An Overview of the 2005 Bankruptcy Reform Act: A Teaching Supplement

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ABSTRACT

This research provides an academic tool for filling a potential gap in education related to the importance of bankruptcy for small business owners’ financial decisions. We develop a teaching supplement that provides a critical and comprehensive analysis of the 2005 Bankruptcy Reform Act’s effect on business owners’ risk taking decisions. The supplement also provides empirical statistics on the bankruptcy outcomes for small businesses and unincorporated entrepreneurs. Renewed attention to this area should enable educators to increase students’ awareness of the rapid changes and provide a practical application for the theoretical concepts within financial economics.

Introduction

Since 1995, legislators have called for reform to expedite small business bankruptcies. A Commission appointed by President Clinton, Chief Justice Rehnquist and the House and Senate studied the impact of new Chapter 11 provisions on small business. (National Bankruptcy Review Commission, 1997). Although most of the recommendations made by the Commission were adopted by the 2005 bankruptcy reform act, few text books in the financial economics literature discuss the importance of the law or its policy implications for small business. This paper is a teaching supplement and it contributes to the literature by outlining the key concerns regarding the law.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, e.g., “the bankruptcy reform act”, was signed into law on April 20, 2005 and implemented on October 17, 2005. The explicit legislative intent is to discourage filings in federal court under Chapter 7 of the bankruptcy code by individual debtors. However, as pointed out by Lawless and Warren (2005), about one in seven persons filing in bankruptcy court as a consumer is actually there because of their small business. It is apparent with the passage of the bankruptcy reform act that most federal legislators believe that initially filing for Chapter 7 bankruptcy has become too attractive of an alternative to repayment for a growing number of individual debtors (Zywicki, 2005). However, legislators overlooked the fact that entrepreneurs and other small business owners are grouped with wage earners because they are classified as non-business filers if unincorporated. In addition the characterization of debt as predominantly consumer would include the second mortgages and credit card charges that entrepreneurs are likely to use to finance their ventures. The new provisions do not consider the fact that entrepreneurs have personal liability of their business debts. Consequently, the provisions of the bankruptcy reform act intended to discourage individuals from initially filing for Chapter 7 will most likely result in (1) entrepreneurs incorporating so that they can file for bankruptcy as a business, and (2) entrepreneurs refusing to personally guarantee loans as a condition of lending, thus limiting their access to capital. Hence, the odyssey of entrepreneurs who try, fail, and try again will diminish.

Our study presents a comprehensive analysis and empirical statistics that will enable students, legislators, practitioners and academics to better understand the bankruptcy process and its impact on entrepreneurs. The new code prevents individuals from directly filing for Chapter 7 without establishing

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eligibility. These eligibility requirements which impose additional costs on the individual and legal representative are designed to discourage debt liquidation. To date, little empirical evidence exists regarding either the number of small firms that initially file for Chapter 7 or the costs associated with the bankruptcy process prior to the reform. This study fills that gap in the entrepreneurial, financial economics and legal literatures by providing documented statistics regarding four issues: 1) the incidence of small firms that directly file for Chapter 7; 2) the financial characteristics of the self-employed businesses that traverse the bankruptcy courts; 3) the cost and timing of small business bankruptcies; and 4) the incidence of multiple filings by small business owners.

The historical evidence in our study is inconsistent with the purported concern in passing the new code regarding debtor opportunism. Our data shows that less than twenty percent of the incorporated and unincorporated business owners initially filed for Chapter 7. In contrast, the majority of small firms attempted to restructure their debt within either Chapter 11 or 13. Thus, Lawless and Warren’s (2005) assertion that the associated reform is problematic not only for individual consumers but also for those engaged in business is an accurate one. In fact they urge that bankruptcy law should distinguish between wage earners and entrepreneurs. We agree.

