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Business Law Reform in the United States: Thinking Too Small?

BY DOUGLAS C. MICHAEL*

I. INTRODUCTION

Dean Johan Henning presents the South African experience with business entity reform as one part of a coordinated whole. It included, for example, government funding for business, tax reforms, accounting and securities changes.¹ Henning says that these reforms, though multi-faceted, had a uniform purpose: to use small business as an engine to improve the economy and to move “historically and socially disadvantaged groups” into the mainstream of the economy and the society.²

These are noble goals and far reaching efforts, and a lot to ask of business entity reform. But because the South African experience was nonetheless successful by all counts, it is worth asking whether we could have—or have had—similar noble motives for business entity reform in the United States in the past decade. The efforts have proceeded on both state and federal levels, in response to many different motivations at many different times. Has the United States, nonetheless, somehow furthered a noble purpose even in this haphazard, piecemeal fashion? To answer this question, I will consider the United States’ counterparts to Dean Henning’s description of South African initiatives in three principal legal areas: business entity organization, federal income tax, and financial reporting and disclosure.

Each area is a fundamental part of small business policy in the United States.³ Further, each of these areas had revolutionary developments in the

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¹ Johan J. Henning, *Reforming Business Entity Law to Stimulate Economic Growth Among the Marginalized: The Modern South African Experience*, 91 KY. L.J. 773, 778-79 (2003).

² *Id.* at 778.

³ See, e.g., *Legal Reforms for Small Business—A Symposium*, 33 BUS. LAW. 847 (1978) (emphasizing structural, tax, and securities law aspects of small business legal reform).

1990s. In substantive business entity law, we saw the creation of the limited liability company ("LLC") and limited liability partnership ("LLP"), and reform of corporation law to make it more consonant with the needs of closely-held businesses. In tax, we saw the development of the "check-the-box" rules for classification of entities for federal income tax purposes. Finally, in financial reporting and disclosure law, we saw important initiatives to simplify the tasks and ease the burdens on small businesses. In each area, I will review and attempt to reconstruct some of the evident policies. I conclude that in the attempt to provide alternatives for small businesses in the United States, there are now too many alternatives. Dean Henning urges to "think small, first."⁴ We have, perhaps, been thinking *too* small.

II. REFORMS AND RATIONALES

A. Business Entity Law

Substantive business entity law in the United States has developed recently along parallel tracks. First, reformers of corporation law have concluded a long effort to make business entity law more useful to closely-held corporations. Second, we have seen the rise of the limited liability company ("LLC") and its afterthought, the limited liability partnership ("LLP"). I will review each in turn.

The study of the needs of the small business corporation appears to have been fairly coordinated and longstanding. In general, reformers long recognized that changes were needed in corporation law in two broad areas: management flexibility and dissenting shareholder "exit" rules.⁵ Although

⁴ Henning, *supra* note 1, at 778 n.18.

⁵ See Edwin J. Bradley, *An Analysis of the Model Close Corporation Act and a Proposed Legislative Strategy*, 10 J. CORP. L. 817 (1985) (describing shareholder agreement validation and judicial relief for shareholder oppression); *Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Closely Held Corporations*, 46 BUS. LAW. 297, 297-98 (1990) [hereinafter *Closely Held Corporations Amendments*] (proposing new §§ 7.32 and 14.34 of the Model Business Corporation Act to deal with shareholder agreements and buyouts); William S. Hochstetter & Mark D. Svejda, *Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, 10 J. CORP. L. 849, 893-980 (1985) [hereinafter *Empirical Study*] (discussing main issues: providing management flexibility, loosening formalities, protecting shareholders, and resolving dissension and deadlock); Dennis S. Karjala, *An Analysis of Close Corporation Legislation in the*

an exhaustive 1985 survey indicated practitioners preferred a separate elective close corporation statute,⁶ there were many practical drawbacks to the use of such a statute.⁷ Adopted instead were three provisions of the Model Business Corporation Act intended to reach the same result but not requiring special choices.⁸ This was considered by many to be better, in part, because small businesses could take advantage of these provisions without special legal assistance.⁹

