

1-1-2012

For a Few Dollars Less: Explaining State to State Variation in Limited Liability Company Popularity

Daniel M. Häusermann

Follow this and additional works at: <http://repository.law.miami.edu/umblr>



Part of the [Law Commons](#)

Recommended Citation

Daniel M. Häusermann, *For a Few Dollars Less: Explaining State to State Variation in Limited Liability Company Popularity*, 20 U. Miami Bus. L. Rev. 1 (2012)

Available at: <http://repository.law.miami.edu/umblr/vol20/iss1/2>

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Business Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.

FOR A FEW DOLLARS LESS: EXPLAINING STATE TO STATE VARIATION IN LIMITED LIABILITY COMPANY POPULARITY

DANIEL M. HÄUSERMANN*

August 25, 2011

The limited liability company (LLC) is a much more popular business entity in some U.S. states than in others. This empirical study provides the first detailed analysis of this phenomenon.

I find that formation fees, rather than taxes or substantive rules or anything else, explain the variation in LLC popularity best. Differentials between the fees for organizing an LLC and the fees for organizing a corporation explain 17% to 28% of the state-to-state variation in LLC popularity. These formation fee differentials are not very big, but they are highly visible at the moment the business entity is formed. In contrast, the data show no relationship between LLC popularity and differentials in annual fees and entity-level taxes. Differences in substantive rules contained in LLC statutes are likely to be trivial in the sense that they are not important enough to affect entity choice. However, LLCs are more popular in those states whose LLC statutes expressly uphold the principle of contractual freedom and thus reassure LLC members that courts will not rewrite their contract in the event of a lawsuit. Finally, I found no evidence that LLC popularity is related to different levels of uniformity of LLC statutes, the age of LLC statutes, and other factors.

The Digital Object Identifier of the dataset compiled for this study is doi:10.3886/ICPSR31561.

* Scholar in Residence, University of Virginia School of Law; Visiting Researcher, Harvard Law School. I thank Professors Lynn M. LoPucki and Katherine M. Porter for their guidance throughout the research and writing process, Professors Jens Dammann and Guhan Subramanian for their comments on specific issues, Professor Mark J. Roe for providing hard-to-get data, Dr. Parina Patel for statistical advice, Joshua Boehm, Kevin Caldwell, Mazen Elfakhani, Thomas Ferriss, Sara Greene, Jason Iuliano, Ruth Lee, Andrew Meiser, Jonathan Miller, Jared Rinehimer, David Simon and Gita Srivastava for their comments, and my wife, Dr. Claudia F. Brühwiler Häusermann, for critically reviewing the paper.

CONTENTS

CONTENTS 2
I. INTRODUCTION 3
II. DATA AND METHODOLOGY..... 9
III. FINDINGS AND IMPLICATIONS 13
 A. *The Fee Paradox* 17
 B. *The Dubious Significance of Substantive Rules* 22
 1. *Minority Protection* 22
 2. *Third-Party Protection* 26
 3. *Fiduciary Duties* 27
 4. *Small Business Default Rules*..... 29
 5. *Mandatory Rules*..... 31
 6. *Conclusion: Is LLC Law Trivial?*..... 32
 C. *The “Freedom of Contract” Puzzle* 33
 D. *What Does Not Explain the State-to-State Variation* 36
 1. *Uniformity of Statutes* 36
 2. *Age of LLC Statute*..... 39
 3. *Series LLCs* 40
 4. *Debtor Protection* 41
 E. *California’s Ban of Professional LLCs* 42
 F. *The Big Picture: LLC Popularity and the Wild West*..... 42
IV. DIRECTIONS FOR FUTURE RESEARCH 44
V. CONCLUSIONS 46

I. INTRODUCTION

Limited liability companies (LLCs) are a much more popular business entity in some states than in others. For instance, people in Connecticut form twelve times as many LLCs than corporations each year. In contrast, more corporations than LLCs are still formed in Illinois, New York, and California. This empirical study provides the first detailed analysis of the state-to-state variation of LLC popularity, using a partly original set of cross-sectional state-level data. In a nutshell, I find that formation fee differentials explain more of the variation in LLC popularity than all other factors taken together. Differentials in recurring fees and entity-level taxes are unrelated to LLC popularity, and substantive rules contained in LLC statutes are probably of trivial importance. However, LLCs are more popular in those states whose LLC statute expressly endorses the principle of contractual freedom.

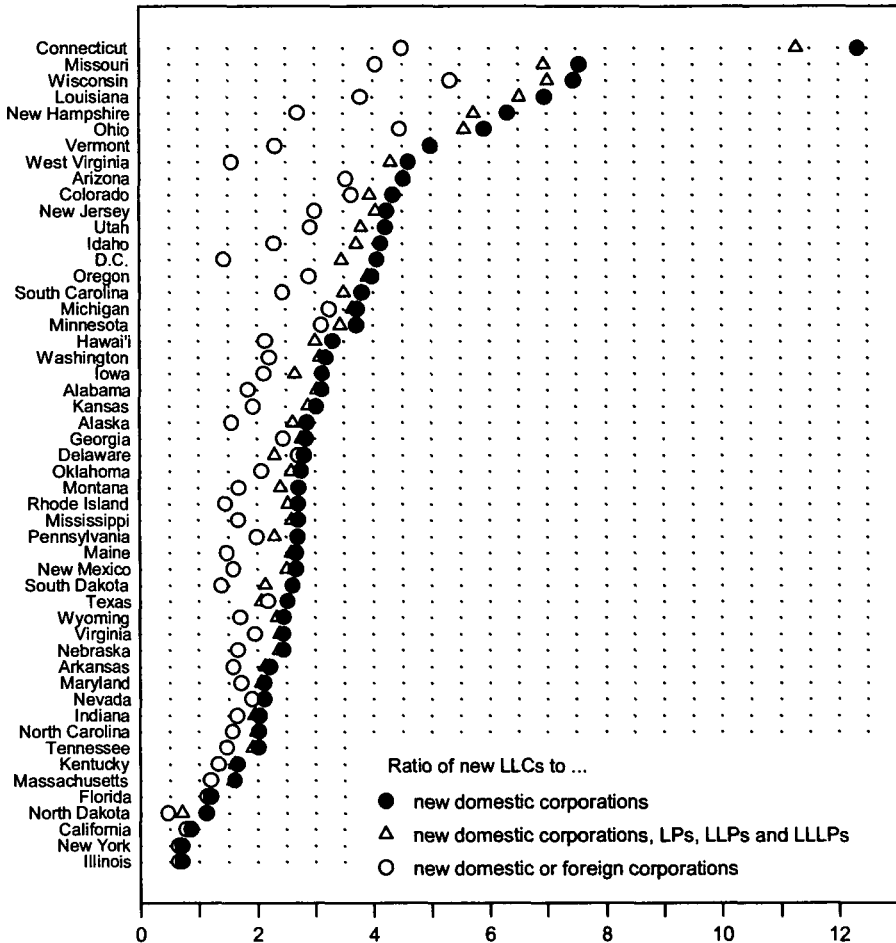
Figure 1 illustrates how the popularity of the LLC varies across the 50 states and the District of Columbia. I measure LLC popularity in three different ways. My first measurement is the ratio of new domestic LLCs to new domestic business or professional corporations formed in the most recent year available. The second measurement has a broader denominator, which comprises all other domestic entities that provide for limited liability, namely corporations, limited partnerships (LPs), limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs). The third measurement is different from the first in that its denominator includes not only domestic corporations, but also corporations from other states that have registered to do business in the respective state. By all three measurements, the popularity of the LLC varies substantially from state to state. The highest ratio of LLCs to domestic corporations is 17.7 times higher than the lowest.¹ The highest ratio of LLCs to other limited liability entities is 16.3 times higher than the lowest,² and the highest ratio of LLCs to corporations including out-of-state corporations is still 11.6 times higher than the lowest.³

¹ Connecticut's ratio of LLCs to domestic corporations is 12.3, Illinois' is 0.70. 12.3 divided by 0.70 equals 17.7. See *infra* Figure 1.

² Connecticut's ratio of LLCs to other limited liability entities is 11.3, Illinois' is 0.69. 11.3 divided by 0.69 equals 16.3. See *infra* Figure 1.

³ Wisconsin's respective ratio is 5.3, North Dakota's is 0.46. 5.3 divided by 0.46 equals 11.6. See *infra* Figure 1.

Figure 1: State-to-state variation in LLC popularity

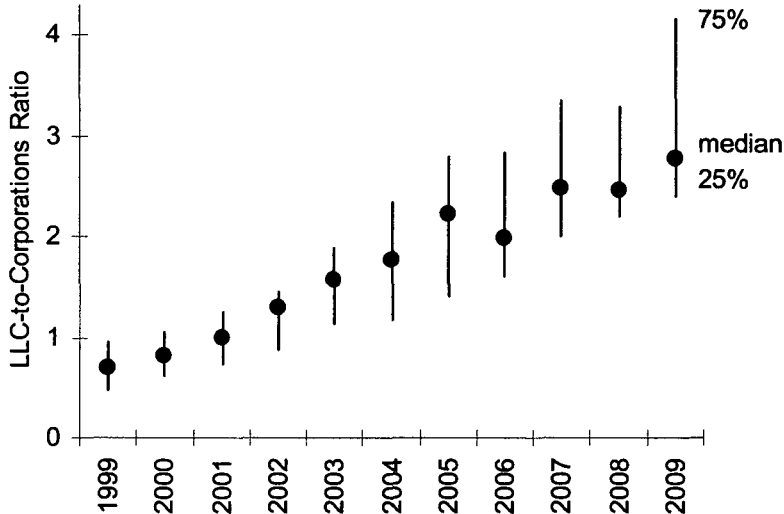


Source: Calculated from the International Association of Commercial Administrators' (IACA) Annual Reports of Jurisdictions. Note: Corporations include business and professional corporations. 2009 data except for the following states, for which more recent data are unavailable: WV (2008); AL, AZ, DC, MD, TN (2007); AK, OK, ND (2006); SC (2005); NM (2004). The ratio of new LLCs to new domestic corporations, LPs, LLPs and LLLPs for AZ and VT is unavailable.

The differences in popularity of the LLC have been remarkably persistent over time. Figure 2 shows how LLC-to-corporations ratios (the first of the three measurements introduced above) have changed across the 50 states and D.C. between 1999 and 2009. In that period, the median LLC-to-corporations ratio increased from 0.70 to 2.77. The gap between

the state whose LLC-to-corporations ratio is at the lowest quartile⁴ and the state whose LLC-to-corporations ratio is at the highest quartile has widened correspondingly.⁵

Figure 2: LLC-to-Corporations Ratios in the 50 states and D.C.



Source: Calculated from the International Association of Commercial Administrators' (IACA) Annual Reports of Jurisdictions.

Note: Data from 2004 through 2009 represent the ratio of new LLCs to new domestic corporations. Data from 1999 through 2003 represent the ratio of new LLCs to new domestic or out-of-state corporations. Number of jurisdictions reporting: 1999: n=40; 2000: n=47; 2001: n=47; 2002: n=50; 2003: n=48; 2004: n=46; 2005: n=50; 2006: n=45; 2007: n=43; 2008: n=31; 2009: n=40.

The business entity of the LLC was designed to be popular. Forty-nine jurisdictions enacted LLC laws between 1990 and 1997,⁶ and

⁴ I use quartiles and not the highest and lowest LLC-to-corporations ratios in Figure 2 because not all states have reported data for each year and quartiles are less sensitive to missing values than the highest and lowest values. A year-by-year comparison of the highest and the lowest values would have said more about which states had not submitted a report than about the long-term trends in LLC-to-corporations ratios.

⁵ This has mathematical reasons: If the median ratio is 1.0 and the first and third quartiles are 40% below and above the median, the difference between the third and the first quartile is 0.8. If the median is 2.0 and the first and third quartiles are 40% below and above the median, the difference between the third and the first quartile would be 1.6. See *infra* Figure 2.

⁶ For year-by-year figures see Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous*

virtually all state legislatures wanted the LLC to be a business-friendly entity that would attract business and revenue to the state.⁷ Indeed, since 2004, when LLC formations surpassed incorporations for the first time, the LLC is the most popular business entity in the United States.⁸ 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.⁹ However, as Figure 1 shows, the LLC is not equally popular in all U.S. states.

In an empirical study from 2001, Professors Ribstein and Kobayashi found that LLC-to-LLP ratios vary considerably across states.¹⁰ They explained this variation with differences in income taxation, among other things.¹¹ Professor Howard Friedman was the first to note that the proportion of LLCs in the total number of business formations varies widely from state to state.¹² He examined the six states that had the lowest percentage of LLCs to total business formations at the time, and he surmised that this was due to fee and franchise tax differentials, unfavorable state tax treatment and—in two cases—inaccurate reporting

Uniformity: Evidence from the Evolution of Limited Liability Company, 34 ECON. INQUIRY 464, 472-73 (1996).

⁷ Professor Goforth summarized the motives for enacting LLC laws as follows: "In virtually every state, those responsible for drafting and/or enacting LLC legislation cite motives which relate to attracting business and revenue to the state In many instances, the speed with which LLC legislation has been implemented is due at least in part to an express desire not to be left behind as neighboring or competing jurisdictions authorized the new business form." Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1272 (1995). For a detailed overview of the legislative history of the LLC, see *id.* at 1222-62.

⁸ Compare Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 37 (2004) (reporting that in 2003, 45% of business filings were for LLCs), with Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 469 (2010) (reporting that in 2004, 52% of business filings were for LLCs, 45% for corporations, and 3% for limited partnerships).

⁹ Chrisman, *supra* note 8, at 476.

¹⁰ See Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 121-27, 130-34 tbl.2, 138 tbl.4 (2001) (reporting LLC-to-LLP ratios for each state for the years 1993 through 1999 and performing a regression analysis showing that LLC-to-LLP ratios are lower in those states that tax LLCs adversely, in those four states that have a very long LLC statute, and in those states in which LLP members are fully shielded from liability).

