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"NAT WEST THREE"

The following case of the three Nat West Bank personnel who stole over US $ 9 million from Enron is set out in stages to illustrate the fraud using Special Purpose Vehicles:

US v Gary Steven Mulgrew, Giles Robert Hugh Darby and David John Bermingham [2002]. This was a criminal case, indicted and convicted, of the conspiracy to defraud by the three men who were involved with an Enron "Special Purpose Vehicle", called Rhythms NetConnections, an internet business. The purpose of Rhythms NetConnection was to use it to hedge risk. Enron owned 5.4 million shares in Rhythms NetConnection. In 1999, Enron waived its 'conflict-of-interest' rule to allow its CEO Fastow to form a company called LJM Cayman to hedge Enron's risk in Rhythms NetConnections. In exchange for 3.4 million of Enron shares, LJM Cayman gave Enron $64 million of promissory notes and created a subsidiary called Swap Sub. Swap Sub "wrote" to Enron some derivative options. This enabled Enron to sell its Rhythms NetConnection shares at a certain price on certain dates. LJM Cayman had two limited partners, Campsie Limited and Enron's Rhythms Net Bet (ENRB). The banks Credit Suisse First Boston established ENRB in the Cayman Islands and Nat West established Campsie, also in the Cayman Islands. At this time Gary Muldrew was Managing Director and also Head of the Nat West Structured Finance Group of Nat West Bank's London, Greenwich branch. Giles Darby was junior joint Managing Director with Gary Muldrew. David John Bermingham, a solicitor who also worked at the Nat West Bank, Greenwich branch, was Chief Officer of the Nat West Structuring Group. David John Bermingham reported to both Mulgrew and Darby. These 3 and other Nat West staff had negotiated in the establishment of Campsie.

The conspiracy to defraud of the Nat West bank employees

The charge of conspiracy to defraud was founded on the fact that these three bank employees executed a scheme to cause Nat West to sell its interest $7.5 million in Campsie for $1 million, then bought it themselves for $250,000, and then sold it quickly within weeks for $7.3 million.

The Preparatory stage of the crime

Before this stage the bank employees hatched a plan to cause LJM Cayman's liability of the promissory notes to be paid off. The three bank employees had transferred LJM Cayman's Enron shares to Nat West and CSFB. Both Credit Suisse Bank and Nat West Bank made an instant "paper" profit of $20 million. This instant $20 million paper profit transpired because the three bank employees created derivatives transactions using their bank's Enron shares. In the finance industry," articles "or instruments such as swaps are used. The basic principle of swaps is simple as a swap is an exchange of one asset or liability for another. Swaps originated as a means of exploiting the arbitrage opportunities between the banking and capital markets and also between different capital markets.
Therefore the use of swaps by these three Nat West bankers is an abuse of swaps and would fall under the Fraud Act 2007, were it a retrospective Act. They were exploiting arbitrage opportunities, they argued. In that way, they are gaming contracts, and would have been unenforceable under the Gaming Act 1845, section 18, which was repealed by the Gambling Act 2005. Therefore today swaps and derivative contracts are enforceable under English law, notwithstanding the particulars of each case, motivations, and intentions. However, even before the Gambling Act 2005, swaps were deemed not to be gaming contracts (see *Westdeutche Landesbank Girozentrale v Islington London BC, Kleinwort Benson Ltd v Sandwell Borough Counci*l [1996] 2 All ER 961.

Generally a swap, used legally, is for reducing borrowing costs or increasing investment yield or to manage a portfolio risk. A party to a swap takes the risk that its counterparty may be unable to make the swap payments. Swaps today, are the largest component of financial derivatives, the first such derivatives in the world introduced by the Chicago Mercantile Exchange in 1972, coming into use in London in 1978, with the UK daily average turnover in derivatives being nearly 200 billion pounds in 2001. Yet, it is not generally known that the United Kingdom has, since 1978, been using the "article" of the Special Purpose Vehicle, contrary to the Gaming Act 1848, section 18, which Act made the SPV illegal betting. It was not until the Gambling Act 2005 that Special Purpose Vehicles were made legal. Section 334(1) (c) of the Gambling Act 2005 repealed section 18 of the Gaming Act 1845. Section 356(3) (d) provides that the Gaming Act 1845 ceases to have effect and is repealed (see section 356(4) of the Gambling Act 2005). It is only at this point that a Special Purpose Vehicle transaction such as a swap or a derivative contract was made legal. In theory, before this point, i.e. from 1978 to 2005, the United Kingdom's financial "article" the Special Purpose Vehicle was a fraud. And an unenforceable gaming contract, in theory.

