

Former CFO testifies in Enron case

By Joe Kay
10 March 2006

Former Enron chief financial officer Andrew Fastow continued testimony on Thursday in the trial of the company's former CEO Ken Lay and former president Jeffrey Skilling. Fastow testified that Lay and Skilling were personally involved in the various illegal activities, accounting manipulations, and fraudulent statements for which Enron has become notorious.

Fastow is a key witness for the prosecution, since he was directly involved in the various special-purpose entities used to hide Enron's debt and boost its earnings reports. He has agreed to testify for the government in a plea deal made in December 2005. He is only one of a number of former Enron executives who have agreed to do the same.

Much of Fastow's testimony for the prosecution on Tuesday and Wednesday focused on the construction and operation of the LJM partnerships. These were entities set up and controlled by Fastow himself, but were not accounted for on Enron's books. They were used to do various deals with Enron that would help improve the company's financial statements, while enriching Fastow and a number of other executives involved.

According to the defense, the partnerships, which were approved by Enron's board, were not by themselves illegal. The central question at issue in Fastow's testimony is whether the LJM partnerships had any real independence from Enron that justified their being categorized as separate entities for accounting purposes.

LJM1, the first of the LJM partnerships (named after the initials of Fastow's wife and two children) was set up in June 1999. It was financed with \$1 million of Fastow's own money, and \$15 million in funds from outside investors. Fastow, however, held the position of managing partner, which meant that he maintained control of the entity while also taking home a large salary. He was able to earn back his initial investment within one year of LJM1's creation.

"The whole purpose of the partnership," Fastow testified, "was to help Enron make its numbers look the way it wanted to look." For example, one of the deals that LJM engaged in was to purchase a stake in an Enron power plant project in Brazil, which allowed Enron South America to book a gain for quarter. Fastow said that from a business point of view, the deal was terrible, and that "no one would buy it." However, LJM1 did, in return for what Fastow said was a guarantee from Skilling that Enron would guarantee the deal against any loss for LJM and Fastow.

At the time, Skilling was president and chief operating officer of the company. Lay was both the CEO and chairman of the board of directors throughout the period, except for a brief period in 2001 when Skilling assumed the role of CEO.

In essence, Enron was giving money to itself. LJM1, which was functioning as an Enron subsidiary, was giving money to a section of Enron by purchasing an undesirable stake in a failing project. According to Fastow, Skilling promised that Enron would give this money back at a later time, meaning that there was little or no risk to Fastow that the deal would result in a loss. However, because LJM1 was reported to be an independent entity, the earnings were included on Enron's financial books, while the loss was not.

Fastow provided what is likely a fairly accurate description of the thought-processes of major executives at many US companies: "I was making money and taking little risk," he said. "And for Enron, it was helping Enron make its numbers. So, if you will, I thought I was being a hero for Enron...If Enron makes its numbers, the stock price goes up. I owned a lot of stock. If I help Enron make its numbers, I get a bigger bonus. And it was...what I thought was a win-win situation for me."

There was a definite element of farce in Fastow's testimony, and at one point he was forced by the defense to acknowledge that he had been "very greedy." One might be entitled to ask: For what executive at a major company is this statement not true?

Of course, Fastow was not the only person to benefit personally from the arrangement. He testified that he was not too worried that Skilling would back off his guarantee to secure the LJM investment. "If Mr. Skilling didn't honor his guarantee," he noted, "then it would shut off the LJM valve," which was helping Enron make its numbers. It was not only Fastow, after all, who was benefiting from keeping Enron's stock price up. "A significant number of senior management participated in this activity to misrepresent our company," Fastow said. "And we all benefited financially from this at the expense of others."

A few months after LJM1 was formed, a second entity of the same character, LJM2, was set up, but with much higher capitalization of nearly \$400 million. According to Fastow, LJM2 was approved after LJM1 proved inadequate and Skilling urged him to "get me as much of that juice as you

can.” The partnership engaged in six deals during the end of 1999 to help Enron meet its earnings targets for that year, Fastow said. Among these was the purchase of a number of barges owned by Enron in Nigeria.

