

*Dutch SMEs in International Perspective*

# Business failures and entrepreneurship in international perspective

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# Contents

<b>1</b>	<b>Introduction</b>	5
<b>2</b>	<b>Business failures in the European Union</b>	7
2.1	Concepts and definitions	7
2.2	Insolvency and liquidation in national legislation	8
2.3	Rescue possibilities	10
2.4	Quantative data	12
<b>3</b>	<b>Business failures and entrepreneurship in the USA</b>	21
3.1	Bankruptcy Legislation and Procedures	21
3.2	Business Failure, Start-Ups and Survival – a Statistical Overview	24
3.3	Obstacles to Post-Failure Entrepreneurial Activity	32
3.4	Post-Failure Start-Ups and Support Measures	38
<b>4</b>	<b>Business failures and entrepreneurship in the Netherlands</b>	45
4.1	Bankruptcy legislation and procedures	45
4.2	Business failures and survival	49
4.3	Obstacles to Post-Failure Entrepreneurial Activity	52
4.4	Post-failure Start-Ups	54
<b>5</b>	<b>Conclusions</b>	55
	<b>Appendix</b>	
	Selected Bibliography for the American study	59



# 1 Introduction

In recent years there is a growing interest in starting entrepreneurs. Starting entrepreneurs play an important role in the business dynamics and the quickly changing economy. From this perspective politicians, policy-makers, financial institutions and researchers pay more attention to this target group. Restarters, who start a business again after a business failure, form a part of this target group. It is an interesting group, as one of the results of research among starters is that the survival rate of starters with experience is higher than the survival rate of starters without experience. It is evident that the restarters, who start again after a business failure, have a lot of experience and should have learned many lessons. Nevertheless, it seems that the attitude towards entrepreneurs who have failed in their business venture is more negative in the Netherlands than in other countries like the USA and this can hamper the attitude and willingness of entrepreneurs to start again<sup>1</sup>.

This publication deals with bankruptcies and failures and obstacles for restarting after business failure. Besides the aforementioned issues, it is also of importance from different perspectives of stakeholders. First of all, a business failure is in general a very radical change for an entrepreneur as it destroys human and physical capital which has been invested in the enterprise. Employees are also heavily involved as they lose their job and therefore their income. Furthermore, creditors like banks, suppliers and tax authorities are likely to receive only a small amount of what is owed to them. Secondly, a business failure is, for many entrepreneurs and employees involved in a bankruptcy, also disastrous in terms of social status. Thirdly, will it be possible for an entrepreneur to start again after a business failure?

Chapter 2 of this publication is mainly devoted to the chapter on bankruptcies and failures as published in the Fifth Annual Report of the European Observatory for SMEs<sup>2</sup>. This chapter deals with concepts and definitions, rescue possibilities and quantitative data concerning bankruptcies and failures in European countries.

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1 Economisch Bureau Ing, *Ondememers op herhaling (Entrepreneurs on retraining exercises)*, Amsterdam, 1998.

2 European Network for SME Research, *Fifth Annual Report of the European Observatory for SMEs*, Netherlands, 1997. The chapter on bankruptcies and failures was co-ordinated by OBSERVA (Switzerland).

The results of research in the USA is presented in chapter 3<sup>1</sup>. This research in the USA tried to provide answers on four main questions:

1. Does a significant proportion of entrepreneurs in the United States found new start-up companies despite previous experience of business failure? The latter is taken to mean the forced closure of a business through bankruptcy or insolvency.
2. What barriers are faced by entrepreneurs with previous experience of failure when they attempt to start new businesses? Barriers could include difficulties in obtaining credit or finance, bureaucratic or legal hindrances, social stigma and so on.
3. Alternatively, is learning lessons from business failure seen as a positive factor in the United States?
4. With regard to bankruptcy and entrepreneurship, what characteristics of society and the economy in the United States are most favourable or unfavourable in determining the ability of individuals to start again and found new businesses?

In the Netherlands research on entrepreneurs who restart again after bankruptcy and the obstacles related to this is limited. However, some interesting reports on these topics have been published recently<sup>2</sup>. Chapter 4 provides the results of an analysis of the aforementioned issues in the Netherlands on the basis of these reports. Furthermore, comparisons between the Dutch and American situation are presented in this chapter.

The publication ends with the conclusions in chapter 5.

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1 The research in the USA was carried out by Micronomics (USA) in commission of EIM Small Business Research and Consultancy.

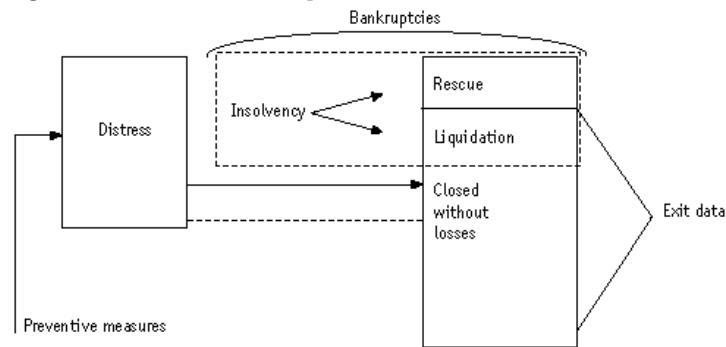
2 Economisch Bureau Ing. *Ondememers op herhaling (Entrepreneurs on retraining exercises)*, Amsterdam, 1998.  
B&A Groep. *Klaar voor de herstart? - Onderzoek naar de omstandigheden van bedrijfsbeëindigers (Ready for the restart? - Research on the circumstances of business terminators)*, The Hague, May 1998.

## 2 Business failures in the European Union

### 2.1 Concepts and definitions

No internationally accepted definition of 'bankruptcy' exists. In some countries the term is used to mean the declaration 'insolvency' of an enterprise (e.g. France), in others to mean the 'liquidation' of the enterprise following the initiation of an insolvency procedure (e.g. Austria). In order to avoid any misinterpretation the terms 'insolvency declaration', 'rescue measures' and 'liquidation proceedings' will be used instead of 'bankruptcy' wherever possible.

Figure 2.1 Theoretical conceptual framework



Source: Observa.

Figure 2.1 puts 'bankruptcy' in the context of the economic and legal processes to which it belongs. It suggests, among other things, that rescue possibilities may be offered at different stages of the process. It also shows that a situation of distress can lead to closure without losses to third parties and without insolvency proceedings. Depending on national legislation, insolvency can lead either to compulsory liquidation (as in Luxembourg), or to rescue (as, in Portugal). In most countries, however, insolvent enterprises have the possibility of opting for a rescue package and delays (as in the Netherlands, and Belgium). The consequences for the enterprise of being declared insolvent also vary among countries, but seem to depend on whether the enterprises have the possibility of being rescued before such a declaration. In Iceland, for example, an enterprise can seek protection from creditors – by payment suspension – when they feel the threat of insolvency; but should it fail to do so, and the insolvency procedure be initiated, the enterprise will automatically be liquidated.

To add to the complexity of the issue – which in reality extends beyond the scope of the above diagram – one has to stress that even the legal liquidation of an enterprise does not necessarily coincide with its economic dismantling. Some national laws – mostly where bankruptcy legislation has recently been revised – explicitly emphasise the possibility of an insolvent enterprise, with appropriately restructured capital and staff, being sold as an entity. In Austria, the Netherlands, Germany (a reform of 1996), Finland (1993), Portugal (1996), France, and to some extent in Norway, the sale of the business entity has been declared the prime objective of liquidation procedure.

## **2.2 Insolvency and liquidation in national legislation**

In Table 2.1 an attempt is made to classify a legal framework according to two criteria:

1. by the kind of balance it strikes between the competing stake holders groups; and
2. by the degree of intervention of the authorities in the proceedings.

### **2.2.1 Type of balance**

Each legal system tries to strike a balance between the two – often conflicting – interests of creditors and the employees. The interest of creditors is to recover their claims to assets, if necessary, by dismantling the enterprise and selling it off piecemeal. Employees, by contrast, tend to favour the preservation of the business as a going concern, even if some of the claims of creditors have to be abandoned to the latter's detriment.

The late payment problem lies exactly at the cross-roads of the dilemma with which legislation is confronted. A legal framework facilitating the ultimate or even temporary postponement of commercial debts protects insolvent enterprises, but, indirectly, encourages late payment. A recent study argues that this in turn hinders growth in some four out of ten SMEs and even threatens the survival of one third of enterprises<sup>1</sup>. This analysis suggests that the interests of creditors and of the enterprise tend to converge rather than conflict when the scope of analysis is raised from the micro- to the macro-economic level.

Despite the above issues, laws are designed to function at a specific level. In consequence each legal system strikes a different balance between creditors' and enterprise's interests and adopts different means to achieve it.

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1 Intrum Justitia, *European Payment Habits*, Survey, Amsterdam 1997.



Table 2.1 Main characteristics of national bankruptcy legislation

Country	Degree of intervention	Interests protected	Justification of the classification
Austria	XXX	both enterprise survival and cred. interest.	Compulsory preventive measures with early warning ratios Various reorganisation measures. Under liquidation the enterprise is sold as a whole, provided this is feasible.
Belgium	XX	enterprise survival	Preventive measures exist (Commission for Preventive Enterprise policy). Definitive postponement of debt is possible. Reorganisation is possible with management assistance.
Denmark	XX	creditor's interests	No preventive measures. Debtor must find agreement within 3-5 months to avoid liquidation. Severe personal consequences. Composition and reorganisation are possible.
Finland	XX	creditor's interest	No preventive measures. Reorganisation is possible but only to protect interests of creditors.
France	XXX	enterprise survival	Preventive measures exist. Three different rescue schemes are available, one of which is a reorganisation plan. May last up to 15 years.
Germany	X (X)	until 1996 cred. from 1996 ent. survival	No preventive measures. Reorganisation is possible. Legal framework changed in 1996. Until then, enterprises were sold piecemeal at short notice. The goal of new legislation is to keep the enterprise intact for as long as possible.
Greece	X	creditor's interest	No preventive measures. In case of insolvency, in 95% of cases fixed assets are sold.
Ireland	XX	both ent. survival and creditor's interest	No preventive measures. Reorganisation under the control of a Receiver is possible. But main objective to ensure debts are paid. Therefore part or all of assets may be sold.
Italy	XX	both ent. survival and creditor's interest	No preventive measures. Reorganisation is possible if court considers crisis temporary. If not, enterprise is liquidated.
Luxembourg	X	creditor's interest	No preventive measures. Personal consequences for owner are severe. No reorganisation plan. Liquidation follows quickly in case of insolvency.
Netherlands	XXX	enterprise survival	No preventive measures. More than one creditor is needed to initiate a procedure against an enterprise. Rescue and reorganisation possibilities are numerous.
Portugal	XXX	enterprise survival	No preventive measures. Substantial support if potential cash flow is positive. Four rescue and reorganisation possibilities are available.
Sweden	XXX	creditor's interest	No preventive measures. A creditor may ask for the claim enforcement service even before a declaration of insolvency, i.e. without waiting until all claimants are known. Rescue is possible.
Spain	XXX	both ent. survival and creditor's interest	Preventive measures exist. Severe personal consequences. If liabilities are greater than the assets, the enterprise is liquidated – unless there is an agreement with creditors. Intervention by regional government is possible.
United Kingdom	XX	both ent. survival and creditor's interest	Preventive measures exist. One objective is to push administrators to apply for assistance. Rescue possibilities exist. Administrators may be dismissed (CCDA) and made personally responsible.
Iceland	XX	creditor's interests	Preventive measures exist. The enterprise may ask for postponement of debt before legal insolvency, but when a creditor opens the proceedings the enterprise is liquidated.
Liechtenstein	XX	creditor's interests	No preventive measures. Postponement of debts is possible. Administrator may run the business
Norway	XXX	creditor's interests	Preventive measures exist. The enterprise may ask for postponement of debt before the legal insolvency, but as soon as a creditor opens the proceedings the enterprise is liquidated.
Switzerland	XX	enterprise survival	No preventive measures. Reorganisation is possible with a two years' postponement of debts. An administrator may run the business.

Source: Observa – Compiled on the basis of the information provided by ENSR partners.

### 2.2.2 The degree of intervention

The degree to which the public authorities are involved in the bankruptcy procedure is a significant issue as intervention may imply high direct and indirect costs, and may induce distortions in competition, favouring enterprises that benefit from rescue packages. In Table 2.1 we denote a low level of intervention by 'X' defined as when the authorities do not interfere with the operations of the insolvent enterprise and restrict their role to a purely legal intervention. We denote a high level of intervention by 'XXX', defined as when the state grants support to insolvent enterprises through advice or reorganisation, or in some other form.

Table 2.1 shows that it is rare for countries to protect creditors' and enterprise's interests to the same extent. It also indicates that countries have relatively sophisticated forms of legislation, indicated by the high level of intervention (and correspondingly high costs) of public administration.

