Mitigating Financial Risk for Small Business Entrepreneurs

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ABSTRACT

Financial distress by definition threatens a company's viability. Entrepreneurial and start-up entities are particularly vulnerable to this threat. Yet, much of the discussion following the recent recession focuses almost exclusively on financial institutions and "too-big-to-fail" entities. This essay re-examines lessons gleaned from the recession in the context of smaller, entrepreneurial entities. Specifically, it analyzes how small business entrepreneurs might invoke principles of enterprise risk management to mitigate the long-term impact of financial distress on their business models. It also considers related refinements to extant small business regulations, including the U.S. bankruptcy laws. The essay's primary objective is to help policymakers, entrepreneurs and investors rethink financial distress and recognize opportunities for "successful failures."

I. INTRODUCTION

Small businesses make up approximately 99.7% of all U.S. employer firms and frequently are cited as engines of economic growth.[1] Yet, the

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[1] U.S. Small Bus. Admin., *Frequently Asked Questions: Advocacy Small Business Statistics and Research,* http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24 (last visited Aug. 1, 2011) [hereinafter *Frequently Asked Questions*]. The U.S. Small Business Association defines "employer firm" as "businesses with . . . employees." U.S. Small Bus. Admin., *Firm Data*, http://archive.sba.gov/advo/research/data.html (last visited Aug. 1, 2011). According to the Small Business Association, small businesses "[g]enerated 65 percent of net new jobs over the past 17 years." *See*

odds of building a successful small business are stacked against entrepreneurs. An estimated seven out of ten new small businesses survive their first two years of existence but only five out of ten remain in operation past the five-year mark.[2] These statistics are not surprising given the regulatory burdens imposed on small businesses and the multiple (and often unaccounted for) operational, legal, financial and other risks facing small business entrepreneurs.

This essay re-examines the risks encountered by small business entrepreneurs and the potential value of enterprise risk management (ERM) in helping entrepreneurs identify and manage those risks. ERM is a holistic approach to firm risk management that considers and reconciles firm-wide risks in a single process.[3] Although typically viewed as a method of helping large, complex firms understand how risks across their various divisions interact, ERM also can assist smaller firms in understanding their risks and developing a proactive plan to mitigate overall risk exposure. In this context, ERM can help small business entrepreneurs turn potential liquidation into a "successful failure."

The successful failure concept recognizes the inherent risk in new ventures and encourages entrepreneurs to embrace this risk. By taking inventory of potential risks (or barriers to success), entrepreneurs can better utilize available tools, such as the U.S. Bankruptcy Code, to address their operational or financial challenges or recreate themselves altogether. Business owners have a tendency to ignore problems or evaluate their ventures through rose-colored glasses, thereby postponing remedial actions that could save or strengthen their operations.[4] Policymakers and investors can help entrepreneurs take a more proactive approach and facilitate successful failures by incorporating ERM tools into small business regulations.

Frequently Asked Questions, *supra*; *see also* Brian Tracy, *Are You Cut Out to Be an Entrepreneur?*, ENTREPRENEUR.COM (Mar. 21, 2005), http://www.entrepreneur.com/startingabusiness/startupbasics/article76814.html ("Entrepreneurs occupy a central position in our market economy. They serve as the spark plug in our economy's engine, activating and stimulating all economic activity.").

[2] *See Frequently Asked Questions*, *supra* note 1.

[3] *See also* Comm. of Sponsoring Orgs. of the Treadway Comm'n (COSO), *Enterprise Risk Management—Integrated Framework: Executive Summary* (2004), *available at* http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf [hereinafter COSO Report] (describing ERM).

[4] *See, e.g.*, John Tribe, *Symptoms of Debtor Ostrich Syndrome?*, BANKR., INSOLVENCY AND CORP. RESCUE BLOG (Apr. 10, 2009), http://bankruptcyandinsolvency.blogspot.com/2009/04/symptoms-of-debtor-ostrich-syndrome-r3s.html (explaining "that those with financial problems do not think they 'need' debt advice, while those that do seek advice are not always going to the right places for it"). *See also* discussion *infra* Part II.B.

This essay explores the potential role of ERM in small business planning and regulation. Part II describes the small business landscape and entrepreneurs' typical challenges in navigating that landscape. Part III explains the origins and applications of ERM in the general business context. It considers various perspectives on risk, including the distinction between quantifiable risk and unquantifiable uncertainty and the small business entrepreneur's tendency to ignore or underestimate risks falling into the latter category. Part IV then analyzes how small business entrepreneurs might use ERM tools to overcome cognitive biases and better anticipate potential risks to their business operations. This part merges several of the concepts discussed in the first two parts and evaluates the potential applications and limitations of ERM in the small business context. It also proposes ways in which policymakers and investors might encourage entrepreneurs to incorporate ERM tools into their business planning strategies. The essay concludes by suggesting ERM as a means to help small business entrepreneurs better anticipate potential risks to their business operations and create more opportunities for success—or at least successful failures.

II. THE U.S. SMALL BUSINESS LANDSCAPE

One of the first challenges in considering the plight of small business entrepreneurs is defining the universe of businesses within the analysis. The terms "small business" and "entrepreneur" have multiple meanings and there are no prevailing terms of art.[5] Moreover, the two terms are not synonymous; indeed, large corporations can be entrepreneurial in nature

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[5] *See, e.g.*, HANS LANDSTROM, PIONEERS IN ENTREPRENEURSHIP AND SMALL BUSINESS RESEARCH 10 (2005) ("Recent entrepreneurship research is characterized by ambiguity about the content of the concepts 'entrepreneur' and 'entrepreneurship.'"); Kruno Kukoc & Dominic Regan, *Measuring Entrepreneurship*, AUSTRALIAN TREASURY (2008), http://www.treasury.gov.au/documents/1352/HTML/docshell.asp?URL=02_Entrepreneurship.asp (last visited Aug. 1, 2011) ("Modern definitions of entrepreneurship emphasize a strong link between entrepreneurship and innovation and distinguishing entrepreneurship from simple form of management."); ANDERS LUNDSTROM & LOIS A. STEVENSON, ENTREPRENEURSHIP POLICY: THEORY AND PRACTICE 41–42 (Int'l Studies in Entrepreneurship Vol. 9, 2005) ("Arguments persist about whether every business owner is an entrepreneur or whether only innovative and growth-oriented business owners merit the label 'entrepreneur.' There is no unified definition."). Likewise, there is no agreement and ongoing debate regarding related terms such as "entrepreneurship" and "entrepreneurial opportunity." *See, e.g.*, David J. Hansen, et al., *Defragmenting Definitions of Entrepreneurial Opportunity*, 49 J. SMALL BUS. MAN. 283, 283–304 (2011) (qualitative study of competing definitions of entrepreneurial opportunity and "opportunity-related processes"); LUNDSTROM & STEVENSON, *supra*, at 41–45 (discussing related terms including entrepreneurship, entrepreneurial process and entrepreneurial culture).

and some small businesses may appear less so.[6] For purposes of this essay, I use the term entrepreneur in its most basic sense, meaning "one who organizes, manages, and assumes the risks of a business or enterprise."[7] Accordingly, I consider individuals who create or operate small businesses to be entrepreneurs and within the parameters of this essay.

