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A Rational Approach to Business Entity Choice

Eric H. Franklin*

Whatever happened to “‘Hey, I have some apples, would you like to buy them?’ ‘Yes, thank you!’” That’s as complicated as it should be to open a business in this country.

- Ron Swanson

I. INTRODUCTION

Imagine an inventor. She has a prototype that is testing well in a wide-open market. She would like to start modestly, with a small team. Eventually, she will scale-up and expand geographically, but she would like to test her product before investing too much time and money. She has a detailed business plan and the promise of some seed funding, but she will need much more capital to bring her operations to a national scale.

Our inventor has no shortage of entrepreneurial spirit, but she unfortunately lacks both legal and tax training. Her uncle tells her that she should form a limited liability company (LLC). He owns a sandwich shop, and he formed an LLC when he started. But our inventor is not sure what, precisely, an LLC is. She knows that contestants on Shark Tank are expected to form either an LLC or a corporation, but she does not know the difference between the two entities. Regardless of the legal benefits gained by establishing a legal entity (whatever they may be), she is keen to take advantage of the immediate legitimacy inherent in adding “Inc.” or “LLC” to her business cards. But what legal form protects her

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personal assets? What legal form attracts outside investment? What legal form is best for her personal tax situation?

Ideally, our inventor would seek legal and tax advice to learn what entity option would be best for her endeavor. Unfortunately, this is not the usual course for most entrepreneurs. If our inventor is like most entrepreneurs, she will simply go to her state’s Secretary of State website and form the entity without consulting an attorney or an accountant. And even if she seeks legal advice, there is a chance that she would not receive thoughtful advice. Many legal advisors see the decision as a foregone conclusion, with the conventional wisdom offering that if you are seeking outside investment, form a corporation; if not, form an LLC. This advice drastically over-simplifies a decision that requires considerable forethought. It not only belies the substantive differences among the available entity forms, but also invites potential business owners to form business entities in a hasty and uninformed manner.

Selecting the appropriate legal entity is only the first step in a long and difficult path to success for the entrepreneur. It is not easy to create a successful business, and most businesses will fail within five years of formation. There are a number of reasons that this is this case. Many are expected, such as difficulties associated with access to capital, finding and hiring the best employees, and competition from existing market leaders. However, other obstacles remain unforeseen by most entrepreneurs. These obstacles are those inherent in our complex bureaucratic regime. For example, entrepreneurs must decode annual state and local filing requirements, federal and state tax exposure, and licensing obligations from all levels of government. It may therefore not be surprising that we have managed to complicate the very first step of business formation: legal entity choice.

This was not always the case. Indeed, forming a business in the United States was once a reasonably simple decision. An entrepreneur

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3. Indeed, some commentators suggest the differences amongst the entities are virtually meaningless. See, e.g., Richard A. Booth, *Form and Function in Business Organizations*, 58 BUS. LAW. 1433, 1433 (2003) ("Lawyers and academics who deal with the law of business organizations on a regular basis tend to minimize the differences between partnerships, corporations, and other forms of business organization.").


5. See *Frequently Asked Questions About Small Business*, SBA OFF. ADVOC. 3 (Sept. 2012), https://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf ("About half of all new establishments survive five years or more and about one-third survive 10 years or more.").

would opt to form a corporation or a partnership, depending on the endeavor’s perceived liability exposure and the entrepreneur’s personal tax situation. But this once simple decision has grown substantially more complicated. Rather than simply choosing between a corporation or a partnership, an entrepreneur in most states will have over a dozen different legal entity forms from which to choose. These forms include the more familiar (and popular) forms, such as the general partnership, LLC, and corporation, as well as more esoteric forms like the limited liability limited partnership and series LLC. Making matters more complicated, state legislatures continue to add new business entity forms to the already crowded slate of available forms on a near-annual basis. Such entities, like the low-profit limited liability company (L3C) and the benefit corporation contribute to an increasingly complex array of business entity options for potential business owners. What was once a relatively straightforward decision has become remarkably complex.

It is difficult to pinpoint the precise genesis of this problem, but legal academics, practicing attorneys, and judges first seriously addressed it after the widespread embrace of the LLC. The dramatic rise in popularity of the LLC, and the amount of time it took for the legal community to fully comprehend the consequences of such popularity, led commentators to wrestle with the issue of numerous and confusing entity forms. Many commentators wondered if the LLC rendered some entities redundant, and others wondered if adding new entities should be encouraged, given the costs associated with entity additions.

Legal commentators identified the issue as entity proliferation. At the time, the leading commentators noted that entity proliferation has resulted in a system that is “bewildering to practicing lawyers, judges, law professors, and legislators.” Professor John H. Matheson and attorney Brent A. Olson stated: “The law of business organizations has . . . become a hodge-podge of unwieldy, illogical, and even irrational

(2003) (“The world once was a simpler place in which to form a business.”).


9. See id.

10. Id. at 85.
legislation and decisions bristling with incoherence and inconsistencies.” As damning as this observation appears, Professor Matheson’s statement is even more remarkable when one considers that it was published almost a decade ago.

Matheson and Olson were speaking during a period of unprecedented entity proliferation. Indeed, the IRS’s “check-the-box” regulations\(^\text{12}\) thrust the LLC into the fore, and the 1990s and 2000s witnessed the LLC become the dominant business entity option for new businesses.\(^\text{13}\) Further, “[n]ew forms of business association [were] introduced on a relatively regular basis, and state legislatures continu[ed] to tinker with existing forms of entity.”\(^\text{14}\) But even with such a tumult of entity proliferation, Professor Matheson’s era was relatively tame compared to the current atmosphere. In the time since these early thoughts on entity proliferation, the situation has only worsened, with redundant forms remaining available in every state and many states continuing to add new and unnecessary forms.\(^\text{15}\)

The elusive cure for entity proliferation was called entity rationalization. Put simply, entity rationalization is the creation of a simple and uniform slate of business entity forms. The entity rationalization movement\(^\text{16}\) peaked in the late 1990s\(^\text{17}\) and presented


\(^{12}\) LEANDRA LEDERMAN, UNDERSTANDING CORPORATE TAXATION 6–7 (2002).

\(^{13}\) See Clark, supra note 7, at 60 (“Because LLCs resolve the tension between the availability of partnership taxation and a full liability shield, and because they also provide maximum freedom of contract to order their internal affairs, LLCs have become the most popular choice for the formation of a new entity today.”).

\(^{14}\) Joan MacLeod Heminway, Teaching Business Associations Law in the Evolving New Market Economy, 8 J. BUS. & TECH. L. 175, 178 (2013) (discussing the term entity proliferation). See also Kellye Y. Testy, Adding Value(s) to Corporate Law: An Agenda for Reform, 34 GA. L. REV. 1025, 1026–27 (2000) (“The last decade has witnessed a sea change in the selection and use of business forms. Traditional sole proprietorships, partnerships, and corporations have given way to more creative forms of business, many of which combine attributes across the lines of the three traditional forms.”).

\(^{15}\) See Haynsworth, supra note 8, at 89–90 (quoting Professor Matheson and noting that “[i]f anything, the situation is worse today”).

\(^{16}\) This is a generous characterization, given the fact that the entirety of the “movement” existed in a handful of law review articles and a symposium.

\(^{17}\) See generally Thomas F. Blackwell, The Revolution Is Here: The Promise of a Unified
three potential avenues: (i) replacing the multitude of options with two general business forms: one for public companies and one for closely held businesses;\(^{18}\) (ii) a “hub and spokes” option which would provide entrepreneurs with a few core entity options (the “hubs”) that are customizable with the desired entity characteristics (the “spokes”);\(^ {19}\) and (iii) simply allowing the evolution to continue and let the market determine which entities are most desirable.\(^ {20}\)

Arguments on both sides of the entity rationalization movement were compelling. The pro-rationalization side argued that the plethora of options creates confusion among entrepreneurs, consumers, legislators, judges, and lawyers, while the anti-rationalization side argued that any attempted solution would either further complicate the issue or prove too difficult to implement. Ultimately, inertia prevailed and the movement lost momentum. However, recent additions to the legal entity field—specifically, entities designed for social entrepreneurs such as L3Cs and benefit corporations—further complicate the field of available entity options and provide greater urgency for a renewed entity rationalization debate.

The failure of the entity rationalization movement is unfortunate, as ignoring the problem of entity proliferation is not a viable option. As Dean Haynsworth noted, entity proliferation has resulted in such an unduly complex system that “‘[f]undamental reform of business organization law is both imperative and inevitable.’”\(^ {21}\) This Article reinvigorates the entity rationalization movement and will ultimately argue that there are only three necessary entity options: corporations, 

\(^{18}\) Ribstein & Sargent, supra note 17, at 610 ("Each state could get by with only two statutes—one designed to provide governance rules for public companies and one designed to provide governance rules for nonpublic companies."). See also Matheson & Olson, supra note 11, at 30–48.

\(^{19}\) Ribstein & Sargent, supra note 17, at 619 ("The ‘hub’ would identify the common default rules, public policy constraints, and administrative provisions applicable to business entities generally. The ‘spokes’ would provide a rational array of entity choices with a separate set of special default rules appropriate to each entity (and its constituency.").

\(^{20}\) Id. at 618 ("There is a concern that there’s too much choice out there. But I don’t understand why variety shouldn’t be made available for those who want it.").

\(^{21}\) Haynsworth, supra note 8, at 90 (citing Matheson & Olson, supra note 11, at 3).
partnerships, and nonprofit organizations. Part I defines the issue of entity proliferation and, along with the Appendix, presents a state-by-state analysis of the types of legal entities available, an endeavor that has not yet been conducted. The Appendix contains a chart that enumerates each legal entity available in each of the fifty states and the District of Columbia. Part II discusses the problems associated with entity proliferation from the perspective of the public, potential business owners, small business attorneys, and judges. Part III discusses the necessity and utility of several of these entities and ultimately argues for entity rationalization and dictating the steps necessary to address the issues.

II. DEFINING ENTITY PROLIFERATION

Despite widespread awareness of the issue, no one has tried to properly define and quantify the issue of entity proliferation. While many commentators have bemoaned the sheer number of entity options available across the states, no one has quantified the actual entities (number, type, characteristics, etc.) offered by each state. This is perhaps due to the fact that clearly outlining the problem of entity proliferation is not as straightforward as one might imagine. Professor Robert Hamilton first identified this difficulty when he noted:

The analysis of “entity proliferation” is complex, primarily because there are serious problems of definition and classification. It is often difficult to decide whether a modification or change in a specific business form should be viewed as the creation of a genuine “new” business form or whether it is the “same as” or a “minor variation of” an older business form, perhaps with just a new wrinkle or two. If it is only “somewhat” different from an existing business form, should it be counted as a new business form at all and thus part of the process of “entity proliferation”?22

To Professor Hamilton’s concern, if two entities are functionally the same but have different names, do they count as two separate entities?23 And what about tax elections? Because a corporation may file an S election with the IRS and, in effect, become a different entity (an S Corp), should we include S Corps as an available option in each state?24

23. Id. at 860.
Although Professor Hamilton concedes that the term “entity proliferation,” however vague, is a “useful general description of an impossibly broad subject,” he ultimately concludes that a state-by-state enumeration of available business entities would be folly. Professor Hamilton supports this argument in part by noting that an entity name does not ensure similar treatment, as states with similar LLC statutes may have different formation costs, taxation schemes, and liability rules. Professor Hamilton noted that when one combines the liability, management, and tax characteristics with the variation among the states, “it seems clear that any effort to classify and count ‘different’ business forms in fifty states necessarily leads to chaos.” Following Professor Hamilton’s lead, most commentators have attempted to define the issue of entity proliferation in purely qualitative terms, and there have been no efforts to quantify the problem.

Rather than following the trend of simply stating that there are too many entities without providing any supporting data, this Article will tackle this “impossibly broad subject” by first (i) identifying each of the different business forms and (ii) placing each available business entity in one of the following categories: corporations, partnerships, nonprofit organizations, and hybrid organizations.

A. The Methodology of Defining Entity Proliferation

To properly frame the issue of entity proliferation, this Article will address Professor Hamilton’s concern of the multitude of “liability, management, and tax characteristics” by partially ignoring the individual characteristics of the entities. If an entity form is the practical equivalent of another entity form, Professor Hamilton suggests that it should not be counted twice. However, this Article will ignore the fact that, for example, an L3C is the functional equivalent of an LLC that has voluntarily limited some of its activities. Thus, in this Article’s
enumeration of entities, if a state makes both an LLC and an L3C available to a potential business owner, then each entity will be listed separately.

