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Love among the Ruins

On a clear afternoon in May 1986, Michael Price boarded a Lexington Avenue subway near his office in lower Manhattan and rode uptown to the electric razor-topped Citicorp Center. There, in a second-story, glass-enclosed conference room looking out on the atrium lobby, Price took over a $62 million loan from Citibank to the Storage Technology Corporation, a maker of data-storage devices. He paid roughly $41.9 million. When he was finished there, he strolled the several blocks to Bank of America's New York offices, where he assumed a $16.4 million loan from that West Coast institution to Storage Technology, for which he paid only about $10.5 million. The two deals together were the last in a string of Storage Technology bank debt and bond purchases that Price had orchestrated over the previous year and a half. The three portfolios that made up his Mutual Series Fund had socked $100 million of their $2 billion in assets under management into this one company and now owned about 35 percent of its total debt. The interesting twist here was that Storage Technology was bankrupt. Price is a vulture investor, and he was changing the direction of one of the largest bankruptcy cases in history—and making a killing in the process. To vulture investors today, it was one of the seminal deals in the recent history of their business.

It took Price nine years of buying the debt of distressed companies before he dared attempt a deal of this magnitude, and in 1986, shaky bank loans were still unfamiliar territory for investors. In the early 1980s, Price was one of the pioneer vultures trafficking in bank debt; the difficulty of buying into it and selling out of it kept most people away. In late 1984, he galloped away triumphantly from his first bulk

purchase in the case of AM International, a bankrupt maker of mimeograph machines. In retelling the story, there was no boasting in his tone, just the facts: “I had zero competition, all by myself, at great prices, with no risk.” Price’s fund earned annual returns of more than 30 percent on its investment, and he soon began putting those profits to work elsewhere.

That was when he began considering an investment in Storage Technology. The Louisville, Colorado, company had sought bankruptcy court protection from creditors the previous fall when losses became too heavy to bear. With heightened competition from IBM, a rushed installation of disk drives that ended up having faulty parts, and an overly ambitious expansion program, earnings had evaporated. Price scanned the financial statement and saw cash, real estate, and receivables from a respectable customer list. In a word, value. Before year-end, he started buying bonds.

In January 1985, he called Ryal Poppa. The bespectacled, fifty-two-year-old chief executive of Storage Technology had been on the job just two weeks. A turnaround manager by trade, he’d been brought in by directors to revive the beleaguered company. “Michael introduced himself in his matter-of-fact voice,” Poppa recalled. “He said, ‘Here’s what I do. I seldom get in people’s way. I want to profit on your bonds, and I can help you in a reorganization.’ I said, ‘Why don’t we get together?’ Then Michael said, ‘I just have one question to ask. Why did you leave a secure job in Minnesota for this?’ I said, ‘Because I believe in this company and its products, and I think I can turn it around.’ ”

That must have been what Price wanted to hear. In the days and weeks that followed, he started adding to his position with heaping portions of bonds and bank debt. Later he explained to Poppa: “If you thought *you* could make money, I thought *I* could make money.” He acquired his first bank loan for fifty cents on the dollar and subsequent loans for as little as thirty-seven cents. At times Poppa would ask Price for his assistance in buying out creditors who might hinder the company’s reorganization. “When we had creditors who were tired of the bankruptcy or who didn’t like management or trust me or whatever, I’d call Michael and say, ‘This creditor is in my way. Can you see if you can take him out?’ ” But Price was always one step ahead of Poppa: “I had a sense as to who was constructive and who was not,” Price said. “Ryal and I had a common goal.”

He even helped Poppa ward off a bidder for the whole company, Bennett LeBow, whose offer was far below what the CEO considered

fair. “Ben, in frustration with me, thought I was stiff-arming him, which I was,” Poppa recounted. “He called Michael, who arranged a meeting of the three of us at my hotel in New York, the Park Lane. At one point Michael turned to me and said, ‘I know Ben LeBow. Let me handle this.’ I said, ‘All right, but I’ll not take less than nine hundred million dollars.’ Bennett went as high as four hundred and fifty, and Michael explained to him that the company was worth a lot more. He helped me hold him at bay.”

By early 1986, Price’s fund owned more than a third of the Storage Technology bank debt, which gave him considerable clout in the process of developing a reorganization plan—which pays off outstanding creditors and reformulates company’s financial structure to bring the company out of bankruptcy. Since a plan must be accepted by a majority of voting creditors in each class who hold two-thirds in amount of the claims of those voting, Price’s holding gave him the power to block any reorganization plan that he didn’t like. But he didn’t own enough debt to push through a plan if enough other creditors were opposed.

At the time, the head of the creditors’ committee was a representative of Citibank who had been spurning the company’s proposals for a reorganization plan, holding out for a much higher recovery. He had a paralyzing effect on the bankruptcy—and on Price. “I had all this money tied up,” Price said. “There’d be no progress unless that guy was changed.” Price was already working on buying him out when Poppa phoned to ask Price to buy out the loan, which at $62 million was the granddaddy of Storage Technology’s bank loans. It was the very next day that Price took that uptown subway to close the Citibank purchase, and as soon as he was finished, he picked up the phone to report to Poppa. “Listen, I just bought out your problem, Citicorp. Let’s go do our deal.” They made a date to have dinner on June 11.

It was raining that evening when Poppa and his advisers and Price and his attorneys, including the esteemed bankruptcy lawyer Harvey R. Miller, sat down to a multiple-course dinner at The Box Tree, a dark-paneled Continental restaurant located in an East Side townhouse. In between hearty servings of smoked salmon, pâté, salad, duck, and steak, the assembled negotiators sipped on two bottles of Opus 1, the $100-a-bottle cabernet sauvignon coproduced by Baron de Rothschild and Robert Mondavi. The discussion centered on the structure of the bonds to be issued in the reorganization. Late in the evening, when the two sides locked over some crucial points, Price and Poppa left the table

so that they could speak freely, one on one. It was eleven P.M. The two men stepped out into the wet blackness of Forty-ninth Street, and, stopping under a tree between Second and Third Avenues, they talked for a short while and settled on the amount of bonds to be issued, a call provision, and a thirty-month deferral of interest payments. This last point was especially critical for the company. Poppa told Price that he needed to hold off paying interest in order to have $70 million a year to develop a library storage device that retrieves vast amounts of information for insurance companies and airline reservations systems. Without the development funds, Storage would not be able to jump-start its business. Price was willing.

