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Serpent on the Rock

Kurt Eichenwald
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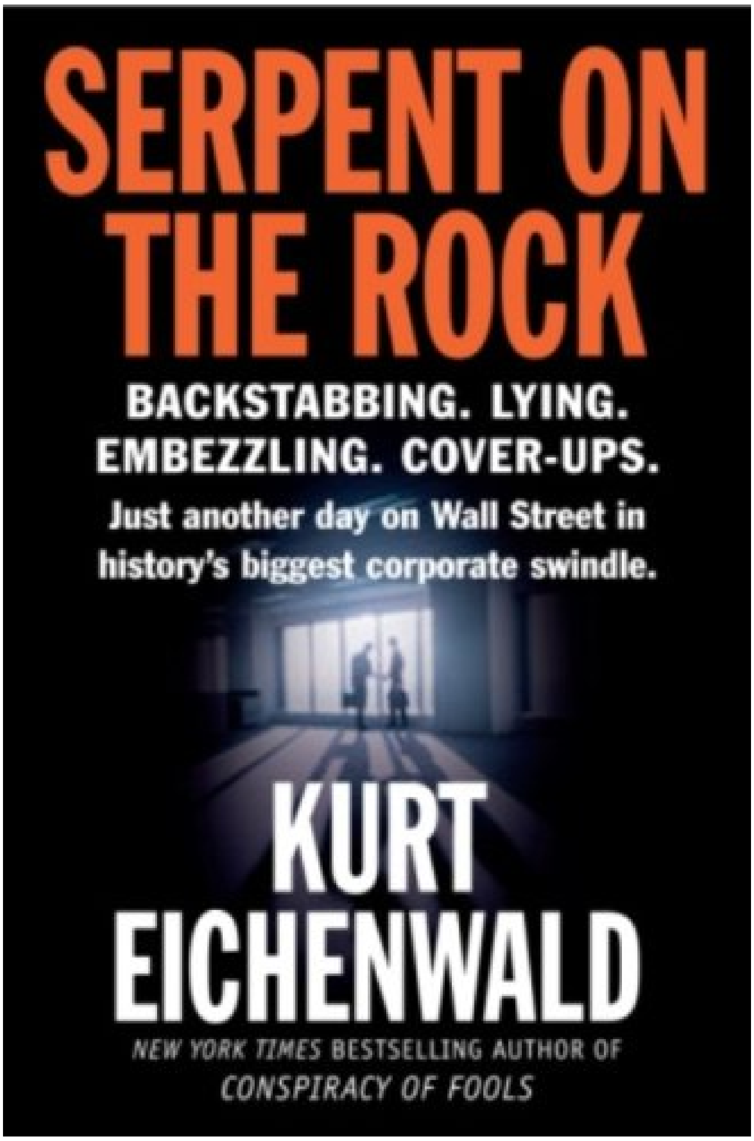

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A real-life thrillermdash;the story of kickbacks and payoffs, of shady deals struck in secret with known felons; a story in which half a million people lose enormous sumsmdash;some their lifersquo;s savingsmdash;in the largest securities fraud of the 1980s, with names like Onassis and Bush numbered among the victims.From the Trade Paperback edition.

