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Velvet Bankruptcy

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This Article discusses a triangle of forces that affect the activity of small-medium enterprises (SMEs). These forces are: limited liability, shareholder guarantees, and bankruptcy. Limited liability encourages entrepreneurship by reducing the personal risks shareholders are exposed to as a result of business failure. However, the limited liability shield creates the potential moral hazard of overinvestment. That is, the entrepreneur may involve the corporation in overly risky projects. To combat this risk, the lending practice requires entrepreneurs to sign a personal guarantee for corporate debt. The guarantee serves as a bonding device that forces the entrepreneur to internalize the costs of the corporate activity. This Article first argues that while personal guarantees can serve this economic goal, the lending industry demands them excessively and they are overused. The overuse of guarantees unnecessarily subjects good corporate borrowers as well as bad ones to this practice and causes underinvestment. The third force of the triangle, a discharge of the shareholder's debts in bankruptcy, may balance this inefficiency. It potentially softens the effect of the guarantee and thus requires the lender to further gather borrower-specific information at the lending stage. Unfortunately, personal bankruptcy is underused by individual debtors mainly because of the stigma it implies.

To rebalance the triangle, this Article proposes to encourage the shareholder's partial relief of the guarantee through an amicable procedure. I call this procedure Velvet Bankruptcy. Velvet Bankruptcy would first procedurally consolidate the private collection from the

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shareholder-guarantor with the pending corporate bankruptcy case, by authorizing the court to extend the automatic stay to protect the shareholder-guarantor. To the extent the court is convinced that the collection would render the shareholder insolvent, it could reduce the guarantor's liability. This would effectively constitute discharge without officially declaring the shareholder bankrupt.

> Government must help create an ambitious business culture, which enables people from all walks of life to realize their creativity, innovative ability and entrepreneurial potential. We must help any person with the will and the ability to create and grow a successful business. And honest business failure should not mean that you cannot have another go.[**]

INTRODUCTION

Financial difficulties of corporations are part of the business cycle of any economy. Such difficulties directly affect the rights of corporate creditors. Specifically, the fulfillment or frustration of a creditor's right to payment is a function of three doctrines: the limited liability of the corporate shareholders, the personal guarantee of a shareholder to a corporate lender, and the bankruptcy laws of any given legal regime. Limited liability shields the shareholders of a corporation from the corporate creditors. Thus, the creditors may collect only from the corporation. In contrast, a personal guarantee undertaken by a shareholder exposes that shareholder to the guaranteed corporate lender. Against this creditor, the guarantee effectively reverses the principle of limited liability. The corporate and personal bankruptcy laws determine the extent of debt that the corporation and its guarantor-shareholder will ultimately have to pay the creditor upon the insolvency of the corporation.

This Article examines the delicate interplay between the three legal cornerstones mentioned above by focusing sequentially on a different pair of doctrines. Part I discusses the interplay between *limited liability* and *personal bankruptcy law*. It shows the similar role of the principle of

** Quoted in the opening of The Insolvency Service, Insolvency — A Second Chance, 2001, Cm. 5234, *available at* http://www.archive.official-documents.co.uk/document/cm52/5234/5234.htm (July 2001).

limited liability of a shareholder and of a personal bankruptcy discharge. By reducing the liability which the shareholder will have to bear as a result of her business activity, both can function as catalysts of entrepreneurial activity. Part I then continues by revealing the damaging aspect of limited liability: it exposes corporate creditors to potential moral hazard activity by the controlling shareholders. That is, the controlling shareholders are inclined to engage the corporation in overly risky activity while hiding behind the limited liability shield, at the expense of corporate creditors.

Part II introduces the third cornerstone, *personal guarantees*. It shows how the practice of demanding personal guarantees from corporate shareholders can mitigate this externality of *limited liability*. Yet it also shows that the practice of demanding personal guarantees is problematic. First, this practice has become so standardized that it is used excessively, even where the actual risks do not merit the guarantee. In addition, personal guarantees affect entrepreneurs, who become relatively more risk-averse. Thus, the overuse of personal guarantees is liable to distort the balance between the goals of encouraging entrepreneurship and minimizing the moral hazard associated therewith. Thus, returning to the goals outlined in Part I, limited liability alone may prove inadequate.

Part III then discusses the effect of *personal bankruptcy law* on *personal guarantees*. It shows how the discharge of debts in personal bankruptcy may potentially counter-balance the distortions of personal guarantees discussed in Part II. By eliminating part of the shareholder-guarantor's liability, the law both encourages the entrepreneur's innovative activity and forces the lenders to examine the borrower more closely *ex ante*. Indeed, the limitation a discharge imposes on the lenders' collection rights forces them to gather additional borrower-specific information at the lending stage. Thus, under a perfect personal bankruptcy regime, the coexistence of the three cornerstones would reach a harmonized equilibrium that would streamline the corporate borrowing market efficiently. Unfortunately, as Part III shows, personal bankruptcy law is far from being perfect. As other articles in this volume outline, personal bankruptcy law is subject to various problems, the most significant of which are the connotation of failure and the accompanying stigma that personal bankruptcy entails. As a result, many individuals are reluctant to resort to bankruptcy and the efficacy of this procedure within the internal tri-part balance is undermined.[1]

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1 This problem with personal bankruptcy affects business-related debtors and consumer-related debtors alike. Thus, the ultimate correction of the debt-relief process ought to come through a *general* reform of personal bankruptcy law and a change of the social-cultural perceptions of and attitude towards bankruptcy. While

To restore the internal balance, Part IV then proposes the procedure of Velvet Bankruptcy. Velvet Bankruptcy would procedurally consolidate the lender's collection recourse against the (insolvent) shareholder with the pending corporate bankruptcy case. To the extent that the collection of the guarantee is liable to render the shareholder insolvent, Velvet Bankruptcy proposes a quicker and more amicable debt relief procedure than that of contemporary personal bankruptcy law. Encouraging shareholder guarantors to resort to this legal relief is expected to establish an effective debt-relief regime. Such an effective regime would adequately interact with the principle of limited liability and the practice of personal guarantees and propel the corporate borrowing market towards its desired equilibrium.

I. LIMITED LIABILITY AND BANKRUPTCY LAW

A. The Role of Limited Liability

Limited liability is one of the fundamental principles of corporate law theory. Its principal purpose is to serve as a shield that protects the corporate shareholders from any claim of a corporate creditor arising from its legal relationship with the corporate entity.[2] Moreover, it also protects the shareholders' creditors from a claim to the shareholders' assets by the corporation or its creditors. This is known as asset partitioning.[3] Limited liability affects the risk-bearing of the corporation's business failure. Under

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such a general reform is welcome, realistically such a change is likely to take years to implement, as it requires legal as well as extralegal changes. *See infra* Section III.B. Empirically, in certain jurisdictions around the world, business-related insolvencies comprise a significant percentage of total individual insolvencies. *See* Rafael Efrat, *The Rise and Fall of Entrepreneurs: An Empirical Study of Individual Bankruptcy Petitioners in Israel*, 7 Stan. J.L. Bus. & Fin. 163, 170 (2002). Focusing on the potential constructive role of debt-relief on the borrowing market, and acknowledging the widespread phenomenon of business-related insolvencies, I believe that certain legal measures proposed in this Article ought to be adopted to encourage business debt-relief and to improve the overall functioning of the corporate credit market, even if overall personal bankruptcy reform is years away. Moreover, a mini-reform, as proposed herein, may later serve as a catalyst for the desired overall reform.

2 Paul L. Davies, Gower and Davies' Principles of Modern Corporate Law 27-34 (7th ed. 2003); John H. Farrar & Brenda M. Hannigan, Farrar's Company Law 66-81 (4th ed. 1998).

3 Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387 (2000).

a full liability regime, the shareholders would be the ultimate risk-bearers. However, risk-averse people would fear the personal ramifications of the downside probabilities of their business ideas and thus would hesitate to pursue these ideas. Limited liability shifts the downside risks of business failures to more efficient risk-bearers, the creditors.[4] Under limited liability, the innovative, but cash constrained, entrepreneur may entertain business ventures without the shadow of failure following her activity. Indeed, it has long been understood that limited liability is corporate law's tool to spearhead entrepreneurship.[5]

Limited liability is also considered a proxy for personal bankruptcy law's discharge.[6] Under personal bankruptcy law, any debtor may ultimately, absent any findings of fraudulent conduct on her behalf, obtain relief from her pre-bankruptcy liabilities. This relief is known as an order of discharge. The discharge allows the debtor, *ex post*, to address her financially constraining obligations and start anew. Limited liability functions as *ex ante* debt relief. Once corporate law allows an entrepreneur to shield herself from business liabilities through the principle of limited liability, the entrepreneur effectively obtains legal relief in advance. Thus, limited liability and a bankruptcy discharge are surrogate measures. To the extent that one is readily available with no painful side effects, the need for the other, within the business context, is pretty much obviated.

One note should be made explicit here. This Article analyzes the interplay between limited liability, a discharge in bankruptcy, and personal liability of entrepreneurs in small-medium enterprises (SMEs). That is, it discusses businesses conducted through corporations. It does not analyze the legal protection of sole proprietorship businesses. This Article assumes that entrepreneurs who seek legal protection from liability will normally incorporate. Indeed, the corporate form serves primarily this purpose.[7] Any entrepreneur who wishes to conduct business may incorporate and enjoy the protections of the law within the corporate arena. Thus, the analysis of this

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4 Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 44-49 (1991).

5 Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. Corp. L. 573, 587-95 (1986).

