TRENDS
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Bankers' Complicity in Enron's Fraud

➤ **ON JULY 28, 2003, REGULATORS** announced that Citigroup and J.P. Morgan Chase settled charges that their bankers helped Enron commit fraud. But on that same day, a more damning and detailed report of six banks' complicity in Enron's fraud was made public yet drew far less attention.

The voluminous third interim bankruptcy report in the Enron bankruptcy, by court-appointed examiner Neal Batson, is explicit in detailing the bankers' role in Enron's fraud, replete with names, internal memos, phone conversations, faxes, sworn testimony, and e-mails.

In addition to Citigroup and J.P. Morgan Chase, bankers from Barclays, Canadian Imperial Bank of Commerce, Deutsche Bank, and Merrill Lynch also knew about and participated in Enron's schemes, the report says.

The backdrop of the story is this: Enron was failing miserably. The company needed a way to get cash while maintaining its investment grade credit rating. Enron owed the banks, especially Citigroup and J.P. Morgan, billions of dollars. So the banks needed Enron to stay afloat. The result? Off-balance-sheet special-purpose entities (SPE)—some masterpieces of sophisticated financial engineering—and highly aggressive accounting to understate debt and overstate cash flow.

Consider the SPE known as Mahonia. J.P. Morgan Chase set up Mahonia as a hollow corporation chartered in the Jersey Channel Islands, and Mahonia served as a front for J.P. Morgan Chase. Batson looked at 12 transactions involving Mahonia between 1992 and 2000. The deals were structured like commodity trades in which Enron agreed to deliver oil or gas in the future in exchange for a prepayment with interest. But the trades were on paper only; they were loans. More than $3.7 billion in financing flowed through Mahonia, allowing Enron to understate debt and overstate cash flow from operating activities. In 2000 alone, the net cash flow from Morgan to Enron increased Enron's cash from operating activities by 21% and reduced its debt by 23%.

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Enron reported the loans as

price risk management liabilities rather than debt, and the cash was reported as cash flow from operations so that Enron's financial statements were, as Batson observes, "materially misleading and its key credit ratios were improperly enhanced."

Here's another relatively straightforward deal Citigroup bankers devised, called Project Nahanni: Citigroup loaned Enron money to buy Treasury bills. Within days, Enron sold the Treasury bills and paid the money back to Citi. Citigroup told Enron that it could report the $485 million it received from selling the bills as operating cash flow for its 1999 fiscal year. It did just that, reassuring investors and credit rating agencies that its profits were genuine. Nahanni represented 41% of Enron's total reported operating cash flow for 1999.

Batson's report makes it clear that the banks were not "looking the other way." Their financial products allowed Enron to mislead. Some of those products appeared barely within accounting rules, but even then the banks knew their practices would invalidate the accounting. Batson's report further argues that:

- The banks had "actual knowledge" of wrongful conduct of Enron's senior officers;
- These institutions gave "substantial assistance" to Enron's officers by participating in the structuring, promoting, funding, and assisting of the SPE transactions;
- Assistance also came by entering into undisclosed side agreements and understandings that the banks knew wouldn't get approval from Enron's accountant, Arthur Andersen, if disclosed;
- The magnitude of the money involved makes the accounting misrepresentations "material"; and
- The banks, by helping to disguise Enron's true condition and by causing injury to Enron that "was the direct or reasonably foreseen result of such conduct," harmed other creditors.

Beyond the banks, the evidence suggests former Enron executives acted improperly. During much of the period Batson examined, Enron officers responsible for SPE transactions reported to two groups: one headed by Andrew Fastow, the chief financial officer, and the other by Richard Causey, chief accounting officer. These employees "breached their fiduciary duties to Enron by causing Enron to enter into certain SPE transactions that were designed to manipulate the debtors' financial statements and that resulted in the dissemination of financial information known to be materially misleading," Batson's report says.

When asked whether the Enron officials had misled investors and creditors, Batson reports that witnesses said they relied on Andersen's approval in deciding to proceed with these SPEs. But the report notes that while this may be an attempt to shield themselves from liability, it appears Enron hid key details from Andersen. "The evidence also reflects numerous instances in which Enron officers carefully controlled the flow of information to Andersen in order to achieve a specific accounting result."

All of Batson's incriminating third interim report and much more on Enron and its accomplices is available for free at http://news.findlaw.com/legalnews/lit/enron/.

Batson's next report will be about roles of the top two Enron executives, Kenneth Lay, former chairman, and Jeffrey Skilling, former president and chief executive officer, and other officers and directors; other bankers; and other "professionals" involved with the SPE transactions. ■