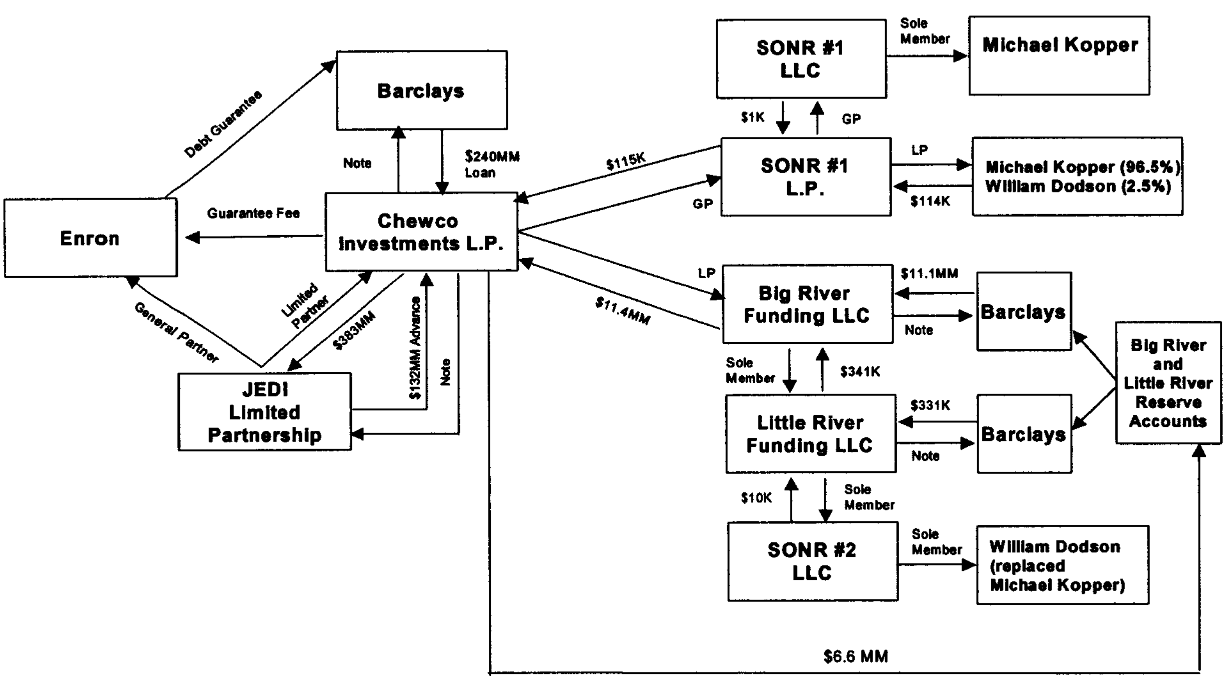
Coda Energy, Inc., and its subsidiary Taurus Energy Corp.[11/] Chewco's share of the proceeds of that sale was $16.6 million. In a letter agreement dated December 30, 1997, Enron and Chewco agreed that Chewco could utilize part of the $16.6 million to "fund . . . reserve accounts in an aggregate amount equal to $6,580,000: (a) the Little River Base Reserve Account . . . in an amount equal to $197,400 and (b) the Big River Base Reserve Account . . . in an amount equal to $6,382,600." The letter agreement was prepared by Vinson & Elkins and was signed by an officer of Enron and by Kopper. Pursuant to the agreement, at closing on December 30, JEDI wired $6.6 million to Barclays to fund the reserve accounts.

A diagram of the Chewco transaction is set forth below:



11/ Enron employees told us that JEDI's decision to sell Coda was not related to Chewco's purchase of CalPERS' interest in JEDI.

The existence of this cash collateral for the Barclays funding was fatal to Chewco's compliance with the 3% equity requirement. Even assuming that the Barclays funding could properly have been considered "equity" for purposes of the 3% requirement, the equity was *not* at risk for the portion that was secured by $6.6 million in cash collateral. At a minimum, Chewco fell short of the required equity at risk by that amount and did not qualify as an adequately capitalized SPE.[12] As a result, Chewco should have been consolidated into Enron's consolidated financial statements from the outset and, because JEDI's non-consolidation depended upon Chewco's non-consolidation status, JEDI also should have been consolidated beginning in November 1997.

Many of the people involved in this transaction for Enron profess no recollection of the Barclays funding, the reserve accounts, or the $6.6 million in cash collateral. This group includes the Enron officer who signed the December 30 letter agreement and the authorization for the $6.6 million wire transfer to Barclays at closing. By contrast, others told us that those matters were known and openly discussed. Their recollection is supported by a substantial amount of contemporaneous evidence.