6 *See* Charles J. Tabb, *The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 Geo. Wash. L. Rev. 56, 100 (1990); Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev. 499, 503 (1975).

7 Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 Md. L. Rev. 80 (1991).

Article is inclusive in its treatment of business entrepreneurs. To the extent that there are costly limitations on incorporation, however, entrepreneurs would act as sole proprietors. Indeed, this would merit an additional analysis of liability protection for the sole proprietor. This discussion is beyond the scope of this Article.[8]

B. Limited Liability: Encouraging (Over-?)Entrepreneurship

Limited liability comes with a cost. It harbors the hazard of entrepreneurs engaging in overly risky business activities. This is called overinvestment.[9] Once the entrepreneur stands to collect the profitable fruits of the investment without having to internalize the costs of failure, entrepreneurs are likely to engage in business ventures that carry net negative values. The risks of failure will be borne by the creditors. In the ordinary course of business, the creditors, unlike the entrepreneur, are not involved in the control of the business activity. Thus, the entrepreneur may exploit the principle of limited liability and engage the corporate entity in excessive and inefficient risk-taking. As a result, in the limited liability landscape one of the goals of the law is to find an appropriate balance between limited liability and the risks of overinvestment. One of the tools used to mitigate the excessive-risk hazard is the entrepreneur's personal guarantee. This tool will be discussed in the following paragraphs.

Because of limited liability and other entrepreneurship-encouraging legal tools, such as tax benefits, the literature on entrepreneurship and its appropriate extent is divided. It is difficult to measure the optimal level of entrepreneurship empirically, and thus it is no surprise that there are no conclusive formulae for achieving the optimal result. Some commentators believe that current legal regimes are overly entrepreneur-friendly and should screen more stringently against unwarranted business initiatives.[10]

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8 For such an analysis, see Mitchell F. Crusto, *Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)*, 2001 Colum. Bus. L. Rev. 381.

9 Robert Parrino & Michael S. Weisbach, *Measuring Investment Distortions Arising From Stockholder-Bondholder Conflicts — An Analysis of Bond Covenants*, 53 J. Fin. Econ. 3 (1999). For elaboration on different meanings of "overinvestment" in the financial literature, see Evgeny Lyandres & Alexei Zhdanov, Underinvestment or Overinvestment: The Effects of Financial Leverage on Investment (Dec. 1, 2005) (Simon School Working Paper No. FR 03-28), *available at* http://ssrn.com/abstract=446681.

10 *See, e.g.*, Joshua Aizenman, *Capital Mobility in a Second-Best World: Moral Hazard with a Costly Financial Intermediation*, 11 Rev. Int'l Econ. 1 (2003); David de Meza, *Overlending?*, 112 Econ. J., at F-17 (2002); David de Meza & David Webb, *Wealth, Enterprise and Credit Policy*, 109 Econ. J. 153 (1999).

However, others believe that the development of the economy requires an accommodating environment for entrepreneurship, including laws that signal that it is perfectly reasonable to try, even if one fails.[11] Failure would not be the end of the road for an honest but unsuccessful entrepreneur. According to this view, laws that facilitate entrepreneurship, either *ex ante* (through corporate law) or *ex post* (through bankruptcy law), are welcome. Indeed, some modern legislative reforms within the Western World show that it is the latter view that has been more widely accepted by legislators and policymakers.[12] This Article's starting point is the broadly accepted policy that entrepreneurship ought to be encouraged for the sake of economic development.[13] I will argue, however, that the current practice of unlimited personal guarantees undertaken by entrepreneurs is subject to certain market failures that adversely impair the development of businesses. Thus, legal correction is needed.[14]

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11 *See* Seung-Hyun Lee et al., *Bankruptcy Law and Entrepreneurship Development: A Real Options Perspective*, Acad. Mgmt. Rev. (forthcoming), *available at* http://www.utdallas.edu/˜sxl029100/LeePengBarney040904_final.pdf (June 2004); Stijn Claessens & Leora F. Klapper, *Bankruptcy Around the World: Explanation of Its Relative Use*, 7 Am. L. & Econ. Rev. 253, 254 (2005) (a good insolvency regime is measured, *inter alia*, by its preserving entrepreneurship in the economy in the sense that it does not stifle risk-taking); Kenneth M. Ayotte, Bankruptcy and Entrepreneurship: The Value of a Fresh Start (2002) (CEPR working paper), *available at* http://www.cepr.org/meets/wkcn/5/582/papers/ayotte.pdf (concluding that a liberal discharge of debts for distressed entrepreneurial firms enhances entrepreneurial activity).

12 Such reform initiatives may involve insolvency law (the *ex post* law) or corporate law (the *ex ante* law). An example of the former reform initiative may be found in the UK. The goal of the Enterprise Act, 2002, c. 40 (Eng.) was, *inter alia*, to facilitate entrepreneurship by reducing the adverse effects of personal bankruptcy. *See* The Insolvency Service, *supra* note **, para. 1.1. As an example of the latter reform initiative one should explore legislative reforms in US business organization legislation. In the US, corporate law, along with tax law, has been reformed in recent years to facilitate the formation of new types of entities, such as LLCs, through which investors can enjoy the benefits of limited liability along with certain tax benefits not available in the form of a regular corporation. *See* Larry E. Ribstein, *Limited Liability Unlimited*, 24 Del. J. Corp. L. 407 (1999).

13 On the importance of entrepreneurship to the economic market process, see John M. Czarnetzky, *Time, Uncertainty, and the Law of Corporate Reorganizations*, 67 Fordham L. Rev. 2939, 2956-60 (1999).

14 Qimiao Fan et al., *Whither SME Policies?*, *in* World Bank Special Report: A Better Investment Climate for Everyone, *available at* http://www1.worldbank.org/devoutreach/mar05/article.asp?id=286 (Mar. 2005):

> Policy-makers need to be cognizant of the fact that while improving the investment climate will help all firms, the same investment climate policies may have different impacts on SMEs due to their size. Specific market and

II. LIMITED LIABILITY VS. PERSONAL GUARANTEES

A. The Real World: Personal Guarantees

Limited liability is considered to be one of the cornerstones of corporate law. Personal liability is a key element that a potential entrepreneur takes into account before engaging in business, and thus, limited liability is perhaps the single most important reason for incorporating. Nonetheless, the real world's landscape of small-medium enterprises (SMEs) depicts a strikingly different picture. A common practice for SMEs is that in order to obtain financing, usually in the form of a bank loan,[15] the primary shareholder (the entrepreneur) is required by the bank to undertake a personal guarantee of the corporation's obligations to the bank. Indeed, the prevalence of personal undertakings by primary owners of businesses is documented in the literature on SMEs. Ronald Mann posited that the wide use of personal guarantees as security for bank loans to small businesses explains the existence of unsecured credit in this sector.[16] His findings support the commonly accepted perception that lenders insist on obtaining the personal guarantee of the business owner in all but rare cases.[17] Berger and Udell examined financing of small firms in the form of lines of credit. Their data show that 53% of the firms examined collateralize assets as security for the financing obtained, and 41% secure the financing by personal guarantees.[18] Similarly, Avery, Bostic, and Samolyk found that for small firms, relying heavily on loan financing, the personal

institutional failures facing SMEs means that additional policies beyond general investment climate improvements may be needed to strengthen the SME sector. Such policies would not provide special preferences or subsidies to SMEs, rather they would help level the playing field for firms of all sizes.

15 *See* Allen N. Berger & Gregory F. Udell, *Relationship Lending and Lines of Credit in Small Firms Finance*, 68 J. Bus. 351, 355 (1995) [hereinafter Berger & Udell, *Relationship Lending*]; *cf.* Allen N. Berger & Gregory F. Udell, A More Complete Conceptual Framework for SME Finance (2004) (World Bank conference paper), *available at* http://www.worldbank.org/research/projects/sme/Financing_Framework_berger_udell.pdf.

16 Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 Geo. L.J. 1, 12-13, 22-24 (1997).

17 *Id.*

18 Note that the collateral figure includes both corporate collateral and the owner's personal collateral. Berger & Udell, *Relationship Lending*, *supra* note 15, at 361. *Cf.* John D. Leeth & Jonathan A. Scott, *The Incidence of Secured Debt: Evidence from the Small Business Community*, 24 J. Fin. & Quantitative Analysis 379, 379 (1989) (reporting that the 1982 Interagency Task Force on Small Business Finance study found that almost 80% of dollar volume of large and small business loans

obligations of the owners are crucial for obtaining the requisite financing.[19] According to their data, personal guarantees are more prevalent than personal collateral, although the two serve as complementary measures. Personal guarantees serve as practical substitutes for the collateralizing of corporate assets. Thus, firms short of assets available for collateralization will tend to rely on personal commitments of the owners.[20]

The undertaking of a personal guarantee by the entrepreneur is a contractual bypass of the legal principle of limited liability. The result of this contractual opt-out is that the entrepreneur is protected by virtue of limited liability against most of the corporate creditors other than the bank. In other words, the personal guarantee lifts the limited liability shield selectively. The protection of limited liability is contractually waived in favor of the SME's principal creditor, the bank. The lending bank usually holds a large percentage of the aggregate claims against the SME.[21] Thus, effectively, despite the *de jure* protection of limited liability, *de facto* the entrepreneur is exposed to significant personal liability vis-à-vis the bank. The theoretical premise of limited liability as an entrepreneur-friendly feature of incorporation is simply outdated.[22]

B. The Normative Role of Personal Guarantees

It has been shown that under contemporary corporate law, limited liability is a baseline principle, from which SMEs invariably deviate selectively in favor of their lending bank. This begs the question: What economic purpose is served by the personal guarantee, and should this purpose be condoned by the law? One possible purpose could simply be the desire of the bank to enhance its collection rights, should the SME default on its loan. For those firms whose assets would prove insufficient to pay off the loan, a personal guarantee widens the pool of assets available for payment to the lenders. In addition, to the extent that the lender is concerned with its priority vis-à-vis

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were secured, and that the 1983 National Federation of Independent Business study found that 78% of total volume of small-business loans were secured).

