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MICHAEL MILKEN:

A CASE STUDY IN AMERICA'S MORAL SCHISM

Kevin R. Douglas

ABSTRACT

This article explores competing views on Michael Milken in order to draw insights about American law and culture. Milken has been described as a genius, a thief, an industrial revolutionary, a rapacious predator, and the person you would want your children to be when they grow up. Some praise Milken for inspiring the use of high yield debt to finance acquisitions. His approach to corporate finance helped birthed a merger wave in the 1970s and 80s and normalized the use of high-yield debt as an investment vehicle and a reorganization tool.¹ Others see Milken as a symbol of personal greed and social pathology. Critics have charged that his use of debt to takeover and restructure companies (often laying off employees) is akin to piracy and represents the very worst of a capitalist economy.

These conflicting interpretations of one man's career point to a schism in moral values. Some see the reports of Milken's work ethic, ambition, and mathematical genius as qualities to encourage in our society. Others see these attributes as a threat to social

¹PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, & CORPORATE RESTRUCTURINGS, 371–375 (7th ed. 2018).

stability and decency. To demonstrate this moral divide, this article explores the financial rise and the regulatory fall of Milken and compares the commentary of his detractors and supporters. In addition, this article highlights how conflicting notions of fairness lead to disparate legal treatment of otherwise identical behavior. For example, the law views buying real property based on an informational advantage as fair and legally acceptable, while buying stock with an informational advantage is considered unfair and often results in legal liability.

The evidence suggests that this moral divide is based on more than disagreements among Americans about what constitutes moral business behavior and the required characteristics of a just society. The evidence suggests that many Americans are internally conflicted on these questions.

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I. The Rise of Milken

Although Milken received his master's degree in business administration from the Wharton School in Philadelphia, it was at U.C. Berkeley where he developed his passion for high-risk, high-yield debt securities.² At Berkeley, Milken discovered two empirical studies that supported an investment strategy that he had already put into practice as a college student.³ Studies by W. Braddock Hickman and T. R. Atkinson showed that over

² CONNIE BRUCK, *THE PREDATOR'S BALL: THE INSIDE STORY OF DREXEL BURNHAM AND THE RISE OF THE JUNK BOND RAIDERS*, 27–28 (1989).

³ *Id.*

the long-term, investments in low-rated bonds provided a higher return than investments in high-rated bonds.⁴ Upon reading those studies, Milken “became convinced that the market . . . did not understand the true riskiness of bonds.”⁵ After graduating from Wharton in 1970, Milken took his passion to the bonds trading desk of Drexel Firestone, a once prestigious investment bank.⁶ Critics scorned him for dealing with low-grade investments and because of his Jewish ancestry, but Milken regularly generated profits for Drexel while more prestigious divisions of the bank were losing money.⁷

When the noticeably Jewish Burnham and Company acquired the predominantly Protestant Drexel Firestone in 1973, they gave Milken \$2 million to trade on the firm’s account.⁸ He made a 100% return on investment for the firm.⁹ Milken’s continued success convinced the owners of the new Drexel Burnham to make Milken the head of a new department focused on trading high-yield and convertible debt instruments.¹⁰ He shaped his trading division into a group of Milken protégés.¹¹ His group started off selling low-rated debt to investment management firms and mutual funds that had already bought into the Hickman philosophy, and it grew into a deal-financing powerhouse.¹² He built a network of investors that helped him to finance takeovers using high-yield and convertible bonds.¹³ Milken and his team regularly made personal investments in the equity

⁴ *Id.*

⁵ DANIEL FISCHER, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION, 23 (1996).

⁶ *Id.*

⁷ BRUCK, *supra* note 2, at 29.

⁸ *Id.* at 31.

⁹ *Id.*

¹⁰ *Id.* at 32.

¹¹ *Id.* at 32–33.

