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Ten Common Mistakes of Entrepreneurs

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The Question of Failure

What if I fail? That is undoubtedly the biggest question on your mind as you establish your own business. As an entrepreneur, you are excited about your new business venture. You also know the possibility of failure looms. Given the time, money and effort that it takes to start a business, not to mention the high rates of small business failure, it is a wonder that anyone ventures out on their own. It is monumentally challenging to convince prospective investors and lenders that your idea is worthy of the risk they will take while you have your own questions about the business' viability. Despite these obstacles, you, like most entrepreneurs, will have no problem developing your business, getting excited about its prospects, and sharing your excitement with others.

Like many entrepreneurs you may establish your company with the best of all worlds in mind and fail to consider what will happen when the worst of all worlds happens. An old maxim warns: when you fail to plan, you plan to fail. The remedy? Spend adequate time thinking through the business in advance.

The risks attendant to starting your own business can be minimized by analyzing mistakes made by other entrepreneurs and avoiding them. The more time you spend minimizing risk, the happier you and your investors will be.

Avoiding ten mistakes made by budding and seasoned entrepreneurs alike will put you far ahead in the game. At the root of most of these mistakes is a lack of planning and a failure to check with reality. When you start out, you may operate in a state of euphoria.

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Nothing can possibly go wrong and no one else could possibly have your idea. While the latter may be true for the time being, the former is a delusion. In every new venture, something is bound to go wrong at some point.

Rarely will everything happen just as you've envisioned. An event may be catastrophic or seem hardly noticeable; in either case there will be some effect on the business. So why should you even try to plan ahead? Because most events are foreseeable, at least as to the probability of occurrence. When they are foreseeable, they are preventable, or, at least, their effects can be mitigated. Another well-known maxim: success comes about when preparation meets opportunity. A business caught without a plan or options is a business that will soon be gone.

The Ten Mistakes

1. Failure to Take the Money

Do not get caught short of money when it is available to you. Generously estimate your costs, recognizing that hidden costs always arise. Just be realistic about the costs associated with the business. You will be happier because you will have the funds you need to both run and grow the business. Your lenders and investors will be happier to lend or invest their money because they will feel that you are not hiding anything.

Problems in the acquisition of financing arise when there is a distrustful relationship between the entrepreneur and the lender or investor. When raising capital for your idea, don't let your optimism for the venture overshadow your sense of reality and common sense.

Why would you ever refuse funding? You might, if you are one of those entrepreneurs who believes that "bootstrapping" is a virtue.¹ In today's market, interest rates are as low as they have been for many years; the economy has slowed while technology is moving at a light-speed pace. That makes this the time to borrow, grow, and invest to prepare for when the market turns around. Insist on bootstrapping and you could put yourself and your business in the position of being unprepared for the future if cash flow and profits fail to materialize as projected.

Other less direct ways you can refuse to take the money include failure to agree to loan requirements and unwillingness to give up any control of your business to lenders or investors. These factors are within

¹ Interview with Ruthann Quindlen (Joseph Rosenbloom), *I Used to Love Bootstrapped Companies, Inc.*, July 1, 2000, at 104.

your control. Plan ahead, accurately assess the needs of your business, and take enough money when it is offered.

2. Unrealistic Valuation Expectations

As a member of a group of some of the world's most optimistic people, you may think you have more than you actually do. Indeed, belief in the success of your business is one of the key ingredients in a successful business venture -- if you don't have total faith in your idea, no lender or investor will, either. Optimism about your business is crucial to the your ability to raise sufficient capital from investors and lenders.

Recognize that lenders and investors are not naive. They know that entrepreneurs put as positive a spin on the business as possible. While you explain your project viewed through your rose-colored lenses, creditors and lenders will clarify that view with a healthy dose of reality. In October 1990, the Los Angeles Times reported that lenders and investors are becoming increasingly wary of businesses with the "fail-proof" idea.² They are more interested in finding real incentives for investment. If a business has been sitting around for some time with no serious potential buyers, the asking price is probably excessive.

When you seek early funding from lenders and investors, the problem can be much the same -- the valuation is too high. The theory behind valuation closely resembles that of pricing -- in the end you need to come up with the largest number possible based on valid and measurable factors. In pricing, this number has to be high enough to cover costs and allow for a profit, but low enough to keep customers coming back.³ It is the same for valuation -- the result has to be high enough to cover anticipated costs and allow for adequate cash flow. It also must be low and realistic enough to cause lenders and investors to trust your numbers and be more willing to assist your business in the future.

In his article on the "Dos and Don'ts" of financial projection, Paul A. Broni gives some good advice on how you can avoid the common mistakes made by entrepreneurs who attempt to acquire funding.⁴ He recommends keeping the numbers realistic and demonstrable. When your projections and valuations are reasonable, funding - present and future - will become easier to acquire.

² Tom Petruno, *Market Beat: Wary Venture Capitalists Looking for an Incentive*, L.A. Times, Oct. 12, 1990.

³ Bo Burlingham, *The Downsizer's Dilemma*, Inc., Dec. 1, 2001.

⁴ Paul A. Broni, *Business 101 - Predicting the Future is Never Easy*, Inc., Apr. 1, 2000, at 163.

3. The “If You Build It, They Will Come” Syndrome

Failing to recognize that a good idea may not translate into a viable business can mean the death of a business before it has even begun. In the film “Field of Dreams” (Universal Studios 1989), the main character, played by Kevin Costner, hears a voice that whispers, “If you build it, they will come,” and tills over his prime corn-growing acreage in Iowa to build a beautiful baseball diamond in the middle of nowhere. Costner’s character is vindicated in the end, but the same is not always true of entrepreneurs.

Your optimism may include your unwavering belief that your idea is the newest, hottest thing out there; you know exactly who needs it and how to sell it. You may not enjoy the same outcome as Kevin Costner in “Field of Dreams” if you risk building it and they do not come. This trap looms in product development, a business start-up, or a simple marketing strategy. You need to ask some important questions. “Who really can or will use this?” “Why?” More importantly, “What if they don’t like, use, buy, need, or want it?” Recognizing that potential current failure may necessitate setting an idea aside for the time being may not mean giving up on the idea altogether. Perhaps it just needs some adjustments. Internet retail companies are infamous for making the wrong assumptions initially. For that market, success requires that changes be made as quickly as possible.

One common mistake is selection of the wrong target market. In an interview in *Inc.* in 1996, Peter Drucker, author of *Innovation and Entrepreneurship* (Harper & Row, 1985), attributed the inability of many entrepreneurs to adapt to new circumstances and opportunities to their close, personal attachment to their original idea. “[T]hey insist that they know better than the market . . . [and reject] success.”⁵ A suggestion that they may be mistaken is an insult. They would rather go out of business than change.

Drucker cites the example of John Wesley Hyatt, who developed the roller bearing. Hyatt was sure that it was perfect for use on the axels of railroad freight cars. No one accepted the idea. Failing to recognize when he needed to change his focus, he continued to try to convince people that he was right. The company ended up in bankruptcy. A few years later, Alfred Sloan, another entrepreneur who later founded General Motors, bought the company at a minimal price and changed the target market to automobiles. The company enjoyed great success for years. When you are able to recognize that your good

⁵ George Gendron, *Flashes of Genius: Peter Drucker on Entrepreneurial Complacency and Delusions*, *Inc.*, May 15, 1996, at 30.

idea may not translate into a viable business in the market you've identified and you make adjustments accordingly, your business will likely be better off in the long run.

4. Failure to Strike When the Iron is Hot

Much is said about the importance of perfecting a product or business plan before actually introducing the product to the market. The value of having a plan and a marketable product should not be overlooked, but neither should it be overemphasized. Your company may risk failure because you spent too much time and money on these preparations while the market passed you by.

You may misread your intended market and waste time and money perfecting a product or plan that is not a good fit with the market. Because the potential to misread a market is great, your business plan and product must be adaptable to the circumstances encountered after entrance into the market.

Spending too much time preparing a product for market risks failure of your enterprise. Rapidly changing consumer interest, such as in the rapidly evolving entertainment industry or vast improvements in technology, can make your product obsolete. For example, delay in the computer market can cause an entrepreneur to miss the short period of time in which the product is considered "cutting edge." Delay in preparation may give your competitors an opportunity to secure additional market share, ruining your chance to grab a sufficient share of the market.

Missing an opportunity is not the only negative outcome of over-preparation. You also risk misreading the market and wasting time and money. A good illustration of misreading a potential market can be seen in the story of iVillage.com. Co-founder Robert Levitan and his team spent months preparing the launch of iVillage.com's parenting channel, ParentSoup. Mr. Levitan's product was an online magazine for parents. To prepare for the launch of the channel, Mr. Levitan and iVillage.com had over 2,000 articles on parenting written at a substantial cost. Focus groups loved the idea. When Mr. Levitan launched the product, consumers ignored the articles, while the ParentSoup chat-room was a hit. Mr. Levitan pointed out that "You could spend six months planning a product or service, but sometimes it's better to just launch it and adapt to feedback."⁶ Although over-preparation was not the direct cause of a failure, lack of working capital to absorb the losses from misreading the market can cause a start-up to fail before it begins. While a good plan

⁶ Lauricella, Tom, *If I knew then . . . Valuable lessons learned the hard way by four successful entrepreneurs*, SmartMoney Magazine (December 19, 2000).

and product is essential, an entrepreneur must balance these needs with the need to get into the market rapidly and adapt to unforeseen circumstances.

5. Not Understanding Your Strengths and Weaknesses.

It is essential that you fully appreciate your own strengths and weakness. First, an understanding of your weaknesses will enable you to hire employees whose strengths and weaknesses complement your own. Second, understanding yourself allows you to specialize and focus on your core competence. Finally, an understanding your strengths and weaknesses allows you to understand how potential customers may view you and your business so you can work to enhance the customer's perception.

Do not underemphasize the value of hiring appropriate initial employees. Imagine you are a sole proprietor producing a product for sale to retailers. You have the energy and skill to perfect and produce your innovative product, do the accounting, and be a skilled manager. Your weakness is a lack of enthusiasm for outside sales. Without a thorough understanding of this weak spot, you hire an employee to help you - a friend much like yourself. After a couple of years of struggle, you fail, mainly because there was no one to generate sales and growth on a daily basis. A hire with the desire and ability to achieve success in outside sales can create a very different outcome in the ultimate success of the enterprise.

Understanding your strengths as an entrepreneur will help you to develop a core competence.⁷ The theory of core competence is that in a competitive market the entrepreneur must concentrate on being the best in some area of its business in order to attract those customers who prize this particular attribute over others. Consider the retail clothing market. To compete for customers each of the leading retailers focuses on a particular attribute. Marshall Fields focuses on perceived quality. Wal-Mart focuses on price. Others, such as Target, may fall between these concepts but offer more products and convenience. To develop your core competence, you must understand your strengths and weaknesses and analyze the competition. This is the most effective way to specialize and gain market share.

6. Unsuitable Legal Structure

Utilizing the appropriate legal structure is essential to limit potential liability. Most new businesses fail. Yet most entrepreneurs

⁷ C.K Prahalad and G. Hamel, The Core Competence of the Corporation, Harvard Business Review, May-June 1990.

begin taking business development steps before they even consider a legal structure.

There are many different legal structures you can adopt to protect yourself. The form of business you choose should be based on the particular facts of your enterprise. If your company's operations will create the potential for lawsuits, you need a legal structure that offers protection from lawsuits. If you fail to create a protective legal structure, you may find yourself in personal bankruptcy. Personal bankruptcy will create additional problems for your next attempt at starting a business, not to mention the personal and family chaos it can produce.

According to the United States Small Business Administration, four out of five new businesses start out as sole proprietorships.⁸ The sole proprietorship offers no liability shield to the owner. If your sole proprietorship fails, creditors can go after your personal assets as well as the assets of the business. As an optimistic entrepreneur, you may fail to see that potential liability is everywhere. Merely driving a company car or inviting customers onto business property can create the potential for enormous liability. Given the risks, it makes little sense to operate as a sole proprietorship in most businesses, because there are relatively few costs or drawbacks to forming an entity that limits personal liability.

One alternative to the sole proprietorship is the wholly owned C corporation. Although taxed as a separate entity, the C corporation provides the structure necessary to protect your personal assets. An S corporation, where business income is passed through to the owner, does not carry the double tax liability of the C corporation, but does provide some protection from liability. For partnerships, there is the option of limited liability designation, which can be acquired by filing a one-page form with the appropriate state agency. Each of these is a simple way to achieve liability protection. Beginning with the appropriate legal structure is essential to your success.

