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CHOICE OF FORM AND NETWORK EXTERNALITIES

LARRY E. RIBSTEIN & BRUCE H. KOBAYASHI*

ABSTRACT

This Article provides the first detailed empirical analysis of firms' choice of organizational form. It provides important evidence on whether there is an efficient market in organizational forms or firms' choice of form is impeded by network externalities. We focus on formations of limited liability partnerships (LLPs) and limited liability companies (LLCs) in examining the effect of various factors on firms' choice of business form. Our data provides important evidence against the network externalities hypothesis. Because the LLP and LLC forms are similar except for the LLPs link to the existing "network" of partnership law, firms would prefer the LLP to the LLC form if network externalities mattered. In fact, we find that firms prefer the LLC form. Moreover, the reduced relative popularity of LLCs in states that impose entity taxes on LLCs but not LLPs, and the increased relative popularity of LLCs in states and years in which LLCs have particular inherent advantages, provide further evidence that the inherent characteristics of the two business forms, rather than network externalities, are driving choice of form.

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There have been significant changes over the last decade in organizational forms for closely held business associations. Prior to 1988, closely held firms had two major organizational forms from which to choose. The general partnership form was designed for very closely held or professional firms, and featured unlimited liability for owners combined with no entity-level tax. The corporate form combined limited liability with taxation at both the owner and entity levels unless the firm complied with the organizational and other requirements imposed by Subchapter S of the Internal Revenue Code.¹ There were many other organizational forms, most notably including the limited partnership, which combines limited liability for passive owners with flow-through taxation for closely held firms. In general, however, tax rules prevented firms from obtaining full-fledged limited liability without entity-level taxation.

The landscape changed in 1988 when the Internal Revenue Service (IRS) for the first time de-emphasized the link between limited liability and entity-level tax. This led to the rapid spread of two new organizational forms, the limited liability company (LLC) and limited liability partnership (LLP). These business entity forms allowed firms to combine corporate and partnership characteristics. The development of state business forms led to increased tax flexibility, culminating in the elimination in 1996 of any restrictions on the organizational rules firms had to adopt in order to avoid federal entity-level tax.

The recent proliferation of organizational forms raises important questions about why and how firms choose particular forms. On the one hand, firms may select business forms based on their business needs and the forms' inherent attributes. Under this theory, there is an efficient market for business forms, and the most successful forms are those that minimize firms' operating costs.² On the other hand, some kind of "lock-in" phenomenon may bind firms to business forms that are not best suited to their needs. Under this theory, removing or minimizing the impediment, for example by not

1. Generally, S Corporations are certain small businesses that are tax exempt at the entity level. I.R.C. §§ 1361-1363 (West 2000).

2. "Efficient" in this context means that firms make optimal choices in light of the tax and regulatory background, and not that the tax laws and regulations that drive choice of form are themselves optimal.

enforcing or narrowly interpreting some default terms of business associations or limiting firms' choices through uniform or federal laws, would increase social welfare. One particular type of lock-in phenomenon that the literature has emphasized is attributable to "network externalities." According to this theory, firms may stick with organizational forms that provide networks of case law, forms, and other materials even if a move to a new organizational form would otherwise better suit their needs.

The literature on choice of form so far has presented little if any evidence for or against any particular theory. A laboratory for testing theories of choice of form, specifically whether firms are impeded in moving to optimal forms, now exists, however, thanks to the relatively recent development of alternative organizational forms for closely held firms, changes in firms' choice of organizational form over a relatively short time period, and tax and other legal developments affecting choice of form. The quick spread of LLC statutes since the initial change in tax rules and rapidly increasing numbers of LLCs indicate that restrictive tax rules were the main impediment to efficient choice of form and that in a no-tax world firms will select the business form best suiting their needs. On the other hand, LLCs seem mainly to be replacing partnerships and there seemingly is no widespread migration from the corporate form despite the change in tax rules. This is despite the fact that corporate-type default rules apparently are inappropriate for closely held firms because they provide for centralized management and unrestricted exit. Thus, the persistence of incorporation may be because of network externalities.

We address these issues by presenting data on the choice between LLCs and LLPs. Our approach provides a more precise analysis of firms' reasons for choice of organizational form than has been presented so far. LLCs and LLPs are closely similar from the standpoint of tax and organizational rules except that the LLP is linked to the existing partnership law "network." Thus, our data enables a focus on the role of network externalities in the choice of form. The data indicate that the inherent characteristics of the business forms, such as their state tax implications, are much more significant factors in choice of organizational form than network externalities.

The Article proceeds as follows. Part I provides an overview of the recent history of choice of organizational form by closely held firms. In general, this history indicates that tax considerations play a major role in choice of form but that other factors may impede closely held firms from choosing the organizational form that is optimal in the sense of minimizing firms' operating costs. Part II discusses some possible impediments to choice of optimal form. Part III discusses data on the choice between the LLP and LLC forms that illuminate the role of tax and non-tax factors, particularly including network externalities, in the choice of organizational form. Part IV presents implications and conclusions.

I. THE RECENT HISTORY OF CLOSELY HELD FIRMS

The business association landscape for closely held firms once featured only corporations and partnerships. In general, this choice forced firms to make tradeoffs concerning three elements: asset partitioning, governance, and taxation.

The owners of most firms can be expected to prefer to separate their personal assets from their business assets. This involves restricting business creditors' recovery to business assets and not the owners' personal, non-business assets, a rule that is commonly referred to as limited liability,³ as well as permitting personal creditors to recover only out of personal assets.⁴ Although owners of many closely held firms offer personal guarantees to particular business creditors, they may still prefer default rules providing for both types of asset partitioning because of the costs of contracting for partitioning when the default rules are otherwise.⁵

3. Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 427-38 (1992) (discussing need for limited liability in closely held firms).

4. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 393-96 (2000) (distinguishing between "affirmative" and "defensive" asset partitioning).

5. Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 407-10 (1995). For a contrary views of the importance of limited liability in closely held firms, see generally Richard A. Booth, *Profit-seeking, Individual Liability, and the Idea of the Firm*, 73 WASH. U. L.Q. 539 (1995).

The corporate form provides for both types of asset partitioning, while state partnership law provides for neither.⁶

With respect to taxation, an incorporated firm is subject under Subchapter C of the Internal Revenue Code (IRC) to "double" taxation on profits at the corporate level and on distributions to the owners⁷ unless it elects to be covered by, and complies with, Subchapter S of the IRC.⁸ A partnership is generally subject only to an owner-level tax under Subchapter K of the IRC.

With respect to governance, partnership statutes are designed for closely held firms with only a few owners and illiquid ownership interests, while corporate statutes are designed for firms with many owners and liquid interests and are relatively unsuited for closely held firms. Default rules in the two types of firms reflect the basic tradeoff between exit and voice. Corporate shareholders can exit freely by selling their shares but have no direct say in management. Partners cannot transfer management rights without co-owner consent,⁹ but participate directly in management of the firm and approve important matters by unanimous vote.¹⁰ Reflecting the illiquidity of partnership interests and partners' personal liability for partnership debts, partnership statutes give each partner the power to dissolve at will.¹¹ Corporations can be dissolved only by majority shareholder and director vote.¹²

Thus, the traditional choice between corporation and partnership offered firms two extremes of organizational form. Choosing the corporate form involved a tradeoff of limited liability for entity-level taxation and default rules that were basically unsuited for closely held firms. Choosing the partnership form involved a tradeoff of default rules designed mainly for closely held firms and no entity-

6. The Unif. P'ship Act § 40 (1914), 6 U.L.A. 901 (1995), provides for priority of personal creditors in personal assets and business creditors in partnership assets. However, this rule was disregarded in bankruptcy and is not included in the Revised Unif. P'ship Act (1994), 6 U.L.A. (1995). Larry E. Ribstein, *The Illogic and Limits of Partners' Liability in Bankruptcy*, 32 WAKE FOREST L. REV. 31, 66-68 (1997).

7. I.R.C. § 11 (West 2000) (corporations subject to tax on their taxable income); § 61(a)(7) (requiring shareholders to include distributions in their income).

8. See *infra* notes 16-17 and accompanying text.

9. Revised Unif. P'ship Act § 27; Unif. P'ship Act § 503.

10. Revised Unif. P'ship Act § 401; Unif. P'ship Act § 18.

11. Revised Unif. P'ship Act § 801; Unif. P'ship Act § 31.

12. E.g., DEL. CODE ANN. tit. 8, § 275 (1991).

level tax for features that many closely held firms would not want, including personal liability¹³ and dissolution-at-will. This basic relationship is depicted in Table 1.¹⁴

The organizational form landscape first began to change with the development of corporate law provisions designed for closely held firms. This involved developments at both state and federal levels. State legislatures passed special close corporation provisions, which applied default rules appropriate for close corporations, including share transfer and dissolution provisions, as well as clarifying close corporations' ability to opt out of standard corporate terms such as requirements for management by a board of directors and annual shareholders' meeting.¹⁵ These provisions applied to firms that both elected coverage in their certificates and met certain qualifications intended to bar access by publicly held firms.¹⁶

At the federal level, beginning in 1958, corporations were permitted to elect taxation under Subchapter S of the Internal Revenue Code. This section generally provides for partnership-type tax for relatively small firms (restricted to 75 owners)¹⁷ meeting requirements for simple capital structure (i.e., one class of stock)¹⁸ and type of shareholders. By restricting partnership-type taxation to the smallest and simplest firms, Subchapter S minimizes revenue loss and offers relatively little opportunity for manipulation. Meanwhile, the largest firms—those that have liquid markets for their shares—are subject to the corporate tax regardless of organizational form.¹⁹ One important difference between

13. As to the unsuitability of personal liability for many closely held firms, see Ribstein, *supra* note 3.

14. Tables 1 through 5 may be found *infra* pages 129-40.

15. For general discussions of close corporation statutes, see F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS (3d ed. 1986); Dennis S. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207 (1980); Dennis S. Karjala, *An Analysis of Close Corporation Legislation in the United States*, 21 ARIZ. ST. L.J. 663 (1989); Tara J. Wortman, Note, *Unlocking Lock-In: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362 (1995).

16. For a summary of types of provisions, see LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS 189-90 (3d ed. 1996).

17. I.R.C. § 1361(b)(1)(A) (West 2000). The original limit of 35 was raised to 75 by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1301, 110 Stat. 1755, 1777 (1996).

18. I.R.C. § 1361(b)(1)(D).

19. I.R.C. § 7704(a) (providing that a "publicly traded partnership" is taxed as a

partnership-type taxation under Subchapter K and taxation under Subchapter S is the relative difficulty in the latter case of stepping up the basis of firm property and thereby avoiding tax on the appreciation.²⁰

A big part of the business form story is the rapid rise of the limited liability company (LLC). The LLC began in Wyoming in 1977.²¹ In 1988 the IRS approved partnership tax treatment of LLCs organized under the Wyoming statute.²² Thus, for the first time firms could have full-fledged limited liability without a separate entity-level tax.²³ This triggered the rapid spread of LLC statutes²⁴ and increases in new formations of LLCs beginning in the early 1990s.²⁵ Within eight years of the 1988 tax ruling, all states had adopted LLC statutes providing for recognition of foreign LLCs.²⁶ Unlike the special close corporation statutes, the LLC was a new form, and was not linked to an existing form.²⁷

LLPs were developed shortly after LLCs started to become popular. The LLP was first invented in Texas in 1991, primarily to help lawyers to escape sudden tort and regulatory liability arising out of savings and loan cases.²⁸ It was adopted in Louisiana in 1992, in three more jurisdictions in 1993 and in thirteen additional

corporation).

20. John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885, 928 (2000) (stating that "[t]he most significant distinction between Subchapters K and S entities is the inability to step up the basis of inside S Corporation assets upon the death of a shareholder or redemption of her stock interest, as ... under a Section 754 election").

21. William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 855-59 (1995).

22. Rev. Rul. 88-76, 1988-2 C.B. 361.

23. The IRS reacted to the Wyoming development by first proposing to amend the classification rules to classify it as a corporation, *Classification of Limited Liability Companies*, 45 Fed. Reg. 75,709-10 (proposed Nov. 17, 1980), and then withdrawing the proposal and announcing it was studying the issue, *Announcement 83-4*, 1983-2 I.R.B. 31.

24. Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 4 (1995).

25. See Table 2 *infra* p. 130 (listing formations by state).

26. Statutes are analyzed and tabulated in LARRY E. RIBSTEIN & ROBERT R. KEATINGE, *RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES* app. 13-1, (1992 & Supp. 2000). For a history of the LLC, see Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459 (1998).

27. See Table 1 *infra* p. 129.

28. Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1068-74 (1995).

jurisdictions in 1994. Virtually all states had adopted LLP statutes by early 1998.²⁹ LLPs closely resemble LLCs except that LLPs are explicitly linked to the existing body of partnership law and practice.³⁰ LLP statutory provisions are part of the states' partnership laws, and these laws explicitly define an LLP as a partnership.³¹ A general partnership therefore does not lose the advantages of its existing set of contracts by becoming an LLP as it might if it became an LLC. Moreover, the LLP is closely equivalent to the LLC in the critical respect of tax treatment. Particularly in the wake of the elimination of the tax classification rules there is no significant difference between LLCs and LLPs with regard to federal income taxation.³²

The above history provides the backdrop for several phenomena that must be explained by theory and data:

(1) Fewer than half the states adopted special close corporation provisions,³³ and only a small fraction of firms have incorporated under those provisions that have been adopted.³⁴ It is not clear why that should have been the case, since the combination of these statutes with Subchapter S seems to provide a way that firms could advantageously combine the characteristics of the corporate and partnership forms.

(2) The history of the LLC form is ambiguous. On the one hand, the rapid acceptance of the LLC soon after clearing the tax classification hurdle indicates that this form more successfully addressed

29. The spread of the LLP form is discussed in ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT § 1.01 (2000).

30. See Table 1 *infra* p. 129.

31. BROMBERG & RIBSTEIN, *supra* note 29, § 1.02(a).

32. *Id.* § 7.05. There are, however, a few differences with respect to their treatment under other federal and state tax laws. See *infra* notes 66-136 and accompanying text.

