Phoenix or Soufflé?
The Economics of the Rise, Fall and Second Rise of the National Scheme

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Abstract: In Wakim, the High Court decided that Commonwealth legislation was incapable of consenting to the conferral of state jurisdiction on the Federal Court. In Hughes, the High Court decided that Commonwealth legislation could accept the conferral of the power to prosecute offences under state law only where a head of legislative power supported the enactment. This article uses economic analysis to show that the decision in Wakim is less problematic than that in Hughes simply because of the availability of state courts, whereas Hughes's flaws arise from its attempt to lock states out of the enforcement and administration of corporate law. I argue that in light of these constitutional impediments, Australia needs more thorough reform to give states a more active role in legislation, administration and enforcement.

Introduction

An American Professor of Law once said to me that he had heard that the only reason Australia had a federal system of government was to provide the basis for interstate football competition. The political significance of the Australian states has been diminishing over the first century of federation. The reasons for that are many and varied, but two of the main ones are taxation, in particular the so-called vertical fiscal imbalance, and an increasingly centralist High Court. It is remarkable, therefore, that the impending fall of the national scheme for corporations occurred as a result of a much narrower and literal reading of the Constitution, and against the backdrop of the introduction of the Goods & Services Tax, which is meant to correct partially the VFI. Trying to understand the economic consequences of the fall of the national
scheme is difficult in several ways. First, the precise degree of damage to the national scheme inflicted by the High Court is still unclear in various ways. So far as the question of federal court jurisdiction, post-Wakim¹ the complexity of accrued jurisdiction makes the Federal Court’s precise jurisdictional parameters unclear. So far as the capacity of the Commonwealth to allow the Director of Public Prosecutions to enforce the state laws, post-Hughes² it remains to be seen which provisions of the Corporations Law fall through the cracks of the heads of power in section 51.

Second, an economic analysis of these events depends on what comparison one is drawing and how much of the political environment one is prepared to take for granted. Are we comparing the national scheme before a referral of powers but after Hughes and Wakim with the scheme after a referral of powers? Or is the comparison between the national scheme as it operated before any of the High Court decisions, and the national scheme after a referendum confers new legislative powers on the Commonwealth? Or may we consider, inconsistently with the American perception of Australian federalism, other solutions in which the states re-assert their role as more active legislators. For the purposes of this paper, I take a perspective which takes a less constrained view of the workable alternatives to the national scheme. My justification, if I need one, is that a High Court judgment which limits the means of centralising the making, enforcement and adjudication of law deserves a response that does not assume that further centralisation is needed, just as one who is drowning rarely needs more water. My method in this paper is to consider the implications of each of the recent developments in this unfolding constitutional episode as an issue in its own right.

In this paper, I discuss first the economic issues that Wakim raises associated with the impossibility of vesting state jurisdiction in a federal court. Second, I discuss the issue that

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¹ Re Wakim Ex parte McNally (1999) 163 ALR 270.
Hughes raises, which explores the capacity of the states to confer, and the Commonwealth to accept executive power on a federal instrumentality to enforce state laws. The third part of the article returns to the proposed and other possible solutions in more detail.

Jurisdictional Questions After Re Wakim

ReWakim decided by majority that courts of federal jurisdiction could not be invested with state jurisdiction, as the cross-vesting legislation attempted to do (both the general legislation and the specific provisions in the national scheme corporations legislation). The states were incapable of vesting the jurisdiction and the Commonwealth was incapable of consenting to the exercise. This prohibition flowed from the fact that the Constitution allows state courts to be invested with federal jurisdiction but is silent on the reverse possibility. Gummow and Hayne JJ, with whom Gleeson CJ and Gaudron J agreed, posed the dispositive question in terms of whether Commonwealth law permitted or required federal courts to exercise state jurisdiction. In their opinion, and having regard to R v Kirby; ex parte Boilermakers’ Society of Australia, the matters enumerated in ss 75 and 76 exhaust the manner in which the judicial power of the Commonwealth might be vested. Gummow and Hayne JJ also did not think that a legislative head of power to vest state jurisdiction in federal courts could be found in the incidental power (either s 51(39) or by implication from s 71). That is because the laws would have to be incidental to the exercise of the judicial power given in Ch III. It is not necessary to the exercise of Commonwealth judicial power that federal courts be conferred with state judicial power.

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2 The Queen v Hughes [2000] HCA 22.
3 The general cross-vesting scheme is established by the Jurisdiction of Courts (Cross-vesting) Act 1987 (Cth) and by mirror legislation in each State. The scheme took effect in 1988. In addition, the national scheme for corporations also provides for cross-vesting of jurisdiction: see Corporations Act 1998 (Cth), s 56 and Corporations [State] Act 1990, s 42 in each State.
4 Constitution s 77.
5 (1956) 94 CLR 284.
7 Ibid at 135.
Wakim like Hughes has two sets of consequences. The first set of consequences, which I discuss in this section, is the immediate effect in the current political-legal equilibrium allocation in the federation. The second set of consequences, which I discuss after the section on Hughes, relates to the effect of potential shifts between political-legal equilibrium states — in effect, the future solutions for the woes of the national scheme. I consider Wakim in this way because its immediate effects illuminate the justifications of larger equilibrium shifts.

