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Minority Entrepreneurs and Fast Failure

Minority businesses now make up more than a quarter of all U.S. businesses; yet, due to discriminatory lending practices, cultural aversions to debt, and limited access to capital, these businesses continue to have higher failure rates. At the same time, minority entrepreneurs are more likely to rely on informal lending and less likely to turn to bankruptcy for relief of debt. Doing so slows down failure for minority entrepreneurs—contra Silicon Valley’s new mantra, “fail fast”—and diminishes the minority entrepreneur’s ability to efficiently reallocate resources towards more productive ventures. In this essay, I distinguish the minority entrepreneurial fast failure decision from that of the majority entrepreneur and propose both private ordering and regulatory solutions that could help minority entrepreneurs fail faster. I begin by generally modeling the fast failure decision for the majority entrepreneur, highlighting the social costs of failing fast, and describing how formal lending and bankruptcy affect this model. I then explain how this model is distorted for minority entrepreneurs by discriminatory lending practices, cultural aversions to debt, and access to legal counsel. I conclude by suggesting, and critically assessing, proposals that could diminish these distortions, including peer-to-peer (P2P) lending platforms, mandatory educational programs, color-blind and big data loan and credit assessments, and minority loan subsidies.

I. INTRODUCTION

Minority businesses now make up more than a quarter of all U.S. business.¹ This level of entrepreneurship represents a significant stride for minorities and could be the “key [for many] to escap[e] poverty.”² That said, minority businesses also continue to have higher rates of failure than non-minority businesses.³ This high failure rate is not necessarily a foreboding statistic in the context of entrepreneurship, but it becomes detrimental when minority entrepreneurs fail to recover as quickly as their majority counterparts. That is, “fast failure” is the new mantra among entrepreneurs⁴ and, while some criticize this slogan as nothing more than Silicon Valley “hype,”⁵ failure can produce significant educational and innovative benefits.⁶

1. Minority Bus. Dev. Agency, Fact Sheet: U.S. Minority-Owned Firms (Jan. 2016), https://www.mbda.gov/sites/mbda.gov/files/migrated/files-attachments/2012SBO_MBEFactSheet020216.pdf (hereinafter Fact Sheet).

2. Reuben Abraham, *Entrepreneurship key to escaping poverty*, CNN (Jan. 23, 2012), <http://www.cnn.com/2012/01/17/opinion/world-economic-forum-reuben-abraham/>; see also Stephanie Rugolo, *Increasing Entrepreneurship Is a Key to Lowering Poverty Rates*, GOLDWATER INST. (Oct. 29, 2014), <http://www.goldwaterinstitute.org/en/work/topics/free-enterprise/entrepreneurship/increasing-entrepreneurship-is-a-key-to-lowering-2/>; STEPHEN SLIVINSKI, INCREASING ENTREPRENEURSHIP IS A KEY TO LOWERING POVERTY RATES, GOLDWATER INSTITUTE Policy REPORT (Nov. 13, 2012), <http://www.realclearmarkets.com/docs/2012/11/PR254%20Increasing%20Entrepreneurship.pdf>; The World Bank, *Innovation & Entrepreneurship* (July 8, 2015), <http://www.worldbank.org/en/topic/competitiveness/brief/innovation-entrepreneurship>.

3. Rafael Efrat, *Minority Entrepreneurs in Bankruptcy*, 15 GEO. J. ON POVERTY L. & POL’Y 95, 99, 121 (2008).

4. See BERNHARD SCHROEDER, FAIL FAST OR WIN BIG 143–67 (2015); RYAN BABINEAUX & JOHN KRUMBOLTZ, FAIL FAST, FAIL OFTEN: HOW LOSING CAN HELP YOU WIN 23–52 (2013); John Donohue, *Fail Fast, Fail Often, Fail Everywhere*, THE NEW YORKER (May 31, 2015), <http://www.newyorker.com/business/currency/fail-fast-fail-often-fail-everywhere>; *Fail Often, Fail Well*, THE ECONOMIST (Apr. 14, 2011), <http://www.economist.com/node/18557776> (hereinafter *Fail Often*).

5. See, e.g., Jon Terbush, *The 14 Most Bullshit Motivational Slogans in Silicon Valley*, GQ (Oct. 13, 2015), <http://www.gq.com/story/the-most-bullshit-motivational-slogans-in-silicon-valley>; Rob Ashgar, *Why Silicon Valley’s ‘Fail Fast’ Mantra Is Just Hype*, FORBES (July 14, 2014), <https://www.forbes.com/sites/robashgar/2014/07/14/why-silicon-valleys-fail-fast-mantra-is-just-hype/#651681b324bc>; Ajeet Khurana, *Failure Is the New Buzzword*, YOUR STORY (July 12, 2013), <https://yourstory.com/2013/07/failure-is-the-new-buzzword/>;

6. See *Fail Often*, supra note 5; see generally BABINEAUX & KRUMBOLTZ, supra note

These benefits, however, depend on the entrepreneur's ability to both fail and recover quickly.

The problem for minority entrepreneurs is that they are failing slower than their majority counterparts.⁷ This result is likely due to their reliance on informal lending and aversion to bankruptcy.⁸ That is, without the contractual and legal mechanisms of formal lending and bankruptcy, minority entrepreneurs are unable to efficiently organize debt obligations and recover through a "fresh start."⁹

In this essay, I show that failing slowly not only inures the minority entrepreneur's ability to learn and innovate, but also limits their ability to efficiently reallocate resources towards more productive ventures.¹⁰ Thus, if "[e]ntrepreneurship [is, in fact,] key to escaping poverty,"¹¹ and "failing fast" is essential to productive entrepreneurship,¹² minority entrepreneurs need access to contractual and legal mechanisms to ensure that, if their businesses fail, they fail fast. After demonstrating this result, I distinguish the minority entrepreneurial fast failure decision from that of the majority entrepreneur and propose both private and regulatory solutions that could help minority entrepreneurs fail faster.

4; ED CATMULL & AMY WALLACE, CREATIVITY, INC.: OVERCOMING THE UNSEEN FORCES THAT STAND IN THE WAY OF TRUE INSPIRATION Ch. 6 (2014); GEORGE DEEB, 101 STARTUP LESSONS: AN ENTREPRENEUR'S HANDBOOK 104 (2013); SUNIL GODSE, FAIL FAST. SUCCEED FASTER. (2013); SONIA LIN, SECRET TO STARTUP FAILURE: FAIL FAST. FAIL CHAP. FAIL HAPPY (2014); JOHN C. MAXWELL, FAILING FORWARD (2007); BERNARD SCHROEDER, *Introduction to FAIL FAST OR WIN BIG: THE START-UP PLAN FOR STARTING NOW* (2015).

7. See Efrat, *supra* note 3, at 99, 121. Yet, it should be noted that "minority-owned small businesses are not significantly less profitable than majority-owned small businesses." *Id.* at 74 (citing K.S. Cavalluzzo et al., *Competition, Small Business Financing, and Discrimination: Evidence from a New Survey*, 75 J. OF BUS. (1999)).

8. *Id.* at 121.

9. See *infra* Section II.C.

10. See Javier Gimeno et al., *Survival of the Fittest? Entrepreneurial Human Capital and the Persistence of Underperforming Firms*, 42 ADMIN. SCI. Q. 750, 750–51 (1997); Fahri Karakaya, *Market Exit and Barriers to Exit: Theory and Practice*, 17 PSYCHOL. & MARKETING 651, 659 (2000).

11. See sources cited *supra* note 2.

12. See sources cited in *supra* notes 4 & 5.

This comment proceeds as follows. In Section II, I provide a general model of the “typical entrepreneur’s”¹³ fast failure decision. This model compares the monetary benefits of delaying failure with the social costs. From this model, I conclude that, in the aggregate, it is more likely than not that the monetary benefits of fast failure are more valuable than the associated social costs for the typical entrepreneur. In doing so, I highlight that this conclusion rests on the assumption of formal lending and bankruptcy, decreasing the overall cost of failure by lowering transaction costs and forgiving part of the typical entrepreneur’s debts.

In Section III, I turn to the fast failure decision for the minority entrepreneur and describe the distortions on the typical entrepreneur model that affect her decision. These distortions include discrimination, cultural aversions, and lack of access to legal counsel. I critically discuss existing proposals that could diminish these distortion costs and conclude that further innovation and intervention is necessary.

In Section IV, I suggest a novel set of proposals, both private and regulatory, for diminishing these distortion costs. As a private ordering solution, I suggest using peer-to-peer (P2P) lending to circumvent the costs posed by discrimination and cultural aversions. I also suggest four incremental, regulatory proposals: first, a required educational program for those who obtain SBA loans that teaches borrowers about the benefits of fast failure and bankruptcy; second, a truly color-blind loan application process; third, a requirement that loan applications being assessed using a process that avoids judgment of soft skills and rests on statistical methods that have been proven not to have a disparate impact on minority entrepreneurs; and fourth, an SBA loan guarantee program that particularly targets minority entrepreneurs.

13. By “typical entrepreneur,” I mean the average SBA borrower.

II. THE FAST FAILURE DECISION

While fast failure is a moral truth among Silicon Valley entrepreneurs,¹⁴ and online fora provide varied advice on when an entrepreneur should call it quits,¹⁵ the general entrepreneurial fast failure decision has never been formally modeled.¹⁶ Thus, I begin by creating this model, highlighting the key considerations of an entrepreneur deciding between accelerating or decelerating failure. After doing so, I further describe the social benefits and costs at stake in this decision and argue that, in most situations, the social costs of failing fast do not outweigh its monetary reward. I conclude by explaining how my model rests on the assumption that the entrepreneur take advantage of formal lending and bankruptcy, as contractual and legal mechanisms affecting the speed and costs of failure and recovery.

A. The General Model

Most discussions of failing fast revolve around its educational and innovation benefits.¹⁷ Yet, there is also a straightforward economic argument for failing fast: if you know your

14. Cf. sources cited in note 4.

15. See, e.g., George Meszaros, *15 Ways Successful Entrepreneurs Know When to Give up or Keep Fighting*, SUCCESS HARBOR (last visited May 5, 2017), <https://www.successharbor.com/entrepreneurs-know-give-forge-ahead-01192015/>; *Knowing When to Quit*, ENTREPRENEUR (July 18, 2005), <https://www.entrepreneur.com/article/78774>; Chand Brooks, *Why the Best Entrepreneurs Know When to Quit*, BUS. NEWS DAILY (May 21, 2013), <http://www.businessnewsdaily.com/4520-entrepreneurs-know-when-to-quit.html>.

16. Fast failure has been formally explored in the context of pharmaceutical and technological innovation. See, e.g., Rajat Khanna et al., *Fail Often, Fail Big, and Fail Fast? Learning from Small Failures and R&D Performance in the Pharmaceutical Industry*, 59 ACAD. OF MGMT. J. 436, 436–37 (2016); Jim Shore, *Fail fast [software debugging]*, IEEE SOFTWARE Vol. 21:5, 21–25 (Sept.–Oct. 2004), <http://ieeexplore.ieee.org/document/1331296/>. In addition, while never using the term “fast failure,” the concept has been explored in the context of barriers to market exit. See sources cited *supra* note 10. My model is consistent with these models, but simplifies the variables.