There is little doubt that Kopper (who signed all of the agreements with Barclays and the December 30 letter) was aware of the relevant facts. The evidence also indicates that Glisan, who had principal responsibility for Enron's accounting for the transaction,

[12] Even if the Barclays loans did qualify as outside equity at risk, there is a question whether Chewco met the 3% requirement because a small portion of the required 3%—Kopper's $125,000—came from a person affiliated with Enron. If Kopper's contribution is not counted, even with the Barclays funding Chewco had slightly less than 3% outside equity.

attended meetings at which the details of the reserve accounts and the cash collateral were discussed. If Glisan knew about the cash collateral in the reserve accounts at closing, it is implausible that he (or any other knowledgeable accountant) would have concluded that Chewco met the 3% standard.[13/]

Although Andersen reviewed the transaction at the time it occurred, we do not know what information the firm received or what advice it provided. Enron's records show that Andersen billed Enron $80,000 in connection with its 1997 review of the Chewco transaction. The CEO of Andersen testified in a Congressional hearing on December 12, 2001 that the firm had performed unspecified "audit procedures" on the transaction in 1997, was aware at the time that $11.4 million had come from "a large international financial institution" (presumably Barclays), and concluded that it met the test for 3% residual equity. He also testified, however, that Andersen was unaware that cash collateral had been placed in the reserve accounts at closing.

The Andersen workpapers we were permitted to review indicate that Andersen was aware of the $16.6 million distribution to Chewco in 1997, and that it had traced the cash disbursements to JEDI's records. We do not know what Andersen did to trace those disbursements, or whether its review did or should have identified facts relating to

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13/ Documents from 1997 indicate that Glisan was actively monitoring the accounting literature and guidance on the substantive outside equity requirements for non-consolidated SPEs. We located a handwritten note apparently made by Glisan that identifies one of the "unique characteristics" of the Chewco transaction as "minimization of 3rd party capital." We do not know what Glisan meant by this reference because he declined to be interviewed by us (other than a brief interview on another subject).

funding the reserve accounts. We have been otherwise unable to confirm or disprove Andersen's public statements about the transaction.

Largely because Kopper, Glisan, and Andersen declined to speak with us on this subject, we have been unable to determine why the parties utilized a financing structure for Chewco that plainly did not satisfy the SPE non-consolidation requirements. Enron had every incentive to ensure that Chewco was properly capitalized. It is reasonable to assume that Enron employees, if motivated to protect only Enron's interests, would have taken the necessary steps to ensure that Chewco had sufficient outside equity. We do not know whether Chewco's failure to qualify resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper or other Enron employees putting their own interests ahead of their obligations to Enron.

E. Fees Paid to Chewco/Kopper

From December 1997 through December 2000, Kopper (through the Chewco general partner) was paid approximately $2 million in "fees" relating to Chewco. It is unclear what legitimate purposes justified these fees, how the amounts of the payments were determined, or what, if anything, was done by Kopper or Chewco to earn the payments. These fee payments raise substantial management oversight issues.

During this period, the Chewco partnership agreement provided that Chewco would pay an annual "management fee" of $500,000 to its general partner, an entity called SONR #1 L.P. Kopper was the sole manager of the general partner of SONR #1, and owned more than 95% of the limited partnership interest in SONR #1. (Dodson owned the remainder of the interest.) None of the persons we interviewed could identify how this fee was determined or what "management" work was expected of the Chewco general partner. Through December 2000, SONR #1 received a total of $1.6 million in Chewco management fees. With minor exceptions, these fees were not paid out of income distributed to Chewco from JEDI. Instead, they were drawn down by Chewco from the revolving credit agreement with JEDI.[14/]

Chewco apparently required little management. The principal activities were back-office matters such as requesting draws under the JEDI revolving credit agreement, paying interest on the Barclays subordinated loan to Chewco (until December 1998 when it was repaid) and on the Barclays "equity" loans to Big River and Little River, and preparing unaudited financial statements for internal use. For most of the relevant period, these tasks were performed by an Enron employee on Enron time. In addition, during certain periods, these tasks appear to have been performed by Fastow's wife, who had previously worked in Enron's Finance group. We do not know if she received compensation for performing these services.

In December 1998, Chewco received a payment of $400,000 from Enron. This payment is variously described as a "restructuring" fee, an "amendment" fee, and a "nuisance" fee. None of the people we interviewed could identify a basis for this payment. Although both the JEDI partnership agreement and revolving credit agreement were amended in November and December 1998, those amendments appear generally to

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14/ As discussed below, upon Enron's repurchasing Chewco's interest in JEDI in March 2001, Enron permitted Chewco to extend repayment on $15 million of the then-outstanding balance on the revolving credit agreement. That $15 million obligation is unsecured and non-recourse.

be *beneficial* to Chewco and, therefore, should not have required compensation to induce Chewco's consent.[15/] Glisan signed the approval form for the wire transfer of the $400,000 fee to Chewco.

