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Does debtor protection really protect debtors? Evidence from the small business credit market

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ABSTRACT

This paper analyzes how different levels of debtor protection across US states affect small firms' access to credit, as well as the price and non-price terms of their loans. We use an individual-specific measure of debtor protection that has its maximum value when the borrower's home equity is lower than the state homestead exemption (the debtor's home equity is fully protected), and is decreasing in the difference between the home equity and the homestead exemption (the amount that the creditor can seize). We find that unlimited liability small businesses have lower access to credit in states with more debtor-friendly bankruptcy laws. In addition, these businesses face tighter loan terms – they are more likely to pledge business collateral, have shorter maturities, and borrow smaller amounts. For limited liability small businesses, we also find a reduction in credit availability, but of smaller magnitude, together with an increase in the loan rate.

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1. Introduction

Recent research points to the important role of creditor protection in determining the size and breadth of capital markets (e.g., La Porta et al., 1997, 1998; Djankov et al., 2003, 2007; Qian and Strahan, 2007; Davydenko and Franks, 2008). Poor creditor protection decreases firms' opportunities for external financing, which, in turn, hampers economic growth (King and Levine, 1993). While most of the recent empirical literature focuses on lending to large companies, the effect of creditor protection on bank lending to small businesses is largely unexplored. This is despite the fact that small businesses constitute a crucial sector of virtually all economies, contributing about half of private non-farm GDP and employment in the US.[1]

We try to help fill this void by exploiting the differences in US personal bankruptcy law across states. We study the effect of weak creditors' rights to seize borrowers' assets that are embedded in debtor protection laws on small firms' access to credit, and the price and non-price terms of their loans when they are able to obtain credit. While personal bankruptcy law is designed for consumers, it also affects unlimited liability firms (sole proprietorships and most partnerships) whose owners are legally liable for the firm's debts. To a lesser extent, it could also affect small limited liability firms (corporations and limited liability partnerships), as long as lenders require the owners of these firms to personally guarantee their firms' loans or these firms could transfer assets to their owners. For the sake of exposition, we will henceforth refer to the unlimited liability and limited liability groups as proprietorships and corporations, respectively.

Although federal law governs personal bankruptcy in the US, the states are allowed to adopt their own bankruptcy exemption levels. Debtors who file for personal bankruptcy under Chapter 7 (discussed below) must turn over any assets they own above a predetermined exemption level, but their future earnings are exempt from the obligation to repay, the so-called "fresh start" principle. A

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[1] The Small Business Administration (SBA) reports that of the 116.3 million non-farm private sector workers in 2005, small firms with fewer than 500 workers employed 58.6 million, while large firms employed 57.7 million.

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higher exemption level therefore provides partial wealth insurance to debtors, reducing the assets that the lender can seize in the event of bankruptcy.

Our focus is on the *ex ante* incentives introduced by bankruptcy exemptions. Exemptions should affect both the demand for and the supply of credit. As argued by Gropp et al. (1997), wealth insurance makes risk-averse borrowers better off, increasing the demand for credit. However on the supply side, because banks anticipate that exemptions increase the probability of default and the expected loss given default on a loan, higher exemption levels should lead to a retraction in credit supply. This retraction should then translate into tighter loan contract terms, such as higher rates, smaller credit amounts, and/or shorter maturity, and may result in credit rationing. To some degree, the higher exemption levels may be offset by the pledging of collateral, given that the exemptions do not apply to secured assets.

We investigate these issues using confidential data from the Surveys of Small Business Finances (SSBF). We include data from the 1993, 1998, and 2003 waves in our descriptive statistics and univariate tests. However, for our regressions, we restrict the sample to the last two waves, because one key variable in our analysis, the home equity of the firm's owner, and one important control variable, the owner's net worth sans home, are not available for the 1993 Survey. The Surveys contain detailed information on whether and when the firm obtained credit, the contract features of the most recent loan obtained by the firm if credit was granted, as well as detailed firm and owner characteristics. We supplement these data with state-level control variables that may be correlated with state exemptions, allowing us to better identify the effect of the exemptions. We employ two main measures of debtor protection. The first measure is the homestead exemption in the state in which the firm is located. This is the maximum home equity value that a debtor can exempt when filing for personal bankruptcy. The second, our preferred measure, is a borrower-specific variable that also takes into account the value of the home equity of the firm owner. This measure has its maximum value when the home equity amount is lower than the exemption (the debtor's home equity is fully protected), and is decreasing in the difference between the home equity value and the exemption (the amount of home equity that the creditor can seize). Because it measures the home equity value that is shielded from creditors under the bankruptcy law, this measure delves directly into the agency problems associated with the bankruptcy law, and allows for a sharper test of the main hypothesis.

