

BANKRUPTCY LAWS AND ENTREPRENEUR-FRIENDLINESS

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[Abstract]

Using bankruptcy laws as a case of formal institutions, we show how formal institutions impact entrepreneurship development. Historically, bankruptcy laws have been usually harsh. Recently, many governments have realized that entrepreneur-friendly bankruptcy laws can not only lower exit barriers, but also lower entry barriers for entrepreneurs. Since bankruptcy laws are not uniform around the world, it is important to understand how they differ in their friendliness to entrepreneurs. This article focuses on six dimensions of entrepreneur-friendliness: (1) the availability of a reorganization bankruptcy option, (2) the time spent on bankruptcy procedures, (3) the cost of bankruptcy procedures, (4) the opportunity to have a fresh start in liquidation bankruptcy, (5) the opportunity to have an automatic stay of assets during reorganization bankruptcy, and (6) the opportunity for entrepreneurs and managers to remain on the job after filing for bankruptcy. In an effort to cover both developed and emerging economies and to draw on geographically diversified examples, we use data from Australia, Canada, Chile, Finland, Hong Kong, Japan, Norway, Peru, Singapore, South Korea, Thailand, the United States, and other countries to illustrate these differences. Overall, this article contributes to the institution-based view of entrepreneurship by highlighting the important role that formal institutions such as bankruptcy laws play behind entrepreneurship development around the world.

In entrepreneurship practice and research, institutions matter (Baumol, 1996; North, 1990; Scott, 1995; Yamakawa, Peng, & Deeds, 2008). Market-friendly institutions generally facilitate more vibrant entrepreneurship development, which, in the aggregate, would translate into economic development (Baumol, 1996; North, 1990). Moving from this widely accepted and thus uncontroversial proposition that institutions matter, the next generation of research on the institution-based view of entrepreneurship needs to probe into *how* institutions matter (Peng, 2003; Peng, Lee, & Wang, 2005; Peng, Wang, & Jiang, 2008). Following Lee, Peng, and Barney (2007), we argue that whether bankruptcy laws are entrepreneur-friendly has a direct bearing on the level of entrepreneurship development at the societal level.¹ Specifically, this article focuses on the impact of corporate bankruptcy laws (hereafter labeled “bankruptcy laws” for compositional simplicity)—a crucial formal institution governing the insolvency of entrepreneurial firms that has been largely neglected in entrepreneurship research.²

Starting up an entrepreneurial firm is a risky and uncertain endeavor that has very strong likelihood of ending in bankruptcy. While the small number of successful entrepreneurs and their firms receive disproportionate scholarly and media attention, a sad and predictable fact is that a *majority* of entrepreneurial firms end up in bankruptcy.³ Given that most governments encourage

¹ Our focus is on productive (not unproductive or destructive) entrepreneurship (Baumol, 1996). While a majority of unproductive and destructive entrepreneurship is active in the underground economy, we argue that more lenient bankruptcy laws would provide more incentives to firms to use formal bankruptcy laws. Given that using formal procedures of bankruptcy processes would require firms to engage in legal business, it is likely that unproductive and destructive entrepreneurship would be discouraged should a country make bankruptcy laws more friendlier to entrepreneurs.

² Although personal bankruptcy laws may also affect entrepreneurship development (Armour & Cumming, 2008; Ayotte, 2007), we do not deal with personal bankruptcy laws in this article.

³ While we acknowledge that “bankruptcy” and “failure” can be two different concepts, we focus specifically on the former, and not the latter. One can argue that many young and small firms just disappear without going through the formal process of bankruptcy and that many more established and larger firms formally declare bankruptcy. However, studies have shown that, for example, among U.S. firms that filed bankruptcy, nearly 60 percent of them were less than five years of age (White, 1990). Nearly 90 percent of bankrupt U.S. firms employed fewer than 20 employees and had under \$1 million in assets (Warren & Westbrook, 1999). Thus, more younger and smaller firms are going through the formal

more entrepreneurial start-ups and that most such start-ups fail, societies that are friendlier and more forgiving to failed entrepreneurs are likely to attract more individuals to start up new ventures and to have stronger economic development that comes with vibrant entrepreneurial activities. Conversely, societies that are harsher to failed entrepreneurs whose start-ups end up in bankruptcy will discourage entrepreneurship development. Therefore, in the context of bankruptcy laws, we define “entrepreneur-friendliness” as bankruptcy laws’ disposition to be friendly, helpful, and forgiving to entrepreneurs whose firms are bankrupt.

