BANKRUPTCY - A POSSIBLE NEW START FOR THE SMALL BUSINESS?

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ABSTRACT: Many factors (internal and external) can make a business vulnerable. In the context of the international financial crisis, the firms, and especially the small and medium enterprises (SMEs) have to face new challenges. Smaller businesses are particularly prone to financial difficulties as they often lack resources to adapt to the changing market conditions. Very often the business distress or even business failure is not yet sufficiently understood as a normal economic development and an opportunity for a new start. In order to take the full potential of business in Europe, should be created the background that genuinely talented entrepreneurs have every opportunity to get another second chance. The European Commission lays out proposals to actively help businesses at financial risk and prevent bankruptcy. In the same time, the national insolvency systems should provide more options for restructuring and rescue. Thus, EU supports simpler and faster procedures for bankruptcy and encourages giving a second chance to honest entrepreneurs who have failed.

KEY WORDS: bankruptcy; financing; SMEs; warning signals; failure; financial crisis

JEL CLASSIFICATION: G01, G33, M21

1. INTRODUCTION

Small enterprises are the backbone of the European economy, they represent 99% of all enterprises in the EU, being a key source of jobs (around 65 million jobs) and a breeding ground for business ideas, entrepreneurship and innovation.

The small enterprises are the most sensitive to changes in the business environment. In that sense, they are the first affected by the crisis but in the same time, they are the first to flourish from initiatives to cut red tape and reward success. By its nature, entrepreneurship involves a considerable risk and requires much self-confidence. The readiness to take risks are closed related to business creation, business

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success and business failure and they are inherent to the reality of the market economy. "Anyone who has never made a mistake has never tried anything new" said Albert Einstein. Over the centuries, the society has not come up with the inventions by avoiding mistakes - but rather by learning from them.

However, many times the business distress or even business failure is not yet sufficiently understood as a normal economic development and an opportunity for a new start. Business failure has to be taken seriously, but in order to take the full potential of business in Europe, should be created the background that genuinely talented entrepreneurs have every opportunity to get another second chance.

The Lisbon Strategy on Growth and Jobs, relaunched in 2005, focused on sustainable growth as well as on more and better jobs in the EU. Some factors contributing to sustainable growth are higher birth than death rates of enterprises, survival of newly born enterprises and increase of employment in them. More people should be encouraged to start their own business, to foster a positive attitude to risk-taking and failure, as well as providing appropriate support.

2. SMEs DEMOGRAPHY - SOME FACTS

An important deterrent to entrepreneurship is the stigma attached to business failure in Europe. In general, Europeans are relatively risk-averse, and this can restrain many people with otherwise great business ideas from starting their own company. The most common concerns are the risks of going bankrupt and losing personal property, in particular the negative impact on the family. The statistics indicate that 50% of enterprises do not survive the first five years of their life (based on the available data from the Czech Republic, Estonia, Spain, Finland, Hungary, Lithuania, Luxembourg, Latvia, the Netherlands, Portugal, Romania, Sweden, Slovenia, Slovakia, UK) (figure 1).

![Figure 1. Year to year survival rates of enterprises born in 2001, by activity (%)](source: Eurostat, Business Demography: growth in the population of enterprises Statistics in focus no 70/2009)
enterprises born in 2001. Subsequently the rates increased but even in the fifth year of the enterprises’ life the rate was still slightly lower than the first year’s. The corresponding percentages for the separate aggregates were 53.2% for industry, 51.1% for construction and 49.4% for services (Eurostat, 2009).

The first five years in an enterprise’s life are more or less equally difficult in the sense that survival does not seem to improve markedly its prospects of surviving one more year. The yearly average death rate of companies in the EU-25 was 8.5% while the overall birth rate was 9.8% in 2006. National death rates vary between 2.5% and 14.8%. (figure 2).

The highest birth rates were registered by the service sector activities which report also the highest death rates. The pattern is roughly the same for the three activity aggregates. By employee size class, the large majority of enterprises that die are small, with up to 4 employees (90% in all countries with available data) (Haiden and Seidl, 2006). Enterprises with 10 or more employees also took away a considerable proportion of the jobs lost due to enterprise deaths (figure 3).

Bankruptcies account for 15% of all company closures. About 700,000 SMEs are affected on average every year, and about 2.8 million jobs are involved throughout Europe on an annual basis (EC, 2007). In the last years, the bankruptcy risk increased dramatically as effect of the international financial crisis. Thus, the number of enterprise bankruptcies in Europe amounted to approx. 150,000 in 2008, which shows an increase by 11% compared to 2007. The largest share of enterprise bankruptcies was observed in the service sector.

However, the number of insolvent gives only a vague indication of the number of business failures because many enterprises are abandoned without formally declaring themselves insolvent.