According to Fastow, he received personal assurances from Skilling that all of these various deals would be backed up by Enron. However, there is no email or solid paper trail of this charge. The main piece of evidence that the prosecution has presented is a hand-written note, initialed by Fastow and former chief accounting officer Richard Causey, including the names of all the arrangements between Enron and LJM. Fastow said that Causey presented this list to Skilling and received a “bear hug” guarantee that Fastow would not be subject to any risk as a result of these deals.

In addition to the charges against Skilling, Fastow testified that Lay participated in a number of meetings in the summer of 2001, in which the poor financial state of Enron was discussed. Fastow described a August 2001 meeting in which the “hole in earnings” at Enron was discussed. He said that at one meeting he told Lay that the company required major restructuring, since it was in such dire straits. At the time, Enron’s share price was beginning to fall, which was unraveling many of the partnerships that had been set up, since these were heavily invested in Enron’s stock.

In spite of this general acknowledgement of the poor state of the company, Lay continued to boost the company and lie about its situation, Fastow testified. In an interview with *BusinessWeek* only a few days later, Lay stated that Enron was in its “best shape” ever. “There are no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues,” he said. “The company is probably in the strongest and best shape that it has ever been in.” This was only a few months before Enron collapsed into bankruptcy.

The defense has sought to base itself on the claim that there is in fact no direct evidence for most of the claims that Fastow has made. It is arguing that all the LJM partnerships were legitimate and properly accounted for, that Fastow stole money from Enron to enrich himself, but that neither Skilling nor Lay has any hand in this. The greatest asset they have is the fact that Fastow a fairly unwholesome person, has lied repeatedly in the past, and therefore, it is argued, there is every reason to believe that he is lying again.

In particular, the defense attacked Fastow on Thursday over the circumstances surrounding the list of side agreements and “bear hugs” between LJM and Enron. The list was only discovered by Fastow in 2004, in the midst of plea discussions between the government and Fastow’s wife over charges of tax fraud. The defense has suggested that the list helped Fastow curry favor with the government, thereby questioning its veracity.

The defense’s argument is essentially that Lay and Skilling were duped and had no real idea of what was going on in the company. It was merely fortuitous, from their point of view,

that Fastow, as head of a supposedly independent entity, was investing in Enron in a way that allowed Enron to consistently meet its earnings targets. The top Enron executives thought that Fastow—and, it should be noted, the many banks and institutional investors that contributed funds to the LJM partnerships—were, for entirely business reasons, taking up the underperforming assets that Enron was seeking to unload. Because Lay thought all of these arrangements were legitimate, he had every reason to believe that Enron was in fact healthy. Indeed, the defense has argued that for the most part these arrangements *were legitimate*, so the company was in fact healthy.

This position is absurd. However, even if one were to accept it as true, it raises the question of what Lay and Skilling were doing as the head of their company. It suggests a level of incompetence that is staggering. It is often argued that executives deserve their enormous salaries because their skills are in such high demand. If this is how Lay and Skilling perform—two executives who were lauded endlessly in the press up until Enron’s collapse—it says something about the state of management in the United States.

Whether one accepts as credible the defense of Lay and Skilling or not, the ongoing trial continues to expose the complete rot that has developed at the top of American corporations. Criminal or superfluous—it is hard to say which is a more damning indictment of the American ruling class.

The focus of the prosecution thus far has clearly been on Skilling, particularly with regard to Fastow’s testimony. In part, this may be due to the particular dynamics of the case and the evidence available. However, it must also be kept in mind that Lay is a man with extensive political and historical connections to Bush and the Bush administration. There are no doubt high level discussions behind the scenes regarding the strategy of the prosecution, and the entire trial has been set up in a way to deliberately contain any political fallout.

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