State corporation law, as indicated by the Model Business Corporation Act, is probably a good model of adjustment of a statute intended largely for public corporations¹⁰ to the needs of small businesses. Some commentators have indicated that courts have done better than special statutes in this regard.¹¹ We remain, however, without a uniform statutory approach in this area. Many states retain separate statutes available for close corporations.¹² Others have adopted the new approaches of the Model Act.¹³ Others have still different provisions.¹⁴ Although pioneering efforts have been made, life as a small corporation remains difficult without a good lawyer.

United States, 21 ARIZ. ST. L.J. 663, 672-77 (1989) (listing goals of close corporation legislation as addressing the "internal governance problem" and "minority shareholder oppression").

⁶ See *Empirical Study*, *supra* note 5, at 1019-26.

⁷ See *Closely Held Corporations Amendments*, *supra* note 5, at 297 (citing Bradley, *supra* note 5).

⁸ *Id.*

⁹ See, e.g., Bradley, *supra* note 5, at 843 ("Failure to use these statutes in many cases is traceable to a lack of proper understanding of the statute and the prevalence of a sort of puritanical conservatism in the practice of law.").

¹⁰ See Karjala, *supra* note 5, at 664-65; John M. Cunningham, *Making Life Easier for Mom & Pop: Fine-Tuning the Law for Close Corporations*, BUS. LAW TODAY, Jan.-Feb. 1994, at 56.

¹¹ See generally Karjala, *supra* note 5 (presenting the history of close corporation statutes and judicial interpretations of the same); *Empirical Study*, *supra* note 5, at 856-58 (analyzing the use of "judicial exceptions"). Karjala admits his view is probably a minority one. See Karjala, *supra* note 5, at 702.

¹² See 4 MODEL BUS. CORP. ACT ANN. CC-71 to CC-72 (Supp. 1998-99) (listing eighteen states with separate close corporation statutes, five of which have since adopted MBCA § 7.32); Cunningham, *supra* note 10, at 60 (Delaware and California); Karjala, *supra* note 5, at 680-88 (North Carolina, Delaware, and 16 states following the Delaware approach).

¹³ See 2 MODEL BUS. CORP. ACT ANN. at 7-249 to 7-251 (Supp. 2000-2002) (listing sixteen states having adopted MBCA § 7.32 and five others with similar provisions); 3 MODEL BUS. CORP. ACT ANN. at 14-155 (Supp. 2000-02) (listing twenty-one states having adopted MBCA § 14.34).

¹⁴ See, e.g., KY. REV. STAT. ANN. § 271B.8-010(3) (allowing for more flexible rules for corporations with fifty or fewer shareholders).

Modification of partnership entities, by contrast, began as a quest for “technical corrections” in the Uniform Partnership Act, and was swept up in the tax-fueled rise of the LLC and LLP in the 1990s. It is a story well told by Dean Vestal in his contribution to this symposium.¹⁵ In our decade of “great change and little accomplishment,”¹⁶ he notes, we have proceeded with no underlying unifying theory, no goals in sight, and no account taken of social costs and benefits.¹⁷ It is anything but clear that the interests of the small business were considered.

Yet, in all this activity, surely we have the right answer in there somewhere. Surely we should have flexible rules that restrict choice only in cases of demonstrated need to do so.¹⁸ This we have done, with a contractarian approach to both partnerships¹⁹ and corporations.²⁰ At the same time, we should provide default rules for those who do not, or do not want to, make their own bargains.²¹ This, too, we have done. And surely, we should protect the small business, to make sure that an efficient regime

¹⁵ Allan W. Vestal, *Business Law Reform in South Africa: The Right Path, the Right Reason*, 91 KY. L.J. 829 (2003).

