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Who Needs Bankruptcy Law?

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This essay summarizes four of Professor Morrison's papers: "Bargaining Around Bankruptcy: Small Business Distress and State Law," J. of Legal Stud. (forthcoming); "Bankruptcy's Rarity: An Essay on Small Business Bankruptcy in the United States," in 5 Eur. Co. & Fin. L. Rev. 172 (2008); "Small Business Bankruptcy and the Bankruptcy Abuse and Consumer Protection Act of 2005," A Report to the United States Small Business Administration (2007); and Douglas G. Baird & Edward R. Morrison, "Serial Entrepreneurs and Small Business Bankruptcies," 105 Colum. L. Rev. 2310 (2005).

Few small businesses use the Bankruptcy Code to reorganize or liquidate. For every one hundred that fail, at most twenty file for bankruptcy. Figure 1 makes the point using data supplied by Dun & Bradstreet (D&B), which maintains financial records on small businesses throughout the United States. Standard texts portray federal bankruptcy law as an inevitable choice of distressed businesses, yet we see that bankruptcy is far from inevitable. It is exceptional. Why?

One reason is cost. Among businesses with assets worth less than $1 million, professional fees and other bankruptcy costs consume more than five percent of the median firm's assets. These costs encourage distressed businesses to find alternatives to bankruptcy. There are many. Some are contractual—the business could undergo a foreclosure, or it could reach a "workout" agreement with creditors. Some are based in trust law—the business could assign its assets to a trustee, who auctions them and distributes proceeds to creditors ("assignment for the benefit of creditors"). These and other options can be cheaper than a bankruptcy filing.

These options will be cheaper for businesses with a small number of creditors, each with well-defined priority. The simpler a firm's capital structure, the simpler (and cheaper) it is to liquidate under state law procedures. And among reorganizing businesses, the fewer the creditors and the clearer their priorities, the higher is the likelihood they will cooperate with the failing business. Cooperation is essential because, unlike a bankruptcy case, state-law procedures generally do not halt creditors from pursuing collection efforts. On the other hand, only the number of *senior* creditors needs to be small. Senior creditors—those with security interests or large unsecured claims—have strong incentives to monitor the business and demand a payout from any insolvency procedure, state or federal. Junior creditors, such as trade vendors, generally have such small claims that they rarely monitor the debtor or participate in an insolvency proceeding.

This theory—that state-law alternatives are cheaper for businesses with simpler capital structures—finds support in the D&B data. *Figure 1* showed that corporations are twice as likely as noncorporate entities to file a bankruptcy petition. *Figure 2* shows that corporations also have significantly more complicated capital structures. Similarly corporations in bankruptcy are larger and have significantly more complicated capital structures than those that resolve distress using state-law procedures, as *Figures 3* and *4* show.

Cost and capital structure are not the whole story. Senior creditors will disrupt state-law procedures unless they trust the business's disclosures or can verify them at reasonable cost. When creditors suspect insider self-dealing, they can audit the business. But if multiple parties pursue independent audits, state-law procedures become as costly as a bankruptcy filing. Trust is, of course, hard to measure. One proxy is whether the business has defaulted on senior debt or been habitually late in payments. This behavior damages the business's relationship with the lender, which may lead it to be more skeptical about the owner's disclosures. Applying this proxy, *Figure 5* analyzes a sample of distressed small corporations in Cook County, Illinois (drawn from D&B data), comparing those that filed for bankruptcy to those that resolved distress using state-law alternatives. Corporations in bankruptcy are significantly more likely to have defaulted on secured debt, consistent with the theory that state-law procedures are infeasible without creditor trust.

There is more to the story. Laws governing state-law procedures vary significantly. Some states, such as New York and Texas, have vigerous regulations. Courts oversee insolvency proceedings; creditors can sue insiders or others that were favored as the business hemorrhaged. In other states, including Connecticut and Illinois, no statute governs important insolvency procedures. There is little court monitoring; creditors have limited power to sue insiders.

Legal variation can affect the choice between bankruptcy and state-law alternatives. These non-bankruptcy alternatives will be more expensive in states with vigorous regulation, due to court fees and other costs. If these costs are large, state-law alternatives will be less attractive and bankruptcy filings will be *more* common, in states with vigorous regulation. On the other hand, even heavily regulated state-law alternatives may be cheaper than a bankruptcy filing for many small businesses. These businesses will prefer state-law alternatives, regardless of regulation, provided senior lenders consent. Interestingly a lender may be more likely to consent in states with vigorous regulations because the regulations give the lender broad power to audit businesses and attack self-dealing. If so, bankruptcy filings could be *less* common in states with vigorous regulations.

Which effect dominates in practice? It depends. Chapter 11 bankruptcy filings (used for reorganization) are indeed *less* common in states with vigorous regulations. Chapter 7 filings (used for liquidation) do not vary by state. This makes sense: vigorous laws, which give lenders broad auditing powers, will matter most when the lender is deciding whether to continue dealing with an ongoing, reorganizing business.

