference was lower in IPO allocations, the difference was still significant (7.4 per cent).[149] The allocation value itself, representing relatively certain gains during the first trading days, accounts for the lower difference.[150]

Another situation indicates unusually low institutional-investor participation in internet stocks. In 1999 and early 2000, a number of internet-based mutual funds were created. The emergence of these internet mutual funds was not necessarily due to an institutional view of internet valuations. While these mutual funds statistically increase the share of institutional holdings, "it is clear that the funds themselves are simply pass-throughs to retail investors."[151] At the same time, the trading volume was relatively high. The average volume per stock during the tech bubble was three times higher for internet firms than for others,[152] which might be explained by large numbers of investors speculatively day-trading on volatility. High trading volume is a proxy for retail activity, because

149 Ofek & Richardson, "DotCom Mania", *supra* note 82 at 1121.
150 Boehmer & Fishe, *supra* note 114.
151 Ofek & Richardson, "DotCom Mania", *supra* note 82 at 1121.
152 *Ibid.* at 1116.

institutional investors do not typically flip their stocks.[153] Finally, levels of block trading, which functions as a proxy for institutional trading,[154] decreased. Lower block-trading levels represent less institutional trading and more retail trading in the market. Thus, low block trading seems to add to soaring stock prices.[155] Therefore, "most of the puzzling high returns [from trading in internet stock] are associated with institutions avoiding at least one side of the transactions, presumably the buy side."[156] Consistent with the theories mentioned above, lower institutional participation means fewer rational sales with a correcting effect on noise trades if prices soar and fewer shares for the supply side of arbitrage business and hence less hedging against soaring prices.

Noise Trading and Limits on Arbitrage in Income Trusts

Proving that overoptimistic noise traders have taken control of the income trust markets due to an absence of institutional investors, in the same manner as during the Tech Bubble, would require sufficient reliable data on block trades and trading volume, which are not publicly available.[157] The data that are available allows some basic suggestions to that effect.

A rising overall market capitalization of income trust units relative to a broad market index can function as a very rough proxy for generally optimistic investors. In 2003, the S&P/TSX trust index was up 38.3 per cent, as compared to a 26.7 per cent rise in the broader S&P/TSX composite benchmark. The market capitalization of income trusts as of December 2003 was approximately Cdn$63.3 billion.[158] As of April 15, 2004, 147 issuers represented a market capitalization of approximately Cdn$90 billion, which would mean an increase of more than 55 per cent.[159] Two factors, however, distort the data. First, new units were issued in the first quarter of 2004. These were predicted to amount to

153 See "The Wall-Street / Bay-Street Industry", above at 81.

154 Charles Lee & Balkrishna Radhakrishna, "Inferring Investor Behavior: Evidence from TORQ Data" (2000) 3 Journal of Financial Markets 83; Gideon Saar, "Price Impact Asymmetry of Block Trades: An Institutional Trading Explanation" (2001) 14 Review of Financial Studies 1153.

155 Ofek & Richardson, "DotCom Mania", *supra* note 82 at 1123ff show that the median return in the first day of the IPO in Internet stocks was 125.4 per cent when block trading levels were low, versus only 27.1 per cent when block trading levels were high. For the end of the quiet period, the median return was 11.7 per cent (low block trades), versus 6.0 per cent (high block).

156 *Ibid.* at 1123-1124.

157 The data are available at Bloomberg, or directly from TSX, at a cost. The author intends to examine these data if he is provided access to one of these institutions.

158 Allan Robinson, "Underwriting deals rise to highest in 5 years" *The Globe and Mail, Report on Business* (10 February 2004) B14; Willis & Church, *supra* note 30; Mintz & Aggarwal, *supra* note 5 at 4 (Mintz & Aggarwal have estimated that market capitalization of income trusts totalled approximately $57 billion and 123 issues at 9 September, 2003).

159 Investcom, *supra* note 1.

approximately Cdn$2 billion.[160] Second, different categories for the distinction between mutual funds and income funds might influence the quality of the data.

Figure 2 (below) demonstrates the overall returns of income trust units (Payout and Unit Price) in the period between April 2001 and April 2004. Despite the fear of rising interest rates, income trust unit returns are still more than 10 per cent higher than stock returns. Due to the low average beta values of income trusts (generally between 0.3 and 0.4), one would assume that in the spring of 2004, when many economists predicted a general economic recovery, stocks of higher-risk businesses would soar higher than low-beta income trust units. Many income trusts issued new units in 2003.[161] Thus, higher payouts are an unlikely explanation for the different levels of returns, since it would assume that underwriters and PEIs did not foresee these higher payouts when issuing prospectuses. Instead, Figure 2 suggests that prices for income trust units, on average, rose significantly during the last quarter of 2003 and the first quarter of 2004. During this period, most retail investors made their annual RRSP investments.

Figure 3 (below) shows data by CIBC World Markets in September 2004.[162] These data indicate that the performance of investments in shares that are listed in the TSX composite index rose 15 per cent within 32 months, while investments in income trusts gained 70 per cent, with income trust small caps gaining approximately 75 to 80 per cent. As discussed above, net tax advantages are probably insubstantial and thus could not explain a difference in performance between shares and income trust units that extended to approximately 60 per cent within that period, given the environment of depressed share evaluations in the aftermath of the tech bubble in the winter of 2001. However, as unit prices are one factor in measuring the overall performance of a portfolio, the presence of irrationally optimistic market pricing symptomatic of a bubble does explain the extraordinary performance of income trust units, as compared to shares.

---

160 Willis & Church, *supra* note 30.

161 *Ibid.* (stating that 85 existing trusts tapped the markets in addition to 22 income trust IPOs).

