

Story of Michael Lissack's Whistle Blowing on Wall Street in Yield-burning Scandal

Excerpted from, *Giant Killers: The Team and the Law that Help Recover America's Stolen Billions* by Henry Scammell,

[Michael Lissack was a highly placed executive in investment banking for Smith Barney in their municipal bonds section]. One morning a particular story brought him [Michael Lissack] bolt upright in his chair. The United States Attorney's Office in Boston was investigating Merrill Lynch and Lazard Freres on allegations the two firms had been illegally collaborating with each other and their competitors, splitting fees and markets in public finance transactions. The particular focus of their investigation had been a bond issue by the Los Angeles Metropolitan Transit Authority, LAMTA. Michael knew that both banking firms were still under investigation for similar charges on bond issues in Massachusetts and the District of Columbia. What galvanized his attention was not the possibility that two of his biggest rivals were involved in fee and market splitting. What astonished him was that in the course of chasing after this relatively penny-ante offense, the government had stuck its nose into one of the biggest swindles in history—and had no idea what it was looking at. He put down the article and pondered his options. His first impulse was to turn his rivals in. But could he do it in a way that wouldn't ring down the curtain on his career in investment banking?

The practice of yield burning was protected by a far-reaching network of secrecy and quid pro quo, and an attack on a single perpetrator would be universally regarded as an attack on the industry as a whole. If it ever came out that he had given up one of his own—even though it was a competitor—his life on Wall Street would be finished. Yield burning was rampant throughout the industry, and Michael himself was as deeply into it as most of his colleagues. Indeed, one of the reasons he had become unhappy with his job was that he didn't like where it was taking him.

One of Lissack's particular talents was risk assessment, and now he weighed the choices before him. Even if he pointed to the fraud, it was apparent the investigators would need someone to explain it. He knew there were ways he could do the pointing without giving away his identity. After all, he was turning the government on to a fraud of enormous proportions. How much explaining would it take before the government saw the light and his revelation took on a life of its own? He found a pay phone near the beach and called the United States Attorney's Office mentioned in the story. Moments later, he was speaking with a government investigator in Boston. Michael wasn't going to give his name, he said, because what he had to say could stand on its own. (Even though the phone number had been set up to encourage anonymous tips, he suspected the subject of his identity might arise later in the conversation.) Instead of objecting, the voice on the phone asked him if he'd be willing to call back in a half hour. It would take that long, he explained, to round up the other people in the office who needed to hear whatever it was Michael had to say. Dutifully, Michael hung up and passed an almost endless thirty minutes before dialing again. This time, the call was put on a

speakerphone in the office of Assistant United States Attorney Brian O'Connor, who introduced a number of FBI agents on the Boston end of the conversation.

Lissack wasted no time in getting down to business. The reason for the call, he said, was that the government was on the wrong track. The big secret at Merrill Lynch and Lazard Freres was only marginally related to fee or market splitting. For years, the two investment banks had been working in illegal collaboration with each other even while they worked hard on the appearance of being competitors. They were stealing the socks off the government, he said, through a practice known as yield burning. The voices at the other end of the telephone line were silent, and Michael asked if the investigators were familiar with the term. Someone in the room told him to keep talking, which Michael took as an admission that none of them had ever heard of it.

The trouble with this kind of a call, Michael realized, was that there was a limit to how much the government agents were willing to learn. This wasn't like a tip on a drug deal or a ring of car thieves, where once a veneer of secrecy was removed the wrongdoing was immediately obvious. This crime was protected by its fundamental complexity, which made it inaccessible to all but a handful of specialists. Most of the time, even the agencies issuing the bonds had no idea that a theft had occurred. The challenge in this telephone call would be to not only point to the fraud, but to explain it—and in language that the prosecutor and the agents would be able to understand. The agents listened as he laid out the basics of the scheme, and they even asked occasional questions, but it was hard to tell how much they were really able to take in. Lissack was worried that they might be attempting to trace the call back to the coffee shop's pay phone, and when he sensed they were approaching saturation, he decided it was time to end the call. He promised to contact them again—he would identify himself as "your friend from Florida"—after the investigators had a chance to discuss the conversation....

In the weeks following... Michael made several more calls to a steadily growing audience in Boston. As the government's "friend from Florida," he laid out the basics of the fraud. His listeners now included finance specialists from the United States Attorney's Office and special FBI agents assigned to the ongoing fee- and market-splitting investigation. Municipal financings had long been a source of tension between federal regulators and Wall Street. Tax exemption for interest payments made to municipal bond holders was supposed to be limited to situations in which bond proceeds were used to further a public purpose, such as building bridges, schools, or public roads. This was a form of federal subsidy for municipalities, because the federal government forgoes taxes on municipal bond interest income it would have otherwise collected. But the differential between the lower interest rate for tax-exempt investments and the higher rates paid for taxable investments created an irresistible temptation. Wall Street bankers set about developing schemes to invest tax-exempt bond proceeds in high-yielding taxable investments, and to capture the difference between the yields—sometimes referred to as "arbitrage"—for their own profit.