Historically, entrepreneur-friendliness and bankruptcy laws are like an “oxymoron,” because bankruptcy laws are usually harsh and even cruel. The very term “bankruptcy” is derived from a harsh practice: In medieval Italy, if bankrupt entrepreneurs did not pay their debt, debtors would destroy the trading bench of the bankrupt—the Italian word for broken bench, “banca rotta,” has evolved to become the English word “bankruptcy.” The pound of flesh demanded by the creditor in Shakespeare’s *The Merchant of Venice* is only a slight exaggeration. The world’s first bankruptcy law, passed in England in 1542, considered a bankrupt individual a criminal and punishments ranged from incarceration in prison to death sentence (bankruptcydata.com, 2008).

Around the world, being entrepreneur-friendly is a relatively new concept in bankruptcy lawmaking, which is in radical contrast with traditional bankruptcy laws and practices that generally favored the creditor and were harsh toward the bankrupt (Halliday & Carruthers, 2007). Recently, many governments around the world have increasingly realized that entrepreneur-friendly bankruptcy laws can not only lower exit barriers, but also lower entry barriers for entrepreneurs. The central question that we address in this article is: How do bankruptcy laws around the world differ in their friendliness to entrepreneurs? In an effort to

bankruptcy procedures than more established and larger firms, thus justifying our focus on the impact of bankruptcy laws on smaller, entrepreneurial firms.

cover both developed and emerging economies and to draw on geographically diversified examples, we use data from Australia, Canada, Chile, Finland, Hong Kong, Japan, Norway, Peru, Singapore, South Korea, Thailand, the United States, and other countries to illustrate these differences. Overall, this article contributes to the institution-based view of entrepreneurship by highlighting the crucial role that formal institutions such as bankruptcy laws play behind entrepreneurship development around the world. In other words, to facilitate entrepreneurship development, formal institutions not only need to help facilitate more entrepreneurial entries, but also need to reduce the pain associated with bankruptcies in order to facilitate less painful exits.

BANKRUPTCY LAWS AS FORMAL RULES OF THE GAME

As “rules of the game,” institutions have two broad categories: formal and informal institutions (North, 1990).⁴ Of course, entrepreneurship is driven by a combination of formal and informal rules of the game. A substantial body of research has focused on the informal norms and cognitions exhibited by entrepreneurs, such as the urge for action, the fuel to take risk, and the drive to succeed (Mitchell et al., 2002; Yamakawa, Peng, & Deeds, 2009). A relatively smaller body of entrepreneurship research has dealt with formal rules of the game, by concentrating mostly on the impact of lowering *entry* barriers such as providing more loans (Le, Venkatesh, & Nguyen, 2006) and reducing tax rates (Bruce & Moshin, 2006). Little research in the entrepreneurship literature has examined *exit* barriers such as bankruptcy laws.

As a formal institution governing corporate insolvency, bankruptcy laws represent “rules of the *end* game.” By lowering *exit* barriers, entrepreneur-friendly bankruptcy laws can curtail downside losses of entrepreneurial failures. Moreover, by imposing relatively less painful and

⁴ There are two schools of thoughts on institutional theory—a more economic angle starting from North (1990) and a more sociological one stemming from Scott (1995). In this article, we follow the economic angle and focus more on formal institutions represented by bankruptcy laws. For a more integrative approach, see Peng, Sun, Pinkham, and Chen (2009).

less costly procedures, entrepreneur-friendly bankruptcy laws also lower *entry* barriers. This is because more would-be entrepreneurs may be attracted to join the start-up game if they feel the cost of bankruptcy is not prohibitive (Lee et al., 2007).