162 CIBC World Markets Income Trust Benchmark Indices, online: CIBC World Markets <http://www.cibcwm.com/home/buyit_august.pdf>. Reprinted with permission from CIBC World Markets.

Figure 2: Overall Returns of Income Trusts, as measured by S&P/TSX Capped Income Trust Index vs. S&P/TSX Total Return; © 2004 Bell Globemedia Inc., its affiliates and/or licensors. All rights reserved.

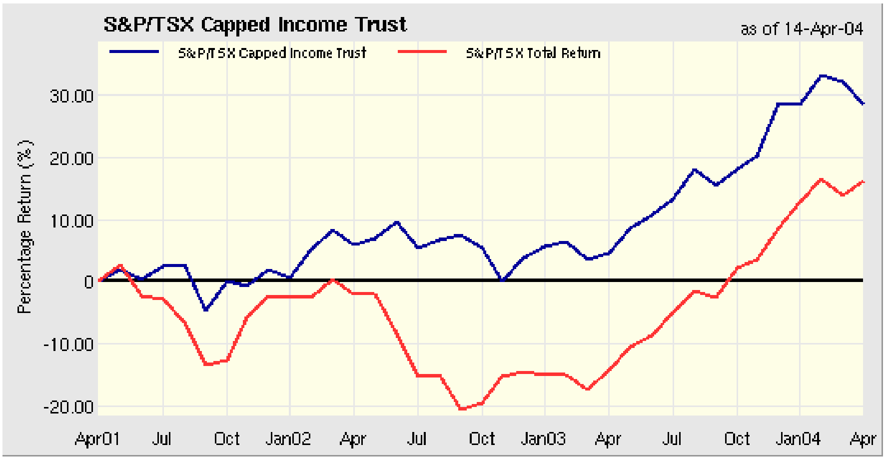
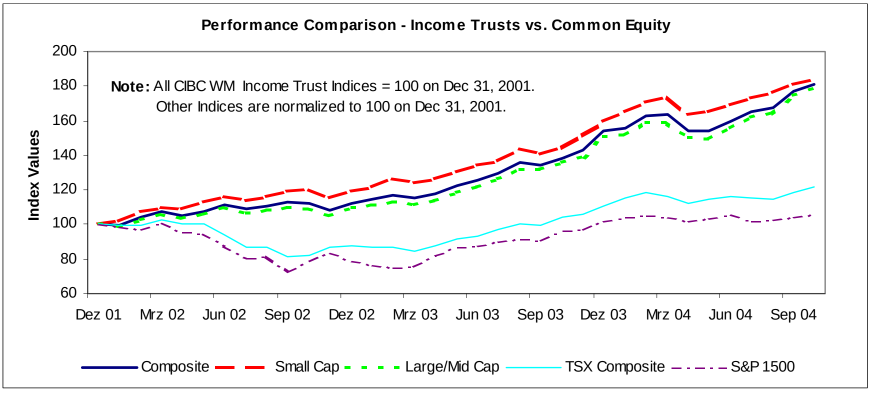


Figure 3: Performance Comparison – Income Trusts vs. Common Equity, January, 2002 to October, 2004. © 2004 CIBC World Markets. All rights reserved.



Restrictions on arbitrage might have contributed to this high level of evaluation. Specifically, in the income trust market the restrictions might result from escrow agreements, which prohibit arbitrage by directors, officers, and large shareholders of income trust issuers with a market capitalization below Cdn$100 million after the conclusion of a share issue. Some income trust issues were smaller issues, and thus some limits on arbitrage seemingly exist. Escrow agreements, however, are likely to cover relatively fewer stake holdings than during the tech bubble, as PEIs sell their shares in income trust offerings and, since 2002, large issues are not subject to escrow agreements at all.[163]

Some data does exist regarding the number of potential arbitrageurs dealing in income trust units. Notwithstanding the holdings of non-resident holders, which can include foreign institutions as well as individuals, Aggarwal & Mintz have provided evidence that institutional investors in income trusts hold 25.6 per cent of the overall units, as compared to 45.9 per cent in stocks.[164] In business trusts, institutional holdings are estimated to comprise about 10 to 20 per cent of the units, while the institutional share in royalty trusts and REITs is between 30 and 40 per cent.[165] In light of these data, the difference with respect to business trusts is highly significant and signals that there are very few investors in business trusts who could lend shares to short-selling arbitrageurs.

Table 1 lists data pertaining to investor participation in 36 Canadian income trust IPOs between February 2003 and October 2004, measured in percentage of the offering size.[166]

In the periods covered by the data, between 36.4 per cent and 51.34 per cent of the trust units were allocated to institutional investors in each quarter. Measured in average weight of the offerings, institutional participation varies between 37.64 per cent and 51.33 per cent per quarter. The highest institutional participation reached a height of 66.3 per cent in March 2004, with the lowest institutional participation in IPOs at 9.4 per cent in May 2003.[167] In contrast, usually 75 to 85 per cent of share IPOs are assigned to institutional investors.[168] The data, however, does not distinguish between mutual funds and pension funds. Only the latter are likely to participate in arbitrage, and thus contribute to efficient securities prices.

[163] For details, see NP 46-201, *supra* note 105. With respect to the size of recent income trust issues, see Table 1.

[164] Mintz & Aggarwal, *supra* note 5 at 20 (data topical as of November 2003).

[165] *Ibid.* at 19.

[166] This table is based on data that were provided to the author by one of the commentators who declined to be mentioned by name. I sought to verify the data and although I did not find evidence of errors, it is important to note that some inaccuracies may remain. Consequently, the strength of the evidence provided by the data is limited.

