STATEMENT OF SENATOR CARL LEVIN, CHAIRMAN

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

HEARING ON

THE ROLE OF THE FINANCIAL INSTITUTIONS IN ENRON'S COLLAPSE

JULY 30, 2002

Last week, the Subcommittee looked at the sham transactions that Enron used to obtain billions in loans from major financial institutions without showing any debt on Enron's books. The hearing revealed that the financial institutions not only were aware that Enron was engaged in misleading accounting, but actively assisted Enron in its deceptions. The documentation included an internal email from a JPMorgan Chase banker reporting how "Enron loves these transactions because it can hide debt from its equity analysts." We saw how Chase and Citigroup helped Enron construct false energy trades by providing offshore entities, effectively controlled by the banks, to participate as sham trading partners. The banks then helped orchestrate multi-party trades with no price risk that canceled each other out except for the equivalence of interest payments by Enron on loans Enron was trying to hide and the phony cash flow from operations Enron was trying to magically create.

Chase and Citigroup did more than just help Enron carry out its deceptions; they also pitched Enron-style, phony prepays to other companies, further spreading into the U.S. business community the poisonous practice of misleading accounting.

At the hearing, through the witnesses and, after the hearing, through statements by their CEO's, the two banks claimed this was all business as usual, reflecting "industry practices," and that their companies "acted properly and with integrity." William Harrison, the CEO from Chase, even lauded Chase's witnesses because, in his words, they "stood tall" in the face of Subcommittee questioning. Neither company has admitted responsibility for helping Enron doctor its financial statements, much less admit to any misjudgment or wrongdoing.

The evidence presented at the hearing, however, was clear and convincing, and when the banks' witnesses were confronted with the documentary evidence that showed the banks knew that the phony prepays were being used by Enron to book loans as cash flow from operations in order to keep their credit rating and stock prices up, the witnesses worked hard to obfuscate the plain meaning of their own words.

Look at the testimony of Jeffrey Dellapina of Chase when confronted with a recording and transcript of a phone conversation in which he participated where an Enron employee said to Mr. Dellapina, "That goes to the same point you were raising. . .Jeff, that from your side you also want to make sure that Mahonia seems independent." When questioned about the use of the phrase "seems independent," Mr. Dellapina challenged the taped conversation. "I don't believe I would have wanted it to seem independent, " he said. He then said he didn't agree with the transcript.

When asked about an internal Chase document describing Mahonia, the special purpose entity used in the Enron prepays, as "formed by Chase," Donald McCree, a senior Chase official testified that the words "formed by Chase" were "loose and inaccurate."

When Robert Traband of Chase was asked if he would call the Enron prepays with Chase a "circular" deal, Mr. Traband testified he didn't know. The Subcommittee then played a tape of a conversation involving Mr. Traband were he specifically described the prepays as "circular." When asked what he meant by that term, Mr. Traband said, "I don't recall."

Citigroup often took the same tack of saying its documents didn't mean what they said. When asked about a memo in which a Citigroup employee suggested adding a penny to the price spread in an Enron prepay to make "the prepaid structure a little more like a trade," Richard Caplan of Citigroup denied that the memo actually meant what it said.

A similar response was given by James Reilly of Citigroup when he was asked about three different memos regarding the so-called Roosevelt prepay. In those memos Mr. Reilly refers to Enron's undisclosed agreement to repay $125 million by September 30, 1999, an arrangement that, if known, would have forced recategorization of the so-called prepay as Enron debt. At the hearing, Mr. Reilly said, "agreement is . . . a word that could mean different things," and, "I did not intend that to mean that it was a binding agreement." In one exchange, when confronted with the discrepancy between what the memos said and what he was testifying to at the hearing, Mr. Reilly said "The memo is wrong." He was, in effect, disputing the plain words of three contemporaneously written memos.

Finally, when David Bushnell was asked whether he agreed that it is the responsibility of a financial institution like Citigroup not to participate in a deception, believe it or not, Mr. Bushnell said, "it depends upon what the definition of a deception is." I guess that's what is meant by "standing tall."

So last week Chase and Citigroup denied the plain meaning of words in their own contemporaneous documents. Today, looking at the prepared statement of Merrill Lynch, it is more of that same approach -- deny the plain meaning of words in your own documents. Merrill Lynch will say "commitment" doesn't mean "commitment;" "guarantee" doesn't mean "guarantee;"they mean something else -- maybe "best efforts." And "loan" doesn't mean "loan" -- it means "purchase."

Last week we showed how two major financial institutions helped Enron hide debt. This week we'll see how a major financial institution, Merrill Lynch, helped Enron artificially and deceptively create revenue.

But the underlying truth is the same as last week: Enron couldn't have engaged in the deceptions it did without help from a major financial institution. Merrill Lynch assisted Enron in cooking its books by pretending to purchase an existing Enron asset when it was really engaged in a loan.

