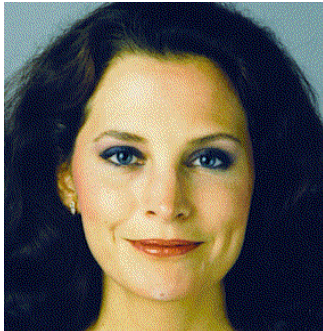


## Enron, J.P. Morgan, and Offshore Special Purpose Vehicles

By Janet Tavakoli,  
Founder, President  
Tavakoli Structured Finance, Inc.



When Enron declared bankruptcy on December 2, 2001, J.P. Morgan Chase Bank had \$965 million in losses from payments due on oil and gas contracts with Enron. J.P. Morgan Chase Bank thought the contracts were hedged with surety bonds. The surety bonds were advance payment bonds that guaranteed Enron's credit risk on pre-paid oil and gas forward delivery contracts.

Surety bonds are a form of insurance, and protect against losses on specific assets. The insurance companies or *sureties* included Citigroup's Travelers Property Casualty, Liberty Mutual Insurance, and St. Paul companies among others. The insurers claimed J.P. Morgan Chase Bank and Enron used fraudulent inducement to cause them to enter into the contracts. They used this as a defense against not making immediate payments under the terms of the surety bonds. J.P. Morgan Chase Bank ("J.P. Morgan") sued in an attempt to recover payments.

J.P. Morgan lost a pre-trial bid in the Southern District of New York to get immediate payment from the insurance companies. As reported by Bloomberg news, in an affidavit filed in New York District Court, David Wilson outlined the gist of Enron's transactions, and the following is a possible reconstruction of one of the transactions based on my interpretation of that account.

J.P. Morgan lent \$330 million to Mahonia, an offshore special purpose vehicle also known as a special purpose entity, a corporation set up by J.P. Morgan in Jersey, one of the U.K.'s Channel Islands. In December 28, 2000, Enron sold gas forward to Mahonia, and agreed to make a series of deliveries from April 2001 to November 2005. J.P. Morgan bought protection in the form of surety bonds on Enron's obligation to deliver the gas, but the insurers are challenging the contracts with Mahonia Ltd., which were "guaranteed" with surety bonds. Mahonia Ltd. got a 7% discount from Enron for the gas, and prepaid \$330 million to Enron. Enron booked the upfront payment of \$330 million from Mahonia for the forward sales as revenue. At the same time, Enron bought gas forward from Stoneville Aegean Ltd., another offshore special purpose entity, a corporation set up by J.P. Morgan in Jersey. In fact, Stoneville and Mahonia had the same address and the same board of directors, and it appears Stoneville was under the control of Mahonia. In exchange for a series of forward deliveries from Stoneville, Enron agreed to make a series of ongoing payments to Stoneville totaling \$394 million.

The following diagram shows the cash flows of the transactions involving J.P. Morgan, Enron, Mahonia, and Stoneville:



It appears as if the \$330 million J.P. Morgan lent Mahonia ended up at Enron. It further appears that the loan payments due from Mahonia to J.P. Morgan are originating from Enron. Furthermore, it appears that Enron is booking what could be a \$330 million loan as upfront revenue instead of booking it as a liability.

Mahonia prepaid the amount owed for the forward delivery of natural gas. Mahonia Ltd. and Stoneville Aegean Ltd. had the same address in Jersey and the same board of directors. The proposed deliveries of natural gas Enron owed Mahonia matched the proposed deliveries Stoneville owed to Enron. It appears the contracts would be matched off, and there was never any intention to make delivery in the first place.

The surety bonds cover obligations by Enron on the series of forward deliveries to Mahonia, which are similar in value to the series of cash flows Enron owed to Stoneville. The upfront payment of \$330 million Mahonia made to Enron appears to match the amount of the \$330 million loan J.P. Morgan made to Mahonia. The series of monthly payments owed by Enron to Stoneville seems identical to the series of monthly payments owed to J.P. Morgan by Mahonia. The cash flows Enron owed to Stoneville seem to be the present value of cash flows on a series of loan payments at 7% interest, which would equal the amount lent to Mahonia by J.P. Morgan. Although ownership of the offshore vehicles isn't disclosed, it is possible that Stoneville is 100% owned by Mahonia.

The insurers claimed the loan and the forward contracts were linked, and they were victims of a fraudulent scheme between J.P. Morgan and Enron. They claimed J.P. Morgan and Enron tried to disguise a loan from J.P. Morgan to Enron by using offshore vehicles and sham forward contracts. Surety providers cannot insure loans under applicable New York law, so they claimed that by entering into these transactions, J.P. Morgan and Mahonia could induce the surety providers to insure the loans. The insurers argued that since they provided the surety bonds based on fraudulent inducement and fraudulent concealment, they had a valid defense against having to perform under the surety bonds.

J.P. Morgan denies the forward contracts were a *de facto* loan and that the transactions were linked. J.P. Morgan also denies knowing that Enron employed creative accounting and booked the forward sales as upfront revenue. It's possible they didn't know, but it reminds me of an incident that happened in my graduate school tax class. One of my classmates asked the professor a question.

“Professor, let’s consider a scenario. What if I don’t receive my 1099 (statement of interest on accounts issued by banks in compliance with U.S. tax law) from my bank on time, do I have to declare the interest on my tax return?”

The professor walked a couple of circles shaking his head with an amused look on his face. Finally he turned to the student.

He was barely able to disguise his mirth when he said: “I would love to be there to hear your defense to the Internal Revenue Service. What could it possibly be? ‘You forgot you had a bank account? You didn’t know you owed tax on the interest? You didn’t know how to calculate the interest on the account?’ You mean to say that you have an MBA from the University of Chicago and your defense will be *ignorance*?”

