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Failing Fast in the Gulf: Entrepreneurship, Bankruptcy, and Islamic Law

I. Introduction

One evening in Manama, Bahrain, I came across a young man selling food from a booth in the popular Block 338 restaurant district. He had started his business when he was only seven years old. This young man was but an example of the thriving entrepreneurial spirit in the Gulf. Yet, despite such anecdotes, the Gulf States¹ are not typically seen as a hotspot for entrepreneurship. One reason that Silicon Valley has been so successful at cultivating startup companies is because the business ecosystem there has reduced the costs of becoming an entrepreneur, largely through reducing the cost of becoming a *failed* entrepreneur. Operating under the premise that “an economy unwilling to shoulder the costs of certain entrepreneurial failures is not likely to reap the benefits of a vibrant entrepreneurial sector and the growth it may bring,”² this paper explores how Gulf economies can reduce the cost of entrepreneurial failure. In particular, I focus on the interplay between bankruptcy law and entrepreneurship and how Islamic law affects this dynamic. In Section 2, I discuss the role that failure plays in entrepreneurship and why entrepreneurs need to “fail fast.” Section 3 focuses on bankruptcy law and the broad application of Islamic principles. Finally, Section 4 adds some more specific nuance by looking at other programs in Qatar, Bahrain, and the UAE that could help lower the costs of becoming an entrepreneur.

¹ In researching for this paper, I visited Qatar, Bahrain, and the UAE. When I use the term “Gulf States” I am generally referring to these three countries but the paper is also applicable to other countries within the region.

² Seung-Hyun Lee, Mike W. Peng, & Jay B. Barney, *Bankruptcy Law and Entrepreneurship Development: A Real Options Perspective*, 32 THE ACAD. MGMT. REV. 257, 267 (2007); *see also*, Michael H. Morris, Xaver Neumeyer, & Donald F. Kuratko, *A Portfolio Perspective on Entrepreneurship and Economic Development*, 45 SMALL BUS. ECON. 713 (2015).

II. Failing Fast and Bankruptcy

Why do we need entrepreneurs?

For decades, economists have held that “[e]ntrepreneurship is widely seen as one of the most important drivers of economic growth.”³ Even if we assume this maxim is true, it does not by itself mean that society would be better off with *higher* levels of entrepreneurship. Maybe we already have an optimal, or super-optimal, number of entrepreneurs. In theory, decreasing the cost of entrepreneurship only provides a social benefit if the aggregate benefit of the marginally added successful entrepreneurs is greater than the aggregate cost of the marginally added unsuccessful entrepreneurs. Lee, et al. view this dilemma through a lens of uncertainty. Despite all the alleged expertise in Silicon Valley, it is extremely difficult to predict which startups will be successful and which ones will fail. But, Lee et al. argue that “uncertainty is not always a bad thing even when most entrepreneurs fail if a few successful entrepreneurs can generate more value to a society than when all entrepreneurs survive, but hardly add value.”⁴ Lee, et al. conclude that, because society cannot predict which startups will be the winners, the optimal strategy is to cultivate a large number of entrepreneurs.⁵ The expectation here is that the benefit of discovering the next Google will make up for all the failed startups along the way.

³ Seung-Hyun Lee, et al, *supra* note 2, at 506 (citing JOSEPH SCHUMPTER, CAPITALISM, SOCIALISM, AND DEMOCRACY (1942)).

⁴ *Id.* at 507 (citing, Rita Gunther McGrath, *Falling Forward: Real Options Reasoning and Entrepreneurial Failure* 24 ACAD. MGMT. REV. 13 (1999)).

⁵ This assertion should come as no surprise to venture capitalists whose business model is based on casting a wide net in hopes that the rare success will provide them with such a great return that it pays for all the other failures.