This is not the first time that the UK has acted illegally

This is not the first time that the United Kingdom has acted illegally. In the case of *Lankhorst- Hohorst GmbH v Finanzampt Steinfort* (Case C-324/00) [2003] STC 607, it was revealed that the UK Transfer Pricing Rules, in force since 1951, were illegal and in breach of the European Treaty. LH was a German company whose ultimate shareholder was a Netherlands company . LTBV, in December 1996, loaned 3 million DM to LH, repayable over 10 years in annual instalments. In its Corporation Tax assessment notices, of June 1999,with regard to tax year 1997-8,the German tax authorities decided that the interest paid to LTBV for the loan was equal to a covert distribution of profits . The government quickly changed the law to read that from 1st April, 2004, UK to UK business transactions were no longer exempt from tax on the difference in prices except for transactions between small and medium sized [1] companies. Medium sized businesses are those having fewer than250 employees and either turnover of less than50 million Euro, or assets of less than 43 million Euro. (Commission Recommendation 2003/361/EC of 6 May 2003). Under the new rules, companies who have borrowed from an UK Company or overseas parent will need to show that the loan could have been made on a stand-alone basis or face possible transfer pricing penalties. This means that if a branch of a company incurs a loss on its Profit and Loss Account for £1000, it cannot carry forward this loss to another UK branch. It must restrict only carry forward losses made in the UK to other branches of the same company only. And if a branch in the UK paid interest to the parent company which is based outside the UK, the interest on the loan it borrowed is treated as the parent company's dividend. If the borrowing exceeded a given debt to equity ratio. The legislation applies to all parent companies abroad with branches in the UK and also to all branches in the UK of a company based outside the UK.

The Crucial Timing

Immediately after the instant paper profit of $20 million was created for Nat West Bank, in October 1999, curiously there appeared some other potential paper transactions, i.e. takeover bids by Bank of Scotland and Royal Bank of Scotland for Nat West Bank. How coincidental the takeover banks' names were similar, although none of these paper transactions were ever questioned by the UK regulators. At this same time, Nat West Bank tried to quickly sell off its Greenwich branch and its SPV Swap Sub. In March 2006, Royal Bank of Scotland took over Nat West Bank.

The criminal evidence

There were crucial emails between Bermngham, Darby and Mulgrew during January 2000. These emails showed that the three men had planned to make their own secret profits. In February 2000, Bermingham and Mulgrew's emails showed that they were planning to go to the US to make a slideshow presentation to Enron's CEO Fastow about a restructure of Swap Sub. The emails revealed that Bermingham and Mulgrew knew that their proposal did not guarantee the Enron profits of $25 million that their slideshow purported would arise. The emails showed that Bermingham wrote to Mulgrew about this unrealistic purported profit. One email stated: '*We should be able to appeal to his greed.'* Mulgrew's email in reply, stated, '*Why can't we squeeze the LPs a bit more?'* Bermingham and Mulgrew also exchanged emails on 26 February 2000. These February 26th emails discussed potential tax consequences for themselves after they had made their planned paper profits. The $7 million profit they received through the conspiracy was exactly the amount of profit their newly formed company, Southampton K Co, set up by the Mulgrew, Bermingham and Darby, could saturate in order to cancel out the 'paper' virtual losses it would suffer in their series of transactions, in order to bear no taxes. Their scheme to defraud was executed between March 2000 and July 2000.