Bankruptcy: The Text Book Application

Most text books discuss bankruptcy within the financial leverage and capital structure policy chapter. For example on page 552 Ross, Westerfield, and Jordan state that the firm’s likelihood of failure, e.g., bankruptcy, is directly related to the extent management relies on debt. In particular, they state that “a limiting factor affecting the amount of debt a firm might use comes in the form of bankruptcy costs.” Direct costs refer to the legal and administrative fees. The costs associated with lost sales, employee departure, low moral, and unproductive management time are considered indirect. Both types of costs are a disincentive to debt financing. Similar to other books, the company examples in the text refer to large publicly traded companies such as Enron or Delta Airlines instead of small firms and unincorporated entrepreneurs. Therefore, a supplement discussing the effect of bankruptcy on small business owners is needed.

On pages 562 through 565 the authors provide a quick look at the bankruptcy process. This section describes the liquidation process within Chapter 7 and the reorganization process within Chapter 11. The information, however, applies to the outdated Federal Bankruptcy Reform Act of 1978. Moreover, many entrepreneurs file for reorganization under Chapter 13. Consequently, the omission of the Chapter limits most text books application to small businesses. Our supplement provides an extensive evaluation of the most recent reform.

Bankruptcy: Literature Review

Much of the research in the law literature has been done on individual bankruptcies, while the research in the financial economics literature has focused on publicly traded firm reorganizations. The most recent studies in the law literature look at the effectiveness of the proposed act from the consumer debtor perspective (Carlson and Hayes, 2005 and Buckley and Brinig, 1996). Little has been written on the impacts of the new code, since it went into effect October 17, 2005.

Historically, legal researchers have also looked at the number and types of personal bankruptcy filings (Chapters 13 and 7). The consensus is that personal bankruptcy filings have increased at the alarming rate of 7% or more annually subsequent to the 1984 amendment to the code. The US Bankruptcy Courts have reported that individual, “non-business” bankruptcies rose from 1.3 million in 1999 to 1.625 million in 2003. In the case of individuals, the bulk of their indebtedness has increasingly been made up by debt on credit card accounts (Warren and Westbrook, 2001).

Personal and unincorporated business bankruptcies, however, are sometimes commingled. For instance, one study reports that as many as seventy five percent of all Chapter 7 petitions for businesses are filed by “natural persons”, not corporate entities (Warren and Westbrook, 2001). A recent study by Lawless and Warren (2005) documents the incidence of business bankruptcy filers that apply for consumer bankruptcy and shows that the business filings have risen at the same pace as individual filings. They find that the Administrative Office of the U.S. Courts drastically understated the number of business related bankruptcies because the office categorizes unincorporated entrepreneurs, self employed individuals and
independent contractors as consumers. Consequently, the current bankruptcy law and finance textbooks continue to fail to consider the special needs of entrepreneurs; those wage earners who are self-employed or who have a business on the side.

In the financial economics literature, Schwartz (1993) suggests that the high cost of restructuring encourages publicly traded firms to resolve financial distress through informal negotiations rather than formal bankruptcy channels, also see, Franks and Torous 1994; John 1993; Gilson, John and Lang 1990; Wruck and Hopper 1980; and Altman 1984. Consistent with Schwartz’s supposition, Betker (1995) shows that management and creditors are often able to decrease both the cost and length of bankruptcy by agreeing to a prepackaged plan. Also, according to Chatterjee, Dhillon and Ramirez (1994) approximately one third of all large (over $100 million) bankruptcies are prepackaged plans. However, very little is known about small business bankruptcies primarily because of researchers’ inability to obtain information for closely held firms (Carlson and Hayes, 2005). Stanley and Girth (1971), Ang, Chua and McConnell (1982) and Evans and Sillah (2002) are three exceptions. These papers provide empirical statistics regarding the percentage of direct costs to total assets for a sample of 90, 55, and 97 closely held firms, respectively. Our results and the findings from these three studies will enable future researchers to determine whether the costs associated with the 2005 bankruptcy reform act are a deterrent to unincorporated small firms.

