Washington Decoded

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LBOs: Enough Already!

By Max Holland and Viveca Novak

Washington, not just Wall Street, must share the blame for the latest panic in the stock market. It had its chance to do something decisive about the market's speculative orgy, in the guise of leveraged buyouts, but so far has backed off.

A key reason: the growing political clout of what might be called the LBO lobby. Buyout artists are using a portion of their lucre to make investments in key politicians. Inaction on Capitol Hill is the buyout artists' prized commodity, and so far their investment is paying good dividends.

The last election cycle graphically illustrates how the buyout lobby is putting its money where its interests lie. An analysis of contributions by 239 LBO practitioners, including their wives and children, shows they invested a total of $3.5 million in presidential candidates, key members of Congress, party committees, and PACs – including $1.2 million in "soft money" to the Bush campaign. The list reads like a *Who's Who* in the buyout world: Henry Kravis, $182,000; George Roberts, $124,000; Theodore Forstmann, $131,000; Raymond Chambers, $154,00 and so on.

Common sense and public opinion are decidedly against the speculative leveraging of corporate America. Yet it wasn't until the RJR Nabisco buyout last fall that Washington took serious notice. At $25 billion, the deal was more than triple the largest previous LBO and had other eye-popping features: RJR head Ross Johnson put his own company into play in a proposed LBO that would have enriched him by more than $100 million; but he lost out to Henry Kravis, head of the Kohlberg, Kravis, Roberts & Co. buyout boutique.

It looked, for a moment, as if the RJR Nabisco deal might rouse the politicians to take action. In early November, Senate Minority Leader Robert Dole (R-Kansas) told an American Stock Exchange conference that corporate buyouts do not contribute to the U.S. economy and that LBO loans feed on loopholes in the tax code. Then-House Speaker Jim Wright (D-Texas) told reporters the government should act swiftly to stem LBOs. Finance Committee Chairman Lloyd Bentsen (D-Texas), said LBOs "have gotten out of hand." By New Year's Day, nine congressional committees had announced hearings.

That sort of talk threatened the dealmakers and their staggering incomes. Senior buyout engineers at KKR each took in about $50 million last year, according to *Financial World*, and more than 150 buyout boutiques and departments of long-established Wall Street firms are doing LBOs – up from half a dozen in 1981.

Both Wall Street and Capitol Hill knew that any effort not supported by the incoming Bush administration would be tough going, if only because of the LBO interests' clout. But Congress also remembered that, back when the market crashed in October 1987, the House Ways and Means committee had been blamed by some for approving a limit on interest deductibility for debt incurred from buyouts.

If the administration's position was pivotal, then the LBO community had every reason to believe it was holding some good cards. During his campaign, Bush had pushed all the right buttons by proclaiming himself heir to the pro-market, anti-regulatory environment nurtured under Reagan. The buyout interests had responded by going all out financially for the Bush campaign.

Six weeks after the 1987 market meltdown, Henry Kravis arranged a Wall Street luncheon that took in more than $500,000 for Bush; subsequently Kravis became finance co-chairman for the candidate's New York campaign. Kravis and his partner George Roberts each gave at least $100,000 to the Bush "soft money" drive, thereby earning a place on "Team 100." All told, KKR's 19 professionals and their spouses gave a total of $418,200 to Bush and various campaign funds.

"Obviously the people who give want to be invited to the party, the White House, the lunch, the dinner," says veteran political consultant David Garth. In late June, for instance, Kravis and his fashion-designer wife, Carolyne Roehm, helicoptered to Washington for dinner at the home of top Bush fund-raiser and Commerce Secretary Robert Mosbacher and his wife, Georgette, where they mingled with the likes of Republican National Committee Chairman Lee Atwater, House Speaker Tom Foley (D-Washington) and Michael Boskin, chairman of the president's Council of Economic Advisers.

Still, administration support wasn't a *fait accompli*. One of the most intriguing divisions on Wall Street and within the GOP pits old money, in the person of Treasury Secretary Nicholas Brady, against the cocky and frequently ostentatious buyout entrepreneurs who now reign. Brady's unease, in part, reflects his concern that much of the cash financing LBOs is coming from the government's coffers. "The substitution of tax-deductible interest charges for [taxable] income is the mill in which the grist of takeover premiums is ground," Brady told Congress in January. Nearly every leveraged company pays no income taxes for a few years after a buyout and some even get large refunds: RJR Nabisco may get back most of the $1 billion it paid in taxes in the three years prior to the buyout.

But if Brady is discomfited by contemporary Wall Street, he has hardly led a charge against LBOs. When Treasury testified in May, it rejected 25 of the Ways and Means panel's 27 ideas for dampening LBO fervor, urged extreme caution if the committee pursued the other two – and offered no ideas of its own. In July the administration finally made one recommendation eliminating the interest deduction for certain types of junk bonds. As Representative Byron Dorgan (D-South Dakota) puts it, "Treasury's taken a vacation on this issue."

The focus on the administration didn't mean buyout interests ignored either party on Capitol Hill. Democrats, who control both houses, received $517,500 from the 239 buyout activists and their families, versus $440,000 to Republicans in 1987-88. The top 10 Banking and Finance recipients in the Senate – far more popular than the House with this group – took in $222,000 in individual contributions from LBO players, and LBO-connected PACs supplied an additional $255,197.

The largest single amount went to Senator Bill Bradley (D-New Jersey), a smart, influential member of the Finance Committee who wasn't even up for reelection. He took in at least $96,000 from individuals in the buyout community, including more than 60 contributions of $1,000 each from employees of just two firms, Wesray and Hambrecht & Quist. Bradley's staff says the senator isn't sure there is a buyout problem or how to fix it if there is one.

Members of the leadership were also favorite targets. In March 1988, when Representative Foley was House majority leader, 41 executives of the securities firm Salomon Brothers (which has many interests, including a growing LBO fund) attended a $500-per-person breakfast fund-raiser for him or sent in checks.

Still, some argue that Wall Street's contributions didn't make the difference on LBOs – that uncertainty over a complex issue did. But by using its relatively easy access, the LBO gang was able to effectively exploit that uncertainty and cultivate confusion.

The buyout interests sang two refrains to Congress: that buyouts are good for the economy; and, anyway, a cure could be worse than the disease. Some top firms prepared their own studies. The first and most important was a KKR report released in January, claiming outstanding results, not only for investors, but the economy as a whole.

The KKR report was immediately accepted on the Hill as self-serving, but solid. Several months later, the report was undercut at a hearing arranged by the House Subcommittee on Telecommunications and Finance. Bill Long, a former Federal Trade Commission economist researching buyouts at the Brookings Institution, took apart KKR's methodology, and argued that nearly all the claims were misleading. But Long's testimony came late – in May – and by that time the terms of the LBO debate had shifted decisively.

Meanwhile the LBO lobby fed the Democrats' nagging fear of being blamed for another Black Monday, though they rarely made their argument publicly. At 17 days of hearings before various panels over five months, only two buyout boutiques agreed to testify, and they weren't from the top ten buyout firms.

Only two proposals are included in the pending budget bills passed by each house – one based on the administration's junk bond interest deduction idea and another limiting refunds of past taxes. Experts say both measures would likely affect only deal-pricing, not deal-making. If Washington started out intent on curbing buyout mania, an intimidating and tenacious lobby has so far dulled its impulse.

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