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Senate Panel Is Expected to Review an Enron Deal

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J. P. Morgan Chase engineered a complex transaction for [Enron](#) last year to allow the company to obtain hundreds of millions of dollars in tax deductions that normally would not have been permitted, people involved in the inquiry into the company's finances said yesterday.

The transaction — known internally at J. P. Morgan as Slapshot — was put together by the company's structured finance group. It involved entities in Nova Scotia, Quebec City and the United States and was intended to give Enron enormous financial benefits through a reduction of its tax obligation in Canada, where it owned a paper mill.

The transaction is expected to be one of several reviewed next week by a Senate subcommittee that is conducting continuing hearings on financial engineering put together for Enron by banks like J. P. Morgan and [Citigroup](#).

In the end, 80 percent of the economic benefit from the \$440 million tax deduction created by the transaction flowed through to Enron. The other 20 percent went to Citigroup, a competitor of J. P. Morgan that indirectly owned a stake, along with Enron, in a entity involved in the transaction. There is no indication that Morgan knew that Citigroup was receiving a benefit from the transaction.

While the outcome of the transaction — which allowed Enron to benefit from a traditional deduction of interest as well as an untraditional deduction of principal from a financing deal — was unusual, there is no indication that it was illegal. Indeed, structured finance deals are designed to achieve particular outcomes — even ones that may seem illogical or misleading — by building the transaction through an aggressive and rigorous reading of the rules.

In the case of Slapshot, lawyers approved of the deal before it was executed. "The structure was reviewed with two Canadian law firms and found to be legal and appropriate under Canadian law," said Kristin Lemkau, a spokeswoman for J. P. Morgan.

The transaction began in early 2001, when an affiliate of Enron bought a pulp and paper mill in Quebec

City for \$375 million. According to people who have reviewed records from the transactions, Enron raised the money by issuing short-term debt and then lent it to the affiliate to make the purchase. The result was that Enron added to its books \$375 million in debt, plus the offsetting asset of the loan.

By June, the company was ready to put permanent financing in place. That was where Slapshot came in. Under normal tax rules, the Enron affiliate — Compagnie Papiers Stadacona, or C.P.S. — would be able to deduct its interest payments from its taxable income, using the same tax treatment available to homeowners with a mortgage. But with Slapshot, the affiliate could deduct the total expected interest plus the principal.

Accomplishing this required several steps, all of which took place on June 22, 2001, according to people who have reviewed the records of the deal. The first stage involved an entity affiliated with Morgan known as Flagstaff. Morgan, leading a consortium of four banks, gave a five-year \$375 million loan to Flagstaff. Simultaneously, Morgan gave a one-day loan of slightly more than \$1 billion to Flagstaff.

At that point, another special-purpose entity came into play. This one, known as Hansen, was based in Nova Scotia. Flagstaff provided a loan of about \$1.4 billion — the total of the two loans that it had received — to Hansen. That loan came due in five years and one day. Under its terms, the loan was what is known as a bullet, requiring only interest payments until the final day of the loan, at which point the full amount of the principal would have to be repaid.

All told, the quarterly interest owed by Hansen to Flagstaff was identical to the quarterly interest and principal payment owed by Flagstaff to the bank consortium. The amount totaled \$22 million a quarter, or \$440 million over the life of the loans.

The connection to the paper mill came from Hansen. That entity lent the full \$1.4 billion it received to C.P.S., the Enron affiliate. C.P.S. then used \$375 million of that loan to repay Enron for the original loan used to buy the paper mill. The remaining billion dollars also went to Enron, although it was not clear whether that was in the form of a loan or some other financial instrument.

As a result, C.P.S. was then obligated for interest payments totaling \$440 million over the life of the loan — payments that, as interest, would be fully deductible. However, the Enron affiliate was also still obligated to pay \$1.4 billion in principal. The next steps of the transaction were designed to eliminate the economic effect of that obligation.

To accomplish that, one more special entity — called Newman — came into play. Newman agreed to buy shares in Hansen in five years. The purchase price was \$1.4 billion, the same amount being swapped around among the various entities.

Newman then turned back to Flagstaff and agreed to turn over just more than \$1 billion. In exchange, Flagstaff agreed to pay Newman's obligation to Hansen in five years.

The result was that Flagstaff used the \$1 billion to repay the one-day loan from Morgan. In five years, on the very day that Hansen would owe Flagstaff \$1.4 billion, Flagstaff would owe Hansen the exact same amount. Both debts would cancel each other out.

Throughout the transaction, obligation after obligation was designed to cancel out. In the end, the only pieces left standing would be the interest payments from C.P.S. to Hansen of \$440 million. In other words, the \$375 million in original principal was converted into interest through a loan where ultimately very little real money changed hands.

The benefit to Enron was twofold. One, the \$375 million in debt was moved off its balance sheet and into C.P.S. Two, it received a share of the economic benefit from the transaction through its ownership of C.P.S. This entailed yet another special-purpose entity, called Sundance, which was jointly owned by Enron and Citigroup. Enron's economic share of Sundance was 80 percent, which is why it received that portion of the benefit from the tax deduction.

But, despite all the effort, Enron never really saw a dime of benefit, because only one interest payment was made. In less than six months, Enron was bankrupt, defaulting on all of the obligations it had taken on.