Although it may seem simplistic to ignore the more picayune aspects of an entity’s characteristics while categorizing all available entities, it is important to note that one of the primary goals of the entity rationalization movement is to reduce the number of redundant and unnecessary forms. It is therefore important to identify all forms, regardless of whether or not they offer an actual distinct option from a tax, liability, or governance perspective. In other words, if two legal forms are practically identical, but they have different names, they are enumerated individually in this Article. This is because the confusion associated with entity proliferation has as much to do with the absolute number of options as it does with the different characteristics each entity presents. Without competent legal advice, the potential business owner has no reason to know that Entity A is the functional equivalent of Entity B. This Article will therefore detail the absolute number of options available for business formation, regardless of whether or not a particular entity presents a legally distinct option.

Even with the simplification that comes with partially ignoring the specific characteristics of entities and focusing on each entity’s name, it is no simple undertaking to properly present the issue of entity proliferation in concrete terms. The total number of entities available across the states is impossibly large, with each state boasting its own slate of entities with its own array of peculiar names and characteristics. Thus, to simplify the presentation of the legal entities available in each state, it is helpful to create some categories. To do so, this Article focuses on the shared characteristics amongst the entities, separating them into the following groups: (i) corporations, (ii) partnerships, (iii) nonprofit organizations, and (iv) hybrid organizations.31 The following section will describe the characteristics of the entities placed in each category.

31. In his article arguing for a unified business organizations code (itself a form of entity rationalization), Dean Haynsworth offered the following categories for organizations: (i) corporations, (ii) partnerships, and (iii) special purpose organizations. Unfortunately, Dean Haynsworth did not elaborate on the reasoning for such categories. See Haynsworth, supra note 8, at 83–84.
B. The Categories

The entities placed in the “corporations” category will, unsurprisingly, have the typical characteristics of the corporate form.\(^32\) This category contains entities that generally have the following three constituents: shareholders,\(^33\) officers, and directors. The shareholders are the owners of the entity and they elect the board of directors; the board dictates the general direction of the entity and owes fiduciary duties of care and loyalty; and the officers, appointed by the board, carry out the day-to-day activities of the entity. In addition to these common constituent members, entities in this category have separate and limited personhood and provide limited liability to the shareholders, officers, and directors. This category contains entities such as corporations, close corporations, and professional corporations.

In similar fashion, this Article places those entities that have the characteristics of partnerships in the “partnerships” category. This category will generally contain those entities that (i) fit within the Revised Uniform Partnership Act’s definition of a partnership,\(^34\) (ii) enjoy a governance structure that is significantly less rigid than those in the corporations category, and (iii) feature a default pass-through tax treatment by the IRS.\(^35\) The partnerships category contains entities such as general partnerships, limited liability partnerships, limited partnerships, limited liability limited partnerships, and LLCs.

The primary defining characteristic of the entities in the “nonprofit” category is the lack of owners.\(^36\) These entities do not have shareholders or an equivalent owner. This lack of ownership is the characteristic hallmark of the entities in the nonprofit category, which includes entities such as nonprofit corporations, religious organizations, and nonprofit associations.

The fourth and final category, “hybrid organizations,” reflects the growth of a relatively recent phenomenon: for-profit entities that desire

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32. Corporations are characterized as entities with limited personhood, owned by shareholders, and governed by a board of directors. See Corporation, BLACK’S LAW DICTIONARY (10th ed. 2014).
33. Or stockholders, depending on your state’s nomenclature.
34. A partnership is defined as an “association of two or more persons to carry on as co-owners a business for profit.” REVISED UNIF. P’SHIP ACT § 101(6) (UNIF. LAW COMM’N 1997).
35. However, it is important to note that many entities in the partnership category may opt to be taxed as either corporations or partnerships.
36. Owners have different names depending on the entity. Corporation statutes refer to owners as shareholders or stockholders, depending on the state. Regardless of the state, owners of partnerships are referred to as partners, and owners of LLCs are referred to as members.
to incorporate a social or environmental goal in their organizing documents. Such entities have conventional for-profit characteristics, such as shareholders (or other owners) and the ability to distribute profits, but the entities in the hybrid category explicitly permit goals that may be counter to the traditional goal of profit maximization. The organizations in the hybrid category have experienced remarkable growth in recent years, and include such legal forms as benefit corporations, social purpose corporations, and L3Cs.

One quick note before we dive into defining the hitherto undefinable problem of entity proliferation: this Article will not count federal tax elections as separate entities. If a corporation meets and maintains certain requirements, it may file an election to avoid corporate-level taxation. This is called an S election and is a federal designation bestowed upon an entity that has already formed at the state level. S corporations are, of course, very important participants in the small business universe, but they are not separate entities on the state level. This Article’s focus is on entity formation at the state level, and therefore any federal statuses shall be ignored for categorization purposes. As such, in addition to S corporations, this Article will not count real estate investment trusts, better known as REITs, as separate entities unless a state specifically enumerates them as a separate entity. Similarly, this Article will not count the various different types of tax-exempt statuses for which nonprofits may apply. Finally, it is important to note that this Article limited the inquiry to the fifty U.S. States and the District of Columbia, and this Article therefore does not identify the entities available in other jurisdictions, such as Indian tribes and U.S. territories.

C. Current State of Affairs

1. Category One: Corporations

It should come as no surprise that many of the more traditional legal

37. To qualify for S corporation status, the entity must have: only certain types of shareholders (owners may not be partnerships, corporations, or non-resident aliens), no more than 100 shareholders, and only one class of stock. See S Corporations, IRS, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporations (last updated Aug. 5, 2015).

38. A real estate investment trust is a company that allows investment in a pool of properties. If such an entity meets certain federal requirements (e.g., paying out at least 90% of income to shareholders on an annual basis), it will enjoy beneficial tax treatment.

39. There are currently twenty-nine different types of 501(c) organizations, but they all start as nonprofit organizations at the state level.
entity forms are available in every state. Corporations, for example, the once-dominant legal entity, are available for formation in all fifty states. Further, cooperatives, loosely defined as an entity owned by the individuals who use the entity’s services, are available in some form in every state. This is not, however, true for all of the entities that belong in the corporations category. For example, close corporations, a form of corporation with very few shareholders and limitations on stock transferability, appear in nineteen states. While many more states have case law that provides certain rights to shareholders in corporations with a small number of owners, only these states have an actual entity called a “close corporation.” Not content to rely upon corporations, close corporations, and cooperatives, some states provide special entities specifically designed for certain enumerated professions, known as professional corporations. Although they vary by state, these statutes are generally used for attorneys, architects, engineers, accountants, and physicians. Further complicating matters, a few states determined that a blanket “professional corporation” is too broad and created separate entity choices for specific professions, including entities specifically for dentists, lawyers, physician’s assistants, and optometrists.


An entity (usu. a business) having authority under law to act as a single person distinct from the shareholders who own it and having rights to issue stock and exist indefinitely; a group or succession of persons established in accordance with legal rules into a legal or juristic person that has a legal personality distinct from the natural persons who make it up, exists indefinitely apart from them, and has the legal powers that its constitution gives it.

Id.

41. See infra Appendix.

42. Cooperatives come in many forms, including worker cooperatives, producer cooperatives, and agricultural cooperatives. For the purposes of this Article, this category includes a state if it has any single cooperative option.

43. See Cooperative, BLACK’S LAW DICTIONARY (10th ed. 2014) (“An organization or enterprise (as a store) owned by those who use its services.”).

44. See infra Appendix.

45. See id.


47. Pennsylvania has insurance corporations (15 PA. STAT. AND CONS. STAT. ANN. §§ 3101–3138 (West 2013 & Supp. 2014)) and management corporations (15 PA. STAT. AND CONS. STAT.
Dakota, for example, has the following entity options: dental corporations, health care corporations, medical corporations, nursing corporations, optometric corporations, physician’s assistants corporations, podiatric corporations, cemetery corporations, chiropractic corporations, professional corporations for the practice of law, professional corporations for the practice of public accounting, and veterinary corporations.

This category also includes all trusts, as well as those forms specifically designed for business and industrial development. There are statutory trusts in three states and the District of Columbia, thirty-four states offer some form of a business or industrial development corporation, and fourteen states offer an entity known as the business trust.

ANN. §§ 2701–2722 (West 2013 & Supp. 2014)).

49. Id. §§ 47-11F-1 to -19.
50. Id. §§ 47-11-1 to -21.
51. Id. §§ 47-11E-1 to -20.
52. Id. §§ 47-11B-1 to -23 (2007 & Supp. 2014).
53. Id. §§ 47-11D-1 to -23 (2007).
54. Id. §§ 47-11C-1 to -23.
56. Id. §§ 47-11A-1 to -20 (2007).
57. Id. §§ 47-13A-1 to -10.
58. Id. §§ 47-13B-1 to -18.
59. Id. §§ 47-13-1 to -21.


61. These are most often called a business development corporation, business and industrial development corporation, BIDCO, or industrial development corporation. See infra Appendix.

The balance of the corporations category includes more obscure entity choices: Vermont offers a scrip corporation;\(^63\) Washington has mutual corporations\(^64\) and granges,\(^65\) and Pennsylvania offers a registered corporation.\(^66\)

2. Category Two: Partnerships

The partnerships category, not coincidentally, is populated by entities that are treated by the IRS as partnerships for tax purposes. In other words, the IRS treats all income of the entity as if it passed directly to the owners.\(^67\) Such entities include traditional partnerships that are

\(^{63}\) See Vt. STAT. ANN. tit. 11, §§ 921–938 (West 2007 & Supp. 2013). A scrip corporation is a company formed for “the sole purpose of issuing scrip.” Id. § 921. Scrip is defined in the Vermont code as “certificates having no fixed maturity, transferable by delivery and payable . . . out of the assets pledged to secure such scrip.” Id. § 923(a). Scrip corporations are under the supervision and purview of the Vermont Commissioner of Financial Regulation. Id. § 925.

\(^{64}\) See WASH. REV. CODE ANN. §§ 24.06.005 to .920 (West 2005 & Supp. 2014). A mutual corporation is one that is “organized to accomplish one or more of its purposes on a mutual basis for members and other persons.” Id. § 24.06.005(16) (West, Westlaw through 2015 3d Spec. Sess.). Several other states have references to “mutual corporations” or “mutual companies” in their codes. See, e.g., ARK. CODE ANN. § 4-26-1204 (West 2004); IOWA CODE ANN. § 524.538A (West Supp. 2014); MINS. STAT. ANN. §§ 66A.01 to .43 (West, Westlaw through 2015 1st Spec. Sess.); OKLA. STAT. ANN. tit. 18, § 438.33 (West 2012); S.C. CODE ANN. § 38-90-200 (2015).


\(^{66}\) See 15 PA. STAT. AND CONS. STAT. ANN. §§ 2501–2588 (West 2013 & Supp. 2014). A registered corporation is:

A domestic business corporation: (i) that: (A) has a class or series of shares entitled to vote generally in the election of directors of the corporation registered under the Exchange Act; or (B) is registered as a management company under the Investment Company Act of 1940 and in the ordinary course of business does not redeem outstanding shares at the option of a shareholder at the net asset value or at another agreed method or amount of value thereof; or (ii) that is: (A) subject to the reporting obligations imposed by section 15(d) of the Exchange Act by reason of having filed a registration statement which has become effective under the Securities Act of 1933 relating to shares of a class or series of its equity securities entitled to vote generally in the election of directors; or (B) registered as a management company under the Investment Company Act of 1940 and in the ordinary course of business redeems outstanding shares at the option of a shareholder at the net asset value or at another agreed method or amount of value thereof.


A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it “passes through” any profits or losses to its partners. Each partner includes his or her share of the
found in every state, such as general partnerships, limited partnerships, and limited liability partnerships. Traditionally, the general partners of a limited liability partnership are jointly and severally liable for debts and obligations of the partnership while any limited partners enjoy limited liability. This reality gave rise to the awkwardly-titled limited liability limited partnership, a form of limited liability partnership used primarily in the real estate field that extends liability protection to the general partners of limited liability partnerships.

