A RISKY DECISION OR AN INFORMED CHOICE: RE-ENTRY AFTER FIRM FAILURE

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ABSTRACT

We use utility theory to investigate how entrepreneurs frame the decision to re-enter self-employment after experiencing firm failure. We suggest that in the context of re-entry individuals have valuable information regarding the return to their human capital in self-employment and factor this into their decision making. We develop hypotheses that incorporate this reduction in uncertainty regarding the returns to human capital in self-employment for predicting the likelihood that an individual re-enters self-employment after experiencing firm failure. We explain our results using utility theory and prospect theory and suggest that there are two types of entrepreneurs who re-enter after experiencing firm failure – those who make an informed choice based on the return to their human capital in self-employment and those who take the chance to 'win back' prior loses.

INTRODUCTION

Human capital theory has been frequently used to understand the occupational choices that people make. The basic assumption is that people maximize utility by comparing the expected present value of the incomes from different occupations and choose the occupation that gives them the greatest utility. This logic has been applied also to understand the entry into self-employment (e.g. Douglas & Shepherd, 2000). A complication of applying a utility maximization framework in the entrepreneurship context is that an individual must make the decision to enter self-employment under the conditions of uncertainty (Knight, 1921) so the returns to this option are largely unknown. Consequently, the appropriateness of this approach has been questioned by entrepreneurship scholars.

In this paper, we suggest that the utility maximization framework is particularly relevant when it comes to understanding habitual entrepreneurship because prior entrepreneurial experience reduces the uncertainty associated with this occupational choice. Increasingly, entrepreneurship research has focused on understanding why some entrepreneurs start more than one firm and become habitual entrepreneurs and the implications of this choice. In particular, this emerging research stream has begun to use theories from psychology to understand the implications of failure for serial entrepreneurship (Hayward, Forster, Sarasvathy, & Fredrickson, 2010; Shepherd, Wiklund, & Haynie, 2009). Resilience has been suggested as a crucial factor helping entrepreneurs maintain their entrepreneurial motivation after experiencing setbacks (Hayward et al., 2010; Hmieleski & Carr, 2007).

In this paper we complement this approach by investigating the economic implications of failure and how this influences the framing of the re-entry decision. There is reason to believe that habitual entrepreneurs who start multiple firms can be a particularly important source of wealth creation (Scott & Rosa, 1996). Their prior self-employment experience can create opportunities
for learning (Shepherd, 2003) increasing the likelihood of improved performance in subsequent firms (Minniti & Bygrave, 2001). It also enhances their human capital specific to entrepreneurship, which facilitates their ability to identify and exploit superior opportunities (Ucbasaran, Alsos, Westhead, & Wright, 2008) resulting in some of the fastest growing firms being started by habitual entrepreneurs (Scott & Rosa, 1996). Thus understanding why some entrepreneurs re-enter self-employment and not others can provide valuable insights into the likelihood of serial entrepreneurship (Shepherd, Wiklund, & Haynie, 2009).

In this paper we show how the assumptions of utility theory are better suited for explaining re-entry into self-employment rather than first time entry into self-employment. In doing so, we make three principle contributions to the literature.

First, we extend the utility maximization framework to the context of re-entry into self-employment. Prior self-employment experience provides valuable information to entrepreneurs regarding the return on their human capital in self-employment and it is likely that they factor this into their decision making (cf. Folta, Delmar, & Wennberg, 2010). This decreases the uncertainty associated with self-employment making the assumptions of utility theory more appropriate for predicting re-entry into self-employment in comparison to initial entry into self-employment.

Second, we take into consideration not just the implications of the most recent failure for re-entry into self-employment but also the outcome and nature of prior self-employment experiences. Thus we deconstruct the prior experience variable to consider the influence of previous failures and successes on re-entry into self-employment. Third we contribute to the habitual entrepreneurship literature by showing how the financial position of individuals after firm failure influences the framing of the decision to re-enter self-employment.

The remainder of the paper is organized in the following way. We use utility theory to derive our hypotheses. We then outline the method used to test these hypotheses. This is followed by a presentation of the results and a discussion of the main findings.