¹² *Id.*

¹³ GAUGHAN, *supra* note 1, at 372–373.

portions of their deals, and they reaped astounding returns.¹⁴

Over the course of the 1970s and early 1980s, Milken and Drexel helped reshape American industry and corporate finance. They turned relatively small entrepreneurs (owners of multimillion-dollar companies) into captains of industry. In 1985, for example, Drexel helped Nelson Peltz and Peter May—the owners of Triangle Industries—take over National Can.¹⁵ Triangle Industries generated \$291 million in revenue in 1984, compared to National Can's \$1.9 billion in revenue. By the beginning of 1986, National Can reported record earnings and its stock price quadrupled.¹⁶ Peltz and May became the envy of many on Wall Street.

Correlated with the competing moral evaluations of Milken and his leveraged buyout movement were the competing theories on the social and financial effects of his success. Milken made several small-scale businessmen into multimillionaires, while simultaneously dethroning many incumbent management teams and boards of directors.¹⁷ Daniel Fischel categorized the winners and losers of Milken's revolution, respectively, as "new-money challengers" and "the establishment."¹⁸ Fischel and other supporters of the leveraged buyout movement praise Milken as an innovator and attribute his fall to the envy of well-connected old-money managers, who were able to rally lawmakers and enforcement officials to their defense.¹⁹ Yet some described Drexel as creating "monsters" when funding takeovers by men like Peltz and May.²⁰ Critics were skeptical that takeovers created real economic

¹⁴ BRUCK, *supra* note 2, at 32–33

¹⁵ *Id.* at 105–108.

¹⁶ *Id.* at 108–109.

¹⁷ FISCHEL, *supra* note 5, at 23.

¹⁸ *Id.*

¹⁹ *Id.* at 26–28.

²⁰ *Id.* at 142.

value, and likely saw leveraged buyouts as an example of the age-old concern that financiers are merely engaged in paper shuffling.²¹

II. The Decline of Milken

It is ironic that Milken's rise occurred during the 1970s while the SEC was clamping down on what it saw as unfair trading, and that his fall occurred during the 1980s when the Commission's authority was being reined in by the anti-regulatory Reagan administration.²² The turning point in Milken's career came when federal prosecutors succeeded in having Ivan Boesky plead guilty to a series of securities violations and enlisted Boesky to become a witness and informant in other securities cases.²³

In 1986, Boesky pleaded guilty to buying inside information from Dennis Levine, a former employee of Drexel Burnham.²⁴ As a part of his deal with prosecutor Rudolph Giuliani, Boesky agreed to wear a wire and record Milken and other targets admitting to securities law violations.²⁵ In the fall of 1986, the Department of Justice recorded a conversation between Boesky and Milken in which the men discussed how they would explain the \$5.3 million that Boesky paid to Drexel for what was only billed as consulting services.²⁶ Milken described the \$5.3 million as a payment made to close out a partnership between Drexel and Boesky.²⁷ More than

²¹ YARON BROOK & DON WATKINS, *IN PURSUIT OF WEALTH: THE MORAL CASE FOR FINANCE*, 3–4 (2017).

²² JOHN ANDERSON, *INSIDER TRADING: LAW, ETHICS AND REFORM*, 37 (2018); FISCHEL, *supra* note 5, at 40.

²³ FISCHEL, *supra* note 5, at 105–106.

²⁴ *Id.*

²⁵ *Id.*

²⁶ JESSE KORNBLUTH, *HIGHLY CONFIDENT: THE CRIME AND PUNISHMENT OF MICHAEL MILKEN* 26–29 (1992).