Poppa admired Price's negotiating savvy. "He could be an emotional, strong-willed table pounder," he said. "But he never raised his voice with me. We went back and forth until we came to a midpoint."

After the dinner broke up, Price and his chief lawyer, Miller, left the others and walked down the street together. Impressed by what he'd just seen and heard, Miller asked Price, "Where did you learn to negotiate? Did you ever work in the garment district?" He knew that when the garment center was thriving, it was full of shrewd traders. A deal was never a deal until delivery. Miller's instincts about Price were right on: Years before, during college vacations, he had worked on Seventh Avenue as an assistant sportswear buyer. He worked for his father, who had not finished his own college education at Wharton Business School because he ran out of money, but who then became co-owner and chief buyer for a West Coast chain of women's apparel stores. After looking over stock and sales figures in the mornings, the younger Price spent the afternoons haggling with clothing manufacturers, trying to get them to ship their "hot" dress or sweater to the stores at a good price. That process was known in the district as *handling* (a Yiddish word pronounced "hondeling"). Said Miller: "I would describe Michael as a 'handler.' Handlers never give up. You could slap him in the face and kick him in the teeth, and he'd come back and say, 'Well, how about another penny?" Irrepressible Michael was irrepressible—a slowly grinding force." Together, Price and Miller sold the Storage Technology creditors' committee on the reorganization package.

The company emerged from bankruptcy in June 1987 pretty much as Price and Poppa had arranged that night under the shelter of a tree on Forty-ninth Street. Price had paid an average of about forty-seven cents on the dollar for his holdings. In exchange for them, he got roughly fifteen cents in cash, forty-five cents in bonds, and 23 percent

of the stock in the reorganized Storage Technology. Put another way Mutual Series got a large minority stake in a company for nothing. The company redeemed the bonds at a premium to par, and over the years Mutual Series slowly sold the stock, which flew as the company flourished. Total annual returns on Mutual Series's investment over five years through the end of 1991: between 35 and 40 percent. Price says it's all in the homework. "Our goal is to do that early work, and then if we think the time is right, to really aggressively go after the banks for a large slug of paper," he explained, as naturally as a hunter describing the operation of his gun.

From Storage Technology, Price went on to forage in the bank loans of Manville, LTV, Western Company of North America, Zapata, Smith International, Maxicare, and Integrated Resources and was a major player in Columbia Gas and Zenith Labs. In the case of Manville, the asbestos manufacturer, a $50 million investment in bank debt, bonds, and preferred stock became cash, preferreds, bonds, and more than three million shares of stock when the company emerged after five years of bankruptcy. Mutual Series scored about 25 percent in annualized returns. But in the late 1980s, the spreads on bank debt began to narrow. "The mid-eighties were really unique in the bankruptcy game," Price said wistfully. "There was a real window. Inefficiency. I had no competition. That doesn't happen as much any more." So he had to look elsewhere for the big prizes. And he found them.

Hailing from a middle-class background on Long Island, Price took to investing at an early age. In high school, while playing football and lacrosse, he became intrigued with the stock market; and in college at the University of Oklahoma, he studied finance (and the history of science). By the end of college he'd moved from negotiating purchases of clothing stock to negotiating purchases of common stock as an assistant to his father's stockbroker. The following year, 1974, he moved to Mutual Shares, the first of the three Mutual Series funds.

By the age of forty (in 1992), Price was a seasoned vulture and value investor sitting atop a mountain of $4.2 billion in assets under management. He owned Heine Securities, the advisory company that managed the Mutual Series's assets. Based on the rule of thumb that fund operators are worth 2 to 5 percent of assets under management, Heine Securities was worth $84 million to $210 million (although the value of a money management firm is intangible and considered worth whatever someone is willing to pay at the time). At Mutual Series's headquarters in posh Short Hills, New Jersey, where the company had

moved from sweaty lower Broadway, Price led a team of twenty-five analysts and traders, plus twenty-five other employees. His private office overlooking the John F. Kennedy Parkway was filled with inviting, cushiony furniture. On one wall, overpowering the room, was a near-life-size portrait of a master of the fox hunt seated stiffly on a horse, painted by Lionel Edwards in the early 1900s. The office appeared untouched, as if the last person in it had been the interior decorator. Price was usually found several yards away, perched on a hard-backed chair in the middle of a cluttered trading desk, ear pressed to the phone, reviewing a lineup of four computer screens. There, he immersed himself in the funds' major dealings while guiding the traders around him.

Medium in height, with receding black hair and a steady voice that could turn a hard edge in an instant, Price ran his office informally, operating on a personal basis with everyone. He was mercurial and could be abruptly critical, but because he was well aware of these tendencies, he made a conscious effort to confer praise. People liked his to-the-point, sometimes glib, manner. Asked at a bankruptcy conference in 1991 how he dealt with trade creditors, which are a company's suppliers, Price had this to say: "Trade creditors as a class are normally small. So you pay them too much and get rid of them. It's a cost of doing business, like paying the lawyers." Enough said. Or listen to Price on golf: "It's worse than going to the dentist." (He preferred an occasional polo match and horseback riding with his wife, Bunny, whom he has since divorced, and his three children near their New Jersey estate home.)

In his first seventeen years of managing Mutual Series's money, Price built a solid performance record. The three funds scored compounded annual returns in the high teens over the long term. The results would have been better but for Mutual Series's ownership of some of the bonds and nearly 13 percent of the preferred stock of R. H. Macy & Company. The funds wrote off that investment in 1990; and partly as a result, they suffered losses of between 8 and 10 percent. Macy declared bankruptcy early in 1992. (It was later acquired by Federated Department Stores.)

Over the years, a substantial amount of the money under Price's guard has gone into the securities and other claims of bankrupt companies, and the size of these investments rises and falls according to the opportunities. How he has managed to do so well in one specialty, while investing in the vast expanse of other, healthier companies as well, is explained in part by a methodology that seeks out value at every

stage of a company's life cycle. At one point, a company may be an undervalued growth stock; later it might become an acquisition target and, for Price, become an arbitrage opportunity; or at some point it might go bankrupt and become a vulture investment. As he put it: "You own the cheap stock, it becomes the target of a deal, you do the arbitrage, they screw up the deal, it becomes a bankruptcy, and you play that. We don't forget the companies we trade in. We try to watch companies over all parts of that cycle. We watch the acquisitions, we think about whether they're sensible, and we don't lose track." They are sensible, in general, if they have the potential to earn returns of 20 percent or more. By that measure, Storage Technology turned out to make tremendous sense. In that case, of course, Price showed how taking control of a situation can make a big difference in those numbers.

