

## 'Milken's Monsters' and the junk bond debacle

by Harley Schlanger

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### **The Predators' Ball: The Inside Story of Drexel Burnham and the Rise of the Junk Bond Raiders**

by Connie Bruck

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On April 20, Michael Milken reached an agreement with the Department of Justice to plead guilty to five counts of insider trading, pay a \$600 million fine, and work with the government to make other cases. I believe that, despite the bellyaching from the *Wall Street Journal* and others about the "police state" nature of the investigations and charges against Milken, most of the charges against him were designed to cover up and thereby leave untouched, the changes in corporate finance and trading wrought by Milken and his fellow predators.

The decision was made to sacrifice Drexel and the Milken operation, but there never was an investigation of what was behind Milken and what has been established by this operation. The reason was simply that Milken's operation, which paved the way for the boom in mergers and acquisitions and, eventually, the leveraged buy-outs (LBOs) of the 1980s, was a continuation of the policy launched by Donald Regan, William Simon, Walter Wriston, and others in the mid-1970s, and implemented when the Trilateral Commission installed the Carter administration. Their policy was to destroy the savings and loan associations, streamline the commercial banking system, and give complete control over U.S. credit and financial policy to a few, selected investment bankers and trading houses, like Merrill Lynch or Salomon Brothers.

The purpose was to transform the United States into a "post-industrial" society, which was made public in the Council on Foreign Relations' multi-volume program *Project 1980s*, which they called "controlled disintegration of the economy." Federal Reserve Chairman Paul Volcker's usurious interest rates set the stage. In quick succession, the early 1980s witnessed deregulation, the Securities and Exchange Commission (SEC) turning a blind eye to charges of "insider trading," and the incredible expansion of the high-yield bond markets ("junk bonds"), all as part of this transformation, which then became known as the Reagan "recovery." The disintegration continues under George Bush.

Especially interesting is how many of the important players in creating the junk bond hustle also turn up as owners or big players in the S&L scandals; and how many of them are either directly or indirectly tied to fortunes made through organized crime; and, of course, the fact that many are connected to the Anti-Defamation League. This group was appropriately named by Meshulam Riklis, "Milken's Monsters."

### **Background on Drexel**

Drexel was founded in Philadelphia in 1838. In 1871, it opened an office in New York under the name of Drexel, Morgan and Co. This soon became a single partnership, operating as J.P. Morgan and Co. in New York, and as Drexel and Co. in Philadelphia, and engaged in both commercial and investment banking. With the passage of the Glass-Steagall Act in 1934, prohibiting the same institution from engaging in both commercial and investment banking, Morgan and Drexel split, with Morgan staying in commercial banking (eventually becoming Morgan Guaranty Trust Co.) and Drexel remaining in investment banking. In 1966, Drexel merged with Harriman Ripley and Co. of New York. In 1970, there was an infusion of funds from Firestone Tire and

Rubber Co., and the name became Drexel Firestone. The next year, with Drexel merged with Burnham and Co., Connie Bruck characterizes the merger as being between a blueblood firm in need of funds (Drexel) and a Jewish firm with funds but no status (Burnham). In 1976, Drexel Burnham merged with William D. Witter, in which Campaignie Bruxelles Lambert (controlled by Baron Léon Lambert) had a controlling interest.

Michael Milken came to work at Drexel in 1970, after graduating from the University of California at Berkeley with a degree in business administration in 1968 and from the Wharton School. Milken came to the attention of I.W. Burnham II as early as 1973, when his complaint that he was being starved for capital reached Burnham. Burnham extended \$2 million to him, from which Milken made \$2 million for the firm—a 100% return—and Burnham made sure that Milken had ample funds and the autonomy he desired.

According to author Bruck, there was a major change in financial underwriting on Wall Street in 1975. Firms stopped paying fixed commissions to their underwriters, which meant that the traditional investment banking relations, in which one firm relied on one underwriter, was dropped and was replaced by “transactional banking,” in which investment banks were forced to compete anew on every deal. The result was that whichever investment bank could raise funds most quickly would win the position of underwriter for a firm seeking funds. As interest rates became more volatile, this became an immense advantage.

The question was ultimately raised at a Drexel corporate strategy session in 1979, “What if there were no difference between corporate finance and the high-yield bond department?” The answer was obvious: Drexel would then be the firm that would hold the advantage, as Milken had proven his ability to raise funds more rapidly than anyone else on Wall Street, especially through his zeal for the so-called “high-yield bond” market.