[167] Overall, the institutional participation varies from quarter to quarter. I assume that this variety partially reflects the different stages of discussion with respect to unitholder liability and tax advantages for income trust investors. Thus, these data signal that institutional investors respond to some extent to the political uncertainty that surrounds the investment in income trusts. However, while the uncertainty decreased in the third and fourth quarter of 2004, the institutional participation in this period has not reached the level of the first quarter of 2004.

[168] Mintz & Aggarwal, *supra* note 5 at 33 (Appendix), citing sources at Merrill Lynch. The authors note, however, that institutions tend to reduce their ownership after IPOs. Thus, “a fair estimate of stable institutional ownership is 60 – 70%.”

Table 1: Allocation of Income Trust IPOs in 2003-2004

2003

Period	Jan-Mar (pt)	Apr-June	Jul-Sep	Oct-Dec
Income Trust IPOs	3	6	4	8
Amount Raised (in Cdn$ millions)	311	902	1,509	1,359
Retail Investors	58.50%	63.60%	52.32%	59.80%
Institutional Investments (by numbers)	41.5%	36.4%	47.68%	40.2%
Institutional Investments (weighted average)	42.57%	37.64%	50.62%	47.08%
Highest Institutional Participation	46.1%	60.0%	54.1%	63.3%
Lowest Institutional Participation	35.0%	9.4%	41.8%	29.6%

2004

Period	Jan-Mar	Apr-June	July-Sep	Overall
Income Trust IPOs	5	4	6	36
Amount Raised (in Cdn$ millions)	720	541	595	5,937
Retail Investors	48.66%	61.80%	51.87%	57.69%
Institutional Investments (by numbers)	51.34%	38.2%	48.13%	42.31%
Institutional Investments (weighted average)	51.33%	40.48%	46.87%	45.90%
Highest Institutional Participation	66.3%	56.0%	60.7%	
Lowest Institutional Participation	43.0%	28.1%	29.6%	

Data also exist on investor demand-driven fund products. Mutual funds expressly marketing fixed income investments raise about Cdn$1.2 billion per month, primarily for income trust investments,[169] which, on an annual basis, would be sufficient to purchase all income trust issues of 2003. If these mutual funds invest according to their marketing, they cannot effectively diversify away from their prime investments, even though there are only weak products in the market. If

[169] Willis & Church, *supra* note 30.

Canadian mutual funds, like their US counterparts, generally refrain from arbitrage business,[170] the money flowing into these funds will not be apt to bring the prices back in line. It is, indeed, likely that Canadian mutual funds will continue to refrain from arbitrage business as well: mutual funds have no incentive to bet against rising prices in their fund products, since they benefit from investor enthusiasm in their specific class of securities.

Due to insufficient underlying data or the necessity to rely on undisclosed data, the results of this article should be viewed with some caution. The data does, however, support the arguments that optimistic investors prevail in the market for income trusts and that there is a shortage of lenders for arbitrage business in income trust units, at least in business trusts. It is therefore likely that the prices of some income trusts have diverged from the fundamental value of the underlying business. Altogether, it seems quite evident that noise trading and a lack of arbitrage—a consequence of relatively less institutional investor participation in the market—probably tipped the market and triggered an ongoing bubble during the last quarter of 2003 and the first quarter of 2004. Admittedly, these observations do not prove that the Canadian income trust market is now a full-blown bubble, but they certainly indicate that a bubble probably exists to some extent. Rebutting this claim thus demands equally cogent counterarguments based on sound observations. In a sense, the burden has shifted. Sell-side marketers and commentators who support growth in and entry into the income trust market need to explain why the market is probably not a bubble. What is their counter-proof?

Arguments Against the Existence of a Bubble

After examining the sensitivity of prices of income trust units to general economic variables, Halpern, Norli, and Timbrell have maintained that the bubble risk in income trust units is low.[171] They have held that there is no indication that income trust units have been overpriced as an asset class and that overpricing is unlikely to develop in the future.[172] Their sample of

170 Joseph Chen, Harrison Hong & Jeremy C. Stein, "Breadth of Ownership and Stock Returns" (2002) 66 Journal of Financial Economics 171. According to the American Securities and Exchange Commission, "Implications of the Growth of Hedge Funds, Staff Report No. 41 to the United States Securities and Exchange Commission" (September 2003), at 108, online: U.S. Securities and Exchange Commission <http://www.sec.gov/news/studies/hedgefunds0903.pdf>, only 43 per cent of mutual funds are authorized by their charters to sell short and only 2.5 per cent of the registered investment companies in the US are actually engaged in short selling.

171 Ofek & Richardson, "DotCom Mania", *supra* note 82 at 1133.

172 Halpern, Norli & Timbrell, *supra* note 1 at 19.

economic factors and income trust performance is based on the period from 1996 to 2002.[173] In contrast, as stated above, this article argues that noise trading and a lack of arbitrage tipped the market during the last quarter of 2003 and the first quarter of 2004. Therefore, Halpern, Norli, and Timbrell's study deals with market analysis of a different time period and for that reason cannot offer valid counter-proofs of the present findings.