17. See sources cited *supra* in note 5; see also Dean A. Shepherd, *Learning from Business Failure: Propositions of Grief Recovery for the Self-Employed*, 28 ACAD. OF MGMT. REV. 318, 319–20 (2003).

business is failing, then it is best to accelerate that failure as much as possible so that you can reallocate your resources to more productive ventures.¹⁸ A similar concept, market exit, has previously been modeled by marketing researchers.¹⁹ However, to more adequately account for entrepreneurial behavior and the distinctions between majority and minority entrepreneurs, I produce a more general model below.²⁰

To begin, I model the “fast failure” condition; namely, if failing fast is optimal, then the expected utility of failing fast, $E(F)$, should be greater than the expected utility of delaying failure or extending survival, $E(S)$:

$$(1) E(F) > E(S).$$

Further, I assume that, at time n_1 , the entrepreneur knows that the business will fail, but also that the business can survive until some time n_2 . Essentially, the entrepreneur’s fast failure decision is whether to fail at n_1 or n_2 .²¹

Next, I define the expected value of extending survival as the difference between the individual social benefits accrued from extending survival, b_s ,²² and the cost of failure at some time n_2 , C_{n_2} :

$$(2) E(S) = b_s - C_{n_2}.$$

Likewise, the expected value of failing fast is defined as the difference between the individual social costs of failing fast, C_F ,

18. Cf. Gimeno et al., *supra* note 10, at 750–51; Karakaya, *supra* note 10, at 659.

19. See Gimeno et al., *supra* note 10, at 754–56.

20. I do not claim my model is in any way inconsistent with Gimeno’s model of thresholds of venture survival. Cf. *id.* I created a new model simply because I wanted to better account for the distortion costs in Section III. For more detail regarding the unique characteristics of successful and unsuccessful entrepreneurs, I recommend a careful read of Gimeno’s piece.

21. I forego this assumption and build a probabilistic model below. See *infra* equations (2p), (3p) and (1’p).

22. See *infra* Section II.B.

such as decreased civic capital,²³ and the cost of failure at some time n_1 prior to n_2 :

$$(3) E(F) = -C_F - C_{n_1}.$$

At this point, an entrepreneur will opt to fail fast when the individual social costs of failing fast combined with the cost of failure at time n_1 is less than the difference between the costs of failure at time n_2 and the individual social benefits of extending survival; i.e., an entrepreneur will opt to fail fast when:

$$(1') -C_F - C_{n_1} > b_s - C_{n_2}. \quad ^{24}$$

Next, I define the entrepreneur's cost of failure at the end of year n , C_n , as the difference between an entrepreneur's assets and liabilities at the end of year n . That is, assuming that the entrepreneur has an annually compounding loan with a term of n years, that the business's assets depreciate at a normalized rate, and that the business will fail in year n , the entrepreneur's cost of failure is

$$(4) C_n = -\{n(R - E) + A(1 - d)^n - L(1 + i)^n\}, \quad ^{25}$$

where R = the entrepreneur's average annual revenue, E = the entrepreneur's average annual expenses, A = the value of the entrepreneur's assets in year zero, d = the annual depreciation rate of the entrepreneur's assets, L = the entrepreneur's loan principal, and i = the entrepreneur's annual compound interest rate on her loan.²⁶

23. For more examples, see *infra* Section II.C. One may argue that failure may increase social capital in spheres such as Silicon Valley; however, because this appears to be a relatively unique phenomenon, I do not integrate such benefits into this model.

24. Because the individual social costs of failing fast and the costs of failure are negative values, the inequality is flipped.

25. I have placed a negative value in front of this expression because, if a business is failing, the value will always be negative.

26. I acknowledge that the threshold for failure is likely much more complicated than

The following example demonstrates the operation of this model. Suppose Joe is a typical entrepreneur looking to borrow money for a business venture.²⁷ Joe needs a \$300,000 loan and has two options: obtain a 5-year loan at a 5% compounded interest rate or obtain a 10-year loan at the same rate.²⁸ Further, suppose Joe knows that, should his business plan be successful, he will be able to pay off this loan (with interest) after five years. However, if his business plan is unsuccessful, he will know by year five that his business is failing and can survive for only another five years. Finally, assume that at the termination of the loan, Joe will have no additional ways of capitalizing his business and will either need to pay off the loan or close his business.

Using the numbers provided above, and assuming that $(R - E) = \$27,000$ ²⁹, $A = \$200,000$, and $d = 10\%$ or 0.1, Joe's cost of failure in year ten, C_{n_2} , is approximately \$148,932.70 while his cost of failure in year five, C_{n_1} , is only approximately \$129,786.47. Thus, Joe would rationally choose to fail fast when:

$$(1'a) -C_F - \$129,786.47 > b_s - \$148,932.70.$$

That is, Joe will rationally prefer the 5-year loan when the sum of the individual social costs of failing fast and the individual social benefits of survival is less than \$19,146.23; i.e., when:

simply a function of assets and liabilities. See, e.g., Gimeno et al., *supra* note 10, at 753.

27. Once again, I assume "typical" means the average SBA loan borrower.

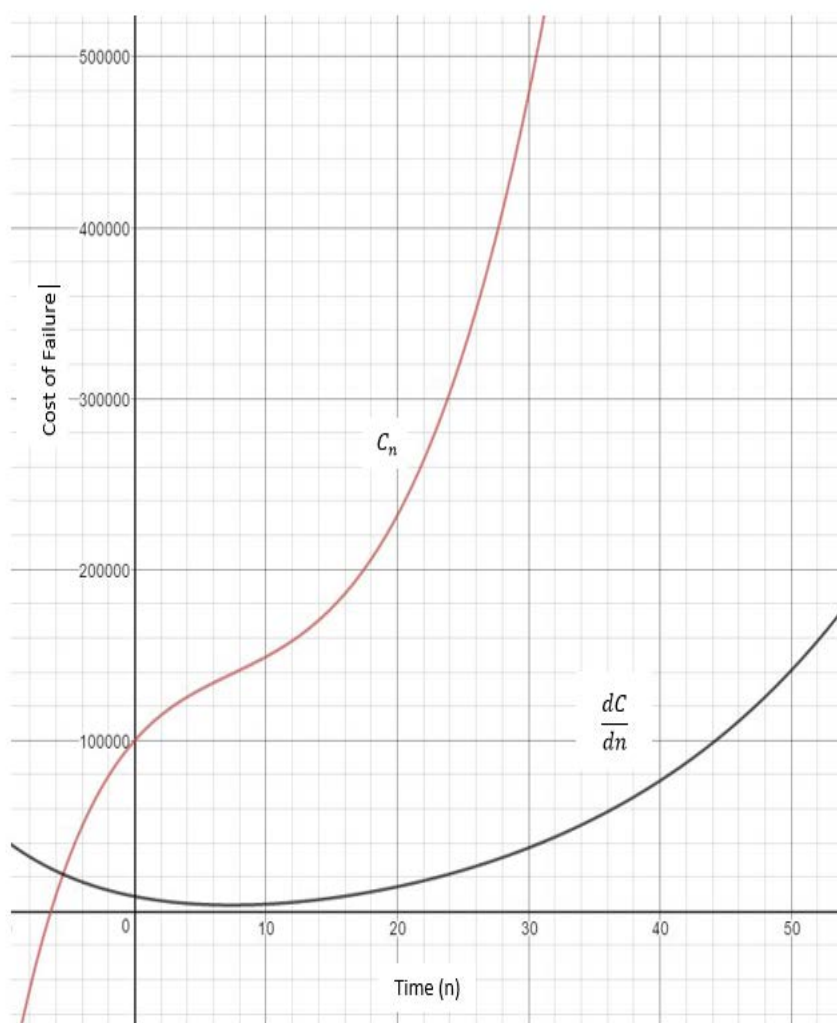
28. Note that the average SBA loan in 2015 was \$371,628. Small Business Administration, *7(a) Loan Amounts, Fees & Interest Rates* (last visited May 5, 2017), <https://www.sba.gov/funding-programs/loans>. The normal rate for the SBA loan is 3%. However, lenders may vary from that rate by at most 2.25%. *Id.*; see also *Average Small Business Loan Interest Rates in 2017: Comparing Top Lenders*, VALUE PENGUIN (last accessed Apr. 1, 2017), <https://www.valuepenguin.com/average-small-business-loan-interest-rates>.

29. Note that I have purposefully chosen a number that would entail Joe's business would fail. If I chose a number in which Joe's business would be successful, then Joe would not opt to fail faster.

$$(1'a') \ C_F + b_s < \$19,146.23.$$

Figure 1 (below) depicts Joe's cost of failure in year n , C_n , based on the facts above. In addition, Figure 1 depicts the additional annual cost of failure for each year Joe postpones failure, $\frac{dC}{dn}$. Notice that Joe's cost of failure increases at a greater rate as time progresses. This is largely the effect of Joe's compounding interest rate on his loan and would be mitigated if he made annual interest payments towards it. That said, he would still suffer a significant cost by delaying failure.

Figure 1. Depiction of C_n and $\frac{dC}{dn}$ for Joe's hypothetical business.



Before proceeding, I acknowledge and demonstrate that the assumption that the typical entrepreneur knows outright that their business will fail at year n is unproblematic. The objection runs that, because entrepreneurs often overestimate

their success,³⁰ and because it is highly unlikely that an entrepreneur will know their average revenue and expenses before beginning their venture, one must consider the probability of failure in framing the fast failure decision. This requires including the coefficient P_n , the probability of failure at time n , in front of C_n in the expected utility functions described above. Thus, $E(S)$ becomes

$$(2p) \ E_p(S) = b_s - P_{n_2} C_{n_2},$$

and $E(F)$ becomes

$$(3p) \ E_p(F) = -C_F - P_{n_1} C_{n_1}.$$

The typical entrepreneur will rationally opt for faster failure when:

$$(1'p) \ -C_F - P_{n_1} C_{n_1} > b_s - P_{n_2} C_{n_2}.$$

For a numerical value on the probability of failure, the entrepreneur may look to the aggregate statistics from the Small Business Administration on the survival rates of small businesses. These rates follow an inverse, exponential curve in which approximately 80% of businesses survive their first year, 50% survive after five years, and 33% survive after ten years.³¹ Because, out of those businesses that did not survive, approximately one-third were successful and simply purchased,³² the entrepreneur may discount each non-survival rate by one-third.

Returning to the hypothetical above, suppose that Joe uses these statistics to compute his probability of failure is 33%

30. David Thesmar, *Financial Contracting with Optimistic Entrepreneurs*, 22 REV. OF FIN. STUD. 117, 117 (2009).

31. See Small Business Administration, Office of Advocacy, *Small Business Facts* (last accessed May 5, 2017), <https://www.sba.gov/sites/default/files/Business-Survival.pdf>.

32. See Ryan Jorden, *What Are the Real Small Business Survival Rates?* LINKEDIN (Sept. 15, 2014), <https://www.linkedin.com/pulse/20140915223641-170128193-what-are-the-real-small-business-survival-rates>.

in year five and 44% in year ten. Joe would, therefore, rationally opt to fail faster when:

$$(1'pa) - C_F - (.33)\$129,786.47 > b_s - (.44)\$148,932.70.$$

In other words, Joe will rationally opt to fail faster when

$$(1'pa') C_F + b_s < \$22,700.85,$$

which is only marginally more than the amount found in equation (1'a') above. Thus, from this analysis, I have shown that Joe's decision to fail fast is hardly altered when considered in the context of probabilities of failure rather than foreknowledge of failure.³³

In the end, the general model demonstrates that the individual social benefits of delaying failure and individual social costs of failing fast must be substantial for the entrepreneur to decide to extend the survival of her business. In the next subsection, I describe these individual social benefits and costs in further detail and conclude that their aggregate social worth is, in most situations, likely less than the monetary value of failing fast.