The immediate effects of consequences all relate to the jurisdictional insecurity of the Federal Court in the national scheme. They can be subdivided into the past, the present, and the (near) future. First, the orders of the federal court that have been made in the past are potentially invalid, since the court lacked jurisdiction to make orders. This would be a very real worry, had it not been addressed by state legislation validating federal court orders. There are of course costs associated with the enactment of that legislation but those costs have already been sunk, unless there are to be further constitutional challenges to this legislation. Thus, this matter need not worry us much.

Second, the present insecurity of the federal court’s jurisdiction has required transfers of cases pending before it to state courts. Again, there are clear costs associated with this because civil procedure steps are not perfectly interchangeable between forums. Thus, there are inevitable waste and delay costs. I analyse below whether these costs will recur in future litigation once parties understand the implications of Wakim for the validity of forum choice. For existing litigation, however, they are simply an unavoidable transitionary cost.

Third, there may be costs associated with the future choice of the federal court as a jurisdiction for corporation cases. In recent years, the federal court has become the pre-eminent forum for corporate cases. It has the advantages of good civil procedure, a nation-wide

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8 See, eg, Federal Courts (State Jurisdiction) Act 1999 (NSW).
jurisdiction, and competent judges. The decision in Re Wakim does not eliminate the federal court as a jurisdiction. This is because a federal court can exercise state jurisdiction under the associated or accrued jurisdiction doctrine, if the issues arising in state jurisdiction form part of a single justiciable controversy over parts of which federal jurisdiction arises. What this means, however, is that there are significant uncertainties associated with the invocation of its jurisdiction. This issue cannot be dismissed as the last two issues could.

I want to provide a very simple model of these cost influences. Let the plaintiff’s costs of litigating in court $k$ be called $P_k$. Let the defendant’s costs of litigating in court $k$ be called $D_k$. In the case of interest to us, the litigation may occur in either the federal court, which I will denote by subscript $f$, or a state supreme court, which I will denote as $s$. If the plaintiff commences in the federal court, the defendant has the option to challenge its jurisdiction over the case as not lying within accrued jurisdiction. Let the probability of a challenge being made by the defendant be called $K_f$. I assume that $K_f$, which describes the defendant’s willingness to challenge, is a function of the probability that the court’s jurisdiction will be successfully challenged (let this be called $J_f$) and the costs of the challenge (which includes the cost of appeals and so on) to the defendant (let this factor be called $C^d_f$). I assume that $\frac{\partial K_f}{\partial J_f} > 0$ and that $\frac{\partial K_f}{\partial C^d_f} < 0$. That is, the probability of a challenge rises as the probability of a successful challenge rises, and falls as the cost of a challenge rises. Moreover, if jurisdiction is challenged successfully, further costs must be incurred to recommence in the state court, and the costs incurred in the federal court up to that point are wasted. These can be treated as part of the costs of the

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10 This section is a simplified and adapted version of my modeling of civil procedure in private international law cases in my unpublished paper, “Choice of Forum, the Stay Application, and Jurisdictional Trade: An Economic Model of International Litigation”.

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challenge for each party, \( C_f \) for the defendant, and \( C_p \) for the plaintiff. Thus, the total costs to the plaintiff of choosing the federal court \( (T_f^p) \) can be defined thus:

\[
T_f^p = K_f J_f P_s + (1 - K_f J_f)P_f + K_f C_f^p
\]

The total costs to the plaintiff of choosing a state court \( (T_s^p) \) can be defined similarly. However, under the cross-vesting legislation, it is effectively impossible to successfully challenge the jurisdiction of a state court. Thus, whereas post-\text{Wakim}, \( J_f > 0 \), \( J_s \) continues to equal zero. Since \( K_s = f(J_s) \), and \( \frac{\partial K_s}{\partial J_s} > 0 \), I assume not unreasonably that \( K_s(0) = 0 \) and that \( K_s C_s^p = 0 \). Thus:

\[
T_s^p = P_s
\]

The plaintiff will choose forum \( k \) to minimise \( T_k^p \). If the federal court is the more efficient forum in the sense that its costs are lowest (translating its aforesaid advantages into pecuniary terms), then it must follow that \( P_f > P_s \). Notwithstanding that, the plaintiff will choose a state court where \( T_f^p > T_s^p \) which occurs where:

\[
P_s < K_f J_f P_s + (1 - K_f J_f)P_f + K_f C_f^p
\]

\[
P_s - P_f < K_f J_f (P_s - P_f) + K_f C_f^p \quad \text{(Rewriting)}
\]

\[
1 < K_f (J_f + \frac{C_f^p}{P_s - P_f}) \quad \text{(Dividing both sides by } P_s - P_f\text{)}
\]

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This means that where this inequality holds, the plaintiff will choose the state court, despite its higher costs of resolving the suit. Because \( \text{Wakim} \) has the effect of increasing \( J_f \) across a broad range of cases, inefficient forum selections will be made more often.