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[6] *See, e.g.*, Martin Carree & Roy Thurik, *Understanding the Role of Entrepreneurship for Economic Growth,* INSTITUTE FOR DEVELOPMENT STRATEGIES AMERITECH DISCUSSION PAPERS (Dec. 2005), *available at* http://www.indiana.edu/~idsspea/papers/ISSN%2005-14.pdf ("Entrepreneurship and small business are related but far from synonymous concepts."); Paul C. Light, *Searching for Social Entrepreneurs: Who They Might be, Where They Might be Found, What They Do*, NYUWAGNER, (Nov. 17–18, 2005), http://wagner.nyu.edu/performance/files/Searching%20for%20Social%20Entrepreneurship.pdf ("The phenomenon of entrepreneurship is intertwined with a complex set of contiguous and overlapping constructs such as management of change, innovation, technological and environmental turbulence, new product development, small business management, individualism and industry evolution."). Many of the concepts discussed in this essay also are applicable to larger, entrepreneurial firms, particularly those that take on significant uncertainty in the context of innovation. For a discussion of entrepreneurs in this context, *see generally* JOSEPH SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (1934) (viewing entrepreneurs as agents of change—those creating change through "new combinations," which can take various forms and largely equates to modern notions of innovation). *See also* Carree & Thurik, *supra*, at 1 (exploring role of small businesses in economic development and noting that "small businesses can be a vehicle for both Schumpeterian entrepreneurs introducing new products and process that change industry as well as for people who simply run and own a business for a living"). Moreover, innovation is not limited to larger firms; small businesses also can be entrepreneurial in the innovative sense. *See, e.g.*, Suresh de Mel et al., *Innovative Firms or Innovative Owners?* (The World Bank, Policy Research Working Paper 4934, May 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1407952 (discussing among other things data showing extent and types of innovation important to micro and small firms).

[7] *Entrepreneur,* MERRIAM-WEBSTER UNABRIDGED DICTIONARY, *available at* http://www.merriam-webster.com/dictionary/entrepreneur (last visited Aug. 1, 2011). Notably, I do not intend to include only simple management functions in my use of entrepreneur; rather, my focus is on individuals who pursue a commercial venture and accept the risks associated with that venture. *See, e.g.*, LUNDSTROM & STEVENSON, *supra* note 5, at 41–42 (explaining debate concerning various definitions of entrepreneur and including within their use of the term "business start-up, ownership and management of an owned-business"). I also embrace entrepreneurial concepts endorsed by various commentators in my use of the term, such as Frank Knight's focus on entrepreneurs bearing and profiting from uncertainty. *See generally* FRANK KNIGHT, RISK, UNCERTAINTY AND PROFIT (1921). *See also* discussion *infra* Part III.

The Small Business Association (SBA) generally defines "small businesses" as "those with fewer than 500 employees."[8] Nevertheless, the overwhelming majority of small businesses in the United States are significantly smaller in size, with most having fewer than twenty employees.[9] In addition, the SBA separately classifies non-employer and self-employed small businesses.[10] The SBA touts small businesses as "the creators of most net new jobs, as well as the employers of about half of the nation's private sector work force, and the providers of a significant share of innovations, as well as half of the nonfarm, private real gross domestic product."[11]

Although commentators sometimes question the data supporting the SBA's claims and the extent of economic contributions made by small businesses, small business entrepreneurship is an important and integral part of the U.S. economy.[12] Several studies document the shift in economic

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[8] U.S. SMALL BUS. ASS'N, THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 1 (2010) [hereinafter SMALL BUSINESS ECONOMY], *available at* http://www.sba.gov/sites/default/files/sb_econ2010.pdf. The SBA estimates 5,815,800 small business employer firms in 2009—the most recent year for which statistics are available. *Id.* at 114.

[9] *Id.* at 121–122.

[10] The SBA estimates 21,691,600 small business non-employer firms and 9,831,000 self-employed small businesses in 2009—the most recent year for which statistics are available. *Id.* at 114.

[11] *Id.* at 1.

[12] *See, e.g.*, George L. Priest, *Small Business, Economic Growth, and the Huffman Conjecture*, 7 J. SMALL & EMERGING BUS. L. 1, 17 (2003) (discussing perceived importance of small businesses to economy but concluding that "[f]rom the standpoint of economic analysis, it is not evident that there are clear normative grounds to prefer employment or productivity in a firm of larger or smaller size"); Tracy, *supra* note 1; Kelly Edmiston, *The Role of Small and Large Businesses in Economic Development*, FED. RES. BANK OF KAN. CITY, ECON. REV. 79–80 (2007), *available at* http://www.kc.frb.org/publicat/econrev/PDF/2q07edmi.pdf (recognizing important role of small businesses in economy and explaining some of the potential inconsistencies in small business data). Discourse regarding the role of entrepreneurship in economic development is not limited to the United States but is global in scope. *See, e.g.*, Kruno Kukoc & Dominic Regan, *Measuring Entrepreneurship*, AUSTRALIAN TREASURY, *supra* note 5; David B. Audretsch, et al., *Impeded Industrial Restructuring: The Growth Penalty*, INST. FOR DEV. STRATEGIES (Jan. 2001), http://www.spea.indiana.edu/ids/pdfholder/issn-01-2.pdf (discussing "process of industrial restructuring . . . where large corporations are accounting for less economic and small firms are accounting for a greater share of economic activity" in Europe and elsewhere); *Entrepreneurship and Economic Development: The Empretec Showcase*, U.N. CONF. ON TRADE AND DEV. (Jan. 2005), http://www.unctad.org/en/docs/webiteteb20043_en.pdf (discussing, on a global basis, entrepreneurship and its role in economic development); *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*, ORG. FOR ECON. COOP. AND DEV., http://www.oecd.org/dataoecd/10/59/2090740.pdf

development from large corporations to small, innovative firms.[13] The role of small businesses in economic development has received increased attention as the United States and other countries seek to recover from the Great Recession.[14]

Despite their status as "engines of economic growth," small businesses face significant operational, financial and regulatory challenges.[15] A new start-up venture is as likely to fail as it is to survive.[16] These challenges, as well as the potential barriers to small business entrepreneurs overcoming them, are discussed below.

(older study analyzing role of "SMEs (small and medium-sized enterprises)" in economic development in OECD countries).

[13] *See, e.g.*, Edmiston, *supra* note 12, at 73 (exploring emerging trend of "abandoning traditional approaches to economic development that rely on recruiting large enterprises" and "relying on building businesses from the ground up and supporting the growth of existing enterprises"); Audretsch, et al., *supra* note 12, at 6 (summarizing literature discussing shift in the United States and elsewhere "from large firms to small" and noting studies that document "the changing role of small businesses in the U.S. economy).