## 2.3 Rescue possibilities

Rescue possibilities may take a number of forms that extend from the most common, namely, a temporary postponement of debts, to the least common, a ten year restructuring plan. In Iceland, Luxembourg, Austria, France, the Netherlands, Belgium, Sweden, Norway, and Germany rescue is available even before the actual insolvency declaration. Indeed, by asking for a moratorium, the enterprise in difficulty is temporarily protected, partially or completely, against the claims of creditors. In most cases, however – typically in Italy, Denmark, Spain, Finland – the rescue plan follows an insolvency declaration. New laws tend to make the rescue options available at different phases of the liquidation proceedings. In some cases rescue is even possible – but under very specific circumstances – after the decision to liquidate has been taken.

### Moratorium

A temporary debt moratorium is the most frequently encountered measure and exists in almost all countries. For example in Germany it is known as the *Vergleichsverfahren*, in Liechtenstein the *Nachlassstundung*, in Luxembourg the *concordat préventif à la faillite*, in Iceland the *Greidslustöðvun*, in Norway the *Tvangsakkord*, in Belgium the *agreement*, in the Netherlands the *moratorium*, in Spain the *suspension de pagos*, in Austria the *Ausgleich bzw. Zwangsausgleich*, in Switzerland the *sursis concordataire*, in Finland

and France the *règlement à l'amiable* and in Italy the *amministratio - ne controlata*.

### **Reorganisation**

Effective reorganisation measures following a formally approved plan are more infrequent. A few countries apply such measures. These include Belgium (*agreement procedure*), Finland (*velkasaneeraus*), France (*redressement*), Netherlands (*throughstart*), Portugal (*gestao controlada*). Austria has recently implemented a new measure called *Reorganisationsverfahren* – commencing in 1997 – which introduces the concept of early warning ratios. Enterprises not satisfying these ratio-driven criteria are obliged to reorganise even before they become insolvent. Experience will demonstrate whether the benefits of this system are higher than its administrative costs.

#### **Reorganisation in Finland: 'velkasaneeraus'**

The purpose of Finland's Reorganisation law is to provide a legal framework for economically viable enterprises to avoid 'unnecessary' bankruptcy. The official/administrator is expected to propose a plan within four months to deal with the situation. This reorganisation plan consists of a statement of the conditions of the business and a review of the operations during the planned period of reorganisation. If the company cannot follow the reorganisation plan, the reorganisation procedure may be discontinued or a ruling on the enterprise may be made in bankruptcy.

After a reorganisation plan has been decided upon, the enterprise has a reasonable time to adapt itself to the plan's requirements. During this period debts are frozen or need not be fully repaid. The duration of the plan is variable; it can be as short as 2 years (as in Portugal) or as high as 10 years (as in France). These measures imply the supervision of an external tutor or adviser. In the case of Belgium, the commissioner appointed has to be familiar with the management of enterprises and with bookkeeping. However, in practice it proves difficult to attract highly qualified professionals to take up these jobs. In consequence the organisational measures do not supply the necessary valuable external advice.

### **External advice**

Recent trends in bankruptcy legislation involve the support of enterprises in difficulty by the provision of advice. Most of the countries creating new legislation in the last three years have adopted this approach (e.g. Finland, France, Portugal and Switzerland). Similar moves are also currently observable in Germany and Austria.

## **Evaluations of rescue measures**

Evidence from Austria shows that in 1996, 63% of rescue procedures resulted in the recovery of the enterprise. However, this success rate should not be extrapolated to other countries. Austria, which has four different rescue measures, has a particularly high degree of public intervention. It is therefore particularly difficult to evaluate the success of recent legislative changes – especially the introduction of advice – because of both their newness and complexity.

## **2.4 Quantative data**

### **2.4.1 Closures**

The Fourth Annual Report of the European Observatory for SME showed that the economic meaning of the term ‘exit’ is far from harmonised across the countries of Europe-19 (see Figure 2.1). ‘Closure’ figures may cover simply ‘liquidation’ or encompass any kind of formal dissolution of an enterprise; for example, through changes in the business’ name or legal form. This latter definition applies to Austria, Belgium, Finland, Italy, Luxembourg, Liechtenstein and Switzerland. Despite these caveats, some statistical findings can be stated:

- ‘Liquidations’ represent only 15% to 20% of closures;
- The broader the definition of ‘closure’ the greater the proportion of closures to the total enterprise population. The closure rate varies greatly among countries ranging from 13% in Germany to 1% in Portugal, Spain and Luxembourg;
- High closure rates accompany high birth rates, mainly because national definitions are usually either rather broad or rather narrow. For this reason the net closure rates<sup>1</sup> across countries lie in a narrower range between –1% (Iceland) and + 4% (Germany and the Netherlands).

### **2.4.2 Trends in insolvency and liquidation since the 1980s**

National statistics are collected at various stages of the legal proceedings towards insolvency and liquidation, making them difficult to compare. Countries such as Belgium, Denmark, France, Greece, Italy, the Netherlands and Norway count commencements of insolvency procedures; whereas Finland, Ireland, Luxembourg, Portugal, Spain, Sweden, the United Kingdom and Iceland report the number of actual liquidations. Only Austria was able to provide a ‘full’ set of data covering insolvency openings, liquidations and rescue operations.

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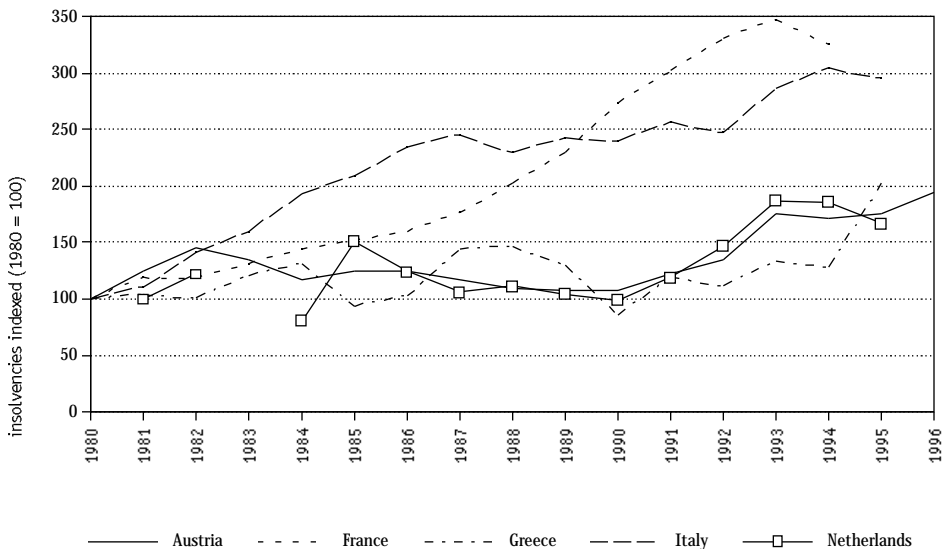
<sup>1</sup> Defined as births *minus* closures.

Austrian data show that more than one half of the insolvency proceedings opened are dropped because of insufficient assets. For Germany this refers to almost 70% of the insolvency proceedings opened. This suggests that in countries where only 'liquidation' figures are compiled, the corresponding numbers are lower by some 50 units than those using 'insolvency' data, since there are cases in which insolvency does not lead to legal liquidation and claims are dropped. The same problem is encountered in data concerning asset losses. Finally, the problem is even greater for job losses, since jobs lost are counted at the moment of the formal liquidation, whereas enterprises usually reduce their workforce well in advance of this event.

Another statistical problem relating to comparisons of liquidation or insolvency data arises from the fact that the treatment of self employed differs across countries. Thus insolvencies of the self employed may be counted either as insolvency of private persons or as insolvency of enterprises. Therefore, in Figures 2.2 and 2.3 national data of indexed growth rates (1980 = 100) are compared rather than absolute numbers.

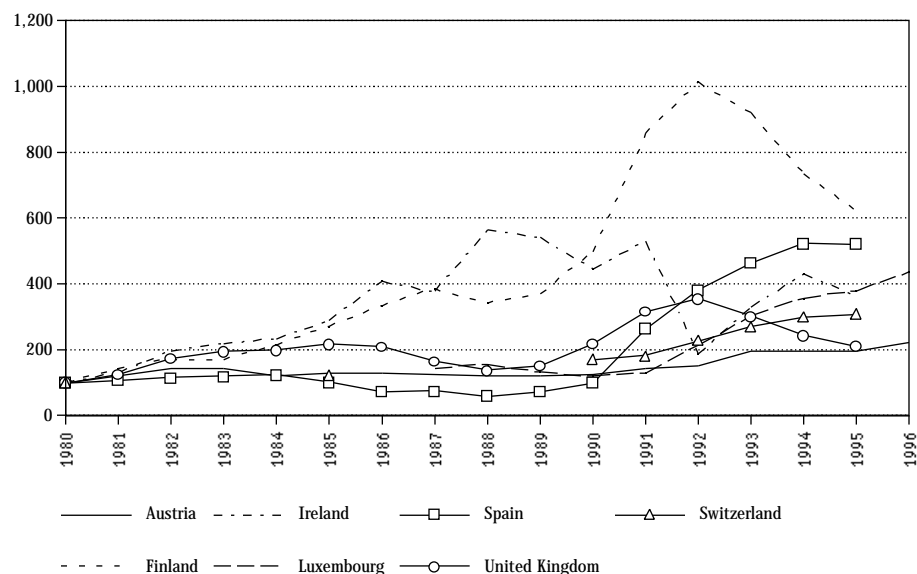
Figure 2.2 Opening of insolvency proceedings, 1980-1996

Sources: Insolvency: Austria: Statistics by Kreditschutzverband of 1870; Belgium: Graydon Belgium; France: until



1989 ANCE - Observatoire (opening of proceedings), from 1990 INSEE (revised opening of proceedings); Germany: Statistisches Bundesamt Wiesbaden, Greece: NSSG-Statistics of justice; Italy: Istat and Cerved Data; Netherlands: Centraal Bureau voor de Statistiek.

Figure 2.3 Liquidations of enterprises indexed (1980=100), 1980-1996

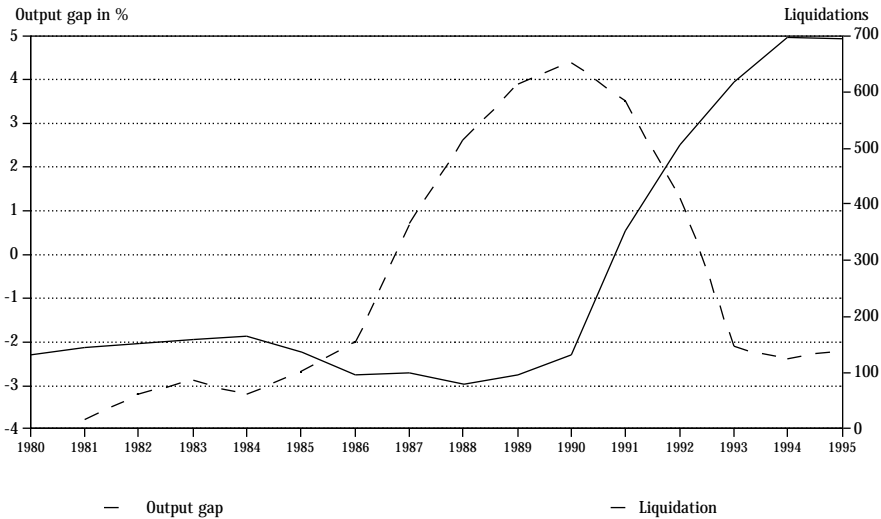


Sources: Liquidation: Austria: Statistics by Kreditschutzverband of 1870; Finland: Small Business Database/Small Business Institute and Federation of Finnish Enterprises; Ireland: Companies Report, published by Stationery Office, Dublin; Luxembourg: Mémorial STATEC; Portugal: MOPE; Spain: Instituto Nacional de Estadística; Sweden: Statistics Sweden; Switzerland: Office fédéral de la statistique, statistique des faillites.

The common perception of a correlation between the business cycle and the volume of liquidation is corroborated in this data. Insolvency and Liquidation both rise sharply with the economic slowdown. However, numbers do not drop back significantly in recent upswings. This fact may be explained by the growth of the stock of enterprises in a recovery: a constant volume of liquidations implies a fall in relative terms, which is the quantity of interest. A long term study carried out by INSEE of France analysing the reasons for failures from 1820 to 1988 showed that the average annual growth rate of insolvency was of the order of 1.5%.

The relationship between the phases of the business cycle and liquidation was apparent in most countries, but for reasons of space we illustrate with a single example, namely, that of Spain.

Figure 2.4 Liquidation and output gap in Spain, 1980-1995



Source: Instituto Nacional de Estadística, and OECD economic outlook.