The potential for abuse of tax-exempt financings was enormous, and the bankers showed endless creativity in their schemes to skim off the price difference between interest payments on tax-exempt and taxable investments. In the 1970s it was the "invested sinking fund"; in the early 1980s it was the "blind pool funds"; in the late '80s it was "hedge funds." Congress tried to stop Wall Street from abusing tax exemption, but at every turn bankers found a loophole—and slid through it. In 1986, Congress thought it put an end to the abuse by requiring that whenever tax-exempt bond proceeds were invested in taxable investments, the differential between the nontaxable and taxable yields had to be returned to the U.S. Treasury. Congress repeatedly made clear that it did not provide tax-exempt status for municipal bonds in order for Wall Street to reap the financial benefit. Lissack explained that the Wall Street of the 1990s was once again circumventing federal law. Yield burning was possibly the biggest fraud yet. When interest rates decline, state and local governments often refinance their municipal bonds to lower their borrowing costs, not unlike a person refinancing a home mortgage when interest rates drop. These refinancings are known as "advance refundings." As part of the transaction, banks purchase on behalf of municipalities higher-yielding Treasury securities with the proceeds of tax-exempt advance refunding bonds and use the income to retire over time the higher-interest tax-exempt bonds it originally issued.

By law, their investments with those proceeds cannot earn higher aggregate yields than the yield earned on the newly issued tax exempt bonds. Any excess profit must be paid to the federal government. By adding large price markups to Treasury securities purchased with bond proceeds, Wall Street bankers were making illegal profits by artificially depressing—"burning"—the yield on those securities, so that the yield appeared to be within the allowed limits even though it would have been above the limit had the securities been priced at fair market value. The practice infected thousands of transactions across the country and touched nearly every public issuer of municipal debt. "Yield burning was costing the Treasury more than a billion dollars," Lissack estimated, far more than the illegal sharing of fees and markets, which the government was pursuing. The fraud was undiscovered, Lissack explained, because it was buried 'within incredibly complex muni-financing transactions. But at its heart, it really was nothing more than a garden variety rip-off. Wall Street bankers were overcharging the municipalities for Treasury securities, and *nobody* noticed because the theft was concealed in the arcana of convoluted bond refinancings, nearly opaque rules, and hundreds of minute details.

The investment bankers, Michael told his listeners, lied for each other, certifying that the outrageously inflated prices being charged for these securities met the requirement of "fair market value." Obviously the certifier, presumed by the issuer to be neutral, was in on the *fix*, approving prices it knew were inflated, often more than a hundred times over the cost of an honest deal. There was no direct sharing of the secret profits; the participants repaid each other in subsequent deals, when the beneficiary from the last issue might become the certifier for the next one. In the course of Michael's

conversations with the government investigators, it was nearly impossible for him to gauge his listeners' true reactions. They were all trained interrogators, and they weren't about to give anything away or allow a witness to revise the basic inequality in their roles. The fact that he was calling anonymously may have made him appear less reliable than an informant whose identity they knew, but Michael realized their relationship would never approach anything like parity or allow for the possibility of reciprocal candor.

However, there was one thing he could do that might enable him, eventually, to monitor how seriously they were taking his calls. In one of their last conversations, Michael gave the FBI the names of ten people to interview about his charges. His own name was on that list. In anticipation that his initiative would eventually stir up turmoil and probably some personal liability, Michael hired an attorney, a solo practitioner in New York. It was a relief to finally have someone he could talk with, but the expected reaction from the government was slow in coming. Weeks passed, and then months. ...At the office, with his attorney's cautious approval, he began speaking openly with colleagues about his dissatisfaction with Smith Barney's—and his own—growing involvement in the very practice over which he had anonymously blown the whistle on two of the company's competitors. More than once, he even went so far as to suggest that he ought to drop the dime on Lazard Freres and Merrill Lynch for the LAMTA yield-burning debacle, which he described as daylight robbery. Whenever he brought it up, his colleagues responded with the same comment: If he did make such a call, he'd be dead. It wasn't said as a threat, because no one in the office seemed to take Michael's rantings literally. Their response to his remarks suggested that reporting a rival—and exposing the scheme—would be tantamount to betraying Smith Barney, which would mean exposing himself as well. If his comments weren't exactly driving people crazy, there was a certain satisfaction in stirring the pot, and he kept speaking up. If his employers knew what he had already done, Michael thought, there was a possibility that the metaphor of his being dead could become a literal reality.