¹¹ *Id.*

¹² See Friedman, *supra* note 8, at 37-39 (tabulating LLC formations as percentages of total business formations in each state in 2002 and 2003 and finding that LLCs predominate in 29 states, while incorporations double LLC formations in six states).

of filing statistics.¹³ In 2006, Miller, Greenberg and Greenberg calculated the LLC-to-corporations ratios of seven states and postulated that the differences in their results were driven by some states' unfavorable treatment of the LLC, such as cumbersome filing procedures and highly regulated statutes.¹⁴

Closely related to this study is a strand of empirical literature on the choices of formation state by closely held companies.¹⁵ Professors Dammann and Schündeln studied the formation choices of LLCs with twenty or more employees and found that these companies are more likely to be formed outside the state of their primary place of business if the state of their primary place of business does not allow LLC members to trigger the dissolution of the company in case of oppression, or if it does not shield LLCs from veil piercing for the mere failure to observe formalities.¹⁶ In a similar study, Professors Kobayashi and Ribstein found little evidence that substantive law explains the formation choices of LLCs, regardless of firm size.¹⁷ Instead, they found that LLCs are more likely to be formed out of state if the state of their primary place of business has a low court quality index.¹⁸ In a study of the incorporation choices of closely held corporations, Dammann and Schündeln found that corporations with more than 1,000 employees are more likely to be formed out of state if court quality in the state of their primary place of business is low, the risk of veil piercing is high in that state, or if its

¹³ See *id.* at 55-58.

¹⁴ See Sandra K. Miller, Penelope Sue Greenberg & Ralph H. Greenberg, *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609, 620-21 (2006).

¹⁵ Generally, there is much more literature on the choice of formation state by closely held companies than on the incorporation choices of *public* firms. As to the latter, see generally Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J. L. & ECON. 383 (2003); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002); Stephen P. Ferris, Robert M. Lawless & Gregory Noronha, *The Influence of State Legal Environments on Firm Incorporation Decisions and Values*, 2 J. L. ECON. & POL'Y 1 (2006); Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?* 22 J. L. ECON. & ORG. 340 (2006); Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into a Lax Law*, 5TH ANN. CONF. ON EMPIRICAL LEGAL STUD. PAPER (March 27, 2011), available at <http://ssrn.com/abstract=1644974>.

¹⁶ See Jens Dammann & Matthias Schündeln, *Where are Limited Liability Companies Formed? An Empirical Analysis*, U. TEX. SCH. L., L. & ECON. RESEARCH PAPER NO. 126; 5TH ANN. CONF. ON EMPIRICAL LEGAL STUD. PAPER (June 28, 2010), <http://ssrn.com/abstract=1633472>.

¹⁷ See Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91 (2011).

¹⁸ *Id.* at 137. As to the measurements of court quality used by the authors, see *id.* at 104.

corporate statute has a high level of minority protection or permits waivers of the duty of care.¹⁹

To explore potential explanations of the state-to-state variation in LLC popularity, I performed regression analyses of a partly original dataset of cross-sectional state-level data on business formations in the fifty United States and the District of Columbia. My findings are the following:

I find that LLCs are more popular in those states in which the fees for organizing an LLC are lower than the fees for organizing a corporation, and less popular in those states in which the fees for organizing an LLC are higher than the fees for organizing a corporation.²⁰ Formation fee differentials, which are highly visible at the moment the business entity is formed, account for 17% to 28% of the variation in LLC popularity. Their explanatory power is greater than the explanatory power of all other variables taken together.

Paradoxically, LLC popularity is not associated with differentials in recurring fees (such as annual report fees) and franchise taxes, although these differentials tend to be greater than the formation fee differentials.

Generally, the data show no connection between the variation in LLC popularity and substantive provisions in LLC statutes that protect minority LLC members or third parties, or define the fiduciary duties of LLC members and managers.²¹ Likewise, the popularity of the LLC is unrelated to the prevalence of particular mandatory rules and to the content of select default rules that presumably suit the needs of small companies. Only one out of the many substantive-law variables tested is associated with LLC popularity, which is likely a random result. Thus, substantive LLC law is likely to be trivial in the sense that state-to-state differences in this respect are not important enough to affect entity choice, given that the most important characteristics of the LLC are the same in all states.

I also find that LLCs are more popular in those states whose statutes expressly provide that “maximum effect” shall be given to the principle of “freedom of contract.”²² The respective variable is highly robust and explains about 10% of the variation in LLC popularity. If this is not a result by chance, it could be viewed as evidence that “freedom of contract”

¹⁹ Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J. L. ECON. & ORG. 79, 106-07 (2011).

²⁰ See *infra* Part 0.

²¹ See *infra* Part 0.

²² See *infra* Part 0.

provisions reassure firms that courts will not rewrite their LLC contracts in case of a lawsuit.

Finally, the variation in LLC popularity cannot be explained by the following factors: The degree to which LLC statutes are uniform; whether a state has adopted the Uniform Limited Liability Company Act (ULLCA) or the Revised Uniform Limited Liability Company Act (RULLCA); the age of LLC statutes; whether a state permits the formation of series LLCs; and whether a state limits the rights of creditors of LLC members to those of an assignee of the member's financial interest in the company.²³ In addition, California is the only state to prohibit LLCs from providing professional services. This might explain that state's exceptionally low LLC-to-corporations ratio.²⁴

I proceed as follows: In Part II, I explain the data and the methodology. In Part III, I discuss my findings and their implications. In Part IV, I discuss directions for future research. In Part V, I conclude the paper.

II. DATA AND METHODOLOGY

To explain the variation in LLC popularity, I performed ordinary least-square regressions using a partly original dataset of cross-sectional state-level data with 51 observations (50 states plus D.C.). The dataset is posted on the data repository of the Inter-University Consortium for Political and Social Research (ICPSR).²⁵

My dependent variables are based on the three measurements of LLC popularity introduced at the beginning of this study.²⁶ I use three different dependent variables as a robustness check because there is no single correct measurement for the popularity of LLCs. All three dependent variables are calculated the same way, though with different denominators. The first dependent variable, *LLCs over Domestic Corporations*, is the ratio of new domestic LLCs to new domestic business or professional corporations, divided by the median of that ratio among all states in the same year, logged.²⁷ *LLCs over Domestic Corporations* is no less

²³ See *infra* Part 0.

²⁴ See *infra* Part 0.

²⁵ Daniel M. Häusermann, *State-Level Data on Limited Liability Companies (LLC), United States, 2004-2009*, INTER-UNIV. CONSORTIUM FOR POL. & SOC. RES. (Jun. 27, 2011), <http://dx.doi.org/10.3886/ICPSR31561.v1>.

²⁶ See *supra* p. 3.

²⁷ The formula for calculating the dependent variables is:

a measurement of the popularity of domestic corporations than of LLCs. This is a problem because the popularity of corporations may vary as widely as the popularity of the LLC. The second dependent variable, *LLCs over Domestic Entities*, therefore uses a broader denominator, namely the sum of new domestic business or professional corporations, LPs, LLPs, and LLLPs. Including LPs, LLPs, and LLLPs broadens the denominator only to a small extent, as comparatively few of these partnerships are formed (*see above* Figure 1). The third dependent variable, *LLCs over Domestic and Foreign Corporations*, uses yet another denominator, namely the sum of new domestic and out-of-state business or professional corporations. This measurement of LLC popularity yields much lower ratios than the first one (*see above* Figure 1). It is imperfect as well because it counts those corporations that register to do business in another state at least twice: If a corporation is formed in state A and registers to do business in state B (where it may have its headquarter) as well as in state C, it is counted towards *LLCs over Domestic and Foreign Corporations* for all three states. When viewed together, the three dependent variables give a fairly accurate picture of the state-to-state variation in LLC popularity.

I took the data for the dependent variables from annual filing statistics that state filing offices report to the International Association of Commercial Administrators (IACA) on standardized forms. The IACA compiles these data and publishes them online as IACA Annual Reports of Jurisdictions.²⁸ Not all filing offices submit a report every year, and there are some inconsistencies and errors in the data as well.²⁹ I complemented the IACA data and corrected errors, to the extent possible,

$$DV_i = \ln \left(\frac{R_y}{\text{median}(R_y)} \right)$$

whereas DV is the value of the dependent variable, i is the state for which the value of the dependent variable is calculated, R is the measurement of LLC popularity used, and y is the year of observation. It was necessary to log the dependent variables to render the regression residuals normal.

²⁸ *Annual Jurisdictional Reports*, INT'L. ASS'N COM. ADMINS. (May 12, 2011, 4:30 PM), <http://www.iaca.org/node/80> (compilation of reports from 2002 onwards). The IACA reports for 1999 to 2001 are a courtesy of Professor Mark J. Roe and are on file with the author.

²⁹ *See supra* note 28. For instance, filing offices sometimes reported the total number of entities on file instead of yearly filings. These errors can be detected because of their magnitude. Additionally, some jurisdictions include nonprofit corporations in their filing statistic for business and professional corporations. These cases are flagged in the reports. They affect the dependent variables only marginally because these data were only used to calculate the denominator of the dependent variables, $\text{median}(R_y)$. *See supra* note 27. None of the data used to calculate the numerator of the dependent variables, R_y , *see supra* note 27, included nonprofit corporations. *See supra* note 28.

by filing statistics published by the individual filing offices on their websites.³⁰ Until 2006, filing offices reported their data to the IACA twice: once as of the actual report year, and a year later as previous year data. This allowed me to detect discrepancies between the data for a given year. These discrepancies were mostly marginal and may be due to revisions of filing data by the filing office. The data used to calculate the dependent variables may contain some modest errors, but these data are the most accurate and complete data compiled to date.

Since not all filing offices submit a report every year, I used data from the most recent year available. For 40 states, that year was 2009. The data for West Virginia are from 2008; data for Alabama, Arizona, D.C., Maryland, and Tennessee are from 2007; data for Alaska, Oklahoma, and North Dakota are from 2006; data for South Carolina are from 2005; data for New Mexico are from 2004. From 2004 to 2009, the median ratio of new LLCs to new corporations (and other limited liability entities) has increased from 1.77 to 2.77. I corrected this overall increase in LLC popularity by dividing the three measurements of LLC popularity by their median in the relevant year of observation. Otherwise, the popularity of LLCs in states with older data would have been understated.

I describe the independent variables and their sources at appropriate places in Part 0 of this study. Many of these variables were coded by Dammann and Schündeln or Kobayashi and Ribstein, who published the data in the appendices of their studies on out-of-state formations of LLCs.³¹ Dammann and Schündeln coded their variables as of January 1, 2007.³² The reference date of Kobayashi and Ribstein's study, whose original version dates from July 9, 2009,³³ is unknown. There are some

³⁰ Select states publish filing statistics on their respective Secretary of State websites at least for some years. See *Corporate Entities Formed By Year*, GEORGIA SECRETARY OF STATE, <http://sos.ga.gov/cgi-bin/EntitiesFormedByYear.asp> (last updated Nov. 9, 2011); *New Business Entity Filings by Year*, IDAHO SECRETARY OF STATE, <http://www.sos.idaho.gov/corp/bestats.htm> (last visited Dec. 24, 2011); *Annual Business Filing Statistics*, KENTUCKY SECRETARY OF STATE, <http://apps.sos.ky.gov/business/businessfilingstatistics/> (updated nightly); *Filing Statistics*, NEVADA SECRETARY OF STATE, (2010), <http://nvsos.gov/index.aspx?page=147>; *Business Entity Statistics: Seven Biennial Histories*, STATE OF NORTH DAKOTA, OFFICE OF THE SECRETARY OF STATE, <http://www.nd.gov/sos/pdf/statisticalhistorybieniums-20070806.pdf>; *Corporation Statistics*, TENNESSEE SECRETARY OF STATE, (2010), http://www.state.tn.us/sos/bus_svc/bus_stats.htm; *Statistics*, UTAH DIVISION OF CORPORATIONS AND COMMERCIAL CODE, (2011), <http://corporations.utah.gov/services/statistics.html>; *New Business Start-Ups*, VERMONT SECRETARY OF STATE, (Aug, 2011), <http://www.sec.state.vt.us/corps/dobiz/stats.htm>.

³¹ See Dammann & Schündeln, *supra* note 16, app. at 37-40; Kobayashi & Ribstein, *supra* note 17, app. at 138-43.

³² Dammann & Schündeln, *supra* note 16, at 7.

³³ See Bruce H. Kobayashi & Larry E. Ribstein, *Jurisdictional Competition for Limited Liability Companies*

discrepancies between these variables and the law that was in force in the year of observation of my dependent variables (i.e., mostly 2009), which I took as a reference date. Notably, Idaho and Iowa revised their LLC statutes in 2008,³⁴ and other states may have amended relevant parts of their statutes over the last years as well. I therefore checked and updated those variables that were statistically significant and robust in the regression analyses.³⁵ Of those variables that I coded myself based on state statutes, the reference date is June 30 of the dependent variables' year of observation.

A word is warranted here about the number of variables and the construction of the regression models. A study of the relationship between the popularity of the LLC and state law faces the problem that there is a large number of substantive rules that could theoretically explain the state-to-state variation in LLC popularity, yet there is no a priori criterion to determine which of these rules are relevant and which are not. For example, we can only guess which rule is more important to business organizers, one that requires a unanimous vote to dissolve the LLC, or one that gives minority LLC members a right to withdraw from the company. To deal with this issue, I took a two-pronged approach.

First, I tested a large number of individual variables, selected those that were statistically significant, and included them in a model that explains the dependent variables best. (Because the dataset comprises only 51 observations, I could not test more than six independent variables in a single model.³⁶) Using this approach, the likelihood of obtaining results that are statistically significant by chance is substantial because of the large number of variables tested. I tested 24 individual variables in my study.³⁷ As Table 1 shows, if the 24 variables were random variables, the likelihood of finding one or more variables statistically significant by chance is quite high.

(U. Ill. L. & Econ. Research Paper No. LE09-017, July 9, 2009); compare with Kobayashi & Ribstein, *supra* note 17.

³⁴ Idaho and Iowa adopted the Revised Uniform Limited Liability Company Act (RULLCA) in 2008. See IDAHO CODE ANN. §§ 30-6-101 to -1104 (2011); IOWA CODE §§ 489.101-.1304.

³⁵ See *infra* notes 39-40, 63-66 and 117-119 (discussing these variables known as "Freedom of Contracts" and "Default Withdrawal Right" as well as their coding details).

³⁶ With a larger number of independent variables, the degrees of freedom for error would have been too low for the statistical tests to be powerful. For additional information pertaining to this topic, see <http://ordination.okstate.edu/MULTIPLE.htm>.

³⁷ See *infra* Table 1. Note that the table does not include alternative codings and index variables that compound several of the independent variables tested.

Table 1: Likelihood of finding significance with 24 random variables

		Level of significance chosen:			
		p=0.10	p=0.05	p=0.01	p=0.001
Number of significant variables:	≥1	92%	71%	21.4%	2.4%
	≥2	71%	34%	2.4%	<0.1%
	≥3	44%	12%	0.2%	<0.1%

Example: There is a 92% chance that at least one out of 24 random variables will be significant at a 0.10 level.

Source: Calculated using the calculator for binomial distributions $B(24, p)$ on StatTrek.com, <http://stattrek.com/Tables/Binomial.aspx>.

