



Fastow under investigation

Jeremy Weinstein examines the indictment of former Enron chief financial officer Andrew Fastow and speculates on his – and the Enron management’s – motives

On October 31, 2002, Andrew Fastow, the former chief financial officer of Enron, was indicted on 78 federal counts of money laundering, wire fraud, securities fraud, conspiracy and obstruction of justice. Two months earlier, one of Fastow’s chief lieutenants, Michael Kopper, had entered into a co-operation agreement with the Department of Justice and pled guilty to one count of wire fraud for a kickback to Fastow from fees he received from a special-purpose entity (SPE) used to manipulate Enron’s financial statements.

The indictment makes it clear that Kopper’s co-operation will loom large in Fastow’s prosecution. For example, the obstruction of justice count alleges that Fastow persuaded Kopper to destroy

Under supervision: Andrew Fastow is driven from the federal courthouse

laptop and desktop computers. It is also apparent from the particulars of the money laundering counts that Fastow’s wife, Lea Weingarten Fastow, has personal exposure to criminal charges, which may end up as a pressure point applied on Fastow in the course of the unfolding drama.

Ends and means

The indictment states that, starting in 1997, Fastow and others devised schemes to defraud, with goals including: “(a) falsification of Enron’s reported financial results so that Enron would appear more successful than it was; (b) artificial manipulation of the share price of Enron stock; (c) circumvention of federal regulations so that Enron could obtain benefits to which it was not entitled; (d) illusion of business skill and

success on the part of Fastow and other Enron senior management; and (e) personal enrichment of Fastow and others at the expense of Enron, its shareholders and others to whom they owed a duty of honest services.”

The means of the schemes included: “(a) Enron’s engaging in fraudulent transactions with SPEs; (b) Enron filing materially false and misleading financial statements with the SEC [US regulator the Securities and Exchange Commission]; (c) Enron’s making false and misleading public statements about Enron’s financial performance; and (d) Fastow’s and others’ taking advantage of their simultaneous control over SPEs and Enron’s business operations.”

Kopper admitted to much of this in his co-operation agreement. Similar

Photos: Reuters/Popperfoto

allegations are made in pending SEC enforcement actions.

Fastow's indictment includes specific charges that he:

- took a kickback from Kopper of fees from an SPE transaction;
- manipulated reported financial results by improperly parking poorly performing deals off-balance-sheet in SPEs;
- manufactured earnings through sham transactions with SPEs;
- transferred power plants that benefited from 'qualified facility' (QF) special treatment to SPEs without transferring control away from Enron, thus keeping the QF status under false pretences through transactions in which he skimmed payments for himself, his wife, his children and Kopper; and
- improperly inflated the value of Enron's investments by backdating transactions.

The abovementioned sham transactions brought Fastow "continued prestige, salary, bonuses and other benefits from Enron", as well as management fees and skimmed-deal profits.

The victims include "Enron and its shareholders", "the investing public" and, in one count, UK bank NatWest. NatWest bankers, believing they were to be laid off in a restructuring, tricked the bank into selling its interest in an SPE at a fraction of its real value and then split the profits with Fastow's people.

A private matter?

While the indictment states that Enron's management, including Fastow, used SPEs to "avoid inclusion of unfavourable information in its reported financial statements, thereby presenting itself more attractively to Wall Street analysts, credit rating agencies and others", it is noteworthy that the indictment focuses on "public" statements and "reported" results. In other words, not charged as predicate acts in the indictment and not listed among the victims of any of the indictment's 78 counts are the private statements Enron and its officers made to the credit rating agencies and the trading counterparties with whom it did business.

As US credit rating agency Standard & Poor's (S&P) pointed out in March in its testimony to Congressional committees investigating Enron, in assigning ratings to public companies, the agencies are often given access to non-public information, on which they rely in addition to public reports when assigning credit ratings.

S&P says senior Enron executives –

including Fastow and former Enron chairman Kenneth Lay – intentionally deceived it in order to obtain a BBB+ credit rating for Enron and while lobbying to increase that rating.

In fact, an Enron presentation to S&P on January 29, 2000, coquettishly includes the following: "Kitchen Sink Disclaimer: Enron does not recommend using this analysis for anything other than illustrative purposes and for the purpose of concluding that the off-balance-sheet obligations are not material to Enron's consolidated credit analysis. Cigarette smoking may be harmful to your health." The presentation also lists as a "myth" that Enron's "management does not communicate its true financial position to the investor community or the rating agencies."

Yet Moody's, another major credit rating agency, said its March 2000 increase of Enron's credit rating from Baa2 to Baa1 was based on the misleading and incomplete information it got from Enron.

provide that a party holding an AA rating need only post collateral to the extent that the position needed more than a \$50 million collateral threshold against it, with that collateral threshold falling to \$15 million for a party holding a BBB+ rating. Most in the industry set a collateral threshold of zero for a counterparty at or below BBB-, the lowest investment grade.

Free credit

One could argue, then, that Enron's main goal in using SPEs to move debt off its balance sheet was to fool the credit rating agencies to grant it higher ratings than it deserved, which it could use to obtain free, unsecured lines of credit for the amount of margin it would have had to post as collateral were its true credit rating known. With the false credit rating – as well the false financial statements in published reports – Enron was able to obtain hundreds of millions of dollars' worth of free credit from its trading counterparties, many of

The sham transactions cited in the indictment brought Fastow continued prestige, salary, bonuses and other benefits from Enron, as well as management fees and skimmed-deal profits

Trading counterparties rely on credit ratings not only in choosing with whom to do business, but also in supplying their counterparties with trading lines of credit. After any trade is entered into, the market will move, and the trade will be profitable, or not. The financial risk of the other party's performance increases as the position moves in a party's favour. Public derivatives exchanges do not take on any of this risk. For example, if a trader were to buy a crude oil futures contract for 1,000 barrels on the New York Mercantile Exchange, for every dollar the market price of oil fell, he would be required to post \$1,000 in margin cash collateral.

However, parties to private, over-the-counter derivative products, can choose to allow each other leeway with regard to posting margin cash collateral, by requiring it only above a set 'collateral threshold'. Such thresholds can be seen as free, unsecured lines of credit and are – in bilateral contracts such as the collateral annex to the International Swaps and Derivatives Association Master Agreement and the Edison Electric Institute Master Power Purchase and Sale Agreement – set at levels tied to a party's credit rating.

For example, the agreement could

whom would probably not even have done business with Enron in the first place had they been aware of the company's true credit standing.

That is also why Enron's loss of its investment-grade credit rating pushed the firm into bankruptcy. The downgrade moved the collateral thresholds on Enron's trading contracts to zero and triggered collateral calls, thus forcing the company to post the margin it should have been posting all along and pay for the credit it had until then been getting for free. This is what former Enron president Jeffrey Skilling, in his testimony before Congress, mischaracterised as a "classic run on the bank" causing Enron's downfall.

While waiting for Fastow's possible conviction and jail sentence, one hopes that prosecuting authorities will examine how Enron's management and Enron itself, as a criminal enterprise, obtained credit under false pretences from Enron's trading counterparties, which included federally insured financial institutions and state and federal government agencies. **EPRM**

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