In order to achieve more focused results, three methodological changes for further studies might nevertheless be recommended. First, Halpern, Norli, and Timbrell compare the returns of specific kinds of businesses (*old* and *large*) with a mix of businesses within the S&P/TSX Index. In order to achieve comparable results, all businesses with a different market beta than the average income trust market beta (between 0.3 and 0.4) should be excluded from the sample. Otherwise, a sample of weak and strong firms, in terms of free cash flow and the TSX Index, will be compared with a sample comprised exclusively of strong firms. Second, the analysis does not distinguish between royalty trusts and REITs on the one hand and, on the other hand, firms that have nothing to sell but a strong business position repackaged as an income trust. Third, the sample period of the analysis should take into account at least one business cycle of the underlying businesses. Taking the extraordinary costs of restructuring, the repeated public offerings, the restraints on growth, and research and development into account, restructuring a business as an income trust might not yield extraordinary returns that can account for stock prices soaring up to 17.12 per cent (which is, according to Halpern, Norli, and Timbrell, the premium that investors in the market put on securities of businesses that announce a plan to restructure into an income trust).[174]

Halpern, Norli, and Timbrell have predicted, under the condition that there are institutional investors in the market, that overpricing is unlikely to occur in the future. Thus, the presence of institutional investors would enhance the maturity in the market for income trusts, resulting in an improvement in the quality of operating companies structured as income trusts as well an improvement in corporate-governance provisions.[175] In the past, the discussion about unitholder liability might have discouraged institutional investors from investing in income trust units. Legislation in Alberta,[176] legal opinions holding that unitholder liability is unlikely,[177]

173 *Ibid.* at 15.
174 *Ibid.* at 13.
175 *Ibid.* at 4.
176 The *Income Trusts Liability Act*, *supra* note 66, states that unitholders are indemnified from liability.
177 Gillen, *supra* note 7.

and forthcoming legislation in Ontario[178] are designed to clarify the situation.

Even if concerns about unitholder liability are resolved, it does not follow that institutional investment in income trusts will escalate to relative holdings on par with that observed in other types of businesses. Other obstacles to institutional investment still exist and, in the meantime, more were arising. The assumption by Halpern, Norli, and Timbrell that the tax treatment of income trusts would not change[179] has become dubious given the proposed federal government plan to limit pension fund investment in these businesses. In fact, this contemplated development in tax law observably stalled pension fund investment in the income trust market.[180] Another problem that still exists as a check on institutional investment involves uncertainty surrounding the laws of trust governance.[181] Institutional investors have lobbied for mandatory governance requirements because the inclusion of income trusts in TSX stock indices practically forces institutional investors to purchase trust units.[182] In addition, the Canadian Coalition for Good Governance has signalled that it is "going to become more aggressive" with respect to income trust governance.[183] The fact that institutional investors are so concerned about governance issues implies that their current investment levels in the income trust market are lower than their investments in the broader market.

---

178 Bill 35, *Trust Beneficiaries' Liability Act, 2003*, 1st Sess., 38th Leg., Ontario, 2003, online: Legislative Assembly of Ontario <http://www.ontla.on.ca/documents/Bills/38_Parliament/Session1/b035_e.htm> (reintroduced as the *Trust Beneficiaries' Liability Act, 2004* by Bill 106, *Budget Measures Act, 2004 (No. 2)*, 1st Sess., 38th Leg., Ontario, 2004 (second reading debated October 12, 14, 18), online: Legislative Assembly of Ontario <http://www.ontla.on.ca/documents/Bills/38_Parliament/Session1/b106_e.htm>). The *Trust Beneficiaries' Liability Act, 2004* specifies that the beneficiaries of a trust are not liable, as beneficiaries, for any act, default, obligation or liability of the trust or any of its trustees. However, this protection for beneficiaries is restricted: it applies only for acts, defaults, obligations or liabilities that occur when a trust is a reporting issuer under the *Securities Act* and is governed by the laws of Ontario, and it applies only for acts, defaults, obligations or liabilities that occur after the Bill receives Royal Assent.

179 Halpern, Norli & Timbrell, *supra* note 1 at 2-3.

180 See "Long-Term Investment Argument?", above at 59. One could also interpret the Federal Government's tax step as risk reduction that is designed to avoid liquidity problems of pension plans, in case the bubble bursts.

181 See "Debt as Discipline?", above at 62.

182 Karen Howlett, "Governance rules urged for trusts before TSX entry" *The Globe and Mail, Report on Business* (19 February 2004) B6.

183 Elizabeth Church, "Income trusts to face more scrutiny, panel told" *The Globe and Mail* (29 September 2004) B12.

In summary, while Halpern, Norli, and Timbrell's analysis may suggest that fears about a bubble in the income-trust market were probably unfounded as of a few years ago, it does not provide valid evidence that the market price of income trust units has not recently diverged from the fundamental value of the underlying businesses.

Conclusion

The current income trust boom shares three characteristics with the tech bubble. First, normal businesses have leveraged on the income trust story. Second, a strong convergence of interests exists among private-equity investors, managers, financial consultants, and even politicians. All of these groups benefit from the boom in the income trust market. The structural complexity of income trusts and the nature of unit offerings to the public suggest that private equity investors, financial industry professionals, and managers probably prosper even more from the income trust boom and experience an even stronger convergence of interests than they did during the Tech Bubble. Finally, the data suggests that overoptimistic retail investors dominate the income trust market, so there is a smaller constituency of institutional investors—particularly large, long-term funds such as pension plans—to supply funds for efficiency-improving arbitrage.

Under these conditions, although this article has not technically proven that prices have diverged from the values inherent in the underlying businesses, it seems probable that overpricing in the market for income trust units exists. The counter-proof provided by Halpern, Norli, and Timbrell is inconclusive, since it covers a different time period. Additionally, their predictions rely on increasing institutional investor activity, but the relative level of institutional investment in income trusts is still lower than in ordinary corporations.

V POLICY RECOMMENDATIONS

Whether the Bubble characteristics result from incomplete tax integration, policies for debt and equity distributions,[184] irrational cognitive biases of individual investors, or institutional limits on arbitrage, the same three consequences follow, each of which warrants advisories to investors and policy recommendations.