As a second prong, I combined related variables to indices, which I describe at appropriate places in Part 0 of this study. The intuition behind this method is that a large number of favorable (or unfavorable) substantive-law provisions are more likely to affect LLC popularity than a single provision. When an index was statistically significant, I tested its components individually in order to see whether one of them drives the results alone. For that reason, the use of indices cannot avoid the problem of obtaining results that are significant by chance.

III. FINDINGS AND IMPLICATIONS

My most important finding is that it is formation fees, not taxes or substantive rules or anything else, that explain the variation in LLC popularity best. Table 2 presents a selection of regression models in which one or more independent variables were statistically significant. All models in Table 2 use the first dependent variable, *LLCs over Domestic Corporations*. Model (5) explains the variation in LLC popularity best. Models (1) to (4) and (6) are variations of that model.

The values of the variable “Formation fee differential (‘low scenario’)” equal the formation fee for an LLC minus the formation fee for a business corporation if the entity has paid-in equity of \$10,000 or less.³⁸ This variable is negatively correlated with *LLCs over Domestic Corporations*, and it was highly significant (with $p < 0.001$) in all models tested. Hence, LLCs tend to be more popular in those states in which it is cheaper to form an LLC than a corporation and less popular in those states in which it is more

³⁸ See *infra* notes 53–56 and accompanying text (providing coding details and alternative codings for “medium” and “high” scenarios).

expensive to form an LLC than a corporation. I will discuss this finding in Part 0.

Table 2: Regression Results

	Dependent variable: LLCs over Domestic Corporations					
	(1)	(2)	(3)	(4)	(5)	(6)
Filing fee differential ("low" scenario)	-0.0026*** (0.0006) p<0.001	-0.0027*** (0.0006) p<0.001	-0.0030*** (0.0006) p<0.001	-0.0030*** (0.0006) p<0.001	-0.0028*** (0.0005) p<0.001	-0.0028*** (0.0006) p<0.001
Statute contains "freedom of contract" provision	0.3292* (0.1344) p=0.019	0.3221* (0.1252) p=0.013			0.4172** (0.1314) p=0.003	0.4233** (0.1333) p=0.003
Member has default right to withdraw from LLC		0.3985** (0.1380) p=0.006		0.3379* (0.1501) p=0.029	0.3734** (0.1348) p=0.008	0.3632* (0.1380) p=0.012
Unanimous vote required for transfer of management			0.2014 (0.1636) p=0.224	0.1573 (0.1581) p=0.325	0.3004† (0.1559) p=0.060	0.3169† (0.1617) p=0.056
Modifications of agency powers in articles of organization			0.2822* (0.1350) p=0.042	0.2047 (0.1340) p=0.134		
Proportion of firms in real estate and professional services sectors						-0.9026 (2.038) p=0.660
Constant	0.0684 (0.0859) p=0.430	-0.0280 (0.0867) p=0.748	-0.0703 (0.1592) p=0.661	-0.0894 (0.1530) p=0.562	-0.2879† (0.1591) p=0.077	-0.1682 (0.3145) p=0.595
Observations	51	51	51	51	51	51
Adjusted R-squared	0.34	0.43	0.32	0.37	0.46	0.45
Root M.S.E.	0.46	0.43	0.47	0.45	0.42	0.42

†p≤0.10, *p≤0.05, **p≤0.01, ***p≤0.001. Standard errors are reported in parentheses.

Note: The observations include all 50 states plus D.C. The dependent variable is the ratio of new LLCs and new domestic business or professional corporations, divided by the median ratio in the respective year of observation, logged.

The variable “Statute contains ‘freedom of contract’ provision” (in short: *Freedom of Contract*) is a dummy variable coded by Dammann and Schündeln,³⁹ which takes the value one for those 19 states whose LLC statute expressly provides that it is the statute’s policy—or that the statute has to be construed—to give “maximum effect” to the principle of “freedom of contract,” and zero for all other states. The variable is positively correlated with the dependent variable, and it was significant at $p \leq 0.01$ or $p \leq 0.05$ in all models tested. This means that LLCs are more popular in those states that have a “freedom of contract” provision than in those that do not. I will discuss this result in Part 0.

The variable “Member has default right to withdraw from LLC” (in short: *Default Withdrawal Right*) is the inverse of a dummy variable coded by Dammann and Schündeln.⁴⁰ It takes the value one for those 13 states in which an LLC member has a right to exit the company with or without notice and to be paid the value of the membership interest, unless the parties have agreed otherwise. The variable is positively correlated with the dependent variable, and it was significant with $p \leq 0.01$ or $p \leq 0.05$ in all models tested. In other words, LLCs are more popular in those states in which LLC members have a right to withdraw from the company, if the parties have not agreed otherwise. I will discuss this finding in Part 0.

The variable “Unanimous vote required for transfer of management” (in short: *Unanimous Management Transfer*) is a dummy variable that I coded,⁴¹ which takes the value one for those 40 states in which an LLC may only transfer the right to manage the company with the consent of all of its members, and zero for all other states. The variable is positively correlated with the dependent variable and marginally significant ($p \leq 0.10$) in models (5) and (6), but it is not significant in models that do not include the *Freedom of Contract* variable, such as models (3) and (4) in Table 2).⁴² I will discuss this result in Part 0.

The variable “Modifications of agency powers in articles of organization” (in short: *Agency Powers Modifications*) is a dummy variable that I coded,⁴³ which takes the value one for those 21 states in which the

³⁹ Dammann & Schündeln, *supra* note 16, at 14, 40 (naming the variable “Freedom”).

⁴⁰ *Id.* at 9-10, app. at 37, 41-43 (naming the variable “Withdrawal”); For coding details see *infra* p. 26 and notes 63-66.

⁴¹ See 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 7:7 (2011), available at Westlaw RKLLC (exhibiting that the variable is based on a synoptical table of state-law provisions concerning the transfer of management rights compiled herein).

⁴² Although not reported in Table 2, the variable is significant in other models provided that they include the *Freedom of Contract* variable.

⁴³ The variable is based on a synoptical table of state-law provisions concerning agency powers

powers to bind the company that LLC members have by statutory default may only be changed in the articles of organization, and zero for all other states. The variable is positively correlated with the dependent variable and significant ($p \leq 0.05$) in model (3), but not in model (4). I will discuss this finding in Part 0.

The values of the last variable reported in Table 2, "Proportion of firms in real estate and professional services sectors," equal the number of firms in the real estate sector plus the number of firms in the professional services sector (NAICS sectors 53 & 54),⁴⁴ all divided by the total number of firms in a particular state.⁴⁵ The variable serves as a control variable because there are reasons to believe that the LLC form is particularly attractive to businesses in these two sectors for tax reasons.⁴⁶ However, the variable was not statistically significant in any of the models tested, and it did not affect the coefficients and the standard errors of the other variables to a notable extent.

I also tested models that use the two alternative dependent variables, *LLCs over Domestic Entities* and *LLCs over Domestic and Foreign Corporations*. The predictive power of these models, as measured by their R-squared values, is slightly lower than the predictive power of the models reported in Table 2, which use *LLCs over Domestic Corporations* as dependent variable. Hence, the predictive power of the variables reported in Table 2 does not depend greatly on how the popularity of LLCs is measured.

In the following sections, I discuss the findings reported in Table 2 as well as my other findings and their implications.

compiled by Ribstein and Keatinge. RIBSTEIN & KEATINGE, *supra* note 41, app. 8-3.

⁴⁴ NAICS is the North American Industry Classification System. See *North American Industry Classification System, Introduction*, U.S. CENSUS BUREAU, <http://www.census.gov/eos/www/naics/>.

⁴⁵ I calculated the values based on the 2002 Economic Census. *2002 Economic Census, Sector 00: All sectors: Core Business Statistics Series: Comparative Statistics for the United States and the States (1997 NAICS Basis): 2002 and 1997*, U.S. CENSUS BUREAU (July 17, 2006), available at http://factfinder.census.gov/servlet/IBQTable?_bm=y&-geo_id=D&-ds_name=EC0200CCOMP1&-_lang=en. More recent data are unavailable.

⁴⁶ The reason is that these businesses may elect to be taxed as partnerships if they are organized as an LLC. If they are organized as a corporation, they may only elect to be taxed as S or C corporations. Partnership taxation is considered particularly attractive for these firms. For a detailed analysis see John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885, 889-90, 895, 922-24 (2000); see also Ribstein & Kobayashi, *supra* note 10, at 99-100.

A. *The Fee Paradox*

Business entities cost money. These costs comprise, among other things, the fees for organizing the entity and keeping it active, and entity-level taxes that only business entities (but not individuals or sole proprietorships) have to pay. To test whether fee and tax differentials explain some of the variation in LLC popularity, I created two types of variables, *Formation Fee Differential* and *Periodic Cost Differential*. As the fee and tax burden sometimes depends on the size of a company, I calculated fee and cost differentials for three hypothetical companies of different sizes, resulting in a total of six fee and tax-related variables. The variables are my own calculations based on state statutes and fee schedules.

The values of the first type of variable, *Formation Fee Differential*, equal the fee for filing articles of organization of an LLC minus the fee for filing articles of incorporation of a business corporation. The values exclude recording fees as well as fees for the reservation of a company name and the registration of an agent because there is little transparency about whether business organizers can avoid these fees or not. The value for New York takes into account conservatively estimated costs of \$500 for publishing a notice of LLC formation, which is a mandatory requirement in that state.⁴⁷

The values of the second type of variable, *Periodic Cost Differential*, equal the periodic fees and state entity-level taxes that an LLC has to pay every year minus the periodic fees and taxes that a business corporation has to pay each year. The values include annual or biennial report fees, other annual fees (e.g. renewal fees), state franchise taxes and any other state entity-level taxes, but exclude taxes on nonresident LLC members. Annual report fees are flat rates in all but three states, in which they are based on the paid-in capital (South Dakota and Wyoming) or the number of members (Tennessee).⁴⁸ Those states that impose an income tax on

⁴⁷ The state of New York requires newly formed LLCs, but not corporations, to publish a notice of formation six times in two newspapers. N.Y. LTD. LIAB. CO. LAW § 206 (McKinney 2011). Publication cost estimates range from \$200 to \$2,500, depending on the place and newspaper. See Blumberg Excelsior, *New York LLC Formation Online*, <http://www.blankrupter.com/bio/nyllcintro.aspx>. According to a local small business law firm, publication costs range from \$700 to \$1,000 in New York City and from \$295 to \$1,250 elsewhere. See Brodsky Law Firm PLLC, *LLC Publication*, <http://www.llcpublication.net/>. In addition, the state imposes a \$50 fee on the filing of a certificate of publication. N.Y. LTD. LIAB. CO. LAW § 1101(s) (McKinney 2011). This fee is also included in the variable.

⁴⁸ See S.D. CODIFIED LAWS § 47-34A-212(a), (c) (2011); WIS. STAT. § 17-15-132(a) (repealed 2010); TENN. CODE ANN. § 48-249-1007(d), (e) (2011); For an overview of the filing fees and methods of computation, see Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal*

business entities treat LLCs and corporations equally because they recognize the election that businesses make for federal income tax purposes under the “check-the-box” regulations of 1997.⁴⁹ Those states that impose franchise taxes on LLCs and corporations base these taxes on receipts, net income, assets, equity, or the par value of stocks.⁵⁰

As mentioned, I calculated the formation fee and periodic cost differentials for three different scenarios. I defined these scenarios based on the IRS tax statistics in a way that the scenarios cover the range in which the median firm is likely to be found.⁵¹ The “low” scenario is a company with domestic receipts of \$25,000 per year, zero net income, assets of \$50,000, paid-in equity of \$10,000, and minimal par value of its certificates.⁵² The “medium” company has domestic receipts of \$150,000 per year, a gross income below \$100,000, \$5,000 net income, assets of \$100,000, \$20,000 in paid-in equity, and minimal par value. The “high” scenario is a company with \$1,000,000 of domestic receipts, \$250,000 gross income, \$20,000 net income, \$250,000 of assets, \$100,000 of paid-in equity, and a par value of \$100.

The formation fee differentials are identical in all three scenarios in 46 states. In three additional states, the scenarios differ by less than \$50 as seen in Table 3.⁵³ Table 3 sets out the formation fees and formation fee differentials for the “low” scenario.

Indeterminacy, 52 B.C.L. REV. 189, app. at 261–66 (2011).

⁴⁹ Treas. Reg. §§ 301.7701-1 to -3 (as amended in 1996). Under the “check-the-box” regulations, an LLC can elect to be treated for federal tax purposes as a C corporation, an S corporation, a partnership, or a sole proprietorship, respectively. See *id.* A corporation can choose to be treated as a C or S corporation, but not as a partnership or sole proprietorship. See *id.* For an overview of state income tax classifications, see DAVID J. CARTANO, FEDERAL AND STATE TAXATION OF LIMITED LIABILITY COMPANIES ¶¶ 512 and 2301 (2010 ed.).

⁵⁰ For an overview, see Manesh, *supra* note 48, app. at 263–66.

⁵¹ From 2004 to 2009, the receipts of the median entity taxed as a S or C corporation were in the \$100,000 to \$250,000 bracket. The average net income of entities in this bracket was \$6,600 in 2003 and median assets were below \$100,000 in 2000. For entities taxed as partnerships, median receipts were below \$25,000 from 2004 to 2009. The average net income for those entities was negative in 2003 and the median entity’s assets were between \$100,000 and \$250,000 in 2000. See IRS, *SOI Bulletin Historical Table 12: Number of Business Income Tax Returns, by Size of Business for Income Years, 1990–2008 Expanded*, <http://www.irs.gov/taxstats/article/0,,id=175843,00.html> (last reviewed Apr. 13, 2011); see also IRS, *SOI Tax Stats – Integrated Business Data, Table 2: Number of Businesses, Business Receipts, Net Income, Deficit, and Other Selected Items, by Form of Business, Industry, and Business Receipt Size, Tax Year 2003*, <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html> (last updated Jan. 27, 2010).

⁵² For the calculation of filing fees, only the amount of paid-in capital is relevant to the definition of the “low” scenario because all states either charge flat-rate filing fees or base them on the paid-in capital.

