Philosophy 104, Business Ethics, Queens College, Spring 2007
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Lecture Notes, February 13

I. Quiz: Describe Enron's gas bank.

II. Motivations for misusing SPEs

Last week, I spoke about Enron's core businesses, its pipeline, gas bank, and energy trading.
Also, I mentioned Skilling's adoption of mark-to-market accounting, and how it helped foster an unhealthy, competitive work environment at Enron.
In addition to the kind of work environment fostered by Enron's bonus structure, mark-to-market accounting brought two other kinds of problems.
First, because Enron was taking profits from long-term contracts, there was no good way to be sure of the real value of those contracts.
The profits from the quarter in which the contract was signed depended on the price of gas all the way through the contract.
Enron thus had to predict the future, and there were no good tools for doing so.
There was no history of such predictions, because deregulation was so new.
So, Enron accountants had to make up values.
Of course, the higher the predicted values were, the higher the bonuses for those involved.

Second, if all of one's profits for a deal in the current quarter were to be taken now, Enron could not rely on that contract for profits in the future.
If Enron wanted to book profits later, it had to make more deals.
The motivation for new deals tended to outweigh, at Enron, the motivation to make sure that current deals were maintained.

In addition, the trading business relied heavily on good credit ratings.
Enron ensured good trading terms, and thus trading profits, by having a good credit rating.
Without good credit ratings, Enron could not get the favorable trades they needed.
In order to maintain good credit ratings, Enron could not report losses, and they could not have a lot of debt.

Similarly, people at Enron, especially Skilling, were obsessed with their stock price.
Smartest Guys, p 125.
In part they wanted a good stock price for personal reasons, their own salaries and bonuses.
To keep the stock price high, they had to keep the analysts happy.
To keep the analysts happy, they also could not report losses, and they could not have a lot of debt.

SPEs helped resolve short-term difficulties with stock prices, credit ratings, income reporting, debt management, and other issues.

II. Bad SPEs

Enron owned stock in many smaller companies.
Often, they purchased shares when the price of a stock was high, but bad deals are just bad business.
(For Friedman, bad business is unethical. What does this say about Friedman's position?)
Additionally, Enron had liabilities in their loans to gas producers, since production was very risky.
When a producer went bankrupt, as they often did, mark-to-market accounting meant that Enron would have to restate their earnings.

To protect themselves against volatile investments, Enron wanted hedges.
A hedge is an investment whose value will go up when another goes down.
Normally, a company like Enron will contract with an independent party willing to take on the risk of an investment, for some price.
Hedges will limit your earning potential, since you have to pay for the protection.
But, a hedge will limit your loss potential.
The hedging counterparties, according to accounting rules, must be independent of your company.
They have to be real companies, intended to earn real profits.

Besides hedging, the other main goal for the SPEs was for asset sales.
When Enron sold an asset to an SPE, as it often did at the end of a quarters, Enron was able to book the sale as profit for the quarter, and remove any debt involved in the asset.
Enron created SPEs solely to absorb their mark-to-market losses: Chewco, JEDI, Southampton, LJM1, LJM2, and Raptors 1-4, which were called Talon, Timberwolf, Bobcat, and Porcupine.

III. The Rhythms hedge

Rhythms NetConnections was an internet start-up.
Enron's broadband division had invested $10 million in March 1998: 5.4 million shares at $1.85.
At the Rhythms IPO, the share price tripled.
It was offered at $21 and it ended its first day at $68.125
Enron's $10 million investment was suddenly worth almost $400 million.
Skilling wanted to lock in the new value, and so wanted to find a hedge.
But, no one would hedge it at $68 a share.
Enron owned half the available stocks, which were thinly traded; no legitimate hedge was available.

In order to lock in the profit, Enron used LJM1 (which was also known as LJM Martin or LJM Cayman.)
LJM1 was Fastow's first personal SPE; it was a fund that he managed himself, for a $500,000 annual fee.
To fund LJM1, Enron contributed $276 million in stock.
Greenwich NatWest and CSFB added $15 million; Fastow himself contributed $1 million.
LJM in turn funded a new entity, Swap Sub, which provided the put option, the hedge, for Rhythms.

Notice that the idea of hedging Rhythms with an entity funded almost entirely Enron is odd.
If the stock price goes up, then Enron loses just a bit of profit to the independent investors.
But, the stock is going up, so there is no real harm.
On the other hand, if the stock goes down, then LJM will take the loss.
Since LJM1 is mostly Enron, Enron still loses.

The only advantage is in the accounting, not in the real gains and losses.
The Rhythms hedge was really just a bet that Enron's stock would go up, as Victor Kaminski discovered.
See *Conspiracy* 242-3, et seq.