The execution of the SPV fraud

In a step-by-step approach they made the following moves:-

On 4 March 2000 Fastow had dinner with Bermingham and others. He told Bermingham that: '*Now was the time to do it.'*

A notebook confirmed this. In March 2000, Mulgrew told Nat West Bank that Enron was offering to buy-out Nat West's interest in Swap Sub at a low price of $1 million. Mulgrew told Nat West that Nat West's interest was not even worth $1 million at that moment. So Nat West, with full knowledge of the new Special Purpose Vehicle formed by Darby, Mulrew and Bermingham, i.e.'Southampton K Co' sold their interest for $1 million.

On 10 March 2000, Darby formally wrote to Enron's Mr. Kopper to confirm the sale of Nat West's interest in Swap Sub. This sale of the paper interest in the Special Purpose Vehicle Swap Sub was to a newly formed Enron Special Purpose Vehicle named NewCo, controlled by Mr. Kopper himself. On 14 March 2000, Bermingham went to meet Mr. Kopper in New York .In New York, Bermingham had drafted, a form option agreement from Kopper to Mulgrew, Bermingham and Darby, for an option to purchase SPV Southampton K Co., a partner to SPV Southampton L.P, controlled by Enron's Kopper. On 17 March 2000, SPV Campsie's interest in SPV Swap Sub was sold for $1 million to SPV Southampton L.P. and Credit Suisse Bank's interest in SPV Swap Sub was also sold at the same time to SPV Southampton L.P for $10 million. The option form agreement which Bermingham's US lawyers drafted in New

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York, had been signed by Bermingham, Mulgrew and Darby. This option form agreement created for these three men the right to buy all issued and outstanding equity of SPV Southampton K Co for $250,000, plus interest, before 31 May 2000. On 20March 2000 Enron and SPV Swap Sub entered agreements to terminate the SPV Rhythms NetConnections' put options. On 27 March 2000 Bermingham resigned from Nat West Bank. On 17 April 2000 Darby resigned from Nat West Bank, his resignation becoming effective from 31 July 2000. On 21 April 2000, Bermingham, Mulgrew and Darby notified Enron's Kopper that they wished to exercise their rights under their option agreement. Kopper confirmed and on 2 April 2000, Mulgrew transferred the $250,000 from his bank account into Bermingham's bank account. On 27 April 2000 the virtual paper transactions were complete and at this point Bermingham sent a bank draft for $251,993 (i.e. $250,000 plus interest) to Enron's Kopper's bank account with Chase Bank of Texas. Also on 27 April 2000, Bermingham caused to be drafted, an option agreement to Mulgrew and Darby to purchase one-thirds interests in SPV Southampton K Co no later than 31 August 2000. Thus Mulgrew, Darby and Bermngham instantly made a total of $7 million profit on their virtual paper investment of $83 898 each ($251,993 divided by 3, of which $1,193 was interest payable because this was an owner trust Special Purpose Vehicle. An owner trust will not qualify as a non-taxable trust because the appointed trust manager is empowered to deal with the cashflows of the receivables in an instructed and prudent manner. Instead of the income flowing from the receivables to the investors (the three men) it is withheld by the trust manager and paid according to the income demands of the investors. An owner trust will issue interests in the trust backed by receivables with different maturity dates and amortisation schedules.). On 27 June Mulgrew resigned from Nat West Bank. On 31 July 2000, Bermingham instructed Bank of Bermuda to transfer $2.3 million from SPV Southampton K Co's account to an account controlled by Darby, the date that Darby's resignation from Nat West became effective. The structure of the SPV arranged so that surplus funds are extracted by the originator. There is no single method used to extract profits and the tax treatment of the monies extracted varies according to the methods used, including dividend payments. On 1 August 2000, Bermingham instructed Bank of Bermuda to transfer $390,000 From SPV Southampton K Co account to Bermingham's own Nat West, London account in Greenwich branch. On 8 August 2000, Bermingham instructed Bank of Bermuda to transfer $2.38 million from SPV Southampton K Co's account to Muldrew's own account. On 17 August 2000, Bermingham instructed Bank of Bermuda to transfer the remaining funds in the SPV Southampton K Co's account to his English solicitor's account. Based on the above, a charge of knowingly executing a scheme and artifice to defraud was bought in the United

States. All three men partook of Federal government plea-agreement and are currently in a United States prison. Had they been prosecuted in the UK, a whole hornet's nest of virtual paper transactions such as in the Guinness case of 1986 might have been uncovered.