A second source of inefficiency is that parties, wishing to litigate in the federal court, attempt to attract its accrued jurisdiction by altering the case they plead in order to include some clear issue which raises federal jurisdiction, such as a section 52 action under the Trade Practices Act. Thus, overpleading may be encouraged, which raises additional costs associated with legal advice and resolving the matter.

Having raised these issues, which encapsulate a more formal version of the common intuition, we should note that the reasons for the federal court's superiority are by no means "forum-specific", in the sense that the advantages are either unable to be emulated or that the investments in this superiority are wholly unsalvageable. In other words, the measure of deadweight costs, \( (T_f^p - T_f^p) + (T_f^p - T_f^p) \), is not an exogenous variable. Judicial expertise is highly portable, especially for national law. A good Federal Court judge will be a good Supreme Court judge. Other states can appropriate this expertise simply by paying more for good corporate judges or recruiting federal court judges. Innovations in procedure are also easy to copy. Many American States adopt legislation shadowing changes to Delaware law. As economists have pointed out, Delaware's competitive advantages don't lie in its statute, but in the reliability of its judges.\(^\text{12}\) Only the federal court's nation-wide jurisdiction is genuinely irreplaceable, but it remains a wholly empirical question how valuable those properties actually are when state supreme courts have no jurisdictional hiatuses under the unaffected parts of the cross-vesting legislation.

If, as I posit, states are able to emulate the advantages of the federal court in corporate adjudication, it remains unclear whether they have the incentive to do so. It is difficult to see what the state gets out of increased corporate litigation. In particular, what does a state get out of subsidising a litigation system which is sometimes for the benefit of out-of-state residents? Having said that, the Federal Court’s own incentives in this respect were never particularly clear. It is true that it did not need to worry about conferring benefits on those out of the jurisdiction, because its jurisdiction was national. On the other hand, the benefits to it were relatively limited. We should not discount the relevance of subsidiary motives such as the judicial desire for peer prestige and for the relative panache of corporate cases (compared, say, to criminal law) as a potential basis for a forum wanting to be the pre-eminent corporate jurisdiction. It may be that judges will therefore lobby for these resources and opportunities.

It may also be the case that an incentive influencing the Federal Court in obtaining the “first mover advantage” under the national scheme, prior to Wakim was the federal government’s desire to maintain its constitutionally tenuous in corporate law, and, if possible, to enhance it. Investing a substantial amount of expertise in federal instrumentalities that it cannot salvage if it loses its power may be a way of doing this. Such an investment increases the dislocating effect if the constitutional position is challenged successfully — which is exactly the position we are in now. The Commonwealth has, like William the Conqueror and Hernan Cortés, burnt its ships by investing in the human capital of its judges and in the expertise of the ASIC. If this is convincing, it suggests that any solution to the Wakim problem should not give the Federal Court a monopoly over litigation, because of the risk that its monopolistic position can then be abused by decreasing the quantity and quality of adjudication supplied.

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A further source of incentive with respect to the states to improve procedure is the legal profession itself and its desire to increase the number of instructions available to it. With the present inactivity of the federal court, the state supreme courts must take a more substantial role in corporate adjudication. State-based firms with significant corporate practices, and, depending on structure, the local offices of national firms will seek to improve the quality of corporate adjudication in state supreme courts so as they do not lose litigation to other states. To return again to the instance of Delaware, lawyers are important interest group affecting corporate law, its legislation production and its judicial administration.14

We have already seen the Supreme Court of New South Wales position itself as a front runner for pre-eminence, which it is well placed to do because of the depth of knowledge and experience of judges like Justices Austin and Santow.15 Thus, the deadweight costs imposed by the federal court’s jurisdictional insecurity may not be anywhere near as large as might previously be thought.

One of the risks of the new regime is that even if some courts rise to the challenge of improving their adjudication, some courts may do nothing. There may be opportunities for strategic litigation in these forums by a plaintiff, especially where it suits the plaintiff to delay the defendant and tie him or her down. This may enable the plaintiff to bring a “nuisance” suit solely to induce an offer of settlement, especially in circumstances where the plaintiff’s costs to prosecute are low and the defendant’s costs to defend are high.16 An obvious instance of this is the bringing of a derivative suit under the new law in Part 2F.1A of the Corporations Law since

there is a good chance that the plaintiff may obtain a costs indemnity. On the other hand, this is not a new risk. This has always been possible and Re Wakim does not make it any more likely. Wakim does not itself increase the risks of forum shopping. Defendants remain able to seek a transfer of proceedings under the cross-vesting provisions, just not to the federal court in most cases.

After considering Hughes, I evaluate some issues in relation to the “reform” of the law in relation to federal jurisdiction.

Enforcement Questions After Queen v Hughes

Hughes involved a prosecution brought by the Commonwealth Director of Public Prosecutions (DPP) against Hughes and another person, alleging that there had been a contravention of the former prescribed interest provisions of the Corporations Law. Specifically, the DPP alleged that the defendants (not being public corporations) had induced Australian investors to invest money through a securities firm in the United States.