7. Failure to Protect Intellectual Property.

When entrepreneurs think about intellectual property when starting a new business, most recognize the need for patents on new inventions. The most apparent danger for many start-ups is the loss of the right to market and sell the product that is the cornerstone of the business. Consider the Minnesota corporation Wakat Design Systems, Inc. (Wakat). The corporation was formed in 1997 to create and market an innovative indoor paint product. Investors were found and in under a

⁸ Small Business Administration - Office of Advocacy, *The State of Small Businesses, A Report of the President, Economic Statistics and Research* (1998).

year the company was fully operational and had sold over a million dollars worth of product. Unfortunately, prior to the incorporation of Wakat, the inventor had formed a partnership with another investor that had fallen apart. The patent was not adequately secured and the former partner was granted the patent. Wakat was immediately out of business because of the exorbitant liability created by the loss of the right to sell the product.

New products are not the only protectable intellectual property. Amazon.com patented a "One-Click" shopping system for Internet purchases, enabling a repeat Amazon customer to place orders without re-entering personal information such as a credit card number or address. While it is now questionable whether Amazon originally invented this process, it owns the patent and has made progress in enforcing it.⁹

A more aggressive reason for protecting a patent is that patents can create revenue and garner market share. By patenting a product or process, an entrepreneur like Amazon can enforce royalties or receive other compensation from companies that attempt to use or who are already using the innovation. Some businesses have, as a primary activity, inventing business processes, patenting them, and selling them to other businesses. Whether you are merely protecting your business or trying to create alternate streams of income, failing to adequately protect your intellectual property can result in business failure. Patents are not the only potentially valuable or vulnerable intellectual property. Unique and attractive logos, trademarks, or presentation vehicles are all intellectual property deserving of protection. Failure to protect any of this material can have disastrous consequences for your business.

8. Not Listening

One of your shining qualities as an entrepreneur is your indomitable spirit and perseverance in the face of adversity, even when you are surrounded by others offering little but discouragement. Block out most of the negative voices around you. One successful merchandising entrepreneur who built his store from a \$1,000 start-up to two locations with 15 employees in seven years attributed his success to not listening to people who told him to "grow up and get a real job."¹⁰

At age 29, Troy Williams is CEO and founder of Questia Media, Inc. He raised \$151 million for his enterprise, which he calls the world's

⁹ Amazon.com, Inc. v. Barnesandnoble.com, Inc., 73 F.Supp.2d 1228 (W.D.Wash. 1999).

¹⁰ Daniel Kost, *This is No Mall Store, for Sure*, Democrat & Chronicle (Rochester, NY), Sep. 24, 2001, at F6.

largest online library of books.¹¹ During his exhaustive search for financial backers, Williams had to ignore experts who told him his idea would never work. They said publishers wouldn't give him the rights and users wouldn't pay for the Internet service. Even though the advice of experts often seems reasonable, successful entrepreneurs often recommend ignoring the advice when it doesn't feel right in their gut. On the other hand, even when entrepreneurs are shutting out the negative outside voices and listening to their inner gut, they still may integrate the negative comments productively. Williams notes that he used the negative feedback to rewrite a business plan which was eventually accepted by an investor group.

Once you get your business off the ground, it is still important to listen to your investment backers, attorneys and accountants. Incorporating their advice will help you avoid unforeseen pitfalls. Ignoring professional advice can risk alienating your advisors. You may need them when their help is essential to the survival of the business.

Adequately compensating professionals for their advice is also important. It sets the tone for the relationship, which may be crucial when the business is least able to compensate the professionals. This may mean giving up a certain amount of ownership in order to have them firmly on board. Better to be an entrepreneur with a percentage of something than an entrepreneur with 100 percent of nothing.

9. Avoiding Champagne Tastes with Your Beer Budget

Few of us ever will have the beer budget of August A. Busch III, chairman and president of the world's largest brewery, whose recent salary was reported at \$1,152,600 and included an additional \$3 million bonus.¹² So it is driven into most of us from childhood to live within our means. This message is driven even more strongly into the minds of those who lived through or had parents who lived through the Great Depression. Notwithstanding the message, many of us have a propensity to live beyond our beer-budget means, with champagne tastes.

You risk spending yourself into financial difficulty because you unrealistically compare your business needs to those of a Fortune 100 company. You can keep your spending in check and still realize some Fortune 100 tastes by thinking creatively and recognizing your realistic needs. For example, a business can realize champagne networking and software solutions on a beer budget by retaining outside help rather

¹¹ Jay Mathews, *Doing Good, Doing Well; Dot-com: An Online Library Offers Deep Resources to its Subscribers*, Newsweek, Oct. 29, 2001.

¹² Al Stamborski, *Busch III Collects Over \$4 Million in Bonus, Salary Still, That Pales in Comparison to Extra Bump of \$87 Million Awaiting Coke's Daft*, St. Louis Post-Dispatch, Mar. 14, 2001, at Bus. Sec. C1.

than hiring additional inside IT personnel.¹³ One such contractor, Zero Effort Networking, Inc., bills itself as being able to provide instant virtual private networks and monthly software rentals to small to medium-sized businesses. They create complete IT solutions for network managers while eliminating upfront investments in hardware, software, and other costs associated with the in-house network management of larger businesses. According to Zero Effort's CEO Michael Day, "Small companies and individual users can benefit from the same kind of technology and applications used by Fortune 100 companies."

10. Not Recognizing We Are Always Selling

The greatest sales challenge you will have as an entrepreneur will be when you secure one or more rounds of venture financing. "Exude confidence and be straightforward about what you're doing and why it's an attractive deal to an investor," advises Crysteel Manufacturing Sales Vice President Bob Miller.¹⁴

As in any sale, it is important to target carefully whom you will approach. Investors tend to specialize by industry and investment levels. Even an unsuccessful call will have some value, as you lay the groundwork and build the level of trust essential to secure financing.

Being a strong sales person is vital for you at other levels. Even CEO's of major corporations such as Wendy's and Chrysler tout their own products. Particularly in an uncertain economy, it is important to sell customers on the fact that your business will be around for the long run. Pehong Chen, CEO of BroadVision Inc., has noted that in today's economy customers are in a state of uncertainty. He spends a considerable amount of his time emphasizing the fact that his company has been around eight years and they "will continue to be there to help . . . through this very tough time."¹⁵

Avoid the Mistakes -- Avoid the "Unlucky Seat."

It is axiomatic that smart people learn from their mistakes. It is equally true that smart people learn from the mistakes of others. This list of Ten Common Mistakes, while not exhaustive, addresses the mistakes most frequently cited in studies of entrepreneurs. Learn these mistakes and determine how to avoid them.

¹³ *Champagne Networking and Software Solutions on a Beer Budget*, Technology Marketing Corporation, vol. 20, issue 2, <<http://www.tmcnet.com/>>.

¹⁴ Rick Weber, *A Primer on Picking the Best Type of Steel*, Trailer/Body Builders, Vol. 42, Num.6, Apr. 1, 2001.

¹⁵ John Evan Froom, *One CEO Tells How He Sells*, B to B, Vol. 86, Num.12, Jun. 11, 2001.

Nike has the catchy slogan, "Just Do It." Don't do it, however, without proper forethought. Perhaps no one said it better than Former Brooklyn Dodgers Manager Branch Rickey when he spoke about the need to properly combine action and thought for success:

Things worthwhile generally don't just happen. Luck is a fact, but should not be a factor. Good luck is what is left over after intelligence and effort have combined at their best. Negligence or indifference is usually viewed from the unlucky seat. The law of cause and effect and causality both work the same with inexorable exactitudes.¹⁶

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¹⁶ Robert D. Behn, Branch Rickey as a Public Manager: Fulfilling the Eight Responsibilities of Public Management, *Journal of Public Administration Research and Theory*, J-PART 7 (1997) Vol. 1 at 9.

Banks and Venture Capitalists: Are the New Rules Too Tough, Too Weak, or Just Right?

BRETT MCDONNELL*

Our images are quite different. The venture capitalist—a modern figure, dressed Banana Republic casual, high-tech, high-stakes—resides in Silicon Valley. The bank lending officer—formal dress, low-tech, limited loans—resides in Main Street, USA.

While investing, venture capitalists and bankers encounter similar problems. Deciding which young companies are most likely to flourish can be very hard. Making sure that those companies which receive funds are using their money wisely and in the interests of investors, not those running the companies, can be even harder. In solving those problems, bankers and venture capitalists use similar tools.

Similarities aside, they differ in important ways, too. Venture capitalists make their investments in the form of equity, receiving shares of stock in the firms in which they invest, or of debt convertible into equity, while banks invest in debt, generally short-term. One important reason for this difference is that under the Glass-Steagall Act and the Bank Holding Company Act, banks have been strictly limited in their ability to invest in equity. That has changed significantly with the recent passage of the Gramm-Leach-Bliley Act (“GLB” or the “Act”).¹⁷

How much have the limits on banks changed with GLB and the Federal Reserve’s regulations implementing it? Is that change for the better?

Banks and Venture Capitalists: Handling the Challenges

As noted above, banks and venture capitalists have shaped similar tools to handle the challenges of choosing and monitoring the companies in which they invest. Both tend to specialize in companies of a particular type for which the bank or venture capitalist has particular expertise. Bank lending officers are expert in the needs and contours of their local economy. Venture capitalists specialize by industry.

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¹⁷ Pub. L. 106-102, 113 Stat. 1338 (1999).

Note: As a matter of editorial policy, consecutive citations to a source in an article have been eliminated. Readers may assume references are to immediately preceding cited source until the context indicates otherwise.

Both types of intermediaries have more specific strategies which resemble each other. For instance, both use strategies of staged investments. Making investments in stages, rather than all at once, gives the receiving companies incentive to use the money well, increasing their chances of receiving later stages. Also, it allows the investor to update its information on how wise its investment choice has been and to limit its losses if the choice turns out to be unwise.

Both banks and venture capitalists frequently negotiate detailed covenants affecting many areas of governance of the companies in which they invest. These covenants allow the investors to block many decisions they find unwise or against their interests.

But banks and venture capitalists do differ, and one key difference is that venture capitalists typically make equity investments while banks make loans. Equity, as opposed to debt, is particularly well-suited for investments in high-risk start-ups in the high-technology sector. For such companies, the expected stream of future profits is uncertain and variable—the companies may do extremely well, or they may be a complete bust. Furthermore, intangible assets such as intellectual property, reputation, and employee skill are often a high percentage of total assets.

These two features make such companies poor candidates for debt investment. On the one hand, if the new company crashes and burns, the creditor will be able to recoup little from its investment, as the lack of tangible assets leaves little to salvage from the wreckage. On the other hand, if the new company soars, the creditor does not share in the upside beyond receiving the fixed amount the company has promised to repay.

For these reasons, investment in high-risk, high-technology companies frequently takes the form of equity. Since outside shareholders, who lack a contractual claim to a specified stream of payments, are particularly vulnerable to managerial misuse of funds, venture capitalists will frequently become actively involved in the day-to-day affairs of their portfolio companies, often by putting themselves on the boards of those companies.

Why Don't Banks Take Equity Stakes?

When considering investing in such companies, why don't banks follow the path of venture capitalists and make equity investments rather than loans?

Once, at least some of them did. A century ago a few companies which combined commercial banking and investment banking dominated

American corporate finance: J. P. Morgan and Company, Kuhn, Loeb, and Company, First National Bank, National City Bank, and a few others. Partners, directors, and officers in these banks held interlocking directorates in many of the largest companies in the U. S. and also held shares in those companies. In other countries, a fairly similar pattern remains in place today, with Germany and Japan as the most notable examples.

In the U. S., this era came to a close in 1933 with the Glass-Steagall Act. That act prohibited banks and their subsidiaries from owning shares in most kinds of non-financial companies and prohibited commercial banks from underwriting or selling securities.¹⁸ Later, the Bank Holding Company Act stopped affiliates of banks within a holding company structure from owning shares in non-financial companies, with limited exceptions.¹⁹

It may be that the GLB has changed all that. Before looking at the new Act, though, I would ask whether there is any justification for the regulatory scheme which began in 1933.

Should Banks Be Allowed to Take Equity Stakes?

The limits on investments by banks are at least troubling, and require justification. After all, banks are a key source of funding for new businesses. Banks have much experience in identifying promising new companies and in monitoring their progress. Limiting the ability of banks to become involved in some of the most dynamic areas of new business may be a real loss to the economy. Perhaps bankers are not very knowledgeable in the high-tech area and would not do well in competition with expert venture capitalists. Then again, perhaps the limited knowledge of bankers in this area is due to the old rules limiting their ability to invest in equity, and with those rules removed, banks could become valuable players in this area.

Even after companies in which a bank has invested have been around for a while, a continuing role for banks in corporate governance may still be useful. Even established public companies are often not well run, and it is not clear that capital markets always do a good job of disciplining them. J. P. Morgan a century ago, and Japanese and German banks today, may help to monitor management. Increasingly those interested in good corporate government in the U. S. look to large institutional investors to oversee and discipline managers. If the law allowed them, banks might be able to do this, too.

¹⁸ 12 U.S.C. § 24.

¹⁹ 12 U.S.C. § 1843(a), <<http://www4.law.cornell.edu/uscode/12/1843.html>>.