[14] The phrase "Great Recession" refers to the economic crisis that developed in 2007 and continued into 2009 and, to some extent, 2010. For a discussion of the history of economic development in the United States, including economic development initiatives pursued during the Great Recession and their relation to small businesses, *see* Major L. Clark, III & Radwan N. Saade, *The Role of Small Business in Economic Development of the United States: From the End of the Korean War (1953) to the Present*, OFF. OF ADVOC., U.S. SMALL BUS. ASS'N (Sept. 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1803161.

[15] *See, e.g.*, Tracy, *supra* note 1; *Entrepreneurship and Economic Development*, *supra* note 12, at 3 ("Entrepreneurship is a source of innovation and change, and as such spurs improvements in productivity and economic competitiveness."); Priest, *supra* note 12, at 2 ("In the United States, largely for political and, perhaps, historical reasons, small business has attained a status of veneration as constituting the most basic foundation of economic growth in the economy."). *See also* U.S. OFF. OF MGMT. AND BUDGET, *Budget Fiscal Year 2012 Small Business Administration* 159 (2011) http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/business.pdf ("Small businesses play a vital role in job creation, economic recovery, global competitiveness, and the long-term, strength of the Nation."); Carree & Thurik, *supra* note 6 (collecting literature exploring role of small businesses in economic growth and development); *Small Businesses, Job Creation and Growth*, *supra* note 12, at 3 ("SMEs (small and medium-sized enterprises) account for 60 to 70 percent of jobs in most OECD countries, with a particularly large share in Italy and Japan, and a relatively smaller share in the United States . . . .").

[16] *See Frequently Asked Questions*, *supra* note 1 (explaining that at least half of all small businesses fail in the first five years of their existence).

A. *Challenges to Firm Survival*

Small business entrepreneurs often have a great idea, concept or method for providing or improving a desirable product or service. Predictably, they also are enthusiastic and optimistic about their prospects and willing to accept the risks inherent in any start-up venture.[17] Unfortunately, the potential risks may prove insurmountable and, as discussed *infra* Part II.B, many small business entrepreneurs fail to appreciate or anticipate the extent of those risks.

Small business entrepreneurs frequently self-finance their initial ventures. "Startups rely about equally on owners' cash injections into the business and bank credit; young firms receive about three-quarters of their funds from banks via loans, credit cards, and lines of credit."[18] Depending on the nature of the start-up, these financing techniques may or may not be adequate to fund operations. The amount of available financing may be inadequate, or the entrepreneur may not accurately identify in advance all potential costs associated with operations.[19]

In calculating operational costs, the entrepreneur must identify both quantifiable and unquantifiable risks.[20] Entrepreneurs typically can quantify and even mitigate risks such as fluctuation in the market prices of materials or supplies. In contrast, they do not always accurately assess risks such as employee and contract disputes, market acceptance of the concept, product or service, or potential legal obstacles to the successful implementation of the underlying business concept.[21] Notably, even in the case of quantifiable risks, circumstances such as an economic downturn can create

[17] *See, e.g.*, Tracy, *supra* note 1 ("Entrepreneurs are optimistic and future oriented; they believe that success is possible and are willing to risk their resources in the pursuit of profit."). *See also* discussion *infra* Part II.B.

[18] *See Frequently Asked Questions*, *supra* note 1.

[19] *See, e.g.*, *What are the Major Reasons for Small Business Failure?*, U.S. SMALL BUS. ADMIN., http://www.sba.gov/content/what-are-major-reasons-small-business-failure (last visited Oct. 26, 2011) (citing MICHAEL AMES, SMALL BUS. MGMT. (1983), and listing "lack of experience, insufficient capital (money), poor location, poor inventory management, over-investment in fixed assets, poor credit arrangement management, personal use of business funds and unexpected growth"); Jay Goltz, *Top 10 Reasons Small Businesses Fail*, N.Y. TIMES (Jan. 5, 2011, 2:05 PM), http://boss.blogs.nytimes.com/2011/01/05/top-10-reasons-small-businesses-fail/ (citing similar concepts for failures).

[20] For further discussion of quantifiable risks versus uncertainty, *see infra* Parts III and IV. The concept of uncertainty also is described as "ambiguity" typically associated with a "lack of information or lack of confidence" in an ability to quantify. *See, e.g.*, Robert A. Olsen & George H. Troughton, *Are Risk Premium Anomalies Caused by Ambiguity?*, 56 FIN. ANALYSTS J., Mar./Apr. 2000, at 24.

[21] *See, e.g.*, Robert N. Lussier, *Reasons Why Small Businesses Fail*, 1 ENTREPRENEURIAL EXEC. 10, 11–14 (1996) (noting that there is no agreement on the factors that cause small businesses to succeed or fail but noting that lack of adequate financing is among the most commonly cited factors for failure).

unanticipated consequences. Many small businesses experienced this precise situation during the Great Recession when credit markets froze and consumers stopped spending.[22]

Widely published statistics reflect the impact of the Great Recession on small businesses. For example, small business failures increased by 40 percent between 2007 and 2010.[23] In addition, "[a]s the recession deepened in 2009 . . . small firms accounted for almost 60 percent of . . . job losses."[24] An estimated 552,600 small business employer firms were created in 2009, an estimated 660,900 closed and 60,837 filed for bankruptcy.[25]

Politicians and commentators took notice of these and other related trends involving small businesses emerging from the Great Recession and renewed efforts to streamline small business regulations and ease related regulatory burdens.[26] The total cost of regulations borne by businesses in

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[22] *See, e.g.*, NETWORK SOLUTIONS, LLC & THE CENTER FOR EXCELLENCE IN SERV. AT THE UNIV. OF MD.'S SMITH SCH. OF BUS., THE STATE OF SMALL BUSINESS REPORT 1 (July 2010), *available at* http://www.networksolutions.com/smallbusiness/wp-content/files/Network_Solutions_Small_Business_Success_Index.pdf (discussing impact of recession on small businesses and noting that the "recession has taken its toll on the overall health of small business").

[23] DUN & BRADSTREET, THE STATE OF SMALL BUSINESSES POST GREAT RECESSION (May 2011), *available at* http://www.dnb.com/asset/document/dnb_pdfs/15607032.pdf ("Small businesses . . . still face many challenges including the continued housing market slump, wavering consumer confidence and slow job growth across all business segments.").

[24] SMALL BUSINESS ECONOMY, *supra* note 8, at 2.

[25] *See Frequently Asked Questions*, *supra* note 1.

[26] *See, e.g.*, Jill R. Aitoro, *House Committee Passed Bill to Ease Regulatory Burden on Small Businesses*, WASH. BUS. J. (July 14, 2011, 8:21AM), http://www.bizjournals.com/washington/blog/fedbiz_daily/2011/07/House-committee-passed-bill-to-ease-regu.html

> The [House Small Business Committee] passed the 2011 Regulatory Flexibility Improvements Act, which would require a full assessment of the impacts that regulations will have on small businesses, force agencies to perform better periodic review of rules, and grant the Chief Counsel for Advocacy at the Small Business Administration greater powers for enforcement of the 1980 Regulatory Flexibility Act.