The literature on entrepreneurship also focuses on survival rates for new firms but these authors do not analyze bankruptcy law’s impact on new small firm survival even though researchers agree that new business formation is a critical element in the wealth of nations. For example, Tang and Koveos (2004) find a positive relationship between countries’ innovation index and their gross domestic product. Yet, despite the economic costs associated with small business failure, few studies have analyzed how bankruptcy law affects owners’ ability to survive (see, for example, Simon and Houghton 2002). Knowledge of the most recent bankruptcy act is important because small firms are plagued with relatively high failure rates (Simon and Houghton, 2002 and Moulton, Thomas and Pruett, 1996).

Important Aspects of the 2005 Bankruptcy Reform

Several major changes altered the bankruptcy law on October 17, 2005. It appears that the bankruptcy courts’ primary goal has changed from preserving employment through rehabilitating individuals to protecting the rights of unsecured creditors (Zywicki, 2005). It is apparent with the passage of the bankruptcy reform act, that most federal legislators believe that not only is filing for bankruptcy no longer considered something to be avoided, but the current code has been used, or “abused” as a means to elude creditors and escape unwanted financial obligations (see Zywicki, 2005). The sum of the changes will be a certain increase in the costs of filing any type of bankruptcy action. The amount of increase will depend on circumstance of course, but some experts have projected an increase on the order of 200% or more (CBO, 2005). With this backdrop, a review of the major changes is in order.

Means test for Chapter 7 eligibility is applicable to individuals not incorporated firms

The new bankruptcy law alters the process at the pre-petition filing stage for unincorporated entrepreneurs or for owners of corporations who personally guarantee their companies’ debts. Now, a means test for eligibility is required to initially file under Chapter 7 (Bankruptcy Code (“BC”), Sec.707b6A-C). The means test compares individual debtors’ pre-filing income to the median income of other individuals within their state. If an individuals’ income is greater than the median income, the person is barred from Chapter 7 and must be so informed by any legal counsel that is retained in the matter. If the debtor fails the test--i.e. his income is too high--the filing she made under Chapter 7 raises a presumption of bad faith. The presumed bad faith is rebuttable only by a documented showing of extreme, “special circumstances” that leaves no reasonable alternative to the relief offered by liquidation.

Lawless and Warner (2005) argue that the means test does not apply to small business owners and entrepreneurs because it presumes that the pre-filing income will continue post filing. They note that this assumption may be true for wage earners but is highly unlikely for debtors who operate a failing business. Thus, they assert that the means test will needlessly penalize entrepreneurs who are truly insolvent and should be allowed to file for Chapter 7 as individuals.

Court certified credit counselor for personal finance
The new legislation further stipulates that debt-counseling must come from a court-certified credit counselor. The responsibility for certification will rest with the court-appointed, U.S. Trustee officers in each separate jurisdiction (BC, Sec. 111(b)). This part of the new code requires that all individuals show a documented, good faith effort to obtain and implement debt-counseling before filing a bankruptcy petition. This requirement may not be appropriate for entrepreneurs who fail because of industry or economic adverse changes. Yet, small business owner incur indirect costs by attending personal financial management classes, discharges in Chapter 7 and 13 would be denied.

Another problem is that certified counselors will have to compare earnings from Schedule C statements with the average wage in the state for unincorporated individuals. The proponents of the amendments did not specify how the certified creditors are supposed to apply the means test standard to entrepreneurs of failed businesses. Likewise, the Director of the Executive Office of the United States Trustees is required to issue schedules of “reasonable and necessary administrative expenses of administering a Chapter 13 plan.” A uniform schedule of fees, however, is most likely inappropriate for entrepreneurs because there is not a clear demarcation between their personal and business debts. For example, many entrepreneurs use personal guarantees and unsecured consumer debt proceeds to buy inventory and equipment for their businesses. In this situation, a standardized fee schedule would be inappropriate due to the complexity of the legal case.

