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"Could Bankruptcy Reform Help Preserve Small Business Jobs"

I want to thank Chairman Whitehouse, ranking Member Sessions, and the members of the Subcommittee for inviting me to testify on this crucially important topic.

Bankruptcy law is a crucial stabilizer to economic growth. The philosophy that indebted persons should be able to carry forward after discharging as much of their debt as possible without being completely wiped out has been held dear for several hundred years. But even from the inception of that philosophy, it has also been held that some individuals and entities deserve special treatment relative to others. The British roots of bankruptcy law, therefore, allowed relief for the landed but not the commoner.

US bankruptcy law is no different, giving the landed interests similar special treatment. The rationale for such treatment in the US, however, was not peerage but the perceived importance of farmers to US economic growth since the times of Thomas Jefferson. The idea is that the "uncertain nature of the farm business with its attendant wide fluctuations in commodity prices and frequent weather problems," deserved special consideration. Such treatment was accompanied by restrictions on financial institutions that lent money to the farms, so that those would be so undiversified – as well as legally hobbled in bankruptcy law – that they had no alternative but to forbear on farmers in times of poor harvests.

As the US economy grew and as industrialization took hold, the traditional family farm became considered a "small business." As railroads and banks took precedence for special treatment in the bankruptcy code, bankruptcy concerns for small businesses of all types fell by the wayside. It is laudable, therefore, that the Subcommittee consider changes to the bankruptcy code that can make sense of some of the dynamics of today's volatile business environment.

Unfortunately, the approach under consideration will hurt both economic growth as well as small business owners. The proposed remedy does not separate between business and personal asset in a manner that can clarify business and personal financial relationships a priori, therefore reducing unexpected distress ex post. In fact, nothing can ever fully solve the business bankruptcy problem because it, like personal bankruptcy, is caused primarily by several well-known triggers that typically manifest at very personal levels. Moreover, even changes to bankruptcy code cannot stem the tide of macroeconomic troubles, but only help entrepreneurs smooth the transition to new opportunities and help creditors retain value. Both, preserved, will be more prone to drive economic growth than if both creditors and entrepreneurs waste time and money sorting through the rubble to try to find something of value, preserving meager economic activity at the cost of high growth potential.

Small Business Assets and Personal Assets and Liabilities are Often Commingled

It is hard, sometimes, to see where the boundaries of personal lives and business lives exist, especially in small businesses. Small business owners often work out of their homes or finance business investment on their personal credit cards. Small businesses are more likely to contract on insufficient terms or fail to carry sufficient liability insurance. And small businesses are more prone to personal liability on the part of the business owner or partners, as a result.

One simple example is the prevalence of small business subprime home lending that played a part in the run-up to the recent crisis. While there are no official figures on such activity, a significant number of the firms active in such lending experienced dramatic difficulties well before the common crisis. One such firm, American Business Financial Services, was the subject of its own spectacular bankruptcy in the Philadelphia region early in the crisis.

American Business Credit originated "business purpose loans to corporations, partnerships, sole proprietors and other business entities, or to individuals, for various business purposes... collateralized by a first or second mortgage lien on a principal residence of the borrower" American Business Credit generally charged origination fees of 4.75% to 5.75% of the original principal balance. The weighted-average (simple) interest rate on American Business Credit's portfolio for the first six months of fiscal 2003 was 15.86%. According to the company, "although prepayment fees imposed vary based upon applicable state law, the prepayment fees on American Business Credit's business purpose loans can be a significant portion of the outstanding loan balance."[1]

ABFS and others ultimately found that small business owners of any particular credit quality were more likely to repay their mortgages in the event the ABFS held sway not only over their home, but their business as well. Such subprime business loans explicitly exploit the commingling of business and personal assets for greater profitability and repayment. I argue that it is those boundaries between the personal and business obligations that lead to the most disruptive losses in small business bankruptcy.

The Causes of Small Business Bankruptcy and Personal Bankruptcy are also Commingled

While many studies (as well as conjectural notions) seek to categorize the causes of small business bankruptcies, the chief risks are cash flows, lawsuits, and key-man risk. Cash flows speak for themselves. Microbusinesses can go bankrupt if a single client misses a payment. Sometimes there can arise a domino effect (we call that systemic risk in the financial world) where the failure of one small business to get paid results in it not being able to pay others. Such trickle down is common in the construction business, where a contractor will fail to pay their subcontractors. That is why every homeowner knows to contract in a manner in which the subcontractors only have recourse to the contractor, not the homeowner.

Small businesses that serve larger business clients can often have payments held up, as well. If the small business turns down subsequent business before getting paid for the previous contract, they can lose a significantly large client. If they choose to litigate, they can lose the entire amount and the client to attorneys. As mentioned above, small businesses are more likely than large

[1] American Business Financial Services, Inc. and a number of its subsidiaries filed for protection under Chapter 11 of the Bankruptcy Code on January 21, 2005. The firm is now in liquidation. Prospectus of Bear Stearns Asset Backed Securities Inc. 424B5, "ABFS Mortgage Loan Trust 2003 1" 3/31/03, at S-35, http://www.secinfo.com/dr89b.2fp.htm#23iy

businesses to have significant shortfalls in liability coverage. Hence, in the event a client sues over a job – whether for completion or injury – the small business owner can lose both personal and business assets.