The professor stopped for a moment because he couldn’t stop himself from laughing. He composed himself again and said: “Sir, *you are going down!*”

The transactions between Enron and the two offshore vehicles were odd. Futures contracts on commodities are exchange-traded contracts with standard terms. Futures contracts are standard, liquid, and allow for a number of delivery locations, but specify the delivery month. They specify a grade of commodity eligible for delivery, but allow for penalty and premium payments if the actual grade delivered is different than the specified grade. Futures contracts are usually netted out on a cash basis before delivery becomes an issue. Although delivery is rarely made on futures contracts, their standardization makes them a liquid method of exchange to hedge or speculate on commodity prices.

Forwards are over-the-counter contracts, and the terms of the contract are negotiated by the specific parties involved in the transaction. They are most frequently employed when physical delivery is expected. They are private non-standard contracts. Settlement of the terms of the contract is either in the form of a physical asset or cash, and it occurs on the negotiated settlement date. These contracts are often very detailed.

If you are long a forward commodity contract, you have an obligation to purchase the commodity or give its cash equivalent on the pre-agreed delivery date. The settlement terms will specify either the cash settlement amount or the grade of commodity you have to deliver on the settlement date, and the location to where you must deliver it.

If you are short a forward commodity contract, you have an obligation to sell the commodity (or you will receive its cash equivalent) on the pre-agreed delivery date.

When the parties enter into a forward contract, usually no money changes hands. *At-market* contracts have zero initial value and zero cash flow on the trade date. Usually cash only changes hands in an *off-market contract*. The cash flow would equal the discounted *expected net present value* “NPV” of the contract on the trade date and would be paid by the party for which the NPV is positive to the party for which the NPV is negative. If you wish to create a non-standard long forward, the purchaser of the commodity could choose to prepay the money in one upfront payment.

With forward contracts, you know the price you will pay or receive in advance. The pricing technology is straightforward. The parties to the contract build their forward interest rate curves, and for each date, they

can plug their figures into formulas depending on whether they are long or short (See also the section titled “*Accruing Errors*” for more on forward price calculations). It is highly unlikely the futures contracts would accidentally match a series of cash flows that would be so close in appearance to loan repayments.

The outcome of the case is that JP Morgan Chase and the insurers agreed to a settlement just before the case was due to go to jury trial in January 2003. Instead of \$965 million, JP Morgan Chase will get about \$600 million and will take a fourth quarter pre-tax charge of about \$400 million to recognize the net loss.

What would have been the outcome had the case gone to trial? Unfortunately we’ll never know. The judge, Jed Rakoff ruled that a senior J.P.Morgan official’s e-mail describing the transactions as “disguised loans” could be used in the trial. On the other hand, he dismissed claims that J.P. Morgan aided in Enron’s financial fraud.

But J.P. Morgan still has civil suits pending related to its dealings with Enron. All of these issues may be reopened.

Suppose for a moment that these transactions were a convoluted way of hedging Enron credit risk. Why didn’t J.P. Morgan just enter into a credit derivatives contract and hedge the credit risk? Credit derivative contracts were more expensive than surety bonds. Structurers overlooked the fact that insurers may have defenses against payment if the language of a surety bond isn’t very tightly constructed. Institutions, which hedged their Enron risk with credit derivatives, may have paid more money for the protection, but all of them received immediate payment under their contracts.

Before the settlement, a J.P. Morgan spokesman said that the “good faith of insurance companies will be on trial”. I don’t agree. These transactions were highly unusual, and I believe the insurers would have been remiss if they didn’t raise a legal challenge that is available to them under New York law. That’s just good business sense. When one is being very clever, it is important to remember that the other people we do business with are also very clever. If we want to exploit form over substance opportunities, others may wish to do the same.

Game theory is the study of conflict between thoughtful and potentially deceitful opponents. In his *minimax theorem* John von Neumann mathematically proved there is always a rational solution to a precisely defined conflict between two players whose interests are completely opposed. When Enron declared bankruptcy, the interests of the insurers and of J.P. Morgan were opposed. The insurers were merely making their logical move, and the documentation may have made the move available.

Were these transactions a good idea in the first place? What we consider clever finance today, may be viewed as fraud tomorrow and vice versa. Tax avoidance is legal; tax evasion is illegal. Tax avoidance today may become tax evasion under tomorrow’s public policy. Whenever someone is getting something for nothing, there is always that added risk.

In this series of transactions, it appears that Enron received a loan and at the same time got to book it as immediate revenue. It appears the loan payments would be accounted for as forward liabilities. From a public policy point of view, use of Special Purpose Entities for this kind of benefit is on shaky ground. Anytime we use offshore vehicles to legally translate the character of cash flows, we need to be aware of

public policy risk. Where were the clearer heads questioning how this transaction would look to a disinterested party?

Some good may come out of this dispute. Surety bonds are a good way to protect risk, and can be a good alternative to credit derivatives. Structurers may use surety bonds with more - rather than with less - confidence in future. Lawyers will draft tighter language for surety bonds to bind the insurers to immediate payment on demand. Separately, if the surety bond providers believe fraud is involved, they can pursue a fraud claim or claim of breach of contract against the beneficiaries to recover their payments and damages.

**Janet Tavakoli is the Founder and President of Tavakoli Structured Finance, Inc., a Chicago based consulting firm for structured financial products. Ms. Tavakoli has over 20 years of experience in senior positions on Wall Street trading, structuring, and marketing structured financial products. She is a former adjunct professor of derivatives at the University of Chicago's Graduate School of Business and author of the global bestsellers in their respective fields: *Credit Derivatives & Synthetic Structures 2<sup>nd</sup> Edition*, 2001, and *Collateralized Debt Obligations & Structured Finance*, 2003, both published by John Wiley & Sons.**

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