**Liability for Bankruptcy Professionals**

Regardless of motive, as a matter of discouraging individuals to file under Chapter 7, the new law creates new responsibilities and new liabilities for the debtor and any advisor or other bankruptcy professional upon whose advice she relied. The burden for documenting the need for bankruptcy now rests with the debtor and, by extension, the debtor’s legal counsel. In fact, the signature of legal counsel attesting to that effort and other claims of the debtor will incur a rather extreme form of liability for the attorney under the revised act. With the reform act, attorneys are now required to investigate and document the claims of individuals and are liable for court costs and creditors’ attorneys’ fees when those claims are later found to have been false or misleading. The extent of enforcement of such provisions is as yet unknown. In the interim, however, it is clear that law firms specializing in bankruptcy practice will need to create and streamline new forms of record-keeping and procedures for conducting investigations into client assets. It is presumed these costs will be passed on to debtors. Attorneys are liable for court costs and creditors’ attorneys’ fees where those claims are later found to have been false and misleading.

**Multiple Filings**

Another point of alleged abuse which the new law addresses is that of multiple and serial filings by the same debtor. Under past law, liquidations for individuals under Chapter 7 were commonly combined with subsequent filing for reorganization of personal debt under Chapter 13. The result of that combination was a complete discharge of consumer unsecured debt, and then, through reorganization under 13, preservation of home equity and institution of a repayment plan on all secured debt. The debtor often remained in possession of their assets and the secured obligations were frequently stripped of interest payments.

Courts traditionally allowed this type of serial filing based on one of the overriding policy goals of bankruptcy: to preserve employment, both in terms of individuals as income-earners and business entities as employers. The rationale was that conversion of cases from Chapter 7 to 13, and interest stripping of secured loans for debtors in possession, allow bankrupt persons to remain employed and therefore able to complete repayment plans.

The combination of Chapter 7 filings with later conversion to Chapter 13 had become so common a practice that it is known colloquially as a “Chapter 20” (Warren and Westbrook, 2001). In order to discourage Chapter 20’s and other forms of serial filings, the new act revises the rules so that Chapter 13’s may only be filed once every two years, and three years must pass between filing of a Chapter 7 and a subsequent 13. To further discourage serial 7 filings, the period between Chapter 7’s has been extended from six to eight years as well. Similar provisions exist for Chapter 11 and Chapter 7.
Small Business Provision of the Code

Historically, the rationale for Chapter 11 has been that firms need the provisions when the restructuring of debt claims is not enough to make the firm economically viable. Carlson and Hayes (2005) argue that too much time passes before Chapter 11 cases are either converted or dismissed and this incurs costs which erode the value of the assets that could be paid to creditors. For example, an economically viable firm may not be able to restructure due to conflicts of interest and hold out problems among unsecured creditors. They further maintain that one of the principal reasons for this time delay is ineffective oversight of the debtor: trustees or creditors should be in a position to determine if a debtor has reorganization potential fairly quickly. The new small business provisions are designed to overcome that deficiency. With an accelerated process it is hoped that Chapter 11 cases will be converted before needless loss of value. Nonetheless, the following provisions remain intact under the new bankruptcy law act: (1) debtors are able to stay some of the collection efforts of creditors; (2) debtors are able to receive a discharge of their unsecured debts; (3) debtors are able to reorganize their indebtedness, which may include a reduction of interest payable on secured loans; and (4) creditors must show documentation of indebtedness or a proof of claim.

A small business debtor is defined as a person engaged in commercial or business activities (other than real estate) that has aggregate secured and unsecured debt at the date of filing of no more than two million dollars and has no active creditor’s committee. Small business debtors are required to proceed under these special sections of the code unless they have an active creditor’s committee.

Under section 431, a small business filing a Chapter 11 can take advantage of flexible rules regarding its disclosure statements and its final plan in order to accelerate the reorganization process and minimize costs. Small business may even be able to get a waiver from the court to provide any disclosure statement at all and to combine the confirmation hearing on the plan with that of the disclosure statement. Both options would reduce the associated administrative costs to small businesses.