²⁷ *Id.* at 29.

once during the conversation Boesky made statements like “we have to have [the same story].”²⁸ Enforcement officials described Milken’s failure to reject these seemingly benign statements as an admission to organizing an illegal “stock parking” scheme in connection with the attempted Fischbach takeover.²⁹

Stock parking involves an agent purchasing securities in its name on behalf of an undisclosed principal, with the principal guaranteeing the agent against any losses associated with the purchase. The practice is used by large purchasers to prevent tipping-off the rest of the stock market about its desire to buy, which might inadvertently drive up the price of the target stock. However, when certain undisclosed purchases are not followed by the timely filing of a schedule 13D or 13G, the practice violates U.S. securities regulations. Schedules 13D and 13G have been described as necessary “to protect companies and the investing public by giving them notice of such accumulations because of their potential effect on control of the company or the price of the company’s securities.”³⁰

In the case of the attempted Fischbach takeover, a company owned by Posner began accumulating the equity of Fischbach in January 1980.³¹ By August of that year, Posner signed a standstill agreement with the management of Fischbach, in which he agreed not to accumulate more than 24.9% of the company’s outstanding equity unless an unaffiliated investor acquired 10% or more of Fischbach’s outstanding stock and disclosed that acquisition in a Schedule 13D.³² In 1984, Executive Life, an insurance company, acquired

²⁸ *Id.* at 26.

²⁹ *Id.* at 29.

³⁰ *S.E.C. v. Drexel Burnham Lambert Inc.*, 837 F.Supp. 587, 589 (S.D.N.Y. 1993), *aff’d sub nom. S.E.C. v. Posner*, 16 F.3d 520 (2d Cir. 1994).

³¹ *Id.* at 590–92.

³² *Id.*

more than 10% of Fischbach and filed both a 13D and 13G disclosing that fact.³³ Fischbach management responded by acquiring Executive Life's position for a premium. This began a dispute over whether Executive Life's initial purchase and filing triggered an end to the standstill agreement. Before this dispute could be resolved, Boesky called Milken to ask if he should purchase shares in Fischbach.

Milken and Boesky both agree that Milken encouraged Boesky to purchase Fischbach stock, but they disagree about the meaning of the words Milken used to persuade Boesky. When describing the conversation between himself and Boesky years later, Milken stated "I do not remember what I told him six years ago, but I indicated to him that he would not lose money . . . I assured him that Drexel would make good on his losses."³⁴ Shortly after the conversation, Steve Posner called Boesky at Milken's request to assure him of the safety of an investment in Fischbach. Boesky testified that Posner responded with variations of "don't worry about it," when he asked Posner for assurances that he would not lose money if he bought Fischbach stock.³⁵

At least one court found that Milken's commitment to "making good" on a client's losses and Posner's advice not to "worry about it" were evidence of an illegal "stock parking" scheme.³⁶ However, Milken described his assurances as a benign practice aimed at retaining Boesky's firm as a client.³⁷ He denied a commitment to specifically reimburse Boesky for any losses on his Fischbach investment and describes his assurances as an implied commitment to be a source of other successful investment opportunities in the future. He and Boesky both agree that they never discussed any

³³ *Id.* at 591

³⁴ *Id.* at 593.

³⁵ *Id.* at 594.

³⁶ *Id.* at 593.

³⁷ *Id.* at 594.

commitments by Posner to purchase stock from Boesky or any impending takeover plans for Fischbach. However, Boesky described Milken and Posner's vague assurances as Wall Street code for a request for Boesky to engage in illegal stock parking and a commitment from Milken to insure Boesky against any losses.³⁸

Despite eventually having his shares purchased by Steve Posner for a premium over the market price,³⁹ Boesky lost \$2 million on his Fischbach investment.⁴⁰ In 1987, Boesky pleaded guilty to several securities violations, including stock parking and filing a false Schedule 13D when purchasing his Fischbach shares.⁴¹ He also implicated Milken as a co-conspirator in that transaction.⁴² In 1989, the government charged Milken and Drexel with 98 counts of securities fraud, tax evasion, and mail and wire fraud.⁴³ Milken initially proclaimed his innocence in a public statement and committed to vindicating himself in court.⁴⁴ However, one year later Milken pleaded guilty to six federal crimes, three of which were associated with stock parking through Boesky.⁴⁵

For many, Milken's conviction was anticlimactic. After almost a decade-long investigation and being charged with 98 crimes, Milken pleaded guilty to just six of the charges. He also agreed to give up \$600 million, which many knew was just slightly more than his

³⁸ *Id.* at 597–98 (“Employing a shorthand dubbed ‘Wall Street-ese’ by Boesky in his trial testimony, Milken ‘encouraged’ Boesky to buy more than 10 percent of the outstanding stock of Fischbach and assured Boesky he would not lose any money if he did.”).