**Utility Theory for Understanding Employment Decision**

Applied to the entrepreneurship context, utility theory uses economic logic to understand how individuals’ choose between self-employment and paid employment. This framework assumes that individuals weigh up their expected utility from self-employment and paid employment and choose the employment option that maximises the present value of their utility over their lifespan (e.g. Douglas & Shepherd, 2000). Utility consists of both the economic benefits that the individual’s human capital can render in each employment option and the psychic benefits such as work effort required and enjoyment from the work tasks (Becker, 1975; Gimeno, Folta, Cooper, & Woo, 1997). Utility from self-employment and paid employment differ because individuals’ receive different returns on their human capital in the different employments options and they also receive different levels of enjoyment from each option depending on their preferences for the occupation or personal satisfaction (Evans & Leighton, 1989; Gimeno et al., 1997).

The economic return to human capital depends on the individual’s investment in different forms of education and training. This investment can provide general skills which are useful in a variety of work settings and specific skills which are useful in a particular employment context
(Becker, 1975). Thus the economic return to human capital in self-employment is dependent on the individual’s general human capital and his or her human capital specific to self-employment. Likewise the economic return to human capital in paid-employment is dependent on the individual’s general human capital and his or her human capital specific to paid employment. Each form of employment is also associated with psychic income that is derived from the respective form of employment. The individual therefore enters self-employment if the combined economic and psychic utility is greater than the combined economic and psychic utility from paid employment.

A limitation of this approach for understanding the decision to enter self-employment is that an individual cannot know the return to their human capital in self-employment a priori (Knight, 1921). Profit from self-employment is dependent on an individual’s human capital, their effort level and a range of factors such as consumer preferences, competitors’ prices and product offerings, macroeconomic variables, among others (Douglas & Shepherd, 2000). This implies that in self-employment an entrepreneur can expend effort without any guarantee for remuneration (Cramer, Hartog, Jonker, & Van Praag, 2002; Lévesque, Shepherd, & Douglas, 2002). It is only after running the firm for a period of time that the individual can gauge their return to human capital in self-employment and make an informed choice regarding their options (Jovanovic, 1982). In contrast, paid employment is a relatively risk free occupational choice, an employee can know with relative certainty that they will receive a pre-determined wage for work done and the risks associated with employment can be insured against – unemployment insurance (Eisenhauer, 1995).

In the context of re-entry, however, individuals have had the opportunity to develop their human capital specific to self-employment and they have also received information regarding their return to this human capital. It is likely that they factor both their total stock of human capital specific to self-employment and the return to this human capital in their decision making (Jovanovic, 1982). Prior to considering how prior self-employment experience can reduce the uncertainty associated with this occupational choice we consider the role of stock of human capital in influencing the decision to re-enter. We do not consider the influence of general human capital on the decision to re-enter self-employment as this form of human capital positively influences both the type of paid employment the individual can obtain and the type of opportunities the individual can exploit.

**Stock of Specific Human Capital**

Through the process of starting and running a firm entrepreneurs accumulate human capital particularly valuable to self-employment. For example, knowledge gained from starting one business enables an entrepreneur to see opportunities for other businesses – the corridor principle - (Ronstadt, 1988) and can be important for overcoming liabilities of newness (Shepherd, Douglas, & Shanley, 2000). Through the process of running a firm entrepreneurs have the opportunity to revise their total stock of knowledge that is relevant for self-employment (Minniti & Bygrave, 2001). Prior start-up experience, however, is probably less useful in the context of wage work and therefore less valued by an employer. Hamilton (2000) found that with the exception of the top 25 percent of performing entrepreneurs, individuals who are self-employed earn comparatively less than their counterparts in paid employment. Stated differently, the payoff of entrepreneurial experience is likely to be larger in self-employment than in wage work. Thus we hypothesize:

\[ H1: \text{The higher the human capital specific to self-employment the greater the likelihood of re-entry} \]
Return on Human Capital Specific to Self-Employment