### 2.4.3 Characteristics of insolvent and liquidated enterprises

As shown in Table 2.2, only a few countries were able to provide data on insolvencies and liquidations by size class. In all five cases, very small enterprises (up to 9 employees) represent the bulk of insolvency or liquidation. This does not mean, however, that very small enterprises are more likely to fail than those in other size classes. On the contrary, the proportion of very small enterprises among insolvent and liquidated enterprises is lower than their share in total enterprise population. Very small enterprises seem to be more resistant to insolvency than small enterprises (with 10 to 49 employees).

In the Netherlands, very small enterprises comprise 90.5% of total population whereas their share in total insolvency is only 80.9%. On the other hand, small enterprises represent 7.5% of Dutch enterprises but 18.2% of insolvencies – more than double the proportion. In Italy the ratios are 94.4% and 83.4% respectively. The only country where the share of very small enterprises in liquidation is higher than their proportion in the economy as a whole is Sweden. The difference in this case is a mere 2.4%.

Table 2.2 Insolvencies or liquidations by size class, 1993

	size class: number of employees					Total
	0/1 to 9	10 to 49	50 to 99	>100	>200	
<i>Belgium</i> , insolvencies	5,637	431	43	24		6,135
% insolvencies in size class	92	7	1	0		100%
% enterprises in size class	96	3				
<i>Finland</i> , liquidations	5,738*	754	43	32		6,567
% insolvencies in size class	87	12	1	1		100%
% enterprises in size class	94	5				
<i>Italy</i> , insolvencies (1994)	13,352**	2,344	232***		88	16,016
% insolvencies in size class	83	15	2		1	100%
% enterprises in size class	94	5				
<i>Netherlands</i> , insolvencies	3,590	806	39			5,353
% insolvencies in size class	81	18	1			100%=4,435
% enterprises in size class	91	8				
<i>Sweden</i> , liquidations	17,457	1,137	89	41		18,724
% liquidations in size class	93	6	0	0		100%
% enterprises in size class	91	8				

\* Finland: size class is 1 to 9 employees, self employed are excepted from liquidation statistics.

\*\* Italy: size class is 1 to 9 employees, self employed are excepted from insolvency statistics.

\*\*\* Italy: size class is 50 to 199 employees.

Sources: Insolvency: Belgium: Graydon Belgium; Italy: Istat and Cerved Data; Netherlands: Centraal Bureau voor de Statistiek

Liquidation: Finland: Small Business Database/Small Business Institute and Federation of Finnish Enterprises; Sweden: Statistics Sweden.

Data on enterprises estimates by EIM Small Business Research and Consultancy, adapted from Eurostat (DG XXII). Enterprises in Europe, Fifth Report. Brussels/Luxembourg.

Six countries were able to provide information about the age of liquidated or insolvent enterprises, and Switzerland provided an estimated distribution. With the exception of Portugal, the data confirm that young enterprises are particularly at risk. Data from Sweden, Luxembourg and Denmark provide a very similar age distribution for liquidation or insolvency: 60% existed for less than 6 years, 30% to 40% existed for less than 3 years. In Germany 80% of the liquidated or insolvent enterprises were younger than 8 years. In the Netherlands, 28% of the liquidated enterprises existed less than 3 years, 54% less than 6 years and 64% less than 8 years. These figures suggest that the liquidated enterprises in the Netherlands are somewhat older than the liquidated enterprises in the countries mentioned before. But as data on the age distribution of the stock of enterprises do not exist, it is not possible to state whether the age distribution of failed enterprise differs from that of the total enterprise population.



The liquidation of enterprises which have existed over 50 years is not frequent (4.97% in Portugal in 1996). This, however, does not mean that SMEs do not face transmission problems; it indicates more probably that the closure of mature enterprises does not lead to losses for third parties. Therefore, these cases do not enter the insolvency statistics.

Private liability seems to be a deterrent to insolvency. In consequence, enterprises without private liability become insolvent earlier in their existence than others. The different personal and financial consequences for the owner account for this fact. As many very small enterprises are based on unlimited liability, their underrepresentation in the set of insolvent enterprises may be explained by their legal form.

#### **2.4.4 Insolvencies and bankruptcies by sector**

As shown in Table 2.3 manufacturing and construction enterprises have in recent years been more prone to insolvency and liquidation than those of the service sector. In some countries, however, – for example, Portugal and Greece – there are relatively few construction enterprises in financial difficulty, whilst in others (e.g. Austria) almost all liquidations take place in the service sector.

Finally, a comparison is made between the number of insolvencies or liquidations and the number of enterprises. When interpreting the results one has to keep in mind that national statistics are collected at various stages of the legal proceedings towards insolvency and liquidation, making them difficult to compare. Countries such as Belgium, Denmark, France, Greece, Italy, the Netherlands and Norway count commencements of insolvency procedures; whereas Finland, Ireland, Luxembourg, Portugal, Spain, Sweden, the United Kingdom and Iceland report the number of actual liquidations. Also the treatment of self employed differs among countries as they may be counted as insolvency of private persons or as insolvency of enterprises. As can be seen in table 2.4, the differences in the number of insolvencies or liquidations per 10,000 enterprises varies enormously between the European countries from almost nothing in Portugal and Spain to hundreds of insolvencies or liquidations per 10,000 enterprises in a number of countries.

Table 2.3 Insolventcies and liquidations by sector as compared to national sectoral distribution\*

Country	Manufacturing		Construction		Tertiary sector		Total** insolventcies or liquidations
	in % of total insolventcies or liquidations	in % of enterprises in the sector	in % of total insolventcies or liquidations	in % of enterprises in the sector	in % of total insolventcies or liquidations	in % of enterprises in the sector	
Austria	3	13	n.a.	6	97	80	1,732
Belgium	n.a.	6	13	9	34	86	6,135
Denmark (95)	18	13	17	12	57	73	1,718
Finland	18	13	15	13	58	73	6,566
France	17	10	19	13	64	87	60,476
Germany	20	10	18	9	62	87	12,821
Greece	29	6	3	17	67	76	996
Italy	34	16	n.a.	10	58	73	15,592
Luxembourg	1	7	13	7	83	86	271
Netherlands	15	10	13	9	69	80	5,353
Portugal	38	15	8	15	22	69	269
Spain	33	10	16	10	49	80	618
Sweden (95)	8	11	11	11	65	77	11,315
Iceland	28	14	13	18	53	68	442
Norway (95)	20	11	37	20	36	69	3,902

\* All data apply to 1993 except Denmark, Norway and Sweden.

\*\* Total is not equal to 100% in some cases because parts of insolventcies or liquidations could not be attributed to a sector and are registered as others. In the case of Finland: 518, for Italy: 1066, for Belgium 3270, for Portugal 88.

Sources: Enterprises 1993 Eurostat (new dataset).

Liquidation: Austria: Statistics by Kreditschutzverband of 1870; Finland: Small Business Database / Small Business Institute and Federation of Finnish Enterprises; Ireland: Companies Report, published by Stationery Office, Dublin; Luxembourg: Mémorial STAT/EC; Portugal: MOPE; Spain: Instituto Nacional de Estadística; Sweden: Statistics Sweden; Switzerland: Office fédéral de la statistique, statistique des faillites.

Insolvency: Austria: Statistics by Kreditschutzverband of 1870; Belgium: Graydon Belgium; France: until 1989 ANCE – Observatoire (opening of proceedings), from 1990 INSEE (revised opening of proceedings); Germany: Statistisches Bundesamt Wiesbaden, Greece: NSSG-Statistics of justice; Italy: Istat and Cerved Data; Netherlands: Centraal Bureau voor de Statistiek.

Table 2.4 Insolvencies and bankruptcies in relation to the stock of enterprises

Country	Total insolvencies or liquidations	Number of enterprises	Insolvencies or liquidations per 10,000 enterprises
Austria	1,732	231,200	75
Belgium	6,135	805,500	76
Denmark (95)	1,718	246,000	70
Finland	6,566	181,400	362
France	60,476	2,014,800	300
Germany	12,821	3,180,200	40
Greece	996	549,600	18
Italy	15,592	3,253,800	48
Luxembourg	271	13,700	198
Netherlands	5,353	595,900	93
Portugal	269	635,800	4
Spain	618	2,171,600	3
Sweden (95)	11,315	239,400	473
Iceland	442	22,100	200
Norway (95)	3,902	159,500	245

Source: see table 2.3.



## **3 Business failures and entrepreneurship in the USA**

### **3.1 Bankruptcy Legislation and Procedures**

#### **3.1.1 Introduction**

The main purpose of bankruptcy legislation is to assist parties in eliminating debt in situations where they face extreme financial distress. Bankruptcy provides an opportunity to individuals and businesses to start fresh with no debt, albeit with a blemished credit history.<sup>1</sup> Parties filing for bankruptcy may find themselves in a variety of situations. For this reason, there are three types of bankruptcy relevant to this discussion: Chapter 7, Chapter 11, and Chapter 13. All three chapters grant the debtor an automatic stay that allows the entity in debt to avoid foreclosures, evictions and harassment by creditors. The appropriate chapter of filing is based on criteria such as the magnitude of debts and assets involved and the form of the debtor (individual or business). The type of business is also relevant: where sole proprietorships and general partnerships are concerned, business owners are personally responsible for the businesses' liabilities and therefore often file as individuals. Corporations, meanwhile are separate legal entities from their owners. In general, Chapter 7 is applicable to entities filing either as individuals or businesses, Chapter 11 is applicable only to those filing as businesses, and Chapter 13 is applicable to some small businesses but is mainly for individuals.

#### **3.1.2 Chapter 7**

##### **General description**

Chapter 7 of the Bankruptcy Code refers to the liquidation of assets to pay as many debts as possible. Most debts that cannot be paid are discharged, freeing the debtor from liability. Any individual, partnership or corporation may file for Chapter 7 bankruptcy. When individuals file under Chapter 7 but have sufficient assets to pay creditors or the ability to reorganize under Chapter 11 or Chapter 13 plans, their petitions can be dismissed or converted. Bankruptcy procedures can be voluntary or requested by creditors.

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<sup>1</sup> Business entities filing under Chapter 7 are, of course, liquidated and cease to exist.

## **Procedures**

The Chapter 7 process is initiated by filing a petition with the Bankruptcy Court of the debtor's district. Once this has taken place, the debtor is granted an automatic stay of payment. The latter refers to an automatic injunction which halts any collection activity. The debtor must then report assets, liabilities, creditors and their respective claims, income, property and living expenses to the court. Holdings not exempt from liquidation are placed under the control of an appointed trustee, whose primary role is to provide the maximum return to unsecured creditors by liquidating assets.

Individual Chapter 7 bankruptcy cases are typically 'no asset' cases, with unsecured creditors receiving no compensation for the debts owed to them.<sup>1</sup> Secured creditors typically repossess (or have handed over) the assets that provided the collateral.<sup>2</sup> If the value of these assets is less than the debts owed (which is often the case), then the difference is simply written off. On occasion, a debtor and unsecured creditor may voluntarily agree for the former to continue making payments on the secured loan or line of credit (most likely in respect of a vehicle or real estate), albeit at what is likely to be at a written-down rate.

At the conclusion of a Chapter 7 case, individual debtors are left with few assets but also no debt (even to secured creditors)<sup>3</sup> Business entities are terminated and cease to exist. Consequently, they have no assets or liabilities remaining.

### **3.1.3 Chapter 11**

#### **General description**

The chapter of the bankruptcy code that deals mainly with the reorganisation of a business is Chapter 11. In principal, a business filing for Chapter 11 bankruptcy should be able to repay a greater proportion of its debts by remaining in business rather than liquidating assets. Chapter 11 gives the debtor the opportunity to execute a repayment plan that eradicates debt over a period of time. A debtor can willingly file for Chapter 11 bankruptcy, or creditors can file an involuntary petition.

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1 American Bankruptcy Institute, *Bankruptcy Overview: Issues, Law and Policy*. Third edition, 1997.

2 In States where homes are exempt assets, lenders do not secure loans or credit on the residential property for obvious reasons.

3 Exceptions include, *inter alia*, tax arrears (see section 4.1), child maintenance, amounts owed in respect of student loans and other lines of credit where the individual debtor has agreed voluntarily to continue making payments to a secured creditor.

## **Procedures**

Once a voluntary petition has been filed, an automatic stay goes into effect. In involuntary cases, the debtor must file for an Order for Relief before the stay is enacted. When the stay goes into effect, the debtor becomes known as the debtor-in-possession. At this point, if the debtor-in-possession wishes to propose a reorganisation plan, a disclosure statement must be filed that provides adequate information regarding the history of the debtor and the condition of the debtor's records.

For the first 120 days after the stay is established, the debtor-in-possession has the exclusive right to file a plan of reorganisation. A total of 180 days from the beginning of the stay is allowed for the debtor-in-possession to have the plan approved. However, if no plan is submitted during the 120-day period or no plan is approved during the 180-day period, creditors are given the opportunity to present the court with alternate plans that may include liquidation. These time periods can be extended or shortened according to the discretion of the court. Furthermore, in the cases of businesses with less than \$ 2,000,000 in aggregate debt at the filing of the petition, the exclusivity period to file a plan is 100 days, while the time for approval is 160 days from the date of bankruptcy filing or Order of Relief.