Despite the universal existence of general partnerships, limited partnerships, and limited liability partnerships throughout the states, none of these represent the most popular form of partnership. In terms of popularity, the more traditional partnership forms have ceded ground to the LLC. Also available in all fifty states, LLCs are far and away the most popular legal entity form for new businesses. This is certainly no accident. Indeed, the LLC was designed specifically to appeal to entrepreneurs, boasting flexible governance, limited formalities, and pass-through taxation. Perhaps in response the LLC’s popularity, many states offer innovations to the basic LLC form. The series LLC,

partnership’s income or loss on his or her tax return.

Id. 68. See infra Appendix. A general partnership is formed when two people associate to carry on as co-owners of a business for profit. Generally speaking, each partner of a general partnership is subject to joint and several liability for the debts and liabilities of the partnership, and has equal control to bind the partnership. Perhaps most importantly, a general partnership does not bestow limited liability upon the owners of the partnership.

69. See id.

70. See id.

71. A limited liability limited partnership is available in twenty-three states. See id.

72. Clark, supra note 7, at 60 (“Because LLCs resolve the tension between the availability of partnership taxation and a full liability shield, and because they also provide maximum freedom of contract to order their internal affairs, LLCs have become the most popular choice for the formation of a new entity today.”).

73. See infra Appendix.


Forty-nine jurisdictions enacted LLC laws between 1990 and 1997, and virtually all state legislatures wanted the LLC to be a business-friendly entity that would attract business and revenue to the state. Indeed, since 2004, when LLC formations surpassed incorporations for the first time, the LLC is the most popular business entity in the United States. The numbers of LLC formations are impressive. From 2004 to 2007, the latest period for which complete data are available, 4.9 million LLCs were formed nationwide, compared to 3.3 million corporations and 0.2 million limited partnerships.

Id. 75. Id. at 5 (“[T]he LLC was designed to be popular.”).
available in a significant minority of states, is a bureaucratically-streamlined method to administer numerous lines of business under a single entity without the liabilities of the businesses negatively affecting one another. The attraction of the series LLC is that it represents “a way around creating multiple LLCs—only a single entity need be created, but assets, ownership and, therefore, liability, can be allocated exactly as if multiple entities had been formed.” States also adopted the professional limited liability company to sate the overwhelming desire of the so-called “professional” entities to have access to the tax advantages and governance flexibility of LLCs. In addition to the series LLC, some states have added entities to respond to the popularity of the LLC. Wyoming, for example, offers a form known as the close limited liability company, an LLC with statutory restrictions based on the presumed needs of family-owned businesses.


77. Jennifer Avery et al., Series LLCs: Nuts and Bolts, Benefits and Risks, and the Uncertainties That Remain, 45 Tex. J. Bus. L. 9, 10 (2012) ("A Series LLC is, effectively, a collection of subunits within one LLC that can be created according to statute without actually forming multiple LLCs").

78. A professional limited liability company is an LLC available to certain professions and is available in twenty-two states (not including those states that list specific professions). See infra Appendix.


While many LLC acts positively provided for professional LLCs from the time of their initial adoption, other statutes were silent on the matter or excluded professional LLCs. . . . This authorization for the formation of the professional LLC is especially understood in light of the liability concerns of the professions arising as the LLC explosion began. This desire to adopt the LLC form for professional practices was especially acute and consequently well-organized with respect to the accounting profession.

Id.

3. Category Three: The Nonprofit Category

Given that this Article frames the problem of entity rationalization in terms of entrepreneur confusion, the nonprofit category may at first appear superfluous. Given that there are no owners of nonprofit organizations, one might assume that it is highly unlikely that an entrepreneur will opt to form a nonprofit corporation. Whatever truth lies in that assumption, it is an important category to address in this Article. One of the primary concerns of the entity rationalization movement is the sheer confusion faced by individuals forming organizations. Given that most Secretary of State websites—where entities are generally formed—list “nonprofit corporation” as an option for formation, this entity option contributes to entity proliferation. Further, some states do not have “nonprofit corporations” and instead offer an organization known as a “nonstock corporation” to serve as the primary entity for nonprofit activity. There is little reason to assume that an entrepreneur will know that a “nonstock corporation” is intended for nonprofit activity; an LLC, after all, has membership interests and does not have stock, and an entrepreneur might be forgiven for assuming that some nonstock entities are intended for for-profit activity. Thus, there is likelihood for entrepreneur confusion, and nonprofit organizations are an important family of entities to define.

An entrepreneur may form a nonprofit entity in each of the fifty states, nonprofit cooperatives in thirteen states, and nonstock corporations in five states. The following entities also belong in the nonprofit category: religious associations, corporations, societies, and nonprofit cooperatives in thirteen states, and nonstock corporations in five states. The following entities also belong in the nonprofit category: religious associations, corporations, and nonprofit cooperatives in thirteen states, and nonstock corporations in five states.
organizations,87 and churches,88 unincorporated nonprofit organizations available in eighteen states;89 South Carolina’s entity called the “Corporation Not-for-Profit Financed by Federal or State Loans;”90 fraternal organizations;91 medical societies;92 and Texas’ grand lodge.93

4. Category Four: The Hybrid Organizations Category

The fourth and final category includes the most recent additions to the legal entity crazy quilt: so-called hybrid organizations. In broad terms, a hybrid organization is a for-profit entity that pursues a socially-beneficial purpose while simultaneously pursuing profits. Hybrid
organizations were created to address the belief that for-profit companies owed a duty to maximize the wealth of their owners. This is known as the shareholder primacy or shareholder wealth maximization norm. This norm posits that for-profit entities may not engage in an activity unless such activity has the aim of increasing the entity’s profits. Following the shareholder wealth maximization line of thought, socially-beneficial activities are for charities, and for-profit entities do not appropriately engage in such activities if they harm the entity’s bottom line. This line of thinking posits that if you are an eyeglasses manufacturer and distributor and you want to give away a free pair of glasses for every pair of glasses that you sell, you should not form a for-profit company. Or if you make and sell ice cream and you would like to pay more for milk from responsibly-raised cattle (rather than pay less for mass-produced milk), you are engaging in an activity that needlessly wastes money and you should not form a for-profit entity. The concern of for-profit company owners interested in expending resources toward a socially-beneficial end is that their shareholders might sue the directors for taking actions that are against the interests of the entity’s bottom line. In response to this concern, policymakers took action to create entities that explicitly permit for-profit organizations to engage in socially-beneficial activities.

Although relatively new, the hybrid organization category boasts several organizational forms. The most popular hybrid organization is the benefit corporation, some form of which appears in a majority of the states. The benefit corporation statute generally relies upon a state’s corporation statute, using a large portion of the corporate statute to provide the bulk of the statute’s substance. It should therefore not be

94. Felicia R. Resor, Benefit Corporation Legislation, 12 WYO. L. REV. 91, 95 (2012); see infra notes 98–107 and accompanying text.

95. This is a slightly simplified description of the business model of Warby Parker. See Buy a Pair, Give a Pair: The Whole Story Begins with You, WARBY PARKER, https://www.warbyparker.com/buy-a-pair-give-a-pair (last visited Feb. 19, 2016). For every pair of Warby Parker glasses sold, Warby Parker makes a donation to VisionSpring, a separate nonprofit, that allows VisionSpring to manufacture and distribute a pair of glasses. Id.


97. In a more cynical view, it is not hard to trace the recent popularity of hybrid organizations to the fact that the most popular hybrid organization, the benefit corporation, has model legislation that requires a third party to review and evaluate the benefit corporation’s success in meeting their stated socially-beneficial goals. The most visible and established of such third-party evaluators is B Corp., an entity that lobbies to have benefit corporation statutes passed.

98. See infra Appendix. Thirty-one states have either a benefit corporation, public benefit corporation, sustainable business corporation, or a social purpose corporation.
surprising to learn that benefit corporations have more in common with traditional corporations than not. The primary differences between a benefit corporation and a more traditional corporation are that the benefit corporation must (i) incorporate a beneficial purpose into its corporate purpose 99 and (ii) prepare a report that reflects the progress (or lack thereof) toward its beneficial purpose.100

The second-most popular hybrid organization is the L3C, offered in eight states.101 Just as a benefit corporation is a more charitable version of a traditional corporation, an L3C is a low-profit “variant form of a limited liability company.”102 The L3C was specifically “designed to provide capital to those enterprises that operated in the space between the nonprofit and the place where traditional for-profits existed.”103 More specifically, L3Cs were designed to attract Program-Related Investment (PRI) by private foundations.104 Other than including certain PRI specific language in the L3C statutes, an L3C statute is virtually identical to an LLC statute.

The balance of the entities in the hybrid organizations category include variants on the benefit corporation and L3C, including Hawaii’s sustainable business corporation,105 Maryland’s benefit limited liability company,106 and the social purpose corporations of California, Florida,

99. See DEL. CODE ANN. tit. 8, § 362(a)(1) (West Supp. 2016) (“In the certificate of incorporation, a public benefit corporation shall . . . identify within its statement of business or purpose . . . 1 or more specific public benefits to be promoted by the corporation . . . .”).

100. See DEL. CODE ANN. tit. 8, § 366(b) (West Supp. 2016) (“A public benefit corporation shall no less than biennially provide its stockholders with a statement as to the corporation’s promotion of the public benefit or public benefits identified in the certificate of incorporation and of the best interests of those materially affected by the corporation’s conduct.”). There are other minor differences, such as the “benefit enforcement proceeding,” a claim brought by a benefit corporation shareholder for failure of the benefit corporation to pursue or create public or specific benefits, but they are not the focus of this Article.


103. Id.

104. Id.


and Washington. 107

III. PROBLEMS WITH ENTITY PROLIFERATION

At this point, one might reasonably ask if entity proliferation is a problem worth addressing. As the previous section clearly illustrates, there are certainly a large number of entity choices for potential business owners. However, what is the harm of too much choice? Why not provide a “smorgasbord of entity types available to entrepreneurs and lawyers when forming a business”? 108 Are options not a good thing? Or as Professor Larry Ribstein stated: “There is a concern that there’s too much choice out there. But I don’t understand why variety shouldn’t be made available for those who want it.” 109

Notwithstanding Professor Ribstein’s vote for choice, the entity rationalization movement identified several potential problems associated with entity proliferation. 110 This section will focus on the two most problematic issues of entity proliferation: confusion and cost. This section will then discuss a troublesome potential side effect of cost and confusion: the fact that American business formation refuses to rise after the dramatic drop associated with the Great Recession.111

A. Confusion

1. Entrepreneur Confusion

The sheer number of legal entity options in many states will overwhelm many potential business owners. Such befuddlement is reasonable and, perhaps, understandable. The successful entrepreneur is one that is hyper-focused on his or her product or service, 112 often to the

109. Ribstein & Sargent, supra note 17, at 618.
110. See, e.g., Ribstein & Sargent, supra note 17. See also Blackwell, supra note 17, at 336 (“Although once relatively simple, the laws concerning various forms of business entities have become increasingly complex and numerous.”).
111. In a future article, the author plans to explore how entity proliferation has contributed to the growth of an informal economy in which entrepreneurs fail to formalize their businesses because of the daunting task of navigating the legal entity regime.
It should therefore not be a surprise that entrepreneurs would fail to focus on the legal regime governing entity formation. The more business-savvy entrepreneur will take care to understand the regulatory regime that affects his or her business: an entrepreneur interested in developing commercial applications for unmanned aerial vehicles will learn the ins and outs of aviation regulations; a real estate investor should learn local and state property laws; and a restaurateur ought to become familiar with food safety standards and other health regulations. But these industry-specific legal regulations have little to do with legal entity formation, an area with nuances that are lost on many entrepreneurs.

Faced with the myriad of options available in most states, many potential business owners experience near-crippling confusion on the legal entity decision. Or worse, they ignore the issue altogether, blindly choose an entity, and hope that the choice will prove correct. According to a recent study, fifty-two percent of startups faced legal issues concerning entity choice and formation. While it is notable to think that more than half of the study participants required some form of legal advice regarding entity choice, this study may undersell the problem. This study’s participants consisted of startups that completed surveys as they were receiving legal advice. In other words, these participants were self-aware enough to realize that they had legal questions. There is no study that measures the entity formation needs of startups which either (i) do not have access to legal resources, or (ii) do

and small business owners, long hours can take a toll on personal relationships, leaving your partner feeling taken for granted while you focus on growing your business.”].