B. Barriers to Exit

As mentioned above, failing fast may not be advantageous to an entrepreneur if the monetary benefits of doing so are less than the sum of the individual social costs of failing fast

33. Note, however, that other studies have found that "[i]f there is uncertainty about future payoffs, owners may be willing to accept low levels of performance with the hope that conditions will improve." Gimeno et al., *supra* note 10, at 751 (citing generally AVINASH K. DIXIT & ROBERT S. PINDYCK, *INVESTMENT UNDER UNCERTAINTY* (1994)). Because it is unclear what "low levels of performance" means in the model above, these studies are not necessarily inconsistent with my finding that fast failure is still optimal under similar conditions when probability of failure is taken into account.

and the individual social benefits of delaying failure.³⁴ These individual social costs and benefits belong to the broader category of an entrepreneur's "barriers to exit."³⁵ Below, I further detail these barriers to exit by explaining how failing fast can negatively affect individual stability and individual social capital. In addition, I discuss how delaying failure can increase an entrepreneur's civic capital. Finally, I contrast these individual social costs and benefits with their aggregate counterparts.

The individual social costs of failing fast are connected to individual stability and individual social capital. With respect to individual stability, business failure can cause entrepreneurs to suffer significant grief.³⁶ That is, even serial entrepreneurs are motivated, beyond profit, by phenomena such as loyalty to a product, a market, or customers, as well as proving oneself.³⁷ Further, if the entrepreneur is engaged in a family-owned business, failure can be even more detrimental because the business is "a context for family activity and [an] embodiment of its pride and identity."³⁸ Finally, "fear of the unknown" can deteriorate an entrepreneur's confidence,³⁹ motivating them to simply stay on course with their current failing venture. In total, these factors create significant grief in response to failure.

Some scholars have suggested that delaying failure can diminish the intensity felt by entrepreneurs through the mechanism of anticipatory grief.⁴⁰ That is, just as prolonging the life

34. For simplicity, I do not discuss the benefits of innovation and education that are often pointed to within the failing fast literature. It is questionable whether these benefits are actually connected to failing fast in situations similar to the hypothetical above. That is, the entrepreneur has already failed, thus likely learned what caused the failure as well as thought of ways not to fail in the future. If anything, delaying failure as discussed above simply postpones the benefits of innovation.

35. See Karakaya, *supra* note 10, at 651 (citing M.E. Porter, *Please Note the Location of Nearest Exit*, 19 CAL. MGMT. REV. 21, 21–33 (1976)).

36. See Dean A. Shepherd, Note, *Learning from Business Failure: Propositions of Grief Recovery for the Self-Employed*, 28 ACAD. OF MGMT. REV. 318, 319–20 (2003).

37. *Id.* at 319.

38. Gimeno et al., *supra* note 10, at 751 (citing MARSHALL W. MEYER & LYNNE G. ZUCKER, PERMANENTLY FAILING ORGANIZATIONS 78 (1989)).

39. See Karakaya, *supra* note 10, at 653.

40. See Dean A. Shepherd et al., *Moving Forward: Balancing the Financial and Emo-*

of a loved one who is terminally ill diminishes intensity of grief at their passing, prolonging the life of a failing business may diminish the intensity of grief at the moment of failure.⁴¹

Yet, delaying failure may also increase the emotional commitment of the entrepreneur to the business venture through further financing and time commitments, and thus intensify the grief at the loss of the business.⁴² Thus, while an entrepreneur may find some benefit from delaying failure, the individual stability benefits of doing so are likely limited.⁴³

With respect to individual social capital, failing as an entrepreneur in some communities can lead to being perceived as a drab businessman or businesswoman.⁴⁴ That is, past and future employees may become more skeptical of working with a failed entrepreneur.⁴⁵ An owner who is willing to “redeploy assets in a more profitable arena” may injure relationships with employees “who have developed firm-specific skills” and thereby, at the close of the firm, lack job security.⁴⁶ In addition, the entrepreneur’s ability to redeploy her assets toward a new business venture may be diminished because her failure will lead institutions and her peers to view her as a riskier investment.⁴⁷

tional Costs of Business Failure, 24 J. OF BUS. VENTURING 134, 142 (2009).

41. See *id.* at 139–40.

42. See *id.* at 138–39.

43. See *id.* at 142–43.

44. Cf. Karakaya, *supra* note 10, at 653 (discussing how businesses that put out failed product lines can appear to be “drab businesses”). I admit that failure appears to have a counter-effect, as a right of passage, within Silicon Valley culture. See, e.g., Rana Florida, *Why You Should Brag About Your Failures*, FAST COMPANY (Oct. 29, 2014), <https://www.fastcompany.com/3037704/what-it-really-means-to-fail-forward>. However, such an attitude is unique to the growing tech and biomedical industries and may not sustain itself. See Rory Carroll, *Silicon Valley’s Culture of Behavior . . . and “the Walking Dead” It Leaves Behind*, THE GUARDIAN (June 28, 2014), <https://www.theguardian.com/technology/2014/jun/28/silicon-valley-startup-failure-culture-success-myth>.

45. See Karakaya, *supra* note 10, at 653 (citing M. Wartenberg, *How to Merge and Survive*, 79 MGMT. REV. 64, 64–70 (1995)).

46. Gimeno et al., *supra* note 10, at 751. The almost universal skill-set of programming is likely why the fail fast mentality has become so prominent in Silicon Valley.

47. See *infra* Section II.C discussing the effect of formal lending on the model. Essentially, a business failure may decrease a person’s credit score.

The individual social benefit of delaying failure for the typical entrepreneur is that it increases to the entrepreneur's "civic capacity."⁴⁸ Small business owners will often "leverage financial resources, cultivate political clout, establish civic alliances, [and] gain access to local and citywide neighborhood planning debates."⁴⁹ Further, "institutional embeddedness" creates more opportunities for entrepreneurial rent-seeking. Thus, an entrepreneur that believes her venture could be successful after obtaining certain government benefits, or who is concerned about influencing community projects, may rationally opt to delay failure.

The social costs diminishing individual stability and social capital and the benefits of increasing civic capital are, in the aggregate, less likely desirable to society than the monetary benefits of failing fast. For example, while a surviving business may provide individual stability (and potentially stability within a community),⁵⁰ it may make it more difficult for a community to attract investment because it will be identified as a stagnant or failing commercial area. Likewise, while an entrepreneur may take a hit to her reputation at the failure of her venture, this decrease in social and civic capital will likely be even more significant if it is discovered that the entrepreneur purposefully sustained her business to retain a position of influence. Thus, while the social costs of failing fast and the social benefits of delaying failure may be significant, it is likely more optimal for the typical entrepreneur to fail fast.

C. The Effects of Formal Lending and Bankruptcy

Formal lending and bankruptcy both incentivize and deter fast failure. That is, while formal lending organizes the rela-

48. Stacey Sutton, *Rethinking Commercial Revitalization: A Neighborhood Small Business Perspective*, 24 ECON. DEV. Q. 352, 366 (2010).

49. *Id.*

50. See Shepherd et al., *supra* note 40, at 134.

tionships between creditors and debtors, it also relies on a credit market that limits repeat entrepreneurs, who formerly failed, from receiving the same value from future loans.⁵¹ Further, while bankruptcy reorganizes debt obligations and provides a “fresh start” to failed entrepreneurs, these benefits may be used unadvisedly to allow an otherwise significantly failing business to survive in debt without absorbing the full monetary cost of such debt. I describe both of these considerations below as well as their effects on the typical entrepreneur model.

1. Formal lending

I define “formal lending” to include all transactions between a borrower and an arm’s length third party where business capital is exchanged for a written contract to repay the amount to the third party at a specific interest rate, under a specific set of terms. By contrast, I define “informal lending” as any type of lending transaction that excludes one of the above conditions.

While informal lending may cut down on the entrepreneur’s initial transaction costs, it also leads to a slower, more costly failure (amplifying C_n) because it does not, formally, resolve disputes that may arise in the lending process *ex ante* such as:

- When will the loan be repaid?
- How will the loan be repaid?
- What happens if part of the loan is not repaid?
- What happens if the borrower takes out another loan?

That is, the informal lending increases transaction uncertainty, including “the ability [of each party] to establish property rights

51. That is, they will likely have a higher interest rate on their repeat loans.

over their investments.”⁵² Without establishing such rights *ex ante*, these transaction costs are postponed and amplified.⁵³

In addition, informal borrowers “are more likely to default,”⁵⁴ but less likely to participate in bankruptcy proceedings.⁵⁵ Because bankruptcy is a legal mechanism that speeds up failure,⁵⁶ avoiding bankruptcy likely delays the failure process and adds additional costs to the entrepreneurs. This practice of avoiding bankruptcy is likely caused by the fact that informal creditors are typically not given priority in the entrepreneur’s reorganization of their debts.⁵⁷ Thus, informal creditors, who are typically non-arm’s length parties, will pressure the entrepreneur to repay their loan before paying off other debts or pursuing bankruptcy.

While formal lending is thus generally advantageous for organizing debt obligations, it may also discourage entrepreneurs from speeding up failure due to its potentially detrimental effect on an entrepreneur’s credit rating. That is, if an entrepreneur knows she will not be able to pay off her debts with her current business venture, she may opt to postpone failure, continue paying interest on her loans, and then use her current credit to develop another business venture, from which she would hope to profit. This type of entrepreneurial behavior

52. Harshana Kasseeah, *The Performance of Small Firms: Does Formality Matter?*, 28 J. OF SMALL BUS. & ENTREPRENEURSHIP 431, 432 (2016).

53. I have not yet located literature that makes this general assertion; however, I believe the point is analogous to the common intuition among lawyers that carefully drafting contracts will decrease litigation costs. The problem here would be that some informal networks develop efficient norms that make formality in the transactions redundant. It is unclear whether informal lending has such norms.

54. Edmund J. Malesky & Markus Taussig, *Where Is Credit Due? Legal Institutions, Connections, and the Efficiency of Bank Lending in Vietnam*, 25 JOURNAL OF LAW, ECONOMICS, & ORGANIZATION 535, 537 (2009). See also Meghana Ayyagari et al., *Formal Versus Informal Finance: Evidence from China*, 23 REV. OF FIN. STUDIES 3048, 3051–52 (2010); Efrat, *supra* note 3, at 119 (discussing specifically the actions of minority entrepreneurs).

55. See generally Amanda E. Dawsey & Lawrence M. Ausubel, *Informal Bankruptcy*, TWELFTH ANNUAL UTAH WINTER FINANCE CONFERENCE (2002), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=332161.nh

56. See *infra*.

57. See generally Dawsey & Ausubel, *supra* note 58.

is captured by the typical entrepreneur model described above because it presumes to encompass the total possible debt an entrepreneur could reasonably take on as well as the total annual average of her revenue over expenses, including any additional ventures that might be pursued. Therefore, while formal lending may discourage fast failure in some instances, these instances are accounted for in the model when the behavior of the entrepreneur is aggregated.

2. *Bankruptcy*

Likewise, bankruptcy is the unique legal mechanism that restores social and individual productivity to a failing firm.⁵⁸ It increases the speed of failure by efficiently reorganizing the obligations of debtors as well as providing them with a “fresh start.”⁵⁹ Yet, the “fresh start” policy may also incentivize entrepreneurs to delay failure, permitting the entrepreneur to continue running a business with skyrocketing debts because it will be forgiven of a significant amount of such debt. Each of these points are discussed below.