[184] Mintz & Aggarwal, *supra* note 5 at 23ff.

1) Capital markets price income trust units too optimistically. Investors cannot rely on the quoted prices of units to inform themselves about the underlying value of a business; instead investors need to evaluate a full array of available information on their own.

2) Overpricing facilitates a misallocation of capital. When investors are overly enthusiastic about a sector's prospects, the sector will receive more capital than justified by the real economic productivity of businesses in that sector. This capital misallocation results in wealth destruction: resources are diverted from investment in businesses that could use them to generate relatively higher real economic returns.[185]

3) Inefficient capital markets distort managerial incentives. This occurs in two ways. First, capital markets do not furnish accurate information about management performance. As a result, bad managers have more leeway than is appropriate and good managers are deprived of their rewards. Second, unjustified high valuations render takeovers less likely. (As far as disciplining management, it should be re-emphasized that direct investor control in income trusts is also unlikely to be feasible or effective.[186]) In these times of intensifying international competition in product markets, Canada is well advised to avoid a long period in which capital markets allocate capital inefficiently.

The above consequences indicate that capital market inefficiency in income trusts is a serious issue that needs to be addressed by policy-makers. The greater question is whether, and to what extent, Canadian income trust vendors should address not only this issue but also all of the related problems with income trusts that have been explained in this article.

First, do we need regulatory action? (This is a question on which the Alberta government has recently asked stakeholders to comment.[187]) One may answer this question in the negative by calling for renewed faith in market forces, arguing that the market has already addressed

[185] Hendershott, *supra* note 82 at 283.

[186] See "Debt as Discipline?", above at 62.

[187] Alberta Revenue, *Income Trusts: Governance and Legal Status* (discussion paper) (July 2004), online: Alberta Finance Ministry <http://www.finance.gov.ab.ca/publications/2004_0728_income_trusts_discussion_paper.pdf>.

and will continue to address the most pressing issues surrounding income trusts. The liability problem being solved, one might see some growth in institutional investment as a reason to believe that the threat of a full-blown bubble is unfounded. Furthermore, development of income trust rating criteria by DBRS and Standard & Poor might increase transparency in the market for income trusts.[188] Turning to income trust governance, one could cite the rarity of management companies which mitigate unitholder influence over governance. It has been observed that sponsors have a harder time selling income trust issues in which unitholders have no say. One could provide evidence for a viable capital market: even though at least four income trusts have suspended their monthly distributions,[189] investors have not been affected by a panic pertaining to income trusts units in general. Instead, the market has distinguished between good and bad products, just like other, more mature security markets do. In addition, a recent fear of increasing interest rates has led to a decline in income trust unit prices,[190] demonstrating that the income trust market is not disconnected from macroeconomic developments. In short, one could argue that the market is maturing, and thus no regulation is necessary.

This view neglects three lessons offered by the tech bubble. First, we do not know how seriously the bust period will depress investor confidence. While the American market received a relatively soft landing after the tech bubble, the international experience demonstrates that bubbles can seriously undermine investor confidence in securities markets in the long run. For example, the bust period following the tech bubble hit German capital markets particularly severely. Though there is no evidence that large and established corporations were involved in fraudulent activities, investor confidence was devastated.[191] The traditionally weak IPO market literally ceased to exist for over a year, which prevented primarily young firms from gaining external financing, and led to a decline in share issuances by large firms as well.[192] Thus,

---

188 Carrick, *supra* note 15.

189 Hot House Growers Income Fund, Harterm Income Fund, Atlas Cold Storage Income Trust, and Legacy Hotels REIT.

190 Andrew Willis, "Trust units are in slide" *The Globe and Mail* (24 April 2004) B7.

191 German shareholders associate corporate scandals primarily with young tech stocks and the Neuer Markt; see the list of 45 firms that either went bankrupt or were subject to examinations by the Federal Agency for Financial Services, Manager Magazin Online: <http://www.manager-magazin.de/geld/artikel/0,2828,186368,00.html>. See also Dirk Zetzsche, *Explicit and Implicit System of Corporate Control – A Convergence Theory of Shareholder Rights* (LL.M. thesis, University of Toronto, Faculty of Law, 2004) [unpublished], at 80ff, online: SSRN Electronic Library <http://ssrn.com/abstract=600722>.

192 In 2003, there was not a single IPO of domestic issuers in Germany. The IPO market, measured in market value and Million €, developed as follows: 10,474 (1999), 26,558 (2000), 2,692 (2001), 249 (2002), 0 (2003), 1,977 (January to August 2004). Already listed firms issued shares,

advocates of income trusts should not gamble on a soft landing and on the market's ability to easily restore investor confidence. Second, income trust units are a product in which retail investors heavily invest as part of their retirement and pension plans. These funds secure a livelihood for retirees and should not be gambled with. This lesson was taught to American corporate pension funds of major companies, such as General Electric, in the aftermath of the tech bubble. There is no indication that Canadian investors are more inclined to take risks than their American neighbours when their pensions may potentially be affected. Finally, many market measures that currently exist, while ensuring profitable business for the securities industry, do not effectively address retail investors' concerns. For example, ratings are a nice add-on if investors may exercise strong rights on the basis of this information. Ratings do not, however, solve the problems of investors that are locked into firms with sponsor-oriented, rather than investor-oriented, governance structures. Not all income trusts are rated; thus investors may suffer from adverse selection in a market where information about investment quality is not always available and standardized. This makes it difficult to compare businesses and weed out those that are bad investments. Well-managed heavyweight players, such as TransCanada Power, Yellow Pages, or Gaz Metro, benefit from ratings. In contrast, the bad apples—or, in the case of Hot House Growers, bad tomatoes—are unlikely to strive for ratings. With more than 160 income trusts already in the market, many of them issued under the promise of high distributions while at the same time foregoing high governance standards, regulatory activity is required to protect investors from the bad, rather than from the good, players in the market.