BEGINNINGS

Modern-day vulture investing has its roots in the rubble of 1929. And Price is a key link between today's activist vulture investing and the pioneering era of bankruptcy investing, for his mentor and longtime partner was Max Heine, a man who many consider the dean of bankruptcy investing in the postdepression era. In many ways, he helped set the stage for the era that would follow. With a passion for investing, Heine took advantage of the gap he saw between the price of a bankrupt company's stocks and bonds and the value of that company's assets—a gap formed by the scarcity of people treading among the corporate wounded. Over time, Heine's involvement as a broker and trader in depressed bonds of distressed companies revealed the opportunities to others. As the numbers and the size of bankruptcies grew, the business of investing in them took off. That second generation went a step farther than Heine ever did, taking active roles in the reorganization of companies.

The son of a doctor, Heine emigrated to New York from Berlin in 1934 when he was in his early twenties and soon began sifting through the scrap heap of companies shattered by the Great Depression. When he was married, he and his bride were given a check that the giver specified was to go toward buying furniture. Instead, he invested it in the bonds of a busted railroad. But as a brokerage firm operator, Heine was not obsessed so much with making money as he was with the intellectual rewards of discovering value in the rough. Even-tempered, gentle in manner, he operated above the usual Wall Street frenzy in which traders test their physical limits for every point. "Wall Street is

made up of a bunch of pretty greedy people," said Price. "Max wasn't that way. Wall Street's made up of a lot of arrogant people. Max had zero arrogance. He had patience. So he had a very stand-back-and-think-it-over view of companies."

In 1949, Heine and a partner launched the Mutual Shares Fund—an open-end, no-load mutual fund—as a subsidiary of his brokerage firm. The fund was designed specifically to serve Heine's German refugee friends and their families, for whom he'd been investing for years. Now instead of shelling out huge commissions to invest a few thousand dollars here and there in individual stocks, they could buy shares in Heine's fund. He would remain fiercely loyal to these old friends into their old age, making sure that they continued to get the best, most personal service. With Heine as its broker, the fund concentrated on value investments of all kinds, including bankruptcies. His guiding principle was that of all value investors: Don't Lose Money. In bankruptcies, that meant investing in senior securities that were first in line to be paid off. Most often, too, he would wait to invest until the debtor had filed its reorganization plan in which the recoveries for bondholders were clearly defined. Even then, so few investors pursued bankruptcies that the bonds were trading at bargain prices—much lower than what they would eventually be worth when the company emerged from bankruptcy. It was one of the first forms of arbitrage, which in strict terms is buying a security in one market and selling it in another to profit from price discrepancies.

In the early 1960s, Heine led his brokerage and mutual fund operations much farther into bankruptcy investing when he ran across Hans Jacobson, a towering man who had made bankrupt railroads his life. Like Heine, Jacobson was a German Jew who had fled the growing hatred in his native country. When he arrived in New York in 1939, he began working as a trader for A. G. Becker, the old-line Chicago investment bank; but the slow days of a listless stock market soon drove him to distraction. Out of sheer boredom, he enrolled in a course at the New York Institute of Finance on investing in bankrupt railroads, taught by railroad analyst Pat McGinnis. At the time, the vast majority of railroad companies were in bankruptcy: the Central Railroad of New Jersey, the Erie Railroad, Lehigh Valley Railroad, Chicago Rock Island Railroad, Missouri Pacific Railroad, Chicago & North Western Transportation Company, Western Pacific Railroad, Denver Rio Grande Railroad, the Soo Line, and the Texas & New Orleans Railroad, among others. Jacobson was hooked. As the war in Europe escalated and drew

in the United States, the rail industry was coming alive. Jacobson and other brokers stirred up investor interest in the bonds. “Most of the railroads were now making real money and would be able to do something for their defaulted bonds,” the eighty-seven-year-old Jacobson recounted in 1991, with an accent still richly flavored with German. “Then, eventually some of them started formulating plans of reorganization, and then you had some indication of what these securities conceivably could be worth.”

Jacobson was actually one of the smaller investors who were then trafficking in broken trains. Trading alongside him in the 1940s and continuing on into the 1970s were some of the men who would become great names on Wall Street. Seymour (Cy) Lewis, the legendary trader and chairman at Bear, Stearns & Company, invested in bankrupt railroads and some distressed public utility companies. Charles Allen, of Allen & Company, and Gustave Levy, the chairman of Goldman Sachs & Company, also made boxcarloads of money buying the bonds of troubled utilities and bankrupt railroads—money that helped them pursue other types of businesses later on. In fact, Levy and Lewis also took the Pat McGinnis course that turned Jacobson into a railroad man.

One day in 1963, shortly after Jacobson had quit a trading job, he was walking near Wall Street when he ran into Heine, whom he had met only once before. Heine recognized him, greeting him as if they were old friends, and asked him what he was doing. Jacobson replied, “Quite frankly, I’m looking for a job.” On the spot, Heine offered him a position as a trader in his brokerage shop. He became one of the Street’s experts in trading bankrupt railroad bonds and someone on whom Heine relied considerably. Years later, two traders were surprised when they paid a visit to Jacobson to discuss some investments. “We were sitting in a room,” said one, “and every ten minutes this other old guy would knock on the door and come in very meek and say to Jacobson, ‘Hans, they’re bidding thirty for the Erie Lackawanna.’ Hans would say, ‘Take it.’ And this man would go away and come back ten minutes later with another trade. And we thought, ‘Who the hell is this guy?’ Lo and behold, it’s Max Heine asking Jacobson what to do with the railroad bonds.”