The court makes the final decision to confirm or approve any proposed plans. The court may also have to choose between competing viable plans submitted by different parties. Upon confirmation, the debtor must adhere to the provisions of the plan or risk having the case dismissed or converted to Chapter 7. Plans for repayment set out schedules, amounts to be paid to different creditors and so on. Repayment plans typically take months, if not years, to complete. Debtors remain under Chapter 11 protection until plans have been completed.<sup>1</sup>

### **3.1.4 Chapter 13**

#### **General description**

Chapter 13 of the Bankruptcy Code targets parties that have a regular income but are currently unable to pay their debts. Only individuals and small businesses with unsecured debts less than \$ 250,000 and secured debts less than \$ 750,000 are eligible for Chapter 13 relief. Debtors must submit a repayment plan to the court within 15 days of filing the bankruptcy petition. The duration of the repayment

<sup>1</sup> Subject to the already noted proviso that if the terms of a plan are not met, the debtor risks having its case dismissed or converted to Chapter 7.

period is three years, except for cases where the court grants a longer period up to a maximum of five years. Once a plan has been confirmed and executed, the debtor is discharged of most remaining debt.

### **Procedures**

The debtor files a petition and proposed repayment plan with the Bankruptcy Court in the region of the debtor's residence. The party in debt must also include a list of creditors and the nature of claims, property, living expenses and source of income. Within 20 to 40 days of the filing, a meeting of creditors takes place. The trustee assigned to the case and the debtor also attend this meeting. Unsecured creditors then file claims within 90 days of this meeting. The plan usually must pay the full amounts of claims or commit to creditors all income not necessary for the survival of the debtor and dependents. A confirmation hearing is held by the court, at which creditors can object to the plan. The most common objection is that the creditors would receive more money if the debtor was forced to liquidate as delineated in Chapter 7. Upon confirmation of the plan, the debtor must make payments to the trustee who distributes funds to creditors. Failure to make payments can lead to dismissal or conversion to Chapter 7.

## **3.2 Business Failure, Start-Ups and Survival – a Statistical Overview**

### **Introduction**

There are three main sources of data on business start-ups, failures and survival rates in the United States. These are Dun & Bradstreet, the Small Business Administration and the Bankruptcy Yearbook & Almanac. This chapter provides a statistical overview of key points relating to the above topics using these and certain other sources.

### **3.2.1 Start-Ups**

According to figures provided by Dun & Bradstreet, the total number of new business start-ups in the United States in 1997 amounted to 166,740 (table 3.1).<sup>1</sup> These figures represented a decline of approximately 2.2% compared to 1996. As shown in table 3.1, over 50% of these new start-ups had two or fewer employees. Three-quarters had no more than five employees.

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<sup>1</sup> Figures made available by Dun & Bradstreet on the number of business start-ups are subject to a certain level of downwards bias. This is because a business will not appear in Dun & Bradstreet's records unless a credit analysis is requested for it within three years of its inception.



**Table 3.1 Business starts by employment size in the USA, 1996-1997**

Employees	1996		1997	
	Firms	Percent	Firms	Percent
2 or less	98,671	57.9	89,927	53.9
3 to 5	38,129	22.4	40,304	24.2
6 to 10	18,135	10.6	19,393	11.6
11 to 20	8,727	5.1	9,402	5.6
21 or more	6,813	4.0	7,714	4.6
<b>Total</b>	<b>170,475</b>	<b>100.0</b>	<b>166,740</b>	<b>100.0</b>

Notes: (1) Business starts consist of newly opened active establishments. It does not include changes in ownership of previously operating businesses, mergers or changes in the business name, location or legal type.

Sources: (1) Dun & Bradstreet Corporation, '1996-1997 Business Starts Record'.

Given the size distribution of new start-ups revealed in the Dun & Bradstreet data, it might be expected that most of these new businesses would be sole proprietorships or partnerships. However, as shown in table 3.2, this was not the case. In fact, the majority of new business start-ups in 1997 were incorporated. This is shown in table 3.2 (below).

**Table 3.2 Business starts by type of enterprise in the USA in 1997**

Type of enterprise	No. of new business starts
Unknown	2
Proprietorship	61,045
Partnership	14,949
Corporation	90,744
<b>Total</b>	<b>166,740</b>

Notes: (1) Business starts consist of newly opened active establishments. It does not include changes in ownership of previously operating businesses, mergers or changes in the business name, location or legal type.

Sources: (1) Data provided to Micronomics, Inc. by Dun & Bradstreet Corporation.

Available data confirms that almost 80% of new business start-ups in the United States in 1997 were in the service sector. Relatively few were started in either the primary or secondary sector. This is shown in table 3.3 (overleaf).

**Table 3.3 Business starts by industry in the USA in 1997**

Industry Sector	No. of new business starts	Share of total no. of new business starts (%)
Agriculture, forestry & fishing	2,275	1.4
Mining	655	0.4
Construction	18,513	11.1
Manufacturing	13,144	7.9
Transportation & public utilities	8,741	5.2
Wholesale trade	15,780	9.5
Retail trade	36,377	21.8
Finance, insurance & real estate	12,198	7.3
Services	50,253	30.1
Unclassifiable establishments	8,804	5.3
<b>Total</b>	<b>166,740</b>	<b>100.0</b>

Notes: (1) Business starts consist of newly opened active establishments. It does not include changes in ownership of previously operating businesses, mergers or changes in the business name, location or legal status of enterprises

Sources: (1) Dun & Bradstreet Corporation, '1996-1997 Business Starts Record'.

## **3.2.2 Business failure**

### **Recent trends**

As shown in table 3.4 (overleaf), the total number of business failures in the United States rose considerably over the period 1984-1992. In the following three years, business failures fell somewhat. Provisional figures show a significant increase in 1997. This increase is most likely a delayed effect of the increase in new firm formation observed in the early to mid-1990s. The link between new firm formation and business failure (a high proportion of new businesses fail for reasons unconnected to the business cycle) is a complicating factor in the otherwise pro-cyclical relationship between the state of the US economy and the number of business failures. The decline observed in average liability per business failure that occurred from the early to mid-1990s onwards is a likely result of strong economic growth in the US.

Table 3.4 Number of business failures in the USA, 1984-1997

	Number of failures	Average liability per failure (\$)	Number of failures per 10,000 firms with employees	Total number of firms with employees
1985	57,253	645,160	112	5,127,000
1986	61,616	725,850	118	5,213,000
1987	61,111	568,209	113	5,393,000
1988	57,097	693,084	104	5,510,000
1989	50,361	840,507	90	5,570,000
1990	60,747	923,996	108	5,641,000
1991	88,140	1,098,539	155	5,685,000
1992	97,069	971,653	169	5,741,000
1993	86,133	554,438	147	5,851,000
1994	71,558	404,956	119	5,992,000
1995	71,128	524,175	117	6,068,000
1996	71,931	411,071	111	6,463,000
1997	83,384	448,970	n/a	n/a

Notes: (1) Figures for 1997 are preliminary only.

(2) Business failures include businesses that ceased operations following assignment or bankruptcy, ceased operations with losses to creditors after such actions as foreclosure or attachment, voluntarily withdrew leaving unpaid debts, were involved in court actions such as receivership, reorganisation or arrangement, or voluntarily compromised with creditors.

(3) Total concerns represent the total number of business enterprises included in the Dun & Bradstreet U.S. database.

Sources: (1) Dun & Bradstreet Corporation, '1997 Business Failure Record' and number of enterprises is originating from the Small Business Administration (SBA).

### Number of filings by type of enterprise and business failure

In 1997, approximately 60% of all business bankruptcy filings (including sole proprietors and partnerships), were made under Chapter 7. Detailed figures are shown in table 3.5 (overleaf). To some extent, however, this figure could be argued to understate the relative importance of Chapter 7 bankruptcy filings, since many Chapter 11 and Chapter 13 filings ultimately become Chapter 7 cases. Unfortunately, it is difficult to draw any firm conclusions about the distribution of bankruptcy filings between different types of enterprise because of the large number of entries in the unknown category.

**Table 3.5 Business failures by type of enterprise and chapter in the USA in 1997**

	Unknown	Chapter 7	Chapter 9	Chapter 11	Chapter 12	Chapter 13	Total
Unknown	917	37,524	12	2,417	425	11,988	53,283
Proprietorship	844	7,741	2	440	54	3,062	12,143
Partnership	283	716	1	264	18	239	1,521
Corporation	6,423	5,106	7	4,544	24	333	16,437
<b>Total</b>	<b>8,467</b>	<b>51,087</b>	<b>22</b>	<b>7,665</b>	<b>521</b>	<b>15,622</b>	<b>83,384</b>

- Notes: (1) Data are preliminary only.  
 Chapter 12 deals with the adjustment of debts of family farmers with regular annual income.  
 (3) Business failures include businesses that ceased operations following assignment or bankruptcy, ceased operations with losses to creditors after such actions as foreclosure or attachment, voluntarily withdrew leaving unpaid debts, were involved in court actions such as receivership, reorganisation or arrangement, or voluntarily compromised with creditors.  
 (4) The large number of entries in the 'unknown' category reflects inadequacies in data reported in bankruptcy filings. A comparison of previous preliminary and revised data for earlier years indicates that the preliminary nature of the figures presented in table 3.5 is not the cause.

Sources: (1) Data provided to Micronomics, Inc. by Dun & Bradstreet Corporation.

### **Average Age of Business Failure**

In general, a greater percentage of businesses fail within the first five years of their lifetimes than businesses that survive for six to ten years. This is shown in the figures cited in table 3.6 (below). The available evidence does not suggest that significant differences exist in this respect between different types of business (table 3.7, over-leaf).

Table 3.6 Proportion of business failures in different age cohorts in the USA in 1997 (%)

Age of business (years)	Agriculture Forestry Fishing	Mining	Construction	Mfg	Transport & Public Utilities	Wholesale Trade	Retail Trade	Finance, Insurance, Real Estate	Other Services	Total
1 or less	9.7	8.8	7.4	7.7	11.3	7.4	13.2	10.1	12.2	10.7
2	8.0	6.2	7.8	8.1	11.2	8.9	12.8	7.3	10.4	10.1
3	6.7	6.1	7.3	8.9	10.4	8.1	10.2	6.0	8.5	8.7
3 or less	24.4	21.1	22.5	24.7	32.9	24.4	36.2	23.4	31.1	29.5
4	4.4	7.9	7.5	7.8	8.3	8.7	8.5	6.5	7.6	7.8
5	5.6	3.5	6.6	7.9	7.2	7.6	7.1	5.9	6.8	7.0
5 or less	34.4	32.5	36.6	40.4	48.4	40.7	51.8	35.8	45.4	44.3
6	5.1	7.0	6.4	5.8	5.7	6.3	5.7	4.4	6.1	5.9
7	5.3	4.4	5.8	4.8	6.2	5.1	4.9	4.8	5.4	5.3
8	4.4	3.5	5.9	5.2	5.0	5.2	4.4	5.4	5.1	5.0
9	4.4	3.5	4.0	4.5	4.3	4.4	3.5	4.8	3.8	4.0
10	3.4	2.6	4.0	4.3	3.2	3.5	3.2	5.1	3.9	3.7
6 to 10	22.6	21.0	26.1	24.6	24.4	24.5	21.7	24.5	24.3	23.9
Over 10	43.0	46.5	37.3	35.0	27.2	34.8	26.5	39.7	30.2	31.8

Notes: (1) Data are preliminary only.

(2) Business failures include businesses that ceased operations following assignment or bankruptcy, ceased operations with losses to creditors after foreclosure or attachment, voluntarily withdrew leaving unpaid debts were involved in court actions such as receivership, reorganisation or arrangement, or voluntarily compromised with creditors.

Sources: (1) Dun & Bradstreet Corporation, '1997 Business Failure Record'.

Table 3.7 Average age of business failures by type of enterprise in the USA in 1997

	Years
Unknown	6.53
Proprietorship	9.62
Partnership	9.42
Corporation	10.76

Notes: (1) Business failures include businesses that ceased operations following assignment or bankruptcy, ceased operations with losses to creditors after such actions as foreclosure or attachment, voluntarily withdrew leaving unpaid debts, were involved in court actions such as receivership, reorganisation or arrangement, or voluntarily compromised with creditors.

Sources: (1) Data provided to Micronomics, Inc. by Dun & Bradstreet Corporation.

### Chapter 11 cases

According to popular belief, Chapter 11 bankruptcy cases are dominated numerically by large, publicly owned companies. In fact, the opposite is the case. According to a study published by the American Bankruptcy Institute, for instance, approximately 85% of all Chapter 11 cases are accounted for by enterprises with under \$ 10 million in assets and liabilities.<sup>1</sup> Overall, 65% of all enterprises in the study had between \$ 500,000 and \$ 10 million in assets and liabilities. Another 20% had assets and liabilities in the \$ 100,000 to \$ 500,000 range. In numerical terms, SMEs dominate Chapter 11 filings.