33. Wortman, *supra* note 15, at 1364 n.11. It has been theorized that there was little demand for such provisions, Roberta Romano, *State Competition for Close Corporation Charters: A Commentary*, 70 WASH. U. L.Q. 409, 412-14 (1992), and that state legislatures had little incentive to fill any demand that existed in the absence of a market for foreign incorporation business, Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 372-76 (1992). This Article focuses on the demand side of the story inherent in firms' reasons for choosing a particular form. The political story is outside this focus, but it is worth noting that it appears to be directly refuted by the widespread adoption of LLC and LLP statutes. Ribstein, *supra* note 5, at 372.

34. Wortman, *supra* note 15, at 1362-63.

the needs of closely held firms than had the close corporation form and was being held back by tax impediments. On the other hand, data indicate that most LLCs are firms that had been partnerships, or would have been partnerships if the LLC form were unavailable.³⁵ In other words, the LLC evidently is not replacing the close corporation form. Why should this be the case if the LLC offers not only limited liability and partnership-type taxation but also greater organizational flexibility than corporations?

(3) As shown by Table 2, the LLP form has been much less successful than the LLC, despite the fact that LLPs offer LLC-type features plus the seemingly advantageous linkage with the substantial existing body of partnership law. Does this indicate that linkage is a cost rather than a benefit?

These questions are addressed by the theories discussed below in Part II, and then by the data discussed below in Part III.

II. ALTERNATIVE EXPLANATIONS FOR CHOICE OF BUSINESS FORM

This Part presents possible reasons why firms might choose particular business forms, and some potential explanations for the phenomena noted at the end of Part I. Subpart A compares the internal organizational rules of the various business entity statutes. Subpart B examines the different ways tax and regulatory rules apply to these entities. Both subparts discuss the choices facing newly forming firms. Subpart C discusses the costs that confront existing firms that are changing from one type of business entity to another. Finally, Subpart D focuses on the main issue addressed in this paper—the extent to which “network externalities” might impede starting up a new type of business entity.

A. *Optimal Default Rules*

Firms' choice of organization form depends to some extent on finding default governance rules that best fit the basic relationship among the owners.

35. Lee, *supra* note 20, at 936-42.

1. *Close Corporation Provisions*

Because state legislatures designed close corporation provisions to deal specifically with the needs of closely held firms it is not clear why firms largely spurned the provisions. One reason may be that the provisions did not offer a significant advantage over the standard corporate form. Statutes that merely clarify enforcement of the firms' customized agreements essentially duplicated what the cases already were permitting for firms incorporated under the standard provisions.³⁶ Statutes that provide for default share transfer, dissolution and other rules for closely held firms may not be useful for many firms because of the extra difficulties entailed in meshing the special close corporation default rules with the firms' own agreements and with the standard corporate default terms that continue to apply to closely held firms.³⁷

2. *LLCs vs. Corporations*

Like special close corporation provisions, LLC statutes are better adapted than standard corporation statutes to closely held firms. LLC statutes include provisions based on the limited and general partnership statutes closely held firms long have used. These include provisions for direct management by owners, default rules for allocation of profits among owners, restricted transferability of management rights, and member power to dissociate from the firm. The statutes eliminate complex formalities and procedures that create unnecessary costs in closely held firms.

36. See, e.g., *Zion v. Kurtz*, 405 N.E.2d 681 (N.Y. 1980) (enforcing management provisions of Delaware corporation despite failure to comply with formalities required by close corporation provisions); *Triggs v. Triggs*, 385 N.E.2d 1254 (N.Y. 1978) (enforcing share transfer provision in shareholder agreement that did not comply with statute); *Boyd, Payne, Gates & Farthing, P.C. v. Payne, Gates, Farthing & Radd, P.C.*, 422 S.E.2d 784 (Va. 1992) (law partners who formed a professional corporation for tax purposes could have their rights determined according to partnership law, reasoning in part that statutory close corporation provisions merely codified prior law). Note that Delaware apparently permitted standard firms to opt out of board management, see DEL. CODE ANN. tit. 8, § 141(a) (1991); to provide for share transfer restrictions, *id.* § 202; and clarified that this was not altered by the existence of a special close corporation subchapter, *id.* § 356.

37. Ribstein, *supra* note 5, at 404-06.

The "chameleon" nature of LLC management permits more flexibility than may be the case for entrenched corporate rules. Thus, the agreement may define authority of particular managers with less risk that the authority will be given by corporate customs or standards unless the third party is explicitly notified otherwise. The LLC also permits flexibility over time as well as among firms. For example, the firm might be manager-managed only until, or only after, the firm attains designated financial targets.³⁸

LLCs, like other partnership-type firms, also have greater financial flexibility than corporations. Each owner's financial rights can be separately determined through capital account, and these financial rights can be separated from voting rights. This operational flexibility is also reflected in greater tax flexibility in LLCs and other partnership-type firms regarding allocating gains and losses among members.³⁹ Although this flexibility is difficult to duplicate in corporations, LLCs can duplicate corporate-type standardization of interests for trading and other purposes by designating membership interests as units with comparable economic rights.⁴⁰

On the other hand, the benefits of the LLC default rules compared with those of corporate form have not always been clear. LLCs under many statutes⁴¹ have the impermanence of the partnership form and therefore may be more susceptible to hold-up problems than corporations, where owners have no default right to "put" their interests back to the firm.⁴² The corporate form also offers a clearer centralized default management structure than the "chameleon" LLC form that lets firms elect between centralized and

38. RIBSTEIN & KEATINGE, *supra* note 26, § 2.03.

39. See *infra* note 92 and accompanying text.

40. RIBSTEIN & KEATINGE, *supra* note 26, app. A-4.

41. See RIBSTEIN & KEATINGE, *supra* note 26, app. 11-1. Some LLC statutes, however, have adopted corporate-style permanence that makes them more comparable to corporations and distinguishable from partnerships. See *infra* note 107 and accompanying text.

42. FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 239-40 (1991); Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216, 238 (1992); Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 377-401 (1987); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 918-20 (1999); see also Naomi R. Lamoreaux, *Partnerships, Corporations, and the Theory of The Firm*, 88 AM. ECON. REV. 66 (1998) (discussing hold-up problems in limited partnership where there is a potential conflict of interest between limited and general partners).

decentralized management.⁴³ In other words, the LLCs flexibility may be a drawback for some firms.

An important question concerning LLC statutes is why they succeeded while special close corporation provisions failed. The answer may be that, while LLC statutes provide comprehensive standard forms, close corporation provisions continue to be part of, and therefore linked to, standard corporate statutes. Thus, closely held corporations formed under such provisions were potentially subject to default statutory rules outside of the close corporation chapter—rules that were designed for publicly held firms. For example, courts might apply standard corporate fiduciary duties.⁴⁴ Because remote managers of publicly held firms are agents in the classic sense of managing other peoples' money they should be subject to a strong duty of unselfishness. But the conflicts among the manager/owners of closely held firms who vote their self-interest rather than delegating control may require different rules. Ill-fitting default rules may force close corporation owners to engage in substantial customized planning.

3. *LLPs vs. Corporations and LLCs*

LLPs are essentially general partnerships that obtain limited liability through registration.⁴⁵ LLPs, like LLCs, therefore offer the partnership-type default rules discussed above that suit the needs of closely held firms.

The main advantages of LLPs over LLCs, at least for some firms, are due to LLPs' clearer resemblance to partnerships. To begin with, LLPs, like other partnerships, generally do not impose creditor-protection-type restrictions on distributions as do other limited liability business association statutes.⁴⁶ These restrictions can be particularly burdensome for service firms that usually pay out a significant portion of income as compensation to the

43. See generally RIBSTEIN & KEATINGE, *supra* note 26, § 8.02 (discussing LLC statutory choice).

44. Larry E. Ribstein, *The Closely Held Firm: A View from the United States*, 19 MELB. U. L. REV. 950, 957 (1994).

45. BROMBERG & RIBSTEIN, *supra* note 29, §§ 2.01-.09.

46. *Id.* § 4.04(d).

professional partners. Indeed, this may be true of most firms that do not incorporate, since incorporation makes most tax sense for firms that do not utilize the corporate "inside" tax shelter by retaining earnings rather than distributing them to owners.⁴⁷

In several other respects, the general partnership default rules may better suit very closely held and informal firms than LLC default rules.⁴⁸ First, rules permitting owners to dissociate or dissolve at will give minority owners an effective veto power, as compared with the restrictions on exit at will in many LLC statutes.⁴⁹ Second, partnership unanimity voting on amendments⁵⁰ better prevents majority owners from changing the agreement over the minority's objection than majority voting provided for in many LLC statutes.⁵¹ Third, sharing according to capital ratios, as is the case under many LLC statutes,⁵² can disadvantage service contributors as compared with the rule of equal financial sharing that prevails in partnerships.⁵³ Fourth, the requirement for a written agreement, found in many LLC statutes,⁵⁴ may trip up informal firms.

On the other hand, LLPs' greater similarity to partnerships may be a disadvantage for some firms as compared with the LLC form. First, many of the early LLP statutes were so called "partial-shield," providing limited liability for torts but not contracts.⁵⁵ However, most states have full-shield LLP provisions substantially mimicking the limited liability of LLCs.⁵⁶ Second, while partnerships, and therefore LLPs, are defined as having two or more

47. See *infra* notes 97-103 and accompanying text.

48. See Fallany O. Stover & Susan Pace Hamill, *The LLC Versus LLP Conundrum: Advice For Businesses Contemplating the Choice*, 50 ALA. L. REV. 813 (1999).

49. RIBSTEIN & KEATINGE, *supra* note 26, app. 11-1. Note, however, that LLCs initially were based on the partnership form and many statutes retain exit at will. *Id.*

50. Revised Unif. P'ship Act § 401(j) (1994), 6 U.L.A. 52 (1995); Unif. P'ship Act § 18(h) (1914), 6 U.L.A. 526 (1995).

51. RIBSTEIN & KEATINGE, *supra* note 26, § 8.03.

52. *Id.* app. 5-1, at 3.

53. Revised Unif. P'ship Act § 401(b); Unif. P'ship Act § 18(a).

54. RIBSTEIN & KEATINGE, *supra* note 26, app. 4-1, at 28.

55. BROMBERG & RIBSTEIN, *supra* note 29, § 3.02.

56. *Id.* at 157-60 tbl. 3-1 (charting types of statutes adopted in each state). It is not clear how much of a disadvantage the partial shield is because firms can avoid personal liability for contracts through the contracts themselves.

members,⁵⁷ almost all LLC statutes now explicitly or implicitly permit for single-member LLCs.⁵⁸

Third, general partnership default rules—particularly regarding fiduciary duties, decentralized management, transferability, and dissociation and dissolution—better suit personal liability firms than those in which owners' liability is limited.⁵⁹ This unsuitability is a risk inherent in linking a limited liability business form with a form characterized by personal liability.⁶⁰ For example, since unlimited liability owners are assumed to be active in the business, partnership law makes every partner an agent of the firm unless third parties are notified of a contrary rule.⁶¹ LLC statutes let firms opt out of this rule by adopting centralized management,⁶² which better suits some limited liability firms.⁶³ Also, the owners' personal liability justifies a default rule that lets owners end their responsibility for business debts by forcing the firm's dissolution and liquidation. For reasons discussed above,⁶⁴ the costs of such discontinuity may exceed the benefits in limited liability firms. Although LLPs may opt out of these and other default rules, they would then lose the advantages of applying the standard partnership form, and would therefore be better off with a standard form that better accommodates their needs.⁶⁵

B. Tax and Regulation

Federal and state tax and regulatory statutes provide some explanations for choice of form. If firms choose, for tax and regulatory reasons, forms whose default rules would be less

57. Revised Unif. P'ship Act § 101(4); Unif. P'ship Act § 6.

58. See *infra* note 207 and accompanying text.

59. See BROMBERG & RIBSTEIN, *supra* note 29, §§ 4.01-.08; Larry E. Ribstein, *Possible Futures for Unincorporated Firms*, 64 U. CIN. L. REV. 319 (1996).

60. See Larry E. Ribstein, *Linking Statutory Forms*, LAW & CONTEMP. PROBS., Spring 1995, at 187 (evaluating linkage of forms).

61. Revised Unif. P'ship Act § 301; Unif. P'ship Act § 9.

62. RIBSTEIN & KEATINGE, *supra* note 26, §§ 8.02-.04.

63. LLCs still suffer some uncertainty, however, regarding the ability to isolate agency powers in particular members. See *id.* § 8.06.

64. See *supra* note 42 and accompanying text.

65. Moreover, the default of easy exit may have adverse tax consequences for some firms. See *infra* note 107 and accompanying text.

suitable, this choice points to a cost of such provisions that lawmakers and regulators could reduce by restructuring the statutes.

1. Close Corporation Statutes

As discussed below, firms may have tax or regulatory reasons to incorporate rather than to select one of the other business forms. These reasons would not lead firms to form under special close corporation statutes rather than the standard corporate form. At the same time, these statutes at least provide more favorable default rules for closely held firms that have other reasons to incorporate. Of course, to the extent that firms seek to avoid the corporate form, they would prefer to be LLCs or LLPs.

2. LLCs

The LLC form presents a complex set of tax and regulatory advantages and disadvantages as compared to corporations and LLPs.

a. Avoidance of Double Taxation

The conventional tax explanation of LLCs is that they enable firms to avoid entity-level corporate tax. A corporation taxed under Subchapter C of the Internal Revenue Code pays tax at the corporate level, while its owners pay tax on distributions they receive. In contrast, a partnership taxed under Subchapter K of the Internal Revenue Code is not taxed at the entity level. Rather, the firm's income is taxed directly to the owners and losses are deductible against owners' income from other sources.