Special purpose vehicle used for fraud

This English case, involved Special Purpose Vehicles (SPV) as used in the ENRON fraud. The English court used the precedent of 'piercing the veil of incorporation' to unravel the potential fraud and put right the wrong.

Piercing the corporate veil

The classic authority of *Salomon v Salomon and Co. Ltd*.(1897) AC 22, House of Lords, sets out that the court is required to recognise the separate legal personality of a limited company from its owners. But the courts have since then, lifted or pierced that so-called corporate veil when it suspected fraud. In the 1990's the English courts began to be stricter in respecting an incorporated entity's veil of incorporation, citations being *Adams v Cape Industries Plc* [1991][2] and *Ord v Belhaven Pubs* [l998] when the court drew a distinction between a corporate structure created to evade rights of relief that third parties might in future acquire (a legitimate method of ensuring that any legal liability would fall on a particular member of the group rather than upon its parent or associated companies) and the deliberate divestment by a company of its assets with the purpose of ensuring they wound be unavailable to meet existing liabilities.

Element of impropriety and dishonesty

Since 1933, in the case *Gilford Motor Co. Ltd v Home*[4] the English courts have been allowing a company's veil of incorporation to be lifted, but only under strict circumstances, these being when there is present both 'an element of impropriety and dishonesty' on the part of the defendant; and when there are 'transactions or business structures' being used as a device or strategy to mask, cloak or act as a SPV device in order to disguise the true situation.

In the case *Re Hellenic and General Trust Ltd* [1975][5] the court lifted *the veil of incorporation* to allow a group of companies to be regarded as one, because in reality, they were not independent either in human or commercial terms. An element of impropriety or dishonesty is required in order for a court to pierce the veil of incorporation. Creditors seeking to recover monies owed by defaulting sovereign debtors was the issue in the case *Kensington International Limited v Republic of the Congo.*[6] The Court decided that private creditors of the Republic of Congo could enforce their judgments in [1975] 3 All ER 382. In this case, a company called MIT which was a wholly owned subsidiary of Hambros Ltd, held 53% of the ordinary shares of Hellenic. A scheme of arrangement was put forward under which Hambros was to acquire all the ordinary shares of Hellenic for a cash consideration of 48 pence per share. The ordinary shareholders including MIT met and over 80 percent approved the scheme. But the National Bank of Greece, which was a minority shareholder" opposed the scheme because it would be liable for a heavy tax burden under Greek law as a result of receipt of cash for its shares. Justice Templeman ruled that holding company Hambros would have been regarded with the subsidiary MIT as one economic unit in the class meeting and not as two independent companies with independent interests. there should have been a separate class meeting of ordinary shareholders excluding MIT. This is one of two recent cases where the English courts pierced the corporate veil[7] to reveal Special Purpose Vehicles used to avoid paying debts, the other case being *Walker International Holdings v Republique Populaire du Congo* [December 2005].

What Kensington International did next

Kensington International obtained four judgments against the Congo in 2002/2003 for sums due under loan and credit agreements. Kensington had bought up what has been described as a ‘vulture fund.’ A ‘vulture fund’ is a company that buys up a developing country’s debt cheaply then pursues full repayment of the debts to make a huge profit.