In the national scheme, the Commonwealth Corporations Act provided that regulations could permit legislation, such as the Corporations Law enacted by the states, to confer functions and powers on prescribed Commonwealth authorities and officers. The WA Corporations Act provided that an offence under the Corporations Law was to be treated as a Commonwealth offence; to do that the legislation applied Commonwealth law, including the Director of Public Prosecutions Act, to offences thereunder. Thus, Western Australian law had conferred the necessary power on the DPP. The question, however, was whether as a matter of Commonwealth law, the DPP could be conferred with these authorities. Specifically, was there a

17 Corporations Laws 242.
18 See, eg, Corporations [State] Act s 44A(2).
19 Corporations Act s 46.
legislative head of power authorising the Commonwealth to accept the conferral of this state power? 21

First, the High Court discussed whether the exercise of power could be supported under the incidental head of power in s 51(XXXI), to the extent that the power was incidental to the execution of a power vested by the Executive Government under Ch II of the Constitution? In a previous case, Mason J had indicated that the executive power extended to entry into governmental agreements between the Commonwealth and the states on matters of joint interest. 22 The judgment of Gleeson CJ, Gaudron, McHugh, Gummow, Hayne and Callinan JJ does not express a concluded view on the subject apart from doubting that the “Parliament may legislate in aid of any subject which the Executive Government regards as of national interest and concern.” 23

Second, the joint judgment also refused to decide whether the exercise of power could be supported as an exercise of the corporations power. One possible argument to that effect was that only “financial corporations” had the privilege to deal in prescribed interests and engage in certain other forms of financial activities.

Third, the joint judgment supported the exercise of power by reference to the provisions of s 51(i), in particular, matters of trade and commerce with other countries, and given the relationship to transactions occurring outside Australia, the external affairs power of s 51(XXIX). 24 The court added an interesting qualification. After noting that the definitions in relation to the offering of prescribed interests were drawn to operate “in Australia or elsewhere” or “in

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20 Corporations (WA) Act ss 28, 29.
21 [2000] HCA 22 at 34.
22 R v Dunn; Ex parte Australian Iron and Steel Pty Ltd (1983) 158 CLR 535 at 560.
23 Para 39.
24 Para 42.
[Western Australia] or elsewhere, the court said that “a law of the Commonwealth could not take these definitions as criteria of operation for a prosecution unless they were read down to exclude purely domestic dealings of the proscribed varieties.” The question, therefore, is whether a transaction in, say, prescribed interests which was not international but was interstate could be upheld as valid. It seems that if s 51(i) can uphold transactions of trade and commerce with other countries, then, by its wording it should be able to uphold transactions “among the States”. Only those transactions that occur exclusively within the bounds of a single state would be immune from the reach of s 51(i).

Thus, the greatest concern associated with Hughes is the uncertainty as to which provisions fall outside the scope of the provisions of s 51 of the Constitution. We know from the Incorporation Case that it lies outside the power of the Commonwealth to make laws with respect to the incorporation of companies. But under what circumstances are prosecutions ever brought in relation to the incorporation process? There may be cases brought in the context of incorporation, in particular securities offerings, where the law implicated arises in Part 7. But in most cases the offeror corporation has already been incorporated (which would be likely to support legislation under the corporations power), and, unless the securities offering is confined to state borders, the transaction is likely to fall under trade and commerce among the states. Most of the core corporate law issues in chapters 2A to 2M, such as directors’ duties, members rights, and so on, would be legitimated by the corporations power. Likewise, matters under chapter 5 would seem to fall under the insolvency head of power. Takeovers in chapter 6 seem to fall under the corporations head of power. The most problematic issues seem to relate to securities and the futures industry. It would be difficult to see, for example, how the licencing of

25 Formerly Corporations Laws 1064.
26 Para 43.
27 New South Wales v The Commonwealth (The Incorporation Case) (1990) 169 CLR 482.
28 Constitution s 51(xvii).
securities dealers (particularly natural persons) would be upheld in general terms, except on a broad reading of the trade and commerce power. The prohibitory provisions with respect to market manipulation, insider trading and so on are not quite as problematic because they could presumably be seen as an exercise of the corporations power, at least in the context of dealing in corporate securities.

What are the economic consequences of the uncertainty about these provisions? Again, I will restrict my comments to the current state of affairs prior to any attempt to address longer term solutions. First, corporate law in Australia is thought to rely more on public enforcement than it does on private enforcement. The doubts about the capacity of the DPP to prosecute certain contraventions of the Law fundamentally effect those provisions. However, without new legislation, there is no simple solution lying in the state Director of Prosecutions filling the gap in cases where Commonwealth legislative power does not support the conferral of prosecutorial power on the DPP. As regards the domains of the Corporations Law in which Commonwealth legislative power is lacking, I do not think that the injunction provision in s 1324 can be used as a substitute means of restraining potential violations at the suit of the ASIC. The capacity of the ASIC to bring suit under state law still depends on the existence of a Commonwealth law requiring it to exercise that power. Clearly, the states cannot step into any gap, without amending their legislation to deprive contraventions of the legislation of their character as offences against Commonwealth law. Hughes is therefore very different to Wakim where the state courts are alternatives to the federal courts.