If legislative activity is required, what should promulgators do in order to protect investors? The American *Sarbanes-Oxley* legislation has proven how easily legislative activism may replace sound legislative considerations.[193] In light of this experience, participants in the income trust market should be aware of the dangers of overreaction. For example, recommending the abolishment of income trusts would overlook investors' desires for higher current cash payouts (at

---

measured in market value and Million €, as follows: 31,341 (1999), 18,721 (2000), 7,971 (2001), 3,025 (2002), 12,231 (2003). Source: Deutsches Aktieninstitute, Factbook (2003), online: Deutsches Aktieninstitute <http://www.dai.de>.

193 See Michael Skapinker, "'Thou shalt not steal' would have done nicely, thanks", *Financial Times* (1 December 2004), 8.

the expense of future payouts or share price increases). Consequently, a recommendation needs to carefully distinguish between the good and the bad aspects of income trusts. According to the above argument, the basic principle of income trust regulation must be to avoid creating any incentive that makes investment in income trusts more advantageous than investment in other business models for reasons independent of fundamental valuations. Ideally, regulators should aim for a regime where incentives for income trust investment are only related to the quality of the underlying business and the specialty pay-out service (that is, its policy to favour higher cash distributions in the present).

This analysis reveals four idiosyncratic features of income trusts that render the income trust boom less advantageous to society than many vendors and other interested parties would have public investors believe: tax advantages for investments in low-growth businesses, unclear trust governance, management discretion with respect to future payouts, and insufficient participation of institutional investors. Furthermore, the problem of potential conflicts of interest in which broker-dealers and mutual fund managers find themselves when selling income trust related products are also discussed. Rather than providing an analysis of all of the implications, the following recommendations on these issues are intended to enrich future debate. Hence, they might miss some aspects that future research will reveal.

Avoid Investment Incentives for Low-Growth Businesses

The tech bubble revealed that retail investors are more responsive to seemingly simple, but false, theories about business value than are sophisticated investors. Misleading claims about the advantageous nature of an investment are particularly persuasive when they involve supporting reasons based on opinions about preferential legal treatment such as lower assessments. Retail investors are more inclined to believe expert opinions, insofar as they are made with respect to matters that can be analysed on the grounds of reason. Thus, income trust promulgators should generally avoid creating legal advantages that may further investment in one investment form over the other, notwithstanding one exception: externalities provided by innovative businesses justify a differential legal treatment as the *societal* benefits exceed the investors' *private* benefits.[194]

---

[194] See Jeffrey G. MacIntosh, "Legal and Institutional Barriers to Financing Innovative Enterprise in Canada" (monograph prepared for the Government and Competitiveness Project, School of Policy Studies, Queen's University, Discussion Paper 94-10, 1994) [unpublished] at 8; see also Paul A. Gompers & Josh Lerner, *The Money of Invention: How Venture Capital Creates New Wealth*

Innovative businesses are, however, unlikely to be structured as income trusts: if all available cash is invested in invention, they cannot provide the necessary distributions. Therefore, in terms of general policy choices, recognizing the social waste from capital misallocation and the impressionability of retail investors in a bubble market, regulators should strive to implement policies such as tax reforms that neutralize incentives to invest high levels of capital in income trusts in order to take advantage of perceived benefits from preferential legal treatment such as tax savings. This makes it more likely that the pricing function of capital markets will allocate financial resources to businesses that can use them most productively.[195]

Corporate Law as the Minimum Standard for Quoted Trust Units

Given that the promise of high distributions is unlikely to effectively discipline managers[196] and given that market control over income trusts is inefficient due to the bubble characteristics, I recommend an asymmetric paternalistic approach.[197] I propose default rules that sophisticated investors can avoid but that are nonetheless binding on unsophisticated investors. Asymmetric paternalism has become common in securities regulation. With the assumption that sophisticated investors are less prone to irrational arguments than are retail investors, Canadian securities regulation exempts "accredited investors" from the prospectus requirement for public distributions.[198] The prospectus requirement is thus a default rule for retail investors.

What kind of default rule is most likely to solve the income trust problems? The problems that the "bad apples" provide to the market, and that were mentioned above, are similar to those that corporate

---

(Cambridge, MA: Harvard Business School Press, 2001); OECD, *The New Economy: Beyond the Hype*, Final Report on the OECD Growth Project: Executive Summary (Paris: OECD, 2001) at 12ff, online <http://www.oecd.org/dataoecd/2/26/2380634.pdf>.

195 One could argue that the actual success of income trusts in recent years furthers investor trust in capital markets, in general, and is thereby a good thing. However, this effect is unlikely to last longer than the bubble itself.

196 See "Debt as Discipline?", above at 62.

197 Colin Camerer *et al.*, "Regulation for Conservatives: Behavioral Economics and the Case for 'Asymmetric Paternalism'" (2003) 151 U. Pa. L. Rev. 1211.

198 See *e.g.* Ontario *Securities Act*, R.S.O. 1990, c. S.5, s. 72 [*OSA*], as supplemented by R.R.O. 1990, Reg. 1015 and as further supplemented and qualified by s. 1.1 of Rule 45-501 (2001) 24 OSCB 7011. The exemption is modelled after U.S. Regulation D, Rule 501, 17 C.F.R. § 230.501.

law deals with.[199] Corporate law works out and supplies rules that, if uniformly applied, will maximize the value of the corporate endeavour as a whole.[200] Although Anglo-American corporate law is primarily enabling or facilitative, mandatory rules are not objectionable per se. A basic framework of rules is necessary as a means of protecting the process of private ordering from abuse. A minimum of mandatory rules on investor protection is thus part of the value maximization through corporate law.

