

## Bankruptcy regulation

Bankruptcy regulation may significantly affect innovative businesses by shaping the perceived risk of innovating and the conditions for access to finance. Evidence shows that countries with poorer investor protections tend to have smaller and narrower capital markets, which may make access to finance more difficult. Public policy can support innovative businesses by achieving the right balance in bankruptcy legislation to fit both firms' and creditors' interests. An efficient judicial system is also important to ensure that the targets of bankruptcy law are met (e.g. by assuring timely and predictable sentences on fraudulent bankruptcy cases).

### What are bankruptcy regulations?

#### Definition

Bankruptcy regulations can be broadly defined as the **full set of norms and regulations that govern individual and corporate distress, administration, insolvency and liquidation.**

Well-designed bankruptcy legislation should meet a number of different, and sometimes divergent, objectives:

- preserving firms' repayment incentives
- protecting creditor rights
- maximizing the total value of the recovered debt
- balancing conflicting stakeholders' interests
- encouraging entrepreneurship and risk taking
- discouraging premature liquidation of sustainable businesses but at the same time not allowing unproductive companies to remain permanently on the market
- solving bankruptcy and insolvency cases in inexpensive, timely and predictable ways.

#### Differences across economies

**Bankruptcy laws are complex**, and significant differences exist across national legislations.

- In the treatment of **personal bankruptcy**, countries differ in terms of discharge, in the extent to which assets owned by the debtor at the beginning of the bankruptcy procedure might be withheld from creditors, in disabilities (i.e. restrictions on the debtor's civil and economic rights during bankruptcy), and composition (i.e. the achievement of a discharge by agreement with creditors).
- In **corporate bankruptcy**, countries differ in the amount of restrictions on a debtor who wants to file for reorganisation. They also differ in the extent to which secured creditors are able to seize collateral after a reorganisation petition is approved (due to procedures of "automatic stay", i.e. injunctions that halt actions by creditors or "asset freezes").

The recent international financial crisis generated a sharp increase in the number of bankruptcy or insolvency cases and highlighted the need for reforms in the field. **Since the onset of the crisis in late 2008, no fewer than 65 economies have amended their bankruptcy legislation** (World Bank, 2012).

## **How do bankruptcy regulations affect innovative firms?**

### **Effects on capital markets**

**More lenient bankruptcy regulations may reduce self-selection, leading to lower quality projects, increased expenses, and ethical dilemmas.** The risk can be only partially addressed with additional screening and monitoring, since such activity is costly and information is asymmetric. As a consequence, **access to credit might be more difficult and costly** (Armour and Cumming, 2008; Stiglitz and Weiss, 1981). A lax bankruptcy regime is therefore likely to increase the cost of raising external finance to fund innovative projects or will increase the cost of new investments.

At the same time, La Porta et al. (1997) find that **countries with poorer investor protections have smaller and narrower capital markets**. Rodano, Serrano-Velarde and Tarantino (2012) study two bankruptcy reforms in Italy, finding that the introduction of a reorganization procedure increased the interest rates on loan financing for firms by up to 0.2 percentage points (thus more punitive repayment incentives outweigh efficiency gains), while the reform that accelerated liquidation procedures decreased the cost of finance and relaxed credit constraints. Bravo-Biosca, Criscuolo and Menon (2012) find that in sectors that are highly dependent on external finance, stronger creditor rights are associated with a more dispersed growth distribution, with a higher number of growing and shrinking firms, and a lower number of stable firms.

### **What are specific impacts of bankruptcy regulation on innovative entrepreneurship?**

Bankruptcy legislation may affect innovative entrepreneurship directly, through the perceived risk of being an entrepreneur, or indirectly, through the credit market. The two mechanisms may have opposite effects: pro-creditor legislation, for instance, generally increases the perception of risk and lowers the cost of credit.

### **Effect on entrepreneurship rates**

**Regimes that severely penalise “failed” entrepreneurs**, whether by forcing liquidation or limiting entrepreneurs’ ability to start new businesses in the future, are likely to **reduce their willingness to take risks**.