In addition, commentators and lobbyists voiced new concerns regarding small business regulation in the context of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the Credit Card Accountability, Responsibility and Disclosure Act of 2009. *See, e.g.*, Ben Protess, *Lawmakers Revisit Some Worries About Consumer Bureau*, N.Y. TIMES DEALBOOK (July 28, 2011), http://dealbook.nytimes.com/2011/07/28/lawmakers-revisit-some-worries-about-consumer-bureau/?ref=consumerfinancialprotectionbureau ("With the new Consumer Financial Protection Bureau formally opening its doors this month, a year

2008 is inherently unknowable, but has been estimated at as much as $1.75 trillion, most of which was borne by small businesses.[27] The undeniable conclusion is that small businesses pay far more in regulatory costs than medium or large businesses. By some estimates, they pay $10,585 in regulatory costs per employee every year—a staggering amount in the abstract, but especially because "[c]osts per employee thus appear to be at least 36 percent higher in small firms than in medium-sized and large firms."[28] As of 2006, this cost represented a "forty-five percent greater regulatory burden per employee than their large business competitors."[29] Medium-sized firms must pay $7,454 per employee in regulatory costs; large-sized firms pay $7,755 per employee in regulatory costs.[30] These figures have been at approximately the same levels for the past twenty-five years, indicating definitively that small businesses face steep and disproportionate regulatory hurdles.[31]

Concerns regarding the regulatory burden on small businesses are not new. Congress sought to address these concerns through various legislative means at various times, including the Regulatory Flexibility Act of 1980 (RFA) and the Small Business Regulatory Enforcement Fairness Act of

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after Congress created it to oversee Wall Street's biggest banks, some lawmakers have begun sounding alarms once again about its impact on community banks and other small businesses."). *See also* Statement of Honorable Nydia M. Velazquez, Ranking Member, House Committee on Small Business, *Help Wanted: How Passing Free Trade Agreements Will Help Small Businesses Create New Jobs, available at* http://democrats.smbiz.house.gov/Statements/2011/Tradehearing040611.html ("Small businesses are at the forefront of this recovery. They generate nearly two out of every three new jobs . . . . Despite the immense advantages of trade, it remains exceedingly difficult for entrepreneurs to sell their goods overseas."). The regulatory burden on small businesses is not a new concern. *See, e.g.*, Priest, *supra* note 12, at 3 (discussing regulatory burden and noting that "[v]arious commentators have addressed the seeming relative disadvantage of small business to large in responding to and complying with increasing levels of local, state, and federal regulation in our society").

[27] U.S. SMALL BUS. ASS., OFF. OF ADVOC., EXEC. SUMMARY, *available at* http://www.sba.gov/content/impact-regulatory-costs-small-firms-0. Notably, there appears to be no consensus as to the actual number; for example, the U.S. Office of Management and Budget estimates this number to be between $62–73 billion. *See* NICOLE V. CRAIN & W. MARK CRAIN, THE IMPACT OF REG. COSTS ON SMALL FIRMS 2–3 (Sep. 2010), *available at* http://archive.sba.gov/advo/research/rs371tot.pdf.

[28] CRAIN & CRAIN, *supra* note 27.

[29] Keith W. Holman, *The Regulatory Flexibility Act at 25: Is the Law Achieving its Goal?*, 33 FORDHAM URB. L. J. 1119, 1123 (2006). *See also* U.S. SMALL BUS. ADMIN., REPORT ON THE REGULATORY FLEXIBILITY ACT FY 2005 (Apr. 2006), *available at* http://archive.sba.gov/advo/laws/flex/05regflx.pdf.

[30] CRAIN & CRAIN, *supra* note 27.

[31] *Id.*

1996.[32] Such legislation directs agencies to consider the impact of their regulations on small businesses.[33] In addition, issue-specific legislation, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), frequently includes similar mandates. For example, Title X of the Dodd-Frank Act, which creates the Consumer Financial Protection Bureau, provides certain regulatory exemptions for small businesses and instructs the Bureau to consider the impact of its regulations on such enterprises.[34] Nevertheless, the impact of these new regulations remains uncertain and other regulatory burdens continue to challenge small businesses.[35]

Identifying and properly assessing these multi-faceted risks would be difficult for even the most sophisticated risk managers. The task often is Herculean for small business entrepreneurs either because of their lack of experience, resources or professional guidance; or, as discussed below, their entrepreneurial characteristics.

B. *Barriers to Entrepreneur Action*

As discussed above, entrepreneurs typically are described as "optimistic and future oriented."[36] They also generally are more comfortable with true uncertainty than most individuals—what some commentators describe as a "'taste' for uncertainty."[37] Although most businesses generally will accept quantifiable risk, typically only the entrepreneur will take on true uncertainty, or that risk which cannot be quantified.[38] As explained by

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[32] JENNIFER A. SMITH, SQUEEZING BACK: MAKING FEDERAL AGENCIES MEASURE THEIR ECONOMIC IMPACT ON SMALL ENTITIES, 5–2 (2006), *available at* http://archive.sba.gov/advo/laws/rfa_impact07.pdf.

[33] *Id.* The SBA estimates that the RFA and similar initiatives, including Executive Orders encouraging flexibility and easing of small business regulations, produced significant cost savings for small businesses in both one-time savings and recurring annual savings. *See, e.g.*, Holman, *supra* note 29, at 1131–32.

[34] *See, e.g.*, *Reducing Regulatory Burdens on Smaller Financial Institutions: Requirements the Consumer Financial Protection Bureau Must Meet,* CONSUMER FED. OF AM., *available at* http://www.consumerfed.org/pdfs/CFPB-Reduced-Regulatory-Burden-Requirements-6-17-11.pdf ("Like all agencies, the [Consumer Financial Protection Bureau] must thoroughly evaluate the potential impact of a rule on small businesses (under the Regulatory Flexibility Act)"). *See also* Dodd-Frank Act § 1027(a)(D), 12 U.S.C.A. § 5517 (West 2010).

[35] For an example of the regulations potentially applicable to small businesses solely issued by the Occupational Safety and Health Administration, *see* OSHA, SMALL BUSINESS HANDBOOK (2005), *available at* http://www.osha.gov/Publications/smallbusiness/small-business.pdf.

[36] Tracy, *supra* note 1.

[37] *See* Carree & Thurik, *supra* note 6, at 6.