We report several empirical results. First, we find that increased debtor protection is associated with a significantly higher probability that a proprietorship is denied credit or is discouraged from borrowing. This effect is economically significant – the probability of being denied or discouraged from borrowing increases by about 12 percentage points for a firm located in a state with the highest exemption level (the debtor's home equity is fully protected) compared to a firm located in a state with zero exemption (the debtor's home equity is totally unprotected). Moreover, proprietorships borrow significantly smaller amounts in high-exemption states. We also find that the pool of borrowing proprietorships is significantly less risky (i.e., has higher credit scores) than non-borrowing proprietorships in high-exemption states, while these two groups do not show any significant difference in terms of credit score in low exemption states, suggesting that credit is less available for riskier firms in high-exemption states.

Second, while high levels of debtor protection seem to be associated with only marginally higher interest rates, more debtor protection appears to considerably tighten non-price terms for the proprietorships that do receive credit. Specifically, these firms' loans have significantly shorter maturities and are significantly more likely to be secured by business assets in high-exemption states. The data suggest that moving from a state with zero exemption to a state with unlimited exemption increases the probability that a median firm pledges business collateral by 13 percentage points and decreases average loan maturity by 19%. This result suggests that exemptions may be especially harmful for R&D-intensive firms that lack tangible assets that can serve as collateral.

Importantly, the results from our preferred measure indicate that both the decrease in credit availability and the tightening of credit terms induced by high-exemptions are particularly acute for business owners with low home equity values. We note that our results hold after controlling for other state-level characteristics (such as the median state income), type of lender, and potential selection effects, leading us to conclude that exemptions reduce the supply of credit to proprietorships.

For the corporations, we find significantly weaker effects. There is, nevertheless, some evidence of a small reduction in access to credit and increase in interest rates for this group of firms.

These results have important policy implications. High levels of debtor protection seem to distort the legal purposes of the unlimited liability company form, since debtors are in practice not fully personally liable for their firm's debts. The institutional framework may prevent some of these small firms from pre-committing to harsh penalties, limiting their access to credit and making the non-price terms of their loan contracts tighter. We finally note that the effects of debtor protection highlighted in our paper have not been addressed by the reform to the personal bankruptcy law that was passed in 2005, which specifically excludes small business owners as long as their debts are mainly business debts.[2,3]

The paper proceeds as follows. Section 2 gives a very brief literature review and Section 3 details the institutional background of bankruptcy law in the US. Section 4 describes the data set, the empirical methodology, and the variables used in the analysis. Section 5 presents the results and Section 6 provides some robustness tests. Section 7 concludes.

2. Literature review

Our paper contributes to the growing literature that shows that the strength and enforcement of creditors' rights improves the functioning of credit markets (e.g., La Porta et al., 1997, 1998; Djankov et al., 2003; Esty and Megginson, 2003; Djankov et al., 2007; Qian and Strahan, 2007; Davydenko and Franks, 2008).

Our paper is also related to the literature focusing on how differences in bankruptcy exemption levels affect household credit. For example, Fay et al. (2002) find that the probability of filing for bankruptcy increases with the financial benefit of filing (i.e., the debt discharged minus the value of non-exempt assets). Consistent with this result, Gropp et al. (1997) find that state bankruptcy exemptions have a positive effect on the probability that households will be turned down for credit or discouraged from borrowing. They also find that generous exemptions redistribute credit from low-asset borrowers towards borrowers with high assets. Finally, Berkowitz and Hynes (1999) and Lin and White (2001) study whether exemptions affect secured lending, specifically mortgages. Their results are mixed. While Berkowitz and Hynes (1999) find that exemptions have neither increased mortgage rates nor the probability of being denied a mortgage, Lin and White

[2] Bankruptcy Abuse Prevention and Consumer Protection Act 2005, effective since October 17, 2005.

[3] However, we should note that state governments may benefit. They may spend less in state-supported welfare programs, given that individuals that go bankrupt and file for Chapter 7 will not only have their future earnings exempt from the obligation to repay, but will also keep some of their wealth. We thank an anonymous referee for suggesting this additional perspective.

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