Working for Heine, Jacobson played the arbitrage game in railroads, sharing a field populated mostly by big brokerage houses like Goldman Sachs; Bear, Stearns; and Salomon Brothers. Jacobson did not always wait around for the plan of reorganization to be filed. In one case in the 1970s, he brokered the sale of several million dollars’ worth of Erie

Lackawanna bonds at about ten cents on the dollar to a mutual fund. For a year or two, the bonds sat at that level. “They called me in one day and asked what should they do with them. Should they sell them? I said, ‘If you want to sell them, I will buy them from you because I’m firmly convinced that the bonds are going to be worth several times over what I’m offering you.’ ” He bought them back at about the price he’d sold them for and sold them to yet another investor. Whoever ended up with the bonds at the time of reorganization received $1,100 for each Erie mortgage bond—110 cents on the dollar.

THE PENN CENTRAL

But it was the bankruptcy of the Penn Central Railroad in the 1970s that marked a turning point in the practice of bankruptcy investing. Because it was the largest bankruptcy of its time by far and offered dozens of different bond issues, the Penn Central attracted more investors than had any previous case. And because it was profitable for them, it would multiply the population of vulture investors. Heine and Jacobson would no longer be among the relative few, and the returns that they would reap would not be as easy to come by nor as plump as those they had taken before.

For years, the Pennsylvania Railroad had hauled coal from West Virginia to Ohio, competing almost directly with the Chesapeake & Ohio and the New York Central Railroads. To eliminate the redundancies between them, the Pennsylvania and New York Central Railroads merged in 1968. But the unions insisted on guaranteed jobs for all workers. Worse, inept management created chaos in newly merged operations, and the economy slipped into a recession, draining cash from the company. In 1970, the new Penn Central declared bankruptcy, with $3.6 billion in liabilities. Under the Railroad Reorganization Act, the government merged all the railroad operations of the Penn Central and the other bankrupt northeastern railroads into Conrail in 1976. Without a railroad, Penn Central was left as a conglomerate of real estate, natural resources, and amusement parks. Its financial structure contained multiple levels of debt—much of it secured by mortgages on property or individual tunnels or acreage—and preferred and common stock.

Over the eight years of the bankruptcy, the values in Penn Central emerged gradually. For one thing, real estate, which hit the skids in the early 1970s, began to spring back around the middle of the decade. Also, Victor Palmieri, a maestro among turnaround managers who had

taken charge of the company, added value as he managed the nonrail operating assets and sold off some. As the bankruptcy wore on, a growing horde of investors moved into the various bonds and certificates of participation—especially in the few years before the consummation of the reorganization plan.

One investor in Penn Central bonds was a young Michael Price. Heine hired Price on the very day he interviewed him for a job in 1974. By then, the Mutual Shares Fund had grown to some $5 million, and although that was hardly an astounding amount, Heine needed help handling it. Price, who had recently graduated from college, had been working at the brokerage operation owned by one of Heine's former partners, Howard Spingarn. When he told his boss that he was going to work for Heine, Spingarn said, "That's good. Max is a good man. Plus, they have this little fund." Later Heine would tell *Business Week:* "Finding Mike was like winning the lottery." With three daughters, Heine treated him like the son he never had, and they worked side by side. By 1976 Price was making all his own investment decisions; by the following year he was doing half the work on the fund; and by the mid-eighties he was president. As the managers' performance shined, the money came rolling in to Mutual Shares and later two newer funds, and all the funds ballooned in size. Heine and Price continued their extraordinarily close collaboration until Heine died in 1988 at the age of seventy-seven when he was struck by a car while on vacation in Tucson. In 1991, after a rare down year, Price told *Forbes*: "I wish I had Max around, somebody to give me perspective. There are very few people I can talk to [with his experience]. It's the difference between being a coach and being a quarterback."

Price learned all the basics from Heine and Jacobson. During his first year at the small brokerage-investment firm, he'd listen to them talk about railroad bankruptcies and took reading home to learn more. The first block of bonds he bought on his own was a Chicago & Erie issue due in 1982 and yielding 5 percent, which represented a major section of the Erie Lackawanna Railroad, one of the many northeast railroads that, like the Penn Central, defaulted on their loans in the 1970s. For $5,000 worth, he paid roughly thirteen cents on the dollar. Not only were they cheap, but these bonds were secured for more than their principal amount, or face value (bonds usually carry a face value of $1,000 apiece), by warehouses, 2,500 miles of track that could be picked up and sold as scrap, locomotives, railcars, and real estate. Four years later, when the Erie Lackawanna reorganized, Price collected

roughly ten times his money for the holdings. At one point at the end of 1978, 7 percent of Mutual Shares's funds were invested in bankrupt railroad securities.

The players in the Penn Central bankruptcy included some of the preeminent junk bond investors of the 1980s and vulture investors of the late 1980s and early 1990s. Vulture investor Martin Whitman put his money down after the reorganization plan was released. He shelled out $100,000 for senior "first mortgage" bonds that were solidly secured by assets; and within a year, he made five times his money when he received the full face value of his bonds in the reorganization. Goldman Sachs bought bonds when they were trading in the teens and wound up getting 100 cents on the dollar for them. Years later the venerable firm would storm into activist vulture investing with the $783 million Water Street Corporate Recovery Fund and would exit just as abruptly. Talton Embry, head of distressed-securities manager Magten Asset Management, was also a Penn Central Player.

New York vulture Balfour Investors bought the bonds of a Penn Central subsidiary, the New York, New Haven, and Hartford Railroad, for twenty cents on the dollar; and a few years later, in the late 1970s, sold them for seventy-eight cents on the dollar to Saul Steinberg. Steinberg, who a decade earlier had staged a hostile raid on Chemical Bank and who would later take on The Walt Disney Company, among others, accumulated a 13 percent stake in the newly reorganized Penn Central. He then sold his position to the shrewd Cincinnati investor Carl Lindner, who later took control of the shell of the old railroad.

The broker for Steinberg and Lindner on these trades was a young man named Michael Milken, who was then investing in bankrupt and near-bankrupt companies at Drexel, Burnham, Lambert and would later achieve fame and infamy as the czar of the junk bond market. Another trader, Randall Smith Jr., who at the time was mainly a convertible bond specialist at Bear, Stearns, later went on to found the largest brokerage firm trading exclusively in vulture investments, R. D. Smith & Company. Penn Central was his first big hit in the bankruptcy game.