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GREAT WRITING THAT MAKES YOU WANT TO KEEP THE PAGES TURNING. mdash;San Diego Union-TribuneBLOWS AWAY THRILLERS BY JOHN GRISHAM AND TOM CLANCY . . . This book has it all: suspense and horror, greed and pure malice, along with heartbreak and the eternal, valiant struggle of the little guy against the forces of evil . . . By two sentences into Serpent, I found myself hooked, unable to put the book down.mdash;InsightFrom the Trade Paperback edition.About the AuthorKurt Eichenwald has written about Wall Street for The New York Times since 1987. He began investigating the Prudential scandal in 1989 and, in 1993, took a leave from his daily Market Place column to investigate Prudential Bache full time. His efforts yielded Serpent on the Rock and a Publisher's Award from the Times.Excerpt. copy; Reprinted by permission. All rights reserved.CHAPTER 1Somebody at Bache Company was out to get them. The lieutenants in the firm's tax shelter department just knew it. They recognized all the old tricks--the sudden audits of expense statements, the false whispers about misconduct, the unrealistic sales expectations. Probably, they guessed, this was the revenge of that skirt chaser, Bob Sherman. But their boss, Stephen Blank, disregarded the signs. A political war was under way, and Blank would not even arm himself.It was the spring of 1979, and a quiet power struggle at Bache was coming to a head. Blank, a handsome, dark-haired thirty-three-year-old, won some dangerous enemies at the firm during his six years running the tax shelter department. His tough standards in selecting deals for Bache had stepped on the toes of the executives whose pet projects he rejected. When certain of his decision, Blank refused to yield in his judgment--he often told colleagues that reputations in the business were built not on the successful deals that were sold but on the flops that weren't.Still, Blank surprised even some admirers when he refused to sell a real estate deal brought in by Sherman, who as the cohead of retail sales stood higher on the Bache corporate ladder. Sherman was a tough, demanding executive who did not like to be turned down. For Blank, the refusal was a fatal move, one that helped set in motion a series of decisions that reshaped the firm forever.Steve Blank wound up running the tax shelter division at Bache almost by default. A former high school teacher, he backed his way onto Wall Street in 1970 as a consultant helping brokerage firms manage their paperwork. The timing was perfect--the back offices of brokerages were being crushed by the huge volume of paper they needed to move each day in a booming market. When the back-office problems started clearing up, Blank took a job at Bache sprucing up its training programs.Two years later, in 1973, Blank's big opportunity arrived. The executive who ran Bache's tiny tax shelter department abruptly resigned, and the firm launched a desperate search for a successor. Blank quickly emerged as the top candidate. He seemed the only one likely to have instant credibility with the sales force--he had already forged strong relationships with brokers and managers from his work in the training program. Until a permanent replacement could be found, Bache turned the business over to Blank. He was twenty-seven years old.The selection of such a young and relatively inexperienced manager to run a division of a major brokerage firm was met mostly with shrugs. At the time, the tax shelter business was something of an unwanted stepchild on Wall Street. The shelters, also known as limited partnerships or direct investments, raised pools of capital from individuals to invest in business favored by the tax code. Many of those preferences were built in by Congress to encourage investments in certain industries, such as construction and oil exploration. Over years of backroom deals, Congress also granted favorable tax treatment to an array of businesses of less economic value, such as horse breeding, movie production, and even Bible publishing. Any of those businesses could be used in a tax shelter.The risks of tax shelters were large, since investors sank huge amounts of cash into a single asset. If a big tenant pulled out of an office building owned by a shelter, for example, investors in that deal could well lose their money. But with high risk came the potential for high returns. The shelters usually allowed investors to defer paying or even reduce their taxes. But the shelters also provided income--such as the rents from an apartment building--and the potential of earning a profit when the asset was eventually sold.The high risks and tax-based rewards attracted only a small cadre of the wealthiest and most sophisticated clients--the people in a high income-tax bracket. With such a specialized and limited clientele, interest among stockbrokers in tax shelters remained fairly low in the early 1970s.Besides, the obscure real estate and oil deals left Wall Street's stock and bond brokers uneasy. Except to the experts, different pieces of real estate, or different oil wells, all looked pretty much alike. So investors had to trust Wall Street to sift through the available deals and offer the tax shelters with the highest likelihood