The accounting sham involved the sale of an interest in three Nigerian barges that operated as floating power stations. Enron wanted to sell these barges before the end of calendar year 1999, so it could report the sales income as earnings in its 1999 financial statements. But Enron was unable to find a buyer willing to complete the sale before the end of the year.

In mid-December 1999, Enron asked Merrill Lynch, as a favor, to set up a special purpose vehicle (subsequently called Ebarge) to take an Enron asset, barges, for a short period of time for a $28 million purchase price consisting of a $7 million cash payment from Merrill Lynch and a purported loan of $21 million from Enron to Ebarge. This transaction would allow Enron's African division to book sales income of $12.5 million.

Merrill Lynch agreed but, this is the key, only after receiving Enron's committment that it would find a buyer for Merrill's interest in the barges within 6 months. Merrill also received assurances of a 15 percent return on its $7 million plus an immediate payment of $250,000. This so-called sale arrangement violated elemental accounting rules which allow a seller to book sales income only for a transaction that is a real sale. Enron's guarantee to Merrill functioned as an ongoing obligation that kept Merrill from assuming the risks accompanying ownership. In a real sale, the risks and rewards of the asset are completely transferred from the seller.

The evidence is clear that Enron and Merrill were aware of this accounting problem and, in order to facilitate Enron booking the transaction as a sale, it had to keep Enron's oral guarantee a secret, omitting it from the documentation and leaving it as an oral understanding.

As the 6-month deadline approached on June 30, 2000, Merrill became concerned that Enron would not fulfill its promise.

One day before the deadline, LJM2, an investment vehicle run by Enron's Chief Financial Officer, Andy Fastow, stepped in and took over an interest in the barges from Merrill at the previously agreed-upon terms. It paid Merrill the $7.525 million that had been assured to Merrill by Enron at the beginning of the transaction -- the $7 million principal and 15% interest over 6 months - and assumed the $21 million note that Enron initially loaned to Ebarge. By the way, Ebarge never paid any interest on the note, notwithstanding loan documents that required it to do so. Three months later, in September 2000, Enron and LJM2 sold the barge interest to a third party.

When you look at the elements of this transaction, it is obvious that it's not a real sale.

* Through an unwritten side agreement, Enron provided a guarantee to take Merrill Lynch out of the deal within 6 months.

* Merrill Lynch was guaranteed and received a specified 15% return on its $7 million payment.

* Merrill Lynch never received the periodic cash flow payments from the operation of the barges as promised under the agreement and never complained about it to Enron.

* Ebarge, the Merrill Lynch special purpose vehicle, didn't pay any interest on the $21 million loan advanced by Enron.

* Enron paid all of the costs associated with the formation, operation and management of Ebarge.

* The risks of owning Ebarge weren't transferred to Merrill Lynch.

This wasn't the only troubling transaction that Merrill had with Enron. In an April 1998 memorandum, two high ranking Merrill employees informed Merrill's President Herb Allison that Merrill had lost a chance to co-manage a large Enron stock offering solely because Enron objected to what Enron saw as a lack of support by Merrill's Enron analyst John Olson. The memorandum stated that Enron's decision to deny Merrill participation in the offering was "based solely on the research issue and was intended to send a strong message as to how 'viscerally' Enron's senior management team feels about our research effort."

A few months later, Mr. Olson was gone from Merrill. The new Merrill analyst assigned to Enron then upgraded the Enron stock from the equivalent of a neutral to a "buy" rating. A January 1999 memorandum thanked Mr. Allison for telephoning Kenneth Lay at Enron about Merrill's "difficult relationship in Research" and projected additional fees from Enron in the range of $45 million. Earlier this year, Merrill paid $100 million to the New York State Attorney General for compromising the independence of its financial analysts in a case not involving Enron.

Among the additional business that Merrill Lynch picked up that year and the next was handling the private placement offerings for Enron's off-balance sheet partnerships, LJM2 and LJM3. Merrill was not blind to the conflicts of interest raised by these partnerships. But Merrill Lynch decided to go ahead and it helped raise some $390 million for LJM2. The money that Merrill raised for LJM2 helped Enron inflate its earnings and mislead investors and analysts in the way that it did.

Merrill described Enron internally as one of its biggest clients and the key to its Houston office. In 5 years, from 1997 until 2001, Merrill received approximately $43 million in fees from Enron. There's nothing wrong with making money honestly - that is part of the American dream. But making money by assisting a company like Enron to engage in misleading accounting or by discouraging analysts to provide honest ratings or by touting a questionable investment partnership is more like a nightmare than a dream. It misleads investors, rewards the wrong companies for the wrong reasons, and produces the situation we are in today with a crisis of investor confidence.

Today we will find out why a company like Merrill Lynch would risk its reputation to do what they did. Hopefully, when the details come to light Merrill Lynch will take action against those who participated in deceptions with Enron and set a firmer, straight course for the future.