In the EU, the stigma of failure is still present and society underestimates the business potential of re-starters. Today, 47% of Europeans would be reluctant to order from a previously failed business. At the same time, making a new start is complicated

![Figure 2. Enterprise birth and death rates for EU countries](image-url)
by lengthy bankruptcy proceedings. The average time to complete a bankruptcy in the EU varies between 4 months and 9 years (EC, 2008).

![Graph showing insolvent enterprises by number of employees](image)

**Figure 3.** Insolvent enterprises by number of employees

### 3. HOW TO GET A SECOND CHANCE?

#### 3.1. Early warning signals

Small businesses are especially prone to running into financial difficulties as they often lack the resources to adapt to rapidly-changing market conditions. It is essential they keep a close eye on their finances, especially as potentially serious problems are not always immediately apparent.

The fact is that if such businesses can be saved, their assets could be more valuable if they were retained in the business rather than being sold off to pay creditors. This approach would be more likely to preserve jobs, give creditors a larger return on their investment and allow the company to continue making a contribution to the economy. So should be enhanced the survival rate of viable businesses and encourage entrepreneurs in distress to take action early on.

In practice, the key to overcoming the financial problems is to anticipate them and act quickly. The early warning signs can be internal or external.

The internal early warning signals are:

- **Management**: unclear responsibilities, decisions repeatedly postponed, uncoordinated management, burn-out with nothing to show for it,
- **Staff**: unable to fill key positions, staff not working to full capacity, employees discuss internal problems with customers/business partners, increased turnover of staff, rising absenteeism,
- **Monitoring performance**: lack of up-to-date figures on company development or available figures are unstructured and uninformative,
- **Finances**: dwindling liquidity reserves, maximum available credit used more frequently, unable to benefit from early-payment discounts, getting harder to pay invoices on time.
The external warning signals are:

- **Customers:** loss of regular customers, large unpaid invoices, bad debt losses, customer complaints piling up,
- **Market, competition:** more intense competition, new competitors, falling market share, declining sales, increasing price pressure,
- **Suppliers:** declining delivery reliability, suppliers offer poor conditions, insistance on payment in advance,
- **Lenders:** worse terms offered, more frequent business development reports required, more collateral demanded, credit curtailed,
- **Others:** critical media reports about company, complaints from neighbouring land owners/residents, or from interest groups, about environmental protection, consumer rights etc.

SMEs often rely too little on external advice, which leads to late recognition of difficulties and thus excessive delays in taking action. Support measures should focus on early warning, timely intervention, expert advice, and obtaining fresh money. Efforts are needed to make enterprises aware of the opportunities of rescue procedures as a means of avoiding bankruptcy.

### 3.2. Business failure – new approaches

The business closure should not be seen as the end of the business, it should be considered as an element compatible with economic development in a global economy. In fact Charter for small enterprises considers that some failure is concomitant with responsible initiative and risk-taking and must be mainly envisaged as a learning opportunity.

However, the role of business failure in economic life is not well understood in the society. For instance, public opinion perceives a strong link between business failure and personal incapacity or fraud.

A low survival rate is thus not necessarily a cause for concern – entry by new firms is part of the process whereby entrepreneurs react to market reality. Increasing global competition force the entrepreneurs to react more rapidly and more flexibly, even by closing their business and opening another one. In this context, the death of companies can be compatible with economic dynamism.

Available analysis also shows that only a small fraction of failed entrepreneurs make another attempt to start up (Metzger, 2006), despite the fact that the majority of ex-entrepreneurs still have entrepreneurial preferences (Stam et al, 2006). This is because insolvency has a particularly great impact on entrepreneurs themselves.

Being part of economic life, insolvency has a negative impact on jobs, consumers and public and private creditors. In 2006, about 135,000 company insolvencies in the EU-15 threatened the jobs of 1.4 million employees (1.5 million in 2005) and the number of personal insolvencies amounted to more than 237,000 in Germany and the UK alone (Economic Research Unit, 2006).

Bankruptcy law is a complex set of rules which is influenced by and has influences on many disciplines and policies, such as company law, taxation, employment, access to finance and administrative procedures. Excessively severe legal
consequences of bankruptcy can obstruct entrepreneurship in two ways – on the one hand, they can deter entrepreneurs from starting afresh and contribute to the negative image of bankruptcy; on the other hand, they can become a deterrent to market exit.

When only 4 to 6% of bankruptcies are fraudulent, it is important for the economy to offer a second chance to honest entrepreneurs who have failed.

Evidence has shown that entrepreneurs who fail are generally more successful the second time. Restarters usually do experience faster growth than newly established companies and after five years their start-ups have good survival rates. The fact is that entrepreneurs learn from their mistakes and become better at assessing risks and opportunities.