¹⁶ *Id.* at 834 (quoting Allan W. Vestal, “Drawing Near the Fastness?”—*The Failed United States Experiment in Unincorporated Business Entity Reform*, 26 J. CORP. L. 1019, 1019 (2001)).

¹⁷ *Id.* at 833-36.

¹⁸ See Mark J. Loewenstein, *A New Direction for State Corporate Codes*, 68 U. COLO. L. REV. 453, 459 (1997) (“If the parties affected by the provision do not want it, why does the state insist upon it? And if the parties, freely contracting, would prefer the state-mandated provision, then why should the state bother to mandate it?”); Uriel Procaccia, *Crafting a Corporate Code From Scratch*, 17 CARDOZO L. REV. 629, 630-31 (1996).

¹⁹ See Vestal, *supra* note 15, at 834.

²⁰ See 2 MODEL BUS. CORP. ACT ANN. § 7.32, official comment (1997 Supp.) (noting that the section “affords participants in closely-held corporations greater contractual freedom to tailor the rules of their enterprise”); Cunningham, *supra* note 10, at 58 (characterizing MBCA § 7.32 as “a statutory trump card that, in designing their corporate structure, close corporation shareholders may use to override otherwise applicable [statutes]”); Loewenstein, *supra* note 18, at 453-54 (noting dominance of contractarian philosophy in modern state corporation laws).

²¹ See Loewenstein, *supra* note 18, at 453-57 (arguing for a set of rules for protection of shareholders); see also J. Mark Meinhardt, Note, *Investor Beware: Protection of Minority Stakeholder Interests in Closely Held Limited-Liability Business Organizations: Delaware Law and its Adherents*, 40 WASHBURN L.J. 288, 309-10 (2001) (concluding that instead of contractual freedom with no rules, we should provide default rules for exit protection and fiduciary duties and allow the sophisticated investors contract around them).

is available at low cost. This, however, we have not done very well. We have lost sight of the small entrepreneur, the one Dean Henning identified as needing support and guidance.²² Indeed, as one reviewer notes:

Most businesses in this country are unincorporated sole proprietorships, businesses owned and operated by one person. Unincorporated sole proprietorships are often found in underdeveloped, poorer communities, including inner cities and rural areas that are challenged by limited capital, poor access to insurance coverage, limited training, and unsophisticated legal and technical skills.²³

In our pluralistic attempt to provide the right answer somewhere, we have forms with a bewildering variety but no purposeful distinctions.

B. Tax Law

Dean Henning observes that “in order to enhance the prosperity of small enterprises, governments should ensure that these enterprises are not over-taxed.”²⁴ Small business federal income tax policy in the United States, however, has often run on a different track. While tax relief for small business is occasionally a stated objective of tax policy, it more often involves tax simplification and a continuing debate over “entity” versus “aggregate” form.²⁵

Broad tax relief for small businesses is occasionally a focus of federal income tax policy. When Congress enacted Subchapter S in 1958, it was intended as tax relief for the type of business that Dean Henning has in mind: “the corner grocery store [or] pharmacy. . . . The intent was to allow smaller businesses to incorporate but be taxed like partnerships, allowing passthrough of start-up losses and only one level of taxation once the

²² See *supra* note 2 and accompanying text.

²³ Mitchell F. Crusto, *Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)*, 2001 COLUM. BUS. L. REV. 381, 383-84 (internal citations omitted).

²⁴ Henning, *supra* note 1, at 779.