19 Robert B. Avery et al., *The Role of Personal Wealth in Small Business Finance*, 22 J. Banking & Fin. 1019, 1058-60 (1998).

20 *Id.* at 1059.

21 *See* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901, 948-50 (1986); *cf.* Berger & Udell, *Relationship Lending*, *supra* note 15.

22 *See* Tabb, *supra* note 6, at 101 ("limited liability for individuals running small businesses is a myth because the individual principals almost always have to guarantee personally the corporate debts").

the other corporate creditors, a personal guarantee allows the lender to enjoy a private source of collection in which it does not share *pro rata* with the other creditors.[23]

However, interestingly enough, the use of personal guarantees is not correlated with the owner's personal wealth.[24] Even owners with very few collectible assets are often required to sign a personal guarantee. In addition, such an explanation of the personal guarantee arrangement is troubling. Of all the SME's creditors, only banks, the most sophisticated and diversified creditors, are careful to enhance their collection rights. Other creditors: trade creditors, the government, employees, and tort creditors, do not enjoy such an economic benefit. Like insurance companies, because of the large number and diversification of their unrelated customers, banks are the most efficient risk-bearers of the borrowers' defaults. Easterbrook and Fischel explained the rationale of limited liability by relying on the banks' superior risk-bearing capabilities.[25] Why, then, would the most efficient risk-bearer contract around limited liability while the other creditors remain to bear its legal consequences?[26] If limited liability altogether is unsatisfactory and has gone bankrupt, then it should be abolished and *all* creditors should be able to collect from the entrepreneur.[27] But if the law still recognizes the virtue of limited liability, then the preferential treatment of lending banks invites a different justification for personal guarantees.

A bank's demand of a personal guarantee from an SME's entrepreneur serves as a bonding device that combats the perils of excessive risk-taking at the corporate level.[28] It was shown earlier that the economic cost of limited

23 To the extent the lender is concerned about priority at the owner's personal level (i.e., vis-à-vis the *owner's* other creditors), it will likely insist on personal collateral in addition to the guarantee.

24 Avery et al., *supra* note 19, at 1059.

25 *See* Easterbrook & Fischel, *supra* note 4.

26 *Cf.* Jay L. Westbrook, *Two Thoughts About Insider Preferences*, 76 Minn. L. Rev. 73, 79 n.30 (1991).

27 At least with respect to a corporation's tort creditors, it has been suggested that limited liability should be replaced by a *pro rata* unlimited shareholders' liability. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879 (1991). *Cf.* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 Colum. L. Rev. 1565, 1643-50 (1991); Hanoch Dagan, *Restitution in Bankruptcy: Why All Involuntary Creditors Should be Preferred*, 78 Am. Bankr. L.J. 247 (2004) (suggesting that tort creditors be accorded priority within the corporate bankruptcy case).

28 Daniel R. Fischel, *The Economics of Lender Liability*, 99 Yale L.J. 131, 136 (1989); Marshall E. Tracht, *Insider Guaranties in Bankruptcy: A Framework for Analysis*, 54 U. Miami L. Rev. 497, 516-24 (2000); Alberto F. Pozzolo, The Role of Guarantees

liability is the risk of overinvestment by the entrepreneur. The effective way to reduce this hazard is to take away some of the protection that the entrepreneur enjoys and expose her to some personal liability. By tying the entrepreneur's personal wealth to the results of the corporation's business performance, the controlling person — the entrepreneur — is expected to manage the business with more restraint and financial responsibility.[29] As the controlling person, the entrepreneur is most likely the most efficient risk-avoider in the SME. By undertaking personal liability the entrepreneur internalizes the risks of the SME failure. Shifting the risk of insolvency from the most efficient risk-bearer (the lending bank) to the most-efficient risk-avoider (the entrepreneur) lowers the probability of its occurrence. This, in turn, reduces the lender's costs associated with dealing with the corporate entity, whose owners enjoy limited liability under corporate law.[30] The selectivity of this shift, that is, that only the bank enjoys the personal liability of the entrepreneur while the other creditors continue to bear the SME's risk of failure, may be explained as a matter of agency. Among corporate creditors, the bank is best positioned to monitor effectively, and at the lowest cost, the actions of the SME and its controlling entrepreneur. The other creditors can enjoy these monitoring services of the bank. The personal guarantee may be explained as the legal device that effectuates the bank's monitoring. By allowing the bank to collect from the entrepreneur, should the SME default, the bank is provided with an enforceable legal measure to keep the entrepreneur at bay. The bank receives an exclusive guarantee in exchange for the benefit the SME's other creditors enjoy. Otherwise, the other creditors would likely free-ride and the bank's incentive to monitor would decrease.[31]

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in Bank Lending (2004) (Economics and Statistics Discussion Paper No. 21/04), *available at* http://www.unimol.it/progetti/repec/mol/ecsdps/ESDP04021.pdf.

29 In an empirical study conducted in Spain, the authors found similarly that collateral-backed credit is associated with greater probability of default, thus suggesting that the taking of collateral is intended to combat moral hazard risks of debtor misbehavior. *See* Gabriel Jimënez & Jësus Saurina, *Collateral, Type of Lender and Relationship Banking as Determinants of Credit Risk*, 28 J. Bank. & Fin. 2191 (2004).

30 Mann, *supra* note 16, at 10; Douglas G. Baird, *The Politics of Article 9: Security Interests Reconsidered*, 80 Va. L. Rev. 2249, 2263-66 (1994); Avery W. Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. Chi. L. Rev. 47 (1999).

31 *Cf.* Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 Yale L.J. 49 (1982) (analyzing the justification of security interests in light of potential free-riding by creditors).

C. The Costs of Personal Guarantees

In the context of SMEs, the pendulum has swung from full entrepreneur protection under limited liability to significant entrepreneur exposure by virtue of the practice of personal guarantees. While the personal guarantee mitigates the moral hazard of excessive risk-taking, it nonetheless comes with some costs of its own. First and foremost, personal guarantees are liable to be used excessively by the lending industry, thus creating unnecessary costs for borrowers. In addition, many entrepreneurs are risk-averse and thus would underinvest as a result of the guarantees. These costs are analyzed in the following sections.

1. Excessive Use of Guarantees by Lending Banks

When banks demand a personal guarantee of a shareholder as a condition for a corporate loan, a concern of excessive use of the guarantees by the banks arises. Indeed, the common practice of lending banks is to obtain unlimited guarantees from guarantors.[32] Banks may insist on receiving unlimited guarantees from entrepreneurs even when a guarantee is unwarranted, or when a limited guarantee is sufficient, for several reasons.[33] The first reason is that lending banks hold superior market power over their borrowers, which allows them to demand excessive contractual guarantee terms.[34] While this problem is acute particularly in concentrated banking economies,[35] in the context of financing SMEs it may

32 Peter A. Alces, *An Essay on Independence, Interdependence, and the Suretyship Principle*, 1993 U. Ill. L. Rev. 447, 457.

33 An unlimited guarantee obligates the guarantor for the entire amount owed by the primary debtor to the creditor. Often, such guarantees are also continuous, that is: they cover present and future advances of credit by a lender.

34 *See* Neil B. Cohen, *Striking the Balance: The Evolving Nature of Suretyship Defenses*, 34 Wm. & Mary L. Rev. 1025, 1043 (stating that effectively, all lenders possess sufficient market power against borrowers); *Cf.* Westbrook, *supra* note 26, at 80-86 (differentiating between economically legitimate insider's guarantees of corporate loans and unjustifiable "pure-leverage" guarantees demanded by the lending banks). *But see* Peter A. Alces, *Rethinking Professor Westbrook's Two Thoughts About Insider Preferences*, 77 Minn. L. Rev. 605, 621-23 (1993) (questioning Westbrook's dichotomy of "good" and "bad" guarantees and opining that all guarantees are "ugly" and stand on a continuum between pure economically justified guarantees and extreme, unjustified, ones).

35 On the financing problems of entrepreneurs in concentrated banking markets, see Nicola Cetorelli, *Real Effects of Bank Competition*, 36 J. Money Credit & Banking 543 (2004); Sandra E. Black & Phillip E. Strahan, *Entrepreneurship and Bank Credit Availability*, 57 J. Fin. 2807 (2002); Emilia Bonaccorsi

prove relevant even in other economies.[36] As acknowledged earlier, SMEs rely primarily on bank lending. Small corporations have a relationship with a primary commercial bank[37] and do not normally have ready access to alternative, competing sources of cash.[38] Under these conditions, the bank can dictate rather than negotiate the terms of the loan, such as the interest rate that the loan will bear, and also demand a personal guarantee to further cover itself.[39]

Even barring a discussion of bank exploitation of corporate borrowers

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di Patti & Giovanni Dell'Ariccia, Bank Competition and Firm Creation (2001) (International Monetary Fund, Working Paper WP/01/21), *available at* http://www.imf.org/external/pubs/ft/wp/2001/wp0121.pdf; Nicola Cetorelli & Phillip E. Strahan, Finance as a Barrier to Entry: Bank Competition and Industry Structure in Local U.S. Markets (Oct. 2004) (NBER Working Paper No. W10832), *available at* http://papers.nber.org/papers/w10832.pdf; Marianne Bertrand et al., Banking Deregulation and Industry Structure: Evidence from the French Banking Reforms of 1985 (2004) (CEPR Discussion Papers, 4488), *available at* http://www.cepr.org/pubs/dps/DP4488.asp (finding that distortions in bank lending as a result of the banking structure create artificial barriers to entry in the real sectors of the economy).