### ‘Milken’s Monsters’

Milken’s early customers, for whom he made huge profits and who, in turn, were among those he could count on in raising funds, were largely “outsiders,” who, Bruck says, had “alienated the establishment” through their “onslaughts on major banks.” This group, which included Meshulam Riklis, who gave them their name, included:

- Carl Lindner, who took over Cincinnati’s Provident Bank in 1966, then acquired Great American, a property- and casualty-insurance company, run by the financial holding company American Financial Corp. In 1974, when he began his relationship with Milken, Lindner was under investigation by the SEC for violating anti-fraud and anti-manipulation regulations. Lindner soon became Drexel’s biggest client, in both trading and corporate finance. Charles Keating is one of Lindner’s protégés, whom Lindner set up with the mortgage company in Arizona that became the parent of

Keating’s Lincoln S&L.

- Saul Steinberg, who started a computer leasing business, Leasco, in 1961, shortly after graduating from Wharton. With money made from stock market appreciation of Leasco, he took over a conservative, 150-year old company, Reliance Insurance Co. In 1969, he tried to take over Chemical Bank.

- Meshulam Riklis, who like Lindner and Steinberg, Bruck describes, made his own fortune by “relying on leverage, invention, keen business acumen, and a disdain for the unwritten as well as some of the written rules.” And like the other two, he was under investigation by the SEC throughout the 1970s. When Riklis first met Milken, he already had control of Rapid-American, which included companies such as International Playtex, Schenley Industries, Lerner Shops, and RKO-Stanley Warner Theatres. When Riklis took Rapid-American private in 1980, he worked out the details with Stanley Sporkin, then deputy to William Casey as head of enforcement for the SEC. Soon afterward, Lindner and Steinberg followed suit, taking their firms private with aid from Milken.

- Laurence Tisch, whose insurance company, CNA, invested heavily in junk bonds with Milken.

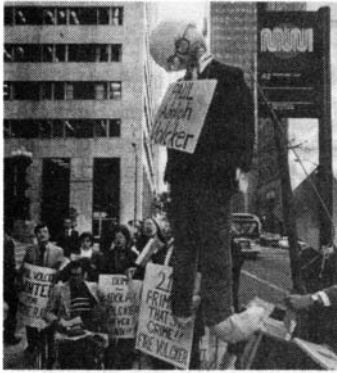
These four all invested heavily in each others’ enterprises. For example, throughout the 1970s, Lindner, through American Financial, was the second largest shareholder in Steinberg’s Reliance Financial. He was also a major shareholder in Riklis’s Rapid-American, and the second largest shareholder in Tisch’s Loews Corp.

It was to these interconnected networks that Milken would turn when he needed to raise funds. Others who became part of this grouping soon included:

- Nelson Peltz, described as the most unlikely character for this group, because he had little money or backing. Peltz was literally created by Milken, beginning in 1980, when Milken helped him and partner Peter May to take a 9.5% share of Sterling Bancorp, a New York bank holding company. In 1982, they took over Triangle Industries, which was used to leverage up for later acquisitions, such as Beverly Hills Savings, which they unsuccessfully tried to acquire in mid-1984. (Beverly Hills Savings was one of the S&Ls which bought Milken’s junk bonds. In 1985, Federal Savings and Loan Insurance Corp. (FSLIC) shut it down as insolvent.) They were more successful with National Can, which they took over in 1985.

- Victor Posner became an important client for Drexel in the mid-1970s, and was involved with Peltz and May in the National Can battle. He was another of those who joined with Steinberg, Riklis, and Lindner to buy each others’ Drexel-issued paper in the early 1980s. When he ran into tax problems in 1986, his attorney was Edward Bennett Williams.

- Carl Icahn, who conducted much of his “greenmailing”—forcing companies in which he held a sizable chunk



*A San Francisco demonstration in 1980 targets Paul Volcker's policy of "controlled disintegration of the economy." By raising the prime lending rate to 21%, Volcker set off the process that produced the junk bond and S&L diseases.*

to buy back their own stock at inflated prices lest they be taken over—with the backing of Milken and Drexel.

- Fred Carr, whose First Executive life insurance company was one of the leading purchasers of junk bonds.
- Thomas Spiegel, whose Colombia S&L, which was recently declared insolvent and taken over by the FDIC, at one time had over \$10 billion in junk in its portfolio.