Although his identity was still unknown to the Justice Department investigators, and despite his own involvement in the very sort of crime he had reported, ever since placing the first phone call from Florida he'd felt as though he were an undercover agent for the federal government. The problem was, because he alone knew the identity of the FBI's "friend from Florida," his sense of mission did not include the comfort and advice that even a James Bond could reliably expect from those he served. There was no one at the office he would be foolish enough to confide in, he had virtually no friends outside of work, and he wasn't getting a lot of comfort at home.

...He took a six-month leave of absence from his job. When he learned that Smith Barney wanted to fire him during that leave, he countered that the stress was work-related, and that he would sue for job discrimination. That summer, while he was on leave, he read an article in the *Wall Street Journal* about a case being prosecuted under the False Claims Act. He spoke with his attorney about it, suggesting the possibility of

filing a *qui tam* lawsuit as a way of getting the government to examine his allegations. The lawyer agreed he had the basis for such an action, but he knew nearly nothing about the law and mistakenly thought the legal basis for their case was tax fraud. Neither of them acted on Michael's idea. The conversation occurred during the time when the firm was threatening to fire Lissack, and the lawyer told him they were far better off focusing on an employment lawsuit against Smith Barney.

The firm didn't go through with firing him, but when he returned to work in September 1994, he found that he essentially had lost his job anyway. He learned about it from a memorandum outlining his new assignment. He was required to come to work, and the company provided an office. But that was about it. He was to sit in the office and do virtually nothing. His attorney referred to the document as the "potted plant memo" because he had suddenly become little more than an office decoration. Finally, in November, he heard from the government attorneys. They didn't contact him directly; the query came through Smith Barney's legal department. Nearly a year after his initial call from Florida, the Bureau wanted permission to depose Michael Lissack in connection with a public finance investigation. Obviously the FBI did not yet know he was their anonymous source, and the method by which it initiated this contact gave the firm no reason to suspect it either. Michael feigned bewilderment when his superiors told him of the request, and because the query appeared to have arrived out of the blue he decided to add a warning, as though the idea had just come to him. If the subject turned out to be yield burning, he told them, he would answer honestly. There was no immediate response, but he knew it was not the kind of assurance they were hoping to hear.

Privately he was elated at this evidence that the government had been working its way down his list and had finally gotten to his name, and he spent the next few days rehearsing his answers to the expected questions. But when the interview finally took place, that elation quickly vanished. The conversation was held in Lissack's office, but it was done by telephone, and under the watchful eyes of two of Smith Barney's attorneys. To his astonishment, it soon became apparent that the subject was "pay-for-play"—essentially bribes paid by investment banking firms to participate in municipal bond transactions. Yield burning was never even mentioned. The FBI was interviewing him because it was investigating Smith Barney's business practices in Texas; the selection of his name was simply a coincidence, and had nothing to do with his initiatives of the previous December. With the Smith Barney legal counsel watching his every move, there was no way he could bring up the subject on his own. His long, anonymous tutorials had fallen on deaf ears, and a year of waiting had been in vain. He realized then that the government would not act unless he took more deliberate steps. His new nonstatus in the firm gave him plenty of free time to ponder what those steps might be. One morning shortly after the devastating interview, he was sitting in his office leisurely reading through the *Wall Street Journal* when he came upon a possible source of guidance. This story was about John Phillips and his False Claims Act practice, Phillips & Cohen

which was now based in Washington, D.C. This was just the kind of perspective his situation demanded, and after some coaxing he persuaded his attorney to call Washington.

The lawyer's call was put through to Erika Kelton, a bright, creative, voting attorney who had only recently joined Phillips & Cohen, after working on *qui tam* cases in the Washington office of one of New York's largest and most prestigious law firms. ..She told Lissack and his lawyer that the False Claims Act had never been applied in a securities case, but that it was the perfect law for the fraud described by Lissack. Under the act, they could be prosecuted for falsely certifying compliance with federal yield restrictions and pocketing the government's money. Lissack estimated the extent of that theft to be in the hundreds of millions. He signed a contingency contract with Phillips & Cohen, and Kelton immediately set about the long, complicated process of drawing up the complaint. Lissack's New York attorney, who remained focused on the employment lawsuit, proposed holding a press conference to publicize the *qui tam* action as a way to pressure Smith Barney into an early, favorable settlement. Kelton had to explain to him why that couldn't be done, that the case had to remain under seal until the government had investigated the facts and decided whether to join the action. Any public discussion of the case by Lissack or his attorneys, she warned, could automatically end it.