Through the process of owning and managing firms, entrepreneurs also receive feedback information regarding the return on their human capital in self-employment. They are likely to factor this into their decision making when deciding whether or not they re-enter self-employment (cf. Folta et al., 2010). This information decreases the uncertainty regarding the pay-off in self-employment. Individuals who received a positive return on their human capital in self-employment are likely to view self-employment as comparatively less risky. These individuals are likely to assume with greater certainty that they will receive a positive return on their human capital in future efforts in self-employment. On the other hand, individuals who experience a negative return on their human capital in self-employment are likely to view self-employment as comparatively more risky. These individuals have received a negative return on their human capital in self-employment and are thus likely to be more certain that they will receive a negative return on their human capital in future efforts in self-employment. An entrepreneur’s financial position after exiting self-employment is thus an indication of the return to his or her human capital in self-employment. This information can therefore be used to decrease the uncertainty associated with payoffs in future self-employment. In other words entrepreneurs learn about their performance in self-employment and this reduces the uncertainty associated with the re-entry decision (Jovanovic, 1982).

A negative financial position after firm failure is an explicit indication that the individual has experienced a negative return on their investment in self-employment. Further, this negative return from their investment in self-employment is likely to be greater than the potential negative return they could have received from the same investment in paid employment. In the event of firm failure or unemployment an individual loses a future stream of income. However, because entrepreneurs face liquidity constraints financial investments into self-employment predominately come from personal (friends and family) savings and loans are often give up to the amount that the entrepreneurs can personally guarantee with assets (White, 2001). Thus entrepreneurs who fail can face not only a loss in future stream of income but also a debt burden and a loss of their original investment. In other words individuals can face a debt burden if they secured business loans with personal assets and they can also face a situation of financial strain if savings and financial reserves were invested in the firm. Thus based on a reduction in uncertainty argument in relation to the return to payoffs to specific human capital in self-employment, we hypothesize that a weakened financial position as a result of the failure decreases the probability that a failed entrepreneur re-enters self-employment. This is formally stated in hypothesis 2 below:

\[ H2: \text{The worse the financial position as a result of the failure, the lower the likelihood of re-entry} \]

Habitual entrepreneurs, however, have more than just one experience to base their decision making on. Habitual entrepreneurs who have experienced at least two failure experiences are likely to further increase their certainty that self-employment is not for them. On at least two occasions they have experienced a negative return on their human capital in self-employment. This implies that the strength of the relationship between financial loss and re-entry is likely to be enhanced for entrepreneurs who have experienced at least two failures. In contrast habitual entrepreneurs who have experienced prior success are unlikely to base their decision making on the single failure experience but consider the failure experience in the context of their prior successes. Thus the
single failure experience is likely to increase the uncertainty regarding the payoff to specific human capital in self-employment in comparison to individuals who have had only the single failure experience or multiple failure experiences. Stated differently the strength of the relationship between financial loss and re-entry is likely to be reduced for habitual entrepreneurs with prior success as they have at least one prior success to factor into their decision making. This increases the uncertainty regarding their payoffs in self-employment and thus reduces the strength of the relationship between financial loss and re-entry. This leads to the following hypotheses:

**H3: The relationship between the financial position and re-entry into self-employment is moderated by the type of prior self-employment experience such that for (a) individuals with prior failure the strength of the relationship is enhanced and (b) individuals with prior success the relationship is reduced.**

**METHOD**

**Research Design and Sample**

In line with recent research, we define failure as occurring when a fall in revenues and/or rise in expenses are of such magnitude that the firm becomes insolvent and is unable to attract new debt or equity funding; consequently, it cannot continue to operate under the current ownership and management (Shepherd, 2003; Shepherd et al., 2000). We operationalize this definition as firm bankruptcy. This firm level definition is particularly relevant when investigating whether an individual re-enters self-employment after experiencing failure. The firm has clearly failed and can no longer be operated under current management, thus if an individual wants to start a new firm they must re-enter self-employment. Thus our research design enables us to study re-entry into self-employment without having to consider the role of switching costs.

The sampling frame consisted of all firms that had filed for firm bankruptcy in Sweden in September, October and November 2008, a total of 1000 firms. Firms which had filed for liquidation were excluded from the sampling frame as these firms are systematically different to firms that file directly for bankruptcy. For example, these firms have usually been inactive for a substantial period of time (Oppenheimer, Blomberg, Bruhn, & Reiner, 2007). A key informant approach was used where owners that were also active in the daily running of the firm were considered entrepreneurs (Ucbasaran et al., 2008) and were interviewed over the telephone. Respondents were telephoned in March, April and early May, 2009, approximately 5 to 6 months after filing for bankruptcy. In total 284 telephone interviews were conducted with active owner-managers. 238 respondents accepted to receive the mail questionnaire and after a three-wave mailing (i.e. two reminders) 121 completed mail questionnaires were returned. The response rate to the telephone interview was therefore 28.4 percent and the response rate to the mail questionnaire was 12.1 percent. If just those that could be reached over the telephone are considered, the response rate to the telephone interview was 60.7%. Also if just the respondents who accepted the mail questionnaire are considered, the response rate to the mail questionnaire was 50.1 percent.