36 *See* Cameron Half, Note, *Funding Growth: Leasing and Small and Medium Enterprise Financing in Russia*, 43 Harv. Int'l L.J. 469, 477 (2002).

37 This phenomenon is known as "relationship banking." See Allen N. Berger et al., The Ability of Banks to Lend to Informationally Opaque Small Businesses § 2 (2001) (World Bank Working Paper No. 2656), *available at* http://wdsbeta.worldbank.org/external/default/WDSContentServer/IW3P/IB/2001/11/22/000094946_01090804015360/Rendered/PDF/multi0page.pdf; Arnoud W.A. Boot, *Relationship Banking: What Do We Know?*, 9 J. Fin. Mediation 7 (Oct. 14, 1999), *available at* http://www1.fee.uva.nl/fm/papers/Awaboot/english/Relationship_banking_know_JFI.pdf.

38 *Cf.* Curtis J. Milhaupt, *The Small Firm Financing Problem: Private Information And Public Policy*, 2 J. Small & Emerging Bus. L. 177, 182 (1998) (noting also that the contracting costs for a loan are relatively fixed, and thus small sized financing, which is typical in SMEs, imposes disproportional financing burdens on SMEs); Margaret Miller & Dina Rojas, Improving Access to Credit for SMEs: An Empirical Analysis of the Viability of Pooled Data SME Credit Scoring Models in Brazil, Colombia & Mexico (Oct. 2004) (conference paper), *available at* http://siteresources.worldbank.org/INTFR/Resources/475459-1107891190953/661910-1108584820141/Miller_ImprovingAccesstoCredit.pdf (noting that in concentrated banking markets a bank that already provides credit to a small business and obtains certain information on the creditworthiness of that business often chooses to withhold such information and thus exacerbates the borrowers' dependency problem); Eric de Bodt et al., Credit Decisions and Adverse Selection: An Empirical Study of Banking Behavior (July 2000) (SSRN Working Paper Series), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=244555 (noting that relationship banking creates an effective monopolistic position for the bank, which may be exploited to extract rents from the borrower).

39 *But see* Ed Vos et al., The Happy Story of Small Business Financing

and their entrepreneurs, there are other reasons to suspect that guarantees are undertaken excessively. The second reason for this concern relates to the information asymmetry between the borrowing SMEs and the financing banks and the potential rat race it creates. This asymmetry is a result of several contributing factors. First, many SMEs are first time borrowers and lack a credit record. Obtaining accurate credit information on such borrowers is prohibitively costly. Thus, barring a standard guarantee, many lenders will simply turn down SMEs' credit applications. Secondly, with respect to start-up businesses, many of the ideas relating to the new business are privately held by the entrepreneur, and it is difficult for the bank to assess the value of these business ideas.[40] Indeed, such soft information may only be analyzed by credit officers over time. While relationship banking may mitigate this information gap,[41] the asymmetry nonetheless exists in the early stages of the SME's existence. In addition, many lending institutions are not designed to process and evaluate applications for small loans, but only large ones. These institutions are not willing to bear the additional costs that microlending entails.[42] Therefore, they enter microlending only on the basis of a standard guarantee, as a type of creditworthiness signal from the borrowers. As a result, entrepreneurs of competing corporations will undertake guarantees even if this is unnecessary, in order not to be automatically discounted by lenders, and to signal to the banks that they are as creditworthy as their competitors.[43] Absent the guarantee, the banks would withhold credit altogether. This standardization applies to honest borrowers and to those who

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(Feb. 2005) (Working Paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671263 (arguing that small businesses do not suffer from a shortage of financing, as they can also obtain equity-based financing).

40 *See* Robin Broadway & Jean-Francois Tremblay, Public Economics and Startup Entrepreneurs (Apr. 2003) (Workshop on Venture Capital, Entrepreneurship and Public Policy paper), *available at* http://www.econ.queensu.ca/pub/faculty/boad way/bt-cesifo.pdf.

41 *See* Allen N. Berger & Gregory F. Udell, *Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure*, 112 Econ. J. at F32 (2002); Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. Fin. 3 (1994).

42 *See* Alvaro Ruiz Navajas, Credit Guarantee Schemes: Conceptual Frame (Nov. 2001) (Financial System Development Project), *available at* http://www.fondesif.gov.bo/CGS-Conceptual%20Frame.pdf; Latimer Asch, *Credit Scoring: A Tool for more Efficient SME Lending*, 1(2) SME Issues 1 (Nov. 2000), *available at* http://info.worldbank.org/etools/docs/library/159695/smetech/pdf/CreditScoring_SMELending.pdf.

43 *But see* Gines Hernandez Canovas & Pedro Martinez Solano, Bank Relationships: Effects on the Debt Terms of the Small Spanish Firms (Jan. 2003) (EFMA 2003 Helsinki Meetings) (finding that in Spain banks take guarantees from, and reduce

are prone to engage in excessive risk-taking alike.[44] This standardization is a rat race created by the personal guarantee.[45] The use of personal guarantees reduces the banks' incentives to gather borrower-specific information.[46] In lieu of accurate creditworthiness information, banks invariably demand a standard personal guarantee, often unlimited in its amount.[47] This represents an excessive and counterefficient use of the personal guarantee.[48]

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interest rates to, those borrowers who have established a significant relationship with them).

44 *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 Am. Econ. Rev. 393 (1981). *Cf.* de Bodt et al., *supra* note 38 (finding a behavioral pattern of banks to gradually acquire information over time. However, in early stages of the borrowers' businesses there is no effective separation of information on borrowers).

45 Katz, *supra* note 30, at 87. On ineffective signaling and resultant rat races in the labor market, see George Akerlof, *The Economics of Caste and of the Rat Race and Other Woeful Tales*, 90 Q.J. Econ. 599 (1976); Renee M. Landers et al., *Rat Race Redux: Adverse Selection in the Determination of Hours of Work in Law Firms*, 86 Am. Econ. Rev. 329 (1996); Stuart S. Rosenthal & William C. Strange, The Urban Rat Race (May 2003) (CEPR working paper), *available at* http://www.cepr.org/meets/wkcn/2/2328/papers/strange.pdf (discussing modern life's long working hours as the "urban rat race"); A.A. Sampson, *Weekenders and Workaholics*, 18 European J. Pol. Econ. 193 (2002) (same); Dan Bernhardt & Steeve Mongrain, The Layoff Rat Race (Feb. 1, 2005) (SSRN Working Paper Series), *available at* http://ssrn.com/abstract=658422. *But see* Scott A. Baker et al., The Rat Race as an Information Forcing Device (May 25, 2005) (NYU Law and Economics Research Paper No. 04-034; UNC Legal Studies Research Paper No. 05-01; Georgetown Law and Economics Research Paper No. 649083), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649083 (discussing the potential information revelation virtue of rat race employment tournaments).

46 Olarn Chaipravat & Pongsak Hoontrakul, *Thai Credit Market Failures: The 1997 Aftermath*, 15 Thail. Dev. Res. Inst. Q. Rev. 16, 23 (2000).

47 Although the lending agreement can contractually cap the guarantee at a certain monetary amount, the banks' common practice is nonetheless to obtain a personal guarantee for the entire business loan. See Allen N. Berger & Gregory F. Udell, *Small Business and Debt Finance*, *in* Handbook of Entrepreneurship Research: An Interdisciplinary Survey and Introduction 305 n.7 (Zoltan J. Acs & David B. Audretsch eds., 2003). Indeed, banks won't accept capped-guarantees because they wish, *inter alia*, to secure from the outset all future advancements of credit to the borrowing corporation, the total amount of which is unknown at the time. *See supra* note 33. Indeed, to an extent, a non-capped guarantee is in itself evidence of the standardization of the lending practice. However, even if banks were to cap the guarantees, the core problem of demanding guarantees when the moral hazard potential of the controlling shareholder does not justify this means would still exist.

48 For a similar analysis of the potential counterproductive effects of secured lending that banks would insist be the terms for any loan to a small firm, see Henry

A third possible reason to believe that the practice of personal guarantees is excessive and overreaching may stem from a gap between the banks' approach to the role of entrepreneurs' guarantees and the normative role of these guarantees. The lending banks may demand guarantees to enhance their collection rights.[49] Indeed, it is not far fetched to assume that bank management would be primarily concerned with the bank's overall financial statements and the extent of uncollectible debts that would be included therein.[50] These are accounting considerations that may be at odds with the economic value of an entrepreneur's guarantee.[51] It has been emphasized above that the normative role of an entrepreneur's guarantee is the bonding incentives it creates to combat the moral hazard of excessive risk-taking at the corporate level. Enhancement of collection is of secondary importance and is normatively questionable.[52] To the extent that banks insist on guarantees for enhancing their collection rights, even where the borrower is one that does not justify imposing bonding devices upon, a problem of excessive use of guarantees occurs.[53]

2. The Problem of Underinvestment

The problem of excessive use of personal guarantees is exacerbated by

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Hansmann & Reinier Kraakman, *Hands-Tying Contracts: Book Publishing, Venture Capital Financing, and Secured Debt*, 8 J.L. Econ. & Org. 628, 648-50 (1992).