Before we can conclude that this situation is unreservedly problematic we need also to consider what will happen in the absence of public enforcement. This is in effect a question about the economic effects of regulation in the areas in which Commonwealth legislative

competence is lacking. This is a massive question to answer — too difficult to answer in a brief article. There may be various aspects of the law in this area which show interest group influences. For example, the regulation of securities dealers is likely to reflect the interests and preferences of securities dealers. This is a claim made by the economics of regulation.30 Likewise, many of the more paternal provisions in this area are probably unnecessary if investors act rationally, or as a result of the presence of reputational constraints. Private enforcement may in some cases be an effective substitute given the possible availability of privately enforced causes of action (including actions under the injunction section) available to them under the Corporations Law or elsewhere.31 Those interest groups who gain from rent-protecting provisions of current legislation — for example, licenced securities dealers — may themselves take a role in its enforcement. The effect of Hughes equates to the social benefits of the use of criminal law and public enforcement in these domains, either to deter opportunism or to litigate in cases where the social benefits justify litigation but the private benefits don't.

The situation is therefore a very complex one — much more so than the commentary in the media, with its “sky is falling” overtones leads one to believe. It depends on the constitutionality of each provision of the Corporations Law in which the Commonwealth instrumentalities are involved and its welfare calculus. That welfare calculus depends on whether the provision increases welfare or functions redistributively, and whether the provision can be privately enforced, without imposing additional deadweight costs. I discuss solutions to Hughes in the next section of this paper.

31 See, eg, Corporations Law ss 798-805.
After the Fall

The problems created by the High Court’s decisions in *Wakim* and *Hughes* do not lend themselves inevitably to a single answer. The appropriate response depends in large part upon one’s commitment to federalism in corporate law and the effect of state involvement in a regulatory scheme. When *Hughes* was decided, three principal answers were available to the Commonwealth. The first is a referendum which gives the Commonwealth power to regulate corporations and securities which is substantially wider than the current corporations power in s 51(xx). The second is a referral of powers by the states under s 51(xxxvii) to enable the federal government to legislate. The third is to work within constitutional limitations and accept a more substantial involvement on the part of the states. We know now that the Commonwealth and the States have agreed to the second provisionally, on the basis that there will be attempt to use the first option, the constitutional amendment, as a longer-term solution. At the time of writing, the text of the referral of powers legislation is not yet settled. I discuss these, after first discussing the economic relevance of political structure to corporate regulation.

Economic Analysis

In the context of a federal system, such as Australia’s, where would one ideally prefer to locate the responsibilities for regulating corporate law?³² Whereas the momentum of opinion in Australia has converged on the proposition that the responsibility should be at the federal national level, that is not true of the other principle Western federations, in particular Canada and the United States, where responsibilities have been shared between the levels of the

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federation. The principal arguments for national law are, first, that it addresses an externality concern. In particular, it prevents states from passing laws the benefits of which are retained locally, and the costs of which are borne substantially out of the state. An example might be a Victorian law which protected Victorian incorporated companies against hostile takeovers. There would be few out-of-state beneficiaries, but where shareholders are located in other states, the costs would be externalised. The flip-side is that public enforcement activity may be discouraged where the beneficiaries exist out of the state. Nonetheless, this sort of argument is not a bulletproof defence of national law. The structure of the federal system may often provide means to address externalities without imposing a single body of law. An important example is the decision by the United States Supreme Court that the first generation of state anti-takeover laws, which acted to protect in-state businesses, were unconstitutional. By contrast, the second-generation laws, which operated only with respect to companies incorporating within the state, were upheld as valid, since those not liking the laws had the opportunity to reincorporate at relatively low costs. Another possible means of addressing externality concerns is a provision such as section 117 of the Constitution, which protects residents against discrimination not applying to other residents. Finally, sensible choice of law rules, which the Commonwealth probably has the power to make under s 51(xxiv), can reduce the capacity of laws to operate unfairly.

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35 For a real-life example, see IM Ramsay, "Company Law and the Economics of Federalism" (1990) 19 F L Rev 169 at 194.
36 Ulen, supra n 34.
37 Edgar v MITE Corp, 457 US 624 (1982).
38 CTS Corp v Dynamics Corp 481 US 69 (1987)
Second, national law may have the substantial advantage of providing greater economies of scale in law-making and law-enforcement.\textsuperscript{39} A national government may therefore be more willing to invest in innovation and expertise than a state jurisdiction with fewer corporations in its domain. This argument is related to the last point about the difficulties states have in trying to internalise the benefits of their own administration. Ultimately, though, this is a question of incentives to innovate and provide first-class administration rather than differences in capacity. Delaware, the most innovative of all jurisdictions, is the second smallest states in the United States (after Rhode Island). Economic analysis has cited the greater abilities of smaller states, because they benefits they internalise from winning the race for competitions are proportionally greater than those for a larger state.\textsuperscript{40} The state's commitment to enact and maintain good laws is thus more credible than a larger state's. Moreover, if there are indeed economies of scale, those economies can still be achieved if the states actually pool some of the administrative tasks in front of them by delegating these responsibilities to a common administrator with the lowest marginal costs.\textsuperscript{41}

