AMERICAN BANKRUPTCY LAWS: Encouraging Risk-Taking and Entrepreneurship

Nathalie Martin

Business failure in the United States, unlike in many other countries, is not regarded negatively. In fact, U.S. bankruptcy laws are structured so that those who fail in business are encouraged to continue entrepreneurial pursuits. "If a business in the United States fails, the individual can move on with his or her life without living in shame or total poverty," the author writes. "The ability to start over is what makes some Americans willing to take risks in business, which can be good for the overall economy."

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An Illinois furniture store that filed a Chapter 11 bankruptcy petition.

The United States relies heavily on the use of credit by both individuals and businesses to fuel its economy. The country also has forgiving bankruptcy laws that protect individuals and businesses if they become financially insolvent. As such, these laws support capitalism and the growth of small businesses by encouraging people to take business risks.

For individuals, there are two main types of bankruptcy:

- One type, known as Chapter 7, allows people in financial trouble to "discharge"—be forgiven for—most debts for which there is no collateral (security). This type of bankruptcy does not help a person become current with secured debts, where the borrower has pledged some form of collateral, such as property.
- The second type, known as Chapter 13, allows people in financial trouble to pay back a portion of their debts through a payment plan extending over three to five years. At the end of the period, assuming the debtor has contributed all of his or her disposable income to the payment plan, the remaining debts are forgiven. This type can be used to pay off past-due secured debt and thus keep the collateral.

For businesses, the law is a bit different. Some can stay in business under Chapter 11 while they reorganize their debts. Thus, unlike most bankruptcy systems around the world, U.S. laws allow a bankrupt company to continue in operation, with the same management, while it tries to restructure its debts. In other words, typically, no trustee or custodian is appointed. Some people think this system, known as a debtor-in-possession system, promotes economic and job growth because more companies remain in business and their assets are protected. Businesses can also simply liquidate their assets under Chapter 7 and use the sale proceeds to pay creditors.

THE UNDERLYING PHILOSOPHY

The American economy is extremely vibrant and active. The more activity in the economy, the stronger the economy will be. The U.S. regulatory structure has been developed to encourage people to create businesses, with the hope that they will succeed, hire employees, pay taxes, and otherwise improve the economy as a whole. We acknowledge that in the process, some businesses will fail.

Thus, as a culture, we value a person's willingness to risk his or her job and money (and borrowed money, too) for the chance to succeed.

These ideas are not new. As a society, Americans have always encouraged economic activity through the extensive use of credit. As early as the 1700s, when the U.S. economy was competing with much more developed European economies, it grew faster than anyone could have imagined and quickly became the world's largest economy.

The extensive use of credit in the early U.S. economy was unique in the world, with some people being paid for goods and supplies months and even years after the credit was granted. This allowed people to start businesses without much money in their pockets. The availability of credit caused economic activity to soar, and a strong credit-based economy was born.

Having this much credit in the system had a downside as well. Some of the businesses failed. Even so, America was friendly to the capitalist spirit since its goal was to encourage people to take risks in business in order to fuel its young economy. A legal culture of tolerance of nonpayment developed that encouraged people to continue entrepreneurial pursuits, even if they had failed before.

The relative lenience of American bankruptcy law, as compared to the law on the European continent, shocked some people, including French philosopher Alexis de Tocqueville, who, in the early 1800s, commented on the "strange indulgence" shown to bankrupt companies in the American union. He claimed that in this respect, "the Americans differ not only from the nations of Europe, but from all the commercial nations of our time."

Modern Bankruptcy Laws in Practice

If a business in the United States fails, the individual undertaking it can move on with his or her life without living in shame or total poverty. This is more than just a nice theory.

Many of America's most successful businessmen failed in early business endeavors, including ketchup magnate John Henry Heinz, Henry Ford of Ford Motor Company, and Phineas Barnum, who founded the American circus. All of these men eventually became very rich, in part because they were given a chance to try a business, fail, and start over.

Small businesses in the United States are the driving force behind the economy, employing more people than