14. Mark J. Kohler, 7 Mistakes to Avoid When Choosing Your Business Entity, ENTREPRENEUR (Sept. 3, 2013), http://www.entrepreneur.com/article/228160 (“Many new business owners believe choosing and forming their business entity is something to check off their list on a weekday night after researching on the web for an hour or so.”).


Among the hard-charging, iconoclastic startups of Silicon Valley, “regulation” and “legal structure” are unlikely to be top agenda items during the daily scrum. In this world of failing fast and disrupting obsolete business models, legal needs and regulatory issues are often pushed onto the backburner or dealt with hastily in the interest of focusing resources on product and business development.

Id.

17. Id. (manuscript at 9).
not know enough about the legal regime surrounding entity formation to
ask for help. The percentage of all startups that require legal help in
selecting an entity has yet to be quantified.

Because there is no study that details how business owners choose
the legal entity for their business, we are left to anecdotal accounts.
Luckily, there is no shortage of such stories. Indeed, one needs only to
ask any small business lawyer or consultant to learn that entrepreneurs
are woefully underinformed in the legal entity formation process.118
Needless to say, the phenomenon of entity proliferation only exacerbates
the confusion.119

2. Practitioner Confusion

While confusion amongst entrepreneurs and potential business
owners is expected, it is merely the beginning of the problematic effects
of entity proliferation. Perhaps most disturbing, the confusion associated
with entity proliferation extends beyond entrepreneurs and potential
business owners to plague small business lawyers.120 Indeed, the
“complex endeavor” of choosing a legal entity is not only “likely to
mystify a prospective business owner,” but also will befuddle “an
attorney who has not been regularly and recently involved with choice of
entity issues.”121 It stands to reason that the continued addition of legal
entity choices exacerbates the problem for small business lawyers.
Perhaps the immediate concern is that an attorney may give middling or
poor legal advice, potentially harming small businesses. But beyond
harming the clients, entity proliferation carries potentially dire
consequences for practicing attorneys. Professor Blackwell noted:

Unless an attorney has done his or her homework on each of the
different forms of entities and their recent revisions (and revisions are
indeed being made on an ongoing basis), setting up the wrong form of
business entity is a very real possibility—with all of the attendant
economic and liability concerns (for the business owner) and

118. As a personal aside, after performing countless community presentations to potential
business owners covering the salient differences amongst the most common business entity options,
I found that many participants remained unable to articulate the differences amongst the entities after
a several hour presentation. This may reflect a failing on my part more than anything else, which is
something I am prepared to accept.
119. See generally Ribstein & Sargent, supra note 17, at 612.
120. Haynsworth, supra note 8, at 85–86.
malpractice concerns (for the attorney) that such a mistake implies.\textsuperscript{122}

Small business lawyers must understand the differences among the more common entities—such as corporations, partnerships, and LLCs—while additionally making sure that they know how courts and agencies apply law to such entities.

Compounding the issue of confusion among the practicing bar is the fact that mastery of the legal entity regime becomes increasingly more complicated as new entities are added. Professor Schwidetzky noted: “[L]awyers and their clients are awash in law now. They need time to catch up with the current law changes. If we have too many different entity statutes . . . the primary result may be not choice but confusion.”\textsuperscript{123}

As most transactional lawyers know, it is difficult enough to keep up with state law related to common legal entity forms without the addition of novel entity forms.\textsuperscript{124} This confusion is perhaps best illustrated by the addition of the LLC in the late 1990s. As LLCs grew in popularity, many transactional lawyers were flummoxed by the new entity’s characteristics. Even sophisticated attorneys had difficulty learning how to apply LLC laws. In a symposium partly addressing the rise of the LLC, Anthony Mallgren, a practicing attorney, described a query from a real estate lawyer tasked with forming an LLC for real estate purposes:

She is very bright (law review and federal judicial clerkship), with many years of experience. Her client did not want her to bring in a tax or LLC expert so she was trying to form [an LLC] by herself. She was totally befuddled by our default rules, flexibility, and tax provisions. It is a malpractice case waiting to happen.\textsuperscript{125}

Although only an anecdote, attorney confusion about legal entity characteristics is a widespread problem. Mr. Mallgren continued to note: “We need some time to digest all of these entity laws, or something much simpler that small businesses and nonspecialist lawyers can deal with efficiently and economically.”\textsuperscript{126}

Despite this enduring confusion, most transactional attorneys

\textsuperscript{122} Id. at 337.

\textsuperscript{123} Ribstein & Sargent, supra note 17, at 617.

\textsuperscript{124} Haynsworth, supra note 8, at 85 (“The increase in the number of business forms is bewildering to practicing lawyers, judges, law professors, and legislators.”). See also Jack B. Jacobs, Entity Rationalization: A Judge’s Perspective, 58 BUS. LAW. 1043, 1044 (2003); Oesterle & Gazur, supra note 17, at 104–05.

\textsuperscript{125} Ribstein & Sargent, supra note 17, at 618.

\textsuperscript{126} Id.
probably feel fairly comfortable forming a simple LLC. However, this relative comfort came after decades of working with the form and allowing the courts to provide appropriate guidance. In other words, this is not a comment on the intellectual ability of lawyers. It is perfectly reasonable for it to take some time for lawyers to fully comprehend a new entity’s particular characteristics because it is not immediately clear how courts will treat a new entity. Courts need time to determine how existing case law will apply to a new entity (e.g., how or if the laws applicable to piercing the corporate veil apply to limited liability companies), and provide guidance on novel issues presented by the new statutes. Once these rulings are in place (a process that takes a significant amount of time), practitioners need time to fully grasp the import of the governing statute and the associated case law. Given the pace of our legal system, this process can take many years. Further, this lengthy process is multiplied every time we adopt a new entity form.

Unfortunately, the problem presented by the rise of the LLC is not a singular occurrence. In recent years, with the number of available legal entities multiplying, the so-called “traditional entities” (corporations, partnerships, and LLCs) represent a small fraction of the total available entities. It is therefore a near-full-time job for a transactional lawyer to maintain a working knowledge of the essential characteristics of each available business entity. As most transactional lawyers who focus on business formation will note, hardly a month goes by without an entrepreneur asking about the salient differences among not only corporations and LLCs, but also benefit corporations, cooperatives, and L3Cs. Thus, the problem presented by the rise of the LLC—characterized by the unfamiliar statute, the uncertainty of how courts will treat the entity, and the unclear tax treatment—is played out with each introduction of a new entity. Similar to LLCs, it may take over three decades for practitioners to feel comfortable with, for example, the

127. Ribstein & Sargent, supra note 17, at 618 (“We need some time to digest all of these entity laws . . . .”).
128. Id. at 617–18.
129. Id.

When it comes to law, variety may be too much spice. Beyond that, I suspect real lawyers (as opposed to fake ones, i.e., we law professors) would prefer fewer entities, perhaps even a single one, with the ability to vary its provisions (not necessarily in an unlimited way) according to the needs of the client.

Id.

As anecdotal evidence, the question and answer sessions following semi-regular presentations on “Selecting the Correct Legal Entity” were invariably littered with questions regarding benefit corporations.
benefit corporation. In other words, “[w]ith every innovation in state law, we make it harder for lawyers to keep up and harder for them to get clients up to speed.”\textsuperscript{130} While practitioners may understand that it takes some time for the legal profession to fully understand a new legal entity, explaining the uncertainty of the legal regime to entrepreneurs is met with well-earned disbelief.

3. Judiciary Confusion

The difficulty of lawyers to suss out the attributes of numerous legal entities has a predictable outcome: litigation. The burden of such litigation falls directly upon the judiciary. Thus, entity proliferation affects judges in addition to business owners and lawyers. This burden has both quantitative and qualitative elements.\textsuperscript{131} The quantitative aspect is obvious: with the absolute number of entity options increasing, there is a concomitant increase in the amount of necessary case law.\textsuperscript{132} Vice Chancellor Jack B. Jacobs noted: “[W]hat has proliferated is not so much the number of different alternative entities, as the volume of litigation that those new entities spawned.”\textsuperscript{133} This increase in litigation should not be surprising; each new entity presents an opportunity for innovative attorneys to find new avenues of liability. In describing the burden on the judiciary, Vice Chancellor Jacobs emphasized the problem associated with the rise of LLCs, when judges were forced to “develop an entirely new, predicate layer of analysis” prior to addressing the substantive claims of litigants.\textsuperscript{134} Faced with a conflict concerning a new entity form, a judge must, for example, “determine what body of principles—fiduciary law, contract law, or a combination of both—is the appropriate source of law for resolving the substantive governance issues for a particular entity form.”\textsuperscript{135} The judiciary has responded to this challenge

\textsuperscript{130} Ribstein & Sargent, supra note 17, at 627.
\textsuperscript{131} Jacobs, supra note 124, at 1044.
\textsuperscript{132} Id.
\textsuperscript{133} Id.
\textsuperscript{134} Id.
\textsuperscript{135} Id.

To illustrate the point, I am holding up a cumulative survey of the Delaware case law in the “alternative entity” area. The survey . . . is over seventy-five pages long. That, by itself, might not be remarkable, except for the fact that the booklet is printed in the smallest possible font and, with a few exceptions, the cases it discusses were all decided beginning in 1990. That is, almost all of the relevant alternative entity case law development has occurred in only twelve years.
admirably and has helped move our understanding of new entities forward, but the effort has been significant.  

While the quantitative element is expected, many judges are more concerned with the qualitative aspect. The qualitative aspect highlights the struggle among competing policies. For example, with respect to LLCs and other so-called “alternative entities,” there is a strong policy favoring freedom of contract. Judges must balance the “inherent tension between the policy requiring the protection of the legitimate expectations of investors and the policy favoring freedom of contract that underlies many alternative entity enabling statutes.” Thus, the core purpose of the new entity (in the LLC’s case, the freedom of contract) creates a peculiar issue for the judiciary to weigh and evaluate.

It does not take a great leap of imagination to envision that there will be similar competing policies with the hybrid organization form. Judges may face the issue of weighing the appropriate balance between director fiduciary duties of care and loyalty against the freedom of contract. The judiciary may also be forced to reckon with the investor’s traditional expectation of profit, or ignore such traditional expectations in favor of the benefit corporation’s stated socially-beneficial purpose. Vice Chancellor Jacobs noted that the rise of the LLC forced “judges to reinvent ‘rules of the road,’ that is, the choice of doctrine for each alternative entity and for each particular case that arises in a specific alternative entity context. That amounts to a lot of reinventing.” While Vice Chancellor Jacobs was specifically referring to the Chancery Court’s efforts to determine the proper manner of handling claims involving LLCs, the observations are equally true for other new entities.

4. Consumers/Public

During the height of the entity rationalization movement, commentators ably illustrated the burdens of entity proliferation on business owners, lawyers, and judges. But lost in many discussions is how entity proliferation affects the general public. This omission is

136. But see Ribstein & Sargent, supra note 17, at 612 (“Even a cursory reading of early LLC opinions is sufficient to convince me that courts expend lots of time and effort trying to comprehend these new business forms, often without much success.”).
137. Jacobs, supra note 124, at 1045–46.
138. Id. at 1045.
139. See generally Kevin V. Tu, Socially Conscious Corporations and Shareholder Profit, 84 GEO. WASH. L. REV. 121, 130 (2016).
140. Jacobs, supra note 124, at 1050.
perhaps understandable. Why would a consumer care if he or she purchases goods from a corporation rather than an LLC? Does a consumer care if a service provider pays entity-level taxes? Does a consumer need to know that managers of LLCs have the option to contractually opt out of fiduciary duties to its owners? Given that most consumer rights laws are drafted without regard to entity type, how does the entity proliferation confusion affect consumers?