Are there any good reasons for limiting the ability of banks to compete with venture capitalists and institutional investors by making equity investments? The main justification for the heavy regulation of banks is the unique source of their capital and the potent impact they can have on the economy, for good and for ill.

Banks traditionally get their funds for making investments from the deposits they hold. Depositors leave money with the bank, with the promise that they can withdraw any or all of it whenever they want. Banks do not hold this money in a vault somewhere, waiting to pay out withdrawals. They know that not everyone is going to withdraw all of their money at once—they only need to keep a fraction of funds available to cover withdrawals. The money that they do not plan to keep in place as reserves is available for the bank to invest.

However, this makes banks vulnerable to runs. If for some reason many depositors think that a bank may be running out of money, they may all try at once to withdraw their deposits. If the amount to be withdrawn exceeds the bank's reserves, trouble ensues. Even the soundest of banks is vulnerable, as all hold only a fraction of total deposits available as reserves. If an epidemic of runs breaks out in an economy, it can have devastating consequences. Consumers who have lost their deposits cut back on spending. Businesses who can no longer get loans lay off workers. The payment system, which runs through banks, may break down. The economy can spiral downwards from there. This was a central part of the dynamic which led to the Great Depression.

Given this ever-present threat, long-term and illiquid investments are problematic for banks. If a run develops or appears an imminent possibility, the bank would like to be able to liquidate its investments to quickly increase its reserves. If the bank is holding shares in a start-up which is not publicly traded, the bank will find it very difficult to quickly recoup the funds it has invested in that company. Holding shares in a public company is less problematic, as the bank can sell its shares. However, the bank runs the risk of a loss on its investment if it must sell when shares prices are low, and if the bank holds a large fraction of a company's shares, it may find those shares hard to sell except at a low price.

This does not in itself justify governmental regulation prohibiting banks from making equity investments. If there is such a risk, why not allow bank managers to weigh that risk against the benefits of such investments? There are two main answers. First, the risk of a run can be contagious. If bad investments by one bank lead it to failure, that may scare depositors even in healthy banks and lead to a run on them. Bank managers have no incentive to take this effect into account. Second, in

order to deal with the problem of runs, the U. S. in the 1930s created deposit insurance, so that even if a bank fails, depositors in that bank will be able to get back at least some of their deposits. This makes runs less likely and less damaging. However, it creates an incentive problem in the behavior of banks by encouraging them to make overly risky investments—if the investments succeed, the bank makes greater profits, and if they fail to the point of causing bank failure, the government bears much of the cost of that failure. Governmental regulation is justified as a way of limiting such risky behavior by bank managers.

Even if persuasive, this argument does not yet justify prohibiting all forms of bank-related equity investing. First, perhaps banks should be able to invest *some* of their funds in equity, as long as such investments are not too large a share of their total investing, so that the risk is correspondingly limited. Second, banks have ways of limiting their exposure to equity investments and yet still using their expertise to become usefully involved in such investing. Rather than directly investing themselves, banks can set up related companies which make equity investments. These companies may be subsidiaries of the banks or affiliates owned by a bank holding company which also owns the bank itself. Investment by these related companies can then be funded by sources other than bank deposits. Moreover, the use of a separate corporation limits the liability of the bank to what it has invested. The banks can still use their investing skill to determine the investments their related companies make.

Such a structure gets around the direct problem created by bank equity investing. It does raise, potentially, an indirect problem. Suppose an affiliate of a bank has a large equity investment in a company. The bank may have an incentive to make a loan to that company which is overly risky to the bank on its own terms but which is worth it overall to the bank because it improves the value of the affiliate's equity investment. Equity investments by affiliates may, in this way, still lead to overly risky lending by banks themselves.

This concern is a major traditional justification for both limiting the ability of bank affiliates to make equity investments and for regulating transactions and relationships between banks and their affiliates. The concern may be somewhat valid and may justify some degree of regulation and oversight. However, the problem under this structure is less severe than where banks directly invest in equity. Other mechanisms, for instance a bank's reputation, exist to limit overly risky investing. Arrayed against the cost of overly risky investing is the benefit to be gained from bank involvement in venture financing. Banks have

much expertise to offer in this area, and they potentially offer to start-ups a greater smorgasbord of services than can venture capitalists.

Several different arguments consider bank equity investing may harm the companies in which they invest or their competitors. One argument is that if banks are allowed to have nonfinancial subsidiaries, those subsidiaries will have an unfair advantage against their competitors. Perhaps this argument had some plausibility back in the days when many banks were local monopolies and product and service markets were more local. Today, with more national markets and many more sources of financing, this concern is unconvincing.

A slightly better argument is that if banks are given too much control over a company, they may direct actions which help creditors but hurt shareholders. Creditors tend to prefer that a company take too little risk (relative to the value-maximizing standard), while shareholders prefer that it take too much risk. Bank interests may thus diverge from that of shareholders. However, if the banks hold a significant equity stake in a company, their interests will diverge less from that of other shareholders. Indeed, banks that hold both equity and debt may have more incentive to maximize value than those who hold either equity or debt alone.

Thus, there is probably good reason for restricting the ability of banks themselves to make equity investments. However, bank subsidiaries and affiliated companies should have a freer rein. Although some regulation of bank relations with such affiliates, and loans to companies affiliates have invested in, is appropriate, such regulation should not be so heavy-handed as to preclude bank involvement in this area. Do the new rules under GLB strike an appropriate balance?

How Does GLB Change the Terrain?

As mentioned above, prior to passage of GLB, banks and bank-holding companies were quite limited in their ability to make equity investments in non-financial companies. Under 12 U.S.C. section 24 (Seventh), national banks are prohibited from investing in most equity securities. There are some exceptions, the most important of which is 15 U.S.C. section 682(b), which allows banks to acquire the stock of small business investment companies, so long as the aggregate of such stock owned by the bank does not exceed 5 percent of the bank's capital and surplus. Through this provision large banks can engage directly in fairly extensive venture capital investment, as long as they limit it to small business investment companies. The 5 percent limit responds to the safety and soundness concerns surrounding direct bank investment in stock described above, although one can argue plausibly that 5 percent

is an overly low limit. GLB does not change these rules limiting the activities of banks themselves.

Traditionally, bank subsidiaries have been held to essentially the same limits as banks themselves. GLB does not really change this—indeed, it reinforces the point.²⁰ The Act provides (in section 122) that five years after it becomes effective the Federal Reserve and the Treasury Department may adopt rules which allow bank subsidiaries to engage in the activities described below which GLB permits to holding company affiliates. This provision was a compromise.

The Federal Reserve and the House wanted to limit equity investing to holding company affiliates, while the Treasury and the Senate wanted to allow bank subsidiaries to engage in the same activities as affiliates. It is not clear whether there is any real policy advantage to allowing affiliates but not subsidiaries to engage in these activities. What is clear is that the Fed regulates holding company affiliates while the Treasury regulates subsidiaries of national banks. The agency positions become easier to understand once that fact is taken into account.

That brings us to the heart of the change under GLB— holding company affiliates of banks. For a long time banks have been allowed to establish a structure such that a parent company owns both the bank and some other corporations. The Bank Holding Company Act has limited what type of companies can be affiliated with a bank through this structure. GLB allows banks that meet specified conditions to form financial holding companies, which are allowed to engage in some activities not allowed mere bank holding companies. The new 12 U.S.C. section 1843(k)(4)(H) allows financial holding company affiliates of banks to engage in “merchant banking,” which is essentially venture capital-like equity investment.

Section 1843(k)(4)(H) imposes two limits on merchant banking activity. Subsection (iii) provides that such investments may only be held “for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with” the merchant banking activities. Subsection (iv) provides that the bank affiliate may not “routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.” In addition, pre-existing limits on transactions between banks and affiliates, embodied in sections 23A and 23B of the Federal Reserve Act, remain in place. The issue then becomes whether these three sets of restrictions on merchant banking activity have achieved an appropriate regulatory balance.

²⁰ 12 U.S.C. § 24a(a)(2)(A), <<http://www4.law.cornell.edu/uscode/12/24a.html>>.

Investment Time Limits

The wording of subsection (iii) is fuzzy: how long is long enough to enable the sale of the stock on a reasonable basis? This fuzziness could hurt investment decisions by bank-affiliated companies by creating uncertainty as to how long they may hold on to stock. Luckily, the Federal Reserve has created a regulation which provides greater clarity.

In February 2001, the Fed and the Treasury promulgated a final rule governing merchant banking investments allowed by GLB. Under the final rule, the Fed said that a bank affiliate may hold an investment for up to 10 years, and an interest in a private equity fund for up to 15 years. Companies may go beyond these periods only with the Fed's permission.²¹

The Fed's regulations provide a much more bright line rule than GLB itself. Considered in the light of standard venture capital practice, the time limits are reasonable—a venture fund would rarely hold a portfolio company for longer than 10 years, and funds rarely last longer than 15 years. A better approach might have been to make the specific periods safe harbors, so that a company could go beyond the time period without having to get Fed approval, although it would make its position uncertain. This would provide more flexibility while still providing a clear safe ground.

A more basic question is why any limit on length of investment is required at all. GLB seems designed to respond to the venture capital model, where venture capitalists invest in new companies for a limited time; help those companies either go public, get acquired, or go bust; and leave. This model is a fine one, and it makes sense to allow bank affiliates to compete in this market. However, the experience of J.P. Morgan, Germany, and Japan suggests that banks can provide helpful services even for longstanding public companies and aid in corporate finance and governance even beyond the start-up period. Why not allow banks to play this continuing role if they choose? How does the investment time limit help safeguard against any of the legitimate concerns about bank investment in equity?

Routine Management and Operation

Subsection (iv) creates a potentially more serious ambiguity. Venture capitalists often take a hands-on approach to the governance of their portfolio companies. Monitoring and advising the managers of such companies is one of the main functions venture capitalists serve. If bank affiliates are seriously limited in how much of this they can do, they will

²¹ 12 C.F.R. §§ 225.172, 225.173,
<http://www.access.gpo.gov/nara/cfr/waisidx_01/12cfr225_01.html>.

be at a distinct disadvantage relative to venture capitalists. Even if the rules are simply uncertain rather than clearly prohibitive, this could cause bank affiliates to limit themselves or cause them to engage in costly legal consultation.

GLB itself is vague here. When does someone “routinely manage or operate” a company? When does it become necessary to routinely manage in order “to obtain a reasonable return on investment?” GLB does not answer these questions, and one can imagine a large number of possible answers.

Fortunately, the Fed’s final rules provide more guidance. The rules list a variety of situations which constitute routine management, and a variety which do not.

Relationships which do not constitute routine management include:

- Bank representation on a company board;
- Covenants concerning activities outside the ordinary course of business, including the acquisition of significant assets, significant changes to the company’s business, removal of executive officers, redemption of securities, and amendments to the articles and bylaws; and
- Advisory, underwriting, or consulting services.²²

The rules also list some relationships which do constitute routine management:

- Employees of the bank affiliate serving as executive officers of the company;
- Executive officers of the bank affiliate servicing as officers or employees of the company; and
- Covenants restricting routine business decisions.²³

The Fed’s rules also provide some guidance as to when routine management may be “necessary or required to obtain a reasonable

²² 12 C.F.R. § 225.171(d).

<http://www.access.gpo.gov/nara/cfr/waisidx_01/12cfr225_01.html>

²³ 12 C.F.R. § 225.171(a).

<http://www.access.gpo.gov/nara/cfr/waisidx_01/12cfr225_01.html>

return on investment upon resale or disposition,” such as when the company:

- Experiences a significant operating loss; or
- Loses senior management.²⁴

Once action is taken to deal with the problem, the bank affiliate must stop its routine management. If such management lasts more than nine months, it must notify the Fed.

Given the constraints of GLB, the Fed’s rules appear reasonable, though one can always quibble with details. The rules provide somewhat more clarity and certainty, although some examples of what do and do not count as routine management contain weasel words like “significant” and “routine,” which re-introduce a degree of vagueness.

The bigger problem, again, lies with the GLB limitation itself. Why should bank affiliates be barred from routine management of portfolio companies? How would such management increase the risk the banks face? Is there any reason to believe banks would be more prone to make bad loans to companies in which their affiliates become involved in routine management than to companies in which their affiliates have comparable investments but are not involved in routine management? Indeed, wouldn’t active involvement in routine management, where helpful to the portfolio company, actually decrease the risk of losses by improving the company’s performance?

The routine management limit may arise from concern that banks may direct behavior in a way that privileges the interests of creditors over shareholders. However, as analyzed above, so long as banks have substantial interests as both creditors and shareholders, the conflict is lessened. Indeed, entities holding both debt and equity may well have a better incentive to maximize value created than those who hold just equity or just debt.

Sections 23A and 23B

Sections 23A and 23B of the Federal Reserve Act place a variety of limits on transactions between banks and their “affiliates.” The limited transactions include extending credit, issuing guarantees, purchasing assets, accepting securities as collateral, and investing in securities. The total value of such transactions with any one affiliate cannot exceed 10 percent of the bank’s capital. The total of such transactions with all

²⁴ 12 C.F.R. § 225.171(e).