FROM RAILROADS TO REAL ESTATE

The railroad bankruptcies produced the first surge of vulture investing in modern times. But in the 1970s, as Penn Central was in the thick of its restructuring, vultures had a new wave to ride: real estate investment trusts (REITs). The REITs were essentially mutual funds that held real estate instead of stocks or bonds. They had grown out of the 1960

legislation that provided exemption from corporate income tax for qualified trusts. By 1974, they had burgeoned in number to more than 200 and in assets to $20.5 billion. The collapse of the real estate market in 1974 brought down hundreds of the trusts. Many of them liquidated their assets, but others continued operating by selling off assets to pay off bank lenders. The REITs were not actually in bankruptcy, but they were severely depressed.

Vulture investors romped in the REITs' bonds, some of which had sunk to as low as a tenth of their face value. Among the most enthusiastic was Deltec Securities, which had been a pioneer in such outposts as Latin American debt. The firm's then-president, Arthur Byrnes, visited about forty REITs. "Their assets were all over the country," he said. "If you wanted to know them well you had to go see the properties." He would buy bonds at twenty and thirty cents on the dollar and collect interest; later, in the out-of-court restructuring, he would trade them in for new bonds or stock. "The REITs were a roaring success in our case because we were right on the trend." Byrnes said. "The real estate market got better. These managements worked themselves out of it—inflation bailed them out of it—and they managed to get the banks satisfied and ended up having an ongoing company with no debt and a big tax loss carry forward and some value for the shareholders."

Some investors like Goldman Sachs made money by investing in the bonds of REITs that were liquidating. The environment was so inflationary that between the time of the announcement of the liquidation and the completion, rising prices boosted values far beyond original expectations. As the railroad bankruptcies had, the REIT disasters drew new investors into the vulture community. Among them were Stanford Phelps; Morgens, Waterfall, Vintiadis & Co.; and Samuel Zell—a man who would later become known as "the Grave Dancer." And here, again, was Milken. He bought into REITs that were liquidating and REITs that were turning their operations around. Nervous about the firm's investment in such low-grade companies, Drexel's conservative chairman, Tubby Burnham, ordered Milken to withdraw. He complied—but only by buying out the firm's position himself with a group of colleagues. Needless to say, he made a bundle. Late in the day, Carl Icahn, then an arbitrageur and soon to become a corporate raider, turned up in this market. In 1978, he gained control of a $30 million REIT by the name of Baird and Warner. He renamed it Bayswater, after his childhood home in Bayswater, Queens, New York, and turned it into a vehicle for staging raids on corporations.

THE MODERN ERA

In the 1980s, the playing field for vultures grew for two reasons. First, severe downturns in sectors of the economy such as energy and steel sent many companies reeling. Second, executives at struggling corporations began to realize that the 1978 revision of the bankruptcy code encouraged bankrupt companies to reorganize, and they took advantage of the new system. Before, managements of large companies that entered bankruptcy were obliged to hand over control to a trustee and to obtain 100 percent approval of the creditors in any given class. Under the Chapter 11 section of the new code, managements keep their jobs. And getting out of bankruptcy is made easier by requiring yes votes of only two-thirds in principal amount and half in number of those voting in any given class of claims.

More opportunities attracted even more investors. At the same time, the veterans among these discount investors began to move from passive purchaser to active vulture. They now had the experience, the contacts, and the money to influence companies and their bankruptcy reorganizations. And they also had the need, because the growing competition in their arena was hoisting the prices of busted bonds and squeezing returns on the investments. Here and there, scavenging investors began to throw their weight around in attempts to secure a bigger return for themselves. Michael Price's masterful engineering at Storage Technology was one of the most prominent examples.

Another was accomplished by Balfour Investors, a partnership of two men who had started out as securities analysts, Harry Freund and Jay Goldsmith. Balfour became the principal catalyst in the bankruptcy of Nucorp Energy, Inc. Mainly a real estate concern until 1979, Nucorp responded to the sharp rise in oil prices by conducting a massive expansion into the oil and gas business as a drilling equipment supplier. Revenues gushed from $91 million in 1980 to $461 million in 1981—helped, unfortunately, by management's fraudulent accounting practices. The following year, when the price of oil sank in the oil glut, Nucorp was unable to foot the interest on $300 million in debt and filed for bankruptcy. Balfour entered the scene in 1984, buying up the most senior issue of bonds; and right away Goldsmith received a call from the Drexel, Burnham, Lambert trading desk. As he told it: "Michael Milken's and my relationship goes back to when he started at Drexel Firestone [the precursor to Drexel, Burnham, Lambert] in Philadelphia. I knew him a long time. I always had great respect for him. So Drexel

called me and said, 'Jay, you're buying the wrong piece.' " They argued that Balfour was not actually buying a senior class of bonds.

But Goldsmith and Freund stuck to their original inclinations, ultimately picking up $37 million of the bonds for $14 million; and indeed the court did consider their holdings to be senior to the other issue. The task remained of negotiating a reorganization plan with other creditors—among them, vulture investors Ronald LaBow of New York's Neuberger Berman and Talton Embry of Magten Asset Management—and the banks, led by Continental Illinois. But relations were not always amicable. In one negotiating session with about thirty people, Goldsmith criticized the bank for its past support of the company and spoke his mind so harshly that he drove one woman to tears. She raged at Goldsmith, he recounted, "You New York j-j-j-j-j-junk peddlers!" After that, he said, "They hated me." They worked out an agreement whereby the banks would get paid cash and equity in the reorganized Nucorp—which was still going to be an oil and gas concern, but one with a $350 million tax loss carryforward. The senior bondholders, including Balfour, would take 76 percent of the equity, and the other more junior bondholders would receive 6.5 percent of the equity.

But there was a final sticking point. The bank group refused to accept Goldsmith as a director. The bank representatives called Freund at home while he was observing a Jewish holiday to tell him that his partner would not be allowed to serve on the board. As Freund recalled, "They said, 'The whole thing hinges on this; we will simply not accept him.' I said, 'Fine. Then, forget the whole deal.' " They didn't, and when the company emerged from bankruptcy in 1986, Freund and Goldsmith were chairman and vice chairman, respectively. By the end of the year, they had sold their stock, in part to Sam Zell who eventually became the chairman. All told, Balfour had quadrupled its money in two and a half years.