AP/Wide World Photo

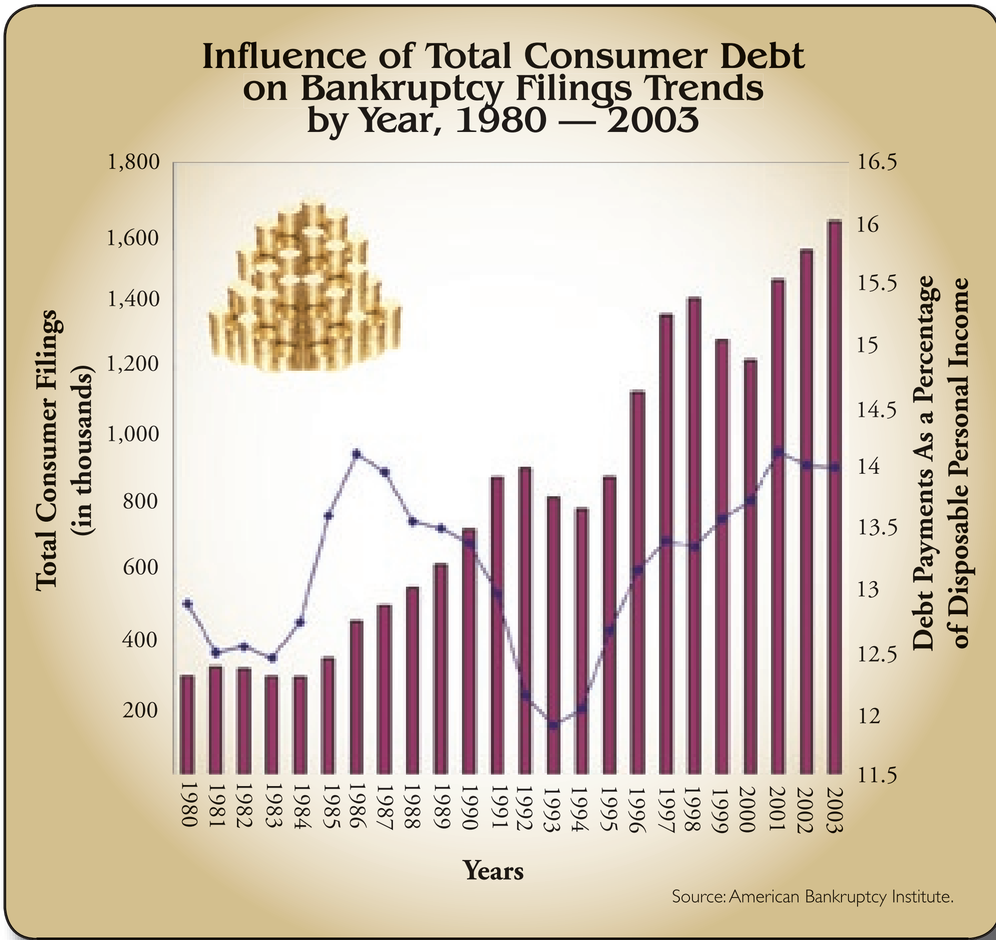
A photo film processing store going out of business in an economically depressed section of Pittsburgh, Pennsylvania.

do huge, multinational companies. The credit system and its counterpart, the bankruptcy system, clearly support small businesses and entrepreneurship. Yet the sheer amount of credit available in the United States is daunting by global standards, with many average Americans able to get credit of $50,000 or more from bank loans, credit cards, and other sources, even without posting collateral. Many new entrepreneurs start their businesses with money from these sources.

Many people outside the United States find the U.S. bankruptcy laws odd, in part because they are so different from the laws in their own countries. Debt is not easily forgiven in most parts of the world, and there often is a stigma associated with financial failure. In many parts of Europe, any business failure is viewed as an embarrassment, even if you work for someone else's business and it fails. Someone associated with a business failure may even have trouble finding another job. In some parts of the world, such as Japan, my research has found that the stigma from financial failure is strong enough to lead people to commit suicide.

Nevertheless, other countries—including Japan, Italy, France, the United Kingdom, and Germany—are starting to make their own laws more forgiving in order to promote entrepreneurialism and to fuel more active economies. In some places, lawmakers believe that a more forgiving bankruptcy system will save assets and fuel economies that are not growing quickly. Deflationary Japan is one example of a country attempting to use more forgiving bankruptcy laws to create more borrowing and more economic activity. Since most of these laws are quite new, it is not yet clear whether these changes will help promote small-business development. Sometimes, cultural factors might also keep people from availing themselves of these new, more forgiving laws.

There is much less stigma associated with a failed business in the United States. Some prospective employers might even consider an employee from a failed company to be more valuable because of the lessons learned at the prior job. Moreover, research shows that many U.S. owners who do well in business have failed in prior business ventures. The ability to start over is what makes some Americans willing to take risks in business, which can be good for the overall economy. The extensive availability of credit is also very helpful for the new entrepreneur.



The Economic Role of Consumer Debt

In addition to the debt Americans take on to start businesses, they also use credit to buy consumer items such as homes, cars, furniture, and clothing. Americans use credit cards rather than cash more frequently than people in other parts of the world. As a group, they also buy more consumer goods, even more than people living in other rich countries such as Japan and Canada. Maintaining a high level of consumer spending is great for the American economy, particularly when business spending is down.

However, U.S. bankruptcy laws are not as forgiving as they are for business for those individual consumers who use credit extensively to buy consumer goods. As the accompanying chart shows, there is a strong correlation between consumer debt and financial failure, and bankruptcy resulting from consumer spending.

Moreover, individuals who overextend themselves financially on consumer goods will find it harder to discharge their debts. This is the result of a recent change in U.S. consumer bankruptcy laws designed to reign in consumer spending.

A Final Word

Fueling an active economy in the United States can be seen almost as a civic duty. Taking on credit risks to start a business can provide great financial rewards. If the business does well, the entrepreneur will flourish. If it fails, the person will get a second chance. Taking on extensive consumer debt carries the same risks with almost none of the rewards. ■

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