of eventually producing a capital gain. That meant both the best properties and, equally as important, the most competent and reliable general partner to manage the shelter.But too often, these general partners, mostly real estate developers and oil wildcatters, impressed stockbrokers as a little too slick, maybe even sleazy. Some general partners sold shelters without knowing much about the business they were promoting--their fortunes were tied to the fat management fees they could charge, not to the growth of their deals. And the deals were complex, with few brokers having the knowledge to explain them properly to their clients. So tax shelters existed largely as a Wall Street footnote, a business that most firms had but did not particularly want.Then came May 1, 1975. On that day, known ever since on Wall Street as May Day, the securities industry bowed to congressional pressure and abandoned fixed commissions on the sale of stocks and bonds. The competition so often championed by brokerage firms for other industries suddenly romped down Wall Street, setting off a major rate war. Commissions plummeted. No longer could brokerage firms subsidize bloated operations through fat commissions on securities trades. Firms unable to adjust collapsed by the dozens. The industry had to either dramatically cut back expenses or find new products with higher commissions that could be pumped through the sales force. Suddenly tax shelters, which could be sold for higher commissions than stocks and bonds, didn't look so unappealing.Across Wall Street, firms like E. F. Hutton and Merrill Lynch rapidly built up financial firepower for the tax shelter business. At Bache, Blank had already started expanding slowly. In 1974, he hired Curtis Henry, a tough-talking Texan with a blunt style who had worked as a regional tax shelter marketer at Du Pont-Walston until that firm went under. Henry was given the job of finding and examining tax shelters that Bache could sell. At about the same time, Blank offered a full-time marketing job to David Hayes, a broker in Bache's Washington office who had worked with the department on a part-time basis for years.With Henry and Hayes as his anchor, Blank aggressively expanded around the country. He hired James Ashworth in San Francisco to market the shelters to Bache brokers in that region of the country. He also brought on John D'Elisa in Smithtown, New York, to perform the close examination, or due diligence, to make sure the deals were good for investors. Legally, Bache had an obligation to its clients to ensure it sold only shelters with the highest potential to succeed. The department had to resist the temptation to sell easily available, lousy deals that could bring huge commissions to the firm but saddle clients with disastrous investments.By 1978, Blank's temporary assignment had lasted five years. His department now housed twenty professionals and about ten administrative staffers working in the firm's cramped offices at 100 Gold Street in lower Manhattan.Even with the constant expansion, the department had trouble keeping up with business. Demand for shelters exploded--with high inflation, clients wanted investments like real estate that would likely increase in value at least as fast as consumer prices rose. As more deals were sold, brokers realized the juicy fees available to anyone who could land the lucrative job of general partner.Suddenly every Bache broker seemed to have a cousin or a friend or a neighbor who wanted to be a general partner in a tax shelter. Their proposals arrived in New York almost every day, some little more than handwritten scrawls on scraps of paper. The department uniformly tossed out those shaky deals, but brokers simply appealed to more senior executives in the firm. Even though the effort was rarely successful, the folks in tax shelters joked that Vince Lombardi, the famed football coach of the Green Bay Packers, didn't invent the power sweep--the end run had come out of Bache.The biggest political battle over the sale of a shelter began that same year, 1978. One afternoon, Blank received a telephone call from Bob Sherman in San Francisco. Sherman, a hard-driving former stockbroker with an aggressive hunger for profits, ran Bache's retail business in the West and was calling with a pitch: The Robert A. McNeil Corporation was putting together a new partnership investing in California apartment buildings. A buddy of Sherman's who worked for McNeil told him of the deal, and Sherman had promised his friend that Bache would sell it. Now he wanted Blank and his team to give the deal the once-over and get it ready for marketing.But the proposal left Blank uncomfortable. A number of similar tax shelters were already in the pipeline, and he did not want to offer the same kind of investment over and over. Deals needed sizzle to maintain brokers' attention, and nothing bored the sales force more than repetition. Beyond that, Blank had other concerns about the McNeil Corporation. The company was a polarizing force in the business--some thought it was the greatest, others thought it was the worst--and Blank did not want that kind of headache. As head of the department, he was responsible for accepting each deal, and he always wanted to be untroubled