Another popular perception is that Chapter 11 debtors remain in bankruptcy for several years. According to a recent literature survey, there is some element of truth in this belief.<sup>2</sup> Studies covered by the review variously reported the average time large, publicly held debtor companies remain under Chapter 11 protection as ranging from 16.2 to 32 months. The relatively wide range of figures obtained in these studies was due to differences in sample size and possible selection bias. In general, the larger the sample size, the lower the average time the debtors spent under reorganisation. What data exists does not necessarily confirm the view that smaller companies spend substantially less time in reorganisation.<sup>3</sup>

### 3.2.3 Firm Survival

A fundamental tenet of business economics is that start-ups are more vulnerable than more mature companies. Similarly, it is often re-

1 Fenning, Lisa Hill, 'Measuring Chapter 11: The Real World of 500 Cases,' *American Bankruptcy Institute*.

2 LoPucki, Lynn M., 'The Trouble with Chapter 11,' *Wisconsin Law Review*, 1993.

3 LoPucki, Lynn M. *Supra* note 3.

ported that smaller companies are more likely to fail than larger ones. The data for the United States are in accordance with these views (see tables 3.8 and 3.9).

Table 3.8 Business survival rates by age cohort in the USA

Age cohort (years)	1978	1980	1982	1984	1986
0-2	0.769	0.562	0.493	0.404	0.344
3-4	0.719	0.521	0.471	0.399	0.347
5-9	0.716	0.567	0.522	0.453	0.402
10-19	0.739	0.624	0.585	0.520	0.469
20+	0.741	0.639	0.601	0.539	0.488

Notes: (1) This table shows the proportion of firms that were within a given age class in 1976 that survived through 1978, 1980, 1982, 1984 and 1986.

Sources: (1) Business Survival Rates by Age Cohort of Business, prepared for the Office of Advocacy, U.S. Small Business Administration by Joel Popkin and Company, April 1991.

Table 3.9 Business survival rates by firm employment size cohort in the USA

Employment size class	1978	1980	1982	1984	1986
1-4	0.662	0.475	0.433	0.358	0.309
5-9	0.810	0.692	0.639	0.570	0.512
10-19	0.858	0.763	0.707	0.644	0.586
20-49	0.880	0.794	0.732	0.670	0.610
50+	0.892	0.810	0.749	0.689	0.628

Notes: (1) This table shows the proportion of firms that were within a given employment size class in 1976 that survived through 1978, 1980, 1982, 1984 and 1986.

Sources: (1) Business Survival Rates by Age Cohort of Business, prepared for the Office of Advocacy, U.S. Small Business Administration by Joel Popkin and Company, April 1991.

No studies exist at present in the United States which compare the survival rates of businesses owned or managed by individuals with no prior experience of business failure, to those owned or managed by individuals that have prior experience of business failure. The literature has, however, explored certain other issues. One recent study, for instance, examined survival rates among franchise and non-franchise small firms started between 1984 and 1987.<sup>1</sup> In tracking survival rates through late 1991, the author found that the survival prospects of independent business start-ups are better than those of franchises. A separate study concludes that new business survival rates are as high in rural areas as they are in urban areas.<sup>2</sup>

1 Bates, T. 'A Comparison of Franchise and Independent Small Business Survival Rates,' *Small Business Economics*, 1995.

2 Buss, T. F. and X. Lin, 'Business Survival in Rural America: A Three-State Study,' *Growth and Change*, 1990.

## **3.3 Obstacles to Post-Failure Entrepreneurial Activity**

### **Introduction**

In this section an assessment is provided of the main obstacles faced by persons seeking to start a new venture after previous experience of business failure. In this context, a noteworthy degree of consensus was evident amongst the survey's respondents. This was true regardless of the different opinions held by respondents, for instance, about the likely impact of proposed legislative reforms. With the exception of the overall summary, each subsection presented relates to a single potential obstacle.

### **3.3.1 Relief from debts**

As intended, United States bankruptcy law is generally successful in providing effective relief for individuals and businesses from the claims of creditors.<sup>1</sup> This is reinforced by the fact that an individual cannot be sued in respect of contract debt after certain state-specific time limits have expired, often six years (ten years for debt related to real estate). Legally, therefore, persons are able to make a fresh start after bankruptcy. The same is essentially true for businesses that have had a Chapter 11 case confirmed.

The above notwithstanding, the Internal Revenue Service (IRS) is empowered to pursue individuals without time limit in respect of arrears on payroll taxes and social security obligations. In addition, the IRS can pursue the key officers of a business entity for arrears, even if the business entity no longer exists. The IRS does, however, make efforts to arrive at reasonable settlements with individuals, providing there is no evidence of fraud.

One further qualification to be made is that the financial affairs of parties (not least sole proprietorships and the self-employed) filing for bankruptcy are often in complete disarray. Indeed, professionals directly involved in bankruptcy proceedings often observe that an alarmingly high proportion of SMEs filing for bankruptcy do not have even rudimentary accounting or management information systems in place. Providing relief from debts does not solve this problem.

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<sup>1</sup> This is true with the proviso, of course, that legal business entities are liquidated and dissolved in Chapter 7 bankruptcies.



### **3.3.2 Credit history**

In the United States, a number of organisations collect and provide detailed information on the credit histories of individuals and businesses. For businesses, the principal provider is Dun & Bradstreet.<sup>1</sup> For individuals, the main credit reporting agency is TRW.<sup>2</sup> Both services are used by banks, credit card companies and other providers of finance to judge the creditworthiness of applicants. Suppliers use these services to judge the creditworthiness of their customers or clients.

In its credit rating reports, Dun & Bradstreet identifies major shareholders or owners of each enterprise (unless a publicly owned company is involved), the names of its directors and principal executive officers, and other companies these individuals have been associated with in a similar capacity. It also details court actions filed against either the business in question or individuals named within its reports. Given this, and the fact that Dun & Bradstreet is also able to provide personal credit reports on request (through Equifax, an individual credit reporting agency), an extended credit history can be built-up on a business, its major shareholders or owners (except publicly owned companies), directors, principal executive officers and any other business entities it is linked to through either ownership or management.

Unlike Dun & Bradstreet, TRW does not provide credit ratings as such. Rather, it provides extended information on the credit and payment history of individuals which subscribers use to make their evaluations of creditworthiness. TRW obtains its information from banks, credit card companies, public utilities, department stores and court records.

In principle, someone who is revealed by either TRW or Dun & Bradstreet to have a poor credit history, or a past association with business failure, may find access to credit restricted or more expensive. Similarly, such a person may find himself or herself offered worse terms by suppliers. These potential barriers to post business-failure start-ups are considered in more detail in the following sections.

### **3.3.3 Access to loan and overdraft finance**

Individuals who have a past association with business failure typically find themselves excluded from the prime or first-tier market for bank finance or credit. This is true largely regardless of the type of

<sup>1</sup> This includes sole proprietorships.

<sup>2</sup> The credit reporting division of TRW has recently been sold and now operates under the name Experian.

business that failed, since banks typically carry out comprehensive credit checks that extend to personal histories using both their own resources and the services of outside companies. Precisely how long access is denied is likely to depend on the bank or credit provider concerned, the reason why an individual's business failed and the nature of the new business that finance is sought for. If there were good reasons for a business failure (e.g., partner fraud, divorce), the individual concerned subsequently has a good track record, earns a regular income, approaches a bank or credit provider with a solid business plan and is able to provide collateral (unlikely in all but a few cases), then he or she may regain access to the prime lending market after just 4-5 years. In certain circumstances, some lenders might even judge past experience of business failure to be a positive factor. This notwithstanding, more conservative banks reject any application for a bank loan or overdraft finance if there is any previous association with business failure. It should be noted, however, that United States legislation requires that credit reporting agencies (Dun & Bradstreet, TRW) remove from their databases all information pertaining to bankruptcy filings after ten years at most. The same is true regarding instances of payment delinquency.

Whilst persons who have a previous association with business failure are likely to face restricted access to the prime lending market in the United States, they are still likely to find it relatively easy to raise finance in the sub-prime or second tier market.<sup>1</sup> Indeed, it is now common for individuals to finance new business ventures using credit card finance. This is particularly the case vis-à-vis sole proprietors and the self-employed. Finance can also be readily obtained by remortgaging home equity (subject to state-specific upper limits, home equity is exempt from creditors' claims in bankruptcy proceedings). At most, it may take an individual two years before he or she is able to obtain loan finance or credit in the sub-prime market.

Given the above, restricted access to loan finance does not represent as severe a barrier to post-failure entrepreneurial activity as it might appear to. However, sub-prime interest rates often reach as high as 25% annual percentage rate (APR), compared to perhaps 7.5-10.5%

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<sup>1</sup> No standard definition of what constitutes the sub-prime market exists. In general, it refers to the segment of the lending market that is concerned with making loans or credit available to individuals or businesses that have poor credit ratings. In the past, sub-prime lending was dominated by a few finance companies (not least ones owned by automobile manufacturers). Today, credit card companies, credit unions and even banks have entered the market. A brief overview of the market is provided by the Senate Banking, Housing and Urban Affairs Subcommittee on Financial Institutions and Regulatory Relief, 'Oversight Hearing on the Condition of the Banking and Thrift Industries and the Condition of the Bank Insurance Fund and Savings Association Insurance Fund.' Prepared Testimony of the Honorable Andrew Hove, Acting Chairman, Federal Deposit Insurance Corporation, September 24, 1997.

APR in the prime market.<sup>1</sup> Re-mortgaging home equity in the sub-prime market will also typically involve high arrangement fees, sometimes in excess of \$ 5,000 on relatively small loans. The implication of this is that persons who have a relatively recent association with business failure can face a significantly higher cost of capital than do entrepreneurs who have no such association. This compounds the obvious difficulty faced by those concerned, i.e., that they do not have spare resources to invest or assets loans cannot readily be secured, if at all. At least in the short run, therefore, a barrier to entry exists, particularly in more capital intensive industries. The reverse is true in sectors which do not require a lot of capital, e.g., certain service sectors. It should, of course, also be noted that sophisticated businesses are sometimes able to minimize the amount of external finance they need to attract by delaying payments to suppliers, obtaining payment for services or goods supplied in advance and so on. Furthermore, it should be emphasised that a poor credit history leads in itself to restricted access to the prime lending market. The fact that a person or business has actually filed for bankruptcy is thus not the sole determining factor.

### **3.3.4 Access to venture capital**

As part of the due diligence process, venture capital companies perform extensive credit checks on individuals who approach them in an effort to raise capital. Such checks are typically performed using a combination of internal resources and external services such as TRW and Dun & Bradstreet. If an applicant is relatively young (as might be the case in high technology fields), then credit checks are likely to be less extensive. Credit checks play a part in judging the merits of applications for venture capital finance, but numerous other factors are also considered. These factors include the specifics of the business plan submitted, ownership of intellectual property, results of a competitor analysis, possession of agreements of principle to purchase from prospective customers and so on. Past association with business failure does not, therefore, necessarily prevent someone from obtaining venture capital. It is also not likely to lead to an applicant being offered worse terms or conditions than would otherwise be the case. Indeed, previous experience of business failure may even be seen as a positive factor. This depends on the reasons why a business failed, what lessons were learnt and the nature of the experiences gained. Experience of business failure is more likely to be seen positively in progressive, liberal areas where there is a

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<sup>1</sup> The annual percentage rate (APR) payable on a loan or debt corresponds to the compounded yearly equivalent of the monthly rate. A monthly interest rate of 1%, for instance, is equivalent to an APR of 12.68%.

preponderance of high-technology start-ups than in isolated rural communities or areas dominated by traditional industries. Silicon Valley is often cited as a region in which failure is regarded as an important opportunity for learning.<sup>1</sup> One reason for this is that many of the founders of what have become the largest and most successful Silicon Valley companies failed in previous enterprises. Cultural factors which emphasize entrepreneurship and risk taking are also crucial.<sup>2</sup> In short, a previous association with business failure does not necessarily adversely affect access to venture capital. New business ventures are typically judged on their own merits. This notwithstanding, it should be noted that many (if not most) sole proprietors and self-employed individuals are not engaged in lines of business where access to venture capital is an issue.

### **3.3.5 Contractors bonds and license requirements**

In many states, a contractor is required by law to obtain a contractors' bond or pay a deposit to a regulatory body responsible for issuing contractors' licenses. Contractors' bonds are arranged through private companies in a manner akin to obtaining insurance. The bonds are intended to cover claims for faulty or unfinished work, damage to property and so on. Contractors pay an amount each month in respect of the bonds they are required to obtain. The amounts paid depend on the sector worked in and the credit rating of the contractor concerned. Self-employed contractors or ones owned by individuals who have a past history of business failure or bankruptcy (public companies excepted) may have some difficulty in obtaining a contractors' bond on good terms, or be required to make very high monthly payments.