Small business debtors are also obligated under section 435 to file periodic financial and other reports containing information relating to the debtor’s profitability, the debtor’s cash receipts and disbursements, and whether the debtor is filing timely tax returns and paying other administrative costs when due. The law encourages the court and trustee to ask for simple and inexpensive reports from small business owners. In fact the bankruptcy court may schedule conferences only as are necessary for the ‘expeditious and economical’ resolution of the case. The small business case should run no more than a year, 300 days to file the plan and another 45 to approve it at the maximum.

In our opinion, unincorporated entrepreneurs should also be allowed to file for bankruptcy under some special provision of the bankruptcy code if their failure is due to business activities and not overspending of corporate cash flow on consumer expenditures. The inclusion of entrepreneurs in the bankruptcy process would promote entrepreneurial activity within the United States.

Data Collection

The sample consists of both incorporated closely held firms and unincorporated small business ventures that completed the Chapter 7, 11 or 13 processes at the Northeast Division of the Atlanta Bankruptcy Court in the one-year period beginning December 31, 1993 and ending December 31, 1994. This one year period was used in order to accommodate the court generated list of filings.

The court documents report financial information at the beginning of the filing period, terms of the process, the final resolution, and the nature of debts outstanding. The nature of debts outstanding refers to business or personal liabilities. In the filings, we select all of the incorporated firms that filed for Chapter 7 or 11. Since the firms are closely-held, the financial information is limited to book values. The terms of the bankruptcy include the length and cost of the process, recovery amounts for creditors and debt elimination amounts.

The analysis conjectures whether unincorporated entrepreneurs who filed for Chapter 7 prior to the recent reform should be classified as a business entity subsequent to the reform. The study uses empirical data to provide a baseline for future researchers who will examine the impact of the 2005 bankruptcy act on entrepreneurs. The data allows us to analyze the following issues for both unincorporated individuals and incorporated small firms: 1) the incidence of initial Chapter 7 filings; 2) the solvency characteristics; 3) the incidence of multiple filings; and 4) the cost of filing bankruptcy.
The incidence of initial Chapter 7 filings prior to the reform will allow us to assess whether unincorporated entrepreneurs and incorporated small business owners abused the process. Since the intent of the legislation is to reduce the number of filings, we analyze whether the percentage of initial filings is alarming. The solvency characteristics of the firms and the incidence of multiple filings will also enable us to measure the degree of abuse. The firm’s solvency level is measured as the ratio of liabilities to total assets (leverage) and the recovery percentage as measured by the dollar amount of debt repaid to creditors divided by the total amount of allowable creditor claims. The rationale is that firms with the highest leverage ratios are the most insolvent and least likely to be able to repay their debt. Alternatively, the firms with the highest recovery percentages are perceived as more solvent and best able to repay their debt. If the restrictions on filing for bankruptcy are warranted we anticipate that bankrupt entrepreneurs and small firm owners will have lower leverage ratios and higher recovery percentages.

Should unincorporated entrepreneurs and incorporated small businesses be treated differently? In essence, should entrepreneurs be forced into a bankruptcy system designed to deal with consumer problems? We think not. The next section provides empirical baseline statistics regarding the bankruptcy process.

Under section 431, small firms with debt claims of $2,000,000 or less are more or less required to file for bankruptcy under flexible rules that are intended to accelerate the reorganization process and minimize costs. The median size of debtors’ liabilities in our study is much smaller than the $2,000,000 minimum. The median liabilities for incorporated firms that initially filed for Chapter 11 bankruptcy is $327,087. In contrast, unincorporated individuals who classified themselves as having business debts and who initially filed for Chapter 13 had a median debt amount of $193,002.