There were other ways to apply pressure, however, and soon Lissack had a powerful new incentive to use them. At the end of January 1995, when the firm distributed its annual bonus checks for the year just ended, he was stunned to discover that his reward was less than half his salary—and nearly \$400,000 less than the bonus he had been paid the year before. First Smith Barney had taken away his work, and now it had cut off his income. He knew he was still viable in the banking industry, but considering all the elements that he had already set in motion, he decided his viability wouldn't last long either. He had nothing left to lose. He began liquidating stock options, in preparation fiat being tired.

On the morning of the first Wednesday of February 1995, anyone passing Lissack's office might have wondered what he was doing to keep himself so busy at his desk. He was putting the finishing touches on a detailed memorandum to senior Smith Barney executives, written with the help of his New York attorney. It identified specific questionable practices in one of the company's bond offerings in Dade County, Florida, and cited "tradeoffs" in municipal business with the executive at Lazard Freres who was being investigated by the FBI. Predictably, reactions to the memo were uniformly negative. How dare he raise these issues? Who did he think he was? 'What on earth did he have in mind?

...On Friday morning he faxed Smith Barney's management a sixpoint memorandum, each point signaled by a typographic bullet, listing the specific practices by which he felt the firm had violated securities laws. At the end of the memo, he put his employers formally on notice that he was no longer going to withhold this information from the

authorities. He read the memo to himself after it had been sent, then said to his attorney, with a kind of grim glee, "Bullet, bullet, bullet, bullet, bullet, bullet." The following Monday, Smith Barney informed his attorney that Michael was no longer welcome to return to the office. Lissack then faxed his memos of the week before to the United States attorney, the SEC, and the FBI, with a note explaining that his bulleted memorandum referred to a bond issue in Florida and suggesting that the agencies might want to call him. A few days later a couple of officials from the SEC's Dade County office called and interviewed him, but they were investigating Smith Barney for other reasons and didn't seem interested in anything Lissack had to say about yield burning.

Three weeks after his termination from Smith Barney, Michael Lissack filed *a qui tam* lawsuit under seal against more than a dozen Wall Street and regional investment banks. Several days later, the story of his allegations of yield burning against the municipal bonding industry appeared on the front financial page of the *New York Times* without any mention of his False Claims Act case. In a self-deprecating reference to his baldness, Lissack described himself as "a Samson—blowing out the industry and pulling down the walls as I leave." He said that everyone in the business knew about the fraud, and that competing firms would help each other get away with it by taking turns as "objective" experts, certifying to issuers that the outrageously inflated prices were reasonable. "We even kept track of whom we did opinions for and who owed us," he told the reporter. No Wall Street insider had ever broken ranks in such a spectacular way, and in quick succession, similar articles appeared throughout the business press.

The response from the accused bankers was complete denial. Smith Barney attempted to dismiss the charges of irregularities by describing Michael Lissack as a disgruntled employee seeking revenge in a salary dispute. Neither alibi got many takers outside the industry. Four months after the story became public, *Fortune* wrote about yield burning in an article entitled "The Big Sleaze," saying that "even if [Lissack] is hell-bent on revenge against Smith Barney, what matters is whether he is telling the truth." It was only after the filing of his lawsuit and his identity becoming known to the federal government that the government actually began to investigate the charges he had made anonymously from the pay phone in Florida more than a year before.

Lissack's charges hit Wall Street at a bad time. Virtually the whole municipal bond industry already was under investigation for a variety of other illegal practices. A particular target was gifts or political contributions made to local and state officials in return for preference in the assignment of underwriting business, a widespread form of bribery known as "pay-to-play." Just a few months earlier, the husband of former Kentucky governor Martha Layne Collins went to prison for regularly demanding and getting payments from Wall Street firms in exchange for a piece of the state's municipal bond business. In New Jersey, a former chief of staff to ex-governor Jim Florio had pled guilty to securities fraud for sharing in \$200,000 in kickbacks from a local bank. And several dealers were facing similar charges in the aftermath of a securities fraud that had bankrupted Orange County, California. But yield burning was by far the biggest,

most pervasive fraud in the municipal bond market. The earlier cases were mere firecrackers compared with Lissack's five-hundred-pound bomb. Within the industry, there was a lot of maneuvering to be elsewhere when it went off. That October, the National Association of Bond Lawyers, which represent municipalities on bond deals, was careful to disavow any liability on its part. Its members "do not possess the necessary financial and market expertise to perform these reviews and verifications," the association told the IRS, that its clients purchased securities at fair market prices.