While it is true that the average consumer is not affected by a business’s choice of entity, the more recent additions to the legal entity realm have brought consumers to the fore. Indeed, one might argue that the advent of the most popular hybrid entity—benefit corporations—was primarily for public perception. As noted above, the goal of hybrid entity forms is to provide a fundamental means for for-profit entities to incorporate socially-beneficial activities into their formation documents. By forming as “low profit” LLCs or “benefit” corporations, the entities suggest that they will take certain steps to ensure that the entity will forward the socially-beneficial activity of choice. By forming as a benefit corporation, the state provides free marketing of such for-profit entity’s intention to engage in some socially-beneficial activity. The states with hybrid organization statutes permit entities to include suffixes such as “low profit liability company” and “benefit corporation” in their formation documents and such appellations appear on Secretary of State web searches for such entities. Thus, a hybrid entity’s socially-beneficial purpose is given the imprimatur of the state. A consumer may reasonably assume that if a particular state has deemed a corporation a “benefit corporation,” then the state has engaged in some diligence to determine that the business engages in activities that provide some sort of “benefit” beyond shareholder enrichment.

However, nothing in the L3C or the benefit corporation statutes actually requires hybrid entities to engage in socially-beneficial activities. Further, there is no mechanism for consumers to ensure that hybrid organizations act in any particularly beneficial manner. Although L3C statutes require the entity’s organizational documents to state that the L3C cannot have a significant purpose of income production or property appreciation, L3C statutes create no means to monitor an

L3C’s activity.

There is no requirement that the L3C’s articles of organization set forth any charitable or educational purpose. Instead, [an entity] becomes an L3C by its own designation as such in its articles of organization and its use of the L3C appellation. Importantly, there is no process in which an administrative agency determines whether the [L3C] “significantly furthers” any permitted purpose or would not have been organized but for that purpose. Because the L3C process is self-actualizing, it has no meaning.144

Thus, unlike tax-exempt charitable organizations that apply for the exemption from the IRS,145 the L3C’s charitable purpose is not reviewed by a governmental agency and the L3C’s activities are unmonitored.146 It does not take a criminal mastermind to imagine how someone may use the largely unmonitored L3C form to dupe consumers.147 Indeed, “a number of scholars and lawyers . . . see the L3C as, at best, redundant and, at worst, an invitation to fraud.”148

Commentators hold similar concerns for the benefit corporation. Unlike the L3C, benefit corporation statutes attempt to install a standard by which to gauge an entity’s allegiance to their socially-beneficial purpose. Most benefit corporation statutes require the benefit corporation to issue a report that assesses the entity’s “social and environmental performance” against a third-party standard that is comprehensive, credible, independent, and transparent.149 This is known


145. But see Lang & Minnigh, supra note 102, at 24. Interestingly, in order to form a nonprofit, all that is required is to fill out a form for the IRS, pay them a few hundred dollar fee, and if the form is properly filled out they will almost always grant nonprofit status. Filling out the form properly is really the only requirement. There may be a little negotiation, but if the intent is legal and genuine then approval is likely.

146. With the chronic defunding of the IRS, it is not a stretch to say that 501(c)(3)s are also largely unmonitored, but that is for a different article.

147. Callison & Vestal, supra note 144, at 284 (“[T]he pessimist would note that the L3C form creates opportunities for charlatans to establish business entities lacking bona fide charitable or educational purposes, call them L3Cs, and then use the goodwill arising from the form to further bad purposes.”).


as the “annual benefit report” and is required to be made public.\textsuperscript{150} Thus, a benefit corporation’s progress (or lack thereof) toward its stated beneficial purpose is available for public scrutiny. However, if a benefit corporation does not make any significant progress toward its stated socially-beneficial purpose, there is no meaningful mechanism in place to hold the benefit corporation to account. There is a loose equivalent of a derivative suit, where shareholders may take action against the board of directors for failure to engage in socially-beneficial activities, but a consumer has no standing to bring an action against a benefit corporation if it fails to make any progress toward its beneficial purpose.\textsuperscript{151} In other words, there is disclosure, but the disclosure has no immediate consequences.

Thus, hybrid organizations are not actually compelled to take actual steps toward their stated socially-beneficial purpose. At first blush, perhaps this is not a terribly disconcerting conclusion. L3Cs and benefit corporations are, after all, for-profit entities, and maybe we do not think they should be forced to engage in anything other than profit-producing activities. From a policy perspective, do we care that for-profit hybrid organizations may jettison their beneficial purpose in favor of pursuing profits? The problem is not with shareholders or members, who have some access to formation documents and, perhaps, the governing bodies. Rather, the issue is that the general public is left without recourse. When a state bestows titles that include “benefit” or “low-profit” on legal entities, it is eminently reasonable (albeit incorrect) for a consumer to assume that the state has some oversight over the entity and is taking steps to ensure that the entity engages in some charitable activities.\textsuperscript{152} Unfortunately, this assumption is not true.

\textbf{B. Administrative Costs of Entity Proliferation}

An issue closely related to the problem of business owner, consumer, practitioner, and judicial confusion is the fact that entity proliferation

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{150}] Id. at 7.
\item[\textsuperscript{151}] This is unlike, for example, 501(c)(3) organizations, which endanger their tax-exempt status if they fail to pursue their charitable purpose.
\item[\textsuperscript{152}] Lloyd Hitoshi Mayer & Joseph R. Ganahl, \textit{Taxing Social Enterprise}, 66 STAN. L. REV. 387, 397 & n.39 (2014) (noting some concerns that L3Cs “simply represented a desire to trade on the cachet of government imprimatur” and highlighting one commenter’s concern that there is a “risk that the perception of governmental approval will mislead the public into believing that hybrids are subject to oversight akin to that of nonprofits”).
\end{enumerate}
\end{footnotesize}
results in rising administrative costs. As noted above, each new form presents novel issues for both lawyers and judges to interpret. However, the costs of compliance do not end there. There are administrative costs for each new entity. For each new entity form, the government agencies in charge of business formation and compliance (usually the Secretary of State) must produce new formation forms and annual compliance documents. Such administrative costs are difficult to ascertain and precise costs are not readily available, but when Colorado first considered adopting a benefit corporation statute, the state legislature estimated it would cost over $50,000 simply to modify the Secretary of State’s computer system to accept benefit corporation formations. In addition, state agencies must also amend instructions and associated documents to include the new entity forms. But the administrative costs do not end with simply providing the infrastructure necessary to physically form the new entities. Indeed, this administrative burden is relatively simple compared to the legislative burden. Ideally, state legislatures would review existing entity laws to ensure that the new forms comport with existing statutes. This is no simple task, and “[t]he investment of state and bar resources in updating and maintaining multiple statutes is enormous.”

C. What Can We Do to Encourage Business Formation

America was once the leader in forming new businesses. Indeed,

153. See Ribstein & Sargent, supra note 17, at 612 (“The bottom line is that advocates of the crazy quilt grossly underestimate the costs of maintaining multiple statutes.”).

154. Id.

Then, of course, there are . . . the lawyers who have to revise all of their existing private forms, and the judges who will have to interpret the new statutes (‘Does this provision in the LLC act mean the same thing that it does in the limited partnership act? After all, they are different entities, aren’t they?’).


156. There is some concern that this does not occur, and state legislatures instead simply adopt the model form and append it to the existing corporate statutes.

157. See Ribstein & Sargent, supra note 17, at 612.

158. The United States is no longer the leader in the world for starting a business. According to a Gallop Poll, the United States is “12th among developed nations in terms of business startup activity.” Jim Clifton, American Entrepreneurship: Dead or Alive?, GALLUP (Jan. 13, 2015),
economists credit the success of American capitalism to the fact that American business formation outpaces American business closings. This concept, known as “business dynamism,” is exemplified by the fact that “[h]istorically in the U.S., about one new business has been formed every minute, while another shuts its doors every 80 seconds.” However, there is a disturbing new trend strongly suggesting that we, as a country, are becoming less entrepreneurial because we are forming fewer businesses. Perhaps more alarming than the fact that we are forming fewer businesses is that American businesses are closing at a higher rate than they are forming. This trend is captured in the following chart:

As the chart clearly indicates, as of 2011, the number of business dissolutions (470,000 per year) outpaced the number of business startups.

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161. See id. at 1.
More alarming, this is not a problem of a particular region or state, and the trend is evident throughout the U.S. The Brookings Institute noted that business dynamism:

has declined in all fifty states and in all but a handful of the more than three hundred and sixty U.S. metropolitan areas during the last three decades. Moreover, the performance of business dynamism across the states and metros has become increasingly similar over time. In other words, the national decline in business dynamism has been a widely shared experience.163

While there is a chance that this trend may have reversed in recent years (or at least slowed),164 the troubling fact remains that business formation in the U.S. is not as strong as it once was. The expected results of a lagging business formation rate range from the sober and optimistic (“economic crises set the stage for great bursts of innovation”)165 to the dire and ominous (“when small and medium-sized businesses are dying faster than they’re being born, so is free enterprise. And when free enterprise dies, America dies with it.”).166

Hyperbole aside, there is reason to identify the culprit behind the slowing of business formation rates.167 Many economists believe that business dynamism is a prerequisite for sustainable economic growth and general productivity. Without business dynamism, there is a real threat to job creation and job sustainability. Small businesses are responsible for sixty-four percent of America’s net new private sector jobs168 and represent forty-six percent of the private nonfarm U.S. gross domestic product.169 Given the fact that many new businesses have a short lifespan,170 it is clear that it is in our interest to maintain the steady

162. Id.
163. Id. See also Florida, supra note 159 (“Only one metro—McAllen, Texas—had a higher rate of firm entry in 2009–2011 than in 1978–1980.”).
164. Hathaway & Litan, supra note 160, at 6 (noting the possibility that “these trends have reversed—or at least stabilized—since then”).
165. Florida, supra note 159 (“Patent activity has ticked up since the crisis, and venture capital activity has surged in recent years.”).
166. Clifton, supra note 158.
167. See Christopher Ingraham, U.S. Businesses Are Being Destroyed Faster Than They’re Being Created, WASH. POST (May 5, 2014), http://www.washingtonpost.com/blogs/wonkblog/wp/2014/05/05/u-s-businesses-are-being-destroyed-faster-than-theyre-being-created (“If the decline persists, it implies a continuation of slow growth for the indefinite future.”)).
170. This is especially true when one considers that only “[a]bout half of all new establishments survive five years or more and about one-third survive 10 years or more.” Frequently Asked
growth of small business formation by identifying the causes of the downturn in business formation.

While there is little doubt that the slump was one of the many symptoms of the Great Recession, there is no consensus for how to reverse the trend. Some suggest that tax policies can negatively affect business formation. Others posit that lack of access to capital is the primary problem. However, evidence suggests that these common culprits may not help reverse the downturn in entity formation. States with tax policies favorable to corporations have suffered as much, if not more, as states with a heavier corporate tax burden. Further, the decline in business formations coincides with a similar drop in taxes. With respect to a lack of financing and an inhospitable market, the fact remains that most early-stage companies lack outside financing and many entrepreneurs fund their businesses through personal savings, family loans, and personal credit cards. Thus, it does not appear that the lack of financing and the consolidation of financial power represent the reason that business dynamism has not yet rebounded.

With the refutation of the more obvious potential causes (onerous tax regimes and lack of access to capital), some commentators have looked to more obscure reasons. Seemingly grasping at straws, commentators and politicians argue that one or all of the following would help

Questions About Small Business, supra note 5, at 3.


173. Ingraham, supra note 167. For kicks I tried to correlate the drops in new businesses in each state with the states’ scores on the Tax Foundation’s 2014 State Business Tax Climate Index. There was no significant relationship one way or the other. For example, New York, which showed the lowest decrease in new businesses, actually scored dead last in the Tax Foundation’s ranking. Wyoming had one of the largest declines, even though it ranked first in the Tax Foundation’s report.

Id. 174. See Lynn & Khan, supra note 172 ("[T]ax rates have generally gotten lower during exactly the period when entrepreneurship rates have been in decline.").

175. Id. ("The single biggest factor driving down entrepreneurship is precisely the radical concentration of power we have seen not only in the banking industry but throughout the U.S. economy over the last thirty years.").

176. Id. ("While the rise of the venture capital business might give the impression that financial support for entrepreneurs has never been easier to obtain, the truth is that only a tiny fraction of start-ups have access to venture funds.").
ameliorate the issue of lagging business formation: business-favorable immigration reform;\textsuperscript{177} higher scrutiny on business combinations and market consolidation;\textsuperscript{178} and incentives or regulations to encourage the financial system to invest in small businesses.

While there is some argument on the precise primary contributor to the persistently flagging business dynamism, the path to reformation for many of these issues is politically fraught. In today’s political climate, there is not likely to be significant movement on tax or immigration reform. This Article argues for a much simpler and less controversial means to encourage business formation: make the formation process easier. Perhaps the most effective and direct way to ease the business formation process is to address entity proliferation.