By 1983, Posner, Spiegel, and Carr had become part of Milken's Monsters.

### How the takeovers worked

There were two basic methods Milken used in raising funds for takeovers. In one, he would issue what is called a "highly confident" letter. Milken would raise an initial amount of funds (usually from his "Monsters") to back a takeover bid, and then he would issue a letter, announcing that he had already raised a certain amount of funds and was "highly confident" that he could raise the rest. When one of these would circulate, his team at Drexel would raise additional funds from regular clients and investors very rapidly, creating the pool of funds needed for the takeover. Quite often his team raised more funds than necessary, and Milken would sometimes refund the initial seed money to his donor Monsters, plus a return for their help. This method was used when there was a raider prepared to launch a takeover bid, such as Peltz for National Can or Ronald Perelman's takeover of Revlon.

In another method, when Drexel had a target, but no takeover client in mind and no money, they would nevertheless announce that they had money—what they called an "Air Fund." According to an unnamed official cited by Bruck, "it was just a threat. The Air Fund stood for our not having a client with deep pockets who could be in a takeover. It was a substitute for the client we didn't have . . . we manufactured out of thin air—almost thin air—a credible takeover guy."

One of the more interesting figures among the Milken coterie who benefited from both of these methods is Ronald Perelman, who now controls Revlon. Perelman's start in finance came through his marriage to Faith Golding, the granddaughter of the founder of Sterling National Bank and

owner of the Essex House Hotel of New York. (When Perelman later divorced her, his lawyer was "his longtime friend," the late mob lawyer Roy Cohn.) Perelman was backed by Milken in his takeover of Pantry Pride, which he then used to take over Revlon.

Perelman's law firm in the takeover was Skadden Arps, a leader in the field, but he also benefited from advice from Arthur Liman, of Paul, Weiss, Rifkind, who became famous as chief counsel for the Senate's Iran-Contra committee hearings. Bruck reveals that Liman is a protégé of Simon Rifkind, who in turn was a board member of Revlon during the takeover attempt, and whose firm represented Revlon in their fight to fend off Perelman. Liman, who also wears the hat of Michael Milken's attorney, obviously saw no conflict in advising Perelman, saying he thought that Revlon should "negotiate" with Perelman, rather than fight him.

Perelman was later involved in the last, and most outrageous, takeover of S&Ls sanctioned by Federal Savings and Loan Insurance Corp. chief Danny Wall, whose "Southwest Plan" in December 1988 sold thrifts at fire sale prices. Perelman was given control over five insolvent Texas S&Ls and a \$900 million tax credit, which he could apply to Revlon, in return for some pocket change. This deal is presently under investigation by the House Banking Committee.

### 'Predators' Ball' in Japan

In November 1986, Milken went to Tokyo for an affair similar to the highly successful "Predators' Balls" he used to hold in the United States, where he would bring his major clients together for strategy sessions and schmoozing. The 1986 Predators' Ball in the U.S. included as speakers Ronald Perelman and Armand Hammer. Others who spoke were Senators Bill Bradley (D-N.J.), Frank Lautenberg (D-N.J.), Howard Metzenbaum (D-Ohio), and Alan Cranston (D-Calif.)—the last two being among the "Keating Five." Also attending, but not speaking, were Democrats Timothy Wirth, then a representative from Colorado, and Sen. Ted Kennedy. At this meeting Nelson Peltz joked to the assembly, many of whom had helped finance his takeovers, "Never have so few owed so much to so many."

Milken was convinced that the Japanese, who had previously limited themselves to purchase of triple-AAA credits in U.S. bond markets, were ready to get into the junk market. Bruck says that Milken wanted to compress his fundraising process, which had taken seven to eight years in the United States, to two years in Japan.

He had three steps in this process:

- 1) Build a client base of buyers. This had been facilitated in the United States to a large extent through "Milken's Monsters."
- 2) Raise capital for small-time entrepreneurs.
- 3) Transform the entrepreneurs into challengers, who would conduct raids on the giants of Japanese industry.

According to Bruck, Milken figured that if he could not

conduct hostile raids in Japan, he would at least increase the reservoir of capital with which to conduct raids in the United States.