To prove the case, he and his lawyers had to show how extensive yield burning was and how much the government had lost as a result of the fraud. This required analyzing security prices on hundreds of individual escrow transactions. Lissack spent days at the New York Public Library, scanning back issues of the *Wall Street Journal* to gather historical Treasury bond prices. He searched Municipal Securities Regulatory Board filings for more data. By July, preliminary analysis clearly demonstrated the huge markups banks were adding to the prices they charged their government clients for securities. Working on the case nearly full-time, Lissack set about designing analytical software to draw a more detailed picture of the fraud. Phillips & Cohen bought data tiles of historical Treasury bond prices for analysis by those programs, and the firm wrote to more than five hundred public agencies around the country requesting the closing documents from advance refundings to get bond prices.

Government officials were eager to get more information from Lissack about fraud in the muni bond industry. His attorneys presented what amounted to a series of informal tutorials to officials of the SEC, justice Department, and FBI that were designed to bring the government up to speed about fraud in the municipal bond industry. He also testified before a grand jury in Boston. During those sessions, Lissack provided detailed insights into the politics of landing municipal bond deals, such as high-priced lunches, golf outings, and the hiring of politically connected consultants. His audiences couldn't have had a better tutor. It would have been hard to find an expert with a more intimate understanding of the bond market, let alone one who was willing to tell what he knew. On the inside, Wall Street is a small town, and municipal reinvestment specialists were an exceptionally small and exclusive group. They were zealous competitors, but also close colleagues who migrated constantly among the rival firms. And within their tiny circle, they liked to gossip. In many instances, a refunding transaction could not be accomplished without the participation of another firm, which had to verify that the prices of the Treasury securities were reasonable. That second firm was likely to pass on information about investment pricing practices to others in the circle. Not all of the federal agencies were equally enthusiastic about the False Claims Act, or about going after Lissack's choice of targets.

In one of the first sessions with justice Department officials from Washington and the Manhattan U.S. Attorney's Office, Lissack and his lawyers got a preview of the obstacles that lay ahead. "I don't get it," said one of the Washington attorneys. "Usually in *qui tam* cases we sue over something tangible, like widgets. What's tangible in this case? It's

just about money." "It's a billion dollars!" John Phillips stammered in response. He knew this attorney was antagonistic to *qui tam* cases in principle, but he nearly choked in astonishment at her dismissive comment. This was hardly the way Phillips and his firm had expected the case to be received. At the outset, they had been thrilled at the prospect of working with the famous Southern District of New York. Under the previous U.S. attorney, Rudolph Giuliani, the Justice Department's Manhattan office had taken on Ivan Boesky, Michael Milken, and other so-called Masters of the Universe in the 1980s and sent them to prison.

But times had changed, and so had the Southern District's leadership. The new U.S. attorney in charge was Mary Jo White. Several of the convictions the office had won during the heady 1980s had been overturned, apparently at a high cost to the office's crusading spirit. The team of Justice Department attorneys assigned to Lissack's case, led by the Manhattan office's Civil Division, seemed to have little interest in taking on Wall Street's big names and New York's top law firms. Attorneys from the Southern District and the main Justice Department office in Washington attended meetings with the SEC, IRS, and Lissack's attorneys on the case, but that was about the extent of their involvement. From 1995, when Lissack filed his *qui tam* case, until 2000, when the government settled essentially the last remaining yield-burning charges, the Justice Department never issued a subpoena, deposed a witness, or even calculated the government's losses from the fraud. Whatever leadership and support Lissack's attorneys or the SEC might have expected from the Justice Department in Manhattan and Washington, nothing of the sort ever materialized.

But this time, the Justice Department wasn't the only game in town. By then, California had passed its own False Claims Act, drafted by John Phillips and modeled after the federal statute, allowing *qui tam* lawsuits for recovery of losses to local and state entities. A few months after he had brought his federal case, Lissack sued Lazard Freres & Co. in California, with Phillips's guidance, over the municipal bond deal with the Los Angeles Metropolitan Transit Authority. This second litigation front was entirely independent of the federal government. With the newspaper story on the LAMTA offering he had read while in Key West the starting point for his long crusade, Lissack knew this was a particularly blatant case of yield burning.