First, bankruptcy efficiently reorganizes the debts of an entrepreneur, reducing the total cost of failure by reducing the entrepreneur’s expenses.⁶⁰ Without this reorganization mechanism, “parties would [need] to contract out of bankruptcy and design their own arrangements for the case of insolvency” on a case-by-case basis,⁶¹ which would likely create a “hold-out incentive [for] the last creditor to threaten to upset the reorgani-

58. See Nicholas L. Georgakopoulos, *Bankruptcy Law for Productivity*, 37 WAKE FOREST L. REV. 51, 88–95 (2002).

59. See *id.* For a discussion of the distinctions between the commonly used mechanisms of Chapter 7, Chapter 11, and Chapter 13 as well as their utilization by entrepreneurs, see Simon C. Parker, *Law and the Economics of Entrepreneurship*, 28 COM. LAB. L. & POL’Y J. 695 (2007).

60. See Georgakopoulos, *supra* note 58, at 69–70.

61. *Id.* at 70.

zation.”⁶² In addition, reorganization helps prevent false liquidations—i.e., situations in which a firm appears to be failing, but is in actuality simply feeling the effects of a recession—by providing an alternative to imperfect auctions.⁶³ That is, reorganization provides the entrepreneur with more time to better evaluate her probability of failure, P_n .

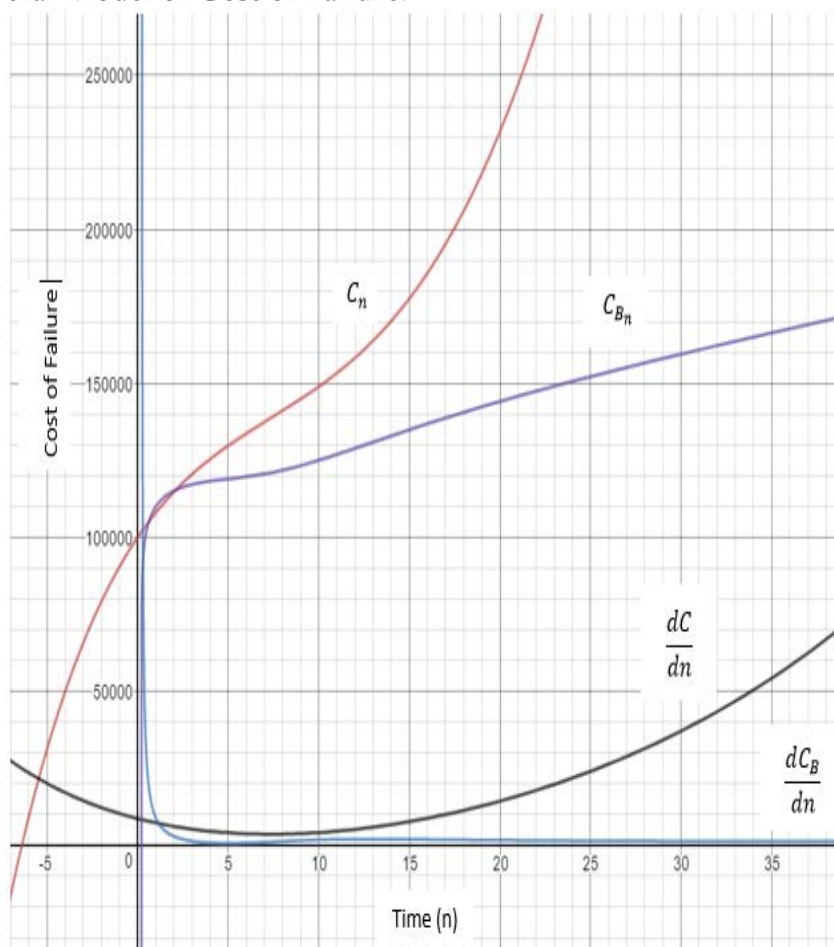
Second, the “fresh start” policy of bankruptcy essentially forgives “the debts of honest insolvent individuals”⁶⁴ and, thereby, speeds up the failure of an entrepreneur by decreasing the cost of failure. That is, bankruptcy dampens the cost of failure, C_n , logarithmically by forgiving debts that would otherwise essentially enslave the debtor; this is represented by the function C_{B_n} in Figure 2.

62. *Id.* at 72.

63. *See id.* at 73–74.

64. *Id.* at 56.

Figure 2. Logarithmic Effect of Bankruptcy on the General Model of Cost of Failure.⁶⁵



Without the “fresh start” policy, some entrepreneurs would be forced to “devot[e] the whole or a considerable portion of [their] earnings for an indefinite time in the future to the payment of indebtedness incurred prior to [their] bankruptcy.”⁶⁶ Doing so would essentially force some failed entrepreneurs into “pauperism,” as any incentive to work for “material

65. As this figure demonstrates, the cost of failure without bankruptcy increases over time significantly faster than the cost of failure with bankruptcy.

66. *Local Loan Co. v. Hunt*, 292 U.S. 234, 245 (1934).

remuneration” would be significantly diminished because such remuneration would simply be passed straight to the debtors’ creditors.⁶⁷

This “fresh start” policy, however, could diminish an entrepreneur’s incentive to fail fast when the entrepreneur has already reached her maximum debt threshold such that all other incurred debt would be forgiven. In other words, if an entrepreneur knows that filing for bankruptcy would likely mean that additional debt does not need to be paid off, then she has no monetary incentive to fail immediately instead of fail later because her cost of failure will remain the same.⁶⁸

While it may be questionable whether an entrepreneur could engage in such behavior and still satisfy the “good faith” requirement,⁶⁹ the “fresh start” policy does significantly decrease the additional annual cost of failure for entrepreneurs who have reached their maximum debt threshold (represented in Figure 2 as $\frac{dC_B}{dn}$). In doing so, the “fresh start” policy would likely allow an entrepreneur with marginal individual social benefits associated with delaying failure, or marginal individual social costs associated with immediate failure, to rationally opt to delay failure and thus create an aggregate social loss.

67. Georgakopoulos, *supra* note 58, at 59. The “fresh start” policy may also be utilized to relieve debtors from certain contractual provisions that would slow down their ability to reenter the market after failure. *See id.* at 83–86. For example, debtors have been relieved of certain intellectual property agreements. *See Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985); Georgakopoulos, *supra* note 58, at 84, as well as certain non-competes: *see In re Register*, 95 Bankr. 73 (Bankr. M.D. Tenn. 1989); Georgakopoulos, *supra* note 58, at 84. Some have argued against the “fresh start” policy, claiming that it pushes lenders to simply increase interest rates; however, such an increase would likely be negligible because there are already significantly low odds of repayment in situations where the “fresh start” policy is applied. *See* Georgakopoulos, *supra* note 58, at 59–60. Moreover, implementations of more forgiving bankruptcy policies has actually demonstrated a higher correlation of self-employment. *See* John Armour & Douglas J. Cumming, *Bankruptcy Law & Entrepreneurship*, 10 AM. L. & ECON. REV. 303 (2008).

68. Other than reallocating her resources toward more productive activity, or avoiding tax consequences which would, at most, simply be a decrease in the taxpayer’s basis in her business’s property, *see* 26 U.S.C. § 108.

69. *See* Georgakopoulos, *supra* note 58, at 56.

This result suggests further investigation of whether entrepreneurs could, or actually do, delay failure when they have reached their maximum debt threshold. Such an investigation is beyond the scope of this comment. For now, I believe I can assume that such activity is not incentivized by the “fresh start” policy because, even without this policy, most debtors in the hole enough to rely on the policy are unlikely to pay off their creditors;⁷⁰ thus, the fact that they would get their debt forgiven is not dependent upon the “fresh start” policy. Instead, this policy is aimed more at improving the recovery of such debtors, incentivizing them to fail faster.

In the end, formal lending and bankruptcy increase the entrepreneur’s speed of failure by organizing, reorganizing, and potentially forgiving an entrepreneur’s debt obligations. While the “fresh start” policy in bankruptcy may incentivize entrepreneurs to delay failure because they will only incur a minimal additional cost of failure, this incentive likely does not exist due to the “good faith” requirement and the actual benefits conferred by the “fresh start” program.

In this section, I created a general model of the fast failure decision for the typical entrepreneur, described and evaluated the social benefits of delaying failure and the social costs of failing fast, and explained how formal lending and bankruptcy effect the fast failure decision. In the next section of this comment, I now turn my focus to the application of this model to minority entrepreneurs. In doing so, I specifically discuss how discrimination and certain cultural aversions distort the fast failure decision for minority entrepreneurs.

70. See *id.* at 59–60.

III. DISTORTIONS TO THE MODEL FOR MINORITY ENTREPRENEURS

As mentioned above, minority-owned firms represent more than a quarter of all U.S. businesses;⁷¹ and, commentators continue to point to minority entrepreneurship as a gateway to improving impoverished communities.⁷² Yet, minority businesses are also disproportionately underrepresented in bankruptcy proceedings due to a prevalence of informal lending,⁷³ and there is a dearth of discussion of how this phenomenon affects the timing of failure for minority businesses. In this section, I account for costs that distort the fast failure decision for low-income and minority entrepreneurs, C_D . In general, these costs distort the entrepreneur's expected value of failing fast, $E(F)$, by adding additional costs of access to mechanisms that encourage fast failure. The fast failure function for the minority entrepreneur thus becomes:

$$(3m) E_m(F) = -C_D - C_F - C_{n_1}.$$

This entails that fast failure is rational for the minority entrepreneur only when:

$$(1'm) -C_D - C_F - C_{n_1} > b_s - C_{n_2}.^{74}$$

The distortion costs I will focus on in this section are discrimination, cultural aversions, and access to counsel. Each

71. Fact Sheet, *supra* note 1.

72. See sources cited *supra* note 2.

73. Efrat, *supra* note 3, at 121–23.

74. If one prefers the probabilistic model rather than the determinate future model, the expected value of failing fast for the minority entrepreneur would be

$$(3pm) E_{p_M}(F) = -C_D - C_F - P_{n_1}C_{n_1},$$

and the minority entrepreneur would rationally opt to fail faster only when

$$(1'pm) -C_D - C_F - P_{n_1}C_{n_1} > b_s - P_{n_2}C_{n_2}.$$

of these costs diminish the minority entrepreneur's desire for, and access to, fast failure.⁷⁵ By diminishing the minority entrepreneur's demand for and supply of fast failure, the resources of minority entrepreneurs will not be efficiently reallocated to more productive ventures as often as the typical entrepreneur. This entails both an individual social loss to the minority entrepreneur as well as an aggregate social loss to the community.

A. Discrimination in the Formal Lending Market

One of the main causes for minority entrepreneurs' disproportionate under-participation in bankruptcy proceedings is that minority entrepreneurs rely heavily on informal lending.⁷⁶ This reliance developed because minority entrepreneurs generally have "diminished access to . . . debt financing."⁷⁷ That is, financial institutions are less likely to lend or provide adequate rates to minority entrepreneurs because they generally lack sufficient information about them; this lack of information results from the fact that often "minority entrepreneurs lack credit histories or required collateral,"⁷⁸ have a lower loan application submission rate, [and] have fewer ties to financial institutions."⁷⁹ Moreover, because this lack of information makes mi-

75. See A. Mechele Dickerson, *Race Matters in Bankruptcy*, 61 WASH. & LEE L. REV. 1725, 1743–70 (2004) (arguing that the structure of bankruptcy law does not provide nearly the same benefits to minorities as it does to non-minorities). But see Daniel Gill, *Racial Bias Reflected in Bankruptcy Filings*, BLOOMBERG NEWS (Nov. 1, 2016), <https://www.bna.com/racial-bias-reflected-n57982082087/> (discussing a recent panel which shared data that reflects African American debtors are significantly more likely to file Chapter 13 cases than Chapter 7, when compared to non-African debtors).