In California the regulatory body in question is the Contractors' State License Board. It requires that a contractors' bond or deposit of \$ 7,500 be paid prior to the issuance of a license. Applicants for a contractors' license in California must also prove that they have operating capital exceeding \$ 2,500. These requirements exacerbate problems former debtors may have with restricted access to the prime lending market. Sectors such as electrical contracting, construction and painting are most likely to be affected by this factor.

### **3.3.6 Suppliers**

In principle, suppliers of a business are able to check the credit history of its officers or major shareholders, or companies they have pre-

1 Saxenian, A. *Regional advantage*. 1994. Harvard University Press: Cambridge, Massachusetts and London, United Kingdom.

2 Interesting discussions of this topic are contained in a number of articles in *Forbes Supplement On The Information Age*, June 2, 1997.

viously been associated with in a similar capacity. This was explained in the section above. For SMEs in particular, however, the use of such services is relatively expensive. This is especially true if one seeks to trace the credit history of other companies a person has been an officer or major shareholder of, since it would require that credit reports be obtained for multiple companies. Many SMEs therefore do not obtain credit reports on their customers. Given this and the nature of competition in most markets, entrepreneurs who have previously been associated with business failure are unlikely to be offered worse terms by suppliers than ones who have not. No significant barrier therefore exists. The only exception to this might be in isolated, smaller communities where there are very few suppliers within a particular line of business.

### **3.3.7 Overall assessment**

Persons who have experienced business failure in the United States do not face severe obstacles when attempting subsequently to start a new business. Perhaps the only significant barrier faced is that of restricted access to the first-tier market for loan capital and credit. External finance can be obtained readily in the sub-prime market, but at very high interest rates and on worse terms than for preferred customers. Those affected may thus face a higher cost of capital. Although conditions have changed considerably in recent decades, a degree of stigma is still attached to business failure and bankruptcy in parts of the United States. This is most likely to be a problem in small, isolated communities, not in large urban areas.

Whilst the above points might generally be true, a number of qualifications should be made. First, a number of first-tier banks may still provide loan finance, even if an applicant does have a past association with business failure. This would depend on the reason why the previous venture failed, subsequent credit history, the specifics of the business plan submitted and the amount of collateral available. In certain circumstances, some lenders might even judge past experience of business failure to be a positive factor. Either way, access to the prime lending market is likely to be restored after 4-5 years if a new venture proves successful. Second, an association with previous business failure does not necessarily restrict access to venture capital. Credit checks are performed, but numerous other factors are also considered and each case is judged on its own merits. Previous experience of business failure might even be seen as a positive factor. Third, to the extent that external finance is more expensive, this factor will be less important in sectors where significant start-up capital

is not required. Finally, the available evidence suggests that a significant proportion of individuals who experience business failure do start new ventures in subsequent years. This point is explored in greater depth in the next section.

In short, individuals in the United States who have declared bankruptcy, or who have been associated with business failure in the past, do not face insurmountable obstacles when starting again. Indeed, the available evidence suggests that there are few barriers of any great significance. There is also some truth to the view that having experience of business failure is seen within certain circles as a positive factor. More specifically, providers of external finance may regard such experience favourably if it has provided valuable lessons about what mistakes to avoid and how better to solve problems. This is less likely to be true in small, isolated communities or traditional industries where a degree of stigma is still attached.

## **3.4 Post-Failure Start-Ups and Support Measures**

### **Introduction**

In the previous section of this report, it was concluded that, in general, persons who have experienced business failure do not face severe obstacles or barriers when subsequently attempting to start a new venture. The first part of this section presents the evidence there is to confirm that this is true and that a significant proportion of persons who have failed previously in a business venture in the United States are able to try again. The second part of this section describes a number of support measures relevant to the efforts of such individuals.

### **3.4.1 Evidence of post-failure start-ups**

#### **Published survey data**

Very little has been published in the United States about the proportion of individuals who experience business failure only to start new ventures. One reason for this is seems to be that people do appear to be able to start again in business after failure, and often do just that. The issue is thus not contentious. This notwithstanding, two studies are worth noting.

The first study was actually a pilot-study conducted for the Small Business Administration in 1993/94.<sup>1</sup> Unfortunately, a full-scale

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<sup>1</sup> M&R Associates. *Function of failure*. Small Business Administration Office of Advocacy, Contract No. SBA-6644-0A-91. June 1994. M&R Associates: Rockville, MD.

study has never been undertaken, but the results of the pilot are interesting nonetheless. The study succeeded in contacting and interviewing the owners of 101 small businesses that had filed for Chapter 7 bankruptcy over the period 1989-93. Amongst the survey's main findings were that 47% of all respondents had resumed their careers in business after having filed for bankruptcy (this compares to 41% who took up paid employment). A lower percentage was recorded in the trade sector which tends to require long hours and significant capital tied up in inventory. The reverse was true for the service sector. Typically, only 2-3 years would pass before individuals were able to fully adjust to the negative aspects of the bankruptcy experience and start a new business. New businesses were smaller, but it is not clear whether this was because of lessons that had been learned and attempts to be more efficient or because of a more conservative approach to hiring in the start-up phase. The survey also identified a core group of serial entrepreneurs who had owned several businesses during their careers, both before and after the noted Chapter 7 filing.<sup>1</sup>

A second study worthy of note is one funded by the Educational Endowment of the National Conference of Bankruptcy Judges. The results of the study are due to be published in mid-October 1998 at the annual convention of the National Conference of Bankruptcy Judges. One of its main aims was to track outcomes in Chapter 7 and 13 business bankruptcy filings. An earlier paper sets out the study's aims and methodology in full.<sup>2</sup>

### **The experience of respondents**

In general, the views of those individuals contacted as part of this study agreed with the conclusions drawn by the studies described in the previous subsection. In short, respondents confirmed that anecdotal stories are not myth. It is common for people to start again after having a business fail. One respondent who deals with literally thousands of small business Chapter 7 bankruptcies a year stated that the vast majority of his previously self-employed clients start again within one year, even if on a very small-scale basis. Another respondent stated that approximately 90% of all persons filing for chapter 7 small business bankruptcies start new ventures within five years.

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1 Unfortunately, no statistical data was provided on the size of this group or in support of many of the conclusions presented in the pilot-study report. The survey questionnaire also did not ask any questions about the obstacles faced by individuals in attempting to start again. A companion document and full dataset of the results is available from M&R Associates for \$ 21,000.

2 Warren, E. and J. L. Westbrook. 'Searching for reorganization realities.' *Washington University Law Quarterly*. Fall 1994.

Often, such a person would not start out in business immediately. Paid employment would initially be taken to stabilise the financial situation confronting the person in question and to provide time to re-establish access to credit on acceptable terms. This course of action would also allow the person involved to gain experience and perhaps build up a client base.

### **3.4.2 Support measures**

#### **SBA loan guarantee programs**

The U.S. Small Business Administration (SBA) 7(a) Loan Guaranty Program is one of the SBA's primary lending programs, providing loans to small businesses unable to secure financing through normal lending channels. As such, the program can assist individuals attempting to start businesses after a previous history of failure. Private sector lenders provide loans that are guaranteed by the SBA since the agency has no funds for direct lending. The maximum amount the SBA can guarantee is \$ 750,000. With a lender requesting the maximum SBA guarantee of 75%, the total loan amount available under this program is limited to \$ 1 million.

Cash flow and the ability to repay loans are primary considerations of the SBA in evaluating applications. Good character, management capability, collateral, and owner's equity contribution are also important. In addition, owners of 20% or more are required to guarantee personally SBA loans. Prior association with business failure will not necessarily prevent an applicant from securing a loan guarantee.

Under the terms of the program interest rates, which may be fixed or variable, are negotiated between the borrower and the lender but are subject to SBA maximums that are pegged to the Prime Rate. Fixed rate loans must not exceed Prime Plus 2.25% if the maturity is less than 7 years, and Prime Plus 2.75% if the maturity is 7 years or more. For loans of less than \$ 25,000, the maximum interest rate must not exceed Prime Plus 4.25% and 4.75% respectively; for loans between \$ 25,000 and \$ 50,000, maximum rates must not exceed 3.25% and 3.75% respectively. Variable rate loans may be pegged to either the lowest prime rate of the SBA optional peg rate. This rate is a weighted average of rates the government pays for loans with maturities similar to the average SBA loan. The lender and the borrower negotiate the amount of the spread that will be added to the base rate. An adjustment period is selected which will identify the frequency at which the note rate will change. This period must be no more often than monthly and must be consistent.



The SBA charges lenders guaranty and servicing fees for each loan approved. These fees can be passed on to the borrower once they have been paid by the lender and are determined by the amount of the loan guaranty. When the guaranty portion of the loan is \$ 80,000 or less, a 2% guaranty fee will be charged; 3% for loans more than \$ 80,000 but less than \$ 250,000; 3.5% for the next \$ 250,000; 3.875% for any portion greater than \$ 500,000. In addition, all loans will be subject to a fifty basis point (0.5%) annualized servicing fee which is applied to the outstanding balance of SBA's guaranteed portion of the loan.

### **Educational and credit-rehabilitation programs**

One of the conclusions arrived at by the National Bankruptcy Review Commission, amongst others, is that a definite need exists for many individuals and small businesses that file for bankruptcy to be more informed about managing their finances, the true cost of finance (particularly in the sub-prime market) and so on. In the case of small businesses filing for bankruptcy protection, a disturbingly high number lack even rudimentary management information or accounting systems. Accordingly, United States Bankruptcy Trustees in certain parts of the country have initiated educational and credit rehabilitation programs. One such program is found in Nashville, Tennessee and is aimed at helping individuals and small businesses that file for Chapter 13 bankruptcy. More specifically, the program aims to assist participants in avoiding financial problems in the future and to reduce the number of Chapter 13 cases that end up being converted to Chapter 7 cases because the individuals or small businesses concerned fail to complete a repayment and reorganisation plan.

The Tennessee program was started by a local United States Bankruptcy Trustee approximately 20 years ago. The Trustee in question presently oversees about 3,000 Chapter 13 bankruptcy cases a year. The program has three elements.

The first element of the program is the holding of a series of debt counselling classes aimed at improving the understanding of participants about why they got into difficulties, how to better manage their finances and so on.<sup>1</sup> These classes are attended at different times during the completion of the Chapter 13 reorganisation plans. The first class is mandatory.

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<sup>1</sup> In conjunction with the National Association of Chapter 13 Trustees, the National Foundation for Consumer Credit and its member Counselling Service Agencies, VISA USA has produced workbooks which are also aimed at helping Chapter 13 debtors to improve the management of their finances.

The second element relates solely to businesses. It involved the efforts of a business investigator. This person has four main tasks. First, he is required to confirm whether or not there is any question of fraud or criminality involved in each case. Second, the business investigator has the task of identifying any management or general business problems that are likely to prevent completion of a Chapter 13 reorganisation plan. Third, the business investigator assists debtors in setting up basic bookkeeping systems, providing monthly financial reports and completing tax returns as appropriate.<sup>1</sup> Finally, the business investigator draws up a report on his findings with recommendations as to whether or not the case should be confirmed or dismissed. This report is submitted after the initial creditors' meeting, but before the confirmation hearing takes place.

The third element is what the organisers of the program refer to as a voluntary credit re-establishment scheme. The aim of this scheme is to help debtors who wish to regain access to prime lender credit achieve this goal more quickly than would otherwise be the case. To qualify for participation, debtors must complete their Chapter 13 reorganisation plans (which may take 3-5 years) and attend the aforementioned debt counselling classes. Participants are also taught how to correct errors in their credit reports, a right under United States legislation. On completion of reorganisation plans, graduates of the program are put in touch with local banks that agree voluntarily to restore access to prime lender credit. In the case of sole proprietors and the self-employed, the banks agree to consider all business plans submitted in good faith, without reference to past credit history.

Currently, about 1,500 individuals (including many sole proprietors) take part in the program each year. Of those graduating in recent years, approximately 55% decide not to apply for credit re-establishment. A further 45% have their applications for credit or bank loans accepted whilst only 5% have their applications rejected. In the course of the nine years the credit re-establishment scheme has been in existence, a total of \$ 15 million in loans and credit has been advanced. Although no specific tracking study has yet to be completed, very few instances of default have been reported.<sup>2</sup> A further achievement is a 50% completion rate for reorganisation plans compared to a national average of 25-30%. Those running the scheme attribute its success to the fact that debtors are given a strong incen-

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1 Similar tasks are performed during and after Initial Debtor Interviews in a different program run by the United States Bankruptcy Trustee in San Francisco.

2 A study is, however, currently underway to assess more precisely the degree of success enjoyed by the scheme.

tive to complete their reorganisation plans, namely the possibility of re-establishing access to prime lender credit.