Lean startups and the risk of entrepreneurship

In recent years, American entrepreneurs—mostly concentrated in Silicon Valley—have begun converting to the “lean startup” methodology.⁶ In a nutshell, the lean startup is one that forsakes the front-end-loaded nature of a traditional business plan and instead chooses to hit the ground running. A lean startup is characterized by “its principles of *failing fast* and continually learning.”⁷ For a startup, there are two types of failure—what I will call “micro-failures” and “complete failures.” Micro-failures are those decision made during the course of business that harm the company in some way, usually in the form of losing money. Complete failure occurs when the culmination of the startup's business decisions force it to go out of business. This paper will focus on bankruptcy as a form of complete failure but there are other ways a startup can fail completely.⁸

A lean startups can protect itself from micro-failures.⁹ A traditional business approaches failure by mapping out all of its perceived risks and avoiding movement in a direction that presents a high level of risk. A lean startup will instead create a business hypothesis, start operating with a minimum viable product built to serve that hypothesis, and make adjustments as they seem necessary.¹⁰ Operating under this model, a lean startup treats micro-failures as if they were scientific experiments—the negation of a hypothesis provides valuable evidence. What would traditionally be regarded as a failure is instead treated as a cheaply obtained lesson of

⁶ Steven Blank, *Why the Lean Start-Up Changes Everything*, HARV. BUS. REV. May 2013, at 65, 66. Stephen Blank popularized the concept of the lean startup but it has been the subject of surprisingly little academic study.

⁷ *Id.* (emphasis added).

⁸ Another example of complete failure could be when an equity-financed company can no longer attract new investors and does not have self-sufficient levels of revenue.

⁹ Blank, *supra* note 3.

¹⁰ *Id.* at 67.

what practices should be avoided going forward.¹¹ The lean startup cannot, however, insulate itself from complete failure. At some point, the costs of operating a minimum viable product will be greater than the startup can afford and it will have to shut down. The fact of the matter is that somewhere between thirty and eighty percent of American startups ultimately end in complete failure.¹²

There is no way to completely eliminate the risk of starting a business,¹³ but there are several exogenous factors that can reduce the cost of complete failure borne by entrepreneurs. Broadly speaking, there are two buckets of factors that affect the costs of failure: social dynamics, and laws/institutions. Social factors mainly take the form of risk-tolerance and the amount of shame directed at failed entrepreneurs. This paper will focus on the laws and institutions that promote entrepreneurship, but it is worth noting that social factors in the Gulf region do not appear to put a large price on failure. In fact, a study conducted by the Global Entrepreneurship Monitor found that only 25.5 percent of respondents in Qatar¹⁴ would refuse to start a new business out of fear of failure.¹⁵ In the U.S., a full 29.7% of those surveyed reported that fear of failure would stop them from starting a business, suggesting that the social dynamics in the Gulf do not themselves inflate the cost of failure.¹⁶

¹¹ Perhaps Thomas Edison put it best when he allegedly explained “I have not failed. I’ve just found 10,000 ways that won’t work.”

¹² 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>.

¹³ When economist Richard Cantillon first used the term “entrepreneur” in the modern sense, he defined it as a “bearer of risk.” James Surowiecki, *Epic Fails of the Startup World*, THE NEW YORKER May 19, 2014, <http://www.newyorker.com/magazine/2014/05/19/epic-fails-of-the-startup-world>.

¹⁴ Data was not available for Bahrain, the UAE, or any other Gulf countries

¹⁵ SLAIVA SINGER, JOSÉ ERNESTO AMORÓS, & DANIEL MOSKA, GLOBAL ENTREPRENEURSHIP ASSOCIATION, GLOBAL ENTREPRENEURSHIP MONITOR 2014 GLOBAL REPORT 32 (2015).

¹⁶ *Id.* at 33. For an insightful look at personal grief as another social cost of failure, see Dean A. Sheperd, *Learning from Business Failure: Propositions of Grief Recovery for the Self-Employed*, 28 ACAD. MGMT. REV., 318 (2003).