Empirical Statistics on Small Business Bankruptcy Filings

The Incidence of Chapter 7 and Multiple Filings

An important motivation for the 2005 amendment to the bankruptcy law stemmed from the assumption that debtors take advantage of unsecured creditors by filing for liquidation within Chapter 7 in order to eliminate their unsecured debt. In order to assess whether entrepreneurs or small business owners persistently attempted to take advantage of their unsecured creditors, we computed the incidence of initial Chapter 7 filings for a sample of 420 incorporated firms and a sample of 132 unincorporated entrepreneurs.

Out of 420 incorporated firms that filed for bankruptcy protection only 78 initially filed for Chapter 7. Thus, only 18.6% of the incorporated firms attempted to immediately eliminate their unsecured debt. In our sample, the rate of 37.1% for initial Chapter 7 filings is somewhat higher for unincorporated business owners. A total of 49 entrepreneurs initially attempted to eliminate their unsecured debt. Although we could find no statistics on the percentage of wage earners that filed for Chapter 7 in lieu of Chapter 13, we suspect that the rate for unincorporated individuals is substantially lower. If so, the absence of abuse by unincorporated entrepreneurs may provide a rationale for separating entrepreneurs and wage earners in the bankruptcy process.

Future research will be able to what extent the number and percentage of Chapter 7 filings by unincorporated entrepreneurs decline after the 2005 reform act. One reason for the decline may be that entrepreneurs may become incorporated at the onslaught of financial distress in order to take advantage of the new business provision, although they will have to overcome arguments of the corporation as legal fiction. Alternatively, the change in the bankruptcy law may encourage unincorporated entrepreneurs to only file for bankruptcy when they have negative cash flow and minimal asset value. It remains to be seen whether the new law will encourage more entrepreneurs to repay their unsecured debt within Chapter 13.

Provisions within the new law also limit unincorporated entrepreneurs’ ability to file for multiple bankruptcy filings. The rationale is that individuals use multiple filings to make deals with secured creditors at unsecured creditors’ expense. Our statistics show that limitations on multiple filings will have a profound impact on the bankruptcy system for small firms. Of the 420 incorporated firms that initially filed for Chapter 11 bankruptcy in 1994, 71.7% or 301 went from a Chapter 11 to a Chapter 7 in one
contiguous period. It must be noted that these conversions occur with the consent of the court and creditors, the implication being that it serves the best interests of all involved.

The rate is slightly lower, however, for unincorporated entrepreneurs. Out of the 83 individuals that initially filed for Chapter 13 a total of 54 cases were liquidated either prior to or subsequent to the 13 filing. Thus, 65.1% of the individuals that filed for Chapter 13 had multiple filings. If entrepreneurs are small businesses why should they be treated differently just because they are not incorporated? Without special provisions that allow entrepreneurs to receive fresh starts the only firms that will survive will be those that can work out debt restructure details in a pre-petition workout as most firms will be constrained to choose Chapter 7.

**Is the Means Test a Limiting Factor?**

The financial statistics are inconsistent with entrepreneurs and small firms being able to repay a substantial portion of their debt at the date of filing. In the bankruptcy file, the incorporated debtors have to list their secured and unsecured debt claims, whereas the unincorporated individuals have to list their aggregate amount of debt. For the 49 entrepreneurs that filed for Chapter 7 their reported incomes are either negative or very close to zero. Hence, the entrepreneurs that filed for Chapter 7 did not report supplemental wage income. Therefore, the means test will not have much effect on this filer’s ability to liquidate their unsecured debt immediately. The unincorporated individuals who did report some business activity and filed for Chapter 13 had supplemental wages. Thus, in our sample, it appears that the entrepreneurs who could pay actually tried to pay. Subsequent to Chapter 13, however, several of these individuals also filed for Chapter 7. Consequently, the new law that limits multiple filings will cause these individuals to stop future entrepreneurial activities because they will be forced to work for wages to pay off debt in lieu of creating new enterprises.

