The Impact of Regulation and Litigation on Small Business and Entrepreneurship
An Overview

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SUMMARY

As the economic power of private sector business has grown over the past century, so too has the number of laws regulating business activity. In broad terms, these laws typically serve one of two objectives: to promote market competition and control the market power of large firms over customers and smaller firms, or to mitigate the adverse effects of business activity on individuals and other organizations. Regulations on business can benefit a range of stakeholders, including corporate and financial institutions, interest groups, employees, customers, and the general public. Of course, such regulations impose costs as well as benefits. These costs—including capital and other compliance costs as well as an increased risk of litigation or of civil or criminal penalties—typically fall most heavily on the businesses being regulated.

Although some recent studies have looked at the impact of regulations on the relationship between government and private business in general, less attention has been directed toward understanding precisely how government regulations have affected small businesses. There is good reason to believe that size matters. Precisely because of their smaller size, small businesses are likely to be less diversified and less able to leverage economies of scale or to access capital markets. As a result, small businesses might be more risk-averse and less able to react to unexpected events compared to larger businesses. In addition, the cost of complying with a particular regulation may be roughly comparable for smaller and larger firms, thus placing a disproportionate burden on the smaller firm.

When small businesses respond differently to regulation than do their larger counterparts, these firms might be placed at a competitive disadvantage in the marketplace, undermining the effect of competition policies and antitrust laws. To reduce the incidence of such problems, policymakers and other key stakeholders have sometimes exempted small firms from state, local, or federal regulations or subjected them to differential enforcement requirements. The tort system can affect small businesses differently as well, although the precise nature of that effect is less clear.

The Kauffman-RAND Center for the Study of Small Business and Regulation was established in 2004 to evaluate and inform legal and regulatory policymaking related to small business and entrepreneurship in a wide range of settings. This paper describes a research agenda for the Center that will provide objective, independent, and rigorous analysis of the differential effects of regulations and litigation on small business. The ultimate question for Center researchers is how the differences that distinguish small firms from larger firms impact the extent to which various policies achieve their specific objectives (e.g., improved workplace safety or environmental quality) and contribute to more general social objectives (e.g., promoting
economic competition). The paper focuses attention on laws and regulations in four key regulatory areas: corporate securities, environmental protection, employment, and health insurance.

CORPORATE AND SECURITIES LAW

Corporate and securities law and regulations have real implications for the future growth potential of businesses and are thus relevant to the issue of entrepreneurship. Many small firms are formed with an eye toward becoming large firms, and the road to doing so almost always involves consideration of business form and capital structure.

**Liability exposure.** Perhaps one of the most salient differences between small and large firms lies in the degree to which their respective owners bear personal liability for business risks. A majority of small firms are unincorporated, thus potentially subjecting a firm’s owners to personal as well as business liability risk.1 The threat of financial liability for the firm’s obligations might loom especially large for entrepreneurs and influence their ability to innovate, grow, or even begin operations in the first place. There is also broad concern over the effect of recent changes to the personal bankruptcy law, which make it much harder for individuals to obtain a “fresh start.”

**Organizational form.** The entry, exit, and growth trajectory of entrepreneurial small businesses might also be affected by the proliferation of new business forms, such as the limited liability company (LLC) and limited liability partnership (LLP). LLC/LLPs combine the flexibility and pass-through taxation attributes of partnerships, while simultaneously according owners with a form of limited liability akin to corporate status. At the same time, LLC/LLP also comes with a few costs, including a limited lifespan (frequently in the neighborhood of 35 years), minimum insurance requirements against claims of third-party creditors, and variation in the nature and extent of liability protection that these new business forms afford.

**Securities law.** Securities law and recent securities law reform, such as the Sarbanes-Oxley act of 2002 (“Sarbox”) and related regulations, may also affect economic activity in small firms that are not (at least yet) subject to such securities regulation prescriptions. As entrepreneurial firms grow larger and require access to additional capital, they face a choice as to whether the benefits of publicly traded status are worth the costs associated with regulatory requirements. Although, by all accounts, Sarbox has changed the landscape of securities law for firms that are publicly traded, there is as yet no consensus regarding how the new rules are affecting the interests, prospects, and growth trajectories of companies, including small firms, that are considering going public.

Research on the impact of corporate and securities law on small versus large businesses could assist policymakers in understanding the effects of existing policies and recent reforms in key areas. Questions of particular interest include:

- What are the implications of personal bankruptcy reform for entrepreneurs?
- What are the uses and effects of new business forms for small business?
- In what ways has the Sarbanes-Oxley Act influenced small business?

ENVIRONMENTAL LAW

Although many environmental laws regulating business were shaped with an eye toward regulating large companies, there are several reasons to expect firm size to be an important consideration in formulating and evaluating environmental policy.

Compliance. Compliance with environmental regulations can require firms to respond in several ways, such as by installing pollution control equipment, monitoring and reporting waste streams and pollutant releases, and developing emergency response plans. Small firms might be at a disadvantage due to the cost of pollution control equipment or the resources needed to complete required paperwork. High initial compliance costs may also make it more difficult for small firms to enter the industry.

Statutory variation. The requirements of environmental regulations frequently vary by firm size; this so-called “tiering” means that small firms are exempted from certain requirements or are required to meet less stringent emission or treatment technology standards. In addition, the regulations themselves are often tailored to the experiences and capabilities of large firms.