Governments interested in economic development need to encourage more entrepreneurial start-ups, each of which can be viewed as an experiment or a real option for the society (Lee et al., 2007). While it is long known that some start-ups will succeed and a majority will fail, it is virtually impossible to predict *a priori* which ones will succeed and which ones will fail. Therefore, it is imperative to encourage more entrepreneurs to experiment with their ideas in a friendlier institutional framework (North, 1990). While efforts to make the environment more entrepreneur-friendly can be undertaken along informal and formal dimensions, it is relatively more difficult, challenging, and time-consuming to change the informal aspects affecting entrepreneurship. For example, it is difficult to transform a culture known to be risk averse and avoid uncertainty to generate a large number of entrepreneurial start-ups in a short span of time (Hofstede, 2007; North, 1990). Therefore, countries seeking to encourage more entrepreneurship may see a more immediate impact by adjusting their bankruptcy laws to reduce the cost and pain associated with bankruptcy (Halliday & Carruthers, 2007). For example, Lim and Hahn (2003) show that bankruptcy reforms in South Korea after the 1997 economic crisis *quickly* contributed to productivity growth by allowing inefficient firms to exit, encouraging new entries, and stimulating surviving firms to become more efficient.

DIMENSIONS OF BANKRUPTCY LAWS' ENTREPRENEUR-FRIENDLINESS

The purpose of bankruptcy laws is to resolve conflicts among a firm's stakeholders—in particular, creditors, owners (entrepreneurs in the case of entrepreneurial start-ups), managers, employees, and tax authorities—when a firm is financially insolvent (Jackson, 1986; Longhofer

& Peters, 2004). Literally “stakeholders,” all these parties have significant economic interests at stake. Bankruptcy laws ensure an orderly process in terms of who gets what of the remaining assets (Halliday & Carruthers, 2007). Whether the process is fair or equitable is a point of contention, depending on one’s point of view. For example, bankruptcy laws more forgiving to bankrupt entrepreneurs may be viewed as “unfair” by creditors. *From an entrepreneur’s viewpoint*, we suggest in Figure 1 that bankruptcy laws differ along six dimensions in terms of their entrepreneur-friendliness. These six dimensions are drawn from Lee et al. (2007) as well as from Claessens and Klapper (2005), *Doing Business Report 2008* (2008), La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998), and Lee, Yamakawa, Peng, and Barney (2008). They are (1) the availability of a reorganization bankruptcy option, (2) the time spent on bankruptcy procedures, (3) the cost of bankruptcy procedures, (4) the opportunity to have a fresh start in liquidation bankruptcy, (5) the opportunity to have an automatic stay of assets during reorganization bankruptcy, and (6) the opportunity for entrepreneurs and managers to remain on the job after filing for bankruptcy.

[Insert Figure 1 here]

Extending previous work, we have amassed a database that enables us to draw examples from around the world to illustrate the differences along these six dimensions (Table 1). The country examples in this article are chosen (1) to highlight the variances along a single dimension and (2) to be geographically diverse around the world. We have endeavored to include both developed and emerging economies, and to cover major continents (Asia, Australasia, Europe, North America, and South America). Each pair of two countries chosen for one dimension represents the maximum and minimal levels for that dimension. Numerous other country examples can certainly be chosen. However, a practical constraint is that we prefer to cover countries with no missing data on any of the six dimensions. Because Table 1 also reports

new firm formation (the ratio of new firms to the total number of firms in one country) as an admittedly crude but informative measure of entrepreneurship development at the country level (Lee et al., 2008), we only include countries where we can obtain data on new firm formation.

[Insert Table 1 here]

Availability of a Reorganization Bankruptcy Option: The United States versus Finland

Bankruptcy laws traditionally focus on liquidation, by dismembering the firm and selling its assets to repay creditors—in the same spirit of breaking bankrupt merchants’ trading bench in medieval Italy. More entrepreneur-friendly bankruptcy laws in some countries allow for a second option: Reorganization, which gives a firm certain legal protection while it sheds some debt and reorganizes in order to compete more effectively. Known as Chapter 11 in the United States, such reorganization may enable some firms, which are in temporary financial distress, to eventually become successful. Not all countries have reorganization as a bankruptcy option. For instance, bankruptcy laws in Finland do not have an option for reorganization bankruptcy and bankrupt entrepreneurial firms are thus forced to liquidate immediately.