⁵³ The three scenarios yield different filing fee differentials for the following states:

Table 3: Formation Fees (“low” scenario)

	LLC fee (\$)	Corp. fee (\$)	Differ- ence		LLC fee (\$)	Corp. fee (\$)	Differ- ence
New York	750	125	625	South Dakota	150	150	0
Illinois	500	150	350	North Carolina	125	125	0
Massachusetts	500	275	225	New Jersey	125	125	0
Tennessee	305	105	200	Ohio	125	125	0
Colorado	125	50	75	Pennsylvania	125	125	0
Virginia	100	25	75	Georgia	100	100	0
Kansas	150	85	65	Idaho	100	100	0
Delaware	70	15	55	Maryland	100	100	0
Nebraska	110	60	50	Wyoming	100	100	0
Hawai'i	100	50	50	Alabama	75	75	0
Oklahoma	100	50	50	Nevada	75	75	0
West Virginia	100	50	50	Montana	70	70	0
Missouri	100	58	42	Utah	70	70	0
California	70	30	40	Arizona	50	50	0
Maine	175	145	30	Iowa	50	50	0
Wisconsin	130	100	30	Mississippi	50	50	0
Florida	100	70	30	Oregon	50	50	0
Arkansas	45	15	30	Michigan	50	60	-10
North Dakota	125	100	25	Indiana	75	90	-15
Vermont	100	75	25	Kentucky	40	60	-20
Louisiana	75	60	15	South Carolina	110	135	-25
Connecticut	60	50	10	New Hampshire	50	100	-50
Texas	300	300	0	New Mexico	50	100	-50
Washington	180	180	0	Rhode Island	150	230	-80
Minnesota	160	160	0	D.C.	100	185	-85
Alaska	150	150	0				

Source: Calculated from state statutes and fee schedules. 2009 data except for the following states: WV (2008); AL, AZ, DC, MD (2007); AK, OK, ND (2006); SC (2005); NM (2004).

Sub-Table 1.

Scenario:	“low”	“med.”	“high”
Delaware	55	55	50
Missouri	42	42	7
Nebraska	50	10	-190
Nevada	0	0	-100
Oklahoma	50	50	0

Note: The formation fees are for LLCs and business corporations with authorized capital of \$10,000. Values exclude recording, name reservation, and agent registration fees. The value for New York LLCs includes estimated publication costs of \$500.

In the vast majority of jurisdictions, formation fees for LLCs and corporations differ by less than \$100, and in twenty-one of them there is no differential at all. In contrast, LLC formation fees are substantially higher than corporate formation fees in New York (whose values include, as mentioned, estimated publication costs of \$500), Illinois, Massachusetts, and Tennessee.

Table 4 sets out the periodic fees and franchise tax differentials for the three scenarios. The differentials are smaller than \$100 in most states and zero in 19 to 23 states, depending on the scenario. In some states, however, the differentials are substantial, reaching up to \$2,000.

Table 4: Periodic Fees and Franchise Tax Differentials

Annual fees and franchise taxes for an LLC minus annual fees and franchise taxes for a corporation, dollar amounts							
Scenario	"low"	"med." "	"high"	Scenario	"low"	"med."	"high"
Tennessee	280	280	280	Utah	0	0	0
Delaware	175	175	175	Wisconsin	0	0	0
Illinois	150	150	75	Wyoming	0	0	0
North Carolina	147	147	32	Nevada	0	0	-50
Alaska	50	50	50	Arkansas	0	0	-150
North Dakota	25	25	25	Alabama	-10	-10	-10
Virginia	25	25	25	Oregon	-10	-10	-10
Washington	19	19	19	Vermont	-10	-10	-10
California	0	0	900	Georgia	-10	-20	-100
Kansas	0	0	63	Louisiana	-15	-30	-150
Colorado	0	0	0	Idaho	-20	-20	-20
Hawai'i	0	0	0	Missouri	-20	-20	-20
Indiana	0	0	0	Nebraska	-20	-20	-20
Kentucky	0	0	0	Iowa	-23	-23	-23
Maryland	0	0	0	South Carolina	-25	-35	-115
Maine	0	0	0	Mississippi	-25	-50	-250
Michigan	0	0	0	West Virginia	-30	-40	-100
Minnesota	0	0	0	Arizona	-45	-45	-45
Montana	0	0	0	Massachusetts	-56	-127	-1,810
New Hampshire	0	0	0	New York	-60	-60	-75
Ohio	0	0	0	Connecticut	-65	-65	-65

Oklahoma	0	0	0	New Mexico	-75	-75	-75
Pennsylvania	0	0	0	Florida	-100	-100	-100
Rhode Island	0	0	0	D.C.	-300	-300	-300
South Dakota	0	0	0	New Jersey	-500	-750	-2,000
Texas	0	0	0				

Source: Calculated from state statutes and fee schedules. 2009 data except for the following states: WV (2008); AL, AZ, DC, MD (2007); AK, OK, ND (2006); SC (2005); NM (2004).

Note: For a description of the “low,” “medium,” and “high” scenarios see *supra* text accompanying note 52. Rounded to the nearest dollar.

The data in Table 3 and Table 4 reveal an interesting pattern. For instance, in the “low” scenario, LLC formation fees are higher than corporate formation fees in 22 states and lower in 8 states. Annual fees and taxes, however, are higher for LLCs than for corporations in 8 states and lower in 20 states. Hence, on average, LLCs tend to be more expensive to form than corporations, but cheaper to be kept active.

As mentioned, the *Formation Fee Differential* variable in the “low” scenario is negatively correlated with LLC popularity and was highly significant, with $p < 0.001$, in all models tested.⁵⁴ The coefficients were similar with $p < 0.001$ as well when I used the two alternative dependent variables, *LLCs over Domestic Entities* and *LLCs over Domestic and Foreign Corporations*, and the “medium” and “high” scenarios. Depending on the firm-size scenario and the dependent variable used, formation fee differentials explain between 17% and 28% of the variation in LLC popularity.⁵⁵

In contrast to the formation fee differentials, the *Periodic Cost Differential* variable tested insignificant in all models, regardless of the firm-size scenario and the dependent variable used. Hence, differences between LLCs and corporations in terms of periodic fees and franchise taxes do not explain the variation in LLC popularity. This result is surprising: Given that the formation fee differentials do explain the variation, one might expect periodic fee and tax differentials to explain some of the variation in LLC popularity as well—all the more because of the recurring nature of these duties. A potential explanation of this result is that the founders of LLCs and corporations are aware of the fees due at

⁵⁴ See *supra* tbl.2.

⁵⁵ Models with *Filing Fee Differential* as the sole independent variable have adjusted R-squared values between 0.17 and 0.28. The model that uses *LLCs over Domestic Corporations* as a dependent variable and the “low” scenario has an R-squared value of 0.28. The model that uses *LLCs over Domestic and Foreign Corporations* as a dependent variable and the “high” scenario has an R-squared value of 0.17. The R-squared values of the other models are in between. See *id.*

the formation of the entity, but not of the periodic fees and franchise taxes, when they choose between an LLC and a corporation. Since it is impossible to test hypotheses as to the behavior of individuals in a study that uses state-level data,⁵⁶ further study is needed in this regard.

My results concerning fee and tax differentials answer the question that Friedman left open in his 2004 study, namely “whether such differentials are sufficiently important to deter use of LLCs.”⁵⁷ Formation fees—and New York’s publication costs, which are included in my variable—explain a sizeable portion of the variation in LLC popularity, while periodic fees and franchise taxes explain none of it. Moreover, in contrast to Ribstein and Kobayashi’s 2001 study that compared LLCs with LLPs,⁵⁸ I found no relevant state-to-state variation in income tax treatment between the LLC and the corporation.⁵⁹ Thus, the variation in LLC popularity cannot be explained by the states’ different tax treatments of LLCs.

B. *The Dubious Significance of Substantive Rules*

In addition to the substantive-law variables reported in the regression table (*supra* Table 2), I tested a large number of other variables relating to substantive provisions found in LLC statutes. I report my findings in groups of variables starting with minority protection, followed by third-party protection, fiduciary duties, mandatory provisions, and small-business default rules.

1. *Minority Protection*

I tested four variables that are related to the protection of LLC members who hold a minority interest in the company, namely *Default Withdrawal Right* and *Unanimous Management Transfer*, both of which I described above,⁶⁰ as well as *Unanimous Dissolution* and *Oppression Statute*. The latter two are the inverse of variables coded by Dammann &

⁵⁶ This would constitute an ecological fallacy. See generally W. S. Robinson, *Ecological Correlations and the Behavior of Individuals*, 15 AM. SOC. REV. 351 (1950).

⁵⁷ Friedman, *supra* note 8, at 58.

⁵⁸ See Ribstein & Kobayashi, *supra* note 10, at 122-23, app. at 138, 140 (using regression analysis finding that the LLC-to-LLP ratio was significantly lower in those states which treated LLCs adversely compared to LLPs in terms of income tax).

⁵⁹ See *supra* note 49 and accompanying text.

⁶⁰ See *supra* text accompanying notes 40-41, respectively.

Schündeln.⁶¹ *Unanimous Dissolution* takes the value one for those 36 states whose LLC statute requires that a resolution to dissolve an LLC be unanimous, and zero for all other states. *Oppression Statute* takes the value one for those 19 states in which LLC members have a right to trigger the dissolution of the company in case of oppression, unfairness or on equitable grounds, and zero for all other states. I also combined the minority protection variables in a *Minority Protection Index*. The index values equal the arithmetic mean of the values of these four variables and can thus take the values zero, $\frac{1}{4}$, $\frac{1}{2}$, $\frac{3}{4}$, and one. The higher the index, the higher is the level of minority protection.

The coding of the *Default Withdrawal Right* variable warrants discussion. As mentioned, the variable is based on a dummy variable coded by Dammann and Schündeln, who defined a withdrawal right for the purpose of their variable as an express rule (or set of rules) pursuant to which “(a) the member has the right to cease her membership by voluntary unilateral declaration, either immediately or after giving notice, (b) the company then has to pay the member the value of her membership interest either immediately or within a reasonable or otherwise limited period of time, and (c) the remaining members cannot prevent the withdrawing member from obtaining the value of her membership.”⁶² Kobayashi and Ribstein coded seven states differently according to their reading of the statutes,⁶³ but did not disclose what their readings were. Dammann and Schündeln’s coding corresponds to my reading of the seven disputed provisions.⁶⁴ Accordingly, I used their coding. However, I adjusted the values for Idaho and Iowa, which had revised their statutes in 2008.⁶⁵

⁶¹ See Dammann & Schündeln, *supra* note 16, at 10-11, app. at 38, 43-44 (naming the variable “Dissolution One”); see also *id.* at 8-9, app. at 37 (naming the variable “Oppression One”).

⁶² *Id.* at 10. Conversely, it does not matter for the definition whether the withdrawal leads to a dissolution of the company or not, *id.*, whether the right is called withdrawal, resignation or dissociation, *id.* app. at 41, or whether the withdrawing member has to give notice a certain period in advance. *Id.* On the other hand, a formal right to withdraw does not fall within the definition if the withdrawing member will not be paid until the time he would be paid had he not withdrawn. See *id.* For further coding details, see *id.* app. at 41-43, 52-54.

⁶³ See Kobayashi & Ribstein, *supra* note 17, at 132-33, app. at 140-41 (naming the variable “Withdraw”).

⁶⁴ See ARIZ. REV. STAT. ANN. § 29-707 (2011); IOWA CODE §§ 490A.705, .805 (repealed 2008) MO. REV. STAT. §§ 347.121(1), .103(2) (2011); N.J. REV. STAT. ANN §§ 42:2B-38, 39 (2011); N.D. CENT. CODE §§ 10-32-30(4), -109(1) (2011); S.D. CODIFIED LAWS § 47-34A-603(b) (2011); WYO. STAT. ANN. § 17-15-123 (repealed 2010).

⁶⁵ Dammann and Schündeln’s reference date was January 1, 2007. Dammann & Schündeln, *supra* note 16, at 7. Idaho and Iowa adopted the RULLCA in 2008. See *supra* note 34. Under the RULLCA, a

The regression results in Table 2 show that LLCs are more popular in those states whose LLC statutes allow members to withdraw from the company, unless they have agreed otherwise. This result is robust to different model specifications. The *Default Withdrawal Right* variable is significant at the levels of $p \leq 0.01$ or $p \leq 0.05$ in models that use *LLCs over Domestic Corporations* and *LLCs over Domestic Entities* as dependent variables. With *LLCs over Domestic or Foreign Corporations* as the dependent variable, *Default Withdrawal Right* is significant at levels between $p \leq 0.01$ and $p \leq 0.10$.

As can be seen in Table 2, *Unanimous Management Transfer*—the variable that indicates whether the right to manage the company may only be transferred with the consent of all LLC members⁶⁶—is only marginally significant (with $p \leq 0.10$) in some of the models, and insignificant in those models that do not include the *Freedom of Contract* variable. With the two alternative dependent variables, *LLCs over Domestic Entities* and *LLCs over Domestic or Foreign Corporations*, the significance of *Unanimous Management Transfer* is above the $p = 0.10$ threshold in most models. Due to their lack of robustness, the results concerning the *Unanimous Management Transfer* variable should be treated as negative findings. The other two dummy variables, *Unanimous Dissolution* and *Oppression Statute*, were not statistically significant in any of the models tested.

The *Minority Protection Index* is positively correlated with the popularity of the LLC, but it was only marginally significant (with $p \leq 0.10$) in some models and insignificant in others. These results, however, are driven by the *Default Withdrawal Right* variable. When this variable is excluded from the index, the index loses its significance. Thus, the data do not show that the level of minority protection, as a collection of rights, explains the variation in LLC popularity.

Given the large number of variables that I tested, I cannot rule out that the significance of the *Default Withdrawal Rights* variable is the result of chance.⁶⁷ Moreover, it is difficult to find a theoretical reason as to why, among all minority protection variables, *Default Withdrawal Rights* should be associated with LLC popularity. Nevertheless, my results are consistent with Dammann and Schündeln's finding that the LLCs in their sample were more likely to be formed in the state of their primary place of

member's withdrawal is wrongful by default. See IDAHO CODE ANN. § 30-6-601(2)(b)(i) (2011); IOWA CODE § 489.601(2)(b)(i) (2011).

⁶⁶ See *supra* text accompanying note 41.

⁶⁷ See *supra* text accompanying note 37 and Table 1.

business if LLC members have a withdrawal right by default in that state.⁶⁸ Their finding, however, was not significant in most of the models reported.⁶⁹ Dammann and Schündeln had expected a different outcome, namely that companies would avoid default withdrawal rights, for two reasons. First, a withdrawal may threaten the company's going concern value if the company has to liquidate assets to pay off the withdrawing member.⁷⁰ Second, a statutory withdrawal right may have adverse tax consequences with regard to membership interests in family firms, even if the parties waive their right to withdraw contractually.⁷¹ My findings add to the evidence found by Dammann and Schündeln that there is no indication that companies avoid default withdrawal rights.

