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THE BANKERS TRUST TAPES

In just-released court papers, Procter & Gamble lays out racketeering charges against Bankers Trust. The key evidence: Some 6,500 tape recordings

It's Nov. 2, 1993, and two employees of Bankers Trust Co. are discussing a leveraged derivative deal the bank had recently sold to Procter & Gamble Co. "They would never know. They would never be able to know how much money was taken out of that," says one employee, referring to the huge profits the bank stood to make on the transaction. "Never, no way, no way," replies her colleague. "That's the beauty of Bankers Trust."

That dialogue was automatically picked up by a Bankers Trust recording system--similar to those at other financial institutions--that routinely tapes conversations involving transactions, mainly to settle disputes over trades. It is part of a mountain of evidence--6,500 tapes, as well as 300,000 pages of written material--that forms the basis of a major legal assault by P&G against the bank. P&G contends that the 1993 conversation is just one of many showing that Bankers Trust deliberately misled and deceived P&G, keeping the company in the dark about key aspects of the derivatives the bank was selling.

Once one of the most powerful, profitable, and aggressive banks in the world, Bankers Trust has been humbled over the past 18 months by a series of debacles in its core derivatives business, with numerous clients of the bank sustaining large losses. P&G took a \$102 million aftertax charge for losses on Bankers' derivatives, perhaps the largest of any of its customers. Several other clients have also sued the bank for losses. And the Securities & Exchange Commission, the Commodity Futures Trading Commission, and the Federal Reserve Bank of New York have all investigated Bankers' derivatives sales practices and reprimanded or censured the bank.

Procter & Gamble's fight with Bankers Trust is now taking a new and far more ominous turn for the bank. On Sept. 1, P&G filed a motion with the U.S. District Court in the Western Division of the Southern District of Ohio to add RICO (racketeer-influenced and corrupt organization) charges to its list of allegations against the New York bank and its affiliate, BT Securities Corp. Supporting documents, which contain numerous excerpts of conversations by the bank's employees, were sealed until Oct. 3. On the same day, district court judge John Feikens approved the P&G RICO motion.

Some portions of the tapes, mainly concerning Gibson Greetings, a Bankers Trust client, became public last year. But the newly released portions, some of which are potentially incriminating, are much more extensive. They focus on eight Bankers customers besides P&G. The alleged losses of three of them--Sandoz, Sequa, and Jefferson Smurfit--had not been previously detailed. Other alleged victims in the amended complaint are Gibson Greetings, Equity Group Holdings, Adimitra Rayapratama, Air Products & Chemicals, and Federal Paper Board (table, page 111).

``BLACKMAIL." P&G uses evidence of alleged wrongdoing against these clients to buttress the racketeering charges, which require a showing of broad, systemic fraud. Asserts the P&G filing: ``It is now apparent that Defendants' treatment of P&G was not an isolated incident or a `garden-variety fraud,' but rather part of a pattern of mail, wire, and securities fraud spanning a number of years and involving multiple victims."

In a 400-page filing opposing P&G's claims, Bankers says that ``P&G plainly has proposed adding civil RICO claims at this late date for their in terrorem effect; laymen would call it blackmail." The bank says further that ``The real impetus for these charges is P&G's hope that legitimate criticism of decisions by P&G's senior management and Treasury Dept. staff will be lost at trial in a sea of accusations about customers other than P&G, and that Bankers Trust can be vilified by the sheer number of P&G's accusations." In a statement released after P&G's documents were unsealed, Bankers said that ``What P&G has done is to use material we provided to manufacture a distorted view of transactions, markets, individuals, and the corporation in a manner designed to serve its own objectives and to obscure P&G's own accountability." BW attempted to solicit comments from Bankers Trust's directors, but they either refused, referred calls to the bank, or could not be reached.

P&G provides a detailed case for its side. To substantiate its claim that a ``culture of greed and duplicity" was an element of the general climate in parts of Bankers' derivatives business, P&G cites a videotaped training session for new employees. At the session, a bank employee tells his charges that, in a hypothetical derivative transaction among Sony, IBM, and Bankers Trust, ``what Bankers Trust can do for Sony and IBM is get in the middle and rip them off--take a little money." The employee then adds: ``Let me take that back. I just realized that I'm being filmed." A Bankers spokesman played six minutes of the videotape of the session for BW, which the bank says lends support to the bank's contention that the employee's comment was ``a very poor attempt at humor, but nothing more," in an ``otherwise dull presentation" and that the comment was taken out of context.