Subchapter K applies if the firm is not a "corporation," which the Code defines to include an "association."⁶⁶ In *Morrissey v. Commissioner*,⁶⁷ the Supreme Court held that "association" status

66. I.R.C. § 7701(a)(2)-(3) (West 2000) (defining "partnership" and "corporation" respectively).

67. 296 U.S. 344 (1935).

depended on a firm's "resemblance" to corporations.⁶⁸ Prior to 1997, the IRS interpreted this requirement in the "*Kintner* regulations,"⁶⁹ which provide that a business organization is a corporation and not a partnership if it has at least three of the "corporate" characteristics of continuity of life, centralized management, limited liability, and free transferability of interests.⁷⁰ Although these rules literally called for taxing a firm that had limited liability and one other "corporate" characteristic as a partnership, it was not clear that the IRS would follow this approach as to a new form of business such as the LLC. A 1988 IRS ruling clearly permitted this result.⁷¹ The classification rules continued to generate uncertainty, however, and this may have discouraged some firms from adopting the LLC form.⁷² Not until the beginning of 1997 did the IRS finally eliminate the tax classification rules and permit non-publicly traded partnerships to choose to elect taxation as partnerships or as corporations.⁷³

b. Recognition of Gain or Loss

There are myriad differences cutting many different ways between corporations and partnership-type firms with regard to member or shareholder recognition of tax gains and losses in transactions with the firm. Although an exchange of an asset for an interest in a corporation usually forces the contributing shareholder to recognize gain or loss,⁷⁴ a partner or LLC member does not recognize gain or loss on the contribution in exchange for a partnership or membership interest.⁷⁵ Also, while a partner or

68. *Id.* at 356-58.

69. The name refers to the case that prompted the regulations, *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), in which the IRS unsuccessfully sought to characterize a professional corporation as a partnership. *Id.* at 428.

70. Treas. Reg. § 301.7701-2(a) (1996). For leading cases interpreting the *Kintner* regulations, see *Larson v. Commissioner*, 66 T.C. 159 (1976); *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

71. Rev. Rul. 88-76, 1988-2 C.B. 360-61.

72. Ribstein, *supra* note 3, at 461-65.

73. Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584 (Dec. 18, 1996) (to be codified at 26 C.F.R. pts. 1, 301, 602).

74. I.R.C. § 1001 (West 2000).

75. I.R.C. § 721(a).

member who receives property from the firm may have to recognize gain or loss, the member of a single-member LLC can make a tax-free exchange of the membership interest for the firm's property.⁷⁶ Finally, the Code provides for tax-free reorganizations only between corporations.⁷⁷ This provision has particular relevance for the owners of a closely-held start-up firm who plan to exit through a combination with a public corporation. On the other hand, if the start-up owners exit by incorporating and making an initial public offering, they need not recognize gain even on a move from partnership because there is no recognition if the contributors receive control of the corporation⁷⁸ and the interests of public investors and former partners are combined to determine whether contributors have control of the corporation immediately after the contribution.⁷⁹

c. Subchapter S vs. LLC

One problem with explaining the rise of the LLC in federal income tax terms is that, even before LLCs, limited liability firms could avoid entity-level taxation by forming Subchapter S corporations. Since only "corporations" are eligible for Subchapter S treatment,⁸⁰ this election affects choice of form under state law. To be sure, Subchapter S included numerous eligibility restrictions, most notably on number of owners and classes of stock.⁸¹ Assuming a firm is eligible for either Subchapter S or Subchapter K treatment,⁸² the tradeoffs involved in the choice are complex.

d. Step-up in Basis

When a partner or an LLC member, but not an S Corporation shareholder, dies or redeems her interest, the tax basis of the

76. Priv. Ltr. Rul. 97-51-012 (Sept. 15, 1997).

77. I.R.C. § 368.

78. I.R.C. § 351.

79. Rev. Rul. 78-294, 1978-2 C.B. 141-42.

80. I.R.C. § 1361.

81. See *supra* notes 17-18 and accompanying text.

82. Note that a state law corporation cannot elect to be treated as a partnership for tax purposes. Treas. Reg. § 301.7701-2(b) (1996).

partner's or member's interest in the firm can be stepped up, thus avoiding tax on the appreciation.⁸³ Firms may somewhat offset this advantage of LLCs by tax planning.⁸⁴

e. Pass-through of Losses

S Corporations are somewhat less able than Subchapter K firms to pass losses through to individual owners, but the differences between S Corporations and LLCs in this regard are complex and subtle. This pass-through has been described as particularly important for real estate firms, and has been used to explain the relatively small number of S Corporations that are real estate firms.⁸⁵ But it is not clear that LLCs are much better off in this regard. Owners of both K and S firms can deduct losses up to the tax basis of their interests in S Corporation stock and debt. A shareholder's basis in Subchapter S debt includes only loans that the shareholder made, while the owner's basis in a Subchapter K firm includes her share of all of the firm's debt not classified as "non-recourse."⁸⁶ However, in contrast to standard-form partnerships, LLC members' limited liability makes the firm's debts "non-recourse" to the owners unless the owners assume the liabilities.⁸⁷ LLC owners have an advantage over Subchapter S corporation owners in that the former are "at risk" for purposes of using the firm's losses, deductions, and credits if they guarantee the firm's obligations.⁸⁸ On the other hand, LLC members may be considered to have non-deductible "passive losses"⁸⁹ unless they spend the

83. I.R.C. § 743 (stating general rule on optional adjustment of basis); I.R.C. § 754 (stating manner of electing optional adjustment of basis); Lee, *supra* note 20, at 895-96, 928. See generally Susan Kalinka, *Death of a Member of an LLC*, 57 LA. L. REV. 451, 456 (1997) (describing the method of adjusting an LLC member's basis on death).

84. S Corporation shareholders can sell or distribute the firm's assets and then liquidate the S Corporation in the same year through a "somewhat Byzantine technique," Lee, *supra* note 20, at 896, that would seem to be impracticable for the less sophisticated firms that use Subchapter S to avoid complication.

85. *Id.* at 895, 941.

86. I.R.C. § 752(a).

87. RIBSTEIN & KEATINGE, *supra* note 26, §§ 17.09-10.

88. See Prop. Treas. Reg. § 1.465-22(c)(1), 44 Fed. Reg. 32,235 (June 5, 1979); RIBSTEIN & KEATINGE, *supra* note 26, § 17.12.

89. I.R.C. § 469.

requisite number of hours working in the business, but an S Corporation owner may be able to deduct losses even without meeting this test.⁹⁰

f. Built-in Gains and Losses

Cutting in the opposite direction from the previous two points, Subchapter K owners, but not S Corporation owners, are subject to rules requiring allocation to contributing members of unrealized gains or losses in contributed property.⁹¹

g. Partnership Flexibility

The rigidity of the Subchapter S form may be costly for some firms. Partnerships, including LLCs, can allocate income, deductions, and credits in any manner provided in the partnership agreement provided that allocation has "substantial economic effect" or accords with the partner's interest in the partnership.⁹² This flexibility can be particularly important in firms that want to reward specific owners' financial and service contributions. However, an S corporation that makes such payments may be creating a second class of stock and thereby losing its S corporation status.⁹³

h. Subchapter S Certainty

Flexibility is not always a good thing. The tax certainty of the Subchapter S form might be attractive for the simplest firms for which the cost of potential tax error exceeds the costs of the one-class-of-stock constraint. As long as firms play by the well-established Subchapter S rules, they will not be subject to tax penalties such as those imposed under the "anti-abuse" rules.⁹⁴

90. RIBSTEIN & KEATINGE, *supra* note 26, §§ 2.18, 17.13.

91. I.R.C. § 704(c).

92. I.R.C. § 704(b).

93. I.R.C. § 1361(b)(1)(D) (requiring a "small business corporation" have only one class of stock); I.R.C. § 1362(d)(2) (providing for termination of Subchapter S status on corporation's ceasing to be a "small business corporation").

94. Treas. Reg. § 1.701-2 (1995).

However, even as to simplicity the tradeoffs are complex. The rigidity of the S Corporation qualifications means that firms must be careful to operate so as not to lose their Subchapter S eligibility—for example, by unwittingly creating a second class of stock through an employment agreement. In contrast, use of Subchapter K depends largely on election under “check-the-box.”⁹⁵ Although it may be easier to go astray in setting up a Subchapter K firm than in setting up a Subchapter S firm, a small firm is more likely to have good legal advice at the outset than throughout its operation.⁹⁶

These differences between S Corporations and LLCs suggest that some firms would be better off as LLCs than as Subchapter S firms while others would be better off as S Corporations. For all these firms, tax considerations operate at the margin together with the other factors this Part discusses.

i. “Inside” Tax Shelter for Retained Earnings

Although LLCs may have a tax advantage over Subchapter C Corporations in terms of avoidance of entity-level taxation, Subchapter C offers an “inside” tax shelter for corporate earnings retained in the business. Subchapter C corporations may be a better tax vehicle overall for some firms than LLCs or other Subchapter K entities where (1) the owners are taxed at high marginal rates;⁹⁷ (2) the firm retains substantial earnings; (3) the firm can eliminate much of its corporate income through deductions, particularly including high salary deductions for active owners;⁹⁸ and (4) the owners can delay realizing capital gains taxes by holding the stock for a long time. One writer goes so far as to say that “double taxation’ is either an unwitting or ‘briar patch’ argument in most cases.”⁹⁹

There are, however, many firms that do not meet these qualifications, particularly including real estate and other firms

95. See *supra* note 73 and accompanying text.

96. RIBSTEIN & KEATINGE, *supra* note 26, § 2.13.

97. Lee, *supra* note 20, at 910. This depends on the corporate and individual graduated income tax schedules and the division of corporate income. *Id.* at 914.

98. I.R.C. § 162(a), (m) (providing for salary deduction).

99. Lee, *supra* note 20, at 921 (footnote omitted).

with substantial non-operating assets, and personal service firms. These firms, including many partnerships and LLCs, lack business reasons for retaining income and indeed, as in the real estate business, may generate tax losses through depreciation.¹⁰⁰ These facts, coupled with data showing that the growth in LLC formations has not been accompanied by a decline in incorporations,¹⁰¹ and the unlikelihood that business formations generally have declined,¹⁰² suggest that, for tax reasons, LLCs are replacing general partnerships but not corporations.

The income tax story, however, is inconclusive. As already noted regarding Subchapter S corporations, tax factors operate on the margin together with the other factors discussed in this Part.¹⁰³ For example, many firms that have moderate retained earnings and middle-bracket owners may have been marginally better off as C Corporations under the prior limited liability and tax classification regime but better off now as LLCs. Moreover, as discussed above, many firms that can choose between the LLC or Subchapter S forms probably would be better off from a tax standpoint as LLCs. Accordingly, tax considerations may not fully explain many choice-of-form decisions.

j. Estate and Gift Taxes

The owner of a closely held family corporation can minimize the value of interests in the firm for estate and gift tax purposes by restricting distributions. The further into the future the distributions must be discounted, the lower the valuation of the interest, other things being equal. Owners thereby can pass interests in the business to children or other relatives without triggering significant tax liability. This is tricky in a partnership, however, because minority owners under general partnership default rules have the power to cause the firm to liquidate, thereby triggering a distribution. The Code and regulations provide that the firm cannot solve

100. *Id.* at 923-24.

101. *See infra* note 188 and accompanying text.

102. The data was collected over a period of significant economic growth in the United States.

103. *See supra* notes 66-96 and accompanying text.

this problem simply by amending its agreement to restrict liquidation rights.¹⁰⁴ Although a "restriction imposed, or required to be imposed, by any Federal or State law" matters for valuation,¹⁰⁵ the IRS may disregard a restriction that is "more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."¹⁰⁶ Thus, a provision in a limited partnership or LLC agreement prohibiting member withdrawal or liquidation would be ineffective for tax purposes if more restrictive than the applicable state statute. A firm therefore may be better off for estate and gift tax purposes as a corporation than as a partnership-type firm depending on the applicable law. States, however, are rapidly eliminating this choice-of-form consideration for most limited partnerships and LLCs by amending their statutes to provide for restrictions meeting the standards of the IRC.¹⁰⁷

k. Deduction for Fringe Benefits

One reason for forming a corporation rather than an LLC or other unincorporated business historically has been that the former can fully deduct some employee benefits such as premiums for group health, accident and life insurance that the employees receive tax free, while S Corporations and LLCs currently can only partially deduct premiums paid on behalf of certain owner-employees.¹⁰⁸ This difference, however, is being eliminated as full deductions are phasing in for S Corporations and Subchapter K firms.¹⁰⁹

104. I.R.C. § 2704 (West 2000).

105. I.R.C. § 2704(b)(3)(B).

106. Treas. Reg. § 25.2704-2(b) (1992).

107. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 17.02(d)(2), at 17.32 n.21 (1988 & Supp. 2001) (discussing limited partnership provisions); RIBSTEIN & KEATINGE, *supra* note 26, app. 11-1 (charting LLC statutes).

108. Booth, *supra* note 5, at 546-47; Lee, *supra* note 20, at 907-08.

109. I.R.C. § 162(l) (limiting the deduction of partnerships and S corporations for health insurance to 60% of the amount paid for health insurance of self-employed persons (including certain individual members) in 1999 through 2001, 70% in 2002, and 100% in years after 2002).

l. Wage and Self-employment Taxes

A significant disadvantage of LLCs and other partnership-type firms as compared with corporations, including S Corporations, is that the owners of the former are more likely than the latter to have to include their shares of the firm's income as net earnings from self-employment for wage or self-employment tax purposes.¹¹⁰ Although the IRS proposed regulations in 1997 that would have clarified when LLC owners would be treated like limited partners and therefore not subject to the tax,¹¹¹ Congress suspended the effect of these regulations,¹¹² thereby placing LLCs in limbo on this issue and providing a tax incentive to organize as a Subchapter S Corporation rather than an LLC.¹¹³ Of course, firms must weigh this incentive against the other costs and benefits of corporate status, including Subchapter S taxation, as compared with Subchapter K taxation discussed above.

m. State Taxes

States may influence the choice of form by imposing franchise or similar taxes on some types of entities but not others. For example, Florida, Pennsylvania and Texas imposed corporate income taxes on LLCs during much of the period of the development of LLCs, although Florida and Pennsylvania dropped their taxes for LLCs, but not on LLPs, during the relevant period.¹¹⁴ Connecticut taxes corporations but not LLCs.¹¹⁵

110. I.R.C. § 1402 (requiring partners to treat their distributive shares of partnership income as net earnings from self-employment subject to old age, survivors, and disability tax).

111. Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (Jan. 13, 1997).

112. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788 (1997) (providing that "[n]o temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998").

113. RIBSTEIN & KEATINGE, *supra* note 26, §17.19, at 146 n.50-51; Lee, *supra* note 20, at 935-36 & n.269.

114. Bruce P. Ely & Christopher R. Grissom, *LLC and LLP Scorecard: An Update*, 88 TAX NOTES 815 (Aug. 7, 2000) (summarizing state-by-state differences).

115. *Id.*

n. State and Federal Regulation of Business Entities

State and federal regulation may apply to specific types of business entities, or may apply to business entities generally, but based on features that some types are more likely to have than others. The former type of regulation varies so erratically among business forms, laws and jurisdictions that it is unlikely to have had a systematic effect on choice of form, with the possible exception of professional regulation discussed in the next subsection.

o. Regulation Based on Features of Firms' Particular Federal Employment Discrimination and Securities Laws

In general, these laws are intended to protect relatively unsophisticated individuals who have been harmed by firms with which they deal at arm's length as investors or employees. Strong arguments can be made for applying these statutes based on firms' choice of entity for greater predictability and because the entity's default rules are important.¹¹⁶ However, many courts at least purport to apply something like an "economic reality" test that looks beyond choice of form to the actual terms and circumstances of specific firms.¹¹⁷ Accordingly, state or federal regulation probably is having little effect on choice of form.

3. LLPs

Most of the tax and regulatory factors discussed above regarding LLCs also apply to LLPs. In particular, both are taxed under Subchapter K and therefore differ in the same way from corporations taxed under Subchapters C and S. Indeed, the similarity of LLPs and LLCs is central to the data discussed below

116. See Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994).

117. See generally BROMBERG & RIBSTEIN, *supra* note 29, § 7.03(a) (discussing partners as "employees under employment discrimination" laws).

in Part III. This section discusses only the salient tax and regulatory differences between the two forms.

a. Estate and Gift Taxes

The linkage between LLPs and general partnership law may be a disadvantage for some firms attempting to avoid estate and gift taxes.¹¹⁸ General partnership statutes, unlike many LLC and limited partnership statutes, continue to provide for dissolution and dissociation at the will of any partner.¹¹⁹ This reflects partners' need in standard form partnerships to terminate their personal liability for the firm's debts. Accordingly, these firms cannot rely on restrictions on liquidation rights that would apply under state law.

b. Wage and Self-employment Taxes

The more pronounced member-management of LLPs means marginally more exposure to self-employment tax.¹²⁰

c. Cash Method Accounting

Many smaller firms, particularly personal service firms, gain if they can account for tax purposes on a cash basis. LLPs offer somewhat greater assurance that the firm will be able to use the cash method.¹²¹

d. State Taxes

Three states, Florida, Pennsylvania and Texas, imposed corporate income taxes on LLCs but not on LLPs during the relevant period.¹²² Indeed, the LLP's invention in Texas may be at least partly attributable to this fact.

118. See *supra* note 107 and accompanying text.

119. Revised Unif. P'ship Act §§ 601, 801 (1994), 6 U.L.A. 72, 92 (1995); Unif. P'ship Act §§ 29, 31 (1914), 6 U.L.A. 752, 771 (1995).

120. BROMBERG & RIBSTEIN, *supra* note 29, § 7.05(e).

121. *Id.* § 7.05(d).

122. See *supra* note 114 and accompanying text.

e. State and Federal Regulation of Business Entities

To the limited extent that unincorporated entities can escape regulation aimed mainly at corporations, LLPs may provide a marginal benefit over LLCs because the former are more clearly partnerships. The regulatory advantage is mainly important under statutes and rules that authorize use of the LLP, but not the LLC, form by lawyers.¹²³

C. Switching Costs

A fourth factor in choice of form is the costs that existing (as opposed to new) firms incur switching from one form to another. For example, firms that had already offered bondholders takeover protection based on putting the bonds at par would find it hard to offer a subsequent class more precise protection only from takeover-related interest rate fluctuations.¹²⁴ This is a form of path dependence, in which firms have efficiently adapted to initial conditions but are less suited to subsequent conditions than other hypothetical alternatives that are too costly to adopt.¹²⁵ With respect to choice of organizational form, switching costs include the costs of redesigning agreements and accounting for the new format, getting member agreement, making legally required filings, taxes due as a result of the conversion, and the effect of the switch on existing contracts or assets subject to restrictions on transfer.

123. CAL. CORP. CODE § 16101(6) (West Supp. 2001) (permitting formation of LLPs for practice of profession); Act of June 6, 1996, S.B. No. 141, § 30, 1996 Cal. Legis. Serv. Ch. 57, at 213, 239 (West) (providing that nothing in the LLC act shall be construed to allow a LLC to render professional services); R.I. Sup. Ct. art. II, R. 10(a) (1999) (permitting lawyers to practice as professional corporations or LLPs but not authorizing LLCs). See generally BROMBERG & RIBSTEIN, *supra* note 29, § 7.04(a) (discussing professional LLPs); RIBSTEIN & KEATINGE, *supra* note 26, § 15.13 (discussing professional LLCs).

124. Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting* (or "The Economics of Boilerplate"), 83 VA. L. REV. 713, 728 (1997).

125. For discussions of categories of path dependence based on whether the initial and subsequent equilibria are suboptimal, see S. J. Liebowitz & Stephen E. Margolis, *Path Dependence, Lock-in, and History*, 11 J.L. ECON. & ORG. 205 (1995); Mark J. Roe, Commentary, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 647-53 (1996).

1. *Close Corporation Statutes*

In addition to any election necessary to become a statutory close corporation,¹²⁶ a firm may incur costs in revising its charter or other agreements to mesh with the statute. A corporation, on the other hand, switching to close corporation status does not change entity form, and therefore does not trigger tax or other consequences that might follow from change in form.

2. *LLCs*

One reason LLCs seem to have come mainly out of the ranks of partnerships rather than corporations¹²⁷ may be that switching costs are higher on moving from corporate than from partnership form. This involves three types of costs. First, the move from the corporate standard form to a standard form based largely on partnership involves a more significant change in background rules than the move from one partnership-type business to another. This may entail somewhat higher costs of rewriting the parties' agreement to mesh with the new form. For example, corporate shares are fully transferable by default while partners may freely transfer only their financial interests. Accordingly, share transfer agreements that make sense in corporations may not make sense for partnerships.

Second, the continuity of the underlying entity may matter for purposes such as continuation of the firm's contracts. Statutory provisions permitting partnerships to convert into LLCs without changing the underlying entity long have been common.¹²⁸ A conversion involves transforming a single business from one entity form to another, and therefore emphasizes the continuity of the business.¹²⁹ Indeed, statutory conversion provisions commonly state that the new entity is the same for all purposes as the old one.¹³⁰ If,

126. *E.g.*, DEL. CODE ANN. tit. 8, § 344 (1991 & Supp. 2000).

127. *See infra* note 188 and accompanying text.

128. RIBSTEIN & KEATINGE, *supra* note 26, app. 11-1, at 20 (tabulating state provisions).

129. *Id.* § 11.16.

130. *E.g.*, Revised Unif. P'ship Act § 904 (1994), 6 U.L.A. 111 (1995) (governing conversion of limited partnership to partnership).

however, the applicable corporation statute does not provide for conversion, firms that seek to disincorporate into LLCs may have to distribute corporate assets to owners or directly to an LLC. This clearly involves two separate entities, and therefore little likelihood that the successor will be treated as the continuation of the predecessor in the absence of a contrary statutory provision. Some statutes permit mergers between LLCs and corporations,¹³¹ but even this involves two previously separate entities rather than a change in form of a clearly continuous business. Moreover, even if the statute technically permits corporations to convert into LLCs, it is not clear an LLC actually will be treated as the "same entity" as the predecessor corporation.¹³²

Third, and most importantly, a corporation/LLC switch is likely to involve higher tax costs than a partnership/LLC switch. The IRS has ruled that partnerships converting to LLCs do not terminate solely by reason of the conversion.¹³³ An LLC/corporate merger, however, is likely to cause both the corporation and its shareholders to recognize gain.¹³⁴

3. LLPs

As with a close corporation election, an existing partnership incurs decision-making costs and potential costs of redrafting its

131. RIBSTEIN & KEATINGE, *supra* note 26, app. 11-1, at 18-19 (tabulating LLC statutory provisions).

132. There may be some question whether even a partnership-LLC conversion always will be given this effect, as where a third party contract explicitly provides for termination on change of entity form whether by conversion or any other mechanism. *Id.* § 11.16. The point is that these questions are likely to be greater for corporate-LLC conversions than for partnership-LLC conversions.

133. Rev. Rul. 95-37, 1995-1 C.B. 130.

134. RIBSTEIN & KEATINGE, *supra* note 26, § 17.16; I.R.C. § 331 (West 2000) (providing that amounts received on complete liquidation of corporation are treated as in full payment for stock), § 336 (providing for recognition of gain or loss on complete liquidation), § 1001 (providing for determination of gain or loss); Priv. Ltr. Rul. 9701029 (January 3, 1997) (providing that

"merger of a corporation into an LLC is treated as a transfer by the corporation of its assets to LLC in exchange for LLC's assumption of the corporation's liabilities and the corporation's receipt of interests in the LLC, followed by distribution of the LLC interests to the shareholders in a taxable liquidation of the corporation under IRC § 331") (quoting RIBSTEIN & KEATINGE, *supra* note 26, § 17.16, at 107).

agreement when registering as an LLP,¹³⁵ but does not incur the tax or other costs of moving to a new business entity.¹³⁶ In contrast to partnerships switching to LLC form, which involves at least a conversion from one form to another, an LLP remains a general partnership. This continuity is particularly important for professional firms, which historically have been organized as partnerships, and which usually have more elaborate agreements than typical general partnerships. A corporation switching to LLP form would incur costs similar to those of a corporation becoming an LLC.

D. Network Externalities

Scholars have asserted that "network externalities" can impede the development of new products or services.¹³⁷ Sales of the product or service depend on the value other users add. A competitor may be unable to dislodge even an inferior product that has a valuable user network. For example, some argue that network externalities account for the success of the QWERTY typewriter keyboard over the allegedly superior Dvorak alternative.¹³⁸ This theory has been asserted in recent legal cases involving the antitrust and copyright laws.¹³⁹ Most importantly for present purposes, commentators have

135. See *supra* text accompanying notes 124-25. Some revisions may, however, be desirable to reflect the firm's limited liability. BROMBERG & RIBSTEIN, *supra* note 29, § 1.05.

136. From a tax standpoint, when a partnership converts to an LLP, the conversion in itself does not cause a termination of the partnership under I.R.C. § 708, and for federal income tax purposes the LLP is simply a continuation of the partnership. *Id.* § 7.05(c); RIBSTEIN & KEATINGE, *supra* note 26, § 17.16.

137. For general discussions of network externalities, see Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, RAND J. ECON., Spring 1985, at 70, 71-72 (characterizing the problem as one of excess inertia); Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, J. ECON. PERSP., Spring 1994, at 93, 108 (discussing how network effects "retard innovation").

138. Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332 (1985).

139. The most prominent recent example is the use of the theory in the government's antitrust case against Microsoft, where prosecutors relied on a network externality theory to establish the relevant market. See STAN J. LIEBOWITZ & STEPHEN E. MARGOLIS, WINNERS, LOSERS, & MICROSOFT: COMPETITION AND ANTITRUST IN HIGH TECHNOLOGY (1999); John E. Lopatka and William H. Page, *Antitrust on Internet Time: Microsoft and the Law and Economics of Exclusion*, 7 SUP. CT. ECON. REV. 157, 168-71 (1999). For a discussion of this issue in the copyright context, see *Lotus Development Corp. v. Borland International, Inc.*, 49 F.3d 807, (1st Cir. 1995), *aff'd*, 516 U.S. 233 (1996); see also Kenneth W. Dam, *Some*

asserted that network externalities can impede the development of business associations¹⁴⁰ just as they can new products and services. This subpart discusses the network externalities generally, and also in relation to the specific phenomena concerning close corporation statutes, LLCs and LLPs that this Article is attempting to explain.

1. Network Externalities and Alternative Explanations

Business associations, including the statutory provisions, cases and forms based on each business association, exhibit some network characteristics that appear only after other people decide to use them. First, courts interpret ambiguous terms in all similar contracts.¹⁴¹ Second, common practices such as investment banker fairness opinions emerge, implementing contract terms.¹⁴² Third, legal services may be standardized and their cost reduced after parties gain experience in drafting and after books and continuing legal education materials explain contractual terms.¹⁴³ These benefits help reduce errors of ambiguity, inconsistency and incompleteness in contract terms.¹⁴⁴ Fourth, wide use of the terms

Economic Considerations in the Intellectual Property Protection of Software, 24 J. LEGAL STUD. 321, 351-57 (1995).

140. Lucian Arye Bebchuk and Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999); Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLAL. REV. 931 (1993); Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U.L.Q. 347, 351-58, 363-66 (1996) [hereinafter Kahan & Klausner, *Path Dependence*]; Kahan & Klausner, *supra* note 124; Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995); Wortman, *supra* note 15, at 1386-87. For writings critical of this application of network externalities theory, see Clayton P. Gillette, *Lock-in Effects in Law and Norms*, 78 B.U. L. REV. 813 (1998); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 562-86 (1998).

141. Klausner, *supra* note 140, at 774; see also *id.* at 776 (noting that the case law interpretation of a contract "embeds that interpretation in the contracts of all firms that use the same term").