<http://www.access.gpo.gov/nara/cfr/waisidx_01/12cfr225_01.html>

affiliates combined cannot exceed 20 percent of the bank's capital. Transactions must be secured 100 percent or more by collateral, and banks cannot buy low-quality assets from affiliates.²⁵ Banks must deal with affiliates on terms "that are substantially the same, or at least as favorable to such bank . . . as those prevailing at the time for comparable transactions with or involving other non-affiliated companies."²⁶

These limitations directly address the most legitimate worries raised by bank-related companies making equity investments. The percentage limits help assure that even if banks have incentive to make dubious deals with companies in which they have an equity stake, those deals will not commit too much of the bank's capital. The collateral requirement limits the risk posed by a transaction with a portfolio company. The requirement that transactions be substantially the same or at least as favorable to the bank as transactions with non-affiliates, while somewhat vague, does give bank regulators a tool for policing transactions with affiliates.

An important question, then, is when do these rules apply to transactions with the portfolio companies of a merchant-banking affiliate of a bank. The rules apply to any company "that is controlled by the company that controls the member bank."²⁷ Under section 23A, a company has been deemed to have control over another company if it has the power, "directly or indirectly, or acting through one or more other persons" to vote 25 percent or more of any class of voting securities of that other company.²⁸ It would seem that if the merchant-banking affiliate owns at least 25 percent of the voting shares of any class of securities of a portfolio company, that portfolio company becomes an affiliate, and transactions with it are covered by the rules of sections 23A and 23B.

In addition, GLB added a new provision for merchant banking portfolio companies, creating the rebuttable presumption that if a company owns 15 percent or more of the equity capital of a portfolio company, it controls that company.²⁹

This definition of an "affiliate" probably goes as far as is needed. If the investment of a bank affiliate in a portfolio company is under 15 percent of the equity capital of that company and under 25 percent of

²⁵ 12 U.S.C. § 371c, <<http://www4.law.cornell.edu/uscode/12/371.html>>.

²⁶ 12 U.S.C. § 371c-1, <<http://www4.law.cornell.edu/uscode/12/371.html>>.

²⁷ 12 U.S.C. § 371c(b)(1)(A), <<http://www4.law.cornell.edu/uscode/12/371.html>>.

²⁸ 12 U.S.C. § 371c(b)(3)(A), <<http://www4.law.cornell.edu/uscode/12/371.html>>.

²⁹ 12 U.S.C. § 371c(b)(11), <<http://www4.law.cornell.edu/uscode/12/371.html>>.

the voting power of all classes of voting securities, then it is unlikely that the bank will have a perverse incentive to make bad loans to that company.

Still Too Tough, But an Improvement

For decades, American law has strictly limited the role banks and their affiliates can play in financing and governing new companies, by limiting the ability of banks to make equity investments. There are decent reasons for some limits on bank equity financing, but not for the limits which have prevailed in the U. S. since the 1930s.

As long as bank deposits are federally insured, there is a good argument for capping direct equity financing by banks themselves. Since Glass-Steagall the law has done so, with a 5 percent exemption, and GLB does not change this. It might be desirable to raise the rather low limit and extend it beyond small business investment companies, but some such cap is defensible.

The argument for limiting equity investments by bank subsidiaries or affiliates is less strong. Such investments may create incentives to make some bad loans, but the limits on transactions with affiliates imposed by section 23A and 23B go most if not all of the way to regulating those incentives. Little if any additional regulation is needed beyond this.

Even after GLB, regulation goes too far. Bank subsidiaries are still treated differently than holding company affiliates—this may change after 5 years of the Act being effective, but given the Fed's ability to block such regulatory change, I wouldn't hold my breath. GLB's limits on holding periods and routine management of portfolio companies are also unnecessary. Still, GLB has gone a long way toward leveling the playing field and allowing banks to compete with venture capitalists.

The remaining excessive limits may impede some bank entry into the field but not enough to have a terribly strong effect. One hopes that as we gain experience with bank involvement in merchant banking, Congress and the Fed will become willing to go even further.

It's too soon to tell how much of a difference more bank involvement in venture capital financing will make. The law does give us a better chance to see what they can do.

Redefining Business in the Post-September 11 New Economy

JAMES R. SANKOVITZ *

At 9:30 a.m. on September 17, a bell was rung on the floor of the New York Stock Exchange. And trading resumed as it has for 209 years.

That bell meant more to us than business as usual.

It sounded out our deepest thanks for the bravery and sacrifice of so many who unhesitatingly came forward to give so much in this difficult time. It rang out our heartfelt prayers for those we have lost, their families and loved ones. It steeled our collective determination to never let cowardice, intolerance and evil sway this great and free society from its strong and sure course towards a better tomorrow.

We move forward, stronger in spirit and purpose, knowing that history has proven the ability of our financial system to survive the darkest challenges time and again. We vow to do our utmost to preserve the bedrock foundations of worldwide prosperity and well-being. And we will sound that bell again and again.

And let freedom ring.

New York Stock Exchange Statement/Advertisement
September 17, 2001

The tragic events of September 11, 2001, sparked the longest period of halted trading in the American stock markets since the start of World War I. The stock markets experienced considerable depreciation when trading resumed on September 17, 2001, compounding an already recessionary economy.

The United States Securities and Exchange Commission (SEC), the American Stock Exchange (Amex), the New York Stock Exchange (NYSE),

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Note: As a matter of editorial policy, consecutive citations to a source in an article have been eliminated. Readers may assume references are to immediately preceding cited source until the context indicates otherwise.

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the Nasdaq Stock Market (Nasdaq), the Federal Reserve Bank of New York (the Fed), the Internal Revenue Service (IRS), and the United States Congress all responded to the terrorist attacks in an unprecedented manner, forever changing the financial services markets. Their responses strengthened the United States' ability to respond to abrupt and substantial instability and altered the way Americans conduct business. September 11 sparked the dawn of a new economy that will alter the conduct of investors, entrepreneurs, and established businesses alike.

Securities and Exchange Commission

The SEC, whose Northeast Regional Office was destroyed when the World Trade Center tower collapsed, reacted to September 11 by exercising its statutory emergency powers for the first time in history.³⁰ The SEC invoked its powers to ease regulatory restrictions governing publicly traded companies, by adopting numerous temporary rules effective from September 14 through September 17, 2001:³¹

- Authorizing public companies to repurchase their own securities without regard to the volume and timing restrictions of Exchange Act Rule 10b-18;
- Allowing broker-dealers to disregard September 11 through September 14 as business or calendar days when calculating charges associated with Rule 15c-3 net capital and reserve requirements;
- Exempting purchases by affiliates of publicly traded companies from the short-swing profit rules of Section 16(b);
- Relaxing the requirement of in-person mutual fund board meetings and permitting funds to borrow money from affiliated persons and from entities other than a bank;
- Allowing independent auditors to assist clients with bookkeeping services and records recovery without threatening the independence of such auditors; and

³⁰ Emergency Order, Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 44791 (Sept. 14, 2001), <<http://www.sec.gov/rules/other/34-44791.htm>>.

³¹ *SEC Takes Action To Facilitate Reopening of Fair and Orderly Equities Markets*, Press Release No. 2001-91, Securities and Exchange Commission, (Sept. 14, 2001), <<http://www.sec.gov/news/press/2001-91.txt>>

- Permitting Amex specialists to act as floor brokers while Amex shared space at the NYSE.

The SEC ultimately extended the temporary rules relating to net capital and reserve calculations, short-swing profit limitations, mutual fund requirements, and Amex trading through September 28, 2001.³² It extended the rules relating to issuer repurchases through October 12, 2001.³³ During this time, the SEC continuously stressed that the antifraud provisions of federal securities laws remained in effect during temporary relief periods.

Rule 10b5-1 of the Securities Exchange Act of 1934 provides an affirmative defense against allegations of insider trading available when insiders adopt written plans for trading securities in accordance with the specific requirements of Rule 10b5-1.³⁴ Insiders also must adopt such plans in good faith and not as part of a plan or a scheme to evade insider trading rules.

In response to numerous inquiries by law firms and registered companies, the SEC issued an interpretation stating that the termination of a Rule 10b5-1 trading plan between September 11 and September 28, 2001, does not suggest that the plan was not entered into in good faith.³⁵ The interpretation also allowed insiders to disregard the week of September 10, 2001, when calculating average weekly trading volumes that limit insiders' ability to sell securities under Rule 144 of the Securities Act of 1933. These interpretations encouraged trading in publicly held securities by facilitating purchases and sales of stock by insiders.

Decreased air travel and increased insurance claims prompted the SEC to announce temporary measures, effective through the remainder of 2001, allowing the airline and insurance industries more expeditious access to the capital markets.³⁶ These measures included easier limits on

³² Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 44827 (Sept. 21, 2001), <<http://www.sec.gov/rules/other/34-44827.htm>>.

³³ Exemptive Order Pursuant to Section 36(a)(1) of the Securities Exchange Act of 1934 Issuing Exemptive Relief to Respond to Market Development, Release No. 34-44874 (Sept. 28, 2001), <<http://www.sec.gov/rules/other/34-44874.htm>>.

³⁴ 17 CFR 240.10b5-1.

³⁵ Calculation of Average Weekly Trading Volume under Rule 144 and Termination of a Rule 10b5-1 Trading Plan, Interpretative Release No. 33-8005a (Sept. 21, 2001), <<http://www.sec.gov/rules/interp/33-8005a.htm>>.

³⁶ *SEC Announces Assistance to the Airline and Insurance Industries in Reaching the Capital Markets*, Press Release No. 2001-107, SEC Dig 2001-189-3 (Oct. 1, 2001), <<http://www.sec.gov/news/press/2001-107.txt>>.

the use of short-form registrations on Form S-3. By facilitating investment in these large, established industries, the SEC also made available investment possibilities for venture capitalists and entrepreneurs willing to invest in potentially troubled companies for the opportunity to profit when stocks rebound. These actions demonstrated the SEC's commitment to stabilize the financial markets and ease businesses' access to capital in an effort to mitigate the impact of the September 11 terrorist attacks.

Despite disruptions to the financial markets and the need for emergency measures, the SEC maintained its composure. The SEC has gone so far as to publicly state that "[t]he United States securities markets are the world's strongest and most vibrant. The Commission has full confidence that the attacks of September 11, 2001, will have little lasting market impact."³⁷ The SEC relocated its Northeast Regional Office to the historic Woolworth Building in downtown New York City³⁸ and continues to strive to achieve business as usual. This return to normalcy should reassure struggling and burgeoning businesses alike that the American economy once again will prosper.

United States Stock Markets

Amex, the NYSE, and Nasdaq each instituted special measures to resume trading and address market instability precipitated by the events of September 11. These normally competitive venues worked together to ensure the world's leading financial markets would persevere. Though the markets remained closed to most visitors during the 2001 holiday season, they were very much open to trading. As of the end of the last trading day of 2001—December 31—the Nasdaq Composite Index, the Dow Jones Industrial Average, and the Standard & Poor's 500 Index each closed far above their levels immediately prior to September 11, nearly reaching their highest levels of the preceding six-month trading period. Though most reports caution investors that the recession will continue well into 2002, this upward trend suggests the markets may stabilize soon. Reduced volatility undoubtedly increases the ability of investors to predict the outcomes and viability of their endeavors.

American Stock Exchange

The Amex, at 86 Trinity Place in lower Manhattan, was the financial market most significantly affected by the terrorist attacks. Amex could not operate in its own facility when trading resumed in the

³⁷ Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 44791 (Sept. 14, 2001), <<http://www.sec.gov/rules/other/34-44791.htm>>.

³⁸ *SEC Reopens in New Office in Downtown New York*, Wall St. J., Oct. 16, 2001, at C15.

markets on September 17, 2001. Because its building was located literally within a few hundred feet of the disaster site, access to the building would disrupt ongoing search and rescue efforts.³⁹ Significant utility and safety issues also prevented use of the facility.

Beginning September 17, Amex equities and Exchange Traded Funds (ETFs) were traded on the floor of the NYSE, and Amex-registered options traders and specialists were allowed to trade options on the floor of the Philadelphia Stock Exchange.⁴⁰ These measures set aside the competition and enmity that naturally existed between the exchanges. As operations continue to get back to normal, Amex undoubtedly will design contingency plans to address future disruptions and redefine its definition of "normal."