Of course, a skilled manager can help guide a business through those landmines. But the skilled manager in small business is often the owner or managing partner, and without him or her, the business cannot stand. Consider the chief risks facing the "key-man" in the operation are the same personal financial shocks that cause personal bankruptcy: divorce, automobile accidents, health care crises, and addictive disorders. [2]

Change is Costly, so Let's Make it Worthwhile

We are still dealing with the fallout of changes to bankruptcy incentive in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. There, liberal rights granted to unsecured consumer creditors led to increased credit supply and rampant consumer borrowing. On the business side, "BAPCPA's extension of safe harbor provisions to a seemingly unlimited universe of financial contracts… dramatically increased the number of parties who could freely terminate or accelerate agreements, liquidate positions, and set off claims against margin or collateral called in from a debtor without fear of interference by a bankruptcy court."[3] As a result, failed firms had already been drained dry of cash and assets by margin calls on new financial products, leaving the firm a mere shell in the aftermath.

Similar dramatic changes occurred with the implementation of Chapter 12. Shortly after Chapter 12's implementation, agricultural experts argue that "It is doubtful that there currently exists a single provider of funds, farm supplies, and/or agricultural services which has not been directly or indirectly impacted by the advent of Chapter 12. Indeed, some major suppliers of fuel, seed,

[2] See, for instance, Mason, Joseph R., "Demographics and Personal Bankruptcies," Research in Banking and Finance, v. 1, pp. 229-257, 2000.
[3] Julia Whitehead, Viewpoint, Dow Jones DBR Small Cap, Wednesday, April 22, 2009.

fertilizer, and chemicals, operating as large-scale holders of unsecured claims on agricultural producers, have been forced into Chapter 7 liquidation as a result of their customer's treatment under Chapter 12. In our highly integrated and interdependent agricultural economy, it would appear that the domino theory is well supported by recent experience."[4]

As a result, while Chapter 12 appears to have provided a short-run benefit to family farmers in crisis, it has become a burden to secured creditors. Under the revised Chapter 12, secured creditors were, "forced to make a loan equal to the liquidated value of their claim," even though the farmer had no equity to contribute himself.[5] This turned many agricultural creditor relationships upside down, leaving *secured* creditors to bear the downside risk, while unsecured creditors and farmers gained the upside. Ironically, unsecured creditors (largely providers of farm production supplies) who would normally stand to receive little under a Chapter 7 liquidation, in fact, stood to benefit from Chapter 12 proceedings.[6]

Each time we tinker with bankruptcy law, we impose significant costs on all economic agents. We all know the classic tradeoff. "Higher bankruptcy exemption levels benefit potential entrepreneurs who are risk averse by providing partial wealth insurance and therefore that the probability of owning a business increases as the exemption level increases.[7] But "higher personal bankruptcy exemptions are predicted to cause increased credit rationing and higher interest rates."[8] In a recession, it will be crucial to get the balance right so as not to choke off investment and

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[4] Duft, Ken D. "Chapter 12 Bankruptcy in Retrospect; Its Impact on Agribusiness Firms," Agribusiness Management, Washington State University College of Agriculture, Cooperative Extension, http://www.agribusiness-mgmt.wsu.edu/ExtensionNewsletters/cash-asset/Chap12.pdf at 6.

[5] Innes, R., E. Keller, and H. Carman. "Chapter 12 and Farm Bankruptcy in California." California Agriculture, Vol. 43, No. 6, Nov.-Dec. 1989, pp. 28-31.

[6] Duft, Ken D. "Chapter 12 Bankruptcy in Retrospect; Its Impact on Agribusiness Firms," Agribusiness Management, Washington State University College of Agriculture, Cooperative Extension, http://www.agribusiness-mgmt.wsu.edu/ExtensionNewsletters/cash-asset/Chap12.pdf at 8.