If negotiating trust indentures themselves, sophisticated investors would likely require entitlement to the minimum rights that shareholders have in ordinary corporations. In particular, the right to elect directors and the right to an oppression remedy would be introduced, both of which provide for direct influence on managerial behaviour that goes against investor interests. Thus, investment products that neither meet the minimum standards of corporate law, nor provide viable substitutes for these rights, are sub-optimally structured, as measured by the standard of wealth maximization as a whole. Being confronted with a sub-optimal offer, sophisticated investors would renegotiate, demand a discount, or refrain from the investment. Retail investors, however, might not understand the impact of the complicated trust structure on their investments, even though it is explained in lengthy prospectuses. This lack of sophistication accounts for my proposal that sales of income trust units the do not yield the same minimum rights to investors that are held by shareholders in a corporation should be restricted to "sophisticated purchaser[s] who [are] capable of protecting [their] own interests without legislative interference."[201]

Empower Investors to Approve Distribution Policy

North American corporate law has only recently begun to address the problem of managerial slack by empowering investors to decide upon distributions.[202] The fact that this development did not begin earlier is

---

199 See Robert H. Sitkoff, "Trust Law, Corporate Law, and Capital Market Efficiency" (2003) 28 J. Corp. L. 565.

200 Easterbrook & Fischel, *supra* note 134 at 35-36; for the UK, Robert Goddard, "Modernising Company Law: The Government's White Paper" (2003) 66 Mod. L. Rev. 402 at 406ff.

201 Jeffrey G. MacIntosh & Christopher C. Nicholls, *Securities Law* (Toronto: Irwin Law, 2002) at 177.

202 Though in theory American corporate law enables shareholders to propose special rules, the process necessarily requires the involvement of regulators, insofar as dividends are concerned. For example, shareholders of Cisco Systems, Inc. recently launched a shareholder proposal to vote on the declaration of a quarterly dividend. See Cisco Systems, Inc., 2002 Fed. Sec. L. Rep. (CCH) at para. 78,330 (avail. 19 Sept 2002). In Potlatch Corp., 2002-2003 Fed Sec. L. Rep. (CCH) at para. 78,450 (avail. 18 Feb 2003) shareholders proposed that the board prepare a report explaining a

probably due to the United States' focus on high-growth firms. In the absence of bubble characteristics, high-growth firms have fewer problems related to managerial spending on private returns than do low-growth firms. High-growth firms typically have much less free cash compared to low-growth firms, which have relatively fewer profitable projects in which to invest. Hence low-growth firms experience liquidity restraints that can effectively discipline against managerial slack. VCs take advantage of this disciplining effect by purposefully infusing capital in stages in order to limit the free cash available to management.[203] When those promoting investment in low-growth firms structured as income trusts cite the benefit of reduced managerial slack through distribution policies that create liquidity restraints, those promoters fail to account for the essential fact that managers of the underlying low-growth business usually decide upon the distribution policy and have the discretion to change it. This discretion is likely to offset the effect of the high-yield promise in the prospectus once the firm has failed to meet its payout promise.[204]

One might be tempted to suggest that managerial slack could be reduced by structuring income trusts in a way that leaves management with no discretion over distribution policies. However, this would not be advisable. In order to avoid bankruptcy, as was the case with many management buyouts during the 1980s, even low-growth businesses need flexibility. As an intermediate solution, regulations could be implemented declaring that investors must decide upon, or at least ratify, the distribution policy of the income trusts in which they invest. Like dividends, proposals to unitholders by management seeking to change the distribution policy would send a signal to the market furnishing valuable information that could result in efficiency-improving unit-price adjustments. Specifically, the trust indenture could stipulate that managers need to pay out at least 85 per cent of the cash flow within one year. Managers would have the flexibility to pay out more in profitable quarters and less in unprofitable quarters, as long as they pay out 85 per cent of the annual cash flow.

---

corporation's past and current dividend policy. In both cases, the SEC staff declined permission to omit the proposal from the management's circular, pursuant to Rule 14a-8(i) of Regulation 14A under the *Securities Exchange Act* of 1934. In European companies, the right to decide upon how to use profits of a corporation is usually vested in *shareholders*, see ss. 119 (1) Nr. 2, 174 (1) AktG (Germany); Art. L. 232-11, 232-12 French Code de Commerce; Art. 102 of Table A to British Companies Act of 1985.

203 Sahlman, *supra* note 102 at 507.

204 See "Debt as Discipline?", above at 62.

Changes to such policies should require approval by unitholders. Although investors are likely to follow managerial proposals in the proxy circular, sudden changes will require a satisfactory explanation. Furthermore, under the concept stated above (corporate law as the minimum standard for quoted trust units), changes may affect the re-election prospects of managers.

Avoid Limits on Institutional Holdings

In order to achieve rational market pricing, institutional investor participation, particularly that of pension funds, is necessary in the market for income trusts. Consequently, promulgators should avoid any limit on institutional investment in income trusts, such as the limits included in the federal government's later-withdrawn proposal in the spring of 2004. Assuming that the government heeds this policy recommendation, and assuming that all of the other policy recommendations I have advanced are respected as well, then the market may be able to determine whether the costs incurred in restructuring a business into an income trust (including consulting fees), in addition to the costs incurred in repeat issuances of units to raise capital for new projects, are in total an amount that is likely to offset any beneficial tax treatment of investment in income trusts. If such a determination could be made both repeatedly and reliably, capital market pricing of income trust units would be much more efficient, incorporating more accurate information about the real net value that these business structures generate. As evidenced by the assumption at the outset, such an efficiency-improving calculation is premised upon a greater share of institutional investment in the market for income trusts. However, the claim that an increase in the participation of institutional investors would check the income trust bubble is debatable. The quality of some underlying businesses will attract more institutional investors than today, while institutional investors will avoid investment in other opportunities. Under the conditions stated in this article, however, if institutional investors avoid investing in certain income trusts, there will be no excuses other than concerns relating to the underlying business.