²⁵ See, e.g., Harry J. Haynsworth, *The Need for a Unified Small Business Structure*, 33 BUS. LAW. 849, 861-62 (1978) (beginning with observation that small business needs “a supportive tax system that provides adequate incentives for investment,” but turning quickly to a more detailed discussion of “whether any difference in the treatment of the various forms of businesses is justified, at least as far as small businesses are concerned”).

business became profitable.”²⁶ There are, in addition, many other varied federal income tax benefits or credits aimed at “small” businesses, variously defined.²⁷

Far more common, however, is concern of tax authorities and policy analysts over tax simplification. This is evident in the adoption of the so-called “check-the-box” regulations²⁸ in 1997; these regulations intended to make the “pass through” or one-level income tax more easily available to small businesses by allowing them to select their federal income tax treatment or classification.²⁹ In proposing the regulations, the Internal Revenue Service (“IRS”) noted that taxpayers would be able, without new regulations, to obtain partnership tax classification for any organization of whatever form which is “virtually indistinguishable from a corporation.”³⁰ However, “[t]o accomplish this, . . . taxpayers and the IRS must expend considerable resources on classification issues. . . . Meanwhile, small business organizations may lack the resources and expertise to achieve the tax classification they want under the current classification regulations.”³¹

Although the new regulations were intended to simplify the classification decision, complexity continues to be the dominant feature.

Although in theory, similarly situated businesses have the same opportunity to be treated in the same tax-advantageous manner under current law, the practical reality is probably to the contrary, due to disparities in the quality of advice the businesses receive. By permitting such disparate choices without any apparent underlying conceptual foundation, current law has simply provided a tax benefit for the well-advised and a trap for the ill-advised. There is no particular policy reason why the taxation of

²⁶ Jerald David August, *Benefits and Burdens of Subchapter S in a Check-the-Box World*, 4 FLA. TAX REV. 287, 322-23 (1999).

²⁷ George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 199 & n.168 (1999) (citing twenty-five different provisions).

²⁸ For a history of the proposal and adoption of these rules, see CARTER G. BISHOP & DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* at 2-4 (1999) (noting that these proposals were “[u]nofficially, but ubiquitously, labeled the check-the-box regulations”).

²⁹ Simplification of Entity Classification Rules, Notice of Proposed Rulemaking and Notice of Public Hearing, 61 Fed. Reg. 21,989, at 21,989-90 (1996) [hereinafter *Entity Classification Proposed Rules*]. Final regulations are at Treas. Reg. § 301.7701-3 (2003). *Id.* at 21,997.

³⁰ *Entity Classification Proposed Rules*, *supra* note 29, at 21,990.

³¹ *Id.*

private business firms should result in the minimization of tax liabilities for only the well-advised.³²

Tax simplification is recognized as a necessary counterpart to serious reform, but the major policy question is whether this simplification should move toward the “entity” theory of businesses, with a separate tax (as with a Subchapter C corporation), or toward the “aggregate” theory,³³ with pass-through taxation to the owners of the business (as with a partnership or Subchapter S corporation). The aggregate theory seems on the ascendancy; indeed, the check-the-box regulations have been recognized as extensions of this theory.³⁴ The aggregate theory meets tax objectives of equity and efficiency,³⁵ but remains intractably difficult to implement.³⁶ Indeed, some analysts have suggested that the aggregate theory, while conceptually better, has too many disadvantages, including lack of familiarity to businesses and taxpayers.³⁷

In sum, it appears that United States tax policy lurches here and there toward tax relief for small businesses. However, more effort seems to have

³² Yin, *supra* note 27, at 149-50; *accord* August, *supra* note 26, at 331 (noting that the limits on the use of Subchapter S aggregate tax treatment for corporations results “in greater transactional and compliance costs and rewards the more sophisticated business owners over the less sophisticated”). Yin reports similar conclusions in his capacity as Reporter in AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, TAXATION OF BUSINESS ENTERPRISES, REPORTER’S STUDY 40-47 (1999) [hereinafter FEDERAL INCOME TAX PROJECT].

³³ This is sometimes also called the “conduit” theory, recognizing that the entity should only be a “conduit” of tax items to its owners.

³⁴ See Joel Rabinovitz & Eric M. Zolt, *Tax Nothings*, 75 TAXES: THE TAX MAGAZINE 869, 883 (1997).