³⁹ FISCHEL, *supra* note 5, at 75.

⁴⁰ *Id.* at 77.

⁴¹ *S.E.C. v. Drexel Burnham Lambert*, *supra* note 30, at 599.

⁴² *Id.* at 593.

⁴³ FISCHEL, *supra* note 5, at 157.

⁴⁴ *Id.* at 160.

⁴⁵ *S.E.C. v. Drexel Burnham Lambert*, *supra* note 30, at 599–600.

compensation in 1987.⁴⁶ Despite initially receiving a sentence of 10 years in prison, Milken was ultimately only sentenced to serve 2 years and 9 months in prison and served only 2 years in total. Many were disappointed in this outcome given the intense scorn they felt for Milken and the “junk bond” market he created.

III. The Moral Schism

Accounts of Michael Milken’s rise and fall that depict him as a monster are not hard to find. Connie Bruck published the best-selling book *The Predator’s Ball*, which describes Milken and Drexel’s “onslaught” as introducing “terror and mayhem into countless corporate boardrooms.”⁴⁷ Other authors’ accounts of Milken and Drexel have titles such as *Den of Thieves* and *A License to Steal*.⁴⁸ Some critics describe Milken as a thief for keeping a large portion of the profits on each bond transaction for himself and his team.⁴⁹ These critics seemed to think that Milken’s bond operation should have shared more of the profits with either the ultimate purchasers of the bonds or with Drexel’s traditional investment banking and equity trading divisions. In addition, many described stock parking as a significant abuse of securities markets that harmed ordinary investors.

However, some commentators consider Milken to be somewhere between a humanitarian and an unfortunate scapegoat. For example, in *Payback: The Conspiracy to Destroy Michael Milken and His Financial Revolution* economist Daniel Fischel praised the

⁴⁶ FISCHEL, *supra* note 5, at 150.

⁴⁷ See BRUCK, *supra* note 1, at 19–20.

⁴⁸ JAMES B. STEWART, *DEN OF THIEVES* (Simon and Schuster 1992); BENJAMIN STEIN, *A LICENSE TO STEAL: THE UNTOLD STORY OF MICHAEL MILKEN AND THE CONSPIRACY TO BILK THE NATION* (Simon & Schuster 1992).

⁴⁹ FISCHEL, *supra* note 5, at 131.

leveraged buyout movement in general and Milken in particular. He described the movement and Milken as the source of an economic revolution that forced once unresponsive and inefficient corporate managers to focus on making companies profitable for shareholders.⁵⁰ In addition to encouraging employee layoffs, the revolution put an end to the lavish lifestyles that many corporate executives enjoyed at the expense of their shareholders.⁵¹ Fischel and other economists viewed Milken's fall as the result of a smear campaign by incumbent banks and a U.S. attorney (Giuliani) looking to make a name for himself before seeking public office.⁵²

Enforcement officials and members of the Reagan administration also held conflicting views of Milken and the leveraged buyout movement. On the one hand, some regulators praised the leveraged buyout market as an engine of economic growth. In 1984, Ronald Reagan's treasury secretary wrote a letter to Congress in which he rejected additional anti-takeover legislation and described leveraged buyouts as performing "several beneficial functions in [the] economy."⁵³ On the other hand, some regulators viewed the buyout market with suspicion and spoke out against the business practice. For example, John S. R. Shad—a Securities and Exchange Commissioner appointed by Reagan—attacked the leveraged buyout movement, predicting that the inevitable result "would be more bankruptcies and less long-term planning."⁵⁴

⁵⁰ *Id.* at 15–22.