Broker and Mutual Funds Regulation

Finally, regulators must increasingly watch broker-dealers' and mutual fund managers' conduct. Broker-dealers need to be watched as a means of protecting retail investors from the marketing of investment products on a broad scale to investors for whom the opportunities are inappropriate. Mutual funds, meanwhile, should be monitored in order to avoid an over-supply of investment capital into narrow markets. I have held that the complex structure of income trusts strongly encourages vendors to exaggerate arguments for investment in these entities and, further, that mutual funds acquire more cash than can be invested in good investment opportunities, thereby driving the prices of income trust units higher than what is justifiable upon a fundamental valuation. The incentives of the securities industry to drive up the prices of securities do not primarily regard idiosyncrasies of income trusts. Both problems have been recently addressed by promulgators,[205] but a few issues in particular should be considered by regulators.

With respect to broker-dealers, regulators should require that retail investors receive information about the specific risk and governance structure of income trusts. In particular, prospectuses and brokers must clearly explain the equity-like risk structure and the preconditions of tax advantages to investors. While recent prospectuses disclose these risks, I have some doubts as to whether brokers present these details explicitly when selling income trust units; if they did, the public perception of a bond-like risk structure would not exist in the first place. Furthermore, the prospectuses may contain declarations with regard to intended splits between retail and institutional investment from the planned allotment in an income trust IPO. Broker-dealers should be required to inform retail investors about this split and about the ratio of institutional-to-retail investment in securities with a similar risk structure. In particular, broker-dealers should be required to disclose to investors that a lack of institutional investors may result in lax oversight of management, as compared to corporations.

With respect to mutual funds, two measures may help investors understand the correlation between soaring unit prices and the mutual fund industry. First, as a precondition for purchasing mutual funds, investors should receive information with respect to the (projected) volume of IPOs in the market for specific securities, as compared to the amount of cash that flows into the relevant funds. This, in general, requires a strengthening of the disclosure rules with respect to the fund industry. Second, retail investors should receive a mandatory explanation of the

---

[205] See Ontario, Ministry of Finance, *Five Year Review Committee Final Report – Reviewing the Securities Act (Ontario)* (Toronto: Queen's Printer for Ontario, 2003) c. 19 ("Mutual Fund Governance"). Furthermore, the Supreme Court of Canada dealt with broker liability, for example, in *Laflamme v. Prudential-Bache Commodities Canada Ltd.*, [2000] 1 S.C.R. 638; *Hodgkinson v. Simms*, [1994] 3 S.C.R. 377; the Ontario Court of Appeal in *Anger v. Berkshire Investment Group Inc.* (2000), 141 O.A.C. 301.

possible effects of capital oversupply in narrow markets. Rational investors, however, may nevertheless invest in funds with excess financial resources in order to cash in the short-term gains that a capital oversupply in a narrow market (almost) guarantees. Consequently, the other measures which I have proposed in this section remain important.

VI CONCLUSION

The current income trust boom has striking similarities to the tech bubble of 1999 and 2000. Specifically, overstated marketing arguments induce unsophisticated retailers to invest in businesses which might not be able to benefit from the income trust structure. As a consequence, the income trust boom exhibits characteristics associated with a bubble: story leverage; opportunistic support by interested parties; and overoptimistic retail investors. In order to prevent the bubble from bursting, four steps need to be taken: first, avoiding tax incentives for investments in low-growth businesses; second, structuring trust law to require governance controls equivalent to those mandated by corporate law if the units are to be issued to the public, while restricting investments in trust units that do not meet this condition to sophisticated investors; third, empowering investors to decide upon the distribution policy of a trust; and fourth, avoiding limitations of pension fund holdings in income trusts. Furthermore, a strict approach in regulating broker-dealers' and mutual fund managers' sale practices is apt to augment the aforementioned measures. Income trusts can provide benefits to investors, to businesses, and to the economy in general, but only if they develop with the support of some of the enabling and guiding mechanisms of well-functioning capital markets and sophisticated regulatory regimes.

Heinrich-Heine-Universität Düsseldorf
- Juristische Fakultät –
Arbeitspapiere des Instituts für Unternehmensrecht

Heinrich-Heine-University Duesseldorf / Germany
- Faculty of Law -
Center for Business and Corporate Law Research Paper Series (CBC-RPS)

http://www.cbc.uni-duesseldorf.de/

Autor / Author (E-Mail): ***Dr. Dirk Zetzsche, LL.M.***

E-Mail: dirk.zetzsche@uni-duesseldorf.de

Titel / Title: **The Need for Regulating Income Trusts: A Bubble Theory**

Previously CBC No: CBC-RPS 0008 (10/2004)

SSRN Nummer / Number: http://ssrn.com/abstract=651421

Schlagworte / Keywords: income trusts, income deposit securities, tech bubble, bubble, pension funds, hedge, mutual funds, broker-dealers, bankruptcy threat, tax incentives, cash returns, debt security, equity security

JEL Classifications: D40,E32,G10,G12,G14,G23,G24,G28,G30,G32