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Beyond bankruptcy: Does the US bankruptcy code provide a fresh start to entrepreneurs?

Aparna Mathur *

American Enterprise Institute, 1150 17th Street, NW, Washington, DC, United States

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ABSTRACT

This paper assesses the extent to which the US bankruptcy system is effective in providing small businesses a "fresh start" after a bankruptcy filing. I use data from the 1993, 1998 and 2003 National Survey of Small Business Finances to explore how firms fare after a bankruptcy filing. On the positive side, previously bankrupt firms are not any more burdened than the average small firm by problems relating to profitability, cash flow, health insurance costs, or taxes. Further, the fact that these firms are surviving several years after the filing is itself a testament to the efficient functioning of the US bankruptcy system. It suggests that the bankruptcy system goes a long way toward helping businesses recover after a bankruptcy filing.

However, the one area of concern that persists after a filing is financing or credit access. In general, these firms have a nearly 24 percentage point higher likelihood of being denied a loan and are charged interest rates that are more than 1 percentage point higher than those charged to other businesses. A bankruptcy affects all types of financing, even trade credit, which is a significant form of lending between businesses. In fact, it appears that firms with a bankruptcy record are rationed out of the market, with all types of loans being denied at significantly higher rates than other firms. Further, my results show that bankruptcy leads to a class of discouraged borrowers who are significantly less likely to even apply for a loan.

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1. Introduction

The fundamental philosophy of the US bankruptcy system has not changed for more than a century. The philosophy, first codified in the 1978 law, has guided bankruptcy regulation since the early nineteenth century and centers around the idea of a "fresh start" after bankruptcy.[1] A "fresh start" enables individuals to get rid of their old, unsecured debt through the bankruptcy process and provides them a "new opportunity in life", as highlighted by the Supreme Court in its ruling in Local Loan Co. vs. Hunt (1934). More practically, it allows individuals a financial fresh start by releasing the debtor from past financial obligations. Hence, implicit in the notion of a fresh start is the prospect for a better financial future for debtors since the discharge of debt enables them to enjoy the rewards from any future work effort. This paper assesses whether bankruptcy law has in fact achieved this objective when viewed from the perspective of small business owners. How do once-bankrupt entrepreneurs fare in a post-bankruptcy world? What does a "fresh start" look like?

For reasons stated above, in principle, bankruptcy should enable entrepreneurs to start off with a clean slate. In practice, this is rarely true for several reasons. A bulletin issued by the Maryland State Bar Association (2005) suggests that credit reports of bankrupt filers often inaccurately continue to report the discharged debts as open with balances or missed and late payments.[2] This adversely affects the borrower's ability to take future loans or even obtain insurance. In addition, the bankruptcy filing itself appears on the debtor's credit record for 10 years (Fair Credit Reporting Act; *FCRA Section 605 (a)(1)*). Also, the 10 year rule only applies to credit bureaus. If any creditor deals with an individual who had filed for bankruptcy within that 10 year window, the creditors can continue to use the information about the filing even after it is removed from the credit report. Therefore, there are several reasons why, despite the debt discharge, a bankruptcy filing may not lead to a financial fresh start for debtors.

These effects have been documented in the empirical literature, but there has been no attempt to distinguish consumer and

* Tel.: +1 202 828 6026.
E-mail address: amathur@aei.org

[1] Report of the Commission on the Bankruptcy Laws of the United States H.R. DOC. NO. 93-137, pt. 1, at 71, 79–80 (1973).

[2] http://www.msba.org/departments/commpubl/publications/bar_bult/2005/april05/freshstart.asp.

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business bankruptcies. When looking at consumer bankruptcy cases, research by Musto (2004), Cohen-Cole et al.(2009) and Fisher et al. (2004) shows that having the bankruptcy on file reduces access to credit for previously bankrupt households. Porter and Thorne (2006) surveyed households about their financial situation after a bankruptcy. They found that nearly 25% of households had problems paying routine bills nearly a year after the filing, while more than 30% reported an overall financial situation that was worse or the same as when they had filed for bankruptcy.

Given these costs and benefits of filing for bankruptcy, there is a surprising dearth of literature on how business owners actually fare post-bankruptcy. What impact does the filing have on access to credit and interest rates? What happens to wages and employment? This paper aims to fill this void in the literature. Results using data from the National Survey of Small Business Finances (NSSBF) for the years 1993, 1998 and 2003 suggest that firms with a bankruptcy on their record are more likely to report problems relating to financing. Further, such firms are likely to be relatively low-paying, with significantly lower wage to employment ratios. On the positive side, they are not significantly more likely to report problems relating to profitability or cash flows. The most interesting results, and those which pertain directly to the notion of a "fresh start", deal with access to credit issues. If the bankruptcy system really did wipe the slate clean, then in principle, there should be little to distinguish between firms with and without a bankruptcy filing (controlling for demographic characteristics like firm age and size). However, results suggest that access to credit is a significant constraint for businesses with a bankruptcy filing on their record. Not only are they charged interest rates that are more than 1 percentage point higher than for businesses without a bankruptcy history, but they are also significantly more likely to be denied loans. This is true even of trade credit, which is an informal credit system within businesses wherein one firm allows another to make purchases without immediate cash payment. Further, it appears that bankruptcy leads to a class of discouraged borrowers who are significantly less likely to even apply for a loan. Finally, results suggest that owners of previously bankrupt firms are less likely to own credit cards, and are more likely to look for outside financing from venture capitalists.