49 Paul Dunn et al., A Comparison of the Perceptions of Experienced and Inexperienced Counselors on the Advantages of Incorporating a Small Business (1999) (ASBE research paper), *available at* http://www.sbaer.uca.edu/research/asbe/1999/15.pdf.

50 *See* Eric Grouse, *Banks, Bonds and Risk: The Mycal Bankruptcy and Its Repercussions for the Japanese Bond Market*, 12 Duke J. Comp. & Int'l L. 571, 572 (2002) (noting the reluctance of Japanese banks to sustain losses for bad debts of their borrowing firms and write off those debts); Ross Cranston, *Credit, Security and Debt Recovery: Law's Role in Reform in Asia and the Pacific*, 39 St. Louis L.J. 759, 761 (1995).

51 *Cf.* Katz, *supra* note 30, at 88 (discussing the potential strengthening of borrowers' financial statements when their loans are guaranteed).

52 See the discussion in *supra* Section II.B.

53 It should be noted that some of the market failures described above, such as the banks' market power in concentrated banking economies, appear not only through the excessive use of personal guarantees. They may also lead to other inefficiencies, such as excessive interest rates. While other inefficiencies may be combated, *inter alia*, through the *corporation's* insolvency proceedings, the guarantee's effects may be combated only through proceedings pertaining to the *shareholder*. Because this Article analyzes the triangular relationship among limited liability, personal guarantees, and shareholders' bankruptcies, the main text focuses on these inefficiencies as they pertain to personal guarantees.

entrepreneurs' risk-aversion. Indeed, because of the personal liability they carry, guarantees for corporate debt deter potential entrepreneurs from pursuing business opportunities. If all entrepreneurs were risk-neutral, then, absent any market failure in the contractual arrangement between the lending bank and the entrepreneur, the guarantee would successfully screen between an entrepreneur's business opportunities with net positive values (which would be pursued), and those with net negative values (which would be abandoned). However, many of the entrepreneurs, like humankind in general, are risk-averse.[54] The personal guarantee creates a chilling factor for risk-averse entrepreneurs. Risk-averse entrepreneurs would forego some business opportunities with net positive values because of the increased risk imposed on them personally by the guarantee.[55] This is the problem of underinvestment, which limited liability ameliorated, but personal guarantees have reintroduced.[56]

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54 *See* Brian Wu & Anne Marie Knott, Entrepreneurial Risk and the Entry Decision (Aug. 2005) (Wharton Working Paper), *available at* http://www.olin.wustl.edu/workingpapers/pdf/2005-08-013.pdf (proving that entrepreneurs are risk-averse with respect to exogenous market volatility risks, but risk-seeking and overconfident with respect to endogenous capability uncertainties. As a result, there would be instances where entrepreneurial risk aversion would dominate entrepreneurial confidence and result in insufficient entry); Andrew F. Newman, Risk-Bearing, Entrepreneurship and the Theory of Moral Hazard (Dec. 1999) (workshop paper), *available at* http://www.econ.ucl.ac.uk/downloads/newman/risk.pdf (arguing that "even though entrepreneurs are less risk averse than workers, they are still risk averse, and would be better off if they could share risks"). *Cf.* John Czarnetzky, *The Individual and Failure: A Theory of the Bankruptcy Discharge*, 32 Ariz. St. L.J. 393, 414 (2000) (discussing a potential entrepreneur's concern that he would be subject to contract enforcement by external creditors even in circumstances of non-fault failure as a barrier to entrepreneurship); Hongwel Xu & Martin Ruef, *The Myth of the Risk-Tolerant Entrepreneur*, 2 Strategic Org. 331 (2004). To the extent that an increase in personal wealth reduces risk-aversion, entrepreneurship would be correlated with personal wealth. *See* Robert Cressy, *Credit Rationing or Entrepreneurial Risk Aversion? An Alternative Explanation for the Evans and Jovanovic Finding*, 66 Econ. Letters 235 (2000).

55 *Cf.* Richard A. Posner & Kenneth E. Scott, Economics of Corporation Law and Securities Regulation 269 (1980).

56 A similar analysis is found in the literature concerning the inefficiencies of secured credit. One of the inefficiencies of secured credit is the risk of overinvestment. That is, because the bank's claim is secured by collateral, the bank becomes relatively indifferent to the corporation's actions. As a result, it reduces its monitoring efforts over the corporation's behavior and thus allows debtor misbehavior to go undetected. Lucian A. Bebchuk & Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 Yale L.J. 857, 902-03 (1996). *Cf.* Arturo Bris et al.,

III. PERSONAL GUARANTEES AND PERSONAL BANKRUPTCY

A. The Discharge of Guarantees: A Balance in the System

The costs of personal guarantees by entrepreneurs, which are invariably demanded by the banking industry, may be ameliorated to some extent by the *ex post* relief of a discharge in bankruptcy. In a bankruptcy case, the debtor would ultimately be relieved of her unpaid claims. This would come only after partial payment, generated from the realization of her nonexempt assets or from installment payments over time, has been completed. In effect, bankruptcy law intends to provide a soft cushion for those who have failed financially. This assumes that the failure was a result of unfortunate events,[57] and that the debtor was not engaged in fraudulent activity.[58] The preceding paragraphs have shown that personal guarantees are used excessively and cause underinvestment. These effects can be mitigated by personal bankruptcy law's fresh start policy. The discharge in bankruptcy is intended to facilitate the debtor's return to the regular cycle of life and to allow her to engage in productive activity.[59] For a business entrepreneur, a soft landing in the case of financial distress can serve as a proxy for corporate law's *ex ante* shield of limited liability. If an entrepreneur realizes that a second chance will be provided in case of failure, her willingness to engage in risky business activity will be enhanced. Indeed, from the perspective of the entrepreneur, the excessive costs of the practice of personal guarantees may be reduced.

Who Should Pay for Bankruptcy Costs?, 34 J. Legal Stud. 295 (2005) (discussing *partial* reimbursement of bankruptcy costs to senior creditors as an incentive to invest in value-increasing activities). While personal guarantees protect the bank similarly, they do not increase the danger of overinvestment as much as secured credit. Unlike in the case of secured credit, it is primarily the personal undertaking of the entrepreneur, rather than the actual monitoring of the corporate behavior by the bank, that deters the entrepreneur from allowing corporate misbehavior. The guarantee, unlike the security interest, forces the entrepreneur to internalize some of the costs of corporate failure.

57 *See* Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. 325 (1991).

58 Douglas G. Baird et al., Bankruptcy — Cases, Problems and Materials 469-70 (rev. ed. 2001). *But see* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 Harv. L. Rev. 1393, 1441-42 (1985) (questioning whether a *complete* denial of the discharge is justified whenever a debtor has engaged in creditor defrauding activity).

59 *See* Jackson, *supra* note 58; Charles J. Tabb, *The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 Geo. Wash. L. Rev. 56 (1990).

But does personal bankruptcy tackle the core of the guarantees' inefficiencies? Does it combat banks' inclinations to demand, as standard, personal guarantees in lieu of specific information regarding the creditworthiness of the particular entrepreneur and the business she is establishing? I submit that it carries just such potential. Proceedings in bankruptcy enjoy the benefit of hindsight. Thus, the judge can see the entrepreneur's financial failure and its causes relatively clearly. This judicial hindsight can differentiate between willfully excessive risk-takers (or culpable entrepreneurs) and those whose business has failed as a result of bona fide economic reasons.[60] A bankruptcy discharge would reduce the guarantee liability, as well as other personal debts, of the bona fide failed entrepreneur. But, as explained earlier, the discharge can be denied to the culpable entrepreneur. From the lending bank's perspective, the potential for discharge in bankruptcy affects the guarantee as a potential threat over the entrepreneur. The banks realize that the guarantee is fully effective only against excessive risk-takers, while other failed entrepreneur-guarantors will be protected in the event that they file for personal bankruptcy. It was shown earlier that the lending industry standardizes the personal guarantees of entrepreneurs as a surrogate for firm-specific risk information.[61] As a result, the personal guarantee has exceeded its boundary as a means to combat the moral hazard of excessive risk-taking. It has been imposed on non-creditworthy and creditworthy borrowers alike. The introduction of the discharge in bankruptcy reduces this inefficiency. The lending bank ought to be aware that there is a possibility that the guarantee will be discharged whenever the financial failure is not due to excessive risk-taking, but rather is the result of a bona fide, albeit failed, business idea. As a result, reliance on the personal guarantee as insurance against the risks of the borrower's entrepreneurial ideas may prove inadequate for banks. Thus, the discharge in bankruptcy forces the banks, at the lending stage, to further inquire and

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60 Of course, any after-the-fact judicial determination is liable to be biased. That is, there is a concern that the court would determine bad faith and excessive risk-taking because it already is faced with the eventual outcome of insolvency. *See* Baruch Fischhoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. Experimental Psych.: Human Perception & Performance 288 (1975), *reprinted in* 12 Qual. Saf. Health Care 304 (2003); Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, *in* Judgment Under uncertainty: Heuristics and Biases 335 (Daniel Kahneman et al. eds., 1982). But the legal system is aware of this potential bias and its impact is less destructive than it seems at first glance. *See* Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. Chi. L. Rev. 571, 573 (1998).