³⁵ See Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 464 (2001) (concluding that aggregate approach meets equity and efficiency goals); David I. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1672 (1999) (noting that “under plausible assumptions, the check-the-box regulations are efficient”); Yin, *supra* note 27, at 153.

³⁶ See Yin, *supra* note 27, at 201 (noting “the complexity of subchapter K [partnership taxation rules], the lack of significant IRS auditing of firms subject to those rules, and the general feeling that large parts of subchapter K are misapplied even by very knowledgeable practitioners”); *id.* at 172-247 (designing a simplified method of conduit taxation); *accord* FEDERAL INCOME TAX PROJECT, *supra* note 32, at 109 (asserting that “[s]omething very fundamental must be awry in the basic structure of the rules for the law to have evolved into this unhappy state.”).

³⁷ See generally Postlewaite, *supra* note 35.

been placed on simplification of choices or compliance under existing disparate taxation schemes. Indeed, one question about the check-the-box regulations is whether allowing taxpayers to choose the applicable tax rules will result in unanticipated abuse.³⁸ Whether the simplification effort will ultimately result in simpler federal income tax laws for small business remains questionable.

C. *Financial Reporting and Disclosure Law*

The revolution of the 1990s in financial reporting and disclosure provides, at least initially, a refreshing contrast to the muddled efforts in other areas. From the outset, the Securities and Exchange Commission ("SEC") made clear the end and aim of its proposed reforms of disclosure requirements applicable to small businesses. Small businesses were, said the SEC, "the cornerstone of the U.S. economy," and needed access to capital "without undue regulatory complexity and cost."³⁹ Despite that ringing endorsement, facilitating commerce "has emerged as a goal equally important to that of investor protection,"⁴⁰ and the goals of full disclosure and small business relief remain at cross purposes in many instances.⁴¹

The SEC adopted major reporting reforms for small businesses, both in initial registration of securities for public trading and in registration of securities in the secondary market.⁴² These efforts were an attempt to lighten the burden of compliance with requirements placed on small businesses by the federal securities laws.⁴³ Measured by this standard, the efforts have been only partly successful due in large part to the lack of coordination by the state securities regulators.⁴⁴ Although Congress

³⁸ See Rabinovitz & Zolt, *supra* note 34, at 885-86.

³⁹ S.E.C., Small Business Initiatives, Notice of Proposed Rulemaking, 57 Fed. Reg. 9768, 9768-69 (1992).

⁴⁰ Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula That Fosters the Policies of Securities Regulation*, 25 LOY. U. CHI. L.J. 199, 206 (1994).

⁴¹ *Id.*

⁴² For a concise summary of the SEC's Small Business Initiatives, see Note, *The Impact of the 1992 Small Business Initiatives*, 47 ADMIN. L. REV. 511, 513-15 (1995).

⁴³ *Id.* at 513. "Over the years, federal and state securities regulation has added significantly to the plight of small businesses by making it unnecessarily difficult for them to raise capital." Rutheford B Campbell, Jr., *The Impact of NSMIA on Small Issuers*, 53 BUS. LAW. 575, 579 (1998).

⁴⁴ Note, *supra* note 42, at 524-25.

attempted to mitigate the overlap of federal and state securities regulation in the National Securities Market Improvement Act of 1996 ("NSMIA"),⁴⁵ this effort was at best incomplete. In the most important respects, NSMIA refused to preempt state regulation and left small business issuers in the same situation as before.⁴⁶

With disclosure policy it appears that there is not so much a lack of a clear vision as there is a lack of consensus from federal and state regulators. While the United States has tried to create a "small business" version of disclosure rules, as with substantive business entity and federal income tax law, much work is still needed.

III. EVALUATION

Dean Henning urged policy makers to "think small, first,"⁴⁷ an exhortation endorsed by Dean Vestal.⁴⁸ Perhaps in the United States we have taken that principle to an undesirable extreme. There is no consensus about substantive business organization models,⁴⁹ federal income tax policy,⁵⁰ or disclosure policy.⁵¹ Rather, we provide a multitude of small

⁴⁵ Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C.).