[38] *See, e.g.*, KNIGHT, *supra* note 7, Part III, ch. VIII (explaining that "[t]he practical difference between the two categories, risk and uncertainty, is that in the former the distribution of the outcome in a group of instances is known (either through calculation a priori or from statistics of past experience), while in the case of

Knight, "the differential element [of an entrepreneur's wages] is . . . complex, for it is clear that there is an element of calculation and an element of luck in it."[39]

Interestingly, the personal attributes most characteristic of an entrepreneur also can impede the success of her ventures. "[E]ntrepreneurs not only tend to perceive opportunities differently but also tend to perceive themselves differently . . . . That is, they tend to have higher self-efficacy."[40] Several commentators associate this self-efficacy with an overconfidence bias that can cause entrepreneurs to over-estimate their capabilities and fail to adequately assess risks and uncertainty.[41]

Overconfidence is one of several cognitive biases that commentators suggest can affect decision-making and, consequently, success in the business context.[42] Individuals exhibiting an overconfidence bias have an unrealistic perception of their skill sets.[43] They believe that they can overcome risks and challenges that would defeat others in similar circumstances.[44] For example, they believe that they can better predict market movements in a certain segment, that they can better determine which products to take to market and when, and that they can withstand economic downturn.[45] Such overconfidence can cause individuals to forego contingency planning and contribute to their firm's failures.

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uncertainty this is not true, the reason being in general that it is impossible to form a group of instances, because the situation dealt with is in a high degree unique.").

[39] *Id.*

[40] Evan Douglas, *Perceptions—Looking at the World Through Entrepreneurial Lenses*, *in* UNDERSTANDING THE ENTREPRENEURIAL MIND: OPENING THE BLACK BOX 3, 5 (Alan L. Carsrud & Malin Brännback eds., 2009).

[41] *See, e.g.*, Douglas, *supra* note 40, at 8; Keith M. Hmieleski & Robert A. Baron, *Entrepreneurs' Optimism and New Venture Performance: A Social Cognitive Perspective*, 52 ACAD. MGMT. J. 473, 475 (2009) (discussing the "pervasiveness of optimism among entrepreneurs" and presenting results of study regarding impact of optimism on firm performance).

[42] Douglas, *supra* note 40, at 8; *see also* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124 (1974) (general discussion of cognitive bias in decision-making).

[43] *See* Douglas, *supra* note 40, at 8 ("Overconfidence is a cognitive bias that seems to afflict entrepreneurs more so than other business managers."); Hmieleski & Baron, *supra* note 41 (same). *See also* Dan Lovallo & Daniel Kahneman, *Delusions of Success*, HARV. BUS. REV., July 2003, at 58 (examining cognitive biases applicable to entrepreneurs and explaining that the "inclination to exaggerate [their] talents is amplified by [their] tendency to misperceive the causes of certain events").

[44] *See* Douglas, *supra* note 40, at 8 (explaining the overconfidence bias "to mean the overestimation of one's knowledge and abilities in relation to the successful completion of a specific task").

[45] *See id.* at 8–9 (citing study finding "that entrepreneurs exhibit higher self-efficacy than other managers, and consequently they think that they are better equipped to deal with risks than are non-entrepreneurs").

Overconfidence also can produce overoptimism in individuals.[46] Similar to an overconfidence bias, overoptimism can undermine a firm's performance.[47] Individuals exhibiting an overoptimism bias "overestimate benefits and underestimate costs. They spin scenarios of success while overlooking the potential for mistakes and miscalculations."[48] Such individuals are said to operate their businesses wearing "rose-colored glasses," blinding them to fatal operational or financial issues until it is too late.[49]

Cognitive biases are not *the* reason small businesses fail.[50] Many factors contribute to a firm's demise.[51] Overconfidence, overoptimism and similar biases simply explain a piece of the small business failure story. As discussed above, operational inefficiencies, inadequate financing, excessive or too-rapid growth, mismanagement, regulatory burdens and the like often complete the story.[52] In considering ways to mitigate these other factors, however, cognitive biases may play a significant role.

ERM may help small business entrepreneurs recognize and overcome these biases in their business planning strategies. Nevertheless, risk management often is viewed as potentially stifling innovation and quashing entrepreneurial spirit. As discussed *infra* Parts III and IV, ERM can co-exist with and enhance innovation and the entrepreneurial spirit by encouraging entrepreneurs to accept risks and uncertainty with their "eyes wide open." Achieving that worthwhile objective, however, requires thoughtful application of ERM tools in the small business context.

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[46] Notably, cognitive biases often overlap or trigger similar traits. For example, in addition to overconfidence or overoptimism, an individual also may overestimate the degree of control they exert or frame issues so that failures are attributable to factors beyond their control. *See, e.g.*, Lovallo & Kahneman, *supra* note 43 (discussing relation among overconfidence, overoptimism, control and other management biases); Hmieleski & Baron, *supra* note 41, at 475–76 (same). For discussion of framing bias in the corporate context, *see* Richard W. Painter, *Governance and Competition in Rules Governing Lawyers*, 29 J. CORP. L. 397, 404 (2004); Robert B. Thompson, *Securities Regulation in an Electronic Age: The Impact of Cognitive Psychology,* 75 WASH. U. L.Q. 779, 784 (1997) ("But I think that there are enough examples where framing leads investors to violate simple economic principles that the SEC and the courts would want to recognize it.").

[47] Lovallo & Kahneman, *supra* note 43, at 58–59.

[48] *Id.* at 58.

[49] *Id. See also* Vladas Griskevicius et al., *The Many Shades of Rose-Colored Glasses: An Evolutionary Approach to the Influence of Different Emotions*, 37 J. CONSUMER RES. 238 (2010) (discussing evolution of the bias that "makes everything appear more desirable").

[50] As discussed above, various factors typically contribute to small business failure. Nevertheless, anecdotal evidence and at least one study suggest that entrepreneurs' overoptimism is a primary factor in small business failure. *See* Hmieleski & Baron, *supra* note 41.

[51] *Id.*

[52] *See supra* notes 19–21 and accompanying text.

III. AN OVERVIEW OF ERM

ERM commonly is defined as:

> a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.[53]

Traditional risk management tends to view risks in particular areas or silos of operation, such as tax, foreign currency or human resources.[54] In contrast, ERM analyzes risks throughout the subject firm to gauge the firm's overall risk exposure.[55]

Notably, ERM is not a process designed or even intended to eliminate all risks associated with a firm's operations. First, such a result likely is not feasible. Second, such a result generally is not desirable.[56] Risk is inherent in business operations, and some level of risk typically is necessary to facilitate profits and productivity. ERM thus is designed to help firms determine their risk appetite—i.e., the level of risk that is acceptable to the firm's management and that does not threaten the firm's long-term viability.[57] In this vein, ERM is not counterproductive for small business entrepreneurs.

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[53] COSO Report, *supra* note 3, at 2; Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis*, FIN. MKT. TRENDS, Feb. 2009, at 7, *available at* http://www.oecd.org/dataoecd/32/1/42229620.pdf.

[54] *See, e.g.*, THOMAS L. BARTON ET AL., MAKING ENTERPRISE RISK MANAGEMENT PAY OFF 11 (2002) (explaining traditional silo approach to risk management); JOHN FRASER & BETTY SIMKINS, ENTERPRISE RISK MANAGEMENT: TODAY'S LEADING RESEARCH AND BEST PRACTICES FOR TOMORROW'S EXECUTIVES 3, 31 (2010) (distinguishing ERM from traditional silo risk management); Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 581, 584 (2008) (same).

