UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:		**Chapter 11**
	:	
ENRON CORP., ***et al.,***	:	**Case No. 01-16034 (AJG)**
	:	
Debtors.		**Jointly Administered**
	:	

FINAL REPORT OF NEAL BATSON, COURT-APPOINTED EXAMINER

November 4,2003

TABLE OF CONTENTS

I. INTRODUCTION 1
- A. Background 1
- B. Prior Reports 2
- C. Summary of Conclusions 6
- D. Standard Adopted by the Examiner 13
- E. How to Read This Report 14

II. BACKGROUND 15
- A. Events of Fall 2001 15
- B. The Bankruptcy Filings and Subsequent Events 17

III. ROLES OF ENRON'S PROFESSIONALS, EXECUTIVE OFFICERS AND OUTSIDE DIRECTORS IN SPE TRANSACTIONS AND THEORIES OF LIABILITY 18
- A. Overview 18
- B. Persons and Entities Involved in Enron's Use of SPEs 22
- C. Theories of Potential Liability and Defenses 23

IV. SPECIFIC ROLE OF ANDERSEN AND POTENTIAL LIABILITY 39
- A. Role of Andersen in Enron's SPE Transactions 39
- B. Potential Liability 46

V. SPECIFIC ROLES OF ATTORNEYS AND POTENTIAL LIABILITY 48
- A. Overview 48
- B. Outside Law Firms 48
- C. Enron's In-House Attorneys 52

VI. SPECIFIC ROLES OF LAY, SKILLING AND OUTSIDE DIRECTORS AND POTENTIAL LIABILITY 56
- A. Roles of Lay, Skilling and Outside Directors in Enron's SPE Transactions 56
- B. Potential Liability 60
- C. Lay's and Skilling's Use of Enron Stock to Repay Corporate Loans 61

VII. ROLE OF FINANCIAL INSTITUTIONS IN ENRON'S SPE TRANSACTIONS AND THEORIES OF LIABILITY 63
- A. Theories of Potential Liability 63
- B. Potential Defenses to Aiding and Abetting Claims and Equitable Subordination 64

VIII. SPECIFIC ROLES OF FINANCIAL INSTITUTIONS AND POTENTIAL LIABILITY 66
- A. RBS 66
- B. CSFB 74
- C. Toronto Dominion 78

IX. HOW COULD THIS HAVE HAPPENED? 82
A. Overview 82
B. Why Did Enron Officers Behave This Way? 83
C. Methods Used by Officers to Implement Strategy 93
D. Failure of Professionals to Provide Checks and Balances 110
E. Failure of Lay and Skilling to Provide Checks and Balances 117
F. Failure of Enron Board to Provide Checks and Balances 119

X. FINAL REPORT 137

Appendix A — Certain Defined Terms
Appendix B — Role of Andersen
Appendix C — Role of Enron's Attorneys
Appendix D — Roles of Lay, Skilling and Outside Directors
Appendix E — Role of RBS and its Affiliates
Appendix F — Role of CSFB and its Affiliates
Appendix G — Role of Toronto Dominion and its Affiliates

I. INTRODUCTION

A. Background

On December 2,2001 (the "Petition Date") and on certain dates thereafter, Enron Corp. ("Enron"), an Oregon corporation, and certain of its affiliates (collectively, the "Debtors") filed voluntary petitions for relief under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") with the United States Bankruptcy Court for the Southern District of New York (the "Court") (collectively, the "Bankruptcy Case").[1]

This Court entered an Order on April 8, 2002 (the "April 8th Order") authorizing and directing the appointment of an examiner pursuant to 11 U.S.C. § 1104(c).[2] On May 22, 2002, the United States Trustee appointed Neal Batson (the "Examiner") as the examiner. The Court, by Order dated May 24,2002, approved the appointment.

The Examiner has been authorized to investigate all transactions involving special purpose vehicles created or structured by the Debtors or at the behest of the Debtors (the "SPEs") and those individuals, institutions and professionals involved therein.[3]

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[1] On July 11, 2003, the Debtors filed their Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code. Docket Number 11698. On September 18, 2003, the Debtors filed their Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code (the "Debtors' Joint Plan"). Docket Number 12822. The hearing on the adequacy of the disclosure statement with respect to the Debtors' Joint Plan is presently scheduled for November 18,2003.

[2] Among other things, the April 8" Order authorized the Examiner to:

> investigate all transactions (as well as all entities as defined in the Bankruptcy Code and pre-petition professionals involved therein): (i) involving special purpose vehicles or entities created or structured by the Debtors or at the behest of the Debtors (the "SPEs"), that are (ii) not reflected on the Enron Corp. balance sheets, or that (iii) involve hedging using the Enron Corp. stock, or (iv) as to which the Enron Examiner has the reasonable belief are reflected, reported or omitted in the relevant entity's financial statements not in accordance with generally accepted accounting principles, or that (v) involve potential avoidance actions against any pre-petition insider or professional of the Debtors.

[3] The April 8" Order contained the provision that authorized the Examiner, if appropriate (taking into account the absolute priority rule, the financial condition of the Debtors' estates and the need not to waste value available to creditors), to review possible legal mechanisms pursuant to which the equity holders of Enron could share in the value of the Debtors' estates. There are legal mechanisms that could be used that

On September 21, 2002, the Examiner filed the First Interim Report of Neal Batson, Court-Appointed Examiner (the "First Interim Report"). On January 21, 2003, the Examiner submitted to the Court the Second Interim Report of Neal Batson, Court-Appointed Examiner (the "Second Interim Report"). On June 30, 2003, the Examiner submitted to the Court the Third Interim Report of Neal Batson, Court-Appointed Examiner (the "Third Interim Report"; together with the First Interim Report and the Second Interim Report, the "Prior Reports"). This Final Report of Neal Batson, Court-Appointed Examiner, constitutes the Examiner's fourth and final report (the "Report"; together with the Prior Reports, the "Reports").[4]

B. **Prior Reports**

Six SPE transactions were examined in the First Interim Report, and the Examiner concluded that the transactions were, to varying degrees, susceptible of being recharacterized under a "true sale" challenge. If this recharacterization were to occur, the remaining assets in those structures, having a value of approximately $500 million, would be restored to the Debtors' estates.

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would enable the equity holders to share in the value of the Debtors' estates, including plan provisions that provide that equity holders share in a portion of the proceeds of any allowed claim of any party-in-interest, including the Securities and Exchange Commission (the "SEC"). Based upon: (i) the status of ongoing negotations regarding the Debtors' Joint Plan; (ii) the information contained in the Debtors' amended schedules; (iii) the insolvency analysis undertaken by the Debtors and the Official Committee of Unsecured Creditors (the "Creditors' Committee"); (iv) the comments of the Court regarding the ability of the equity holders to recover in these cases based upon the apparent amount of claims in the cases; and (v) the desire not "to waste value available to creditors," the Examiner has not undertaken an extensive analysis of these legal mechanisms or their viability.

[4] Any references in the Reports to meetings, communications, contacts and actions between the Examiner and third parties are intended to refer to the office of the Examiner, which shall include the Examiner and his professionals. Therefore, references to any meetings, communications, contacts and actions taking place between the Examiner and a third party should not be construed as indicating that Neal Batson was present personally for such meetings, communications, contacts or actions.

The Second Interim Report focused on substantially all of Enron's material SPE transactions identified to date. The Examiner provided his views on the role of the SPEs in the collapse of Enron, including a discussion of how Enron used the SPEs in conjunction with six accounting techniques to impact dramatically its financial statements. The Examiner concluded that Enron manipulated its financial statements in violation of GAAP and failed to make appropriate disclosures of its SPE transactions to the public under applicable disclosure standards. Furthermore, the Second Interim Report sets forth the Examiner's conclusions that many of these transactions were, to varying degrees, susceptible of "true sale" or substantive consolidation challenges which, if successful, would result in assets having an estimated aggregate value between $1.7 billion and $2.1 billion being restored to the Debtors' estates. Finally, the Examiner identified potential avoidable transfers in the face amount of approximately $2.9 billion that may be recovered by the Debtors' estates.[5]

[5] As noted in the Prior Reports, the ability of the Debtors to realize on certain of these avoidance actions is subject to: (i) affirmative defenses of any transferee; (ii) valuation evidence (particularly in the case of constructively fraudulent transfers); and (iii) collectability. As to valuation, both the Debtors and the Creditors' Committee have engaged investment bankers or other valuation experts. In order to avoid duplication of effort, and because the Examiner does not have authority to prosecute actions on behalf of the Debtors' estates, the Examiner has not sought to retain such an expert. To the extent an action is pursued by the Debtors or the Creditors' Committee, investment bankers retained by such party may provide valuation advice.

As set forth in the Prior Reports, the Examiner received assurances from the professionals for the Debtors and the Creditors' Committee to the effect that the Debtors, in coordination with the Creditors' Committee, would undertake to complete an insolvency analysis with respect to the Debtors. Accordingly, for the purposes of the Examiner's analysis of potential avoidance actions as well as for other purposes, the Examiner has assumed insolvency of the Debtors under Section 101(32) of the Bankruptcy Code at the time of any subject transfer. The professionals for the Debtors recently have advised the Examiner that the Debtors' professionals have concluded that Enron and certain of its Debtor affiliates were insolvent as of December 31, 1999, under the tests articulated under the Uniform Fraudulent Transfer Act and/or the Uniform Fraudulent Conveyance Act, as those acts may be applicable. Accordingly, and as discussed in the Prior Reports, there may be additional voidable transfer claims that may inure to the benefit of the Debtors' estates by virtue of the application of Section 544(a) of the Bankruptcy Code and the use of state law fraudulent transfer theories to challenge transfers made, or obligations incurred, more than one year prior to the Petition Date. The Examiner has been advised that the Debtors and the Creditors' Committee are investigating these claims. The Examiner also has been advised that the Debtors are investigating

The primary focus of the Third Interim Report was on certain persons and entities that, under applicable legal standards, may have responsibility for the Debtors' misuse of its SPE structures. The Examiner concluded that there was sufficient evidence from which a fact-finder could conclude that certain senior officers of Enron, including Andrew Fastow ("Fastow"), Rick Causey ("Causey"), Ben Glisan ("Glisan") and Jeff McMahon ("McMahon"), breached their fiduciary duties under applicable law by causing the Debtors to enter into SPE transactions that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information known by these officers to be materially misleading. In addition, the Examiner concluded that there was sufficient evidence from which a fact-finder could conclude that certain financial institutions involved in Enron's SPE transactions: (i) aided and abetted these officers in breaching their fiduciary duties; and (ii) engaged in inequitable conduct such that a court could determine that the claims of such financial institutions, totaling in excess of $5 billion: should be equitably subordinated to the claims of other creditors. This would be in addition to any affirmative recovery that may be available to the

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possible avoidance actions arising out of Enron's equity forward transactions (as described in foonote 22 of the Third Interim Report).

[6] This amount could be significantly greater. As discussed in Appendix B (Legal Standards) to the Third Interim Report, published case law is unclear as to what happens if the "tainted" claim of a financial institution is purchased by another entity. That is, if a financial institution engaged in inequitable conduct such that equitable subordination was warranted, and if that financial institution then sold all or a portion of its claim (or syndicated a portion of the loan to other financial institutions after the closing of the transaction), would the claims of these purchasing financial institutions be subject to equitable subordination on the basis of the transferor's conduct? If the answer to that question is "yes," then an analysis of what claims, if any, were sold (or syndicated post-closing) by the financial institution that engaged in misconduct should be undertaken. The Examiner did not undertake this analysis given the expense involved and the uncertainty of the case law.

This amount does, however, include the claims of certain entities (primarily trusts) that filed proofs of claim relating to or based on certain transactions in which a financial institution is the beneficial holder of the debt.

Debtors against these financial institutions for aiding and abetting the officers' breach of fiduciary duty, assuming that the Debtors have the requisite standing to pursue such a claim.[7]

The Examiner also considered whether Section 548(a)(1)(A) of the Bankruptcy Code, which allows the avoidance of obligations and transfers made with the intent to hinder, delay or defraud creditors, could be applied to the Debtors' SPE transactions. If such a theory is applicable, and if a fact-finder determined that the Debtors entered into an SPE transaction with actual intent to hinder, delay or defraud its creditors, then the *obligations* incurred in that SPE transaction would be unenforceable. Either as a result of such a finding or if the fact-finder determined that the *transfers* made in connection with such SPE transactions were made with intent to hinder, delay or defraud, such transfers could be recovered by the Debtors' estates. Any transferee that entered into such an obligation or received such payments in good faith, however, would have a defense to this claim to the extent value was given to the Debtors.[8]

[7] On September 24,2003, Enron and Enron North America Corp. (f/k/a Enron Capital & Trade Resources Corp.) ("ENA") filed the Debtors' Complaint for the Avoidance and Return of Preferential Payments and Fraudulent Transfers, Equitable Subordination, and Damages, Together With Objections and Counterclaims to Creditor Defendants' Claims with the Court against certain of these financial institutions and their affiliates. Enron Corp. v. *Citigroup Inc.,* No. 03-09266 (AJG) (Bankr. S.D.N.Y. filed Sept. 24, 2003). In this complaint, the Debtors seek, among other things, to: (i) equitably subordinate the financial institutions' claims; (ii) recover in excess of $3 billion from these financial institutions as alleged avoidable transfers or obligations; and (iii) recover unstated damages resulting from alleged aiding and abetting on the part of these financial institutions.

[8] While the Examiner has not made a case-by-case analysis pursuant to this theory, there is sufficient evidence for a fact-finder to conclude that, with respect to Enron's overall use of SPEs, Enron entered into these transactions with the intent to hinder, delay or defraud its creditors. The Examiner also notes that the facts applicable to the potential claims of aiding and abetting a breach of fiduciary duty, or the potential equitable subordination of certain financial institutions' claims, are facts that would be relevant to the good faith defense.

Finally, the Examiner identified additional potential avoidable transfers in the face amount of approximately $438 million that, to varying degrees, may be recovered by the Debtors' estates.[9]

C. Summary of Conclusions

Enron's officers, directors, accountants, attorneys and financial institutions had different roles and duties in the SPE transactions. As discussed in the Third Interim Report and in this Report, certain of these persons and entities may be liable to Enron or others for their roles in these transactions. Regardless of their respective legal liability, these parties are included within a circle of responsibility for Enron's financial demise.

In the Third Interim Report, the Examiner reported on the role and potential liability of Enron's officers and certain financial institutions. The primary focus of this

[9] The Examiner's analysis, for the most part, has not addressed the inter-estate avoidance action issues that may be implicated by the various SPE transactions discussed in the Reports. For example, in a number of transactions, ENA was the financial counterparty to an SPE, such as Delta or Mahonia – the SPEs used in certain of the Prepay Transactions. To the extent that ENA paid those obligations, and its obligations were guaranteed by Enron, ENA may be able to assert a preference claim against both the transferee (Delta or Mahonia) or against Enron under Sections 547 and 550 of the Bankruptcy Code. There also may be fraudulent transfer or obligation actions available to some estates against other estates by virtue of the SPE transactions. For example, as noted by the Examiner in the Third Interim Report, where ENA made certain payments in respect of the Mahonia transactions on behalf of its affiliate, ENG, the bankruptcy estate of ENA may be able to assert a fraudulent transfer claim with respect to those transfers to the extent that the subsidiary was insolvent at that time. ***See*** Third Interim Report, Annex 1 to Appendix J (Avoidance Actions), at 22 n.56. In addition, because Enron guaranteed many of the obligations of ENA under commodity swaps, total return swaps and similar derivative instruments in connection with the SPEs, if both Enron and ENA were insolvent at the time of the execution of the guaranty, the Enron estate may be able to assert that it did not receive reasonably equivalent value as a result of the incurrence of the obligation under the guaranty. The success of this type of avoidance claim would require, among other things, a finding of insolvency on the part of Enron and the applicable subsidiary as well as a finding that the value of the bundle of rights received by Enron in connection with the transaction was less than reasonably equivalent value for the obligations incurred. That bundle of rights could include, among other things, cash received by Enron by virtue of Enron's cash management system (although upon Enron's receipt of such funds, an intercompany debt to the subsidiary was created) as well as a contingent claim against the subsidiary for indemnification, contribution or subrogation in the event Enron was required to honor the guaranty, even if that claim was subject to a standstill provision.

Report is on additional persons and entities that may have liability under applicable legal standards for the Debtors' misuse of its SPE structures.[10]

Specifically, in this Report the Examiner concludes that:

Andersen

- There is sufficient evidence fiom which a fact-finder could conclude that Andersen: (i) committed professional negligence in the rendering of accounting services to Enron; and (ii) aided and abetted certain Enron officers in breaching their fiduciary duties to Enron by causing Enron to enter into SPE transactions that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information known by these officers to be materially misleading. Because Enron's officers participated in the wrongful conduct, however, Andersen may assert that the actions by the Enron officers should be imputed to Enron and consequently, that claims by Enron should be barred or reduced under comparative fault rules."

In-house Attorneys

- There is sufficient evidence fiom which a fact-finder could conclude that certain Enron in-house attorneys committed legal malpractice by: (i) failing to advise Enron adequately regarding the disclosure of its SPE transactions, including the related party transactions; (ii) failing to

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[10] The scope of the Examiner's investigation is limited by the terms of the April 8" Order. Generally, the Reports do not address any potential causes of action that may arise as a result of any transactions or arrangements that do not involve the Debtors' use of SPEs or other matters specifically identified in the April 8" Order. For example, many of the financial institutions discussed in the Reports were involved in transactions and arrangements with Enron that are not related to subjects listed in the April 8" Order and, as a consequence, the Examiner generally expresses no opinion as to whether there are potential causes of action that may arise as a result of such other transactions or arrangements.

In the Prior Reports, the Examiner analyzed and reported on certain legal, structural and accounting issues that arose from Enron's SPE transactions. In the course of that analysis, the Examiner identified a number of third parties whose relationships with Enron appeared to warrant further investigation given the scope of the April 8" Order. Generally, these parties had the most significant involvement in Enron's SPE transactions and the most substantial claims against the Debtors' estates. Furthermore, the Examiner analyzed and discussed various causes of action that may be available to the Debtors in each of the Reports. Neither the identified third parties nor causes of action are necessarily exhaustive. In many cases, there may be alternative theories or claims that could be available to the Debtors against the parties identified in the Reports or others, which the Debtors may or may not elect to pursue.

[11] As used in this report, "comparative fault rules" include Texas' "Proportionate Responsibility" statute, Tex. Civ. Prac. & Rem. Code Ann. §§ 33.001-002, and the equitable principle of *in pari* delicto. The legal standards applicable to Andersen, including comparable fault rules, are discussed in detail in Annex 2 to Appendix B (Role of Andersen). It is possible that choice of law determinations could require consideration of similar doctrines that impact Enron's standing to bring such claims.

advise adequately Enron's Board of Directors (the "Board" or the "Enron Board") and certain of its committees with respect to legal and corporate governance issues raised by certain related party transactions; and (iii) failing to advise the Enron Board of material facts surrounding Enron's use of SPEs.[12] There is also sufficient evidence from which a fact-finder could conclude that certain in-house attorneys breached their fiduciary duties by assisting certain officers who breached their fiduciary duties to Enron by causing the Debtors to enter into SPE transactions that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information known to be materially misleading. Because Enron's officers participated in the wrongful conduct, however, these attorneys may assert that the actions by the Enron officers should be imputed to Enron and consequently, that claims by Enron should be barred or reduced under comparative fault rules.

Outside Attorneys

- There is sufficient evidence from which a fact-finder could conclude that certain of Enron's outside attorneys:[13] (i) committed legal malpractice in connection with their legal services provided to Enron with respect to the SPE transactions; or (ii) aided and abetted certain Enron officers in breaching their fiduciary duties.[14] Because Enron's officers participated in the wrongful conduct, however, these attorneys may assert that the actions by the Enron officers should be imputed to Enron and consequently, that claims by Enron should be barred or reduced under comparative fault rules.

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[12] As set forth more fully in this Report (including its Appendices), the types of claims, weight of evidence, availability of defenses and other mitigating factors differ among the in-house attorneys.

[13] Enron's outside law firms discussed in this Report are: (i) Vinson & Elkins L.L.P. ("Vinson & Elkins"); and (ii) Andrews & Kurth L.L.P. ("Andrews & Kurth"). As set forth more fully in this Report (including its Appendices), the types of claims, weight of evidence, availability of defenses and other mitigating factors differ among the outside attorneys.

[14] As set forth in Annex 1 to Appendix C (Role of Enron's Attorneys), there is a lack of consensus among the courts as to whether a cause of action by a corporate client against its attorney based upon aiding and abetting a fiduciary duty breach is a separate cause of action or is subsumed within a malpractice cause of action. The Examiner expresses no view on this issue. For purposes of this Report, the Examiner's analysis of the attorneys' conduct includes consideration of the elements of an aiding and abetting cause of action, regardless of which label may ultimately attach to any potential cause of action.

Lay and Skilling[15]

- There is sufficient evidence from which a fact-finder could conclude that Kenneth Lay ("Lay"), Enron's Chairman and Chief Executive Officer, and Jeffrey Skilling ("Skilling"), Enron's President and Chief Operating Officer, in their capacities as officers, breached their fiduciary duties under applicable law by failing to provide adequate oversight of Enron's use of SPEs because they failed to respond appropriately to the existence of "red flags" indicating that certain senior officers were misusing SPE transactions to disseminate materially misleading financial information. If a fact-finder so concludes, the director exculpation provision in Enron's articles of incorporation would not protect Lay and Skilling from such a claim because this failure occurred in their capacity as officers.[16]

- There is sufficient evidence from which a fact-finder could conclude that Lay and Skilling, in their capacities as members of the Enron Board, breached their fiduciary duty of good faith under applicable law in approving the LJM1/Rhythms non-economic hedging transaction (the "LJM1/Rhythms Hedging Transaction") and certain LJM2/Raptors non-economic hedging transactions (the "LJM2/Raptors Hedging Transactions") because there is evidence that they were in possession of facts necessary to conclude that these

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[15] Lay appeared for a one-day interview with the Examiner that was not conducted under oath, and he has provided no sworn testimony to any party in connection with any examination of Enron conducted after the Petition Date. Skilling invoked his Fifth Amendment privilege and did not provide the Examiner with either testimony or an interview. Skilling, however, provided sworn testimony to the SEC and a subcommittee of the House of Representatives Energy and Commerce Committee (the "HEC"). Both Lay and Skilling apparently were infrequent users of email and produced little relevant written material in response to the Examiner's subpoenas. As a result, the evidence available to the Examiner with respect to Lay and Skilling consisted primarily of: (i) Lay's one-day interview by the Examiner; (ii) Skilling's sworn testimony to the SEC and the HEC; (iii) Lay's and Skilling's interviews with the Powers Committee; (iv) interviews with and testimony of others, including members of Enron's Board and certain Enron officers; and (v) documentary evidence produced by Enron and others.

[16] Enron's articles of incorporation contain an exculpation provision that provides that a director of Enron shall not be personally liable to Enron or its shareholders for monetary damages for conduct as a director, except for liability: (i) for any breach of the director's duty of loyalty to Enron or its shareholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) for any unlawful distribution under Or. Rev. Stat. § 60.367; or (iv) for any transaction from which the director derived an improper personal benefit. ***See*** Article VII, Section A, Articles of Incorporation of Enron Corp. [AB0785 03888-AB0785 041471. As set forth more fully in this Report (including its Appendices), the weight of evidence, availability of defenses and other mitigating factors differ between Lay and Skilling.

transactions lacked any rational business purpose.[17] If a fact-finder so concludes, the director exculpation provision in Enron's articles of incorporation would not protect Lay and Skilling from such a claim because it involves acts or omissions not in good faith.

- There is sufficient evidence from which a fact-finder could conclude that Skilling, in his capacity as an officer, breached his fiduciary duties under applicable law by failing adequately to inquire into red flags with respect to the transactions between LJM1 and Enron and LJM2 and Enron, including red flags relating to the compensation that Fastow received in connection with LJM1 and LJM2. Because this failure occurred in Skilling's capacity as an officer, the director exculpation provision in Enron's articles of incorporation would not apply to such a claim.

- There is sufficient evidence from which a fact-finder could conclude that: (i) Lay's repayment to Enron of more than $94 million of loans with Enron stock was not duly authorized or approved by the Enron Board under applicable corporate law; and (ii) the repayment is voidable by Enron, which would result in Lay being obligated to repay in excess of $94 million to Enron and Enron returning the stock to Lay.[18]

- There is sufficient evidence from which a fact-finder could conclude that: (i) Skilling's repayment to Enron of more than $2 million of loans with Enron stock was not duly authorized or approved by the Enron Board under applicable corporate law; and (ii) the repayment is voidable by Enron, which would result in Skilling being obligated to repay in excess of $2 million to Enron and Enron returning the stock to Skilling.

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[17] As discussed below, the LJM1/Rhythms Hedging Transaction and the LJM2/Raptors Hedging Transactions were non-economic hedges. That is, they were accounting hedges (with the sole purpose of providing financial statement benefits) and did not provide economic protection to Enron because the assets used to support the hedge were Enron's own assets.

[18] The Examiner concluded in the Second Interim Report that Enron has an alternative claim against Lay for $74.025 million of this amount under Section 548(a)(1)(B) of the Bankruptcy Code. ***See*** Second Interim Report, Appendix P (Avoidance Actions). The Creditors' Committee is currently prosecuting a suit against Lay on account of these transfers. ***Official Comm. of Unsecured Creditors of Enron Corp.*** v. ***Lay,*** No. 03-02075-AJG (Bankr. S.D.N.Y. filed Jan. 31,2003).

Outside Directors[19]

- Although the oversight of the SPE transactions by the Enron Board, the Audit and Compliance Committee of the Enron Board (the "Audit Committee") and the Finance Committee of the Enron Board (the "Finance Committee") may be criticized, the Examiner has not discovered sufficient evidence from which a fact-finder could conclude that members of the Enron Board who served during the period 1997 to the Petition Date, other than Lay and Skilling (the "Outside Directors") and these committees either (i) abdicated or displayed sustained inattention to their monitoring responsibilities or (ii) consciously disregarded red flags indicating Enron officers were misusing the SPE transactions to disseminate materially misleading financial information. In the absence of this type of conduct, because of the director exculpation provision in Enron's articles of incorporation, the Outside Directors would not have liability to Enron arising out of their duty of oversight.

- There is sufficient evidence from which a fact-finder could conclude that certain of the Outside Directors breached their fiduciary duty of good faith under applicable law in approving the LJM1/Rhythms Hedging Transaction and certain of the LJM2/Raptors Hedging Transactions because there is evidence that they were in possession of facts necessary to conclude that these transactions lacked any rational business purpose. If a fact-finder so concludes, the director exculpation provision in Enron's articles of incorporation would not

[19] Under certain circumstances, the courts have held that the fiduciary duties of a board to the corporation and to its shareholders may expand to include fiduciary duties to creditors. The more recent decisions in the area find that upon the corporation's insolvency (or when the corporation is within the "zone of insolvency"), the board of directors must manage the corporation in a manner consistent with the interests of creditors (and, potentially, shareholders as well). Certain courts have recognized the standing of creditors (and, in certain cases, bankruptcy trustees as the representative of creditors) to initiate litigation against directors to recover damages for the breach of the fiduciary duty to creditors. These cases typically involve situations where the directors have breached their duty of loyalty (such as preferring themselves). Other courts have held that claims of this sort are individual or personal creditor claims, which a trustee or debtor in possession does not have standing to assert. Ultimately, the law of the state of incorporation should govern these types of claims and the law in Oregon is not fully developed on this particular set of issues. Accordingly, individual creditors and/or the Debtors (in their capacity as debtors in possession and representatives of the estates) may be able to state a claim against the Enron Board in connection with certain decisions made by the Enron Board while Enron was insolvent. One aspect of that litigation may be the ability of the plaintiff to take the position that the director exculpation provision in Enron's articles of incorporation does not apply to the plaintiff (suing on behalf of the creditors) and, potentially, that the so-called business judgment rule does not apply. The Examiner has analyzed the conduct of the Enron Board under the assumption that the director exculpation provision contained in Enron's articles of incorporation and the business judgment rule would apply. If, and to the extent, litigation were brought by a plaintiff with standing (be that the debtor in possession, a litigation trustee appointed under the terms of the Debtors' Joint Plan or an individual creditor), the conduct of the Enron Board may be subject to review without consideration of these doctrines.

protect the Outside Directors from such a claim because it involves acts or omissions not in good faith.[20]

Additional Financial Institutions[21]

- There is sufficient evidence from which a fact-finder could conclude that certain financial institutions not previously discussed in the Prior Reports (the "Financial Institutions") that were involved in Enron's SPE transactions[22] aided and abetted certain Enron officers who breached their fiduciary duty by causing Enron to enter into SPE transactions that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information known by these officers to be materially misleading. However, because Enron's officers participated in the wrongful conduct, the Financial Institutions may assert the actions by the Enron officers should be imputed to Enron and consequently, either that Enron lacks standing to assert any such claim or that the doctrine of *in pari delicto* is a defense to defeat a claim by Enron.[23]

- There is sufficient evidence from which a fact-finder could conclude that: (i) certain of the Financial Institutions that were involved in the LJM1/Rhythms Hedging Transaction had *actual knowledge* of the wrongful conduct of Fastow in this transaction, which resulted in Fastow breaching his fiduciary duty of loyalty; (ii) these Financial Institutions gave *substantial assistance* to Fastow by participating in transactions designed to circumvent restrictions imposed by the Enron Board (as reflected in LJM1's partnership agreement) in connection with the LJM1/Rhythms Hedging Transaction; and (iii) injury to the Debtors was the direct or reasonably foreseeable result of such

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[20] As set forth more fully in this Report (including its Appendices), the weight of evidence, availability of defenses and other mitigating factors differ among the Outside Directors. The Examiner has not assessed the potential liability of individual Outside Directors.

[21] As set forth more fully in this Report (including its Appendices), the weight of evidence, availability of defenses and other mitigating factors differ among the Financial Institutions.

[22] The financial institutions discussed in this Report (collectively, the "Financial Institutions") are: (i) The Royal Bank of Scotland plc and its affiliates and predecessors (collectively, "RBS"); (ii) Credit Suisse First Boston, Inc. and its affiliates and predecessors (collectively, "CSFB"); and (iii) Toronto Dominion Bank and its affiliates and predecessors (collectively, "Toronto Dominion"). The order of presentation of each Financial Institution is based upon the apparent size of the Financial Institution's claims in the Bankruptcy Case (as measured by the proofs of claim filed by the Financial Institution or on its behalf), from the largest to the smallest claims.

[23] See Third Interim Report, Appendix B (Legal Standards) for a discussion of principles of standing and *in pari* delicto under New York law. If Texas law governs, comparative fault rules, discussed above, would apply.

> conduct. As a result, a fact-finder could conclude that these Financial Institutions aided and abetted Fastow in breaching his fiduciary duties.
>
> There is sufficient evidence of inequitable conduct by the Financial Institutions in connection with the SPE transactions for a court to determine that the claims of such Financial Institutions, totaling in excess of $1 billion,[24] may be equitably subordinated to the claims of other creditors.[25]

Finally, in Section IX of this Report, the Examiner addresses the question that many people have asked: how could this have happened?

D. Standard Adopted by the Examiner

The Examiner is not the ultimate decision maker on these matters. The Examiner has analyzed the evidence he has gathered to date against the legal standards applicable to the issues identified in this Report. The Examiner has considered direct evidence and the reasonable inferences that can be drawn therefrom. If there are sufficient facts to support a claim, even though there is evidence to the contrary, then a court would submit that claim to a fact-finder. Where the Examiner reaches the conclusion that there is *sufficient evidence for a fact-finder to conclude* that a claim exists, the Examiner has determined that in a legal proceeding regarding such matter, the proposition would be submitted to

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[24] This amount could be significantly greater. ***See supra*** n.6.