Lazard had risen to prominence under investment banker Felix Rohatyn, when the firm helped New York City out of a huge financial crisis in the 1970s. But as LAMTA's financial adviser in Los Angeles in 1993, the firm was nowhere nearly as public-spirited. Lazard bankers convinced the agency to use their firm rather than a competitor to purchase the Treasury escrow securities for a \$560 million municipal bond refunding transaction. The agreement didn't come without conditions. Lazard had promised it would sell the Treasury securities to LAMTA at the lowest possible cost, and that the prices were at fair market value. When the numbers were fed to Lissack's new software for the analysis of muni bond re-financing transactions, however, it was obvious that neither promise had been kept. Lissack was intimately familiar with the Lazard deal because he had

competed for the business for Smith Barney, and after it was awarded to Lazard he still followed the transaction closely. His lawsuit charged that Lazard secretly and illegally overcharged LAMTA by more than \$3 million.

When the California lawsuit was unsealed in April 1996, LAMTA joined the action and hired Phillips & Cohen as its attorney. By representing both Lissack and the state agency, the firm became, in effect, both the private and public attorneys general. The firm added new claims on behalf of LAMTA for breach of fiduciary duty, and sought punitive damages. It was the kind of story the media love to get mad about, and there was no shortage of sound bites from obliging public officials. Zev Yaroslavsky, a Los Angeles County supervisor who sat on the LAMTA board, said Lazard Freres had "set out to cheat and steal money that was rightly the taxpayers'." Yaroslavsky also had some encouraging thoughts about the punitive damages. "While it's important for us to recover our money, it is just as important for us to send a clear message to the financial and investment banking community that they can't and won't get away with manipulating and defrauding their public agency clients and the taxpayers."

Lazard offered a few bites in return, but they were not nearly as tasty. "We continue to believe that our markup for the securities sold was fair and consistent with accepted market practice," a company spokesman told the *Los Angeles Times*. It was a familiar line. Other investment banks had likewise defended the markups with the claim that the prices reflected the risks. If the deals fell through, they said, the banks would be stuck with the bonds that they held in escrow for their clients. The problem with that argument, Lissack and the attorneys pointed out, was that the deals never fell through.. And even if they ever did, the banks were more than likely to make money than to lose it.

Based on what they had learned from Lissack's groundwork, Phillips & Cohen hired an exceptionally bright economic analyst, Steven Feinstein, a young professor of finance at Babson College, near Boston, to measure the extent of the theft. Kelton worked closely with Lissack and Feinstein to gather detailed information about hundreds of advance refunding deals and to analyze each one—something no one, apparently, had done before. They debated and critically examined their findings to ensure they held up against any argument Wall Street could muster. Their analysis torpedoed the banks' argument that the amount they charged clients for securities was based on risk by showing that a Wall Street bank would charge one client substantially more than it charged another on the same day for the very same securities. The only explanation was the amount of arbitrage the banks could rip out of the deal. They analyzed the price difference between sole-source refunding deals like the Lazard-LAMTA transaction, and deals in which there had been open competition. Nothing like it had ever been done before—one reason why bond dealers got away with yield burning for so long.

The economists analyzed more than three hundred muni bond refinancing transactions based on responses to the earlier query by Phillips & Cohen. They looked at big deals

and small ones, competitive and noncompetitive, those involving Lazard and those involving other firms. The hard numbers proved the offense and showed its scope. The Wall Street bankers didn't have a leg to stand on.

The analysis demonstrated that widespread yield-burning abuses in municipal bond transactions in the early 1990s had cost the federal government and state and local governments hundreds of millions of dollars. It demonstrated that no-bid refunding deals present identical risks to those associated with competitive bidding deals, and that they should have been priced in exactly the same way. Instead, while competitive deals were indeed priced close to their fair market value, noncompetitive deals were on average twenty times higher. The average markup of bonds on competitive deals was only about four cents per \$1,000 worth of bonds; in sole-source deals, the markup was a breathtaking hundred times as much. The analysis showed how opportunistic Wall Street firms would routinely charge different markups on securities sold to different issuers on the same dates. They would settle for modest profits of five cents per \$1,000 worth of bonds in a competitive offering, then charge another issuer \$5 per \$1,000 for the same thing when the fix was in. Except in a few cases where the greed was even more outrageous, the local and state agencies issuing the bonds weren't the ones who suffered from these enormous pricing differences. By law, the excess profits didn't belong to them but to the federal government, and by inflating their commissions the bankers were stealing money that actually belonged to the United States Treasury. The issuing agencies had little incentive to question whether the banks' charges were really at fair market price.

There was another reason public agencies were often so willing to forgo competitive bidding. Banks encouraged their clients to view bond refinancing as a complicated juggling act that was best left to the professionals. They frequently claimed to know more about the issuer's needs than the agency did, and would promise to tailor a mix of securities accordingly. The economic analysis revealed that lie as well, demonstrating that noncompetitive bidding was always for the benefit of the banks, never for the issuers.

