4 at Merrill Accused Of an Enron Fraud

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The Securities and Exchange Commission yesterday accused four Merrill Lynch executives of helping Enron fraudulently inflate its annual profits in 1999 through two bogus transactions.

In a civil lawsuit filed in Federal District Court in Houston, the S.E.C. contends that Enron was able to increase its reported earnings by engaging in what amounted to fictitious sales of assets to Merrill, then booking the proceeds of those transactions.

The two transactions -- one involving the sale of electricity barges being built in Nigeria, and the other circular energy trades with little economic substance -- have been under investigation for months. Yesterday's suit offered only a little new information about the transactions.

From early in the multiple investigations of Enron, enormous attention has been directed at the roles played by the lawyers, bankers and advisers who assisted Enron in its financial dealings. Yesterday's case, however, was the first to accuse any of those individual advisers of assisting the company in a fraud.

Indeed, S.E.C. officials said yesterday that the filing of the complaint signaled a new stage in the investigations of Enron. "This is obviously a significant step for the division of enforcement and the commission with the charging of individual investment bankers with aiding and abetting Enron's fraud," said Luis Mejia, a trial lawyer with the division of enforcement.

Merrill has already agreed to pay $80 million to settle an S.E.C. complaint related to the transactions, and the commission approved that deal yesterday. Under that agreement, Merrill neither admitted nor denied guilt. Most of the money from the settlement -- including restitution, fines and interest -- will go to a fund to compensate investors who were victims of the suspected fraud.

The four executives named in the suit were Thomas W. Davis, former vice chairman for private equity and research; Daniel H. Bayly, former chairman for investment banking; Schuyler M. Tilney, former head of Merrill's energy division within investment banking at the firm's Houston office; and Robert S. Furst, the former relationship manager for the Enron account at Merrill.

All the men except Mr. Bayly invoked their Fifth Amendment right against self-incrimination when asked to testify before the S.E.C. Afterward, Mr. Davis and Mr. Tilney were dismissed from the firm; Mr. Furst resigned in 2001, before the commission sought his testimony. Mr. Bayly initially testified before the commission but later declined to provide additional testimony.

Robert Trout, a lawyer for Mr. Tilney, and Daniel Horwtiz, a lawyer for Mr. Furst, said in separate interviews that their clients were men of integrity who did not engage in any wrongdoing, and both vowed to fight the suit.

Lawyers for Mr. Davis and Mr. Bayly noted that their clients were charged only in relation to the barge transaction, which was approved by lawyers for Merrill who had access to the same information at the center of the S.E.C. complaint. Thomas Fitzpatrick, a lawyer for Mr. Davis, said that his client had been involved in the transaction only in giving final approval for it, adding that his client would fight the complaint.

Lanny Breuer, a lawyer for Mr. Bayly, added that his client had done nothing wrong, and "is a man of great integrity whose limited actions in this matter were undertaken in complete good faith."

The two transactions each raise multiple and different issues of fact and law. Despite its seeming complexity, the case ultimately can be reduced to three questions: Was Merrill Lynch exposed to any investment risk through its purchase of an interest in the Nigerian barges? Were two electricity trades that seemingly canceled each other out properly accounted for by Enron? And if not, did the Merrill executives have reason to believe that something was wrong with the trades?

Both transactions were made in late 1999. At that time, according to the S.E.C. complaint, Enron faced substantial shortfalls in the earnings that Wall Street was anticipating for the company. Failure to hit earnings targets -- particularly in the frothy markets of the late 1990's -- often resulted in a company's stock being battered by disappointed investors and investment houses.

According to the S.E.C. complaint, to avoid that outcome and to ensure that senior Enron executives obtained bonuses that were tied to the company's performance, executives within the company assembled the ideas for the two transactions and approached Merrill with them.

The Nigerian barge transaction, according to the S.E.C. complaint, amounted to "a fraudulent asset parking arrangement." Under that deal, Enron sold an interest in the barges to Merrill for $28 million, which allowed the energy company to book profits of $12 million.

But, according to the complaint, the transaction was a bogus sale. Enron lent $21 million of the purchase price to Merrill, which itself invested only $7 million. Then, the complaint says, the firm received verbal assurances from Enron executives -- including Andrew S. Fastow, its chief financial officer at the time -- that Merrill would get back its investment plus a 22.5 percent annualized return within six months.

Senior officers at Merrill Lynch reviewed the transaction, and it was ultimately approved. Six months later, the complaint says, Mr. Fastow made good on his promise and bought out Merrill, complete with the promised return.

The S.E.C. contends that the promise transformed the sale into a sham, with Enron retaining all of the risks of the investment. In essence, the complaint says, it received the financial benefit of a sale without ever truly selling anything. In the past Merrill officials have contended that the firm assumed the risk of ownership for those six months, so that if, for example, the barges were somehow destroyed, it would have lost its investment. These are expected to be the chief arguments in any trial.

The electricity trade appears to present the bigger challenge for any defendant. In that deal, Enron approached Merrill with a proposed electricity option transaction, involving back-to-back trading of two virtually identical contracts. Under one, Enron sold Merrill an option that entailed physical delivery of electricity. Under the other, Merrill sold Enron an offsetting option that involved the delivery of the cash value of such a trade.

To do the deal, Merrill demanded a $17 million fee, an amount the S.E.C. says surprised Enron because of the low risk from the transaction. Ultimately, about $8 million was paid.

Merrill learned from Mr. Tilney and Mr. Furst that the transaction was intended to meet year-end earnings targets, the complaint says, and then asked that they receive an assurance from Enron's chief accounting officer that the accounting was proper. That officer, Richard A. Causey, provided a so-called warranty letter on Dec. 31 of that year to Merrill, saying that Arthur Andersen had signed off on the deal.

Merrill then approved the closing of the deal. Enron booked nearly $50 million in earnings from the deal that year, the complaint says.

Photos: Schuyler M. Tilney, top, and Robert S. Furst, both former Merrill Lynch executives, deny any wrongdoing in their business dealings with Enron.