76. Efrat, *supra* note 3, at 122.

77. *Id.*

78. For example, in another empirical study, the interviewers learned that it took one minority entrepreneur five years to develop the credit necessary to take out a small business loan. See Sterling A. Bone et al., *Rejected, Shackled, and Alone: The Impact of Systemic Restricted Choice on Minority Consumers' Construction of Self*, 41 J. OF CONSUMER RES. 451, 458, 465–67, 470–71 (August 2014).

79. Efrat, *supra* note 3, at 99, 122 (citing U.S. Dep't of Commerce, Expanding Financing Opportunities for Minority Businesses, 2, 3, 11 (2004) (unpublished manuscript), Ying Lowrey, U.S. Small Bus. Admin., Dynamics of Minority-Owned Employer establishments, 1997–2001 9 (2005), [https://www.sba.gov/advocacy/archived-owner-demographic-economic-](https://www.sba.gov/advocacy/archived-owner-demographic-economic)

minority entrepreneurs unlikely customers, some financial institutions simply engage in “ethno-racial discrimination,” precluding minority entrepreneurs from even getting the chance to apply for the loan.⁸⁰ This lack of information/discrimination practice quickly becomes a vicious cycle as often the only way minority entrepreneurs can develop sufficient creditworthy information is by being able to take out loans at reasonable interest rates.

No doubt, discrimination based on race alone is technically prohibited by the The Equal Credit Opportunity Act (ECOA).⁸¹ The Consumer Financial Protection Bureau (CFPB) has further broadly interpreted this law to mean that a creditor cannot, on the basis of race: “[r]efuse [a borrower] credit if [they] qualify for it; [d]iscourage [a borrower] from applying for credit; [o]ffer [a borrower] credit on terms that are less favorable, like a higher interest rate, than terms *offered to someone with similar qualifications*; [and,] [c]lose [a borrower’s] account.”⁸² Yet, aggregate studies of lending practices continue to demonstrate that lending agencies discriminate against minority entrepreneurs.⁸³

For example, significant evidence shows that the average credit rating of minorities is lower than their non-minority counterparts.⁸⁴ Moreover, “loan denial rates are significantly

research (Archived), David L. Torres, *Success and the Mexican American Businessperson*, 6 RES. IN THE SOC. ORGS. 313, 314 (1988), Arnold C. Cooper et al., *New Business in America: The Firms and Their Owners* 4 (1990) (unpublished manuscript), Tresa V. Menzies et al., *A Study of Entrepreneurs’ Ethnic Involvement Utilizing Personal and Business Characteristics*, 20 CAN. COUNCIL FOR SMALL BUS. & ENTREPRENEURSHIP 5 (2003)).

80. Efrat, *supra* note 3, at 122.

81. 15 U.S.C. § 1691(a)(1) (2012) (prohibiting “any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction on the basis of race”).

82. Consumer Financial Protection Bureau, *What protections do I have against credit discrimination*, CONSUMER FINANCIAL PROTECTION BUREAU (last accessed on April 14, 2017) (emph. added), <https://www.consumerfinance.gov/fair-lending/>.

83. See *infra* notes 84-97.

84. Loren Henderson et al., *Credit Where Credit is Due?: Race, Gender, and Discrimination in the Credit Scores of Business Startups*, 42 REV. BLACK POLIT. ECON. 459, (2015); see also Ken Cavalluzzo & John Wolken, *Small Business Loan Turndowns, Personal Wealth, and Discrimination*, 78 J. OF BUS. 2153 (2005).

higher for black-owned firms than for white-owned firms even after taking into account differences in an extensive array of measures of creditworthiness and other characteristics.”⁸⁵

In addition, discrimination is also prevalent at the threshold inquiry stage, prior to the application and denial stage.⁸⁶ For example, a recent study examined the types of questions asked from, and information provided to, persons of different races at lending agencies.⁸⁷ Three white, three black, and three Hispanic men—each dressed the same, with almost identical financials—were interviewed after inquiring at the same set of banks about a business loan of \$65,000 to develop their computer services business.⁸⁸ The white businessmen were provided the loan fees and loan terms significantly more often than their minority counterparts.⁸⁹ Further, the minority businessmen were asked more frequently to provide financial statements, tax returns, and bank account information.⁹⁰ In addition, they were also asked more frequently about their personal savings and investments, credit card debt, and auto loan debt.⁹¹ Lastly, the minority businessmen were less frequently offered a business card, help with future banking needs, or help to complete the loan application.⁹²

In a broader study, when whites were asked what they sought for in a lender, they described the future lender as an “equal,” “friend,” and “partner.”⁹³ In contrast, minorities responding to the same question simply stated they were looking for a “minority lending company,” or “for a ‘personal bank’ be-

85. David G. Blanchflower et al., *Discrimination in the Small-Business Credit Market*, 85 REV. OF ECON. & STAT. 930, 942–43 (2003).

86. Bone et al., *supra* note 78, at 455.

87. *Id.*

88. *Id.* at 454–55.

89. *Id.* at 455.

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* at 459–60.

cause there was ‘no hope’ with the big banks.”⁹⁴ In general “[m]inority consumers described structural marketplace barriers that prevented them from accessing financial resources.”⁹⁵

These practices of discrimination distort the minority entrepreneur’s choice between failing fast and delaying failure. That is, the minority entrepreneur faces an additional set of costs, which make obtaining a formal loan with a quicker termination far less desirable. Further, as discussed in the next subsection, perceptions of discrimination among minority entrepreneurs create cultural aversions to formal lending,⁹⁶ increasing the individual social costs of opting for fast failure.

One set of scholars has suggested that the SBA guaranteed lending program provides a framework for limiting, and has actually limited, disparate impact discrimination in the lending industry.⁹⁷ In general, the SBA guaranteed lending program attempts to solve the asymmetric information problem that has led to the aggregate disparities in lending practices toward minority and majority entrepreneurs.⁹⁸

That is, the SBA views the problem as follows. Minority entrepreneurs typically have lower loan approval rates, and higher interest rates on those loans that are approved.⁹⁹ These results correlate with the finding that while “minority-owned small businesses are not significantly less profitable than majority-owned small businesses,”¹⁰⁰ they do “tend to have a higher failure rate relative to White-owned businesses.”¹⁰¹ Further,

94. *Id.* at 460.

95. *Id.* at 465.

96. See Blanchflower et al., *supra* note 85, 932–34.

97. See Ben R. Craig et al., *Small Firm Credit Market Discrimination, Small Business Administration Guaranteed Lending, and Local Market Economic Performance*, 613 THE ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE 73, 75 (2007) (special issue “Advancing Research on Minority Entrepreneurship”).

98. See *id.*

99. See sources cited *supra* note 84. See also Blanchflower et al., *supra* note 85.

100. Craig et al., *supra* note 97, at 74 (citing K.S. Cavalluzzo et al., *Competition, Small Business Financing, and Discrimination: Evidence from a New Survey*, 75 J. OF BUS. 641, 641–79 (2002)).

101. Efrat, *supra* note 3, at 99 (citing U.S. Dep’t. of Commerce, Expanding Financing

both of these results correlate with the fact that “certain groups of minority entrepreneurs have lower education and lower managerial experience.”¹⁰² These effects are all consistent with the likely cause, namely the asymmetric information problem—when a lender is assessing the likelihood of repayment of a minority-owned business, they will likely assess such a business as riskier than that of a majority-owned business because there is generally more information available about the latter.¹⁰³

The SBA’s solution is a guaranteed lending program that partially alleviates this asymmetric information problem by essentially subsidizing the minority’s higher probability of default with a guarantee on part of the loan provided to the small business.¹⁰⁴ Currently, the SBA will guarantee as much as 85% on loans up to \$150,000 and 75% on loans between \$150,000 and \$5 million.¹⁰⁵ This guarantee not only increases the supply of loans, but also lowers the interest rate on such loans, increasing demand by less risky borrowers and ensuring a higher repayment rate.¹⁰⁶

The SBA guaranteed lending program has produced “a positive and significant impact on the average level of employment in a local market. . . , [and] the magnitude of this impact is relatively larger in high-minority markets.”¹⁰⁷ Yet, while the SBA loan guarantee program appears to increase access to capi-

Opportunities for Minority Businesses, 2, 3, & 11 (2004) (unpublished manuscript, on file with Efrat)). This higher failure rate has been blamed on “inferior human capital as certain groups of minority entrepreneurs have lower education and lower managerial experience,” as well as minority entrepreneurs’ “limited access to credit . . . due to lower asset levels.” *Id.*; see also Karlyn Mitchell & Douglas K. Pearce, *Availability of Financing to Small Firms Using the Survey of Small Business Finances*, U.S. SMALL BUS. ADMIN. 1–2 (2005)).

102. Efrat, *supra* note 3, at 99–100 (citing U.S. Dep’t. of Commerce, Expanding Financing Opportunities for Minority Businesses, 13, 25 (2004) (unpublished manuscript, on file with author); Mitchell & Pearce, *supra* note 101).

103. See Craig et al., *supra* note 97, at 74–75.

104. See *id.*

105. 7(a) *Loan Amounts, Fees & Interest Rates*, U.S. SMALL BUS. ADMIN., <https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/general-small-business-loans-7a/7a-loan-amounts-fees-interest-rates> (last visited July 5, 2017).

106. See Craig et al., *supra* note 97, at 79–82.

107. *Id.* at 92.

tal for minority entrepreneurs, there are no “direct measures of whether SBA guaranteed lending is really reducing discrimination at the microeconomic level.”¹⁰⁸ Thus, while the SBA guaranteed lending program increases the economic performance of minority-owned firms and, thereby, reduces the aggregate distortion costs of reliance on informal lending, it remains unclear whether it is actually combatting the individual distortion costs of discrimination that minority entrepreneurs must overcome in order to be fully on par with the typical entrepreneur in their fast failure decision. In Section IV, I propose a regulatory intervention that would be modeled after the SBA guaranteed lending program, but specifically combat the individual distortion costs of discrimination.¹⁰⁹

B. Cultural Aversions

In some minority communities, there is “strong[] social peer pressure and shame associated with bankruptcy filing.”¹¹⁰ In others, there are “culturally embedded aversions to undertaking debt.”¹¹¹ Further, perceptions of discrimination can produce, or reinforce, cultural aversions to both formal debt and bankruptcy.¹¹² Each of these cultural aversions distorts the expected value of failing fast for the minority entrepreneur by increasing her cost of accessing and utilizing a culturally averse tool that would speed up her failure. Further, these costs may amplify the social costs of failure and the social benefits of survival already assessed by the typical entrepreneur.¹¹³

108. *Id.* at 93.

109. *See infra* Section IV.B.4.

110. Efrat, *supra* note 3, at 122 (citing Thomas M. Begley et al., *The Socio-Cultural Environment for Entrepreneurship: A Comparison Between East Asian and Anglo-Saxon Countries*, 32 J. INT'L BUS. STUD. 537, 539 (2001)).

