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RESEARCH SUMMARY

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Financial Difficulties of Small Businesses and Reasons for Their Failure

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Purpose

The purpose of this study was to determine the factors that cause small firms to file for bankruptcy by choosing a representative sample of bankruptcy cases under chapters 7, 11, or 13 of the bankruptcy statutes, and examining the impact of the bankruptcy on the individual's ability to re-enter business. In addition, through interviews, the authors were able to understand the impact of the bankruptcy on the individual's finances and that of their family, if applicable.

Scope and Methodology

This study, begun in 1994, was the first national longitudinal study of bankrupt firms. As part of a larger study, it attempted to select roughly equal numbers of bankrupt firms in using the three major bankruptcy statutes (Chapters 7, 11 and 13). Cases were chosen in each of the 23 federal districts in which bankruptcy can be filed. The sample encompassed up to 50 cases in each chapter in each district selected from each calendar quarter in 1994. The final study followed the bankruptcy experience of 3,377 non-farm businesses that first filed for bankruptcy in 1994, and traced their experiences through court proceedings from 1994 to the end of 1997. It observed how cases were resolved, whether Chapter 11 firms emerged from bankruptcy, their condition when they emerged from bankruptcy, and how the experience affected the owners. In addition, very detailed information was collected on the assets and liabilities of each bankrupt firm. Furthermore, 834 debtors or roughly 25 percent of the cases were interviewed and re-interviewed by telephone one year later. Interview questions focussed on the reasons for bankruptcy, the finances of the firm if it continued to operate, the future plans of the owners if the firm was no longer in business, and detailed information, if available, about the effect of bankruptcy on the ability of the (former) business owner to re-enter business.

Highlights

- At the time of the second round of interviews, the bankrupt companies were organized as follows: about one-third had filed a Chapter 7 bankruptcy petition, 40 percent were in Chapter 11, and the remaining 28 percent were in Chapter 13. The relatively large percentage of Chapter 13 filers was somewhat surprising to the research team, and indicative of the mix of business and consumer debt by many very small companies. Corporations cannot file bankruptcy under Chapter 13.

- Bankruptcy petitioners were experienced in their industries. About a quarter had owned a similar business in the past, and about a third had worked in a similar business in the recent past.

- One-third of the bankrupt businesses had less than $100,000 in debts, and 79 percent had less than $500,000 in debts. Mean assets were $841,000, with median assets of $94,700.

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- About 45 percent of the bankruptcy cases had one or no employees. This does not mean that the business did not formerly have more employees, but at the time of filing for bankruptcy, most of them had been dismissed. Less than 5 percent of the bankruptcy cases represented companies with 50 or more employees.

- The reasons for filing for bankruptcy were among the most interesting findings of the study. The reasons for filing were broken down into the following categories: outside business conditions (mentioned by 39 percent of filers), financing problems (28 percent), inside business conditions (27 percent), tax-related reasons (20 percent), dispute with a particular creditor (19 percent), personal problems (17 percent), and calamities (10 percent).

- Outside business conditions included such factors as new competition, increases in rent, insurance costs, or declining real estate values.

- Inside business conditions included: a bad location, inability to manage people, the loss of major clients, or inability to collect accounts receivable. Personal problems often included divorce and health problems.

- Of those debtors mentioning tax-related reasons for bankruptcy filing, many were worried that the Internal Revenue Service (IRS) would padlock the doors, take over a bank account, or access unreasonable penalties.

- One year after filing for bankruptcy, 18.9 percent of the Chapter 7 filers were still open, 56 percent of the Chapter 11 filers were still open, and 56 percent of the Chapter 13 filers were still open.

- Bankruptcy did not squash the entrepreneurial spirit of the petitioners. Thirteen percent had already opened another business since filing for bankruptcy, while 11 percent planned to open another business. Adding that total to the 41 percent of the firms still open and in bankruptcy yields nearly two-thirds of the sample still running a business.

Ordering Information

The complete report, along with research summaries of other studies performed under contract to the SBA Office of Advocacy, is available on the World Wide Web at: www.sba.gov/advo/research

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