### **Where were the regulators?**

As Milken's Monsters were unleashed on corporate America, there was pressure on Congress to look into the explosion of the junk bond market and the LBO craze it had spawned. The phenomenon of leveraging buyouts began in earnest in 1983 when former Treasury Secretary William Simon's Wesray backed the Gibson Greetings cards takeover. Hearings in Congress on takeovers were held in 1984 and again in early 1985 before the House Subcommittee on Telecommunications, Consumer Protection and Finance, chaired by Rep. Timothy Wirth. Wirth had initially been hostile to junk bonds, but was courted extensively by Drexel. In 1985, Wirth received approximately \$24,000 in contributions from Milken's networks. Eventually, he became a strong supporter of Drexel and junk bonds, to the point of attending the 1986 Predators' Ball. One of his top aides, David Aylward, left his staff to form a lobbying group called Alliance for Capital Access. The purpose of this lobby, backed by Drexel clients at Drexel's request, was to oppose the imposition by Congress of any limits on junk-bond financing. The leader of the Alliance was Larry Mizel of MDC Holdings, who was a close ally and business partner of Saul Steinberg.

Mizel's MDC is the holding company for Silverado S&L of Denver, which was declared insolvent by the FSLIC. Moreover, the Colorado thrift is being investigated for fraud and possible involvement in laundering funds to finance CIA covert operations. A prominent former board member of Silverado, and business partner of Mizel, is President George Bush's son, Neil Bush.

When the House proved unwilling to tackle the issue of LBOs, legislative initiative passed to the Senate. At the time, the chairman of the Senate Banking Committee's Subcommittee on Securities was Sen. Alfonse D'Amato (R-N.Y.). From 1981 to 1986, D'Amato had received \$70,750 in donations from Drexel, and \$40,600 from Morgan Stanley. Although D'Amato had pledged to his colleagues that there would be action, no legislation ever made it through the committee. He instead suggested that a federal study be conducted into junk bonds!

Of the 30 bills dealing with regulating takeovers—that were considered during 1984-85, not one passed.

Bruck points out that the legislative inaction was heavily influenced by the fact that the SEC did not favor any of the bills. In fact, the SEC and the Justice Department had what she calls a "pro-takeover attitude . . . that had fueled the M&A [mergers and acquisitions] activity of the early 1980s."

As in the case of the S&Ls, in which the mania for deregulation led FSLIC regulators to at least turn a blind eye to highly questionable activity, the SEC also took a hands-off

attitude toward the predators. In a report issued in June 1986 on the use of junk bonds in financing takeovers, the SEC concluded that there was no "justification for new regulatory initiatives aimed at curbing the use of this kind of debt issuance in takeover bids or indeed as it relates to any other aspects of corporate financing activity."

A similar conclusion was reached by the President's Council of Economic Advisers, which concluded in its 1985 annual report that mergers and acquisitions "improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management." This is precisely the pitch put forward by Milken, et. al., in justifying their raids.

### **Post mortem of a 'neat idea'**

The bankruptcy of Drexel Burnham Lambert and the plea-bargain agreement reached between the government and Milken's attorneys must not be the end of this saga. The damage done by the transformation of the financial system of this nation by those who opened the doors for Milken, combined with that done by deregulation of banking, cannot be undone without a full investigation, and proper punishment of those who are guilty. In the name of "free enterprise" and "deregulation," the U.S. economy has been pushed over the edge into bankruptcy.

To use Oliver North's terminology, it may have been a "neat idea" for the financial elites to use "outsiders" like Drexel and Milken's Monsters for their "controlled disintegration" restructuring of the U.S. economy. It is Milken's belief that he led what Bruck calls a "revolt of the underclass to scale the walls of corporate America and depose the rich, credentialed and powerful." In the process, he placed their wealth and power into the hands of thugs and crooks, with the full backing of officials in the last three administrations.

Those who facilitated this transformation must be put on trial for the genocidal implications of their policies. Billions of dollars were pulled out of necessary investment in infrastructure, home building, and research and development, and diverted instead to the speculative pool of junk and LBOs. Millions of jobs were lost, communities deprived of funds, while the junk bond dealers lived like kings, imposing their philosophy of greed and hedonism on the U.S. population.

As the junk markets collapse, it is not just paper that is lost. In the S&Ls fiasco, family savings have disappeared and the cost to the government—i.e., to the taxpayer—is estimated to be at least \$500 billion. Insurance companies and pension funds, drooling at the prospect of the high rates of return promised by the junk bond dealers, poured over \$150 billion into junk, much of which is trading today at 20-30¢ on the dollar.

The coverup of this operation must end. Until we as a nation come to terms with how we were so easily seduced and corrupted by the promise of quick wealth, we will not regain our soul.