Third, there may be an advantage associated with uniformity of law and its enforcement. Many people criticised the cooperative scheme and its predecessors for resulting in a legal environment which varied from state to state. The national scheme has overcome that not so much by a single set of laws (which we have had since the cooperative scheme), but by way of a single administrator. Uniformity however is neither uncontroversially desirable nor exclusive to a system of national law. Uniformity can only be unequivocally good if there are homogeneous preferences for a single body of law. But unless we assume that the legislature is both omniscient and public-regarding, it is unlikely that the uniform law will be optimal law in the

\textsuperscript{39} Ramsay, supra n 35.
\textsuperscript{40} Romano, supra n 33.
\textsuperscript{41} Whincop, \textit{Political Economy}, supra n 32.
absence of options for parties to express their preferences by specific choice.\textsuperscript{42} One area in which this question has been specifically agitated recently is the need for uniformity in securities regulation matters, and particularly in requirements of mandatory disclosure. The debate has been inconclusive so far, with several authors arguing that choice in securities regulation would result in inefficient levels of regulation,\textsuperscript{43} while other authors argue that choice would be more flexible and overcome current inefficiencies.\textsuperscript{44}

Fourth, and related to the last point, a national system of law diminishes the capacity for the evasion of laws. This point depends on the need for particular laws to apply in mandatory fashion to all relevant subjects — a need that most economic scholarship does not recognise.

Two points need to be introduced to allow these issues to be balanced against each other. The first is that the capacity of the states to provide legal rules, administration and enforcement that is superior to those of a national government depends on state incentives. If states have strong incentives to compete for incorporations, as they do in the United States through the mechanism of franchise taxes, the argument for national governments to have a monopoly over law-making is untenable. There is strong evidence that choice in jurisdiction is beneficial to investors, and it seems to be associated with more enabling legislation. But the same fiscal incentive does not exist in Australia.\textsuperscript{45} States can only really gain from incorporation fees. States therefore have less incentive to want to attract incorporations. Moreover, if law-making is to be coordinated so that there are no substantive discrepancies between states, states can only then compete on the basis of their administration of the law. Moreover, many companies, especially

\begin{itemize}
\item \textsuperscript{43} See, eg, M Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment" (1999) 85 VaL Rev 1335.
\item \textsuperscript{44} See, eg, R Romano, "Empowering Investors: A Market Approach to Securities Regulation" (1998) 107 Yale LJ 2359.
\item \textsuperscript{45} Ramsay, supra n 35, Whincop, Political Economy, supra n 32.
\end{itemize}
those that are closely held may be inframarginal consumers of administrative quality; a sufficient
number of them may quash the incentive to innovate. The incentive to innovate and develop
expertise therefore seems somewhat limited, although it is not non-existent and it could be
intensified in various ways.

The second is that particular allocations of political power determine the scope and nature
of interest group activity. Under what circumstances is rent-seeking behaviour most likely to
influence the making of corporate law? Again, the answer to this question is not simple, as it
depends on a number of factors. First, it depends on the relative power of interest groups in
states versus federations. Interest groups may be particular influential in some states but not on
a national basis. In those circumstances, a national law — although highly desirable because of
its greater scope — may limit the capacity of that interest group to obtain legislation, because of
the inability to compete at the national level. So the distribution of interest groups is important.

Second, interest group activity depends on the cost to those who lose as a result of
particular legislative bargains to exit from the scope of that bargain. Where inefficient rules are
enacted as a result of interest group activity, those rules might be avoided if the parties have a
low-cost means to evade them. An obvious way is by reincorporation in some other jurisdiction
lacking that rule (assuming that choice of law condition the application of a state's corporate law
on the place of incorporation). The lower the cost of evasion (a demand-side influence), the
more pressure will be brought to bear on governments not to enact inefficient legislation. To
link with the discussion above, conditions may also exist for their to be supply-side competition

46 See BH Kobayashi and LE Ribstein, “Contract and Jurisdictional Competition” in FH Buckley (ed), The Fall
47 J Macey, “Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-
Choice Explanation of Federalism” (1990) 76 Va L Rev 265
48 Kobayashi and Ribstein, supra n 46
between jurisdictions to attract firms. Following Tiebout’s famous analysis, state law-making can therefore maximise social welfare by encouraging optimal law-making.\(^{49}\)

The national scheme laws on corporations are an interesting case-study in light of these considerations. As such, any benefits from interjurisdictional competition are foregone, at the price of uniformity and evasion. Of course the Commonwealth has the principal responsibility for legislative reform. However, the system depends on state support. It is at least arguable that the capacity of the Commonwealth to respond to interest groups that are influential at the Commonwealth level may be disciplined by the opposition of states in which the losers from any such interest group bargain may be, or become, influential. This may diminish the capacity of the federal government to indulge interest groups, compared to a model in which the cooperation of the states is not required. The states can do this in two ways. They can act in concert in order to block the Commonwealth’s attempt to change aspects of the law (other than takeovers, securities, futures, and public fundraising which are in the Commonwealth’s sole responsibility). This is difficult, because of the collective action required, but that is at least possible in some cases. Second, the state could desert the national scheme altogether, although they remain vulnerable to the risk of federal preemption under s 109 of the Constitution if they legislate independently. As I argue elsewhere in more detail, the unwillingness of the High Court to allow substantial liberty to the states and the Commonwealth to structure intergovernmental agreements, such as the national scheme, has the effect of discouraging these agreements.\(^{50}\) Instead, it restricts the states and the Commonwealth to more sweeping conferrals of legislative power, if they seek to centralise the law.


