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# THROUGH THE LENS OF INNOVATION

MIRIT EYAL-COHEN\*

## ABSTRACT

*The legal system constantly follows the footsteps of innovation and attempts to discourage its migration overseas. Yet, present legal rules that inform and explain entrepreneurial circumstances lack a core understanding of the concept of entrepreneurship. By its nature, law imposes order. It provides rules, remedies, and classifications that direct behavior in a consistent manner. Entrepreneurship turns on the contrary. It entails making creative judgments about the unknown. It involves adapting to disarray. It thrives on deviation as opposed to traditional causation. This Article argues that these differences matter. It demonstrates that current laws lock entrepreneurs into inefficient legal routes. Through specific legal classifications, it points to significant distortionary effects. It theorizes that a legal culture that wishes to entice entrepreneurship is one that requires legal agents to think like entrepreneurs. Thereafter, it offers a bridge between law and entrepreneurship by providing policymakers with tools to recognize its distinctive modus operandi.*

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## I. INTRODUCTION

The American economy is at a critical moment in history. The aftermath of the latest downturn reveals that we have experienced one the deepest recessions in recent times.<sup>1</sup> Yet, our economy has not yet regained its full strength.<sup>2</sup> Now, more than ever, there is a need for economic renewal and mobility.<sup>3</sup> Entrepreneurship is essential for revitalization, economic growth, job creation, and technological renewal.<sup>4</sup> These elements are the driving force behind improvements in well being and standards of living.<sup>5</sup> Governments have long realized

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1. See, e.g., Peter Baker, *Big Business Joins Obama Effort to Aid Long-Term Unemployed*, N.Y. TIMES (Jan. 31, 2014), <http://www.nytimes.com/2014/02/01/us/politics/big-companies-join-obama-in-initiative-to-help-long-term-unemployed.html> (“The challenge for the long-term unemployed has become especially acute as the economy struggles to recover from one of the deepest recessions in modern times.”); William C. Rhoden, *Focus on Bonds Misses the Big Picture*, N.Y. TIMES (Feb. 5, 2009), <http://www.nytimes.com/2009/02/06/sports/baseball/06rhoden.html> (“At a time when the nation is in one of the deepest recessions in its history, when hundreds of thousands of Americans are barely surviving, the government is spending millions of dollars to prosecute Barry Bonds.”); *Washington’s Tax Oracles*, WALL ST. J. (Jul. 21, 2010, 12:01 AM), <http://www.wsj.com/articles/SB10001424052748704518904575365173477277974> (“[O]n January 1 we will enact one of the largest tax increases in history, coming out of one of the deepest recessions in a century.”); Peter Whoriskey & Kendra Marr, *GM, Chrysler Seek Billions More in Aid*, WASH. POST (Feb. 18, 2009), <http://www.washingtonpost.com/wp-dyn/content/article/2009/02/17/AR2009021702510.html?sid=ST2009021702827> (“The companies said they plan to cut an additional 50,000 jobs worldwide, drop as many as six brands and shutter 14 plants in an attempt to survive one of the deepest recessions in decades.”).

2. See, e.g., Wendy Guillies, *Kauffman Foundation 2015 State of Entrepreneurship Address* (Feb. 11, 2015), [http://www.kauffman.org/~media/kauffman\\_org/resources/2015/soe/2015\\_state\\_of\\_entrepreneurship\\_speech.pdf](http://www.kauffman.org/~media/kauffman_org/resources/2015/soe/2015_state_of_entrepreneurship_speech.pdf) (in her speech, the Acting President and CEO of the Ewing Marion Kauffman Foundation warns against thinking we have passed the recent recession).

3. *Id.* (“[T]he headline numbers may look good, but something isn’t right when you dig a little deeper. The United States doesn’t just need economic growth. We need economic renewal. We need renewed mobility. We need a renewed notion of shared prosperity. We need a renewed sense of possibility.”).

4. See *infra* Section II.B; see also Robert Cooter et al., *The Importance of Law in Promoting Innovation and Growth*, in *RULES FOR GROWTH: PROMOTING INNOVATION AND GROWTH THROUGH LEGAL REFORM* 1, 9-14 (2011).

5. See, e.g., CARL J. SCHRAMM, *Preface to RULES FOR GROWTH: PROMOTING INNOVATION AND GROWTH THROUGH LEGAL REFORM*, *supra* note 4 (“All economies have rules and institutions that govern the behavior of their actors. The rules that govern the U.S. economy so far have helped guide unprecedented growth and well-being.”); Andrew Beckerman-Rodau, *Patent Law—Balancing Profit Maximization and Public Access to Technology*, 4 COLUM. SCI. & TECH. L. REV. 1, 2 (2002) (noting that intellectual property provides for new creations including drugs, business methods, songs, and financial products); Justin Desautels-Stein, *Pragmatic Liberalism: The Outlook of the Dead*, 55 B.C. L. REV. 1041, 1076 (2014) (“[H]uman well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by

that continuous growth depends upon a vibrant society of entrepreneurs.<sup>6</sup> While the current global pressure to capture entrepreneurship is strong, our competitive edge is being diminished by countries that have developed superior ways to attract intellectual wealth.<sup>7</sup> Accordingly, entrepreneurship warrants distinct legal attention.

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strong private property rights, free markets, and free trade.” (alteration in original) (quoting DAVID HARVEY, *A BRIEF HISTORY OF NEOLIBERALISM* 22-23 (2005)); Randall S. Kroszner et al., *Economic Organization and Competition Policy*, 19 *YALE J. ON REG.* 541, 541 (2002) (“This period saw private sector technological advances and entrepreneurial innovation that fueled productivity growth and improvements in our standard of living.”); Marina Lao, *Unilateral Refusals to Sell or License Intellectual Property and the Antitrust Duty to Deal*, 9 *CORNELL J.L. & PUB. POL’Y* 193, 211-13 (1999) (discussing the relationship between innovation and economic growth); Ruth L. Okediji, *Public Welfare and the Role of the WTO: Reconsidering the TRIPS Agreement*, 17 *EMORY INT’L L. REV.* 819, 836-37, 918 (2003) (referring to the relationship between intellectual property, innovation, and welfare); J.H. Reichman & Paul F. Uhlir, *Database Protection at the Crossroads: Recent Developments and Their Impact on Science and Technology*, 14 *BERKELEY TECH. L.J.* 793, 817 (1999) (positing a direct connection between certain intellectual property regime and progress); Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 *YALE J. ON REG.* 229, 294 (2009) (maintaining the crucial factor for economic growth and prosperity is entrepreneurs that dramatically increase worker productivity and, accordingly, a nation’s standard of living).

6. For example, the Australian government has published a new agenda to encourage entrepreneurship by embracing risk and pursuing ideas. As part of this initiative to generate more high-impact start-ups and fast-growing “Gazelle” firms, the government addressed legal areas that relate mostly to changes to taxation and company regulation. These initiatives are designed to assist entrepreneurial firms to access venture capital and address commercial risk, such as making it easier to access crowd-sourced equity funding, increasing access to company losses, reforming insolvency laws, and making changes to legal rules for venture capital limited partnership. See *Taking the Leap*, NAT’L INNOVATION & SCI. AGENDA, <http://www.innovation.gov.au/theme/taking-leap> (last visited Mar. 15, 2016); see, e.g., SPIKE INNOVATION, OFFICE OF THE CHIEF SCIENTIST, AUSTRALIAN GOVERNMENT, *BOOSTING HIGH-IMPACT ENTREPRENEURSHIP IN AUSTRALIA: A ROLE FOR UNIVERSITIES 2* (2015), <http://www.chiefscientist.gov.au/wp-content/uploads/Boosting-High-Impact-Entrepreneurship.pdf> (reinforcing the Australian commitment to turn great ideas into products and practices that help build businesses and create jobs in Australia); *Australia Proposes Tax Reforms to Encourage Employee Share Ownership, Entrepreneurship*, BLOOMBERG BNA, Oct. 15, 2014; Rod McGuirk, *Australia to Invest \$800 Million in Boosting Innovation*, ASSOCIATED PRESS (Dec. 6, 2015, 9:47 PM), <http://bigstory.ap.org/article/607312aa0500491196d56595c8ffd67f/australia-aims-boost-innovation-and-entrepreneurship> (announcing that the Australian government will introduce new laws to enable innovation and entrepreneurship).

7. See Nicholas Bloom et al., *Trade Induced Technical Change? The Impact of Chinese Imports on Innovation, IT and Productivity* (Ctr. for Econ. Performance, CEP Discussion Paper No. 1000, 2011), <http://cep.lse.ac.uk/pubs/download/dp1000.pdf>; see also Abigail Klein Leichman, *Israeli Startup’s Life Sciences Labs Get an Inventory Overhaul*, JEWISH BUS. NEWS (Dec. 28, 2015), <http://jewishbusinessnews.com/2015/12/28/israeli-startups-life-sciences-labs-get-an-inventory-overhaul/> (reporting public Israeli initiatives to “encourage[] innovation through entrepreneurial courses, business accelerator programs and competitions”); Sterling Immigration Ltd., *Canadian Startup Visa v UK Tier 1 Entrepreneur*, LEXOLOGY (Dec. 13, 2015), <http://www.lexology.com/library/detail.aspx?g=2eee06c9-837e-430d-b4c9-3aca6911e4e8> (describing U.K. and Canadian efforts to attract prospective entrepreneurs through special immigration visas); *The Yuan and Chinese Reform*, WALL ST. J. (Nov. 30, 2015, 7:21 PM), <http://www.wsj.com/articles/the-yuan-and-chinese-reform->

Law plays a significantly active role in creating an environment in which entrepreneurs can successfully act. Lawmakers can utilize law to encourage entrepreneurs to create opportunities by reducing transaction and information costs. Law can function as a stabilizing force that allows private actors to contract about future market conditions and reduce their uncertainty.<sup>8</sup> It has the power to increase or reduce the regulatory costs of pursuing entrepreneurship.

Law can also impose rules that obstruct entrepreneurial opportunities.<sup>9</sup> For example, patent laws ensure that entrepreneurs retain control of their discoveries and entrepreneurial gains.<sup>10</sup> They facilitate risk-taking by ensuring that entrepreneurs reap the benefits of successful speculation. Nevertheless, if taken to the extreme, patent laws can hamper entrepreneurship by generating monopoly positions over discoveries and preventing other entrepreneurs from developing and improving them.<sup>11</sup>

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1448929275 (reporting that “Japan is saddled with less competitive financial companies that shy away from financing entrepreneurial start-ups.”); *Tracking Tax Runaways*, BLOOMBERG BLOG, <http://www.bloomberg.com/infographics/2014-09-18/tax-runaways-tracking-inversions.html> (last updated Apr. 13, 2015) (providing an updated list of companies that effectively renounced their U.S. citizenship by adopting a legal address abroad); *US Tech Startups Look to China for Funding, Success*, CHINA DAILY, [http://europe.chinadaily.com.cn/china/2015-12/20/content\\_22753813.htm](http://europe.chinadaily.com.cn/china/2015-12/20/content_22753813.htm) (last updated Dec. 20, 2015) (reporting American startup companies competing for funding for their business development in China); Mahendra Ved, *Rise of India’s Self-Made Billionaires*, NEW STRAITS TIMES, Apr. 4, 2015, at 16 (“The list reflects a pluralist India. Entrepreneurship transcends faith, class and region.”).

8. See JAMES WILLARD HURST, *LAW AND THE CONDITIONS OF FREEDOM IN THE NINETEENTH CENTURY UNITED STATES* 10-11 (1956) (arguing that the law can create a framework of reasonable expectations within which rational decisions could be taken for the future). *But see* Christine Hurt, *The High Cost of Entrepreneurship*, CONGLOMERATE BLOG: BUS., LAW, ECON. & SOC’Y (Jan. 31, 2013), <http://www.theconglomerate.org/2013/01/the-high-cost-of-entrepreneurship.html> (contending that the laws in the United States do more to hinder entrepreneurship than assist it).

9. *Cf.* D. Gordon Smith & Darian M. Ibrahim, *Law & Entrepreneurial Opportunities*, 98 CORNELL L. REV. 1533, 1537 (2013) (“[W]e also recognize circumstances in which this value [entrepreneurship] has largely been absent from policy debates.”).

10. See, e.g., 157 CONG. REC. S5433 (daily ed. Sept. 8, 2011) (statement of Sen. Mark Kirk) (noting legal rules that “strengthen our patent system . . . bolster our global competitiveness”); William Hubbard, *The Competitive Advantage of Weak Patents*, 54 B.C. L. REV. 1909, 1947 (2013) (noting “commentators have long recognized that patents generally promote innovation but undermine competition and that many patent law doctrines affect this tradeoff”); Oskar Liivak & Eduardo M. Peñalver, *The Right Not to Use in Property and Patent Law*, 98 CORNELL L. REV. 1437, 1444-45 (2013) (“[U]nlike copyright, not only can an owner choose not to use the invention, the owner can also sue to prevent others from using it (or its equivalents), even if they (re)discover the invention on their own.”). *But see* MICHELE BOLDRIN & DAVID K. LEVINE, *AGAINST INTELLECTUAL MONOPOLY* 11 (2008) (criticizing intellectual property as an “unnecessary evil” and contending there is no evidence the monopoly it grants “achieves the desired purpose of increasing innovation and creation”).

11. See, e.g., Sean M. O’Connor, *The Lost ‘Art’ of the Patent System*, 2015 U. ILL. L. REV. 1397, 1398 (2015) (arguing that the loss of an “art”-based concept of the patent system

Congress has frequently declared that enticing entrepreneurship is a fundamental value in American society.<sup>12</sup> Yet, our laws are not compatible with current economic and technological advances. Recent literature has begun to investigate the ways in which the law can improve production of goods and labor expansion.<sup>13</sup> Legal reform proposals have suggested ways in which the legal system—the contents of specific laws, judicial doctrines, regulations, and legal processes—can be improved to spur production and growth.<sup>14</sup> These proposals

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causes confusion over the proper scope and nature of the patent system, over- and under-inclusive senses of patent eligible subject matter as well as amnesia as to the long-standing importance of method patents). For the definition of “monopoly” in this Article, see *infra* note 198.

12. See, e.g., Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301-305, 126 Stat. 306, 315-23 (2012); 161 CONG. REC. H913 (daily ed. Feb. 10, 2015) (statement of Rep. Rohrabacher) (describing the anticipated consequences of enacting H.R. 9 by stating that “[i]rreparable damage will be done to our research universities, to our inventors and entrepreneurs. All of these people are going to be hurt.”); 161 CONG. REC. H421-22 (daily ed. Jan. 20, 2015) (“I intend to protect a free and open Internet, extend its reach to every classroom and every community, and help folks build the fastest networks so that the next generation of digital innovators and entrepreneurs have the platform to keep reshaping our world.”); 157 CONG. REC. E10-11 (daily ed. Jan. 5, 2011) (statement of Rep. David Dreier) (“[I]nnovation and entrepreneurship [are] vital to our economic recovery.”); see also CRAIG K. ELWELL, CONG. RESEARCH SERV., RL32987, LONG-TERM GROWTH OF THE U.S. ECONOMY: SIGNIFICANCE, DETERMINANTS, AND POLICY 15 (last updated May 25, 2006), <http://fpc.state.gov/documents/organization/68789.pdf> (“This infrastructure [of economic growth] is comprised of laws, government policies, socio-economic institutions, and cultural attitudes that are conducive to the entrepreneurial activity that generates sustained long-term economic growth.”); DAVID A. HARPER, FOUNDATIONS OF ENTREPRENEURSHIP AND ECONOMIC DEVELOPMENT 1-2 (2003) (“Entrepreneurship is critical to enhancing the innovativeness and responsiveness of businesses, to boosting productivity and to improving cost structures and trade performance. . . . Individual entrepreneurs and entrepreneurial teams bring to light the resources, technologies and trading opportunities that make economic development possible.”); J. Bradford DeLong et al., *Sustaining U.S. Economic Growth* 28-29 (2002), [http://scholar.harvard.edu/lkatz/files/sustaining\\_us\\_econ\\_growth.pdf](http://scholar.harvard.edu/lkatz/files/sustaining_us_econ_growth.pdf).

13. See, e.g., JOSH LERNER, BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP AND VENTURE CAPITAL HAVE FAILED—AND WHAT TO DO ABOUT IT 4-7, 10 (2009) (discussing ways by which the public sector can stimulate high potential new entities and criticizing the focus on size and existing institutions such as the Small Business Investment Company); Sean M. O’Connor, *The Central Role of Law as a Meta Method in Creativity and Entrepreneurship*, in CREATIVITY, LAW & ENTREPRENEURSHIP 87, 88 (Shubha Ghosh & Robin Paul Malloy eds., 2011) (“[A]n obsessive focus on ‘great works’—artifacts that stand the test of time—has obscured the proper role for innovation methods and meta methods. At the same time, some of the most contentious issues in IP today involve exclusive rights to lower levels of these methods such as business and tax method patents.”); see also *infra* note 39 and accompanying text.

14. The recent Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301-305, 126 Stat. 306, 315 (2012) was the first real stab at attempting to do so but attracted much criticism for failing to accomplish its goal. See Douglas W. Elmendorf, Director, Nat’l Bureau of Econ. Research, Presentation at the Kaufmann Foundation Conference on Federal Tax Policy and Entrepreneurship (Sept. 27, 2013) (examining federal policy options to increase innovation in the U.S.); see also Investing in Innovation for Education Act of 2015, H.R. 847, 114th Cong. (2015) (a bill to amend the Elementary and Secondary Education Act of 1965 to invest in innovation for education); Technology-Enabled Education Innovation Partnership Act, H.R. 566, 114th Cong. (2015) (a bill to award grants to improve

have outlined changes in the laws governing immigration, taxation and financial institutions, as well as contracts, torts, patents, education, land use, and other concerns.<sup>15</sup> They have focused on improving the range of property rights and the rule of law.<sup>16</sup> Yet, the question remains: To what degree are they successful in capturing the phenomenon?

All of these reform discussions lack something fundamental: they fail to recognize the contradicting nature of their topics. Legal rules impose duties and establish rights.<sup>17</sup> The practice of law seeks order and authority and the continuity of tradition.<sup>18</sup> Through causal reasoning, it advances an aim and pursues the means to achieve that aim.<sup>19</sup> Using logical deductions lawyers create legal models and doctrinal rules to apply to complex circumstances.<sup>20</sup> Law denotes the ex-

equality of access to technology-enabled education innovations); Accelerating Biomedical Research Act, S. 318, 114th Cong. (2015) (a bill to prioritize funding for the National Institutes of Health to discover treatments and cures, to maintain global leadership in medical innovation, and to restore the purchasing power the NIH had after the historic doubling campaign that ended in fiscal year 2003); Innovation Act, H.R. 9, 114th Cong. (2015) (a bill to make improvements and technical corrections, and for other purposes).

15. See generally RULES FOR GROWTH: PROMOTING INNOVATION AND GROWTH THROUGH LEGAL REFORM, *supra* note 4 (a book devoted to legal reform proposal to stimulate growth through innovation); Zoltan J. Acs & Laszlo Szerb, *Entrepreneurship, Economic Growth and Public Policy*, 28 SMALL BUS. ECON. 109, 113-16 (2007) (making policy recommendations including trade policy, immigration policy, access to foreign technology, education, science and technology policy, and, finally, litigation and regulation).

16. Sean M. O'Connor, *Controlling the Means of Innovation: The Centrality of Private Ordering Arrangements for Innovators and Entrepreneurs*, in HANDBOOK ON LAW, INNOVATION AND GROWTH 274 (Robert Litan ed., 2011) (maintaining that the confidential treatment of many private ordering arrangements limits access to crucial source material needed for research); James Bessen and Michael J. Meurer, *Do Patents Perform Like Property?* ACAD. MGMT. PERSP. 22 (2008); Smith & Ibrahim, *supra* note 9, at 1537-38; see also Peter J. Boettke & Christopher J. Coyne, *Entrepreneurship and Development: Cause or Consequence?*, 6 AUSTRIAN ECON. & ENTREP. STUD. 67, 77 (2003) ("The two most important 'core' institutions for encouraging entrepreneurship are well-defined property rights and the rule of law.").

17. See generally JOHN AUSTIN, *THE PROVINCE OF JURISPRUDENCE DETERMINED* (London, John Murray 1832) (identifying the essence of law with command: laws are orders backed by threats).

18. See, e.g., Paul W. Kahn, *Community in Contemporary Constitutional Theory*, 99 YALE L.J. 1, 84-85 (1989) (arguing that legal theory, which seeks truth through truly open discourse, and constitutional practice, which seeks order and authority and the continuity of tradition, will increasingly part ways).

19. See, e.g., JULES L. COLEMAN, *THE PRACTICE OF PRINCIPLE: IN DEFENCE OF A PRAGMATIST APPROACH TO LEGAL THEORY* 11 (2001) (arguing a social practice takes a causal-functional explanation and a Dworkinian interpretation); Paul H. Robinson, *Imputed Criminal Liability*, 93 YALE L.J. 609, 636 (1984) (arguing that some legal doctrines, such as felony murder, the Pinkerton doctrine, the natural and probable consequence rule, and vicarious liability, have been strongly criticized for imposition liability where the causal connection is weak).

20. See Jeffrey M. Lipshaw, *Why the Law of Entrepreneurship Barely Matters*, 31 W. NEW ENG. L. REV. 701, 705 (2009).

istence of norms that deliver sanctions and remedies when certain conditions hold.<sup>21</sup> It enforces rules and creates classifications that aim to direct behavior in a uniform manner.<sup>22</sup>

Entrepreneurship thrives on freedom and creativity.<sup>23</sup> Its essence is making judgments about the unknown.<sup>24</sup> Entrepreneurs make their decisions in a state of uncertainty, without being able to calculate the likelihood or probabilities of an imminent sequence of events.<sup>25</sup> Therefore, entrepreneurship involves the creative reading of

21. See, e.g., David Morris Phillips, *The Commercial Culpability Scale*, 92 YALE L.J. 228, 265 (1982) (“Once relative culpability is established, greater causal responsibility follows as a matter of law.”); Anthony J. Sebok, *Misunderstanding Positivism*, 93 MICH. L. REV. 2054, 2061-72 (1995) (providing a thorough history of basic tenets of legal positivism).

22. Martha A. Field, *Sources of Law: The Scope of Federal Common Law*, 99 HARV. L. REV. 881, 953 (1986) (“A dominant consideration is whether there is a need for a uniform national rule.”); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (arguing that the basic law of the corporate form aims to achieve a high degree of uniformity); Gary E. O’Connor, *Restatement (First) of Statutory Interpretation*, 7 N.Y.U. J. LEGIS. & PUB. POL’Y 333, 334 (2004) (advocating for incorporation of the “Restatement of Statutory Interpretation” as advancing clarity, uniformity, and conservation of judicial resources). *But see* Thomas E. Baker & Douglas D. McFarland, *The Need for a New National Court*, 100 HARV. L. REV. 1400, 1405 (1987) (“Were the Supreme Court’s primary task to correct errors of lower federal courts and state supreme courts and to achieve absolute uniformity in the national law, the Court would be doomed to failure.”).

23. Schumpeter famously was the first to refer to innovation as “creative destruction.” JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM & DEMOCRACY* 81-87 (5th ed. 1976); see also Brett M. Frischmann, *An Economic Theory of Infrastructure and Commons Management*, 89 MINN. L. REV. 917, 1018 (2005) (“[T]he social benefits of Internet-based innovation, creativity, cultural production, education, political discourse and so on are not confined to those who use the Internet; the social benefits spill over.”); R. Keith Sawyer, *The Western Cultural Model of Creativity: Its Influence on Intellectual Property Law*, 86 NOTRE DAME L. REV. 2027, 2052 (2011) (arguing that the Western cultural model conflicts with a scientific explanation of creativity and innovation); Mark C. Suchman, *Invention and Ritual: Notes on the Interrelation of Magic and Intellectual Property in Preiterate Societies*, 89 COLUM. L. REV. 1264, 1293 (1989) (“[S]uch magic-using collectivities restrict creative activity to a relatively small and socially isolated subgroup, buffering the society’s core technology from unproven techniques.”); R. Polk Wagner, *Information Wants to be Free: Intellectual Property and the Mythologies of Control*, 103 COLUM. L. REV. 995, 1001 (2003) (noting that creativity and invention is a profoundly dynamic process).