when he did.He checked with his regional marketers and heard the same negative reaction: Curtis Henry had worked with McNeil after the Du Pont collapse and told Blank he was uneasy about the company. He was also concerned about loans it arranged from the partnerships to other McNeil entities. The loans may have been legal, Henry said, but they sure would be fodder for future lawsuits if the investment went south. Blank's position hardened, and he rejected the proposed deal.Sherman couldn't believe it. He sent the same proposal back to Blank with instructions for him to look at it again. Blank stood firm. He had no tolerance for political gamesmanship; he wasn't about to let a deal he rejected get shoved down his throat. The marketing staff sensed a dangerous battle in the offing."Goddamned Sherman is trying to get me to sell this deal again," Blank grumbled to them in a conference call. To resolve the dispute, he was turning the proposal over to an outside law firm, Kutak, Rock Huie from Omaha. He would let it check out the matter and decide if Bache should be doing the deal.At the San Francisco branch, Sherman fumed. What kind of organization was this that a senior executive couldn't get a perfectly good deal done?Sherman directed the brunt of his anger at Jim Ashworth, the tax shelter coordinator for the West who occupied the adjoining office. Time and again, Sherman told Ashworth that he wanted the deal done. It was a good deal. What was the problem? he demanded. But the McNeil deal bothered Ashworth, too, and he said so. As Sherman seethed, Ashworth told him that he did not want to do business with McNeil.A few weeks later, Kutak, Rock delivered its findings. The lawyers refused to tell anyone in the tax shelter department what they learned. Instead, they insisted on reporting their findings to John Curran, Bache's general counsel. Curran met in his office with the lawyers and listened. In about an hour, he emerged with a judgment: Bache would not be doing McNeil's new partnerships.The McNeil deal was dead at Bache. The tax shelter boys had won. Sherman couldn't possibly reverse the firm's top lawyer. But they knew the battle was far from over. Their victory could transform the powerful Sherman into a dangerous enemy. The members of the department anxiously awaited any signs of trouble.Jim Ashworth hefted a carry-on bag over his shoulder as he hustled through a terminal at the Phoenix airport. He was looking for a pay phone so that he could call the office. It was early 1979, and Ashworth had just arrived on a flight from San Francisco. As a regional marketer, he spent most of his time on the road, visiting brokers at Bache branches in the West. Over a meal or a drink, he would tell them about upcoming tax shelters. Phoenix was just supposed to be another stop on his busy travel schedule.To a degree, Ashworth was glad to be getting away from the Bache branch in San Francisco for a while. Since the McNeil blowup, his relationship with Bob Sherman had been strained. Then, just the day before, the two men had bumped into each other at an out-of-town party. Sherman was with a woman who wasn't his wife. And from the look on Sherman's face, Ashworth knew the encounter was only going to cause more trouble.Ashworth found a bank of pay phones and called to check his messages. Steve Blank had called several times, he was told. His boss wanted to talk to him immediately. Ashworth called him from the airport."Jim, you need to get on the next plane for New York," Blank said."Why?""Take my word for it," Blank replied. "You've got to be here."Still in the dark, Ashworth booked the next flight to New York. Had he wanted to, Blank could not have shed much light on what was going on--he had been told very little himself. All he knew was that Ashworth, one of his best people, was under investigation by the firm.Ashworth arrived at the Bache Manhattan headquarters the next morning and was taken to a white, barren room near the firm's security department. Leo McGillicudey, the head of Bache security, came in and sat down. The meeting started off ugly, and quickly grew worse."Mr. Ashworth, you are under investigation," McGillicudey announced. "We are accusing you of cheating Bache on expense account items. I want to tell you, this is a very serious matter. You could go to jail. Do you understand?"Ashworth felt his heart sink. Like every other regional marketer, he submitted dozens of expense reports each year, with some $80,000 in annual charges from around the country. No one had ever questioned them before."Do you have financial problems?" McGillicudey asked."I don't have any financial problems," Ashworth sputtered. "I didn't do anything wrong. Why do you think I did?""I have your records. I have your expense accounts. I want you to tell me about them."McGillicudey pulled out a pile of Ashworth's expense statements submitted over four years and tossed it on the desk. Then he asked about each statement, day by day, item by item. Why did he spend each penny? On some days, he billed the firm fifty cents for crossing the Bay Bridge. Where were those receipts? The interrogation dragged on for eight hours, with Ashworth struggling to remember why he spent $50 here, $1.25 there. Finally he couldn't take any more.