In April 2005, Kensington obtained interim third-party debt orders in respect of each judgment, together with supporting injunctions relating to two consignments of Congolese oil that were bought by an English company, Glencore Energy UK Limited, from an entity called Sphynx (Bermuda) Ltd. Sphynx(Bermuda) Ltd. had, in turn, bought the oil from an entity called Africa Oil and Gas, (AOGC) which itself bought the oil from CoTrade SA, a wholly owned subsidiary of SNPC, Societe Nationale des Petroles du Congo, an entity owned by the Congo government. It was found that at least $472 million has passed through Sphynx (Bermuda) Ltd., nearly all of it in the form of bogus oil trades. Sphynx (UK) Ltd. was incorporated in London to act as a service company for Sphynx (Bermuda) Ltd. According to the records of the Registrar of Companies, the four-year-old company, incorporated on February 14th, 2002, which has never filed any accounts, is still active. Registrar of Companies documents show that Sphynx (Bermuda) Ltd. was incorporated on February 14, 2002. The share capital ofSphynx

(Bermuda) Ltd. was $12,000, the minimum amount required to incorporate an exempt company. Listed as shareholders on the incorporation documents are Arthur E.M. Jones, Trevor J. Williams and Don P. Dunstan.

The transfer of assets so as to divest a company of these assets for the purpose of ensuring they would not be available to meet existing liabilities may justify piercing the corporate veil. This means that the court will look for the legal substance, rather than its economic substance, if different. But the veil will not be lifted where the corporate structure was created in order to evade rights of relief which third parties might, in the future acquire. The corporate structure could legitimately be used so as to ensure that the legal liability [if any] in respect of particular future activities of the group [and, correspondingly, the risk of enforcement of that liability] would fall on a particular member of the group, rather than upon its parent or associated companies. Mr. Williams and Mr Jones acted as professional directors for Sphynx (Bermuda) Ltd. from 2002 to 2005. Mr. Williams and Mr. Jones were also directors of Lockwood Ltd., a company based in the British Virgin Isles and the holding company for Sphynx (Bermuda) Ltd. The company Consolidated Nominees Ltd. held the shares of Lockwood Ltd. in trust for the benefit of Mr. Gokana who is a signatory of the HSBC bank account of Sphynx (Bermuda) Ltd. Mr. Gokana lived in France.

Using a Special Purpose Vehicle to launder 'oil' money

This is how the SPV companies laundered the 'oil' money to keep it from the Congo government's creditors. The Congo government sold shipments of oil to Sphynx (Bermuda) Ltd. at heavily discounted prices. Sphynx (Bermuda) Ltd. then sold it on at market prices, depositing the proceeds to the bank account of the Africa Oil and Gas Corporation (AOGC), a company controlled by Sphynx (Bermuda) Ltd.

The court found that the scheme was embarked upon to evade the effect of court seizures of SNPC's assets by passing the sale of oil through a series of SPV companies. The structure deliberately sought to conceal any connection between the companies and the state. The only real transaction was found to be between Glencore Energy UK Ltd. and Sphynx (Bermuda) Ltd. and that since SNPC and CoTrade were part of the Congo government, the transactions were SPVs. In a true-sale securitization, the transaction can be split into three steps. The entity that wishes to raise finance sells or pledges intangible assets to a legally separate entity called a Special Purpose Vehicle.

The SPV issues bonds or certificates in the capital markets so that it can raise funds to purchase the intangible assets from the originator or lend funds to the originator. The SPV pays the originator the purchase price or gives a loan from the proceeds of the bond or certificate issue.

The special purpose vehicle is the receiving entity sponsored by the originator to satisfy the legal, accounting and bankruptcy principles. Securitisation structures utilise either a public or private corporation or a trust as a SPV. The veil of incorporation is lifted by the courts to counter fraud, sharp practice, oppression and illegality.

UK Companies Act and transparency

What does statute say about companies which are not as transparent as should be? Companies Act 1985, section 306 states that the memorandum of a company may provide that the liability of its members shall be limited BUT the liability of its directors shall be unlimited. Also, section 229 Companies Act 1985 states that where there is a holding and subsidiary relationship between companies, the holding company is required to prepare individual accounts plus group accounts, suggesting that for financial purposes, the companies within a group are one.