24. Oren Bar-Gill & Gideon Parchomovsky, *Law and the Boundaries of Technology-Intensive Firms*, 157 U. PA. L. REV. 1649, 1683 (2009) (noting that “[m]ost jurisdictions strictly require that an idea be absolutely and objectively novel—meaning unknown in the field in general—in order to receive protection.”); Linda J. Demaine & Aaron Xavier Fellmeth, *Reinventing the Double Helix: A Novel and Nonobvious Reconceptualization of the Biotechnology Patent*, 55 STAN. L. REV. 303, 451 (2002) (stating that innovation involves unexpected results and previously unknown circumstances); Richard T. Rapp, *The Misapplication of the Innovation Market Approach to Merger Analysis*, 64 ANTITRUST L.J. 19, 46 (1995) (“the optimal amount of R&D is unknown”). See generally LAWRENCE LESSIG, *THE FUTURE OF IDEAS: THE FATE OF THE COMMONS IN A CONNECTED WORLD* (2001) (alluding that market actors seek to protect themselves against innovation because it is an unknown).

25. Frank Knight distinguished between risk—events with likelihood that can be estimated probabilistically—and uncertainty—events with unknown likelihood. See FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 19-20 (1971); see also Ronald J. Gilson et al.,

the present and the imaginative prediction of the future.<sup>26</sup> It prospers on deviations as opposed to traditional causation, and it involves adapting to disarray.<sup>27</sup> In a state of disequilibrium, the entrepreneur's alertness discovers profitable opportunities to match unmet demand with untapped supply.<sup>28</sup> Therefore, entrepreneurs prefer legal structures that provide them with greater autonomy.<sup>29</sup>

This Article argues that these differences matter. The nature of a legal solution is essentially cognitive and causal; it does not address the effectual aspects of entrepreneurship. The friction between law and entrepreneurship creates significant distortionary effects.<sup>30</sup> Through theoretical discourse, this Article maintains that a new ap-

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*Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 433 n.2 (2009).

26. See, e.g., YOCHAI BENKLER, *THE WEALTH OF NETWORKS: HOW SOCIAL PRODUCTION TRANSFORMS MARKETS AND FREEDOM* 133 (2006) ("The emergence of the networked information economy has the potential to increase individual autonomy. First, it increases the range and diversity of things that individuals can do for and by themselves."); Jack M. Balkin, *Digital Speech and Democratic Culture: A Theory of Freedom of Expression for the Information Society*, 79 N.Y.U. L. REV. 1, 45-48 (2004).

27. Amir N. Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 COMP. LAB. L. & POL'Y J. 817, 819 (2007) ("[B]eyond seeking material success the crucial element in the entrepreneurial spirit is openness to change—an interest in the different and in new experiences while deemphasizing the safe and the proven."); Lipshaw, *supra* note 20, at 706 ("I suggest that entrepreneurs are far more at home with inconsistency and indeterminacy."); KNIGHT, *supra* note 25, at 269 (claiming that entrepreneurs differ in their intellectual capacity to decide what should be done, in their degree of confidence in their judgment, in their confidence and in how "venturesome [they are] to 'assume the risk' or 'insure' the doubtful and timid by guaranteeing to the latter a specified income in return for an assignment of the actual results").

28. See Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach*, 35 J. ECON. LIT. 60, 62 (1997) ("These positive elements focus on the role of knowledge and discovery in the process of market equilibration. In particular this approach (a) sees equilibration as a systematic process in which market participants acquire more and more accurate and complete *mutual knowledge* of potential demand and supply attitudes, and (b) sees the driving force behind this systematic process in what will be described below as *entrepreneurial discovery*").

29. Matthias Benz, *Entrepreneurship as a Non-Profit-Seeking Activity* 1 (Inst. for Empirical Res. in Econ., Univ. of Zurich, Working Paper No. 243, 2006), <http://ssrn.com/abstract=733283> ("Being an entrepreneur seems to be rather rewarding because it entails substantial non-monetary benefits, like greater autonomy, broader skill utilization, and the possibility to pursue one's own ideas."); see also Marco van Gelderen et al., *The Multiple Sources of Autonomy as a Startup Motive* (SCALES, Working Paper No. 200315, 2003), <http://www.ondernemerschap.nl/pdf-ez/N200315.pdf> (studying a sample of 167 nascent entrepreneurs motivated by autonomy and finding that beneath the surface of autonomy, entrepreneurs differ in their relative emphasis on the underlying sources of the autonomy motive); cf. Marco van Gelderen et al., *Explaining Entrepreneurial Intentions by Means of the Theory of Planned Behaviour*, 13 CAREER DEV. INT'L 538, 529 (2008) (examining empirically the entrepreneurial intentions of business students and concluding their main motives are entrepreneurial alertness and the importance attached to financial security).

30. Cf. Phillips, *supra* note 21, at 276 (claiming that certain tort rules consider causes for purposes of the causal contribution defense, resulting in the law discouraging plainly desirable commercial activity for no good reason).

proach is necessary. It contends that a legal culture that wishes to entice greater innovation is one that requires its legal agents to think like entrepreneurs. While some scholars have developed frameworks for crafting laws that facilitate entrepreneurship, they have mostly focused on theories of risk.<sup>31</sup> However, there is more to entrepreneurship than taking risks.

Legislators advocating for reform have been unable to make much collective headway in fully capturing the essence of entrepreneurship.<sup>32</sup> A fundamentally different type of outlook is needed. This Article takes an original approach to conceptualizing entrepreneurship by rethinking the process and visualizing it from the eyes of the entrepreneur. It offers a bridge between law and entrepreneurship by considering the four main elements that transmit entrepreneurship and that are inherent to the entrepreneur's agenda: knowledge intensity, transiency, uncertainty, and exit motive. It provides policy-makers with more comprehensive tools to recognize the distinctive *modus operandi* of entrepreneurship while proposing to reform the law.

Part II of this Article defines entrepreneurship as it is used in this paper and explains why entrepreneurs are worthy of receiving special attention in the law. Part III frames the entrepreneurship process and the various elements of entrepreneurial actions. Part IV isolates the distinct characteristics of the entrepreneurship process while Part V points to the dissonance between the nature of the law and entrepreneurship using as case studies organizational and bankruptcy classifications. More specifically, it illustrates the ways in which the legal system can facilitate entrepreneurial success or failure by viewing it through the lens of innovation. Part VI concludes by discussing the ways that this Article can stimulate future scholarship and empirical studies on the role law plays in the entrepreneurship process.

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31. See, e.g., *infra* note 39.

32. See, e.g., Edward C. Prescott & Lee E. Ohanian, *Behind the Productivity Plunge: Fewer Startups*, WALL ST. J. (Jun. 25, 2014, 7:07 PM), <http://www.wsj.com/articles/behind-the-productivity-plunge-fewer-startups-1403737197> (suggesting various reform proposals while criticizing the lack of success noting that “[i]n the absence of these reforms, there is little reason to believe that the depressed rate of new business creation will reverse itself”); Sudeep Reddy, *U.S. News: Jobs Panel Pushes Help for Start-Ups*, WALL ST. J., Oct. 11, 2011, at A4 (“We are sympathetic to the political sensitivities around the topic of immigration reform,” the members said in the report. “But when it comes to driving job creation and increasing American competitiveness, separating the highly-skilled worker component is critical. We therefore call upon Congress to pass reforms aimed directly at allowing the most promising foreign-born entrepreneurs to remain in or relocate to the United States.”).

## II. WHAT IS ENTREPRENEURSHIP AND WHY DOES IT MATTER?

### A. *Defining Entrepreneurship*

The concepts of entrepreneurship and innovation play central roles in this Article. It will be helpful, therefore, to clarify the meaning of these terms at the outset. Entrepreneurship has many potential connotations; the implications of the term are widely varied. The concept of “entrepreneur” was first mentioned in the seventeenth century by scholars such as Irish-French economist Richard Cantillon and French economist Jean-Baptiste Say.<sup>33</sup> Cantillon defined the entrepreneur as “the agent who buys means of production at certain prices . . . that are uncertain at the moment.”<sup>34</sup> Say portrayed the entrepreneur as the agent “who unites all these means of production, and who finds . . . the value of the products.”<sup>35</sup> Following Cantillon and Say, other theorists began to distinguish between ordinary businessmen and entrepreneurs.<sup>36</sup> The work of Mises stressed the dynamic and competitive entrepreneurial process, while Hayek stressed the informational processing capability of the market economy.<sup>37</sup>

Today, however, anyone can be considered an entrepreneur. Entrepreneurship may refer to individuals, groups, or firms, whether small or large, private or public, domestic or international. It can involve moral or social, political or educational, individual, or collective characteristics.<sup>38</sup> It may have distinct characteristics such as

33. See JOSEPH A. SCHUMPETER, *Economic Theory and Entrepreneurial History* (1949), reprinted in *ESSAYS ON ENTREPRENEURS, INNOVATIONS, BUSINESS CYCLES, AND THE EVOLUTION OF CAPITALISM* 260 (Richard V. Clemence ed., 1989) [hereinafter SCHUMPETER, *Economic Theory*]. Schumpeter also criticized Say's contribution to the theory of entrepreneurship describing it as “the pithy statement that the entrepreneur's function is to *combine* the factors of production into a producing organism. Such a statement may indeed mean much or little. He certainly failed to make full use of it and presumably did not see all its analytic possibilities.” JOSEPH A. SCHUMPETER, *HISTORY OF ECONOMIC ANALYSIS* 555 (1954) [hereinafter SCHUMPETER, *HISTORY*] (footnote omitted).

34. SCHUMPETER, *Economic Theory*, *supra* note 33, at 254; see also SCHUMPETER, *HISTORY*, *supra* note 33, at 555.

35. JEAN-BAPTISTE SAY, *CATECHISM OF POLITICAL ECONOMY* 28 (John Richter trans., London, Sherwood, Neely, & Jones 1816).

36. For a survey of the history of the definition, see Steven H. Hobbs, *Toward a Theory of Law and Entrepreneurship*, 26 CAP. U. L. REV. 241, 242 (1997). For a historical overview of Austrian School of Economics on the topic of entrepreneurship and innovation, see Peter J. Boettke, *Information and Knowledge: Austrian Economics in Search of its Uniqueness*, 15 REV. AUSTRIAN ECON. 263, 263-74 (2002).

37. LUDWIG VON MISES, *HUMAN ACTION: A TREATISE ON ECONOMICS* 253 (3d ed. 1966) (arguing that the functions of the entrepreneur, the landowner, the capitalist, and the worker are very often combined by the same person); F. A. von Hayek, *Economics and Knowledge*, 4 *ECONOMICA* 33, 34 (1937).

38. See, e.g., David E. Pozen, *We Are All Entrepreneurs Now*, 43 WAKE FOREST L. REV. 283, 283 (2008) (“Nowadays, ‘social entrepreneurs’ tackle civic problems through innovative methods, ‘policy entrepreneurs’ promote new forms of government action, ‘norm entre-

creativity and risk-taking.<sup>39</sup> Many factors, including independence, confidence, and resilience, have been found to affect entrepreneurial decisions to take risks and be innovative.<sup>40</sup> Yet no agreement exists today on the qualities that are inherent to the entrepreneurial persona.<sup>41</sup>

Notwithstanding the proliferation of the term, this Article will focus on theorizing the economic entrepreneurial phenomenon as a *process* and isolating its distinct traits. In this Article, “innovation” denotes a process through which economic leaders (referred to as “entrepreneurs”) act “entrepreneurially” by way of discovering and im-

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preneurs’ seek to change the way society thinks or behaves, and ‘moral entrepreneurs’ try to alter the boundaries of duty or compassion. ‘Ethnification entrepreneurs,’ ‘polarization entrepreneurs,’ and other newfangled spinoffs pursue more discrete objectives. Entrepreneurial rhetoric has never been so trendy or so plastic.”); Pramodita Sharma & James J. Chrisman, *Toward a Reconciliation of the Definitional Issues in the Field of Corporate Entrepreneurship*, 23 ENTREPRENEURSHIP: THEORY & PRAC. 11, 12 (1999) (“Entrepreneurship has meant different things to different people.”).

39. On the entrepreneurial spirit and an overview of the psychological theories of entrepreneurial attributes, see Licht, *supra* note 27, at 832 (“Entrepreneurs are indeed special individuals in that they tend to exhibit a particular combination of psychological attributes compatible with their role in the economy as new venture creators. Needless to say, this does not mean that all entrepreneurs exhibit these attributes equally strongly during their entire career.”); see also Edward P. Lazear, *Balanced Skills and Entrepreneurship*, 94 AM. ECON. REV. 208 (2004); Viktor Mayer-Schönberger, *The Law As Stimulus: The Role of Law in Fostering Innovative Entrepreneurship*, 6 INFO. SOC’Y J.L. & POL’Y 153, 170 (2010) (“[Entrepreneurs] are somehow better than the average human . . . they are better able to evaluate risks and rewards.”); Manju Puri & David T. Robinson, *Who Are Entrepreneurs and Why Do They Behave That Way* (unpublished manuscript), [http://www.lse.ac.uk/fmg/documents/events/conferences/2006/comparativeAdvantage/751\\_Puri\\_Manju.pdf](http://www.lse.ac.uk/fmg/documents/events/conferences/2006/comparativeAdvantage/751_Puri_Manju.pdf) (last visited Mar. 15, 2016). In the beginning of his writing, Schumpeter emphasized individual-level psychological factors to explain the behavior of the entrepreneur but later moved to a social level explanation underlying collective level. *Introduction to THE ENTREPRENEUR: CLASSIC TEXTS BY JOSEPH A. SCHUMPETER* 1, 16 (Markus C. Becker et al. eds., 2011).

40. See, e.g., Licht, *supra* note 27, at 823 (“[P]eople differ in the qualities necessary to engage in entrepreneurship. Relative to the average person, the entrepreneur is therefore particularly ‘venturesome’ . . .”) (footnote omitted); see also Robert H. Brockhaus, Sr., *Risk Taking Propensity of Entrepreneurs*, 23 ACAD. MGMT. J. 509 (1980).

41. See Larry T. Garvin, *Small Business and the False Dichotomies of Contract Law*, 40 WAKE FOREST L. REV. 295, 337 (2005) (describing studies using the Myers-Briggs Type Indicator to categorize entrepreneurial personality types); Pozen, *supra* note 38, at 293 (“Many have linked entrepreneurship to economic growth and to a characteristic menu of personality traits.”); Hao Zhao et al., *The Relationship of Personality to Entrepreneurial Intentions and Performance: A Meta-Analytic Review*, 36 J. MGMT. 381, 392-94 (2010); see also Carl P. Kaiser, *Entrepreneurship and Resource Allocation*, 16 E. ECON. J. 9, 10 (1990) (“[P]rospective entrepreneurs will differ with respect to how much risk they are willing to bear, and with respect to how much utility they receive from undertaking ‘their own’ projects. Accordingly, the rate of return required by an individual to undertake a given venture is determined by the individual’s opportunity rate of return, the degree to which the individual prefers risk, and the degree to which the individual receives utility from the act of creating a new enterprise and exercising complete and absolute control over the venture.”).

plementing knowledge of value.<sup>42</sup> The type of entrepreneurship that is relevant for this purpose is that which contributes to economic development.<sup>43</sup> Economists called for a distinction between different types of businesses.<sup>44</sup> They differentiated between necessity entrepreneurship, which is created because of a lack of other employment options, and opportunity entrepreneurship, which is an active choice to pursue an unexploited or underexploited business opportunity. Others found that necessity entrepreneurship causes negative GDP growth, while opportunity entrepreneurship has a positive and significant effect on economic development.<sup>45</sup> A nation's economic development, they concluded, depends on successful opportunity entrepreneurship combined with the force of established corporations.<sup>46</sup>

Accordingly, entrepreneurship in this Article refers to the actions of for-profit firms or sole proprietors that are innovative, rather than imitative, and more likely to contribute to economic growth.<sup>47</sup> Undoubtedly, the actions of social entrepreneurs and non-for-profit organizations are extremely valuable in society.<sup>48</sup> Yet these types of ac-

42. For similar delineations, see *THE ENTREPRENEUR*, *supra* note 39, at 67.

43. See D. Gordon Smith & Masako Ueda, *Law & Entrepreneurship: Do Courts Matter?*, 1 *ENTREPRENEURIAL BUS. L.J.* 353, 357 (2007) ("While various disciplines study issues relating to entrepreneurship, such as the characteristics of entrepreneurs or the performance of entrepreneurial firms, law and entrepreneurship studies should focus on the study of the optimal legal structures that facilitate the commercialization of entrepreneurial opportunities, as well as the regulation of entrepreneurial firms.") (footnotes omitted).

44. KARL MARX, 1 *CAPITAL: A CRITIQUE OF POLITICAL ECONOMY* 293 (Samuel Moore & Edward Aveling trans., Frederick Engels ed., Charles Kerr & Co. 1994) (1867) (comparing entrepreneurs to capitalists); see also Zoltan Acs, *How Is Entrepreneurship Good for Economic Growth?*, 1 *INNOVATIONS* 97, 98 (2006); John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 *ARIZ. ST. L.J.* 861, 863 (2005) (differentiating between entrepreneurial entities and livelihood businesses, describing the latter as "job churners"); Erik P.M. Vermeulen, *Corporate Governance in a Networked Age*, 50 *WAKE FOREST L. REV.* 711, 729 (2015) (noting that there is a distinction between entrepreneur and investor, "opportunity-driven" and "operationally driven" leaders).

45. Acs, *supra* note 44, at 99.

46. *Id.* at 97, 104; see also Zoltan J. Acs, "Entrepreneurial Capitalism" in *Capitalist Development: Toward a Synthesis of Capitalist Development and the "Economy as a Whole,"* in *ENTREPRENEURSHIP, GROWTH, AND PUBLIC POLICY* 319, 319 (Zoltan J. Acs et al. eds., 2009).

47. See William J. Baumol, *Return of the Invisible Men: The Microeconomic Value Theory of Inventors and Entrepreneurs* 2-3, Paper Presented at the American Economic Association Annual Meeting (Jan. 7, 2006). Schumpeter clarified that the deployment of existing resources in an ordinary manner is not a new combination. JOSEPH A. SCHUMPETER, *The Theory of Economic Development* (1934), reprinted in *THE ENTREPRENEUR*, *supra* note 39, at 50 [hereinafter SCHUMPETER, *The Theory*]; JOSEPH A. SCHUMPETER, *Entrepreneur* (1928), reprinted in *THE ENTREPRENEUR*, *supra* note 39, at 245 [hereinafter SCHUMPETER, *Entrepreneur*].

48. See Pozen, *supra* note 38, at 283 ("People who tackle civic problems through innovative methods are 'social entrepreneurs.'"); Usha Rodrigues, *Entity and Identity*, 60 *EMORY L.J.* 1257, 1279 (2011) (arguing that the nonprofit form can create a special "warm-

tors require a different set of incentives and characteristics and are a topic for a separate paper. Instead, this Article relies on the Schumpeterian definition of entrepreneurship as combining resources and creating new market demands that lead to large economic gains.<sup>49</sup> It focuses on differentiating between ordinary businessmen and entrepreneurs based on the extent and nature of their actions, their motives, and the conditions in which they act.<sup>50</sup> While identifying entrepreneurial firms from others is not an easy task, studies focused on the actions of firms that invest a high proportion of their income in knowledge procurement in hope of deriving profits and expanding their labor force.<sup>51</sup> The next Section will further discuss these aspects after establishing the importance of entrepreneurship to the economy.

### B. *The Significance of Entrepreneurship to the Economy*

Law is a key conduit for Congress to support entrepreneurship.<sup>52</sup> Every commercial process can enjoy a legal system that emphasizes balance, flexibility, and predictability. What is it about the entrepreneurship process that merits distinct consideration? The answer is simple: entrepreneurship is the driving force of economic development.<sup>53</sup> From 1980–2005, firms less than five years old accounted for nearly all net job growth in the country, and in 2007 alone, these

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glow” identity that cannot be replicated by the for-profit form). The author later notes that some call a social entrepreneur anyone who starts a nonprofit organization. *Id.* at 294; see also Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 *FORDHAM L. REV.* 2437, 2463-64 (2005) (providing a taxonomy of social entrepreneurship, non-profits and “venture philanthropy”); Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 *EMORY L.J.* 681, 690 (2013) (describing the new forms of social enterprises such as the low-profit limited liability company (L3C), benefit corporation, and flexible purpose corporation (FPC) as a forum for social entrepreneurs to safely proclaim their blended missions proudly); Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with Fly Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 *B.C. L. REV.* 1495, 1544 (2013) (describing the phenomenon of the social enterprise).

49. SCHUMPETER, *The Theory*, *supra* note 47.

50. See *infra* Part IV.

51. For an attempt of providing a model that identifies entrepreneurial firms, see Mirit Eyal-Cohen, *Legal Mirrors of Entrepreneurship*, 55 *B.C. L. REV.* 719, 740 (2014).

52. SCHUMPETER, *The Theory*, *supra* note 47, at 55.

53. See PETER F. DRUCKER, *INNOVATION AND ENTREPRENEURSHIP: PRACTICE AND PRINCIPLES* 21-22 (1985); PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 10 (2d ed. 2004) (examining empirically the various aspects of economic contribution of venture capital); ISRAEL M. KIRZNER, *COMPETITION AND ENTREPRENEURSHIP* 81 (1973) (arguing that entrepreneurship is important primarily in enabling the market process to work itself out in all contexts); KNIGHT, *supra* note 25, at 41 (claiming that the entrepreneur plays a unique importance in a productive economy); JOSEPH A. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST, AND THE BUSINESS CYCLE* 74 (1955) (referring to entrepreneurship as the “fundamental phenomenon of economic development”).

same young firms accounted for nearly two-thirds of job creation.<sup>54</sup> Accordingly, a government that emphasizes the promotion of (or the removal of restrictions to) economic growth should focus on the elements that yield such an outcome.

F. A. Von Hayek and Ludwig Von Mises, the founders of the Austrian School of economics, portrayed entrepreneurs as responsible for creating economic cycles. Hayek perceived entrepreneurs as forward-looking and responsible for market innovation.<sup>55</sup> Mises portrayed the entrepreneur as the “acting man” who is “exclusively seen from the aspect of the uncertainty inherent in every action,” that, when correct, leads to growth and prosperity.<sup>56</sup> They both held that upward economic movements are the result of means of production and labor devoted to new enterprises.<sup>57</sup>

Joseph Schumpeter is considered the leading economist of the Austrian School of Economics and the sire of entrepreneurship theory.<sup>58</sup> In his essay, *The Analysis of Economic Change*,<sup>59</sup> he presented his view of the economic process.<sup>60</sup> He portrayed economic development as a dynamic process of change through “Creative Destruction.”<sup>61</sup> The circular flow of economic life, he claimed, evolves through a process of cycles of punctuated equilibria disrupted by sudden leaps of endogenous innovations.<sup>62</sup> According to Schumpeter, entrepreneurship is the destabilizing force and principle agent of change in economy.<sup>63</sup> Entrepreneurs are special because they create “new combinations,” namely by introducing new products, developing new methods

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54. See John Haltiwanger et al., *Who Creates Jobs? Small Versus Large Versus Young*, 95 REV. ECON. & STAT. 347, 360 (2013); *Global Entrepreneurship Week*, FED. NEWS FEED (Dec. 15, 2015, 4:51 PM).

55. Hayek, *supra* note 37, at 33.

56. VON MISES, *supra* note 37, at 253 (stating that “the term entrepreneur as used by catallactic theory means: acting man exclusively seen from the aspect of the uncertainty inherent in every action”).

57. Ludwig Von Mises, *The “Austrian” Theory of the Trade Cycle* (1936), reprinted in *THE AUSTRIAN THEORY OF THE TRADE CYCLE AND OTHER ESSAYS* 25, 29 (1996).

58. See *THE ENTREPRENEUR*, *supra* note 39, at 4 (noting that Schumpeter’s most famous work is on the theory of entrepreneurship).