IV. LJM2 and the Raptors

There were four Raptors, all intimately connected with a much larger fund, initially also managed by Fastow, called LJM2.
Talon, for example, one of the four Raptors, was created mostly by $537 million of Enron stock.
To keep Talon independent, $30 million came from another fund, LJM2.
LJM2, also would have to be independent, and so some banks, mostly, and pension funds, invested as a favor to Fastow, with the assurance that their investments in LJM2 would pay off.
Note, that since LJM2 is an independent investor for Talon, any investments that Talon made would need only three percent of three percent independent investment.
Fastow reduced the already laughable three percent to less than .1%.

The investments LJM2 made were generally poor ones, since that was how they were useful to Enron.
But, since LJM2 was run by Fastow, he was able to ensure payments to the LJM2 investors from Enron.
When the stock that Talon owned went down, Enron kept it afloat with payments.
The main thing was to keep the losses off of Enron's books.
Talon could lose money.
But, the LJM2 investors were assured that would not lose money, that they would be protected by Enron.
To protect LJM2 investors, there were initial, and periodic, payouts.
Also, Fastow received tens of millions of dollars in management fees, from the LJM2 funds.
The arrangements with LJM2 would never have been given to a truly independent party.

Fastow had been hired specifically for his ability to create these kinds of entities.
Skilling had emphasized creativity, and he got it in Fastow.
The SPEs were not the only unethical financial structures Fastow developed.
Unconnected to the SPEs was Project Nahanni.
At the end of 1999, Enron borrowed cash from Citibank to buy treasury bonds.
Then, it sold the treasury bonds immediately, reporting the cash from the sale as income from operations.
After the new year, they paid back Citibank.
Project Nahanni was used to generate more than forty percent of its operating cash flow for 1999.
See *Conspiracy* 301.

In fact, Fastow did not generally perform the kinds of duties that other CFOs generally perform.
He admits as much in his deposition:

> I was hired at Enron by Mr. Skilling in 1990 primarily to execute off-balance-sheet financing. In 1997, when I assumed responsibility for finance at Enron, I engaged in transactions, such as Nighthawk and Nahanni, with certain of Enron's banks that had a material impact on Enron's financial statements. Nighthawk, presented to me by Citi's Larry Nath before he moved to DLJ/CSFB, enabled Enron to report a healthier balance sheet than it otherwise would have. Mr. Nath explained to me that the purpose of Nighthawk was to convert debt into minority interest. Nahanni, also designed by Citi, was done primarily to generate funds flow from operations. I

> cannot think of another reason why, in practical business terms, a BBB+ rated firm like Enron would buy and monetize T-Bills, as Enron did in Nahanni other than to generate funds flow from operations. I can recall no real business purpose associated with Nahanni or Nighthawk. (Fastow's declaration, page 4)
>
> I believe that I received higher compensation because I engaged in structured-finance transactions that contributed to causing Enron to meet its financial reporting objectives. I do not believe that I would have received the same compensation had I not executed structured-finance transactions. Most of the other traditional CFO responsibilities were handled by people who did not report to me. (Fastow's declaration, page 5)

There were really four ethical and legal problems with the Raptors.

1. They violated the three percent rule, since they were really funded by Enron.
2. They were controlled by Fastow, not independently.
3. They had no real financial liability, so should have been on Enron's books. (Enron protected them from losses.)
4. There was no real hedge.

V. LJM2 and asset sales

The bad SPEs were also used for asset sales, to pretty up Enron's books at the end of quarters.
In the last days of 1999, for example, Enron sold to LJM2:

1. A Polish power plant, Nowa Sarzyna, twenty-five percent of which it would have to buy back again in three months according to its contractual obligations; Enron booked $16 million in earnings;
2. The Nigerian power barges, which first went through Merrill Lynch; Enron booked $50 million;
3. A pool of poorly performing financings, which allowed them to removed the risk of reporting losses;
4. Certificates in a low-yield trust called Yosemite;
5. $24 million worth of equity in MEGS, a natural gas gathering system in the Gulf of Mexico.

All these deals allowed Enron to book $500 million in cash flow and $125 million in profits.
See *Conspiracy* 292-302, for details.

VI. Fastow's conflict of interest

Fastow's role as manager created an obvious conflict of interest with his role as CFO of Enron.
The board of directors had to approve of his duties.
They did so, under direction of Skilling and Lay.
Fastow promised that he was working no more than a couple of hours each week.
But, he was working about half the time on each, it seems.
More problematically, he was bullying Enron into selling on good terms to LJM, rather than getting good

prices for Enron.
And he was taking large fees.
For example, in closing out Swap Sub, which had provided the Rhythms hedge, Fastow received, for a $25,000 investment, $4.5 million, in two months.
In the end Fastow made over $25 million on LJM1.
Michael Kopper made about $12 million from LJM1.
Ben Glisan, Fastow's young treasurer, and Kristina Mordaunt, a lwayer who had worked on the deal, each received $1 million in the same two months, for investing $5800.
Glisan and Mordaunt were fired immediately after the board heard of their arrangements, in November 2001; see *Smartest Guys* pp 196-7.
Fastow misrepresented his role, and more importantly his compensation, to Skilling, to Lay, and to the board of directors.