[25] In addition, if Section 548(a)(1)(A) of the Bankruptcy Code, which allows the avoidance of obligations incurred and transfers made with the intent to hinder, delay or defraud creditors, can be applied to the SPE transactions to which these Financial Institutions were parties, and a fact-finder determined that Enron entered into these SPE transactions with actual intent to hinder, delay or defraud its creditors, obligations incurred in these SPE transactions would be unenforceable. Either as a result of such a finding or if the fact-finder determined that the transfers made in connection with such SPE transactions were made with intent to hinder, delay or defraud, such transfers made to the Financial Institutions could be recovered by the Debtors' estates. The Financial Institutions that entered into the transaction giving rise to such an obligation or received such payments in good faith, however, would have a defense to this claim to the extent value was given to the Debtors. ***See*** Third Interim Report, Appendix B (Legal Standards), at 114-33.

the fact-finder for decision.[26] In most cases, the fact-finder would be a jury, although in equitable subordination actions the bankruptcy court serves as the fact-finder. The decision of the fact-finder would be made after evaluating the documentary evidence, the testimony and credibility of witnesses and the reasonable inferences that may be drawn from this evidence.

E. How to Read This Report

The remaining Sections of this Report provide an overview of the Examiner's conclusions with respect to the matters identified above. More detailed analyses and supporting evidence are set forth in the Appendices to this Report. Therefore, the reader should review the applicable Appendices (and any Annex attached thereto) for a more complete understanding of the issues addressed in the summaries below.

The first appendix to this Report – Appendix A (Certain Defined Terms) – is designed to provide the reader with certain definitions used throughout this Report.

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[26] In connection with any claims against a professional that are based on malpractice, the plaintiff would generally be required to produce a qualified expert to give his or her competent opinion as to, among other things, whether the defendant satisfied the applicable standard of care. Where the Examiner reaches the conclusion ***that there is sufficient evidence for a fact-finder to conclude*** that these types of negligence claims exist, the Examiner has determined that the plaintiff would be able to produce a qualified expert to express such an opinion. The Examiner's conclusion does not mean that the defendant would be unable to produce a qualified expert who would give a competent opinion contrary to that expressed by the plaintiffs expert. As noted in Appendix *C* (Role of Enron's Attorneys), Vinson & Elkins has offered certain opinions of law school professors and practitioners on several matters as to which the Examiner took testimony.

II. BACKGROUND

A. Events of Fall 2001

Until the fall of 2001, Enron was one of the largest companies in the world and was considered to be one of the most innovative and successful.[27] In the fall of 2001, however, Enron made a series of financial disclosures and restatements of its financial statements that triggered a chain of events culminating in its bankruptcy filing.

In an earnings release issued on October 16, 2001,[28] Lay announced that Enron was taking "after-tax non-recurring charges" of $1.01 billion in the third quarter.[29] On that same day, although not disclosed as part of its earnings release, Enron disclosed that it would record a $1.2 billion reduction in shareholders' equity as of the end of the third quarter.[30] On November 8, 2001, Enron announced its intention to restate its financial

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[27] According to the 2001 Fortune 500 Rankings, Fortune magazine ranked Enron as the seventh largest corporation in the world, based upon revenues. ***The** 500 **Largest U.S. Corporations,*** Fortune, Apr. 16, 2001, at F-1. On February 19,2001, Fortune magazine named Enron as the Most Innovative Company in America for the fifth consecutive year. ***America's Most Admired Companies,*** Fortune, Feb. 19, 2001, at 104.

[28] Enron Press Release, "Enron Reports Recurring Third Quarter Earnings of $0.43 Per Diluted Share; Reports Non-Recurring Charges of $1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of $1.80 for 2001 and $2.15 for 2002; And Expands Financial Reporting," Oct. 16, 2001, at ELIB00001783-00003 [ELIB00001783-00001-ELIB00001783-00005]. Enron's third quarter ended September 30th.

[29] Although there were several components to the charge, one component related to Enron's "early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity." The "previously disclosed entity" was LJM2 Co-Investment, L.P. ("LJM2"), a private investment limited partnership founded in December 1999. LJM2 was run by Fastow and Michael J. Kopper ("Kopper"), an Enron employee, and had as its limited partners a significant number of institutional and individual investors. Enron Form 10-Q filed with the SEC for the Quarter ended Sept. 30,2001 (the "10-Q for 3Q/2001"), at 18-19, Note 4 to Consolidated Financial Statements in connection with related party transactions. The charge related to Enron's termination of four SPEs known as Raptor I, II, III and IV (the "Raptor SPEs") pursuant to which Enron had entered into the LJM2/Raptors Hedging Transactions. As a result of this termination, Enron recognized a $544 million after-tax charge to net income for the third quarter 2001. The pre-tax charge was $710 million. ***Id.***

[30] October 16, 2001, 9:00 a.m. C.T., Enron Corp. Conference Call regarding Third Quarter 2001 Earnings Release, Moderator: Mark Koenig (the "Earnings Release"), at AB0252 04610 [AB0252 04603-AB0252 046291.

statements for 1997 through 2000, and the first and second quarters of 2001, to reduce previously reported net income by an aggregate of $586 million.[31]

On November 19, 2001, Enron filed its third quarter Form 10-Q, including interim financial statements that gave effect to the previously announced "non-recurring charges" and restatement of prior financial statements.[32] In addition, in its third quarter 2001 balance sheet, Enron reported total debt under generally accepted accounting principles ("GAAP") of $12.978 billion.[33] On the same day, senior Enron executives informed certain of its bankers that, while the debt reflected on its third quarter 2001 balance sheet under GAAP was $12.978 billion, Enron's "debt" (as described in the presentation) was $38.094 billion.[34] Thus, as Enron noted, $25.116 billion of debt was "off-balance sheet," or in some cases, reflected on the balance sheet, but classified as something other than debt. Approximately $14 billion of this $25.116 billion of additional "debt" was incurred through structured finance transactions involving the use

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[31] Enron Form 8-K filed with the SEC on Nov. 8,2001. This filing also contained additional information surrounding the related party transactions. At the time of the announced restatement, the third quarter 2001 financial statements had not been filed, but a loss of $618 million had been announced in the Earnings Release. On October 31, 2001, Enron announced that its Board of Directors had formed a Special Investigative Committee, headed by William Powers, Jr., Dean of the University of Texas Law School (the "Powers Committee"), to examine and recommend actions with respect to transactions between Enron and entities connected with related parties. *Id.* LJM2 and another partnership, LJM Cayman, L.P. ("LJM1"), as well as other investment partnerships, were the principal focus of the Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., released February 1,2002 (the "Powers Report").

[32] 10-Q for 3Q/2001. These financial statements gave effect to the previously announced "non-recurring charges" and restatement of prior financial statements. Due to the pending investigation by the Powers Committee and the previously announced restatement, Andersen was unable to finalize its review of these quarterly statements as required by SEC Rule 10-01(d) of Regulation S-X.

[33] *Id.* The debt consisted of $6.434 billion of short-term debt and $6.544 billion of long-term debt.

[34] Enron Corp. PowerPoint Bank Presentation, Waldorf Astoria, New York, N.Y., Nov. 19, 2001 (the "Bank Presentation"), at 48-62 [AB000321534-AB000321605].

of SPEs. Enron's presentation to the banks divided the additional debt into eight categories, shown in the following table:

Category of Additional "Debt"	**Amount at 9130101 in billions**
FAS 140 Transactions	$2.087
Minority Interest Financings	$1.690
Comrnodity Transactions with Financial Institutions	$4.822
Share Trusts	$3.352
Equity Forward Contracts	$.304
Structured Assets	$1.532
Unconsolidated Affiliates	$10.733
Leases	$.596
Total	**$25.116**

B. The Bankruptcy Filings and Subsequent Events

Less than one month after meeting with its bankers, Enron and certain of its affiliates filed for bankruptcy. In the months immediately following Enron's disclosures, allegations surfaced of securities fraud, accounting irregularities, energy market price manipulation, money laundering, breach of fiduciary duties, misleading financial information, ERISA violations, insider trading, excessive compensation and wrongdoing by certain of Enron's bankers.[35]

[35] Numerous Congressional Committees have investigated aspects of Enron's business activities or practices. In addition, there have been several class action lawsuits filed on behalf of shareholders and employees, which are still pending, naming the Debtors, certain of their directors, Andersen, certain other professionals, and others as defendants. These include *Newby v.* Enron Corp., No. 01-CV-3624 (S.D. Tex. filed Oct. 22, 2001), a lawsuit alleging, among other things, violations of securities laws (the "Newby Class Action"). Other class actions include Severed Enron Employees Coalition *v.* Northern Trust Co., No. 02-CV-267 (S.D. Tex. filed Jan. 24,2002) and Tittle v. Enron Corp., No. 01-CV-3913 (S.D. Tex. filed Nov. 13, 2001), lawsuits alleging, among other things, breach of fiduciary duty under ERISA. (Shortly after it was filed, the Severed Enron Employees Coalition case was administratively closed and consolidated with the Tittle case.) Another lawsuit, Chao v. Enron Corp., No. 03-CV-2257 (S.D. Tex. filed June 26, 2003), alleges that Enron, its directors and certain employees did not manage the assets of Enron's pension plans in accordance with the standards set forth in ERISA. The Examiner expresses no opinion as to the merits of any of these lawsuits.

III. ROLES OF ENRON'S PROFESSIONALS, EXECUTIVE OFFICERS AND OUTSIDE DIRECTORS IN SPE TRANSACTIONS AND THEORIES OF LIABILITY

A. Overview

In his Second Interim Report, the Examiner concluded that, through the pervasive use of structured finance techniques involving SPEs and aggressive accounting practices, Enron so engineered its reported financial position and results of operations that its financial statements bore little resemblance to its actual financial condition and performance. As an example, the Examiner used 2000, the last year for which Enron issued audited financial statements, to illustrate the impact of these techniques.[36] That year, Enron's use of six accounting techniques produced 96% of its reported net income and 105% of its reported funds flow from operating activities and enabled it to report $10.2 billion of debt rather than $22.1 billion of debt. The six accounting techniques are summarized as follows:

- ***FAS 140 Transactions.***[37] Enron's FAS 140 Transactions were essentially bridge financings of illiquid assets. Although Enron treated these transactions as sales to SPEs for accounting purposes, Enron assumed liability for repayment of the debt incurred and retained substantially all of the economic benefits and risks of ownership of the asset.[38]

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[36] The financial impact of Enron's use of its six accounting techniques to produce and disseminate materially misleading financial information is not limited to its 2000 annual financial statements. The effect of these techniques on the 2000 annual financial statements is presented only as an illustration. The Examiner has concluded that use of these techniques caused the 1999 annual financial statements and earlier financial statements to be misleading as well.

[37] *See* Second Interim Report, at 107-12; Second Interim Report, Appendix M (FAS 140 Transactions).

[38] These transactions are structured finance transactions that were intended to comply with either Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards No. 125 (Financial Accounting Standards Bd. 1996) ("FAS 125"), or its successor, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000) ("FAS 140"). FAS 125 was the accounting standard that governed securitizations of financial assets from January 1, 1997, until it was replaced by FAS 140, which became effective with respect to transactions closed on or after April 1,2001. Although this Report discusses some transactions that were governed by FAS 125 and

- ***Tax Transactions.***[39] Enron's Tax Transactions were, for the most part, artificial transactions lacking a bona fide business purpose other than the creation of accounting income for Enron. The Tax Transactions were designed to allow Enron to record the potential benefit of speculative future tax deductions as current income on its financial statements and, in some cases, as pre-tax income rather than as after-tax income resulting from reduced tax expense in the tax provision of Enron's income statement.

- ***Non-Economic Hedges.***[40] Through these transactions, which include the LJM1/Rhythms Hedging Transaction and the LJM2/Raptors Hedging Transactions, Enron "hedged" the decrease in value of certain of its investments that it had marked-to-market by entering into derivative contracts with counterparties that were related to Enron. These transactions were accounting hedges and did not provide economic protection to Enron because the assets used to support the hedge were Enron's own assets.[41]

- ***Share Trust Transactions.***[42] Enron's Share Trust Transactions were off-balance sheet financing structures through which an issuing entity would issue notes and equity certificates in the institutional private placement market. The proceeds would be used, in part, to fund the purchase or refinancing of assets owned by Enron or its affiliates.

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others that were governed by FAS 140, this Report refers to this type of transaction and other similar transactions generally as a "FAS 140 Transaction."

[39] *See* Second Interim Report, at 87-94; Second Interim Report, Appendix J (Tax Transactions).

[40] These transactions were part of a group of transactions among Enron and its related parties (collectively, the "Related Party Transactions") described in Appendix L (Related Party Transactions) of the Second Interim Report.

[41] In explaining that the LJM2/Raptors Hedging Transactions did not transfer any of Enron's economic risk, the head of Enron's research group, Wincenty Kaminski ("Kaminski"), gave the following example: "So you have—you have a mortgage, and the mortgage company insists that you insure your house, but if you go to a -- but if you go to your wife and buy insurance from her, there's a chance that the mortgage company will object to this insurance because there's no effective risk transfer to a third party." Sworn Statement of Wincenty Kaminski, Managing Director, Enron Wholesale Services, to William C. Humphreys, Jr., A&B, May 9, 2003, at 184. Kaminski, a Ph.D. in economics, also testified that he "thought [the LJM2/Raptors Hedging Transactions] were terrible, terrible economic hedges." Id. at 183. He testified that these transactions "were poorly structured and they created a huge reputational risk for the company . . . ." Id.; *see also* Memorandum from Steven Rosen, Wilmer Cutler, to Enron Files, regarding Interview of Wincenty Kaminski, Dec. 19,2001, at 2 (describing Kaminski's background) [AB000000462-AB000000470].

[42] *See* Second Interim Report, at 67-78; Second Interim Report, Appendix G (Whitewing Transaction); Second Interim Report, Appendix H (Marlin Transaction). This Report refers to these transactions as "Share Trust Transactions," or individually as "Whitewing" or "Marlin."

Repayment of the notes and certificates was supported by Enron stock and ultimately by Enron's promise to pay.

- Minority Interest *Transactions.*[43] Enron's Minority Interest Transactions allowed Enron to obtain funds while showing the proceeds as a "minority interest" on the balance sheet between liabilities and equity, rather than as debt.

- Prepay *Transactions.*[44] In the Prepay Transactions, Enron obtained financing through a combination of offsetting commodity trades and swaps. Although the transactions were loans in economic substance, Enron reported its obligations as price risk management liabilities rather than debt. Moreover, the increase in the outstanding prepay balance from one period to the next served to increase cash flow from operating activities.

In the Third Interim Report, the Examiner concluded that there is sufficient evidence from which a fact-finder could conclude that Fastow, Causey, Glisan and McMahon, among others, breached their fiduciary duties to Enron by causing Enron to enter into certain SPE transactions that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information known to be materially misleading.[45] That is, they engaged in a course of conduct, through the

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[43] ***See*** Second Interim Report, at 79-86; Second Interim Report, Appendix I (Minority Interest Transactions). This Report refers to these transactions as "Minority Interest Transactions."

[44] ***See*** Second Interim Report, at 58-66; Second Interim Report, Appendix E (Prepay Transactions). This Report refers to these transactions as a "Prepay" or a "Prepay Transaction." As discussed in the Second Interim Report, Enron engaged in billions of dollars of Prepay Transactions.

[45] Because Fastow, Causey, Glisan and McMahon exercised their Fifth Amendment rights, the Examiner's conclusions are based on a review of documentary evidence and the testimony of others. See the Third Interim Report, Appendix C (Role of Enron's Officers) for a full review of this evidence. The Examiner subpoenaed or otherwise requested the opportunity to take the testimony of a number of witnesses who responded by asserting the privilege against self-incrimination contained in the Fifth Amendment to the United States Constitution (the "Self-Incrimination Clause") (U.S. Const. amend. V). ***See*** Third Interim Report, at 23 (identifying Enron employees that had asserted their privilege against self-incrimination). Where a witness asserted the Self-Incrimination Clause in writing, the Examiner took no further steps to compel any examination of that witness. At least one of those witnesses had either testified in other proceedings, or had produced documents in this bankruptcy proceeding. The Examiner concluded that either of those actions created, at best, only a small chance that the Self-Incrimination Clause had been waived with respect to testimony compelled by the Examiner and, as a result, the Examiner did not pursue this waiver argument. ***See United States*** v. ***Balsys,*** 524 U.S. 666, 672 (1998); ***United States*** v. ***Housand,*** 550 F.2d 818, 821 n.3 (2d Cir. 1977); ***United States*** v. ***Miranti,*** 253 F.2d 135 (2d Cir. 1958); ***United States***

use of SPE transactions, that resulted in the false and misleading presentation of the financial condition of Enron by overstating its cash flow from operating activities, overstating its earnings and understating its obligations. In addition, the Examiner concluded that there is sufficient evidence from which a fact-finder could conclude that breaches of the fiduciary duty of loyalty occurred in connection with certain of the Related Party Transactions, most notably the involvement of Fastow and other officers in the LJM1 and LJM2 transactions.

As stated in the Third Interim Report, an officer of a corporation has fiduciary duties of good faith, due care and loyalty. Whenever corporate fiduciaries communicate publicly or directly with shareholders, they must do so honestly, candidly and completely in all material respects. Knowing dissemination of false information about the financial condition of the company is a breach of these fiduciary duties.

Although its SPE structures were complex, Enron's objectives were simple: (i) borrow money on what the financial institutions required to be essentially a recourse basis without recording debt; and (ii) record the loan proceeds as cash flow from operating activities.[46] Enron's financial reporting of the transactions discussed in the Reports resulted in the materially misleading presentation of Enron's financial condition by failing to disclose the substance of such transactions, regardless of whether the accounting was technically correct. Furthermore, in many of these transactions, the terms

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v. *Wilcox*, 450 F.2d 1131, 1141-42 (5th Cir. 1971); *Marcello* v. United States, 196 F.2d 437 (5th Cir. 1952); Poretto v. United States, 196 F.2d 392 (5th Cir. 1952).

[46] The Tax Transactions were designed to allow Enron to produce reported income but did not generate any cash flow. The Non-Economic Hedges in the LJM1/Rhythms Hedging Transaction and the LJM2/Raptors Hedging Transactions were designed to allow Enron to record income that would offset any decline in the value of certain fair value assets, so that Enron could avoid recording a charge to earnings. The Non-Economic Hedges did not generate any cash flow.

required by certain of the financial institutions violated GAAP rules and precluded the desired accounting treatment. The evidence suggests that Enron officers nonetheless achieved the desired accounting treatment by entering into undisclosed side agreements, arrangements with no business purpose and "hardwired"[47] transactions in an attempt to circumvent GAAP.

B. Persons and Entities Involved in Enron's Use of SPEs

Given the magnitude of Enron's misuse of its SPEs, it is clear that Enron's officers could not have acted alone. Instead, these officers received assistance, in varying degrees and through different means, from a number of third parties. Under the terms of the April 8th Order, the Examiner is authorized to investigate, among other things, persons and entities involved in Enron's use of SPEs.

Enron's officers, directors, accountants, attorneys and financial institutions had different roles and duties in the SPE transactions. Regardless of their respective legal liability, these parties are included within a circle of responsibility for Enron's financial demise. In the Third Interim Report, the Examiner reported on potential liability for certain officers and financial institutions. In this Report, the Examiner considers the specific roles of other persons and entities that were involved in aspects of Enron's development, use, approval, oversight and disclosure of the SPEs. These persons and entities include: (i) Andersen; (ii) Enron's attorneys; (iii) Lay and Skilling; and (iv) the Outside Directors. Specifically, with respect to each of these persons and entities, the Examiner considered:

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[47] As used in the Reports, a "hardwired transaction" is one in which the transaction documents are drafted to achieve indirectly an economic result that would have violated applicable GAAP had it been provided for directly.

- The role of the person or entity in Enron's SPE transactions, including whether the person or entity assisted Enron in its misuse of SPEs or was responsible for the monitoring of the SPEs, or both.

- Whether the conduct of the person or entity could give rise to potential liability under applicable legal standards.

- If the person or entity assisted Enron in the misuse of Enron's SPEs or failed to monitor adequately Enron's use of SPEs, the factors that may have caused (or contributed) to this failure.

C. Theories of Potential Liability and Defenses

Andersen

Although Andersen was Enron's auditor, its professionals were certified public accountants. The SEC has noted the CPA's public duty and described the critical importance of auditor independence in fulfilling that duty:

> Independent auditors have an important public trust. Investors must be able to rely on issuers' financial statements. It is the auditor's opinion that furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled professional, and that investors, therefore, can rely on them.[48]

Aside from its duty to the public, Andersen owed a direct duty to the Audit Committee. Statement of Auditing Standards No. 61 ("SAS 61") "requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial

[48] Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 33-7919 [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,406 at 83,990. Additionally, the American Institute of Certified Public Accountants ("AICPA") has stated that "[i]ndependent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence." Independence, Statement on Auditing Standards No. 1 (American Institute of Certified Public Accountants 1972) ("SAS 1"), at § 3 (AU § 220.03). As late as August 2001, Andersen advised the Enron Audit Committee that "AA believed independence was not only the cornerstone of its profession, but the only sound basis to its continued success." Minutes of Enron Audit Committee Meeting, Aug. 13, 2001 (the "Audit Committee 08/13/01 Minutes"), at 2 [AB000203966- AB000203968].

reporting and disclosure process for which management is responsible."[49] Under SAS 61, the matters required to be communicated include:

> The initial selection of and changes in significant accounting policies or their application. The auditor should also determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. For example, significant accounting issues may exist in areas such as revenue recognition, off-balance-sheet financing, and accounting for equity investments.[50]

In addition, SAS 90 (effective for Enron's 2000 financial statements) required Andersen to have "open and frank" discussions on the "quality and not just the acceptability" of Enron's use of accounting principles, and on "items that have a significant impact on the representational faithfulness of the financial statements."[51]

In this Report, the role of Andersen in Enron's SPEs is considered against two legal theories:

- *Accounting Malpractice* – whether there is sufficient evidence for a fact-finder to conclude that Andersen breached the standard of care that an accountant owes to its client such that Andersen may be liable for damages to Enron, assuming that the claim is not barred by the conduct of Enron's officers.

- *Aiding and Abetting a Breach of Fiduciary Duty* – whether there is sufficient evidence for a fact-finder to conclude that Andersen aided and abetted the wrongful conduct of Enron's officers that constituted breaches of fiduciary duty such that Andersen may be liable for

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[49] Communication with Audit Committees, Statement on Auditing Standards No. 61 (American Institute of Certified Public Accountants 1988) ("SAS 61"), at § 2 (AU § 380.02). Statements on Auditing Standards, normally cited as "SAS (statement number)," were also codified, as issued, into the Codification of Statements on Auditing Standards by the AICPA (cited as "AU (section number)"). Where a SAS is cited, a short citation to the related AU codification is provided for ease of reference.

[50] Id. at § 7 (AU § 380.07).

[51] Audit Committee Communications, Statement on Auditing Standards No. 90 (American Institute of Certified Public Accountants 1989) ("SAS 90"), at § 1 (amending SAS 61, at § 11) (effective for audits of financial statements for periods ending on or after December 15,2000) (AU $380.11).

damages to Enron, assuming that the claim is not barred by the conduct of Enron's officers.

Accounting Malpractice. Whether Andersen exercised the degree of care, skill and competence that reasonably competent members of the profession would exercise under similar circumstances is determined by reference to GAAP and generally accepted auditing standards ("GAAS"). An accountant satisfies his or her professional duties by complying with GAAP and GAAS.[52] "GAAP are those principles recognized as appropriate in the recording, reporting, and disclosing of financial information."[53] GAAP "includes not only broad guidelines of general application, but also detailed practices and procedures."[54] GAAP is a technical term: it includes the conventions, rules and procedures that define acceptable accounting practices. GAAP provides the standards for determining a company's assets, liabilities, revenues, expenses, net income or net loss and sources and uses of cash. The ultimate goal of GAAP is to set out financial information that is relevant, reliable and useful.[55] Similarly, GAAS sets forth the accepted standards of practice for auditors in planning and performing audits.[56] An

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[52] ***But see Goss v. Crossley (In re Hawaii Corp.),*** 567 F. Supp. 609, 617 (D. Haw. 1983) ("Compliance with GAAP and GAAS, however, will not immunize an accountant when he consciously chooses not to disclose on a financial statement a known material fact.") (citations omitted).

[53] ***Id.*** at 618.

[54] The Meaning of ***Present Fairly in Conformity With Generally Accepted Accounting Principles*** in the Independent Auditor's Report, Statement on Auditing Standards No. 69, at § 2 (American Institute of Certified Public Accountants 1992) ("SAS 69") (AU § 411.02).

[55] Second Interim Report, Appendix B (Accounting Standards), at 3-5; ***Goss,*** 567 F. Supp. at 620 ("Economic substance should prevail over legal form if there is a difference.").

[56] ***United States v. Arthur Young & Co.,*** 465 U.S. 805, 811 (1984); ***Monroe v. Hughes,*** 31 F.3d 772, 774 (9th Cir. 1994); ***Greenstein, Logan & Co. v. Burgess Mktg., Inc.,*** 744 S.W.2d 170, 185 (Tex. App. 1987); ***see also Bankr. Sews., Inc. v. Ernst & Young (In re CBI Holding Co.),*** 247 B.R. 341 (Bankr. S.D.N.Y. 2000).

auditor's good faith compliance with GAAS generally discharges the auditor's professional duty to act with reasonable care in planning and performing an audit.[57]

Aiding and Abetting. For Andersen to be liable to Enron for aiding and abetting, a fact-finder must first determine that there has been a breach of fiduciary duty by one or more Enron officers. If a fact-finder concludes that there has been such a breach, the fact-finder may then conclude that Andersen is liable to Enron for aiding and abetting such breach if the evidence shows that: (i) Andersen had actual knowledge of the wrongful conduct giving rise to the breach; (ii) Andersen gave substantial assistance to the wrongdoer; and (iii) injury to the Debtors was the direct or reasonably foreseeable result of such conduct. While there is some authority to the contrary, the actual knowledge standard is strict – "should have known" or "suspicion" will not suffice.

Defenses Available to Andersen. The facts and circumstances surrounding Andersen must be considered independently, and Appendix B to this Report analyzes these issues in more detail. The Examiner has reviewed a substantial amount of evidence, including documentary and testimonial evidence, and has noted the reasonable inferences that could be drawn from the evidence. A fact-finder may draw alternative or contrary inferences from the same evidence. Whether Andersen will succeed on one or more defenses to any of these causes of action will depend upon the fact-finder's resolution of the facts.

Andersen may contend that the evidence is not sufficient to establish one or more essential elements of these claims (e.g., a breach of the standard of care, or Andersen's

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[57] *Monroe,* 31 F.3d at 774; *In re CBI Holding Co.,* 247 *B.R.* at 362; *Greenstein, Logan & Co.,* 744 S.W.2d at 185.

knowledge of wrongful acts by Enron's officers). Andersen also may assert that the wrongful acts committed by Enron's officers should be imputed to Enron so as to defeat such claims. There are few Texas cases that address the circumstances under which the wrongful conduct of a corporation's officers would be imputed to the corporation to defeat such claims, but it appears that imputation is a factual matter. If the officers' wrongful conduct is imputed to Enron, then Andersen could assert that Enron's wrongful conduct was greater than Andersen's wrongful conduct, and therefore claims by Enron should be barred or reduced under comparative fault rules.

Attorneys

Enron's attorneys – whether in the role of in-house counsel or outside counsel – owed professional duties to their corporate client, Enron,[58] which included the duty to provide competent legal advice on the matters on which the attorneys were hired to work,[59] and, in so doing, to "exercise independent professional judgment and render candid advice."[60] Unlike accountants, attorneys generally owe their professional duties to their client, rather than to any third party or to the public, as a whole.[61] Ordinarily, Enron's attorneys had to "abide by [Enron's] decisions," as communicated by Enron's officers and employees, and could not substitute their own judgment or objectives for those of Enron.[62]

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[58] See generally Texas Disciplinary Rules of Prof1 Conduct (available following Tex. Gov't Code Ann. § 84.004) (the "Texas Rules").

[59] Texas Rule 1.01.

[60] Texas Rule 2.01.

[61] See, *e.g.*, Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991).

[62] Texas Rule 1.02(a) and 1.12(a).

Attorneys who represented Enron on many of the SPE transactions or in regard to related public disclosures at times between 1997 and the Petition Date were confronted with instructions from certain Enron officers, including Fastow, Causey, Kopper and Glisan, that, if carried out, constituted a breach of a legal duty to Enron (such as a breach of fiduciary duty) or a violation of law (such as inadequate disclosure). As discussed more fully in this Report, these circumstances potentially altered the attorneys' duties such that they had to determine whether they were required to take "reasonable remedial actions," that potentially included "asking reconsideration" of instructions received or "referring the matter to higher authority [at Enron], including, if warranted by the seriousness of the matter, referral" to the Enron Board.[63] In short, Enron's attorneys in numerous situations were required to balance all information available to them in order to determine whether their usual role – of abiding by decisions of Enron's officers – had been materially altered to require that those attorneys take information over the heads of these Enron officers and call into question the appropriateness of the officer's conduct.

The role of certain of Enron's in-house attorneys, and certain of its outside counsel, in Enron's SPEs is considered against two legal theories:[64]

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[63] Texas Rule 1.12(a).

[64] In the case where a law firm has filed a claim against the Debtors, this Report also considers whether there is sufficient evidence for a court to conclude that such claims should be equitably subordinated to the claims of the other creditors. An attorney's claim filed in the Bankruptcy Case may be equitably subordinated to the payment of other claims filed in the case if (i) the attorney engaged in inequitable conduct and (ii) that conduct resulted in harm to other creditors. In the case of creditors that are not insiders or fiduciaries of the debtor, the standard of inequitable conduct is high and has been said to require a breach of a recognized duty. Several cases stand for the proposition that a creditor's participation in the debtor's misrepresentation of its financial condition to other creditors may constitute inequitable conduct that will justify the equitable subordination of the creditor's claim. If an attorney engaged in inequitable conduct by participating in Enron's misrepresentation of its financial condition, a fact-finder could conclude that other creditors were injured by this conduct because they relied on this information in extending (or continuing to extend) credit to Enron.

- *Legal Malpractice* – whether there is sufficient evidence for a fact-finder to conclude that an attorney breached the standard of care owed to his client such that the attorney may be liable for damages to Enron, assuming that the claim is not barred by the conduct of Enron's officers.

- *Aiding and Abetting a Breach of Fiduciary Duty* – whether there is sufficient evidence for a fact-finder to conclude that an attorney aided and abetted Enron's officers' breaches of fiduciary duty such that the attorney may be liable for damages to Enron, assuming that the claim is not barred by the conduct of Enron's officers.

Legal Malpractice. An attorney (whether in-house counsel or outside counsel) may become liable to his or her client as a result of a failure to exercise the competence and diligence normally exercised by attorneys in similar circumstances. Such a failure, as well as reckless or knowing conduct that constitutes a breach of an attorney's duty to his or her client, is usually referred to as legal malpractice. To prevail on a claim for legal malpractice, Enron must prove: (i) the attorney owed a duty to Enron; (ii) the attorney breached his or her duty; (iii) there is a causal link between the breach and Enron's injury; and (iv) damages resulting from the breach. To establish an attorney's breach of his professional duty, Enron must show that the attorney failed to act as an attorney of reasonable prudence would have in a similar situation. As a general rule, a plaintiff must rely upon competent, admissible expert testimony to establish the relevant standard of care, the corresponding breach and causation.

A relevant provision of the Texas Disciplinary Rules of Professional Conduct (the "Texas Rules") may be considered by a fact-finder in understanding and applying the standard of care for malpractice when that rule is designed for the protection of persons in the position of the plaintiff. Texas Rule 1.12 addresses the attorney's role when the attorney represents an organization (such as a corporation), and learns that a

representative of the organization has committed or intends to commit a violation of a legal obligation to the organization (such as a breach of fiduciary duty) or a violation of law that reasonably might be imputed to the organization (such as the dissemination of misleading financial information). Ordinarily, an attorney must comply with the directives received fi-om the officers of the client. In the circumstances set forth in Texas Rule 1.12(b), however, the attorney "must take reasonable remedial actions" that are in the best interest of the organization. Those circumstances are:

> whenever the lawyer learns or knows that:
>
> (1) an officer . . . has committed or intends to commit a violation of a legal obligation to the organization or a violation of law that reasonably might be imputed to the organization;
>
> (2) the violation is likely to result in substantial injury to the organization; and
>
> (3) the violation is related to a matter within the scope of the lawyer's representation of the organization.