59. Joseph A. Schumpeter, *The Analysis of Economic Change*, 17 REV. ECON. & STAT. 2 (1935).

60. *Id.*; see also SCHUMPETER, *The Theory*, *supra* note 47 (“Development in our sense is then defined by the carrying out of new combinations.”).

61. SCHUMPETER, *supra* note 23.

62. Pozen, *supra* note 38, at 290-91; see also *THE ENTREPRENEUR*, *supra* note 39, at 18 (stating that in the book *Capitalism, Socialism and Democracy*, Schumpeter describes the economic process as a long period of stability interrupted by shocks that are followed by a period of static economy).

63. SCHUMPETER, *Economic Theory*, *supra* note 33, at 262-63 (“What we observe is . . . the effects of entrepreneurial activity upon the industrial structure that exists at any moment . . .”).

of production, devising new business models, and creating new markets—creations that confront and eventually defeat previously existing economic orders.<sup>64</sup> By implementing innovations, entrepreneurs destroy the basis for the old economy while paving the way to a new economic order of prosperity and welfare.<sup>65</sup>

Contemporary economic theorist William Baumol emphasized the importance of entrepreneurship in stimulating growth.<sup>66</sup> Baumol argued that economic evolution is dependent on two determinants: innovations and entrepreneurs.<sup>67</sup> He argued that entrepreneurs are responsible for revolutionary breakthroughs.<sup>68</sup> He attributed the success of the capitalist economy primarily to competitive pressures by these players, with innovation as their prime weapon.<sup>69</sup> Cutting-edge innovation, rather than pricing and economies of scale, is the key to economic success.<sup>70</sup> Rapid diffusion of innovation throughout the economy, he argued, ultimately results in economic growth.<sup>71</sup>

Economist Israel Kirzner also portrayed entrepreneurship as a function of innovation and economic evolution.<sup>72</sup> He observed economic growth as originating from entrepreneurial activity.<sup>73</sup> He argued that the market state of disequilibrium creates opportunities for entrepreneurs.<sup>74</sup> In his view, economic development is driven by entre-

64. SCHUMPETER, *supra* note 53.

65. *See id.* at 74-75.

66. *See* WILLIAM J. BAUMOL, *THE FREE MARKET INNOVATION MACHINE: ANALYZING THE GROWTH MIRACLE OF CAPITALISM 2* (2002) (“[O]nce capitalism was in place and fully operational, a flow of innovation and the consequent rise in productivity and per capita gross domestic product were to be expected. Whatever the deficiencies of the free market, it is certainly very good at one thing: the manufacture of economic growth.”); William J. Baumol, *Entrepreneurship: Productive, Unproductive, and Destructive*, 11 J. BUS. VENTURING 3, 4 (1996); William J. Baumol, *Formal Entrepreneurship Theory in Economics: Existence and Bounds*, 8 J. BUS. VENTURING 197, 198 (1993).

67. *See* William J. Baumol, *Entrepreneurship in Economic Theory*, 58 AM. ECON. REV. 64-66 (1968).

68. *See* BAUMOL, *supra* note 66, at 30-31.

69. *Id.* at 12-15.

70. *Id.* at 3-4 (“It is clear that innovation plays a far larger role in the activities of many key firms and industries than the current theoretical literature takes into account.”).

71. Baumol points to the computer industry for example, “whose new and improved models appear constantly, each manufacturer battling to stay ahead of its rivals.” *Id.* at 4.

72. *See* KIRZNER, *supra* note 53, at 81; *see also* Kirzner, *supra* note 28, at 67.

73. *See* ISRAEL M. KIRZNER, *THE MEANING OF MARKET PROCESS: ESSAYS IN THE DEVELOPMENT OF MODERN AUSTRIAN ECONOMICS 5* (1992). Kirzner was a student of Ludwig von Mises, another one of the key contributors to the Austrian economic school of thought. For a review of Austrian school of economics literature, see Boettke, *supra* note 36 at 263-74.

74. *See* KIRZNER, *supra* note 53, at 81. *See generally* ISRAEL M. KIRZNER, *DISCOVERY AND THE CAPITALIST PROCESS* (1985) [hereinafter KIRZNER, *DISCOVERY*] (expanding the work of Mises and Hayek, Kirzner establishes the importance of entrepreneurial alertness to profit opportunities); ISRAEL M. KIRZNER, *THE DRIVING FORCE OF THE MARKET: ESSAYS*

preneurs who act as agents responsible for equilibrating the market.<sup>75</sup> Entrepreneurs are unique in that they can identify and grasp opportunities ignored by others.<sup>76</sup>

Scholars today continue the Austrian School's central view of entrepreneurship as a central determinant to stimulate an economy.<sup>77</sup> They have illustrated that young, entrepreneurial firms are the engine of employment growth in the United States.<sup>78</sup> On the other hand, studies have indicated that intrapreneurship (entrepreneurial divisions or employees within large or established firms) is also responsible for developing vigorous internal entrepreneurship.<sup>79</sup> Thus, it is the entrepreneurial character of the firm that matters, not its size.<sup>80</sup> American economist and Nobel laureate Robert Solow acknowledged that long-term economic growth has moved to the top of the political and intellectual agenda.<sup>81</sup> His work continued to establish the primacy of innovations as responsible for economic growth through increases in output per worker.<sup>82</sup> Scholars from the New Keynesian School of Economics, such as Carl Shapiro, Joseph Stiglitz, and Paul Romer also emphasized the central role of technological progress in economic development.<sup>83</sup> Throughout history many

IN AUSTRIAN ECONOMICS (2d ed. 2002) (continuing the Mises-Hayek legacy and examining the market economy and theories of Competition and Entrepreneurship).

75. See ISRAEL M. KIRZNER, PERCEPTION, OPPORTUNITY, AND PROFIT: STUDIES IN THE THEORY OF ENTREPRENEURSHIP 110-11 (1979).

76. *Id.* at 109 (“[T]he essence of the entrepreneurial decision consists in *grasping* the knowledge that might otherwise remain unexploited.”).

77. Licht, *supra* note 27, at 821 & n.9 (surveying the modern literature holding innovation key to economic development).

78. See John Haltiwanger, *Entrepreneurship and Job Growth*, in ENTREPRENEURSHIP, GROWTH, AND PUBLIC POLICY, *supra* note 46, at 119, 119.

79. See generally Karina Skovvang Christensen, *Enabling Intrapreneurship: The Case of a Knowledge-Intensive Industrial Company*, 8 EUR. J. INNOVATION MGMT. 305 (2005) (describing the phenomenon of intrapreneurship in a large knowledge-intensive industrial firm); see also Arshad M. Khan & V. Manopichetwattana, *Innovative and Noninnovative Small Firms: Types and Characteristics*, 35 MGMT. SCI. 597, 598 (1989); Smith & Ueda, *supra* note 43, at 356.

80. See generally Mirit Eyal-Cohen, *Down-Sizing the “Little Guy” Myth in Legal Definitions*, 98 IOWA L. REV. 1041, 1045-46 (2013) (arguing that current legal demarcations concentrated on “smallness” generate undesirable distributional effects, produce inefficient allocation of government resources, and defeat policy considerations of promoting entrepreneurship and economic growth).

81. Robert Solow, *Robert Solow on Joseph Schumpeter*, ECONOMIST'S VIEW (May 17, 2007), [http://economistsview.typepad.com/economistsview/2007/05/robert\\_solow\\_on.html](http://economistsview.typepad.com/economistsview/2007/05/robert_solow_on.html) (reviewing Thomas K. McCraw, *Prophet of Innovation: Joseph Schumpeter and Creative Destruction*).

82. See *id.*

83. See generally NEW DEVELOPMENTS IN THE ANALYSIS OF MARKET STRUCTURE (Joseph E. Stiglitz & G. Frank Mathewson eds., 1986) (containing sixteen essays that test economic development hypotheses); Paul M. Romer, *The Origins of Endogenous Growth*, 8

economists from different schools of thought postulated that entrepreneurial change is a core variable of economic growth driven by the introduction of innovation by entrepreneurs.<sup>84</sup> Entrepreneurship, they contended, contributes to growth by creating new businesses and jobs, intensifying competition, and increasing productivity.<sup>85</sup>

A vast amount of empirical research has established that entrepreneurship can facilitate growth through dissipation of knowledge.<sup>86</sup> Steven Klepper recently reiterated these ideas in a study on knowledge spillover in Silicon Valley.<sup>87</sup> He showed that in open markets with free market-entry entrepreneurs function as a conduit for facilitating the spillover of knowledge. They take knowledge that might otherwise have remained uncommercialized and use it to launch new products.<sup>88</sup> Other scholars, such as Lemley, Jaffe,

J. ECON. PERSP. 3 (1994) (offering an assessment of scale-variant Schumpeterian growth model).

84. See Horst Hanusch & Andreas Pyka, *Principles of Neo-Schumpeterian Economics*, 31 CAMBRIDGE J. ECON. 275, 275 (2007). See generally Horst Hanusch et al., *A Neo-Schumpeterian Approach Towards Public Sector Economics* (Universität Augsburg, Institute for Economics, Discussion Paper Series No. 306, 2009), <http://ideas.repec.org/s/aug/ausgsbe.html>.

85. See CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL 86 (1997) (contending that established firms are captive to the financial structure and organizational culture inherent in the value network in which they compete—a capacity that can block any rationale for timely investment in the next wave of destructive technology).

86. See, e.g., DAVID B. AUDRETSCH ET AL., ENTREPRENEURSHIP AND ECONOMIC GROWTH 5 (2006); ANDRÉ VAN STEL, EMPIRICAL ANALYSIS OF ENTREPRENEURSHIP AND ECONOMIC GROWTH 1 (2006) (“The importance of entrepreneurship for achieving economic growth in contemporary economies is widely recognized, both by policy makers and economists.”); Zoltan J. Acs et al., *The Knowledge Spillover Theory of Entrepreneurship*, 32 SMALL BUS. ECON. 15 (2009); Ricardo J. Caballero & Adam B. Jaffe, *How High Are the Giants’ Shoulders: An Empirical Assessment of Knowledge Spillovers and Creative Destruction in a Model of Economic Growth*, 8 NBER MACROECONOMICS ANNUAL 15 (1993); see also David B. Audretsch & Maryann P. Feldman, *Knowledge Spillovers and the Geography of Innovation*, in 4 HANDBOOK OF REGIONAL AND URBAN ECONOMICS 2713, 2714 (2004); Brett Anitra Gilbert et al., *Clusters, Knowledge Spillovers and New Venture Performance: An Empirical Examination*, 23 J. BUS. VENTURING 405, 406 (2008); Zvi Griliches, *The Search for R&D Spillovers* (Nat’l Bureau of Econ. Research, Working Paper No. 3768, 1991), <http://www.nber.org/papers/w3768>. See generally ENTREPRENEURSHIP, INNOVATION, AND THE GROWTH MECHANISM OF THE FREE-ENTERPRISE ECONOMIES (Eytan Sheshinski et al. eds., 2007).

87. Steven Klepper, *Silicon Valley, A Chip off the Old Detroit Bloc*, in ENTREPRENEURSHIP, GROWTH, AND PUBLIC POLICY, *supra* note 46, at 79, 79-81 (contending that entrepreneurs function as a conduit for facilitating spillover of knowledge, as they take knowledge that might otherwise have remained uncommercialized).

88. See *id.* at 80; see also Rajshree Agarwal et al., *The Process of Creative Construction: Knowledge Spillovers, Entrepreneurship, and Economic Growth*, 1 STRATEGIC ENTREPRENEURSHIP J. 263, 263 (2007) (discussing how entrepreneurial ideas and opportunities are generated and how knowledge spillovers create a process of creative construction).

Thompson, and Shane, contended that entrepreneurship not only facilitates technological change but also generates opportunities for third-party firms, thereby driving regional development.<sup>89</sup>

Zoltan J. Acs and David B. Audretsch argued that innovation capital leads to a higher level of economic growth and is instrumental in providing a missing link in the development of the economy.<sup>90</sup> Entrepreneurship is important in commercializing investments in knowledge and ideas that might otherwise have remained untapped.<sup>91</sup> It contributes to economic growth by creating new jobs, intensifying competition, and increasing productivity.<sup>92</sup> As knowledge context increases, spillover effects stimulate more entrepreneurship.<sup>93</sup>

Indeed, from 1948–2012, “over half of the total increase in U.S. productivity growth, a key driver of economic growth, came from innovation and technological change.”<sup>94</sup> Economic recovery has accelerated in recent years, growing from “2.8 percent over the past two years, compared with 2.1 percent over the first three-and-a-half years of the recovery.”<sup>95</sup> The U.S. “labor market is in the midst of the longest stretch of monthly job growth on record.”<sup>96</sup> Realizing the significance of entrepreneurship to the economy, the next Part models its progression.

89. See Brett M. Frischmann & Mark A. Lemley, *Spillovers*, 107 COLUM. L. REV. 257 (2006); Adam B. Jaffe et al., *Geographic Localization of Knowledge Spillovers as Evidenced by Patent Citations*, 108 Q.J. ECON. 577, 577-98 (1993); Scott Shane, *Technological Opportunities and New Firm Creation*, 47 MGMT. SCI. 205, 205-20 (2001); Peter Thompson & Melanie Fox-Kean, *Patent Citations and the Geography of Knowledge Spillovers: A Reassessment*, 95 AM. ECON. REV. 450, 450-60 (2005).

90. See generally, e.g., AUDRETSCH ET AL., *supra* note 86; Zoltan J. Acs et al., *Why Entrepreneurship Matters*, in ENTREPRENEURSHIP, GROWTH, AND PUBLIC POLICY, *supra* note 46, at 1.

91. Acs et al., *supra* note 90, at 8; see also CHRISTENSEN, *supra* note 85, at 86 (contending that established firms are captive to the financial structure and organizational culture inherent in the value network in which they compete—a capacity that can block any rationale for timely investment in the next wave of destructive technology).

92. See CHRISTENSEN, *supra* note 85, at 86 (arguing that established firms are captive to the financial structure and organizational culture inherent in the value network in which they compete—a capacity that can block any rationale for timely investment in the next wave of destructive technology).

93. See generally AUDRETSCH ET AL., *supra* note 86; Acs et al., *supra* note 90.

94. White House Office of the Press Sec’y, *Fact Sheet: The White House Releases New Strategy for American Innovation, Announces Areas of Opportunity from Self-Driving Cars to Smart Cities* (Oct. 21, 2015), <https://www.whitehouse.gov/the-press-office/2015/10/21/fact-sheet-white-house-releases-new-strategy-american-innovation>.

95. Jason Furman, Chairman, Council of Econ. Advisers, Remarks at The Brookings Institution: Trade, Innovation, and Economic Growth 1 (Apr. 8, 2015), [https://www.whitehouse.gov/sites/default/files/docs/20150408\\_trade\\_innovation\\_growth\\_brookings.pdf](https://www.whitehouse.gov/sites/default/files/docs/20150408_trade_innovation_growth_brookings.pdf).

96. *Id.*

### III. THE ENTREPRENEURSHIP PROCESS

Innovation is a function of economic evolution.<sup>97</sup> Over the last few decades, a vast amount of literature has been developed that establishes the characteristics of individual entrepreneurs, especially from a psychological perspective.<sup>98</sup> This type of scholarship portrays entrepreneurs as special individuals who tend to exhibit a particular combination of traits that enable them to assume the role of innovators.<sup>99</sup> Such literature has emphasized that entrepreneurs are better able to understand and evaluate certain risks and their returns.<sup>100</sup> Factors such as independence, creativity, confidence, and resilience were found to affect an entrepreneur's decision to take risks and be innovative.<sup>101</sup> Yet to date, there is no agreement on the qualities that are necessary for entrepreneurs to be successful.<sup>102</sup>

It is difficult to isolate human actions that fully capture entrepreneurial elements. Behind every entrepreneurial firm are individuals

97. Cf. Kirzner, *supra* note 28, at 67 (discussing how the modern Austrian economists learned to "see the market as an *entrepreneurially* driven process" and to "appreciate the role of *knowledge* and its enhancement through market interaction").

98. See, e.g., Licht, *supra* note 27, at 832 ("Entrepreneurs are indeed special individuals in that they tend to exhibit a particular combination of psychological attributes compatible with their role in the economy as new venture creators. Needless to say, this does not mean that all entrepreneurs exhibit these attributes equally strongly during their entire career."). In the beginning of his writing, Schumpeter emphasized individual-level psychological factors to explain the behavior of the entrepreneur but later moved to a social level explanation underlying the collective level. THE ENTREPRENEUR, *supra* note 39, at 16.

99. See, e.g., G.T. Lumpkin & Gregory G. Dess, *Clarifying the Entrepreneurial Orientation Construct and Linking It to Performance*, 21 ACAD. MGMT. REV. 135 (1996) (proposing contingency framework for investigating the relationship between entrepreneurial orientation and firm performance.).

100. Mayer-Schönberger, *supra* note 39, at 170 ("[Entrepreneurs] are somehow better than the average human . . . [T]hey are better able to evaluate risks and rewards."). Other studies found that entrepreneurs are usually able to identify opportunities due to their knowledge in a particular sector or industry and therefore perceive lower risks than others do. See generally, e.g., Daniel Ellsberg, *Risk, Ambiguity, and the Savage Axioms*, 75 Q.J. ECON. 643 (1961); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

101. See Licht, *supra* note 27, at 823 ("Like Schumpeter and previous writers, Knight too believed that people differ in the qualities necessary to engage in entrepreneurship. Relative to the average person, the entrepreneur is therefore particularly 'venturesome,' self-confident, and tends to act independently on her own opinion.") (footnote omitted). Yet, economists, such as Brockhaus, that followed Schumpeter's theory argued that risk-taking behavior cannot be used as a distinguishing characteristic of entrepreneurship. Brockhaus, *supra* note 40, at 509.

102. See Kaiser, *supra* note 41, at 10 ("[P]rospective entrepreneurs will differ with respect to how much risk they are willing to bear, and with respect to how much utility they receive from undertaking 'their own' projects. Accordingly, the rate of return required by an individual to undertake a given venture is determined by the individual's opportunity rate of return, the degree to which the individual prefers risk, and the degree to which the individual receives utility from the act of creating a new enterprise and exercising complete and absolute control over the venture.").

or groups of people with unique characteristics and entrepreneurial spirits. Regulating the commercialization of entrepreneurial opportunities is mostly administrable at the entity level.<sup>103</sup> Actions, rather than psychological attributes, are what give meaning to the entrepreneurship process.<sup>104</sup> Accordingly, this Part will consider entrepreneurship from the womb to the tomb. It will unfold the entrepreneurship process and frame it in four main stages: discovery, concept development, implementation, and harvesting success or failure.

### A. *Discovery of Opportunities*

The main element that distinguishes the entrepreneurship process from other business undertakings is novelty.<sup>105</sup> Decision-making in the business context involves entrepreneurial and non-entrepreneurial actions. The latter usually entails the task of calculation,<sup>106</sup> the deployment of production factors that happen to be unused, or the readjustment of production means.<sup>107</sup> The entrepreneurial aspect of decision-making is discovery.<sup>108</sup> Innovative ideas challenge the current body of knowledge and eventually push society forward by destroying old premises.<sup>109</sup> Discovery is a self-determining decision to carry out "new combinations" by introducing new products, new markets, or deploying existing means of production in a unique way.<sup>110</sup>

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103. Smith & Ueda, *supra* note 43, at 356-57 ("While various disciplines study issues relating to entrepreneurship, such as the characteristics of entrepreneurs or the performance of entrepreneurial firms, law and entrepreneurship studies should focus on the study of the optimal legal structures that facilitate the commercialization of entrepreneurial opportunities, as well as the regulation of entrepreneurial firms.") (footnotes omitted). For a discussion on the entrepreneurial spirit and an overview of the psychological theories of entrepreneurial attributes, see generally Licht, *supra* note 27.

104. See Jeffrey G. Covin & Dennis P. Slevin, *A Conceptual Model of Entrepreneurship as Firm Behavior*, 16 *ENTREPRENEURSHIP THEORY & PRAC.* 7, 8 (1991).

105. Smith & Ueda, *supra* note 43, at 354-56 ("In Schumpeter's view, the *entrepreneur* is the agent of creative destruction, and the distinguishing attribute of entrepreneurial activity is *novelty*.") (footnotes omitted).

106. KIRZNER, *supra* note 53, at 40, 46; KIRZNER, *DISCOVERY*, *supra* note 74, at 16-17.

107. SCHUMPETER, *The Theory*, *supra* note 47, at 51 ("There are always unemployed workmen, unsold raw materials, unused productive capacity, and so forth. This certainly is a contributory circumstance, a favorable condition and even an incentive to the emergence of new combinations; but great unemployment is only the consequence of noneconomic events—as for example the World War—or precisely of the development which we are investigating.")

108. See Tom Bottomore, *Introduction to JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY* ix (Harper & Row 1976) (1942) (noting that Schumpeter regarded innovation as the essential feature of capitalism); KIRZNER, *supra* note 53, at 16.

109. See SCHUMPETER, *The Theory*, *supra* note 47, at 50.

110. See *supra* text accompanying note 64; see also SCHUMPETER, *supra* note 53, at 68 ("The carrying out of new combinations means, therefore, simply the different employment of the economic system's existing supplies of productive means—which might provide a

Kirzner developed the notion of entrepreneurial “alertness” to denote the quest for innovative knowledge.<sup>111</sup> He argued that entrepreneurs are often dissatisfied with the current available knowledge. That dissatisfaction inspires them to be alert to changing conditions and overlooked possibilities.<sup>112</sup> Entrepreneurial discovery ensues when entrepreneurs believe they have revealed possibilities for innovation that actual or potential competitors had hitherto not seen.<sup>113</sup>

Some entrepreneurial discoveries may also generate negative externalities.<sup>114</sup> Creativeness at its peak can also create societal harms or wasteful, inefficient, or destructive outcomes.<sup>115</sup> Nevertheless, when used in a positive manner, entrepreneurship overall improves the efficiency of our lives.<sup>116</sup> The first step in the entrepreneurship process, then, is the search for the discoveries or new combinations that will achieve a constructive effect.<sup>117</sup> This entails observing cur-

second definition of development in our sense. That rudiment of a pure economic theory of development . . .”).

111. KIRZNER, *DISCOVERY* *supra* note 74, at 12.

112. See KIRZNER, *supra* note 53, at 38-39; see also VON MISES, *supra* note 37, at 112 (“Understanding is always based on incomplete knowledge.”); Hayek, *supra* note 37, at 35.

113. See JOSEPH A. SCHUMPETER, *Business Cycles* (1939), reprinted in *THE ENTREPRENEUR*, *supra* note 39, at 292 [hereinafter SCHUMPETER, *Business Cycles*] (“Of course the reverse would not be true: not every new plant embodies an innovation; some are mere additions to the existing apparatus of an industry bearing either no relation to innovation or no other relation than is implied in their being built in response to an increase in demand ultimately traceable to the effects of innovations that have occurred elsewhere.”) (footnote omitted); SCHUMPETER, *The Theory*, *supra* note 47.

114. Entrepreneurs can create harms such as terrorism, pollution, pornography, etc. See, e.g., FREDERICK S. LANE III, *OBSCENE PROFITS: THE ENTREPRENEURS OF PORNOGRAPHY IN THE CYBER AGE* xiv-xv (2000); Daniel B. Kelly, *Strategic Spillovers*, 111 COLUM. L. REV. 1641, 1646 (2011) (examining situations in which “pollution entrepreneurs” generate harm purposely, in order to extract payments in exchange for desisting); Gaia J. Larsen, *Skewed Incentives: How Offshore Drilling Policies Fail to Induce Innovation to Reduce Social and Environmental Costs*, 31 STAN. ENVTL. L.J. 139, 163 (2012) (“These breaks encourage innovation to increase drilling, but not to reduce the resulting environmental and social harms.”).

115. See Garry Wills, *New Statesman*, N.Y. TIMES (Aug. 2, 2013), <http://www.nytimes.com/2013/08/04/books/review/philip-bobbitts-garments-of-court-and-palace.html> (“Terrorists are ‘entrepreneurial,’ so our market state must be an entrepreneurial state.”); Jenna Wortham, *Founder of a Provocative Web Site Forms a New Outlet*, N.Y. TIMES (Mar. 13, 2011), <http://www.nytimes.com/2011/03/14/technology/internet/14poole.html> (“For most entrepreneurs, running a Web site that is rife with pornography and frequently criticized as a menace to society would not be considered a résumé booster. Many venture capitalists would head in the opposite direction. But Christopher Poole, the 23-year-old founder of 4chan, one of the largest forums on the Internet and widely considered to be one of the darkest corners of the Web, has never shied away from his first creation.”).