My negative findings concerning the *Oppression Statute* variable⁷² qualifies Dammann and Schündeln's finding that LLCs are more likely to be formed out of state if the state of their primary place of business has not enacted an oppression statute.⁷³ Their result may be coincidental. It is also to be noted that my study is the third study in which the *Unanimous Dissolution* variable was not statistically significant.⁷⁴

To sum up, the only variable that is significant is *Default Withdrawal Right*, but that result is difficult to interpret. The other three minority protection variables are either not significant at all (*Oppression Statute* and *Unanimous Dissolution*) or only marginally significant (*Unanimous Management Transfer*). Thus, minority protection rules do not explain the variation in LLC popularity in a satisfactory way. In other words, whether a state statute offers minority LLC members strong or weak protections does not say much about the popularity of the LLC form in that state.

⁶⁸ See Dammann & Schündeln, *supra* note 16, at 16 tbl.2, 21 tbl.3, 22 tbl.4, 24 tbl.5.

⁶⁹ See *id.* Kobayashi and Ribstein did not find significance with their revised variable. See Kobayashi & Ribstein, *supra* note 17, at 120 tbl.3A, 122 tbl.3B, 124 tbl.3C, 127 tbl.4. This result is hard to interpret, as their coding criteria are unknown. See *supra* text accompanying note 63.

⁷⁰ See Dammann & Schündeln, *supra* note 16, at 17 (stating that an LLC may be forced into liquidation when it has to pay out a withdrawing member).

⁷¹ *Id.* at 18 (stating that a withdrawal right may render membership interests in family firms ineligible for the so-called marketability discount in valuing their membership interest for gift and estate tax purposes because § 2704(b) of the Internal Revenue Code allows contractual restrictions on the right to liquidate the membership interest to be ignored).

⁷² See *supra* note 61.

⁷³ Dammann & Schündeln, *supra* note 16, at 16 tbl.2, 17.

⁷⁴ *Cf. id.* at 16 tbl.2; Kobayashi & Ribstein, *supra* note 17, at 120 tbl.3A, 122 tbl.3B, 124 tbl.3C, 127 tbl.4.

2. Third-Party Protection

I tested three dummy variables that encode statutory provisions aimed at protecting third parties who deal with an LLC, namely *Agency Powers Modifications*, *Veil Piercing*, and *Member Disclosure*. As explained, *Agency Powers Modifications* takes the value one if the power of LLC members to bind the company may only be changed in the articles of organization, and zero in all other cases.⁷⁵ Since the articles of organization are public documents, such a rule creates transparency about who has the power to act on behalf of the LLC, and who has not. Thus, the rule protects third parties. The variable *Veil Piercing* is the inverse of a variable coded by Dammann and Schündeln.⁷⁶ It takes the value zero for those 36 states whose LLC statute explicitly shields LLCs from veil piercing in case of a failure to observe formalities, and one for all other states. Such a rule may adversely affect third-parties, as it limits creditors' ability to have the "LLC veil" pierced.⁷⁷ The variable *Member Disclosure*⁷⁸ takes the value one for those 23 states that require member-managed LLCs to disclose publicly the identity of their organizers or their members, and zero for all other states. Public disclosure of the identity of LLC organizers or members may make it easier for creditors who believe that they have a personal claim against one of these persons to learn that person's identity.

I also combined the three dummy variables described above in a *Third-Party Protection Index*. The variable is the arithmetic mean of the values of the three dummy variables and serves as a proxy for the overall level of third-party protection that a LLC statute offers. The index can take the values zero, $\frac{1}{3}$, $\frac{2}{3}$, and one. The higher the index, the higher is the level of third-party protection.

As Table 2 shows, the variable *Agency Powers Modifications* is positively correlated with the dependent variable, but it is not in all models statistically significant. *Veil Piercing* and *Member Disclosure* were not significant in any of the models tested. The *Third-Party Protection Index* was marginally significant in some models, and insignificant in others. The results of the index are driven by the variable *Agency Powers Modifications*. When this variable is excluded from the index, the index

⁷⁵ See *supra* text accompanying note 43.

⁷⁶ Dammann & Schündeln, *supra* note 16, at 8, app. at 39, 46-47 (naming the variable "Formalities").

⁷⁷ See *id.* at 7-8.

⁷⁸ I coded the variable based on a tabulation of state-law provisions concerning required disclosures compiled by RIBSTEIN & KEATINGE, *supra* note 41, app. 4-5.

loses its significance. Hence, my results cannot be taken as evidence that LLCs are more popular in those states that protect third parties better.

These negative findings were not necessarily to be expected in light of the intuition that businesses prefer lax third-party protections, which would allow them to impose external costs on voluntary or involuntary creditors. Indeed, Dammann and Schündeln found that LLCs are more likely to be formed in the state of their primary place of business if that state prohibits piercing the LLC veil for nonobservance of formalities.⁷⁹ However, Kobayashi and Ribstein were unable to replicate this result in their study.⁸⁰ My data likewise do not show a relationship between those third-party protections that I tested and the variation in LLC popularity.

One reason for the negative finding could be that provisions in LLC statutes that aim to protect third-parties do not have enough practical importance as to affect the popularity of the LLC form. For once, the statutory provisions might not be very effective. Alternatively, businesses may not have incentives to externalize costs on third parties even if no statutory protections were in place. Thus, for instance, an LLC may voluntarily honor a contract that one of its members has signed on its behalf in excess of his authority,⁸¹ because the company could lose its reputation as a reliable business partner if it dishonored the contract.⁸² My findings do not provide a positive answer to the question of how much bite the third-party protections that I tested have. Nevertheless, my findings suggest that the importance of these provisions should not be overestimated.

3. *Fiduciary Duties*

I tested three dummy variables concerning the fiduciary duties of LLC members and managers. The first variable, *Fiduciary Duties Waivable*, was coded by Kobayashi & Ribstein and takes the value one for those 14 states that allow all fiduciary duties (i.e., the duty of care, the duty of loyalty and the duty of good faith) to be waived, and zero for all other

⁷⁹ Dammann & Schündeln, *supra* note 16, at 16.

⁸⁰ See Kobayashi & Ribstein, *supra* note 17, at 120 tbl.3A, 122 tbl.3B, 124 tbl.3C, 127 tbl.4.

⁸¹ For a policy analysis of different rules on the transparency of agency power restrictions of LLC members, see David M. Deaton, *Check-the-Box: An Opportunity for States to Take Another Look at Business Formation*, 52 SMUL REV. 1741, 1777-78 (1999).

⁸² This argument is of course based on Stewart Macaulay's famous finding that, at least in local business relations, social relations are much more important to businesspeople than legal rights and duties. See generally Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

states.⁸³ The second variable, *Duty of Care Modifiable*, was coded by Dammann and Schündeln and takes the value one for those 40 states in which the duty of care can be waived or modified, and zero for all other states.⁸⁴ The third variable, *Gross Negligence*, which was also coded by Dammann and Schündeln, takes the value one for those 23 states in which fiduciary duties are limited to grossly negligent or willful conduct, unless the parties have agreed otherwise, and zero for all other states.⁸⁵ Based on these variables, I created a *Fiduciary Duties Index*, which reflects the degree to which fiduciary duties can be waived or modified. The index is an ordinal variable that takes the value three if all fiduciary duties (duty of care, duty of loyalty and duty of good faith) can be waived, two if only the duty of care can be waived or modified, one if fiduciary duties may not be waived, but are by default limited to grossly negligent or willful conduct, and zero if fiduciary duties may not be waived and are not limited to grossly negligent or willful conduct by default.⁸⁶

None of the fiduciary duties variables were statistically significant in any of the models tested. In other words, the data show no connection between the popularity of the LLC and the extent to which LLC statutes allow people to waive or relax the fiduciary duties of LLC members and managers. This result contrasts with Dammann and Schündeln's finding that larger LLCs "are migrating away from states with lax norms on managerial liability,"⁸⁷ but it is consistent with Kobayashi and Ribstein's

⁸³ See Kobayashi & Ribstein, *supra* note 17, at 104-105, app. at 138-39 (naming the variable "Fiduciary Waiver"). I revised the values for those three states whose statutes I read differently. California law refers to the law of partnerships in this matter, see CAL. CORP. CODE § 17153 (West 2011), which restricts the waivability of both the duty of care and the duty of loyalty. CAL. CORP. CODE § 16103(b)(3)-(4) (West 2011). Utah and Wisconsin only allow contracting for higher liability standards than the statutory default. See UTAH CODE ANN. § 48-2c-807(1)(c) (West 2011); WIS. STAT. § 183.0402(3) (2011).

⁸⁴ See Dammann & Schündeln, *supra* note 16, at 13, app. at 39, 45-46 (naming the variable "Care_Two_Alt").

⁸⁵ See *id.* at 12, app. at 39, 44-45 (naming the variable "Care_One").

⁸⁶ The *Fiduciary Duties Index* is calculated from the three dummy variables just described as follows:

Sub-Table 2.

	Values			
Fiduciary Duties Waivable	1	0	0	0
Duty of Care Modifiable	1	1	0	0
Gross Negligence	0 or 1	0 or 1	1	0
Fiduciary Duties Index	3	2	1	0

⁸⁷ See Dammann & Schündeln, *supra* note 16, at 18.

results, who did not find evidence that LLCs flee states with lax fiduciary standards.⁸⁸

4. *Small Business Default Rules*

I tested three dummy variables relating to default rules that can be assumed to fit the needs of small companies.⁸⁹ The first variable, *Profits per Capita*, takes the value one for those 18 states in which profits or losses are allocated to LLC members per capita unless members have agreed otherwise, and zero for all other states.⁹⁰ The second variable, *Vote per Capita*, takes the value one for those 29 states in which each of the LLC members has one vote unless members have agreed otherwise, and zero for all other states.⁹¹ The third dummy variable, *Member Management*, takes the value one for those 44 states in which LLCs are managed by all of their members unless members have agreed otherwise, and zero for all other states.⁹² I also combined the three dummy variables in a *Small-Business Default Index*. That index variable is the arithmetic mean of the values of the three dummy variables and can take the values zero, $\frac{1}{3}$, $\frac{2}{3}$, and one.

None of these variables were statistically significant in any of the models tested. Thus, my data show no connection between the popularity of the LLC and the content of default rules.

This result qualifies the importance of default rules in LLC statutes. A number of authors have argued that default rules in LLC statutes matter to business organizers,⁹³ and that the optimal default rule should suit the needs of small companies.⁹⁴ They thus implicitly endorse the theory of

⁸⁸ See Kobayashi & Ribstein, *supra* note 17, at 120 tbl.3A, 122 tbl.3B, 124 tbl.3C, 127 tbl.4, 133-34.

⁸⁹ Cf. Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L. Q. 369, 412-13 (1995) (arguing that member management suits the needs of small companies and discussing a number of objections to this hypothesis), 419-21 (arguing that per capita allocation of voting and financial rights suits the needs of small company because these arrangements correlate with member management and the restricted transferability of ownership interests and avoid valuation and record-keeping problems).

⁹⁰ The coding is my own based on RIBSTEIN & KEATINGE, *supra* note 41, app. 5-2 (tabulating default allocation of profits, losses and distributions).

⁹¹ The coding is my own based on *id.* app. 8-4 (tabulating the default allocation of member votes).

⁹² The coding is my own based on *id.* app. 8-2 (tabulating the default method of management).

⁹³ See *id.* § 3:2 (citing drafting costs, information costs concerning potential contract provisions, and uncertainty about courts' willingness to enforce agreements that deviate from the statute as reasons); see also Friedman, *supra* note 8, at 42 (citing the fact that LLC default rules are more suited to small businesses than corporate default rules as an advantage).

⁹⁴ One group of scholars explains this by the fact that small companies are the largest numbers and

the so-called “majoritarian defaults,”⁹⁵ according to which those terms that most contracting parties would have wanted should be the default rules.⁹⁶ This would minimize overall transaction costs.⁹⁷ As mentioned, however, my data do not support this theory. A likely reason is that the transaction costs of contracting around a default rule are low enough not to prevent people from organizing an LLC when they would want to change the default rules.⁹⁸ Relatedly, practitioners widely use form LLC agreements,⁹⁹ and templates for LLC operating agreements are easily available.¹⁰⁰ This further reduces the costs of avoiding unsuitable defaults. Moreover, it is unclear whether majoritarian defaults are optimal at all: A competing theory, called the theory of “penalty defaults,” states that it is sometimes efficient to have default rules that induce parties to state explicitly those contract terms that are important to them.¹⁰¹ Yet both proponents and critics of penalty defaults acknowledge the difficulties that

most price-sensitive towards customized contracting. See Ribstein, *supra* note 89, at 374; see also Kobayashi & Ribstein, *supra* note 17, at 98; RIBSTEIN & KEATINGE, *supra* note 41, at § 3:2. Deaton argues that defaults should protect those parties who do not retain a lawyer when forming an LLC. Deaton, *supra* note 81, at 1768. This view arguably leads to the same result because larger businesses can be expected to be more likely to retain a lawyer when forming an LLC.

⁹⁵ The term was coined in an article by Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 93 (1989) (distinguishing “majoritarian defaults” from their competing rationale of default rules, called “penalty” or “minoritarian” defaults).

⁹⁶ *Id.* at 88-90.

⁹⁷ *Id.* Perhaps the most prominent followers of the majoritarian defaults theory in the law of business organizations are Frank R. Easterbrook and Daniel R. Fischel. See FRANK R. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 34 (1991) (“Corporate law . . . fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems . . .”).

⁹⁸ Cf. DOUGLAS BAIRD ET AL., *GAME THEORY AND THE LAW* 150 (1994) (stating that default rules matter most when transaction costs are at an intermediate level).

⁹⁹ See Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351, 383, 399 (2003) (discussing a survey among 770 attorneys in four states, in which over two thirds of the respondents confirmed the widespread use of form LLC agreements). See also Miller et al., *supra* note 14, at 622 (reporting that a survey among more than 500 lawyers in five states showed that lawyers are often asked to form “no-frills” LLC agreements).

¹⁰⁰ See RIBSTEIN & KEATINGE, *supra* note 41, apps. B1-B6, B8; CARTER G. BISHOP & DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* app. A (2010), available at Westlaw WGL-LLC; MARK A. SARGENT AND WALTER D. SCHWIDETZKY, *LIMITED LIABILITY COMPANY HANDBOOK* apps. ST. to WI (2010), available at Westlaw SECLLCHB. Hence, the finding of Miller and coauthors is surprising that even lawyers frequently form LLCs without an operating agreement. See Miller et al., *supra* note 14, at 622.

¹⁰¹ See Ayres & Gertner, *supra* note 95, at 97-100; see also Ian Ayres, *The Possibility of Inefficient Corporate Contracts*, 60 U. CIN. L. REV. 388, 390 (1991) (arguing that with regard to corporate law, corporate contracts may be inefficient even if transaction costs to contract around a given default are zero).

lawmakers face when called to identify the situations in which a penalty default is efficient.¹⁰² All of these factors may, alternatively or collectively, render irrelevant the content of the small business default rules.

