

Life After Death: A Field Experiment With Small Businesses On Information Frictions, Stigma, and Bankruptcy

Based on BFI Working Paper 2023-23, “Life After Death: A Field Experiment With Small Businesses On Information Frictions, Stigma, and Bankruptcy,” by Shai Bernstein, Harvard University; Emanuele Colonnelli, Chicago Booth; Mitchell Hoffman, University of Toronto; and Benjamin Iverson, Brigham Young University

Many US small businesses assume that bankruptcy necessarily entails the death of a business and do not know about Chapter 11 bankruptcy, for example, where debts are renegotiated so a business can continue operating, among other misunderstandings.

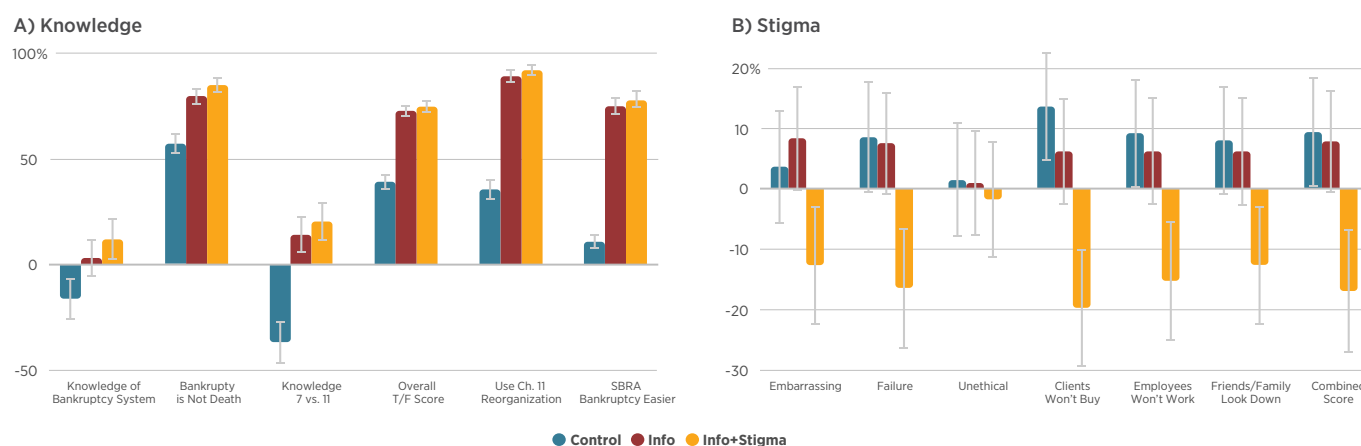
Large US firms often view bankruptcy as a strategic option when facing distress, for example, by utilizing a Chapter 11 filing (reorganization) vs. Chapter 7, liquidation. As such, corporate bankruptcy can be thought of as part of the social safety net, providing some insurance against negative outcomes and giving entrepreneurs and capital providers the confidence to take risks and make important investments.

However, such benefits may prove elusive for many small and medium-sized firms, which may be unaware that bankruptcy can provide protection, for example, so a firm can negotiate with creditors to remain in business.

Despite efforts to make bankruptcy more accessible and less costly for small businesses, including the February 2020 passage of the Small Business Reorganization Act (SBRA), little is known regarding small firms’ knowledge about bankruptcy. Further, the popular phrase “going bankrupt” is synonymous with closing one’s business and not preserving it, and may also suggest a commonly held stigma associated with bankruptcy that could further dissuade small- and medium sized firms from exploring its benefits.

This research examines the relationship between small- and medium-sized firms and bankruptcy by posing

Figure 1 • Survey Results Based on Firms’ Knowledge and Stigma around Bankruptcy



Note: Panel A shows the average and the 95% confidence interval for the authors’ main knowledge measures per treatment group. Panel B shows the average and the 95% confidence interval for the authors’ main stigma measures per treatment group.

three questions: First, do small businesses exhibit lack of information and stigma about bankruptcy? Second, if so, is it possible to reduce the lack of information and stigma, both immediately and in the long run? Third, what are the implications for firms of reducing information unawareness and stigma?

To answer these questions, the authors conduct a novel large-scale randomized controlled trial (RCT) with US small businesses. In partnership with SCORE, the leading US organization dedicated to mentoring small businesses at all stages of development, the authors surveyed about 1,500 firms in fall 2020. Please see the working paper for more methodological details, but broadly speaking, two groups of firms were given hypothetical scenarios about a struggling business owner, with one group receiving additional information about the differences between Chapter 7 and 11 bankruptcy, or additional information that addresses stigma, including information that bankruptcy protection is fundamental to US law and is part of the US Constitution. Questions to both groups reveal the following:

- Among respondents in the Control group, almost half of the firms are unaware that it is possible for a firm to continue operations after filing for bankruptcy. Only 34% are familiar with the differences between Chapter 7 and Chapter 11 bankruptcy, and only 11% are aware that the SBRA (which was passed 9 months prior to our survey and was highly publicized) made it easier for small businesses to file for bankruptcy.
- Regarding stigma, 70% of the respondents in the Control group believe that business owners who file for bankruptcy are viewed as failures. Almost two-thirds of respondents feel that friends and family will look down on a business owner who files for bankruptcy, and over half of the entrepreneurs agree that clients and employees will be less willing to work with a business owner who has filed for bankruptcy.

- The information treatment increases the share of firms recognizing the possibility of “life after death” by 25 percentage points (pp), increases the share of firms that know that Chapter 11 is the type of bankruptcy that allows firms to continue operating by 45pp, and increases the share of firms that are aware of the SBRA by 65pp. Importantly, these effects remain strong after 4 months.
- Viewing a video about stigma greatly reduces its effects, a result that holds over the short run.
- The two treatments (Information and Information+Stigma) led firms to increase their immediate willingness to consider bankruptcy, intended investment, and intended risk-taking.
- Finally, and somewhat surprisingly given the above findings, the authors do not see longer-run real outcomes from their treatments, nor do they observe any firm actually filing for bankruptcy. The authors’ explanation of this phenomenon includes the behavioral role of entrepreneurs’ overconfidence and, to a lesser extent, excessive perceived legal fees as explanations.

Bottom line: This work reveals a stark reluctance by small businesses to take advantage of the bankruptcy protection system. For policymakers, the authors’ treatments inform potential designs for policies that attempt to further increase the use of the bankruptcy system by small businesses.

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