116. Steven H. Hobbs, *Entrepreneurship and Law: Accessing the Power of the Creative Impulse*, 4 ENTREPRENEURIAL BUS. L.J. 1 (2009) (citing DONALD F. KURATKO & RICHARD M. HODGETTS, *ENTREPRENEURSHIP: A CONTEMPORARY APPROACH* 121 (5th ed. 2001)).

117. SCHUMPETER, *The Theory*, *supra* note 47, at 48-50.

rent opportunities and studying inefficiencies, wasteful processes, or failed projects with the aim of improving them or creating new ones. It could yield either valuable or useless results that will lead to entrepreneurial success or failure.<sup>118</sup>

At this critical stage of discovery, entrepreneurs heavily invest in knowledge procurement, more so than others, in observing their environment, collecting market research data, and determining current and future resources required to develop the opportunities.<sup>119</sup> Next, entrepreneurs conceptualize the idea. This is far from being an easy task. Doubts and uncertainties are inevitable elements of this process.<sup>120</sup> Entrepreneurs need to overcome the uncertainty hurdle and proceed with developing what they perceive as the future.<sup>121</sup>

### B. Resourcing and Concept Development

Following the discovery stage, the entrepreneurship process proceeds to conceptualizing and planning. This stage entails evaluating the discovery, looking at available resources, calculating the return on investment, the real and perceived value of the opportunity, and its risks and rewards.<sup>122</sup> It includes establishing the goals of the project and identifying its uniqueness and competitive advantage over existing rivals. Entrepreneurs do so in the shadow of uncertainty lacking future market information.<sup>123</sup>

The business model and strategy are essentially the entrepreneurs' theory regarding how they will make money from their idea. It involves an assumption of a market need and a hypothesis about how much customers would be willing to pay for the product.<sup>124</sup> Entrepre-

118. See KIRZNER, *supra* note 53, at 51.

119. See, e.g., Mark G. Brown & Raynold A. Svenson, *Measuring R&D Productivity*, 31 RES. TECH. MGMT. 11, 11 (1988).

120. See KIRZNER, *supra* note 53, at 67.

121. See *id.* at 22-23.

122. See JAMES O. FIET, THE SYSTEMATIC SEARCH FOR ENTREPRENEURIAL DISCOVERIES 128 (2002) (describing the search and evaluation process); Nicholas Dew et al., *Affordable Loss: Behavioral Economic Aspects of the Plunge Decision*, 3 STRATEGIC ENTREPRENEURSHIP J. 105, 107 (2009) ("In this conceptualization, risk is a product of uncontrollability . . .").

123. See Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior and Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 63 (2002) (arguing that if "a venture capitalist could adequately observe and quantify the effort level of the entrepreneur (and it knew the optimal effort level to be taken), it could then base the entrepreneur's compensation on the amount of effort exerted").

124. James C. Anderson & James A. Narus, *Business Marketing: Understand What Customers Value*, HARV. BUS. REV., Nov.-Dec. 1998, at 53, 54 (noting that a value model can demonstrate to prospective customers how the technology should be implemented); James C. Anderson et al., *Customer Value Propositions in Business Markets*, HARV. BUS.

neers design for the target consumer market by envisioning the buyers of the new product.<sup>125</sup> At this stage, establishing an organization is a way to gather resources and express their creativity and autonomy.<sup>126</sup> Once a sufficient amount of planning has been conducted, entrepreneurs will choose the organizational form they see as the best fit for their venture and goals.<sup>127</sup>

### C. Realization and Implementation

Innovation is distinct from invention.<sup>128</sup> Innovation and “economic leadership”<sup>129</sup> are more relevant to the economy than invention. Inventions are economically insignificant if they are not successfully delivered to the market.<sup>130</sup> The task of the entrepreneur is to carry the invention into practice.<sup>131</sup> The entrepreneurship process takes the previously unnoticed opportunities that entrepreneurs discovered and translates them into profitable exchanges.<sup>132</sup> Production begins and creates new demand in the market that rapidly generates large revenues and sustainable profits by successfully transforming knowledge into economic value.<sup>133</sup>

Entrepreneurs need to carefully and surreptitiously develop their product. They need to navigate their way through this process with-

REV., Mar. 2006, at 90, 91 (claiming that when managers construct a customer value proposition, they often simply list all the benefits their offering might deliver).

125. See Candida G. Brush et al., *From Initial Idea to Unique Advantage: The Entrepreneurial Challenge of Constructing a Resource Base*, 15 ACAD. MGMT. EXECUTIVE 64, 64 (2001) (illustrating that entrepreneurs in emerging organizations encounter many challenges in assembling resources, identifying, attracting, combining, and transforming personal resources into organizational resources).

126. Sean M. O'Connor, *Speech, Authorship, and Inventorship: A New Approach to Corporate Personhood* 8 (Univ. of Wash. Sch. of Law, Research Paper No. 2012-03, 2012), <http://ssrn.com/abstract=2016568>.

127. See Gabriele Pellegrino et al., *Young Firms and Innovation: A Microeconomic Analysis*, 23 STRUCTURAL CHANGE & ECON. DYNAMICS 329 (2012) (arguing that in-house R&D is linked to the propensity to introduce product innovation both in mature firms and young firms, but innovation intensity in young firms is mainly dependent on technical change); see also Howard E. Aldrich, *Entrepreneurship*, in THE HANDBOOK OF ECONOMIC SOCIOLOGY 451 (Neil J. Smelser & Richard Swedberg eds., 2d ed. 2005) (“[E]ntrepreneurship ensures the reproduction of existing organizational populations and lays a foundation for the creation of new populations.”).

128. See THE ENTREPRENEUR, *supra* note 39, at 5.

129. As Schumpeter often termed entrepreneurship. SCHUMPETER, *The Theory*, *supra* note 47, at 67.

130. *Id.*; see also SCHUMPETER, *Entrepreneur*, *supra* note 47, at 248 (noting that the entrepreneur may be a different person than the technical inventor).

131. See SCHUMPETER, *Entrepreneur*, *supra* note 47, at 248.

132. JOSEPH A. SCHUMPETER, *The Entrepreneur in Today's Economy* (1928), reprinted in THE ENTREPRENEUR, *supra* note 39, at 263.

133. See SCHUMPETER, *Entrepreneur*, *supra* note 47, at 241.

out losing control over the essence of the entrepreneurial action. They have to create demand that will transport that sought-after, supra-competitive entrepreneurial gain.<sup>134</sup> They need to make decisions while assessing market uncertainties and taking risks. The presence of specialists and departments may restrict entrepreneurs' thought processes and key decisions.<sup>135</sup> At this crucial point, entrepreneurs may realize their interests have separated from that of their organization.<sup>136</sup> The implementation of the entrepreneurial idea can result in a successful process that yields quick but substantial entrepreneurial gains. However, it can also result in failure, as the next Section reveals.

#### *D. Harvesting Entrepreneurial Success or Recognizing Failure*

Entrepreneurs create economic value by successfully pulling together a unique package of resources that exploit untapped opportunities.<sup>137</sup> They infuse economic value into the market by creatively securing and allocating the necessary skills and resources.<sup>138</sup> This economic value is what Schumpeter called "entrepreneurial gains"—the outcome of a successful delivery of the discovery to the market recognized via upsurge in the firm's growth.<sup>139</sup> This reflects the firm's ability to convert valuable knowledge into superior economic performance.<sup>140</sup>

Following the moment when entrepreneurs realize success, they begin to reap "supra-competitive gains."<sup>141</sup> These gains are pure profits emanating from the creation of new market demand and the ab-

134. See THE ENTREPRENEUR, *supra* note 39, at 28.

135. See SCHUMPETER, *supra* note 132, at 261, 274 ("In the large unit, in the trust organization, a phenomenon emerges that limits the importance of the entrepreneurial function, though it does not change its essence: the mechanization and bureaucratization of decisionmaking.").

136. See *id.* at 276 ("The crucial point is that success of the man, and success of the enterprise, are not one and the same thing anymore. They are no longer different words for the same matter. In contrast, there is now an interest of the entrepreneur, which has to be distinguished from the interest of the enterprise.").

137. See THE ENTREPRENEUR, *supra* note 39, at 16.

138. *Id.* at 28.

139. See SCHUMPETER, *Economic Theory*, *supra* note 33.

140. See ALEX COAD, *THE GROWTH OF FIRMS: A SURVEY OF THEORIES AND EMPIRICAL EVIDENCE* 77 (2009).

141. SCHUMPETER, *Economic Theory*, *supra* note 33 (contending that the economy is dominated by a series of transitory monopolies that compete with each other on the next breakthrough innovation); see also PAUL STONEMAN, *THE ECONOMIC ANALYSIS OF TECHNOLOGICAL CHANGE* 13-27 (1983) (stressing the importance of profit making in converting an invention into an innovation and then into an essential product).

sence of competitors.<sup>142</sup> What makes entrepreneurial gains uniquely different? Schumpeter distinguished between entrepreneurial gains and ordinary business profits by emphasizing the scope and timing of their onset.<sup>143</sup> Entrepreneurial gains are the portion over and above a normal profit. They follow innovation and do not arise as a response to preexisting demand in the market.<sup>144</sup> The prospect of receiving large rewards and personal gains leads to and maintains alertness to potential economically or socially significant opportunities.<sup>145</sup> Nevertheless, as will be further discussed, entrepreneurial profits are only temporary premiums of successful innovation.<sup>146</sup>

Not all entrepreneurs succeed. The implementation stage can also result in entrepreneurial failure. But entrepreneurial failure is an important part of the entrepreneurship process. Kirzner argued that when there is no room for error, there is no room for opportunities for entrepreneurial discovery.<sup>147</sup> Entrepreneurs often tend to be over-optimistic about the outcomes or the availability of production means. They may also miscalculate the market reaction to their innovation. Making “correct” decisions requires more than reaching an accurate mathematical answer.<sup>148</sup> It involves a detailed assessment of current and future realities and anticipating changes in market conditions in an uncertain environment.<sup>149</sup>

Entrepreneurial failure is economically and culturally valuable. It signals to the market what ideas do not work and provides lessons about new possibilities for improving the process. Entrepreneurial failure is a vital element of the entrepreneurship process and a catalyst for growth. Entrepreneurial failure diffuses knowledge among entrepreneurs and points to other solutions that may lead to entre-

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142. SCHUMPETER, *Economic Theory*, *supra* note 33; see also Daniel F. Spulber & Christopher S. Yoo, *Mandating Access to Telecom and the Internet: The Hidden Side of Trinko*, 107 COLUM. L. REV. 1822, 1844 (2007) (“[S]hort-run supra-competitive returns not only allocate the scarce network resources, they signal industry participants that the market is in short-run disequilibrium and provide incentives to invest in additional network capacity.”).

143. SCHUMPETER, *Economic Theory*, *supra* note 33 (“[E]ntrepreneurial gain may also be called a monopoly gain, since it is due to the fact that competitors only follow at a distance.”).

144. SCHUMPETER, *The Theory*, *supra* note 47, at 50.

145. See ISRAEL M. KIRZNER, PERCEPTION, OPPORTUNITY AND PROFIT: STUDIES IN THE THEORY OF ENTREPRENEURSHIP 110-11 (1979); KIRZNER, *supra* note 53, at 52.

146. SCHUMPETER, *supra* note 132, at 272 (Entrepreneurial profit is “a profit that in each individual case is temporary.”); see *infra* Section IV.C.

147. See KIRZNER, *supra* note 53, at 25.

148. *Cf. id.* (discussing entrepreneurial profits).

149. See *id.* at 18-19.

preneurial success.<sup>150</sup> Knowledge spillover occurs when failure is followed by entrepreneurial actions of others.<sup>151</sup> Learning from entrepreneurial errors increases the competitiveness of the market.<sup>152</sup> Some entrepreneurs are quick to spot unnoticed opportunities, while others notice only those revealed by the errors of others.<sup>153</sup> Some succeed in pursuing entrepreneurship while others produce waste and fail.

The scope of entrepreneurship, therefore, must include the possibility of discovering errors.<sup>154</sup> Studies on economic growth demonstrate that the benefits of entrepreneurial success outweigh the cost of entrepreneurial failure.<sup>155</sup> Overall, society reaps more benefits from entrepreneurial action. Accordingly, entrepreneurship requires distinct legal considerations. The next Part reveals the unique elements of the entrepreneurship process that policymakers should take into account when reforming the law.

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150. See Agarwal et al., *supra* note 88 (discussing spillover strategic entrepreneurship whereby knowledge investments by existing organizations are coupled with entrepreneurial action by individuals resulting in new venture creation, heterogeneity in performance, and subsequent growth in industries, regions, and economies).

151. See Benjamin Chinitz, *Contrasts in Agglomeration: New York and Pittsburgh*, 51 AM. ECON. REV. 279, 280 (1961) (arguing that the supply of entrepreneurship diffuses and differs across space); see also Edward L. Glaeser et al., *Clusters of Entrepreneurship*, 67 J. URB. ECON. 150, 151 (2010) (claiming that entrepreneurship is higher when fixed costs are lower and when there are more entrepreneurial people); Edward L. Glaeser & William R. Kerr, *Local Industrial Conditions and Entrepreneurship: How Much of the Spatial Distribution Can We Explain?*, 18 J. ECON. & MGMT. STRATEGY 623, 623 (2009) (finding that the Chinitz effect was a very strong predictor of new firm entry; the effect dominated other agglomeration interactions among firms or local area traits).

152. See, e.g., ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 111, 128 (1994) (arguing that learning from failure increases the competitiveness of the region).

153. SCHUMPETER, *Business Cycles*, *supra* note 113, at 298 ("Considerations of this type entail the consequence that whenever a new production function has been set up successfully and the trade beholds the new thing done and its major problems solved, it becomes much easier for other people to do the same thing and even to improve upon it. In fact, they are driven to copying it if they can, and some people will do so forthwith.").

154. KIRZNER, DISCOVERY, *supra* note 74, at 51; SCHUMPETER, ESSAYS ON ENTREPRENEURS, INNOVATIONS, BUSINESS CYCLES, AND THE EVOLUTION OF CAPITALISM, *supra* note 33, at 207; STONEMAN, *supra* note 141, at 27 (discussing the fact that the margin for error is large).

155. See Rita Gunther McGrath, *Falling Forward: Real Options Reasoning and Entrepreneurial Failure*, 24 ACAD. MGMT. REV. 13, 13 (1999) (developing a model that demonstrates the role of entrepreneurial failure in wealth creation); Pierre Azoulay & Scott Shane, *Entrepreneurs, Contracts, and the Failure of Young Firms*, 47 MGMT. SCI. 337, 337 (2001) (arguing that failed entrepreneurs undertake "contractual experiments" based on the information they possess and are rewarded for their superior information with survival).

## IV. THE UNIQUE NATURE OF THE ENTREPRENEURSHIP PROCESS

A. *Knowledge Intensive*

The essence of the entrepreneurship process is discovery. Yet in order to discover and generate ideas, one must investigate. Entrepreneurs are devoted to innovation in their routine operation. They are inclined to invest more than ordinary businesspersons on research and knowledge procurement in hopes of discovering the next breakthrough:

[H]uman alertness at all times furnishes agents with the propensity to discover information that will be useful to them. Without resorting to any assumption of systematic, deliberate search, and without our relying on sheer luck, I postulate a continuous discovery process—an entrepreneurial discovery process—that, in the absence of external changes in underlying conditions, fuels a tendency toward equilibrium.<sup>156</sup>

Grasping future opportunities or “seeing” the “divergence between the envisaged future and the realized future” requires hard work and creative action.<sup>157</sup> While the future is unknown, Kirzner stated, it is not unimaginable.<sup>158</sup>

Knowledge, therefore, is the key to unlock the entrepreneurship process.<sup>159</sup> The perception of new combinations or entrepreneurial opportunities can be realized only after conducting sufficient exploration. Entrepreneurs need to engage in substantial procurement of knowledge.<sup>160</sup> The payoff for this massive investment is that it may lead to significant entrepreneurial gains in the future. Naturally, this endeavor involves much uncertainty, as will be further discussed below.<sup>161</sup> Yet, by employing careful examination of current and future possibilities, entrepreneurs can reduce the uncertainty surrounding their decisions. The more knowledge entrepreneurs obtain about the future, the less uncertain their position is.

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156. KIRZNER, DISCOVERY, *supra* note 74, at 12.

157. *Id.* at 67; see also James W. Carland et al., *Differentiating Entrepreneurs from Small Business Owners: A Conceptualization*, 9 ACAD. MGMT. REV. 354, 358 (1984) (arguing that entrepreneurs make up their creative groups).

158. See SCHUMPETER, *The Theory*, *supra* note 47, at 67.

159. See Wesley M. Cohen & Steven Klepper, *The Anatomy of Industry R&D Intensity Distributions*, 82 AM. ECON. REV. 773, 773 (1992) (emphasizing the nature of the distribution of firm innovation and R&D).

160. KIRZNER, DISCOVERY, *supra* note 74, at 52 (“[A]n entrepreneurial element in action is evoked by the existence of as yet unexploited private opportunities. To act entrepreneurially is to identify situations overlooked until now because of error.”).

161. See *infra* Section IV.C.

Nevertheless, entrepreneurs are not scholars. They do not examine current market imperfections for the sake of increasing the present body of knowledge. They are involved in the exploration of “knowledge of value,” that will produce pure economic profit for its founder.<sup>162</sup> Entrepreneurs are also aware that the cost of the search effort can be high enough to render the entire endeavor not worthwhile.<sup>163</sup> This is part of the uncertainty entrepreneurs must face. The next Section discusses this distinct characteristic of the entrepreneurship process, namely, its ambiguous nature.

### B. Uncertain

Like every acting man, the entrepreneur is always a speculator. He deals with the uncertain conditions of the future. His success or failure depends on the correctness of his anticipation of uncertain events.<sup>164</sup>

Businesspersons bear “natural” market risks.<sup>165</sup> They make decisions based on a subjective analysis of the risks and rewards that may result from their choices.<sup>166</sup> These risks include, but are not limited to, preemption, miscalculation, and failure.<sup>167</sup> According to the Ellsberg paradox, risk with known specific likelihoods is routinely preferred over risk with ambiguous probabilities—even though the known probability might be lower than the unknown probability.<sup>168</sup> Individuals always prefer definite information (albeit negative) to that which is indefinite or impossible to calculate.<sup>169</sup> This is where entrepreneurs fundamentally differ from ordinary businesspersons.

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162. KIRZNER, *DISCOVERY*, *supra* note 74, at 86.

163. JOSEPH A. SCHUMPETER, *BUSINESS CYCLES: A THEORETICAL, HISTORICAL, AND STATISTICAL ANALYSIS OF THE CAPITALIST PROCESS* 105 (1939) (noting the temporary nature of the entrepreneurial profit in the process of competition and adaptation).

164. VON MISES, *supra* note 37, at 290.

165. See, e.g., Kent D. Miller, *A Framework for Integrated Risk Management in International Business*, 23 *J. INT'L BUS. STUD.* 311, 312 (1992) (developing a framework that categorizes the risks faced by firms operating internationally).

166. Carolyn Y. Woo, *Path Analysis of the Relationship Between Market Share, Business-Level Conduct and Risk*, 8 *STRATEGIC MGMT. J.* 149, 150 (1987) (evaluating the impact of market share on three measures of business-level risk: ROI variation, share instability, and the difference between growth in price and growth in cost).

167. *Id.*

168. Daniel Ellsberg, *Risk, Ambiguity, and the Savage Axioms*, 75 *Q.J. ECON.* 643 (1961).

169. See YAKOV BEN-HAIM, *INFO-GAP DECISION THEORY: DECISIONS UNDER SEVERE UNCERTAINTY* (2d ed. 2006); see also Sarah B. Lawsky, *Modeling Uncertainty in Tax Law*, 65 *STAN. L. REV.* 241, 242 (2013) (presenting a formal model of tax compliance that takes unknown probabilities into account).

Entrepreneurs are unique in their ability to handle uncertainties and ambiguous probabilities.<sup>170</sup> The entrepreneurial decision-making process includes not only known risks but also future uncertainty. The potential market for the new discovery, its possible uses, and its forthcoming effects, are often unnoted.<sup>171</sup> This fog of uncertainty is what distinguishes entrepreneurial decisions from calculative decisions. While the former involves assumptions regarding future undiscovered conditions, the latter selects between several identified alternatives.<sup>172</sup> As opposed to a measureable risk, uncertainty refers to unknown future events with unidentified uninsurable probabilities.<sup>173</sup>

Because these economic uncertainties are high, their rewards are greater and result in immense entrepreneurial profits:

[T]he cognate idea that business decisions in a world that is full of uninsurable risks (“uncertainty”) will in general produce results that diverge more or less widely from the expected ones and thus lead sometimes to surplus gains and sometimes to losses, is one that common experience presses upon us very strongly.<sup>174</sup>

Entrepreneurs are mindful that uncertainty makes their decisions far from being complete.<sup>175</sup> Indeed some of their errors can be tracked to the ambiguous conditions in which they were made.<sup>176</sup> Various opportunities may even remain unnoticed and undiscovered simply because of their failure to correctly pierce “the fog of uncertainty.”<sup>177</sup> But the speculative and creative character of entrepreneurial activity also wins entrepreneurs large gains when they anticipate future market conditions correctly.<sup>178</sup>

170. Cf. KIRZNER, *DISCOVERY*, *supra* note 74, at 52-53.

171. Cf. *id.* at 53 (emphasizing that the entrepreneur is the bearer of market uncertainty).

172. See *id.*; SCHUMPETER, *Economic Theory*, *supra* note 33, at 257-58.

173. For the differences between risk and uncertainty, see, e.g., FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT*, 43-44 (Dover ed. 2006) (arguing that risk embodies unknown future events with known probabilities whereas uncertainty represents unknown and uninsurable future events); SCHUMPETER, *Economic Theory*, *supra* note 33, at 257-58.

174. SCHUMPETER, *Economic Theory*, *supra* note 33, at 257.

175. Mayer-Schönberger, *supra* note 39, at 177 (“For example, rather than having a fifty percent chance of receiving a subsidy, entrepreneurs may prefer receiving a hundred percent chance – and thus absolute certainty to – receiving half of the subsidy. The expected value in both instances is the same, but the latter offers entrepreneurs certainty.”).

176. KIRZNER, *DISCOVERY*, *supra* note 74, at 53 (“It is of course true that past error (from which, on the one view, we look to entrepreneurial discovery to provide a rescue) may be attributed to the pervasive uncertainty that characterizes our world (and to the inevitably kaleidic changes responsible for that uncertainty.)”).

177. *Id.*

178. See *id.* at 44.

Entrepreneurship, therefore, involves not only bearing, but also overcoming uncertainty.<sup>179</sup> Entrepreneurs become experts in lifting the veil of uncertainty.<sup>180</sup> What makes individuals with entrepreneurial visions so unique is their ability to be superior evaluators.<sup>181</sup> Entrepreneurs endeavor to secure a greater correlation between their predictions and the way events actually unfold.<sup>182</sup> Their imagination and creativity are helpful in looking for information and clues about the future. They develop skills in dealing with uncertainty and taking risks.<sup>183</sup> Uncertainty is not easy to diffuse; it is essentially a matter of knowledge. The more knowledge entrepreneurs have about the future, the less uncertain their predictions are.<sup>184</sup>

The entrepreneur's undertaking is, therefore, different from the typical businessperson. The businessman or executive seeks to portray a certain picture by computing known conditions.<sup>185</sup> The entrepreneurial choice is an endeavor to identify a more "correct" depiction of the future market.<sup>186</sup> Entrepreneurship involves making a judgment about which opportunities have been left unexploited by others and pursuing those opportunities.<sup>187</sup>

[T]he lure of pure entrepreneurial profit to be grasped in stepping from a less accurately envisaged future to a more accurately envisaged one. Each step taken in moving toward a vision of the future that overlaps more significantly with the truth is not merely a step toward truth (that is, a positive entrepreneurial success); it is also a profitable step (that is, a step that enhances the value of the resources with which action is available to be taken).<sup>188</sup>

Accordingly, we must keep in mind the uncertain conditions that entrepreneurs bear and recognize entrepreneurs' role in counter-

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179. See Mayer-Schönberger, *supra* note 39, at 177-79.