IV. SOLVING ENTITY PROLIFERATION

As noted in the Introduction, the entity rationalization movement produced several proposed solutions to the entity proliferation problem. The three solutions that got the most traction were: (i) ignoring proliferation until the market determines the most desirable entities;\textsuperscript{179} (ii) creating two general business forms, one for public companies and one for private companies;\textsuperscript{180} and (iii) installing the hub and spokes option (discussed more below). As Part II of this Article illustrates, simply ignoring the issue is not a viable course. The negatives of entity proliferation do not brook waiting to see if the problem will solve itself. The second option is also not ideal. It would be very difficult for a single entity option to encompass the multitude of characteristics necessary for all private companies. Of the three most popular solutions, only the hub and spokes approach strikes the appropriate balance between addressing

\textsuperscript{177} See Florida, supra note 159.

A key advantage of the United States has been its openness to foreign talent, foreign innovators and foreign entrepreneurs. They have provided a great deal of this country’s entrepreneurial energy, from the early industrial revolution to today’s Silicon Valley tech boom, where one quarter of all companies were founded by a person born outside the U.S. . . . Making America the world’s most welcoming magnet for global talent is the most direct path to jumpstarting our economy and getting the U.S. job market back to where it needs to be.

\textit{Id.}


\textsuperscript{179} Ribstein & Sargent, supra note 17, at 618–19.

\textsuperscript{180} Id. at 610 ("Each state could get by with only two statutes—one designed to provide governance rules for public companies and one designed to provide governance rules for nonpublic companies."). See also Matheson & Olson, supra note 11, at 36; Oesterle & Gazar, supra note 17.
the cost and confusion of entity proliferation and taking advantage of the plethora of innovations and advances in many of the existing entity options.

Early proponents of the hub and spokes model suggested that the first step of implementation is to gather and examine all the available entities to identify which specific aspects of each entity should be a hub (i.e., default) and which should be a spoke (i.e., optional). However, before implementing the hub and spokes model, there are several entities that can be jettisoned. Rather than include all entities in the group to be “gathered and examined,” it is more efficient to first identify the specific entities that will not survive in the new regime (as either a hub or a spoke).

While there are several entity forms that have questionable utility and should not survive the entity rationalization process, this Article will focus on the most glaring entity structures: the L3C, the benefit corporation, and the other hybrid entities. These entities are the obvious candidates not only because they are the most recent additions to the legal entity field, but also because none of these entities has any justification for its continued existence. Supporters of these entities claim that hybrid organizations appeal to entrepreneurs who desire the flexibility and revenue streams commonly associated with for-profit entities, but believe that traditional for-profit entities are ill-equipped to encompass both profit-driven and social benefit-driven motives. Unfortunately for adherents of hybrid entities, the justifications for their continued existence are based primarily on an incorrect (but widely-held) understanding of corporate law: that the more traditional for-profit entity forms do not permit pursuit of a social mission. Thus, the hybrid entity forms purport to combine “the capital and innovation that results from the ability to generate a profit for investors with the public benefit goals that characterize most nonprofits.”181 These hybrid forms are growing in popularity at a rapid pace, and many states are moving quickly to enact enabling statutes. However, as the balance of this section will prove, they are not only unnecessary, but they are doing little more than contributing to the problem of entity proliferation.

181. Meyer & Ganahl, supra note 152, at 387.
A. Abolish Unnecessary Entities

1. Abolish the Low Profit Limited Liability Company

The L3C is a special type of LLC that was created to promote corporate social responsibility. First, by simply having the term “low-profit” in the entity title, the form’s founders hoped to signal to the public that any entity that forms as an L3C has a socially-beneficial purpose. However, the L3C entity form was designed not only for signaling and marketing purposes, but also to provide a streamlined process for attracting PRI from private foundations. If the L3C form succeeded in attracting PRI, then the L3C might have a viable argument for its existence. Unfortunately for L3C advocates, the advent of the L3C failed to encourage PRI and is therefore doing little more than exacerbating the entity proliferation problem.

To understand why L3Cs are unnecessary, it is important to have some background of 501(c)(3) private foundations and the constraints under which they operate. In exchange for favorable tax treatment, private foundations are subject to a number of regulations that restrict the manner in which they may expend their funds. More specifically, private foundations are required to expend a certain amount of their assets toward their charitable purpose on an annual basis. This is why, for example, The Bill & Melinda Gates Foundation spent over one billion dollars toward global health in 2013. The federal government rewards such largesse with favorable tax treatment.

A large portion of the billion dollars distributed by the Bill & Melinda Gates Foundation was given as grants to other charitable and nongovernmental organizations. However, the distribution requirement for private foundations may be satisfied through other

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182. See Lang & Minnigh, supra note 102, at 19–20.
183. Kelley, supra note 142, at 371–72 (“The first and most obvious [change to the LLC form] was simply branding the new entity by including the term ‘low profit’ in its name and in its statutory statement of purpose.”).
185. Taxes on Failure to Distribute Income - Private Foundations, IRS (Mar. 27, 2015), http://www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Taxes-on-Failure-to-Distribute-Income-Private-Foundations (“Private foundations are required to spend annually a certain amount of money or property for charitable purposes, including grants to other charitable organizations.”).
187. Id. at 6 (noting that the expenditures on global health “include grants and direct charitable expenses”).
means. In addition to grants, private foundations may also invest money in programs that are related to the foundation’s charitable purpose. Or in the negative language of the Internal Revenue Code, a foundation is prohibited from engaging in investments that would “jeopardize the carrying out of any of [the foundation’s] exempt purposes.”\textsuperscript{188} Such jeopardy occurs when “it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence . . . in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.”\textsuperscript{189} This determination is made on a case-by-case, “investment by investment” basis.\textsuperscript{190}

The outcome of any case-by-case investigation is, by definition, unpredictable, and such investigations are therefore not popular among private foundations. However, if an investment qualifies as a PRI, it “shall not be classified as an investment which jeopardizes the carrying out of the exempt purposes of a private foundation.”\textsuperscript{191} In other words, PRIs are exempt from this inquiry and they are therefore an attractive alternative for private foundations interested in investment. To qualify as PRI, an investment must have three primary characteristics (the “Three Characteristics”). First, the investment must have the “primary purpose” of “further[ing] the accomplishment of the private foundation’s exempt activities,” and it must be true that the investment “would not have been made but for such relationship between the investment and . . . the foundation’s exempt activities.”\textsuperscript{192} The second characteristic is that any income from the investment must be incidental. In other words, the investment may produce income, but such income may not be a “significant purpose of the investment.”\textsuperscript{193} Finally, the third characteristic is that the investment may not involve any attempt to “influence legislation” or “participate in, or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office.”\textsuperscript{194} If an investment meets all Three Characteristics, then the investment may be deemed PRI and may count toward the private foundation’s distribution requirement.

\textsuperscript{188} I.R.C. § 4944(a)–(b).
\textsuperscript{190} Id. (“The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation’s portfolio as a whole.”).
\textsuperscript{191} Id. § 53.4944-3(a)(1).
\textsuperscript{192} Id. § 53.4944-3(a)(1)(i), (2)(i).
\textsuperscript{193} Id. § 53.4944-3(a)(1)(ii).
The inventors of the L3C\textsuperscript{195} went to great lengths to provide some certainty to private foundations that investments in L3Cs would qualify as PRIs.\textsuperscript{196} To do so, the Three Characteristics are mirrored in L3C statutes.\textsuperscript{197} Although the statutes differ slightly by state, most L3C statutes require the L3C to (1) significantly further a charitable purpose;\textsuperscript{198} (2) have no significant purpose of producing income or the appreciation of property;\textsuperscript{199} and (3) not engage in lobbying.\textsuperscript{200} This is not an accident. L3C proponents hoped that these statutorily-required organizational obligations would convince the IRS to automatically deem investments in L3Cs as PRI. In other words, the hope was that “any social enterprise that qualified for L3C status under state law would ipso facto qualify for program-related investments under the IRS Code.”\textsuperscript{201} With the IRS’s blessing, private foundations “could invest with confidence in any organization that was designated as an L3C without needing to perform an exhaustive investigation or obtain a private letter ruling.”\textsuperscript{202}

Unfortunately, the IRS did not cooperate, and such certainty never materialized. The IRS’s refusal to grant an automatic determination that investments in L3Cs would qualify as PRI was certainly disappointing, but was, perhaps, not surprising. After all, L3C statutes are the products of state legislation, and there is no principled reason to assume that state legislation can alter federal tax laws.\textsuperscript{203} Thus, the best hope of L3C


By statute, an L3C’s purposes are tightly restricted. The restrictions are designed to implement the L3C’s central purpose—“to dovetail with the federal IRS regulations relevant to Program Related Investments (PRIs) by foundations”—so as to allow foundations to invest some of their assets in private, profit-making enterprises formed to advance socially desirable goals. Id. (citation omitted).

\textsuperscript{197} Id. ("[T]he language of the \[L3C statutory\] restrictions . . . derive from the Treasury Regulations delineating permissible PRIs and cite sections of the IRC.") (citation omitted).


\textsuperscript{199} Id. § 3001(27)(B).

\textsuperscript{200} Id. § 3001(27)(C).

\textsuperscript{201} Kelley, supra note 142, at 373.

\textsuperscript{202} Id. See also Lang & Minnigh, supra note 102, at 22 ("[I]n the time that one foundation got one private letter ruling, 100 L3Cs were formed.") (quoting Arthur Wood).

\textsuperscript{203} As if that were an arguable claim, the Treasury Regulations clearly state: "[N]o State law
proponents is that the IRS would issue a ruling indicating that foundation investments in L3Cs would presumptively qualify as PRI. Unfortunately, the IRS has not issued any such statement.

As such, the L3C is an entity without a purpose. It is, in effect, the practical equivalent of an LLC with restrictions in its formation documents. Indeed, due to the LLC’s flexibility, if the members of an LLC would like to restrict the entity’s purpose to reflect the L3C restrictions, they may do so under LLC statutes. If the IRS determined that investments in L3Cs automatically qualified as PRI, then L3C proponents would have an argument for the entity’s continued existence. Absent such a statement, which does not appear to be forthcoming, there is no compelling need for states to adopt the L3C form. As noted by a prominent lawyer, “[i]t’s a well-motivated attempt to facilitate a good thing, but in practice it doesn’t work.”

Given the problems of entity proliferation outlined above and the failure of the IRS to bestow favorable treatment on private foundation investments in L3Cs, there is a persuasive argument that the L3C form should be removed from state statutes. Indeed, there may already be some movement toward the abolition of L3Cs, as North Carolina decided to eliminate the entity form in 2014. One of those responsible for North Carolina’s removal of the L3C noted that “[t]here was no objection on the policy side. The objection was that [the L3C] is not necessary.” Calling the L3C form “deadwood” and noting that the contractual flexibility of the LLC rendered the L3C useless, the group responsible for streamlining the North Carolina LLC statute deemed the L3C superfluous. In the interest of ameliorating the negatives of entity proliferation, the rest of the country would be wise to follow suit.

[shall] exempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in section 4944 and the regulations thereunder.” Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 2009).

204. Kelley, supra note 142, at 373.

Owen and Lang envisaged a master list—perhaps one maintained by the IRS—that would track the organizations around the country that had qualified under state law as L3Cs. If a private foundation were interested in investing in or loaning to a hybrid social enterprise in the form of a PRI, it could simply check the list to be sure the organization had qualified and then proceed with its investment.

Id.

205. Field, supra note 101.

206. Id.

207. Id.

208. Id.
2. Abolish the Benefit Corporation

Like the L3C, the benefit corporation was formed to address a perceived failure to promote charitable activity by for-profit organizations. L3C proponents attempted to rectify the perceived deficit of corporate social responsibility by promoting private foundation investment in for-profit entities. Likewise, proponents of benefit corporations hoped to create an entity that would promote socially-beneficial activity by for-profit companies, regardless of the investment source.

