

Entrepreneurs' Legal Status Choices and the C Corporation Survival Penalty

Over 800,000 enterprises are born in the United States each year, creating approximately four million new jobs. The ability to easily and rapidly start a new business is a foundation of the American Dream. However, a crucial step in forming an enterprise appears to have become more complicated in recent years: the process of choosing a legal status. In the aftermath of the limited liability company (“LLC”) revolution of the late 1980s, a variety of exotic new business entity statutes were adopted by state legislatures. The choice became even more nuanced when the federal tax classification of the LLC became unrestrictedly elective. For entry-level entrepreneurs, the complexity of the legal status choice is frequently cited as a source of confusion and frustration.

The paper begins by identifying a fundamental tension between two stories about choice-of-legal-status in the theoretical business organizations literature. On the one hand, Larry Ribstein and others have offered an “efficient contracting” story: a robust range of legal statuses can be welfare-enhancing for smaller and larger businesses alike. In particular, more legal statuses means that entrepreneurs with limited resources can customize their business relationships at lower cost. This permits them to select away from entities that fit poorly with their business objectives. The efficient contracting story predicts that, on average, legal status should not affect firm survival outcomes when entrepreneurs are choosing rationally among competing legal statuses.

On the other hand is a “regressive complexity” story. Scholars critical of “entity proliferation” are skeptical that the benefits of contractual customization can outweigh the aggregate costs of legal complexity. They express concern that entrepreneurs at the bottom of the sophistication and resource spectrum will be disproportionately harmed. The harm may come in the form of confusion and stress, but also through costly mismatches between an entrepreneur’s objectives and her chosen legal status for her business. Contrary to the efficient contracting story, the regressive complexity story predicts that legal status may affect firm survival outcomes for a particular cohort of entrepreneurs: the under-resourced.

What is at stake in assessing these two competing stories about expanded choice of business legal status? This paper answers that question by focusing on an overlooked issue in the context of new firm formation: distributive justice. As a legacy of having few sources of reliable data, the empirical literature on entrepreneurs’ choice of legal status is still in its infancy. In particular, how entrepreneurs with varying measures of financial, social, or informational resources fare in choosing a legal status for their enterprise is an open question.

To begin to fill this gap, the paper exploits a large and recently-released data set on entrepreneurs and their firms’ performances over time. The Kauffman Firm Survey (“KFS”) collects legal status, owner, financing, sector, employment and other firm-specific data from a national panel of nearly five thousand enterprises that were formed in 2004 and followed through 2011. The paper uses the KFS to evaluate the predictions of the efficient contracting and regressive complexity stories, and presents four key results. First, controlling for a range of entrepreneur and firm characteristics, enterprises organized as C corporations are approximately 11 percent more likely to fail by their eighth year than enterprises with other legal status classifications. Second, this C corporation survival penalty is concentrated exclusively on a subset of less-

sophisticated C corporations characterized by the absence of both (a) venture capital investors and (b) contingent equity compensation (stock option) plans for their employees. Third, being non-white or foreign-born is significantly associated with an entrepreneur's choice to form a less-sophisticated C corporation. Fourth, there is a high degree of correlation (0.93) between less-sophisticated C corporations and C corporations that met the eligibility criteria for electing into tax-advantaged S corporation status, suggesting that they may have intended but failed to file the paperwork to make the election. Taken together, these results cast doubt on the efficient contracting story about legal status choice and provide evidence that the complexity costs of organizing a new business can be distributionally regressive. The paper concludes by discussing possible policy implications, including a proposal to level the playing field for less-sophisticated entrepreneurs by switching the default tax classification for corporations from subchapter C to subchapter S.