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2 Early Enron Lenders Didn't See the End Coming

By PATRICK McGEEHAN

Enron (news/quote)'s modern era dates back to the mid-1980's, and throughout that period Citigroup (news/quote) and J. P. Morgan Chase (news/quote) have been there to lend with both hands.

The two giant banks were the biggest lenders to Enron when it collapsed late last year, tacking a painful ending onto long- running and mutually beneficial relationships. Both were also around in the early days of Kenneth L. Lay's tenure as Enron's chief executive: J. P. Morgan Chase helped to finance the merger that created Enron in 1985 and Citigroup helped Mr. Lay pay off a corporate raider a year later.

Over the years, Enron and the partnerships it controlled paid Citigroup and J. P. Morgan Chase, and their corporate predecessors, for a variety of lending, investment banking and insurance services. Last week, Citigroup disclosed that its exposure to Enron easily exceeded $1 billion, making it one of the company's biggest lenders. J. P. Morgan Chase had even more exposure to Enron at the end.

The ties have been so broad and deep that it is possible one or both of the banks will have made money from Enron even after the big losses they estimated they would suffer. Together, they took more than $680 million in charges against their fourth-quarter earnings to cover potential losses related to the company.

Officials of both banks declined to discuss details of their relationships with Enron.

Banking industry executives and analysts are not surprised the nation's two biggest and most aggressive banks were the biggest lenders to Enron, a company so active in deal making that some investment bankers described it as the "fifth- biggest wallet on Wall Street." Indeed, some are not altogether surprised that two giant banks that pride themselves on being smart lenders did not seem to see the Enron debacle coming.

"Banks have a habit of making mistakes," said Henry T. C. Hu, a professor of banking and finance law at the University of Texas. "There's a long tradition there."

Mr. Hu traced the banks' Enron mistakes in part to the way they are organized and the way they reward employees. In the minds of midlevel bankers, he said, the danger of missing out on doing business with a "deal machine" like Enron surely outweighed the risk that the company would implode.

"When you're talking about making loan decisions and the like, especially when you're confronted with a client that is at least by outward appearance successful and rapidly growing, you as an individual banker hate to be the one who raises his hand and says the emperor has no clothes," Mr. Hu remarked.

The banks' judgment may also have been clouded by the length of their relationships with Enron. Citigroup's bond was forged in 1986, when it helped the company fend off Irwin Jacobs, an aggressive Minnesota investor who was accumulating a big stake in Enron stock. Another financial company, Leucadia National (news/quote), had bought a smaller stake.

Enron had been formed in mid- 1985 by the merger of Houston Natural Gas and InterNorth. Among the banks providing financing for the deal was one that later became part of what is now J. P. Morgan Chase.

The presence of the two big investors as Enron stockholders was most unwelcome, coming as it did in Mr. Lay's first year as the company's chairman and chief executive. To fend them off, he and Enron's other directors decided to buy back the shares for more than they were worth, a practice known as Wall Street as greenmail.

Enron paid $357 million to buy back 7.6 million shares, or 16.4 percent of those outstanding, from Mr. Jacobs and Leucadia. At $47 a share, Enron was buying its own stock at 6 percent above the market price, which had risen on speculation that Enron would be taken over.

The company resold the shares to a newly created Enron employee stock ownership plan. The plan used $230 million Enron said was left over when it merged the pension plans of Houston Natural Gas and InterNorth. That drew criticism from T. Boone Pickens, another aggressive investor of the 80's who was chairman of Mesa Petroleum. "Greenmail is a symptom of weak management, and Enron's executives have folded in a big way," Mr. Pickens said a week after the buyback.

To help pay for the shares it bought, Enron borrowed more than $100 million from Citibank, now a unit of Citigroup, and another bank. The assistance that Citibank gave Mr. Lay then formed the cornerstone of the complex relationship between Enron and Citigroup in recent times.

Citibank has since lent Enron large amounts for everything from working capital to building a power plant in India. Citigroup's investment banking unit, formerly called Salomon Smith Barney, has underwritten bonds the company sold and has advised it on acquisitions.

Salomon Smith Barney was an adviser to the company on its failed effort to sell itself to Dynegy (news/quote) last fall. The firm also played a role in structuring and raising money for some Enron partnerships and invested more than $10 million of its own money in one named LJM2.

A spokesman for the firm declined to discuss its role in creating the partnerships.

Since J. P. Morgan Chase came up with some of the money for the merger that created Enron, the bank has also played several roles in the company's growth. It was the lead manager of a $500 million bond offering in 1999 and co-manager with Salomon Smith Barney on a convertible bond offering last year.

J. P. Morgan also advised Enron on a series of acquisitions, including several in Brazil. In 1998, it advised Enron on the purchase of a controlling stake in Elektro Eletricidade e Servico, a state-run utility in São Paulo. In 1999, it advised a subsidiary, Enron Oil and Gas, on a purchase of its own stock from Enron.

Despite all those connections and all of the smart investment bankers, commercial bankers and analysts who were charged with closely monitoring Enron's financial condition, the banks are stuck with big unpaid debts. Of all banks, Mr. Hu said, J. P. Morgan was supposed to be too smart for that.

"What does this say about the quality of their risk management?" he said. "Banks have to compete with each other on the basis of their ability to provide good judgment."

J. P. Morgan's pitch, Mr. Hu added, was that it was "the one bank you could trust, not only unimpeachable but really smart and unassailable in terms of these credit issues."