Enforcement. There is currently no consensus on whether government enforcement practices have favored or worked to the disadvantage of small firms.

Policy questions of interest regarding the differential effect of environmental law on small business include:

- Compliance with and enforcement of current laws. How have recent trends in environmental regulation, enforcement, and liability affected businesses along size dimensions? Which aspect of environmental regulatory and liability policy cause the greatest problems for small firms? What are the benefits of reducing environmental damage caused by small firms?

- Need for new approaches. Given that many environmental initiatives were originally shaped with large firms in mind, is a different approach to source control, pollution prevention, compliance assistance, and enforcement needed to deal with small firms?
- **Effect of government-industry agreements.** How have different public-industry negotiated agreements (such as the Common Sense Initiative, which aims to make environmental regulation and performance “cleaner, cheaper, and smarter”) been used by small firms, and what types of modifications to these programs would make them more attractive to small firms?

**EMPLOYMENT LAW**

Employment laws, regulations, and policies, which can range from minimum wage laws and anti-discrimination laws to non-compete agreements and regulations on workers’ compensation and unemployment insurance, can protect or benefit one party (usually employees), but typically impose some cost on the other party. In designing employment laws and regulations, policymakers strive to strike a balance between costs and benefits, which often means adjusting the application or enforcement of employment-related regulations according to firm size. The impact of employment law is likely to vary by firm size for several reasons.

**Administrative enforcement of government regulations.** Firms of all sizes are potentially at risk of a civil action in response to claims that the firm’s actions have harmed an employee. This risk is increased due to regulations that invest government agencies with the authority to investigate firm behavior and take legal action. Very small firms falling under the employment threshold for a regulation to take effect may face a lower risk of legal action. It is therefore plausible that very small businesses might consider the implications of growth that would carry them over the employment threshold to avoid the reporting requirements and related administrative costs as well as the threat of fines or legal action.

**Court enforcement policies.** One of the key differences between small and large firms is the level of resources available to them to spend on litigation, either as plaintiffs or defendants. Large firms with deep pockets might be more frequent targets of employee discrimination, wrongful discharge and other suits. Large firms might also have a stronger incentive to spend substantial resources aggressively defending any one suit so as to deter future suits. On the other hand, small firms may be more vulnerable to breach of a non-compete agreement or violation of trade secrets rules as the entire business may depend on that trade secret. As a result, they may be more likely to prosecute, in spite of the costs and the risks of bankruptcy.

**Costs of providing worker’s compensation and unemployment insurance.** Employers are required either to purchase workers’ compensation insurance to cover potential workers’ compensation losses or to demonstrate sufficient financial resources to self-insure. Large firms typically have a greater ability to self-insure and thus opt-out of the system. In addition small firms often face higher insurance premiums due to the imperfect application of experience rating. Unemployment taxes are typically determined by a firm’s experience with unemployment,
although new firms are assigned a flat rate, which will change over time based on the stability of their labor force and the number of layoffs they experience. As a result, small firms may have less potential relative to large firms in reducing their rate because of less flexibility in response to changing economic conditions and or the potential of layoffs.

These issues lead to a number of questions of potential interest to policy makers involving small business.

- **Effect of thresholds.** Do small firms avoid adding employees when they are close to an employment threshold for particular regulations?

- **Court enforcement of regulations.** Does court enforcement of employment regulation vary by firm size?

- **Workers’ compensation and unemployment insurance.** Do these insurance systems have a differential impact on small business?

- **Regulation of employment contracts.** What are the cost-benefit tradeoffs involved in the regulation of employment contracts for different-sized firms?

**HEALTH INSURANCE REGULATIONS**

Health insurance regulations are generally targeted to insurance companies that sell group health insurance products to firms, rather than toward the firms that offer health insurance to their employees. Nonetheless, these regulations might have differential effects for small versus large firms.

**Health insurance coverage and premiums.** Health insurance regulations that affect small firms differently from large firms might be expected to impact the likelihood that small firms will offer health insurance coverage or lead to changes in health insurance premiums. Studies to date, however, have not found evidence of either of these effects.

**Business size.** The explicit size thresholds in many health insurance regulations suggest that firms considering changing their workforce size might be influenced by health insurance regulations. In the case of small group health insurance regulations, small firms that can obtain health insurance that is protected by these regulations might choose not to expand beyond the upper size threshold. On the other hand, if the regulations result in higher premiums and lower availability, small firms might prefer to expand to a size that is beyond the reach of small firm regulations. Other regulations such as state-mandated benefits may also affect business size, since larger firms can self-insure and avoid state regulation.

Policy questions concerning health insurance regulations include the following:

- **Access and pricing.** Should policymakers consider pricing regulation to accompany health insurance access regulations?
• **Insurance reforms.** What is the impact of recent insurance reforms on small firms? Have health insurance mandates influenced firm behavior (including the choice of firm size and the decision to offer health insurance)? Have small businesses made use of some of the new health insurance innovations such as Health Savings Accounts?

**CONCLUSION**

This review has highlighted some fruitful areas for research on the impact of regulation on small business. Regulations or programs designed to benefit small business are rarely criticized or questioned. However, it is important to consider whether such are meeting their objectives, whether they are well targeted and whether they have unintended consequences that interfere with intended aims.

A systematic comparison of the costs and benefits of regulations, as well as regulatory implementation and enforcement, is a promising avenue for research. Information on the cost-benefit tradeoffs could help policymakers design more effective policy.