Remedial action may include "referring the matter to higher authority in the organization," which, "if warranted by the seriousness of the matter," may mean the board of directors.[65] In some circumstances, the attorney may be required to withdraw from the representation.[66] An analogous rule provides that a lawyer may not participate in a client's fraudulent conduct.[67]

Thus, an attorney for Enron who knew that (i) an officer was engaging in wrongful conduct, (ii) substantial injury to Enron was likely to occur as a result of that

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[65] Texas Rule 1.12(c)(3).

[66] *See* Annex 1 to Appendix C (Role of Enron's Attorneys).

[67] Texas Rule 1.15(a)(1) and 1.02, cmt. 8.

conduct and (iii) the violation was within the attorney's scope of representation, but failed to take appropriate affirmative steps to cause reconsideration of the matter – including referral of the matter to a higher authority in the company, including, if appropriate, the Enron Board – would not have acted as an attorney of reasonable prudence would have in a similar situation.

Aiding and Abetting. For an attorney to be liable to Enron for aiding and abetting, a fact-finder must first determine that there has been a breach of fiduciary duty by one or more Enron officers. If a fact-finder concludes that there has been such a breach, the fact-finder may then consider whether an attorney is liable to Enron for aiding and abetting that breach if the evidence shows that: (i) the attorney had actual knowledge of the wrongful conduct giving rise to the breach; (ii) the attorney gave substantial assistance to the wrongdoer; and (iii) injury to the Debtors was the direct or reasonably foreseeable result of such conduct. While there is some authority to the contrary, the actual knowledge standard is strict – "should have known" or "suspicion" will not suffice. Although the legal standards applicable to outside attorneys are also applicable to in-house attorneys, in light of the fiduciary duties that an in-house attorney who is also an officer owes to the corporation as an officer, it is more appropriate to evaluate the actions of an in-house attorney on the basis of his or her fiduciary duties as an officer of the corporation rather than from the perspective of aiding and abetting.

Defenses Available to Enron's Attorneys. The facts and circumstances surrounding Enron's attorneys must be considered independently, and Appendix C (Role of Enron's Attorneys) to this Report analyzes these issues in more detail. The Examiner has reviewed a substantial amount of evidence, including documentary and testimonial

evidence, and has noted the reasonable inferences that could be drawn from the evidence. A fact-finder may draw alternative or contrary inferences from the same evidence. Whether an attorney will succeed on one or more defenses to any of these causes of action will depend upon the fact-finder's resolution of the facts.

All of the defenses available to Andersen, including defenses based upon comparative fault rules, would be available to the attorneys defending against these claims.

Outside Directors

The role of a corporate director includes two principal functions: a decision-making function and an oversight function.[68] The decision-making function generally involves action taken at a particular point in time, while the oversight function generally involves ongoing monitoring of the corporation's business and affairs over a period of time. As a result, the role of the Outside Directors in Enron's SPEs is considered against two legal theories:

- Decision-Making – whether there is sufficient evidence for a fact-finder to conclude that the Outside Directors breached their fiduciary duties by approving any of the SPE transactions; and

- Oversight – whether there is sufficient evidence for a fact-finder to conclude that the Outside Directors breached their fiduciary duties by failing to provide adequate oversight with respect to the SPE transactions and related matters.

Decision-Making. As explained more fully in Appendix B (Legal Standards) to the Third Interim Report, when directors of a corporation make business decisions on

[68] 2 *ABA* Model *Bus. Corp. Act Ann.* (3d ed. 2000 & **Supp.** 2002) § 8.31 Official cmt. at 8-204.

behalf of the corporation, they must satisfy their fiduciary duty of care.[69] A doctrine known as the "business judgment" rule focuses the legal scrutiny of business decisions on the process by which the decision was reached (e.g., was all material information reasonably available taken into consideration), as opposed to the substance of the decision itself (e.g., was a reasonably careful, or risk free, course of action selected).[70] Accordingly, where the business judgment rule applies, the duty of care may be characterized as a duty to exercise informed business judgment. Under Oregon law, the adequacy of the decision-making process (i.e., whether the business decision was sufficiently informed) likely would be measured by concepts of ordinary negligence.

There is a limit, however, on the amount of judicial deference afforded to the substance of a business decision under the business judgment rule. Even if a director makes a business decision in a manner that satisfies the duty of process due care, the business judgment rule will not protect a decision that cannot be attributed to any rational business purpose.[71] Moreover, a business decision that lacks any rational business

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[69] Directors also must satisfy their fiduciary duties of good faith and loyalty, each of which is discussed in Appendix B (Legal Standards) to the Third Interim Report.

[70] See Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is process due care only.") (emphasis in original).

[71] The limited substantive review contemplated by this outer limit of the business judgment rule may be thought of as a manifestation of the fiduciary duty of good faith. See, *e.g.*, Parnes v. *Bally Entm't* Corp., 722 A.2d 1243, 1246 (Del. 1999) ("The presumptive validity of a business judgment is rebutted in those rare cases where the decision under attack is 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'") (quoting West Point – Pepperell, Inc. v. J.P. Stevens & *Co.* (In re J.P. Stevens & Co.), 542 A.2d 770, 780-81 (Del. Ch. 1988)); In re RJR *Nabisco, Inc.* S'holders Litig., No. 10389, 1989 WL 7036, at *22 n.13 (Del. Ch. Jan. 31, 1989) (stating that the limited substantive review contemplated in the business judgment rule (i.e., whether the decision is irrational or egregious or so beyond reason) is really a way of inferring bad faith), appeal refused, 556 A.2d 1070 (Del. 1989).

purpose may be evidence of a breach of the duty of good faith. Violations of the duty of good faith are not protected by a director exculpation provision.

Oversight. A board of directors' oversight responsibility has two principal components: a duty to monitor corporate affairs and a duty to inquire into circumstances, or "red flags," indicating that potential problems exist within the corporation. A director who negligently fails to fulfill his or her duty of oversight, but who does not (i) abdicate his or her monitoring responsibilities, (ii) exhibit a conscious disregard for known risks, or (iii) otherwise fail to act in good faith, may be protected from liability to a corporation and its shareholders, if the corporation has adopted a director exculpation provision in its charter, as Enron has done. A director exculpation provision, however, does not protect a director who is also an officer of the corporation from liability for negligence when acting in his or her capacity as an officer.

Lay and Skilling

As explained in Appendix B (Legal Standards) to the Third Interim Report, although officers and directors are generally held to the same standards of conduct, the roles and responsibilities of officers present a different context in which to apply those standards and may subject officers to a higher degree of scrutiny than that of directors.[72] For example, "full-time officers will generally be expected to be more familiar with the affairs of a corporation than outside directors."[73] Similarly, "[o]fficers will be expected

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[72] *See* Third Interim Report, Appendix B (Legal Standards), at 6-8; ***see also Mixon v. Anderson (In re Ozark Rest. Equip. Co.),*** 41 B.R. 476 (Bankr. W.D. Ark. 1984), ***rev'd on other grounds,*** 61 ***B.R.*** 750 (W.D. Ark. 1986); ***Bynum v. Scott,*** 217 *F.* 122 (E.D.N.C. 1914); ***Taylor v. Alston,*** 447 P.2d 523 (N.M. Ct. App. 1968); ***Raines v. Toney,*** 313 S.W.2d 802 (Ark. 1958).

[73] American Law Institute, ***Principles of Corporate Governance: Analysis &Recommendations*** § 4.01 cmt. a (1994).

to be more familiar with business affairs under their direct supervision than officers who do not have such responsibility."[74] Oregon's statutory standard of care for corporate directors allows for these differing circumstances to be taken into account by requiring directors to exercise the care of an ordinarily prudent person "in a like position . . . under similar circumstances."[75] Indeed, the drafters of the Model Act observe that the phrase "in a like position . . . under similar circumstances" is intended to recognize, among other things, that the "management responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care."[76] Finally, when an inside director acts (or fails to act) in his or her capacity as an officer, he or she does not enjoy the protections of a director exculpation provision.

In summary, due to the inapplicability of Enron's director exculpation provision to officers, liability for the failure of an inside director of Enron to recognize and respond to red flags that arise in an area for which he or she has management responsibility as an officer likely would be evaluated under standards of ordinary negligence. Moreover, due to an inside director's greater role in and responsibility for the corporation's day-to-day affairs, he or she has more occasion to encounter red flags and, correspondingly, more responsibility for responding to them in the exercise of ordinary care.

Defenses Available to Lay, Skilling and Outside Directors

The facts and circumstances surrounding Lay, Skilling and the Outside Directors must be considered independently, and Appendix D to this Report analyzes these issues

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[74] Id.

[75] Or. Rev. Stat. § 60.357(1).

[76] 2 ***ABA Model Bus. Corp. Act Ann.*** § 8.30 Official cmt. at 8-170.

in more detail. The Examiner has reviewed a substantial amount of evidence, including documentary and testimonial evidence, and has noted the reasonable inferences that could be drawn from the evidence. A fact-finder may draw alternative or contrary inferences from the same evidence. Whether Lay, Skilling and the Outside Directors will succeed on one or more defenses to any of these causes of action will depend upon the fact-finder's resolution of the facts.

Reliance on Officers. Under Oregon law, officers and directors are entitled to rely on information provided or presented by other officers or employees of the corporation whom the officers or directors reasonably believe to be reliable and competent in the matters presented.[77] Lay, Skilling and the Outside Directors may assert that they relied on information provided to them by senior officers of Enron. Lay and Skilling may also assert that as CEO and COO, they could not have possessed complete information about all aspects of Enron's operations and, therefore, necessarily relied on their subordinate officers. This reliance by Lay, Skilling and the Outside Directors must be reasonable, however, and it would not be reasonable if they were aware of facts or circumstances concerning the matter in question that rendered such reliance unwarranted. An officer or director does not act in good faith if he or she is aware of facts or circumstances concerning the matter in question that render reliance on such information, opinions, reports or statements unwarranted.[78]

Reliance on Professionals. In addition to relying on Enron officers who were experienced accountants and lawyers, Lay, Skilling and the Outside Directors may assert

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[77] Or. Rev. Stat. § 60.357(2)(a) and Or. Rev. Stat. § 60.377(2)(a).

[78] Or. Rev. Stat. § 60.357(3).

that they relied on an array of highly qualified professionals, including Andersen and Enron's attorneys. Oregon law expressly permits a director or an officer to rely on information provided by "[l]egal counsel, public accountants or other persons as to matters the [director or officer] reasonably believes are within the person's professional or expert competence."[79] A fact-finder would have to decide whether Lay, Skilling and the Outside Directors actually relied on these professionals and, if so, whether their reliance was reasonable. The reasonableness of their reliance will be considered in light of any facts that Lay, Skilling and the Outside Directors may have known that rendered such reliance unwarranted. A fact-finder would also likely consider circumstances where the professionals may not have been candid with management or the Board, and also circumstances where officers at the company failed to provide the professionals with all relevant information about Enron's transactions.

Reliance on Board Committees. A director is also entitled to rely on information and reports provided by a committee of the board if the director reasonably believes the committee merits confidence.[80] For example, certain SPE transactions were presented to the Finance Committee, which then recommended them to the Board for approval. In some instances, important details about the transaction were provided to the Finance Committee but not to the Board. Members of the Board who approved the transactions, but who were not present at the Finance Committee meetings, might argue that they had a right to rely on the recommendations of the Finance Committee. However, such reliance

[79] Or. Rev. Stat. § 60.357(2)(b) and Or. Rev. Stat. § 60.377(2)(b).

[80] Or. Rev. Stat. § 60.357(2)(c).

'must be reasonable and, therefore, the directors who assert such reliance must not have known facts that would make such reliance unwarranted.

Exculpation and Indemnity. Consistent with applicable Oregon law, Enron's articles of incorporation provide that a director shall not be personally liable to Enron or its shareholders for monetary damages for conduct as a director except for liability for, among other things, "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."[81] This director exculpation provision likely will apply to any claim by Enron or its shareholders against the Outside Directors alleging breach of fiduciary duty, so long as the Outside Directors acted in good faith. This director exculpation provision is not available to Lay or Skilling acting (or failing to act) in their capacities as officers because, by its terms, the provision does not extend to officers.[82]

[81] Article VII, Section A, Articles of Incorporation of Enron Corp. [AB0785 03888-AB0785 041471.

[82] *Id.* Under certain circumstances, directors and officers of Oregon corporations can be entitled to indemnification from the corporation with respect to claims made against them in their capacity as directors or officers. ***See*** Annex 2 to Appendix D (Roles of Lay, Skilling and Outside Directors); Third Interim Report, Appendix B (Legal Standards), at 32-34. However, such claims may be subject to disallowance pursuant to Section 502(e)(1)(B) of the Bankruptcy Code. An officer's or director's right of indemnification would not, however, provide relief from, or alter the liability standard for, any claims brought by the company against such officer or director. ***See*** Annex 2 to Appendix D (Roles of Lay, Skilling and Outside Directors), ***Exculpation and Indemnity.***

IV. SPECIFIC ROLE OF ANDERSEN AND POTENTIAL LIABILITY

A. Role of Andersen in Enron's SPE Transactions

Enron was described by Andersen as "the largest client of our firm by a wide margin in Fiscal 1999."[83] Fees paid by Enron to Andersen totaled $26.5 million in 1998, $46.4 million in 1999 and $47.9 million in 2000. The majority of these fees came from services related to Andersen's attestation of Enron's internal controls and financial statements, and from accounting consultation on the design and implementation of Enron's SPE transactions. From 1989 through 2000, at least eighty-six Andersen accountants left Andersen to become employed by Enron, some of whom became key executives in Enron's accounting and treasury functions.

As discussed in the Prior Reports, Enron's financial statements and related disclosures were materially misleading. For example, virtually all of Enron's $979 million of net income and $3 billion of funds flow from operating activities for the year 2000, and approximately $8.6 billion of fully recourse indebtedness not reflected on Enron's balance sheet as of December 31, 2000, were attributable to six accounting techniques used by Enron. Each of these accounting techniques was implemented with Andersen's assistance and approval. Each also was designed so that Enron could report the SPE transactions in a manner that was materially more favorable than their economic substance.

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[83] Email from James D. Edwards, Andersen, to Thomas H. Bauer, Andersen, et *al.*, Oct. 13, 1999 ("Congratulations to you and the entire Enron team for the unbelievable results of service to this client in Fiscal 1999. With $47 million in fees and a growth rate of 88%, Enron became the largest client of our firm by a wide margin in Fiscal 1999.") [AB0971 023771.

As set forth in Appendix B (Role of Andersen), the evidence reviewed by the Examiner indicates that Andersen provided extensive guidance and assistance to Enron in planning and executing numerous SPE transactions for which the Examiner has determined that Enron's accounting treatment and disclosures were materially misleading. In particular, the evidence reviewed by the Examiner is sufficient to permit a fact-finder to conclude that:

- Andersen assisted Enron's abuse of rules-based GAAP by helping Enron design accounting techniques or "models"[84] that Enron could use to report income, cash flow and financial position more favorably than if the financial statements and related disclosures faithfully represented the economic substance of the transactions.[85]

- Andersen failed to exercise due care in auditing whether the third party entities used by Enron in its Prepay Transactions were SPEs,[86] and

[84] These "models" include each of the six accounting techniques described in the Examiner's Second Interim Report. See generally Second Interim Report; see also Appendix B (Role of Andersen).

[85] "Representational faithfulness" is a concept found in Financial Accounting Concept No. 2, ("FAC 2"), and stands for the proposition that the accounting for a transaction should "faithfully represent" the substance of the underlying transaction. The FACs are not a part of the "GAAP hierarchy" described in SAS 69. Thus it is perhaps possible, at least under the standards that accountants have adopted for themselves, that financial statements could "fairly present in accordance with GAAP" the financial condition, results of operations and cash flow of an entity, but still not faithfully represent the economic substance of the entity's financial condition, results of operations and cash flow. That does not mean, however, that GAAP statements cannot be materially misleading. See United States v. Simon, 425 F.2d 796 (2d Cir. 1969) ("critical test" is whether financial statements as a whole "fairly present" the financial position and results of operations of the company for the period under review; compliance with GAAP "persuasive" but not "conclusive" that the facts as certified were not materially misleading). The work of the Blue Ribbon Committee, as evidenced in SAS 90, amending SAS 61 effective for financial statements issued after December 15,2000, sought to clarify the accountant's responsibility in this regard: if an entity is using rules-based GAAP to report financial information that does not faithfully represent the economic substance of the entity's financial condition, results of operations and cash flow, the accountant must report this to the audit committee. See SAS 90. In responding to one of his colleagues who suggested that a particular accounting result might violate Financial Accounting Concepts, John Stewart of the Andersen Professional Standards Group ("PSG) stated, "The conceptual framework has little to do with how we in practice respond to day to day questions. . . . As you know, the FASB's conceptual framework was developed primarily to help the FASB itself as it developed new standards not so much to aid practice on a day to day basis." Email from John E. Stewart, Andersen, to Kieva M. Skinner, Andersen, and copy to H. Ronald Weissman, et *al.*, Andersen, regarding ANZ Transaction, Aug. 9, 1999, at 1 [AB0633 2448-AB0633 24561.

[86] See Appendix B (Role of Andersen), Accepting Questionable Audit Evidence.

whether the 3% equity investments in the SPEs utilized by Enron in its FAS 140 Transactions were at risk.[87]

- Andersen failed to discharge its duty under applicable auditing standards to "determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus."[88]

Without Andersen's certification of Enron's financial statements and various other approvals provided by Andersen, Enron would not have been able to employ those transactions to distort Enron's reported financial condition, results of operations and cash flow. The evidence suggests that Andersen approved Enron's SPE transactions in an environment that permitted literal, or often no more than arguable, compliance with GAAP, despite the fact that the result often was financial presentation inconsistent with economic substance. The Examiner has concluded, however, that Enron's accounting for many of its significant SPE transactions did not comply with GAAP.

As noted in the Third Interim Report and as discussed in Appendix B (Role of Andersen), evidence suggests that, in numerous instances, Enron officers concealed material transaction information from Andersen. For example, Andersen accountants have indicated that they were unaware that Enron officers had entered into side agreements guaranteeing repayment of equity that was supposedly "at-risk" in SPE

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[87] *See* Appendix *B* (Role of Andersen), *Evidence of Enron's Deception of Andersen.*

[88] SAS 61, at § 7 (AU § 380.07). Similarly, the evidence suggests that Andersen failed to discharge its duty under applicable auditing standards to have an "open and frank" discussion with Enron's Audit Committee concerning the "quality, not just the acceptability, of [Enron's] accounting principles as applied in its financial reporting" and by failing to discuss "items that have a significant impact on the representational faithfulness . . . of the accounting information included in the financial statements, which include related disclosures." SAS 90, at § 1 (amending SAS 61, at § 11) (AU § 380.11); *see also* Appendix *B* (Role of Andersen), *Andersen's Interaction with Enron's Audit Committee.*

transactions.[89] Andersen accountants also indicate that, had they known this information, they would not have approved Enron's accounting for those transactions.[90] While these facts demonstrate that Enron officers were deceiving Andersen, a fact-finder could conclude that, under the circumstances, Andersen overlooked obvious risks that such activities were occurring and should have implemented an audit plan designed to detect them.

The evidence reviewed by the Examiner also indicates that Andersen failed to discharge its duty under applicable auditing standards to "determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus."[91] Many of Enron's significant SPE transactions fell squarely within the foregoing description, but Andersen consistently failed to determine whether Enron's Audit Committee was informed about the "effect" of Enron's SPE transactions and other significant accounting policies on its financial statements.

For example, Andersen quantified and summarized for its internal analysis the effect on Enron's 1999 and 2000 income statements of Enron's FAS 140 Transactions,

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[89] In-Person Interview with Kimberly Scardino, Andersen, by H. Bryan Ives, III and William T. Plybon, A&B, May 29, 2003 (the "Scardino Interview"); Sworn Statement of Debra A. Cash, Andersen, to H. Bryan Ives, III, A&B, June 5, 2003, at 139-42; Sworn Statement of Carl E. Bass, Andersen, to H. Bryan Ives, III, A&B, June 4, 2003 (the "Bass Sworn Statement"), at 31-32; In-Person Interview with Benjamin S. Neuhausen, Andersen, by H. Bryan Ives, III, A&B, June 13, 2003; In-Person Interview with John E. Stewart, Andersen, by H. Bryan Ives, III, A&B, June 12,2003 (the "Stewart Interview"); Sworn Statement of Patricia Grutzmacher, Andersen, to H. Bryan Ives, III, A&B, June 11, 2003 (the "Grutzmacher Sworn Statement"), at 106-07.

[90] Scardino Interview; Stewart Interview; Bass Sworn Statement, at 44-46.

[91] SAS 61, at § 7 (AU § 380.07).

mark-to-market accounting and fair value accounting.[92] Andersen also quantified and summarized for its internal analysis the effect of the related party transactions with LJM and Whitewing on Enron's 2000 income and cash flow.[93] However, Andersen did not share this quantitative summary analysis with the Enron Audit Committee. There is evidence that in his oral presentation Andersen partner David Duncan may have warned the Audit Committee of the risk that others could have a different view of Enron's aggressive accounting and disclosure. Such comments were, however, accompanied by assurances that "[we] are on board with the company's positions or you would hear about them."[94] Evidence suggests that Andersen failed to determine that the Audit Committee was informed about the effect of these transactions on Enron's financial statements or the specific aspects of the transactions that introduced the risk or the impact of these transactions on the representational faithfulness of Enron's financial statements. Indeed, multiple Audit Committee members have stated that they were not informed by Andersen of the magnitude of the transactions that involved "high risk" accounting judgments.[95]

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[92] Enron Client Retention Meeting Presentation (the "Retention Meeting Presentation"), at 5 [AA-EX00269472-AA-EX00269499].

[93] *Id.*

[94] David Duncan, Handwritten Notes on Audit Update Presentation entitled, "Selected Observations – 1999 Financial Reporting" (the "Duncan Notes on 1999 Selected Observations") (presentation slide attached to Audit Committee 2/7/00 Minutes) [AB0911 2265].

[95] See, *e.g.*, Sworn Statement of Ronnie C. Chan, Enron, to William C. Humphreys, Jr., A&B, Aug. 9, 2003 (the "Chan Sworn Statement"), at 57, 243, 247-49; Sworn Statement of Paulo V. Ferraz Pereira, Enron, to William C. Humphreys, Jr., A&B, Sept. 12, 2003, at 179-80; Sworn Statement of Wendy L. Gramm, Enron, to William C. Humphreys, Jr., A&B, Aug. 20, 2003 (the "Gramm Sworn Statement"), at 111-13, 131-33, 156; Sworn Statement of John Mendelsohn, Enron, to William C. Humphreys, Jr., A&B, Sept. 9, 2003, at 84, 85, 94-97, 99, 103-04; Sworn Statement of Joe H. Foy, Enron, to William C. Humphreys, Jr., A&B, Aug. 26, 2003 (the "Foy Sworn Statement"), at 138-39, 143; Sworn Statement of Lord John Wakeham, Enron, to John L. Latham, A&B, Dec. 5,2002, at 52, 73-78, 99-100, 120-22, 140-42, 203-04.

In an internal February 2001 Andersen meeting regarding whether Enron should be retained as a client, the Engagement Team presented a slide prepared for its anticipated presentation to the Audit Committee that disclosed that the application of GAAP to Enron's structured transactions often requires "extreme" judgment.[96] When Andersen made the actual presentation to the Audit Committee a week later, however, the word "extreme" was replaced with the word "significant" on that slide.[97] The evidence suggests that Andersen took a similar approach in other aspects of its presentations to Enron's Audit Committee, in which "accounting risk" and "disclosure risk" were described as a product of the complexity of Enron's business, when in fact that risk arose from the aggressive accounting techniques that Enron employed with Andersen's support, to enhance Enron's financial presentation.[98]

There were other occasions on which Andersen failed to advise the Audit Committee and the Enron Board of its concerns regarding the SPE transactions. For example, in an internal email dated May 28, 1999, one senior Andersen accountant discussing the LJM1/Rhythms Hedging Transaction noted:

> Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme?

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[96] Retention Meeting Presentation, at 23 (presentation slide entitled, "Selected Observations – 2000 Financial Reporting").

[97] Compare Audit Update Presentation entitled, "2000 Audit Update: Selected Observations - 2000 Financial Reporting," at AB000204304 (attached to the Audit Committee 2/12/01 Minutes) [AB000204301-AB000204305] (handwriting redacted to improve legibility), *with* the Retention Meeting Presentation, at 23. Notes related to that meeting suggest that in his oral presentation, David Duncan may have described the risks as "extreme." David Duncan, Typed Notes entitled, "Financial Comments," undated [AB0911 2292].

[98] See, *e.g.*, Audit Update Presentation entitled, "Selected Observations – 1999 Financial Reporting," at AB000201144 (attached to Audit Committee 2/7/00 Minutes) (stating that "[s]ophistication of Company's Business Practices Introduced A High Number of Accounting Models and Applications Requiring Complex Interpretations and Judgement [sic].") [AB000201141-AB000201144].

> Plus, even if all the accounting obstacles below are overcome, it's a related party, which means FAS 57 disclosures of all transactions. Would Enron want these transactions disclosed every year as related party transactions in their financial statements?"

While accountants are not responsible for their client's business decisions, there is no evidence that Andersen raised the nature or degree of its internally expressed concerns over these structures. Evidence indicates that Enron officers persuaded Andersen to acquiesce in the aggressive presentation of Enron's transactions, and that Enron officers sometimes failed to heed more conservative advice from Andersen. For example, Andersen suggested, prior to Enron's issuance of both its 1999 and 2000 financial statements, that Enron disclose the impact of the Prepay Transactions on the financial statements. Management refused to make the disclosures, however, and Andersen determined that Enron's financial presentation would not be materially misleading absent the disclosures. The Prepay Transactions accounted for all of Enron's $1.2 billion of operating cash flow in 1999, and $1.5 billion of Enron's $4.8 billion of operating cash flow in 2000. Yet, without additional disclosure, it was not possible, without some independent knowledge of the Prepay Transactions, to determine from Enron's financial presentations that such a large amount of operating cash flow was actually the proceeds of borrowings through the Prepay Transactions. Putting aside whether Andersen's judgment as to the materiality of these transactions was appropriate, applicable professional standards reserved for the Audit Committee, in the exercise of its duties, the determination of whether it was appropriate for Enron to be taking these accounting and disclosure risks. When Andersen failed to inform the Audit Committee about the nature

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[99] Email from Benjamin S. Neuhausen, Andersen, to David B. Duncan, Andersen, May 28, 1999, at 1 (the "Neuhausen/Duncan 5/28/99 Email") [ELIB00003903-00001-ELIB00003903-00002].

and magnitude of these risks, Andersen omitted a critical step in the financial disclosure process.

B. Potential Liability

The evidence reviewed by the Examiner is sufficient for a fact-finder to conclude that Andersen breached its professional duty of care and was negligent as to certain portions of the work it performed for Enron. In public statements and testimony, Andersen has acknowledged that it made material accounting and auditing errors. The Examiner has discovered facts that suggest additional acts of negligence beyond those previously acknowledged, including evidence indicating a failure to inquire about facts that were critical to Andersen's understanding of the transactions.

Beyond instances of negligence, there is also evidence from which a fact-finder could conclude that Andersen gave substantial assistance to Enron's officers who breached their fiduciary duties to Enron by causing it to disseminate materially misleading financial information, by:

- providing consultation services with respect to the SPE transactions necessary for Enron's accounting and other financial officers to design and implement the accounting techniques they used to manipulate Enron's reported financial condition, results from operations, cash flow, and MD&A;

- agreeing with Enron's accounting and financial officers that full disclosure regarding the SPE transactions was not necessary despite the requirement that the financial presentations not be materially misleading; and

- failing to ensure that the Audit Committee was informed about the effects of these accounting and disclosure decisions by management and Andersen before the Audit Committee approved Enron's financial statements for issuance to the public.

Based on Andersen's substantial assistance to Enron's accounting and financial officers described above, as well as a clear understanding of the effects of these efforts on Enron's public financial information, a fact-finder could conclude that Andersen had actual knowledge of the breaches of fiduciary duty by these officers. As a result, a fact-finder could conclude that Andersen aided and abetted the officers' breaches of fiduciary duty.

V. SPECIFIC ROLES OF ATTORNEYS AND POTENTIAL LIABILITY

A. Overview

Enron employed over 250 in-house attorneys and retained hundreds of law firms. Certain of these attorneys were involved in providing legal advice and assistance to Enron in the SPE transactions that have been the subject of Prior Reports. Some of these same attorneys advised Enron on disclosures, which the Examiner has concluded in Prior Reports were materially misleading.

B. Outside Law Firms

Vinson & Elkins

Vinson & Elkins was Enron's primary outside law firm. Enron paid fees to Vinson & Elkins of $18.6 million, $26.6 million, $37.8 million, $42.8 million, and $36.4 million in 1997, 1998, 1999, 2000 and 2001, respectively. Vinson & Elkins represented Enron in a wide variety of matters, including approximately sixty-six SPE transactions consummated by the Debtors between 1997 and the Petition Date, many of which have been criticized in Prior Reports. This work included rendering legal opinions in many transactions, including certain FAS 140 Transactions, which opinions were required by Andersen to allow Enron to obtain the accounting treatment that it sought for these transactions. Vinson & Elkins also served as Enron's outside counsel in many of the Related Party Transactions that were discussed in the Second Interim Report. In addition, Vinson & Elkins advised Enron on certain disclosure matters.

The Examiner concludes that there is sufficient evidence fi-om which a fact-finder could determine that Vinson & Elkins committed malpractice based on Texas Rule 1.12, aided and abetted breaches of fiduciary duty by Enron officers, or committed malpractice

based on negligence in connection with several transactions. The events or transactions where such liability may be found include Vinson & Elkins' representation of Enron with respect to:

- The delivery of true issuance opinions in connection with certain FAS 140 Transactions in light of Vinson & Elkins' knowledge that (i) these opinions did not address the critical issues under FAS 140, as Vinson & Elkins understood those issues, (ii) Andersen was using its opinions to support Enron's financial reporting, and (iii) these transactions were significant to Enron's earnings.

- Project Nahanni, a transaction that had no business purpose except to create cash flow from operating activities at year-end 1999 through a loan that was "hardwired"[100] to be repaid within one month after closing.

- The LJM1/Rhythms Hedging Transaction, which was a hedge for financial statement purposes only and lacked any economic substance or rational business purpose, but was intended by certain of Enron's officers to manipulate Enron's financial statements.

- The LJM2/Raptors Hedging Transactions from January 2000 through their restructuring in early 2001, which provided hedges for financial statement purposes only, and lacked any economic substance or rational business purpose, but were intended by certain of Enron's officers to manipulate Enron's financial statements.

- The delivery of a true sale opinion in the Sundance Industrial transaction that enabled Enron to book a $20 million gain, even though Vinson & Elkins knew that there was no valid business purpose for this feature of the transaction and that a valid business purpose was essential to a true sale opinion.

- Enron's related party transaction disclosure for the proxy statement filed in 2001, for which Vinson & Elkins rendered advice regarding the non-disclosure of the amount of Fastow's interest in LJM without knowing the amount of that interest, even though Vinson & Elkins knew that Fastow wanted to prevent the Enron Board from learning how much he was making from the LJM transactions with Enron.

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[100] *See* Third Interim Report, Appendix C (Role of Enron's Officers), at 61-66 (defining "hardwired").

- The Watkins' Investigation, without making full disclosure of Vinson & Elkins' role in the transactions being investigated, including the concerns Vinson & Elkins had about the transactions, some of which were similar to those raised by Watkins.

- The delivery of tax opinions in connection with certain Tax Transactions which enabled Enron to "generate" accounting income from projection of future tax savings.

