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Entrepreneurship and the Barrier to Exit: How Does an Entrepreneur-Friendly Bankruptcy Law Affect Entrepreneurship Development at a Societal Level?

by Seung-Hyun Lee, Yasuhiro Yamakawa, and Mike W. Peng of the University of Texas at Dallas under contract no. SBAHQ-06-M-0536 to the Babson College Entrepreneurship Research Conference for the Award. 2008. [18] pages.

Introduction

This paper was originally presented in Madrid, Spain, at the Babson College Entrepreneurship Research Conference (BCERC) in June 2007. It was awarded the Office of Advocacy Best Paper Award at the 2008 BCERC meetings in Chapel Hill, North Carolina.

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Purpose

How a society's formal institutions, such as bankruptcy laws, govern bankrupt entrepreneurs and firms is an important component of the institutional framework within which entrepreneurs and firms operate. The legal procedures associated with bankruptcy vary significantly across countries. Some countries provide only limited protection for entrepreneurs and managers of bankrupt firms, while others have a more entrepreneur-friendly bankruptcy law. Overall, whether the institutional framework encourages or discourages entrepreneurship may determine a society's long-run economic performance.

The authors examine the relationship between bankruptcy law and the value-creating activities in a society associated with risk-taking behaviors by entrepreneurial firms. They argue that an entrepreneur-friendly bankruptcy law may increase the number of corporate bankruptcies, which may be indicative of a vibrant entrepreneurial economy.

This paper tests hypotheses relating to seven key aspects of bankruptcy laws using a longitudinal database covering 35 countries and spanning 10 years.

Overall Findings

The authors find that a lenient, entrepreneur-friendly bankruptcy law encourages entrepreneurs to take risks and thus lets entrepreneurship prosper. This risk-taking can generate variety in the economy by increasing the number of firms with high growth potential, which may lead to more entrepreneurship and economic development—in short, failure may be good for the economy. The study pushes for a more informed understanding of how formal institutions governing bankruptcy matter for entrepreneurial behavior and outcomes. It emphasizes that a society that is not willing to absorb the "pain" of having a large number of entrepreneurial failures, via an entrepreneur-friendly bankruptcy law, is not likely to reap the "gain" of vibrant entrepreneurship development and economic growth.

This report was developed under a contract with the Small Business Administration, Office of Advocacy, and contains information and analysis that was reviewed and edited by officials of the Office of Advocacy. However, the final conclusions of the report do not necessarily reflect the views of the Office of Advocacy.

Highlights

The study analyzes seven components of an entrepreneur-friendly bankruptcy law and finds:

• The availability of reorganization procedures as a choice for bankrupt firms encourages bankruptcy filings.

• Less time and less cost associated with a bankruptcy proceeding encourages entrepreneurs to file for bankruptcy and is consistent with higher filing rates in a country.

• The more resources entrepreneurs recover from bankruptcy—which would mean a fresher start—the higher the filing rate in a country.

• An automatic stay on assets is likely to encourage entrepreneurs to file bankruptcy.

• The protection of creditors at the time of bankruptcy leads to a higher rate of bankruptcy filing.

• One result appears contradictory—that is, allowing incumbent managers to stay on the job does not lead to a higher rate of bankruptcy. Rather, management turnover leads to an increase in filing. More capable managers may have moved elsewhere.

Note

This paper was prepared for presentation at the Babson College Entrepreneurship Research Conference. The report references “space limitations” and “suppressed” control variables in the tables. The authors needed to comply with strict guidelines for submission to the BCERC, including a page limitation. The Office of Advocacy is releasing as a working paper the BCERC version of the paper, which adheres to these guidelines. This research was supported, in part, by a National Science Foundation (NSF) CAREER grant (SES 0552089) to Mike W. Peng. The views expressed are those of the authors and not necessarily those of the NSF or the SBA Office of Advocacy.

Scope and Methodology

The authors collected data for 35 countries during the 10 years 1990-1999 (inclusive). Data were drawn from commercial bankruptcy filings, legal rules, and other data from the World Bank, the World Health Organization (WHO), and the International Monetary Fund (IMF).

Analysis of reorganization procedures is based on bankruptcy data from government and private sources. Data on closing time, closing cost, and fresh start (measured by rate of recovery from a closing) were obtained from the World Bank. Data on legal rules covering protection of corporate shareholders and creditors, their origin, and the quality of their enforcement and on the regulation of entry are gathered from past studies.

The authors test hypotheses that predict how various components of bankruptcy law can curtail the downside risk of entrepreneurs and help encourage risk-taking behavior such as filing for bankruptcy. A log-linear model is used to model the changes in bankruptcy filings. The dependent variable is the bankruptcy rate—the ratio of the number of bankruptcies to the total number of firms—and is allowed to take both positive and negative values rather than being constrained to be positive. The model controls for four major factors: (1) the previous year’s number of bankruptcies for each country, (2) regional effects, (3) possible time effects across all countries, and (4) one social dimension of bankruptcy law that reflects the level of social stigma concerning failure and is measured by the suicide rate.

This report was peer-reviewed consistent with Advocacy’s data quality guidelines. More information on this process can be obtained by contacting the director of economic research by email at **advocacy@sba.gov** or by phone at (202) 205-6533.

Ordering Information

The full text of this report and summaries of other studies performed under contract with the U.S. Small Business Administration's Office of Advocacy are available on the Internet at **www.sba.gov/advo/research**. Copies are available for purchase from:

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