111. *Id.* (citing Timothy Bates, *Financing Small Business Creation: The Case of Chinese and Korean Immigrant Entrepreneurs*, 12 J. BUS. VENTURING 109, 120–22 (1997), Timothy Bates, *An Analysis of Korean-Immigrant-Owned Small-Business Start-Ups with Comparisons to African-American and Nonminority-Owned Firms*, 30 URBAN AFF. Q. 227, 231 (1994)).

112. *See* Blanchflower et al., *supra* note 85, at 932–34.

113. *See supra* Section II.B.

As far as I am aware, there is not significant work being done to help minority entrepreneurs overcome these cultural aversions. In Section IV, I propose a modest educational program that would help minority entrepreneurs internalize the benefits of fast failure and decrease these amplified social costs.

C. Access to Legal Counsel

Minorities typically have significantly lower asset levels than non-minorities.¹¹⁴ Further, they do not have the same ties to legal institutions as their majority counterparts.¹¹⁵ For example, a recent empirical study found that “minority entrepreneurs in bankruptcy were less likely to have been represented by an attorney in the bankruptcy process than their non-minority counterparts.”¹¹⁶ This lack of representation entails a delay in the failure of minority entrepreneurs as there will be increased transaction costs at each step of failure. This distortion cost may be represented as either a delay on the timeline of actual failure within the general model or an incorrect probability of failure within the probabilistic model.¹¹⁷

A recent proposal to a similar problem of lack of access to legal services suggests the equivalent of public defenders be provided for defendants in debt proceedings.¹¹⁸ Defendants would need to qualify as “low income,” set at 125% of the federal poverty line, to qualify for legal counsel.¹¹⁹ Such counsel could inform the debtor of the intricacies of bankruptcy,¹²⁰ and may even be able to help the debtor overcome her cultural

114. Alicia M. Robb & Robert W. Fairlie, *Access to Financial Capital Among U.S. Businesses: The Case of African American Firms*, 613 THE ANNALS OF THE AM. ACAD. OF POL. AND SOC. SCI. 47, 55 (Sep. 2007) (“Advancing Research on Minority Entrepreneurship”).

115. Efrat, *supra* note 3, at 122.

116. *Id.*

117. *See supra* Section II.A.

118. Joel Tay, Note, *Consumer Debt Collection in Massachusetts: Is Civil Gideon a Solution?*, 11 HARV. L. & POL’Y REV. S1 (2017).

119. *Id.* at S9.

120. *Id.* at S3, n.10.

aversion to bankruptcy. This service could be provided for minimal costs,¹²¹ and would likely increase aggregate efficiency by decreasing the transaction costs in reallocating the individual's resources. That said, it remains unclear whether this proposal would ever be adopted given the strong legal presumption against a right to counsel "unless the defendant faces a potential deprivation of physical liberty."¹²² Moreover, legal counsel would likely only be available *ex post*, resulting in a minimal effect on the initial fast failure decision. I attempt to resolve this *ex post* problem in Section IV with a modest educational program that could provide baseline guidance to borrowers prior to their fast failure decision.

In the end, the expected value of fast failure for the minority entrepreneur is distorted by the costs of discrimination, cultural aversion, and lack of access to counsel. While the SBA loan guarantee program provides increased access to capital for the minority entrepreneur, it does not directly address these costs. Likewise, while access to a public defender would help the minority entrepreneur resolve debt disputes *ex post*, it would fail to address the lack of guidance when making their fast failure decision. In the next section, I discuss direct solutions to diminishing these distortion costs and helping the minority entrepreneur face the same fast failure decision as the typical entrepreneur.

IV. PROPOSALS TO DIMINISH THE DISTORTION COSTS ON THE FAST FAILURE DECISION FOR MINORITY ENTREPRENEURS

If minority entrepreneurs delay failure because of the distortion costs described above, they will likely use resources inefficiently. Further, they will not be able to compete with

121. *Id.* at S9.

122. *Id.* at S5 (citing *Lassiter v. Dep't of Soc. Servs.*, 452 U.S. 18, 31 (1981)).

non-minority entrepreneurs who engaged in similarly failed ventures and were able to innovate and learn from such ventures. Thus, to both ensure the efficient reallocation of resources as well as equality of opportunity for minority entrepreneurs, it is imperative to diminish these distortion costs.

In the following section, I present a set of possible remedies to diminish the distortion costs discussed above. I begin by describing a possible private ordering solution to discrimination and cultural aversion costs through the emerging peer-to-peer (P2P) lending industry. While P2P lending still remains promising, it is unclear whether it can resolve these concerns in its current form because of ambiguities in the law surrounding these lending platforms as well as social network effects that could potentially incur an increase in discrimination.

Without a private ordering solution, I turn to a set of incremental regulatory proposals. First, I propose a modest mandatory educational program for small business borrowers that would decrease access to counsel costs by informing them of the efficiencies of failing fast as well as utilizing formal lending services and bankruptcy laws. Next, to diminish discrimination costs, I initially propose a blind loan application process that would isolate the instances in which discrimination could occur and ensure that race is not a factor in the loan application process. Yet, because relying on non-racial data may permit lending institutions to still rely heavily on red-lining and other disparate impact tactics, I propose a higher standard for banks when assessing a loan application that directly confronts disparate impact. Finally, to diminish remaining disparate impact discrimination and cultural aversion costs, I propose a loan guarantee program like the SBA Loan Guarantee program that is targeted directly at minority entrepreneurs.

A. Peer-to-Peer Lending

P2P lending essentially provides an online platform for individuals (and institutions) “to borrow and loan money.”¹²³ P2P lending could diminish the distortion costs of discrimination by providing a method for minority entrepreneurs to apply for a loan without revealing their race. Further, it can diminish the distortion costs associated with a minority entrepreneur’s cultural aversions to formal borrowing by making the transaction more private and accessible. That said, P2P lending may actually lead to increased discrimination costs because individual lenders are not regulated by the ECOA, nor the Community Reinvestment Act (CRA).¹²⁴ Further, because P2P lending currently serves only a minimal number of small businesses,¹²⁵ it is unclear whether it will be able to move into the small business loan market.

My description of P2P focuses on “the two primary platforms,” Prosper and Lending Club, which currently facilitate “98% of [P2P] loans in the United States.”¹²⁶ These lending institutions allow potential borrowers to begin their quest for a loan by completing an application on their host website.¹²⁷ This application typically requires providing only a home address, email, type of loan, loan amount requested, employment status, annual income, credit score, and age.¹²⁸ To qualify for a loan

123. Zachary Adams Mason, *Online Loans Across State Lines: Protecting Peer-to-Peer Lending Through the Exportation Doctrine*, 105 GEO. L.J. 217, 220 (2016–17).

124. 12 U.S.C. § 2901; see Lisa T. Alexander, *Cyberfinancing for Economic Justice*, 4 WM. & MARY BUS. L. REV. 310, 336 (2012–13). I describe this Act in further detail below.

125. See Mason, *supra* note 123, at 227 (explaining that the two major P2P lenders primarily serve customers looking to consolidate debt, and that only 2% of their customers borrow for a “business” purpose).

126. *Id.* at 221. Kiva is an additional well-known P2P platform, but because it is a non-profit, it has a relatively small market share, and it is mostly focused on microlending, *id.* at 221, I omit it from my discussion.

127. *Id.* at 222.

128. See generally *Get Your Custom Rate*, PROSPER, https://www.prosper.com/borrower/#/prospect/registration?loan_amount=35000&listing_cat

from Prosper, “the applicant must: ‘(1) have at least a 640 credit score, (2) have fewer than seven credit bureau inquiries within the last 6 months, (3) have an annual income greater than \$0, (4) have a debt-to-income ratio below 50%, (5) have at least three open trades reported on their credit report, and (6) have not filed for bankruptcy within the last 12 months.’”¹²⁹ Lending Club has a slightly more strict standards for “screening potential borrowers,” including verification of applicants’ self-reported employment information¹³⁰ and a credit score requirement of 660.¹³¹

As should be clear from the discussion above, credit scores can be used as a form of disparate impact discrimination against minority entrepreneurs. The credit score requirements for P2P lending came as a response to “increased scrutiny by the SEC.”¹³² While a 640 credit score “is considered fair,” and “[p]eople with this credit score may be considered subprime borrowers,”¹³³ this bar may be too high for minority entrepreneurs who have no credit history or a minimal credit history that is predominately negative.¹³⁴ This effect may be evidenced by the fact that Prosper and Lending Club’s current loan appli-

ory_id=3&credit_quality_id=3&offer_code=0&prospect_id=CA7F126B-6E02-456F-9B88-97B5B437B0C0&ref_ac=GoogSearch&ref_mc=BorGenAcq&ref_d=cm:SEM-Brand%7C%7Ckw:prosper%7C%7Cad:104726616971%7C%7Cdv:c&type=dm_(last visited July 5, 2017); *Check Your Rate*, LENDING CLUB (last accessed July 5, 2017), https://www.lendingclub.com/apply/personal/identity?utm_campaign=pl_biz_purpose&loanAmount=40000&loanPurpose=small_business&creditScore=POOR.

129. Mason, *supra* note 123, at 222 n.34 (quoting Prosper Funding LLC & Prosper Marketplace, Inc., Prospectus at 32 (Form 424(b)(3)) (Aug. 13, 2015) https://www.prosper.com/Downloads/Legal/Prosper_Prospectus_2015-08-13.pdf).

130. *Id.* at 224 (citing Paul Slattery, *Square Pegs in A Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative*, 30 YALE J. REG. 233 (2013)).

131. Alexander, *supra* note 124, at 345.

132. *Id.*

133. *640 Credit Score: Is it Good or Bad?* EXPERIAN, <http://www.experian.com/blogs/ask-experian/credit-education/score-basics/640-credit-score/> (last visited July 5, 2017).

134. These credit score requirements roughly approximate the average credit scores of Black and African Americans (677) as well as Hispanic Americans (701). Robert Harrow, *Average Credit Score in America: 2017 Facts & Figures*, VALUE PENGUIN (March 29, 2017), <https://www.valuepenguin.com/average-credit-score>.

cation approval rate is only 10%.¹³⁵ Therefore, some circumvention of this requirement would likely still be necessary for P2P lending institutions to diminish disparate impact discrimination costs.¹³⁶

Once a potential borrower applies and receives approval from the lending platform to pursue a loan, the borrower then posts a request to the platform which “include[s] relevant information about the requested loan.”¹³⁷ For Prosper, this includes the term (either three or five years), the rate (between 5.99% and 36%), and the amount that would be borrowed (between \$2,000 to \$35,000), all of which are “determined by Prosper . . . based upon the borrower’s credit score.”¹³⁸ Potential lenders see these terms as well as the borrower’s “Prosper Rating”—a letter grade rating prescribed by Prosper.¹³⁹ In addition, at the option of the borrowers, they may disclose addi-

135. Mason, *supra* note 123, at 231 (citing Alexandra Mateescu, *Peer-to-Peer Lending*, DATA & SOC’Y RES. INST. 21 (July 1, 2015), <http://www.datasociety.net/pubs/der/PeertoPeerLending.pdf>).