Andrews & Kurth

Over time, Andrews & Kurth became Enron's firm of choice for its **FAS** 140 Transactions. This work generated fees of $1 million, $2.4 million, $6.7 million, $9.7 million and $9.3 million in 1997, 1998, 1999, 2000 and 2001, respectively. From November 1998 through October 2001, Andrews & Kurth provided legal services to Enron in connection with twenty-eight **FAS** 140 Transactions. Andrews & Kurth assisted Enron with fifteen related transactions whereby Enron caused the initial **FAS** 140 Transaction to be prepaid, thereby unwinding fifteen of the twenty-eight initial **FAS** 140 Transactions. Andrews & Kurth delivered at least twenty-four legal opinions regarding true issuance or true sale and substantive consolidation in the **FAS** 140 Transactions. Andrews & Kurth was concerned about several terms in these transactions that created questions about whether a sale had occurred. In an early transaction, this included concerns about the ability of Enron to prepay at any time and get the asset back.[101] There

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[101] On December 21, 1999, in the midst of closing the Discovery transaction, Andrews & Kurth asked Enron:

> Assuming a buyer is found for the FirstWorld Interests, ENA may desire to unwind the FASB 125 transaction by prepaying the facility during the first two months of 2000. Would prepayment and sale so soon after the FASB 125 sale by ENA jeopardize the FASB 125 treatment of the transaction? Does it matter if ENA *intends* to arrange such a sale and prepay the facility at the time of entering into the FASB 125 transaction?

Memorandum from Mike Blaney and David Grove, Andrews & Kurth, to Project Discovery and Enron Communications FirstWorld Working Groups, regarding Project Discovery Issues List, Dec. 21, 1999, at 2 (12121199 draft) (emphasis in original) [AKED00083764-AKED00083767]. The Examiner has not

is evidence suggesting that Andrews & Kurth knew that these planned early unwinds were a problem for the intended accounting of the transactions both from a legal and an accounting standpoint. For example, an Enron memo that Andrews & Kurth revised at Enron's request states:

> Keep in mind that the Auction-related mechanisms will come into play ONLY if the indebtedness is not prepaid by the Sponsor, which is always Global Finance's planned means of unwind and has been, with one exception I'm aware of, the actual means of unwind. Nonetheless, because this prepayment plan is not memorialized in any deal documentation (and cannot be for financial accounting and legal opinion purposes), these mechanisms still must be analyzed from a tax perspective.[102]

The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Andrews & Kurth committed malpractice based on Texas Rule 1.12, aided and abetted a breach of fiduciary duty or committed malpractice based on negligence in connection with these FAS 140 Transactions. A fact-finder could determine that Andrews & Kurth knew that Enron had no intention to relinquish control over, or the risks and rewards of, the assets transferred in certain of the FAS 140

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discovered any evidence that Andrews & Kurth received an answer to this question. Andrews & Kurth appeared to think that the answer required an accounting judgment, but the question called for a legal conclusion.

[102] Email from Bill Bowes, Enron, to Tom Popplewell, Andrews & Kurth, May 22,2001, at 1 (emphasis in original) [AK 0067236-AK 00672381. Bowes' email to Popplewell stated, "I would appreciate your thoughts and comments on the accuracy of my description. . . ." *Id.* at 1. Popplewell's reply stated: "Here are our comments." Email from Tom Popplewell, Andrews & Kurth, to Bill Bowes, Enron, May 24, 2001, at 1 [AK 0067236-AK 00672381. As early as November 1998, in connection with the first FAS 140 Transaction that Andrews & Kurth handled for Enron, Andrews & Kurth was aware that Enron did not intend to transfer the monetized asset to a third party. "GB [Gareth Bahlmann, former Assistant General Counsel, Enron Global Finance] did not want to mention the auction in the consent. I said this was okay as long as Enron were [sic] absolutely confident that there would never in practice be a sale to a third party. GB said that this was correct . . . ." Memorandum from Danny Sullivan, Andrews & Kurth, to File, regarding Enron/Sarlux, Nov. 19, 1998 [AK 00733311.

Transactions and therefore was engaging in the FAS 140 Transactions to produce materially misleading financial statements.

C. Enron's In-House Attorneys

Derrick

From 1991 until after the Petition Date, James V. Derrick ("Derrick"), a former partner at Vinson & Elkins, served as General Counsel to Enron. Although Derrick attended meetings of the Enron Board, his participation was generally limited to making presentations regarding litigation matters, and it appears that he rarely provided any legal advice to the Enron Board. The Examiner concludes there is sufficient evidence from which a fact-finder could determine that Derrick committed malpractice based on negligence in connection with the performance of his duties as General Counsel of Enron with respect to:

- Derrick's failure to inform himself and then the Enron Board with respect to the Related Party Transactions, or to confirm that those to whom he had delegated the responsibility were taking adequate steps to do so.

- Derrick's failure to become familiar with the facts of the LJM1/Rhythms Hedging Transaction and the conflict of interest issues presented by that transaction and governing law, so as to enable proper execution of his responsibilities as legal advisor to the Enron Board.

- Derrick's failure to inform himself about (i) the content of the "anonymous letters" delivered to Lay in August 2001 or (ii) the extent of Vinson & Elkins' involvement in the transactions criticized by the "anonymous letters," which meant that he was unable to advise Lay properly with respect to the investigation or the propriety of retaining Vinson & Elkins to conduct that investigation.

Rogers

As Associate General Counsel, Rex Rogers ("Rogers") was the in-house lawyer primarily responsible for disclosure in Enron's periodic SEC filings. The Examiner

concludes that there is sufficient evidence from which a fact-finder could determine that Rogers failed to inform himself about the SPE transactions so that he could advise Enron with respect to the related disclosure issues and accordingly, committed malpractice based on negligence. A fact-finder could determine that Rogers committed malpractice based on Texas Rule 1.12 or breached his fiduciary duties, or both, in connection with his failure to inform the Enron Board of the restructuring of the Raptors SPEs in early 2001, which involved, among other things, Enron's infusion of 12 million additional shares of its stock, valued in excess of $600 million.

Mordaunt

Kristina Mordaunt ("Mordaunt") served as a senior in-house attorney within Enron Global Finance and its predecessor on several SPE transactions. The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Mordaunt committed malpractice based on Texas Rule 1.12, committed malpractice based on negligence or breached her fiduciary duties with respect to:

- The Chewco transaction, because she was aware of the conflict of interest created by Kopper's role as general partner of Chewco but did not take steps to analyze the Code of Ethics with respect to his conflict of interest or to inform the Enron Board of the related party nature of the Chewco transaction when it was asked to approve that transaction.

- The LJM1/Rhythms Hedging Transaction, which was a hedge for financial accounting purposes only, lacking any economic substance or rational business purpose, but was intended by certain Enron officers to manipulate Enron's financial statements.

The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Mordaunt committed malpractice and breached her fiduciary duties in connection with her investment of $5,826 in Southampton and her receipt of more than $1 million as a return on that investment without advising Derrick or the Office of the

Chairman of the investment and without receiving the necessary approval as required by the Code of Ethics and rules of professional conduct.

Sefton

Scott Sefton ("Sefton") served as General Counsel of Enron Global Finance for one year, between September 1999 and early October 2000. The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Sefton committed malpractice based on Texas Rule 1.12, committed malpractice based on negligence, or breached his fiduciary duties with respect to:

- Project Nahanni, a transaction that had no business purpose except to create cash flow from operating activities at year-end 1999 through a loan that was "hardwired" to be repaid within one month after closing.

- The LJM2 transactions, where he failed to advise (or make appropriate efforts to have Derrick or another Enron attorney advise) the Enron Board of numerous significant conflict of interest issues relevant to LJM2 matters.

- Two of the four LJM2/Raptors Hedging Transactions, all of which were non-economic hedges, lacking any economic substance or valid business purpose, but which were intended by certain Enron officers to manipulate Enron's financial statements.

Mintz

Jordan Mintz ('Mintz") was Sefton's successor as General Counsel to Enron Global Finance. The Examiner concludes that there is sufficient evidence from which a fact-finder could determine that Mintz committed malpractice based on Texas Rule 1.12, committed malpractice based on negligence or breached his fiduciary duties with respect to:

- Certain matters pertaining to LJM2, including (i) his knowledge that the Enron Audit and Finance Committees had not been informed of Enron's repurchases of certain assets from LJM2 during 2000, (ii) his knowledge that Enron employees (in addition to Fastow) were acting

in furtherance of the interests of LJM2 in a manner contrary to Enron's interests and (iii) his knowledge that Fastow wanted to prevent the Board from learning how much money he was making from the LJM transactions with Enron.

- Enron's related party transaction disclosure in the proxy statement filed in early 2001, and its failure to disclose the amount of Fastow's interest in the LJM transactions.

- Enron's tax indemnity payment to Chewco, demanded by Kopper in the Chewco unwind, despite the fact that Mintz knew the documents as originally drafted did not require that payment.

VI. SPECIFIC ROLES OF LAY, SKILLING AND OUTSIDE DIRECTORS AND POTENTIAL LIABILITY

A. Roles of Lay, Skilling and Outside Directors in Enron's SPE Transactions

During the period 1997 through the Petition Date, Lay and Skilling held the top two officer positions at Enron. Lay was Chairman and CEO, and Skilling was President and COO, and both men served on Enron's Board. For a six-month period, from February through August 2001, Skilling held the position of CEO and Lay continued as Chairman. In August 2001, when Skilling abruptly resigned all his positions with Enron, Lay resumed the role of CEO.

Lay joined the predecessor of Enron in 1984, and Skilling joined Enron in 1990. Both hold advanced degrees: Lay has a Ph.D. in economics, and Skilling received an MBA from Harvard where he was in the top 5% of his class. Together, they led Enron during its steep climb to become the seventh largest public company in America, and, during its dramatic plummet to become, in December 2001, the world's then-largest bankruptcy petitioner.

The Enron Board for the five years from 1997 through 2001 was comprised of between fifteen and nineteen directors, including Lay and Skilling. The Outside Directors[103] included a group of men and women who were highly successful in their

[103] In addition to Lay and Skilling, there were three directors who had other roles at Enron including Rebecca Mark-Jusbasche ("Mark-Jusbasche"), Ken Harrison ("Harrison") and John Urquhart ("Urquhart"). Harrison and Mark-Jusbasche were full-time Enron employees, and Urquhart provided full-time consulting services for Enron for a period of time. For purposes of this Report, however, the term "Outside Directors'; includes all of the members of Enron's Board who served during the period 1997 to the Petition Date other than Lay and Skilling. Although Harrison, Mark-Jusbasche and Urquhart were employed or engaged by Enron, based on the evidence available to the Examiner, their positions with the company were such that they would have had effectively no involvement with the SPE transactions beyond that of the non-officer and non-employee directors.

professional careers. Most had advanced degrees, many held senior leadership positions in U.S. and international businesses, and many served on the boards of other for-profit U.S. corporations. Enron's Outside Directors included, for example, four people who held Ph.D.s and one with an honorary doctorate, two medical doctors who each served as president of one of the world's leading cancer treatment centers, and two law school graduates. The group also included twelve people who had served as CEOs, a Dean of the Stanford University School of Business, a member of Great Britain's House of Lords who served under then Prime Minister Margaret Thatcher, and a former chair of the Commodity Futures Trading Commission.

The evidence available to the Examiner regarding the roles of Lay, Skilling and the Outside Directors in Enron's SPE transactions was limited. Lay submitted to a one-day interview with the Examiner, but Skilling invoked his Fifth Amendment privilege and refused to provide either testimony or an interview. Skilling has provided some sworn testimony to other parties investigating Enron, but Lay has not. None of the Outside Directors invoked a Fifth Amendment privilege in response to the Examiner's request for testimony, but many of the officers at Enron who worked with Lay and Skilling and who attended virtually all of the Board meetings have invoked their Fifth Amendment privileges. Also, with respect to documentary evidence, both Lay and Skilling were infrequent users of email, and they also apparently did not retain many documents. They produced very little relevant written material in response to the Examiner's subpoenas.

Although limited by the lack of sworn testimony from certain key officers, and by the small amount of relevant documents, the evidence is sufficient to show that Lay,

Skilling and the Outside Directors were actively engaged in performing their monitoring functions. Lay and Skilling were hands-on managers involved in the daily operation of Enron's business. The Outside Directors on the Board and its committees were not involved in the day-to-day operations, but they were generally engaged in activities designed to fulfill their supervisory roles.

The evidence shows that, as a result of their day-to-day involvement at the company, Lay and Skilling knew or should have known their subordinate officers misused the SPE transactions in a manner that resulted in the dissemination of materially misleading financial information. Both Lay and Skilling failed to respond to indications of potential problems related to the use of SPE transactions. For example, Lay and Skilling apparently ignored repeated inclusions of the Prepay Transactions on interest rate exposure charts presented by Fastow, even though, as Lay admitted in his interview with the Examiner, a prepay that was a commodity transaction would not cause Enron to have interest rate exposure. Had Lay and Skilling inquired as to why the Prepay Transactions were included on those charts, they may have been told that Enron was engaging in circular Prepay Transactions that were substantively debt, with no disclosure of that fact in the company's published financial statements. There were similar indications of problems with other SPE transactions.

With respect to the SPE transactions that Enron entered into with LJM1 and LJM2, entities in which Fastow had a personal interest and fi-om which he received substantial compensation, there is evidence that Skilling ignored red flags regarding the

lack of arm's length negotiation of those transactions and regarding Fastow's compensation.[104]

The Outside Directors, however, may not have recognized the same red flags regarding the SPE transactions as indicators of the wrongful conduct of the senior officers. They did not have the intimate knowledge of Enron's day-to-day operations that Lay and Skilling shared. In addition, although Enron officers often provided voluminous information to the Outside Directors, helping the Outside Directors understand fully the financial activities at Enron apparently was not a high priority for Enron management. The officers often presented information to the Board and its committees in ways that obfuscated the facts, and there are several instances of apparent intentional misrepresentations by officers.

The Outside Directors, however, together with Lay and Skilling, authorized Enron to enter into the LJM1/Rhythms Hedging Transaction and certain of the LJM2/Raptors Hedging Transactions, none of which had a rational business purpose. In these transactions, Enron transferred substantial value for non-economic hedges, meaning the value of each hedge to Enron was based solely on the value of securities and cash that Enron itself had transferred to the hedging vehicles, providing Enron no economic value but only a financial statement benefit. There is evidence that Lay, Skilling and the Outside Directors were in possession of facts necessary to conclude that the transactions lacked a rational business purpose before approving the transactions.

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[104] There is also evidence that in connection with a transaction called Chewco, Skilling failed to disclose to the Board that an Enron employee, Kopper, was involved, which might have been a material fact to the Board because it created a conflict of interest. Thus, there is evidence that Skilling breached his duty of candor. *See* Report, Appendix *D* (Roles of Lay, Skilling and Outside Directors), ***Actions of Lay, Skilling and Outside Directors Regarding SPE Transactions – Duty of Candor.***

B. Potential Liability

The evidence available to the Examiner regarding the roles of Lay and Skilling in Enron's SPE transactions, and the reasonable inferences that may be drawn from such evidence, is sufficient for a fact-finder to conclude that Lay and Skilling knew or should have known that the senior officers were misusing the SPE transactions to disseminate materially misleading financial information. Thus, the evidence and the reasonable inferences that may be drawn therefrom are sufficient for a fact-finder to conclude that Lay and Skilling, as officers, were at least negligent in fulfilling their duty of oversight. Lay and Skilling, acting in their capacities as officers of Enron, are not entitled to exculpation fiom liability for their breach of fiduciary duty.

The Outside Directors, because they had less knowledge of and involvement in Enron's day-to-day operations, may not have recognized the same red flags regarding the SPE transactions as indicators of the wrongful conduct of the senior officers. Although the Outside Directors may properly be criticized for failing to inquire about aspects of Enron's financing activities that might have led them to more knowledge of the senior officers' wrongful conduct, the evidence does not support a conclusion that the Outside Directors failed to act in good faith, or acted with a conscious disregard for known risks, in failing to recognize and respond to red flags. Thus, based on the evidence available to the Examiner, and the reasonable inferences that may be drawn fiom such evidence, the Examiner cannot conclude that there is sufficient evidence fiom which a fact-finder could conclude that the Outside Directors failed to fulfill their duty of oversight.

Lay, Skilling and the Outside Directors, however, approved the LJM1/Rhythms Hedging Transaction and certain LJM2/Raptors Hedging Transactions. None of those

transactions had a rational business purpose, which means the approval decisions are not protected from judicial scrutiny by the business judgment rule. There is evidence that Lay, Skilling and the Outside Directors were in possession of facts necessary to conclude that the transactions lacked a rational business purpose and that they acted in bad faith in approving the transactions. Thus, the evidence, and the reasonable inferences that may be drawn from such evidence, is sufficient for a fact-finder to conclude that Lay, Skilling and the Outside Directors breached their fiduciary duty of good faith in approving the LJM1/Rhythms Hedging Transaction and certain LJM2/Raptors Hedging Transactions. Enron's director exculpation provision does not protect a director from liability for actions not taken in good faith.

C. Lay's and Skilling's Use of Enron Stock to Repay Corporate Loans

Between May 1999 and October 2001, Lay repeatedly borrowed the full amount of his $4 million Enron line of credit and repaid it with shares of his Enron stock. In total, he borrowed and repaid with stock over $94 million. Skilling had a $4 million term loan from Enron, and in May 1999, he repaid $2 million of that amount with shares of his Enron stock. The Compensation and Management Development Committee (the "Compensation Committee") of the Board granted each officer the right to make the repayments with stock, but Enron's Board apparently never approved the repayments or ratified the approval granted by the Compensation Committee.[105] It does not appear that

[105] Outside Director John Duncan testified about a conversation he had with Lay after the Petition Date, after he had learned about Lay's use of the line of credit:

> Now I get a call from Ken Lay. And how are you doing? I said not – something like, Not doing too well.
>
> And why?
>
> And I said, The magnitude of the trades of stock against your credit.

any of the Outside Directors were aware of Lay's repeated borrowings and repayments, or the substantial aggregate amount that Lay borrowed and repaid, until the fall of 2001.

As described in Annex 1 to Appendix D (Roles of Lay, Skilling and Outside Directors) to this Report, the Compensation Committee did not have authority under Oregon law to approve the repayments of these loans with Enron stock, which were effectively the same as Enron repurchasing the shares. Because the Board apparently neither approved nor ratified the approval of the repayments by Lay and Skilling, such repayments are voidable at the election of Enron. Upon such event: (i) Enron would return to Lay 2,131,282 shares of common stock, and Lay would be liable to repay loans in the amount of $94,267,163, plus any applicable interest; and (ii) Enron would return to Skilling 26,425 shares of common stock, and Skilling would be liable to repay his loan in the amount of $2,000,042, plus any applicable interest.

> And he said, Well, something like you know, my contract permitted that.
>
> And I said, Ken, in the nuances of life, I don't think any lawyer's been born that can write all the variables, so even if your contract said that, do you think in your wildest dreams that the compensation committee would have approved that loan if you would have said what you could do with it and maybe would do with it?
>
> Then I added, Especially in the light of the company finding out it's [sic] in financial trouble, and may be aiming for bankruptcy?
>
> And his reply was: Bankruptcy is not in the contract.
>
> And the conversation was over, because there wasn't too much to talk about at that point.

Sworn Statement of John H. Duncan, former Director, Enron, to John L. Latham, A&B, Nov. 26, 2002, at 90.

VII. ROLE OF FINANCIAL INSTITUTIONS IN ENRON'S SPE TRANSACTIONS AND THEORIES OF LIABILITY

A. Theories of Potential Liability

In this Report, the Examiner analyzes the participation of three Financial Institutions in Enron's SPE transactions and measures each Financial Institution's conduct against two legal theories:

- *Aiding and abetting a breach of fiduciary duty* – whether there is sufficient evidence for a fact-finder to conclude that a Financial Institution aided and abetted wrongful conduct of Enron's officers that constituted a breach of fiduciary duty such that the Financial Institution may be liable for damages to Enron, assuming Enron has standing to pursue such a claim; and

- *Equitable subordination* – whether there is sufficient evidence for a court to conclude that the claims of that Financial Institution should be equitably subordinated to the claims of other creditors.

Aiding and Abetting

For a Financial Institution to be liable for aiding and abetting, a fact-finder must first determine that there has been a breach of fiduciary duty by one or more Enron officers. If the fact-finder concludes there has been such a breach, the fact-finder may then conclude that a Financial Institution is liable to Enron for aiding and abetting such a breach if the evidence shows that: (i) the Financial Institution had *actual knowledge* of the wrongful conduct giving rise to the breach; (ii) the Financial Institution gave *substantial assistance* to the wrongdoer; and (iii) injury to the Debtors was the direct or reasonably foreseeable result of such conduct. While there is some authority to the contrary, the actual knowledge standard is strict – "should have known" or "suspicion" will not suffice. Also, "routine" services provided by a Financial Institution will not constitute substantial assistance. With regard to injury to the Debtors, a fact-finder could

conclude that Enron suffered damages as a result of the officers' improper use of the SPE transactions, consisting of, among other things, the cost of governmental investigations, the administrative costs of a bankruptcy proceeding and other losses caused by Enron's "deepening insolvency."[106]

Equitable Subordination

A Financial Institution's claims filed in the Bankruptcy Case may be equitably subordinated to the payment of other claims filed in the case if (i) the Financial Institution engaged in inequitable conduct and (ii) that conduct resulted in harm to other creditors. In the case of creditors that are not insiders or fiduciaries of the debtor, the standard of inequitable conduct is high and has been said to require a breach of a recognized duty. Several cases stand for the proposition that a creditor's participation in the debtor's misrepresentation of its financial condition to other creditors may constitute inequitable conduct that will justify the equitable subordination of the creditor's claim.[107]

If a Financial Institution engaged in inequitable conduct by participating in Enron's misrepresentation of its financial condition, a court could conclude that other creditors were injured by this conduct because they relied on this information in extending (or continuing to extend) credit to Enron.

B. <u>Potential Defenses to Aiding and Abetting Claims and Equitable Subordination</u>

In assessing whether a fact-finder could determine that a Financial Institution has any liability under an aiding and abetting theory or should have its claims equitably

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[106] See Third Interim Report, Appendix B (Legal Standards), at 75-78.

[107] Id. at 85-95.

subordinated, the Examiner has considered defenses available to the Financial Institutions. The Examiner has considered potential defenses to equitable subordination by reference to the elements of aiding and abetting. The facts and circumstances surrounding each Financial Institution's potential liability must be considered independently, and Appendices E through G to this Report analyze these issues in more detail. The Examiner has reviewed a substantial amount of evidence, including documentary and testimonial evidence, and has noted the reasonable inferences that could be drawn from the evidence. A fact-finder may draw alternative or contrary inferences from the same evidence. Whether a Financial Institution will succeed on one or more defenses to any of these causes of action will depend upon the fact-finder's resolution of the facts.

Parts B and C of Section IV of the Third Interim Report set forth a discussion of the various defenses available to the financial institutions reported on in the Third Interim Report.[108] All of those defenses, including those based on the wrongful conduct of Enron's officers, such as standing issues and *in pari delicto* defenses,[109] would be available to the Financial Institutions.

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[108] **Third Interim Report, at 36-50.**

[109] **Third Interim Report, Appendix B (Legal Standards), at 54-79.**

VIII. SPECIFIC ROLES OF FINANCIAL INSTITUTIONS AND POTENTIAL LIABILITY

A. RBS

RBS and its predecessor, National Westminster Plc ("NatWest"), had extensive dealings with Enron prior to RBS's takeover of NatWest in March 2000. Prior to the takeover, NatWest was one of Enron's Tier 1 banks. After the March 2000 takeover, RBS became a Tier 1 bank, and the merged bank continued to work closely with Enron until the Petition Date. NatWest and RBS participated in Enron transactions known as:

- the LJM1/Rhythms Hedging Transaction;[110]
- the Sutton Bridge FAS 140 Transaction;
- the ETOL I, II and III FAS 140 Transactions; and
- the Nixon Prepay Transaction.

Examiner's Conclusions

As set forth in Appendix C (Role of Enron's Officers) to the Third Interim Report, the Examiner has concluded that there is sufficient evidence for a fact-finder to determine that certain of Enron's officers breached their fiduciary duties by causing the Debtors to enter into the LJM1/Rhythms Hedging Transaction and certain other SPE transactions, including the RBS FAS 140 Transactions and the Nixon Prepay Transaction, that were designed to manipulate the Debtors' financial statements and resulted in the dissemination of financial information they knew to be materially misleading. In addition, the LJM1/Rhythms Hedging Transaction and other transactions

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[110] In addition to the LJM1/Rhythms Hedging Transaction, RBS assisted certain Enron officers with other transactions involving LJM1 and affiliated entities.

relating thereto present facts sufficient to support the conclusion that Fastow and other Enron officers engaged in self-dealing in violation of their duty of loyalty.

In Appendix E (Role of RBS and its Affiliates), the Examiner discusses RBS's involvement in the SPE transactions. The Examiner concludes that there is evidence that: (i) RBS had actual knowledge of the wrongful conduct in these transactions giving rise to the breaches of fiduciary duties; (ii) RBS gave substantial assistance to certain of the Debtors' officers by participating in the transactions; and (iii) injury to the Debtors was the direct or reasonably foreseeable result of such conduct. This evidence is sufficient for a fact-finder to conclude that RBS aided and abetted certain of the Debtors' officers in breaching their fiduciary duties. In addition, there is sufficient evidence of inequitable conduct that RBS's claims, totaling approximately $537 million, may be equitably subordinated to the claims of other creditors.

The Examiner's findings are based upon a review of testimony and documentary evidence that is set forth in Appendix E (Role of RBS and its Affiliates), which the reader should review for a more complete understanding. Transactions considered by the Examiner in which RBS participated include the following:

The LJM1/Rhythms Hedging Transaction. A fact-finder could conclude that RBS's conduct in the formation and funding of LJM1 assisted Enron in the formation of the LJM1/Rhythms Hedging Transaction, through which Enron inappropriately recognized $95 million of income in 1999, representing 10.6% of its originally reported net income for that year. A fact-finder could also conclude that RBS's conduct in the LJM1/Rhythms Hedging Transaction and other transactions related thereto enabled Fastow improperly to enrich himself and other Enron officers in violation of their

fiduciary duties to Enron. The evidence would allow a fact-finder to conclude that RBS, as a result of the restructuring of LJM1, including a series of Total Return Swaps between RBS and American International Group ("AIG), assisted Fastow in investing and profiting from approximately $25 million, which circumvented (i) restrictions in the LJMl partnership agreement, (ii) Fastow's representations to the Enron Board and (iii) transfer and hedging restrictions placed on the Enron shares transferred to LJMl upon which PricewaterhouseCoopers LLP ("PWC") relied in issuing its fairness opinion in connection with the formation of LJM1.

Fastow formed LJM1, with the approval of the Enron Board, to engage in transactions with Enron, including the LJM1/Rhythms Hedging Transaction. Fastow, as the owner of the general partner of LJM1, controlled LJM1, and RBS and CSFB, through their affiliates, were the only limited partners.[111] The RBS affiliate purchased its partnership interest for $7.5 million (the same price paid by CSFB's affiliate for its partnership interest) and Fastow contributed $1 million, for total capital contributions of $16 million.

Enron transferred to LJM1 6,755,394 shares of Enron stock, with an aggregate stock price of $276 million, in exchange for the LJM1/Rhythms Hedging Transaction and two promissory notes totaling $64 million.

The Enron Board approved the LJM1/Rhythms Hedging Transaction with the understanding that Fastow could not profit from or have any direct pecuniary interest in the Enron stock held by LJM1. Instead, Fastow could only profit from the capital contributions from LJM1's partners and proceeds from LJM1's other investments. In

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[111] *See* Second Interim Report, Appendix L (Related Party Tranasctions).

addition, the Enron Board understood that a fairness opinion would be obtained with respect to the consideration received by Enron in exchange for the Enron stock. A fairness opinion was obtained from PWC, but only after hedging and transfer restrictions were placed on the Enron stock transferred to LJM1, thereby permitting Enron to assign a value to the stock that was significantly below its aggregate stock price.

When Enron first presented RBS with the opportunity to participate in LJM1, a senior RBS manager who was the lead banker on the proposed transaction, characterized it as follows:

> The fact is that a two bit LLC called Martin [the original name for LJM1], owned by a couple of Enron employees, will all of a sudden be **gifted** $220m of Enron stock. It could never bother about the borrowing base, sell the stock in the market, pack up [its] bag and disappear off to Rio. If you owned it, wouldn't you? Now I'm beginning to understand why these guys are so keen to get in on it. . . .
>
> What am I missing???????
>
> There needs to be consideration given to the Enron group.[112]

KPMG Audit Plc, engaged by RBS to analyze the bank's internal accounting for the transaction, noted that:

> the nature of the transaction is highly unusual. The role of the CFO of Enron and the use of its own shares, raises significant concerns as to the potential reputational risk to the bank if the transaction is not disclosed appropriately by Enron or shareholders claim to have been disadvantaged.[113]

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[112] Email from David Bermingham, RBS, to Kevin Howard and Mike Ellison, RBS, May 28, 1999 (emphasis in original) [RBS 40164101. Ironically, Bermingham ultimately was indicted and charged with wire fraud for his role in allegedly improperly profiting from LJM1 and allegedly is evading authorities. Indictment, United States v. Bermingham, Cr. No. H-02-0597 (S.D. Tex. filed June 27, 2002) (the "RBS Bankers Indictment"); see also Criminal Docket, United States v. Bermingham, No. 02-CR-0597-ALL (S.D. Tex. filed June 27,2002) (claiming David Bermingham is a "fugitive").

[113] Letter from Iain Cummings, KPMG Audit Plc, to Chris Learmonth, RBS, et al., June 23, 1999 (the "KPMG Letter, June 23, 1999"), at RBS 3030570 [RBS 3030569-RBS 30305701; see also Memorandum from P.E. Commons, Head of Credit Risk, RBS, to William Martin, Group Risk Director, RBS, regarding

Besides the prohibition against Fastow sharing in any value fiom the transferred Enron stock, the hedging and transfer restrictions on the Enron shares transferred to LJMl were set forth in a "lock-up agreement." RBS took actions that circumvented these restrictions and, as a result, generated substantial profits for each of the partners, including Fastow. It did so through the Total Return Swaps with AIG, despite recognizing that the effect of the Total Return Swaps was to produce results counter to the conditions upon which LJMl was approved. RBS noted in internal correspondence that a competing CSFB proposal was aimed at providing Fastow with "[l]iquidity of (net) $66m, which is entirely windfall (it was NEVER the intention in the original deal)."[114]

While continuing to derive substantial profits fiom its interest in LJM1, RBS in March 2000 sold its interest in a subsidiary of LJMl to a number of Enron insiders. The sale allegedly was planned by Fastow, Kopper and three RBS bankers and timed so as to allow these and other insiders to profit personally fiom an imminent termination fee to be paid by Enron to the LJMl subsidiary. RBS did not, however, receive the full sale price of $20 million that Enron was told would be paid to RBS for its interest in the subsidiary. Instead, RBS received $1 million because its three key bankers on the transaction allegedly siphoned off the remaining $19 million of the represented purchase price for themselves personally, Fastow, Kopper and the other Enron insiders who were invited to contribute to the purchase of the subsidiary.[115]

Project LJM, June 29, 1999 (the "Project LJM Memorandum"), at RBS 3030461 [RBS 3030461-RBS 30304631.

[114] Email fiom David Bermingham, RBS, to Kevin Howard, *et al.*, RBS, Aug. 6, 1999, at RBS 4016350 (emphasis in original) [RBS 4016350-RBS 4016351].

[115] See RBS Bankers Indictment.