Clearly, providing an opportunity for bankrupt firms to reorganize is more entrepreneur-friendly than forcing them to liquidate. Note that providing this option deviates from the norms of traditional bankruptcy laws that were typically harsh on the bankrupt. In the United States, the Bankruptcy Act of 1898 was the first to give firms in distress some protection from creditors (bankruptcydata.com, 2008). The widely used Chapter 11 reorganization was enacted by the Bankruptcy Reform Act of 1978 that took effect on October 1, 1979.

The post-1979 entrepreneurship development in the United States has been enviable. That is why there is a recent global trend to add the U.S. Chapter 11-type reorganization bankruptcy as one of the choices for bankrupt firms in many countries such as Argentina, Australia, Great Britain, Indonesia, South Korea, and Thailand (Halliday & Carruthers, 2007). Most recently, as

of June 2007, China reformed its bankruptcy laws to allow for the reorganization option that had not existed before (Kargman, 2007).

Time Spent on Bankruptcy Procedures: Singapore versus Chile

The cost of bankruptcy is positively related to the length of time spent on bankruptcy procedures (Bebchuk, 2000). In a liquidation bankruptcy, a fast procedure allows the quick reallocation of assets of failed firms to better uses. At the same time, a fast procedure can provide entrepreneurs the opportunities to start up a new business.

If a firm files reorganization bankruptcy (such as Chapter 11 in the United States), a fast procedure may protect the value of the assets of the firm and improve its chance for an eventually successful turnaround (Bebchuk, 2000). A lengthy process characterized by an uncertain outcome, however, may make business partners (such as buyers and sellers) reluctant to maintain their business relationships. This in turn may reduce earnings and the value of firm assets (LoPucki & Doherty, 2002). One recent study drawing on data from 88 countries finds that on average 48 percent of the firm value is lost during the typically lengthy bankruptcy process (Djankov, Hart, McLiesch, & Shleifer, 2008).

Managers are likely to become frustrated with the long bankruptcy procedure, which distracts them from focusing on more important operations. An inefficient, time-consuming procedure may end up forcing a firm to liquidate by increasing financial distress while a fast procedure could have saved the firm. In Singapore, it only takes about ten *months* to go through bankruptcy. In contrast, in Chile, it takes 4.5 *years* to go through the process. A longer time spent in the liquidation bankruptcy also means that the resources will not be put to better use in a timely manner, which in turn will slow entrepreneurship development at the societal level.

In Japan, even when financially insolvent firms decide to file for bankruptcy, courts will scrutinize the case and decide whether to allow certain firms to declare themselves bankrupt. In

other words, some insolvent firms are *not* allowed to go bankrupt. This procedure alone takes more than three months (Alexander, 1999). It is, therefore, not surprising that in Japan, half of all liquidations took more than three years and more than 75 percent of reorganizations exceeded five years from application to conclusion (Alexander, 1999). Obviously, failed entrepreneurs stuck with existing firms going through a lengthy bankruptcy procedure are not in a position to start new firms (Harada, 2005). Overall, a more efficient bankruptcy procedure may encourage more entry of new firms—in Silicon Valley, this is known as the motto of “fail fast, fail cheap, and move on” (Saxenian, 1994). In this spirit, Mexico reformed its bankruptcy laws since 2000, significantly shortening the average bankruptcy process from 7.8 to 2.3 years (Gamboa-Cavazos & Schneider, 2007).

Cost of Bankruptcy Procedures: Norway versus Thailand

The actual cost involved in filing bankruptcy can also be intimidating. One may think that the direct cost of bankruptcy is not very high. This indeed is the case for Norway, where the direct cost of bankruptcy is only 1 percent of the value of the assets of the firm. However, around the world, this is clearly not the norm. In Thailand, bankruptcy costs 36 percent of the value of the assets of the firm. In comparison, the United States is in the midrange between these two extremes. The direct cost is approximately 7 percent of the assets of the average U.S. firm.