Together, these patterns point to an important balance in bankruptcy policy. Any reform will have two effects. It will alter outcomes among businesses that enter bankruptcy court. It also will alter the attractiveness of bankruptcy relative to alternatives. The second effect can offset the first. A reform that expands protections for unsecured creditors, for example, may make bankruptcy more expensive and induce some businesses to use less-protective state procedures instead.

The evidence also points to the benefits of a broad range of bankruptcy alternatives: the broader the range, the better the fit between the financial problems facing the business and the legal mechanism for resolving them. We see businesses with simple capital structures use relatively simple state-law devices; more complex businesses invoke the relatively complex Bankruptcy Code.

But a question remains: Do small businesses need a *federal* bankruptcy law? Without it, state-law alternatives might be wholly adequate. Indeed, federal law may be chosen only when the debtor or its owners behaved badly or were overly aggressive in bargaining with creditors. Bankruptcy law, in other words, may only increase the bargaining power of owners in times of distress. It is unclear whether this is good policy. ♔

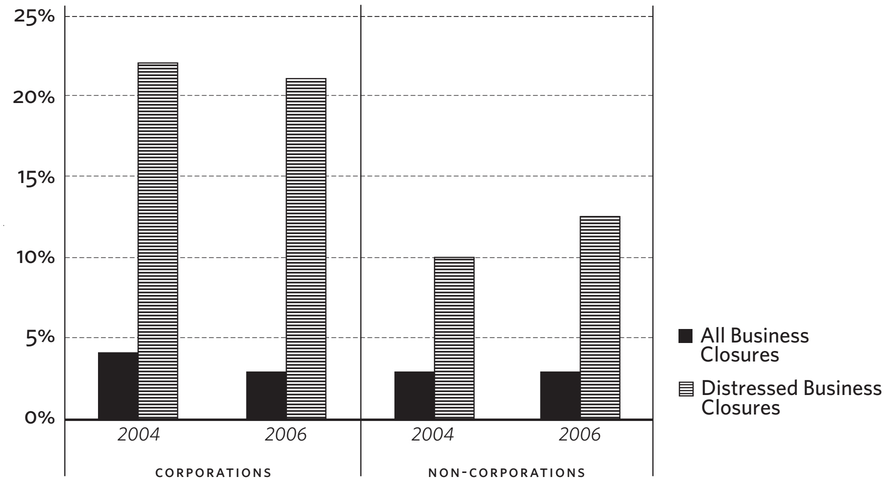

Figure 1: Federal Bankruptcy Filings Expressed as a Percentage of Business Closures During 2004 and 2006

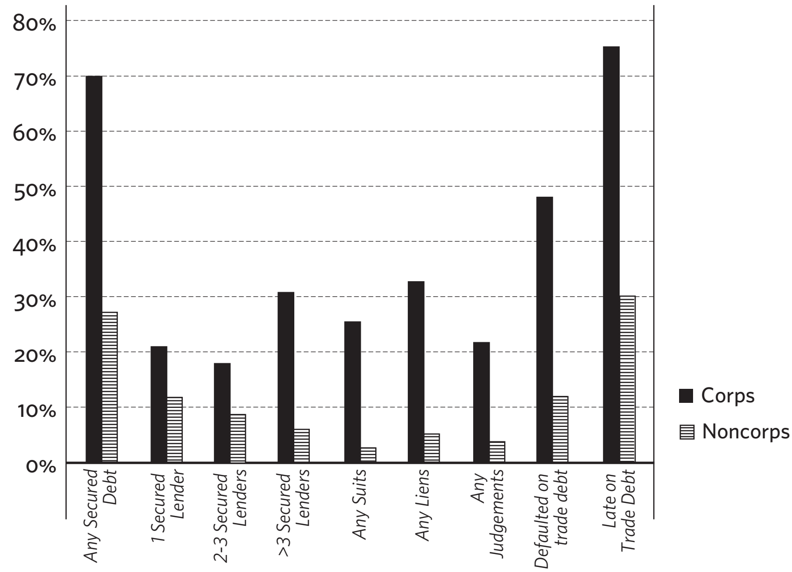

Figure 2: Capital Structure of Corporations and Non-Corporate Entities that Closed or Filed for Bankruptcy During 2004, 2006. Each bar indicates the percentage of businesses with a particular characteristic. If the difference between corporations and non-corporate entities is statistically significant at the five percent level, the bar for "noncorps" is cross-hatched instead of solid white.