RBS profited considerably from its participation in LJM1. One of the means by which it did so was by completing the Total Return Swaps with AIG. It also profited through receipt of distributions declared by Fastow and through proceeds of Enron's repurchase (at a premium) from LJM1 of its interest in a Brazilian electric generation facility. On August 31, 2001, with no assets remaining in LJM1, RBS calculated that it had received in the aggregate from the LJM1 transactions, "a total return on our $7.5m investment of approx [sic] $22.7m or in excess of 1200% IRR. This is a most satisfactory result and underlines the way Enron supports its Tier 1 banks."'[16]

The FAS 140 Transactions. RBS repeatedly received verbal assurances from top Enron officials, including Fastow, of repayment of the bank's equity investment in each of the FAS 140 Transactions.[117] RBS understood this equity needed to be "at risk" and understood that these verbal assurances could neither be "formally documented for accounting reasons"[118] nor publicly disclosed[119] if Enron was to derive the accounting

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[116] Email from Kevin Howard, RBS, to Iain Robertson, *et* al., RBS, Aug. 31, 2001, at RBS 6021378 [RBS 6021378-RBS 60213791.

[117] Credit Application, Sept. 18, 2000 (the "ETOL I Credit Application"), at RBS 3141124 and RBS 3141129-RBS 3141130 [RBS 3141118-RBS 3141165]; Credit Recommendation by Chris Clarke, Senior Manager, RBS, Sept. 19, 2000 (the "ETOL I Credit Recommendation"), at RBS 3141116 [RBS 3141115-RBS 3141117]; Memorandum from Konrad Kruger, Chief Executive, *et* al., Greenwich NatWest, regarding Enron Sutton Bridge Ltd., undated, at RBS 3038535 (referencing the handwritten comments) [RBS 3038532-RBS 30385351; RBS CBFM Credit Committee Minutes, Sept. 20, 2000 (the "CBFM Credit Committee Minutes, Sept. 2000"), at RBS 3121434 [RBS 3121434-RBS 31214361; RBS Group Credit Committee Minutes, Sept. 22,2000 (the "Group Credit Committee Minutes, Sept. 2000"), at RBS 3121150 [RBS 3121150-RBS 3121151]; Credit Application, Mar. 15, 2001, at RBS 3124939 [RBS 3124926-RBS 31249491; Credit Recommendation by Chris Clarke, Senior Manager, RBS, Mar. 16, 2001, at RBS 3124953 [RBS 3124952-RBS 31249531; RBS Group Credit Committee Minutes, Mar. 20, 2001, at RBS 3120874 [RBS 3120874-RBS 31208751.

[118] ETOL I Credit Recommendation, at RBS 3141116 ("We are therefore looking to verbal undertakings (they cannot be formally documented for accounting reasons) from Enron that they will ensure that RBS is kept whole through the exit strategy.").

[119] ETOL I Credit Application, at RBS 3141124; ETOL I Credit Recommendation, at RBS 3141116; The Royal Bank of Scotland: Proposed Transaction with Enron, Author unknown, undated, at 1 [RBS 3104222-RBS 31042261; *see* also Sworn Statement of Susan Milton, Director, RBS, to John E. Stephenson, Jr., A&B, Sept. 9,2003, at 73, lines 7-13, and at 163, lines 22-25.

benefits that it sought from these transactions. RBS also knew that Enron booked accounting gains not permitted in view of the existence of such assurances.[120] In each of the FAS 140 Transactions, RBS placed "significant reliance" on Enron's verbal assurance to "make the Bank whole" regardless of the cash generated by the underlying asset in the transaction.[121] RBS did not disclose the existence of these verbal assurances of repayment of the equity plus stated yield, which RBS referred to as its "required return," to any third party. Within the bank, however, RBS officials characterized the FAS 140 structure through which RBS facilitated Enron's booking of purported gains on sales and cash flow from operations as "21st Century Alchemy."[122]

*Nixon **Prepay**.* The Nixon Prepay, which also involved Citigroup, Barclays and Toronto Dominion (as a conduit between each of the three other banks and Enron), provided Enron with $110 million of funding from RBS in December 1999, which Enron improperly recorded as cash flow from operating activities. The RBS credit committees were informed by an RBS senior research analyst that the proposed transaction was "effectively a window dressing request" that Enron would employ "to reduce [its] reported year-end net debt position."[123] RBS also recognized that the transaction's "whole structure [was] set up to remove the commodity risk for all parties, [so] all

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[120] Memorandum from Nicola Goss, RBS, to Peter Whitby, RBS, *et* al., regarding ETOL equity purchase, Sept. 6,2000, at RBS 3141015 [RBS 3141015-RBS 31410171; Memorandum from Janis Wallis, Associate Director, RBS, regarding ETOL, Sept. 26,2001, at RBS 3089524 [RBS 3089524-RBS 30895271; ETOL I Credit Application, at RBS 3141124; Memorandum from Nicola Goss, Associate Director, Project and Export Finance, RBS, to Iain S. Robertson, *et* al., RBS, regarding additional ETOL funding, Mar. 1, 2001, at RBS 3141241 [RBS 3141241-RBS 31412431; *see* also Email from Chris Clarke, Senior Manager, Structured & Specialised Credit, RBS, to Thomas Hardy, *et al.*, RBS, Mar. 9,2001 [RBS 31412451.

[121] CBFM Credit Committee Minutes, Sept. 2000, at RBS 3120874.

[122] Group Credit Committee Minutes, Sept. 2000, at RBS 3121150.

[123] ARD Memorandum from A.W. McAlister, Senior Analyst, RBS, Dec. 6, 1999 (the "ARD Memorandum, Dec. 6, 1999"), at RBS 3118972 [RBS 3118972-RBS 31189731.

payments against commodity price moves are exactly off-set by receipts fiom the party on the other side."[124] Indeed, RBS personnel believed that the Nixon Prepay "raise[d] issues over the absolute level of manipulation undertaken by Enron in its financial statements."[125] RBS understood that Enron accounted for proceeds fiom transactions such as the Nixon Prepay as cash flow fiom operating activities.[126] RBS nonetheless provided Enron with the funding that it sought, then extended the maturity date at Enron's request, having internally noted in connection with another Enron transaction in the same time period that "[b]ecause this is balance sheet management, it pays better than straight Enron corporate risk."[127] RBS agreed to the extension of the Nixon Prepay maturity date despite an internal credit analysis at the time of the proposed extension that reflected increasing alarm regarding "financial period manipulation" by Enron:

> [t]he scale of financial period manipulation [by Enron] is exceedingly worrying and I don't yet understand it, nor am I sure that anyone in the bank does. . . . Such concern has been a theme of all our discussions for a while. We have twice increased exposure since doing this deal, [including] another manipulation when we joined in the JM Trust [i.e., Ghost] 18 month bridge. . . .
>
> I can see from a relationship/business perspective that there is a temptation to write another income generating transaction on the basis of the comfort we are drawing from it being very short term, but the concern must obviously be that if lots of counterparties are doing this then any bad news (or shortage for whatever reason of counterparty capacity) will cut refinance ability dramatically and/or end Enron's ability to manipulate

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124 Application for Facilities Requiring Credit Committee/Board Approval, Dec. 6, 1999, at RBS 3118966 [RBS 3118960-RBS 3118984].

125 ARD Memorandum, Dec. 6, 1999, at RBS 3118973.

126 Email from Wilson McAlister, RBS, to Derek Weir, et al., RBS, Feb. 1, 2000, at 1 ("Other income includes unrealised gains and losses from price risk management activities . . . . These activities are reported as part of operational cash flow, boosting the reported position by $550M over the last two years . . . and representing 30% of reported operating cash flow in that period.") [RBS 3112211-RBS 3112213].

127 Email from Derek Weir, RBS, to Alan Dickinson, RBS, and copy to Brian McInnes, Relationship Manager, RBS, etal., Jan. 31,1999, at RBS 3112212 [RBS 3112211-RBS 31122131.

> thus leading to a horrendous on-balance sheet position which would further exacerbate the position. The question is when do we stop . . . .[128]

B. CSFB

CSFB was one of Enron's most valued investment banks and by mid-1999 consistently achieved Tier 1 status. CSFB regarded Enron as "one of [its] top accounts, if not the number one relationship."[129] Enron paid CSFB more in fees in 1999 – over *$23* million – than any other of its Tier 1 banks.[130] In early 2001, Enron rated CSFB its "Best Bank" in North America, and recognized, in particular, CSFB's strength in debt capital markets.[131]

CSFB played important roles in several of Enron's SPE transactions, including the following:

- the LJM1/Rhythms Hedging Transaction;[132]
- the CSFB Prepay Transaction; and
- the Nile FAS 140 Transaction.

Examiner's Conclusions

As set forth in Appendix C (Role of Enron's Officers) to the Third Interim Report, the Examiner has concluded that there is sufficient evidence for a fact-finder to

[128] Email from Alex Sinclair, RBS, to Brian McInnes, et al., RBS, Mar. 10,2000 [RBS 31188621.

[129] Email from James Moran, Director, CSFB, to Geoff Smailes, CSFB, Dec. 14, 2000 [CSFBCO 000044034]; see also Memorandum from James Moran, Director, CSFB, to David Maletta, Managing Director, and Ed Devine, Managing Director, CSFB, Dec. 11,2000, at 3 (describing Enron as a "Priority 1 client") [CSFBCO 000044755-CSFBCO000044758]; Sworn Statement of Osmar Abib, Managing Director, CSFB, to Frank G. Smith, A&B, May 6-7, 2003, at 299, lines 18-19 ("Enron was a priority one client.").

[130] Enron Relationship Review January 2000, at AB000538544 [AB000538536-AB000538624].

[131] Enron Debt Investor Relationship Review Highlights January 2001, at AB0911 1958, AB0911 1962 [AB0911 1956-ABO911 19641.

[132] In addition to the LJM1/Rhythms Hedging Transaction, CSFB assisted certain Enron officers with other transactions involving LJM1 and affiliated entities.

determine that certain of Enron's officers breached their fiduciary duties by causing the Debtors to enter into the LJM1/Rhythms Hedging Transaction and certain other SPE transactions that were designed to manipulate the Debtors' financial statements and resulted in the dissemination of financial information that such officers knew to be materially misleading. In addition, the LJM1/Rhythms Hedging Transaction and other transactions related thereto present facts sufficient to support the conclusion that Fastow and other Enron officers engaged in self-dealing in violation of their duty of loyalty.

In Appendix F (Role of CSFB and its Affiliates), the Examiner discusses CSFB's involvement in the SPE transactions. The Examiner concludes that there is evidence that: (i) CSFB had actual knowledge of the wrongful conduct in these transactions giving rise to the breaches of fiduciary duties by certain Enron officers; (ii) CSFB gave substantial assistance to certain of the Debtors' officers by participating in the transactions; and (iii) injury to the Debtors was the direct or reasonably foreseeable result of such conduct. This evidence is sufficient for a fact-finder to conclude that CSFB aided and abetted certain of the Debtors' officers in breaching their fiduciary duties. In addition, there is sufficient evidence of inequitable conduct that CSFB's claims, totaling at least $417 million, may be equitably subordinated to the claims of other creditors.

The Examiner's findings are based upon a review of testimony and documentary evidence that is set forth in Appendix F (Role of CSFB and its Affiliates), which the reader should review for a more complete understanding. Transactions considered by the Examiner in which CSFB participated include the following:

The LJM1/Rhythms Hedging Transaction. **A** fact-finder could conclude that CSFB's conduct in the formation and funding of LJM1 assisted Enron in entering into the

LJM1/Rhythms Hedging Transaction, described above in connection with RBS's participation in that transaction, and through which Enron inappropriately recognized $95 million of income in 1999 (10.6% of its originally reported net income for that year). A fact-finder could also conclude that CSFB's conduct in the LJM1/Rhythms Hedging Transaction and other transactions related thereto enabled Fastow improperly to enrich himself and other Enron officers in violation of their fiduciary duties to Enron.

For example, through a transaction known as the SAILS transaction, CSFB effectively monetized its interest in the Enron shares held by LJMl and then contributed $45.1 million in cash to LJM1. The parties treated the proceeds of the transaction as an additional capital contribution to LJM1, from which Fastow could profit, rather than proceeds resulting from the Enron stock, from which he could not profit, pursuant to representations made to the Enron Board in connection with its approval of LJM1. LJMl's other limited partner made a similar contribution. A fact-finder could conclude that, as a result of these transactions, an additional $25 million was contributed to LJMl and recharacterized by the parties so that Fastow could profit directly from these funds. CSFB was aware of this restriction on Fastow's ability to profit fiom the Enron stock because certain terms of LJMl's Partnership Agreement, to which CSFB's affiliate was a party, provided that distributions and allocations with respect to the shares of Enron stock transferred to LJMl were to be made only to the limited partners and not the general partner.

From LJMl's formation in June 1999 through its dissolution just over two years later in October 2001, CSFB received distributions and other payments on its LJMl investment in excess of $38 million.

CSFB Prepay. ***In*** the CSFB Prepay Transaction, CSFB loaned funds to Enron in the amount of $150 million. As in other Prepays, and as acknowledged by a CSFB employee at the time, the transaction was "an obvious loan transaction,"[133] which Enron accounted for as a commodity transaction. As Enron officers were aware, a $150 million Prepay Transaction would enable Enron to improperly record $150 million of cash flows from operating activities and understate the debt by the same amount on its December 31, 2000 balance sheet. The evidence would allow a fact-finder to conclude that CSFB assisted Enron in completing the CSFB Prepay Transaction, even though CSFB knew that Enron's accounting for this transaction, with no other meaningful related disclosure, would contribute to materially misleading financial presentation.

FAS 140 Transactions. CSFB also funded a FAS 140 Transaction known as Nile in the aggregate amount of $25 million. The Nile transaction monetized shares of common stock in an Enron subsidiary called ServiceCo Holdings, Inc. CSFB funded the debt portion of the transaction and provided the 3% equity necessary for Enron to take the position that it was not required to include that debt on its balance sheet. CSFB's equity investment was, however, supported by Enron's agreement to repurchase the equity at par, thereby precluding the accounting treatment that Enron adopted. As reflected in a contemporaneous internal CSFB memorandum, Enron's agreement resulted in CSFB's credit risk on its equity investment in Nile being "100% Enron via put."[134]

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[133] Email from Ian Emmett, CSFB, to Steven Wootton, Director, CSFB, Dec. 12, 2000 ("Is it ok for us to be entering into such an 'obvious' loan transaction?") [AB0507 000641.

[134] Memorandum fiom Brian McCabe, Vice President, David Koczan, Assistant Vice President, and James Moran, Director, CSFB, *et al.,* to Robert O'Brien, Chief Credit Officer, David Maletta, Managing Director, and Ed Devine, Managing Director, CSFB, Sept. 24, 2001, at 5 [CSFBCO 000043589-CSFBCO 000043609].

C. **Toronto Dominion**

Although it engaged in a variety of transactions with Enron, ranging from traditional commercial loans to underwritings, Toronto Dominion's most prominent role was in Enron's Prepay Transactions. From December 1998 through December 2000, Toronto Dominion participated in six Prepay Transactions with Enron, with total proceeds of approximately $2 billion.

Examiner's Conclusions

As set forth in Appendix C (Role of Enron's Officers) to the Third Interim Report, the Examiner has concluded that there is sufficient evidence for a fact-finder to determine that certain of Enron's officers breached their fiduciary duties when they caused the Debtors to enter into certain SPE and related transactions, including the Prepay Transactions, that were designed to manipulate the Debtors' financial statements and that resulted in the dissemination of financial information such officers knew to be materially misleading.

In Appendix G (Role of Toronto Dominion and its Affiliates), the Examiner discusses Toronto Dominion's involvement in the Prepay Transactions. The Examiner concludes that there is evidence that: (i) Toronto Dominion had actual knowledge of the wrongful conduct in connection with these transactions giving rise to the breaches of fiduciary duty by certain Enron officers; (ii) Toronto Dominion gave substantial assistance to certain of the Debtors' officers by participating in such transactions; and (iii) injury to the Debtors was the direct or reasonably foreseeable result of such conduct. This evidence is sufficient for a fact-finder to conclude that Toronto Dominion aided and abetted certain of the Debtors' officers in breaching their fiduciary duties. In addition,

there is sufficient evidence of inequitable conduct such that Toronto Dominion's claims, totaling approximately $57.8 million, may be equitably subordinated to the claims of other creditors.

The Examiner's conclusions are based upon a review of testimony and documentary evidence that is set forth in Appendix G (Role of Toronto Dominion and its Affiliates), which the reader should review for a more complete understanding. Transactions considered by the Examiner include the following:

Prepay Transactions. The six Prepay Transactions that Toronto Dominion completed with Enron between December 1998 and December 2000 (the "Toronto Dominion Prepays") totaled approximately $2 billion. Toronto Dominion knew that Enron did not transfer any commodity or any associated price risk in the Toronto Dominion Prepays and that the transactions were effectively debt. Toronto Dominion also knew that Enron did not report the Toronto Dominion Prepays as debt. Evidence exists from which a fact-finder could conclude that Toronto Dominion understood Enron reported the proceeds fi-om the Toronto Dominion Prepays as cash flow from operating activities. Finally, Toronto Dominion knew that Enron's accounting for the Toronto Dominion Prepays, with no disclosure in the financial statement footnotes or MD&A, did not provide an investor with any understanding of the amount of Enron's repayment obligations or the terms of such obligations.

Toronto Dominion was concerned that Enron used these transactions to manipulate its balance sheet:

- "To address head office's concern regarding balance sheet manipulation, we have discussed the use of this structure with Enron."[135]

- "[W]e've been warned about the balance-sheet games at least twice in the last few months . . . ."[136]

- "Enron has approached us again to help them manage their balance sheet for the rating agencies and the analysts. The Company is coming to TD as we have demonstrated the ability to deliver, on a short-time frame, the same prepaid structured transaction."[137]

Toronto Dominion was also aware that Rating Agency pressure was an important part of Enron's motivation in doing Prepay Transactions. In the credit approval request for the December 1998 prepay, it was noted that:

> Based on conversations with Enron, the sole purpose of this facility is to satisfy promises made to the rating agencies early this year about reducing leverage.[138]

Despite this knowledge, and despite the knowledge that Enron did not adequately disclose its prepay obligations, Toronto Dominion executed the Toronto Dominion Prepays, likely because the Prepay Transactions were "highly profitable" for Toronto Dominion.[139] During the two year period in which Toronto Dominion entered into Prepay Transactions with Enron, Toronto Dominion's Risk Adjusted Return on Capital for the Enron relationship was 39%, nearly twice the return of 20% that Toronto

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[135] Toronto Dominion Corporate Credit Review for Enron, Firefly Trust and ENA, Dec. 10, 1999, at 20 [TDB-EX 002319-TDB-EX 0023451.

[136] Email from Cori Novellino, Toronto Dominion, to Robyn Zeller, Toronto Dominion, Nov. 7, 2000 [TDB-EX 0012661.

[137] Toronto Dominion Speedy Review, June 22, 1999, at TDB-EX 000040 [TDB-EX 000033-TDB-EX 0000421.

[138] Toronto Dominion USA Division Speedy Review, Dec. 17, 1998, at TDB-EX(1) 015115 (emphasis in original) [TDB-EX(1) 015111-TDB-EX(1) 015120].

[139] Toronto Dominion Corporate Credit Review, Nov. 8, 2000, at 29 ("These Swaps are highly profitable for us and well received by [Enron].") [TDB-EX(1) 000054-TDB-EX(1) 0000901.

Dominion targeted for its corporate customers. This 39% return stands in sharp contrast to the return of 12% that the Enron relationship provided Toronto Dominion in 1997, just prior to the period in which the Toronto Dominion Prepays were executed.

IX. HOW COULD THIS HAVE HAPPENED?

A. Overview

The Examiner has previously reported on: (i) the role of the SPEs in the collapse of Enron; (ii) those SPE structures that are subject to legal challenge; (iii) Enron's use of SPEs to manipulate the financial information it reported to the public in violation of GAAP and applicable law; and (iv) officers, directors, accountants, attorneys and financial institutions involved in such transactions who may have liability under applicable legal standards.

The Examiner previously concluded that a group of senior officers at Enron adopted a strategy of using complex SPE transactions in order to manipulate Enron's financial statements. Specifically, through the use of six accounting techniques and hundreds of transactions, these officers distorted Enron's reported financial condition, results of operations and cash flows. The "tangled web" created by the complexity and magnitude of these structures was extraordinary.[140] .

The Examiner now addresses the question that many people have asked: how could this have happened?[141] That is, how could the seventh largest company in the

[140] "Oh what a tangled web we weave When first we practice to deceive!" Sir Walter Scott, *Marmion*, Canto vi, Stanza 17 (1808).

[141] The Examiner's views concerning this question are limited by the scope of the April 8th Order and by the refusal of over 20 witnesses, including several senior Enron officers, to provide testimony to the Examiner by exercising their privilege against self-incrimination under the Fifth Amendment.

world, which had been a darling of Wall Street,[142] fall so quickly and disastrously?[143] To answer this question, the Examiner: (i) identifies certain factors that may have caused Enron's officers to adopt their fraudulent and ultimately unsuccessful strategy; (ii) identifies several methods that appear to have been used by these officers to implement their strategy; and (iii) discusses the checks and balances that could have been provided by Enron's professionals and the Enron Board, which, had they been present, might have limited the misconduct.

B. Why Did Enron Officers Behave This Way?

At least two factors may explain the officers' misuse of SPEs to manipulate Enron's financial statements. First was the inherent tension between two apparent Enron goals: (i) seeking a high price/earnings multiple for its stock that was typical of high growth company stocks; and (ii) seeking to maintain an investment grade credit rating that was typical of mature companies with stable, recurring earnings. Second was

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[142] See, *e.g.*, Hillary Durgin, Enron: Huge *Growth from* Unregulated Power, Fin. Times, Dec. 8, 1999, at 3 ("'Today more than three-quarters of Enron's earnings come fiom unregulated businesses,' says Raymond Niles, electric power analyst at Schroder & Co in New York. 'They're growing like wildfire.'"); David Kirkpatrick, Enron Takes its Pipeline to the Net, Fortune, Jan. 24, 2000, at 127 ("Says Steven Parla, an energy securities analyst at Credit Suisse First Boston: 'For Enron to say we can do bandwidth trading is like Babe Ruth's saying, I can hit that pitcher. You tell him to get up there and take three swings. The risk is staggeringly low, and the potential reward is staggeringly high.'"); Rebecca Smith, Enron Net Nearly Tripled in 1st Period, Beating Estimate, as Revenue Rose *72%,* Wall St. J., Apr. 13, 2000, at A4 ("'The real story isn't the earnings,' said utilities analyst David Fleisher at Goldman, Sachs & Co. 'It's what lies ahead. This isn't your father's natural-gas company.'"); David Rynecki, *10* Stocks to Last the Decade, Fortune, Aug. 14, 2000, at 114 (identifying Enron as one of a "buy-and-forget portfolio" of "stocks that we think will be winners over the coming decade"); Business Center: Five Big-Cap Stocks Near Their 52-Week Lows (CNBC television broadcast, June 18, 2001) (Cohn: "[Enron's] stock price is down 37 percent over the last year. . . . Energy analyst Raymond Niles at Salomon Smith Barney says California's energy woes and the risk of re-regulation growing out of federal energy hearings may make investors nervous, but he says Enron's future is bright." Raymond Niles (Salomon Smith Barney): "We're pretty much pounding the table on Enron right now today. It's a company with the best fundamentals in the industry. But right now we think it also has compelling valuation at these levels.").

[143] Enron Corporation Stock Price History Report, undated (providing historical stock prices from January 1, 1996 to June 26, 2002) (showing Enron's stock price growing fiom $40 per share in late 1999 to almost $90 per share in late 2000, then falling to the $50s by April 2001, to the $30s by August 2001, and then rapidly to less than $1 when Enron filed its bankruptcy petition) [AB000499873-AB000499904].

Enron's compensation system which, coupled with readily accessible SPE transactions, provided a tempting incentive to distort Enron's reported financial results. Combined, these factors fueled a competitive, deal-driven corporate culture that valued outward appearances more than actual results. As Lay's Chief of Staff observed in an August 2001 email to Lay, Enron would have been better served by focusing less on managing financial statement presentation and more on getting economic results:

> We should do the economically rational thing in every transaction and business and let the chips fall where they may. Instead of tying ourselves in a knot about managing earnings or write downs or avoiding an asset sale because it's on the books for more than the market, we should just make the rational economic decision. . . . If we make the economically rational decisions over and over, the stock price will come along.[144]

Impact of Conflicting Business Goals

Enron's conflicting business goals are evident in two quotes from Enron's 2000 Annual Report:

- "Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance."[145]
- "Enron's continued investment grade status is critical to the success of its wholesale businesses as well as its ability to maintain adequate liquidity."[146]

Focusing on earnings performance, Enron's 2000 Annual Report touted four businesses with "tremendous opportunities for growth":

- Wholesale services;
- Retail energy services;

[144] Email from Steven J. Kean, Enron, to Kenneth Lay, Enron, Aug. 17, 2001 (the "Kean Email"), at 1 [AB0911 2880-AB0911 2881].

[145] Enron Annual Report for 2000, at 2.

[146] Id. at 27.

Broadband services; and

- Transportation services.[147]

Transportation services housed the pipeline business, which was perceived as a slower-growth business.[148] Wholesale services was a major driver of Enron's growth in revenues, but actually produced relatively modest margins.[149] Retail energy services and broadband services were two of the start-up or speculative investments that Enron hoped would provide growth opportunities. Enron's prior experience with high growth/high risk investments, however, had not been successful.

In prior years, Enron said that its investments in foreign power plants, water systems and other ventures provided growth opportunities,[150] only to have those investments result in significant losses. For example, in its 1998 Annual Report, Enron highlighted its Dabhol power project in India by noting that "[u]pon achieving full commercial operation in 2001, the 2,450 megawatt facility. . . will be the largest independent power project in the world."[151] By September 30, 2001, Enron had spent $1.2 billion on this investment and work on the project ceased following several major setbacks.[152]

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[147] *Id.* at 2.

[148] IBIT from transportation services increased 8% from 1988 to 1999 and 3% from 1999 to 2000. *Id.* at 21.

[149] Wholesale services had operating income of 1.8% on revenues of $93.3 billion in 2000 and 2.5% on revenues of $35.5 billion in 1999. *Id.* at 51.

[150] Enron Annual Report for 1998, at 4, 14-16 and 20.

[151] *Id.* at 16.

[152] See Notes to Enron Corp. and Subsidiaries Consolidated Financial Statements, 10-Q for 3Q/2001, at Note 6 (Litigation and Other Contingencies) (noting that due to disputes with various India governmental agencies, the project's contractors had ceased work on Phase II of the construction, and the project's lenders had stopped funding and had assumed control of the project's bank accounts).

Also, in its 1998 Annual Report, Enron stated that its Azurix water system business "is poised to become a major global water company in a $300 billion market that is ripe for third-party investment. . . ."[153] By September 30, 2001, however, Enron had spent over $1.2 billion on this investment and had been forced to take several significant writedowns.[154]

Enron also sought earnings growth because it wanted its stock to trade at high multiples similar to the high returns enjoyed by venture capital funds in the mid to late 1990s. Enron sought to apply its knowledge of certain energy trading markets to profit from trading markets in other sectors. But, in order to gain the requisite knowledge to create and profit from those other trading markets, in some instances Enron acquired businesses, which also required capital.

For all these reasons, Enron made substantial capital investments. Although Enron established a capital budget at the beginning of each year, it consistently exceeded that budget by significant margins. For example, in 1998, Enron spent over $5.8 billion on capital investments (compared to a budget of $772.5 million); in 1999, it spent $5 billion (compared to a budget of $1.1 billion); and in 2000, it spent $4.4 billion (compared to a budget of just over $2 billion).[155]

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[153] Enron Annual Report for 1998, at 20.

[154] Enron suffered impairment charges related to Azurix of $326 million in 2000 and $287 million in the Third Quarter of 2001. This does not reflect recognition of its recourse liability in the Share Trust structure of approximately $915 million of debt. *See* Notes to Enron Corp. and Subsidiaries Consolidated Financial Statements, 10-Q for 3Q/2001, at Note 2 (Recent Events).

[155] *See* Appendix *D* (Roles of Lay, Skilling and Outside Directors), *Actions of Lay, Skilling and Outside Directors Regarding SPE Transactions – Duty to Inquire.*

Enron could have financed its significant expenditures by issuing stock, but it was reluctant to do so for fear that the dilution would harm its stock price.[156] Enron could not have financed its capital expenditures with earnings because its reported earnings were largely mark-to-market earnings, which generated little current cash flow.[157] Another option would have been to sell merchant assets. However, Enron's merchant portfolio contained a relatively high percentage of poorly performing and illiquid assets.[158] Accordingly, the only viable option remaining was to finance these capital investments with debt.

Debt, however, would have been harmful to Enron's investment grade credit rating, and the credit rating was key to wholesale services, Enron's largest business. Without an investment grade credit rating, Enron would have been required to post collateral in favor of counterparties in its wholesale services business. Enron's solution was to obtain financing through SPE transactions without disclosing Enron's obligation to repay the amounts financed. In addition, in some of these transactions, Enron took the position that it could treat the proceeds of the financings as cash flow from operations.

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[156] *See* Second Interim Report, at 15.

[157] This quality of earnings problem not only precluded Enron from financing its investments from earnings, but drove it to use its Prepay Transactions and FAS 140 Transactions to generate operating cash flow to address the focus on operating cash flow by the Rating Agencies. *See* Second Interim Report.

[158] Enron Vice Chairman Mark Frevert ("Frevert") told Enron employees that "[w]e may have been 'smoking our own dope' as we continued to build the asset portfolio domestically and we pushed a lot into off-balance sheet vehicles." Eric Thode, Enron Net Works, Typed Notes entitled "Enron Net Works Employee Meetings," Oct. 31, 2001 (the "October 2001 Net Works Meeting Notes"), at AB0786 02863 (notes record statements of Frevert, who led the meeting) [AB0786 02859-AB0786 028681; *see also* Deposition of Mark A. Frevert, former Vice Chairman, Enron, by William C. Humphreys, Jr., A&B, May 7, 2003, at 220. Similarly, in meetings with employees, Frevert informed employees that the problems started in the early 1990s with international assets including India, South America and Asia, which were intended to build a merchant portfolio in these areas. "It didn't pan out that way." Although Enron had been trying to sell them, most of the international asset sales were small and the major assets had not been sold. October 2001 Net Works Meeting Notes, at AB0786 02863.

One of Enron's first uses of SPE transactions appears to have been the Prepay Transactions. Structured to be part of Enron's energy trading activities, the Prepay Transactions generated cash and addressed the gap between mark-to-market earnings and operating cash flow.[159] Enron next turned to the FAS 140 Transactions. These were initially used to "monetize" European power plant investments.[160] Enron then began using Minority Interest Transactions to show debt as "minority interest" in the mezzanine section of its balance sheet.[161] In 1998, Enron used its first Share Trust Transaction, known as Marlin, to finance the acquisition of the Azurix water system.

In 1999, when Enron's merchant portfolio produced a big success, Enron officers again turned to SPE transactions to create a desired financial statement presentation. Enron's $10 million investment in the stock of Rhythms NetConnections, Inc. ("Rhythms") skyrocketed in value to approximately $500 million following the public offering of the stock. The stock price was volatile, however, and Enron knew that mark-to-market accounting would result in the increase being reported as current earnings. Enron also knew that a later decline in the value of the investment would result in mark-to-market losses, which Enron wanted to avoid. Due to the large percentage of Rhythms' total equity represented by Enron's investment – approximately 50% of Rhythms' publicly traded shares – and the volatility of the stock price in the market, Enron was

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[159] *See* Second Interim Report, Appendix E (Prepay Transactions).

[160] *See* Second Interim Report, Appendix M (FAS 140 Transactions). After a change in the accounting rules in 1998, Enron could no longer finance power plants through FAS 140 Transactions. *See* Appendix B (Role of Andersen).