These data underscore Mason’s (2005: 1523) argument that costly bankruptcy “can cause sluggish economic growth.” In other words, high bankruptcy cost may provide incentives for firms to delay filing bankruptcies even when, at the societal level, it may be more valuable for them to go bankrupt so that resources and employees can be channeled to more productive use. Also, when the cost associated with bankruptcy is high, some entrepreneurs may be discouraged to start businesses in the first place.

Fresh Start in Liquidation Bankruptcy: Peru versus Japan

Bankruptcy laws can either discharge bankrupt individuals from debt or allow the pursuit of the bankrupt entrepreneurs for years. By discharging bankrupt entrepreneurs, while creditors can claim residual assets, they cannot pursue any remaining claims. Since an entrepreneur's future earnings are exempt from the obligations to repay past debt from bankruptcy, the entrepreneur is given a "fresh start" (Ayotte, 2007). In the absence of a legally protected "fresh start," creditors can pursue any remaining claims, at least for some defined period of time. In Germany, until the recent bankruptcy law reforms (Armour & Cumming, 2008), the debtor would remain liable for unpaid debt for up to 30 years and creditors could go beyond claiming residual assets (Ziechmann, 1997: 12-25). German managers at bankrupt firms could also be personally liable for criminal penalties. It is not surprising that such differences in limiting downside losses can make a huge difference in the risk-taking propensity between American and German entrepreneurs.⁵

Internationally, Peru stands out as one of the most entrepreneur-friendly countries on this dimension, because entrepreneurs can walk away with 75 percent of their debt. In contrast, Japan only allows its bankrupt entrepreneurs to discharge less than one-tenth of their debt and allows creditors to recover more than 90 percent of the debt.

Automatic Stay of Assets in Reorganization Bankruptcy: Canada versus Hong Kong

In some countries, bankruptcy laws may come with an automatic stay of assets and discharge some portion of debt. An automatic stay upon the start of bankruptcy proceedings means that creditors must cease debt collection efforts and move claims to the court. The firm would continue to operate while creditors and firms negotiate. Before deciding whether the firm should be liquidated or not, an automatic stay of assets allows time for managers to communicate

⁵ In 2003, the European Commission recommended the ready availability of a "fresh start" through personal bankruptcy laws to foster entrepreneurship (Armour & Cumming, 2008). Moreover, a number of European countries (e.g., Germany, the Netherlands, and the UK) have recently increased the forgivingness of their bankruptcy laws centered on the notion of fresh start.

with creditors (Franks, Nyborg, & Torous, 1996). La Porta et al. (1998) find that nearly half of the 49 countries they study do not have an automatic stay of assets. While an automatic stay is allowed in Canada, the United States, and other countries in the case of reorganization bankruptcy, it is not guaranteed in countries such as Hong Kong and South Korea.

In an economy where secured creditors are allowed to repossess their assets when a firm files reorganization bankruptcy, it can end up in premature liquidations. Given uncertainty over the future potential of the firm, even when the value of the ongoing concern is higher than liquidation value, some creditors may have a greater interest in liquidating the firm. In Hong Kong, for example, an automatic stay of assets does not extend to secured creditors and these secured creditors thus have incentives to pursue liquidation bankruptcy. Therefore, when an automatic stay is not in place, many firms do not have the opportunity to file a reorganization bankruptcy even when this option is legally allowed. When entrepreneurs know that they would not be given a second chance when their firms are undergoing difficulty, some of them would be discouraged to start new businesses in the first place.

The Fate of Entrepreneurs and Managers: Australia versus South Korea

Entrepreneurs and managers make firm-specific investments. This firm-specific knowledge would be most required when a firm is in financial distress. However, if entrepreneurs and managers are going to be driven out when a firm files reorganization bankruptcy, they may lack incentives to make firm-specific investments in the first place. If entrepreneurs and managers know *ex ante* that they will not be automatically replaced in the case of bankruptcy filing, however, the opportunity to stay with the firm thus works as a “bonding device” (Gaston, 1997). Therefore, when a firm files bankruptcy, offering an opportunity for entrepreneurs and managers to stay may provide them with a better fighting chance to revive the

firm. For example, bankrupt entrepreneurs and managers in Australia are *automatically* granted rights to stay on the job.

