

Citigroup, Morgan Chase fined for Enron deals: corruption at the heights of American finance

By Joseph Kay
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Citigroup Inc. and JP Morgan Chase & Co., the largest and second largest US banks respectively, reached an agreement July 28 with the Securities and Exchange Commission (SEC) to pay a combined \$255 million in fines in connection with their involvement in the fraud perpetrated by Enron.

JP Morgan will pay \$135 million and Citigroup will pay \$120 million to the SEC. In addition, both banks reached a settlement with the Manhattan district attorney that includes an agreement to pay \$12.5 million each to New York City and New York State.

The SEC charged that the two banks aided defunct energy trading giant Enron in disguising loans as cash in order to defraud investors. In December 2001, Enron filed what at the time was the largest corporate bankruptcy in US history. Having sustained itself on the basis of fraudulent accounting practices and illegal financial manipulations, Enron—which had the closest ties to President George W. Bush and other officials in his administration—has become a synonym for corporate criminality. The revelations of the fraud carried out at that company initiated a wave of accounting scandals—including those at WorldCom, Tyco and other firms.

The involvement of the banks in these scandals reveals that the corruption that has come to light over the past several years is not simply a matter of a few “bad apples,” but rather involves the entire corporate and financial elite.

The activities involved in the charges brought by the SEC relate to Enron’s attempts to boost its cash flow. Throughout the period investigated by the SEC, Enron engaged in manipulations designed to boost earnings reports. However, it was even more concerned with boosting its reported cash flow, since this is considered by many investors to be a more reliable indicator of company health than earnings, in part because it is more difficult to manipulate than other figures.

For example, a company’s earnings figures can be artificially inflated by booking ordinary expenditures as capital investments, allowing for costs to be deducted over time, rather than all at once. Enron was fond of another procedure known as mark-to-market, which allowed it to increase the value of present assets held by the company (e.g., long-term contracts for the sale of energy) by estimating future market prices. Since Enron dominated the energy trading business, the prices by which it marked-to-market were largely subjective—that is, determined by Enron itself in accordance with the earnings it wanted to report. These manipulations will not increase reported cash flow, since no money is listed as actually coming into the company.

If a company reports high earnings but not much cash, there is reason to believe that something untoward is taking place, since a healthy company will make profits through the sale of goods—which brings in cash. But this was precisely the problem with Enron.

Like many of the “success stories” of the late 1990s, it was a company whose success was primarily based not on the production of goods or the normal process of capital accumulation, but rather on financial manipulations in the derivative and energy markets. Enron’s main activity consisted of buying and selling energy contracts, and its huge earnings during the late 1990s were based largely on its mark-to-market practices, which allowed it to capitalize on the speculative boom.

Enron was the first non-financial company specifically given permission by the SEC to use mark-to-market accounting.

Robert Bryce, in his book *Pipe Dreams*, describes how Enron’s focus on expanding revenues at the expense of cash reached its pinnacle after Jeff Skilling took over the position of chief executive officer in 1997. Skilling pushed the company to spend much more in expanding its operations, at the same time massively increasing borrowing.

In 1997, cash flow at Enron was negative hundreds of millions of dollars. Enron’s economic health became increasingly dire throughout the late 1990s—in reverse relation to its soaring stock price—and it is then that the company began cooking up the series of manipulations involving offshore entities that would only come to light after the bankruptcy.

To sustain its massive investments in the energy derivatives market, Enron had to borrow billions of dollars. For example, in the first half of 2000, the company borrowed over \$3.4 billion. The interest on these loans had to be paid in cash. As a result the company’s cash flow during the same period was negative \$547 million. According to Bryce, by June of 2000, Enron was paying about \$2 million per day in interest on its loans.

The company’s arrangements with the banks were designed to “solve” the growing cash crunch, which became more severe with the collapse of the telecom stock bubble. Investors became more concerned with the true health of highly valued, publicly traded companies, and therefore more interested in cash flow figures.

One way to accumulate cash is through more loans. However, loans do not contribute to the apparent health of the company, and therefore were of little use to Enron. The trick was to disguise loans from JP Morgan and Citigroup as commodity transactions that accrued cash—rather than debt—for Enron.

The method that Enron developed in coordination with its banks was to use so-called prepaids in order to create a circular trade between Enron, the banks and their nominally independent offshore subsidiaries. In total, Enron and JP Morgan set up seven prepay structures valued at \$2.6 billion, while with Citigroup such contracts totaled \$3.8 billion.

The nature of these prepaids is best illustrated by an example. In one deal involving JP Morgan, Enron sold to a company called Mahonia a long-term contract to deliver gas. Mahonia had a market capitalization of about \$15. It was simply a mask for JP Morgan, which funded its operations.