According to P&G: ``Fraud was so pervasive and institutionalized that Bankers Trust employees used the acronym `ROF'--short for rip-off factor, to describe one method of fleecing clients." An internal document about a proposed derivative for Federal Paper Board allegedly says that Bankers would make \$1.6 million on the deal, including a ``7 [basis point] rip-off factor." In a different instance, two Bankers employees are discussing a client's loss on a trade. One then tells the other: ``Pad the number a little bit." P&G quotes another Bankers Trust employee saying to a colleague: ``Funny business, you know? Lure people into that calm and then just totally f--- 'em."

In responding to conversations by Bankers Trust employees quoted in this story, a bank spokesman says that ``the stupid and crude comments between Bankers Trust employees on these tapes were the basis for our disciplinary actions against these individuals last

year." A number of the employees quoted in the documents have left Bankers, been disciplined, or been reassigned.

UPPING THE ANTE. John E. Pepper, P&G's new CEO, will not comment on the Bankers situation. But the racketeering charge shows he is maintaining the company's well-known aggressive legal posture. A P&G spokeswoman says: "We've reviewed hundreds of recorded telephone conversations and thousands of documents through discovery and believe the RICO claim was appropriate. We plan to proceed with the case." The company further claims that it expects to uncover additional evidence.

In its filings, P&G details three primary schemes Bankers allegedly used to defraud its clients. It says the bank fraudulently induced clients to buy complex derivatives, misrepresented the contracts' value, and then induced clients to buy additional complex derivatives, either for further "alleged gains" or to stanch losses. It quotes one banker describing a client's portfolio as being in total disarray: "If this ever comes out in the press, it is the most insane mess of trading I've ever, ever seen...they just kept trying to trade them out of losses...Everything they put in [the client's account] lost."

"P&G has...manufacture[d] a distorted view of transactions, markets, individuals, and the corporation . . . to serve its own objectives and to obscure P&G's own accountability"

-- BANKERS TRUST PRESS RELEASE

The new charges, which claim \$195.5 million in damages, could prove extremely embarrassing to the bank--or worse. Any company found guilty of civil RICO charges must pay treble damages and plaintiffs' legal costs. Such an outcome could push Bankers to settle the suit regardless of its culpability. "It ups the ante," says attorney Robert Plotkin of Paul, Hastings, Janofsky & Walker in Washington. In addition, clients could become unsettled by the appearance of a corrupt culture, and senior management could come under even more pressure.

Much of the dispute between Bankers Trust and its clients that suffered losses may depend on whether the clients were simply naive and should have known what they were getting into or whether Bankers Trust deliberately deceived them. P&G strongly argues the latter.

On Jan. 20, 1993, P&G had no inkling that its relationship with Bankers would ever deteriorate so badly. That's when it set up a broad agreement with the bank for derivatives contracts. One goal was to lower the rate at which P&G would borrow money. Derivatives are contracts in which companies make payments to each other tied to some underlying asset. The value of the payments--and thus the contract--is derived from those assets. Besides lowering financing costs, buyers may use derivatives to manage risk or speculate on interest and currency rates.

P&G seemed to be an active and sophisticated player in the financial markets: It had \$5 billion in long-term debt outstanding, and it carefully managed its financing costs. In court filings, Bankers describes P&G as "sophisticated, experienced, and knowledgeable about the use of interest-rate derivative contracts and the risks presented by those contracts." The bank adds: "Although P&G would like this court to believe that it is a naive and

unsophisticated user of derivatives transactions, the fact is that as part of its regular course of business and with authorization from top management...P&G's Treasury Department managed a large and sophisticated portfolio of derivative transactions." P&G, the bank says, was a party to derivatives tied to assets with a value of more than \$6 billion as of June, 1993.

In its memorandum opposing P&G's motion, Bankers presents documents, including handwritten notes apparently by Edwin Artzt, P&G's chief executive officer at the time, that suggest the Cincinnati company was knowingly stepping up the riskiness of its financing activities when it entered into the disputed transactions with Bankers. P&G says the note does not apply to debt management or to the transactions in the litigation.

On Nov. 2, 1993, P&G agreed to an offer from Bankers Trust to buy a leveraged derivative product. Leveraged derivatives are a particularly complex type of derivative, and their value can fluctuate to an even greater degree than ordinary, plain-vanilla derivatives. The contract called for P&G to make variable-rate payments to Bankers, with the rate to be set over the next several months.

It is not clear whether P&G knew what the cost of getting out of the contract might be, and P&G has since acknowledged that its internal procedures were not followed when it agreed to this derivative. The company also ultimately reassigned two employees involved with the derivatives, and its treasurer, Raymond D. Mains, who later elected to retire early. Mains declined to comment. But at the time, the company believed it might get interest costs below what they would have been otherwise.