61 *See supra* Section II.C.2.

collect specific information on the borrowing business and its prospects. The screening between borrowers based on their business prospects is enhanced by virtue of the discharge in bankruptcy. "Good borrowers" may be approved without additional, burdensome guarantees imposed on the loan. Personal guarantees would be required from the "bad borrowers," i.e., those who, at the lending stage, pose a realistic moral hazard of overly risking the lending bank's investment.[62]

The personal guarantee-bankruptcy discharge equilibrium functions similarly to the recorded advantages of relationship banking.[63] Both enhance the lending banks' screening process and thus improve the credit market altogether. However, as was noted earlier, relationship banking functions over time. That is, the bank gains information regarding a specific borrower over a period during which a relationship is established.[64] But the information asymmetry nonetheless exists at the initial lending stage. Regarding first time borrowers, the banks have yet to gather borrower-specific information. The personal guarantee-bankruptcy discharge combination creates the proper incentives for banks to gather such information at this early stage of their evolving business relationship.

The availability of personal bankruptcy should balance the costs and inefficiencies of entrepreneurs' personal guarantees. But that would occur only under an optimal bankruptcy regime. The following Section will show why contemporary personal bankruptcy law is suboptimal and how this adversely affects the delicate balance between entrepreneurs' personal guarantees and the discharge in bankruptcy.

B. The Shortcomings of Contemporary Personal Bankruptcy Law

In many countries around the world contemporary personal bankruptcy suffers from two primary shortcomings. The first is the length of time that the bankruptcy case takes until an order of discharge is obtained. The second is the social stigma associated with bankruptcy. These two shortcomings are elaborated upon in the following Sections. To be sure, the problems

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62 Of course, even if bankruptcy were to work optimally, the equilibrium between bankruptcy and personal guarantees would not be perfect. While the banks' screening process is enhanced by the discharge in bankruptcy, nonetheless banks cannot always correctly assess the economic prospects of *all* business ideas introduced to them. Thus, some degree of information asymmetry would remain. *See supra* Section II.C.2.

63 *Id.*

64 *Id.*

of personal bankruptcy impair the state of all individuals who suffer from financial distress, regardless of the background and context of their crisis. This Article, however, shows how these general problems of personal bankruptcy disrupt the important but fragile balance between entrepreneurs and lending banks. Only a well-functioning personal bankruptcy regime can complement the practice of personal guarantees and establish a desirable equilibrium. This Section will discuss the deficiencies of contemporary personal bankruptcy. The Part IV will propose a practical alternative that could modify the distortions caused as a result of these deficiencies within the entrepreneur-lender context.

1. Length of the Time before Discharge is Obtained

In many legal systems around the world, the discharge that the debtor seeks in bankruptcy is available, if at all, only after a significant period has transpired and after the debtor has undergone a grueling procedure. This period is often measured in years. The length of bankruptcy procedures deprives the debtor of various human liberties for a long while, including some that suspend her from activity in the business world.[65] Indeed, with respect specifically to entrepreneurs, while the bankruptcy procedure is pending, the debtor (entrepreneur) is preoccupied with resolving her financial distress and as a result there is much less time available for her to engage in productive business activity even if no official limitations were imposed upon her. As a result, in rigorous bankruptcy law regimes entrepreneurs reject voluntary bankruptcy as the ultimate remedy to their exposure to corporate risks. It is not appealing and is no panacea. Indeed, many initiatives and research projects around the world focus on the goal of shortening the time period for obtaining a discharge in bankruptcy, whether as a general bankruptcy law reform[66] or as a mini reform to promote entrepreneurship.[67] But despite these welcome

65 *See* John Armour & Douglas Cumming, Bankruptcy Law and Entrepreneurship (Mar. 2005) (ESRC Centre for Business Research, University of Cambridge, Working Paper No. 300), *available at* http://www.cbr.cam.ac.uk/pdf/WP300.pdf.

66 *See, e.g.*, Jacob S. Ziegel, *Facts on the Ground and Reconciliation of Divergent Consumer Insolvency Philosophies*, 7 Theoretical Inquiries L. 299 (2006); Jason Kilborn, Behavioral Economics, Overindebtedness and Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions (June 2005) (Cegla Center conference paper), *available at* http://ssrn.com/abstract=690826.

67 A policy goal to promote entrepreneurship through bankruptcy law may be found in France and Belgium. *See* Hortense Trendelenburg, *Discharge in Germany from an International Point of View*, 9 Int'l. Insol. Rev. 111, 116 (2000). Indeed, a recent European empirical study corroborates the intuitive thought that lax bankruptcy laws, in the sense of reduced time periods for obtaining the discharge of debts, serve as an important drive of entrepreneurship. *See* Armour & Cumming, *supra* note

initiatives, there is still a long way to go until the laws become optimal in this respect.

2. The Bankruptcy Stigma

The second problem is a social-cultural one. One of the adverse effects of personal bankruptcy is that it often connotes personal failure.[68] A widely accepted public perception is that filing for bankruptcy means that the debtor has proven inadequate, and imprudent, and thus has justifiably suffered a downfall. The perception of personal failure and guilt is strongly planted in the social and legal environment of Continental Europe,[69] but many argue that it is very much applicable in the US as well.[70] This failure stigma is likely to affect the future prospects of the debtor, that is, his post-crisis affairs. He may

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65. *Cf.* John King, *Moving Beyond the "Hard"-"Easy" Tug Of War: A Historical, Empirical and Theoretical Assessment of Bankruptcy Discharge*, 28 Melbourne U. L. Rev. 654 (2004) (analyzing the effect of fast-track discharges in various jurisdictions).

68 *See* Karen Gross, Failure and Forgiveness 94 (1997) ("Debtors who have submitted to the bankruptcy process have, in a sense, admitted failure."); *Id.* at 249 ("Currently, the word *bankrupt* is often used to mean 'morally bereft.'").

69 European Commission, Bankruptcy and A Fresh Start: Stigma on Failure and Legal Consequences of Bankruptcy § 4.2.3 (July 2002) (Phillipe & Partners Study), *available at* http://europa.eu.int/comm/enterprise/entrepreneurship/support_measures/failure_bankruptcy/stigma_study/stigm a_study.pdf:

> A country's sociological perception of failure plays a huge role in the development of a stigma surrounding a distressed debtor. Strong publicity and availability of information to the public may not create stigma in a society where business partners, consumers and investors do not attach any importance to the potential failure of an enterprise. This is generally the case in the US where commencement of reorganisation procedures is not perceived negatively and can even have a positive effect on the outcome of the debtor. On the other hand, in the EU Member States, where society generally distrusts businesses facing financial difficulties, even limited publicity may be a strong factor in generating a stigma.

70 Teresa A. Sullivan et al., Twenty-First Century Bankruptcy: Two Decades of Evidence About Consumer Debt and the Stigma of Bankruptcy (June 2005) (Cegla Center conference paper), *available at* http://www.utexas.edu/law/news/colloquium/papers/20%20years%20later%20and%20Table%20A.pdf. *Cf.* Gordon Bermont, *Bankruptcy By The Numbers: What's Stigma Got To Do With It?*, 22-6 Am. Bankr. Inst. J. 22 (July/Aug. 2003); Kartik Athreya, *Shame As It Ever Was: Stigma and Personal Bankruptcy*, 90 Fed. Res. Bank Rich. Econ. Q. 1 (Spring 2004), *available at* http://www.richmondfed.org/publications/economic_research/economic_quarterly/pdfs/spring2004/athreya.pdf (suggesting that the rise of unsecured debt and bankruptcy filing in the US is not a result of the decline of the bankruptcy stigma, but rather a result of the implicit reduction in costs of intermediation that has occurred over the past two decades). *But see*

find out down the line that engaging in business transactions and obtaining new credit becomes more difficult once you carry a past bankruptcy filing.[71] Thus, merely expediting the debt relief process is not enough to overcome the deficiencies of personal bankruptcy law. It is the debtor's post-discharge business activity that the law should be concerned about.

Because stigma is a cultural convention, it is expected to continue to taint debtors who have filed for official personal bankruptcy, regardless of the internal rules of bankruptcy. Law and society tell us that policymakers and social reformers ought to move away from a legal-centered orientation, under which it is the law (or at least the law alone) that steers and shapes social thoughts and understandings of public phenomena.[72] The law is influenced by social thoughts and perceptions insomuch that social thoughts are influenced by the law.[73] Thus, the adverse social effect of a personal bankruptcy is the second, and the strongest, shortcoming of personal bankruptcy.

C. Distortion of the Discharge-Personal Guarantee Balance

The deficiencies of personal bankruptcy listed above make the bankruptcy option less attractive for individual debtors. As a result, debtors are likely to file for bankruptcy only as a last resort rather than as a regular course for resolving their financial distress. Indeed, on average, deficiencies that make personal bankruptcy less appealing to debtors' voluntary filings are likely to reduce the overall filings to a suboptimal level. This also reduces the potential constructive effects that a discharge in bankruptcy carries in the entrepreneurial context.[74] Debtors, who to an extent remain filing-averse, also remain risk-averse because their financial rescue is costly. As a result, to the extent that a personal guarantee is required by lending banks as a prerequisite for financing SMEs, many potential entrepreneurs will pass on

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Rafael Efrat, *The Evolution Bankruptcy Stigma*, 7 Theoretical Inquiries L. 365 (2006).

71 *See* Armour & Cumming, *supra* note 65.