In return, Enron made an agreement with another Morgan subsidiary, Stoneville Aegean, to buy gas in monthly installments at the price paid by Mahonia, plus interest. Thus, nearly \$400 million flowed from JP Morgan to Enron and back to JP Morgan. Enron got a lump sum of cash and paid it back periodically, plus interest. In ordinary parlance, this is a loan. But it was not disclosed as such by Enron or the bank.

In one case involving Citigroup, Enron transferred assets it owned to a sham joint-venture company called Fishtail, which was, in fact, controlled by Enron. These assets were then purchased by another Enron-controlled special purpose entity (SPE) with the help of a \$200 million loan from Citigroup. Enron in turn guaranteed payment on Citigroup's "investment," which was returned to Citigroup six months later, after the proceeds of the sale could be recorded on Enron's 2000 earnings report. The fact that Enron guaranteed the investment meant that it was not really an investment, since it involved no risk to the bank.

The banks were not innocent or deceived parties in these transactions: they were active participants in the fraud. While there have been no charges that any of the entities set up by the banks were illegal, the banks were aware that Enron was using the prepaids to defraud investors.

According to a January, 2003 report by the Senate subcommittee investigating the banks' involvement with Enron: "The evidence associated with the four transactions [known as Fishtail, Sundance, Slapstick and Bacchus] demonstrates that Citigroup and Chase actively aided Enron in executing them, despite knowing the transactions utilized deceptive accounting or tax strategies, in return for substantial fees or favorable consideration in other business dealings."

In connection with the deal involving Fishtail described above, the Senate committee quotes senior Citigroup officials as warning: "The GAAP accounting is aggressive and a franchise risk to us if there is publicity." This was an acknowledgement that the bank was aware that Enron's accounting for the deal was "aggressive," a euphemism for deceptive. In another case, JP Morgan actively sought to persuade auditors that Enron's accounting was sound, and signed a letter to this effect.

The prepaids were part of a network of interactions between corporations, banks, auditors and regulatory authorities that facilitated and encouraged fraudulent activities. In return for their services, the investment banks received lucrative fees from corporations such as Enron, which by some accounts was the largest fee payer of all Fortune 500 companies.

Analysts who worked for such banks hyped up the stock of favored companies on the market, despite having knowledge that the financial health of the companies was suspect. Auditors signed off on the accounting manipulations in return for consulting fees, and the government turned a blind eye to the entire process, pushing through deregulation and encouraging stock market speculation.

The banks were involved in more than prepaids. With the help of Citigroup, Dynegy, another energy-trading company, was able to boost its trading volume using a series of transactions that in fact cancelled each other out. Earlier this year, a number of the banks, including JP Morgan and Citigroup, settled with the SEC on charges that they engaged in "spinning"—the granting of preferential access to hot initial public offerings (IPOs) of stock to select executives at companies with which they had investment banking business.

After the collapse of the telecom stock bubble, the network of corruption began to unravel, as corporation after corporation was forced to acknowledge that its profits were far below what had been reported. The government's activities since then—including the prosecution of a few executives, the passage of a weak corporate reform bill and monetary settlements with the big banks—have been directed at containing the fallout. In this light, the settlement reached July 28 with Citigroup and JP Morgan constitutes little more than a slap on the wrist.

The money paid by the banks will go to victims of the fraud. In relation to the extent of the fraud—which involved tens of billions of dollars in the case of Enron alone—the sums are paltry and will hardly put a dent in the banks' finances. Much of the money could go back to the banks themselves, since they are Enron's two largest creditors. Moreover, in accordance with the securities laws adopted in response to the wave of fraud, settlement money in cases brought by the government can be deducted from any fines levied in investor class-action suits. Both banks still face such suits relating to their involvement with Enron.

John Coffee Jr., professor of Columbia University Law School, told the *New York Times*, "From the defendants' perspective, this is a no-brainer. This money is going to do double duty. It settles all charges and it is going to go as a credit against the private class action." Neither company was forced to admit guilt in the SEC case, which would have had severe consequences for the investor class action suits.

The government is hailing the settlement as a great victory. "These two cases serve as yet another reminder that you can't turn a blind eye to the consequences of your actions," said Stephen Cutler, the SEC's enforcement director. "If you know or have reason to know that you are helping a company mislead its investors, you are in violation of the federal securities laws." Manhattan district attorney Robert Morgenthau stated that the settlement sent a signal: "No more phony baloney offshore special purpose vehicles that are not understandable."

However, the settlement will have little real consequences for the operations of the banks. They have promised not to engage in such prepay deals in the future unless the client companies practice full disclosure. Both Citigroup and JP Morgan agreed to put in place tighter risk management controls, but purely on an internal level. According to these new controls—which must be submitted to the Federal Reserve for approval—senior executives will have to exercise greater oversight of complex financial arrangements. There are no provisions for government oversight of banking operations, and no enforcement mechanisms or consequences if the banks do not comply.

As a sign that investors considered the settlement a win for the banks, stock prices rose for Citigroup and JP Morgan the day the agreement was announced.

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