5. *Mandatory Rules*

I created a *Mandatory Rules Index* to test whether some of the variation in LLC popularity could be explained by the rigidity of LLC statutes. I measure the rigidity of an LLC statute by the extent to which it contains mandatory rules, that is, rules that the parties may not override by contract. The index represents the arithmetic mean of nine variables, namely (1) *Unanimous Dissolution*, (2) *Unanimous Management Transfer*, (3) *Oppression Statute*, (4) the inverse of *Fiduciary Duties Waivable*, (5) the inverse of *Duty of Care Waivable*, (6) *Member Disclosure*, (7) *Merger Restrictions*, (8) *Mandatory Contribution*, and (9) *No Certificates*.¹⁰³ Index values may range from zero to one, in increments of one ninth. The higher the index, the more rules are mandatory. The *Mandatory Rules Index* is an imperfect measurement of the rigidity of LLC statutes because it does not contain all mandatory statutory provisions, and because it weighs all index components equally. However, there is no better measure for the rigidity of LLC statutes.¹⁰⁴ It is also noteworthy that the

¹⁰² See Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591, 1609 (1999); Barry E. Adler, *The Questionable Ascent of Hadley v. Baxendale*, 51 STAN. L. REV. 1547, 1547 (1999) (criticizing the concept of penalty defaults).

¹⁰³ The index components are described above. See *supra* notes 41 (Unanimous Management Transfer), 62 (Unanimous Dissolution and Oppression Statute), 79 (Member Disclosure), 84 (Fiduciary Duties Waivable), and 85 (Duty of Care Waivable). The dummy variables *Merger Restrictions* and *Mandatory Contribution* are the inverse of variables coded by Kobayashi and Ribstein. See Kobayashi & Ribstein, *supra* note 17, at 105, app. at 138-39 (naming the variables “Merger” and “Contribution”). *Merger Restrictions* takes the value one for those 36 states in which LLCs are not allowed to merge with all types of entities, and zero for all other states. *Mandatory Contribution* takes the value one for those 9 states in which all LLC members must make a contribution to or have an economic interest in the company, and zero for all other states. The dummy variable *No Certificates* is my own coding based on a tabulation in RIBSTEIN & KEATINGE, *supra* note 41, app. 7-8. The variable takes the value one for those 33 states in which LLCs may not issue certificates of interest, and zero for all other states. For the calculation of the index I inverted the values for *Fiduciary Duties Waivable*, *Duty of Care Waivable*, *Merger Restrictions* and *Mandatory Contribution* so that the value one represents the mandatory character of the rule.

¹⁰⁴ Kobayashi and Ribstein, for instance, tested the prevalence of mandatory rules with only three variables, namely *Fiduciary Duties Waivable*, *Merger Restrictions*, and *Mandatory Contribution*. See Kobayashi & Ribstein, *supra* note 17, at 104-05. As mentioned, I also included these variables in my index.

index values are distributed normally, as one might expect the number of mandatory rules in LLC statutes to be.¹⁰⁵

The *Mandatory Rules Index* was not statistically significant in any of the models tested. Thus, the data do not show a connection between LLC popularity and the rigidity of LLC statutes. This finding corresponds with Kobayashi and Ribstein's results, who found no connection between three mandatory rules and an LLC's likelihood to be formed in a state that is different from the state of their primary place of business.¹⁰⁶

6. Conclusion: Is LLC Law Trivial?

From a lawyer's perspective, substantive rules may be a key factor in entity choice.¹⁰⁷ Yet at state level, different substantive rules do not explain the variation in LLC popularity very well. Most substantive law variables were either not statistically significant at all or, in a few cases, just marginally significant. Only one of them, *Default Withdrawal Right*, was significant and robust, but it is hard to explain why a default rule that gives LLC members a right to withdraw from the company would affect the popularity of the LLC, but none of the many other statutory rules. Furthermore, the indices that I tested were only statistically significant to the extent that one of their component variables was.

All of this suggests that state LLC law is trivial, just like Professor Black has famously argued with regard to state corporate law.¹⁰⁸ According to Black, corporate law is trivial because it "does not prevent companies . . . from establishing any set of governance rules they want."¹⁰⁹ Triviality may have several causes: Some rules mimic the market because they prescribe what the parties would have contracted for anyway.¹¹⁰ Other rules can be avoided, either because they are mere defaults or, if

¹⁰⁵ A Shapiro-Wilk W test for normal distribution yielded a p value of 0.47 for the *Mandatory Rules Index*. Therefore, the hypothesis that the values of the index come from a normally distributed population cannot be rejected.

¹⁰⁶ See Kobayashi & Ribstein, *supra* note 17, at 119 tbl.3A, 121 tbl.3B, 123 tbl.3C, 126 tbl.4, 132.

¹⁰⁷ Correspondingly, there is a considerable amount of practitioner-oriented literature on entity choice. As to the LLC form specifically see, for example, RIBSTEIN & KEATINGE, *supra* note 41; J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, *LIMITED LIABILITY COMPANIES: A STATE BY STATE GUIDE TO LAW AND PRACTICE* (2010), available at Westlaw LLC; BISHOP & KLEINBERGER, *supra* note 100.

¹⁰⁸ See Bernhard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

¹⁰⁹ *Id.* at 544.

¹¹⁰ *Id.* at 552.

they are mandatory, because they can be circumvented easily.¹¹¹ Finally, a given rule may be unimportant because it can easily be complied with or because the situation to which it applies almost never occurs.¹¹² In a similar vein, Kobayashi and Ribstein surmise that even mandatory provisions in LLC statutes may not be very restrictive.¹¹³

It shall be left to future research to assess the triviality of the various rules that can be found in LLC statutes. At this general level, though, it seems plausible that LLC law is trivial in that it does not affect entity choice because many important features of the LLC, such as limited liability, flexible taxation,¹¹⁴ and the permissibility of single-member LLCs,¹¹⁵ are uniform across all states. Compared to these inherent advantages of the LLC form, the remaining state-to-state differences may not be important enough to become apparent in the aggregate filing statistics.

C. The “Freedom of Contract” Puzzle

As mentioned, Dammann and Schündeln’s *Freedom of Contract* variable turns on whether an LLC statute expressly provides that “maximum effect” shall be given to the principle of “freedom of contract.”¹¹⁶ These provisions vary little from state to state.¹¹⁷ A typical example is § 1101(b) of Delaware’s Limited Liability Company Act, which reads: “It is the

¹¹¹ *Id.* at 555.

¹¹² *Id.* at 560.

¹¹³ Kobayashi & Ribstein, *supra* note 17, at 132.

¹¹⁴ See *supra* note 49 and accompanying text.

¹¹⁵ All LLC statutes now allow single-member LLCs. See RIBSTEIN & KEATINGE, *supra* note 41, app. 4-4 (tabulating state statutes).

¹¹⁶ See *supra* p. 14 and note 39.

¹¹⁷ The provisions usually follow the formula: “It is the [intent/policy] of [this state/this statute/the legislature] to give [the] maximum effect to the principle of freedom of contract and to the enforceability of [limited liability company] operating agreements.” The few deviations are indicated in the parentheses of the following citations. See ARK. CODE ANN. § 4-32-1304(a) (2011); COLO. REV. STAT. § 7-80-108(4) (2011); CONN. GEN. STAT. § 34-242(a) (2011); DEL. CODE tit. 6, § 18-1101(b) (2011); GA. CODE ANN. § 14-11-1107(b) (2011); KAN. STAT. ANN. 17-76,134(b) (2011); KY. REV. STAT. ANN. § 275.003(1) (West 2011); LA. REV. STAT. ANN. § 12:1367(B) (2011) (no reference to operating agreements); ME. REV. STAT. tit. 31, § 753(1) (repealed 2009); MISS. CODE ANN. § 79-29-1201(2) (amended 2010); MO. REV. STAT. 347.081(2) (2011); N.H. REV. STAT. § 304-C:78(II) (2011); N.J. STAT. ANN. 42:2B-66(a) (West 2011) (“This act is to be liberally construed to give the maximum effect . . .”); N.M. STAT. ANN. § 53-19-65(A) (2011); OKLA. STAT. tit. 18, § 2058(D) (2011); UTAH CODE ANN. § 48-2c-1901 (West 2011) VA. CODE ANN. § 13.1-1001.1(C) (2011) (“This chapter shall be construed in furtherance of the policies of giving maximum effect . . .”); WASH. REV. CODE § 25.15.800(2) (2011); WIS. STAT. § 183.1302(1) (2011).

policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”¹¹⁸ Dammann and Schündeln hypothesized that business organizers appreciate such commitments to contractual freedom,¹¹⁹ but did not find a connection between the *Freedom of Contract* variable and out-of-state formations of LLCs.¹²⁰

I find that LLCs are more popular in those states whose statutes expressly endorse contractual freedom. The variable was significant with $p \leq 0.01$ or $p \leq 0.05$ in all models tested, no matter which of the three dependent variables I used. The *Freedom of Contract* variable alone explains about 10% of the variation in LLC popularity.

It is difficult to explain this finding in a convincing manner. Dammann and Schündeln, the creators of the *Freedom of Contract* variable, appear to have hypothesized that business organizers appreciate legislative commitments to contractual freedom.¹²¹ This assumption seems intuitive, but it is difficult to identify the channels through which a freedom of contract provision would boost LLC popularity. If states use these provisions to signal a favorable business climate, one would not expect the LLC to be the only business form to benefit from it. Moreover, the *Freedom of Contract* variable expresses a mere commitment to contractual freedom but does not necessarily reflect the actual degree of contractual freedom that the organizers of an LLC enjoy. Business organizers’ actual freedom of contract is limited by the extent to which an LLC statute contains mandatory rules, which they may not override contractually. Therefore, one would expect the *Mandatory Rules Index*, which indicates how many rules out of a sample of nine rules are mandatory, to be negatively correlated with the popularity of the LLC. However, this is not the case.¹²² I also tested for interaction between *Freedom of Contract* and the *Mandatory Provisions Index*, but found none that was statistically significant. Thus, the explanatory power of the *Freedom of Contract* variable does not depend on the prevalence of mandatory provisions in an LLC statute. In other words, LLCs are equally more popular in those states whose statutes

¹¹⁸ DEL. CODE ANN. tit. 6, § 18-1101(b) (2011).

¹¹⁹ See Dammann & Schündeln, *supra* note 16, at 14.

¹²⁰ See *id.* at 16 tbl.2.

¹²¹ The authors did not state their hypothesis expressly but say that their variable targets “drastic commitments” to contractual freedom. Dammann & Schündeln, *supra* note 16, at 14.

¹²² The index is positively correlated with the dependent variable, but it is not significant. See *supra* Part III.B.4.

expressly endorse contractual freedom, no matter if these statutes have many or few mandatory rules.¹²³

An alternative explanation for the significance of the *Freedom of Contract* variable has less to do with contractual freedom as such than with legal certainty.¹²⁴ Business organizers may worry that a couple of years down the road a judge might alter the contractual duties they had agreed upon in the articles of organization or in the operating agreement. Business organizers may view a “freedom of contract” provision as an assurance that courts will stick to the terms of the original contract and refrain from rewriting the contract. This interpretation is consistent with the triviality hypothesis discussed above¹²⁵ because an assurance that courts will not rewrite a contract has value even when the parties are completely free in their contracting. However, we do not know whether business organizers or their attorneys are aware of “freedom of contract” provisions and believe that they have the desired effect on judges. Independently thereof, a “freedom of contract” provision may not be necessary to restrain judges from rewriting the LLC’s founding documents because even those statutes that do not have an express “freedom of contract” provision do provide that the articles of organization or the operating agreement may include any provision that is not prohibited by law or (in the case of the operating agreement) by the articles of organization.¹²⁶

The correlation between the popularity of the LLC and the *Freedom of Contract* variable may also be due to a confounding factor that is correlated with the *Freedom of Contract* variable. Such a factor is not easy to find, however. For instance, none of the many variables that I tested in this

¹²³ I also found that the coefficient of the *Mandatory Provisions Index* does not depend on whether a state has a freedom of contract provision or not. LLC popularity is unrelated with the prevalence of mandatory rules, no matter whether a state expressly endorses contractual freedom.

¹²⁴ I owe this suggestion to Professor Jens Dammann.

¹²⁵ See *supra* Part III.B.6.

¹²⁶ See ALA. CODE §§ 10A-5-2.02 to -4.03(a) (2011); ALASKA STAT. § 10.50.075(6) (2011) ARIZ. REV. STAT. ANN. §§ 29-632(B), -682(B) (2011); CAL. CORP. CODE § 17005(b) (West 2011); D.C. CODE §§ 29-1018(a), -1006(b) (2011); FLA. STAT. §§ 608.407(1), 423(1) (2011); IND. CODE §§ 23-18-2-4(b)(5), -4-5 (2011); MASS. GEN. LAWS ch. 156C, § 12(a)(9) (2011); MICH. COMP. LAWS § 450.4203(2) (2011); MINN. STAT. §§ 322B.115(5), .603(1) (2011); NEB. REV. STAT. § 21-2606(2)(b) (2011); NEV. REV. STAT. ANN. § 86-161(2) (West 2011); N.Y. LTD. LIAB. CO. LAW §§ 203(e)(7), 417(a) (McKinney 2011); N.C. GEN. STAT. § 57C-2-21(b) (2011); N.D. CENT. CODE §§10-32-07(5), -68(1) (2011); OHIO REV. CODE ANN. § 1705.04(A) (LexisNexis 2011); OR. REV. STAT. §§ 63.047(2), .057 (2011); 15 PA. CONS. STAT. §§ 8913(8), 8916(b) (2011); R.I. GEN. LAWS § 7-16-6(a)(5) (2011); TENN. CODE ANN. §§ 48-249-202(b)(1)(B), -205(a) (2011); TEX. BUS. ORGS. CODE ANN. §§ 101.054, .052(c)-(d) (West 2011); Uniform Limited Liability Company Act (ULLCA) §§ 103(a), 203(b)(2) (1996); RULLCA §§ 303(2), 703(1) (2006).

study are strongly correlated with the *Freedom of Contract* variable. It is noteworthy, though, that the “freedom of contract” provisions vary little from state to state.¹²⁷ This suggests that state legislatures have copied them from other states that had enacted their LLC statutes earlier. It could be that they have copied other characteristics of the same statutes as well, which, in their entirety, are more attractive to business organizers than the statutes of other states. In other words, those LLC statutes that contain a “freedom of contract” provision might belong to a whole family of popular LLC statutes.