New York Stock Exchange

The NYSE was instrumental in reopening the United States equities markets on September 17, 2001, and has capitalized on that success as its current theme. The October 2001 issue of the NYSE's publication, *The Exchange*, contained this sub-title in bold type: "Rebuilding, Reshaping, Restoring Confidence."⁴¹ NYSE Chairman Richard Grasso was quoted as saying, "We served notice to the criminals that they failed. America's economic system is intact." The *New York Post* called Mr. Grasso one of the "biggest winners" of 2001 for getting the NYSE back into operation just one week after September 11.⁴² Not only did the NYSE aid in market reopening efforts by allowing Amex equities and ETFs to trade on its floors, it also assisted with the relocation of approximately 35 member firms that were either displaced or could not access their offices as a result of September 11. In its annual *Year in Review* press release, the NYSE viewed its September 17, 2001, reopening as a success, with a record daily share volume of 2.37 billion shares.⁴³

Though the NYSE responded successfully to the terrorist attacks and was able to reopen in a remarkably short time, fears of the effect of potential future catastrophes still exist. The NYSE has broached the idea of dividing operations between two locations as part of an elaborate contingency plan, as well as a continuation of pre-September 11 discussions about creating a new trading facility on the east side of

³⁹ *The American Stock Exchange Resumes Trading On Monday, September 17, 2001*, The American Stock Exchange Press Release (Sept. 15, 2001), <http://www.amex.com/reference/press_resumetrading.stm>.

⁴⁰ Gaston F. Ceron, *Amex's Trading Floor Is Set to Reopen After Hiatus Forced by Terrorist Attack*, Wall St. J., Oct. 1, 2001, at C19.

⁴¹ *The Exchange*, New York Stock Exchange, Vol. 8, No. 10 (Oct. 2001).

⁴² *2001's Biggest Winners & Losers*, N.Y. Post, Dec. 23, 2001, at 36.

⁴³ *NYSE 2001: Year In Review*, New York Stock Exchange Press Release, Dec. 31, 2001.

Broad Street between Wall Street and Exchange Place.⁴⁴ The NYSE and Nasdaq also have discussed adapting their systems to accommodate trading of each other's securities in the event either market is affected by any future events. These discussions would have been inconceivable prior to September 11.⁴⁵ Even though the NYSE was not in close proximity to the World Trade Center, the terrorist attacks appreciably affected the market's operations and outlook.

The Nasdaq Stock Market

Among the criteria necessary to allow a security to remain listed on the Nasdaq National Market and the Nasdaq SmallCap Market is the requirement that listed companies maintain certain minimum bid prices for listed securities. It also requires minimum market values of publicly held securities.⁴⁶ Failure to meet the continued inclusion requirements for 10 consecutive trading days normally places an issuer in default of Nasdaq's continued listing requirements. An issuer in default generally is afforded a 30-day grace period during which its securities must trade at the applicable minimum bid price for at least 10 consecutive trading days. In response to the September 11 terrorist attacks, Nasdaq issued a moratorium suspending the minimum bid price and public float requirements until January 2, 2002, allowing listed companies to ignore such requirements without being delisted from the Nasdaq National Market and the Nasdaq SmallCap Market.⁴⁷

The threat of delisting had affected many Nasdaq-traded companies prior to September 11, with the Nasdaq composite down more than 60 percent at the beginning of September 2001 from its high in March 2000. This moratorium not only helped many small companies continue trading on the Nasdaq market, it also prevented delisting of some prominent companies included in the Nasdaq 100.⁴⁸ Nasdaq National Market companies that failed to maintain required minimum bid prices after January 2, 2002, were allowed to transfer to the Nasdaq SmallCap Market, with its \$1.00 minimum bid price requirement, without

⁴⁴ Kate Kelly, *Deals & Deal Makers: NYSE May Split Into Two Sites; Kinney, Britz to Share Top Posts*, Wall St. J., Oct. 5, 2001, p. C12.

⁴⁵ Kate Kelly, *Rebuilding Wall Street, Exchanges Reach Out to Avoid Future Disasters*, Wall St. J., Sept. 27, 2001, p. C1.

⁴⁶ National Association of Securities Dealers Marketplace Rule 4310(c), 4450(a)-(b).

⁴⁷ *Nasdaq Takes Actions to Help Companies Remain Listed: Temporarily Suspends Minimum Bid Price and Public Float Requirements for Continued Listing on Market*, Nasdaq Press Release, Sept. 27, 2001.

⁴⁸ Kate Kelly, *Small-Stock Focus: Nasdaq, with More of Its Stocks Below \$1, Will Ease Some Listing Rules Until 2002*, Wall St. J., Sept. 28, 2001, p. C1.

first meeting the \$4.00 bid price required for initial inclusion on the SmallCap Market.⁴⁹

In addition to providing relief to help companies maintain their Nasdaq listings, the National Association of Securities Dealers (NASD), Nasdaq's parent company, issued an alert on November 15, 2001, cautioning investors about potentially inaccurate recommendations relating to companies that make defense, anti-terrorism or biological detection products.⁵⁰ Unsolicited faxes and junk e-mail—spam—had been sent to investors and to NASD, claiming certain companies possessed products or services that would aid anti-terrorism efforts or protect consumers from biological threats. These communications were part of an attempt to boost the prices of the companies' stock.

By assisting both companies and investors, Nasdaq demonstrated its concern for the market as a whole. Its relief measures benefited listed companies, investors, and entrepreneurs by helping the companies avoid delisting and ensuring continued liquidity for publicly traded securities.

The Fed's Analysis of the Effects of September 11

The Fed succinctly summarized the effects of September 11 on the United States economy in its third quarter *Report on Treasury and Federal Reserve Foreign Exchange Operations*, issued November 1, 2001. The report states, "The attacks heightened pre-existing concerns about the weakness of the U.S. economy and lent further momentum to the general trends that prevailed earlier in the quarter."⁵¹ Following the terrorist attacks, the Fed established reciprocal swap arrangements with the European Central Bank and the Bank of England to help stabilize the United States dollar, which had depreciated 7.3 percent against the euro and 4.1 percent against the Japanese yen during the third quarter of 2001. Despite these efforts, the Federal Reserve districts that prepare the monthly "Beige Book," a summary of current economic conditions, reported continued "weak" and "soft" economic activity following September 11.⁵²

⁴⁹ Nicholas Johnston, *Local Firms Risk Nasdaq Delisting; Stock Market's Rule Shift Could Hurt 12 Ailing Companies*, Wash. Post, Dec. 25, 2001, p. E01.

⁵⁰ *NASD Alerts Investors on Terrorism and Anthrax Investment Scams*, National Association of Securities Dealers Release, Nov. 15, 2001, <http://www.nasdr.com/news/pr2001/ne_section01_050.html>.

⁵¹ Treasury and Federal Reserve Foreign Exchange Operations, Federal Reserve Bank of New York Report, Nov. 1, 2001.

⁵² Summary of Commentary on Current Economic Conditions by Federal Reserve District, The Federal Reserve Board Beige Book, Federal Reserve Bank of Richmond (Nov. 28, 2001), Federal Reserve Bank Cleveland (Oct. 24, 2001).

Not everyone blames the terrorist attacks for such conditions. The Chicago Federal Reserve District noted that "the weakness is the result of fundamental economic causes prevailing before the attack, higher unemployment, and falling stock prices, rather than the attack itself." The Federal Reserve Bank of New York echoed this assessment by stating that "[t]he attacks heightened pre-existing concerns about the weakness of the U.S. economy and lent further momentum to the general trends that prevailed earlier in the quarter."

The fact that the economy was generally in decline prior to September 11 complicates economists' ability to pinpoint the exact cause of longer-term trends. Anomalies such as the terrorist attacks obscure decision-making by investors and entrepreneurs by reducing the economy's predictability. The threat of future unforeseen events may foster more conservative business management, which could protract the current recession and further complicate economists' ability to predict long-term trends.

Tax Relief and Federal Financial Aid In Response to September 11

Even more important than the terrorist attacks' effects on the American economy are the effects on its victims. The IRS and Congress attempted to ease victims' tax burdens. The IRS recognized that taxpayers may have difficulty meeting federal tax obligations due to lost tax records and disruptions in the delivery of documents. It extended the September 17 deadline to file income tax estimates and extended the due date of federal income tax returns due any time after September 10, 2001.⁵³

To facilitate provision of assistance to victims of the terrorist attacks, the IRS issued special guidelines under which "charities that make contributions to victims or families in which a breadwinner died or was injured need not ask for personal financial information from the victims for any funds distributed through December 31, 2002, as long as the money is distributed in good faith using an objective standard for determining how much each victim receives."⁵⁴ Even without these measures, taxpayers are allowed deductions for casualty losses and like-kind exchanges for relocated businesses. In addition, life insurance proceeds are tax-free.

Congress responded quickly to the terrorist attacks by extending to 52 weeks the term of unemployment assistance under the Robert T.

⁵³ Disaster Relief for Taxpayers Affected by the September 11, 2001 Terrorist Attack, 2001-40 I.R.B. 305 (Released Sept. 15, 2001, Published Oct. 1, 2001).

⁵⁴ Margaret Graham Tebo, *Another Form of Relief: Changes in Tax Rules Accommodate Those Affected By Terrorist Attacks*, A.B.A. J., Jan. 2002, at 63.

Stafford Disaster Relief and Emergency Assistance Act. Congress adopted the law prior to September 11, 2001, to provide unemployment assistance for victims and the families of victims of major disasters and terrorist attacks.⁵⁵ Since September 11, Congress has considered additional relief measures, such as income-tax exemptions for money received from charitable organizations and elimination of income and estate taxes for 2000 and 2001.⁵⁶

The Air Transportation Stabilization Board, consisting of representatives from the Treasury and Transportation departments, the Federal Reserve, and the United States Comptroller, was established on September 22, 2001, to provide assistance to airlines struggling in the post-September 11 economic environment.⁵⁷ The board was allocated \$5 billion for direct airline aid and an additional \$10 billion for loan guarantees. Congress undoubtedly will continue to adopt new laws and establish new groups to address post-September 11 concerns. These new measures will continue to allow businesses, investors, and entrepreneurs to pursue new opportunities in the wake of September 11.

The Effect of September 11 on the Way America Conducts Business

Businesses Must Evolve along with the New Economy

Many companies already have adapted the way they conduct business following September 11. The hijackings of four airplanes understandably caused many people to fear traveling, and a soft economy caused many businesses to cut costs and curtail unnecessary expenses. Consequently, teleconferencing and web-conferencing continue to grow in popularity and use.⁵⁸ While the airline and tourist industries experienced the negative affects of September 11, many web-conferencing stocks, such as WebEx Communications, Raindance Communications, Polycom and ACT Teleconferencing, rallied as corporate America increasingly utilizes more efficient methods of communication. Businesses now realize the importance of utilizing alternative methods of conferencing that effectively avoid both unnecessary travel and decrease meeting costs.

Publicly traded companies have responded to September 11 by adding "terrorism" to the list of potential risks cited in SEC filings. A terrorism risk factor might be warranted. As reported by the Wall Street

⁵⁵ 2001 Cong. US S 1622 (Dec. 20, 2001).

⁵⁶ Tom Herman, *A Special Summary and Forecast of Federal and State Tax Developments*, Wall St. J., Nov. 14, 2001, at A1.

⁵⁷ *Fed Governor Gramlich Is Named to Top Position On Board to Aid Airlines*, Wall St. J., Nov. 12, 2001, at B8.

⁵⁸ Aaron Elstein, *Guess Who's Coming to Web Conferencing*, Wall St. J., Dec. 27, 2001, at C1.

Journal, Federal Reserve Chairman Alan Greenspan told Congress that the September 11 terrorist attacks introduced "a whole new set of uncertainties, which information technology is not going to improve our insight into."⁵⁹ Transportation and other disruptions caused by September 11 forced some businesses such as Toyota Motor Corp. to address their vulnerabilities. They modified their "just-in-time" method of supplying and receiving goods with advanced technology, advanced inventory systems, and dependable and predictable shipping.

Other companies, such as Morgan Stanley, have considered dispersing employees more widely and creating more elaborate systems to back up information. The same Wall Street Journal article quoted Theodore Aronson, managing partner of Philadelphia money management firm Aronson+Partners: "[T]he Sept. 11 attacks proved 'that the impossible, never-could-occur event, can occur. '"

Increased security measures, contingency plan enhancements and inventory and production adjustments will continue to create extra costs for conducting business in the post-September 11 environment. Businesses not directly affected by the September 11 terrorist attacks should use this opportunity to observe how less fortunate companies have coped with the unforeseen calamity.

Financial institutions and companies accepting investments by foreign individuals and entities must be vigilant to ensure customers and investors are not connected to terrorist organizations. These connections could lead to the freezing of assets and unwanted probes by the FBI, the CIA, and the Justice Department. United States President George W. Bush signed an executive order effective September 24, 2001, adding certain terrorist and related organizations and individuals to the Treasury Department's Office of Foreign Asset Control list of Specially Designated Nationals.⁶⁰ The order prohibits any transaction or dealing in property or interests belonging to a list of 27 individuals and entities with known ties to Osama bin Laden, his Al-Qaeda network and other known terrorist organizations.

On October 1, 2001, to assist in identifying appropriate accounts, the Office of Foreign Assets Control issued a bulletin containing descriptive information relating to the individuals and organizations

⁵⁹ Risky Business: As Security Worries Intensify, Companies See Efficiencies Erode, *Wall St. J.*, Oct. 24, 2001, at A1.