[161] *See* Second Interim Report, Appendix I (Minority Interest Transactions). In 1999, Enron also used the Nahanni Minority Interest Transaction to recognize operating cash flow. *See* Second Interim Report, at 27-28.

unlikely to find a third party willing to enter into a hedge on economic terms acceptable to Enron.[162]

Consequently, Enron employed its non-economic hedging technique (in the LJM1/Rhythms Hedging Transaction) to mask the earnings impact of a decline in the value of its investment. In 2000, when faced with a decline in value of many of its other investments, rather than take charges against income, Enron again turned to its non-economic hedging technique. In this instance, Enron used the Raptor SPEs (in the LJM2/Raptors Hedging Transactions) to offset for financial statement purposes the decline in value of a group of underperforming assets selected by the various business units. Shortly thereafter, Enron confronted a major problem on several of these hedge transactions – the decline in its own stock price and the continued devaluation of assets that were being hedged. Because the assets providing credit capacity for the hedges were falling in value, Enron ultimately terminated the Raptor hedging structure. This termination, together with substantial write downs in its failed broadband and water systems businesses, resulted in the $1.01 billion earnings charge on October 16, 2001. Less than two months later, Enron filed for bankruptcy.

Compensation

The incentives created by Enron's compensation system may also help explain the behavior of certain of its officers. The combination of (i) readily accessible, highly-structured, accounting-driven transactions that could be used to manipulate reported financial results and (ii) a compensation system that was tied to Enron's reported

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[162] *See* Appendix C (Roles of Lay, Skilling and Outside Directors).

financial results, likely provided a strong influence on officer conduct. Lay's Chief of Staff described the effects of Enron's compensation system on candor:

> A near mercenary culture which encourages organizations to hide problems (until those problems have become very big), discourages cooperation and teamwork, and drives off people who demand at least a modicum of civility in their work environment.[163]

Enron's system of compensation placed the highest emphasis on reported financial results. Simply put, the higher Enron's reported earnings or funds flow, or the higher its stock price, the higher an officer's compensation was likely to be. Officers and employees understood this important nexus and emphasized their involvement in transactions, even those that lacked economic substance, as they lobbied for higher compensation.[164]

It is common for businesses to look to these financial metrics in setting officer compensation as a means of aligning the interests of management with those of shareholders. However, by using readily accessible, highly structured, accounting-driven SPE transactions that produced reported results inconsistent with their substance, Enron officers manipulated Enron's reported net income and funds flow,

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[163] *See* Kean Email, at 1.

[164] *See generally* Memorandum from Joe Deffner, Enron, to Dave Delainey, Enron, regarding Year End Accomplishments and Overall Past Enron Accomplishments, undated [AB0971 00154-AB0971 001771; Email from Schuyler Tilney, Merrill Lynch, to Dan Gordon, Merrill Lynch, et al., May 30, 2000, at 1 [MLBE 0370956-MLBE 03709571. In addition, the Structured Transactions Group within Enron's tax department, led by R. Davis Maxey, prepared various PowerPoint presentations touting the net income generated by his group, including one discussing pre-tax income from the Steele Transaction entitled "Show Me the Money! Project Steele Earnings Benefits." *See* Third Interim Report, Appendix C (Role of Enron's Officers), at 21 n.85. In the words of another Enron employee, Robert Hermann, Enron found the transactions originating in the corporate tax department "kind of like cocaine—they got kind of hooked on it." In-Person Interview with Robert J. Hermann, former Vice President Tax, Enron Corp., by Philip C. Cook, Partner, A&B, Aug. 8, 2002; see *also* Sworn Statement of R. Davis Maxey, former Vice President Tax, Enron Corp., to Philip C. Cook, Partner, A&B, Dec. 11,2002 (the "Maxey Sworn Statement"), at 148-49.

factors that traditionally have had favorable influences on a company's market value. The evidence suggests that the compensation system provided what proved to be an overpowering motivation for implementing SPE transactions that distorted Enron's reported financial results. Evidence further shows that flawed or aggressive accounting for the SPE transactions enabled the Enron officers to obtain greatly inflated bonuses and to realize substantial proceeds from the sale of Enron stock they received as part of their compensation packages.[165] In fact, during a three-year period from 1998 through 2000, a group of twenty-one officers received in excess of $1 billion in the form of salary, bonus and gross proceeds from sales of Enron stock.[166] Lay and Skilling received substantial compensation from Enron under effectively the same system as the other senior officers, with Lay receiving compensation valued at over $33 million and Skilling over $17 million in the year 2000 alone.[167] A significant amount of that compensation was based on Enron's reported financial results.

The Compensation Committee had responsibility for establishing and implementing Enron's executive compensation philosophy and strategy. The expressed purpose of executive compensation at Enron was to reward performance that created

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[165] See Email from Peter E. Weidler, Enron, to Ray Alvarez, Transredes, et al., Mar. 27, 2000, at 1 [AB0971 01871-AB0971 018781.

[166] See Forms 4 and 5 filed by Enron's officers with the SEC from 1998 to 2000. The stock proceeds figure does not take into account the officers' cost of such shares or any resulting tax liability arising from such sales. Many of the shares included in these sales were obtained as part of long-term incentive awards to these officers in 1998-2000. To avoid duplication, the $1 billion figure does not include the grant-date value of such incentive awards, which would normally be considered part of an officer's total direct compensation for a given year.

[167] See Enron Schedule 14A filed with the SEC on Mar. 27, 2001, at 19-21. This compensation was in addition to proceeds from stock sales. For the four-year period from 1998 through 2001, Lay had gross proceeds of over $209 million from selling shares of his Enron stock, and Skilling had gross proceeds of over $96 million from his Enron stock sales. See transaction report filings made by Lay and Skilling with the SEC during 1998 through 2001 pursuant to Section 16(a) of the Securities Exchange Act of 1934, as amended; see also Appendix D (Roles of Lay, Slulling and the Outside Directors).

long-term shareholder value and to promote teamwork by tying a significant portion of compensation to business unit and Enron performance.[168]

Like many public companies, Enron's compensation program for its senior management team included three primary elements: base salary; annual incentive awards; and long-term incentive pay. Base salaries of all employees, including officers, were targeted at the median of competitive levels, thereby placing emphasis on variable pay based on performance. According to the Compensation Committee's report to shareholders appearing in the proxy statement for the 1999 annual shareholders meeting, approximately 75% of total executive compensation was "at risk" with a strong weighting on long-term performance. Clearly, the Enron compensation structure depended heavily on the reported financial performance of the company, with particular emphasis on the achievement of goals for net income and cash flow.[169]

Overall, the Enron compensation program was not atypical in scope or design as compared to programs of other large public companies at the time. If anything, it was

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[168] "Report from the Compensation and Management Development Committee regarding Executive Compensation" appearing in Enron's Schedule 14A filed with the SEC on Mar. 24, 1998, Mar. 30, 1999, Mar. 21,2000, and Mar. 27,2001.

[169] Enron's annual incentive bonus plan was funded as a percentage of net income. Individual bonus payments were approved by the Compensation Committee based on Enron's performance against pre-established goals, as well as business unit and individual performance. Key performance criteria considered by the Compensation Committee reportedly included funds flow, return on equity, debt reduction and earnings per share improvements, among others. *See* "Report from the Compensation and Management Development Committee regarding Executive Compensation," appearing in Enron's Schedule 14A filed with the SEC on Mar. 21, 2000 and Mar. 27, 2001. Long-term incentive compensation was provided through a variety of awards. Beginning in 1999, long-term awards were made one-half in market-priced non-qualified stock options and one-half in restricted stock that generally cliff vested in four years, with a performance accelerated vesting feature based on Enron's annual cumulative shareholder return relative to the S&P 500. *See* "Report from the Compensation and Management Development Committee regarding Executive Compensation" appearing in Enron's Schedule 14A filed with the SEC on Mar. 30, 1999, Mar. 21,2000 and Mar. 27,2001. Stock options typically had a five-year term and time-vested over three years, but in some cases they had performance accelerators based on Enron's achievement of target levels of compounded growth in earnings per share.

remarkable in the degree of "process" employed to design and implement the program and to continually reassess it for market competitiveness.[170] However conventional the Enron compensation program may have been for its time, it nevertheless motivated the officers to post continually higher income and stock price targets and, in so doing, provided a powerful incentive to manipulate earnings and cash flows to achieve these results. Against this backdrop, it is not difficult to understand the allure of the SPE transactions, which provided a powerful tool to report enhanced financial statement results. Among other things, these readily accessible transactions generated instantaneous earnings and cash flows that were not dependent upon the results of operating businesses. One banker's comments made in a 1999 email to a colleague are insightful: "running a pipeline business can't take much time – Enron seems to spend all its available man hours on various, convoluted financing schemes."[171]

C. Methods Used by Officers to Implement Strategy

As noted in the Second Interim Report, the officers utilized six accounting techniques designed to distort Enron's financial statements. Through many of these techniques, Enron took advantage of GAAP rules and ignored its obligation to make transparent disclosures. In addition, in many of the SPE transactions, the terms required by the financial institutions would have precluded Enron's desired accounting treatment under applicable GAAP rules. In these transactions, Enron officers continued to reflect

[170] For example, in addition to its five regularly scheduled meetings per year, the Compensation Committee met frequently in special session, for a total of fourteen meetings in 2001, ten meetings in 2000, eight meetings in 1999 and seven meetings in 1998. The Compensation Committee relied heavily on third-party executive compensation experts to assist with program design and market competitiveness analysis. Towers Perrin provided at least nine written reports to the Compensation Committee during 2000 and 2001.

[171] Email from Carmen Marino, Managing Director, CSFB, to Tim Bock, Managing Director, CSFB, July 28,1999 [CSFBCO 000019283].

desirable, but incorrect, accounting treatment by entering into undisclosed side agreements, arrangements with no business purpose and "hardwired" transactions that violated GAAP.[172]

The Examiner now focuses on several methods used by these officers to facilitate their use of the six accounting techniques. These methods include:

- *Justification of Desired Results.* In many cases, Enron officers were less concerned about making the correct or best decision, and more concerned with justifying a desired result. Evidence suggests that Enron officers: (i) used accounting rules that did not directly address the accounting question at issue but provided an argument to justify an aggressive position; (ii) searched for reasons to avoid public disclosure; and (iii) obtained professional opinions or advice merely as a necessary procedural step.

  Use of Economic Leverage on Third Parties. Evidence suggests that by using Enron's economic power, Enron officers were able to pressure third parties, such as financial institutions and Enron's professionals, to accommodate Enron's financial statement objectives. In many instances, this economic pressure appears responsible for overcoming concerns about reputational risk or other reservations by these third parties.

- *Lack of Candor.* There are many examples of incomplete disclosure by these officers to the Enron Board and the public. In some cases, it appears that officers provided hints or glimpses of facts suggesting possible misuse of SPEs to the Enron Board. In other cases, Enron officers' frequent use of misleading terms and jargon in connection with Enron's SPE transactions appears to have obscured their economic substance. Finally, evidence indicates that when information was presented by the officers to the Enron Board, the information was delivered in a manner not conducive to a full understanding of the SPEs.

Justification of Desired Results

In many cases, the Enron officers appeared less concerned about making the correct or best decision, and more focused on finding some justification for their desired

[172] *See* Third Interim **Report, at** 27-30.

result. That is, their primary concern seems to have been to ensure that they had an explanation if someone challenged their position, rather than to determine whether their decision was correct or was justified in light of the risks assumed. Examples of this strategy include: (i) using accounting rules that did not directly address the accounting question at issue but simply provided an argument to justify an aggressive position; (ii) searching for ways to avoid public disclosure; and (iii) obtaining professional opinions or advice merely as a necessary procedural step.

Search for Plausible Accounting Support. Evidence suggests that Enron officers often took aggressive accounting positions with little direct GAAP support. Rather than using accounting principles to achieve a fair presentation of Enron's financial condition, both as a means of fulfilling their disclosure obligations and as an effective management tool, it appears that Enron officers (often with the support of Andersen) focused their efforts on using hyper-technical and strained accounting judgments to justify aggressive and misleading financial presentation. For example:

- *Prepay Transactions.* Recognizing that Andersen required three substantive parties to participate in Enron's Prepay Transactions to support Enron's desired GAAP result, Enron employed Mahonia and Delta, shell entities set up by JPMorgan Chase and Citigroup for use in these transactions, or sometimes used a second bank as the accommodation party. Enron's officers knew that they were using Mahonia, Delta and the accommodation banks as intermediaries in order to satisfy Andersen. Andersen recognized that relevant GAAP authority required that the separate legs of Enron's Prepay Transactions be collapsed and that the related obligations be reported as debt if one of the parties was an SPE or an intermediary.[173] Therefore, it required Enron to obtain representation letters from Delta and Mahonia and accepted the letters as evidence that Delta and

[173] The relevant GAAP authority was Fair Value Hedges: Concurrent Offsetting Matching Swaps and Use of One as Hedging Instrument, Derivatives Implementation Group Issue No. F6 (Financial Accounting Standards Bd. 2000), an interpretation issued by the Derivatives Implementation Group of the FASB, which had the force of GAAP.

Mahonia were substantive businesses, even though the facts as represented were insufficient to support that conclusion. It may have been Andersen's discomfort with this approach that caused Andersen to suggest that the Prepay Transactions be disclosed in Enron's 1999 and 2000 financial statements. When management refused, Andersen dropped the issue and did not take it to the Audit Committee.

- *Nahanni Minority Interest Transaction.* Enron officers and Andersen knew that the primary purpose of the Nahanni Minority Interest Transaction was to "[i]ncrease Funds Flows through the sale of Merchant Investments held by a newly formed consolidated subsidiary."[174] Andersen also knew that this objective could not be achieved through the Nahanni transaction unless Enron was permitted to classify U.S. Treasury securities as "Merchant Investments."[175] Accommodating Enron's accounting objectives, Andersen determined that Enron could classify U.S. Treasury securities as Merchant Investments – even though Enron had never before sought to hold U.S. Treasury securities as Merchant Investments – provided that Enron modified its Merchant Activities footnote to reflect this expanded definition of Merchant Investments.[176]

Searching for Reasons to Avoid Disclosure. The evidence suggests that in numerous instances Enron's officers and professionals worked to interpret facts in a manner that avoided transparent public disclosure of its SPE transactions. Examples include:

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[174] Nahanni Memo, at 1.

[175] *See* Grutzmacher Sworn Statement, at 162; *see also* Sworn Statement of Debra A. Cash, Andersen, to H. Bryan Ives, III, A&B, June 5,2003 (the "Cash Sworn Statement"), at 94-96.

[176] Nahanni Memo, at 1. Gary Peng (a member of the Corporate Accounting and Financial Reporting Group who was familiar with the circumstances surrounding the Nahanni disclosure) said: "From a company perspective, Project Nahanni is very sensitive – it has not been discussed in detail with any outside parties. The disclosure found in the Annual Report, Footnote 6 and 8 were as much as management was willing to disclose." Email from Gary Peng, Enron, to Clint Freeland, Enron, May 8, 2000 [AB0971 018591.

SPE Transactions in General

- *Swaps and Guarantees.* Using a Total Return Swap rather than a guarantee was one of Enron's favorite techniques to avoid disclosure.[177] For example:

    - o When comparing the benefits of a Total Return Swap to a guarantee in connection with a FAS 140 Transaction, Kevin Jordan informed others that "[g]uarantees require additional unwanted footnote disclosure."[178]

    - o Charles DeLacey explained that: "The answer is that there is a [sic] obligation of ENE on the swap for $30.2MM but it is not on the balance sheet. The total return swaps are buried in the footnotes under price risk management activities . . . ."[179]

    - o Joel Ephross, an in-house attorney, described a Total Return Swap as "in essence a guaranty that is phrased as a swap. It has the benefit to Enron of being reported by our accountants under price risk management, and footnote disclosure."[180]

    - o Causey's concern about disclosure is captured in this email from Cassandra Schultz who explained that: "Causey's position on the issue of whether we should bother with a swap if there is potential it will be treated as a guarantee is we should still structure it as a swap so we have more flexibility in how and where the support mechanism/guarantee is ultimately disclosed – maybe in the derivative footnote with a blurb about sovereign risk or something."[181]

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[177] In the "Price Risk Management Activities and Financial Instruments" footnote to its 2000 financial statements, Enron described the Total Return Swaps used as guarantees as "price risk management services to . . . customers," and buried the obligation in a table depicting the "notional" amount of derivative investments, and even stated that "notional amounts. . . do not represent the amounts exchanged by the parties to the financial instruments," when in fact the notional amount represented the amount loaned to the SPE and paid to Enron, which Enron was liable to repay in full. Enron Annual Report for 2000, at 38.

[178] Email from Kevin D. Jordan, Enron, to Jas Somrah, Enron, and copies to Philippe Penet, Matthew Landy, Treasa Kirby and Stephen Dwyer, Enron, Feb. 26, 2001, at AB0971 00234 [AB0971 00233-AB0971 002361.

[179] Email from Charles Delacey, Enron, to Steve Pruett, Enron, May 2, 2001, at 1 [AB0971 02304-AB0971 023051.

[180] Email from Joel Ephross, Enron, to Truman Bidwell and Mary Ward, Linklaters, Sept. 27, 2001 [AB0252 00913-AB0252 009141.

[181] Email from Cassandra Schultz, Enron, to Raymond Bowen and David Chang, Enron, and copies to Bob Butts, *et al.,* Enron, Dec. 1,1998, at AB0971 00432 [AB0971 00432-AB0971 004341.

- *Prepay Transactions.* Enron's officers decided against using the proposed disclosure on the Prepay Transactions recommended by Andersen that would have made the nature of Enron's Prepay Transactions ascertainable by a user of Enron's financial statements.[182]

Related Party SPE Transactions

- *Fastow's Compensation/LJM2.* Enron's in-house attorneys, with assistance from Vinson & Elkins, decided that Enron did not have to disclose the amount of Fastow's interest in LJM2 in the proxy statement filed in 2001. That decision was based on the position that it was not "practicable" to quantify Fastow's interest, even though Fastow had said that the amounts were so large that LJM2 would be shut down if those amounts were told to Skilling.[183]

- *Kopper/Chewco.* Enron's in-house attorneys decided that Enron did not have to disclose Kopper's involvement as the general partner in Chewco. That decision was based on the position that Kopper, who was a vice president, was not an "executive officer" of Enron as defined under applicable SEC rules.

- *Kopper/LJM.* In considering the disclosure of Fastow's sale of his interest in LJMl and LJM2 to Kopper (who resigned so he could buy Fastow's interest in LJMl and LJM2 in the summer of 2001), Fastow's preference was for Enron to avoid mentioning that the purchaser of these interests was a former Enron employee.[184] Gary Peng, another Enron employee, agreed with Fastow. "How critical to the disclosure is the phrase '. . . to a former employee of Enron . . .'? The transformation of LJM to a true third-party would seem to be

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[182] Another Andersen client, Aquila Energy Corporation, included such a disclosure in its SEC filing, and Andersen proposed that Enron include a similar disclosure in its financial statements. Aquila Energy Corporation Form S-1 filed with the SEC on Dec. 13,2000 (the "Aquila Form S-1"), at 42-43.

[183] Sworn Statement of Ronald T. Astin, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Aug. 12,2003, at 106-07. In a memorandum to Fastow regarding the obligation to disclose Fastow's financial interests in the LJM entities, Jordan Mintz ("Mintz") indicated that the decision not to disclose "was a close call; arguably, the more conservative approach would have been to disclose the amount of [Fastow's] interest." Memorandum from Jordan Mintz, Enron, to Andy Fastow, Enron, regarding Related-Party Proxy Disclosures, Apr. 6,2001 (the "Mintz 4/6/01 Memo"), at AB0971 00646 [AB0971 00645-AB0971 006461. As set forth in the Second Interim Report, Mintz placed enormous technical reliance on the word "practicable" contained in the relevant SEC regulation. *See* Second Interim Report, Appendix D (Enron's Disclosure of Its SPEs), at 58-59. Going forward, Mintz observed, "[t]his disclosure issue will continue to be a challenge as transactions entered into between Enron and LJM2 settle and, as such, it becomes 'practicable' to quantify and, therefore, be required to disclose the amount of [Fastow's] financial interest." Mintz 4/6/01 Memo, at AB0971 00646.

[184] Email from Jordan Mintz, Enron, to Ron Astin, Vinson & Elkins, *et al.*, Aug. 7,2001 (the "Mink-Astin 8/7/01 Ernail"), at 1 [EVE 543273-EVE 5432741.

more complete if we could exclude the phrase."[185] Jordan Mintz, an Enron attorney, suggested "that we provide the more 'generic' description."[186] When asked about including a phrase describing Kopper as a former Enron employee, Mark Koenig, Executive Vice President of Investor Relations, replied, "If [it is] not absolutely required – no."[187]

- *October 16th Disclosures.* Even as late as fall 2001, in the October 16th earnings release, Enron described its $1.01 billion charge to earnings as "non-recurring," and did not disclose Enron's $1.2 billion write-down of shareholder equity primarily related to an earlier accounting error for the LJM2/Raptors Hedging Transactions. The reason given by Enron for not mentioning this write-down was that it was a "balance sheet item" as opposed to an income statement item.

Using Professional Opinions Merely as Justification. Many times Enron officers appear to have obtained opinions or advice from professionals merely as a necessary step to justify questionable decisions rather than as a tool to assist them in reaching a considered business decision based upon the risks. In these circumstances, it appears that the fact that an opinion or advice was obtained was more critical to the officers than whether the opinion or advice actually addressed the fundamental question at issue. Examples include:

- *LJM1/Rhythms Hedging Transaction Fairness Opinion.* Enron's officers represented to the Board that a fairness opinion would be delivered in connection with the LJM1/Rhythms Hedging Transaction. The analysis underlying the opinion logically arrived at the result that the value given by Enron on day one was approximately equal to the value received. The analysis did not, however, address the non-economic nature of the hedge (i.e., the only assets used to support the hedge were Enron's own assets) and the officers did not address this issue with the Board.[188]

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[185] Email from Gary Peng, Enron, to Ronald T. Astin, Vinson & Elkins, *et al.,* Aug. 5, 2001, at 1 [EVE 543322-EVE 5433251.

[186] Mintz-Astin 8/7/01 Email, at 2.

[187] Email from Mark Koenig, Enron, to Gary Peng, Enron, Aug. 7,2001, at 1 [EVE 543273-EVE 5432741.

[188] *See* Appendix B *(Role* of Andersen), *Andersen's Role in Enron's SPE Transactions – Andersen's Role in the Non-economic Hedges – Rhythms.*

- *True Issuance Opinions.* In nearly all of the FAS 140 Transactions, Enron obtained opinions from its outside law firms that certain equity interests issued by an SPE were legally isolated from Enron (i.e., a "true issuance" opinion). No opinion was obtained as to whether the assets transferred to that SPE (and which were the only source of any value of the equity interest) were legally isolated from the transferor (i.e., a "true sale" opinion). The "true issuance" opinion appears to have had no significance unless a true sale opinion could also be given – which was not always the case – but Enron presented the opinions to Andersen to justify treating the transfer of the asset as a sale.[189]

- *Steele Tax Opinion.* To obtain a tax opinion on the Steele Transaction, Enron officers represented that Enron undertook the transaction for the principal purpose of generating financial accounting benefits. In contrast, Andersen's audit team noted that Enron needed to demonstrate a business purpose that did not involve the transaction's financial reporting impact. Despite the fact that Enron's representations in connection with the tax opinion, and the economic substance of the Steele Transaction, were inconsistent with demonstrating a business purpose apart fiom financial reporting consequences, Andersen eventually accepted a representation fiom Enron officers that recognition of the deferred credit arising from the

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[189] In notes from a meeting held on June 8, 1998, between Joe Dilg, a partner in Vinson & Elkins, and Jim Derrick, General Counsel of Enron, Mr. Dilg expresses his concern about the true issuance opinion letters:

> 1. True Issuance opinions. We a [sic] unsure of how opinion rendered satisfies requirements of FASB125. We are not asked to render accounting advice but qualification we had to take in opinion could be inconsistent with 125 requirements. We have not had direct contact with senior accounting personal [sic]. During Cornhusker we pointed out the qualification to junior AA representative and discussed with (Lance Schuler?) and they said OK. In connection with MidTexas David Keyes raised opinion issue with Lance Schuler again last week. Lance reported back that he had discussed with Ben Glissen [sic] and Ben said opinion in Cornhusker had been reviewed by top levels of AA and they were satisfied. Point out qualification in opinion and difference from Linx opinion in Sutton Bridge and discuss pg 67 of AA field directive.
>
> Concerns: 1. Similar opinion in MidTexas may get focused upon by other accounting types and if asked to remove qualification we cannot. Don't want deal to blow up at last moment and cause earnings surprise.
>
> 2. Possible review in context of MidTexas may cause AA to relook at Cornhusker and cause issues.
>
> **3.** Have raised issue with Lance and apparently everything is OK. Since we have not had contact with AA don't understand the reasoning.

Document entitled, "Notes for meeting with Jim Derrick," undated, at EVE 1250750 [EVE 1250750-EVE 12507511.

transaction, in advance of the recognition of tax benefits, was not Enron's sole reason for entering into the Steele Transaction.[190]

- ***Watkins Investigation.*** In connection with the investigation of accounting and related issues raised by Enron employee Sherron Watkins ("Watkins") in August 2001, Enron so limited the scope of the investigation that it may have been more a matter of ensuring that Enron's corporate compliance policies were followed rather than a genuine inquiry into whether any of the potential problems identified in Watkins' letters were true.[191]

Economic Leverage on Third Parties

Through the use of Enron's economic power, it appears that Enron officers frequently applied significant pressure on third parties to accommodate Enron's financial statement objectives. Examples include:

- In at least two instances, Enron officers made it clear to a financial institution that its securities analyst covering Enron was not sufficiently supportive of Enron. In these cases, these analysts were either terminated or given the clear message that their analysis should take into account the relationship between the financial institution and Enron.[192]

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[190] ***See*** Third Interim Report, Appendix C (Role of Enron's Officers), at 73-75. The former head of the Structured Transactions Group within Enron's tax department testified that "representations with respect to the tax opinions were written from the standpoint of the Internal Revenue Code and, as a result, may not have reflected management's intent." Maxey Sworn Statement, at 163-66.

[191] ***See*** Appendix C (Role of Enron's Attorneys), ***Attorneys' Role in the Watkins Investigation.***

[192] For instance, in April of 1998, Enron excluded Merrill Lynch as a manager for an upcoming $750 million common stock offering because Enron's senior management was angry with the reports and comments of John Olson ("Olson"), Merrill Lynch's equity analyst covering Enron. Merrill Lynch's Chief Executive Officer, Herb Allison, intervened with a call to Lay, and Enron then added Merrill Lynch as a manager for the offering. One month later, Merrill Lynch fired Olson and replaced him with an analyst with a better opinion of Enron's stock. At the same time, Merrill Lynch's revenues from Enron increased fiom $3 million in 1998 to $40 million in 1999. ***See*** Third Interim Report, Appendix I (Role of Merrill Lynch and its Affiliates), at 19-22. In addition, Jill Sakol ("Sakol"), a CSFB fixed income analyst assigned to cover Enron's debt securities in April 2001, testified that she perceived pressure fiom her superiors not to issue negative public comments on Enron due to the importance of Enron as an investment banking client of CSFB. Sakol also documented instances in which she was discouraged from publishing her negative research on Enron to the investing public while CSFB bond traders were using that information to their advantage. ***See*** Appendix F (Role of CSFB and its Affiliates), ***Role of CSFB's Equity and Fixed-Income Analysts.***

- In early 2001, Andersen was informed by an Andersen senior executive that Enron's Chief Accounting Officer, Causey, had requested that Andersen remove Andersen partner Carl Bass from further participation in the Enron engagement, and that Andersen senior executives had agreed to that request.[193] A different Andersen partner later testified:

  > [I] thought it was unprofessional for Enron to make such a request or demand or whatever it was, and I was upset that the firm had agreed to it. . . . [I] can't speak for the whole firm in terms of defining moments, but it was a defining moment to me and me as part of the PSG and our relationship [with Enron]. . . .[194]

- Commenting on Enron's ability to exert pressure on Andersen, one Enron in-house attorney commented:

  > We originally thought that Condor would be the source for equity. However, a very junior person at AA in London said no, that will not work. So, now we have LJM, which is not in any way related to Enron (except that one of its investors is an executive, but we will not talk about that) making the equity investment. This will satisfy AA. We will see if the junior person who has made this trouble is employed with AA after January 1st; however, very few people here are betting on that.[195]

- There are several examples of financial institutions participating in Enron transactions even though they acknowledged that these transactions exposed them to "reputational risk," including:

  - o Citigroup completed a FAS 140 Transaction in December 2000 called Project Bacchus. Despite concerns over "appropriateness" of the transaction, "since there is now an earnings dimension to

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[193] ***United States v. Arthur Andersen,*** LLP, Crim. A. No. H-02-121 (S.D. Tex. 2002), Transcript of the Proceedings, May 6,2002-June 5,2002, at 1163 (testimony of Carl Bass, May 9,2002). Even though he moved from the Engagement Team to the PSG in December 1999, Mr. Bass spent considerable time as a member of the PSG consulting with the Engagement Team on Enron matters in 2000. ***Id.*** at 1123-24 (testimony of Carl Bass, May 9, 2002). Moreover, even after Andersen agreed to his removal from Enron matters in early 2001, he continued to consult on Enron. ***Id.*** at 1175 (testimony of Carl Bass, May 9,2002).

[194] ***Id.*** at 5537-38 (testimony of John Stewart, May 31,2002).

[195] ***See, e.g.,*** Email from Joel Ephross, Assistant General Counsel, Enron, to Fernando Tovar, Attorney, Vinson & Elkins, ***et al.,*** Dec. 3, 1999 [EVE 5226351.

this deal, which was not there before,"[196] Citigroup "made a lot of exceptions to our standard policies" and closed the transaction.[197] A Citigroup employee wrote: "I am sure we have gone out of our way to let them know that we are bending over backwards for them . . . let's remember to collect this iou when it really counts."[198] Later, in June 2001, Citigroup participated in the Sundance Industrial transaction that, in part, unwound the Bacchus FAS 140 Transaction. A Citigroup senior executive was concerned about Enron's accounting for Sundance Industrial: "The GAAP accounting is aggressive and a franchise risk to us if there is publicity (a la Xerox)."[199]

- o Merrill Lynch had concerns of reputational risk arising out of its participation in the Nigerian Barge Transaction. This concern was expressed in one Merrill Lynch employee's notes indicating that the transaction posed a "reputational risk, i.e., aid/abet Enron income stmt. manipulation."[200] Another Merrill Lynch employee testified:

> Well, I raised the matter of, you know, if Enron ever in the future fell apart from a credit – just like a credit meltdown or something, and we had been involved in this transaction, in light of the fact that I had these accounting concerns about [the Nigerian Barge Transaction], would that somehow create a reputational risk for us? Would we have our name in the press?[201]

- o RBS's concern about its participation in the LJM1/Rhythms Hedging Transaction is illustrated in one of its internal memoranda:

[196] Email from Steve Baillie, Citigroup, to William Fox, Citigroup, *et al.*, Nov. 24,2000 [CITI-B 0289702-CITI-B 02897031.

[197] Email from Steve Wagman, Citigroup, to Amanda Angelini and copy to Rick Caplan, Citigroup, regarding Enron/Bacchus, Dec. 27,2000 [CITI-B 02792521.

[198] ***Id.***

[199] Memorandum from Dave Bushnell, Citigroup, to Mike Carpenter, Citigroup, regarding Enron-Project Sundance Transaction, May 30,2001, at 2 [CITI-B 0302091-CITI-B 03020921.

[200] Facsimile fiom Rob Furst, Merrill Lynch, to Jim Brown, Merrill Lynch, Dec. 21, 1999 [MLBE 0111739].

[201] Sworn Statement of James A. Brown, Merrill Lynch, to Robb E. Hellwig, A&B, Apr. 28, 2003, at 77-78.