**Strict regimes may also discourage individuals from leaving salaried jobs to set up their own business**, especially when legislation contains severe personal liabilities, and limitations on civic and economic rights following a bankruptcy. In addition, entrepreneurs may suffer from psychological and social costs (such as stigma) when filing for bankruptcy (Shepherd, 2003).

**Therefore, strict (pro-creditor) bankruptcy legislation may have a direct negative effect on entrepreneurship.** To the extent that innovative ventures are riskier than traditional businesses, pro-creditor bankruptcy regimes may disproportionately discourage the former, thus shifting the economy toward a more conservative growth path.

**Recent evidence suggests that in countries with less forgiving bankruptcy regimes, entrepreneurship rates are lower** (Peng, Yamakawa and Lee, 2010; Armour and Cumming, 2008). The impact of stringent bankruptcy laws is also amplified by restrictions on access to limited liabilities, such as high minimum capital requirements for incorporation (Armour and Cumming,

2008). Furthermore, De Serres et al. (2006) show that **policies improving the efficiency of bankruptcy procedures are found to foster labour productivity and value-added growth**, notably in sectors most dependent on external finance.

### **What is the evidence on bankruptcy regulations and innovative businesses?**

Comparing bankruptcy legislation across countries is not straightforward. Available indicators from the World Bank Doing Business reports are good proxies for the overall efficiency of the insolvency regulatory framework. One of these indicators is the “recovery rate in case of liquidation, foreclosure or reorganization”, expressed as a percentage of the cost the estate acting as collateral. The indicator shows a large variation across economies; high-income countries have higher recovery rates than developing or emerging economies (Figure 1).

The *Doing Business* indicators, however, cannot be interpreted as a direct measure of unfavorable conditions for entrepreneurs. Armour and Cumming (2008) develop five indices assessing the impact of personal bankruptcy legislation in fifteen countries from the 1990 to 2005. Figure 2 shows a snapshot of one of these indicators, which illustrate cross-country differences in the scope and range of legal disabilities.

**Figure 2. Scope and range of legal disabilities after personal bankruptcy, 2005**

Note: the measure relates to restrictions on the debtor’s civil and economic rights related to bankruptcy. Takes value 0 if no disabilities other than loss of power to deal with assets in bankrupt estate; takes value 1 for civic disabilities (i.e. loss of right to vote, hold elected office, or membership of professional groups); takes value 2 for economic disabilities (i.e. restrictions on obtaining credit or being involved in the management of a company); takes value 3 for interference with mail and/or travel (i.e. prohibition on travel without consent or mail opened by trustee); takes value 4 if debtor may be incarcerated for non-payment of debts.

Source: Armour and Cumming, 2008.

### **Figure 1. Recovery rate**

### **What other topics relate to bankruptcy regulations and innovative businesses?**

**Trajectories of innovative new ventures** (see [Trajectories of innovative new ventures](#) [1]).

Bankruptcy regulations affect not only the exit decisions of businesses but also entry and growth. Strict bankruptcy regulations reduce the willingness to take risks, thereby deterring entry into innovative entrepreneurship. However, strict bankruptcy regulations can facilitate access to credit and larger capital markets, which may promote business entry and growth.

**Administrative framework for entry and growth** (see [Administrative framework for entry and growth](#) [2]). A burdensome administrative framework for entry and growth constitutes a barrier to entry, just as strict bankruptcy regulations could severely penalise “failed” entrepreneurs. Moreover, strict bankruptcy regimes may limit entrepreneurs’ ability to start new businesses in the future.

**Entrepreneurial capabilities and culture** (see [Entrepreneurial capabilities and culture](#) [3]). Bankruptcy regulations that severely penalise “failed” entrepreneurs may critically affect attitudes toward entrepreneurship and, more generally, entrepreneurial capabilities and culture. A country’s

entrepreneurial culture may have a bearing on the way bankruptcy laws are implemented and bankruptcies are treated.

### **What policies relate to bankruptcy regulations and innovative businesses?**

A well-developed financial system may be complementary to bankruptcy legislation that is not excessively punitive for failed companies, as it would counteract the risk of credit rationing. An efficient judicial system, assuring timely and predictable sentences in fraudulent bankruptcy cases and adequately protecting investors' rights, is also key in assuring that the goals of bankruptcy law are fully met.

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