The genesis of the benefit corporation form can be traced to a misunderstanding of corporate law. Benefit corporation proponents bemoan the lack of socially-beneficial activities of for-profit companies, and claim that controlling case law prohibits socially-minded corporations from expending any resources in a charitable manner. In other words, benefit corporation proponents believe that corporate law requires for-profit corporations to maximize shareholder value. Their argument is that directors of a corporation have a duty to maximize shareholder value and a for-profit corporation may not engage in any corporate action that fails to result in a concomitant increase in the corporation’s bottom line. The origin of this belief is generally found in two cases: Dodge v. Ford Motor Co.\textsuperscript{209} and eBay Domestic Holdings, Inc. v. Newmark.\textsuperscript{210} As succinctly summarized by Professor Kevin Tu:

The Dodge court wrote that corporations are “organized and carried on primarily for the profit of the shareholder,” and opined that the discretion of directors is limited to a choice of how to achieve that directive . . . . Although eBay involved different factual scenarios and the application of a differing level of judicial scrutiny, the judicial opinion contained language that could be viewed as a similar endorsement.\textsuperscript{211}

There is, however, no such mandate for a corporation to maximize shareholder profits, and no such prohibition on a corporation expending resources in a charitable manner. It is true that the language of Dodge appears to stand for the proposition that corporations must maximize profits. In addition to the language quoted by Professor Tu, the Dodge court also stated: “The discretion of directors is to be exercised in the choice of means to attain [the profit of stockholders], and does not

\textsuperscript{209} 170 N.W. 668 (Mich. 1919).
\textsuperscript{210} 16 A.3d 1 (Del. Ch. 2010).
\textsuperscript{211} Tu, supra note 139, at 137.
extend to... other purposes.

But however clear this language appears, commentators have made compelling arguments against the existence of controlling law in favor of a corporation’s duty to maximize shareholder profits. First of all, the quoted language in Dodge was merely dicta and had no bearing on the court’s holding. But perhaps even more damning for shareholder primacy adherents is the fact that the Dodge court language is less concrete than generally assumed. As Professor Lynn Stout noted, in addition to the dicta regarding the supposed shareholder primacy, the Dodge court also specifically contemplates corporations having the ability to engage in charitable (i.e., non-profit-making) activities. The Dodge court stated that corporations may engage in the incidental humanitarian expenditure of corporate funds for the benefit of the [employees], like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others.

In this manner, the court made it clear that the holding at issue was not focused upon a corporation’s ability to engage in socially-beneficial activities at the expense of profits. Professor Stout noted:

The actual holding in the case... was justified on entirely different and far narrower legal grounds. . . . Thus Dodge v. Ford is best viewed as a case that deals not with directors’ duties to maximize shareholder wealth, but with controlling shareholders’ duties not to oppress minority shareholders. The one Delaware opinion that has cited Dodge v. Ford in the last thirty years, Blackwell v. Nixon, cites it for just this proposition.

Thus, the seemingly authoritative statement of the Dodge decision, a state court decision published almost a century ago, should not stand as a definitive victory for shareholder primacy adherents.

The other authority that shareholder primacy adherents often tout is the Delaware Chancery Court’s more recent holding in eBay Domestic

212. Dodge, 170 N.W. at 684.
214. Id.
215. Dodge, 170 N.W. at 684.
216. Stout, supra note 213, at 167–68.
Holdings, Inc. v. Newmark.\footnote{217} Unfortunately for shareholder primacy enthusiasts, this reliance is similarly misplaced. To understand why, the facts of eBay are important. Although organized as a for-profit corporation, Craigslist primarily operated as a “community service.”\footnote{218} For example, Craigslist declined to charge for hosting a majority of classified advertisements, eschewed advertising revenues, and refused to advertise its services.\footnote{219} Rather than profits, the Craigslist business plan prioritized “seeking to aid local, national, and global communities by providing a website for online classifieds that is largely devoid of monetized elements.”\footnote{220} When eBay became a minority shareholder of Craigslist, the Craigslist directors were concerned that the new shareholder would upset this vision. Thus, the Craigslist directors adopted a poison pill to prevent any “increased monetization”\footnote{221} of Craigslist out of a fear that eBay would threaten Craigslist’s community-oriented vision.\footnote{222} eBay sued to invalidate the poison pill. In other words, a minority shareholder sued the directors of a for-profit company to remove an obstacle designed to prohibit active pursuit of potential profits.\footnote{223}

The eBay court applied Unocal enhanced scrutiny, which, in part, requires a corporation’s directors to “identify the proper corporate objectives served by their actions.”\footnote{224} Despite admitting an admiration of the Craigslist directors’ intent,\footnote{225} the eBay court ruled against the directors, holding that the court “cannot accept as [a proper corporate objective] a corporate policy that specifically, clearly, and admittedly seeks not to maximize the economic value of a for-profit . . . corporation for the benefit of its stockholders.”\footnote{226}

Despite this language, the eBay holding does not provide unqualified support for shareholder profit maximization. Indeed, similar to Dodge, the court’s holding may prove to be much narrower. Professor Tu noted:
Neither [Dodge nor eBay] imposes a definitive and all-encompassing duty on directors to maximize shareholder profit in all matters. Instead, the opinions could be construed as standing for a far narrower proposition. First, the duty to maximize shareholder profit may only arise given the specific facts of Dodge and eBay. Alternatively, it is possible that both cases merely stand as examples of majority shareholders violating fiduciary duties owed to minority shareholders by virtue of oppressive actions.227

It is also important to note that the eBay decision would likely have been different if the Craigslist directors had asserted any business motivation for their actions. Given the deference of the business judgment rule, any such motivation would likely have withheld scrutiny (e.g., the directors could have argued that Craigslist traffic would suffer if the website charged for services or accepted paid advertisements).

Thus, similar to the L3C, the justification for the existence of the benefit corporation is not compelling. In the L3C’s case, the entity form would only make sense if the IRS were to indicate that any investments in L3Cs would automatically be deemed PRI. Absent such a ruling, the L3C is an entity without a purpose. Similarly, the benefit corporation form was established in response to the belief that for-profit corporations were prohibited from engaging in charitable or socially-beneficial actions that harmed the for-profit entity’s bottom line. As outlined above, this belief is a specious conclusion based on nothing more than dicta in a 100-year old holding and a recent case with singular and peculiar facts.

In addition to the dubious existence of the duty to maximize shareholder wealth, the benefit corporation form is poorly conceived. While the benefit corporation model statute requires an entity’s organizing documents to include a requirement to promote “a material positive impact on society and the environment,”228 precisely how the entity determines if it has met this requirement is entirely unclear. Perhaps unsurprisingly, the drafters of the model benefit corporation statute appear to have elected not to embark on the definitional odyssey of identifying what exactly is and is not “material.” Rather, in order to determine if a benefit corporation is having a socially-beneficial impact, the model benefit corporation statute relies upon review by an unidentified, non-governmental third party.229 Given the recent failures of private third-party ratings agencies to maintain independence and

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227. Tu, supra note 139, at 136.
228. See MODEL BENEFIT CORPORATIONLEGISLATION, supra note 149, at 3.
229. Id. at 3, 5–6.
provide consumer protection, the decision to leave such a fundamental determination to a non-government entity is curious, if not negligent. However, the delegation itself is less troubling than the virtual dearth of minimum qualifications of such agencies under the proposed legislation. The qualifications of such third party under the model benefit corporation statute are that it (i) be independent and (ii) use a standard that is transparent. There are no further requirements, and beyond the minimum qualifications stated above, there is no suggested criterion or standard by which the benefit corporation is to be evaluated. Indeed, the model benefit corporation statute fails to explicitly state any minimum requirements in evaluating an entity’s public benefit.

Many commentators have weighed in on the necessity of benefit corporations, and the vast majority has concluded that they represent nothing more than a redundant form with state-sponsored (and potentially misleading) marketing. There is no need to reiterate those arguments here. Combining the marginal utility (if any) of benefit corporations with the negatives of entity proliferation, it is clear that the

230. See Jonathan Katz, Emanuel Salinas, & Constantinos Stephanou, Credit Rating Agencies, WORLD BANK GROUP 3 (Oct. 2009), http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/Note8.pdf ("Credit rating agencies have been extensively criticized for their role in fueling the unsustainable growth of the asset-backed structured finance debt market—a major catalyst for the global financial crisis.").

231. See, e.g., NEV. REV. STAT. ANN. § 78B.080(2)(a) (West Supp. 2014) (requiring the third party to have "no material financial relationship with the benefit corporation or a subsidiary of the benefit corporation").

232. See, e.g., id. § 78B.080(3)(a)–(e). The Nevada statute requires the following information to be made public:

(a) The criteria considered when measuring the overall social and environmental performance of a business;
(b) The relative weightings assigned to the criteria described in paragraph (a);
(c) The identity of the directors, officers, material owners and the governing body of the entity that developed, and controls revisions to, the standard;
(d) The process for revising the standard and changing the membership of the governing body that developed, and controls revisions to, the standard; and
(e) An accounting of the sources of financial support for the entity that developed, and controls revisions to, the standard which provides sufficient detail to disclose any relationships that could reasonably be considered to present a potential conflict of interest.

Id.

benefit corporation form is an unnecessary addition to the already unduly lengthy list of legal entities.

3. Abolish the Balance of Hybrid Entities

The arguments against benefit corporations hold equally true for any other so-called “hybrid” entities, including the social purpose corporation. Indeed, there is little difference between social purpose corporations and benefit corporations. Professor Mayer noted:

The [social] purpose corporation is a sort of benefit corporation lite: the [social] purpose corporation enabling statute merely requires the disclosure of at least one specific “special purpose” in the articles of incorporation, and directors are thereby protected against liability for giving special consideration to that single purpose, even when it is detrimental to the bottom line of the corporation.234

Thus, the only meaningful difference between social purpose organizations and benefit corporations is that benefit corporations have a broad (and vague) obligation to have a “material positive impact on society and the environment, taken as a whole,”235 along with the option to have a specific purpose. Given that this is the only difference between social purpose organizations and benefit corporations, the same arguments against benefit corporations hold true against social purpose organizations.236 The same arguments against benefit corporations and social purpose organizations hold true for other varieties of hybrid organizations.

B. Establish the Hubs

In Part I, this Article identified all the available entities and placed them in one of the following categories: corporations, partnerships, nonprofits, or hybrids. These categories were not chosen randomly. Rather, after we jettison the unnecessary forms (i.e., the “hybrids” category), these categories represent the suggested “hubs” on the modified hub and spokes model.

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234. Mayer & Ganahl, supra note 152, at 400. California’s flexible purpose corporation was renamed to “social purpose corporation” in January 2015.
235. See MODEL BENEFIT CORPORATION LEGISLATION, supra note 149, at 3.
236. See Mayer & Ganahl, supra note 152, at 401 (noting that flexible purpose organizations are “vulnerable to the same criticisms leveled against L3Cs and benefit corporations”).
The idea behind the hub and spokes approach is to provide a single set of default rules to which all for-profit entities must adhere, with entities selecting optional characteristics appropriate for its particular venture. One practicing attorney described the hub and spokes approach as follows:

The “hub” would identify the common default rules, public policy constraints, and administrative provisions applicable to business entities generally. The “spokes” would provide a rational array of entity choices with a separate set of special default rules appropriate to each entity (and each constituency).

The hub and spokes approach views the overlapping characteristics of the various legal entities as a positive, rather than a negative. It “would capitalize on the existing similarities between the separate statutes and resolve the differences between entities of little moment to their constituencies.” To implement the hub and spokes regime,

all of the various business entity statutes are gathered and examined for overlaps, then combined in a structure that places these overlapping areas into a central “hub” that applies to all business entities, with the unique provisions of each type of entity placed in various “spoke” sections that apply only to the respective entities.

The hub and spokes solution presents an appealing approach. It not only maintains the most attractive aspects of the current business entity statutes, but it also provides flexibility for business owners to customize their entities and choose the specific desired characteristics. However, the hub and spokes approach generally contemplates a single hub for all entities. This Article will argue that, in order for the hub and spokes approach to be most effective, we will need more than a one hub. In fact, this Article argues that we need three hubs, one for each of the following: corporations, partnerships, and nonprofit organizations. In other words, the categories used to quantify the available entities shall serve as the hubs of the proposed rationalization.