Then, there are also cases of vultures exercising leverage in companies that were just on the verge of bankruptcy. Take Marty Whitman. In July 1986 his firm invested $25 million in Petro-Lewis Corporation, a Denver-based oil-drilling outfit that, like Nucorp, was a victim of the energy glut. Struggling to avoid bankruptcy, the company was attempting to convince its bondholders to trade their old bonds in for new ones that would lower the company's debt. Whitman, who owned about half of the two senior issues went on the warpath against the proposed

exchange by launching a formal process of soliciting bondholders to vote against the swap. Petro-Lewis countered with a lawsuit. "I think they thought I was the devil," said Whitman. That's when Freeport-McMoran came along. The New Orleans exploration company, headed by a swaggering Texan by the name of Jim Bob Moffitt, wanted control of Petro-Lewis and wanted Whitman's help in getting it. Moffitt and Whitman negotiated the sale of the two senior bond issues to Moffitt—one for eighty-six cents on the dollar and the other for eighty-eight cents, nearly twice what Whitman had paid. Whitman's $25 million had turned into $40 million in just four months.

By the end of the 1980s, the business and financial world had taken a bad fall. The stock market crash of October 1987 sounded an alarm on the economy, and the collapse of the junk bond market two years later was the final bell: the economy was screeching to a halt. On Wall Street, the mergers and acquisitions business stopped cold and silent, and the pink slips started to fly like so many stock sales slips at the New York Stock Exchange. Throughout the economy, business conditions worsened, and the lines at unemployment offices stretched around the corner. Companies that had been taken private through junk bond–financed leveraged buyouts, the magic carpets of the 1980s, plunged to the ground. The rising cash flows that the underwriters had optimistically predicted never materialized, and the companies could not service their crushing debt loads.

In 1988, corporations defaulted on nearly $4 billion of debt, according to figures compiled by Dr. Edward Altman, the Max L. Heine Professor of Finance at New York University's Stern School of Business. That was more than twice the amount of debt that corporations had failed to service the previous year, not including Texaco, which defaulted under unusual circumstance. In 1989, defaults doubled again to $8 billion; and in 1990 and 1991, they soared past $18 billion—although the pace slowed in the fourth quarter of 1991. The default rate reached dizzying heights in 1991: 10.3 percent of the junk bond universe versus a mere 2.7 percent back in 1988. In the meantime, business Chapter 11 filings surged from 18,889 in 1988 to 27,493 in 1991, according to the administrative office of U.S. Bankruptcy Courts.

Altman also measured the breadth of the vulture market. As of May 1991, he estimated the publicly traded vulture market at $98 billion par value of distressed and defaulted securities, with a market value of about $49 billion. When including private debt, bank debt, and trade

claims, the market expanded to about $390 billion and the market value to $247 billion.

The more successful vulture investing feats of the early and mid-1980s became models to be emulated. People who once made their living investing in takeovers and mergers or junk bonds began to drift toward the new hot market: distressed companies. Brand new vulture investors were recently administrators of leveraged-buyout funds, investment bankers, workout specialists, and junk bond investment managers. Money flowed to them and to veterans alike from both institutional and individual investors. Among the old guard, Marty Whitman raised $45 million; Balfour Investors, $60 million; R. D. Smith's Restructuring Fund, $23 million; and Sam Zell, with the help of Merrill Lynch, an astounding $1 billion. Meanwhile, more recent entrants, including some big boys of the investment management world, boasted even more impressive sums. T. Rowe Price raised $107 million in 1988; Trust Company of the West, $97 million in 1988 and $330 million in 1990; Goldman Sachs's Water Street Corporate Recovery Fund, $783 million in 1990; and Leon Black, the former corporate finance head at Drexel, Burnham, Lambert, snared a cool $1.3 billion from Crédit Lyonnais, the huge French banking company, and other investors.

With their pockets bulging, the vultures could exercise greater clout in individual situations. More of them could now afford to accumulate at least a third of a class of debt, enough to block a reorganization plan from going through—the same blocking position Michael Price took in Storage Technology. And more investors could accumulate enough securities to prevent an exchange offer from succeeding, as Marty Whitman set out to do in Petro-Lewis. With their new rich resources, combined with the equally important experience of working through one bankruptcy after another, the vultures have made fortunes for themselves.

In the process, they have played a growing role in the restructuring of corporate America. The mere presence of flocks of vultures in the market has fundamentally changed the dynamics of bankruptcy from a situation in which management has an overwhelming advantage to one in which these new creditors have great sway. Some experts believed the system was designed to be neutral but became biased toward management only because of the inexperience of the creditors. Whatever the case, the vultures came along in numbers and learned

their way around the Chapter 11 maze. "Now you've got sophisticated bondholders on the committees and trading the claims," said bankruptcy attorney Sandra Mayerson. "They can use the system to their advantage." These and other bondholders even began to band together into committees for negotiating with a company right at the point of default, before the word *bankruptcy* even came up.

They do not always use their influence for the better. As more vulture investors dive into the distressed market, there are simply more people fighting for a piece of the pie. Conflicts develop with increasing frequency between these investors, who have purchased their claims at a discount, and bondholders and lenders, who have booked their claims at par. Naturally, those with a lower cost are willing to settle for much less than those who have put up 100 cents on the dollar. The conflicting agendas can prolong a case, forcing even further deterioration of the company's operations and ultimate value. Although they acknowledge the natural conflict and the potential for delay, vulture investors defend the essential role they play in the economy. Their willingness to purchase claims gives suppliers and other creditors the ability to raise cash when they need it, for example. In some cases, they bring equity capital that can make the difference between sickness and health. Most distressed-company investors say that in working for their own gain, they are also working for the reorganization of companies into profitable enterprises, and they try to encourage a speedy reorganization. The bet these investors are making is that the sick business in which they're investing will stabilize so that it can be restructured as a healthy company. If a company dies, vulture investors can lose big. Indeed, vulture investors have been great advocates of the prepackaged bankruptcy in which a company's creditors agree to a reorganization plan before the company files for bankruptcy so that the bankruptcy is then only a matter of administrative duties that can take as little as a few months to accomplish.

Bankruptcy investors resent their image in the press as rapacious speculators, and they deplore the term *vulture*, which reinforces that image and has stuck as tenaciously as *junk* to high-yield bonds. One investor compares the image problem with that suffered by short sellers, who borrow securities and sell them, betting that the price will fall and allow them to buy the same number of securities at a lower price and reap a profit before returning them to the lender. Because they profit on bad news, the short sellers have gained a reputation as cold opportunists. But, said this bankruptcy investor, "If I'm short on

the grain market, I'm hoping the price will go down and poor people can buy food. You'd think there'd be some reward for that." There is a reward for vulture investing. And though it's not in the form of praise for good deeds done, it's rich nonetheless.