III. Bankruptcy

Laws and institutions are less ephemeral than social mores which makes them more suitable candidates for academic study. Of all the legal institutions that could potentially affect entrepreneurship, the most important, or perhaps just the most observable, is bankruptcy.¹⁷ Although bankruptcy is a sign of complete failure, it is not necessarily a corporate death knell. The topic at hand would be ill-served by an exploration of the darkest corners of bankruptcy law, but the point must be made that bankruptcy can take many forms and that each of these forms imposes a different level of cost on the bankrupt entrepreneur. This paper focuses particularly on the effect of bankruptcy regimes on entrepreneurship in the Gulf for three reasons. First, bankruptcy laws have an observable effect on entrepreneurship. Second, legislatures can change bankruptcy laws more easily than they can reform other relevant laws or institutions. Third, and the inspiration for this paper, Islamic law makes bankruptcy extraordinarily costly for entrepreneurs.

Link between bankruptcy and entrepreneurship

The cost of bankruptcy theoretically affects entrepreneurs' incentives during three distinct time periods. The first time period occurs when the potential entrepreneur is still deciding whether or not to start a business. Armour and Cummings posit that during this period, a high cost of bankruptcy will reduce the *ex ante* incentive to start a business.¹⁸ All else equal, "more severe legal penalties for bankruptcy will . . . tend to make marginal would-be entrepreneurs less

¹⁷ Studies have found that other elements of corporate law such as minority shareholder rights, anti-director rights, and creditor rights do not have an effect on the level of venture capital (a close proxy for entrepreneurship) in a market. John Armour & Douglas Cumming, *The Legislative Road to Silicon Valley*, 58 OXFORD ECON. PAPERS 596, 600 (2006). This is not surprising given that venture capital rights are usually the product of investment contracts and not corporate law generally. *Id.*

¹⁸ *Id.* at 602 (citing Wei Fan & Michelle J. White, *Personal Bankruptcy and the Level of Entrepreneurial Activity*, 46 J. Law Econ. 543 (2003)).

willing to leave paid employment so as to pursue innovative business ideas.”¹⁹ This does, of course, assume that potential entrepreneurs are rationally factoring the expected cost of future bankruptcy into their decisions. The second time period for which bankruptcy laws affect entrepreneurial incentives is after a company has been founded but before it declares bankruptcy. Strict bankruptcy rules provide an extra incentive to succeed before bankruptcy, after the entrepreneur has invested resources in the business.²⁰ Finally, a costly bankruptcy regime impairs the ability of an entrepreneur to succeed *after* bankruptcy. Entrepreneurs are better able to succeed if they are not “encumbered by debt obligations carried over from [their] previous failure.”²¹ This is how a low-cost bankruptcy regime allows entrepreneurs to adopt the lean startup’s fail-fast mentality for complete failures. As Kenneth Ayotte explained, “[i]f bankruptcy legally disables failed entrepreneurs from re-engaging in business, then they only have one chance to fail. Conversely, a readily available fresh start means that failed entrepreneurs can be rapidly rehabilitated.”²² This interpretation of bankruptcy is not limited to the niche situation of startup companies. In the 1933 case of *Local Loan v. Hunt* the Supreme Court expressed that the goal of a functional bankruptcy regime was to give “the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”²³

Empirical studies have confirmed that lower bankruptcy costs lead to higher levels of entrepreneurship. Looking at trade association data from 15 different countries, Armour and

¹⁹ *Id.*

²⁰ Kenneth Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J. L., Econ, & Organization 161, 161-62 (2006)

²¹ *Id.* at 179.

²² *Id.* (citing, Nicholas L. Georgakopoulos, *Bankruptcy Law for Productivity*, 37 Wake Forest L. Rev 51 (2002)).

²³ 292 U.S. 234, 244 (1934).

Cumming concluded that “countries in which a fresh start is available systematically have greater levels of fundraising and profits” for entrepreneurs.²⁴ In a more in-depth study, Lee et al. similarly found that lower risk filing bankruptcy correlates with higher numbers of new firms being founded.²⁵

Ability to change bankruptcy regimes

Unlike other institutions that affect levels of entrepreneurship, bankruptcy regimes are susceptible to legislative changes.²⁶ Social mores, for instance, cannot be quickly or easily changed—especially not through governmental action. Even if an entrepreneur-friendly government has the power to change other legal institution, it may find it difficult to identify the exact changes that need to be made. For bankruptcy, Lee et al. found four different components of bankruptcy law that are shown to affect levels of entrepreneurship: time spent on bankruptcy procedure, money spent on bankruptcy procedure, amount of debt discharged in bankruptcy, and presence of automatic stays of assets under bankruptcy laws.²⁷ Using these findings, a legislature would have specific guidance on how to overhaul its bankruptcy regime to be more conducive to entrepreneurship. Another option that has been suggested by some scholars is to avoid overhauling the country’s entire bankruptcy regime and instead adopt a separate bankruptcy procedure specifically for entrepreneurs.²⁸

²⁴ Armour & Cumming, *supra* note 17, at 612.