\(^{50}\) Whincop,
The Centralist Options

I now discuss the foreshadowed reforms to the national scheme. Agreement in principle has now been reached whereby the states refer to the Commonwealth the legislative power needed to address constitutionally doubtful aspects of the system. That would then enable the Commonwealth to assume full power for the regulation of corporations. That referral is to be for five years. In that time, the Commonwealth will propose a referendum for the amendment of the Constitution to expand the corporations power to a plenary grant with respect to corporations, financial markets, securities, and collective investments. Both the referral and the constitutional amendment are strongly centralist solutions. They represent relatively extreme forms of intergovernmental agreements, compared to the sort of deal cut in the Alice Springs Head of Agreement. Under the referral, the states are supposed to have continuing power over amendments to the Law; indeed, the Commonwealth now must win the support of four states for amendments, whereas before it required two. But these powers are only votes, and the Commonwealth remains in control of the reform agenda, which social choice theory treats as more significant. One possible effect of the higher level of support required is that the Commonwealth proposes more “fuzzy” standards or confers discretions on the ASIC, rather than delivering a more certain, precise legal rule.\(^{51}\)

More perplexing is the limitation of referral of power to a five year period. I can see the appeal of that as an interim arrangement if the only possible long-term solution was a constitutional amendment. But the notion that the Commonwealth must have plenary power with respect to all issues with respect to corporations has never been demonstrated except by assertion; moreover, the notion that one confers power until a referendum has passed is like a

\(^{51}\) A Schwartz and R Scott, “The Political Economy of Private Legislatures” (1995) 143 U Pa L Rev 595. However, that may not be the case because of possible logrolling (trading votes on other issues) between the states and the Commonwealth.
reference to a date *ad kalendas Graecas*\(^{52}\). In those circumstances, what happens if, at the end of that time, the Commonwealth has been unable — for instance, because of disagreements between the House of Representatives and the Senate — in gaining an appropriate referendum proposal that the state support? There is a risk that corporate regulation will waft and waver in a climate in which the constitutional basis for its support is constantly being renegotiated. There is also an obvious risk that if the Constitutional amendment is expected to succeed, the Commonwealth will mark time until then, when its costs of legislating falls. The system needs rather more permanence than the law currently has to offer. If the Commonwealth does gain a plenary grant of power, the law will need protection against the demonstrably erratic initiative demonstrated by the Senate in the context of the *Corporate Law Review Act*. The Senate is particularly prone to interest group effects given the pivotal role of minor parties that can form a minimum winning coalition in the legislature.

**The Federalist Options**

Because the conferral of legislative and enforcement power on Commonwealth is highly vexed, and because state competition has proven elsewhere to be highly suitable to corporate governance, a federalist system in Australia is both a desirable option economically and a realistic option constitutionally. The question, then, is what it would involve? I have developed these themes in much more detail elsewhere, describing an optimal allocation of powers between Commonwealth and State, before *Wakim* was decided,\(^{53}\) and various means for addressing the problems associated with *Wakim*.\(^{54}\) This is therefore a useful means of looking back on some of these themes and examining whether they are still legitimate.

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\(^{52}\) “On the Greek calends” was the Emperor Augustus’s sarcastic reference to something that would never happen: Suetonius, *Divus Augustus*, lxxxvii.

\(^{53}\) Whincop, *Political Economy*, supra n 32.

\(^{54}\) Whincop, *Trading Places*, supra n 32.
In my *Political Economy* article, I argued that state competition was preferred in most substantive areas of corporate law, particularly those which have the effect of operating between shareholders and managers. This enabled these parties to select the state of incorporation which maximises the value of the firm. That meant that most of the principal areas of corporate governance should fall within state competence. Areas such as insolvency, the regulation of securities exchanges and dealers, and the futures industry I argued were better suited to Commonwealth law. I argued that Commonwealth law had a number of desirable, non-substantive functions to play in such a system. The first was to allow the pre-selection of forums for the resolution of corporate cases. The second was to provide minimum standards for disclosure in takeover and to provide for some limits on anti-takeover legislation. The third was to provide some limited rights of compensation for minority shareholders in unlisted companies who vote against reincorporation in another state. The fourth was to provide limits on the capacity of states to change their own laws in a way that would alter the terms of the shareholder-manager relation by requiring the parties to opt into the change.

There is a certain irony in revisiting these conclusions after *Hughes*, because two of the areas which I thought most desirably regulated by the Commonwealth — regulation of securities exchanges and dealers and the futures industry — are probably the least likely to fall within Commonwealth competence. These areas do not obviously fall within a legislative power (unless it is s 51(i)), so they seem to depend on state application of laws and there must be doubts about the capacity of Commonwealth instrumentalities and authorities being conferred with powers by state legislation. It seems that the states should consider making a one-time grant of power to the Commonwealth to enable it to regulate securities dealers, securities exchanges, and the futures industry. I return to the terms of the referral later.