142. *Id.* at 780.

143. *Id.* at 782-84.

144. Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 286-89 (1985).

may help the firm in capital markets because of pricing and signaling effects.¹⁴⁵

It is important to distinguish "network benefits" from "network externalities." A network benefit occurs when the advantages of a particular product or standard increase with the number of users. For example, the private benefit of a telephone increases with the number of persons it can reach. Network benefits can also be "externalities" because new adopters of the standard or service consider only their own benefits and not those they would confer on other users by adopting the product or standard. Also, because of risk and the time value of money, future network benefits are worth less to early adopters than to later ones.¹⁴⁶ People therefore may not buy a new product or adopt a new standard even if it is better than the current one apart from network benefits, and a new product or standard might not emerge even if it might have given rise to a superior network but for externalities.

With respect to business associations, firms may fail to adopt a new standard form¹⁴⁷ or adopt an existing standard form even if the alternative standard form would better suit their needs.¹⁴⁸ An example might be large corporations' long-term use of Delaware law in order to take advantage of judicial and legal expertise and other benefits they expect the Delaware legal "network" to continue to produce.¹⁴⁹ It is not clear whether some other statute might have greater benefits for many firms, and might generate a superior network in the absence of externalities. Note that there are possibilities other than a failure to move from a suboptimal to an optimal network: the optimal equilibrium may involve something other than the same choice of statute by all firms; network externalities theoretically might prevent *any* standard from developing as distinguished from preventing a move from one standard to another; or network externalities may not prevent firms from moving to the optimal equilibrium.¹⁵⁰

145. Klausner, *supra* note 140, at 785-86.

146. *Id.* at 790.

147. *Id.* at 814-15.

148. *Id.* at 807-08.

149. *Id.* at 844-47.

150. As Michael Klausner notes, "the point here is not that a suboptimal equilibrium *will* prevail, but that such an equilibrium *may* prevail." *Id.* at 810. He notes that this may be

The network externalities analysis has several possible normative implications for the law of business associations. In general, if there is a market failure because unfettered state competition cannot be assumed to produce efficient results, it arguably follows that academics, uniform lawmakers and others should intercede to help the law along. First, the fact that parties cannot necessarily choose the standard form they want means that courts might interpret existing contracts, including parties' adoption of standard forms, based on what the parties seemed to want rather than what they actually selected.¹⁵¹ Second, if diverse firms are likely to gravitate toward uniform standards, perhaps legislatures should draft open-ended default provisions that judges can tailor to individual cases¹⁵² or offer menus of alternative rules in order to promote optimal diversity.¹⁵³ Third, the law might respond to the problem of sub-optimal diversity by promoting uniform statutes. This suggests a role for institutions such as the American Law Institute and the National Conference of Commissioners on Uniform State Laws. Rules promulgated by these organizations could overcome network externalities by serving as a "focal" provision that new users adopt because they expect others to gravitate toward it.¹⁵⁴

difficult or impossible to determine. *Id.* at 810-15.

151. *Id.* at 814. For example, in *Nixon v. Blackwell*, 626 A.2d 1366, 1379-81 (Del. 1993), the Delaware Supreme Court declined to adopt a special rule for close corporation shareholders, partly because the parties failed to opt for treatment under the Delaware close corporation provisions. Since the standard-form corporation has a much larger user network than the little-used statutory close corporation, however, there is a question whether network concerns effectively foreclosed the close corporation as a realistic option, and therefore whether users should be penalized by their choice.

152. See Klausner, *supra* note 140, at 831-32.

153. See *id.* at 837-41. For evidence on uniformity in LLC statutes, see Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQUIRY 464 (1996).

154. See Klausner, *supra* note 140, at 800, 804. See generally ERIC RASMUSSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* 36 (1989) (noting that a focal point is an example of a Nash equilibrium in which no player will deviate from cooperation as long as the other players do not deviate); THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* 54-58 (1980) (discussing focal points). For discussions of uniform laws as focal points, see LEA BRILMAYER, *CONFLICT OF LAWS: FOUNDATIONS & FUTURE DIRECTIONS*, 155-85 (1991); Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 139-40 (1996).

The wisdom of these alternatives as solutions to network externalities depends, of course, on whether there is a problem to be solved. In the first place, network externalities may not be a factor at all. Business associations may not actually involve clear network characteristics. Interpretive judicial rulings, common practices such as investment banker fairness opinions, standardized services and pricing, and signaling effects would be most important where terms are open-ended or complex enough to require clarification, *and* an interpretation has value for many users in the network. Yet there may not be many such terms because courts often tailor open-ended terms, such as fiduciary duties for specific applications, so that an interpretation in one case has little value for others.¹⁵⁵ Moreover, any network benefits that exist may not increase with the number of users.¹⁵⁶ With respect to clarification provided by case law, litigation may occur too infrequently to provide much clarification irrespective of the number of users,¹⁵⁷ and in any event more cases do not necessarily provide more clarity because courts may reach inconsistent results.

Even if business associations have network characteristics, these may not involve *externalities*. A problem with identifying network externalities is that others besides individual users might internalize the benefits of creating a new standard.¹⁵⁸ In general, entrepreneurs can help shape users' expectations by convincing potential users that a new form is likely to become a standard. These expectations, in turn, determine whether users will adopt or shun a new form.¹⁵⁹ With respect to business associations, academics and practitioners can earn reputational and other benefits by encouraging the development of network benefits relating to standard forms.¹⁶⁰ Thus, lawyers might promote a new business association such as the LLC to have a new product to sell.

155. Lemley & McGowan, *supra* note 140, at 571-72.

156. Klausner assumes both that network benefits grow in a linear fashion over time as more users are added, and that these increases occur indefinitely. Klausner, *supra* note 140, at 793 n.119.

157. Lemley & McGowan, *supra* note 140, at 572-73.

158. See Liebowitz & Margolis, *supra* note 125.

159. Klausner, *supra* note 140, at 800, 802-03, 805.

160. Cf. Lemley & McGowan, *supra* note 140, at 578; Ribstein, *supra* note 5, at 392-95, 400-01.

They can hold continuing legal education programs on the use of a new standard form, which states in effect subsidize by requiring or encouraging lawyers to participate. Lawyers also can write books and articles that help in the interpretation and use of new forms. Private groups such as the state bar may internalize the benefits of promoting these statutes.¹⁶¹ Lawyers also earn reputational benefits from drafting and lobbying for new legislation.¹⁶² Moreover, as with the LLP, the move to a new standard can be facilitated by linking or bundling it with an existing standard form in order to utilize case law and other interpretive materials. This is analogous to engineering a new product with backward compatibility or convertibility features or bundling it with another product.¹⁶³ Although those who believe network externalities are an important phenomenon might argue that the devices just discussed indicate the presence of a network externality problem that must be solved, it might be argued with equal force that the easy availability of such solutions indicates that there was never any problem.

Even if network externalities exist, they may not explain why firms fail to move to a new form. Failure to move to a new standard may be attributable to the suitability of the default rules of the standard form firms adopt.¹⁶⁴ For example, the QWERTY/Dvorak story on which the network externalities theory originally was based broke down upon a closer examination of the factual background. Liebowitz and Margolis demonstrated that the evidence for Dvorak's superiority was weak, and that QWERTY won only after

161. See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998); Klausner, *supra* note 140, at 841.

162. See Ribstein & Kobayashi, *supra* note 154, at 144-45; Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws, and Limited Liability Companies*, 66 U. COLO. L. REV. 947, 959-61 (1995). In general, these activities may arise because lawyers have a kind of property right in the law of their jurisdictions in the sense that licensing rules restrict free entry of other lawyers. Larry E. Ribstein, *Lawyers' Property Rights in State Law* (Nov. 27, 2000) (unpublished manuscript, on file with the William and Mary Law Review). Of course, government may want to limit the extent to which lawyers or anyone else has such property rights in law so as to internalize the costs of moving to a new standard. For example, property rights in legal precedent may be inefficient because this would cause legal precedent to help the "owner" and hurt others. From this standpoint, some network externalities may be socially efficient. We are indebted to D. Bruce Johnsen for this point.

163. Gillette, *supra* note 140, at 820; Lemley & McGowan, *supra* note 140, at 496.

164. See Klausner, *supra* note 140, at 813-14.

proving itself against competing standards.¹⁶⁵ Similarly, Liebowitz and Margolis have attributed Microsoft's dominance in the software market to the superiority of their products, which weakens the argument for network externalities in this context as well.¹⁶⁶ As discussed above in Subparts A and B, comparing the benefits of the default rules of various standard forms, with and without taking tax and regulation into account, is a complex enterprise.

These problems are evident in the examples proposed by Michael Klausner, the leading proponent of the network externalities theory in the context of business associations. Klausner argues that Silicon Valley entrepreneurs' apparent reluctance to use the partnership form despite the evident tax advantages because of their unfamiliarity with partnership equivalents to stock options¹⁶⁷ shows the importance of network marketing benefits because employees would be more comfortable with the partnership form as its use grew.¹⁶⁸ But these firms might have used the standard corporate form for other reasons. They may have wanted the assurance of limited liability, particularly given the risk inherent in a start-up. Although they could incorporate under Subchapter S and obtain partnership-type taxation, this would be subject to the various costs of the Subchapter S form discussed above, including the limitations imposed by the one-class-of-stock limitation.¹⁶⁹ Or the parties might have been concerned that the greater impermanence of the partnership form exposes the members to the risk of opportunistic withdrawal of capital.¹⁷⁰ In short, use of the corporate form might reflect the higher benefits of that form's default rules rather than network externalities.

165. S. J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J.L. & ECON. 1 (1990); see also LIEBOWITZ & MARGOLIS, *supra* note 139 (showing evidence that Microsoft's victory in software markets is due to the superiority of their products rather than network externalities); S. J. Liebowitz & Stephen E. Margolis, *Network Externality: An Uncommon Tragedy*, J. ECON. PERSP., Spring 1994, at 133 (arguing for limited application of the theory of network externalities as market failures).

166. LIEBOWITZ & MARGOLIS, *supra* note 139.

167. See Joseph Bankman, *The Structure of Silicon Valley Startups*, 41 UCLA L. REV. 1737 (1994).

168. Klausner, *supra* note 140, at 821-22.

169. See *supra* note 18 and accompanying text.

170. See *supra* note 42 and accompanying text.

Failure to move to a new form also may be attributable simply to a lack of foresight, mistake, cognitive biases or agency costs rather than network externalities. The choice of form may be simply a mistake in the sense that it is the wrong form even taking into account the above constraints. Or lawyers may cause excessive standardization because their incentives differ from those of their clients.¹⁷¹ Lawyers may receive relatively little reward for successful innovation, but suffer significant losses to their non-diversifiable human capital.¹⁷² Also, lawyers and accountants might not capture enough individual rewards to compensate them for retooling to handle new forms. The market may be imperfectly informed about the quality of the lawyer's efforts and evaluate the lawyer based only on whether her actions, or the outcomes from these actions, diverged from those of other lawyers.¹⁷³ Thus, the lawyer's self-optimizing course may be to conform even if this is not best for the client.¹⁷⁴ To be sure, this cause of lock-in blends with network externalities because a larger network and more information reduce lawyers' risk. But focusing on lawyers' incentives may point to fixing the lawyer-client relationship rather than the underlying legal rules.

With respect to cognitive biases and lock-in, Klausner and Kahan focus on the status quo, anchoring and conformity biases and the endowment effect, which refer to tendencies to favor present states, group judgments and initial "reference points," and to prefer what the actor now owns.¹⁷⁵ As with lawyer-client agency costs, cognitive

171. Kahan & Klausner, *Path Dependence*, *supra* note 140, at 353-55; Edward L. Rubin, *The Phenomenology of Contract: Complex Contracting in the Entertainment Industry*, 152 J. INST'L & THEOR'L ECON. 123, 135 (1996); *see also* Donald C. Langevoort & Robert K. Rasmussen, *Skewing The Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997) (discussing overstatement of risk as a type of agency cost).

172. This is related to the phenomenon of "maverick" risk as applied to pension fund fiduciaries. The business judgment rule may make fiduciaries reluctant to follow investment policies that depart from industry standards even if they are value-increasing because their liability and market exposure outweigh the private benefits of a successful maverick policy. We are indebted to D. Bruce Johnsen for this analogy.

173. Kahan & Klausner, *Path Dependence*, *supra* note 140, at 356-8. Note that the lack of information may itself be attributable to network effects, thereby further entangling network externalities with other causes.

174. On the other hand, innovating lawyers may be able to earn sufficient fees to compensate them for the risks of being first movers. Indeed, lawyers' conservatism might counter-balance their incentive to drive up fees through excessive innovation.

175. Kahan & Klausner, *Path Dependence*, *supra* note 140, at 359-65 (citing the literature

and judgment biases may be hard to separate from network externalities because they may turn out to be learning or network effects.¹⁷⁶ Also, even if the problem is identified, the normative prescription may be unclear. Because legislators, courts and regulators are subject to the same biases, the best solution may be to simply let the market minimize the effect of the biases by clarifying the costs of sticking with inferior solutions.

Finally, even if network externalities prevent a move to new form, the resulting equilibrium may be optimal. A new standard might attract users from an optimal existing standard by offering short-term benefits. A bandwagon attributable to the creation of a new network might then cause a general move to the new standard. It might be better if network externalities prevented the suboptimal move.¹⁷⁷

The ambiguities concerning the network externalities hypothesis will be discussed in the following subsections with respect to the phenomena on which our analysis focuses.

2. *Close Corporation Statutes*

One commentator attributes rejection of special close corporation statutes to firms' being locked-in to the standard corporate form by its established network of cases and practices.¹⁷⁸ However, firms' failure to move to these statutes might be attributable to the costs and uncertainties of close corporation statutes discussed above in Subpart A.

3. *LLCs*

Network externalities seem to be an impediment to acceptance of the LLC form. The benefits of the LLC discussed above in Subpart A, including flexible financial structure and standard form

on these phenomena).