In the LAMTA offering, Phillips & Cohen's experts showed that the bonds had been priced at least fourteen times higher than the prevailing market rate. Lazard had told its client that the bank would make only \$200,000 to \$300,000 in profit from the securities sale; in fact, it made \$3 million. The SEC relied in large part on the economic analysis from Phillips & Cohen to determine what the U.S. Treasury's losses were for yield burning in each bond transaction, and used those numbers as a basis for settlement negotiations.

While the Justice Department continued to sit out the game, the Internal Revenue Service decided to act boldly on its own. In July 1996, the IRS gave notice to muni bond issuers that they had one year to pay the government the illegal profits if they didn't want to lose the tax-exempt status of their bonds. The IRS knew that the investment

banks, not the municipalities, had pocketed the forbidden gains, but the agency's enforcement authority in this area is generally limited to bondholders and state and local authorities. Although in certain circumstances the IRS can go after the underwriter as well, it was subject to limitations; the amount of money the IRS would be able to collect from the banks wouldn't be anywhere close to what they had stolen from the Treasury. Right on cue, local and state officials across the country picked up the phone and called their bond underwriters and investment advisers. If this isn't settled, they said, forget about any more underwriting deals from us. With equal predictability, the state and local issuers and their lobbyists urged the IRS, SEC, Congress, and the White House to redirect the attack and go after just the investment banks. They argued that pulling the tax exempt status of so many issues would drain them of any value and throw the entire municipal bond market into turmoil. The IRS yielded slightly in September 1996 by removing the one-year deadline. But the municipalities continued to feel the pressure from the tax agency. IRS officials made clear in public speeches that they would pursue bond issuers until the matter was resolved.

Soon after the IRS announcement, Treasury Secretary Robert Rubin said his department and the IRS would work with all parties affected by the ruling, including the bond dealers. But it was immediately apparent that Rubin himself was touched by the controversy. Before assuming the top job at Treasury, which oversees the IRS, he had been cochairman of Goldman, Sachs & Co., the first firm named in Lissack's lawsuit and now under investigation for yield burning. The Treasury Department delivered on his promise, but Rubin recused himself from all discussions of the IRS notice. The SEC responded to the pressure as well by going directly after the investment banks. Like the IRS, the commission had never been involved in a False Claims Act case.... In this case, it was up to the SEC to protect the government's interest too, since the Justice Department continued to play a passive role. The SEC, working with Phillips & Cohen, took on the burden of proving the fraud and negotiating settlements.

...One of the SEC's first steps was to send out questionnaires on refunding escrows to more than a dozen major Wall Street banks. Then it began to focus on building evidence against the largest offenders, issuing subpoenas, taking depositions, and gathering documents. The SEC didn't have the resources to go after all of the violators, so it targeted a couple of the worst to serve as a warning to others.... In early 1997, the Government Finance Officers Association, whose members handled municipal bond transactions throughout the United States, invited Phillips & Cohen to present its economic analysis at the GFOA annual meeting in Washington, D.C. The Babson consultant, Feinstein, explained the firm's methodology and then, one by one, stripped away the veils that had been woven to hide this theft from the officials' view. The audience listened attentively as he led them toward the light, demonstrating how investment banks had cheated their government clients out of hundreds of millions of dollars. For many, it was like watching the film from a surveillance camera that had recorded a massive daylight robbery.

...If the bonds lost their tax-exempt status, bondholders could be held liable to the IRS for billions of dollars in back taxes and interest on income they had received over the years that they thought was tax-exempt. A class action on behalf of bondholders, in turn, could make bond dealers liable for billions of dollars for fraud. And for the municipalities that had issued the bonds, the result could be skyrocketing costs in the financing of schools and other construction projects.

...[Many months later, Lissack's] lawyers called to tell him of the first breakthrough in his *qui tam* lawsuit. CoreStates Financial Corp. of Philadelphia agreed to pay \$3.7 million to settle Lissack's case and all other related federal charges against Meridian Capital Markets, which it had acquired two years earlier. The lawsuit said Meridian defrauded the federal government through yield burning in more than a hundred transactions involving advance refundings totaling approximately \$357 million between 1992 and 1995. The news was particularly encouraging because the Justice Department, the SEC, and the IRS had all agreed to the settlement. Lissack wasn't the only one who was glad at the outcome—the issuers of those bonds were relieved to learn that the resolution included an IRS agreement to not challenge their tax-exempt status. Other investment banks pored over the settlement documents, trying to decide whether it would be cheaper to continue the fight or to try for a similar result. But the answer wasn't all that obvious. The settlement did not say what the federal agencies had determined was a "fair" markup on the Treasuries. It gave no hint of how much the government might consider enough to settle similar charges against other banks.