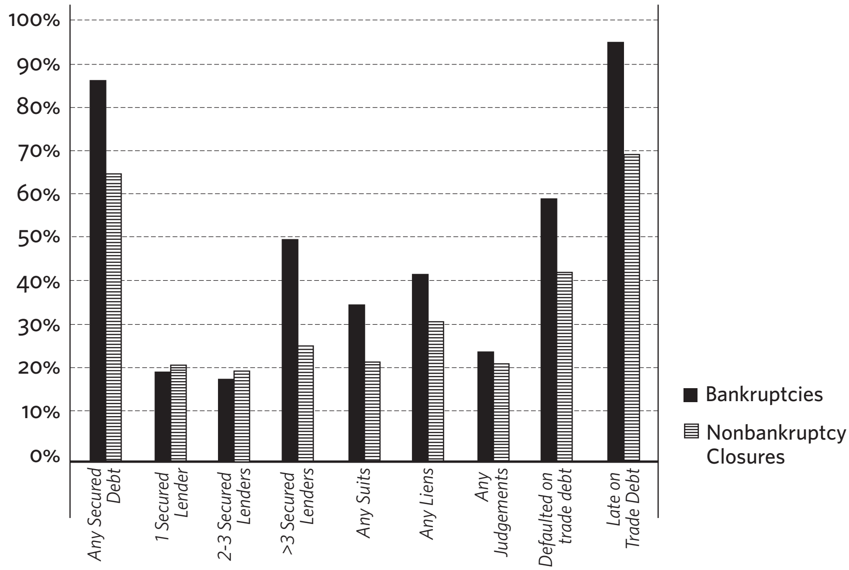

Figure 3: Capital Structure of Corporations that Closed or Filed a Bankruptcy Petition During 2004, 2006. Each bar indicates the percentage of businesses with a particular characteristic. If the difference between bankruptcies and non-bankruptcy closures is statistically significant at the five percent level, the bar for closures is cross-hatched instead of solid white.

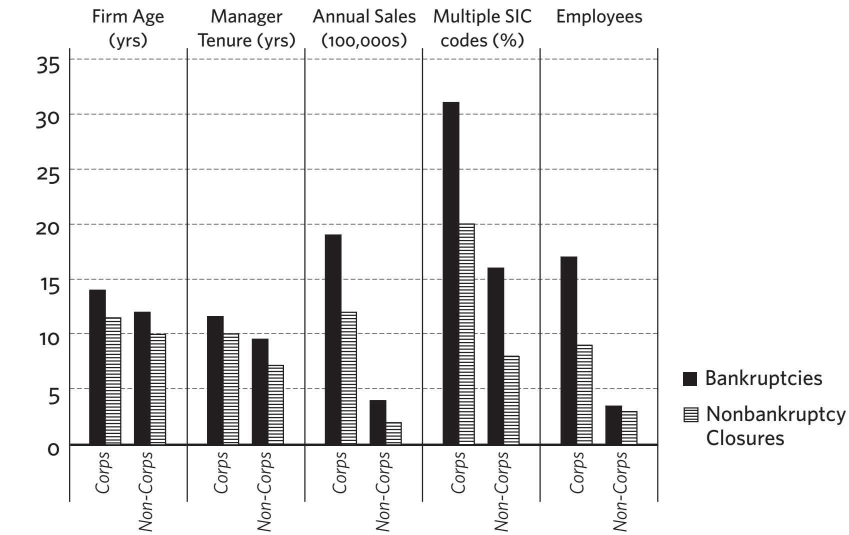

Figure 4: Proxies for Size Among Businesses that Closed or Filed a Bankruptcy Petition During 2004, 2006. Each bar indicates the percentage of businesses with a particular characteristic. If the difference between bankruptcies and non-bankruptcy closures is statistically significant at the five percent level, the bar for closures is cross-hatched instead of solid white.

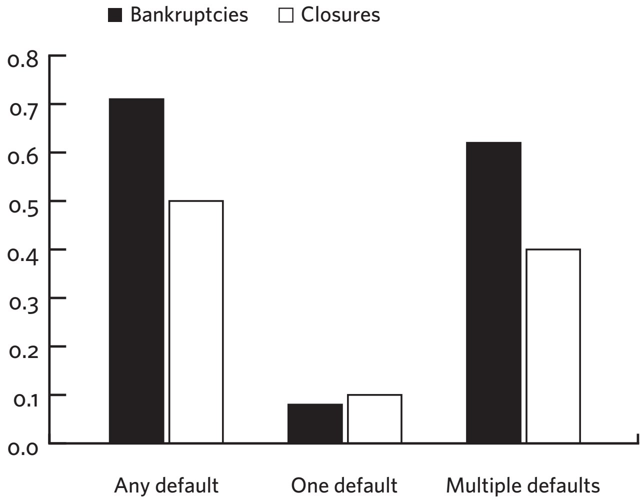

Figure 5: Proxies for the Quality of Lender-Borrow Relations Among Chicago-Area Corporations that Closed or Filed a Bankruptcy Petition Between 1998 and 2005. Each bar indicates the percentages of businesses with a particular characteristic. If the difference between bankruptcies and non bankruptcy closures is statistically significant at the five percent level, the bar for closures is cross-hatched instead of solid white.