136. At some point, if P2P lending integrates with advanced forms of blockchain technology, this threshold for minority entrepreneurs could be diminished because blockchain would likely resolve the asymmetric information problem. That is, blockchain can “transmit richer forms of information, holding promise for many compelling applications beyond” simple monetary value. Trevor I. Kiviat, Note, *Beyond Bitcoin: Issues in Regulating Blockchain Transactions*, 65 DUKE L. JOUR. 569, 603 (2015). Instead, a typical transaction follows a simple script—a set of instructions—that adheres to the three-part structure [of party A sending a value, Party B accepting that value, and other parties verifying the transaction]. If the script were amended to contain additional conditions, users could engage in more sophisticated transactions. For instance, consider that Party A and Party B may want to add a fourth condition to that script structure: they only want the transaction to occur at a certain time, or upon the occurrence or nonoccurrence of a conditional event. Many possibilities branch out from this idea, and it has sparked much discussion around “smart” contracts. *Id.* at 603 (internal citations omitted).

Thus, a lending platform could integrate certain scripts that precluded loaned money to be spent on items outside the business, limited the ability of the borrower from attaining additional loans, and automatically enacted a mock bankruptcy when borrowers were near the zone of insolvency. These scripts are currently unavailable to developers “because protocol amendments require a majority consensus,” but variations on bitcoin do exist and are currently being tested. *Id.* at 603–04. Should such scripts be adopted, one may want to reevaluate the credit reporting requirements of these lending platforms as the scripts may trigger liquidation events with which the entrepreneur otherwise would not have proceeded.

137. Mason, *supra* note 123, at 222.

138. *Id.*

139. *Id.* at 222–23.

tional self-reported information, including “the borrower’s purpose for requesting the loan, income, occupation, and employment status”; borrowers that provide such “narrative information . . . can positively influence a lender’s decision to lend to a borrower with an otherwise poor credit rating.”¹⁴⁰

Lenders, or “investors” as they are referred to on these platforms, “can provide as little as \$25 in a requested loan, regardless of the amount requested by the borrower.”¹⁴¹ If a potential borrower does not receive enough funding over the limited time period of their posting, the transaction is cancelled.¹⁴² However, if a sufficient amount is aggregated, then the transaction is facilitated by Prosper or Lending Club using “WebBank, a [Utah-]chartered bank insured by the FDIC,” to originate the loan.¹⁴³ This aggregation of loans provides more supply of formal loans for minority entrepreneurs, who may be higher risk investments, as investors diversify their portfolio.¹⁴⁴

First, P2P lending could diminish the distortion costs related to cultural aversions to formal lending by providing a cleaner, simpler process of applying for a loan and leaving less room for perceived discrimination.¹⁴⁵ P2P lending does not bundle interest rates with other services; thus, minority entrepreneurs will be able to feel more confident about the terms of the loans in which they enter.¹⁴⁶ Likewise, it allows members of minority communities to formally lend to one another, and decreases the shame that might be associated with being denied a loan from a bank.

In addition, P2P lending can diminish discrimination costs by allowing minority entrepreneurs to receive a loan without ever revealing their race. Furthermore, minority entre-

140. Alexander, *supra* note 124, at 338.

141. Mason, *supra* note 123, at 223.

142. *Id.* at 223–24.

143. *Id.* at 225.

144. See Alexander, *supra* note 124, at 338.

145. See Mason, *supra* note 123, at 228–29.

146. *Id.*

preneurs may be able to strategically use their race within their narrative to obtain credit from those particularly interested in lending to minorities.¹⁴⁷ The application process requires only that the minority entrepreneur “determine the amount of money he or she needs and the length of time he or she needs to pay the money back;”¹⁴⁸ it does not involve investigation of the neighborhood in which the minority entrepreneur resides, which precludes the ability of lenders to red-line.¹⁴⁹

Yet P2P lending may also increase discrimination costs. Minority entrepreneurs are more likely to receive lower ratings because they have lower levels of income, assets, or credit.¹⁵⁰ Therefore, investors may be dissuaded from investing in minority entrepreneurs because of their heightened risk of non-repayment. In addition, if a minority does reveal their race in the narrative section, investors are currently permitted to discriminate against them,¹⁵¹ whether it be conscious or subconscious.¹⁵² For example, if minorities do not share a picture on the platform to avoid discrimination, but majority entrepreneurs do, then minority entrepreneurs may still be less likely to receive a loan because they fail to share enough information; i.e., potential borrowers who disclose minimal information may appear less trustworthy and attract fewer investors.

147. Cf. Elise Schmelzer, *New Website Allows White People to Offer ‘Reparations’ Directly to People of Color*, WASH. POST (August 2, 2016), https://www.washingtonpost.com/news/morning-mix/wp/2016/08/02/new-website-allows-white-people-to-offer-reparations-directly-to-people-of-color/?utm_term=.6cbab048ff3b.

148. Mason, *supra* note 123, at 229.

149. *Id.* However, it still remains unclear whether Prosper or Lending Club is itself engaging in red-lining when determining their credit measure.

150. See *supra* note 136 discussing a way of circumventing the credit requirement.

151. This is due to the fact that the ECOA currently appears to only apply to the lending platform and not the actual lenders. Cf. PETER MANBECK & SAMUEL HU, CHAPMAN & CUTLER LLP, *THE REGULATION OF PEER-TO-PEER LENDING: A SUMMARY OF THE PRINCIPAL ISSUES* 25 (April 2014), <http://www.lendacademy.com/wp-content/uploads/2014/04/Regulation-of-P2P-Lending-Chapman-and-Cutler.pdf>.

152. For example, P2P lending could effectually imitate behavior similar to the Microsoft autobot that quickly became racist. See Rob Price, *Microsoft is deleting its AI chatbot’s incredibly racist tweets*, BUSINESS INSIDER (March 24, 2016), <http://www.businessinsider.com/microsoft-deletes-racist-genocidal-tweets-from-ai-chatbot-tay-2016-3>.

This problem is further amplified by the fact that there appears to be no current enforcement of the Community Reinvestment Act (CRA)¹⁵³ on P2P lenders or platforms.¹⁵⁴ The CRA “requires banks to meet the credit needs of their entire communities, including low- and moderate-income (LMI) neighborhoods.”¹⁵⁵ While the definition of LMI does not take race into account, it includes many minority neighborhoods.¹⁵⁶ Without enforcement of the CRA, many minority communities are subject to aggregate discrimination costs, losing access to a significant credit market.

The CRA is enforced by four agencies.¹⁵⁷ “[R]egulators review a bank’s determination of its assessment areas [i.e., definitions of “community” into which they must reinvest], and issue public written reports that rate banks’ compliance with their CRA obligations.”¹⁵⁸ These ratings are considered anytime a bank applies “to ‘obtain a charter, obtain deposit insurance, establish a branch, relocate a home office or branch, merge with another bank, or obtain the assets or assume the liabilities of another bank.’ A negative CRA rating can cause regulators to deny a bank permission to engage in these activities.”¹⁵⁹

Enforcement of the CRA on P2P lending platforms is unique because it is unclear what the assessment area is and who the lender is. There are likely two options for assessment areas: (a) borrowers on the platform; or, (b) actual, physical neighborhoods of borrowers.¹⁶⁰ In addition, there are likely

153. 12 U.S.C. § 2901.

154. See Alexander, *supra* note 124, at 378–79.

155. Richard D. Marsico, *Enforcing the Community Reinvestment Act: An Advocate’s Guide to Making the CRA Work for Communities*, 17 N.Y.L. SCH. J. HUM. RTS. 129, 129 (2000–01).

156. Alexander, *supra* note 124, at 329.

157. Marsico, *supra* note 154, at 131–32.

158. Alexander, *supra* note 124, at 329–30.

159. Alexander, *supra* note 124, at 330.

160. Alexander suggests that the “assessment area” be particular “cyberspaces,” yet provides no real meat to this proposal; thus I may summarize it, but I have forgone analyzing it for now. *Cf.* Alexander, *supra* note 124, at 378–80.

three options for the lender: 1) the platform, 2) the investors, or 3) the bank controlling the transaction—in Prosper and Fair Lending's Case, WebBank.

A framework in which the actual, physical neighborhoods of the borrowers serve as the assessment area would likely be impossible to administer. First, given the emerging reach of P2P lending, P2P lenders would be charged with serving many physical community definitions with only a few members in each area. Thus, it would be difficult to determine whether the platform was adequately serving an LMI area if, for example, the platform served a very wealthy individual in a LMI community. Further, because geographic information related to borrowers is not shared with individual investors, they would have no way of knowing whether they have appropriately spread their investments to the LMI community of a particular neighborhood in which they have invested.

Thus, it appears that the platform is the most easily identified "assessment area," allowing customers on the platform to be considered the "community." By relying on this virtual definition of community, the platform can ensure it is reaching those least likely to have access to formal lending from those who apply on its platform. That said, these platforms would still need to be regulated so that they did not make themselves to be unattractive to minority entrepreneurs.

With respect to the question of who the "lender" is, it is unlikely to be the individual investor as it would be extraordinarily difficult for a regulator, not to mention the investor herself, to determine whether the loans she provides are proportionately being made to members of the LMI community within the platform. One way around this would be for regulators to require platforms to be configured so that a percentage of each investors' investments go towards an LMI borrower. That said, doing so may significantly dissuade lenders from the

platform if as it requires many lenders to increase their risk tolerance.¹⁶¹

It is also unlikely that the bank controlling the transaction—in our case WebBank—could be considered the lender, because it is simply a facilitator of the loans and does not have control over the lending platform. Thus, the platform is likely the most easily regulated “lender” faced with bearing the burden of ensuring that LMI members of its community are receiving an appropriate amount of loans. The platform could require investors that reach a certain level to put some part of their investment toward an LMI member. Alternatively, the platform could subsidize a proportionate number of LMI members and highlight them on the webpage to encourage other investors to lend.

In total, it is unlikely that P2P lending is a promising tool for diminishing the distortion costs of cultural aversion and discrimination. It is easily accessible by minorities and would likely not have the same stigma as a bank. That said, it would still need to be regulated in such a way that it did not create even more disparate impact discrimination towards minority borrowers. These regulations could come through adapting the CRA to P2P lending, requiring the subsidization of loans to minority entrepreneurs, and developing more minority friendly borrower standards. One other caveat is that it remains questionable as to whether P2P lending will be able to break into the business lending market. The typical P2P loan is to provide debt consolidation; however, only 2% of Prosper and Lending Club’s customers borrow for a business purpose.¹⁶² This result is likely due to the relatively low cap on the allowable borrowed

161. That said, such an activity may actually promote minority entrepreneurs further by requiring interaction between the different social class groups. By doing so, investors who may have never attempted to engage in such investments may be more willing to invest in future minority entrepreneurs.

162. *Id.* at 227.

amount, namely \$35,000.¹⁶³ Both Prosper and Lending Club have developed business loan platforms, OnDeck and Lending Club: Business Loans,¹⁶⁴ respectively, which permit loans of up to \$500,000 and \$300,000. Yet, OnDeck requires that the businesses be operating for at least one year and have a minimum \$100,000 in annual revenue.¹⁶⁵ Similarly, Lending Club requires that the business have a two year operating history with annual revenue of at least \$75,000.¹⁶⁶ These limitations would likely preclude the minority entrepreneur from gaining access to start-up costs for their business and act as further distortion costs within the minority entrepreneur's fast failure decision. Thus, despite its promise, it remains uncertain whether P2P lending will be able to diminish the distortion costs incurred on the minority entrepreneur's fast failure decision. With that in mind, I next turn to a set of incremental regulatory proposals that provide an alternative, as well as coordinative, route to diminish these distortion costs.