176. *Id.* at 365.

177. Thus, lock-in may be analogous to arguments for the efficiency of entry barriers. See Harold Demsetz, *Barriers to Entry*, 72 AM. ECON. REV. 47 (1982); C. C. von Weizsäcker, *A Welfare Analysis of Barriers to Entry*, 11 BELL J. ECON. 399 (1980).

178. See Wortman, *supra* note 15, at 1379 & n.71 (citing Robert C. Clark, CORPORATE LAW § 1.3, at 29 (1986)).

governance structures that can fit both direct member-managed and centrally managed firms, also can be viewed as costs in the sense that there is no partnership or corporate network of rules, cases and forms on which firms, third parties and courts can draw for clarification. For example, many terms in LLC statutes have no case law interpreting them, and there are uncertainties concerning how many regulatory statutes in areas such as employment discrimination, securities law and bankruptcy law should be applied to LLCs. The important question regarding LLCs is whether externalities associated with moving to a new network inhibited firms from taking advantage of the beneficial novelties of the LLC form. A rough look at the data seems to raise more questions than it answers on this point.

a. The Rapid Acceptance of the LLC Form

Table 2 shows that firms have rapidly embraced the LLC form. Because LLCs must adopt new forms and agreements that differ from those already developed for partnerships and corporations,¹⁷⁹ firms' move to the LLC form arguably refutes the network externalities theory. That seems particularly to be the case in light of firms' failure to adopt special close corporation statutes *despite* the latter's linkage with the existing network of corporate case law, customs and expertise. Moreover, there is significant anecdotal evidence that lawyers pushed hard for LLC statutes in their states,¹⁸⁰ thereby supporting the hypothesis that lawyers' groups can internalize the benefits of network creation.

b. The Evolution of LLC Statutes

The evolution of the LLC statutes themselves also tends to refute the hypothesis that network externalities locked firms into existing forms. Network externalities might be expected to lock in early versions of the LLC form, particularly if those versions might be

179. See Lee, *supra* note 20, at 929 n.245.

180. Carney, *supra* note 21, at 857-59; Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193 (1995).

described as "focal." In fact, there has been considerable evolution in LLC provisions.¹⁸¹ For example, the 1977 Wyoming statute, which was essentially a modified limited partnership,¹⁸² did not become the model. Nor did the Delaware statute, despite Delaware's "brand name" in corporate law. Dissociation and dissolution provisions illustrate the absence of lock-in. LLCs initially followed the limited partnership model of permitting members to cash out of the firm at any time on appropriate notice, usually six months. Tax classification rules undoubtedly encouraged use of this format because restrictions on dissolution or dissociation were viewed as corporate features that might lead to corporate tax classification.¹⁸³ LLC statutes gradually evolved to permit contracting for continuity.¹⁸⁴ This response to changing tax law illustrates adaptation rather than lock-in. With the abandonment of tax classification, states rapidly moved toward repealing LLC members' default right to resell their interests back to the firm.¹⁸⁵ This accommodated the use of LLCs for family firms by providing a statutory basis for claiming estate tax discounts.¹⁸⁶ It also increased firms' stability and reduced potential opportunism by exiting members,¹⁸⁷ although those objectives could be accomplished by agreement alone without changing the statutory default rule.

c. The "Stickiness" of the Corporate Form

The average number of incorporations per state has remained steady despite the rise of the LLC.¹⁸⁸ Thus, all other things equal,

181. See Ribstein, *supra* note 5. For similar evidence regarding the evolution of Australian corporate charter provisions, see Michael J. Whincop, *An Empirical Investigation of the Terms of Corporate Charters and Influences on Term Standardization in a Laissez-Faire Environment*, at http://papers.ssrn.com/paper.taf?abstract_id=231048 (Sept. 5, 2000).

182. Carney, *supra* note 21, at 857-59.

183. For a discussion of the prior tax rule, see Ribstein, *supra* note 3, at 458.

184. Ribstein, *supra* note 5, at 425-28.

185. See *supra* note 107 and accompanying text; RIBSTEIN & KEATINGE, *supra* note 26, app. 11-1 (tabulating state provisions).

186. I.R.C. § 2704 (West 2000); RIBSTEIN & KEATINGE, *supra* note 26, §§ 18.01-.13.

187. See *supra* note 42 and accompanying text.

188. Based on 1988 through 1999 annual reports from the International Association of Corporation Administrators (IACA). See 1988 through 1999 IACA ANN. REPS. OF THE JURISDICTIONS. The IACA data is described *infra* note 198.

and assuming total business formations have remained fairly constant, LLCs appear to be replacing partnerships but not corporations. This might be explained by network externalities. LLC statutes are much more similar to partnership than to corporation statutes. This lets LLCs make greater use of the existing network of partnership forms than of the existing network of corporate forms. In addition, Subchapter S corporations appear to involve fewer tax issues that have been left unresolved by the existing network of law and legal opinions than exist under Subchapter K, particularly as applied to the relatively new LLC form.¹⁸⁹ Both types of problems may be inducing firms to stick with the existing corporate “network” rather than forming LLCs.

d. The Timing of the Move

The timing of LLCs replacement of the partnership form may be reconciled with the network externalities story. LLCs arguably replaced partnerships only when the non-network benefits of the move increased to the point they outweighed the network effects. For example, the Tax Reform Act of 1986, which brought down individual tax rates, made the corporate tax shelter less useful and made the search for an unincorporated limited liability business form more imperative.¹⁹⁰ Alternatively, the rise of the LLC might be attributed to increased competition in the legal services market, or to LLCs’ increased salience in the media, creating expectations that a significant number of firms would move to the new network.

e. Should There be More LLCs?

If the corporate form is advantageous for some firms, the fact that firms are continuing to incorporate fails to indicate the presence of network externalities. For example, the defects of LLC default rules for some firms, including the excessive impermanence of the form,¹⁹¹ may explain why some firms prefer to incorporate.

189. Lee, *supra* note 20, at 929.

190. See generally Hamill, *supra* note 26.

191. See *supra* note 42 and accompanying text.

Further, the "inside" tax shelter of the corporate form¹⁹² suggests firms that can retain earnings are still incorporating. Indeed, firms' failure to rush to the LLC form despite these considerations arguably indicates the *absence* of network externalities. If all firms had moved to the LLC form, this might suggest that the rush to the LLC was a bandwagon to sub-optimal uniformity, or "tipping" to a new standard to avoid being stuck in an abandoned product.¹⁹³

4. LLPs

A main point of this Article is that comparing formations of LLCs with those of LLPs provides important insights into theories about choice of organization form, particularly regarding the role of network externalities. In linking LLP provisions to general partnership statutes, legislatures employ a device that avoids network externalities by giving the new form the advantage of an existing partnership network of cases and forms.¹⁹⁴ Thus, linkage may be a cost-effective way to deal with network externalities *if* they exist. Comparing the success of the LLP form with a similar non-linked alternative—the LLC—indicates the significance of network effects. As discussed in Part III, our evidence shows that most firms have preferred the LLC.

The significance of firms' rejection of the LLP form depends largely on whether the LLP has disadvantages that would cause firms to reject it even if network externalities are considerable. Table 1 summarizes differences between LLCs and LLPs. In general, LLP default rules are not as well suited for limited liability firms as those of the LLC, particularly regarding management and dissociation. This suggests that some cases and forms based on the partnership model also will be unsuited for these firms.¹⁹⁵ On the

192. See *supra* notes 97-102 and accompanying text.

193. This effect would be similar to one that Kahan and Klausner assert occurred with regard to event risk bond provisions. Kahan & Klausner, *supra* note 124, at 740-60.

194. See *supra* notes 155-56 and accompanying text.

195. Although the LLP form seems to have been designed for professional firms only, in most states, non-professional firms can use the LLP form. The exceptions are California, Nevada, New York, and Oregon. BROMBERG & RIBSTEIN, *supra* note 29, § 2.03(a)(3). The states may be price-discriminating in their limited liability offerings, reserving the ultimate extension of limited liability only to the specific category of professional firms that lobbied

other hand, as discussed above,¹⁹⁶ LLPs have advantages over LLCs in terms of tax and switching costs. In general, the net disadvantages of the LLP over the LLC would not seem to be enough to deter firms from using the form if network externalities are significant. The data presented below in Part III indicating the role of various choice-of-form factors support this conclusion.

One might argue that firms' rejection of the LLP form does not support the nonexistence of network externalities because LLPs were invented in 1991, three years after the tax ruling that led to the spread of LLC statutes,¹⁹⁷ by which time any network effects may have disappeared. To be sure, our data can be read as consistent with this conclusion. This, however, arguably would suggest that network effects are too short-lived to have important policy implications.

III. DATA ON THE CHOICE OF FORM: LLCs VS. LLPs

Part II shows that there are many diverse and conflicting factors potentially underlying firms' choice of organizational form. Accordingly, it is not surprising that it is difficult to isolate any single explanation. In particular, it is impossible to predict with certainty the effect of network externalities on the LLC/LLP ratio. However, we can isolate the role of network externalities to a certain extent by clarifying our assumptions and simplifying the issues. This Part presents data comparing formation of LLCs in each state with formation of LLPs over the same period. This comparison is significant because, as discussed above, LLCs and LLPs were developed over approximately the same period and are comparable in many respects. This permits isolation of specific factors that matter to firms' choice of organizational form. A key difference between LLCs and LLPs is that the latter link with the partnership "network" of cases and forms. Thus, if network externalities were important, firms would tend to prefer the LLP to the LLC form, other factors being equal. Also, state-by-state

for it.

196. See *supra* notes 114-35 and accompanying text.

197. See *supra* note 28 and accompanying text.

comparisons of formations can reveal the roles of taxes and governance rules in choice of form.

In general, the data show that firms preferred the LLC to the LLP form by wide margins *except* in states where tax or other disadvantages of the LLC form were significant. Table 2 presents LLC and LLP formation data by state for the years 1993-1999.¹⁹⁸ Table 3 shows the average LLC and LLP formations per year by state and the corresponding LLC/LLP Ratio.¹⁹⁹ Figure 1 graphically illustrates the relationship between the average LLC and LLP formations. It is significant that the LLC/LLP Ratio is greater than one in every state in every year, and that only seven of forty-nine jurisdictions have a LLC/LLP Ratio of less than 10:1.

The state-by-state data also shows the effect of tax and other considerations on firms' decisions to adopt the LLC form. If the effects of network externalities were strong, we would not expect such tax or other considerations to cause firms to choose LLCs over LLPs. But Table 3 shows that, of the seven states with LLC/LLP ratios of less than 10:1, two states—Pennsylvania and Texas—imposed corporate income taxes on LLCs but not on LLPs during the relevant period.²⁰⁰ Indeed, Texas's invention of the LLP may be at least partly attributable to this fact. Additionally, two of the states with the lowest LLC/LLP Ratios—Minnesota and North Dakota—have LLC statutes whose unusual corporate-type

198. The data set forth in Table 2 is from annual reports by IACA, which in turn obtains its data from state secretaries of state. The IACA data combines domestic and foreign unincorporated firms. Because we do not know how the reporting states collect their data, we cannot verify the accuracy of these figures. Because filings are relatively objective events, however, it is unlikely that the data are skewed toward one or the other entity, rather than simply reporting too many or too few of both entities. Thus the data probably accurately reflects *relative* numbers of LLCs and LLPs, the subject of interest here.

199. The average figures reflect all years in which a state had both an LLP and an LLC statute in effect for the entire year, and years where both the LLC and LLP statutes were in effect for a part of the year, but became effective in the same month. Table 2 presents a complete listing.

200. See *supra* note 114 and accompanying text; see also RESEARCH INST. OF AMERICA, STATE AND LOCAL TAXES, at 222-D (1999). Currently, only Texas taxes LLCs and LLPs differently. CARTER G. BISHOP AND DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW (1994 & Supp. 2000) §§ 1.08-.08[6]. Florida imposes an intangibles tax only on LLCs, Pennsylvania imposes a franchise tax only on LLCs, and Michigan levies a corporate income tax on both LLPs and LLCs. *Id.*

complexity may have deterred use of the LLC form.²⁰¹ This explanation would emphasize benefits of the LLP default rules rather than network externalities.

Table 4 reports the results of a regression analysis of the state and year data listed in Table 2.²⁰² This analysis examines specific hypotheses concerning the role of various choice-of-form factors. The analysis includes results for states that had both LLC and LLP statutes in effect for the whole year and for those where both statutes were in effect for equal parts of a year. Our initial regression model examines the LLC/LLP ratio and how the two factors discussed above affect this ratio. Specifically, our model considers the effect on the LLC/LLP ratio of a state adversely taxing LLCs relative to LLPs (LLC DIFF. TAX), and having a complex LLC statute (COMPLEX LLC STATUTE).²⁰³

The choice-of-form factors in Part II suggest that, if network externalities were very significant, there would be more LLP than LLC formations. This follows from the fact that the overall advantages and disadvantages of the forms are approximately equal with respect to the other choice-of-form factors we discuss. More specifically, LLPs balance tax and switching cost advantages against disadvantages related to linkage with the general partnership form. For purposes of clarifying our results, we state the "null hypothesis" for network externalities as holding that LLP formations would exceed LLC formations. This means that this result would tend to suggest the existence of network externalities. We do not contend that a particular ratio demonstrates or disproves

201. The complexity test is described *infra* note 203.

202. The Table applies a "logit" model, in which the dependent variable is the log of the LLP/LLC ratio. Under this model, we estimate the probability that a firm in state i during year j chooses to form an LLC by applying the formula $P_{ij} = \text{LLC}_{ij} / (\text{LLC}_{ij} + \text{LLP}_{ij})$. The dependent variable equals $\log(P_{ij}/(1 - P_{ij})) = \log(\text{LLC}_{ij}/\text{LLP}_{ij})$. Thus, the null hypothesis under the network externalities theory, that LLC/LLP ratio is less than one, is equivalent to the hypothesis that the log of the average LLC/LLP ratio is less than zero. ROBERT S. PINDYCK & DANIEL L. RUBINFELD, *ECONOMETRIC MODELS AND ECONOMIC FORECASTS* 289-90 (2d ed. 1981) (discussing logit model).

