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JAMES FLANIGAN

Ex-Enron Chief's Legacy Takes Especially High Toll on Smaller Companies

James Flanigan

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Former **Enron** Corp. Chairman Kenneth L. Lay, led to court in handcuffs last week, has left behind quite a legacy.

The fraud-induced failure of his company destroyed the life savings of thousands of employees, undermined the public's faith in the integrity of corporate America and — thanks to Lay's close ties to the Bush family — could even influence this year's presidential election.

But of all the things that Lay and his Enron cronies helped to bring about, the most far-reaching may well be this: They have made it tougher for smaller corporations in this country to grow and prosper.

That's because the 2002 Sarbanes-Oxley law — passed as a reaction to Enron and a spate of other corporate scandals — has had the effect of discouraging the creation of publicly traded companies, leaving many promising firms without access to what historically has been among the most efficient ways to raise capital and expand.

This is not to say that Sarbanes-Oxley is without its benefits. The law, formally the Public Company Accounting Reform and Investor Protection Act, has certainly helped to restore investor confidence in the markets. Any executives considering cooking the books — and any corporate boards that previously may have turned a blind eye to such behavior — will surely think twice with Sarbanes-Oxley hanging over them.

The question, though, is what is the price of this protection? For smaller companies contemplating going public, the answer is clear: quite steep.

Complying with Sarbanes-Oxley means spending more on auditing, lawyering and other functions. Premiums for insurance policies that indemnify company directors and officers are rising 100% to 300% annually. On average, the cost of being a public company has climbed from \$1.3 million a year to \$2.5 million, according to a study by Foley & Lardner, a Chicago law firm.

Such an increase is sizable for small companies — the kind of companies, of course, that dominate California's economy and represent our best hope for the future.

"The law is one-size-fits-all, and small firms shoulder a disproportionate burden," says Robert Kuhling, a partner at **Onset Ventures**, a Silicon Valley venture-capital firm.

Max Donner of California.com, a San Diego research firm, figures that largely because of Sarbanes-Oxley about 1,000 public companies will eventually cease trading on public exchanges and transition to private ownership. Some start-ups, meanwhile, are electing to be bought out by bigger companies rather than go public — an alternative way to bring in a slug of cash but also, potentially, a way to destroy the culture that made them innovative and thriving.

Thanks to the recovering economy, the number of initial public offerings is on the rise this year — 102 so far in 2004, compared with 83 for all of 2003. But the figure would surely be higher if not for the shackles of Sarbanes-Oxley.

Kenneth Lawler, of **Battery Ventures**, notes that his firm has backed two communications companies "that might have gone public now — but must wait until next year to be properly prepared."

Adequate preparation is no easy trick. Before Sarbanes- Oxley, problems of misstated accounts or exaggerated revenue reports could be settled easily in a quick conference with the company's accounting firm. Now, the accounting firm cannot touch the matter.

A special forensic accountant must be brought in, often accompanied by a law firm, to render a judgment that mistakes or misdeeds have been rectified. Only then can the first accounting firm certify the profit-and-loss statement and the company's chief executive sign off without risking jail time.

"Common sense has lost out," says Alice Peterson, a Chicago-based corporate governance expert who has served on the audit committees of large firms including Kraft Foods Inc. and Sears Roebuck & Co.

In the eyes of some regulators, having fewer public companies is hardly something to cry about. "There were too many public companies in the late 1990s," says Colorado State University professor Lynn Turner, the former chief accountant at the Securities and Exchange Commission. "Their carelessness and fraud cost investors billions of dollars."

Turner says investors are safer now, thanks to laws such as Sarbanes-Oxley — although, he adds, "we must wait and see if the change is long term."

But Brad Jones, a Los Angeles-based partner of **Redpoint Ventures**, sees the post-Enron legal and regulatory atmosphere imposing a hefty cost. "It is nibbling at the edges of a good system that has brought this country a lot of innovation and wealth," he says.

Lay, a self-described energy entrepreneur, used to speak often of changing the U.S. financial system. He appears, in the end, to have done just that — albeit in a way he never intended.

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