163. See generally PROSPER (last accessed July 5, 2017), <https://www.prosper.com/>.

164. ONDECK, https://www.ondeck.com/?targeting=RLSAutm_campaign=Google_Search_Brand_RLSA_All&pcrid=171825922531&utm_term=ondeck&utm_source=google&pdv=c&pmt=e&utm_medium=ppcsearch&mkwid=OrimIWuV&network=g&gclid=Cj0KEQjwicfHBRCh6KaMp4-asKgBEiQA8GH2x8BjZv8YAVuqmKhJ1oJK75uaebluVxQ667Y2fSgC_W4aAuWK8P8HAQ;LENDING CLUB BUSINESS LOANS (last accessed July 5, 2017), https://www.lendingclub.com/business/?utm_source=LC&utm_medium=link&utm_campaign=pl_biz_purpose&u=2 (last visited July 5, 2017).

165. *Check Your Rate*, PROSPER, <https://www.prosper.com/plp/checkyourratev2/?refac=GoogSearch&refmc=BorGenAcq&refd=cm:SEM-Brand||kw:prosper||ad:104726616971||dv:c&gclid=Cj0KEQjwicfHBRCh6KaMp4-asKgBEiQA8GH2x6jPR4fhLjOXacrLtGcrMvUoq6SyLxtcR52gghVF7N1aAi0t8P8HAQ> (last visited July 5, 2017).

166. *Id.*

*B. Incremental Regulations to Diminish Distortion Costs
Within the Minority Entrepreneur's Fast Failure Decision*

Given the lack of a private ordering solution,¹⁶⁷ the following regulatory suggestions would likely diminish the distortion costs of discrimination, cultural aversion, and access to counsel found within the minority entrepreneur's fast failure decision. First, I propose a mandatory educational program to accompany SBA loans that would diminish the distortion costs of cultural aversions and access to legal counsel by informing the borrower of the benefits of failing fast and the different types of bankruptcy. Second, to diminish discrimination costs, I propose that banks be required to defer interactions between a loan assessor and a potential borrower where discrimination could occur to isolated instances near the end of the loan approval process. Third, I propose a stricter standard for assessing loans using big data and avoiding any reliance on personal judgment. Finally, because even with these regulatory tools, minority entrepreneurs may still suffer from significant disparate impact discrimination, my fourth proposal is that the government subsidize minority loans through a program similar to the SBA loan guarantee program.

1. Mandatory educational program encouraging fast failure

As mentioned above, one significant problem for minority entrepreneurs is that they lack access to legal counsel who can advise the entrepreneur prior to the fast failure decision of the benefits of fast failure and the mechanisms that encourage fast failure, such as bankruptcy.¹⁶⁸ My proposal builds on the intuition that if an entrepreneur were required to learn about these benefits upon receiving a loan, the entrepreneur would

167. See *supra* Section IV.A.

168. See *supra* Section III.C.

likely allocate resources would more efficiently because she would have a better sense as to when she should fail and pursue bankruptcy.

Currently there is no mandatory educational program when taking out a small business loan. This contrasts with U.S. microfinancing, which requires micro-entrepreneurs to participate in several meetings and educational programs.¹⁶⁹ Consistent programs that require significant time commitments dissuade entrepreneurs from participating in microfinancing¹⁷⁰ and would likely be inappropriate for minority entrepreneurs looking for credit at higher levels. However, a short, one-to-two-hour online program that requires entrepreneurs to think through certain failure situations would not only educate them on the benefits of failing fast and bankruptcy, but also diminish their cultural aversions to bankruptcy and failure.

Of course, this program could carry a significant initial cost because it would require experts in education, business, and law to construct instructional material. There would also be costs in tailoring the program to multiple education levels and languages. That said, the small business loan guarantee program could easily implement the proposed program by making it an additional requirement on entrepreneurs before providing them with a subsidized loan.¹⁷¹

2. Color-blind loan assessment

Formal lending institutions typically require a face-to-face visit before providing a business loan, and often encourage speaking with a representative.¹⁷² Yet, doing so invites opportu-

169. See Alexander, *supra* note 123, at 327.

170. *Id.*

171. Cf. Steve Nicastro, *How to Qualify for a Small-Business Loan in 5 Steps*, NERDWALLET (April 4, 2017) <https://www.nerdwallet.com/blog/small-business/how-to-qualify-for-small-business-loans/> (discussing the current requirements for qualifying for an SBA subsidized loan).

172. See, e.g., *Securing a Business Line of Credit*, BANK OF AMERICA (last visited May 5,

nities for threshold discriminatory practices.¹⁷³ These opportunities for discrimination potentially increase not only the discrimination costs in the model, but also the cultural aversion costs of individuals who may feel threatened by the institution that engages in discriminatory lending.

Thus, I propose that banks be required to provide sufficient tools online for an entrepreneur to apply for a small business loan without ever revealing their racial identity. Banks are already transitioning to a more online presence and this tool would be another step in that direction. Alternatively, if lenders insist that they must meet the borrower before issuing a loan, the meeting should be the last step before receiving the loan. Placing the meeting last would effectively reduce perceptions of discrimination and isolate any potential discriminatory actions, diminishing discrimination costs.

This regulation could be integrated within the comprehensive “Regulation B” that currently implements the ECOA. Regulation B forbids creditors from “request[ing] or collect[ing] information about an applicant’s race,” except in “situations in which the information is necessary to test for compliance with fair lending rules,” or “[t]o determine the applicant’s eligibility for special purpose credit programs.”¹⁷⁴ The CFPB, which currently enforces Regulation B, could interpret this regulation to mean that banks must avoid requesting such information and require banks organize as color-blind a process for potential borrowers as possible.

Ensuring that loan applications remain color-blind would likely diminish discrimination costs as well as cultural aversion costs developed from perceived discrimination. That

2017), <https://www.bankofamerica.com/smallbusiness/business-financing/working-capital/business-line-of-credit.go>; *Small Business Credit*, WELLS FARGO (last visited May 5, 2017), <https://www.wellsfargo.com/biz/business-credit/>.

173. See *supra* Section III.A.

174. Consumer Financial Protection Bureau, EQUAL CREDIT OPPORTUNITY ACT (ECOA) (June 2013), http://files.consumerfinance.gov/f/201306_cfpb_laws-and-regulations_ecoa-combined-june-2013.pdf (summarizing 12 CFR 1002.5).

said, increasing the color-blindness of the application process may lead to more active red-lining that is untraced because of a lack of initial data, leading to my next proposal.

3. Big data loan and credit assessment

In the world of big data, traditional tests for determining the interest rate of a potential borrower based on zip codes or neighborhoods are likely outdated and inundated with prejudice. While there are potentially significant risks to using big data to assess the creditworthiness of an entrepreneur,¹⁷⁵ lending institutions should be mandated to use the most detailed predictive data that they are cost-effectively capable of utilizing. Further, banks should be required to ensure that their data will not have a disparate impact on minority entrepreneurs.

Once again, this requirement could be integrated through Regulation B. Currently, Regulation B prohibits using information that has “the *effect* of discriminating against an applicant on a prohibited basis.”¹⁷⁶ Yet, “Regulation B neither requires nor endorses any particular method of credit analysis” and permits creditors to “use traditional methods, such as judgmental systems that rely on a credit officer’s subjective evaluation of an applicant’s creditworthiness”¹⁷⁷

Regulation B should require that any subjective evaluation be deferred until the final step of the application process. Subjective evaluations open the assessment up to stereotypes that typically infect a judgment process when the evaluator is less motivated to actually make an independent assessment.¹⁷⁸ Because minority entrepreneurs already are likely to have more

175. See generally Mikella Hurley & Julius Adebayo, *Credit Scoring in the Era of Big Data*, 18 YALE J.L. & TECH. 148 (2016) (describing the challenges with transparency in using big data to calculate credit scores).

176. Consumer Financial Protection Bureau, *supra* note 183, at 6 (emphasis in original).

177. *Id.*

178. See Galen v. Bodenhausen *Stereotypes as Judgmental Heuristics: Evidence of Circadian Variations in Discrimination*, 1 PSYCHOL. SCI. 319, 319 (1990).

credit difficulties, as well as less revenue than their majority counterparts,¹⁷⁹ loan application assessors may use these characteristics, combined with stereotypes, to simply reject the loan application. However, if the applicant's race was not revealed until the end of the assessment stage, the evaluator would have more pressure to ensure the assessment was independent and not based on race, because regulators could more easily isolate whether race was the final variable that prevented the loan applicant from receiving a fair loan.

Therefore, by requiring banks to utilize big data methods that are purposefully designed to avoid disparate impact discrimination—and by postponing the revelation of race, as well as subjective evaluations, until the final step in the loan application process—discrimination and cultural aversion costs would likely see a significant decrease. That said, it may be practically impossible to design a big data assessment tool that completely evades disparate impact discrimination, which means further interference is necessary to balance the scales: affirmative subsidies.

4. Affirmative subsidies for minority entrepreneurs

As discussed above, minority entrepreneurs are typically less creditworthy and have less revenue than their majority counterparts.¹⁸⁰ Thus, even the most sophisticated big data tools may effect a disparate impact on minorities.¹⁸¹ To combat this disparate impact and ensure the distortion costs of discrimination are diminished for minority entrepreneurs, the SBA should create a loan guarantee program specifically target minority entrepreneurs. This program would provide minorities with loans that have higher government guarantees, incentiviz-

179. See Fact Sheet, *supra* note 1.

180. See Fact Sheet, *supra* note 1.

181. See *supra* note 174.

ing lenders to target minority entrepreneurs as profitable customers.

As discussed above, the SBA loan guarantee program has significantly increased economic performance in minority communities.¹⁸² That said, it remains unclear whether it is actually diminishing the individual costs of discrimination for minority entrepreneurs.¹⁸³ Targeting minority entrepreneurs with a similar, more attractive loan guarantee program would likely diminish such costs and incentivize financial institutions to invest in minority entrepreneurs.¹⁸⁴

V. CONCLUSION

In this comment, I provided a novel model of the typical entrepreneur's fast failure decision, examining the social costs and benefits associated with this decision as well as how formal lending and bankruptcy make fast failure possible. Further, I distinguished the minority entrepreneur's fast failure decision from her majority counterpart's decision by highlighting the additional distortion costs on the minority entrepreneur: discrimination, cultural aversion, and access to legal counsel. I spelled out the weaknesses of current attempts to diminish these costs and introduced five proposals that would more directly work to put the minority entrepreneur on par with her majority counterpart: P2P lending; a mandatory "fast failure" education program; a color-blind application process; an assessment system that emphasizes big data and strays from sub-

182. Craig et al., *supra* note 97, at 92.

183. *Id.* at 92–93.

184. Such a program would, of course, need to be implemented with care; however, due to limited space in this essay, I have not specified the particular details of such a proposal. For other programs that incentivize minority entrepreneurship, see Paul M. Ong, *Set-Aside Contracting in S.B.A.'s 8(a) Program*, REV. OF BLACK POL.ECON. 59 (2001); Jess H. Drabkin, *Minority Enterprise Development and the Small Business Administration's Section 8(a) Program: Constitutional Basis and Regulatory Implementation*, 49 BROOK. L. REV. 433 (1982–83).

jective evaluation; and a minority loan subsidy program. Each of these proposals deserve more time to work out their nuances, but I hope this comment provides a groundwork for that project.

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