203. The results were estimated using ordinary least squares. As a proxy for complexity, we set the COMPLEX LLC STATUTE variable at 1 if the state's LLC statute length (in bytes) was more than two standard deviations above the average state's LLC statute length. Under this formulation, we found Illinois, North Dakota, Minnesota and Tennessee to have complex statutes. The relatively high LLC/LLP ratio for Illinois may result from the fact that LLCs but not LLPs may practice law. RIBSTEIN & KEATINGE, *supra* note 26, § 15.14.

the existence of network externalities, but only that the LLC/LLP ratio provides relevant information bearing on the importance of network externalities.

Column 1 of Table 4 shows the CONSTANT term is positive and statistically significant. This result supports rejection of the null hypothesis under the network externalities theory.²⁰⁴ Thus, the data does not support the proposition that network externalities impede development of new statutory business forms. The adoption of the LLP form by only a small fraction of firms suggests that only the firms for which the LLP is most suitable, such as the professional firms for which the LLP initially was invented,²⁰⁵ are forming LLPs.

Other regression results confirm the rejection of the network externalities hypothesis. Table 4 shows that LLPs are most successful where this business form has the highest relative non-network-externality benefits—that is, where it avoids state taxes or avoids a complex LLC statute. States that adversely tax LLCs and that have relatively complex LLC statutes have lower ratios of LLCs to LLPs.²⁰⁶ Thus, we can reject the null hypothesis that tax and other considerations do not affect the rate of LLC adoptions.

We have considered whether specific advantages of LLCs bias choice of form in favor of LLCs and therefore might indicate that firms have chosen the LLC form even though the LLP significantly reduces network externalities. One important factor is the ability to form single-member LLCs, which facilitates use of this form for sole proprietorships and for branches of other firms. Virtually all states allow single member LLCs,²⁰⁷ while partnerships and LLPs

204. The CONSTANT term in the regression equals the log of average LLC/LLP ratio for a "base" firm that lacks any of the other characteristics in the regression (that is, one without differential taxation or a complex statute). The fact that the CONSTANT is positive and statistically significant at standard significance levels allows us to reject the null hypothesis for such a firm. See *supra* note 202.

205. See *supra* note 28 and accompanying text.

206. The average LLC/LLP ratio in a state with equal tax treatment of LLPs and LLCs and with a non-complex LLC statute is 36.23. In states that adversely tax LLCs, this ratio falls to 6.42, and where LLC statutes are complex this ratio falls to 13.33. These coefficients are statistically significant. See *infra* Table 4 p. 138.

207. As shown in Table 2, as of 1999 only Washington, D.C. and Massachusetts did not allow single member LLCs. D.C. subsequently amended its statute to permit single-member LLCs. Limited Liability Company Amendment Act of 2000, D.C.L. 13-133, 1999 D.C. Stat. 133 (West 2000).

must have two or more members. Although formation data does not separate single-member from multiple-member LLCs, we can control for the effect of single member LLCs by comparing ratios during times when LLC statutes did, and did not, provide for single member LLCs. ONE MEMBER LLC variables denote whether states allowed formation of one-member LLCs for all or part of a given year. Column 2 of Table 4 shows that the effects are small and not statistically significant.²⁰⁸ These data reject the hypothesis that single-member benefits of LLCs explain its dominance of the LLP form.

The evolution of LLP statutes provides additional evidence against the role of network externalities. Many LLP statutes originally provided for only a partial liability shield for torts but not contracts.²⁰⁹ This gave firms the liability protection they needed most while, perhaps, smoothing potential political opposition to expanding limited liability to full-fledged partnerships.²¹⁰ However, Table 2 shows that by 1999, most statutes included "full-shield" provisions providing protection for all kinds of liabilities.²¹¹ This indicates that, as with LLCs,²¹² the early form of the statute was not locked-in. Column 2 of Table 4 shows that full year adoption of a full-shield statute increases the ratio of LLPs to LLCs.²¹³

Table 4 also reports the regressions that include a dummy variable denoting whether the state's LLP statute was restricted to use by professional firms (LLP RESTRICTED).²¹⁴ States with this restriction had lower LLC/LLP ratios. This may reflect the tailoring of the LLP statute to professional firms. The effect is not large in magnitude, however, and it is not statistically significant except after eliminating outlier LLC/LLP ratios greater than 300.²¹⁵

208. Based on the regression coefficients reported in Column 2 of Table 4, the average 1993-4 LLC/LLP Ratio in states that do not allow single member LLCs is 15.3, while the average LLC/LLP ratio is 18.7 in those states that do.

209. BROMBERG & RIBSTEIN, *supra* note 29, §§ 1.01(a)-(b).

210. *See supra* note 195.

211. BROMBERG & RIBSTEIN, *supra* note 29, §§ 1.01(c), 3.03, tbl. 3-1 (categorizing current LLP statutes).

212. *See supra* notes 181-86 and accompanying text.

213. The coefficients show that this result is statistically significant. Table 2 shows that part-year adoption negatively affects this ratio, but the result is not statistically significant.

214. *See supra* note 195 and accompanying text.

215. More generally, Columns 3 and 4 of Table 4 report results for observations where the

Figure 2 shows that results are not generally affected by a "sensitivity" analysis that shows the effect of dropping a single state out of the regression. The CONSTANT terms for forty-eight such regressions range from 2.41 to 2.88 (corresponding to an average base LLC/LLP ratio ranging from 11.1 to 17.8) and are statistically significant throughout all regressions. The tax variable ranges from -1.41 to -2.04 and is also statistically significant in all forty-eight regressions.²¹⁶

Table 4 provides further evidence against the importance of network externalities by showing that the LLC/LLP ratio increased during a period of two changes that increased the inherent benefits of LLCs. First, beginning on January 1, 1997, the IRS eliminated, through the adoption of the "check-the-box" rule, the complex tax classification rules for LLCs.²¹⁷ This rule eliminated unpredictability in tax classification of unincorporated firms. The rule might be expected to increase the relative net benefits of using *either* the LLC or LLP form over the corporate form without affecting the LLC/LLP ratio. But viewed in conjunction with other choice-of-form factors, an increase in the LLC/LLP ratio following check-the-box would be consistent with firms' choosing the LLC form over *both* the corporate and LLP forms, with the latter choice attributable to inherent benefits of the LLC over the LLP despite network externalities benefits from the LLP form.

Second, following the change in tax classification rules, many states quickly amended their statutes to restrict member dissociation. This had several potential advantages, particularly a

LLC/LLP ratio is less than 300. This deletes observations from Georgia for all years, and from Delaware for 1996-1999. This has little effect on the results except for the one noted in the text.

216. The magnitude and significance of the coefficient for the COMPLEX LLC STATUTE variable are sensitive to the exclusion of some observations. As noted above, LLC formations may have been deterred by the unusual nature of the North Dakota and Minnesota statutes. See discussion *supra* note 201 and accompanying text. Deleting the North Dakota or Minnesota observations produces smaller and statistically insignificant results for the COMPLEX LLC STATUTE variable. In contrast, LLP formations in Illinois and Tennessee may have been suppressed by those states' rules deterring use of the LLP form by law firms. See *supra* note 203. Deleting Illinois or Tennessee produces COMPLEX LLC STATUTE coefficients of -1.37 and -1.43 respectively. For further discussion of these states, see *infra* note 221.

217. See *supra* note 73 and accompanying text.

stronger basis for firms to claim estate tax discounts.²¹⁸ Thus, the increased LLC/LLP ratio following check-the-box might indicate increased inherent net benefits resulting from eliminating a defect (relatively unrestricted dissociation) in the LLC statutes.²¹⁹ In other words, the change in dissociation provisions helps isolate a benefit of the LLC form that might lead firms to choose this form over the LLP form once freed of tax incentives to incorporate.

Table 5 helps to isolate the effects of these two changes. The RESTRICTED DISSOCIATION variables indicate whether the state statute restricted dissociation for a full year (FY) or part of a year (PY).²²⁰ The analogous CHECK THE BOX variables reflect the effect on LLC/LLP ratios of years in which the simplified federal tax classification rules were in effect. The dissociation variable had positive and statistically significant effects on the ratio of LLCs to LLPs in both regressions. The CHECK THE BOX result is positive in both regressions *but* statistically significant only in the LLC/LLP < 300 regression. This difference in the robustness of statistical significance to outliers indicates that it was changes in dissociation provisions after check-the-box that tended to attract firms to the LLC form. In any event, formation ratios during this period further indicate that inherent benefits, not network externalities, are driving choice of form.²²¹

218. See *supra* notes 186-87 and accompanying text.

219. The increased ability under check-the-box to combine corporate features and partnership taxation might induce fewer firms to incorporate, but this alone would not affect the LLC/LLP ratio.

220. The following states changed their statutes to restrict dissociation after the adoption of the check-the-box rules: AK, CT, IA, MD, MI, MO, NV, NH, OH, RI (1997); AL, KY, MS (1998); AR, FL, IN, ME, NY, NC (1999); KS (2000). In addition, nine states (CA, DE, GA, NE, NJ, OK, OR, VA, WA) restricted dissociation prior to 1997. See RIBSTEIN & KEATINGE, *supra* note 26, app. 11-1.

221. The regressions reported in Table 5 also control for the two states—Illinois and Tennessee—restricting use of the LLP form by law firms. See *supra* note 203. As expected, the coefficient on the LLP NO LAW variable is positive and statistically significant in both regressions. Results for the other variables are substantively and quantitatively unchanged from those reported in Table 4. In addition, during the editorial process we obtained LLC and LLP formation data from IACA for the year 2000. The LLC/LLP ratios for thirty-four states reporting data in 2000 averaged 129.34 with a median of 61.49. The minimum ratio is 2.42 (North Dakota, a state with a complex LLC statute). Only one other state (Minnesota at 3.35, also with a complex statute) has a LLC/LLP ratio under 10. We also re-ran the regression analyses reported in Tables 4 and 5 with an expanded dataset that included the year 2000 data. Inclusion of this data did not change the results reported in the Article or the statistical significance of the coefficients reported in Tables 4 and 5 and caused only minor changes in

IV. CONCLUSIONS AND IMPLICATIONS

We have examined the role of various factors in firms' choice of organizational form. In particular, we present data on the formation rates of LLPs and LLCs. These data are revealing because the two business forms are close substitutes in many respects, which permits us to isolate particular factors that determine choice of form. One key difference is that LLPs' link to the existing "network" of partnership law suggests that firms would prefer the LLP to the LLC form if network externalities matter. Evidence of this preference would support the theory that network externalities are an inherent impediment to choice of organizational form and the normative conclusion that the law should address this defect.

In fact, examination of formations shows that most firms prefer LLCs to the linked LLP form. Moreover, the relative popularity of the LLP form in states imposing entity taxes on LLCs but not LLPs indicates that tax considerations may matter more than network externalities to the choice of business form. Conversely, larger inherent benefits of LLCs in particular states and years appear to cause firms to prefer the LLC form despite the potential network externalities benefits of the LLP form. Thus, our data suggest that network externalities are not a significant impediment to firms' choosing the organizational form appropriate for their business.

Our data has important policy implications. The network externalities theory is a potentially significant argument for market failure relating to choice of business forms. However, there is little hard data on the existence of network externalities in this context. Although our evidence does not definitively negate the role of network externalities in choice of business form, and does not directly relate to network externalities in other contexts, such as the dominant role of Delaware law, it raises enough doubt to suggest the need for more data before basing legal policy on network externalities.

the magnitude of these coefficients. A dummy variable equal to 1 for year 2000 data was both positive and statistically significant at the .001 level or greater for all specifications.

Table 1 – The Attributes of Business Associations

	<i>Unlimited Liability</i>	<i>Limited Liability</i>
<i>Entity Level Taxation</i>		Corporation (Corporate-type provisions)
<i>Partnership Taxation</i>	Partnership (direct management by owners & disassociation rules)	Close Corporation + Subchapter S Limited Liability Company (LLC) Limited Liability Partnership (LLP)

Denotes linkage between new form and existing network.