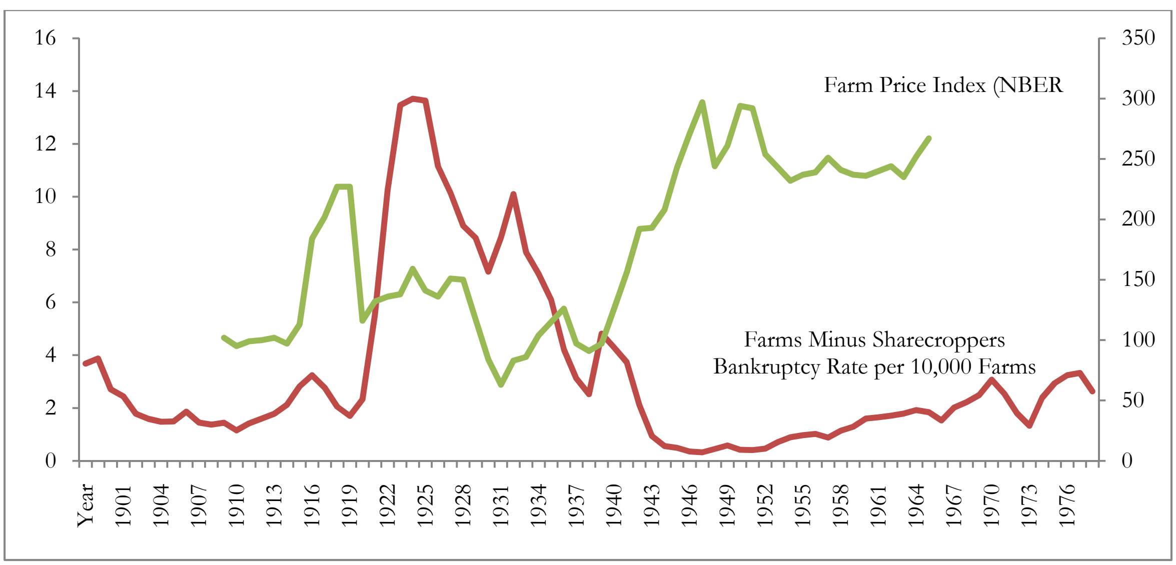
[7] Michelle J. White and Wei Fan, "Personal Bankruptcy and the Level of Entrepreneurial Activity," Journal of Law & Economics, vol. 46:2, October 2003, pp. 543-568.

[8] Michelle J. White and Jeremy Berkowitz, "Bankruptcy and Small Firms' Access to Credit," RAND J. of Economics, vol. 35:1, pp. 69-84, Spring 2004.

economic growth. The problem is that we will experience large numbers of bankruptcies whatever balance is struck.

Bankruptcy Law can Only Help Smooth Short-term Business Fluctuations, not Secular Trends

As stated earlier, we will never do away with business bankruptcies, large or small. Consider, for instance, the classic Ricardian characterization of frontier development. Farms on even the most distant edges of the frontier become profitable – despite high transportation costs and low soil quality/productivity – in times of high prices. It is considered unpalatable to tell farmers they cannot move to such places while prices are rising (and, indeed, it would be economically harmful as prices would increase faster and farther than would otherwise be the case). The problem is it is also considered unpalatable to allow those farms to fail when prices (inevitably) fall. The figure below shows, however, that over 1910-1968 farm bankruptcies have been highly correlated with farm price indices: farm prices stay high, bankruptcies stay low, and vice versa.



The figure also shows that farm prices, at least in the past, fell from roughly 1917 to 1940, a 22-year period that even liberal bankruptcy laws could not bridge. But if you look closely at the figure, the problem is not really the 22-year decline from 1917 to 1940, but the WWI bubble in agriculture prices from 1914-1917. Without the dramatic increases in agricultural prices in WWI, the decline in the 1920s and afterward would most likely not have occurred. As Ricardo described, the problem was too many farms on the inframarginal periphery – the dust bowl – that had little long-term productive potential. Indeed, when Europe began again to compete on world agricultural markets, that inframarginal dust bowl land was the first to be abandoned.

Today, we are on the other side of another bubble, this time a financial market and housing bubble rather than an agricultural bubble. We can predict with confidence that there will be many business failures and among them a large proportion of small business failures. But just like those dust bowl farms, many of those businesses were only viable for a small period of time in a very special competitive environment, which no longer exists.

The challenge before us, therefore, is not how to prevent bankruptcies, for that would be akin to sentencing farmers to die on their dust bowl land. Rather, the greatest challenge is to craft a small business bankruptcy law that can be used. Chapter 12 is probably not the answer. "…Empirical evidence shows that very few farmers actually use Chapter 12 and that bankruptcy relief has not and cannot halt the decline in family farming."[9] It won't save small businesses from a recession, either.

From an economic point of view, we want a small business bankruptcy law that smoothes the transition of the serial entrepreneur, allowing them to flow into and out of businesses in a way that preserves both creditor and entrepreneur value. Such a balance can, indeed, be struck. Some elements, however, remain counterintuitive to policymakers both in the judiciary and banking worlds. Economically, the simple key to retaining value is to intervene *earlier* than is currently the case. Of course, that means more bankruptcies. But as Michelle White famously wrote of personal

[9] Porter, Katherine M., Phantom Farmers: Chapter 12 of the Bankruptcy Code. American Bankruptcy Law Journal, Vol. 79, p. 727, 2005.

bankruptcies even before BAPCPA, the surprising aspect of bankruptcy is not how *many* people use it, but how *few*.[10]

Overall, a leaner Chapter 11 system with simplified filing and streamlined procedures for quick recovery will help those who have the capacity get back to business while preserving collateral value and saving on legal bills for others. Such a system has the potential to be an important impetus for economic growth in the coming recovery.

[10] Michelle J. White, "Why Don't More Households File for Bankruptcy?" Journal of Law, Economics, and Organization, vol. 14:2, pp. 205-231, October 1998.