Likewise, incorporated small firms have substantially more debt than assets when they initially file for Chapter 7. Total equity divided by total assets is a proxy for the firm’s solvency level or its ability to recover from financial distress. The lower the equity/assets ratio the more insolvent the firm is presumed to be and, therefore, the less able to repay its debt and recover. The firms that initially filed for Chapter 7 have equity/assets ratios greater than negative 200%. In contrast, the firms that reorganized within Chapter 11 had equity/assets ratios that averaged negative 46%.

In fact, creditors’ recovery rates for small firm bankruptcies are consistent with the initial Chapter 7 filers not being able to repay their debt in full. On average, unsecured creditors receive nothing in initial Chapter 7 filings and only 3 percent on average in Chapter 7 cases that are initiated subsequent to a Chapter 11 filing. A similar comparison cannot be made for unincorporated individuals that filed for Chapter 7 or 13 because formal creditor committees only exist in Chapter 11.

Yet, if unincorporated entrepreneurs recovery rates are similar to incorporated small firm rates and if absolute priority is followed in the sense that secured creditors will be repaid before unsecured creditors, the increased costs associated with the 2005 reform act will eliminate the small amount recovered by unsecured creditors. The intent of recovering more from individuals who can repay the unsecured debt over time most likely is not applicable to entrepreneurs.

**Will Increased Bankruptcy Costs Harm Unsecured Creditors?**

Although scholars in general agree that the cost of filing for all individual bankruptcies should increase, some experts have projected a 200% or more increase for initial Chapter 7 filings. This devaluation is important to lenders because the recovery percentage for secured creditors is less than one hundred percent and the recovery percentage for unsecured creditors averages zero. Thus, unsecured creditors may want to have unincorporated entrepreneurs avoid the costly process dictated by the 2005 reform act as these individuals may not have wages from which repayment may be made.

Suppose that unsecured creditors induced regulators to force unincorporated entrepreneurs to file for Chapter 11 instead of directly for Chapter 7 under the streamlined business amendment. The costs associated with bankruptcy will increase substantially for the unsecured creditors. If the entrepreneur restructures her debt within Chapter 11 the mean and median relative costs are 27.9 percent and 11.9 percent, respectively. Thus, approximately twelve percent of the median firms’ asset value is dissipated by the bankruptcy process.
Creditors should allow unincorporated entrepreneurs to participate in multiple filings such as filing for Chapter 7 as a business after filing for Chapter 11. The total mean and median relative costs are 10.9 percent and 2.9 percent for the firms supervised by judges and trustees during the negotiations prior to liquidation. Hence, the total cost of liquidation would be 2.9 percent in Chapter 11 plus 5 percent in a subsequent Chapter 7. However, this total cost of 7.9 percent is still higher than the 5 percent cost of filing directly for Chapter 7. Currently, we are unable to compute a similar metric for unincorporated entrepreneurs as they are not required to provide business related balance sheet information when they file as an individual.

Conclusions and Implications

This paper provides supplement for the Financial Structure and Leverage chapters within Financial Management text books. Knowledge of the bankruptcy system and the path that an unincorporated entrepreneur must take is increasingly important. However, students are not given information regarding the recent bankruptcy reform act nor are they given statistics on small business or unincorporated entrepreneurs’ experience within the bankruptcy process. Coverage within academic courses is important because it is anticipated that reform will a ‘chilling effect’ on entrepreneurs brought on by a fear of losing bankruptcy as a strategic alternative in the event their business fails. As such, the number of small business venture start ups may be reduced.

Our analysis should not be misinterpreted. We do not conclude that entrepreneurs should be allowed to erase their business debt at the expense of secured creditors. Rather our conclusions support the necessity of specific legislation which recognizes that consumers/wage earners can and do have business related debt. And further, that debt should be accorded similar treatment to that of a large corporation filing a Chapter 11. The paper highlights a persistent problem, that of the unincorporated entrepreneur: she is the forgotten debtor.

References


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