180. KIRZNER, DISCOVERY, *supra* note 74, at 57 ("To deal with uncertainty means to seek to overcome it by more accurate prescience; to discover error is merely that aspect of this endeavor that ends it with incentive attraction.")

181. See ROBERT RONSTADT, ENTREPRENEURSHIP: TEXT, CASES AND NOTES 28 (1984).

182. See Licht, *supra* note 27, at 829.

183. RONSTADT, *supra* note 181, at 28.

184. KIRZNER, DISCOVERY, *supra* note 74, at 49.

185. *Id.* at 57

186. See *id.* at 58.

187. See RONSTADT, *supra* note 181, at 28 ("[V]alue must somehow be infused by the entrepreneur by securing and allocating the necessary skills and resources.")

188. KIRZNER, DISCOVERY, *supra* note 74, at 57.

balancing them.<sup>189</sup> The next Section highlights another characteristic of the entrepreneurship process: its transient nature.

### C. *Transient*

The first precondition for entrepreneurship is freedom to act. This axiom is rooted in the fact that when entrepreneurs are aware that others are free to join the market whenever they sense an opportunity for gains, they search for more efficient ways to persist.<sup>190</sup> The constant threat of losing one's supra-competitive position to competing entrepreneurs is the driving force behind the entrepreneurship process and the reason for its transiency.<sup>191</sup> As soon as competitors follow suit, these special premiums transform into common business profits.<sup>192</sup>

Competitors do, of course, follow suit. But before that happens, success brings unusual, perhaps even very large profits. To push through something new is the function of the entrepreneur. To fill this function represents the essence of the entrepreneur. The profits linked to it are entrepreneurial profits properly speaking.<sup>193</sup>

While the threat of rivalry is not unique to the entrepreneurship process, the added presence of knowledge intensiveness creates exceptional concerns. Lack of awareness on the part of market participants to entrepreneurial opportunities allows the emergence of profit arbitrage.<sup>194</sup> Large investments in knowledge expose these opportunities and begin a process of translating them into economic value. This is temporary, though. As soon as the market learns about the opportunity, through the grant of intellectual property right or otherwise, knowledge spillover begins.<sup>195</sup>

The temporary gains won by alert entrepreneurs attract competitors to investigate the opportunity or new knowledge. Other market participants become motivated to learn how to reproduce

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189. See, e.g., KIRZNER, *supra* note 53, at 65 (presenting an example of how an entrepreneur, when faced with an uncertainty may decide in their "entrepreneurial judgment" that the cost of a potential negative consequence is worthwhile).

190. See Robert M. Solow, *On Macroeconomic Models of Free-Market Innovation and Growth*, in ENTREPRENEURSHIP, INNOVATION, AND THE GROWTH MECHANISM OF THE FREE-MARKET ECONOMIES, *supra* note 86, at 15, 18.

191. Spulber & Yoo, *supra* note 142, at 1844 (emphasizing the key role that short-run supra competitive returns play in the horizontal competition).

192. SCHUMPETER, *Business Cycles*, *supra* note 113, at 303.

193. SCHUMPETER, *supra* note 132, at 271.

194. See Baumol, *supra* note 67, at 65.

195. Jesper Lindgaard Christensen, *Knowledge Spillovers from the Patenting Process*, in INTELLECTUAL PROPERTY RIGHTS: INNOVATION, GOVERNANCE AND THE INSTITUTIONAL ENVIRONMENT 179 (Birgitte Andersen ed., 2006).

these discoveries.<sup>196</sup> The market immediately begins a tendency of unraveling these opportunities.<sup>197</sup> Legal protection of intellectual products may provide entrepreneurs with a temporary “monopoly” position and extend the duration of their entrepreneurial gains from their new product.<sup>198</sup> While the entrepreneur may hold an exclusive legal right over the *use* of the new product, the discovery or knowledge inherent in it becomes widely available.<sup>199</sup> Immediately thereafter other competitors notice the opportunity and investigate it; the profit arbitrage lessens and eventually closes.<sup>200</sup> The initial entrepreneurial success is eventually consumed and with it the supra-competitive gains.<sup>201</sup> Ultimately, the outcome of the free entrepreneurship process is the transformation of the entrepreneurial special premium into common business profits.<sup>202</sup>

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196. KIRZNER, *supra* note 53, at 208; SCHUMPETER, *supra* note 132, at 266.

197. KIRZNER, *supra* note 53, at 208-09.

198. SCHUMPETER, *supra* note 132, at 268 (“Where an entrepreneur has a patent, or some resources that is inaccessible to others, etc., he has a monopoly position.”). In this Article, the term “monopoly” denotes a temporary position an entrepreneurial firm holds to set the market price of a product due to the lack of competitive products. SCHUMPETER, *supra* note 108, at 16. It results from this firm’s entrepreneurial ability to successfully implement unexploited opportunities and create new demand in the market to its newly created product. In that position the entrepreneurial firm reaps “entrepreneurial gains” from its superior competitive position. SCHUMPETER, *Economic Theory*, *supra* note 33. When the government approves a patent right, it provides entrepreneurs a monopoly position on the right to use the *new product*. It does not prohibit others from using the entrepreneurial opportunity or the knowledge from which the product was developed. Accordingly, the monopoly position granted through intellectual property rights is temporary because as soon as the knowledge on the opportunity is made public, it will spillover to competitors that will work on improving the opportunity and creating competing products and uses.

199. See Dan L. Burk, *The Role of Patent Law in Knowledge Codification*, 23 BERKELEY TECH. L.J. 1009 (2008) (debating the effectiveness of patents); Daniel B. Kelly, *Strategic Spillovers*, 111 COLUM. L. REV. 1641, 1680 (2011) (arguing that the possibility of strategic knowledge spillovers may result in “private negotiations” with the strategic party “agreeing not to disclose and in exchange receiving from the ultimate patentee some form of favorable licensing agreement”); Janusz A. Ordover, *A Patent System for Both Diffusion and Exclusion*, 5 J. ECON. PERSP. 43, 54-55 (1991) (examining the correlation between knowledge spillovers and property rights when research joint ventures are involved); Lisa Larrimore Ouellette, *Do Patents Disclose Useful Information?* 25 HARV. J.L. & TECH. 545, 564 (2012) (“[P]atent citations do provide a statistically significant signal of knowledge ‘spillover’—i.e., that patentees are learning from roughly half the patents they cite.”).

200. SCHUMPETER, *supra* note 163 (Entrepreneurial profit is “the premium put upon successful innovation in capitalist society and is temporary by nature: it will vanish in the subsequent process of competition and adaptation.”); see also WILLIAM J. BAUMOL, *THE MICROTHEORY OF INNOVATIVE ENTREPRENEURSHIP* 101 (2010).

201. SCHUMPETER, *Economic Theory*, *supra* note 33 (“[E]ntrepreneurial gain may also be called a monopoly gain, since it is due to the fact that competitors only follow at a distance.”).

202. See *id.*

For that reason, the entrepreneurship process is usually brief and occurs at a relatively quicker pace than the typical business undertaking. Accordingly, entrepreneurs look for rapid access to entrepreneurial gains by moving swiftly through the entrepreneurship process from a discovered opportunity to a novel product or service.<sup>203</sup> They do so because they realize their supra-competitive position in the market is fleeting. It is a matter of time until their exclusive knowledge becomes available known.<sup>204</sup> Entrepreneurs can try to preserve that position by imposing secrecy restrictions or engaging in anticompetitive strategies.<sup>205</sup> They can also rely on the lack of other market participants' alertness.<sup>206</sup> It is even possible that in certain industries or technologies, the market conditions and the elasticity of demand will allow pioneer entrepreneurs to extend the duration of their supra-competitive position. But entrepreneurs are never immune to dissemination of their success. The market eventually catches on.<sup>207</sup>

Innovations are destined to diffuse to other market players. Knowledge eventually disseminates to academic circles, related industries, and the entire economy.<sup>208</sup> Ultimately, this dissemination results in the forfeiture of the entrepreneur's dominant position.<sup>209</sup> Once an entrepreneurial opportunity is perceived and exploited, it is then developed further or copied by others, so that its "novelty" is spread promptly.<sup>210</sup> Hence, due to knowledge spillover, by its nature, entrepreneurial success is transient. It is necessary to comprehend this transitory nature of the entrepreneurship process in designing better legal frameworks for entrepreneurs. The next Section illustrates the last unique characteristic of the entrepreneurship process: its tendency toward cashing out entrepreneurial gains.

#### D. Exit Driven

The opportunity for a high premium and pure profit sparks potential entrepreneurs' alertness and generates entrepreneurial discov-

203. Cf. Joshua Ronen, *Some Insights into the Entrepreneurial Process*, in *ENTREPRENEURSHIP* 137, 148 (Joshua Ronen ed., 1983) (discussing the "continuum of entrepreneurship").

204. KIRZNER, *supra* note 53, at 208.

205. See Kelly, *supra* note 199, at 1681.

206. SCHUMPETER, *supra* note 132, at 272.

207. KIRZNER, *DISCOVERY*, *supra* note 74, at 208; SCHUMPETER, *supra* note 132, at 266.

208. SCHUMPETER, *supra* note 132, at 266.

209. Cf. SCHUMPETER, *Business Cycles*, *supra* note 113, at 305 (discussing entrepreneurs' efforts to conserve profits).

210. Only complete domination over production resources can guarantee entrepreneurs permanent monopoly positions. See KIRZNER, *supra* note 53, at 209.

ery.<sup>211</sup> Entrepreneurs who realize entrepreneurial gains seek to maximize them while they can. They recognize that as soon as their knowledge is revealed, their competitors will work on dethroning them of their supra-competitive position.<sup>212</sup>

Inspired by the potential for entrepreneurial gains, other market players will attempt to gain access to the entrepreneur's discovery.<sup>213</sup> Motivated by the potential to reap supra-competitive gains, investors will contract with pioneer entrepreneurs to share either their success or handover their knowledge.<sup>214</sup> Entrepreneurs will often contract with skilled employees to exchange labor with equity share in the entrepreneurial success. Yet, to maximize their value, entrepreneurs need to remain in control and choose the right moment to cash out the value of their discovery.<sup>215</sup>

The price for the discovery fluctuates throughout the entrepreneurship process.<sup>216</sup> At first, because there is much uncertainty regarding its market and its value, the price of the knowledge is not exorbitant. As entrepreneurs progress through the resourcing and realization stages of the process, that price increases accordingly.<sup>217</sup> Once entrepreneurs implement the discovery, they begin to create new market demand for their products.<sup>218</sup> The moment their success is made public, they begin to reap supra-competitive gains. This is also the moment the price for their market position is the highest.<sup>219</sup>

211. See SCHUMPETER, *supra* note 132, at 270.

212. KIRZNER, *supra* note 53, at 210.

213. *Id.* at 224.

214. See Frischmann & Lemley, *supra* note 89, at 262, 271-75 (distinguishing innovation spillovers); Brett Frischmann, *Spillovers Theory and Its Conceptual Boundaries*, 51 WM. & MARY L. REV. 801, 806-07, 816-21 (2009) (discussing positive externalities of spillovers).

215. Cf. Camilla A. Hrды, *Commercialization Awards*, 2015 WIS. L. REV. 13, 23-24 (2015) (arguing that the United States already has a system of commercialization incentives that does not require creating new forms of exclusive rights: direct financing for inventors and entrepreneurs in the early stages of technology development seeking capital to fund research and operations. These are sometimes called "commercialization awards.").

216. See John F. Muth, *Rational Expectations and the Theory of Price Movements*, 29 ECONOMETRICA 315, 315-16 (1961).

217. See GEORGE J. STIGLER, *THE THEORY OF PRICE* 15 (1987); Merritt B. Fox, *Securities Class Actions Against Foreign Issuers*, 64 STAN. L. REV. 1173, 1209 (2012) (noting that entrepreneurs get "higher prices when they sell shares in the firms they founded, and labor, who are likely to enjoy higher wages in an economy where capital is allocated and used efficiently"); Andrew P. Morriss, *Returning Justice to Its Private Roots*, 68 U. CHI. L. REV. 551, 563 (2001) ("By providing different levels of services for different prices, entrepreneurs can expand consumers' options."); James C. Spindler, *IPO Liability and Entrepreneurial Response*, 155 U. PA. L. REV. 1187, 1210 (2007) (discussing the correlation between the price at which the entrepreneur sells the securities and IPO liability).

218. See SCHUMPETER, *supra* note 132, at 270.

219. See *id.* at 270-71.

Nevertheless, once knowledge is made public, it begins to disperse to other market players. It is only a matter of time before competitors will duplicate and diffuse this success.<sup>220</sup> Realizing the ephemerality of their market position, many entrepreneurs seek to “cash out” and exit the process with maximum utility instead of waiting for the market to reflect imitation.<sup>221</sup> After framing the entrepreneurship process and isolating its unique characteristics, the next Part will address the tension between law and entrepreneurship and suggest ways to consider the viewpoint of the latter.

#### V. LEGAL CLASSIFICATION FROM THE POINT OF VIEW OF ENTREPRENEURS

The key function of the entrepreneur is to implement innovations effectively.<sup>222</sup> The entrepreneur “is the man who gets things done,”<sup>223</sup> and the “enterprise” is the conduit for implementing the entrepreneur’s novel ideas and discoveries.<sup>224</sup> Entrepreneurs are people who possess the power to set things into motion.<sup>225</sup> They do not act in a void. Law governs transactions.<sup>226</sup> It administers exchanges between the entrepreneur and other market players, such as vendors, inves-

220. SCHUMPETER, *Business Cycles*, *supra* note 113, at 294.

221. See Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 2 (2012) (“The success of venture capital depends on the ability of venture capitalists (‘VCs’) to exit their investments by taking the start-ups they fund public or selling them to a large company.”).

222. See SCHUMPETER, *Entrepreneur*, *supra* note 47, at 248; SCHUMPETER, *The Theory*, *supra* note 47, at 67.

223. SCHUMPETER, *Economic Theory*, *supra* note 33, at 266.

224. SCHUMPETER, *Business Cycles*, *supra* note 113, at 300 (“For actions which consist in carrying out innovations we reserve the term Enterprise; the individuals who carry them out we call Entrepreneurs.”). Some scholars view the mere act of creating a new firm as entrepreneurial. See Avinash K. Dixit & Joseph E. Stiglitz, *Monopolistic Competition and Optimum Product Diversity*, 67 AM. ECON. REV. 297, 297 (1977) (expanding the definition of entrepreneurship to encompass firms that earn profits by selling imperfectly substitutable goods that are produced with increasing returns to scale); see also Agarwal et al., *supra* note 88, at 265 (“[I]nnovations of new entrants generate selection pressures on existing firms.”).

225. SCHUMPETER, *Economic Theory*, *supra* note 33, at 266; Lumpkin & Dess, *supra* note 99; cf. KIRZNER, *supra* note 53, at 35 (explaining that entrepreneurs do more than make passive reactions and take the best course of action given the circumstances).

226. See R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 392 (1937). But see THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 3 (Oliver E. Williamson & Sidney G. Winter eds., 1993) (reviewing and refining Coase’s theory of the firm); Oliver Hart, *An Economist’s Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1758 (1989) (providing a different theory of the firm based not on human capital structure but on property rights); Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, 4 J.L. ECON. & ORG. 119, 120 (1988) (reviewing Coase and other theories of the firm).

tors, employees, and the government.<sup>227</sup> Law imposes order and directs the entrepreneurs' ability to execute innovations. It provides entrepreneurs with advantages;<sup>228</sup> it also presents them with hurdles.<sup>229</sup> This Part will focus on the latter to illustrate legal causal orders that do not correspond well to developments in innovation.

Entrepreneurs are heavily invested in the unknown. They constantly make judgments about contingencies, such as cash flow problems, partner breakups, natural disasters, loss of a major customer, new competition, industry change, loss of key personnel, etc.<sup>230</sup> All of these matters require entrepreneurs to make decisions in the shadow of uncertainty.<sup>231</sup> At each stage of the transient entrepreneurship process, the entrepreneur faces ambiguity regarding future market conditions.<sup>232</sup> In the discovery stage, the focus is on trying to predict future market conditions and the market reaction to the newly discovered opportunity.<sup>233</sup> In the resourcing and concept development stage, uncertainty about obtaining funding looms. In the realization stage, the entrepreneur is uncertain about whether the opportunity will lead to a success or a failure.<sup>234</sup> The uncertainty that surrounds the new discovery differs from business risk because it stems from newly created market conditions and it is difficult to identify or measure.

Unpredictable, changing circumstances benefit from a stable legal order.<sup>235</sup> Yet, setting strict legal rules can lead to stagnation, among other things, and can restrain entrepreneurs from adjusting the process to meet unanticipated developments.<sup>236</sup> The recent development

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227. See, e.g., Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 *FORDHAM L. REV.* 3389, 3390 (2013) (claiming that government intervention has created an investing climate that lets the rich get richer, while the poor get left behind).

228. See *infra* note 318.

229. See *infra* notes 244-50 and Part V.

230. See Lipshaw, *supra* note 20, at 703 (arguing that the only thing truly interesting about the law of entrepreneurship is more akin to the relationship of the law to property and liberty). *But see supra* Section II.B.

231. See *supra* Part III.

232. See *supra* Section III.B.-C.

233. KIRZNER, *supra* note 53, at 37.

234. KIRZNER, *DISCOVERY*, *supra* note 74, at 64-65.

235. Cf. Steve H. Hanke, "Rules Versus Cost-Benefit Analysis in the Common Law": A Comment, 4 *CATO J.* 893 (1985) (noting that he agrees with Professor Rizzo's stance on the proper role of a legal system, but suggesting that Professor's Rizzo's theory is flawed as he fails to recognize that a legal system should engage in some form of cost-benefit analysis).

236. See, e.g., Arthur W. Murphy, *Old Maxims Never Die: The "Plain-Meaning Rule" and Statutory Interpretation in the 'Modern' Federal Courts*, 75 *COLUM. L. REV.* 1299, 1317 (1975) (arguing that certain legal constructions threaten stagnation for the courts); Richard A. Posner, *What Am I? A Potted Plant? The Case Against Strict Constructionism*, *NEW REPUBLIC*, Sept. 28, 1987, at 23, 24-25 (arguing against strict constructionism).

of sharing economy is one example that highlights the dissonance between law and entrepreneurship. In the past few years, new Internet-based platforms have been shaping a new consumer culture, lowering transaction costs and improving accessibility to shared goods and services on a previously unimaginable scale.<sup>237</sup> Companies such as Uber, Zipcar, Airbnb and TaskRabbit developed new ways to allow greater access to services, accommodation, and transportation.<sup>238</sup> The hotel, taxi, and other industries as well as many state regulators responded by demanding that the new sharing economy comply with existing occupancy, consumer, and taxi regulations, including entry controls and price-fixing.<sup>239</sup>

Likewise, a recent California case required the court to decide whether the sharing economy can fit within labor law's classification of employee or independent contractor.<sup>240</sup> The Northern District of California court applied the California independent contractor test and the "right of control" test, which are descendants of traditional legal doctrines that determine whether the law may hold an employer liable for the tortious conduct of an employee.<sup>241</sup> If indeed drivers

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237. See Daniel E. Rauch & David Schleicher, *Like Uber, but for Local Government Law: The Future of Local Regulation of the Sharing Economy*, 76 OHIO ST. L.J. 901, 901-02 (2015) ("The future of sharing economy regulation will be very different from its present, and these changes will pose profound legal, political, and ethical questions for our cities."); see also Roberta A. Kaplan & Michael L. Nadler, *Airbnb: A Case Study in Occupancy Regulation and Taxation*, 82 U. CHI. L. REV. DIALOGUE 103 (2015).

238. Henry Ross, *Ridesharing's House of Cards: O'Connor v. Uber Technologies, Inc. and the Viability of Uber's Labor Model in Washington*, 90 WASH. L. REV. 1431, 1431 (2015) (describing the immense popularity of Uber that expanded into over 270 cities and counting worldwide within a five-year period and has led many to anoint Uber as the most successful Silicon Valley startup ever after just six years with a network of over 160,000 drivers in the United States alone); see also Roberta A. Kaplan, *Regulation and the Sharing Economy*, N.Y. L.J. (Jul. 18, 2014), <http://www.newyorklawjournal.com/id=1202663656633/Regulation-and-the-Sharing-economy>.

239. See, e.g., Joshua Robertson, *NRMA Accuses Taxi Lobby of Self-Interest After Complaint to ACCC over UberX*, GUARDIAN (Aug. 17, 2015), <http://www.theguardian.com/technology/2015/aug/17/nrma-accuses-taxi-lobby-of-self-interest-after-complaint-to-acc-over-uberx>; Dominic Rushe, *Airbnb Close to Securing Private Cash that Would Value Firm at \$10bn*, GUARDIAN (Mar. 20, 2014, 12:15 PM), <http://www.theguardian.com/technology/2014/mar/20/airbnb-funding-talks-10bn-valuation>; Marc Scribner, *Ridesharing Wars: Uber, Regulators, and the California Compromise*, COMPETITIVE ENTERPRISE INST. (June 6, 2014), <https://cei.org/blog/rides-sharing-wars-uber-regulators-and-california-compromise>.

240. *O'Connor v. Uber Techs., Inc.*, 82 F. Supp. 3d 1133, 1152-53 (N.D. Cal. 2015) (presenting plaintiffs' allegations that Uber has made its rapid growth by denying full-employee benefits for its drivers and using the independent contractor designation to save labor costs).

241. *Id.* at 1138-39; see Richard R. Carlson, *Why the Law Still Can't Tell an Employee When It Sees One and How It Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L. 295, 302 (2001) (stating that these tests are based on Blackstone's master-servant model where a master was liable for an act of the servant commanded by the master or committed in the course of the servant's service controlled by his master).

ultimately succeed in receiving employee status, the sharing economy model could face a serious challenge.<sup>242</sup>

In this sharing economy example, instead of applying existing classifications from old laws that fail to account for challenges presented by the new sharing economy, the law can be better designed to ensure regulatory objectives of safety and consumer protection.<sup>243</sup> The regulator could create new experimental regulations for sharing economy that will allow more flexibility and further evaluation of the effectiveness of such regulations as more information on these services becomes available. The new sharing economy is one of many examples of the dissonance between law and innovation. Different areas of the law such as intellectual property,<sup>244</sup> telecommunication law,<sup>245</sup> securities law,<sup>246</sup> immigration,<sup>247</sup> taxation,<sup>248</sup> labor laws,<sup>249</sup> etc.

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242. Ross, *supra* note 238, at 1433.

243. See Rauch & Schleicher, *supra* note 237, at 905 (sketching the future of sharing economy's policy regimes by suggesting that local and state governments subsidize sharing firms to encourage expansion of services that produce public goods and economic redistribution or contract with sharing firms to provide traditional government services).

244. The literature on the right balance law should preserve between overprotecting intellectual property, preventing abuse by "patent trolls," and under-incentivizing research and development is vast. See generally, e.g., JAMES BESSEN & MICHAEL J. MEURER, *PATENT FAILURE: HOW JUDGES, BUREAUCRATS AND LAWYERS PUT INNOVATION AT RISK* (2008); ADAM B. JAFFE & JOSH LERNER, *INNOVATION AND ITS DISCONTENTS* (2004) (discussing bad patents and their legal effects); Robin Feldman & Mark A. Lemley, *Do Patent Licensing Demands Mean Innovation?*, 101 IOWA L. REV. 137 (2015) (pointing to the fact that few patentee-initiated license requests result in increased innovation and suggesting the reexamination of the role of patent licensing in facilitating technology transfer and the development of new technologies by the licensee); Mark A. Lemley & Bhaven Sampat, *Is the Patent Office a Rubber Stamp?*, 58 EMORY L.J. 181, 182 (2008) (criticizing the lax patent rules that provide three-fourths of applicants patents); Mark A. Lemley & A. Douglas Melamed, *Missing the Forest for the Trolls*, 113 COLUM. L. REV. 2117 (2013) (arguing that many of the problems associated with trolls are a symptom of larger flaws in the patent system and that those who have focused on trolls have, in effect, been missing the forest for the trolls); Mark A. Lemley & Mark P. McKenna, *The Scope of IP Rights* (Stanford Pub. Law, Working Paper No. 2660951, 2015), <http://dx.doi.org/10.2139/ssrn.2660951> (arguing that because of the legal separation in patent law between validity, infringement, and defenses, it is often possible for a party to successfully argue that an IP right means one thing in one context and something very different in another and that courts won't necessarily detect the problem because they are thinking of only the precise legal issue before them).