⁵¹ *Id.* at 19 (describing the leveraged buyout of RJR Nabisco as immediately followed by selling off 7 corporate jets, 30 luxury apartments, and eliminating 30 athletes on retainer).

⁵² Henry G. Manne & Larry E. Ribstein, *The SEC v. the American Shareholder: The Drexel Burnham Case*, NATIONAL REVIEW, Nov. 25, 1988, at 26(4).

⁵³ FISCHEL, *supra* note 5, at 38.

⁵⁴ *Id.*

There is even some evidence that individual officials sometimes internalized these conflicts. For example, Shad stated that the markets themselves would be able to handle the threat from leveraged buyouts.⁵⁵ However, opposing the LBO movement while trusting in the market to stop it is strange given that it was the market that produced the movement. In addition, prior to becoming an impassioned prosecutor of white-collar criminals, Giuliani made several public comments describing the focus on white collar crime (instead of on gangs and drugs) as a waste of government resources.⁵⁶ His conversion to a champion of cracking down on Wall Street therefore seems a little inconsistent (if not disingenuous).

Even Michael Milken may not have been fully convinced of the virtue of his business methods. In the late 1980s, after several years of government leaks about the details of the Milken investigation, Milken hired a public relations firm to rehabilitate his image.⁵⁷ Instead of the firm praising the value of leveraged buyouts and high-yield investments, it spent time publicizing Milken's charitable works.⁵⁸ The decision to focus on Milken's work outside of his profession may have been based on the expectation that the public would only respond positively to information about selfless deeds. However, because Milken did not demand a campaign singing the praises of high-yield bonds, it makes sense to suspect that he was not sure that his actions were morally acceptable.

IV. Conclusion

⁵⁵ *Id.*

⁵⁶ *Id.* at 99.

⁵⁷ *Id.* at 161.

⁵⁸ *Id.*

Acknowledging these conflicting moral evaluations by some of the nation's most influential industrialists and government officials is useful for understanding some of the confusion in U.S. securities regulation. There are several areas of securities law in which liability turns on some conception of what kind of market activity is "fair."⁵⁹ It makes for muddled legal doctrines when we cannot agree about the fairness of trading with an information advantage or the fairness of agents purchasing securities for an undisclosed principle.

In *SEC v. Texas Gulf Sulphur*, the defendants faced liability because they were described as unfairly trading in the company's stock based on undisclosed information about a rich mineral find in Timmins, Ontario, Canada.⁶⁰ Yet in *Leitch Gold Mines Ltd. v. Texas Gulf Sulphur*, a Canadian court applying common law contract principles deemed it acceptable for Texas Gulf Sulphur to use undisclosed information to purchase the mineral rights needed to profit from the same discovery.⁶¹ Ivan Boesky was charged and pleaded guilty to insider trading and other securities violations. However, the SEC authorized Boesky to engage in what many considered insider trading by secretly liquidating his portfolio to pay his \$100 million fine.⁶² Outside of securities markets, trade secret doctrine protects and incentivizes trading on asymmetric information and this protection is described as fostering fair competition.⁶³ Moreover, agency doctrine protects the use of

⁵⁹ See, e.g., *SEC Selective Disclosure and Insider Trading*, 17 C.F.R. §§ 240, 243, 249 (describing Regulation FD—Fair Disclosure).

⁶⁰ *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

⁶¹ *Leitch Gold Mines Ltd. v. Texas Gulf Sulphur Co.*, 1968 CarswellOnt 318 (1968).

⁶² FISCHER, *supra* note 5, at 107.

⁶³ See RESTATEMENT (THIRD) UNFAIR COMPETITION § 39. See also *Metallurgical Industries Inc. v. Fourtek, Inc.*, 790 F.2d 1195, 1201 (5th Cir. 1986).

intermediaries to mask the identity of principals in the market place.⁶⁴

Understanding this moral schism may help to either resolve paradoxes or eliminate unnecessary conflicts within American law and culture.

⁶⁴ RESTATEMENT (SECOND) AGENCY § 4.