By contrast, the Commonwealth has power to legislate in most of the areas that I argued should lie within state competence, other than the rather minor topic of incorporation. On the
other hand, this is no problem if the Commonwealth competes with the states as a source of corporate law, much as the federal government competes with the provinces in Canada. The Commonwealth can do this by enacting its own laws, limited to the Capital Territory, but allowing parties to choose to incorporate there if they wish to come under those laws.

If companies choose to incorporate in the Capital Territory there is no reason why, in respect of those companies, and in pursuance of the territories power in s 122, federal jurisdiction cannot be conferred on the Federal Court. This was the gist of my Trading Places article. I argued that the only persuasive test of the advantages of the Federal Court is whether parties, having a free choice as to whether they would prefer to litigate chose to submit to the Federal Court’s jurisdiction. This could be done if legislation provided that the Federal Court had jurisdiction over issues arising with respect to companies incorporating in the Capital Territory. Those looking to incorporate would have to choose between Commonwealth law administered by federal courts and state law administered by state supreme courts.

The new question, then, is what effect Hughes has on this sort of scenario. Its effect is primarily on administration. The two principal questions here are these: first, who will administer and enforce a body of law in which both states and Commonwealth have active law making responsibilities, and second, how do we respond to enforcement and administration in those few areas in which federal law is desirable? As to the first question, I have indicated that I am dubious of the notion that uniformity is a goal that should be put before all else. Therefore, the notion that each state has a regulatory body of its own need not be troubling. ASIC would function as the administrator of companies incorporated under the law of the Capital Territory. The other states would form their own regulatory commissions to address issues of policy and to function as prosecutorial bodies for companies incorporated there. However, that need not preclude substantial inter-agency cooperation. Indeed, if there are economies of scale in enforcement and administration, the states may well agree to delegate substantial parts of the
work of their agency to a body like ASIC. Thus, by analogy with the theory of the firm, economies of scale in administration could be captured by contracting, rather than by formal integration. Of course, there is nothing to say that some of this work need even be done by ASIC or the public sector at all. For instance, monitoring, information collection, investigation and even some of the work done in developing policy might be contracted out to private sector bodies. As an experienced specialist commission with a long institutional memory, ASIC has advantages as a first-mover compared to other public and private bodies, but competition still seems possible in principle.

Second, what of those areas in which Commonwealth law is actually desirable, and public enforcement or administration is needed, but is arguably unsupported by a grant of legislative power? These are primarily the futures industry, securities exchanges and the securities industry. Here, we return to the problems we have already confronted concerning referrals of power and administration. The best means of addressing that is by a referral of power. I do not think that the referral should either be absolute or for a term of years as Williams has proposed. Instead, the referral should simply be on explicit terms that it is revocable by the will of the legislatures of three states. That accomplishes the necessary transfer of legislative power to the Commonwealth, but it provides the means by which the states can cancel the deal. It therefore allows the states to discipline the Commonwealth if the power is misused. On the other hand, it does not give any single state what is in economics called hold-out power — the opportunistic use of the right to withhold (or withdraw) consent.

To conclude, then, it is desirable to replace the national scheme with a much more thoroughly federalist scheme for matters affecting the central corporate contracts. The Commonwealth should regulate insolvency, securities and futures regulation, as well as providing

55 Whincop, Political Economy, supra n 32.
a series of structural devices to increase the integrity of the process of law-making and law-selection. The Commonwealth can achieve the necessary legislative power by a referral of power subject to a majority decision that the referral be revoked. In other matters, the Commonwealth should be permitted to function as a competing law-maker and law-enforcer with the states, which it can do by limiting its legislation to the Capital Territory and allowing corporations to incorporate in it and be subject to federal jurisdiction in the federal court. Each of the states would create a corporations commission and rely on its own prosecutorial authorities, who would be responsible for policy determinations, prosecutions, and other official decisions. Intergovernmental cooperation is possible and would be encouraged.

**Conclusion**

Australia's federal system provides a number of options for the diffusion or concentration of governmental power. Unfortunately, the leitmotiv of virtually all debate in this country for over a decade has been that only national, unified law can address issues of corporate governance and securities regulation. Experience proves that this is false. Although some federalist systems may be inferior to some centralist systems, the proposition is not an axiomatic one. *Wakim* and *Hughes* although lamentable enough decisions in their fussy literalism and their restriction on intergovernmental cooperation, demonstrate to us that we can no longer take national law for granted. It is constitutionally unsound, as well as monstrously convoluted in the legislation used to pull the rabbit of national corporate law out of a constitutionally empty hat.

The experience of *Wakim* shows that rivers do not turn to vinegar when the centralisation of the national scheme was sterilised. State supreme courts started to respond to available opportunities. The system endures because there is choice and competition. The experience of *Hughes* shows how problematic the national scheme was when it attempted to lock up prosecutorial functions at Commonwealth law — no choice or alternative remained. Since the constitution has proved resilient to formal amendment, we must work within its limits to provide
competition and choice, following models in which those attributes have proved practical and successful.