245. For instance, in recent years there is much debate in public policy and academic literature on "network neutrality" regulations and whether they indeed support entrepreneurship. Network neutrality rules forbid network operators from discriminating against third-party applicants, content, or portals or to exclude them from their network. See, e.g., Susan P. Crawford, *The Internet and the Project of Communications Law*, 55 UCLA L. REV. 359 (2007); Susan P. Crawford, *Network Rules*, 70 L. & CONTEMP. PROBS. 51, 52 (2007); Barbara Van Schewick, *Towards an Economic Framework for Network Neutrality Regulation*, 5 J. ON TELECOMM. & HIGH TECH. L. 329, 336 (2007) (arguing that while network neutrality regulations are not without cost, their social benefits exceed these costs and include protecting entrepreneurs from discriminatory practices and reducing the amount of innovation in the markets for applications, content, and portals). But see Christopher S. Yoo, *Beyond Network Neutrality*, 19 HARV. J.L. & TECH. 1 (2005) (proposing, instead of

network neutrality, a “network diversity” approach that would use product differentiation to encourage investment and to mitigate the supply-side and demand-side scale economies associated with the impact of up-front, fixed costs and network economic effects).

246. For criticism on securities law inefficiency in providing rules to govern the entrepreneurial finance gap through the use of crowdfunding, see generally, for example, DJAMCHID ASSADI, *STRATEGIC APPROACHES TO SUCCESSFUL CROWDFUNDING* (2016); Sean M. O'Connor, *Crowdfunding's Impact on Start-Up IP Strategy*, 21 *GEO. MASON L. REV.* 895 (2014); Usha Rodrigues & Mike Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 *VA. L. REV.* 1, 3 (2010) (demonstrating empirically that the current regime under section 406 of the of the Sarbanes-Oxley Act of 2002 is unhelpful and inefficient, long on costly and burdensome disclosures, and short on demonstrable benefit); Seth C. Oranburg, *Bridgdfunding: Crowdfunding and the Market for Entrepreneurial Finance*, 25 *CORNELL J.L. & PUB. POL'Y* (forthcoming 2016) (criticizing securities law for getting Internet investor protection “completely backwards” and actually amplifying fundamental problems in the market for entrepreneurial finance that exposes unsophisticated investors to additional risk and fraud); Andrew Schwartz, *The Digital Shareholder*, 100 *MINN. L. REV.* 609 (2015) (discussing the dissonance between securities law and crowdfunding deals with the fundamental problems of entrepreneurship including uncertainty, information asymmetry, and agency costs).

247. For immigration proposals that will take into account not just monetary investment in the United States, but also talent and promoting the spirit of entrepreneurship, see Note, *Proposing a Locally Driven Entrepreneur Visa*, 126 *HARV. L. REV.* 2403, 2404 (2013) (proposing an entrepreneur visa allowing for entry into the United States of individuals of any skill level who commit to innovation under the sponsorship of a qualified local government entity); see also ANNALÉE SAXENIAN, *PUB. POLICY INST. OF CAL., SILICON VALLEY'S NEW IMMIGRANT ENTREPRENEURS 6-7* (1999), [http://wee.ppic.org/content/pubs/report/R\\_699ASR.pdf](http://wee.ppic.org/content/pubs/report/R_699ASR.pdf) (focusing on the highly skilled immigrant entrepreneurs who are managing high-tech firms in Silicon Valley and concluding that current immigration view of “brain drain” and labor competition is inadequate in the case of entrepreneur immigrants); Michele R. Pistone & John J. Hoeffner, *Rethinking Immigration of the Highly-Skilled and Educated in the Post-9/11 World*, 5 *GEO. J.L. & PUB. POL'Y* 495, 495 (2007); Ayelet Shachar, *Highly Skilled Migrants and Competitive Immigration Regimes*, 81 *N.Y.U. L. REV.* 148 (2006) (discussing the type of legal rethinking that is necessary for effective immigration reform regarding skilled talented individuals); Michael R. Bloomberg, *Commentary, A New Immigration Consensus*, *WALL ST. J.*, (May 2, 2011, 12:01 AM), <http://www.wsj.com/articles/SB10001424052748703387904576279293334248326> (suggesting that “[c]reating a visa for entrepreneurs who already have funding to start their businesses will lead directly and immediately to American jobs. Visa reforms to improve temporary and permanent pathways for companies to fill the current shortages of engineers, scientists and other specialists—whose annual visa caps are often exhausted within days of becoming available—will spur growth at existing U.S. companies”).

248. For a discussion of sharing economy and tax law, see, for example, Shu-Yi Oei & Diane M. Ring, *Can Sharing Be Taxed?*, 93 *WASH. U. L. REV.* (forthcoming 2016) (discussing how sharing economy should be taxed, including whether existing tax laws and regulations are sufficient or whether new ones are needed). For the dissonance between social entrepreneurship and taxation, see generally, for example, Brian Galle, *Social Enterprise: Who Needs It?*, 54 *B.C. L. REV.* 2025 (2013) (suggesting that social enterprise's legislative popularity can best be traced to a race to the bottom among states competing to siphon away federal tax dollars for local businesses); see also Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with FLY Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 *B.C. L. REV.* 1495, 1544 (2013) (suggesting new tax solutions for tax law to facilitate social enterprises); Dana Brakman Reiser & Steven A. Dean, *SE(c)(3): A Catalyst for Social Enterprise Crowdfunding*, 90 *IND. L.J.* 1091 (2015).

249. For example, in recent years there has been a growing debate about the use of “income share agreements” that enable individuals to raise funds by pledging a percentage of their future earnings to investors for a certain number of years. See generally Shu-Yi

consist of similar “friction points” with innovation.<sup>250</sup> The next Section will focus on two illustrations—the classifications under association and bankruptcy laws—to demonstrate that point and suggest possible ways to diffuse it.

### A. Organizing Entrepreneurship

Aside from incorporating predictable legal rules, an entrepreneur-friendly legal system should also be flexible with low-cost transition rules. Entrepreneurs thrive when given freedom to act creatively.<sup>251</sup> Laws tend to limit creativity by creating rules based on causal and logical deduction.<sup>252</sup> Yet, the longer entrepreneurship extends into the future, the higher the uncertainty surrounding it due to the inability to predict unforeseen events.<sup>253</sup> Thus, the progression of entrepre-

Oei & Diane Ring, *Human Equity? Regulating the New Income Share Agreements*, 68 VAND. L. REV. 681 (2015) (suggesting the adoption of a case-by-case approach that examines each income share agreement’s distinctive economics and draws analogies to more familiar financial arrangements in designing its legal treatment); Shu-Yi Oei & Diane M. Ring, *The New “Human Equity” Transactions*, 5 CAL. L. REV. CIR. 266 (2014) (surveying some of the issues raised by these new transactions, and suggesting possible ways in which the law can approach their regulation). Another discrepancy can be found in labor law and employment rules governing “non-compete agreements.” See, e.g., ORLY LOBEL, *TALENT WANTS TO BE FREE* 5 (2013) (arguing that laws governing human capital are counterproductive and stifle innovation). But see FRANK PASQUALE, *THE BLACK BOX SOCIETY: THE SECRET ALGORITHMS THAT CONTROL MONEY AND INFORMATION* 5 (2015) (arguing that free information mobility can be disruptive and damaging to communities and local populations).

250. Cooter et al., *supra* note 4 (prescribing reform proposals in the areas of immigration law, technology licensing, consumption tax, local zoning rules, antitrust enforcement, intellectual property patent system, and corporate governance).

251. See *supra* note 23 and accompanying text.

252. See, e.g., Greg Lastowka, *Innovative Copyright*, 109 MICH. L. REV. 1011, 1027 (2011) (“When we consider phenomena like blogs, wikis, and other forms of internet-based creativity, it seems possible that copyright law today is doing at least as much to limit creativity as it does to enable it.”); Guido Calabresi, *Commentary*, 58 N.Y.U. L. REV. 939, 942 (1983) (claiming that innovation is discouraged when a relatively competitive market does not exist); Richard A. Epstein, *Commentary*, 58 N.Y.U. L. REV. 930, 934-35 (1983) (arguing that innovation is more likely to occur when risk averse manufacturers diversify their product mix); Victor Schwartz, *The Post-Sale Duty to Warn: Two Unfortunate Forks in the Road to a Reasonable Doctrine*, 58 N.Y.U. L. REV. 892, 899-901 (1983) (contending that entrepreneurs that develop new products may be subject to liability for older products manufactured before safety improvements were developed); Note, *Major Operational Decisions and Free Collective Bargaining: Eliminating the Mandatory/Permissive Distinction*, 102 HARV. L. REV. 1971, 1983 (1989) (“By diminishing the autonomy of the parties, the mandatory/permissive distinction tends to stifle creativity in bargaining relationships.”).

253. See Ian Ayres & Paul Klemperer, *Limiting Patentees’ Market Power Without Reducing Innovation Incentives: The Perverse Benefits of Uncertainty and Non-Injunctive Remedies*, 97 MICH. L. REV. 985, 1001 (1999) (demonstrating that lengthening the duration of the patent’s validity can enhance the patentee’s expected profits and thereby offset the innovation effects of uncertainty); cf. Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 483 (2009) (arguing that the longer the interaction between parties, the more each party knows about

neurial ideas and the discovery process require the law to maintain leeway to adjust to changing and new circumstances.<sup>254</sup> This is hardly an easy task. Organization law is one area where it is essential for the legal system to enact stable, predictable rules while allowing for costless transition from those rules in response to changes in the entrepreneurial environment.

Nevertheless, business entity-classification rules illustrate the mismatch between legal requirements and the entrepreneurship culture. They exemplify that while law views entity formation as a causal apparatus to accumulate wealth, entrepreneurship does not. Legal doctrine seeks order through classification by viewing the firm as coordinating and reducing the transaction costs of contracting.<sup>255</sup> Entrepreneurs form entities as conduit of their autonomy and to reduce uncertainty.<sup>256</sup> This dissonance leads to the laws governing organizational choices locking entrepreneurs into inefficient legal classifications that impose high penalties when switching from one classification to another.<sup>257</sup>

In the past, the law provided only two forms of association—the partnership or the corporation.<sup>258</sup> The divide between these classifications rested on a multi-factored “corporate resemblance test.”<sup>259</sup> Since

the other, the higher the switching costs, and the greater the uncertainty and constraint on opportunism).

254. Other scholars argued similarly to allow entrepreneurs more flexibility. See Clayton P. Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1075-76 (1983) (noting liability rules are superior than property rules in permitting entrepreneurs greater leeway to implement their optimistic expectations); José M. Padilla, *What's Wrong with a Washout?: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing*, 1 HOUS. BUS. & TAX L.J. 269, 296 (2001) (“In order to survive and flourish, the management of an entrepreneurial firm needs leeway to make decisions without concern for judicial intervention.”); Utset, *supra* note 123, at 118 (noting entrepreneurs need great leeway in financing due to uncertainty in their environment).

255 See Coase, *supra* note 226, at 392.

256. The story of Madam C.J. Walker is an illustration of a minority entrepreneur who found such freedom in acting independently and selling hair products to an underserved portion of the population. See A’LELIA BUNDLES, ON HER OWN GROUND: THE LIFE AND TIMES OF MADAM C. J. WALKER 121 (2001).

257. See *infra* note 264.

258. In the past, entity classification as partnership or corporation was determined by looking at several factors such as limited liability, continuity of life, free transferability of interests, centralized management, associates, and objective to carry on business for joint profit. See Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 96 (2002).

259. See *Morrissey v. Comm’r*, 296 U.S. 344 (1935) (defining the characteristics of an “association”). See generally Victor E. Fleischer, Note, “If It Looks Like a Duck”: *Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 524 (1996) (surveying the evolution of the corporate resemblance test).

then, the menu of options has somewhat expanded.<sup>260</sup> Nowadays, each of the various entity classifications differs greatly, and each has unique governance and tax consequences.<sup>261</sup> To achieve legal order, entity classifications have been designed with distinct causal consequences.

Over the years, entrepreneurs attempted to break out of those rules and push to change the entity status quo. In 1977, they defied this legal order.<sup>262</sup> While the S corporation provided the best of both worlds: limited liability and pass-through taxation, it imposed many rules and limitations.<sup>263</sup> Losing the S corporation status unintentionally was tremendously costly.<sup>264</sup> Consequently, investors did not like

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260. Today, the main entity choices are a general or limited partnership, a limited liability company ("LLC"), Subchapter C Corporation ("C corporation" or "corporation"), Limited Partnership, General Partnership, and Subchapter S Corporation ("S corporation"). While these are the main forms, there are other entity classifications today such as the LLP, LLLP, and others. Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1392 (2006).

261. See Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. ILL. L. REV. 77, 103 (2005) ("Entrepreneurs long could obtain the benefit of limited liability by incorporating. What the LLC brought to the table, however, was the ability to combine limited liability with the governance attributes of a partnership."); Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1741 (1994) (arguing that because of tax advantages, using an entity with pass-through taxation is a better choice than using a corporation).

262. Mayer-Schönberger, *supra* note 39, at 159 ("Conceived this way, entrepreneurs, like their colleagues in the arts and sciences, cannot help but break the rules and violate the codes of the status quo. That is their defining quality. The law is seen as holding them back and thereby preventing them – and society – from reaching their full potential.").

263. S Corporations are severely limited in the ownership and equity issuance and therefore were typically not favored for the fast-growing entrepreneurial ventures. To be able to qualify as an S corporation, a small business must be a domestic corporation with no more than 100 shareholders and with only one class of stock measured as those with the same rights to distribution and liquidation proceeds. See 26 U.S.C. § 1361 (2012). For an elaborate history of Subchapter S and the birth of S corporations, see Mirit Eyal-Cohen, *When American Small Businessmen Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 PITT. TAX REV. 1, 5 (2008). Shareholders must be individuals or certain trusts, estates and tax-exempt organizations. S corporation shareholders cannot be nonresident aliens, which restricts entrepreneurs from attaining foreign funding. S corporation shareholders are also subject to at-risk loss rules with respect to S corporation losses allocated to them. 26 U.S.C. § 469 (2012).

264. Taproot Admin. Servs., Inc. v. Comm'r of Internal Revenue, 133 T.C. 202, 230 (2009), *aff'd*, 679 F.3d 1109 (9th Cir. 2012) (stating the high costs and complexity involved in converting from and to an S corporation); Gabriel Feldman, *The Puzzling Persistence of the Single-Entity Argument for Sports Leagues: American Needle and the Supreme Court's Opportunity to Reject a Flawed Defense*, 2009 WIS. L. REV. 835, 898 (2009) ("It is self-defeating to engage in a difficult and costly analysis to determine whether a venture classifies as a single entity when the purpose of the classification is to simplify the analysis."); Thomas M. Hayes, *Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect of Entity Classification*, 54 WASH. & LEE L. REV. 1147, 1173 (1997) ("A corporate liquidation is a costly and unexpected surprise to a taxpayer who otherwise thought the entity was in compliance with the reasonable basis standard."); John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the*

to act within the S corporation. In 1977, a group of entrepreneurs, seeking to enjoy limited liability and flexibility without suffering the harsh tax consequences of incorporation, created the Wyoming Limited Liability Company;<sup>265</sup> in doing so, they originated the LLC concept and ushered in its swift nation-wide acceptance as a mainstream business choice.<sup>266</sup> The story behind the birth of the LLC is an example of the tension between law and entrepreneurship where entrepreneurs were able to force an unconventional change upon the law towards greater autonomy in organizational classifications.<sup>267</sup> Yet, while the creation of the LLC brought with it incremental improvement, entity classifications continue to generate confusion and inefficiency among entrepreneurs as described below.

### 1. Tax Considerations

Under the entity classification tax rules, the corporate form produces double taxation.<sup>268</sup> Two layers of tax are imposed on corporate earnings: one at the corporate level and another at the shareholder level when earnings are distributed as dividends.<sup>269</sup> On the other

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*Stars Might Lie but the Numbers Never Do*, 78 TEX. L. REV. 885, 921 (2000) (“In any event, some believe that the tax cost of exiting is not taken into account by clients at the time of choice of tax entity leading to surprises and perhaps recriminations upon exiting.”).

265. See generally Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459 (1998) (using unpublished letters and other documents, the author demonstrates how a group of active entrepreneurs and their attorneys were responsible for inventing the first LLC statute in 1977 and winning a battle to secure partnership classification from the IRS).

266. *Id.* at 1461 (“In the mid-1970s, a few entrepreneurial-minded attorneys and accountants representing a U.S. independent oil and gas company invented the LLC, successfully persuaded the Wyoming legislature in 1977 to enact the first LLC statute, and asked the IRS to grant the new LLC favorable partnership status.”).

267. See Steven A. Bank & Kirk J. Stark, *Introduction to BUSINESS TAX STORIES 9* (Steven A. Bank & Kirk J. Stark eds., 2005) (“The inside story of the LLC involved the creative efforts of two different groups of LLC proponents harnessing the power of state legislatures over new business organizations in order to provide their clients the best results under the federal income tax laws.”); see also Frank M. Burke & John S. Sessions, *The Wyoming Limited Liability Company: An Alternative to Sub S and Limited Partnerships?*, 54 J. TAX’N 232-35 (1981); Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 U. FLA. L. REV. 721 (1989).

268. 26 U.S.C. § 1 (2012); Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 169 (2002) (“This ‘double taxation’ is a much reviled, but stubbornly persistent feature of our current system.”).

269. Under 26 U.S.C. § 1(h)(11), “qualified” dividends are to be subject to tax at the same rate as long term capital gains. Congress enacted double taxation as a way to reach wealthy corporate shareholders that locked their assets into the corporation. See Bank, *supra* note 268, at 167 (arguing that double taxation was used by the administration as a tool to attack the undistributed profits tax on accumulated earnings). Over the years, proposals to integrate the two layers of tax did not prevail. See Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002) (reviewing several integration proposals and their effect on the income tax).

hand, pass-through taxation, available to partnerships, S corporations, and LLCs, imposes a single layer of taxation at the individual level. Consequently, many entrepreneurs choose these entity classifications due to their tax advantages.<sup>270</sup>

Nevertheless, this axiom does not affect all entrepreneurs equally.<sup>271</sup> Double taxation mainly affects shareholders with a “money-out” strategy, namely owners who would like to plow back the corporate earnings rather than reinvesting them in discovery and expansion.<sup>272</sup> Double taxation may affect entrepreneurs in later stages of the firm’s implementation when the enterprise is more profitable; however, it has no effect when the firm has no taxable income. In fact, if the enterprise is profitable, the corporate form may still be beneficial because the firm can be used to prevent an upsurge in the entrepreneur’s individual marginal tax rates.<sup>273</sup> Therefore, double taxation mostly affects entrepreneurs when they begin to reap entrepreneurial gains or at the exit stage.

Aside from avoiding double taxation, the pass-through organizational form’s other advantage is the ability to transfer specific tax attributes to the firm’s owner. Entrepreneurs can claim the enterprise’s losses and immediately deduct start-up costs on their personal tax return.<sup>274</sup> During the first stages of the entrepreneurship process, the losses incurred by entrepreneurs are often greater than their income. Corporations can carry losses forward and backward, but they

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270. Daniel S. Goldberg, *Choice of Entity for a Venture Capital Start-Up: The Myth of Incorporation*, 55 TAX LAW. 923, 923 (2002).

271. See generally Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137 (2003).

272. Eyal-Cohen, *supra* note 263, at 10. Corporations with excessive accumulated earnings beyond the reasonable needs of the business are subject today to a flat twenty percent rate tax on accumulated taxable income. *Id.* Section 531 of Title 26 of the United States Code declares: “In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of each corporation described in section 532, an accumulated earnings tax equal to 20 percent of the accumulated taxable income.”. 26 U.S.C. § 531 (2012).

273. For an illustration of the “money-out strategy,” see Eyal-Cohen, *supra* note 263, at 57.

274. Business start-up and organizational costs are generally capital expenditures. However, taxpayers can elect to deduct up to \$5,000 of business start-up and \$5,000 of organizational costs. These amounts are phased-out and reduced by the amount start-up or organizational costs exceed \$50,000. Any remaining costs must be amortized. 26 U.S.C. § 195 (2012). In his recent tax proposal, President Obama proposed to double the start-up expense deduction to \$10,000. See DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2014 REVENUE PROPOSALS 27 (2013), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>.

remain unused if no gains are present to offset them.<sup>275</sup> Pass-through entities immediately benefit entrepreneurs by offsetting the enterprise's losses against their individual positive incomes at the initial stages of the entrepreneurship process.<sup>276</sup>

Moreover, if losses are left unused until the realization stage of the entrepreneurial process, they are less valuable to traditional venture fund investors.<sup>277</sup> Due to their tax-exempt status, institutional investors that are either tax-exempt organizations or foreign investors do not consider this to be a valuable option.<sup>278</sup> Losses from earlier stages of the entrepreneurship process are worth less to them directly than using those losses in the corporate form to offset the future taxable income of the entrepreneurial enterprise.<sup>279</sup> Additionally, some venture capital managers prefer the corporate form because they would rather not present the portfolio firms' losses on their balance sheets to avoid the possibility of raising scrutiny about their performance.<sup>280</sup>

Loss carryover rules also restrict the use of losses when the ownership changes.<sup>281</sup> Generally, a loss carryover is the ability to postpone the use of a capital loss to future tax years. In order to prevent acquiring corporations that are not economically meaningful solely for their tax losses, Congress added in the 1986 Act limitations on carryover of corporate losses.<sup>282</sup> If the corporation substantially alters its ownership, it will not be able to carry over its losses and offset

275. Otherwise, "[t]he newly-formed company, however, has no material source of present or past income against which to deduct the expense." Bankman, *supra* note 261, at 1743.

276. *Id.*

277. Richard A. Mann et al., *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 801-02 (2004).

278. Additionally, venture capital professionals that structure entrepreneurial transactions care little about utilizing losses as they do not share them personally. See Fleischer, *supra* note 271, at 151 ("Of the four major classes of venture capital investors—U.S. individuals, U.S. corporations, tax-exempt investors, and foreign investors—only a subset of one class, widely-held U.S. corporations with current tax liability, can use the losses fully and is likely to prefer the pass-through structure.")

279. See Fleischer, *supra* note 271, at 138.

280. *Id.* at 140.

281. 26 U.S.C. §§ 381-382 (2012). The limitation in § 382 provides:

Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to—

- (A) the value of the old loss corporation, multiplied by
- (B) the long-term tax-exempt rate.

282. See H.R. REP. NO. 841-99, at 170 (1986) (Conf. Rep.), as reprinted in 1986 U.S.C.C.A.N. 4075, 4258; Daniel Q. Posin, *Three Strikes Are We Out?, Transfer of Loss Carryovers After the 1986 Act*, 7 VA. TAX REV. 697, 697 (1988).

them against future income freely.<sup>283</sup> Yet, this feature may deter investors and greatly limit the ability of entrepreneurs to easily exit the entrepreneurship process.<sup>284</sup>

Another tradeoff of entity classification relates to employment taxes. Entrepreneurs often play several roles. In addition to being owners, they may also serve as directors, managers, and employees. In those cases, self-employment taxes must also be considered.<sup>285</sup> As an employee, an entrepreneur's salary is subject to self-employment taxes whether the organizational form is a partnership, sole proprietorship, LLC, or corporation.<sup>286</sup> However, some of that compensation can be exempt from employment taxes if the firm is classified as an S corporation or a closely held C corporation.<sup>287</sup> Thus, entrepreneurs that are owners-employees are incentivized to choose the S or C corporate form and to characterize their wages as either dividends (from a C corporation) or capital distributions (from an S corporation).<sup>288</sup> Similarly, contributing capital and incurring debt at the enterprise level are treated differently in each organizational form.<sup>289</sup> Indeed, studies show that when entry-level entrepreneurs are making entity

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283. There are also certain tax rules prohibiting many pass-through investment entities from capturing the full benefit of losses. One way to solve these issues may be creating a corporate entity as a subsidiary holding company of the venture capital fund or tax-exempt investors. This type of solution involves planning from both parties and incurring additional transaction costs. See Fleischer, *supra* note 271, at 170 n.134.