⁶⁰ Executive Order Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism, *Bulletin of the Office of Foreign Assets Control*, Sept. 24, 2001.

mentioned in the executive order.⁶¹ This bulletin contained all known aliases, dates of birth, and places of business for each terrorist targeted by the executive order.

The SEC report requested that "all securities-related entities (whether or not registered with the SEC) voluntarily check their records for any relationships or transactions with the individuals or entities listed in [President Bush's] executive order or named by the FBI as being under investigation in connection with the September 11 terrorist attacks."⁶² Companies can report any relationship or transaction with any of the prohibited individuals mentioned in President Bush's executive order via e-mail to a special address. The President's mandate thrust many businesses, especially those in the financial services industry, into the role of enforcement officer by requiring Americans to review records to determine whether continued relations with existing investors, customers, and clients would violate the executive order.

As a further measure to freeze terrorists' assets, the SEC cooperated with the FBI, the Fed, and the Commodity Futures Trading Commission in developing a "Control List," a "mechanism that will assure the expeditious distribution of a unified list of individuals and entities to a broad range of financial institutions."⁶³ The Control List, disseminated by the SEC to certain brokers, dealers, investment advisers, investment companies, transfer agents, exchanges, and other self-regulatory organizations, contains confidential information gathered by law enforcement to assist in freezing terrorist assets. The SEC suggested that businesses first designate one senior-level officer or employee "who appreciates the sensitive nature of the investigation and will exercise appropriate discretion to be the point person for all communications relating to the Control List."

On October 26, 2001, President Bush signed into law the 2001 Financial Anti-Terrorism Act⁶⁴ containing "the most significant U.S. attempts to curb money laundering since it became a crime in 1986."⁶⁵ Some bankers have criticized these new laws because the Treasury Department can require banks to identify parties to transactions and

⁶¹ Bulletin of the Office of Foreign Assets Control to the United States Public (Oct. 1, 2001) (on file with the author).

⁶² Request for Records Search by Securities-Related Entities, Including Brokers, Dealers, Investment Advisers, Investment Companies, Municipal Securities Dealers and Transfer Agents, Sept. 27, 2001, <<http://www.sec.gov/news/headlines/recordsearch.htm>>.

⁶³ SEC Asks Industry Cooperation In Investigations of Terrorists, *Securities Reg. & Law Rpt.* (BNA), Vol. 33, No. 41, at 1503 (Oct. 22, 2001).

⁶⁴ PL 107-56, 2001 HR 3162.

⁶⁵ John Gibeaut, *Show Them The Money: The Anti-Terrorism Laws Target Money Laundering, Forcing Banks to be More Vigilant and Compliance Officers to Take on More Tasks*, A.B.A. J., Jan. 2002, at 48.

pierce through them to determine the identities of foreign customers behind the parties, adding to banks' due diligence when dealing with foreign individuals and foreign banks. The law also forces banks to closely monitor private accounts of \$1 million or more belonging to foreign political officials, their families, or their associates, and prohibits domestic banks from dealing with foreign banks with no physical offices.

While hopefully discouraging terrorist operations in America, this law also could deter foreign investment by forcing innocent parties to subject themselves to the risk of fighting erroneous allegations in American courts. Even after the initial publicity of freezing terrorists' assets subsides, entrepreneurs and businesses must be careful not to associate with any party who might be related to those individuals or entities identified by President Bush. This law, along with other mandates, will continue to complicate business in America, but they are necessary measures to curtail the financial backing of terrorists and ensure stability of the United States markets in the long term.

Entrepreneurs and Small Businesses in the New Economy

Entrepreneurs and small businesses faced difficult challenges during 2001. "Many entrepreneurs felt the downturn long before September 11, and have seen their revenues continue to slide ever since."⁶⁶ On September 11, small businesses averaged only three months' cash cushion to weather hard economic times.⁶⁷ Considering this reality, the federal government and concerned private parties are supporting small businesses and entrepreneurs by establishing resources for troubled businesses.

Small businesses throughout the nation can apply for a Small Business Administration Economic Injury Disaster Loan (SBA Loan) to fund operations suffered as a result of September 11. Through January 2002, more than \$250 million in disaster loans had been approved for approximately 3,100 businesses in New York City through the federal SBA Loan fund.⁶⁸ Businesses that do not qualify for an SBA Loan could receive federal government funding through the Emergency Supplemental Appropriations Bill or assistance from local resources such as the New York City Partnership's Financial Recovery Fund and a similar fund established by the Alliance for Downtown New York.⁶⁹ These resources

⁶⁶ Karen E. Klein, *Home Is Where the Heart Is*, Bus. Wk. Online, Dec. 28, 2001, 2001 WL 25756149.

⁶⁷ Allentown Morning Call, Jan. 22, 2002, at D1, 2002 WL 426179.

⁶⁸ Alan J. Wax, *CITY INC./Popular Restaurant to Re-Open*, Newsday, Jan. 30, 2002, at A43.

⁶⁹ *New Emergency Loans Will Give Mainline Cash Infusion to Struggling Small Firms, Hard-Hit General Aviation Airports*, U.S. Newswire, Jan. 24, 2002, 2002 WL 4573585.

will continue to assist existing businesses economically and support the capitalist spirit that defines the American marketplace.

The effects of September 11, combined with significant depreciation in the equity markets, primarily due to devaluation of dotcoms and an economy-wide recession, caused many individuals to redirect career and business strategies.⁷⁰ Choices of possible business ventures in the new economy differ appreciably from the choices of entrepreneurs and small businesses five years ago. While investors apply considerable scrutiny and skepticism to Internet and travel-related businesses,⁷¹ security and defense ventures are enjoying revived interest.⁷² Survival in the new economy requires entrepreneurs and small business owners to realize the importance of understanding what rapid change means for consumers' needs and wants. Harvard Business School professor Nancy Koehn offers the following advice for business managers:

Learn from your customers. Periods of economic, political, and social change affect not only consumers' income and spending, but their identities, daily routines, and values. Savvy business leaders remain attuned to these shifts and use what they learn to enhance their offerings, distribution channels, and even operating strategies.⁷³

Many successful entrepreneurs have overcome hard economic times by learning from customers, maintaining direct contact with patrons, using consumer information to respond quickly to new priorities, exploring emotional connections, and realizing that values matter. Examples include Howard Schultz's operation of Starbucks, which he purchased two months prior to the October 1987 stock market crash; Scott Cook's redirection of Intuit; Henry Heinz's expansion of his food business resulting from a unique understanding of consumers' wants and needs; Estée Lauder's exploration of what helps women maintain self-confidence; and The Body Shop and Whole Foods' attention to consumer values. Undoubtedly, a new breed of entrepreneurs will revolutionize their industries by acknowledging and responding to the needs of consumers in the post-September 11 new economy.

⁷⁰ Winifred DeSouza and Sonia Alleyne, Getting a foothold on your career, *Black Enterprise*, Volume 32, Issue 7, at 105.

⁷¹ Brian Grow, *Who Gets Disaster Aid? Who Doesn't?*, *Bus. Wk.*, Jan. 28, 2002, at 8.

⁷² Michael Freedman, *Electronic War*, *Forbes*, Jan. 7, 2002, at 66.

⁷³ Nancy Koehn, *Chasing Dreams During Troubled Times: Lessons From the Past*, *Boston Globe*, Jan. 22, 2002, at F5.

The American Economy Will Bounce Back

The recessionary economy and the September 11 terrorist attacks combined to cause a tumultuous year for the United States financial markets. Some analysts claim the American economy remains anemic and will not recover vigorously until the Federal Reserve provides adequate credit to small and medium-sized businesses and Congress further reforms the income tax system.⁷⁴ The Fed's consistently grim Beige Book reports and The Wall Street Journal's November 19, 2001, report that industrial output fell for the thirteenth consecutive month—the longest string of declines since the Great Depression—may serve to fuel such cynical arguments. A record number of publicly traded telecommunications companies filed for bankruptcy protection during the year 2001 and it appears that the telecommunications industry will continue to suffer in the post-September 11 recessionary economy.⁷⁵

Standard & Poor's issued a special report following September 11, designed to assure concerned investors that the financial markets will continue to rebound.⁷⁶ The financial information and rating services giant cautioned investors not to make investment decisions based on short-term market fluctuations and to learn from historical returns following other major crises to gain a long-term market perspective. Standard & Poor's report suggests that investors who stayed in the market during turbulent times are rewarded with long-term gains. This was true following the Pearl Harbor attack, the invasion of South Korea, the Cuban missile crisis, the assassination of John F. Kennedy, the Arab Oil Embargo, the Iran hostage scandal, the Iraqi invasion of Kuwait, and the Gulf War.

Standard & Poor's claims that businesses, investors and entrepreneurs must "[l]ook at a market decline as a buying opportunity. Some stocks may be undervalued following a broad market decline, allowing you to invest more in high-quality companies." Domestic equity fund increases during the fourth quarter of 2001 suggest that American financial markets are poised to repeat trends following earlier turbulent times.⁷⁷ Considering the long-term positive return America's financial

⁷⁴ Steve Forbes, *Fact and Comment*, Forbes, Jan. 7, 2002, at 23.

⁷⁵ Scott Lanman, *Year Brought a Meltdown * * Telecommunications and Chip Companies had a Miserable Time*, Allentown Morning Call, Dec. 23, 2001, at D1.

⁷⁶ *World Crisis and the Stock Market: Learn From History, Prepare for the Future*, Standard & Poor's release, Sept. 21, 2001.

⁷⁷ *Light at the End of the Tunnel?*, Bus. Wk. Online, Jan. 9, 2002, 2002 WL 5144405.

markets historically have provided, "time may just be an investor's greatest ally."⁷⁸

Time will reward those investors who remain resolved to weather the volatile remains of the post-September 11 markets. The recessionary economy of 2001 and the stock market declines following September 11 can be utilized to inform investors and entrepreneurs which prospects and industries will weather volatile markets and unforeseen calamity. Some entrepreneurs have already directed their interests and investments to resources that are uniquely in demand as America emerges from the rubble of the World Trade Center, both literally and figuratively. "[These] unavoidable commercial reactions of businessmen, entrepreneurs and investors to the tragedy of Sept. 11 are . . . symptomatic of a society characterized by freedom and private initiative."⁷⁹ History suggests that a new American economy will continue to emerge successfully in the days to come.

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⁷⁸ *World Crisis and the Stock Market: Learn From History, Prepare for the Future*, Standard & Poor's release, Sept. 21, 2001.

⁷⁹ Peter Foster, *Freedom and the Spirit of Capitalism*, Natl. Post, Jan. 2, 2002, at FP7.

Kommerstad Center Speakers Forum

Reflections on an Entrepreneurial Life
BERNARD MARCUS *

Introduction of Mr. Marcus

Professor Edward S. Adams—co-director of the Kommerstad Center for Business Law and Entrepreneurship:

It is my great pleasure and honor to welcome Bernard Marcus, the co-founder of The Home Depot. His speech today is sponsored by the Kommerstad Center for Business Law and Entrepreneurship, made possible by a generous grant from Robert Kommerstad, a 1952 graduate of this law school and president and CEO of Provident Investment Counsel in Pasadena, California. Unfortunately, Bob cannot be here today—we miss him and regret that he is ill and unable to come.

As a friend of Mr. Marcus, Bob wanted me to share some comments about Mr. Marcus's past that he thought might be enlightening. When Mr. Marcus was a young man in college, he worked at summer jobs in the hotels in the Catskills of upper New York. Among other things, he learned the art of hypnosis and performed this art on stage. We look forward to being hypnotized by him today, and I am delighted and grateful to introduce him here.

Mr. Marcus is a man who took his dream of a start-up business to what it has become today—a company with over \$100 billion in market capitalization, the 25th largest capitalized company on the New York stock exchange. Its stock is 100 times its price in 1984. There are more than 1,260 Home Depot stores with 280,000 employees and it's still growing.

In fact, while layoffs are occurring at entities such as General Electric, Motorola, Proctor and Gamble, and many others, Home Depot will create another 40,000 new jobs for workers this year. Sales in 2001 are expected to exceed \$50 billion.

* Bernard Marcus is one of the cofounders of The Home Depot, Inc., North America's largest home improvement retailer, which has revolutionized home improvement with the warehouse concept. Mr. Marcus has served as chairman of its board of directors since the company's inception and as chief executive officer until May 1997.

Mr. Marcus was the inaugural speaker for the Kommerstad Center for Business Law and Entrepreneurship at the University of Minnesota Law School on October 9, 2001.

Note: As a matter of editorial policy, consecutive citations to a source in an article have been eliminated. Readers may assume references are to immediately preceding cited source until the context indicates otherwise.

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Not only is he a phenomenally successful entrepreneur and businessman, Mr. Marcus is a great humanitarian as well, and he may share some of his experiences in that realm with you today.

I would like to say again how honored and grateful we are that he's here with us. This is an excellent opportunity for us. I can't imagine anybody who could better fulfill the role as the first speaker for our series.