### **Credit counselling**

Credit counselling services for the most part are non-profit educational and social service organisations whose primary objectives are to help individuals improve their credit standings and to provide useful information pertaining to credit issues. These organisations assist clients in communicating with their creditors in a timely manner, eliminating collection calls at home and work (thereby avoiding lawsuits and wage garnishment), avoiding bankruptcy by establishing a plan of repayment to all creditors based upon income and living expenses and overcoming the obstacles created by a negative past credit history. The groups in question are staffed by licensed professional counsellors trained in such diverse areas as banking, financial planning, social work, education, family law, taxes, real estate and accounting. All services are offered free to the general public regardless of income. All operating and administrative costs are covered in part by donations.



## **4 Business failures and entrepreneurship in the Netherlands**

This chapter is devoted to business failures and entrepreneurship in the Netherlands. The structure of this chapter is similar to the previous chapter and the situation in the Netherlands is compared with that in the USA as far as possible. The data from the Netherlands originate mainly from the Central Bureau for Statistics and from a publication on this topic which was based on a survey among entrepreneurs who restarted after a business failure and potential restarters<sup>1</sup>.

### **4.1 Bankruptcy legislation and procedures**

Normally a person with debts strives to pay on time. If he is unable to do so by exception, he will request the creditor for postponement of payment<sup>2</sup>. In most cases, the creditor will be inclined to agree, for example to keep his customer. Sometimes the debtor continues to default or not comply by the agreed time and the creditor can act as follows:

- do nothing;
- hold the opposing side/party liable by fax or registered letter;
- issue a writ of summons, in which proof of default is described and which is provided with a requirement of immediate achievement. After a writ of summons the debtor can be summoned, and the court can give a ruling, in which a claim is recorded. The ruling will provide the creditor with some satisfaction, but surely not the required performance;
- bankruptcy, this is only possible under certain conditions:
  1. the debtor must be in the circumstances that he has ceased to pay his debts;
  2. there must be more than one creditor.

#### **Moratorium (postponement of payment)**

If debts can not (all) be paid for the time being, although the debtor is of the opinion that bankruptcy can be prevented<sup>3</sup>, a moratorium can be requested. For this the intervention of a solicitor is needed. The moratorium provides a chance to put things in order and/or to come

1 B&A Groep, *Klaar voor de herstart? – Onderzoek naar de omstandigheden van bedrijfs - beeindigers (Ready for the restart? – Research on the circumstances of business terminators)*, The Hague, May 1998.

2 Reuvers, M.R. *Insolventie, dreiging en afweer*, Sdu Juridische & Fiscale Uitgeverij, 's-Gravenhage, 1992.

3 *Ondememerswijzer 1996, De praktische gids voor elke ondernemer*, Kluwer B.V., Deventer 1996.

to an agreement with the creditors. Control of assets is not lost (in contrast to bankruptcy), and business can be continued. However, debts are frozen and do not have to be paid for the moment. Normally, the court gives a moratorium for a certain period, appoints a trustee and orders a meeting with creditors. Depending on the findings during these meetings and a possible investigation by experts, a definite moratorium or refusal of moratorium will follow. In the latter case, the court can pronounce bankruptcy immediately. During the moratorium the chances of survival of the firm are examined and creditors are offered a settlement. This can imply discharging part of the debts and/or a settlement for staggered payment. If the settlement is accepted by the creditors and approved by the court, the moratorium is ended. For the creditors it is often better to accept an agreement, for if an enterprise is declared bankrupt they often receive nothing at all. In the latter situation, the available assets will go to the *preferential* creditors (see under the following paragraph Bankruptcy).

### **Bankruptcy**

Bankruptcy can be requested by the creditor or by the debtor himself. Bankruptcy is a *general attachment* on all property of the debtor on behalf of the creditors. Some creditors are privileged, namely the 'boedelcrediteuren' (creditors of the property) and secured debts/creditors. The first are creditors with the right of payment of debts made after the appointment of the trustee or the moratorium and in co-operation with him. The trustee himself is 'boedelcrediteur' and his fees have priority. This also applies to the wages of the employees who keep the business running or liquidating, and for benefits to employees from the Industrial Insurance Board, during a short period after the pronounced bankruptcy. Preferential creditors and the Industrial Insurance Board are the treasury. It is their turn to be paid, immediately after the 'boedelcrediteuren', from the proceeds of the property. However, in many cases nothing or very little remains to pay the other creditors.

All previous attachments lapse once the bankruptcy is official. The bankrupt loses control of his property and is not allowed to do business without the permission of the trustee, a solicitor appointed as such by court.

### **Who can apply for bankruptcy?**

Not only natural persons, also legal persons operating as private limited companies, limited companies, partnerships and estates can be pronounced bankrupt.

- The debtor himself can apply for bankruptcy.
- Any creditor can apply for the bankruptcy of a natural or legal person from whom he claims money, goods or services. The creditor has to use a solicitor, who presents a plea to court on behalf of the creditor.
- The Public Prosecutor can apply for bankruptcy in the public interest.

### **The course of events**

The court appoints a trustee and an official receiver who supervises the trustee. The trustee takes over the management of the property of the bankrupt. Mail will be sent to the trustee. Bank and Giro accounts will be blocked. The bankruptcy will be announced in the Government Gazette: creditors can present their claims to the trustee within a certain period. The bankruptcy will also be registered in the trade register. The trustee collects outstanding accounts. After a certain time, the trustee and bankrupt make a balance: what the proceeds will be after collecting the outstanding accounts and selling the properties and stocks. If there is anything left to be paid to the creditors, the trustee will announce a creditors' meeting ('verificatievergadering'). If not, the trustee will suggest the annulment of the bankruptcy.

### **The annulment of the bankruptcy**

The bankruptcy can be ended in three ways:

1. annulment because of lack of assets, none of the creditors is paid. At most, the treasury and Industrial Insurance Board will receive something. The trustee's fee receives priority;
2. ending by settlement. During the creditors' meeting (verificatievergadering), the contents of the settlement conform the proposal of the trustee are discussed;
3. ending by liquidation. In this case there is a settlement, the trustee capitalises the assets and the proceeds are divided among the creditors.

Most bankruptcies end in annulment because of lack of assets. A legal entity ceases to exist, a natural person, however, can be summoned by his creditors for 30 years. Therefore an agreement with the creditors is better for a natural person. After the bankruptcy the creditors are no longer allowed to summon the debtor.

### **The creditors' meeting (Verificatievergadering)**

Only when the balance of debts and properties is enough to pay the creditors, will a creditors' meeting be held. Creditors submit their

claims with evidence on paper to the trustee, who will discuss them with the bankrupt. In this way a list of provisional and disputed claims is made and deposited for inspection by the court. During the meeting, only those creditors included on the list may speak. They may, as may the trustee, challenge the claims of other creditors. The Public Prosecutor tries to make the creditors come to an agreement, if he does not succeed, the court will decide. Claims that are not challenged, are recognised. During the meeting, claims that take priority will be recorded, the 'boedelcrediteuren' and preferential creditors (see above).

### **The settlement**

In case of a settlement, the creditors will settle for a partial or staggered payment of their claims. This is only possible after the inventory creditors ('boedelcrediteuren') and preferential creditors have been paid. A draft of the agreement is submitted for inspection before the meeting and the trustee notifies the creditors presenting a claim. It is also possible that the bankrupt puts the settlement forward during the meeting. The non-privileged creditors are allowed to vote on the settlement, absentees are regarded as dissentients. A majority of two-thirds of the creditors, representing three-quarter of all non-privileged creditors is a prerequisite. If the settlement is agreed on, the court has to homologate it. Once the settlement has been accepted the application for bankruptcy ends and no more claims may be made against the debtor. Creditors no longer have any claims. Most remarkable about a settlement is the fact that those who voted against the settlement are also committed, including the absentees.

### **Insolvency**

If no settlement is agreed on during the creditors' meeting, insolvency becomes a fact. The trustee sells the inventory and divides the proceeds among the creditors. After a distribution list is made up, bankruptcy ends. A bankrupt private limited company is dissolved; shareholders are liable only up to the amount of their shares, which they lose. A natural person is liable to receive claims for 30 years after the bankruptcy proceedings.

### **Preferential creditors (Separatisten)**

Preferential creditors are those creditors who are less concerned by the bankruptcy. They can try to cash their claim independently, and often have the means to do so. They are the mortgagee, the collateral holder and the credit-giver (for example the bank), who have as



collateral the stock and claims. The holder of the first mortgage has the right, to sell the real estate in public. If the proceeds exceed his claim, the rest goes to the bankrupt's estate. If the trustee agrees, the real estate can be sold privately.

### **The throughstart**

The 'throughstart' is a 'technical bankruptcy'<sup>1</sup> used for a limited liability company. An, in principal, sound enterprise goes bankrupt to restart on a reorganised financial basis and with a drastically reduced staff. The entrepreneur and his consultants are of the opinion that the economic activities of the firm are and can be profitable, but will lead to bankruptcy involving a socially unacceptable loss of capital and employment if continued without changes.

### **Recent developments**

Since 1 December 1998 a new law concerning debt restructuring of natural persons – including private persons and self employed – is in place. The judge can impose a debt restructuring schedule for debtor and creditors if no agreement about a voluntarily debt restructuring can be reached between debtor and creditors. This provides the debtor with more opportunities to start a new business venture after having settled a debt restructuring schedule.

## **4.2 Business failures and survival**

### **4.2.1 Business failures**

The number of bankruptcies has varied strongly in the course of time. The number of bankruptcies in 1993 and 1994 were almost double the number of 1990. The number of bankruptcies is related to the increasing number of enterprises and the state of the Dutch economy. The slowdown in the economy in 1992 and 1993 led – with a time lag – to a considerable increase in the number of bankruptcies. The number of bankruptcies per 10,000 enterprises also shows the volatility with a strong increase in the period from 1990 till 1993 and 1994 and a considerable decrease in the period afterwards. The average liability per bankrupt enterprise decreased considerably from f 808,000 in 1992 to f 688,000 in 1996. But one has to realise that these average liabilities can be notably different in certain years if one or a few bankruptcies involve very high liabilities.

The average debt after bankruptcy proceedings was almost f 623,000 in 1996. This means that only about 10% of the liabilities are paid off from the proceeds of the liquidation. There is quite a big difference

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<sup>1</sup> Mooyen, W.E., Doorstarten in en buiten faillissement, *Accountant-Adviseur*, nr. 5, May 1996.

between sole proprietors and legal entities. The average debt remaining after bankruptcy procedures was f 300,000 for sole proprietors and f 850,000 for legal entities. About 30% of the total bankrupt enterprises (including sole proprietors and legal entities) had less than f 100,000 debt remaining and more than 85% of the bankrupt enterprises had less than 1 million Guilders debt remaining.

A comparison between the situation in the Netherlands and the USA shows a similar pattern of increasing numbers of bankruptcies to the 1991 – 1993 period and a decrease in the later period. and one has to keep in mind that the economic slowdown in the USA took place in the 1990 – 1991 period. The number of failures in the USA also includes voluntary withdrawal with unpaid debts and receiverships and reorganisations. Furthermore, enterprises without employees are not included in the Small Business Administration database (e.g. Eurostat reports 22 million enterprise units in 1991 in the USA, but this figure represents the number of tax reporting units and an enterprise can make numerous tax returns if it has different subsidiaries, branch offices, establishments in other states, etc.). Therefore the number of failures per 10,000 enterprises in the Netherlands is not comparable with the USA. According to Dutch figures the number of enterprises without employees is about the same as the number of enterprises with employees. On the assumption of a number of enterprises about double in comparison with that of the SBA figures, it appears that the number of business failures in relation to the number of enterprises is lower in the USA than in the Netherlands. The average liability per failure is higher in the USA than in the Netherlands, and it should be mentioned that the figures vary more strongly in the USA in the course of time in comparison with the Dutch development.

Table 4.1 Number of bankruptcies in the Netherlands, 1990-1997

	Number of bankruptcies	Average liability per failure (guilders)*	Number of enterprises	Number of bankruptcies per 10,000 enterprises
1990	2,829		552,981	51
1991	3,397		568,829	60
1992	4,369	808,000	583,146	75
1993	5,512		595,888	93
1994	5,333	744,000	607,606	88
1995	4,783		615,922	78
1996	4,534	688,000	620,135	73
1997	4,413		646,260	68

\* This amount includes all liabilities before liquidation and the payment of debts from the proceeds.

Source: Central Bureau for Statistics.

## 4.2.2 Business failures by age cohort

Almost half of the bankruptcies are enterprises which have existed for less than 5 years (see table 4.1<sup>1</sup>). Quite a lot of bankruptcies consist of enterprises which did not survive the first three years. Altogether, about 70 % of the bankruptcies appear to be enterprises which are less than 10 years old.