[55] *See* FRASER & SIMKINS, *supra* note 54, at 33 ("ERM seeks to strategically consider the interactive effects of various risk events with the goal of balancing an enterprise's portfolio of risks to be within the stakeholders' appetite for risk.").

[56] *See, e.g.*, ASWATH DAMODARAN, STRATEGIC RISK TAKING: A FRAMEWORK FOR RISK MANAGEMENT 7 (2007) ("A business that decides to protect itself against all risk is unlikely to generate much upside for its owners; however, a business that exposes itself to the wrong types of risk may be even worse off, because it is more likely to be damaged than helped by the risk exposure.").

[57] *See* COSO Report, *supra* note 3; FRASER & SIMKINS, *supra* note 54.

A. *Origins of ERM*

Risk management is not a novel concept.[58] Individuals have long worked to explain risk and uncertainty and to develop processes to identify and manage them.[59] Most such processes focus on quantifiable risk, but commentators have increasingly discussed the need also to evaluate uncertainty. Modern corporate scandals and the Great Recession have underscored the importance of uncertainty in the risk management equation.[60]

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) initially developed ERM to help businesses respond to increasing regulation of internal and external controls and risk management matters generally.[61] In so doing, COSO created a framework that encourages firms to create a risk-aware culture that permeates from the top of the organizational structure. Although risk managers have a role to play, ERM requires the active participation of boards of directors and senior executives in the process.[62] It also focuses on communication at all levels of the organization and meaningful risk dialogue.

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[58] *See* FRASER & SIMKINS, *supra* note 54, at 19–28 (same); *See also* Michelle M. Harner, *Barriers to Effective Risk Management*, 40 SETON HALL L. REV. 1323 (2010) (explaining origins of risk management).

[59] *See, e.g.*, KIT SADGROVE, THE COMPLETE GUIDE TO BUSINESS RISK MANAGEMENT 1–3 (2d ed. 2005) (explaining the origins of risk management and the progression of risk management techniques); DAMODARAN, *supra* note 56, at 5–6.

[60] *See, e.g.*, CROWE HORWATH, AVOIDING THE BLACK SWAN: BARRIERS TO IMPROVING RISK MANAGEMENT (2009), *available at* http://www.crowehorwath.com/folio-pdf/RISK8094A_CFOSurveyResults_lo.pdf (study discussing risk management failures leading up to the Great Recession); NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (2007) (discussing surprise risk events and challenges in effectively identifying such events); Michelle M. Harner, *Ignoring the Writing on the Wall: The Role of Enterprise Risk Management in the Economic Crisis*, 5 J. BUS. TECH. L. 45 (2010) (discussing risk management failures suggested by events leading up to the Great Recession); Troy A. Paredes, *After the Sarbanes-Oxley Act: The Future of the Mandatory Disclosure System*, 81 WASH. U. L.Q. 229 (2003) (discussing corporate scandals of the early 2000s and the regulatory and legislative responses); Kirkpatrick, *supra* note 53, at 4 (discussing need for ERM given failures leading up to the Great Recession). *See also* Frank A. Schmid, *The Stock Market: Beyond Risk Lies Uncertainty*, THE REG'L ECONOMIST, July 2002 (discussing difference between quantifiable risk and uncertainty and noting that "ignorance of uncertainty may be hazardous to the investor's financial health, as the rise and fall of Long-Term Capital Management illustrates"), *available at* http://www.stlouisfed.org/publications/re/articles/?id=434.

[61] *See* COSO Report, *supra* note 3.

[62] *Id.* at 5–7; FRASER & SIMKINS, supra note 54, at 51–52. *See also* COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N (COSO), STRENGTHENING

ERM does not limit itself to quantifiable risks; rather, the spirit and breadth of the process offer opportunities for firms to evaluate uncertainties (or ambiguity) as well.[63] This aspect of ERM garnered much attention following the Great Recession, as risk discourse turned to notions of unknown risks, "black swans" and the failure of risk modeling.[64] This aspect and the general flexibility of ERM also make it potentially both viable and highly valuable in the small business context.

B. *ERM in the Small Business Context*

Most commentators agree that an ERM-type process is appropriate for any sized firm.[65] Nevertheless, ERM is most commonly discussed in the context of large firms—in particular, large financial firms. This focus is hardly surprising given the various events leading the Great Recession and the perceived failure of financial institutions' risk management functions.[66] But it also is not determinative of the potential applications of ERM.

The ERM framework proposed by COSO is a highly structured process, probably best suited for a mature firm. It includes eight inter-related components for evaluating risks: internal environment (i.e., the "tone at the top" concept discussed above), objective setting, event identification, risk assessment; risk response; control activities, information and communication, and monitoring.[67] COSO then suggests that the eight components be considered in each of four objective categories (i.e., strategic, operations, reporting and compliance) and across all levels of the organization.[68]

A small business application of ERM does not need to be as elaborate as the COSO framework. The key to effectiveness would be to build on the concepts and eight inter-relating components serving as the framework's foundation. A small business entrepreneur thus would want knowingly to adopt a risk-aware approach to business planning activities, creating a culture that likely would benefit the firm as it grows. The entrepreneur also would want to establish a process for analyzing potential risks within the business, either by using the eight inter-related components as a guide or

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ENTERPRISE RISK MANAGEMENT FOR STRATEGIC ADVANTAGE 4–5 (2009), *available at* http://www.coso.org/documents/COSO_09_board_position_final 102309PRINTandWEBFINAL.pdf.

[63] *See* COSO Report, *supra* note 3, at 1 (in explaining focus of ERM, COSO notes that "[a]ll entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value").

[64] *See supra* note 60 and accompanying text.

[65] *See* COSO Report, *supra* note 3, at 5 (explaining that "small entities still can have effective enterprise risk management, as long as each of the components [of the framework] is present and functioning properly.").

[66] *See supra* note 60 and accompanying text.

[67] *See* COSO Report, *supra* note 3, at 3–4.

[68] *See id.* at 5.

consolidating those concepts into broader components focusing primarily on risk identification, assessment and response. The exact format likely is not as important as the discipline of taking an honest assessment of potential barriers to the success of the business.[69]

Based on the ERM literature (and certainly common sense), there is no one right way to implement ERM.[70] The value of ERM lies in encouraging people to think seriously and realistically about risk and uncertainty. It is not infallible; particularly given its reliance on human judgment, the process still is subject to cognitive biases, human deceit and simple human error.[71] Nevertheless, as discussed *infra* Part IV.B, thoughtful questionnaires and guidance, especially in the small business context, might help guard against such pitfalls. In the end, the objective would be to use an ERM-like process to pursue more successfully a goal common to both ERM and entrepreneurs—"proactively realiz[ing] opportunities."[72]

IV. THE POTENTIAL VALUE OF ERM FOR SMALL BUSINESSES

Admittedly, risk and failure are part of the business lifecycle. Not every firm—regardless of size—can or should be saved. But businesses offering necessary or desirable concepts, products or services should be given a fighting chance. ERM could be a very effective tool for small business entrepreneurs in that fight.