72 *See, e.g.*, Austin Sarat & Thomas R. Kearns, *Beyond the Great Divide: Forms of Legal Scholarship and Everyday Life*, *in* Law in Everyday Life 21 (Austin Sarat & Thomas R. Kearns eds., 1995); Anna-Maria Marshall & Scott Barclay, *In Their Own Words: How ordinary People Construct the Legal World*, 28 Law & Soc. Inquiry 617 (2003).

73 *Cf.* Robert W. Gordon, *Critical Legal Histories*, 36 Stan. L. Rev. 57, 110-16 (1984).

74 As mentioned in Section III.B, while the deficiencies of personal bankruptcy affect the personal affairs of all individual debtors, this Article focuses on their effects on the entrepreneur, the lending bank, and their mutual business relationship.

their business ideas because of their risk aversion.[75] Moreover, as was shown earlier, a discharge in bankruptcy has a positive effect on the entrepreneur-bank relationship. The discharge forces the lending banks to rely less on personal guarantees and gather more borrower-specific information at the lending stage.[76] However, a reduction in bankruptcy filings allows banks to rely more heavily on guarantees in lieu of collecting borrower-specific information. This exacerbates the problem of the excessive use of personal guarantees.

IV. VELVET BANKRUPTCY: AN *EX POST* CORRECTION OF PERSONAL GUARANTEES

A. The Velvet Bankruptcy Proposal

The discussion thus far has shown that personal guarantees of corporate loans significantly affect the delicate balance between the policy of protecting entrepreneurs on one hand and the importance of exposing the entrepreneur to some corporate risk, as a restraining measure, on the other hand. While personal guarantees aim to achieve the latter goal, they nonetheless create costs that reduce the optimal entrepreneurial level. A balancing measure that ought to complement the personal guarantee in a constructive fashion is the discharge in personal bankruptcy. However, the preceding Part explained why contemporary bankruptcy fails to adequately balance the entrepreneur's personal guarantee. This Part proposes to reform insolvency law in a manner that I believe would assist in obtaining an available and effective discharge in bankruptcy. Availing the discharge to the entrepreneur in a more amicable procedure would help reach an efficient equilibrium between the practice of personal guarantees of entrepreneurs and their financial relief. This equilibrium would encourage entrepreneurship and improve the practices of lenders.

As a reform of insolvency law for this purpose, I propose the following scheme, which I term "Velvet Bankruptcy." Velvet Bankruptcy is a *de facto* financial resolution of a guarantee given by a financially distressed entrepreneur, without officially declaring the entrepreneur bankrupt. It would utilize the pending corporate bankruptcy case as the appropriate procedure for resolving the entrepreneur's guarantee crisis as well. Velvet Bankruptcy

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75 *See supra* Section II.C.1.
76 *See supra* Section III.A.

would work as follows: Upon the inception of a corporate insolvency case, an automatic stay would bar the lender from independently collecting its claim from the corporate debtor. As a result, the lender would then often wish to turn its collection efforts directly toward the entrepreneur-guarantor and make a payment demand. To the extent that the entrepreneur believes this demand would lead to her ultimate insolvency, she would be entitled to file a motion with the court adjudicating the corporate insolvency case to subject the lender's collection actions on the guarantee to the court's jurisdiction. The court would then examine the merits of the entrepreneur's motion and, *only to the extent it was satisfied that the collection of the guarantee would indeed subject the entrepreneur to personal financial distress*, it would issue an order as requested.[77] The lender's claim would then be treated exclusively within the (expanded) corporate insolvency case. Upon reaching the distribution phase of the case, whether it is a liquidation of the corporate assets and cash distribution to the creditors, or a proposal of a reorganization plan, the guaranteed claim of the lender would be addressed through a combined payment by the corporate debtor and the guarantor-entrepreneur. In other words, at the distribution phase, the court would determine what part of the lender's claim would be paid by the corporation and what part by the guarantor. The corporate part would reflect the pro rata distribution to all unsecured creditors. The guarantor's part would reflect a discounted percent of the remainder of the claim.[78] This discount would effectively constitute a discharge of the guarantee liability.[79] Thereafter, the court's order would bar the lender from pursuing private collection from the guarantor in the future for the remaining unsatisfied part of the original claim. Effectively, the guarantor would be discharged from the lender's claim, but without ever having to officially declare personal bankruptcy.[80] The lender's

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77 In this sense, the court would differentiate between insolvent and solvent debtors and avail only the former of the Velvet Bankruptcy relief. The court's role here is similar to the role it plays in declaring a debtor bankrupt under the existing personal bankruptcy procedure.

78 The maximum discounting of the lender's claim may be determined by statute.

79 As mentioned earlier, the discharge will be available only for bona fide economic failures, but not for willful excessive risk-takings. *See supra* Section III.C.

80 It is imperative that this discharge be obtained in Velvet Bankruptcy within a matter of several months, not years. As explained above, shortening the time period for obtaining a discharge is a focal point of contemporary bankruptcy law reforms around the world. Its efficiency is corroborated empirically by Armour & Cheffins, *supra* note 65. Also, the amicable resolution of the shareholder's liability would require regulation of the report of Velvet Bankruptcy by credit reporting bureaus.

claim against the entrepreneur, which originated in the corporate business context, would eventually be resolved and settled within that context as well.

Interestingly, it is worth noting that the *technique* proposed for Velvet Bankruptcy is found in certain bankruptcy laws, although it is employed for a different purpose. Subjecting the guarantor's liability to the jurisdiction of the corporate insolvency court, which in turn would temporarily enjoin the lender from private collection on the guarantee, is akin to the extension of the automatic stay to non-debtor affiliates in corporate bankruptcy,[81] or to the stay of action against an individual co-debtor liable along with a Chapter 13 debtor on a consumer debt.[82] Similarly, the eventual reduction of the guarantor's liability to the lender is a release of a non-debtor party embroiled within the ultimate resolution of the corporate debtor's financial liabilities.[83] The difference, however, between Velvet Bankruptcy and these contemporary legal doctrines, is that these doctrines focus on aiding the resolution of a distressed *corporation*, while Velvet Bankruptcy is *entrepreneur*-oriented.

B. Restoring the Constructive Role of the Discharge

The main advantage of Velvet Bankruptcy is that it creates an insolvency procedure which is more amicable for debtor-entrepreneurs. Compared to contemporary personal bankruptcy, Velvet Bankruptcy could effectively

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81 In the US, courts were at times willing to extend the bankruptcy automatic stay to non-debtor parties based on the courts' equitable powers, conferred by section 105 of the Bankruptcy Code, 11 U.S.C. § 105 (2000). *See, e.g.*, Paul H. Deutch, *Expanding the Automatic Stay: Protecting Nondebtors in Single Asset Bankruptcy*, 2 Am. Bankr. Inst. L. Rev. 453 (1994); A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir. 1986); MacArthur Co. v. Johns-Manville, Corp. (*In re* Johns-Manville, Corp.), 837 F.2d 89 (2d Cir. 1988); Manville Corp. v. Equity Sec. Holders Committee (*In re* Johns-Manville, Corp.), 801 F.2d 60 (2d Cir. 1986).

82 *See* 11 U.S.C. § 1301(a) (2000). Chapter 13 of the U.S. Bankruptcy Code is titled "Adjustment of Debts of an Individual with Regular Income."

83 The statutory baseline is that only the debtor enjoys a discharge, and no other entity is relieved of its liabilities along with the debtor. *See* 11 U.S.C. § 524(e) (2000). For a discussion of the option of releasing non-debtor entities, see, for example, Deborah A. Crabbe, *Are Non-debtor Releases/Permanent Injunctions Authorized Under the Bankruptcy Code?*, 22-4 Am. Bankr. Inst. J. 34 (May 2003); Jeffrey W. Warren, *Requirements for the Approval of Third-Party Non-debtor Releases*, 22-3 Am. Bankr. Inst. J. 34 (Apr. 2003). *But see* Peter M. Boyle, *Non-Debtor Liability in Chapter 11: Validity of Third-Party Discharge in Bankruptcy*, 61 Fordham L. Rev. 421 (1992) (criticizing the release of non-debtor joint tortfeasors); Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. Ill. L. Rev. 959.

achieve the legal result of discharging the personal guarantee liability relatively quickly,[84] free of the stigma that official bankruptcy is tainted with. Velvet Bankruptcy would not take place automatically in every corporate bankruptcy. Rather, it would only occur when the judge adjudicating the corporate case was convinced that the entrepreneur's guarantee indeed would lead to an insolvency crisis. This is the benefit of hindsight. Velvet Bankruptcy merely encourages the use of this insolvency procedure to achieve the desired result (i.e. the discharge) where contemporary bankruptcy is relatively harsher. A more easily accessible system of debt relief, such as Velvet Bankruptcy, would contribute to the abovementioned positive role of discharge as a means of balancing some of the inefficiencies of the personal guarantee. That is, entrepreneurs would become less risk-averse and the lending banks would be forced to rely less on the standardized personal guarantees and more on borrower-specific information.[85]

C. Preserving the Rights of the Lending Bank

With respect to the lender's original legal rights, it should be noted that the Velvet Bankruptcy proposal is procedural in nature. As such, it would not mark a radical disruption of the lender's rights. Under existing official bankruptcy, the lender's original claim would be modified anyway.[86] The Velvet Bankruptcy proposal merely shifts the legal modification of this claim from the personal proceedings to the corporate legal arena. The modification of the lender's rights (through either individual discharge or the extended corporate moratorium) is not the result of a choice of legal forum. Rather, it is the financial distress of the shareholder that necessitates such a modification of the lender's rights. In addition, the guarantee would remain effective as a bonding measure against willful, excessive risk-taking.[87] Thus, the guarantee would be fine-tuned to serve its normative economic goal. As a result, Velvet Bankruptcy would not interfere with the lender's legal rights.

