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THE 'BAD BOYS' OF CHICAGO ARBITRAGE

When Chicago Stock Exchange officials showed up at the trading firm Scattered Corp. for a routine audit two years ago, principal Leon A. Greenblatt was ready. He answered the door with a toy dart gun sticking out of his pocket, a pool cue in his hand, and a shot of Jack Daniels splashed on his face. Ushering his guests into a room without a table, he handed over the firm's records 10 pages at a time. These days, the auditors ask Greenblatt to send his books across the street to their offices.

No, the Chicago Stock Exchange doesn't like Leon Greenblatt--and it's not just because of his, well, unconventional personal style. Three years ago, at age 33, Greenblatt did something that brought down upon him the kind of regulatory wrath--a \$6 million fine--that is usually reserved for insider traders and penny-stock peddlers. Greenblatt provoked the Chicago exchange's ire during an audacious arbitrage play on the shares of bankrupt steelmaker LTV Corp. Greenblatt sold more LTV stock than actually existed, replacing it with cheap warrants--and reaping a \$27 million profit in 22 trading days. So far, he has gotten away with it--and won a little-noted legal victory in the ongoing war between longs and shorts.

Scattered principals Greenblatt, Andrew Jahelka, and Richard O. Nichols may be "reckless gamblers, sharpies, wise guys, exploiters of loopholes, even violators of the letter or spirit of the rules," wrote Appellate Judge Richard A. Posner, one of the federal judiciary's leading economic thinkers, in a February, 1995, ruling. Posner noted that Scattered's trading in LTV helped bring together the price of the stock and its underlying value, thereby playing a valuable role in the marketplace. Thus, the firm furthered--not violated--the objectives of securities law, the judge concluded, upholding a Scattered victory in a lawsuit brought by disgruntled LTV investors in a lower court. The \$6 million fine the Chicago exchange levied on Scattered is on hold pending appeal. The U.S. Supreme Court on Oct. 2, 1995, let stand the Posner ruling. The Chicago Stock Exchange declined to comment on Scattered or the legal issues involved.

Sentiment still runs hot against the likes of Scattered--and no wonder.

Greenblatt flaunts a bad-boy image even as he continues to profit from bankruptcy arbitrage. "He plays it fast and loose, and the people who are the most pissed off are the old-timers who don't understand the game," says one exchange member.

Greenblatt makes a fetish of secrecy, providing only sketchy details of his arbitrage strategies. In a typical trade, Scattered sells the stock of a company about to emerge from bankruptcy while buying newly issued shares or warrants that replace the old stock. If the old stock trades at a higher price than the new issue, Scattered can make money.

In LTV, Scattered found a huge anomaly: The company had announced a plan of reorganization under which its existing stock would be replaced by new stock. Stockholders received warrants entitling them to purchase some of the new stock at a price of about 3.2 cents per share. Even after the plan was confirmed, the old stock traded at an average of 18 cents. Since the warrants greatly outnumbered the existing shares, Scattered kept selling stock and buying warrants until it had sold 180 million shares--58 million more than existed.

BLIND BANDWAGON. Speculators apparently were betting that the stock would rise just before its terminal plunge. Others simply didn't understand or investigate the planned fate of the old shares. Certainly, the facts were no secret: LTV repeatedly warned that its stock price was unsustainable.

Greenblatt relies on a creative interpretation of the rules. He claims, for instance, that as a market maker performing arbitrage, his firm is exempt from the rule requiring short-sellers to settle up within several days. Asked how he finds his deals, Greenblatt merely smiles. He warns off those who might seek to imitate his strategies: "You have to have the proper experience. If you don't, you get wiped out." An all too familiar experience for short-sellers in recent years.

By Greg Burns in Chicago

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