By the end of the 1990s, the vulture market had matured. In the words of investor Shelley Greenhaus: "In the last five years, the distressed securities market has turned from a cottage industry into a true marketplace."

A lot had changed to make that happen. After the early 1990s, which were what some now call "the golden era of distressed investing," a number of new activist players entered the field. They raised a great deal of money to invest in downtrodden companies from investors looking for high yields in a low-interest-rate economy. Also, all the major brokerage houses and some banks set up trading desks to make markets in distressed bonds and defaulted bank loans and often assigned analysts to research the area. Some of these firms became vultures in their own right.

As a result, the market matured into a much more efficient machine. Before, there was no secondary market for distressed bank debt, and investors had to go directly to a bank to negotiate a purchase of loans in its portfolio. But, by the late 1990s, an investor could buy defaulted loans through practically any bank or brokerage firm. By the same token, a bank saddled with defaulted debt could easily unload it. And many more banks wanted to do so because it became more acceptable to sell out at a discount to avoid the time and hassle of a bankruptcy reorganization. It became much more common to see bankrupt companies that were devoid of all original creditors. Even when original creditors did not sell out, they became more willing to take equity as partial recovery for their claims in a reorganization. And that willingness also helped speed up the bankruptcy process. Indeed, so-called prepackaged bankruptcies became more the rule than the exception. Naturally, these market developments were good for all parties, including the reorganizing company, because they usually meant that the company could more quickly restructure and resume normal life as an operating company.

For shareholders, though, the shorter process was bad news. Longer bankruptcy reorganizations had presented shareholders with opportunities to form committees and to fight for some payment, and often the shareholders received something just for participating in the pro-

cess. When the duration of bankruptcies shortened, shareholders had little clout. What's more, a U.S. Supreme Court ruling took away the priority standing that original equity holders contributing new funds had over new investors when it came to doling out new equity.

At the start of the year 2000, the vulture field is on the verge of even greater efficiencies as it enters the Internet age. Balfour Investors planned to lauch vulture-net.com, and others were also hatching ideas.

Unfortunately for vulture investors—and fortunately for corporations—in the mid-1990s, even as distressed investing became a mature marketplace, the supply of investment opportunities shrank considerably. Default rates plunged as the strong economy provided companies with easy access to capital. In 1995, the face value of defaulted high-yield bonds, $4.6 billion, was just 1.2 percent of the value of all high-yield bonds outstanding, down from $18.9 billion, or 10.3 percent, in 1991, according to Edward Altman's figures.

The nature of troubled companies also changed to make vulture investing a riskier proposition. No longer were most distressed companies just good companies with bad balance sheets reflecting high debt levels that could be fixed with a recapitalization. Those situations were the result of the *overleveraged* leveraged buyouts of the 1980s. Now, a much greater proportion were "bad" companies with operational or commodity pricing problems as well as bad balance sheets. In other words, these broken companies were harder to fix.

Not surprisingly, vultures' performance suffered. According to the Altman-NYU Salomon Center indexes, defaulted bonds lagged the Standard & Poor's (S&P) 500 from 1995 through 1998, and defaulted bank loans underperformed the S&P 500 index from 1996, the loan index's first year, through 1998. Even so, many vulture investors came out all right. For one thing, equity that they held from companies emerging from bankruptcy often outperformed the distressed indexes.

Also, investors who had diversified expertise sought other, more plentiful nourishment, whether it be high-yield bonds, equities, real estate, dollar-denominated bonds of foreign enterprises, debtor-in-possession lending to bankrupt companies, or classic mergers-and-acquisitions arbitrage. Michael Price's funds, for instance, continued their activist ways, not only in the distressed arena but also in other areas. In 1995, Price became the subject of front-page news by playing the pivotal role in the $10 billion merger of Chase Manhattan Corporation and Chemical Bank—by doing what he does best, accumulating a large stake and pushing his weight around, this time as a shareholder activist at a

healthy, but underperforming, company. Over time, that one investment rang up a profit of nearly $1 billion.

That fall, Price sold his funds to California mutual fund family Franklin Resources for an astounding $628 million. In November of 1998, he withdrew from active fund management, continuing in only an oversight role as the chairman of Franklin Mutual Advisers, the investment manager for Franklin Mutual Series Fund, Inc., and turning over the role of chief executive officer to Peter Langerman, who had been chief operating officer. The funds in the group, numbering six by mid-1999, adhered to their pure value investing strategies during the go-go growth era of the stock market, even though they underperformed the bull market and suffered redemptions as a consequence. The fund group remained active in the distressed marketplace, even though it often found the supply of good opportunities wanting. One of its best 1990s investments was in the Canary Wharf office development in London. In 1995, Mutual Series Fund and a small group of other investors bought out the banks. With an initial public offering in March 1999, the value of Mutual Series's initial $150 million investment had multiplied more than four times, Langerman said. The funds continued to own about 15 percent of the equity.

During the 1990s, Mutual Series also participated in the bankruptcy reorganizations of Eurotunnel, the UK-France venture; Mercury Finance Corporation, a subprime auto lender; Zenith Laboratories, a maker of generic drugs; and Columbia Gas, a natural gas distributor. Among the fund group's distressed holdings as of mid-1999 were the nursing home operator Vencor; Dow Corning Corporation, which was bankrupted by problems with its silicone breast implants (Mutual Series was on the creditors' committee); and funeral home operator Loewen Group.

A few vultures made the perilous flight abroad to crisis-ridden Latin America and Asia, where the supply of deals was seemingly endless. (Europe was generally not attractive because of the lack of a well-developed junk bond market, although in 1999 new issuance was booming.) After the devaluation of the peso in late 1994, however, Mexico was not particularly fertile ground for U.S. vulture investors. Most often, distressed companies restructured outside of the courts because the process of reorganizing under the country's bankruptcy laws tended to be highly involved and elongated. But foreign investors then had to go up against the tight-knit banking community and large, politically connected debtors.

