

Beyond Bankruptcy: Does the Bankruptcy Code Provide a Fresh Start To Entrepreneurs?

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Purpose

The U.S. bankruptcy system is designed to recover funds for creditors while giving bankrupt small businesses an opportunity for a “fresh start.” While a fresh start is a goal of the system, little analysis has been done to evaluate the ability of small firms to reset and thrive after bankruptcy. This paper attempts to fill that gap.

Overall Findings

While the bankruptcy system has helped certain small businesses maintain operations, credit access issues after bankruptcy persist. These issues increase the probability that firms will not even seek credit after a bankruptcy.

Highlights

- At some point in the previous seven years, owners of 2.6 percent of firms filed for bankruptcy.
- Previously bankrupt firms perform similarly to firms that have not filed for bankruptcy. They are no more burdened than other small firms by problems such as poor cash flow, high health insurance costs, or excessive taxes, and they attain similar firm sizes, as measured by employment. The firms in existence several years after bankruptcy are evidence that small firms can survive and continue beyond a bankruptcy filing.
- A bankruptcy negatively affects a firm’s ability to obtain loans, especially at reasonable interest rates, even controlling for credit scores. These firms have about a 24 percent higher likelihood of being denied a loan and are charged interest rates that are more than 1 percentage point higher than those charged other businesses.

- The credit rationing of bankrupt small firms leads to a class of discouraged borrowers who are significantly less likely to even apply for a loan.
- The report finds some interesting differences in credit access across minority-owned businesses. Black- and Hispanic-owned businesses are charged higher interest rates and are more likely to be denied loans, while Asian-owned businesses essentially mirror U.S. averages with respect to interest rates and denials.

Scope and Methodology

The study uses National Survey of Small Business Finances (NSSBF) data as a basis for the analysis. The surveys of firms with fewer than 500 employees were conducted by the Federal Reserve Board for data years 1993, 1998, and 2003. The data cover about 4,000 firms per survey. Econometric models were developed, with interest rates and loan denied as dependent variables, and owner, business, and financial characteristics of the firm used as explanatory variables. Note that the NSSBF has been discontinued, but the Kauffman Firm Survey presents an opportunity for further analysis.

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