284. See Lee, *supra* note 264, at 903-07 (arguing that taxation under Subchapter C is more advantageous for a small private C Corporation owned by high-income shareholders than taxation under Subchapter S or Subchapter K).

285. See Richard Winchester, *The Gap in the Employment Tax Gap*, 20 STAN. L. & POLY REV. 127, 134 (2009) (discussing the S Corporation self-employed tax shelter).

286. See Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW 749, 784 (2009) (comparing the LLC and partnership regimes on this point); Sheryl Stratton, *ABA/AICPA Have Legislative Fix for LLC Self-Employment Tax Problem*, 84 TAX NOTES 351 (1999) (noting S Corporations can treat owners of the business as employees and pay salaries for their labor).

287. 26 U.S.C. § 1402(a)(2) (2012).

288. See Satterthwaite, *Entry-Level Entrepreneurs and the Choice-of-Entity Challenge*, 10 PITT. TAX. REV. 139, 158 (2013).

289. For a sole proprietor, there is no business capital structure for tax purposes apart from the balance sheet of the owner. Increases in partnership debt are considered contributions of money by the partners and decreases are considered distributions of money up to the partner's basis in the partnership. These rules apply similarly to LLCs that elected to be taxed as partnerships. In order to allow losses to pass through to the shareholders, S corporations' debt to its shareholder is added to the shareholder's basis. 26 U.S.C. § 1361(b)(1) (2012). C corporations are more flexible in the sense that they allow multiple classes of stock and debt contribution of capital can be tax-free under certain conditions. 26 U.S.C. § 351 (2012). In addition, payments of interest on debt are deductible to the corporation while loan repayment is a non-taxable event.

classification decisions, these tax considerations create biases in favor of certain classifications, even though those forms may not be their ideal choice.<sup>290</sup>

## 2. *Non-Tax Considerations*

Limited liability is an important tool for lowering uncertainty and decreasing transaction costs. If entrepreneurs are personally liable for the results of the entrepreneurship process, their decision-making process is encumbered by negative externalities.<sup>291</sup> Yet, each of the different organizational classifications provides different degrees of protection from joint or several liability for the enterprise's action and obligations to other parties.<sup>292</sup> Corporate officers and directors owe fiduciary duties of loyalty and due care to the corporation and its shareholders.<sup>293</sup> Accordingly, serial entrepreneurs that implement

290. See generally Emily Satterthwaite, *supra* note 288 (arguing that for tax reasons Subchapter S of the Tax Code has important effects on entrepreneurs' entity choices).

291. Throughout the entrepreneurship process, entrepreneurs act in a state of uncertainty and try to predict future market conditions. Entrepreneurs tend to make their decisions independently if they know that their financial accountability is limited.

292. Sole proprietors are personally liable for debts incurred from their business activity. General partners have unlimited joint and several liability for partnership obligations; each general partner serves as an agent for the partnership and can bind the other partners. Unless they agree otherwise, members or managers of an LLC or shareholders in a corporation are only liable to the extent of the capital they have contributed (unless the limited partner participates in the management and control of the entity or receives an improper distribution). Members of an LLC may be found liable for prohibited distributions. The only way to hold them liable for their actions in the firm is through "piercing the veil" of incorporation. Otherwise, the corporation, LLC, and S corporation are separate legal entities and only the entity's assets are liable for its debts. Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct. MODEL BUS. CORP. ACT § 6.22(b) (A.B.A. 2002). See generally Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 155 (1992) (holding that the legislative history of limited liability was to encourage entrepreneurs to start and grow new businesses); see also Bainbridge, *supra* note 261, at 514-34 (contending that veil piercing is unjustified and advocating for its abolishment); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89 (1985) ("[Veil piercing seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled.]; Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 OR. L. REV. 853, 864 (1997) (arguing that a corporation does not have a mind of its own and by definition is a fictitious entity); Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 9 (1997) (arguing that veil piercing usually occurs in close corporations with fewer than ten shareholders.).

293. Fiduciary duties are the duties of loyalty that agents owe their principals under the fiduciary relationship. These duties result from "the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other to so act." RESTATEMENT (SECOND) OF AGENCY § 1 (AM. LAW INST. 1958). Fiduciary duty issues often arise when entrepreneurs play different roles in the enterprise, such as employee-managers or directors. In an LLC, these duties are somewhat more flexi-

several opportunities in various firms at once run into fiduciary issues.<sup>294</sup> Once the enterprise is formed, LLCs are more flexible, have fewer administrative reporting requirements, and managers can set up their management structures as they please.<sup>295</sup>

Obtaining funding for an entrepreneurial enterprise is not an easy task. This type of funding is done in the shadow of uncertainty. Yet, entrepreneurs who wish to exit using venture funding have to either initially choose an organizational form that benefits venture funders or bear the costs of converting to one at a later stage.<sup>296</sup> Nowadays, conventional wisdom holds that venture capital firms generally do not favor investing in partnerships or LLCs.<sup>297</sup> They prefer the less complex and more predictable corporate laws to partnership and LLC state laws.<sup>298</sup> They prefer “safe” default rules for management and governance rather than relying on sophisticated drafting of management agreements.<sup>299</sup>

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ble and they can be customized in the operating agreement. See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993).

294. Smith & Ibrahim, *supra* note 9, at 1559. On entrepreneurial opportunism and fiduciary consequences, see generally Kenneth B. Davis Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 NW. U. L. REV. 1 (1986) (examining private arrangements and incentives between fiduciary and principal designed to deal with the problems created by corporate opportunism); Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291 (1992) (discussing whether judges should supply expansive implied fiduciary duties to discipline a stronger party’s opportunistic behavior in a cooperative venture.); Brian J. Broughman, *Investor Opportunism and Governance in Venture Capital, Companion to Venture Capital* (2009), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1364133](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364133) (discussing VC opportunism in regards to CEO replacement, later-round financing, and VC exit).

295. Unless otherwise specified in an operating agreement, LLC rules do not require carrying annual meetings, board of directors meetings, shareholders meetings, corporate minutes, and so on.

296. See Mitchell L. Engler, *Progressive Consumption Taxes*, 57 HASTINGS L.J. 55, 85 (2005) (“[E]ntity taxation of partnerships would trigger significant transition costs as the full tax liability would shift from the partners to the partnership.”); Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 105-07 (2001).

297. STEPHEN F. REED & ESTHER S. BARRON, *ENTREPRENEURSHIP LAW* 67 (2013); Fleischer, *supra* note 271, at 138.

298. See Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 389 (2003) (arguing that, throughout history, corporate form is more useful due to its restrictions on capital withdrawals). *But see* Larry E. Ribstein, *Should History Lock in Lock-In?*, 41 TULSA L. REV. 523, 524-25 (2006) (arguing that the transaction costs associated with lock-in and its availability to the partnership form call into question the true value of lock-in).

299. These laws have accumulated a substantial amount of case law, and they are much more predictable and reliable. See Deborah A. DeMott, *Agency and the Unincorporated Firm: Reflections on Design on the Same Plane of Interest*, 54 WASH. & LEE L. REV. 595, 611 (1997) (arguing that sophisticated investors are not likely to experiment with organizational innovations that carry uncertain consequences). Unlike LLC case law, the rights of shareholders of C corporations—and their officers’ duties—are well established in

Moreover, many venture capital firms are organized as limited partnerships. They have rules prohibiting their managers from investing in flow-through entities due to the tax implications for their limited partners.<sup>300</sup> Other institutional investors, such as tax-exempt organizations or foreign investors, prefer the corporate form so as to avoid the tax consequences of receiving unrelated business income.<sup>301</sup> Exiting the entrepreneurship process using a public offering also entails converting to the corporate form and incurring conversion costs.<sup>302</sup> Entrepreneurs who anticipate public funding are forced to choose between incorporating in the early phases of the entrepreneurship process or bearing the cost of converting at a later stage.<sup>303</sup> The chosen organizational classification, thus, signals to the market the entrepreneur's exit strategy.<sup>304</sup>

Lastly, during the entrepreneurship process, entrepreneurs often make use of employee stock options to fund their labor force.<sup>305</sup> Employee stock option programs serve as a way to attract qualified em-

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corporate case law. Thus, corporations have a better reputation for serving the needs of the entrepreneurship process. *See* Bankman, *supra* note 261, at 1766 (noting the nonmonetary benefits of the corporate form in reference to investment goals); Fleischer, *supra* note 271, at 163 ("For the venture capital professionals and entrepreneurs who negotiate the deal structure, however, gains are taxed more favorably if the C corp. structure is used."); Calvin H. Johnson, *Why Do Venture Capital Funds Burn Research and Development Deductions?*, 29 VA. TAX REV. 29, 91 (2009) (claiming that venture capital funds form a separate C corporation for each venture that they support within their portfolio of diverse ventures); Lee, *supra* note 264, at 921 ("A few significant contexts, such as business reasons, idiosyncratic investor preferences, or a near-term goal of going public, may induce selection of a C Corporation, even when initial losses are anticipated, foregoing the income tax savings of a passthrough entity.")

300. *See* Mann et al., *supra* note 277.

301. Fleischer, *supra* note 271, at 137-38.

302. *Id.* (arguing that while follow-throughs may be more tax efficient due to the transaction costs, information problems, reputational concerns, and adverse accounting treatment prevent deal planners from using the theoretically tax-favorable form). *But see* Goldberg, *supra* note 270, at 937 (contending that converting from a partnership or an LLC to a C corporation is not too costly).

303. *See* Ribstein & Kobayashi, *supra* note 296, at 106. *But see* Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 869 (2013) (describing the special purpose acquisition corporation ("SPAC") a uniquely public form of private equity fund).

304. Choosing the corporate form allows greater liquidity and possibilities for exiting. Selecting pass-through organizational forms may signal to the market a desire for control and longer anticipated entrepreneurial progression.

305. *See* S. Amdt. 1668 2(a) to S. 783, 103rd Cong. (1994) (enacted) (expressing the importance of employee stock options to businesses in the high growth sectors that rely heavily on human capital); Doug Collom, *Vesting of Founders' Stock: Beyond the Basics*, THE ENTREPRENEUR'S REPORT: PRIVATE COMPANY FINANCING TRENDS 9 (2008); Erica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 NW. U. L. REV. 1123, 1150 (2007) (arguing that high-tech firms perceive employee stock options as a critical mechanism for retaining knowledgeable employees).

ployees by offering them a combination of lower compensation and future equity rights in the entrepreneurial success.<sup>306</sup> These programs personally motivate workers to maximize their labor efforts and collaborate with management to make sure the organization prospers.<sup>307</sup> Entrepreneurs have more ready access to these types of programs in the corporate form than in the other organizational forms.<sup>308</sup>

### 3. Possible Solutions

Current organizational frameworks are not in sync with the nature and characteristics of the entrepreneurship process.<sup>309</sup> Entrepreneurs must contend with too many legal considerations and tradeoffs when they are trying to establish enterprises to implement their discoveries. The flow-through legal classification may be beneficial in passing on the major research and development expenses and losses to the entrepreneur in the discovery and resourcing stages.<sup>310</sup>

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306. See PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 161 (2d ed. 2004) ("Managers and critical employees within a [start-up] firm receive a substantial fraction of their compensation in the form of equity or options. This tends to align the incentives of managers and investors."); Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 880 (2003) ("An overwhelming percentage of management's compensation depends on firm performance. The potential for dramatic appreciation in the value of stock and options thus offsets low salaries.").

307. See Ronald J. Gilson, *Locating Innovation: The Endogeneity of Technology, Organizational Structure, and Financial Contracting*, 110 COLUM. L. REV. 885, 903 (2010) ("The performance incentive is further heightened by requiring the entrepreneur and other members of management to accept a staged vesting requirement on some or all of their stock or stock options."); James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 317-18 (2009) (claiming that investors commonly use performance-based compensation, such as stock options that have the effect of exerting effort instead of shirking them); Ibrahim, *supra* note 221, at 30 ("VCs instill high-powered performance incentives in entrepreneurs and employees by compensating them with start-up stock and stock options.").

308. Such as the C corporation. See 26 U.S.C. §§ 421-423 (2012). Employees who own equity in a partnership are treated as partners and are subject to increasing tax liability issues. While lawyers of partnerships and LLCs can devise profit interests agreements and create different classes of profit participation, they are usually more complex and costly. These increased transaction costs may turn away capable employees from joining the enterprise. See Ribstein & Kobayashi, *supra* note 296, at 106.

309. See Ribstein & Kobayashi, *supra* note 296, at 106; see also Mitchell F. Crusto, *Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)*, 2001 COLUM. BUS. L. REV. 381 (2001) (arguing that to encourage would-be entrepreneurs to create businesses, the law should enact a limited liability statute designed for the sole proprietor); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1630 (1991) ("While limited liability of close corporation shareholders may encourage a certain amount of undue risk, unlimited liability would probably result in excessive risk aversion by entrepreneurs, particularly given the inability of such investors to diversify."); Mann et al., *supra* note 277.

310. See generally Goldberg, *supra* note 270.

However, in later stages, this structure no longer remains attractive to foreign or non-profit institutional investors that have limitations on creating unrelated business income.<sup>311</sup> Each state governs the different entity choices in its region, so entrepreneurs must also master different state law rules.<sup>312</sup> These legal classifications impose unnecessary informational and transactional costs on entry-level entrepreneurs and lock them in inefficient routes.<sup>313</sup>

Due to the unique role that it plays in the economy, entrepreneurship should not be confined to a specific legal framework; rather, it should be permitted to evolve into its optimal form without paying exorbitant transition costs.<sup>314</sup> In 1996, Treasury attempted such change by issuing new regulations known as “check-the-box” to simplify the manner in which the tax system determines how business entities are taxed.<sup>315</sup> These regulations allow taxpayers greater flexibility in electing between pass-through or corporate tax classification irrespective of their non-tax designation.<sup>316</sup> Nevertheless, while check-the-box regulations improved tax simplicity they did not lower the tax costs of conversion and were criticized for their failure to amend the multi-regime system for taxing businesses.<sup>317</sup>

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311. See Fleischer, *supra* note 271, at 137-38.

312. See Daniel J. Morrissey, *Piercing All the Veils: Applying an Established Doctrine to a New Business Order*, 32 J. CORP. L. 529, 555 (2007) (applying veil piercing doctrine to LLCs and LLPs).

313. See *id.* at 554; see also Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 92 n.378 (1996) (suggesting that as an alternative to insurance, entrepreneurs could demonstrate financial responsibility either by posting a bond or by proving their financial condition in the same amount as the limits of the liability insurance policy for which it would substitute); Michael Simkovic, *The Knowledge Tax*, 82 U. CHI. L. REV. 1981 (2015).

314. See, e.g., Ass'n of the Bar of the City of N.Y. Comm. on Taxation of Partnerships and Other Pass-Through Entities, *Report on the Proposed “Check-the-Box” Regulations on Entity Classification*, 51 RECORD 663 (1996) (critiquing check-the-box regulation and entity classification transition rules, default rules, and treatment of changes in classification by election).

315. The new regulation's biggest change was providing LLCs that have more than one member a default classification as a partnership but an option to elect to be taxed as a corporation. See generally Heather M. Field, *Checking in on “Check-the-Box”*, 42 LOY. L.A. L. REV. 451 (2009) (criticizing the entity classification regime twelve years after the promulgation of the regulation).

316. On March 29, 1995, the Department of the Treasury issued Notice 95-141 announcing its intent to simplify the tax entity classification rules. Two years later, on December 17, 1996, the Treasury finalized 26 C.F.R. § 301.7701, also known as the “check-the-box” regulations, by which eligible entities can indicate their desired tax treatment simply by checking a box. See Hayes, *supra* note 264, at 1148.

317. Field, *supra* note 315, at 451 (arguing that the regulations lack a coherent set of limitations, which undermines the goals behind the provision of the election); cf. Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 450-51 (2005) (“By permitting taxpayers to choose, for instance, to treat a limited liability company as a corporation, as an alternative

While the law contains some beneficial rules to embolden entrepreneurship, it is far from attaining a full-fledged entrepreneur-friendly climate.<sup>318</sup> Despite some progress, current transition rules between various organizational classifications place high costs and limit the autonomy of the entrepreneur.<sup>319</sup> These rules widen the disconnect between legal entity choice and the nature of the entrepreneurship process. They restrict entrepreneurs from freely departing the entrepreneurship process and reaping entrepreneurial gains.

Consider, for example, an entrepreneur whose discovery process incurs significantly more research and development costs than initially expected. In order to offset these expenses at the individual level until the discovery begins to pay off the entrepreneur may want to adjust out of the corporation form. Yet, current check-the-box regulations restrict the entrepreneur's ability to change entity classification more than once in a five-year period.<sup>320</sup> De facto, these rules place a serious hurdle on the entrepreneur's ability to adjust the legal framework to the fast-changing nature of the entrepreneurial process. Additionally, once the entrepreneur changes the enterprise from a corporation to a different entity classification, the corporation is deemed to have liquidated, which could entail recognition of significant gains.<sup>321</sup> Finally, should the entrepreneur receive an opportunity to merge or exit the entrepreneurial process, loss carryover rules restrict the amount of pre-change losses that can be used to offset post-change gains to a fraction of the value of the old loss corporation.<sup>322</sup> This may place yet another obstacle in the entrepreneur's way to implementing and realizing entrepreneurial success or failure.

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to the standard partnership treatment, the election spares taxpayers from whatever transactional complexity . . . .").

318. For example, tax law provides for research and development tax credit, see 26 U.S.C. § 41, deductibility of start-up costs, see 26 U.S.C. § 195, etc. See Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 351-52 (2013) (describing three important tax incentives that have been adopted in the United States and Europe to support and stimulate technological innovation in an effort to enhance economic growth: (1) tax credits and super deductions for R&D, (2) patent (or innovation) boxes—the latest European fashion—and (3) special deductions or lower income tax rates for “advanced manufacturing.”).

319. See Satterthwaite, *supra* note 290, at 158 (“[C]onverting to a different type of entity once the business is up and running and has going-concern value as an S Corporation is complicated and can be costly.”); see also *supra* note 263 and accompanying text.

320. Treas. Reg. § 301.7701-3(c)(1)(iv) (as amended in 2005); see also Field, *supra* note 315, at 503-04 (explaining that the rule was placed for administrability of entity classification and anti-abuse function).

321. The liquidation of a corporation requires recognition of gains and losses at both the corporate level and the shareholder level. 26 U.S.C. §§ 331, 336 (2012).

322. 26 U.S.C. § 382(b) (2012).

Finding solutions that balance the nature of entrepreneurship with other legal systemic values such as administrability, simplicity, and prevention of gaming is not an easy task.<sup>323</sup> Naturally, under a purely elective system without limits, entities could abuse the legal system to try to benefit from certain tax and non-tax attributes.<sup>324</sup> Yet, a flexible and adaptable legal system could incorporate more latitude as innovation progresses.

In order to allow more mobility at minimal costs, legal institutions governing the entity choices should make judicious determinations about the consequences of altering selections.<sup>325</sup> The Internal Revenue Service should create a special high-tech division, similar to the large and mid-size or tax-exempt business divisions with agents that possess experience working with entrepreneurs and are guided to think like them.<sup>326</sup> More concretely, costless transitioning more than once within the current 5-years window could be allowed unless the entrepreneur fails to prove that the transaction has a bona fide rather than avoidance purpose.<sup>327</sup> Similarly, just like in the case of

323. See Field, *supra* note 315, at 506.

324. *Id.*

325. For example, when faced with a check-the-box application to change entity choice, the IRS does not consider particular facts and circumstances in making the determination and is limited to time limitation rules. See generally 26 C.F.R. § 301.7701-2 (2015); § 301.7701-3; IRS Form 8832.

326. IRS, INTERNAL REVENUE SERVICE MANUAL 1.1.24.1 (20016), [https://www.irs.gov/irm/part1/irm\\_01-001-024.html#d0e10](https://www.irs.gov/irm/part1/irm_01-001-024.html#d0e10).

327. For example, corporate tax rules allow assumption of liabilities unless there is an apparent tax avoidance purpose:

(b) Tax avoidance purpose

(1) In general If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of proof

In any suit or proceeding where the burden is on the taxpayer to prove such assumption is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

26 U.S.C. § 357(b) (2012).

corporate reorganization, loss carryover can be allowed if a substantial part of the investment and business activity of the acquired corporation (rather than ownership) is preserved.<sup>328</sup>

Undoubtedly, these proposals will not resolve the distortionary effects of organizing entrepreneurship entirely. They may even introduce new costs, gaming opportunities, and inefficiencies. One such inefficiency could be the difficulty in distinguishing entrepreneurial firms from other business entities. While this endeavor is challenging, it is not unfeasible.<sup>329</sup> The proposals above have the potential of lowering transition costs and empowering entrepreneurs to match organizational choices with the fluctuating nature of their discovery.<sup>330</sup> They can be instrumental in narrowing the instances of entrepreneurs having to strike a compromise between financial autonomy, taxation, and governance issues when choosing their vessel for innovation.<sup>331</sup>

Policymakers that seek to foster entrepreneurship should consider further experimentation with opportunities to promote a culture of freedom and creativity.<sup>332</sup> Additional research should be done on ways to achieve costless entity switching in a manner that will not change ex-ante entrepreneurs' organizational considerations. Seeing the issue of organizational choice through the lens of entrepreneurs involves incorporating organizational liberty and realizing that the entrepreneurial environment is highly invested (from its preliminary

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328. For example, corporate reorganization rules afford tax-free treatment under the "continuity of business enterprise" requirement if the principal purpose of the transaction was not to reduce tax liability. 26 U.S.C. § 368 (Supp. II 2014); Treas. Reg. § 1.368-1(d). See generally Gregg D. Polsky & Brant J. Hellwig, *Examining the Tax Advantage of Founders' Stock*, 97 IOWA L. REV. 1085, 1098 (2012); Daniel Q. Posin, *A Case Study in Income Tax Complexity: The Type A Reorganization*, 47 OHIO ST. L.J. 627, 644 n.112 (1986) ("A corporation's historic business is generally the business it has conducted most recently but is not one the corporation has entered into as part of the plan of reorganization."). A similar rule can be found in corporate distributions of stock and securities under § 355(b) which requires, among other things, that the distributing corporation or the controlled corporation is engaged immediately after the distribution in the active conduct of a trade or business. 26 U.S.C. § 355(b) (Supp. II 2014).

329. See, e.g., Mirit Eyal-Cohen, *supra* note 51 (utilizing Schumpeterian economic theory to create a new legal model that measures entrepreneurial qualities).

330. For example, if they are in the computer software industry and will expect to be financed by angel investors or a few individuals, the pass-through form will be beneficial. If they are in the pharmaceutical industry and require institutional investors, the C Corporation form will be ideal for them.

331. See, e.g., Bankman, *supra* note 261, at 1741 (arguing that because of tax advantages, using an entity with pass-through taxation is a better choice than using a corporation).

332. See, e.g., Sean M. O'Connor, *Creators, Innovators, and Appropriation Mechanisms*, 22 GEO. MASON L. REV. 973, 975 (2015) (arguing that policymakers should not allow interested players to narrow the debate to the appropriation mechanisms of only one stakeholder group in creative innovation ecosystems).

stages) in obtaining knowledge, is uncertain, and aims to quickly depart after attaining its rewards. The next Section demonstrates similar concerns pertaining to legal classifications in entrepreneurial failure.