Those who were poking around Asia included Martin Whitman's Third Avenue Fund, Rothschild Inc.'s Recovery Fund, Cerberus Capital Management, and others. But most saw too much risk in going to countries that do not have the equivalent of a Chapter 11 in their bankruptcy laws and, therefore, do not offer as much power to creditors as does the U.S. law—not to mention the lack of a bankruptcy infrastructure (attorneys, accountants, etc.), the language barriers, and the time-zone complication. However, some financial firms and buyout artists were acquiring part or all of bankrupt or troubled Asian companies. In January 1999, for instance, General Electric Company's GE Capital Corp. agreed to buy the leasing business of bankrupt Japan Leasing Corp., foregoing the sick-property loan portfolio. And, later in 1999, Newbridge Capital Ltd. worked out an agreement to acquire control of the ailing Korea First Bank. In South Korea, the state-run Korea Asset Management Corp. sold hundreds of millions of dollars worth of nonperforming real estate–backed loans via distressed-asset auctions to such investors as Goldman Sachs & Company and the Dallas-based Lone Star Fund, a private equity fund that also bought nonperforming Japanese loans.

It was unclear by the end of 1999 how far Asian countries and companies would take the restructuring trend. Some governments continued to protect their companies from the rigors of bankruptcy reorganization, hoping that economic recovery would come in time to prevent failures. And lenders in many countries remained reluctant to write down bad debts. Few governments were reforming bankruptcy laws to encourage the rehabilitation of defaulting debtors by having creditors and debtors work out bad loans, as Chapter 11 does. Marty Whitman was outspoken in 1998 in urging the adoption of such a legal system. But Thailand, for one, appeared to be moving to clean up corporate messes, with a revised bankruptcy law and some significant debt restructurings. And there were positive signs elsewhere as well, in such countries as Korea, Japan, and even China.

Some vultures backed away from the field, especially investors whose other holdings suffered after the market breakdown of August 1998 that was triggered by Russia's devaluation of the ruble. They included a few big investment banks that had been doing proprietary trading in distressed securities. Among those profiled in this book who were no longer consistently practicing vulture investing in corporations by 1999 were Leon Black's Apollo Advisors, Sam Zell in Chicago, and FMR Cor-

poration, which owns the Fidelity funds. For Black and Zell, real estate, mergers and acquisitions, and other investments seemed more attractive. And for Fidelity, its vulture investment activities created potential conflicts of interest with its equity funds and tarnished its overall clean, and highly visible, image.

As the decade wore on, NYU's Professor Edward Altman began predicting an increase in high-yield bond defaults. It only made sense, given the mushrooming growth of the high-yield market, tripling in size from $181 billion in 1990 to $537 billion in 1999. Finally, the prediction came true. In the first nine months of 1999, the default rate in the junk bond market jumped to 3.3 percent from 1.6 percent the previous year, or, in more dramatic terms, from $7.5 billion in face value to $17.5 billion, which on an annualized basis was greater than the defaults for all of 1991. The 1999 defaults comprised 101 issues from sixty-nine companies, including such well-known names as Planet Hollywood, Discovery Zone, Wireless One, Loehman's, Loewen Group, The Singer Co., Filene's Basement, and Harnischfeger Industries.

The overall distressed securities market ballooned. As of October 1999, Altman included seventy-four issues in his public-defaulted bond index with a face value of $13.7 billion, up from $5.5 billion at year-end. His defaulted bank loan index closed in October at a face value of $11.7 billion, up from $3 billion at the end of the year. And these numbers did not include distressed debt that had not defaulted. In October 1999, 12 percent of the bonds in Merrill Lynch High Yield Master Index, representing a third of the high-yield bond market, were distressed, that is, were trading at more than 1,000 basis points over Treasury bonds. That number was up from about 4 percent in July 1998. Large bankruptcies were also up in dollar volume from 1997 to 1998. Experts were predicting a default rate exceeding 4 percent for the full year 1999. Whether the trend would continue remained to be seen, but the potential for more defaults was clearly there.

Given this scenario and the departure of some vulture players to greener pastures a few years earlier, in mid-1999 a gap opened up between supply and demand that showed up clearly in the numbers. In 1997, the average price of a defaulted bond just after the default was $54 (par is $100). But in the first half of 1999, the price after default was $29. The vultures remaining on the scene were ecstatic with their newly full schedules. In fact, most of the vulture investors profiled in this book in 1992 remained active in the market eight years later. Of

course, the assets they were managing had become much larger as they raised new funds based on their earlier positive performance.

Meanwhile, despite the slowdown in defaults, a number of new funds had entered the category. Some were staffed by workout specialists from insurance companies and other institutional investors who had finished cleaning up the defaults stemming from the recession and were looking for a new way to use their talents. For example, PPM America, the U.S. investment management arm of the giant Prudential Corp., plc, the UK's largest life insurance company, began assembling a distressed securities group and raising funds in 1996. The firm, which had a reputation as a bulldog for bondholder rights in the investment-grade bond arena, envisioned a flourishing distressed market up ahead because it saw insurance companies and banks drifting back into high-yield bonds and loans and due diligence slackening. By mid-1999, PPM was managing nearly $900 million in assets in about 40 companies. In about a third of those situations, PPM owned a large enough position to control or to greatly influence the workout process.

Other newcomers included Cerberus Capital Management, DDJ Capital Management, Appaloosa Management, Oaktree Capital Management, Contrarian Capital Management, and Canyon Partners, to name just a few. It should be noted that over the years a few more women were attracted to this career dominated by men. For instance, Marti Murray, a former credit analyst at Bank of America, joined Oppenheimer & Company's vulture investment team and later ran $80 million in distressed investments for the New York investment bank Furman Selz. In 1995, she broke away to form her own Murray Capital, which in 1999 had about $240 million in assets under management.

By the end of the decade, vulture investing strategies had changed, somewhat in line with the changes in the nature of distressed companies. For instance, a much larger percentage of troubled companies were small and midsized compared to the recession era. And so, a number of vulture investors concentrated on smaller deals. What is more, the increase in companies with operational problems meant that vultures had to devote greater resources to research and analysis and even to hiring management consultants. Some vulture investors were participating more actively in helping companies hammer out their various problems. For example, vultures would more frequently be seen arranging mergers, furnishing debtor-in-possession and other loans, and helping to underwrite rights offerings that would provide the capital needed for emergence from Chapter 11.