The notion of re-starters does not necessarily mean that such entrepreneurs have been unsuccessful in their business dealings. As a matter of fact, their businesses could have been sold successfully and they are re-starters since they may wish to start-up another profitable enterprise, re-starters are to mean those who have been bankrupt.

3.3. EU initiatives regarding the second chance for SMEs

The European Commissions had many initiatives in order to identify issues regarding bankruptcy, business restructuring and a fresh start in the European Union.

The Commission has started addressing the need for a new policy to tackle the issue of business at risk and the negative effects of business failure since 2001 and, subsequently, as part of the Entrepreneurship Action Plan (EC, 2004). It renewed its commitment to such a policy in the Modern SME policy, launched in 2005.

In particular, the European Commission has underlined the need to improve bankruptcy procedures. Given its limited competencies in the area the Commission has limited itself to collecting data on the legal and social consequences of business failure, facilitating the identification and dissemination of good practices and recently to working on early warning tools as a means of reducing the stigma of failure.

An important initiative was taken in June 2008 when the European Commission adopted the "Small Business Act" for Europe (SBA), an initiative to further strengthen SMEs’ sustainable growth and competitiveness.

The Small Business Act aims to improve the overall policy approach to entrepreneurship, to irreversibly anchor the “Think Small First” principle in policy-making from regulation to public service, and to promote SMEs’ growth by helping them tackle the remaining problems which hamper their development.

One of the ten principles of the Small Business Act is about bankruptcy and giving a second chance to honest entrepreneurs who have failed. Therefore, EU countries are encouraged to:

- promote a positive attitude in society towards giving entrepreneurs a fresh start, for example through public information campaigns;
- aim to complete all legal procedures to wind up the business in the case of non-fraudulent bankruptcy within a year;
- ensure equal treatment between re-starters and start-ups, e.g. in support schemes.
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Also, in order to translate this principle into practice the European Commission will continue to promote a second chance policy by facilitating exchanges of best practice between Member States.

In many EU countries there is a policy commitment at the level of national and regional authorities to address the issue of business failure and promote fresh starts. In the context of the renewed Lisbon Strategy, around one third of the Member States have put forward plans to reform the national insolvency legislation in their National Reform Programmes. As a result, progress has been made in improving insolvency law: half of the Member States have taken measures to reduce the discharge periods, remove restrictions or streamline bankruptcy proceedings. However, almost half of the EU countries still need to take the first steps in this direction (EC, 2007)

Also, no Member State has yet set up a comprehensive strategy for a second chance policy, to go further to foster a more positive attitude towards entrepreneurship, to encourage more people to start up and to reduce risks and the stigma of failure.

Another initiative of European Commission lays out proposals to actively help businesses at risk of financial meltdown - mainly providing affordable expert advice to enable early action and prevent bankruptcy. National insolvency systems should provide more options for restructuring and rescue.

The EU puts forward solutions to help entrepreneurs tackle practical and psychological difficulties when setting up a second business:

- sufficient financial means should be devoted to fresh starts;
- banks and financial institutions should reconsider their cautious attitude towards re-starters;
- names of those involved in non-fraudulent bankrupts should not appear on lists restricting access to bank loans;
- former non-fraudulent bankrupt entrepreneurs should not be at a disadvantage when applying for public contracts;
- re-starters should enjoy adequate psychological and technical support;
- getting support from customers, business partners and investors should be fuelled by links between them and potential re-starters.

Member States and the business community are therefore invited to further work on a supportive environment for entrepreneurs at risk and those who have experienced a business failure with a view to turning the EU into a more dynamic place for entrepreneurship and second chance.

4. CONCLUSIONS

Some companies would not exist if their founders had given up after their first failure. Therefore, the entrepreneurs who have tried but failed need an opportunity for a fresh start. In general, they learn from their mistakes, and this leads to economic growth, employment and productivity.

Of course, prevention is more efficient than cure. Support measures should focus on early warning, timely intervention, expert advice and obtaining fresh money. A rescue is in many cases preferable to liquidation because it preserves jobs and gives
entrepreneurs the opportunity to generate new profits, all of which are beneficial to society as a whole.

In the case of bankrupts, the entrepreneurs should be encouraged to restart. In legal terms, a rapid discharge is crucial and no unnecessary restrictions should be imposed. Also, the availability of finance and support tailored to the specific needs of restarters should be improved.

Good national framework conditions for entrepreneurship are crucial to the full exploitation of the EU’s entrepreneurial potential and to the creation of dynamic companies. Consequently, the Commission encourages the EU countries to engage more vigorously in reducing the stigma of business failure as part of their commitment to promote entrepreneurship, to ensure the visibility of national good practices, to speed up the pace of reforms, to provide communication material in order to promote a better image of business failure.

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