This part analyzes the potential uses of ERM for small businesses. Specifically, it takes a closer look at why small businesses fail so frequently and how ERM might change those statistics. It then considers how policymakers and investors might encourage small business entrepreneurs to embrace ERM. This discussion recognizes the somewhat natural adverse reaction of entrepreneurs to risk management, as well as additional regulations. Accordingly, it proposes using ERM concepts to streamline various small business regulations and tailoring those concepts to work with, not against, common entrepreneurial traits. The essay concludes by encouraging small business entrepreneurs to use ERM to stack the deck more in their favor and create more successes and successful failures.

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[69] *See* COSO Report, *supra* note 3. *See also* Andrea Bonime-Blanc, *Building an ERM Program for A Small to Medium Size Company: Essential First Steps*, CORPORATE COMPLIANCE INSIGHTS, Apr. 28, 2010 (explaining ERM processes for small and medium sized firms), *available at* http://www.corporatecompliance insights.com/2010/building-an-enterprise-risk-management-program-for-small-medium-size-business-first-steps/.

[70] For an example of different methods for implementing ERM, *see* FRASER & SIMKINS, *supra* note 54, at 442–468.

[71] COSO Report, *supra* note 3 at 5 (explaining limitations of ERM).

[72] *Id.* at 1. *See also* FRASER & SIMKINS, *supra* note 54, at 33 ("The ultimate objective [of ERM] is to increase the likelihood that strategic objectives are realized and value is preserved and enhanced.").

A. *Small Business Failure and ERM*

As discussed above, many factors may contribute to a small business' failure. Among these factors are inexperience, inadequate financing, poor planning, mismanagement, unexpected growth, unanticipated litigation and cognitive biases.[73] Several of these factors go hand-in-hand and may accelerate a firm's demise. For example, an entrepreneur who is over-optimistic may make bad decisions or fail to plan appropriately. She also may be inexperienced or a seasoned entrepreneur who failed to learn from prior experiences.[74] The most common reasons for failure are lack of adequate funding and experience.[75]

Although the literature is continuing to proliferate and evolve, several studies suggest a causal connection between over-optimism and negative firm performance, as well as a significant (though unsurprising) link between a lack of planning and firm failure, in the small business context.[76] These studies align with anecdotal evidence and common sense. For example, the over-optimism study supports the notion that "there needs to be a balance between optimism and realism—between goals and forecasting."[77] Nevertheless, changing behaviors and improving business planning strategies do not naturally flow from such studies. They do, however, flow from ERM.

A tailored ERM process may help small business entrepreneurs ask hard questions and better plan for potential risks and uncertainty. Given the potential personal attributes and biases of many entrepreneurs, standardized questions and some objective review processes likely are necessary components of any effective ERM process. Notwithstanding differences in concepts, products or services offered, many small businesses face similar barriers to success—factors such as experience, financing, planning and litigation exposure. Asking entrepreneurs about each of these potential

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[73] *See supra* notes 19–21 and accompanying text. *See also* TERESA SULLIVAN ET AL., FINANCIAL DIFFICULTIES OF SMALL BUSINESS AND REASONS FOR THEIR FAILURE, U.S. SMALL BUS. ASS'N (1998), *available at* http://archive.sba.gov/advo/research/rs188tot.pdf (study suggesting various factors contributing to small business bankruptcies, which primary investigators group into eight larger categories: outside business conditions; inside business conditions; financing; tax; dispute with a particular creditor; personal; calamities; other).

[74] *See, e.g.*, Hmieleski & Baron, *supra* note 41, at 483 (explaining that "entrepreneurs who are highly optimistic are likely to learn less from their experience than ones who are moderate in optimism . . . .").

[75] *See* Lussier, *supra* note 21.

[76] *See* Hmieleski & Baron, *supra* note 41 (study suggesting overoptimism has negative effect on firm performance); Stephen C. Perry, *The Relationship Between Written Business Plans and the Failure of Small Businesses in the U.S.*, 39 J. SMALL BUS. MGMT. 201–208 (2001) (study suggesting that failed small businesses devoted less attention and resources to planning than non-failed firms).

[77] Hmieleski & Baron, *supra* note 41, at 483.

categories of risk or uncertainty is a first step in improving business planning strategies. Encouraging entrepreneurs to provide meaningful responses to those questions and accordingly, develop appropriate business plans certainly, would be more difficult. Outside assistance likely would be necessary here—either from consultants, investors or policymakers.

B. *Encouraging Entrepreneurs to Embrace ERM*

The SBA, or a similar organization, would be well-suited to develop a basic ERM questionnaire for small business entrepreneurs. The entrepreneur, or the outside party (lender, investor, etc.) requesting that the entrepreneur complete the questionnaire, then could supplement the form with material specific to the operations of the small business. The questionnaire in concept is similar to a traditional exit strategy plan[78] or, in the context of the Dodd-Frank Act, an orderly resolution plan.[79]

The questionnaire could pose questions about, among other things: anticipated costs and financing, potential alternative financing arrangements, research performed regarding concept, product or service and relevant market conditions, the identity of competitors and experience of others in the relevant market, procurement and contracting issues, employee and staffing issues, potential litigation involving concept, product or service, employees or other business related matters, and the prior experience of the entrepreneur. Having to think about these questions at least in sufficient detail to provide responses may help some individuals consider previously unidentified issues.[80] The questionnaire also would provide valuable information to prospective lenders and investors and, in the worst-case scenario, a bankruptcy court.

The potential availability of the questionnaire to outside parties might encourage thoughtful responses, but still may not foster realistic responses from all entrepreneurs. The potential for entrepreneurs to provide overly-optimistic responses exists and might be controlled by prospective lenders and investors through covenants in their transactional documents with the

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[78] *See, e.g.*, Mike Broemmel, *Business Plans: Exit Strategies*, THE HOUSTON CHRONICLE (discussing the value of providing alternative exit strategies in business plans), *available at* http://smallbusiness.chron.com/business-plans-exit-strategy-2712.html.

[79] *See* Title I, Dodd-Frank Act; CADWALADER, WICKERSHAM & TAFT LLP, LIVING WILLS: A USER'S GUIDE TO DODD-FRANK'S BEQUEST TO BANKS (2011) (explaining resolution plans under Title I of the Dodd-Frank Act), *available at* http://www.cadwalader.com/assets/client_friend/061311LivingWillsAUsersGuidetoDF.pdf.

[80] *See, e.g.*, Timothy D. Wilson & Nancy Brekke, *Mental Contamination and Mental Correction: Unwanted Influences on Judgments and Evaluations*, 116 PSYCHOL. BULL. 117, 130–35 (1994) (discussing value of awareness in combating cognitive bias).

entrepreneur. Likewise, providing some use for, and consequences to, the questionnaires in certain small business regulatory contexts also might positively influence (and encourage more realistic) responses.