Last but not least, there is always the possibility that the significance of the *Freedom of Contract* variable is a random result.¹²⁸

In light of the foregoing, it would be premature to deliver a definitive verdict on the puzzle that the predictive power of the *Freedom of Contract* variable presents. I leave it to future researchers to solve the puzzle.

D. What Does Not Explain the State-to-State Variation

The variation in LLC popularity cannot be explained by the uniformity or age of LLC statutes, by the degree of debtor protection that an LLC statute offers, or the possibility of forming series LLCs.

1. Uniformity of Statutes

Uniformity of LLC statutes can be achieved in two ways, either through the adoption of a model act, that is, the Uniform Limited Liability Company Act (ULLCA) of 1996 or the Revised Uniform Limited Liability Company Act (RULLCA) of 2006,¹²⁹ or when legislatures copy parts of one another’s statutes.¹³⁰ Kobayashi and Ribstein call the latter phenomenon “spontaneous uniformity.”¹³¹ Spontaneous uniformity is of gradual character, depending on how strongly the statutes resemble one another.

Following Dammann and Schündeln, I tested a dummy variable named *ULLCA*, which takes the value one for those 10 states in my

¹²⁷ See *supra* note 117.

¹²⁸ Since I tested a large number of variables, the likelihood that one or two of them are significant by chance is substantial. See *supra* Table 1 and text accompanying note 37.

¹²⁹ Both are available at the website of the National Conference of Commissioners on Uniform State Laws (NCCUSL), <http://www.nccusl.org/>.

¹³⁰ See Kobayashi & Ribstein, *supra* note 6 (arguing that this spontaneous uniformity of LLC statutes is efficient).

¹³¹ *Id.*

dataset that had adopted either the ULLCA or the RULLCA, and zero for all other states.¹³² Additionally, I tested three index variables coded by Kobayashi and Ribstein that measure the degree of spontaneous uniformity of LLC statutes:¹³³ *Uniform Third-Party Provisions* measures the degree of uniformity of a set of statutory provisions concerning the protection of third-parties,¹³⁴ *Uniform Member Provisions* measures the uniformity of a set of member-related provisions,¹³⁵ and *Uniform Tax Provisions* provides analogous numbers for a set of tax-related provisions.¹³⁶ For each of these variables, Kobayashi and Ribstein defined a set of provisions that the variable should include.¹³⁷ Then, they determined the uniformity measure for each state with regard to each provision. For example, each of the 19 states that have a “freedom of contract provision” would have a uniformity measure of 19 for that type of provision. Finally, Kobayashi and Ribstein calculated the average uniformity measure for each state and each index. In addition to testing the uniformity variables individually, I compounded them into a *Uniformity Index*. To calculate the index values, I divided the values of each of the three uniformity variables by the mean of the respective variable and then added the results up.¹³⁸

None of these variables were significant in the regression analyses. Thus, the variation in LLC popularity can neither be explained by the degree to which LLC statutes are uniform nor by the fact that a particular state has or has not adopted ULLCA or the RULLCA.

¹³² The ULLCA was adopted by Alabama, Illinois, Montana, Hawaii, South Carolina, South Dakota, Vermont and West Virginia. For references see Ribstein & Keatinge, *supra* note 41, § 1:8. Idaho and Iowa adopted the RULLCA in 2008. See *supra* note 34. The number of positive values in the ULLCA variable is different from Dammann & Schündeln’s coding because their reference date was January 1, 2007. Cf. Dammann & Schündeln, *supra* note 16, at 7.

¹³³ See Kobayashi & Ribstein, *supra* note 17, at 107-08, app. at 138-39.

¹³⁴ The values of the variable range from 17.6 to 30.8; the arithmetic mean is 26.5. Standard deviation is 2.3. See *id.* app. at 138-39.

¹³⁵ The values of the variable range from 10.3 to 36.3, the arithmetic mean is 29.1. Standard deviation is 6.5. See *id.*

¹³⁶ The values of the variable range from 13.9 to 21.3, the arithmetic mean is 18.2. Standard deviation is 1.7. See *id.*

¹³⁷ For the original table of the 69 provisions included in the three indices see Kobayashi & Ribstein, *supra* note 6, at 474-75. The authors cataloged 34 third-party provisions, 31 member-related provisions, and 4 tax provisions. *Id.* at 476. The authors later updated their list to include 39 third-party provisions, 30 member-related provisions, and 4 tax provisions. See Bruce H. Kobayashi & Larry E. Ribstein, *The Non-Uniformity of Uniform Laws*, 35 J. CORP. L. 327, 332-37 tbl.1 (2009). The authors do not state whether the index values in their 2011 study are based on the original or the updated list of provisions. Cf. Kobayashi & Ribstein, *supra* note 17, at 107 and app. at 138-39.

¹³⁸ The index values range from 2.35 to 3.54, the mean is 3.0, and standard deviation is 0.27.

These results add to the existing evidence that the uniformity of LLC statutes is unrelated to the popularity of LLCs. At the outset, there are reasons to believe that there is a positive relationship between statutory uniformity and LLC popularity. Ribstein has shown that those states that were not among the first to adopt an LLC statute tended to adopt rules that he assumes to be more efficient than the rules that were dominant in the early statutes.¹³⁹ Relatedly, Kobayashi and Ribstein have shown that LLC statutes have achieved a substantial degree of uniformity with respect to those rules whose uniformity is likely to be beneficial for businesses.¹⁴⁰ Thus, one might expect LLCs to be more popular in those states that have more uniform statutes. However, neither Kobayashi and Ribstein in their study on out-of-state LLC formations¹⁴¹ nor I have found a statistically significant relationship between statutory uniformity and LLC popularity. As Kobayashi and Ribstein note, this could be either because states have already achieved a high level of uniformity, or because most provisions in LLC statutes are mere default rules.¹⁴²

In addition, my findings have implications for the critique of the uniform LLC acts, ULLCA and RULLCA. Ribstein and Kobayashi have repeatedly criticized these acts for containing many peculiar provisions that are not found in other LLC statutes, and for having failed to achieve uniformity.¹⁴³ Correspondingly, Dammann and Schündeln found that LLCs with twenty or more employees are less likely to be formed in the state of their primary place of business if that state has adopted the ULLCA.¹⁴⁴ Kobayashi and Ribstein, however, did not find that relationship in their similar study, regardless of firm size.¹⁴⁵ My study adds to the evidence that the potential drawbacks of the uniform acts are not big enough to adversely affect the popularity of the LLC in states that have adopted the uniform acts. The uniform acts may have theoretical

¹³⁹ See Ribstein, *supra* note 89, at 412-28.

¹⁴⁰ See Kobayashi & Ribstein, *supra* note 6, at 472-73.

¹⁴¹ Cf. Kobayashi & Ribstein, *supra* note 17, at 120 tbl.3A, 122 tbl.3B, 124 tbl.3C, 126 tbl.4A, 132.

¹⁴² *Id.* at 107-08, 132.

¹⁴³ See, e.g., Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and Limited Liability Companies*, 66 U. COLO. L. REV. 947 (1995); see also Kobayashi & Ribstein, *supra* note 138, at 4-6 (arguing, based on their data, that the ULLCA decreased uniformity of LLC statutes because it was promulgated—and its peculiar provisions were adopted by a few states—after the states had achieved uniformity), 10-20 (analyzing the uniformity of the provisions of the RULLCA).

¹⁴⁴ See Dammann & Schündeln, *supra* note 16, at 16, 18-19 (finding significance at the $p \leq 0.10$, 0.05 and 0.01 levels, depending on model specification).

¹⁴⁵ See Kobayashi & Ribstein, *supra* note 17, at 119-125 tbls.3A, 3B & 3C.

drawbacks, but these do not translate into measurable differences in LLC popularity in the real world.

2. *Age of LLC Statute*

Following Dammann and Schündeln, I tested whether the variation in LLC popularity could be explained by the age of LLC statutes. The values of the variable *LLC Statute Age* equal the logarithm¹⁴⁶ of the number of years since a state's first LLC statute entered into force.¹⁴⁷

The variable *LLC Statute Age* was not significant in any of the regressions. Hence, the age of LLC statutes does not explain the variation in LLC popularity.

This finding is only partially in line with prior literature. In the business planning literature, the “relative newness of the LLC form” is sometimes cited as a disadvantage.¹⁴⁸ Similarly, Dammann and Schündeln hypothesized that the LLC might be more popular in those states with older statutes, notably because lawyers and courts become more experienced with the new business form over time.¹⁴⁹ The empirical evidence is mixed. Dammann and Schündeln found that LLCs are more likely to be formed in the state of their primary place of business if that state has enacted its first LLC statute early, but their results were only significant in a small fraction of their regression models.¹⁵⁰ Kobayashi and Ribstein found no significant relationship between the state of formation of LLCs and the age of LLC statutes.¹⁵¹ My findings cast additional doubt on the theory that the attractiveness of a particular LLC statute is related to that statute's age.

It may seem puzzling that the popularity of LLCs is unrelated to an LLC statute's age, even though LLCs do get more popular over time.¹⁵² One potential explanation is that the age of LLC statutes does not vary greatly. 49 jurisdictions enacted their first LLC law between 1990 and

¹⁴⁶ I logged the variable in order to render the regression residuals normal.

¹⁴⁷ As to the reasons for focusing on the first statute (and ignoring if a statute has been replaced since then) see Dammann & Schündeln, *supra* note 16, at 14-15 (predicting that the experience of judges and lawyers with LLCs will not be lost when the original LLC statute is replaced by a new one).

¹⁴⁸ See RIBSTEIN & KEATINGE, *supra* note 41, § 2:38 (referring to the hypothesis that business entities are subject to network effects); CALLISON & SULLIVAN, *supra* note 107, § 2:20 (citing the smaller degree of legal certainty about the quality of the liability shield).

¹⁴⁹ Dammann & Schündeln, *supra* note 16, at 14.

¹⁵⁰ *Id.*

¹⁵¹ See Kobayashi & Ribstein, *supra* note 17, at 119 Tbl.3A, 121 tbl.3B, 123 tbl.3C, 126 tbl.4, 132.

¹⁵² See *supra* Figure 2.

1997, and 37 alone between 1992 and 1994.¹⁵³ One would need a longitudinal study to find out whether the age of an LLC statute explained the variation in LLC popularity in the 1990s, when LLC statutes were still very young. Another explanation might be that the “start date” for the growth in popularity of LLCs was “reset” in 1997, when the IRS enacted its “check-the-box” regulations. Before the “check-the-box” regulations, the eligibility of LLCs to be taxed as pass-through entities was limited,¹⁵⁴ which is why some states designed their LLC statutes in a way that ensured that LLCs would qualify for pass-through taxation.¹⁵⁵ The “check-the-box” regulations removed the prior restrictions, thus giving the LLC an important boost.¹⁵⁶ Correspondingly, Ribstein and Kobayashi found that LLC-to-LLP ratios increased significantly in the years following the enactment of the “check-the-box” regulations.¹⁵⁷ Hence, the “check-the-box” regulations may have influenced LLC popularity more than the year in which states had enacted their first LLC statute.

3. *Series LLCs*

A series LLC is an LLC that is divided into separate divisions.¹⁵⁸ Each division’s assets are shielded against liability for the debt of the other divisions of the series.¹⁵⁹ The possibility of forming series LLCs can be seen as a bulk discount on formation fees and the costs of keeping multiple LLCs active.¹⁶⁰ The dummy variable *Series LLC* takes the value

¹⁵³ For a detailed statistic see Kobayashi & Ribstein, *supra* note 6, at 472-73.

¹⁵⁴ Under the precursor of the “check-the-box” regulations, the so-called Kintner regulations, an LLC was not eligible for partnership taxation if it had more than two corporate characteristics. See Treas. Reg. § 301.7701-2, 32 Fed. Reg. 15241, 15372-73 (Nov. 3, 1967) (amended 1977, 1983 and 1993, revised 1997); Debra R. Cohen, *Citizenship of Limited Liability Companies for Diversity Jurisdiction*, 6 J. SMALL & EMERGING BUS. L. 435, 445 n.46 (2002); Carol J. Miller, Douglas J. March & Jack E. Karns, *Limited Liability Companies Before and After the January 1997 IRS “Check-the-Box” Regulations: Choice of Entity and Taxation Considerations*, 25 N. KY. L. REV. 585, 587 (1998).

¹⁵⁵ See Cohen, *supra* note 154, at 447 & n.55.

¹⁵⁶ See, e.g., Cohen, *supra* note 154, at 447-48 (“The LLC’s toehold in the spectrum of business organizations became more firmly established.”); Don W. Llewellyn & Anne O’Connell Umbrecht, *No Choice of Entity After Check-The-Box*, 52 TAX LAW. 1, 33 (1998) (“[T]he Treasury has capitulated to the [LLC] trend . . . The LLC is a gift horse.”).

¹⁵⁷ See Ribstein & Kobayashi, *supra* note 10, at 126, 138 tbl.4 (finding a statistically significant increase of LLC-to-LLP ratios in 1998 and 1999, the two years following the enactment of the “check-the-box” regulations, but not in the years 1995-1997).

¹⁵⁸ See CARTANO, *supra* note 49, ¶ 2501.

¹⁵⁹ *Id.*

¹⁶⁰ I owe this analysis to Professor Lynn M. LoPucki.

one for those 10 states that permit the formation of series LLCs, and zero for all other states.¹⁶¹

The *Series LLC* variable was not statistically significant in my regression analysis. In other words, the data do not show a connection between the possibility of forming series LLCs and LLC popularity. The reason for this negative finding might be that series LLCs are not popular enough to affect the statistic. We know little about the prevalence of series LLCs since only Utah publishes separate filing statistics for series LLCs. In that state, however, less than 1% of all LLCs formed in 2003 were series LLCs.¹⁶² Should the figures be of a similar magnitude in other states, the availability of series LLCs is not likely to have an impact on the overall filing statistics.

4. Debtor Protection

If an LLC member defaults on personal debt, the creditors could either be allowed to trigger the dissolution of the LLC, to receive the debtor's full membership interest in the LLC (including voting rights and, potentially, managing rights), or to seek a charging order, through which they will obtain the rights of an assignee of the debtor's financial interest in the LLC, but no membership rights.¹⁶³ Kobayashi and Ribstein surmised that debtors might prefer to form an LLC under a statute that limits creditors' rights to obtaining a charging order and thus bars creditors from managing the company or triggering its dissolution.¹⁶⁴ They created a dummy variable called *Charging Order* that takes the value one for those 23 states in which a charging order is an exclusive remedy for creditors of LLC members, and zero for all other states.¹⁶⁵ They did

¹⁶¹ Presently, Delaware, Illinois, Iowa, Minnesota, Nevada, North Dakota, Oklahoma, Tennessee, Utah, and Wisconsin allow series LLCs. See CARTANO, *supra* note 49, ¶ 2501 (tabulating references to state statutes). Kobayashi and Ribstein used the same variable, but at the time of their test only six states allowed series LLCs. See Kobayashi & Ribstein, *supra* note 17, at 106, app. at 138-39 (synoptical table).