> The fundamental issue from my perspective is one I raised when this transaction was first discussed [internally] and which has, I know, been exercising the minds of everyone concerned over the last two weeks. This is the potential reputational risk given that Enron assets are being transferred into the control of (and for the future benefit of) third-parties, where the third-parties are not necessarily valid 'arms length' counterparties, given the shareholding and control exercised by Andy Fastow.[202]

RBS's concern was shared by its accounting professionals, who noted:

> the nature of the transaction is highly unusual. The role of the CFO of Enron and the use of its own shares, raises significant concerns as to the potential reputational risk to the bank if the transaction is not disclosed appropriately by Enron or [if] shareholders claim to have been disadvantaged.[203]

- CSFB, trying to mitigate any reputational risk, decided to include in the documentation for the CSFB Prepay the firm's standard representations for accounting-driven transactions.[204]

- Barclays also noted its concerns about "reputational issues" associated with refinancing and extending the SO_2 transaction.[205]

***Lack of** Candor*

Enron's approach to incomplete disclosure also appears to have existed in certain officers' dealings with the Enron Board, its committees and the public. There are many examples where these officers provided hints or glimpses of the possible misuse of SPEs,

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[202] Project LJM Memorandum, at RBS 3030461.

[203] KPMG Letter, June 23, 1999.

[204] Sworn Statement of Steven Wootton, Director, CSFB, to M. Russell Wofford, Jr., A&B, May 28,2003, at 42, lines 17-22 and 46, lines 17-23.

[205] Minutes of Barclays Group Credit Committee Meeting, Oct. 26, 2001, at BRC000083218 (discussing "reputational issues" associated with refinancing and extending the SO_2 transaction) [BRC 000083217-BRC 000083219]; ***see also generally*** First Interim Report, at 135-46.

but the information provided appears not to have been presented in a manner that was conducive to a full understanding of the SPEs. Furthermore, the use of misleading terms and confusing jargon by Enron officers when they described SPE transactions exacerbated their complexity. On many occasions, it appears that several groups of persons, including the Enron Board and Rating Agencies, understood the meaning of these terms and phrases in a materially different way than the meaning ascribed to them by the Enron officers. Examples include:

SPE Transactions in General

- *Total Debt Obligations.* In an August 13, 2001 presentation to the Enron Board, Fastow presented an analysis of $36.4 billion in "Outstanding Financings and Debt" of Enron, including the nature and extent of off-balance sheet financings. Since at least 1997, this information had not been presented in this fashion to the Enron Board or to any of its committees.[206]

- *Tax Strategy.* The Enron Board was not informed that a critical function of Enron's tax department was to book earnings and that it was customary for the tax department to generate the "stretch" at the end of the year to meet Enron's earnings targets.[207]

- *Monetized Assets.* Enron officers used the term "monetize" in numerous presentations to the Enron Board. Enron also used this term in its public filings.[208] For example, Enron's officers referred to its

[206] Ironically, Fastow's report actually overstated Enron's outstanding financings and debt by double counting $1.9 billion of Enron's Yosemite Prepays. The Finance Committee received information, never clearly explained or presented, showing that from August 2000 through August 2001, Enron's interest bearing obligations increased from $22.3 billion to $36.3 billion – a $14 billion increase in one year. *Compare* Materials from Enron Finance Committee Meeting, Aug. 7, 2000, at AT30247 01363 (slide from the CFO Report) [AT30247 01347-AT30247 01520] *with* Materials from Enron Finance Committee Meeting, Aug. 13, 2001 (the "8/13/01 Finance Committee Materials"), at AT30247 02302 (slide from the CFO Report) [AT30247 02285-AT30247 023591.

[207] *See* Second Interim Report, Appendix J (Tax Transactions); *see also* Third Interim Report, Appendix C (Role of Enron's Officers), at 16-23.

[208] *See, e.g.*, Enron Form 10-Q filed with the SEC for the Quarter ended Sept. 30, 2001, at 22 ("Between September 1999 and December 2000, LJMl or LJM2 purchased equity or debt interests in nine Enron-sponsored SPEs. LJMl and LJM2 invested $175 million in the nine SPEs. These transactions enabled Enron to monetize assets and generated pre-tax earnings to Enron of $2 million in 1999."); EOG Resources, Inc. Schedule 13D/A filed by Enron with the SEC, Apr. 5, 1999, at 4 ("Enron is currently

FAS 140 Transactions as "monetizations" of the underlying assets and to its Prepay Transactions as "monetizations" of its price risk management assets. Despite its widespread use by Enron, the term does not have a precise definition.[209] It could mean a sale of the asset with perhaps some limited retained recourse to Enron, or perhaps a borrowing with assets serving as collateral but which is otherwise nonrecourse or limited recourse to Enron. The FAS 140 Transactions, however, were fully recourse borrowings in which the asset was in substance not transferred at all since Enron retained at least 97% of the risks and rewards as well as effective control over the asset. The Prepay Transactions were fully recourse borrowings and involved no assets at all. There is substantial evidence that the members of the Enron Board had unclear or conflicting understandings of the meaning of this term.[210] In addition, Standard & Poor's analysts informed the

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evaluating a number of alternatives [with respect to its EOG stake], including without limitation, whether Enron should . . . monetize all or a portion of Enron's investment pursuant to a leverage capitalization or similar transaction.") (Enron's EOG shares were later the subject of a FAS 140 transaction known as Cerberus, which the Examiner concluded in Prior Reports was likely not a "true sale").

[209] The testimony of several Vinson & Elkins attorneys demonstrates the vague and uninformative nature of the word "monetize." *See, e.g.*, Sworn Statement of Joseph Dilg, Managing Partner, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Sept. 24, 2003, at 70 ("I recall in discussion that we had... some conversations about the term monetization, whether anybody really knew what monetization meant. . . ."); Sworn Statement of Scott Wulfe, Vinson & Elkins, to Rebecca M. Lamberth, A&B, Aug. 22,2003, at 149 ("The word monetizing, to me in that context, would be a very broad term that would effectively be probably any type of transaction in which funds are obtained through some transaction involving an asset. Now, whether or not he [Baird] meant it in a more narrow case, I mean, he may have, but I don't know."), at 150 ("I believe in the summer of '98, as best as I recall, my views about these terms was sort of evolving, not having spent that much time thinking about it, so I think I, at different points, had different views about monetization. I think that ultimately -- well, I think I believed that it encompassed a transaction in which funds were obtained, but if you ask -- I'm not sure that I immediately had a definitive reaction to that term."), and at 151 ("I think -- synonymous with sale? I'm not -- I think, generally speaking, monetization is probably a broader term, but could it -- certainly could encompass a sale. Is it synonymous? I'm not sure I ever got to that fine of thinking about it.").

[210] For example, Chan, who was a Finance Committee member, testified that he believed "asset monetizations" meant "just selling outright." Chan Sworn Statement, at 169. LeMaistre, who often attended Finance Committee meetings, testified that if an asset were underperforming, the company could "monetize it in order to free up the money to reinvest it elsewhere at a better rate of return," which would "in most instances" mean selling or disposing of the asset in some fashion. Sworn Statement of Charles A. LeMaistre, former Director, Enron, to William C. Humphreys, Jr., A&B, July 17, 2003 (the "LeMaistre Sworn Statement"), at 142-43. Foy and Willison testified that "monetization" could include either selling or borrowing against an asset. Foy Sworn Statement, at 113 ("In general it means either selling an asset or borrowing up to its full market value."); Sworn Statement of Bruce G. Willison, former Director, Enron, to Jenna L. Moore, A&B, Sept. 3, 2003, at 88 ("Q. [Is monetization] different from a sale? A. No. I think usually it probably is a sale, but in some cases, perhaps you might borrow against a commodity . . . ."). Urquhart, a Finance Committee member, testified that "monetization" was "converting hard assets to several vehicles." Sworn Statement of John A. Urquhart, former Director, Enron, to Steven M. Collins, A&B, Sept. 5,2003 (the "Urquhart Sworn Statement"), at 57.

Examiner that they believed, based on discussions with Enron, that the Prepay Transactions were sales of price risk management assets.[211]

- Off-Balance Sheet Debt. Through the use of various techniques (including Total Return Swaps, share trusts, puts and calls and side agreements) Enron incurred substantial so-called "off-balance sheet" debt. However, off-balance sheet debt did not equate to non-recourse debt.[212] Again, there is substantial evidence that the members of the Enron Board had unclear or conflicting understandings of the meaning of this term.[213]

- Cash Flow from Operations. Enron's "cash flow from operations" included significant amounts of cash flow generated through financings that Enron was obligated to repay.[214]

- Trading Activities. Certain of Enron's "trading activities" (i.e., price risk management activities) consisted of transactions where no risk was ever transferred (or ever intended to be transferred) with respect to the assets being traded.[215]

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[211] Interview of Ronald Baron and Todd Shipman, S&P, by H. Bryan Ives, III, Oct. 8,2003.

[212] As noted in Prior Reports, through the use of a Total Return Swap, Enron or one of its affliates would maintain substantially all of the risks and rewards of an asset even though the asset was purportedly "sold" to a third party. See First Interim Report, at 58-59. Under the share trusts, Enron was the ultimate guarantor of debt supporting assets that were transferred into the Whitewing structure. See, *e.g.*, Second Interim Report, Appendix *G* (Whitewing Transaction), at 54-55.

[213] For example, Urquhart testified that the terms were synonymous, "because once you stop your balance sheet, there is no recourse. Your debt is off your balance sheet, not something they have recourse to." Urquhart Sworn Statement, at 80; see ***also*** Sworn Statement of Frank Savage, former Director, Enron, to Steven M. Collins, A&B, Aug. 13, 2003 and Sept. 4, 2003 (the "Savage Sworn Statement"), at 73 (stating that "typically" off-balance sheet means non-recourse, with some exceptions). Belfer testified that "non-recourse" fmancings would refer to outright dispositions, whereas "off-balance sheet" financings would refer to structured fmancings in which Enron had continuing involvement. Sworn Statement of Robert A. Belfer, former Director, Enron, to Steven M. Collins, A&B, July 31, 2003 (the "Belfer Sworn Statement"), at 132. Chan testified that sometimes off-balance sheet debt was non-recourse, but that sometimes it was recourse, depending on the situation. Chan Sworn Statement, at 53-54. Harrison said that he "most of the time would equate" the terms off-balance sheet with non-recourse, but believed that there was a "technical accounting difference" between the two. Sworn Statement of Ken L. Harrison, former Director, Enron, to Steven M. Collins, A&B, Aug, 27,2003 at 101.

[214] See Second Interim Report, Appendix Q (Schedules Depicting Impact of Enron's Six Accounting Techniques), at 1 (showing that over $3 billion in Enron's reported funds flow from operations during 2000 should not have been characterized as such, and that Enron should have reported over $4.5 billion more in cash flow from financing activities during 2000).

[215] See, *e.g.*, Second Interim Report, Appendix E (Prepay Transactions), at 20-22.

- *True Sales.* Enron reported that "true sales" occurred even though the transferor (or its affiliate) of the asset retained control and substantially all of the risks and rewards of the asset conveyed to the purchaser.[216]

Related Party SPEs

- *Asset Repurchases from LJM2. In* a 2001 presentation to the Enron Board regarding transactions between Enron and LJM2, Enron officers did not disclose to the Enron Board transactions where Enron repurchased assets from LJM2. Several directors have testified that such transactions would have raised their suspicions.[217] The officers intentionally deleted the transactions from a draft of the Audit Committee presentation, with the assistance of Enron in-house attorneys.[218]

- *Raptor Restructurings. In* the spring of 2001, Enron restructured the Raptor SPEs with the infusion of an additional twelve million shares of Enron stock. The restructuring was consummated to cover a shortfall in the credit capacity of the Raptor SPEs that arose because the value of the hedged assets declined, as did the price of Enron's stock that constituted the primary asset providing the credit capacity. Rather than seeking Board approval for this significant transaction, Enron officers, working with the Enron in-house attorneys, reasoned that this transaction fit within a previous Board resolution that provided management with blanket authority to execute and settle equity derivative transactions up to a specified share amount (fifty million shares in the aggregate at any given time).[219]

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[216] *See, e.g.*, First Interim Report, at 67-146 (concluding that the Cerberus Transaction, the Nikita Transaction, the Hawaii Transaction, the Backbone Transaction, and the SO_2 Transaction, were likely not "true sales").

[217] *See, e.g.*, Foy Sworn Statement, at 100; Sworn Statement of Norman P. Blake, Jr., former Director, Enron, to John L. Latham, A&B, Dec. 13,2002, at 174.

[218] Email from Jordan Mintz, Enron, to Ron Baker, Enron, Feb. 2, 2001 [AB0911 2838-AB0911 2840]; Email from Jordan Mintz, Enron, to Tod A. Lindholm, Enron, and copy to George McKean, Gordon McKillop, Ryan Siurek, Enron, Feb. 2, 2001 [AB0911 2841-AB0911 2843]; Email from Jordan Mintz, Enron, to Ron Baker, Enron, Feb. 2,2001 [AB0911 2838-AB0911 2840].

[219] *See* Sworn Statement of Joel Ephross, Assistant General Counsel, Enron, to Rebecca M. Lamberth, A&B, Sept. 19, 2003, at 133-34 ("I recall conversations about the authority to execute a derivative on Enron common stock. I recall that the conclusion was reached that an existing board resolution allowing for derivative transactions on Enron common stock was available to be used and that a decision was that the derivative could be written utilizing the existing resolution, the standing resolution, on derivative transactions."). An email on this subject, dated March 22,2001, began with a message from another Enron attorney to Enron attorneys Joel Ephross and Rex Rogers, stating, "Per my voicemail to you, and Rex's request, here are the resolutions which were adopted by the Board relating to derivatives such as forwards" and attaching a copy of such previously-adopted resolutions. Ephross forwarded the email and stated: "George, as I read the attached, it is exactly what we are looking for, except that the capacity looks short,

- *LJM2/Raptors* ***Hedging Restriction.*** Certain officers failed to inform the Enron Board that the Raptor SPE in Raptor I would not provide its hedge until LJM2 received $41 million for its $30 million investment in Talon, thereby leaving only Enron stock to hedge the notional amount of $734 million.[220] Likewise, Enron in-house attorneys who knew of Glisan's and Kopper's involvement appear to have taken no action to advise the Enron Board of that fact.

- ***Other Enron Officer Involvement in LJM2.*** The Board was not advised at its meeting discussing LJM2 that Glisan and Kopper (in addition to Fastow) were involved in the management of LJM2.[221]

- ***Independent Third Party.*** Although it was the "independent" third party in many of the SPE transactions, LJM2 was actually an entity controlled and managed by senior officers of Enron.[222] In addition, the "special purpose vehicle not affiliated with the Company" that was approved by the Executive Committee for the Chewco/CalPERS transaction was known by the officers and in-house attorneys to be controlled and managed by Kopper, who was present at that Executive Committee meeting.[223]

- ***Arm's Length Transactions.*** Enron reported "arm's length transactions" between Enron and LJM2[224] even though in many

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even if 100% of the shares are available." Email from Joel Ephross, Enron, to George McKean, Enron, Mar. 22, 2001 [EN01647576-EN01647580]; ***see also*** Appendix B (Role of Andersen); Appendix C (Role of Enron's Attorneys); Second Interim Report, Annex 5 to Appendix L (Related Party Transactions).

220 ***See*** Second Interim Report, Annex 5 to Appendix L (Related Party Transactions). Enron's transaction support accountant with responsibility for the Raptors also apparently concealed this fact from Andersen. ***See*** Appendix B (Role of Andersen).

221 ***See*** LJM2 Co-Investment, L.P. Private Placement Memorandum, Oct. 13, 1999, at 2 [MLBE 0006895-MLBE0006915].

222 LJM2 was involved in no less than twenty-one of Enron's SPE transactions. Fastow and Kopper controlled and managed LJM2. ***See*** Second Interim Report, Appendix L (Related Party Transactions).

223 ***See*** Minutes of Enron Executive Committee Meeting, Nov. 5, 1997, at 2 [AB000456818–AB000456821]. The only public discussion of Chewco and Kopper is in the Related Party Transactions section of Enron's 1999 10-K which stated "In addition, an officer of Enron has invested in the limited partner of JEDI and from time to time acts as agent on behalf of the limited partner's management." Enron Form 10-K filed with the SEC for the Year ended Dec. 31, 1999 (the "10-K for 1999"), Notes to Consolidated Financial Statements, Note 16.

224 Minutes of Enron Audit Committee Meeting, Feb. 7, 2000 (the "2/7/00 Audit Committee Minutes"), at 3-4 (Causey "stated that in his opinion all of the transactions had been negotiated on an arms-length basis") [AB000201248-AB000201251]. Enron also made similar representations to the public. ***See*** 10-K for 1999, Notes to Consolidated Financial Statements, Note 16; ***see also*** Enron Form 10-K filed with the SEC for the Year ended Dec. 31,2000, Notes to Consolidated Financial Statements, Note 16.

> instances the negotiations were chilled by senior Enron officers who managed LJM2 and were in a position to exert influence over other Enron officers who were negotiating on behalf of Enron.[225]

Conclusion

Through the use of these and other methods, certain Enron officers implemented their use of the six accounting techniques to distort Enron's reported financial results. In the following sections, the Examiner analyzes how Enron's system of checks and balances failed to prevent this misconduct.

D. Failure of Professionals to Provide Checks and Balances

Enron's professionals could have provided a check against the officers' misconduct. To varying degrees, these professionals were involved in the structuring, documentation and disclosure of these transactions. It appears that they had opportunities to prevent or limit this misconduct at several points in time.

Andersen

As previously discussed, Andersen's certification of Enron's financial statements was indispensable to Enron in accessing the capital markets. Andersen's audits of Enron's financial statements should have provided a check against Enron's misuse of the SPEs. Moreover, Andersen had obligations under GAAS to alert the Audit Committee to any material accounting and disclosure risks arising out of the SPE transactions. This

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[225] These issues were noted in testimony of McMahon, when describing his views of the LJM conflict issues in March 2000 as follows:

> [T]he LJM situation had gotten to basically a point that was just untenable for myself and my group. We found ourselves negotiating against people who represented LJM. They were Enron employees. Andy Fastow was the ultimate senior person that all those people reported to. He set compensation and promotion.

Financial Collapse of Enron: Hearing before the Subcommittee on Oversight and Investigations, 107th Cong. (Feb. 7, 2002), at 55 (testimony of Jeffrey J. McMahon, President and Chief Operating Officer, Enron), ***available at*** http://energycommerce.house.gov/l07/actiodlO7-88.pdf.

was especially critical for Enron's Audit Committee because of the risks presented by the company's highly structured accounting-driven SPE transactions. Technical and undeveloped GAAP relevant to the accounting for SPE transactions significantly increased the risk of accounting mistakes and the divergence of the economic substance of a transaction from its accounting treatment and disclosure. Andersen's compliance with GMS might have enabled the Audit Committee to serve as a more effective check.

Perhaps the primary explanation for Andersen's failure was that it simply lost sight of its duties. Andersen owed duties to the investing public,[226] as well as a direct duty to the Audit Committee. SAS 61 "requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible."[227] Despite these fundamental precepts, on many occasions, it appears that Andersen acted in a manner inconsistent with its duties. Examples include:

> *SAS 61 Violations.* Under GMS, Andersen was required to determine whether the Enron Audit Committee was informed about the "effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus" and to discuss "items that have a significant impact on the representational

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[226] Chief Justice Burger, writing for an unanimous Supreme Court in ***United States v. Arthur Young & Co.***, 465 U.S. 805, 817-18 (1984) (emphasis in original), explained this duty as follows:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a ***public*** responsibility transcending any employment relationship with the client. The independent public accountant performing the special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretation of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

[227] SAS 61, at § 2 (AU § 380.02).

faithfulness, verifiability and neutrality of the accounting information included in the financial statements."[228] The evidence would permit a fact-finder to conclude that Andersen failed to perform this important duty. For example, when evaluating the risks of retaining Enron as a client in February 2001, Andersen analyzed the effect of Enron's mark-to-market accounting, fair value accounting, FAS 140 Transactions, LJM Transactions and Whitewing transactions on Enron's financial statements.[229] One week later, Andersen met with the Enron Audit Committee without sharing this type of clear quantitative analysis with the Audit Committee concerning the effect of these transactions on Enron's financial statements.[230]

- *Related Party Risks.* There were numerous occasions where Andersen failed to advise the Audit Committee and the Enron Board of its concerns regarding the Related Party Transactions. For example:

  - *LJM1/Rhythms Hedging Transaction.* In an email dated May 28, 1999, one senior Andersen officer noted: "Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme? Plus, even if all the accounting obstacles below are overcome, it's a related party, which means FAS 57 disclosure of all transactions. Would Enron want these transactions disclosed every year as related party transactions in their financial statements?"[231]

  - *Raptors.* In an email dated February 4, 2000, one senior Andersen partner who was a member of the PSG noted in connection with the development of what became the Raptor hedging structure: "I believe this SPE is nonsubstantive."[232] In an email dated February 6, 2001, one senior Andersen partner who was a member of the PSG noted: "Significant [internal Andersen] discussion was held regarding the related party transactions with LJM including the materiality of such amounts to Enron's income statement and the amount retained 'off balance sheet.'. . . Ultimately the conclusion

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[228] *Id.* at § 7; SAS 90, at § 1 (amending SAS 61, at § 11) (AU § 380.11).

[229] Retention Meeting Presentation, at 5.

[230] Minutes of Enron Audit Committee Meeting, Feb. 12,2001 (the "Audit Committee 02/12/01 Minutes") [AB000204423-AB000204428].

[231] Neuhausen/Duncan 5/28/99 Email, at ELIB00003903-00001.

[232] *See* Email from John E. Stewart, Andersen, to Carl E. Bass, Andersen, regarding Enron Derivative Transaction, Feb. 4,2000, at 1 [ELIB00003646-00001-ELIB00003646-00002].

was reached to retain Enron as a client.... Take away To Do's.. .. Suggest that a special committee of the BOD be established to review the fairness of LJM transactions (or alternative comfort that the transactions are fair to Enron, e.g., competitive bidding)."[233]

- o *General Considerations.* While an accountant is not responsible for its client's business decisions, there is no evidence that Andersen ever discussed with the Audit Committee the extent of its internally expressed concerns over these SPE structures.

- *Audit Committee Communications.* Andersen may have affirmatively misled the Audit Committee regarding the reason why certain of Enron's accounting and disclosure judgments had a high "risk profile."[234] Specifically, there is evidence that Andersen's presentations to the Audit Committee were designed to and did have the effect of creating the impression that Enron's risky accounting judgments and disclosure judgments were the natural result of Enron's "sophisticated business practices,"[235] when in fact these risky judgments were the result of the intentional use of SPE transactions designed to manipulate Enron's reported financial condition, results of operations and cash flows.

- *Prepay Transactions.* Andersen was aware of the type of disclosure necessary to make the nature of Enron's Prepay Transactions visible to a user of Enron's financial statements. Another Andersen client, Aquila Energy Corporation, included such a disclosure in an SEC filing,[236] and Andersen proposed that Enron include a similar disclosure in its financial statements.[237] When the officers refused, Andersen acquiesced.

- *FAS 140 Transactions.* Andersen understood that the Total Return Swaps constituted unconditional promises to pay principal and interest.[238] However, Andersen was content to accept the Enron

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[233] Email from Michael D. Jones, Andersen, to David B. Duncan and Thomas H. Bauer, Andersen, regarding Enron retention meeting, Feb. 6,2001, at PSI00004467 [PSI00004467-PSI00004468].

[234] Materials from Enron Audit Committee Meeting, Feb. 7, 1999, at AB0246 01067 [AB0246 01057-AB0246 01167].

[235] 2/7/00 Audit Committee Minutes, at 2.

[236] *See* Aquila Form S-1, at 42-43.

[237] Cash Sworn Statement, at 70-75; Scardino Interview.

[238] *See, e.g.*, Memorandum from Kimberly R. Scardino, Andersen, to The Files, regarding Project Generic - Sale of Enron's Sub's Financial Asset (a Hawaii 125-0 transaction), Apr. 9, 2000 [AB0911 1938-AB0911 19431.

officers' classification of these obligations as "derivatives," even though FAS 105 required that "the face, contract, or notional principal amount"[239] of these obligations be separately disclosed, and FAS 140 specifically required that the recourse nature of the Total Return Swaps be disclosed.[240]

- ***Nahanni.*** Andersen was aware that in the Nahanni transaction Enron obtained loan proceeds in the form of Treasury securities, sold those securities before year-end and repaid the loan – all within a period of days straddling year-end 1999.[241] Despite this knowledge, Andersen permitted the officers to report the proceeds of the Treasury securities' sale as cash flow from operating activities.

Attorneys

By analyzing the structure of the SPE transactions and documenting them, and by providing opinions in various transactions, Enron's attorneys also played a vital role in Enron's access to the capital markets. These attorneys could have provided a check and balance against the Enron officers' wrongdoing. Among other things, these attorneys could have apprised Derrick or the Enron Board when they knew of conduct that could result in Enron disseminating materially misleading financial information, or they could have refused to render legal services in connection with SPE transactions when they had concerns about their propriety.

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[239] Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, Statement of Financial Accounting Standards No. 105 (Financial Accounting Standards Bd. 1990).

[240] FAS 140, ¶ 17(f)(2).

[241] See Nahanni Memo, at 1 ("Objective[:] Increase Funds flow through the sale of Merchant Investments held by a newly formed consolidated subsidiary."); Email from Derek Claybrook, Andersen, to Patricia Grutzmacher, Andersen, Dec. 6, 1999, at 1 (identifying purpose of transaction to "liquidate[] T-bills over time resulting in an increase in Operating Cash Flow for Enron") [PSI00006799-PSI00006800]. The Nahanni Memo reflects Andersen's awareness that the Treasury securities were sold prior to the end of 1999 and of the payment of the related debt in early 2000. It is noteworthy in that it contains information that could not have existed as of the date of the memo, i.e., information regarding payment of the debt subsequent to year-end 1999.

One explanation for the attorneys' failure may be that they lost sight of the fact that the corporation was their client. It appears that some of these attorneys considered the officers to be their clients when, in fact, the attorneys owed duties to Enron. Another explanation may be that some of these attorneys saw their role in very narrow terms, as an implementer, not a counselor. That is, rather than conscientiously raising known issues for further analysis by a more senior officer or the Enron Board or refusing to participate in transactions that raised such issues, these lawyers seemed to focus only on how to address a narrow question or simply to implement a decision (or document a transaction). Examples include:

- *LJM1/Conflict of Interests.* Although Derrick, Enron's General Counsel, advised the Enron Board on the conflict of interest issue presented by Fastow's involvement in the LJM1/Rhythms Hedging Transaction, his advice was limited to whether Enron's Code of Ethics applied and whether it could be waived. No advice or discussion appears to have taken place about risks, areas of concern, or ways to minimize risks.

- *Hiding Fastow's LJM2-Related Compensation.* Enron's attorneys worked to avoid disclosure of Fastow's LJM-related compensation. According to Mintz, the General Counsel of Enron Global Finance: "I think the number one item on our list is to resolve the 'where practicable' language in connection with AF's interest in the transactions engaged in with Enron by LJM1 and 2. I spoke, again, with Andy about this earlier today and he believes (perhaps rightly so) that Skilling will shutdown LJM if he knew how much Andy earned with respect to the Rhythms transaction. . . . We need to be 'creative' on this point within the contours of Item 404 so as to avoid any type of stark disclosure, if at all possible."[242]

- *Chewco/Tax Indemnification.* Following Enron's repurchase of Chewco's interest in JEDI, Mintz, then General Counsel of Enron Global Finance, recognized that there was no contractual basis for Enron to pay Chewco a $2.6 million tax indemnification payment.

[242] Email from Jordan Mintz, Enron, to Ron Astin, Vinson & Elkins, and Rex Rogers, Enron, *et al.,* Jan. 16,2001, at 1-2 [AB0911 1156-AB0911 1158].

However, at the instruction of Fastow, Mintz had an amendment to the agreement drafted to provide for the payment and never raised the issue with Enron's General Counsel, Derrick.[243]

In other cases, Enron's in-house attorneys knew that the Enron Board did not have all relevant facts before it, but took no action to correct that problem:

- ***Other Enron Officer Involvement in** LJM2.* Enron in-house attorneys knew that the Enron Board was not informed that Glisan and Kopper, in addition to Fastow, were involved in the management of LJM2.[244]

- ***LJM2 Concerns.*** Enron in-house attorneys never shared with the Enron Board their concerns that there was no substantiation for the conclusion that the Enron/LJM2 deals were "at arms-length" or that Enron got the best price from the LJM2 transactions.[245]

- ***Kopper's Role in Chewco.*** Fastow characterized Chewco as an "unaffiliated" entity to the Enron Board even though Kopper was the managing partner. Enron in-house attorneys knew of Kopper's role in Chewco but never raised the issue with the Enron Board.[246]

- *Raptor **Manipulation Concerns.*** Enron in-house attorneys never discussed their concerns about the Raptor SPEs with the Enron Board. In a memorandum prepared by an in-house attorney, Stuart Zisman, to several senior Enron in-house attorneys, Zisman stated:

  > **Overall Book Manipulation.** The Raptor structure is very cleverly designed to reduce earnings volatility resulting from the rules of fair value accounting. Our original understanding of this transaction was that all types of assets/securities would be introduced into this structure (including both those that are viewed favorably and those that are viewed as being poor investments). As it turns out,

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[243] ***See*** Appendix C (Role of Enron's Attorneys), ***Attorneys' Role in Related Party SPE Transactions – Chewco – Attorneys' Roles in Connection with Chewco Unwind and Tax Indemnity Issue.***

[244] ***Compare*** Email from Bob Baird, Vinson & Elkins, to Scott Sefton and Rex Rogers, Enron, Oct. 4, 1999 [AB0472 01453-AB0472 01455] ***with*** Minutes of Enron Board Special Meeting, June 28, 1999 (the "6/28/99 Board Special Meeting Minutes") [AB000196728-AB0001967401.

[245] ***See*** Memorandum from Jordan Mintz, Enron, to Rick Buy and Rick Causey, Enron, regarding "LJM Approval Process – Transaction Substantiation," Mar. 8, 2001 [AB0472 01933-AB0472 019371.

[246] Facsimile from Carol St. Clair, Assistant General Counsel, Enron, to Richard McGee and Mark Spradling, Vinson & Elkins, regarding Project Chewco Transaction Structure, Oct. 31, 1997 [AB000465826-AB000465830]; ***see also*** Appendix C (Role of Enron's Attorneys), ***Attorneys' Role in Related Party SPE Transactions – Chewco.***

> we have discovered that a majority of the investments being introduced into the Raptor Structure are bad ones. This . . . might lead one to believe that the financial books at Enron are being "cooked" in order to eliminate the drag on earnings that would otherwise occur under fair value accounting. . . .[247]

- *Raptor Restructurings*. *In* March 2001, Enron contributed an additional 12 million shares of Enron stock, then worth in excess of $600 million, to the Raptor SPEs. The contribution was necessitated by the decrease in the value of the Enron stock initially contributed to the Raptor SPEs and the decrease in the value of the assets that were hedged. Enron's in-house attorneys searched to find a way to avoid having to obtain Board approval of this contribution. They concluded that no Board approval was required because this transfer was authorized by a previous resolution of the Enron Board that provided management with blanket authority to execute and settle equity derivative transactions up to a specified share amount.[248]

E. Failure of Lay and Skilling: to Provide Checks and Balances

During the five years leading up to the Petition Date, Enron's organization was structured with the Office of the Chairman, which Lay and Skilling shared, as the top management position. Thus, the senior officers who misused the SPE transactions to disseminate materially misleading financial information reported either directly or indirectly to Lay and Skilling. For example, Fastow and Causey reported directly to the Office of the Chairman, and McMahon and Glisan reported to Fastow.

Lay and Skilling, as the CEO and COO of Enron, respectively, should have been an important check in preventing or minimizing the impact of the subordinate officers' conduct. Lay and Skilling were both actively involved in Enron's day-to-day operations and met at least weekly with the senior officers of the company. Lay and Skilling

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[247] Memorandum from Stuart Zisman, Enron, to Mark Haedicke and Julia Murray, Enron, regarding Project Raptor, Aug. 31,2000, at 1 (emphasis in original) [AB0417 03120-AB0417 03121].

[248] *See* Appendix C (Role of Enron's Attorneys), *Attorneys' Role in Related Party SPE Transactions – Raptors – Attorney Role in Raptors and Board Approval.*

participated meaningfully in Enron's annual budgeting process, and they regularly monitored the financial performance of Enron. Before the end of each quarter, they met with Causey to discuss an estimate of Enron's performance and help allocate resources to complete transactions that would help Enron meet Wall Street's expectations.