For example, a small business that files for bankruptcy might be allowed to file its questionnaire in lieu of the voluminous paperwork otherwise required for small business debtors.[81] Permitting this substitution of paperwork would provide at least two potential benefits: it might encourage completion of the questionnaire and thereby prevent the need for any bankruptcy filing by helping the entrepreneur anticipate downside business risk; it also would streamline the bankruptcy filing process for small businesses and perhaps encourage more entrepreneurs to use Chapter 11 of the Bankruptcy Code to rehabilitate their businesses.[82] The

[81] A small business debtor can file a traditional liquidation bankruptcy case under Chapter 7 of the Bankruptcy Code, 11 U.S.C. § 701, or a reorganization case under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101. In the Chapter 11 context, those managing the business can continue to control the company as a "debtor in possession" during the chapter 11 case. *See* 11 U.S.C. § 1107 (defining role of debtor in possession). In addition, the company may be designated a "small business debtor." *See* 11 U.S.C. § 101(51D) (defining small business debtor). Section 101(51D) of the Bankruptcy Code defines small business debtor as

> a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate non-contingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,190,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor.

In addition, small businesses entrepreneurs may be able to address their business-related debt through an individual rehabilitation case under Chapter 13 of the Bankruptcy Code depending on factors like how the business is organized and financed, 11 U.S.C. § 1301. For a general discussion of the bankruptcy options available to small business debtors and the potential value of these alternatives, *see* Sullivan et al., supra note 73.

[82] The 2005 amendments to the Bankruptcy Code increased the information and disclosures that a small business must provide in order to commence a Chapter 11 small business bankruptcy case. *See* Robert M. Lawless, *Small Business and the 2005 Bankruptcy Law: Should Mom & Apple Pie Be Worried*, 31 SO. ILL. UNIV. L.J. 585 (2007) (discussing issues posed for small business debtors under 2005 amendments to the Bankruptcy Code). For example, Section 308 of the Bankruptcy Code requires, among other things, a small business debtor "to file periodic reports regarding: (1) the debtor's "profitability"; (2) the debtor's projected cash receipts and disbursements; and (3) comparisons of actual cash receipts and disbursements with prior projections." Thomas E. Carlson & Jennifer Frasier Hayes, *The Small*

questionnaires also might provide a bankruptcy court or creditors with meaningful information to facilitate quicker resolutions of any filed cases, in the event of precipitous failure requiring invocation of the protection of insolvency laws.[83]

Other agencies might find similar uses for, or streamlining opportunities associated with, the questionnaires depending on the content of the forms and the quality of responses. The SBA, or other organizations, could work with agencies regulating small businesses to develop an appropriate form and standards for evaluating completed forms. In all contexts, the entrepreneur, outside parties and agencies should consider appropriate procedures to protect any confidential or proprietary information included in the questionnaire.[84]

In addition, some entrepreneurs might find value in using an outside consultant to provide objective feedback regarding questionnaire responses.[85] For example, an outside consultant playing "Devil's Advocate"

Business Provisions of the 2005 Bankruptcy Amendments, 79 AM. BANKR. L.J. 645, 684–85 (2005) (explaining provisions applicable to small business debtors). These additional requirements potentially discourage small businesses from filing a chapter 11 bankruptcy case. *See* Lawless, *supra*. Designing an ERM questionnaire that includes regarding the business' potential risks and uncertainty and proposed action plans to respond to those events likely would provide more meaningful information to those involved in any bankruptcy case. The questionnaire could include annual supplements, which upon a bankruptcy filing could be used to disclose the small business debtor's most recent financial information.

[83] A challenge in this context would be using the questionnaire to help the entrepreneur and outside parties assess the best resolution of the small business' financial distress. Some businesses can successfully use Chapter 11 to reorganize their business operations; others, however, may use the process simply to prolong the inevitable closure of the business operations. *See, e.g.*, Douglas Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies,* 105 COLUM. L. REV. 2310 (2005) (discussing potential for entrepreneurs to use chapter 11 as a delay tactic). The latter use typically is not a productive use of the firm or creditors' resources, but may be facilitated by the business debtor's continuations bias. At least one study has found that the continuation bias is not statistically significant in small business Chapter 11 cases. *See* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small Business Bankruptcies*, 50 J. L. & ECON. 381 (2007).

[84] In the bankruptcy context, all forms and pleadings filed by a debtor generally are publicly available. In fact, the extensive disclosures required in a bankruptcy case can deter or at least concern business debtors. Debtors often feel as if they are "operating inside of a fishbowl" in bankruptcy cases. *See, e.g.*, Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 SEATTLE U. L. REV. 1155, 1156 & n.3 (2011) (discussing disclosure requirements in a bankruptcy case and the fishbowl environment created by such disclosures). Nevertheless, Section 107 of the Bankruptcy Code does provide limitation situations in which information can be protected from public disclosure.

[85] *See* Harner, *supra* note 57, at Part IV.C.1 (discussing use of consultants and role playing in cognitive bias and ERM training for corporate boards). An entrepreneur

might weaken and compensate for any cognitive biases, including any confirmation bias that the entrepreneur may receive from her own team.[86] Of course, not all small business entrepreneurs will have the resources to hire an outside consultant. As such, the SBA or other sponsoring organization might consider an online interactive tool that provides similar feedback (and pushback) to the entrepreneur.[87]

C. *Gambling with ERM to Produce Successful Failures*

ERM has an important role to play in small business planning; a role that could foster more wins on the entrepreneur's scorecard. One final challenge in this process, however, will be educating entrepreneurs about the function of ERM in the context of business planning. ERM for small businesses must be used to help entrepreneurs identify and increase their chances of overcoming potential risks and uncertainty.[88] It should not be used to try to filter out business concepts, products or services before they have been tested in the market. Such an approach likely would stifle innovation and the entrepreneurial spirit.

Any ERM process—whether developed by the entrepreneur or through a standardized questionnaire—should be directly tied to fostering small businesses' success stories. Those stories may include successful failures by allowing the entrepreneur to identify potentially fatal risks or uncertainty in sufficient time to change course, secure alternative financing, alter marketing or production schedules, or even successfully utilize the federal bankruptcy process or other insolvency laws. As COSO explains, "[ERM] enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value."[89]

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also could seek to include individuals on her team who would challenge and disagree with her decisions but the literature suggests that such an approach may be difficult as "optimistic persons prefer to work with individuals similar to themselves"). Hmieleski & Baron, *supra* note 41, at 483.

[86] Hmieleski & Baron, *supra* note 41, at 476 (discussing confirmation bias in which entrepreneurs "focuses on information that supports or validates their current beliefs while largely ignoring information that is not consistent with these beliefs").

[87] In addition, investors and lenders can (and likely often do) encourage entrepreneurs to consider the types of issues most relevant to an ERM analysis in performing their due diligence with respect to the investment or loan. These parties could play a meaningful role in helping entrepreneurs embrace a more standard ERM approach in the small business context.

[88] COSO Report, *supra* note 3, at 1 (explaining that "enterprise risk management helps an entity get to where it wants to go and avoid pitfalls and surprises along the way").

[89] *Id.*