The derivative seemed to work fine at first. Indeed, P&G was sufficiently satisfied to agree to a second leveraged derivative contract on Feb. 14, 1994. But P&G began encountering serious problems almost immediately. On Feb. 4, interest rates had begun rising after more than three years of near-continuous decline. The higher rates sharply pushed up P&G's payments to Bankers under the terms of the complex derivatives.

"IRRESPONSIBLE AND REGRETTABLE." On Feb. 22, P&G claims, Bankers told the company that at that day's rate, P&G stood to pay Bankers an increased interest rate of 4.5 percentage points above the commercial-paper rate on its Nov. 2 derivative, bringing its extra financing costs to over \$40 million. P&G says its officials were alarmed by the unexpectedly large amount. They charge that when they asked Bankers for an explanation, they learned that the bank was using a proprietary model to figure the costs. Bankers, P&G's complaint says, "stated that P&G was bound by a pricing model which [Bankers] did not disclose to the very party that it asserted was bound by such model."

"What Bankers Trust can do for Sony and IBM is get in the middle and rip them off-take a little money....Let me take that back, I just realized I'm being filmed"

-- P&G COURT FILING THAT ALLEGEDLY REFLECTS WHAT WAS SAID AT A BANKERS TRUST VIDEOTAPED TRAINING SESSION

Bankers Trust's court filings include a transcript of an October, 1993, conversation between Bankers and P&G in which Bankers apparently shows a P&G treasury employee how to calculate its rate on the Nov. 2 derivative. Bankers says this transcript

demonstrates that P&G clearly knew how its derivative would perform. The bank also cites file memos from three P&G employees that it says indicate that P&G was made aware of the rising rates on its Nov. 2 derivative in early or mid-February, 1994. As for the Feb. 14 derivative, Bankers presents as evidence notes by P&G's chief financial officer, Erik Nelson, that it says show that he did not feel P&G was misled on that derivative's terms.

P&G, however, claims that those notes were written before the company learned all it now knows about that derivative. And it says Bankers employees were clearly and almost continuously trying to deceive it from the day the derivative contract was initiated. P&G cites a taped conversation between Bankers employees about the Nov. 2 P&G contract where one asks: "Do they [P&G] understand that? What they did?" The other replies: "No. They understand what they did but they don't understand the leverage, no." The first employee then responds: "But I mean...how much do you tell them. What is your obligation to them?" The second employee answers: "To tell them if it goes wrong, what does it mean in a payout formula..."

Bankers employees were often gleeful at the big profits they were booking, according to P&G. The second employee quoted above says P&G undertook an option trade as part of a derivatives contract, and Bankers paid P&G only half what that option was worth. The employee allegedly remarks: "This could be a massive huge future gravy train." He also allegedly discussed how significant one of P&G's contracts had been for Bankers, saying, "This is a wet dream."

In April, P&G claims, Bankers Trust gave the company charts showing that it would have had to pay a penalty to get out of its Nov. 2 contract almost from Day One. According to P&G's documents, one Bankers salesman, discussing P&G's agreement to enter into the Nov. 2 contract, said "we set 'em up." P&G claims that, unbeknownst to the company at the time, there were periods when Bankers' model calculated that P&G's potential penalty payment to exit the derivative was rising even when interest rates were falling.

P&G claims that around that time, some Bankers employees were themselves worrying about the suitability of their activities. It cites a March, 1994, conversation between two employees where one said he had "fears of SEC probes." "This wave was always...made up of polluted water," one says. The other recalls telling a colleague that "as soon as we quit selling dynamite, maybe we'll have a good business."

P&G ultimately locked in interest rates on both of the leveraged derivatives in dispute. But it alleges that by the time it finished doing so, in April, 1994, its financing costs stood to be some \$195.5 million higher than they should have been. That same month, P&G said: "We are seriously considering our legal options relative to Bankers Trust."

In a statement, Bankers concedes that some of the taped conversations "were irresponsible and regrettable." But it says the remarks fall short of proving the deception P&G alleges. Instead, it produces evidence in court filings that P&G's top executives blamed their own personnel for the investment blunders. "Rather than putting its own house in order, and accepting its losses, P&G chose instead to bring this lawsuit."

"Fraud was so pervasive...that Bankers Trust employees used the acronym ROF-short for rip-off factor, to describe one method of fleecing clients "

-- P&G COURT FILING

P&G is also making serious fraud claims about Bankers' dealing with other clients. Several of the alleged victims have already gone public with their derivatives grievances. Gibson Greetings has settled a lawsuit with Bankers, as has Equity Group Holdings. Adimitra Rayapatama also sued, claiming RICO violations, although a ruling dismissing its suit on jurisdictional grounds is under appeal. And Federal Paper Board has settled with Bankers. Bankers Trust says in court filings that it needs much more information before it can refute P&G's allegations about other companies.