Respondents were then interviewed an additional 3 times at 6 month intervals to track whether or not they had re-entered self-employed and started a new firm. The average age of the respondents was 48, 85% were male and 62% had been involved in more than one start-up. The
average age of the business at the time of bankruptcy was 8.5 years and the average number of full time equivalent employees was 4.8.

**Dependent Variable**

*Re-entry into self-employment* was operationalized by asking respondents as part of the telephone interview if they had started a new firm since the bankruptcy. Respondents were asked this question four times at approximately 6 month intervals after the bankruptcy. If they responded positively to this question on one of these occasions, the variable was coded 1 to indicate that they had started a new firm. If they had not started a new firm the variable was coded 0. Within two years of the bankruptcy 43 percent of the sample had started a new firm.

**Independent Variables**

*Human capital specific to self-employment* was measured in ways. The first measure was the number of start-ups the entrepreneur had been involved in. This variable captures specific human capital relevant to opportunity identification and the start-up process. The second measure was the number of years the entrepreneur had own and run the firm that failed. This variable captures specific human capital relevant to managing a firm on a daily basis.

*Financial loss* was also operationalized using two different measures. The first measure was the amount of personal debt the respondent had as a direct result of the bankruptcy. As part of the telephone interview, respondents were asked: “have you today private debts caused by the bankruptcy?” 47% of respondents did not have any private debt as a result of the bankruptcy. If they answered yes, they were then asked “approximately how large are these debts?” The average amount of private debt was 44,000 USD and the standard deviation was SEK 96 300 USD. Five respondents declined to answer this question. In three cases this was because the respondent was not sure if they had any debts until the bankruptcy proceedings were finalized. In the other two cases the respondent was able to answer that their debt was between 15 000 USD and 70 000 USD. The lower bound was used as an indication of their level of debt and these two cases were included in the analysis. Given the range of this variable, a log transformation was performed. To check for robustness the analysis was also performed using the variable without the log transformation and the same results were obtained.

The second measure was the extent of financial strain that the failure caused. To capture this, respondents indicated on a 7 point Likert scale (1 = does not apply at all to me; 7 = completely applies to me) the extent to which the following two items are relevant to them: “My finances are strained” and “My or my family’s financial security has been jeopardized”. These questions were asked as part of the mail questionnaire.

*Prior failure* was measured using financial criteria (Davidsson, 2008). If the respondent had previously closed one or several firms with losses or filed for firm bankruptcy, it was considered that they had previous firm failure experience. The variable was coded 1 for those that had experienced prior failure and 0 for those had not. A total of 15 respondents had experienced one prior failure. No respondent had more than one failure.
Prior success was measured by asking respondents if they had prior start-up experience and the outcome of these firms. If the respondent had previously sold a firm, this was coded as 1 indicating prior success, if they did not have this previous experience their response was coded as 0. A total of 22 respondents had sold at least one firm.

Control Variables

A number of control variables were included in the analysis. First we relax assumption that individuals must exclusively choose between paid employment and self-employment (c.f. Folta et al., 2010) and controlled for whether the respondent had paid employment or another firm at the time of the bankruptcy.

We also controlled for the age and sex of the respondent, the number of years of schooling, the number of years as an owner, the average number of working hours per week in the year leading up to the bankruptcy and firm size (operationalized as number of full time equivalent employees). A log transformation was performed on the number of years as owner, number of employees and number of working hours per week to create variables that are more suitable for logistic regression analysis.