Thank you very much, Mr. Marcus.

Bernard Marcus:

I don't know where Bob dug that up, about me being a hypnotist. It's true. And believe me, in today's consumer environment, you really have to be focused and be a hypnotist to get people to shop.

On the Creation of The Home Depot

Let me tell you a little bit about The Home Depot. It's a unique experience. And since I was asked to talk to you about entrepreneurship, which I think is very important, it's important to know what kind of things can be accomplished in this world.

I'll tell you about myself. At 49 years of age, I was in the retail business in California, caught up in one of these corporate upheavals, and I was fired. I was CEO of a company that was very successful—in fact, the most successful company in the home improvement business. But that didn't make any difference and I was out of work. I decided that I never wanted to go through that experience again—I wanted to go into my own business.

I was very fortunate to have people behind me who were also entrepreneurial—financial people, willing to back my partner and me in an endeavor. We started The Home Depot.

We talked about this idea. All of the stores before The Home Depot were 25,000 to 30,000 square foot stores, kind of small stores, and very cherry-picked—carried maybe 8,000 items. They had three hammers, or two saws, something like that. We decided that we wanted to put under one roof everything that people would need to do a house. We wanted to bring in 30,000 items, an enormous amount, maybe four or five times the amount ever carried before. We would have enough of

an assortment that people would almost be able to do any kind of a job that they'd want to do.

Then we had this great idea to buy not through distributors or wholesalers, but to buy direct from manufacturers so that we could sell the product at a better price. That in itself was a revolution in our business, because everybody bought from wholesalers. So we put that change in. Then we said, "Hey, why are hardware stores successful, small hardware stores?" They're successful because people are there to help you. And you walk into a small hardware store, there's somebody there to help you, walk you through something, walk you through a project. We said, "Let's put people on the floor who know what they're talking about. Now let's give them total service." And that, by itself, was revolutionary in a big store. Now we're talking about opening stores that were 60,000-square feet, probably three times the size of any store like it. There were a couple that were 30,000 feet in those days, but most of them were in the 20,000- to 25,000-foot range.

Then we said, "Let's sell at prices they've never seen before in this industry." And that was another total revolution in the business. In fact, most of the manufacturers did not want to see it happen and none of the retailers wanted to see it happen, and there were many roadblocks put up in front of us. But we thought it was a great concept—being able to buy everything you wanted, being able to buy quality products, being able to buy it at the cheapest prices possible, and having somebody there to help you.

To us it sounded like a great formula. But all of the people who knew what they were talking about said there was no way; and pretty big money was on us not being able to do it. Manufacturers that sold to us made sure that they got paid quickly because they thought we were going to be out of business in a very short period of time.

We hired entrepreneurs. We hired hungry people—people who were highly motivated, who wanted to make it, who were enthusiastic, and didn't care about hours—people willing to put in the time and sweat equity that was necessary. And we gave them a piece of the business—stock in the company. It was not a public company, but if we went public, they would get a piece of the action. They came from all different kinds of places in Atlanta, where we opened our first stores, and we rewarded them for coming with us. We knew if we got wealthy, they would become wealthy with us. And we started this thing out.

I must tell you that the first year was a very, very difficult year—we thought that the naysayers were probably right. Out of our original \$2 million-dollar investment, we lost \$1 million—50 percent of our total investment the first year. Then we began to see that customers were

starting to come back, traveling from as far away as 50 miles to come to our store—traveling in and telling us where they were from, and why they came to us.

For a number of years, it was the greatest secret in the world, because nobody knew how much money we were making. All of our competitors would come in and see this store loaded with merchandise. They'd come in, the competitors, and say to me, "How you doing, Bern?" and I'd say, "Oh my god, I can't pay the bills." And nobody copied us, because they all thought that it was too difficult. *One of the major things about entrepreneurship is keep it to yourself for a while, okay? Get a head start on the competition.*

In 1982, we went public, our first public offering. If you bought original stock in the company, at \$12 a share, today it would be worth about \$1,200. A thousand shares of stock would be worth \$1,200,000. Not a bad return on an investment. And the people who joined us were very, very successful. The company developed, over only 20-some years, into what you see today.

We've become one of the most successful companies, not only in the United States, but also in the world, in retailing. I think we're number three or four, something like that. We don't intend to ever catch Wal-Mart. They're the best—there's nobody better as far as I'm concerned. But they give us the target on where we can go. And, frankly, we think that there's a long way to go.

We have 1,267 stores. By 2004, we'll have 1,000 more stores. We're almost going to double in size over the next three years. That's an enormous amount. We have 290,000 people on our payroll. By 2004, we'll have over 500,000 -- almost half a million people working for us. The growth continues, and the success continues. You look at the numbers and you see that, in our business, we have the highest net profit, the highest sales per square foot, the highest rate of return, and the highest return on equity.

We've run a company that is unique, unusual, and started by entrepreneurs. That's really interesting, because entrepreneurs basically don't have the discipline to do some things they should do. Entrepreneurs are basically nuts—they're crazy. I was crazy. But I was smart enough to surround myself with people who were good managers, who understood that you have to control your numbers, as well as control your emotions. Entrepreneurship is emotional—you're emotional, you're passionate about your business, and you get involved in your business totally. You are totally immersed in what you're doing. If you're not, you can't be successful.

Over the years we've been able to do that; and we've reached the point today where we're a \$50-billion-dollar company looking at being a \$100-billion company. Think about a \$100-billion and you might say to yourself, "How did this come about? What kind of a company is this?"

On Customer Service and Giving Back to the Community

There's something behind the company that you don't know about that's part of our success. It's the one thing I left out when I started to tell you about what we did—the culture of the company. The company was started by two Jews, an Irishman, and an Italian—a pretty good combination. We had one thing in common—we believed that you had to give back to the community. We believed that you had to help your fellow people. We developed a culture in the company that's a very simple one to explain. It says, in very few words, we care for each other, and we care for the customer. We care for each other, and we care for the customer. Think about this sentence; it's very simple.

You hear a lot about customer service. In every business, there's customer service. If you're in the retail business, if you're selling automobiles, if you're in the law business, if you're in the engineering business—you have a customer that you have to satisfy. And if you don't satisfy the customer, they don't come back, so customer service becomes very critical.

How do you get good customer service? You get good customer service when your people want to help the customers. Most retailers put out big books on customer service. They put out pamphlets, they put out books, but they don't typically live by what they've said. We have done almost everything in our power to help customers in our stores—there is nothing we don't do.

There are famous stories where customers have brought products back to our stores that we don't carry. There's a story in our company where people walked in with two tires and wanted a refund. We don't sell tires. We gave them a refund, because they were good customers. They were confused; they thought we carried them. And that's the way we have built our business.

I was reading a letter on the plane from somebody who was with a marketing group in the Midwest, and he told me a story about going in to a Home Depot because he needed to fix a faucet. The fellow who took care of him spent almost a half an hour dismantling a faucet that was there on display, to show him how to fix the leak in his faucet. He said, "I spent a total of \$1.25." A dollar twenty-five and a half an hour. He

said, “Now let me tell you what has happened since. . . .” He spent around \$700 in the next three weeks at The Home Depot store, because of that \$1.25 sale.

Why do our people do it? We don’t pay commissions. We tell our people that if somebody walks in the store, you take care of them—whatever it is, even if you don’t make the sale. We have people come in and we don’t carry the product. Our people will go to a phone, and make a phone call to a competitor, so that the customers know where they can find it. That’s what customer service is all about.

We talk a lot about caring about each other and caring about the customer. How does that come up? I’d like to tell you a story you may never hear about. We recently went through a terrible catastrophe in this country. We had the worst thing that could happen happen to us in New York City. I want to tell you about how Home Depot responded. Around 9:00 the first plane hit; about 9:15 the second plane hit. At 10:30, there were seven stores that had trucks filled up. They ran up and down the aisles, and they picked out axes, picks, generators, flashlights, tarps, wheelbarrows—all of those things that they knew the rescuers would need. By the way, they never called Atlanta—nobody ever called the home office—they did what they knew we wanted them to do.

We had trucks from seven different stores on their way to New York City and the Pentagon. Home Depot had the only trucks allowed in New York City. We supplied all the emergency stuff that they didn’t have themselves for the first three days. We set up a war room in Atlanta, and also in New York. FEMA, the FBI, the Secret Service, the fire department, and the New York City police department were calling to tell us what they needed. They needed different kinds of facemasks—- we got 20,000 to them within seven hours. They needed certain kinds of generators--- we had them brought in from all different parts of the United States. We did that for the first four days.

At the Pentagon, they needed treated lumber to shore up the buildings. We supplied that, mostly by ourselves without manufacturers. We don’t have any idea of what we spent, but that’s the way we react. If a hurricane hits the United States, our people know that they do whatever they have to do. They fill trucks up and they get them out. We do that in floods. We do it in earthquakes. We did it in San Francisco. We did it on the East Coast. I’m not aware of any retail company, or any company in the United States, that reacts that way -- I’m really not. We don’t publicize it. It happens because all of our people, internally, know what we do. When you walk into a Home Depot store, you see people laughing and smiling and enjoying what they do, because of who they work for and what our culture is.

Our company is successful because of how we conduct ourselves. Our people believe in what they're doing because they're part of an organization that conducts itself and has social behavior that's unique and unusual. And we don't have to sell it, because it sells itself.

Everybody in the New York area, every associate that we have, understands exactly what we do, and is proud of what they do. And we know how many people were affected by that bombing--- many, many people. We knew what they were going through, and we felt that we had to do what we had to do.

We've evolved, after 20-some odd years. Stores used to be 60,000 square feet -- they're about 135,000-square feet today, we carry maybe 15,000 - 30,000 items. Next step, we're over 50,000. We're on the Internet--our special order system means that people can order approximately 500,000 items out of our stores.

Seventy-percent of the people in the United States own their own homes. Seventy-percent--the highest amount in the world. And we give them the stuff to do the repairs--fix their houses--and build their own houses. Years ago they could not buy sixty percent of the products that we carry in our stores today--they weren't available to homeowners--they were only sold through electricians, plumbers, or carpenters. The lighting that you have in this place was not available in stores. And there was a double and triple mark-up.

Today it's affordable for everybody. You can re-light a house today, in any market that we have, for as little as \$600.00. That would have cost \$5,000 twenty years ago. We brought the price down on almost everything that you do, and our business is getting bigger and better.

This all happened because of several things. I love to go to universities, because they don't teach this in universities--they don't talk about the American system. The system that we have here, the free enterprise system, is the greatest system in the world. It's the only place in the world that somebody like myself--having grown up in Newark, New Jersey, from immigrant parents that did not speak English--can succeed beyond anybody's wildest dream. Except my mother, who said, "This is a golden country. You can be anything you want to be here." My mother believed it.

The greatest day in her life was the day she got her citizenship in the United States. She cried for days. I remember, she cried for days. She was so proud of being a citizen here--she called it the Golden Lamb--and we don't appreciate how great this country is until something like this terrorist attack hits us.

The people who hit us hate everything this land stands for. What do they hate? They hate freedom of speech, they hate liberty, they don't like criticism, and they want everybody to be what they want them to be. You women in the audience could not be this audience if you were there. In their land you'd have no freedoms whatsoever.

An article I read on the way here was really interesting. It said the Taliban uses the Internet, but they could never have invented it. And it's funny that Bin Laden used video in a speech that he made right after we hit Afghanistan, because they don't allow video in Afghanistan or any country that they're in. The poorest people in the world are in the fundamental Islamic countries, but they don't mind using the systems that we have.

America is the worst enemy that they could have because people like me should never be allowed to achieve what we have achieved. It's not right in their religion. Their religion is not right. This country has allowed me to get where I am.

We have created, in this company, somewhere around 4,000 millionaires. Can I give you a cross-section of 4,000 millionaires? Two-thirds of the associates who work for us have only a college education. These are kids who came to work for us, broke their backs, worked hard, and didn't have the background that you have. These are kids who wanted to make it, and today, they have made it. Today they're giving back to the community. They watched what we did, and they've become major parts of their own community, giving back to their community. Only in America could that have happened—it couldn't have happened anywhere else.

This is a special land, a special place, and you should appreciate it. You have the opportunity for learning, you have the opportunity to dissent, and you have an opportunity to disagree. If you don't like what I'm saying, you can tell me about it, and you will live. You can do this here, but you can't do this in other places in the world—certainly not with these people that have done this terrible thing to us.

But we'll eventually get them, and we're eventually going to win. I know that. I feel a lot of confidence that the President is going to be able to do it.

Those are the basics of the The Home Depot, of how we got where we are. The next thing I'd like to do is open it up, because I'd like to hear what you'd like to hear—comments you may have or questions about some of the things that we've done or why we do what we do.

On Unionization

Student Question: Is unionization an issue for Home Depot?

Mr. Marcus:

No. Never. Never. We've had a couple of union votes, but they don't want to join. We give them the highest benefits, we pay them more than anybody in our industry, and we treat them well.