The P&G filing provides new information about three Bankers Trust clients whose relationship with the bank has not been previously detailed. In the case of Sandoz Corp., P&G claims that Sandoz entered into a leveraged derivative contract with Bankers on Jan. 31, 1994. Beginning in February, P&G says, employees of BT Securities knowingly misled Sandoz about the value of its contract by \$5 million. Sandoz allegedly amended its derivative contract nine times on Bankers' recommendation, spending some \$25 million in the process. At one point, P&G asserts that Sandoz paid \$4.2 million to modify its derivative contract when the change increased its value by only \$2.9 million. That netted Bankers over \$1.4 million.

SETTLEMENT? P&G also claims that a BT Securities representative, knowing that such a move would generate a large profit for Bankers, told Sandoz that the "conservative" way to manage its position would be to double its exposure while increasing the interest rate above which it would be hit with higher payments under the contract. But on Feb. 22, discovering that Bankers did not have the proper hedge to cover such a change, the Bankers rep reversed course--and began encouraging Sandoz to reduce its position. P&G alleges that Sandoz lost \$78.5 million in dealings with Bankers. Sandoz General Counsel Robert L. Thompson says: "We have settled a matter with Bankers Trust. The terms of the settlement are confidential," and he adds that Sandoz continues to have a "productive" relationship with Bankers.

As for Sequa Corp., P&G alleges that Bankers sold it a leveraged derivative--similar to P&G's Nov. 2 contract--on Oct. 1, 1993. In December, Bankers allegedly proposed various amendments to the contract that it told Sequa were costless. But, says P&G, an internal Bankers Trust phone call described it as having a negative value for Sequa of \$600,000 and a profit for Bankers Trust of \$200,000.

With interest rates rising, P&G says Sequa terminated half of the contract in February, 1994, at a cost of \$2.5 million. Sequa allegedly terminated the rest a month later at a cost of \$4.5 million, financing that with another transaction in which it was to pay Bankers \$6 million over the ensuing two years. Total alleged loss: \$7.5 million. Sequa declined comment.

In the case of Jefferson Smurfit Corp., P&G alleges that Smurfit entered into a leveraged derivative contract in May, 1993. The derivative quickly began losing value, P&G says, and Smurfit closed out the contract and was paid \$1.17 million by Bankers. But that was at a time, P&G claims, when Bankers internally valued Smurfit's position in the contract at \$4.4 million.

Smurfit agreed to another leveraged-derivative contract in December, 1993, according to

P&G. The company says Bankers ``induced Smurfit to amend this swap [a kind of derivative] 11 times before it was finally unwound in September, 1994." Meanwhile, the value of Smurfit's contract was declining. P&G says Bankers did not tell Smurfit, however. Alleges P&G: ``As early as February, 1994, BT Securities marketers discussed the fact that Smurfit was \$5 [million] or \$6 million down on the deal and that Smurfit's Treasurer `has no clue' about how far `underwater' his company was on the transaction."

At one point, P&G claims, Bankers Trust employees discussed showing Jefferson Smurfit some information regarding one of its derivatives, and one employee said: ``...what we show them is gonna be kind of baloney...." Ultimately, P&G says, Smurfit lost more than \$2.4 million on its derivatives dealings with Bankers. Smurfit says it is not aware of suffering any losses on derivatives with Bankers.

What's next for Bankers Trust? It's possible that the bank will settle with P&G rather than endure the possible playing of hours of incriminating tapes in open court. The Securities & Exchange Commission, which investigated Bankers Trust's derivatives sales practices, forced a deeply embarrassing settlement on the firm. The SEC says it is continuing to investigate evidence of individual wrongdoing. One thing, though, is clear: The ``massive huge future gravy train" has been permanently derailed.

The Tale Of The Tapes

Procter & Gamble, through discovery, obtained 6,500 tape recordings, as well as 300,000 pages of documents from Bankers Trust. The material concerned nine Bankers Trust clients who lost money dealing with the bank. From this evidence, P&G is alleging that Bankers Trust:

- Engaged in a pervasive pattern of fraud spanning a number of years and involving numerous victims
- Induced customers to purchase complex derivative deals that produced high profits for the bank and often big losses for many of its clients
- Misrepresented to clients the pricing, current value and risks of the products it sold
- Refused to share its secret pricing models and other proprietary devices
- Caused customers who had suffered losses to engage in ever more complex transactions that were supposed to recoup losses but that often brought on even more problems

DATA: BUSINESS WEEK, COURT FILINGS

By Kelley Holland and Linda Himmelstein in New York, with Zachary Schiller in Cleveland

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BusinessWeek

Updated June 13, 1997 by bwwebmaster

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