Results

We present the results from the logistic regression analysis in table 1. The correlation between financial strain and financial loss was .556. Thus these variables are entered separately into the model prior to estimating their combined effect. In the first model the influence of the control variables is shown. In the second model we test hypothesis 1 – the influence of human capital specific to self-employment on re-entry. We found that prior start-up experience had a statistically significant positive influence on re-entry into self-employment ($\beta = .1030, p < 0.05$). However, we did not find that the number of years of firm ownership to have a positive influence on re-entry into self-employment ($\beta = .000, p > 0.10$). Thus we find partial support for hypothesis 1.

Next we test the influence of financial loss on re-entry – hypotheses 2. First we test the individual influence of personal debt and financial strain on re-entry. These results are shown in models 3 and 4. We did not find that personal debt decreased the likelihood or re-entry ($\beta = .028, p > 0.10$). However, we found that financial strain decreases the probability of re-entry ($\beta = -.195, p < 0.10$). Thus we find preliminary partial support for hypothesis 2. Next we test the combined influence of the financial loss variables on re-entry – model 5. Personal debt had a statistically significant positive influence on re-entry ($\beta = .093, p < 0.05$). This was the opposite to what was hypothesized. We also found that financial strain had also had a statistically significant positive influence on re-entry ($\beta = -.363, p < 0.05$). This was in line with what we hypothesized. Thus we received partial support for hypothesis 2.

Lastly we test the interactions of previous self-employment experiences on the relationship between the individual’s financial position and re-entry into self-employment. This is shown in models 6, 7, 8 and 9. Model 7 shows the interaction between prior failure experience and financial strain. This interaction term is negative and statistically significant ($\beta = -1.85, p <0.05$). This provides preliminary and partial support for Hypothesis 3. No significant interactions are found for the other interactions in Models 6 ($\beta = -0.380, p > 0.10$), 8 ($\beta = -0.070, p > 0.10$) and 9 ($\beta = -.375, p > 0.10$).
In order to determine the nature of the interaction between prior failure and financial strain (Hypothesis 3), based on the regression coefficients provided by the analysis presented in model 7, we plotted the effect of predicted probability of re-entry into self-employment with and without prior failure experience at different levels of financial strain as suggested by the literature (Hoetker, 2007). As illustrated in Figure 1, prior failure experience enhances the negative influence of financial strain on re-entry into self-employment, at high levels of financial strain.

**DISCUSSION AND CONCLUSIONS**

In this paper we use utility theory to investigate how individuals frame the decision to re-enter self-employment after experiencing firm failure. Prior research has used utility theory to understand the decision to enter self-employment (e.g. Bates, 1990; Lévesque et al., 2002) and exit self-employment (e.g. Gimeno et al., 1997). In this paper we add to this literature by showing that in the context of re-entry, individuals have information regarding the returns to their human capital in self-employment and use this information when choosing their occupational choice. Hence prior self-employment experience decreases the uncertainty surrounding the returns to human capital in self-employment. Thus our approach overcomes one of the major criticisms of using utility theory in the context of occupational choice— that individuals cannot know a priori the return to their human capital in self-employment.

By choosing a research design where entrepreneurs had experienced firm failure we were able to study the decision to re-enter self-employment without having to consider the role of switching costs. This enables us to focus more specifically on how individuals factor both their stock of human capital relevant for self-employment and the return on this human capital when deciding whether or not they re-enter self-employment.

In relation to the stock of human capital specific to self-employment we found that the number of prior start-ups the individual had been involved in had a positive influence on the probability of re-entry while the years of firm ownership did not influence the probability of re-entry. This suggests that in the context of re-entry after firm failure, the human capital developed from multiple firm experiences is more important than the human capital developed from spending time owning and managing a firm.

We found mixed support for our hypothesis regarding the relationship between the individuals’ financial position and the likelihood of re-entry. We found, as hypothesized, that financial strain had a negative influence on the likelihood of re-entry. We suggest that individuals’ financial position after experiencing firm failure provides them with an indication of their return to human capital in self-employment decreasing the uncertainty regarding the returns to their human capital in self-employment. Thus entrepreneurs who experience financial strain after firm failure make a more pessimistic assessment of the future financial and psychic income from entrepreneurship.