In general it can be concluded that the differences in age cohorts is rather similar for the distinguished sectors. The sectors of hotels, restaurants and cafes, transport and communication and the sector of the so called other services have a relatively high share of bankruptcies in enterprises which are less than 3 years old. This observation is also valid for the period up to five years. These sectors have a pattern rather similar to that of other sectors when it comes to the share of bankruptcies of enterprises which have existed for more than 10 years.

Table 4.2 Proportion of bankruptcies by age cohort in the Netherlands in 1995 (%)

Age of business in years	Agriculture	Manu- facturing	Construction	Trade	Hotels, cafes and restaurants	Transport, and communication	Finance, insurance, real estate	Other services	Total
1 or less	2.2	4.8	3.6	5.6	5.7	6.2	2.9	5.6	4.6
2	8.9	9.7	11.6	10.5	12.6	13.3	9.7	15.0	10.8
3	14.4	11.0	10.8	13.1	16.7	13.8	11.4	11.9	12.4
<i>3 or less</i>	<i>25.5</i>	<i>25.5</i>	<i>26.0</i>	<i>29.2</i>	<i>35.0</i>	<i>33.3</i>	<i>24.0</i>	<i>32.0</i>	<i>27.8</i>
4	6.7	9.7	9.5	9.4	6.1	11.1	10.3	12.5	9.5
5	10.0	7.3	8.9	8.3	8.5	9.3	11.7	5.0	8.9
<i>5 or less</i>	<i>43.2</i>	<i>42.5</i>	<i>44.4</i>	<i>46.9</i>	<i>49.6</i>	<i>53.7</i>	<i>46.0</i>	<i>49.5</i>	<i>46.2</i>
6	15.6	6.8	8.6	6.4	7.7	8.0	9.1	6.3	7.7
7	6.7	7.3	5.3	5.2	3.7	4.4	7.5	5.0	5.8
8	5.6	4.6	3.4	4.3	2.8	6.7	5.4	1.9	4.5
9	1.1	4.4	2.5	4.8	3.7	0.4	4.5	4.4	3.9
10	3.3	2.6	3.4	3.3	2.4	1.3	2.7	5.0	3.0
<i>6 to 10</i>	<i>32.2</i>	<i>25.6</i>	<i>23.1</i>	<i>24.0</i>	<i>20.3</i>	<i>21.0</i>	<i>29.2</i>	<i>23.0</i>	<i>25.1</i>
<i>Over 10</i>	<i>25.6</i>	<i>31.9</i>	<i>32.5</i>	<i>29.1</i>	<i>30.1</i>	<i>25.3</i>	<i>24.8</i>	<i>27.5</i>	<i>28.7</i>

Source: Central Bureau for Statistics.

The Dutch pattern of bankruptcies by age cohort is rather similar to the situation in the USA. In the Netherlands there is a slightly higher share of bankruptcies in the age cohorts of 3 years or less and 5 years or less. In the Netherlands a smaller share of bankrupt enterprises are older than 10 years in comparison with the USA.

<sup>1</sup> The distribution in the table is based on the data from enterprises of which the age is known. For about 20% of the bankrupt enterprises the age cohort is unknown.

### 4.3 Obstacles to Post-Failure Entrepreneurial Activity

This section will pay attention to obstacles perceived by entrepreneurs trying to start again after business failure<sup>1</sup>. The term 'perceived by entrepreneurs' is related to the fact that the research and analysis is based on a survey among entrepreneurs. The survey was carried out among 600 entrepreneurs who had terminated their business. In this survey 69 entrepreneurs were included who had experienced bankruptcy. The analysis in this part is based on the responses of those 69 entrepreneurs.

One has to realise that this section pays attention to the results of a survey among Dutch entrepreneurs and that the questions raised in the survey were from a somewhat different nature than the investigation in the USA. Moreover, the American research on obstacles was mainly based on interviews with representatives of intermediary organisations. Therefore, a full fledged comparison between the Netherlands and the USA is not possible.

In 90% of the cases the entrepreneurs who went bankrupt perceived this as a (very) radical event. One third of the bankrupt entrepreneurs mentioned the debts and one fifth mentioned the loss of income as the most important factor which made the termination a radical event.

In 25% of the cases the social environment of bankrupt entrepreneurs reacted (very) negatively to the termination of the enterprise, in 30% of the cases it was neither negative nor positive and in 45% of the cases the reactions were positive.

More than 50% of the bankrupt entrepreneurs stated that it is difficult or very difficult to start again in the Netherlands after business failure. The existence of debts, difficult access to bank credit and the financial risks of entrepreneurship were mentioned by bankrupt entrepreneurs as factors for not starting an enterprise again. About 40% of the bankrupt entrepreneurs indicated that it was easy to start again after bankruptcy.

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1 The main source for this part are the results from a survey among entrepreneurs who started again after business failure. This information can be found in the publications: B&A Groep. *Klaar voor de herstart? – Onderzoek naar de omstandigheden van bedrijfsbeëindigers (Ready for the restart? – Research on the circumstances of business terminators*, The Hague, May 1998 and Economisch Bureau Ing. *Ondememers op herhaling (Entrepreneurs on retraining exercises)*, Amsterdam, 1998.

Next, a comparison is made between the obstacles experienced by entrepreneurs – who did start again after business failure – in starting their previous enterprise and their current enterprise. About half of the entrepreneurs indicate that they experienced no problems either when starting their current enterprise or their previous enterprise. Internal enterprise problems like finding customers, competition and administrative obstacles were less important in starting their current enterprise than in their previous enterprise. External factors like access to start capital and obstacles in legislation and procedures were more important in starting their current enterprise than in starting their previous enterprise.

Finally, a comparison is made between the situation in the USA and the Netherlands. It has to be kept in mind that the perception in the USA is based on information from intermediary organisations and in the Netherlands from entrepreneurs themselves. This certainly affects the tendencies and perceptions as presented here. It appears that individuals in the United States who have been declared bankrupt do not face unsurmountable obstacles when starting again. The available evidence suggests that there are few barriers of any great significance. The main obstacle is that those individuals will have restricted access to the first-tier market for loan capital and credit. In the American situation there is also some truth to the view that having experience of business failure is seen within certain circles as a positive factor if lessons have been learned as to what mistakes to avoid and how better to solve problems. In the majority of cases Dutch entrepreneurs who have experienced bankruptcy, state that it is difficult or very difficult to start again. Obstacles are the existence of debts, difficult access to bank credit and the financial risks of entrepreneurship. Nevertheless, 40% of the entrepreneurs indicated that it was easy to start again after bankruptcy. About 50% of those that actually started again indicated that they experienced no problems either at starting their current enterprise or at their previous enterprise. Where there were problems, external problems, like access to capital, were perceived as more important than internal problems when comparing starting their current enterprise and starting the previous business venture.

There are some important differences between the Netherlands and the USA when comparing the access to credit and access to venture capital:

- It seems that in general Dutch entrepreneurs who start again after business failure are not using the second-tier market for external financing of business ventures. Even if Dutch entrepreneurs are

interested in using the second-tier market, it seems that they will evaluate the second-tier market as too expensive, while his American colleague will evaluate it as an opportunity for financing his new business venture.

- Venture capital in the Netherlands is mainly focused on management-buy-out (or -in), expanding enterprises and certain sectors (e.g. high tech, IT, biotechnology). Venture capital funds are not very interested in providing equity capital to starting entrepreneurs. Therefore, access to venture capital is very difficult anyway for entrepreneurs who want to start again.

#### **4.4 Post-failure Start-Ups**

The survey mentioned previously among 69 entrepreneurs who went bankrupt indicates that 31% of those entrepreneurs actually started an enterprise again. Another 37% have stated that they have thought about it and/or think that they will try to set up a business again sometime in the future. This group is called potential restarters.

The restarters can be divided in two groups: the ones where only the enterprise went bankrupt and the ones who personally went bankrupt. About 40% of the entrepreneurs where only the enterprise went bankrupt started again and about 25% belong to the potential restarters. About 20% of the entrepreneurs started again after going personally bankrupt and about 40% are so called potential restarters. It seems that the Dutch entrepreneurs who start again a new business venture have learned from their previous experiences. They are more realistic and have a better perception about their possibilities and opportunities and also about the obstacles and constraints. They have also more experience with customers and suppliers and the potential for external financing of the business venture. In combination with the increased management experience and the prudential approach of the new business venture, this provides good possibilities for a more successful business venture than the previous one.

Comparing the survey results in the USA and the Netherlands a similar pattern can be observed. In both countries the survey results indicate that a considerable number of the entrepreneurs who went bankrupt did start a new enterprise again. In the Netherlands this percentage is 31%, but in the USA it is considerably higher at 47%. Both in the USA and the Netherlands the new enterprises were, in general, smaller than the previous enterprises which went bankrupt.

## **5 Conclusions**

This report explores various issues relating to business failure and entrepreneurship in European countries and in particular the Netherlands and the USA.

As far as bankruptcies and failures in European countries and the USA goes, the following conclusions can be drawn:

- The common conception that bankruptcies are weakly procyclical is supported by time series analysis over the 16-year period 1980-1995. The number of bankruptcies surges in a depression, with a one year lag, but does not fall back to its original level when the economy recovers. The current rise of bankruptcies is strongly correlated with the economic slowdown of the early 1990s. In the USA the surge in bankruptcies, with a one year time lag, in a period of serious economic slowdown is also evident. However, in the USA the number of bankruptcies related to the number of enterprises does fall back to the original level.
- Very small enterprises (i.e. those with up to 9 employees) are less bankruptcy-prone than larger enterprises.
- Businesses in which the owner is personally liable for all debts are less bankruptcy-prone than the rest.
- Statistically speaking, bankruptcies account for some 15% of closures. However the statistics on asset and job losses from bankruptcies are biased. They fail to capture job losses where workers were fired before the bankruptcy procedure commenced, and asset losses where claims were dropped because of asset-insufficiency.

The research in the USA leads to the following conclusions:

- Perhaps the most important finding of the research conducted was that persons who have a previous association with business failure in the United States are able, legally and practically, to start again within a relatively short period of time. Furthermore, evidence exists suggesting that a significant proportion of persons previously involved in a business that has failed – perhaps even a majority of such persons – do start again. These conclusions apply as much to sole proprietors and the self-employed as they do to persons who have had a previous association with limited partnerships or incorporated companies that failed.
- The factors that contribute to the observed picture are many and varied. The most significant are the legal framework, an absence of stigma relative to that which is often encountered in other

countries, the entrepreneurial spirit that prevails in the United States and ready access to a sub-prime lending and credit market. It should, however, be noted that the last of these four factors has a negative side. This relates to a risk of irresponsible borrowing and high interest rates for those who seek finance from this segment of the market. Indeed, high rates of interest charged by sub-prime lenders perhaps represent the most significant barrier to post-failure entrepreneurial activity.

Comparing the situation in the Netherlands and the USA concerning the issues related to bankruptcies and failures and obstacles for an entrepreneur to start again after business failure leads to the following conclusions:

- A comparison between the situation in the Netherlands and the USA shows a similar pattern of increasing numbers of bankruptcies in the 1991–1993 period and a decrease in the later period. and one has to keep in mind that the economic slowdown in the USA took place in the 1990–1991 period. It appears that the number of business failures related to the number of enterprises is lower in the USA than in the Netherlands. The average liability per failure is higher in the USA than in the Netherlands, and it has to be mentioned that the figures vary more strongly in the USA in the course of time in comparison with the Dutch development.
- The Dutch pattern of bankruptcies by age cohort is rather similar to the situation in the USA. In the Netherlands there is a slightly higher share of bankruptcies in the age cohorts of 3 years or less and 5 years or less. In the Netherlands a smaller share of bankrupt enterprises are older than 10 years in comparison with the USA.
- A comparison is made between the obstacles to post-failure entrepreneurial activity in the USA and the Netherlands. It appears that individuals in the United States who declared bankruptcy do not face unsurmountable obstacles when starting again. The main obstacle is that those individuals will have restricted access to the first-tier market for loan capital and credit. In the American situation there is also some truth in the view that having experience of business failure is seen within certain circles as a positive factor if lessons have been learned what mistakes to avoid and how better to solve problems. In the majority of cases Dutch entrepreneurs who have experienced bankruptcy, state that it is difficult or very difficult to start again. Obstacles are the existence of debts, difficult access to bank credit and the financial risks of entrepreneurship. Nevertheless, 40% of the entrepreneurs indicated that it was easy to start again after bankruptcy. About 50% of the ones



that actually started again indicated that they experienced no problems neither when starting their current enterprise nor in their previous enterprise. When there were problems, external problems like access to capital were perceived as more important than internal problems when comparing starting their current enterprise and the previous business venture.

- Comparing the survey results about post-failure start-ups in the USA and the Netherlands a similar pattern can be observed. In both countries the survey results indicate that a considerable number of the entrepreneurs who went bankrupt did start a new enterprise again. In the Netherlands this percentage is 31%, but it is considerably higher in the USA with 47%. Both in the USA and the Netherlands the new enterprises were in general smaller than the previous enterprises which had gone bankrupt.



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