¹⁶² See UTAH DEPARTMENT OF COMMERCE, DIVISION OF CORPORATIONS AND COMMERCIAL CODE, STATISTICS 2009: LIMITED PARTNERSHIP & LIMITED LIABILITY COMPANY, available at <http://corporations.utah.gov/pdf/llcpstats2009.pdf>.

¹⁶³ See Kobayashi & Ribstein, *supra* note 17, at 106; CARTANO, *supra* note 49, ¶ 2401.

¹⁶⁴ See Kobayashi & Ribstein, *supra* note 17, at 106-07. This hypothesis is based on Hansmann, Kraakman and Squire's insight that "entity shielding"—the shielding of a business entity from its owners' creditors—is an essential feature of the law of business organizations. See generally Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006); Larry Ribstein, *The Important Role of Non-Organization Law*, 40 WAKE FOREST L. REV. 751, 760-61, 786-88 (2005).

¹⁶⁵ See Kobayashi & Ribstein, *supra* note 17, at 106 and app. at 138-39 (synoptical tables).

not find the variable statistically significant.¹⁶⁶ In my regression analysis, the *Charging Order* variable was likewise not significant in any of the models tested. The exclusivity of a charging order is perhaps a weak shield from creditors, because creditors could challenge the use of an LLC for debtor protection by other means.¹⁶⁷

E. California's Ban of Professional LLCs

LLC statutes do not vary greatly as to the kinds of businesses they allow LLCs to conduct. 50 LLC statutes either allow LLCs to be formed for any lawful business or prohibit a small range of specified businesses whose numbers are typically small, such as banks or insurance companies.¹⁶⁸ The one exception is California, which prohibits LLCs from providing professional services.¹⁶⁹ That state has an exceptionally low LLC-to-corporations ratio, too. For example, model (5) in Table 2 predicts for California an LLC-to-corporations ratio of 2.03,¹⁷⁰ yet the state's actual ratio is 0.87. California's residual is also the largest of all states in this model. It is unknown how many professional entities there are in California.¹⁷¹ If their numbers are small, California's ban of professional LLCs would not greatly affect the overall popularity of the LLC.¹⁷² Due to the lack of such data it is impossible to positively attribute California's low LLC-to-corporations ratio to its ban of professional LLCs.

F. The Big Picture: LLC Popularity and the Wild West

The factors that explain the state-to-state variation in LLC popularity are reminiscent of the Wild West—hence the title of this study:¹⁷³ Money

¹⁶⁶ See *id.* at 132.

¹⁶⁷ See *id.* at 106-07 (stating that creditors could invoke the doctrines of veil piercing or fraudulent conveyance).

¹⁶⁸ See, e.g., RIBSTEIN & KEATINGE, *supra* note 41, app. at 4-9; *supra* note 49, ¶ 203.01.

¹⁶⁹ See CAL. CORP. CODE § 17375 (West 2006). Like all other jurisdictions, California allows professional corporations. See Moscone-Knox Professional Corporation Act, CAL. CORP. CODE §§ 13400-13410 (West 2006).

¹⁷⁰ The predicted value for the dependent variable *LLCs over Domestic Corporations* is -0.312. Accordingly, the predicted LLC-to-corporations ratio for California is $2.77 + (-0.312) = 2.03$ (2.77 is the median LLC-to-corporations ratio for 2009, the year of observation). For the inverse formula see *supra* note 27.

¹⁷¹ California does not publish separate filing statistics for professional corporations.

¹⁷² I owe this suggestion to Professor Lynn M. LoPucki.

¹⁷³ PER QUALCHE DOLLARO IN MENO [FOR A FEW DOLLARS LESS] (Panda Societa per L'Industria Cinematografica 1966) is a parody of the classic spaghetti western PER QUALCHE DOLLARI IN PIÙ [FOR A FEW

is important, legal rules are of dubious significance, and freedom is appreciated.

First, money is important. LLCs are more popular in those states in which it the fees for organizing an LLC are lower than the fees for organizing a corporation, and vice versa. With a pinch of salt, it seems that people tend to choose the entity that they can get “for a few dollars less.” These formation fee differentials explain between 17% and 28% of the variation in LLC popularity. In contrast, the data show no relationship between the popularity of LLCs and differentials in annual fees and franchise taxes. This is all the more paradoxical as even one year’s differentials in recurring fees and taxes tend to be larger than the formation fee differentials.

Second, like in the Wild West, legal rules are of dubious significance. Only one of the many variables that encode substantive rules contained in LLC statutes was statistically significant and robust, and it is hard to explain why that rule, but none of the others, should affect the popularity of the LLC. Thus, LLC law may well be trivial, similar to Black’s famous thesis that state corporate law is trivial:¹⁷⁴ Since the most important characteristics of the LLC are the same in all states, the remaining differences in substantive LLC laws may simply not be important enough to affect entity choice to an extent that it would become visible in the aggregate filing statistics.

Third, (contractual) freedom is appreciated. More specifically, I find that LLCs are more popular in those states whose LLC statutes explicitly uphold the principle of contractual freedom. The respective variable is highly robust and explains about 10% of the variation in LLC popularity. If this is not a result by chance, it could be viewed as evidence that “freedom of contract” provisions reassure LLC members that courts will not rewrite their contracts in case of a lawsuit. Alternatively, “freedom of contract” provisions might be associated with other popular features of LLC statutes.

These findings were not necessarily to be expected. Although there has been anecdotal evidence that the variation in LLC popularity is associated with different levels of formation fees, the extent to which this is the case has been unknown hitherto. These fee differentials, which are relatively small but highly visible when a business entity is formed,

DOLLARS MORE] (Produzione Europee Associati et al. 1965), directed by Sergio Leone and starring Clint Eastwood. See *For a Few Dollars More*, IMDB, <http://www.imdb.com/title/tt0059578/> (last visited Nov. 14, 2011).

¹⁷⁴

See *supra* Part III.B.6.

explain more of the variation in LLC popularity than all the differences in substantive LLC law. Even more surprisingly, differentials in annual fees and entity-level taxes explain none of the variation! In other words, it is formation fees, not taxes or substantive rules or anything else, that explain the variation in LLC popularity best. This is the most important result of this study.

IV. DIRECTIONS FOR FUTURE RESEARCH

There are plenty of opportunities for future empirical research on LLC formations and entity choice. I commend four avenues of inquiry for the consideration of future researchers.

First, future research could explore the costs of organizing a business entity in more detail. A considerable part of the variation in LLC popularity can be explained by formation fee differentials. Yet formation fees are only part of organizing costs, which may also comprise lawyers' fees or fees charged by specialized firms that help people organize a company. Business organizers also incur information costs when they choose an entity. All of these costs may vary according to the type of entity, and these differentials may themselves vary from state to state. For instance, Friedman noted that lawyers in Illinois, which has the lowest LLC-to-corporations ratio in the country, seem to charge more for organizing an LLC than a corporation.¹⁷⁵ The availability of form LLC agreements could likewise differ from state to state. These kinds of costs may provide an additional explanation for the variation in LLC popularity. It would be interesting to analyze these form documents to see whether they modify non-optimal defaults, thereby creating private standard forms that supersede the default rules that LLC statutes provide.¹⁷⁶

Second, it might be worthwhile to explore the impact of local legal culture on entity choice. Local legal culture may be defined as "systematic and persistent variations in local legal practices as a consequence of a complex of perceptions and expectations shared by many practitioners and officials in a particular locality, and differing in identifiable ways from

¹⁷⁵ Friedman, *supra* note 8, at 57 & n.109. The website cited by Friedman still exists: *Starting a Business*, TAXPERTS LTD. & MARTIN FREEMAN, CPA, http://www.taxpertsltd.com/topics/starting_business_body.htm (last revised November 2009). According to that website, forming a corporation costs \$100 to \$500, and forming an LLC costs \$1,000 to \$2,500. *Id.*

¹⁷⁶ For a discussion of statutory standard forms in comparison with private standard forms in the LLC context see Ribstein, *supra* note 90, at 376-84.

[other local legal cultures].¹⁷⁷ For instance, there is a great deal of variation in consumer bankruptcy practices that cannot be explained but by different local legal cultures.¹⁷⁸ Relatedly, there is evidence that the attitudes of lawyers and the characteristics of law firms explain some of the variation in such diverse subject-matters as consumer bankruptcy and corporate charter terms.¹⁷⁹ The situation may be similar with regard to the choice of a business entity.¹⁸⁰

Third, the puzzle of the *Freedom of Contract* variable is still unsolved.¹⁸¹ If the significance of that variable can be verified, one could research the legislative history of those statutes that have a “freedom of contract” provision to find out to what extent state legislatures have copied statutes from other states. The resulting “family tree” of LLC statutes might reveal whether some families of LLC statutes are more successful than others.

Fourth, perhaps most importantly, future studies might examine business entity choices and formations at the individual level, using company-level data instead of state-level data. A better understanding of individual choices may inform our understanding of the aggregate phenomenon, that is, the variation in LLC popularity. For example, a survey among business organizers might reveal that most of them are aware of the formation fees, but not of the periodic fees and franchise taxes. This would explain, at the aggregate level, why formation fees, but not periodic fees and franchise taxes, account for the variation in LLC

¹⁷⁷ Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801, 804 (1994). Originally, the term “local legal culture” was coined by Thomas Church in a study on case disposition speed by criminal trial courts. See THOMAS CHURCH, JR., ET AL., JUSTICE DELAYED: THE PACE OF LITIGATION IN URBAN TRIAL COURTS 54 (1978) (defining “local legal culture” as “established expectations, practices, and informal rules of behavior of judges and attorneys”). I owe the hint to the concept of “local legal culture” to Professor Katherine M. Porter.

¹⁷⁸ See Sullivan et al., *supra* note 177, at 812-39 (finding great state-to-state variation in bankruptcy rates and chapter choice, among other things, over two decades, and explaining the variation by the existence of different local legal cultures).

¹⁷⁹ See Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501 (1993) (finding that lawyers influence debtors to choose chapter 7 or chapter 13 based on their own incentives, attitudes, and beliefs); John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001) (finding that the characteristics of law firms determine whether a firm adopts a takeover defense before its IPO).

¹⁸⁰ The studies by Miller, *supra* note 99, and Miller et al., *supra* note 14, may serve as a starting point of such a study.

¹⁸¹ See *supra* Part III.C.

popularity.¹⁸² Moreover, a future study might analyze the articles of organization and operating agreements of a sample of individual companies, similar to previous studies of public corporations.¹⁸³ Among other things, such a study could shed light on such questions as to what extent business organizers rely on standard form documents¹⁸⁴ or what default rules they modify.

V. CONCLUSIONS

LLCs are much more popular in some states than in others. To explore potential explanations of the state-to-state variation in LLC popularity, I performed regression analyses of a partly original dataset of cross-sectional state-level data. What I found is reminiscent of the Wild West—hence the title of this study:¹⁸⁵ Money is important, legal rules are of dubious significance, and freedom is appreciated.

Money is important in that formation fee differentials explain between 17% and 28% of the variation in LLC popularity and thus have more explanatory power than all other factors together.¹⁸⁶ Yet, paradoxically, the data show no relationship between the popularity of LLCs and differentials in annual fees and franchise taxes.

Legal rules are of dubious significance. Generally, the data show no connection between the variation in LLC popularity and different types of substantive rules of LLC statutes.¹⁸⁷ The only substantive-law variable that was significant and robust indicates whether a state's LLC statute allows LLC members to withdraw from the company.¹⁸⁸ It is hard to explain why this variable, but none of the others, should affect the popularity of the LLC. It seems more plausible that this is a random result, and that substantive LLC law is trivial in the sense that the

¹⁸² As to the "fee paradox," see *supra* Part IIIA.

¹⁸³ For a study of takeover defenses in IPO charters, see for example Coates, *supra* note 179; Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001); Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857 (2002); see also Michael J. Whincop, *An Empirical Analysis of the Standardisation of Corporate Charter Terms: Opting Out of the Duty of Care*, 23 INT'L REV. L. & ECON. 285 (2003) (studying waivers of the duty of care in the charters of a sample of Australian public companies).

¹⁸⁴ See *supra* note 99 and accompanying text. Similarly, Klausner reports that corporate charters at the IPO stage vary very little. See Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 789-91 (2006).

¹⁸⁵ See *supra* note 173 for a reference.

¹⁸⁶ See *supra* Part IIIA.

¹⁸⁷ See *supra* Part III.B.

¹⁸⁸ See *supra* p. 26 and notes 40, 62-65.

differences in substantive LLC laws are not important enough to affect entity choice, as the most important characteristics of the LLC are the same in all states.

Freedom is appreciated—that is, LLCs are more popular in those states whose LLC statutes expressly provide that “maximum effect” shall be given to the principle of “freedom of contract” than in those states that do not have such a provision.¹⁸⁹ The respective variable is highly robust and explains about 10% of the variation in LLC popularity. If this is not a result by chance, it could be viewed as evidence that “freedom of contract” provisions reassure LLC organizers that courts will not rewrite their contract in case of a lawsuit. Alternatively, “freedom of contract” provisions might be associated with other popular features of LLC statutes.

Several factors do not explain the variation in LLC popularity, namely the degree to which LLC statutes are uniform, whether a state has adopted the Uniform Limited Liability Company Act (ULLCA) or the Revised Uniform Limited Liability Company Act (RULLCA); the age of LLC statutes; whether a state permits the formation of series LLCs; and whether a state limits the rights of creditors of LLC members to those of an assignee of the member’s financial interest in the company.¹⁹⁰ Finally, California is the only state to prohibit LLCs from providing professional services, which might explain that state’s exceptionally low LLC-to-corporations ratio.¹⁹¹

The most important finding of this study is that formation fee differentials, which are relatively small but highly visible when a business entity is formed, explain more of the variation in LLC popularity than all other factors combined, including all the differences in substantive law, and the differentials in annual fees and state entity-level taxes. I hope that future studies of individual firms will illuminate the formation choices of closely held companies. For the time being, we must make do with the fact that many people seem to be happy to form an LLC if an LLC costs a few dollars less than a corporation.

¹⁸⁹ See *supra* Part III.C.

¹⁹⁰ See *supra* Part III.D.

¹⁹¹ See *supra* Part III.E.