Critics may argue that the adoption of Velvet Bankruptcy would be countered by lenders demanding substitute security measures, such as additional collateral in corporate assets or in shareholder assets, or the

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84 See also the discussion in *infra* Section IV.D.
85 See the discussion in *supra* Section III.A.
86 *Cf.* Bebchuk & Fried, *supra* note 56, at 917 (noting that security interests confer certain non-priority benefits to the secured creditor, and that these benefits would not be frustrated under the authors' proposal to substitute partial priority for the current full priority regime).
87 See the discussion in *supra* Part II.

imposition of additional restrictive covenants in the loan agreement. However, I believe that this concern would not undermine the efficacy of Velvet Bankruptcy. First, as explained, Velvet Bankruptcy is *procedural* in its nature, and as such is not expected to modify lenders' rights in a substantial fashion. Thus, the very need for countermeasures by lenders is questionable.[88] Second, demands for additional collateral in *corporate* assets or restrictive covenants in the loan agreement would align perfectly with this proposal rather than undermine it. Through these demands the lenders refocus their attention to the *corporation's* borrowing capacity. They reflect the lenders' pricing of the risk of business default, as they are part of the non-recourse lending arrangement, under which the corporation's assets alone would be available for repaying the loan.[89] Thus, compared to shareholder guarantees, these measures do not obviate the lenders' information gathering prior to the extension of credit to the corporation. Where, however, lenders would insist on obtaining collateral in the shareholder's *personal* assets, this would indeed require submission to the court's jurisdiction to modify the guarantee under Velvet Bankruptcy.[90]

D. Ancillary Judicial Administrative Benefits

Another advantage of Velvet Bankruptcy is that it would be likely to enhance certain judicial administrative efficiencies. Invariably, the trigger for the entrepreneur's slide into insolvency is the bankruptcy filing by the corporation and the subsequent lender's demand that the entrepreneur

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88 *Cf.* Lucian A. Bebchuk & Jesse Fried, *The Uneasy Case For Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply for Critics*, 82 Cornell L. Rev. 1279, 1328-32 (1997) (arguing that the authors' proposal to modify secured creditors' priorities reacts to inefficiencies of secured lending, and thus the efficiencies created by their proposal may more than offset any financing costs imposed by lenders as a result thereof).

89 For characterizing the principle of shareholder limited liability as a nonrecourse loan arrangement, see Jason W. Neyers, *Canadian Corporate Law, Veil-Piercing, and the Private Law Model Corporation*, 50 U. Toronto L.J. 173, 235 (2000); Easterbrook & Fischel, *supra* note 4, at 41.

90 Another possible critique of Velvet Bankruptcy would be that lenders would circumvent this proposal by instead lending directly to shareholders, who would in turn lend the amount borrowed to the corporation. However, in my eyes, this critique bears little if any merit. I believe that such back-to-back loan agreements ought to be interpreted by the courts substantively as comprising a loan to the corporation that is backed by a shareholder's guarantee. Thus, such arrangements would also be subject to Velvet Bankruptcy. *See* Bebchuk & Fried, *supra* note 88, at 1336-40 (arguing the same in defense of their call for partial priority for secured credit).

pay the guarantee. Simultaneously, the lender's claim is administered in the bankruptcy case of its principal debtor, that is, the corporation. A procedural linking of the resolution of the entrepreneur-guarantor's financial distress to that of the corporation may assist in expediting the entrepreneur's procedure. Allowing a joint filing of documents and administering both cases in conjunction would also generate a cost-effective procedure by avoiding duplicate filings and hearings on similar financial matters.[91] Indeed, co-adjudication of the bankruptcies of two separate debtors, the corporation and the entrepreneur-guarantor, is a legal cousin of a familiar doctrine employed under contemporary law in various jurisdictions around the world. For example, in the US,[92] bankruptcy courts employ the doctrine of procedural consolidation or joint administration.[93] Similarly, in Canada, it is common practice in the case of financial distress of various corporations that constitute a corporate group to administratively consolidate the bankruptcy cases of the separate entities.[94]

As a result of judicial administrative efficiency, Velvet Bankruptcy would also simplify the differentiation between bona fide and culpable entrepreneurs. Indeed, as was emphasized earlier, availing the former of a discharge in bankruptcy and denying it to the latter creates the proper incentives for lending banks to differentiate between these two types of borrowers.[95] In a personal bankruptcy case the judge would determine whether

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91 On the cost efficiency of procedural consolidation of separate bankruptcy cases, see Jonathan Hightower, *The Consolidation of the Consolidation in Bankruptcy*, 38 Ga. L. Rev. 459, 465-66, 469 (2003).

92 The US is *not* the prototypical country to which this article relates. The comparison to its law drawn in the main text is intended merely to establish that the tools that would be applied in applicable countries under the reform proposed herein are tools that are already in use in certain bankruptcy laws, despite the different context.

93 11 U.S.C. § 302 (2000); Fed. R. Bankr. P. 1015(b). Procedural consolidation is to be distinguished from substantive consolidation. The former entails merely a joint administration of the bankruptcy cases of multiple debtors, that is, the issuing of joint judicial orders and the like, but maintains the legal separation between the different debtors, the estates created in the property of each, and the creditors' claims of each. The latter, however, takes another step in that it combines the estates of the various debtors and pools together all of their creditors, to create in essence one enlarged case. *See* J. Stephen Gilbert, *Substantive Consolidation in Bankruptcy: A Primer*, 43 Vand. L. Rev. 207, 211 (1990).

94 Jacob S. Ziegel, *Corporate Groups and Crossborder Insolvencies: A Canada-United States Perspective*, 7 Fordham J. Corp. & Fin. L. 367, 370 (2002) (noting that in Canada over 70% of bankruptcy cases of corporations that belong to corporate groups are procedurally consolidated).

95 *See supra* Section III.A.

the debtor is entitled to a discharge only after the judge was convinced that the debtor neither behaved fraudulently nor willfully undertook excessive risks for the business. But the judge could make such a determination only after an investigation takes place within the administration of the case. Thus, potentially, dishonest entrepreneurs who file for personal bankruptcy could try to either obtain a discharge if their dishonesty would not be detected, or, at the very least, delay their payment to the creditors by undergoing a (lengthy) bankruptcy procedure. In contrast, Velvet Bankruptcy would prove more efficient in this respect.[96] That is, a corporate bankruptcy case would already be pending. Within that case, all past business affairs of the corporation, including the actions of its controllers, would be reviewed by the judge adjudicating the case for the purposes of resolving the corporation's crisis. Thus, the information concerning the entrepreneur-guarantor's (pre-default) actions would already be present in the courtroom before a single judge. It follows then, that the determination of whether the entrepreneur is worthy of the court's protection or not, and whether her guarantee ought to be modified, would be made by the court relatively quickly. This practice would improve the potential for differentiating between discharge-worthy and unworthy entrepreneurs.

CONCLUSION

The rules of the incorporation game are not what they ostensibly seem to be. Apparently, under the fundamental principles of corporate law, entrepreneurs are encouraged to invest and carry out new business ideas, while their personal wealth would be unaffected in case of failure. But the practice of personal guarantees completely alters the game. It allows banks to collect personally from the shareholder-guarantor. The burden of the corporate failure is thus shifted from the lender to the shareholder. Aside from affecting the entrepreneur's desire to undertake novel business opportunities, this practice also allows banks to hibernate and not closely examine the nature of the particular borrower and her business prospects. Rather, the banks can rely,

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96 Indeed, a personal bankruptcy filing *automatically* allows the debtor to enjoy a stay of all proceedings pending against him (until the conclusion of the case whether by a discharge or by its denial). However, under the Velvet Bankruptcy proposal the entrepreneur would enjoy a stay imposed against the lender's collection efforts *only if* the court (adjudicating the corporate bankruptcy case) would find the entrepreneur worthy of such a stay. Velvet Bankruptcy is a proceeding that is discretionary in nature. *See supra* Section IV.A.

in a standardized fashion, on the personal commitment of the shareholders, rather than differentiating between meritorious borrowers and those who are unworthy. This Article has demonstrated how a discharge in a shareholder's personal bankruptcy can serve both the role of encouraging entrepreneurship and loosening the banks' reliance on personal guarantees. This, in turn, would force banks to focus more closely on borrower-specific information prior to extending credit. Good corporate borrowers would then enjoy affordable credit without having to unnecessarily encumber the personal wealth of the entrepreneur-shareholder. However, personal bankruptcy suffers from the negative stigma associated with it. As a result, debtors tend to avoid filing for bankruptcy and use it only as a last resort. This undermines the efficacy of personal bankruptcy as a balancing measure against personal guarantees. To amend this, this Article calls for adopting a new procedural course, Velvet Bankruptcy. Velvet Bankruptcy would procedurally link the collection of the personal guarantee of an insolvent shareholder to the pending corporate bankruptcy case. It would serve as a *de facto* discharge for the financially distressed shareholder without subjecting her to the rigors and stigma that taint contemporary bankruptcy. Admittedly, the problems of personal bankruptcy adversely affect *all* individual debtors, business-oriented and non-business oriented alike. Allowing amicable discharges for entrepreneurs through Velvet Bankruptcy would serve as a catalyst for a larger, general, progressive reform of personal bankruptcy.