On the other hand we found that the greater the level of personal debt as a result of the failure, the greater the likelihood of re-entry. This finding is at odds with what was predicated using human capital theory. To explain this finding we turn to the literature on prospect theory. Prospect theory explains how individuals make decisions under the condition of risk (Tversky & Kahneman, 1981). In loss situations individuals are generally risk seeking accepting riskier investments then they would otherwise (Kahneman & Tversky, 1979). This is particularly the case if the individual
must choose between a certain loss and a long shot investment (Arkes & Blumer, 1985). This suggests the individuals who have lost money as a result of firm failure may be motivated to re-enter self-employment even if they feel their chances of success are slim to avoid the certain loss as a result of the failure.

Taken together these findings suggest that how individuals frame the re-entry decision depends on whether or not individuals have adapted to their new financial situation – i.e. their new reference point (Tversky & Kahneman, 1981). For individuals who are in a position of financial loss, they will be in a risk seeking position if they have not adjusted to their new and reduced wealth situation. This can increase the likelihood that they re-enter self-employment to try ‘win back’ the money they have lost. On the other hand, if they have adapted to their new reduced wealth position they are likely to factor the negative return on their human capital in self-employment and chose an alternative occupational choice.

This finding can also be interpreted in relation to the types of entrepreneurs who are motivated to re-enter self-employment after firm failure – entrepreneurs who did not experience financial strain and entrepreneurs with personal debt. This suggests that entrepreneurs who re-enter have markedly different returns on their human capital in self-employment. This finding can therefore help explain why there are inconclusive results regarding the relationship between prior experience and subsequent firm performance. Entrepreneurs with high returns to their human capital in self-employment are motivated to re-enter as are entrepreneurs with low returns on their human capital in self-employment.

We find further support for our use of human capital theory for understanding re-entry when we consider the influence of prior failure experiences on the relationship between the individual’s financial position and the probability that they re-enter. To interpret the interaction we plotted the effect of predicted probability of re-entry into self-employment with and without prior failure experience at different levels of financial strain as suggested by the literature (Hoetker, 2007). This is shown in figure 1. The plot of the interaction effect shows that individuals who have experienced prior failure are much more sensitive to the experience of financial strain than individuals who have not previously failed. In particular individuals who have experienced prior failure and high levels of financial strain are less likely to have re-entered, supporting the basic premise of hypothesis three. On the other hand, individuals who have experienced prior failure but do not experience financial strain are much more likely to re-enter self-employment. The previous failure experience may have helped these individuals develop resilience (Hayward, Forster, Sarasvathy, & Fredrickson, 2010; Hmieleski & Carr, 2007) and provided valuable learning opportunities reducing their financial exposure in subsequent self-employment.

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References


### Table 1: Results from the logistic regression analysis

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<thead>
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<th>Control Variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
<th>Model 5</th>
<th>Model 6</th>
<th>Model 7</th>
<th>Model 8</th>
<th>Model 9</th>
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<td>.257</td>
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| Research Variables     |         |         |         |         |         |         |         |         |         |
| Previous Start-Up      | 1.030*  | 1.036** | 1.101** | 1.161** | 1.174** | 1.25**  | 1.15*   | 1.17*   |         |
| Years as Owner         | .000    | -.108   | -.061   | -.227   | -.350   | -.495   | -.278   | -.256   |         |
| Personal Debt          | .028    | .093*   | .117*   | .099*   | .108*   | .108*   |         |         |         |
| Financial Strain       | -.195+  | -.363*  | -.365*  | -.285+  | -.368*  | -.314*  |         |         |         |
| Prior Failure          | 3.80    | 1.00*   |         |         |         |         |         |         | .497    |
| Prior Success          |         |         |         |         |         |         |         |         | 1.93    |
| Prior failure x Personal Debt |       |         |         |         |         |         |         |         | .380    |
| Prior failure x Financial Strain |   |         |         |         |         |         |         |         | -.85*   |
| Prior success x Personal Debt |       |         |         |         |         |         |         |         | -.070   |
| Prior success x Financial Strain |     |         |         |         |         |         |         |         | -.375   |

| $R^2$ McFadden | .060 | .112 | .128 | .128 | .168 | .198 | .222 | .171 | .176 |
| N              | 125  | 125  | 122  | 124  | 121  | 121  | 121  | 121  | 121  |
Figure 1: Predicted probability of re-entry with and without prior failure experience at different levels of financial strain.