These results are robust to the inclusion of several controls. There are also interesting differences in credit access across minority owned businesses. In particular, while Black-owned and Hispanic-owned businesses are charged higher interest rates and are more likely to be denied loans, Asian-owned businesses are charged interest rates not significantly different than the average business, and face loan denial rates that are only marginally higher than the average. The results for Black-owned businesses reflect those found in the literature. Blanchflower et al. (2003), Munnell et al. (1996), Chen and Cole (1988) and Craig et al. (2006) have shown that Black-owned firms face higher interest rates and loan denial rates in credit markets.

To summarize, the analysis finds that the bankruptcy system is partly successful in getting small businesses back on their feet. In the data, approximately 2–2.6% of business owners and approximately 1% of firms reported a bankruptcy on record every year. The fact that these business owners were able to continue to operate a business and showed up in the data – some of them profitably suggests that the bankruptcy system helps at least some businesses to recover and resume operations after a bankruptcy filing, thus enabling a "fresh start". However, whether the bankruptcy system is economically efficient in that it provides the best possible outcome for firms entering bankruptcy is tougher to judge from the data. As defined by the literature (see for example, Blazy et al., 2008; Cornelli and Felli, 1997), the bankruptcy system is ex-post efficient when only economically efficient but financially distressed firms are allowed to continue operating after bankruptcy. When an economically efficient firm enters bankruptcy, the best outcome is for it to continue operating since its capital has no higher value use. On the other hand, when an economically inefficient firm enters bankruptcy, the best outcome is for its assets to be liquidated, thereby releasing its capital to move to higher value uses. However, in practice and particularly with the NSSBF data, it is difficult to tell with certainty which type of firm enters bankruptcy. Therefore any bankruptcy system that incorporates a reorganization procedure, such as the US bankruptcy system, is likely to make Type-1 and Type-II errors. Some economically inefficient failing firms (which should have been liquidated) mistakenly may be categorized as efficient and allowed to reorganize. This is an example of a Type-I error. Conversely, Type-II errors occur when some economically efficient but failing firms may liquidate in bankruptcy because they are mistakenly categorized as inefficient.

Another reason why it is difficult to distinguish between Type-1 and Type-II errors is that of necessity, the sample includes only businesses that survived the bankruptcy filing. Therefore, the results exhibit a survivorship bias to the extent that businesses that did not recover after the bankruptcy are excluded. If these excluded businesses were, for instance, 99% of businesses, then it would be hard to conclude that the bankruptcy system was in fact putting businesses back on their feet. While there is little data on post-bankruptcy survival rates, a paper by Baird and Morrison (2005) focusing on Chapter 11 bankruptcies finds that nearly 70% of such businesses survived the bankruptcy and moved onto found new firms. This conclusion was also reached in a separate paper by Warren and Westbrook (2009). In that paper, the authors studied chapter 11 bankruptcies in 1994 and 2002. They cite statistics showing that nearly half the cases did not even propose a reorganization plan. This probably meant that these businesses were so badly off that reorganization was unlikely. Of the remaining who proposed a plan, more than 70% confirmed the plan. This meant that more than 70% could "successfully" file for the reorganization and continue to operate their business. Therefore, while it is likely that the NSSBF data include most businesses that could survive the bankruptcy process, this is not testable given the sample used.

As far as the implication of this survivor bias to my results is concerned, there are two possibilities. Firms that do not survive the bankruptcy process are either completely unviable or were simply unable to obtain financing at reasonable interest rates. On the one hand, this strengthens the result that bankruptcy does not provide a financial fresh start to struggling, economically inefficient businesses. On the other hand, it suggests that the results for profitability and other indicators are not representative of all firms that undergo a bankruptcy, since clearly firms that do not survive are by definition unprofitable. Therefore, on average, the results represent the best possible outcomes for firms that go through a bankruptcy filing. To the extent that they survive, they continue to face financing constraints, but despite that, they can be profitable and generate average incomes for their employees. Moreover, it is unclear what to interpret about the bankruptcy system for firms that do not reappear in the data. To the extent that they reflect the owner's unwillingness to re-enter the business arena, or other personal circumstances, it would be incorrect to view this as a failure of the bankruptcy system. Headd (2003) discusses the many reasons why firm closures may occur. While the data cover years prior to 2005, one could question whether the analysis would yield different conclusions following the bankruptcy reform of 2005. In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) with the primary intention of making it harder for individuals to file a Chapter 7 bankruptcy. The reform introduced a means-test for Chapter 7 essentially preventing relatively above average income individuals to wipe off their debt by filing under this Chapter. Instead, such individuals would be able to file under Chapter 13 which allows

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