Conversely, in South Korea, bankrupt entrepreneurs and managers are fired and replaced. However, in a manager-replacement system such as a trustee-appointment system, appointing outsiders without firm-specific knowledge for reorganization may end up with improper reorganization (Alexander, 1999). For example, Chapter 11 in the United States allows entrepreneurs and managers to retain control of the firm and provides them the exclusive right to propose reorganization plans. In contrast, in Japan, control rights are rendered to secured creditors (Franks et al., 1996). It is not surprising that the practice of allowing secured creditors to take over has been criticized for causing premature liquidation. Thus, in turn, when entrepreneurs and managers know that they would not be given a second chance to revive their firms under difficulty, some of them may be discouraged to start new businesses in the first place. On the other hand, when entrepreneurs are given opportunities to stay on the job and work on the revival of their troubled firms, they may be more willing to take risk and start businesses.

DISCUSSION

Contributions and Policy Implications

This article has contributed to the institution-based view of entrepreneurship by using bankruptcy laws as a case of formal institutions to demonstrate *how* institutions matter. Given that entrepreneurs rationally respond to the incentives and constraints provided by an institutional framework (Baumol, 1996; Lee et al., 2007, 2008; North, 1990; Peng et al., 2008, 2009; Peng & Khoury, 2008; Yamakawa et al., 2008), it seems that making bankruptcy laws more entrepreneur-friendly may stimulate more entrepreneurial activity—as shown by data on new firm formation in Table 1.

Although management and entrepreneurship research rarely engages in public policy issues (a tendency critiqued by Barney [2005] and Peng et al. [2009]), the public policy implications of our research are clear.⁶ Our central policy advice is that to the extent that governments are interested in attracting more entrepreneurs to start up firms, they are advised to make bankruptcy laws more entrepreneur-friendly, along the six dimensions we have discussed. For example, Armour and Cumming (2006) find that entrepreneur-friendly bankruptcy laws stimulate entrepreneurial demand for venture capital that funds risky ventures. Using data from 33 countries, Lee et al. (2008) report that in a typical country, (1) reducing the time spent on bankruptcy from 1.9 years to 0.4 year leads to a 13 percent increase in new start-ups, and (2) allowing incumbent managers to stay on the job (as opposed to firing them and replacing them with outside trustees) is associated with a 11 percent increase in new start-ups.

Overall, these are non-trivial policy instruments that governments can implement and manipulate to stimulate more entrepreneurship. In emerging economies in particular, more modern and more entrepreneur-friendly bankruptcy laws can give parties greater confidence in the legal framework that underlies lending and investment decisions, including decisions by foreign venture capitalists to invest in entrepreneurial start-ups in a particular country (Ahlstrom, Bruton, & Yeh, 2007; Kargman, 2007; Le et al., 2006; Lu & Hwang, 2009; Wright, 2007; Yamakawa et al., 2008; Yang & Li, 2008).

In addition, it is important to note that we are advocating more entrepreneur-friendly bankruptcy laws, but we are not calling for totally *painless* bankruptcy laws. More entrepreneur-friendly bankruptcy laws are simply less painful bankruptcy laws, and bankrupt entrepreneurs still have to painfully endure a significant amount of financial and reputation losses, as well as a

⁶ This point is underscored by the fact that a longer manuscript of this research, upon which the present article is derived, received the US Small Business Administration Office of Advocacy Best Paper Award for a Babson Conference paper “exploring the importance of small businesses to the US economy and public policy issues of importance to the entrepreneurial community” at the 2008 Babson Conference.

high degree of stigma (Shepherd, 2003). Given the inevitable risk and uncertainty associated with entrepreneurship, reasonable reduction of such risk, in this case through more entrepreneur-friendly bankruptcy laws, is likely to be beneficial.