²⁵ Lee, et al, *supra* note 2, at 516–17.

²⁶ *Id.* at 506. Lower time and money costs are associated with higher levels of entrepreneurship; higher amounts of debt discharged is associated with higher levels of entrepreneurship; and presence of automatic stays is associated with lower levels of entrepreneurship. *Id.* at 516.

²⁷ *Id.* at 509.

²⁸ Ayotte, *supra* note 17, at 161.

Bankruptcy Laws and Islamic Finance

Before evaluating the impact of Islamic bankruptcy law on entrepreneurship, it is worth discussing the role that Islamic law plays in the Gulf States' legal systems. *Shari'a* (Arabic for "path") is a set of religious beliefs that "guides all aspects of Muslim life."²⁹ *Shari'a* law is not, however, ported directly into the laws of the Gulf States at a one-to-one ratio. Rather, *Shari'a* "is by law either a source or the primary source" of many majority-Muslim countries' national legislation.³⁰ A simple example of *shari'a* law in practice is in the field of family law. *Shari'a* prescribes specific rules for marriage and divorce.³¹ But a country with a dual legal system like the UAE will have two separate courts: a secular court for non-Muslims to adjudicate matters of family law and a *shari'a* court for Muslims to do the same. What follows is a description of bankruptcy under *shari'a* law. Therefore, it is not necessarily a restatement of bankruptcy law in any specific country, but an overview of the role that Islam plays in creating a bankruptcy regime.

Bankruptcy under *shari'a* law, called *iflas*,³² is fairly straightforward and occurs either when debt exceeds assets or when expenditures exceed revenue.³³ The bankrupt entity, whether it is an individual or business enterprise, is referred to as the *muflis*.³⁴ What separates *iflas* from bankruptcy in legal systems like the one found in the U.S. is that the *muflis* is never permanently

²⁹ Toni Johnson & Mohammed Aly Sergie, *Islam: Governing under Sharia*, COUNCIL ON FOREIGN RELATIONS (2014), <http://www.cfr.org/religion/islam-governing-under-sharia/p8034>.

³⁰ Abed Awad & Robert E. Michael, *Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy*, 44 INT'L LAW 975, 975 (2010).

³¹ Johnson & Sergie, *supra* note 29, at 2.

³² Awad & Michael, *supra* note 30, at 980 (citing THE HANS WEHER DICTIONARY OF MODERN ARABIC 850 (J.M. Cowan ed., 1994)).

³³ *Id.* at 985.

³⁴ *Id.* at 980.

discharged of its debts. “[O]nce one is a *muflis*, there are only two ways that status ends; full repayment of all unforgiven debts or death.”³⁵ Furthermore, *shari’a* law does not allow for entity shielding used to protect individuals from debt liability.³⁶ However, this apparent harshness is balanced by the countervailing requirement that the *muflis* who is in financial troubles need not pay back his debts until he is financially able.³⁷

Using the above-described framework, the *shari’a* bankruptcy regime should theoretically exert two different influences on potential entrepreneurs. On the one hand, a would be entrepreneur might be more willing to start a business because he knows that, should the business ultimately end in complete failure, he will not have to pay any debts until he is financially able. On the other hand, once an entrepreneur encounters his first complete failure and assumes *iflas* status, it will be exceedingly difficult for him to start a second business. Further empirical research on this subject might identify the equilibrium point between these competing forces but I would expect *shari’a* bankruptcy law to have a negative net effect on entrepreneurship. In a lean startup ecosystem that relies on iteration through trial-and-error, serial entrepreneurs—those entrepreneurs who continually found new business after previous successes or failures—play an important role in innovation. If entrepreneurs are not given a second shot at starting a business, then they lose the ability to learn from their own mistakes.