Special Purpose Vehicles used to avoid payment to creditors

This case essentially concerns an attempt by the government of Congo to avoid payment to creditors who sought to seize Congo's oil assets. The Republic of Congo routed the sale of these oil assets through a number of intermediary Special Purpose Vehicles. Kensington International Ltd. brought an action against the Congo government for the unpaid amount of $120 Million and made out a case for piercing the 'veil of incorporation', on the basis that Congo government had dishonestly attempted to hide assets so as to evade enforcement of these unpaid judgements. The plaintiff Kensington International, applied to the English court for third party debt orders. The court then froze the money held by the third party. Kensington International is what is known as 'a vulture fund'. It had purchased the four judgements against the Republic of Congo and obtained these English third party debt orders.

Money laundering through Special Purpose Vehicles

This is what the Court found. At least $472 million in oil revenue had passed through a SPV[8] Bermuda company. This SPV company, Sphynx (Bermuda) Ltd., had been used by the Republic of Congo to mask the movement of oil revenues to keep the money out of the hands of creditors. Trevor Williams and Arthur Jones, officers of Consolidated Group of Companies, were directors of Sphynx (Bermuda) Ltd. The court ruled that the claimant, Kensington International Ltd. was entitled to third party debt orders in respect of the purchase price for the oil cargo. A SPV agreement is one where the parties do not honour the rights and obligations set out in that agreement. It serves as a smokescreen to the true nature of the contractual agreement, making the agreement ineffective.

Criminal Cartels use Special Purpose Vehicles
Just as companies used English partnership law to form partnerships between companies, they being legal persons, so today, Special Purpose Vehicles are being used to bypass competition law.

European Merger Control
The Commission's thresholds are a worldwide turnover of one billion Euros with a minimum of 50 million Euros for the target company was recommended. Today, in virtually all Member States, governments retain discretionary competences on merger control. The German Federal Cartel Office argued for expanded competence in cases with main effects in one Member State (Bundeskartellamt 2002). As long as the turnover thresholds are met, the Commission has to consent. Anti-competitive practices enjoy the benefits of a decentralised system and create institutional innovation and learning through experimentation it is in the interests of business associations to enhance opportunities and circumvention problems they face. While the Commission intended to secure a consistent application of anti-cartel rules, it has been proved that there are inconsistent treatments of similar cases. This may be due to differences in competition policy traditions and differing procedural rules between the member states and their agencies. Fuelled by the self-interest of certain European member states, enforcement decentralisation has not been favoured, factors relevant being diversity by way of local knowledge, preference orientation, cultural diversity and advantages of experimentation. Merger control issues concern the enhanced rights by merging enterprises to choose the regulating agency. It can be said that merger control facilitates forum shopping. Cooperation between the competition agencies is an important part of antitrust practice.

Networks should serve as an early warning system. Network governance requires a balance of power and network corporate principles are imperative. When networks go wrong because of inadequate corporate governance and examples of such inadequacies are to be seen in the Enron fraud, facilitated by slackness that enabled the following:

Lawyers and accountants in the oil industry
In Enron, the advisors actually participated in a scheme to defraud and did not merely provide routine services to Enron. The lawyers and accountants helped to form the Special Purpose Vehicles (SPV's) and provided legal advice as to how the SPV's should be formed and who should manage them; money was loaned to some of these SPV's so as to buy ownership interests in other SPV's. The lawyers advised the company to set up secret cash reserves to ensure that the

SPV's could repay its loans; the advisors reviewed and approved these SPE's. All these are things to watch out for in the sector of oil and gas production,

Conclusion to the ULVA case study

There is a hornet's nest of Special Purpose Vehicles frauds in the United Kingdom, to date, a secret subject. There has been aggressive use of Special Purpose Vehicles as funding Vehicles**.**

In the United States, the Enron notoriety involved using the concept of securitisation to facilitate financial crime. The masterminds of the fraud cleverly used thousands of securitisation and hedging transactions to raise funds in order to give financial creditability to a giant corporation which on the surface appeared prosperous but, in reality, was breathing to a large extent on borrowed funds. This unrestrained greed, corruption, bribery, conspiracy and collusion is the cause of the present global financial crisis.

ENDS