A Future Research Agenda

For entrepreneurship researchers, this article merely scratches the surface of a promising research agenda that may yield large dividends in future work. Focusing on and testing the impact of each of the six dimensions longitudinally and across a large number of countries will be an obvious first step (Lee et al., 2007, 2008). More detailed, clinical studies focusing on the bankruptcy process and its evolution in one country (such as the study by Gamboa-Cavazos & Schneider [2007] on Mexico) will shed additional light beyond what can be obtained by more global, cross-sectional studies that, of necessity, will be unable to investigate country-specific nuances. Not necessarily limited to the six dimensions discussed in this article, future research can also investigate the impact of *other* dimensions as specified by various bankruptcy laws.

While scholars interested in advancing the institution-based view of entrepreneurship are naturally interested in isolating the impact of specific mechanisms of formal as well as informal institutions on entrepreneurial behavior and performance (Peng et al., 2009), De Soto (2003) reminds us that it is not just piece-meal development of specific institutions that make entrepreneurs to take risk and start up new businesses. Rather, it is well-rounded overall development of the institutions that stimulates entrepreneurship. There are significant problems associated with piece-meal development of institutions in many emerging economies (Puffer & McCarthy, 2007). But the same problem was the source of pain for many developed countries in the past. In his own words, De Soto (2003: 9) argues:

But it is not only former communist and Third World countries that have suffered all of these problems. The same was true of the United States in 1783, President George Washington complained about “banditti ... skimming and disposing of

the cream of the country at the expense of the many.” These “banditti” were squatters and small illegal entrepreneurs occupying lands they did not own. For the next hundred years, such squatters battled for legal rights to their land and miners warred over their claims because ownership laws differed from town to town and camp to camp. Enforcing property rights created such a quagmire of social unrest and antagonism throughout the young United States that the Chief Justice of the Supreme Court, Joseph Story, wondered in 1820, whether lawyers would even be able to settle them.

For this reason, we will have to exercise caution in judging the impact of improving bankruptcy laws in different countries. While it is advised to make bankruptcy laws more lenient to encourage entrepreneurship development, if other institutions that help entrepreneurial success were not in place, the effect of the improvement of bankruptcy laws may not be meaningful. For example, even when an entrepreneur sees starting a new business as a lucrative option due to more lenient bankruptcy laws, should financial institutions in the country be underdeveloped, it is not going to be easy for the entrepreneur to fully appreciate the benefits of lenient bankruptcy laws. Thus, from the standpoint of an entrepreneur contemplating to start a new business, a lenient bankruptcy law not accompanied with sound financial institutions may not look as lucrative as it should be. Therefore, future studies will need to examine how other formal and informal institutions—individually and in combination—affect the effectiveness of entrepreneur-friendly bankruptcy laws in promoting entrepreneurship development.

CONCLUSION

From the age of imposing entrepreneur-hostile bankruptcy laws, countries and governments around the world have come a long way to reform their bankruptcy laws to make them more entrepreneur-friendly. Strengthening market-supporting institutions to stimulate more entrepreneurship development is at the heart of the *institution-based* view of entrepreneurship (Lee et al., 2007; Peng et al., 2008, 2009; Yamakawa et al., 2008).

Sadly but predictably, most entrepreneurial start-ups fail. If failure may cost the bankrupt entrepreneurs a pound of flesh (as in *The Merchant of Venice*), how many of them will want to dive into entrepreneurship? Since entrepreneurs are inherently risk taking, some may still want to do it. However, what we do not know is how many would-be entrepreneurs are deterred by harsh bankruptcy laws and how many potentially significant entrepreneurial ideas and opportunities are lost. Similar to the saying “No pain, no gain,” an economy unwilling to shoulder the costs of certain entrepreneurial failures is not likely to reap the benefits of a strong entrepreneurial sector and the economic growth it may bring (Hoetker & Agarwal, 2007; Knott & Posen, 2005). In conclusion, we advocate more entrepreneur-friendly bankruptcy laws designed to make the “pain” less painful for failed entrepreneurs and their firms, and to “gain” from more vibrant entrepreneurship development around the world.