The corporations hub will have the default characteristics typically associated with the corporate form. To that end, the corporations hub will have default rules regarding limited personhood and will have the typical corporate constituents: shareholders, officers, and directors. The

237. Ribstein & Sargent, supra note 17, at 619.
238. Id.
239. Blackwell, supra note 17, at 345.
directors will owe certain fiduciary duties to the entity and the constituents will enjoy limited liability protections subject to corporate veil-piercing rules. The potential spokes that emanate from this hub could include, for example, limitations on ownership to accommodate close corporations, cooperatives, or professional corporations.

Similarly, the partnerships hub will boast the default characteristics typically associated with the partnership form, such as flexible governance and pass-through taxation. One of the key spokes for the partnership hub will be limited liability. Similar to the general partnership default, the hub will impose joint and several liability absent an election otherwise. Such elections, i.e., the spokes, would include limited liability for certain owners (similar to limited partnerships) or limited liability for all owners (similar to LLCs). Other spokes may include the characteristics of the balance of the entities in the partnership category, like series LLCs, professional LLCs, and close LLCs.

The key characteristic of the nonprofit hub will be the lack of owners and the related restraint on distribution of profits and assets. The spokes on the nonprofit hub might include optional membership (including voting rights) and options for dissolution (i.e., distribution of assets to the state of incorporation or distribution to a 501(c)(3) organization).

After creating these three hubs, states may include whatever spokes they deem appropriate. For example, if a state would like to permit managers of LLCs to opt out of fiduciary duties to members, it may include this as a spoke on the partnership hub. On the other hand, if a state would rather not let LLCs opt out of fiduciary duties, then such duties may be included in partnership hub’s default rules. In such a manner, we can significantly decrease the absolute number of entities to three per state, with all the nuances available in the current entity landscape serving as spokes to the three core entities. Such a regime would be infinitely less costly to maintain, the burden on judges and the practicing bar would be significantly lessened, and entrepreneurs would have a vastly simpler choice to make when forming a company. What was once a choice of over a dozen options will have been reduced to three simple, easily identifiable options, with the opportunity to customize the entity as needed.

V. CONCLUSION

Forming a successful business is not easy. An entrepreneur has to find adequate capital to run a business, identify and secure dedicated employees for the business, deliver a product or service that is appealing to consumers, and compete against established players in the market.
With more than enough unavoidable difficulties facing entrepreneurs, why do we make business formation so difficult?

There is no excuse for maintaining the daunting bureaucratic legal difficulty that legal entity choice has become, and there is no principled reason to provide such a confounding array of entities for potential business owners. With legal entities added to the already crowded legal entity landscape on an annual basis, it is well-past time to address the problem of entity proliferation.

This Article provides the roadmap for policymakers to address the issue of entity proliferation. First, stop adding useless entity structures and remove superfluous entities that already exist. Second, create three legal entity forms—corporations, partnerships, and nonprofit organizations—with the desired default characteristics. Finally, identify and install the variations and optional characteristics for each entity hub. In doing so, a state would then have greatly simplified its legal entity choices. Entrepreneurs, small business lawyers, consumers, and judges will have a vastly simpler regime in which to interact. Once again, America would be a simple place to form a business.\(^{240}\)

\* * *

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\(^{240}\) Ribstein, supra note 6, at 1023 (noting that there was a time when “[t]he world . . . was a simpler place in which to form a business.”).
## Common Business Forms

<table>
<thead>
<tr>
<th>Corporations</th>
<th>Partnerships</th>
<th>Nonprofits</th>
<th>Hybrids</th>
<th>Select Miscellaneous Entities</th>
</tr>
</thead>
</table>

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241. All citations were verified using published, bound volumes of the current codes of each respective state. If a provision appeared in a supplement or pocket part, the year of that supplement is noted. If a provision was enacted after publication of the bound volume and supplement or pocket part, the citation was verified using Westlaw’s electronic database.
<table>
<thead>
<tr>
<th>Common Business Forms</th>
<th>Other Business Entities</th>
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</thead>
<tbody>
<tr>
<td><strong>Corporations</strong></td>
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<td><strong>Hybrids</strong></td>
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# Common Business Forms

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<tr>
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<th>Hybrids</th>
<th>Other Business Entities</th>
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</table>

## Arkansas

- **Cooperative (e.g., ARK. CODE ANN. §§ 4-30-101 to -207 (West 2004)); Corporation (ARK. CODE ANN. §§ 4-26-101 to -1204 (West 2004 & Supp. 2014)):**


- **Nonprofits:**

  - Charitable Organization (e.g., ARK. CODE ANN. § 4-28-207 (West 2004)); Nonprofit Corporation (ARK. CODE ANN. §§ 4-33-101 to -1707, 4-28-201 to -416 (West 2004 & Supp. 2014))

- **Benefit Corporation (ARK. CODE ANN. §§ 4-36-101 to -401 (West Supp. 2014)):**

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<th>Corporations</th>
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<td>Common Business Forms</td>
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<td><strong>Nonprofits</strong></td>
<td><strong>Hybrids</strong></td>
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<tr>
<td><strong>Partnerships</strong></td>
<td><strong>Nonprofit Religious Corporation (CAL. CORP. CODE §§ 9110–9690 (West 2006 &amp; Supp. 2014))</strong></td>
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<tr>
<td><strong>Hybrids</strong></td>
<td><strong>Public Benefit Corporation (COLO. REV. STAT. ANN. §§ 7-101-501 to -509 (West Supp. 2013))</strong></td>
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<td><strong>Select Miscellaneous Entities</strong></td>
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</table>

**Colorado**


**Nonprofits:** Nonprofit Public Benefit Corporation (CAL. CORP. CODE §§ 5110–6910 (West 1990 & Supp. 2014))

242. Please note that a California Unincorporated Association may be a nonprofit entity.
### Common Business Forms

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<thead>
<tr>
<th>Corporations</th>
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<td><strong>Other Business Entities</strong></td>
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<td>Delaware</td>
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### Common Business Forms

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<th>Corporations</th>
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### Florida

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<td><strong>Select Miscellaneous Entities</strong></td>
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</table>

**Georgia**


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**Nonprofits**: Corporation Organized for Religious, Fraternal, or Educational Purpose (GA. CODE ANN. §§ 14-5-40 to -51 (West 2003 & Supp. 2013)); Nonprofit Medical Service Corporation (GA. CODE ANN. §§ 33-18-1 to -33 (West 2003))
## Common Business Forms

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<tr>
<th>Corporations</th>
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<td><strong>Hawaii</strong></td>
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<td><strong>Idaho</strong></td>
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<td></td>
<td>Partnerships: Mining Partnership (IDAHO CODE ANN. §§ 53-401 to -412 (West 2006))</td>
</tr>
</tbody>
</table>

**Select Miscellaneous Entities**

- **Corporations**: Professional Service Corporation (805 ILL. COMP. STAT. ANN. 10/1 to /19 (West 2010 & Supp. 2014))
- **Partnerships**: Professional LLC (805 ILL. COMP. STAT. ANN. 185/1 to /999 (West, Westlaw through 2015 Reg. Sess.)); Special Charter Not for Profit Corporation (805 ILL. COMP. STAT. ANN. 125/0.01 to /6 (West 2010))
- **Nonprofits**: Educational Corporation (110 ILL. COMP. STAT. ANN. 300/0.01 to /6 (West 2006)); Fraternal Benefit Society (215 ILL. COMP. STAT. ANN. 5/282.1 to /315.9 (West, Westlaw
### Common Business Forms

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<tr>
<td><strong>Indiana</strong></td>
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<td>through 2015 Legis. Sess.); German School Educational Corporation (805 ILL. COMP. STAT. ANN. 1300/0.01 to /1 (West 2010)); Veterans Corporation (805 ILL. COMP. STAT. ANN. 150/0.01 to /5 (West 2010))</td>
</tr>
</tbody>
</table>

**Nonprofits**

- Benefit Corporation (IND. CODE ANN. §§ 23-1,3-1-1 to -10-6 (West, Westlaw through 2016 2d Reg. Sess. ))
- Benefit Corporation (IND. CODE ANN. §§ 23-1,3-1-1 to -10-6 (West, Westlaw through 2016 2d Reg. Sess. ))
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<td>Partnerships: Professional LLC (see KY. REV. STAT. ANN. § 275.015(25) (West, Westlaw through 2015 Reg. Sess.))</td>
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<td><strong>Partnerships:</strong> Professional LLC (LA. STAT. ANN. § 12:982.1 (2010))</td>
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<td><strong>Massachusetts</strong></td>
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<tbody>
<tr>
<td><strong>Mississippi</strong></td>
<td>Corporation (MISS. CODE ANN. §§ 79-4.1 to .17.05)</td>
<td>General Partnership (MISS. CODE ANN. §§ 79-13-101 to)</td>
<td>Nonprofit Corporation (MISS. CODE ANN. §§ 79-</td>
<td>Corporations: Professional Corporation (e.g., MISS. CODE ANN. §§ 79-10-1 to</td>
<td>Nonprofits: Professional Corporation (e.g., MISS. CODE ANN. §§ 79-10-1 to)</td>
</tr>
</tbody>
</table>

**Nonprofits:** Nonprofit Consumer Cooperative (MICH. COMP. LAWS ANN. §§ 450.3100 to .3192 (West 2011)); Church Trustee Corporation (MICH. COMP. LAWS ANN. §§ 450.159 to .162 (West 2002))
<table>
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<tr>
<th>Common Business Forms</th>
<th>Other Business Entities</th>
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<tbody>
<tr>
<td><strong>Corporations</strong></td>
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<td>Montana</td>
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- **Partnerships**: Professional LLC (N.H. REV. STAT. ANN. §§ 304-D:1 to :20 (2015))
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<td>New Jersey</td>
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<td>New Mexico</td>
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<tr>
<td><strong>Corporations</strong></td>
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<td>Benefit Corporation (N.Y. BUS. CORP. LAW §§ 1701–1709 (McKinney Supp. 2014))</td>
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<td><strong>Partnerships</strong></td>
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<td>New York</td>
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<td><strong>Ohio</strong></td>
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### Other Business Entities


- **Nonprofits**: Mutual Aid Cooperative (N.D. Cent. Code Ann. §§ 10-12-01 to -05 (West 2008))

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<tr>
<td>Nonprofits</td>
<td>Nonprofits: Manufactured Dwelling Park Nonprofit Cooperative Corporation (OR. REV. STAT. ANN. §§ 62.800 to .815)</td>
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500-101A to -1207A (West 2011 & Supp. 2014)
Pennsylvania. Although nonstock corporations are normally nonprofit organizations, this particular statute appears to be intended for for-profit activities.
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<td><strong>Select Miscellaneous Entities</strong></td>
<td>Supp. 2014</td>
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</table>

**Rhode Island**

- Nonprofit Corporation (7 R.I. GEN. LAWS ANN. §§ 7-6-1 to -108 (West 2006 & Supp. 2014))
- Benefit Corporation (7 R.I. GEN. LAWS ANN. §§ 7-5.3-1 to -13 (West Supp. 2014)); Low-Profit Limited Liability Company (7 R.I. GEN. LAWS ANN. § 7-16-76 (West Supp. 2014))
- Benefit Corporation (7 R.I. GEN. LAWS ANN. §§ 7-5.3-1 to -13 (West Supp. 2014)); Professional Service Corporation (7 R.I. GEN. LAWS ANN. §§ 7-1.1-1 to -12 (West 2006 & Supp. 2014))

**Nonprofits:** Unincorporated Nonprofit Associations (15 PA. STAT. AND CONS. STAT. ANN. §§ 9111–9136 (West Supp. 2014))

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<td><strong>South Carolina</strong></td>
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| **South Dakota** | | | | |

**Nonprofits:** Corporation Not-for-Profit Financed by Federal or State Loans (S.C. CODE ANN. §§ 33-36-10 to -1370 (2006 & Supp. 2015))
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<td>General Partnership</td>
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<td>Nonprofit Corporation</td>
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<td>Social Purpose Corporation</td>
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<td>Corporations: Agricultural Processing and Marketing Association; Corporation Sole; Industrial Development Corporation; Massachusetts Trust; Professional Service Corporation; Nonprofits: Fraternal Organization; Nonprofit Miscellaneous or Mutual Corporation</td>
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<th>Nonprofits</th>
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<td>Fraternal Organization</td>
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<tr>
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<th>Social Purpose Corporation</th>
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<td>State</td>
<td>Corporations</td>
</tr>
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</tbody>
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Common Business Forms

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**Wyoming**

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