³⁵ *Id.* The textual justification for this treatment comes verse 5:1 of the Quran: “O you who believe, you shall fulfill your covenants.” THE QURAN (Abed Awad trans., Penguin Classics, 2008).

³⁶ Awad & Michael, *supra* note 30, at 984 (“All personal and economic activities are conducted through either direct proprietary ownership or one of the ‘nominate’ forms of partnership that were approved by the jurists.”).

³⁷ *Id.* at 980–81 (citing, THE QURAN 2:280 (Abed Awad trans., Penguin Classics, 2008) (“If a person is in difficulties, let there be respite until a time of ease. And if you give freely it would be better for you, if only you knew.”)).

IV. Other Opportunities for Entrepreneurs in the Gulf

Finally, a discussion of entrepreneurship in the Gulf requires careful attention to government programs meant to bolster the local entrepreneurial environment. My studies in Qatar, Bahrain, and the UAE revealed many different government-sponsored programs meant to help entrepreneurs start their business. These programs include direct funding for entrepreneurs,³⁸ government programs that provide resources and expertise for entrepreneurs,³⁹ and startup “incubators” like you would find in the U.S. that provide funding and guidance for entrepreneurs.⁴⁰ A deeper analysis of these government programs would require further research to balance the needs of local entrepreneurs with the expected efficacy of such programs.

Depending on how they are set up, government programs that fund entrepreneurs can have a negative impact on entrepreneurial financing via a crowding-out effect.⁴¹ In the U.S., Armour and Cumming found that government investment had a 100-percent crowding-out effect—it neither increased nor decreased total early stage investment in startups.⁴² Although Armour and Cumming assert that their U.S. findings should hold true for other countries “even accounting for the possible endogeneity of government programs to low national levels of

³⁸ In Bahrain, the government program Tamkeen provides incentive-based funding for small businesses. TAMKEEN, <http://www.tamkeen.bh/en/> (last visited Jan. 21, 2017). In the UAE, the Khalifa fund uses its capital of AED 2 billion to “create a new generation of Emirati entrepreneurs.” KHALIFA FUND, <https://www.khalifafund.ae/SitePages/Home.aspx> (last visited Jan. 31, 2016).

³⁹ Examples in the UAE include Dubai SME, an organization with the goal to “promote innovation and leadership across all segments of the small and medium enterprise sector,” and the Centre for Entrepreneurship and Innovation at the University of Dubai, a partnership with San Diego State University designed help Dubai become “the global leader in entrepreneurship and innovation.” DUBAI SME, <http://www.sme.ae/English/aboutus/Pages/default.aspx> (last visited Jan. 31, 2016); CEI, <http://www.ud.ac.ae/en/cei> (last visited Jan. 31, 2016).

⁴⁰ These include the Qatari Business Incubation Centre in Doha, and InFive and the Dubai Technology Entrepreneurship Centre in Dubai. QBIC, <http://www.qbic.qa/> (last visited Jan. 31, 2016); INFIVE, <http://infive.ae/> (last visited Jan. 31, 2016); DTEC, <http://dtec.ae/> (last visited Jan. 31, 2016).

⁴¹ Armour & Cumming, *supra* note 17, at 601.

⁴² *Id.* at 602.

venture capital activity,” empirical studies in the Gulf region are required to confirm that a substantial startup-financing industry would emerge if not for government interference.

V. Conclusion

Gulf countries have recently taken action to increase local levels of entrepreneurship and attract innovative companies. As these economies move forward in fostering entrepreneurship, they will face many challenges: providing technical infrastructure, attracting sources of venture capital, providing visas for entrepreneurs with no existing sponsor-company. But one of the challenges that will be most addressable through legal structures is creating a bankruptcy regime that lowers the cost of entrepreneurial failure. Low failure costs will, in turn, increase the incentive for new entrepreneurs to start business, allow failed entrepreneurs to have a second chance, and ultimately provide social gain through innovation.