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FIGURE 1
Components of Bankruptcy Laws and Entrepreneur-Friendliness

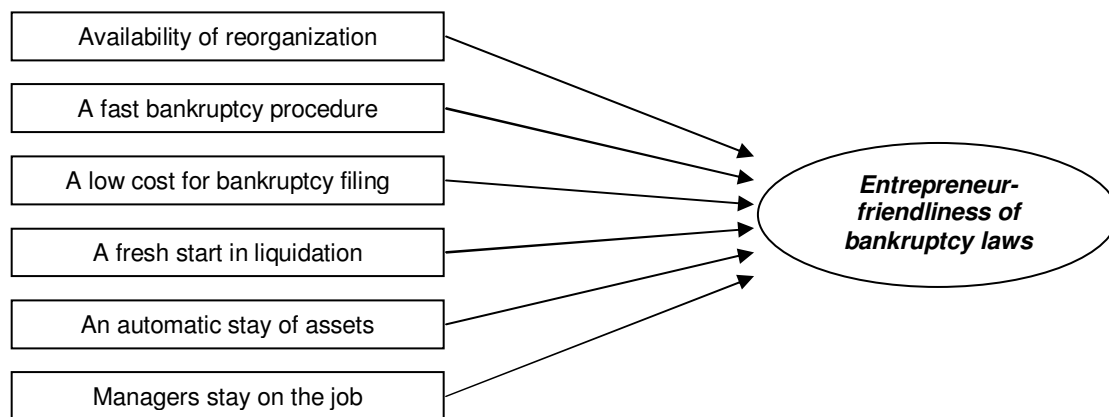


TABLE 1
How Bankruptcy Laws Differ in Their Entrepreneur-Friendliness around the World*

Country	Availability of Reorganization 1: Available 0: Unavailable	Time (Years) Spent on Bankruptcy	Cost (% of Estate) of Bankruptcy	Fresh Start (Recovery Rate: Cents/\$)	Automatic Stay of Assets 1: Stay 0: No Stay	Stay of Incumbent Management 1: Stay 0: No Stay	New Firm Formation**
Argentina	1	2.8	12.0	65.6	1	1	0.07
Australia	1	1.0	8.0	20.8	1	1	0.11
Austria	1	1.1	18.0	27.6	0	1	0.08
Belgium	1	0.9	4.0	14.5	0	1	0.07
Canada	1	0.8	4.0	11.2	1	1	0.13
Chile	1	4.5	15.0	76.2	1	1	0.07
Denmark	1	1.1	4.0	13.0	0	1	0.10
Finland	0	0.9	4.0	11.8	1	1	0.08
France	1	1.9	9.0	52.6	1	1	0.07
Germany	1	1.2	8.0	46.6	0	1	0.17
Greece	1	2.0	9.0	55.2	1	0	0.05
Hong Kong	1	1.1	9.0	21.0	0	0	0.03
Italy	1	1.8	22.0	38.2	1	1	0.08
Japan	1	0.6	4.0	7.4	1	0	0.04
Netherlands	1	1.1	4.0	13.3	1	1	0.09
Norway	1	0.9	1.0	9.3	1	1	0.11
Peru	1	3.1	7.0	75.3	1	1	0.10
Portugal	1	2.0	9.0	26.0	1	1	0.08
Singapore	1	0.8	1.0	8.7	0	0	0.17
South Korea	1	1.5	4.0	18.8	0	0	0.03
Spain	1	1.0	15.0	23.1	0	1	0.09
Sweden	1	2.0	9.0	25.3	1	1	0.06
Thailand	1	2.7	36.0	58.2	0	0	0.08
United Kingdom	1	1.0	6.0	15.4	0	0	0.12
United States	1	1.5	7.0	24.1	1	1	0.11

Sources

Adapted from Claessens and Klapper (2005), *Doing Business Report 2008*, La Porta et al. (1998), Lee et al. (2008), and OECD data.

* In each column, the two countries circled are the one discussed in text as representative examples. They represent the *minimum* and *maximum* levels of one dimension.

** As an indicator of entrepreneurship development in a country, new firm formation refers to the ratio of the number of new firms to the total number of firms (previous year) in a country (average 1991-2004). See Lee et al. (2008) for details.