### B. Entrepreneurial Default

The risk of failure and its adverse legal consequences constantly threaten businesspeople.<sup>333</sup> Yet, due to the unusually high investment in knowledge and discovery, entrepreneurial failure can result in even more massive (positive and negative) consequences. Because of the uncertainty inherent in the entrepreneurship process, entrepreneurs cannot accurately anticipate possible personal injuries or contractual damages or to calculate the probabilities of those occurrences.<sup>334</sup> When a new product creates new market demand and new customers, its failure can cause the firm to default and it can also result in numerous lawsuits and colossal damage payments.<sup>335</sup> Law, thus, plays a vital part in resolving entrepreneurial default.

Failure is as important to the entrepreneurship process as success.<sup>336</sup> Entrepreneurial failure diffuses knowledge and delivers positive spillovers to other entrepreneurs, markets, and industries.<sup>337</sup> It can limit the outcomes of that failure so as not to discourage entrepreneurs from assuming new risks or from entering the market. Entrepreneurs tend to make decisions based on the merits of the innovation independently when the scope of their financial accountability is limited.<sup>338</sup> Indeed, studies have indicated net negative effects of

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333. See generally René M. Stulz, *Six Ways Companies Mismanage Risk*, HARV. BUS. REV., Mar. 2009, <https://hbr.org/2009/03/six-ways-companies-mismanage-risk> (arguing that the failure of conventional risk-management contributed greatly to the current global financial crisis); Nassim N. Taleb et al., *The Six Mistakes Executives Make in Risk Management*, HARV. BUS. REV., Oct. 2009, <https://hbr.org/2009/10/the-six-mistakes-executives-make-in-risk-management> (“Because of the internet and globalization, the world has become a complex system, made up of a tangled web of relationships and other interdependent factors.”).

334. See KNIGHT, *supra* note 25, at 43-45.

335. James T. O'Reilly, *Entrepreneurs and Regulators: Internet Technology, Agency Estoppel, and the Balance of Trust*, 10 CORNELL J.L. & PUB. POL'Y 63, 69 (2000) (“True innovations like novel drugs carry unforeseen consequences that only emerge after market entry. If the innovator's widget breaks so easily that dozens of users bring products liability claims, the entrepreneur's capital will be exhausted in defense of liability lawsuits or suits for economic damages from the failure of the product.”) (footnote omitted).

336. See *supra* Section III.D.

337. See *supra* notes 86-89, 114.

338. See David Millon, *Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability*, 56 EMORY L.J. 1305, 1317 (2007) (“Limited liability therefore encourages entrepreneurial activity by attempting to shift the risk of corporate insolvency from shareholders to the business's creditors.”); Stephen B. Presser, *Thwarting the Killing*

imposing a financial responsibility requirement on entrepreneurs.<sup>339</sup> They have also demonstrated that previous business failures make it extremely difficult for entrepreneurs to receive new funding.<sup>340</sup> Therefore, bankruptcy law plays an important role in reducing uncertainty and in facilitating an exit in the entrepreneurship process.<sup>341</sup>

### 1. *Bankruptcy Classifications*

Bankruptcy law provides procedures for individuals and business debtors to reach discharge of debt<sup>342</sup> and a fresh economic start.<sup>343</sup> In the entrepreneurial context, bankruptcy procedures offer an opportunity for debt relief and to pursue a different route to implement ideas. Yet, the concept of bankruptcy's fresh start, as a theoretical underpinning does not transpire in the entrepreneurial reality<sup>344</sup> and may even lock entrepreneurs into their failed enterprises.<sup>345</sup>

Today, bankruptcy laws are divided into two main categories: Chapter 7 (basic liquidation) or Chapter 11 (rehabilitation or reorganization).<sup>346</sup> Chapter 7 provides relatively quick and straightforward

*of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. L. REV. 148, 155-56 (1992) (stating that limited liability was rooted to encourage small and impecunious entrepreneurs to start and grow new businesses); Smith & Ibrahim, *supra* note 9, at 1536 ("[L]imited liability and asset partitioning—reduce the costs of entrepreneurial action and failure, thus emboldening entrepreneurs to exploit opportunities."). See generally Bainbridge, *supra* note 261, at 106 (discussing corporate opportunism in several stages of VC financing).

339. While entrepreneurs should internalize some risk, these studies focused on the overall societal effect of restraining entrepreneurship. See Seung-Hyun Lee et al., *Entrepreneurship and the Barrier to Exit: How Does an Entrepreneur-Friendly Bankruptcy Law Affect Entrepreneurship Development at a Societal Level?* (Small Bus. Admin., Working Paper No. SBAHQ-06-M-0536, 2008), <http://core.ac.uk/download/pdf/7372321.pdf>; see also LoPucki, *supra* note 313, at 88-89.

340. See PHILIP J. ADELMAN & ALAN M. MARKS, *ENTREPRENEURIAL FINANCE: FINANCE FOR SMALL BUSINESS* 162-63 (2d ed. 2001) (demonstrating the difficulties for these businesses in establishing a line of credit to protect against cash flow deficiencies).

341. *Id.*

342. See generally DOUGLAS G. BAIRD, *ELEMENTS OF BANKRUPTCY* 30-61 (6th ed. 2014) (providing a comprehensive introduction to the basic principles of bankruptcy law).

343. See Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1047, 1059 (1987); see also KAREN GROSS, *FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM* 91 (1997) ("[D]ebtors should have an 'opportunity to begin anew' or a 'chance to start over.'").

344. See, e.g., John M. Czarnetzky, *Time, Uncertainty, and the Law of Corporate Reorganizations*, 67 FORDHAM L. REV. 2939, 2981 (1999) (criticizing the rules governing corporate bankruptcy in the entrepreneurial context).

345. See Katherine Porter & Deborah Thorne, *The Failure of Bankruptcy's Fresh Start*, 92 CORNELL L. REV. 67, 69-72 (2006) (arguing that their empirical findings challenge the fresh start as the theoretical underpinning for consumer bankruptcy relief).

346. Aside from these, Chapter 13 provides for payment plan rehabilitation for sole proprietors, Chapter 9 provides for municipal bankruptcy, Chapter 12 provides for rehabilitation for family farmers and fishermen; and Chapter 15 is designed for international

ward liquidation procedures for individuals and businesses and it is often referred to as “personal bankruptcy.”<sup>347</sup> In Chapter 7 cases a court-appointed trustee liquidates the debtor’s property, distributes the proceeds to the creditors, and discharges the debtor from most (or all) of the debt.<sup>348</sup> Here, the search for a new business opportunity is encouraged by a fresh start that is not conditioned upon keeping the old business intact.<sup>349</sup> Chapter 11 is used primarily by corporate debtors for financial rehabilitation.<sup>350</sup> Debtors negotiate a reorganization plan with their creditors while continuing their operations as going concern and retaining their assets.<sup>351</sup>

Entrepreneurial failure does not entirely fit within these two bankruptcy classifications. In practice, entrepreneurs often face personal liability for their enterprises’ liabilities.<sup>352</sup> Corporate bankruptcy is essentially a sorting mechanism that aims to identify if a firm has greater value as a going-concern rather than as its separate, liquidated parts.<sup>353</sup> It seeks to maximize the firm’s social value by allowing it to continue to operate.<sup>354</sup> It provides rules and procedures to

debtors. *See generally* DAVID G. EPSTEIN ET AL., *BANKRUPTCY* 769-79 (1993); JAMES J. WHITE & RAYMOND T. NIMMER, *CASES AND MATERIALS ON BANKRUPTCY* 171 (3d ed. 1996).

347. As of 2005, Chapter 7 discharge is available only once every eight-year period. *See* The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23. *See generally* Hansmann et al., *supra* note 260, at 1403 n.245 (2006) (claiming the act strengthened the position of creditors at the expense of consumer debtors, in large part by shifting individual cases from Chapter 7 to Chapter 13).

348. Unless the debtor is found guilty of certain types of prohibited behaviors such as concealing records.

349. Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2319 (2005).

350. Chapter 11 is the point of entry for many companies that cannot file under chapter 7. *See* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 605-06 (2009) (providing data to defuse criticism on Chapter 11 procedures as having a relatively low success rate and endless delay).

351. In some cases, the plan of reorganization involves a massive sale of assets. *See* Matthew A. Bruckner, *Improving Bankruptcy Sales by Raising the Bar: Imposing a Preliminary Injunction Standard for Objections to § 363 Sales*, 62 CATH. U. L. REV. 1, 8-9 (2012) (indicating the importance of the quick sale of all or a part of the entity’s assets under Chapter 11 reorganization cases).

352. *See* Jeremy Berkowitz & Michelle J. White, *Bankruptcy and Small Firms’ Access to Credit*, 35 RAND J. ECON. 69, 71 (2004). While much of the bankruptcy theory has focused on corporate bankruptcy, personal bankruptcy is more relevant to sole-proprietor entrepreneurs, some of whose business debts are secured by personal assets. *See generally* THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986) (analyzing the role of bankruptcy law in collective action and debt collection).

353. *See* Baird & Morrison, *supra* note 349, at 2313.

354. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 685-93 (2003) (demonstrating the effect of assets and business relationships on going-concern values).

better coordinate those going-concern values and their economic realities. Yet, in the context of entrepreneurship, it creates a deficit.

Realizing the transient nature of the process, entrepreneurs tend to be over-optimistic and may begin production and expansion before completing the research and discovery stage. In that case, society may benefit from rehabilitating the entrepreneurial enterprise and rebooting the process at a slower pace.<sup>355</sup> Nevertheless, in the typical entrepreneurial bankruptcy scenario, errors often relate to uncertainty in discovering or creating opportunities. When there are few capital assets and most of the inherent value of an entrepreneurial business is built in accumulated knowledge and human capital, it is useless to concentrate on the entity's tangible property and its capital structure.<sup>356</sup> The innovative firm rarely has value outside of the business. This often makes little sense to view the enterprise as a going-concern.<sup>357</sup> Attempts to reshuffle the assets and debts of the entrepreneurial firm in bankruptcy will yield tangential, not significant results. Thus, in some instances bankruptcy law overly penalizes entrepreneurial firms for their errors, and may discourage them from pursuing inherently high-risk opportunities even if they offer a potentially high return.<sup>358</sup>

## 2. *Unraveling Flexibility*

While many entrepreneurial businesses fail, the entrepreneurship culture of self-employment and independence motivates entrepreneurs to start anew.<sup>359</sup> Empirical studies have shown that serial entrepreneurs launch new businesses at a rate much higher than the

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355. Baird & Morrison, *supra* note 349, at 2318 ("The socially optimal strategy for the entrepreneur is to shed the excess capacity and retreat to the core business that she once ran successfully.").

356. *See id.* at 2315; *see also* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J.L. & ECON. 381, 382 (2007).

357. *See* Baird & Morrison, *supra* note 349, at 2311 ("It is therefore a mistake to ask whether the corporate entity that is the subject of the bankruptcy case is worth saving.").

358. *See* Seung-Hyun Lee et al., *How Do Bankruptcy Laws Affect Entrepreneurship Development Around the World?*, 26 J. BUS. VENTURING 505, 506-07 (2011).

359. *See* Baird & Morrison, *supra* note 349, at 2338 ("Among businesses that were shut down in bankruptcy, the owner-operators went on to found another business in 50% of the cases. In about 38% of the cases, the new business was similar to the one that was liquidated in bankruptcy."); Saras D. Sarasvathy et al., *Failing Firms and Successful Entrepreneurs: Serial Entrepreneurship as a Temporal Portfolio*, 40 SMALL BUS. ECON. 417 (2013) (concluding that at least one-third of new firms are founded by entrepreneurs who have started businesses before); U.S. Bureau of the Census, *Statistics for Owners of Respondent Firms by Whether the Owner Previously Owned a Business or Had Been Self-Employed by Gender, Ethnicity, Race, and Veteran Status for the U.S.* (2007), [http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SBO\\_2007\\_00CSCBO06&prodType=table](http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SBO_2007_00CSCBO06&prodType=table).

general population.<sup>360</sup> They rapidly recover from their failure to engage in other entrepreneurial ventures.<sup>361</sup> In the majority of case studies, entrepreneurs express interest in remaining entrepreneurs after completing their bankruptcy procedures.<sup>362</sup> This inclination for freedom and creativity fuels the entrepreneurship process whether the ultimate outcome is exit through failure or success.

The current chapter 11 bankruptcy classification distorts this inclination by encouraging entrepreneurs to tie their human capital to their failed venture.<sup>363</sup> It incentivizes entrepreneurs to reorganize and rehabilitate their business, which are the aims of corporate bankruptcy, but not necessarily entrepreneurial bankruptcy. Unraveling the distinct reasons entrepreneurs enter into bankruptcy proceeding is the first step to bridging this gap. Entrepreneurs may initiate bankruptcy procedures for different reasons. Oftentimes, they seek to benefit from the automatic stay, to attain temporary liquidity, to realize an opportunity to renegotiate debts, and to obtain greater bargaining position with some of their creditors that can only be accomplished by filing for bankruptcy.<sup>364</sup> They do not necessarily wish to continue to pursue the original opportunity. Once initiated, these causal classifications of bankruptcy laws often lock entrepreneurs

360. Baird & Morrison, *supra* note 349, at 2339 (stating that eighty-five percent of the owner-operators in the authors' sample are serial entrepreneurs).

361. See Rafael Efrat, *Minority Entrepreneurs in Bankruptcy*, 15 GEO. J. ON POVERTY L. & POL'Y 95 (2008); see also Kenneth Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J.L. ECON. & ORG. 161, 161-62 (2007) (arguing that a "fresh-start" bankruptcy policy provides greater social surplus due to greater debt relief than creditors would have approved voluntarily); Rafael Efrat, *The Evolution of Bankruptcy Stigma*, 7 THEORETICAL INQUIRIES L. 365, 366-67 (2006) (indicating a shift in public attitudes beginning in the 1960's towards individuals filing for personal bankruptcy in the United States); Frank M. Fossen, *Personal Bankruptcy Law, Wealth, and Entrepreneurship—Evidence from the Introduction of a "Fresh Start" Policy*, 16 AM. L. & ECON. REV. 269 (2014) (demonstrating that the "insurance effect" of a more forgiving personal bankruptcy law exceeds the interest effect and encourages less wealthy individuals to enter into entrepreneurship). But see Baird & Morrison, *supra* note 349, at 2349 (claiming that most businesses enter bankruptcy not to avoid inefficiencies cured by Chapter 11, but rather to exploit potential inefficiencies created by the Code, including the entrepreneur's enhanced bargaining power in disputes with a creditor, landlord, or some other third party).

362. See Rafael Efrat, *The Rise & Fall of Entrepreneurs: An Empirical Study of Individual Bankruptcy Petitioners in Israel*, 7 STAN. J.L. BUS. & FIN. 163, 165 (2002).

363. Baird & Morrison, *supra* note 349, at 2343 ("If given the chance to take advantage of Chapter 11 in this manner, [entrepreneurs] would be acting rationally, just as those who remain in a rent-controlled apartment that is too small or too far from work are acting rationally.").

364. See A. Mechele Dickerson, *The Many Faces of Chapter 11: A Reply to Professor Baird*, 12 AM. BANKR. INST. L. REV. 109, 116 n.42 (2004); cf. Kenneth M. Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J.L. ECON. & ORG. 161, 179-80 (2007) (stating that entrepreneurs can use bankruptcy laws to obtain efficient levels of debt forgiveness).

into their failure entity by incentivizing them to reorganize and interfere with their effort to find a better match for their talents.<sup>365</sup>

Viewing bankruptcy theory through the lens of innovation should focus the analysis on the *entrepreneurs* (whether owners or employees of the bankrupt entity) rather than on the enterprise. The court should emphasize the value of entrepreneurial *knowledge* instead of physical capital and generic tools and equipment.<sup>366</sup> Acknowledging the transient and exit motive nature of the entrepreneurship process should promote a swift resolution and easy transfer of knowledge and intellectual capital to a new venture.<sup>367</sup> Bankruptcy law should target the way in which entrepreneurial assets can best be *implemented* rather than assessing their separate value or contribution to the failed going-concern surplus.<sup>368</sup>

Studies have demonstrated that bankruptcy laws have positive and negative effects on entrepreneurship.<sup>369</sup> They may be improved and made more entrepreneur-friendly without compromising the integrity of the system as a whole. Specialized fast-track bankruptcy proceedings for entrepreneurial entities governed by judges that possess scientific knowledge may achieve better results in sorting out failed from potential opportunities. In the latter cases, it may encourage more channels for debt negotiations and dispute resolutions

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365. Much like basis-shifting tax rules encourage ownership lock-in of appreciating assets. See David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 J. LEGAL STUD. 71, 72 (2000).

366. See Baird & Morrison, *supra* note 349, at 2331-32 (“The only significant asset is the human capital of the entrepreneur, and it can be readily deployed in different businesses. Similarly, the relationships with suppliers, customers, and workers are tied to the entrepreneur, not to the business.”) (footnote omitted).

367. *Id.* at 2311 (“The owner-operator’s human capital is fully portable and is used to start a string of businesses over her lifetime. She moves from business to business—often in the same industry—until finding a good match between her human capital and a particular business model.”). Serial entrepreneurs are entrepreneurs who “specialize in starting innovative companies, and they often voluntarily leave to others the development and ongoing management of the firm.” D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1474 (2002); see also Mark Gimein, *Silicon Valley’s Serial Entrepreneurs: Why Wait for the IPO?*, FORTUNE, Feb. 21, 2000, at 269; Paul Gompers et al., *Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs* 12-13 (Nat’l Bureau of Econ. Research, Working Paper No. 12592, 2006).

368. For example, a patent is worth much less as a separate asset than it is as part of an assembly line implementation process. For the difference between financial and economic distress, see Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573, 580-83 (1998).

369. See Lee et al., *supra* note 358, at 505 (“[W]e find that lenient, entrepreneur-friendly bankruptcy laws are significantly correlated with the level of entrepreneurship.”); *Axtmann v. Chillemi*, 740 N.W.2d 838, 843-44 (N.D. 2007) (criticizing entrepreneurs using a corporate shell); Morrissey, *supra* note 312, at 533 (calling for entrepreneurial liability in cases of fraud and injustice).

to afford entrepreneurs “breathing space.”<sup>370</sup> In the other cases, it may accelerate dissolution to allow entrepreneurs to proceed to their next discovery.

Bankruptcy judges can benefit from using “expert entrepreneur appointees” as restructuring advisers in recommending the court whether to develop a turnaround plan for the company, seek opportunities for merger, provide additional time to reassess the entrepreneurial opportunity, or dissolve the entity. While these proposals may be more costly and difficult to administer they hold value in providing separate procedures for entrepreneurial defaults and expediting resolution of the entrepreneurial process.<sup>371</sup> A legal system with a reputation of embracing greater opportunities for either leeway or a fast exit upon failure could attract more entrepreneurship and generate larger social surplus.<sup>372</sup>

## VI. CONCLUSION

“Law must be stable, and yet it cannot stand still.”

—Roscoe Pound, 1967<sup>373</sup>

A core tension exists between law and entrepreneurship.<sup>374</sup> Entrepreneurial vision is costless.<sup>375</sup> Nevertheless, the legal system plays a major role in encouraging but also inhibiting the entrepreneurship process by placing costly hurdles in its path.<sup>376</sup> Current legal structures demonstrate that focusing on maintaining stability and predictability by enforcing legal order and causality is too narrow and may create significant distortions and misguide entrepreneurs. Reducing particular business circumstance to strict legal

370. See Baird & Morrison, *supra* note 349, at 2315 n.22.

371. See Seung-Hyun Lee et al., *Bankruptcy Law and Entrepreneurship Development: A Real Options Perspective*, 32 ACAD. MGMT. REV. 257, 257 (2007) (“We suggest that a more entrepreneur-friendly bankruptcy law, informed by a real options logic, can encourage more active and vibrant entrepreneurship development.”). For example, Chapter 12—designed for family farmers or family fishermen—allows breathing space and rapid fresh start to debtors.

372. See Viral V. Acharya & Krishnamurthy V. Subramanian, *Bankruptcy Codes and Innovation*, 22 REV. FIN. STUD. 4949, 4986 (2009) (confirming that a debtor-friendly code leads to a higher absolute level of patent activity); Kenneth Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J.L. ECON. & ORG. 161, 162 (2007). See generally ROBERT CLARK, CORPORATE LAW 71 (1986).

373. ROSCOE POUND, INTERPRETATIONS OF LEGAL HISTORY 1 (12th prt. 1963).

374. See, e.g., BENJAMIN N. CARDOZO, THE GROWTH OF THE LAW 3 (1924) (stating that such a balance “is the problem of the ages”); GEORGE P. FLETCHER, BASIC CONCEPTS OF LEGAL THOUGHT 43-59 (1996) (emphasizing the tension between rules and discretion).

375. KIRZNER, DISCOVERY, *supra* note 74, at 27.

376. Justin W. Evans & Anthony L. Gabel, *Legal Competitive Advantage and Legal Entrepreneurship: A Preliminary International Framework*, 39 N.C. J. INT’L L. & COM. REG. 333, 334-35 (2014).

classifications fails to fully encompass the spirit of entrepreneurship; thus, a change in academic, legal, and political debates about entrepreneurship is in order.

Law and entrepreneurship can coexist under more balanced conventions. Legal institutions such as courts and agencies can play a more significant role in facilitating the entrepreneurship process and ensuring an environment in which entrepreneurs can successfully act.<sup>377</sup> Judges should examine legal standards while considering the fact that entrepreneurs bear unusually high uncertainty, they make large investments in knowledge in a process that is usually short and exit-driven. Adjudicating through the lens of entrepreneurship includes embracing the notion legal classifications and determination hold the power to either hamper the entrepreneurial spirit or to encourage a more active and vibrant entrepreneurial environment.<sup>378</sup>

Despite the recent negative spotlight on corporate inversions and global competition on the situs of firms, surprisingly little attention has been paid to the positive ways that our legal system could seize as a strategy for reinforcing our economy.<sup>379</sup> This Article attempted to fill that void and shed light on this new force (entrepreneurship) that has fascinated us over the last decade due to its ability to enrich our lives.<sup>380</sup> It also hopes to instigate future empirical scholarship on the ways in which law affects entrepreneurship. Although this Article focused on the positive externalities of entrepreneurship, there is a need to further assess the negative externalities of law on entrepreneurship. A forthcoming paper will portray the nature of the distribution of regulatory costs on entrepreneurial firms. It will unveil dis-

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377. Magnus Henrekson, *Entrepreneurship and Institutions*, 28 COMP. LAB. L. & POL'Y J. 717, 720 (2007); see Nicholas Dew, *Institutional Entrepreneurship: A Coasian Perspective*, 7 INT'L J. ENTREPRENEURSHIP & INNOVATION 13, 15 (2006) (arguing that legal institutions can establish effective mechanisms to lower transaction costs).

378. See Licht, *supra* note 27, at 833.

379. For recent tax literature dealing with the phenomenon of "corporate inversions," see Ilan Benshalom, *The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase*, 28 VA. TAX REV. 165, 216 (2008) (maintaining that tax corporate residency is an analytically flawed concept when corporations exercise their entrepreneurial rights to expatriate to low-tax jurisdictions); Fred Greguras et al., *2007 Update to Structuring Venture Capital and Other Investments in India* (2007), [http://www.fenwick.com/docstore/Publications/Corporate/2007\\_Update\\_Structuring\\_VC\\_in\\_India.pdf](http://www.fenwick.com/docstore/Publications/Corporate/2007_Update_Structuring_VC_in_India.pdf) ("[A]nti-inversion rules have proven to be very frustrating for a number of our clients seeking to pursue IPOs outside the U.S. Therefore, entrepreneurs must carefully consider whether an offshore structure should be created at the outset."); Andrew Short, *Considering Corporate Inversions*, 5 COLUM. J. TAX L. TAX MATTERS 5, 6 (2014), <http://taxlawjournal.columbia.edu/article/vol-5-no-1/considering-corporate-inversions/> ("Although it may not be feasible for an entrepreneur to initially establish offshore operations, once the entrepreneur has gained some footing, and the tax bill becomes too high, thoughts of inversion arise.").

380. Eyal-Cohen, *supra* note 51, at 721.

criminatory effects of the regulatory action on startup companies that lack economies of scale, scope, and age and their unregulated affiliates.<sup>381</sup>

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381. Mirit Eyal-Cohen, *Downscaling Regulatory Barriers* (work-in-progress).