Given Lay's and Skilling's intimate knowledge of and involvement with Enron's affairs, it is reasonable to infer that they understood the widespread use of the SPE transactions and the significant impact of those transactions on Enron's publicly-reported financial condition. There is evidence with respect to certain of the SPE transactions, including the LJM1/Rhythms Hedging Transaction and the LJM2/Raptors Hedging Transactions, that at least Skilling met with and encouraged officers and other employees of the company to complete those transactions. In addition, Fastow, Causey, McMahon, Glisan and others routinely provided detailed information about Enron's financing activities at meetings of the Finance Committee, which Lay and Skilling always attended.

Lay and Skilling should have used their knowledge of the company to help the Outside Directors understand the information being presented. Lay and Skilling had the opportunity to provide meaningful interpretation of the presented information, as they attended almost every meeting of the Enron Board and its committees. They also set the agendas for the meetings and reviewed and helped shape in advance the presentations that other Enron managers would provide. However, the senior officers continued to provide information to the Outside Directors, particularly the Finance Committee, using misleading terms and confusing jargon, resulting in obfuscation rather than clarity.

There is evidence that Lay and Skilling sometimes participated with their subordinate officers in providing information to the Outside Directors about SPE

transactions.[249] There is also evidence showing that at least Skilling failed to tell the Outside Directors important information about SPE transactions that might have changed the outcome of Board decisions, even though he was present at the Board or committee meetings during which these matters were reviewed.[250]

While the justification for their actions is not clear from the evidence, it is clear that Lay and Skilling failed to respond to red flags that, had they inquired, would have led them to the knowledge that senior officers were misusing SPE transactions and disseminating materially misleading financial information. It also appears that Lay and Skilling did little to help the Outside Directors serve effectively as a check on the wrongful conduct.

F. Failure of Enron Board to Provide Checks and Balances

The Enron Board could have been the ultimate check in preventing or minimizing the impact of the officers' misconduct. The Board had the authority to stop the misconduct by, for example, terminating the employment of these officers, refusing to approve Enron's financial statements, and other disclosures in its 10-Ks and other public filings or notifying the SEC of wrongdoing. In practice, however, particularly in circumstances involving complex matters and obfuscation by officers of a company, there

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[249] For example, with respect to the LJM1/Rhythms Hedging Transaction, both Lay and Slulling "answer[ed] questions from the Directors regarding Mr. Fastow's involvement in the partnership and the economics of the transaction." 6/28/99 Special Board Meeting Minutes, at 6.

[250] For example, in December 1997, Skilling failed to tell the Enron Board that Kopper was involved in Chewco. In addition, despite several opportunities at Board and committee meetings in which LJM2 transactions were discussed, he failed to disclose that he was not receiving information about Fastow's LJM2 compensation.

are limitations to a board serving as an effective check in the area of oversight.[251] This may help to explain why director liability for breach of the duty of oversight is rare absent egregious facts.[252]

The Enron Board did not serve as an effective check on the officers' misuse of Enron's SPE transactions. There are several factors that might explain this failure. Some of these factors were not within the control of the Enron Board. Other factors, however, were within the control of the Enron Board and, if handled differently, might have resulted in the Board limiting the harm caused to Enron.

The Enron Board generally was not asked to, and did not, approve Enron's SPE transactions other than the LJM1/Rhythms Hedging Transaction, certain LJM2/Raptors Hedging Transactions and a few other SPE transactions involving Enron stock (such as

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[251] Courts have acknowledged that actively engaged boards will not always be able to detect and prevent misconduct occurring within the corporation. See, *e.g.*, In re *Caremark* Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) ("And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law.").

[252] As noted in Annex 2 to Appendix D (Roles of Lay, Skilling and Outside Directors), the law regarding board oversight divides oversight responsibility into two principal components: a duty to monitor and a duty to inquire. A failure to discharge the duty to monitor, where found actionable by the courts, has typically been characterized by abdication or sustained inattention, while actionable failures (assuming they are not barred by an exculpation provision) to satisfy the duty to inquire (i.e., failing to recognize and respond to red flags) occur in cases of ordinary negligence. If a director exculpation provision applies, however, as it would in Enron's case, a director's failure to satisfy either component of oversight must amount to conduct "not in good faith" or must involve "intentional misconduct" or "a knowing violation of law" in order to establish liability. Thus, director liability in the oversight area is rare absent egregious facts. There have been several policy reasons advanced by commentators and courts supporting a high threshold for liability. These include: (i) the desire by companies to attract qualified directors; (ii) the need to provide incentives for boards to permit the corporation to take considered risks as opposed to taking the most conservative approach; and (iii) the expense of a different legal framework, whether such expense results from increased insurance premiums for D&O insurance coverage or from the resources a director would require to fulfill a more proactive oversight role. See generally In re *Caremark* Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996); American Law Institute, Principles of Corporate Governance: Analysis & Recommendations § 7.19 cmt. c (1994). Despite a high threshold for the imposition of liability, the Examiner believes that understanding the Enron Board's role and conduct is essential in addressing the question of how Enron's financial demise could have happened.

the Share Trust Transactions). As a result, the Board's role for most of these transactions consisted primarily of providing oversight and being alert for signals or red flags of wrongdoing. The following discusses Enron's policies relating to its transaction approval process and the conduct of the two committees most responsible for monitoring the SPEs: the Finance Committee and the Audit Committee.

Enron Board's Transaction Approval Policies

The Enron Board did not approve most of the SPE transactions. There were several policies established by the Enron Board that were relevant to determining whether a transaction could be consummated without Board approval. These included: (i) Enron's Risk Management Policy;[253] (ii) Enron's Guaranty Policy;[254] and (iii) Enron's asset divestiture policy.[255] Because of the way in which many of the SPE transactions

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[253] Enron's risk management policy set authorized limits on net open position, maturity gaps and value-at-risk for activities Enron designated as being within its commodity groups. Under this policy for most periods, there were generally no value-at-risk limits on the merchant portfolio commodity group. *See* Enron Corp. Risk Management Policy, Oct. 1, 1996, as amended through May 2, 2000 (the "Risk Management Policy") [AB0247 01276-AB0247 012831. There is evidence that there may have been a value-at-risk limit applicable to the merchant portfolio when it first received separate designation under the Risk Management Policy in 1998. Draft Enron Corp. Risk Management Policy, Dec. 8, 1998 (the "Draft 12/8/98 Risk Management Policy"), at Appendix II [AB0245 03302-AB0245 033221. However, subsequent versions of the Risk Management Policy do not reflect a value-at-risk limit for the merchant portfolio. Under the Risk Management Policy, "value-at-risk" or "VAR" meant Enron's potential exposure, using statistical methods for measuring likely outcomes. "Potential exposure" meant change in value resulting from changes in market prices, interest rates, currency rates, counterparty credit risk, liquidity risk, etc. Because VAR limits were set based on a statistical degree of confidence, they were expected to be breached and the Risk Management Policy required that breaches be reported to different levels of management and eventually to the Board, depending upon the size and other circumstances of the breach.

[254] Enron's guaranty policy permitted Enron, among other things, to guarantee debt or enter into Non-Debt Support Arrangements for the obligations of a subsidiary that was at least 75% owned by Enron upon approval by the Office of the Chairman, Chief Financial Officer, Treasurer or (for certain guaranties and certain periods) a Deputy Treasurer, regardless of amount (the "Guaranty Policy"). *See, e.g.*, Exhibit *"A"* to Enron Board Minutes of Aug. 10, 1999, "Amended Policy for Approval of Guarantees, Letters of Credit, Letters of Indemnity, and Other Support Arrangements" [AB000473946-AB000473951].

[255] Enron's asset divestiture policy required that the divestiture of merchant assets valued at "$75 million or more, raised to $500 million by May 2000, had to be approved by the Board. *"See* Enron Corp. Transaction Approval Process, revised Feb. 1, 1999 and May 2, 2000 (collectively, the "Transaction Approval Process") [AB000193935-AB000193936, AB0247 01266]."

were structured, these policies effectively permitted Enron's officers to incur a virtually unlimited amount of debt through the SPE transactions, without prior approval of the Enron Board. For example, on September 30, 2001, Enron had $4.8 billion of Prepay Transaction debt and $2.1 billion of FAS 140 Transaction debt.[256] It does not appear that the Enron Board approved any of the transactions in which this debt was incurred. The way these policies worked in the context of Enron's SPE transactions can be illustrated through their application to Enron's Prepay Transactions and its FAS 140 Transactions.

Enron's Prepay Transactions primarily involved Enron's Risk Management Policy and Guaranty Policy. Under the Risk Management Policy, Enron and any entity directly or indirectly controlled by Enron could enter into a Prepay Transaction in any amount so long as the limits on Enron's net trading positions and exposure risk (including value-at-risk) set under its Risk Management Policy were not breached. A Prepay Transaction with a creditworthy bank did not increase Enron's net trading position or create any material exposure risk because the commodity risk and delivery times under the forward contract pursuant to which Enron received the financing proceeds were exactly mirrored by the commodity swap into which Enron entered to eliminate the commodity risk. Thus, under the Risk Management Policy, Enron or any of its subsidiaries could engage in a virtually unlimited amount of Prepay Transactions, and under the Guaranty Policy, if the Prepay Transactions were executed by a 75% owned subsidiary, the subsidiary's obligations could be guaranteed by Enron, all without obtaining Board approval.[257]

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[256] Bank Presentation, at 42.

[257] The Board received periodic reports on the credit ratio components relevant to Enron's credit rating. If Prepay Transactions caused price risk management liabilities to exceed price risk management assets, the

Enron's FAS 140 Transactions involved the Risk Management Policy, the Guaranty Policy and the Transaction Approval Process. A typical FAS 140 Transaction included three fundamental features: (i) a "sale" by an Enron subsidiary of a merchant investment to an SPE that had borrowed 97% of the purchase price to fund the purchase (the "Loan"); (ii) an Enron subsidiary's obligation, through a Total Return Swap, to pay the principal and interest due under the Loan; and (iii) Enron's guarantee of its subsidiary's obligations under the Total Return Swap.

With respect to the "sale" of a merchant investment, although there is a question of whether "sales" in these transactions constituted asset divestitures requiring Board approval,[258] as a practical matter there were very few FAS 140 Transactions in which an asset sold had a value in excess of the threshold amounts.[259]

Under Enron's Risk Management Policy, while the Total Return Swap provided by the subsidiary may have technically been considered an asset in Enron's merchant portfolio commodity group, there were no value-at-risk or other limits on the merchant portfolio commodity group applicable to FAS 140 Transactions.[260] In addition, under the

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excess would be treated as debt for credit rating purposes. *See* Second Interim Report. Thus, this was the only practical limitation on the Enron officers in incurring debt related to Prepay Transactions.

[258] Enron's asset divestiture policy required "divestitures" of merchant assets valued at "$75 million or more, raised to $500 million by May 2000, had to be approved by the Board. *See* Transaction Approval Process. Because a FAS 140 Transaction may be viewed as simply converting one asset in Enron's merchant portfolio "commodity group" into another asset – the Total Return Swap in the same "commodity group" – FAS 140 Transactions may not have been viewed as divestitures for this reason (except perhaps to the extent of 3% of the purchase price).

[259] The Cerberus FAS 140 Transaction was valued at approximately $517 million but, for reasons not clear in the evidence, this transaction was not presented to the Enron Board for review and approval. *See* First Interim Report.

[260] *See* Risk Management Policy. In addition to the value-at-risk limit for the merchant portfolio under the 1998 version of the policy noted above, the 1998 version also contained a net open position limit for the merchant portfolio. *Compare* Draft 12/8/98 Risk Management Policy with Risk Management Policy. The net open position limit may also have been eliminated as to the merchant portfolio as it does not appear in numerical form in subsequent versions of the Risk Management Policy. In any event, net open position

Guaranty Policy, the Enron Board had delegated to officers the ability to approve Enron's guarantee of the Total Return Swap. Accordingly, no Board approval was required.

The Enron Board apparently devoted significant attention to these policies, as evidenced by seven amendments to the Risk Management Policy fi-om December **1998** through May **2000.** Given the broad parameters of the Guaranty Policy, the Enron Board apparently put significant emphasis on its ability to manage risk under the Risk Management Policy. While these controls may work well in managing true trading activities involving assets that have publicly quoted prices and substantial market liquidity,[261] they did not allow the Board the opportunity to prevent the incurrence of debt through SPE transactions (structured as trading activities).[262]

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limits did not provide a meaningful constraint on management's ability to enter into FAS 140 Transactions because FAS 140 Transactions would not increase the net open position in the merchant portfolio.

[261] **See** Office of the Comptroller of the Currency, Risk Management of Financial Derivatives, Comptroller's Handbook (Jan. 1997).

[262] Testimony from Herbert Winokur, Chair of the Finance Committee, with particular reference to the Prepay Transactions, illustrates his view of how these controls operated:

> A. Well, my understanding of the transactions was that the other party was paying us and we were agreeing to deliver something and we had a number of controls in place. We had the RAC group looking at the value-at-risk exposures and measuring them. We had the four debt ratios we discussed yesterday where we were looking at where were we and where would we be including funds flow obligations. So we had other controls; we just didn't need the transaction approval control on top of the other controls that we had.
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> Q. That's fine. And the reason was from your perspective as the Finance Committee member what?
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> A. The reason was because once we were monitoring the finance plan, including funds flow, and once we knew that these transactions would be picked up in the value-at-risk control and the price risk management book, we believed that those were the only controls that would be required on those.
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> And as for issuance of debt, again, the controls related to our looking at the ratios that related to balance sheet debt coverage.

Sworn Statement of Herbert S. Winokur, Jr., former Director, Enron, to John L. Latham, A&B, Nov. 21, 2002 (the "Winokur 11/21/02 Sworn Statement"), at 73-74 (second day of testimony).

Finance and Audit Committees

Finance Committee. In the area of SPE transactions and off-balance sheet finance transactions, the Finance Committee failed to serve as an effective check. It should be noted that in the area in which its members had an interest and concern, e.g., the value-at-risk status reports about the trading activities (to the extent they related to true trading activities), the Finance Committee appears to have performed well in its oversight function. Perhaps because of this interest and attention on the part of the Finance Committee, this process worked effectively to prevent trading losses at Enron.

The Finance Committee did not do as well in the SPE transactions and the structured finance areas. In its presentation to the banks on November 19, 2001, Enron listed the debt maturities of its on and off-balance sheet financing activities through 2002. Obligations maturing in the last quarter of 2001 and during 2002 totaled $11.1 billion, with $2.5 billion due in the last quarter of 2001 and the first quarter of 2002. From at least 1997 until August 2001, the Finance Committee apparently neither requested nor received a schedule of the total amount and maturities of Enron's on- and off-balance sheet obligations. Although the Audit and Finance Committees were provided a list of all obligations (without maturities) of Enron as of September 1997, at a meeting on February 9, 1998, they apparently did not see or ask for any similar list again until August 2001. In August 2001, lists of Prepay Transactions and FAS 140 Transactions were provided to the Finance Committee without discussion.[263]

[263] 8/13/01 Finance Committee Materials, at AB0247 02309-AB0247 02310 (part of CFO Report).

The Finance Committee Charter required that this committee:

> review and monitor [the Company's] liquidity, including debt maturities, and its contingent liabilities, including its counterparty and currency risk, exposure under outstanding letters of indemnity, letters of credit and corporate guarantees, and review and approve for recommendation to the Board of Directors, if appropriate, the Company's policies with regard thereto.[264]

Instead of monitoring the amounts and maturities of Enron's obligations, however, the Finance Committee focused on the ratios that guided the credit agency ratings. The problems with relying solely on this system of monitoring Enron's obligations were twofold. First, Enron's use of many of its SPE transactions was designed to have no adverse impact on the ratios. For example, $5 billion of Prepay Transactions did not adversely impact'these key financial metrics. Second, the maturities of these SPE off-balance sheet transactions were not apparent from those ratios. Therefore, the $11 billion of obligations coming due from October 2001 through December 2002 were not disclosed in the ratios. Liquidity analyses were presented to the Finance Committee, but not in juxtaposition to the maturities or amount of the obligations. Equally important, these liquidity reports always included a significant amount of funds that could be raised through "merchant portfolio monetizations."[265] As the Prior Reports regarding the FAS 140 Transactions demonstrate, these "monetizations" were merely financing activities that produced more obligations for Enron.

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[264] Enron Finance Committee Charter, undated (the "Finance Committee Charter"), at 1 [AB1114 00003-AB1114 00004].

[265] See, *e.g.*, Materials of the Enron Finance Committee Meeting, May 1, 2000, at 34 (part of Treasurer Report) (listing $8.4 billion of liquidity, of which $3.98 billion is from "merchant portfolio monetizations") [AB0247 01210-AB0247 013271.

Management failed to present clearly Enron's SPE transactions and the total amount and maturities of its off-balance sheet debt to the Finance Committee. Similarly, management failed to disclose these transactions adequately in its financial statements.[266] The Finance Committee, however, is subject to criticism for failing to recognize that they were not getting adequate information from management on this increasingly important part of Enron's financial structure. This criticism is not meant to imply that there was not any information being supplied to the Board. In fact, in some circumstances it appears that there was so much information presented that it inhibited any meaningful discussion. For example, some of the reports provided to the Finance Committee were so detailed that, according to one director's description of a **1998** capital status report, "the level of detail is numbing rather than elucidating."[267]

The Finance Committee received hints and signals of the magnitude of Enron's SPE transactions, including:

- $2.8 billion of financing transactions at the end of 1999 including a "$300mm structured prepay."
- four "monetizations" of assets and investments totaling $1.6 billion and the Nahanni minority interest transaction totaling $400 million.[268]
- a report proclaiming that major finance initiatives for **1999** included executing over $21 billion of funding transactions and over $5 billion of "balance sheet management activities."[269]

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[266] *See* Second Interim Report, Appendix D (Enron's Disclosure of Its SPEs).

[267] Belfer Sworn Statement, at 123. The chart Belfer referred to was a list that identified many types of Enron's on- and off-balance sheet liabilities, listing Prepays under the heading "Debt Classified as Non-Debt Liabilities." Draft Enron Capital Management Capital Activity Report, Jan. 27, 1998, at AB0246 00815 [AB0246 00725-AB0246008461; Agenda for Joint Audit and Finance Committee Meeting, Feb. 9,1998 [AB000473540].

[268] Materials from Enron Finance Committee Meeting, Dec. 13, 1999 (the "12/13/99 Finance Committee Materials"), at 26 (part of Treasurer Report) [AB0247 00947-AB0247 010751.

[269] *Id.* at 18 (part of CFO Report).

- a list of the largest financing transactions between June and December 2000 including a $500 million Chase prepay, a $1 billion add on to Osprey described as an "off-balance sheet acquisition vehicle, allows for positive funds flow."

It is not the use of SPE off-balance sheet transactions *per se* that should have concerned the Finance Committee. As the Examiner has observed,[270] their use is acceptable if accounted for and disclosed properly. The question is whether these presentations to the Finance Committee should have caused its members to ask additional questions. A full discussion of questions as simple as the following may have elicited some useful information:

- How many transactions?
- How much cash was raised?
- What are Enron's obligations under these transactions?
- When are these obligations due?
- How is Enron reporting them?
- Why don't these transactions adversely affect Enron's investment grade credit rating ratios?

Audit Committee. The Audit Committee also did not serve as an effective check. It had many items to watch and devoted too little time to watching them. The Audit Committee meetings in February 2000 and 2001 illustrated the shortcomings. In each of these meetings, the committee had three major items to consider. First, it received, and should have had a full discussion and consideration of, Andersen's SAS 61 report. Second, it was to discuss and approve the annual financial statements for the preceding

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[270] ***See,*** *e.g.*, First Interim Report, at 22; Second Interim Report, at 49-50.

year. Third, it was to review the LJM transactions and make any comments it had on them to the full Board. In addition to these three items, it was to consider any other matters brought before it. In February 2000, these other matters included: (i) a report on final New York Stock Exchange and SEC rules regarding audit committees; (ii) a report on the 2000 Internal Audit Plan; (iii) a report on the significant reserves in the financial statements; (iv) a report on market risk including the 1999 profit and loss and value-at-risk by commodity group; (v) an executive session to consider the appointment of independent auditors for 2000; and (vi) an executive session with Andersen to discuss any problems or disagreements with management. The February 2000 Audit Committee meeting lasted one hour and ten minutes.[271] That amount of time does not appear to be sufficient for meaningful reports, much less full and complete questions and discussion of those matters presented.

There was little discussion of the three major items. The committee received a list of LJM transactions with amounts involved, and assurances by Causey that the transactions were negotiated at arm's length. However, there were no explanations of what those transactions were or why they were done or whether efforts were made to sell the assets to a third party.

Andersen reported that "the Company's sophisticated business practices introduced a high number of accounting models and applications requiring complex interpretations and judgments and that the broadness of the SEC business-related disclosure requirements added to the complexity of the Company's financial

[271] 2/7/00 Audit Committee Minutes, at 1.

reporting."[272] Again, a full discussion of questions as simple as the following may have elicited some helpful information:

- What were some of the disclosure issues in the financial statements that are before us and that we are being asked to approve at this meeting?

- What are some of the areas on the financial statements that required complex interpretations and accounting judgments so that I can see how much is at stake if others were to reach different judgments than you?

- Is there anything we should be doing to make those accounting judgments easier or the disclosures more transparent and complete?

- What is the likelihood that these judgments could be incorrect? If so, what are the consequences?

- What alternative accounting treatments exist and why did management select and you concur in the treatments used in these financial statements?

There is no record of whether or to what extent any meaningful discussion took place in which Andersen was asked to explain the accounting and disclosure judgments or the magnitude of their impact on Enron's financial statements. In the Audit Committee's defense, however, it did not have the benefit of the concerns that Andersen had expressed internally and it was told that a "clean" opinion would be delivered. Nonetheless, asking questions like those described above may have provoked meaningful discussion of some of these issues.

In February 2001, the Audit Committee meeting lasted one how and thirty-five minutes plus an additional ten minutes the following morning when the Audit Committee went into executive session to recommend the approval of Andersen as the company's

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[272] Materials from Enron Audit Committee Meeting, Feb. 12,2001 [AB0246 01755-AB0246 018811.

independent accountants for the following year. In addition to the three major items the Audit Committee was to consider and discuss – Andersen's SAS 61 report, approval of the 2000 financial statements and the LJM transactions – there were six other items: (i) a presentation by Enron's General Counsel, Derrick, on the legal matters in the footnotes to the financial statements; (ii) the required report of the committee to be included in the proxy statement; (iii) the revised Audit and Compliance Committee Charter; (iv) the annual report on executive and director use of company aircraft; (v) a report on the 2001 Internal Control Audit Plan; and (vi) a report on the company's polices and practices for management's communications with analysts.[273]

The minutes of the meeting do not indicate the time spent on individual issues. The length of the meeting, however, raises a question as to whether there could have been meaningful consideration and discussion on any of them. Andersen reminded the Audit Committee, although somewhat obliquely, that "the Company continued to utilize highly structured transactions, such as securitizations and syndications, in which there was significant judgement required in the application of GAAP. [Enron also used] mark-to-market and fair value model accounting in the areas of trading and derivative contracts and stated that these also required significant judgement regarding the applicability of certain models to specific products or transactions."[274] Yet again, a full discussion of questions as simple as the following may have elicited some helpful information:

- What transactions?
- How much money is involved?

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[273] *Id.*

[274] Audit Committee 02/12/01 Minutes, at 2.

- Should we consider other products and transactions?
- Should we consider alternative accounting treatments or models?
- What happens if these judgments are wrong?
- Which transactions or judgments are the most risky and what are the primary issues?

Possible Explanations for the Enron Board's Failure

Many of Enron's Outside Directors had skills and talents that likely were beneficial to Enron in the operation of its business, and these contributions should not be underestimated. It appears from the evidence, however, that the Outside Directors did not understand important aspects about Enron's use of SPE transactions.

There may be several possible explanations for the Board's failure to understand these transactions. As discussed above, Enron officers often used misleading terms and confusing jargon, and they presented information to the Enron Board and its committees in a manner that obfuscated the substance of the SPE transactions. In addition, the length of Board and committee meetings, given the complexity and the number of agenda items covered, raises questions of whether sufficient time was devoted to allowing the Outside Directors to understand the transactions. Finally, Enron's Board was unusually large, which may have increased the tendency for individual directors not to feel personally responsible for understanding complex matters. Despite the large number of directors, however, the Board did not appear to have sufficient expertise in the kinds of complicated structured financings in which Enron engaged.

Time. In addition to being large and complex, Enron changed its business strategy dramatically during the late 1990s, requiring the Outside Directors to learn and

adjust to the company's transition from a "pipeline company" to a "trading company."[275] Board meetings typically lasted a total of about four to five hours, and committee meetings were generally not more than ninety minutes each. With the large number of significant agenda topics presented at each meeting, these circumstances raise questions of whether the Outside Directors had sufficient time to discuss and understand the matters fully. Although none of the Outside Directors admitted in testimony that they felt the Board or committee meetings were too short,[276] several directors provided such criticism in a Board self-assessment they completed in 2001 (the "2001 Board Assessment"):

- "This is a great board (in my opinion). And, if anything, more meeting time (especially committees) would be nice. It is a worlung board and lots going on in the company!"[277]

- "We may need to meet beyond noon more often, to allow for in-depth briefings, and to leave sufficient time for the special reports to present risks, hurdles, alternative scenarios, and requests for specific advice."[278]

- "I think I would support a move to six meetings a year (but not too strongly.)"[279]

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[275] See, *e.g.,* Enron 2000 Annual Report, at 2-5; Savage Sworn Statement, at 61-62; Urquhart Sworn Statement, at 13.

[276] See, *e.g.,* Sworn Statement of Jerome J. Meyer, former Director, Enron, to Steven M. Collins, A&B, Aug. 29, 2003, at 45-46 ("Q. With respect to the board meetings, did you feel that the time that was allotted to the board meetings was sufficient for you to have all your questions answered about the matters that were brought before the board? **A.** Yes. I never felt like we were without time to address everything that needed to be addressed. I'm comfortable with that. Again, time is a commodity you'd always like more of.").

[277] Materials from Enron Nominating Committee Meeting, Feb. 12, 2001 (the "2/12/01 Nominating Committee Materials"), at AB000467840 (part of 2001 Board Assessment) (emphasis in original) [AB000467834-AB000467851].

[278] *Id.*

[279] *Id.*

Reliance on Other Board Members. The Enron Board was unusually large. A recent survey of public companies reported an average board size of 9.4 total directors, with an average of 6.9 "independent" or outside directors,[280] less than Enron's 15 to 19 directors.[281] A consequence of the large size can be a tendency for the individual directors not to feel personal responsibility for understanding complex matters. Several of the outside Directors testified that they might not have understood an area of the company's operations or a particular matter, but they were not concerned because they expected that someone else on the Board did. For example, Chan, who served on both the Audit and Finance Committees, testified that he relied on other Audit Committee members Jaedicke, Gramm and John Duncan to understand whether it was appropriate for Andersen to provide both external and internal audit functions at Enron: "For something like that, I do rely on my colleagues at the audit committee – such as Bob Jaedicke was much more qualified in this regard, and certainly he has, you know, mentioned about – these concepts, and that's how I learned about it."[282]

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[280] Financial Executives International Survey of Corporate Governance Best Practices, May 2002, *available at* http://www.fei.org/download/feigovsur.pdf#xml=http:/fei.org.master.com/texis/master/search/mysite.txt?q=corporate+governance&order=r&id=3860184834ad7a56&cmd=xml (last visited October 24, 2003).

[281] Several of the directors noted that the Board was too large in the "2001 Board Assessment." *See* 2/12/01 Nominating Committee Materials. Comments in the 2001 Board Assessment included: "Board too large"; "Need to reduce the size of the board. . . ."; "Board slightly too big." 2/12/01 Nominating Committee Materials, at AB000467839.

[282] Chan Sworn Statement, at 208. Chan also testified that he considered the Audit Committee to have "experts on this field" and said John Duncan and Gramm were "very qualified" when asked to name those experts. Chan Sworn Statement, at 210. Gramm, however, testified:

> A. I took accounting in, one accounting course in undergraduate school.
>
> Q. Other than that course and just sort of a normal knowledge you picked up reading financial statements and balance sheets, did you have any other particular expertise in dealing, or knowledge, I should say, about accounting and auditing issues?
>
> A. No.

Gramm Sworn Statement, at 34.

Lack of Structured Finance Expertise. The Board did not include a large number of Outside Directors who had hands-on experience in the types of sophisticated financings employed by Enron. In the 2001 Board Assessment, the directors acknowledged this lack of depth on the Board. A summary of the self-assessment responses quoted the directors' responses, but without attributing the quotes to individual directors. Regarding this lack of financial expertise, the directors wrote:

- "Board is too large, but missing skills in technology and very sophisticated finance."[283]
- "Need more technology/risk management and finance skills."[284]
- "Add expertise in derivatives/hedging/trading."[285]
- "Another person with strong background on financial derivatives may also help."[286]
- "Need to reduce the size of the board and add more expertise in finance, technology and possibly entertainment/media."[287]

Enron's use of securitizations and derivatives was so significant that the Enron Board may have been a more effective check if it had considered some of the oversight guidance applicable to U.S. banks. Much has been written about the importance of effective board of director and senior management oversight of securitization and derivatives activities from the standpoint of U.S. banks, because banks have been among the most active participants in these markets. U.S. bank regulatory agencies have issued

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[283] 2/12/01 Nominating Committee Materials, at AB000467839 (part of 2001 Board Assessment) [AB000467834-AB000467851].

[284] *Id.*

[285] *Id.*

[286] *Id.*

[287] *Id.*

detailed guidance on effective risk management of securitization and derivatives activities and continued to refine this guidance over the years. This guidance requires the board to have a general understanding of the risks that these complex activities create for their institutions and, where necessary, to obtain access to auditors and experts external to the organization, including independent legal advice.[288]

Conclusions

For several reasons, the Enron Board did not function as an effective check and balance. This failure may have resulted from (i) a carefully orchestrated strategy of Enron's senior officers, (ii) the failure of Lay and Skilling, in their capacities as executive officers, to assist the Outside Directors, (iii) inadequate assistance from Enron's professionals,[289] (iv) inattention by the Enron Board to its oversight function or (v) insufficient understanding of how the SPE transactions were being used by Enron's officers.

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[288] *See* Board of Governors of the Federal Reserve System, Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities, SR 95-17 (Mar. 28, 1995); Board of Governors of the Federal Reserve System, Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies, SR 95-51 (Nov. 14, 1995).

[289] For example, Mintz, General Counsel of Enron's Global Finance Group, testified regarding the decision of Enron officers, including him, not to tell the Audit Committee of the Board in February 2001 about transactions in which Enron had repurchased assets from LJM2. When Mintz was asked why the officers did not disclose those transactions, he said: "I felt that there was a substantial opportunity for the board to ask questions, perhaps as we as lawyers are trained, Is there anything else that we should be aware of, and I don't recall them doing that. . . ." Deposition of Jordan Mintz, former Vice President and General Counsel, Enron Global Finance, by Rebecca M. Lamberth, A&B, Sept. 29, 2003, at 130. However, Outside Director Herbert Winokur testified, when asked if he had been interested in learning the identity of the person who purchased Fastow's interest in LJM1 and LJM2: "[I]t's management's responsibility to tell me what I should know. . . . I didn't inquire because I assumed somebody would tell me if I needed to know." Winokur 11/21/02 Sworn Statement, at 240.

X. FINAL REPORT

This Report is the Examiner's final report under the terms of the April 8th Order. Absent further order of the Court, the Examiner has completed his investigation.

The Examiner acknowledges the assistance provided by certain of Enron's officers and employees throughout the course of the investigation. They have provided the Examiner with a substantial amount of documents and information and have been helpful in arranging for interviews of numerous witnesses. The Examiner appreciates their efforts in support of the examination.

Dated: November 4,2003

Respectfully submitted,

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