Every single executive of our company must be in the stores at least two days a week, three days a week -- walking in the stores, talking to our associates—that's the only way we find out what's wrong. We don't have a clue sitting in some corporate office somewhere in the 22nd floor. You really don't have a feel for what's happening. It's hands-on. Being in the stores, we understand what they go through, how we create bureaucratic business for them to climb over. When they're right, we do something about it. And that's why there's no need for a union.

Do you know why people need unions? Because people treat people badly. They deserve to have unions—they should have unions. And in this country, many, many, years ago my mother worked in a sweatshop. She worked in the sweatshop that was one of the major stories in our history, that caused all the laws to be changed. She didn't go to work one day, because she was sick. That sweatshop burned down, and many people were killed. But because of that, we changed the laws of the United States. Those people needed to have unions. Unions are healthy, where in fact they need to be.

On Global Expansion

Student Question: I am from Mexico. Do you have plans to expand to other countries?

Mr. Marcus:

We have stores in Chile, Argentina, and Mexico. Mexico is going to be our focus for a great deal of growth—we have a lot of confidence in Mexico. We now have NAFTA, so there's a lot of trading going on back and forth, a lot of products being built. The middle-class in Mexico is going to start growing, and those are our customers. That's really where our customer is—people who have a house and want to fix it. So we're going to have a lot of stores in Mexico. I think we have six now—it's going to be 50 in the future—maybe more.

We think there's going to be a great period of growth in Canada—wonderful growth that will continue to get stronger and stronger. We have stores in Alaska. We have stores in Hawaii. We have stores in Puerto Rico.

We're moving, but we're not going overseas the way Wal-Mart has. We have to go into a country where there is a middleclass, or there's a potential for a middle class to get up; and where we feel we can develop the kind of sales people that we have in the United States, where the culture is a good culture. In many parts of the world, being a salesperson is the lowest form of animal—below public servants, below politicians. They look at them that way. In those places it's very difficult to recruit the kind of people that we want to recruit.

We could open up *buildings* anywhere. I mean, we have a balance sheet that's almost the cleanest balance sheet in the United States of any company—any company. We don't choose to do it because we're not interested in opening numbers—we're interested in opening quality stores. That's really what we're interested in.

On Keys to Success

Student Question: I come from a family of entrepreneurs. I talked to my grandfather, who's started many businesses, and I'm curious what your key to success is. I know his and I'd like to hear yours.

Mr. Marcus:

I'll tell you what some of the keys are. I'm going to share with you what I tell to my children. Number one, you've got to be a good communicator. You can't be successful in this world today unless you know how to communicate. And it doesn't mean being able to get up here and speak—this is lecturing.

Communicating is a two-way street. It means speaking and listening. And it means listening with an open mind. The day you think you know everything, it's very sad, because you know very little—you're pretty stupid.

Once I was a pre-med student. I really wanted to be a doctor—I did not want to sell hammers. My theory, because I understand the human body, is that the jawbone is right in front of your ear and when your mouth is open, your ears close. And some folks never shut their mouths, which means they never hear anything, okay? Listening is the critical factor. In our success, listening is everything. Every change we make in our company is done without hiring outside consultants. That is

the stupidest thing you can do, because all they do is go into your stores and do exactly what you should have been doing in the first place—*listening* to what people tell you. Okay? Number one, listen very carefully.

Number two; you cannot be stopped by failure. Many people throw up their hands the first time failure is thrown in their face. And it's easy to throw in the towel. I watched the Georgia-Tennessee game last week. There were two touchdowns in the last two minutes of that game, and the last touchdown was in the last 10 seconds of that game. Somebody scored a touchdown with one minute and 20 seconds to go. Everybody threw in the towel—people turned off their TV sets, friends of mine who were at the game walked out of the game. I stayed there thinking, something's going to happen here. And sure enough, Georgia scored a touchdown that won the game.

If you have the right idea, if you're focused, if you're goal-oriented, if you know what you want to achieve, and if you believe in it and stay at it, you'll eventually win. People back off, they compromise, or they get talked out of it. When I sit with or play golf with people like Jack Welch from General Electric or Chuck Knight from Emerson, I say, "Come on, tell me about your failures. Tell me about the worst days in your business career. Tell me about where you almost threw in the towel." And every single one of them has a time, or two times, or five times, like that, where the towel was almost thrown in, where they got the courage enough to continue on, and they were successful.

Handling defeat is as important as handling success. Most people cannot handle defeat. I'll give you one lesson. The biggest problem of any single company in the world today is the inability to admit that you made a mistake. I have seen companies go down the drain, great companies, because they did something that was stupid. To get up in front of the world and say, "It was stupid. I did something dumb," is beyond their capacity—there's no way they can do it.

We have taught our people that it's okay to make a mistake. You can make a mistake, as long as your heart was in the right place, as long as it was a judgment call, as long as there was honesty, that you did it because of good reasons It's okay to make a mistake.

Think about bureaucracies in the world today. Sometimes, to look good, you have to lie. So now you go on to other things, and you have this lie behind you. Well, if you keep doing this, you have so many lies behind you, you can't ever think about positive thoughts anymore. You got to keep covering; you got to think about covering your ass all the time. People go through life doing this. Their whole life is built on a lie.

Those are the three things that I think are the most important—good communication, being able to deal with disappointments, and being able to admit that you’ve made a mistake—we do it as a company.

Many years ago, we bought a chain of stores in Texas, and we had promised the financial community that we were going to open these stores, and we were going to do certain things. It was a total disaster. We bought these stores in Texas without the kind of balance sheet we have today and without the background we have today. It was a disaster; we were coming out with earnings that were going to be a horror. With 55 or 60 multiple, which is what we had in those days, you’re talking about losing almost everything that you have in one fell swoop.

I got to the meetings in New York before everybody and in the meeting I said, “I am the CEO of this company and I am a jackass. I made the biggest mistake. It was my decision. It was dumb. It was stupid. I recognize it. And this is what I’m going to do about it.” Know what happened? Our stock went up, because it was the first time they’ve ever had anybody come before them and not make excuses, excuses, excuses, until their backs are up against the wall, and then they have to admit that they made a mistake.

These are all lessons in life, principles that can help you be successful in your own lives. And every one of you is going to go through this kind of situation.

On Good People

Student Question: You were talking about customer service, and you seem to have the people and resources that make that happen. But how do you find the right people?

Mr. Marcus:

In many cases, you don’t hire people like that—you make them, you create them. You put a lot of time and energy into them, a lot of training. We use every resource that we have—we use the Internet, we use television, we use radio; we use every kind of communication to tell the stories. The story that I told you about with the guy with the plumbing thing? That’s going to be disseminated to all the stores. They’re going to know that they’re rewarded for doing things like that. They feel good about themselves. The associate who did that is a hero in our company.

Everybody wants to be a hero. They want to emulate the most successful people. So what we try to do is build up the people who are most successful.

We hold people accountable. That's a frightening word, because when you think about holding people accountable, what do you think of? That someone will have to answer for something, be punished, right?

We use the word accountability in a little different way. We *reward* people for being accountable. In other words, accountability has two sides to it. There's one side that says that we're going to hold you accountable for what you said you were going to do; and then if you do it, we're going to reward you for doing it. By rewarding good service, by rewarding people for doing more than they should have been doing, by rewarding people for being what you want them to be—that's how you hold them accountable. And that's how you develop those kinds of people. If people live in fear in the store, if they're afraid to make a move, they'll be afraid to be entrepreneurs. We want people to be entrepreneurs.

25,000 customers a week come in through an average store. There are 25,000 different stories, there are 25,000 different problems; there are 25,000 times one of our people is face to face, nose to nose, with a customer. And we can't tell them everything to do. We can't give them a list of things to do. We say, "Use your common sense, but always remember that the customer has to be satisfied." The customer walks into that store smiling, they have to leave the same way. And if you do that, we're going to reward you. They all own stock in the company.

On Throwing in the Towel

Student Question: *Can you talk about some of the times when you almost threw in the towel, and what prompted you not to at that time?*

Mr. Marcus:

I'll tell you when I've almost thrown in the towel.

People.

I've always considered myself to be a good judge of people, and I think that if you're not a good judge of people, you make a lot of bad mistakes. You have to trust people to do what you think they're going to do.

My biggest disappointments in life have been in people in whom I've had a lot of confidence who destroyed that confidence. And when enough people do that, you really want to throw in the towel.

No one who has ever left our business has gone into competition with us before—ever, ever, ever. There's someone we made remarkably wealthy—an ordinary guy who happened to be in the right place at the right time. And he went into competition with us. He took his wealth and he went after us, in a way that was not even competitive—it was nasty. When I experience that, I say, "You know what? I'm wealthy myself—I don't need this anymore. I don't need these disappointments. I don't need the disappointment of having people do that to me."

Every time an associate steals money from this company, I get very depressed. It hurts me. It hurts me because we do everything in our power to care for each other.

We do something that no company's ever done, that I'm aware of. The three founders of the company put \$5 million each into a thing called the Homeward Fund. Any one of our people might have something happen to them that's extraordinary and not their fault. For instance, a car is stolen, or an apartment burns down, and they don't have clothes or the money to buy them. We make it available. This is for something they never counted on, that they're not responsible for. We take care of those people. We gave away over \$3 million last year. And on those things that we don't cover, and the store feels like they want to do it, they can. Somebody gets sick, somebody has cancer. A family has a problem, the store raises \$2,000, and we match it—we take care of our people. They feel good about themselves and how we treat them.

Then to have some people disappoint you—and it happens all the time—that's when you want to throw in the towel. Circumstances—we can deal with those things. We've had all kinds of things happen with competitors, things you know are going to happen.

I'll tell you where I almost throw in the towel—over lawsuits. This is why lawyers are at the bottom of my list. I want to talk about tort lawyers and class action suits. We talk about entrepreneurship and building America. As law students, you better understand this, because the game is going to end very shortly. It's going to end soon because somewhere along the line the whole free enterprise system's going to come crashing down.

I'm on a lot of foundation boards. I'm on a foundation board today that works with one of our biggest problems—juvenile diabetes—terrible, terrible problem. Why? Because kids are sedentary—they're

getting fat. We have more juvenile diabetes than we've ever had in this country. And we're going to pay for this in years to come.

When I went to school, we had a thing called gym period, where we used to climb ropes, we used to get on horses. Kids don't have it today. Do you know why we don't have these classes for our kids today? The lawsuit.

Recently, in Dallas, they had a case of a sexual predator, one of their priests in their Catholic Church. They went for \$25 million, and the Catholic Church almost went out of business in the city of Dallas, Texas. Horrible kinds of situations.

There was a lawsuit recently in Mississippi that was incredible—a train burned on the track and everybody was sued. The case went to a jury in Mississippi and the award was \$3.5 million. Nobody was hurt! There was smoke—people had to leave their houses for two days. But nobody in the community was hurt. There wasn't one person with an injury, and the jury awarded them \$3.5 million.

We're seeing this over and over again. We have seven companies in asbestos that went out of business—great companies in America that went into bankruptcy. W. R. Grace went into bankruptcy. U. S. Gibson went into bankruptcy. It happens over and over and over again.

Five years ago, we had an opportunity to go to China and we had stores built there. Then we looked at the laws. I asked, "What happens if they want to confiscate your property?" And the lawyers said, "They take it." When I said, "What's my recourse?" they said, "You have no recourse."

The laws have kept this country together, but the tort system has prostituted itself to an extent to which it's going to have a terrible effect on the economy.

Today we spend more for drugs in the United States than in any other country. Go across the border, to Canada and Mexico where you can buy drugs 30 percent to 40 percent cheaper. Guess why. Liability. I can give you examples over and over again.

I have a foundation that took care of children. This is almost too pathetic to talk about. We were taking care of 2,000 families. They had kids who were autistic, developmentally disabled—kids with real behavioral problems. The families were tied up 24 hours a day with these kids. They couldn't get away from these kids for one day, even for one hour—they couldn't go shopping. We were taking care of 2,000

families, so that they could go away for three hours or one day or for a weekend.

We had volunteers who did this for us until we were sued. They nailed us for \$2 million. There are now 2,000 families not getting that service. That lawyer must be pretty proud of himself for what he did. Two thousand families are suffering today. That's a personal experience I had and it was nothing that anybody could prevent. As lawyers, I'd like to tell you that you have a social responsibility—something that you have to give back to society—and I think it's very important that you remember that. The law is critical in our world. But there are people on the fringe of the law, doing things today that are beyond belief. And somewhere along the line, they're going to have to be stopped.

Let me leave this on a high note. Think about the positive aspects of what you can do. I don't care what school you're in—the business school, the law school—you never know where you're going to end up. Remember, I started out pre-med—I'm a pharmacist. I was in the drug business, and here I am selling hammers. You never know where you're going to be.

Remember: communication—major, major issue—no matter what you do; being able to handle failure; and being able to admit a mistake.

These are all very critical. If you follow those things—you know what? You can be successful, no matter what.

Thank you very much for listening.