What the CoreStates settlement made crystal clear was that the time had come for the investment banks to take Lissack's lawsuit seriously. The major dealers in the muni bond market formed a joint defense group. They each had different attorneys, but all were from New York's top law firms, and they agreed to share information in support of their common goal. The lineup facing Phillips & Cohen and the firm's understaffed government allies comprised an all-star team of legal talent: former prosecutors, former Supreme Court clerks, even a onetime head of enforcement for the SEC. Meanwhile, in California, Lazard had used similar resources to drag out its fight against Lissack's *qui tam* LAMTA lawsuit for three years. The bank was represented by Wachtell, Lipton, Rosen & Katz, one of Wall Street's most aggressive, successful, and rich law firms. In 1997, Wachtell had sent the LAMTA a long, carefully detailed response to the charges against Lazard. It laid out the complexities of the muni bond transactions, explaining Lazard's profits in seemingly rational terms. When Lissack read the letter, he scoffed. It was wrong from beginning to end, he said, packaged in jargon that could be translated only by an insider, a classic example of how the banks had been able to get away with their scam for so many years.

Phillips & Cohen spent thousands of hours preparing legal briefings and arguments, taking depositions, reviewing and analyzing hundreds of thousands of pages of documents. It brought in a local firm to help coordinate the case in Los Angeles. It

invested nearly half a million dollars on a custom-designed, computerized document retrieval system. Erika Kelton led the effort to assemble a detailed, lucid chronology of every step in one Lazard-LAMTA transaction. Over hundreds of pages, the lawyers laid out the dates and content of all correspondence, phone calls, meetings, contracts, and trades. ...Both sides meet with a mediator in San Francisco. LAMTA delegates attended along with Phillips & Cohen attorneys. ...The mediator made one more circuit. This time he returned with Lazard's agreement to pay \$9 million. Phillips, Kelton, and the LAMTA officials were ecstatic. Not only had they won a major recovery, but they felt that this victory might provide a template and a new motive strong enough to persuade the Justice Department to at last join Lissack's much larger federal *qui tam* case and to take an active role.

They would never get all they hoped for. After Kelton and Phillips returned to Washington, the firm sent numerous formal requests to the U.S. Attorney's Office in Manhattan, asking it to request materials from the banks in order to develop evidence. But rather than seizing on the momentum of the Lazard settlement, the Justice Department was trapped in its own inertia. Despite repeated urgings to be as aggressive against the other investment banks as Phillips & Cohen had been against Lazard in California, Justice continued to look the other way. The requests were ignored. Kelton expressed the firm's frustration in a letter to the U.S. Attorney's Office. "We understand that the Justice Department has received documents collected and developed by the SEC in the course of its investigation," she wrote. "We believe, however, that it is not sufficient to rely entirely on those materials for the False Claims Act matter. It is, therefore, up to the Justice Department and relator to investigate each defendant's yield-burning practices." Still there was no response.

So it was left to the SEC to bring the case to its conclusion. One by one, the commission pressured the investment banks to come to the negotiating table to settle the yield-burning charges and put the case behind them, but without anywhere near the leverage it would have had if Justice had participated as well. The banks all balked and grumbled, but when they dutifully fell in line it was likely with a secret sense of relief. In April 1999, Lazard paid \$11 million to settle Lissack's lawsuit and related federal charges. Seven months later BT Alex. Brown paid \$15.3 million. The biggest settlement came in April 2000, when seventeen banks paid [millions] to the federal government. Included were the best-known names on Wall Street: Salomon Smith Barney, PaineWebber, Goldman Sachs, Merrill Lynch, Lehman Brothers, Morgan Stanley Dean Witter. By the end of that year, after the final defendants in the case settled, yield-burning recoveries by the federal and some state governments totaled more than \$200 million.

Using money from his multimillion-dollar reward, Lissack endowed an academic chair in social responsibility and personal ethics at his alma mater, Williams College. Except for a certain pride in being known as "the man Wall Street loves to hate," he was glad to shut the door on the past and get on with his new life. On balance, Lissack and his attorneys had good reason to be pleased with the results. But they all knew—and so did the

Department of Justice— that if the banks had settled on the same terms that the law firm had achieved in California, the amount would have been nearer to a billion. When Congress amended the False Claims Act in 1986, many opponents predicted that whistle-blowers and their attorneys would be freeloaders who would seek rewards for little more than the filing of a lawsuit. In this case, it was Lissack and his attorneys who had done the heavy lifting, and the Department of Justice that had been the easy rider.