⁴⁶ Campbell, *supra* note 43, at 582-83.

⁴⁷ Henning, *supra* note 1, at 778 n.18.

⁴⁸ Vestal, *supra* note 15, at 836.

⁴⁹ *See id.* at 834.

It goes without saying that there is absolutely no consensus that limited liability should be available without taxation, that current patterns and elements of tort liability are inappropriate, or that the taxation of corporations is unjustified. Nor is there consensus on the foundational question of whether business entity statutes for partnership-like firms should be based on a contractual model or on a tort model.

⁵⁰ *See* Yin, *supra* note 27, at 149.

Thus, each set of [tax] rules . . . was designed to apply to a particular business organization form with specific characteristics. Yet, adoption of the check-the-box regulations reflects a policy determination generally to disregard business organization form and characteristics for income tax purposes. Given that, it is difficult to understand why firms are nevertheless allowed a choice regarding how they are taxed and why they are given the particular choices that they are.

⁵¹ *See* Wade, *supra* note 40, at 208 ("[E]xemptions from [disclosure requirements] reflect a willingness, in certain instances, to assist issuers in capital formation at a tolerable cost to investors. . . . When an issuer goes beyond the boundaries drawn under the [Securities Act] exemptions, the goal of information

solutions. The current laws provide any desired governance structure, profit sharing arrangement, or exit rule, whether in a partnership, LLC, or closely-held corporation. It is simply a drafting challenge.⁵² The United States provides pass-through tax treatment in a partnership, LLC, or closely-held corporation, under at least two different tax regimes.⁵³ There are limited disclosure obligations under federal law, but left in place are substantial obligations under various state laws.

What is needed, perhaps, is to think a little larger. There are various proposals for unified and simplified small business organization laws,⁵⁴ tax laws,⁵⁵ and disclosure laws.⁵⁶ Imagine such a structure: easy to understand, easy to use, and ready to make a small business accessible to every entrepreneur. This, indeed, could empower the marginalized.⁵⁷ In the United States, we may have the right answer in there somewhere. We could take Dean Henning's challenge to heart and take bold policy steps with our small business laws. True, this is a lot to ask of business law reform. However, it was not too much in South Africa, and it should not be too much here.

dissemination through disclosure overcomes the goal of facilitating commerce.”).

⁵² See FRANKLIN A. GEVURTZ, CORPORATION LAW 14 (2000).

[T]he factors often suggested as the basis for choosing between corporations and other business forms are, for the most part, things which owners can obtain regardless of which form they use. Contracting can dictate governance, exit rules and even to a great extent limited liability, despite the form chosen. Perhaps choice of business form is irrelevant.

⁵³ Pass-through treatment is generally the rule for partnerships under Subchapter K and corporations electing similar treatment under Subchapter S. A third option, using a traditional (Subchapter C) corporation normally subject to a separate tax, is to “zero out” the corporation through deductible payments to its owner(s). See GEVURTZ, *supra* note 52, at 18 (adding the observation that “[n]eedless to say, there are limits to this approach”).

⁵⁴ See Robert R. Keatinge, *Universal Business Organization Legislation: Will it Happen? Why and When?*, 23 DEL. J. CORP. L. 29, 68 (1998) (noting that the move toward a universal form is already occurring); see generally Haynsworth, *supra* note 25 (proposing a unified structure across all components).

⁵⁵ See FEDERAL INCOME TAX PROJECT, *supra* note 32, at 125-272 (proposal for a unified small business simplified taxation system).

⁵⁶ See, e.g., Campbell, *supra* note 43, at 585-87 (advocating complete federal preemption of state disclosure laws).

⁵⁷ Recall the “marginalized” business described by Crusto. See *supra* text accompanying note 23.