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Enron Posts Surprise 3rd-Quarter Loss After Investment, Asset Write-Downs

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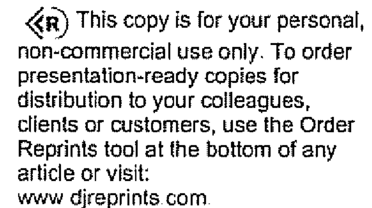
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By JOHN EMSHWILLER and REBECCA SMITH
Staff Reporters of THE WALL STREET JOURNAL
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Enron Corp. Tuesday took a $1.01 billion charge mostly connected with write-downs of soured investments, producing a $618 million third-quarter loss. The loss highlights the risks the onetime highflier has taken in transforming itself from a pipeline company into a behemoth that trades everything from electricity to weather futures.

In addition to the size of the charge, a particular slice raises anew vexing conflict-of-interest questions. The slice is connected with a pair of limited partnerships that until recently were run by Enron's chief financial officer. The company said the charge connected with the partnerships is $35 million and involves the "early termination ... of certain structured finance arrangements."

Two years ago, the chief financial officer, Andrew S. Fastow, entered into the unusual arrangement with his employer. With the approval of the board of Enron, Mr. Fastow set up and ran the partnerships that stood to make him millions or more, according to partnership documents. While the company says that this arrangement was proper, some corporate-governance watchdogs have questioned whether a chief financial officer, who is responsible for overseeing the financial interests of the company, should have been involved in such a partnership that was, among other things, looking to purchase assets from Enron.

The two partnerships, LJM Cayman LP and the much larger LJM2 Co-Investment LP, have engaged in billions of dollars of complex hedging transactions with Enron involving company assets and millions of shares of Enron stock. It isn't clear from Enron filings with the Securities and Exchange Commission what Enron received in return for providing these assets and shares. In a number of transactions, notes receivable were provided by partnership-related entities.

Mr. Fastow's role as chief financial officer made him privy to internal asset analyses at Enron. An offering memorandum for the LJM2 partnership said that this dual role "should result in a steady flow of opportunities ... to make investments at attractive prices." Mr. Fastow would find his interests "aligned" with investors because the "economics of the partnership would have significant impact on the general partner's wealth," according to this document.

In a written statement in response to questions, Enron, based in Houston, said "there never was any obligation for Enron to do any transaction with LJM. Enron and its Board established special review and approval processes with its senior management and external audit and legal counsel to ensure that each transaction with the LJM partnership was fair, in the best interest of Enron and its

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shareholders, and appropriately disclosed."

Mr. Fastow, through an Enron spokesman, declined to be interviewed.

In announcing the third-quarter loss, Enron said the partnership-related write-offs were part of a larger $544 million charge related to the diminished value of investments in a retail-power business, broadband telecommunications and technology. In addition, there was also a $287 million write-off resulting from its investment in Azurix Corp., a water company Enron spun off and then repurchased. In all, Enron posted a third-quarter loss of 84 cents a share, compared with a gain of 34 cents a share in the year-earlier period. Revenue rose 59% to $47.6 billion.

At 4 p.m. Tuesday, Enron's stock was up 67 cents a share to $33.84 in composite trading on the New York Stock Exchange, but remains far below its 52-week high of $84.88. On Monday, the day before the earnings announcement, Enron stock dropped by about 7%.

In an interview, Enron's chairman and chief executive, Kenneth Lay, said the write-offs were designed as part of an effort to "find anything and everything that was a distraction and was causing a cloud over the company."

The quarterly loss is the latest in a series of setbacks faced by Enron recently after years of almost unbroken success. There have been mounting problems from expensive moves into the water and telecommunications businesses.

And there has been a steady stream of executive departures, most notably the surprise resignation in August of Enron's president and chief executive, Jeffrey Skilling, who said he left for personal reasons and because of the fallen stock price.

The partnership arrangement involving Mr. Fastow, the highly regarded chief financial officer, first surfaced in an Enron SEC filing in 1999, but only recently has it attracted Wall Street's concern. In late July, Mr. Fastow severed his relations with the partnerships, according to a company SEC filing. Company officials said that move was partly related to questions raised by analysts and large Enron shareholders.

Little about the inner workings of the LJM partnerships has been disclosed to date. Private partnership documents reviewed by The Wall Street Journal indicate that Enron agreed to a partnership arrangement with potentially huge financial rewards for Mr. Fastow.

The LJM Cayman partnership raised a relatively modest $16 million, according to the documents. The more ambitious LJM2 aimed to raise at least $200 million, the documents show. Among investors were Credit Suisse Group's Credit Suisse First Boston, Wachovia Corp. and General Electric Co.'s General Electric Capital Corp. The Arkansas Teachers Fund committed $30 million, of which $7.4 million had been tapped by late last month. Bill Shirron, a fund manager there, said the LJM arrangement had "already returned $6 million to us." It's been "a home run so far," Mr. Shirron added.

According to the LJM2 offering document, the general partner, made up of Mr. Fastow and at least one other Enron employee, received a management fee of as much as 2% annually of the total amounts invested. Additionally, the general partner was eligible for profit participation that could produce millions of dollars more if the partnership met its performance goals over its projected 10-year life. In exchange, the general partner was obliged to invest at least 1% of the

aggregate capital commitments.

In an interview earlier this year, Mr. Lay said the LJM arrangement didn't produce any conflicts of interest. Such related-party transactions, involving top managers or directors, aren't unusual, he said. "Almost all big companies have related-party transactions."

Typically, related-party transactions involve dealings with partly owned affiliates or a contract with a firm tied to one of the company's outside directors. It is rare for a top executive to be in a position where he could have conflicting fiduciary responsibilities. The LJM2 offering document states that the responsibilities of Mr. Fastow and other partnership officials to Enron could "from time to time conflict with fiduciary responsibilities owed to the Partnership and its partners."

Some institutions approached as potential LJM investors demurred partly because of such potential conflicts.

Enron has publicly stated that the partnership deals were aimed to help it hedge against fluctuating values for its growing portfolio of assets. In the past decade, Enron has seen its asset base rocket to more than $100 billion. As a result of this rapid growth, Enron has at times been strapped for capital and has sought ways to bring in outside investors to help bolster its balance sheet.

Charles LeMaistre, an outside Enron director and president emeritus of the M.D. Anderson Cancer Center at the University of Texas, said he viewed the partnership arrangement partly as a way of keeping Mr. Fastow at Enron. "We try to make sure that all executives at Enron are sufficiently well-paid to meet what the market would offer," he said.

Enron's interest in retaining Mr. Fastow may have been heightened by an exodus of top managers who were cashing out large stock-option grants after the company's success in 1999 and 2000. Mr. Fastow's yield from options for the 12 months through Aug. 31 was $4.6 million, according to disclosure reports compiled by Thomson Financial. Mr. Lay netted about $70 million from exercising options during this period, while Mr. Skilling, the former president, realized nearly $100 million.

Write to John Emshwiller at john.emshwiller@wsj.com and Rebecca Smith at rebecca.smith@wsj.com

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