Table 2 - Formation Data by State

		1993	1994	1995	1996	1997	1998	1999
AL	LLC	114	1208	1800	2548	3430	4624*	5984
	LLP					269	276	
	RATIO					12.75	16.75	-
AK	LLC			163**	335	534*	673	877
	LLP					89	-	-
	RATIO					6.00	-	-
AZ	LLC	2244	3837	5189	6601	8199	10267	13138
	LLP		-	-	115	528	1050 ^{ab}	1373 ^{ab}
	RATIO		-	-	57.40	15.53	9.78	9.57
AR	LLC	**	603	1089	1420	1717	1947	3174
	LLP					23*	47	61
	RATIO						41.43	52.03
CA	LLC		**	8373	12151	17979	23190	27987*
	LLP			171*	530	530	521	521
	RATIO				22.93	33.92	44.51	53.72
CO	LLC	2605	4063*	6562	8094	9184	11307	13841 ^{ab}
	LLP			286*	964	214	570	194 ^{ab}
	RATIO				8.40	42.92	19.84	28.02
CT	LLC		2500**	*	9730	10086*	13456	22268
	LLP				184	198	163	149
	RATIO				52.88	50.94	82.55	149.45
DE	LLC	735	2696	6933*	10888	15967	30793	40131
	LLP	**	10	13	21	44*	42	56
	RATIO		269.60	533.31	518.48	362.89	733.17	716.63
DC	LLC		210**	-	1245	1245	-	-
	LLP		**	-	69	78		
	RATIO			-	18.04	15.96	-	-
FL	LLC	474	933	1399	1892	2357	5124	11555
	LLP				124	202	207	917
	RATIO				15.26	11.67	24.75	12.60
GA	LLC***	13**	369	2417	3832	6532*	9239	12959
	LLP				5	16	12	7
	RATIO			345.29	766.40	408.25	769.92	-

		1993	1994	1995	1996	1997	1998	1999
HI	LLC					768**	1454	1816
	LLP					28**	45	47
	RATIO					27.43***	32.31	38.64
ID	LLC	125**	609	1107	1449	1899	2323	2864
	LLP			43**	97	141	141	142
	RATIO				14.94	13.47	16.48	25.57
IL	LLC		1729	2646	3654	4940	7271	8930
	LLP		49**	88	75	75	87	88
	RATIO			30.07	48.72	65.87	83.57	101.48
IN	LLC****	417**	1692	2465	3152	4022*	5115	5733*
	LLP			59*	246	253	286	253
	RATIO				12.81	15.90	17.88	22.66
IA	LLC	507	612	1325	1641	2189*	2507	3235
	LLP		22**	70	84	60	90	117
	RATIO			18.93	19.54	36.48	27.86	27.65
KS	LLC	499	1096	1658	1867	2397	2444* ^a	3212*
	LLP		37**	103	6	74	24 ^a	138* ^a
	RATIO			16.10	311.17	32.39	101.83	23.28
KY	LLC****		424**	1505	2190	2647	3955*	5942
	LLP		36**	103	98	97	90	83
	RATIO		11.78***	14.61	22.35	27.29	43.94	71.59
LA	LLC	924	1804	2872	3908	5750*	7554	9743
	LLP	89	102	115	107	94	90	84
	RATIO	10.38	17.69	24.97	36.52	61.17	83.93	115.99
ME	LLC			293**	434	708*	1084	1393
	LLP				14	24	21	11
	RATIO				31.00	29.50	51.62	126.64
MD	LLC	1071	1542	2914	4092	4325*	6884	-
	LLP		0**	100	422	379	-	-
	RATIO			29.14	9.70	11.41	-	-
MA	LLC				2193	3363	4973	5224
	LLP				356	307	246	234
	RATIO				6.16	10.95	20.22	22.32
MI	LLC	-**	3921	8868	18579	11053*	17589	21968
	LLP		15**	161	108	162	132	106
	RATIO			55.08	172.03	68.23	133.25	207.25
MN	LLC	609	941	1403	1987	2549*	3844	5376
	LLP		270**	1035	1129	1241	270	290
	RATIO			1.36	1.76	2.05	3.03	4.17

		1993	1994	1995	1996	1997	1998	1999
MS	LLC***		14**	859	1188	1876	1463*	
	LLP			20**	-	40	61*	
	RATIO				-	46.90	47.19	-
MO	LLC***	150**	814	2991	4078	6887*	7043	
	LLP			109*	121	225	277	
	RATIO				32.11	30.61	25.43	-
MT	LLC	-**	-	-	-	1526	1498	1479*
	LLP							
	RATIO				-	-	-	-
NE	LLC	61**	375	610	742	1113*	1157 ^a	1837
	LLP				20**	60	12 ^a	55
	RATIO					18.55	96.42	33.40
NV	LLC	723	1202	1956	3715	5563* ^a	7849	10388
	LLP			8**	24	23 ^a	39	46
	RATIO				154.79	241.87	201.26	225.83
NH	LLC	88*	291	660	861	1495*	2525	2887
	LLP				14**	34	34	28
	RATIO					43.97	74.26	103.11
NJ	LLC			6374*	8442	9998	13609*	-
	LLP				-**	209	218	-
	RATIO					47.84	62.43	-
NM	LLC	193*	739	1039	1296	1647 ^a	1904 ^a	2247 ^a
	LLP					20*	26	35
	RATIO						73.23	64.20
NY	LLC		1317**	8431	11170	14454	18101	21510
	LLP		294*	1068	815	679	689	605
	RATIO		4.48***	7.89	13.71	21.29	26.27	35.55
NC	LLC	2518*	2388	3264	4494	6001*	8162	10423
	LLP	-**	279	251	258	250	270	296
	RATIO	-	8.56	13.00	17.42	24.00	30.23	35.21
ND	LLC	47**	229	269	304	370	477	575*
	LLP			101*	229	251	213	245
	RATIO				1.33	1.47	2.24	2.22
OH	LLC		1270**	4653	6790	8713*	-	-
	LLP		137**	238	362	430	-	-
	RATIO		9.27***	19.55	18.76	20.26	-	-
OK	LLC	944	1432	2356	2904	3721*	4367	5632
	LLP				13**	42*	40	60
	RATIO					88.60	109.18	93.87

		1993	1994	1995	1996	1997	1998	1999
OR	LLC	0**	1708*	2388	9398	10297	14772	20071
	LLP			0**	50	268	351	413
	RATIO				55.28	38.42	42.09	48.60
PA***	LLC			491**	723	1498	3519	5534
	LLP			176**	370	458	473	487
	RATIO			2.79***	1.95	3.27	7.44	11.36
RI	LLC	257	328	510	785	1018*	1448	1636
	LLP				19**	26	38*	57
	RATIO					39.15	38.11	28.70
SC	LLC		279**	1270	2143*	3645	4826	6782
	LLP		51**	235	267	272	299	360
	RATIO		5.42***	5.40	8.03	13.40	16.14	18.84
SD	LLC	83**	297	399	478	550	600*	600
	LLP			31**	91	120	145	120
	RATIO				5.25	4.58	4.14	5.00
TN	LLC		289**	3340	4855	6456	7702	6517*
	LLP			36**	45	49	48	44
	RATIO				107.89	131.76	160.46	148.11
TX	LLC	3014	4252	5446	6628	8664	11935	13919
	LLP	637	520	1457	1664	525	1856	2147
	RATIO	4.73	8.18	3.74	3.98	16.50	6.43	6.48
UT	LLC	2572	3356	4360	6067*	6574	7191	8218
	LLP		18**	28	-	-	-	-
	RATIO			155.71	-	-	-	-
VT	LLC			-**	179	464	676	-
	LLP							-
	RATIO							-
VA	LLC	1733	2963	4215	5398*	8206	9974	12130*
	LLP		29**	56	86	778	773	669
	RATIO			75.27	62.77	46.10	136.63	183.79
WA	LLC		597**	2889	4243	6279	9134	10856
	LLP			300**	133	128	124	177
	RATIO				31.90	49.05	73.66	61.33
WI	LLC		2360	3473	4124*	6149	8136	10298
	LLP			19**	891	973	809	605
	RATIO				4.63	6.32	10.06	17.02
WV	LLC	206	-	-	-*	400	660	-
	LLP					7**	19	-
	RATIO						34.74	-

		1993	1994	1995	1996	1997	1998	1999
WY	LLC	1035	1086	1302	1407	1841*	1879	2389
	LLP						26	31
	RATIO						72.27	77.06

NOTES

= STATUTE NOT EFFECTIVE

- = DATA NOT REPORTED TO IACA

= ONE MEMBER LLCs ALLOWED (* DENOTES PART YEAR)

= LLP STATUE HAS FULL SHIELD (* DENOTES PART YEAR)

** = STATUTE EFFECTIVE PART OF THE YEAR

*** = LLP AND LLC EFFECTIVE AS OF SAME MONTH AND YEAR

**** = NUMBER OF MEMBERS REQUIRED TO FORM LLC NOT SPECIFIED

a = DATA DIRECTLY FROM STATE

b = DATA REPORTED BASED ON FISCAL YEAR

Table 3 – Summary State Formation Data

STATE	LLC/YEAR	LLP/YEAR	N	LLC/LLP	LLC/(LLC+LLP)
ND	431.50	234.50	4	1.84	0.65
MN	3031.80	1192.60	5	2.54	0.72
SD	656.75	119.00	4	5.52	0.85
PA	2614.44	436.44	4.5	5.99	0.85
AK	534.00	89.00	1	6.00	0.86
TX	7694.00	258.00	7	5.32	0.86
WI	5470.50	819.50	4	6.68	0.87
AZ	9551.25	766.50	4	12.46	0.93
SC	3444.55	269.82	5.5	12.77	0.93
MA	3938.25	285.75	4	13.78	0.93
MD	3777.00	300.33	3	12.58	0.93
FL	5282.00	362.50	4	14.25	0.94
AL	4027.00	272.50	2	14.78	0.94
DC	1245.00	73.50	2	16.94	0.94
IN	4505.50	259.50	4	17.36	0.95
ID	2133.75	122.75	4	17.38	0.95
NY	11535.85	638.46	6.5	18.07	0.95
OH	6121.71	333.43	3.5	18.36	0.95
CO	10606.50	560.50	4	18.92	0.95
NC	5788.67	267.33	6	21.65	0.96
IA	2179.40	84.20	5	25.88	0.96
MO	6002.67	209.67	3	28.63	0.97
NE	1369.00	42.33	3	32.34	0.97
KY	3029.64	92.18	5.5	32.87	0.97
KS	2315.60	69.00	5	33.56	0.97
HI	1615.20	48.00	2.5	33.65	0.97
RI	1367.33	40.33	3	33.90	0.97
WV	660.00	19.00	1	34.74	0.97
CA	22420.00	525.50	4	42.66	0.98
OR	13634.50	300.50	4	45.37	0.98
MS	1669.50	35.50	2	47.03	0.98
AR	2560.50	54.00	2	47.42	0.98
LA	4650.71	97.29	7	47.80	0.98
ME	904.75	17.50	4	51.70	0.98
WA	7628.00	140.50	4	54.29	0.98
NJ	11803.50	213.50	2	55.29	0.98
IL	5488.20	82.60	5	66.44	0.99

NM	2075.5	30.5	2	68.05	0.99
NH	2302.33	32.00	3	71.95	0.99
WY	2134.00	28.50	2	74.88	0.99
CT	13885.00	173.50	4	80.03	0.99
VA	7984.60	91.80	5	86.98	0.99
OK	4573.33	47.33	3	96.62	0.99
MI	15611.40	133.80	5	116.68	0.99
TN	6382.50	46.50	4	137.26	0.99
UT	4360.00	28.00	1	155.71	0.99
NV	6878.75	33.00	4	208.45	1.00
DE	17901.33	31.00	6	577.46	1.00
GA	5505.00	10.00	4	550.50	1.00
MT	*	*	0	*	*
VT	*	*	0	*	*
LLC/YEAR LLP/YEAR LLC/LLP LLC/(LLC+LLP)					
MEAN	5535.35	233.05		64.94	0.95
MED.	4360.00	119.00		33.56	0.97
STD. DEV.	4846.30	285.13		112.21	0.07

LLC Diff. Tax
Complex Statute

Figure 1 - LLC & LLP Adoptions

Table 4 – Regression Results

	ALL OBSERVATIONS		LLC/LLP < 300	
CONSTANT	3.59** (37.00)	2.73** (6.89)	3.42** (38.66)	2.82** (8.66)
LLC DIFF. TAX	-1.73** (-4.87)	-1.70** (-4.75)	-1.56** (-4.95)	-1.39** (-4.74)
COMPLEX LLC STATUTE	-1.00** (-3.27)	-0.85** (2.69)	-0.83** (-3.05)	-0.73** (-2.80)
ONE MEMBER LLC (FULL YEAR)		0.19 (0.77)		-0.19 (-0.87)
ONE MEMBER LLC (PART YEAR)		-0.02 (-0.05)		-0.31 (-1.12)
LLP RESTRICTED		0.41 (1.33)		0.74** (2.90)
LLP FULL SHIELD (FULL YEAR)		-0.63** (-3.24)		-0.90** (-5.47)
LLP FULL SHIELD (PART YEAR)		0.13 (0.31)		-0.06 (-0.16)
YEAR = 1995		0.71 (1.51)		0.35 (0.87)
YEAR = 1996		0.79* (1.81)		.64* (1.77)
YEAR = 1997		0.81* (1.82)		.91** (2.48)
YEAR = 1998		1.21** (2.67)		1.40** (3.74)
YEAR = 1999		1.25** (2.69)		1.56** (4.05)
N	193	193	183	183
SSR	290.22	257.58	213.95	163.14
SE REGRESSION	1.24	1.20	1.09	0.98
R SQUARED	0.14	0.24	0.15	0.35
ADJ. R SQ.	0.13	0.19	0.14	0.30
LOG LIKELIHOOD	-313.22	-301.71	-273.96	-249.16

t-statistics in parentheses

** Statistically significant at .05 level for a two-tailed test.

* Statistically significant at .10 level for a two-tailed test.

Figure 2 – Sensitivity Analysis

Table 5 - Additional Regression Results

	<i>ALL OBSERVATIONS</i>	<i>LLC/LLP < 300</i>
CONSTANT	3.12** (18.08)	3.01** (20.86)
LLC DIFF. TAX	-1.65** (-5.37)	-1.43** (-5.67)
COMPLEX LLC STATUTE	-2.34** (-6.05)	-2.19** (-6.91)
ONE MEMBER LLC (FULL YEAR)	0.20 (0.96)	-0.01 (-0.07)
ONE MEMBER LLC (PART YEAR)	-0.02 (-0.08)	-0.22 (-0.91)
RESTRICTED DISSOCIATION (FY)	0.88** (4.63)	0.56** (3.46)
RESTRICTED DISSOCIATION (PY)	0.57** (2.18)	0.31 (1.36)
LLP RESTRICTED	0.11 (0.41)	0.44** (1.99)
LLP FULL SHIELD (FULL YEAR)	-0.20 (-1.12)	-0.40** (-2.69)
LLP FULL SHIELD (PART YEAR)	0.04 (0.10)	-0.03 (-0.09)
LLP NO LAW	3.55** (6.85)	3.32** (7.79)
CHECK THE BOX	0.12 (0.63)	0.51** (3.08)
N	193	183
SSR	191.15	121.52
SE REGRESSION	1.03	0.84
R SQUARED	0.44	0.52
ADJ. R SQ.	0.40	0.49
LOG LIKELIHOOD	-272.92	-222.21

t-statistics in parentheses

** Statistically significant at .05 level for a two-tailed test.

* Statistically significant at .10 level for a two-tailed test.