F. **Enron Revenue Recognition Issues**

Beginning in December 1997, Enron took steps to recognize revenues arising from the JEDI partnership (in which Chewco was Enron's limited partner) that we believe are unusual and, in some cases, likely would not have been undertaken if Chewco had been an unrelated third party. These include fees paid to Enron by JEDI and Chewco that appear to have had as their principal purpose accelerating Enron's ability to recognize revenue. These fees do not implicate the serious management oversight issues that are raised by the fee payments to Kopper, but they present significant questions about the accounting treatment that permitted Enron to recognize certain of these revenues. Moreover, although the revenues at issue on some of these payments are relatively small compared to Enron's overall financial statements, they raise larger questions about Enron's approach to revenue recognition issues in JEDI.

1. **Enron Guaranty Fee**

As described above, Enron provided a guaranty of the $240 million unsecured subordinated loan by Barclays to Chewco in December 1997. Pursuant to a letter agreement, Chewco agreed to pay Enron a guaranty fee of $10 million (cash at closing)

[15/] Although such compensation may not be unusual in the arm's-length, commercial context, it is hard to understand the justification for payment of a substantial fee to Chewco in these circumstances.

plus 315 basis points annually on the average outstanding balance of the loan. This fee was not calculated based on any analysis of the risks involved in providing the guaranty, or on typical commercial terms. Instead, the fee took into account the overall economics of the transaction to Enron and the accelerated revenue recognition that would result from characterizing the payment as a fee.

During the 12 months that the subordinated loan was outstanding, Chewco paid Enron $17.4 million under this fee agreement. JEDI was the source of these payments to Enron. The first $7 million was taken from the $16.6 million distribution to Chewco at closing, and the remainder was drawn down by Chewco from its revolving credit agreement with JEDI. For accounting purposes, Enron characterized these payments as "structuring fees" and recognized income from the $10 million up-front fee in December 1997 (and for the annual fees when paid during 1998). These were not in fact "structuring fees," however, and accounting rules generally require guaranty fee income to be recognized over the guaranty period. Enron's accounting treatment for the $10 million payment was not consistent with those rules.

2. "Required Payments" to Enron

The December 1997 JEDI partnership agreement required JEDI to pay Enron (the general partner) an annual management fee.[16/] Under applicable accounting principles, Enron could recognize income from this fee only when services were rendered. In March 1998, however, Enron and Chewco amended the partnership agreement to convert

16/ The annual fee was the greater of (a) 2.5% of $383 million less any distributions received by Chewco, or (b) $2 million.

80% of the annual management fee to a "required payment" to Enron. Although this had no effect on the amount payable to Enron, it had a substantial effect on Enron's recognition of revenue. As of March 31, 1998, Enron recorded a $28 million asset, which represented the discounted net present value of the "required payment" through June 2003, and immediately recognized $25.7 million in income ($28 million net of a reserve). Glisan was principally responsible for Enron's accounting for this transaction. We were told that he suggested the change to the partnership agreement so that Enron could recognize additional earnings during the first quarter of 1998.

Enron's accounting raises questions concerning whether the "required payment" should have been recognized over the period from 1998 to 2003. If the payment was contingent on Enron's providing ongoing management to JEDI, Enron may have been required to recognize the income over the covered period. Accounting standards for revenue recognition generally require that the services be provided before recording revenue. It seems doubtful that the management services related to the "required payment" (covering 1998 to 2003) had all been provided at the time Enron recognized the $25.7 million in income. If those services had not been provided by March 1998, Enron's accounting appears to have been incorrect.

3. <u>Recognition of Revenue from Enron Stock</u>

From the inception of JEDI in 1993 through the first quarter of 2000, Enron picked up its contractual share of income or losses from JEDI using the equity method of accounting. JEDI was a merchant investment fund that carried its assets at fair value. Changes in fair value of the assets were recorded in JEDI's income statement. JEDI held

12 million shares of Enron stock, which were carried at fair value. During this period, Enron recorded an undetermined amount of income resulting from appreciation in the value of its own stock. Under generally accepted accounting principles, however, a company is generally precluded from recognizing an increase in the value of its own stock as income.

Enron had a formula for computing how much income it could record from appreciation of its own stock held by JEDI. Enron and Andersen apparently developed the formula in 1996, and modified it over time. While Enron could not quantify for us how much income it recorded from the appreciation of Enron stock held by JEDI, Andersen's workpapers for the first quarter of 2000 indicate that Enron recorded $126 million in Enron stock appreciation during that quarter. Anderson's workpapers for the third quarter of 2000 reflect a decision (described as having been made in the first quarter) that income from Enron stock held by JEDI could no longer be recorded on Enron's income statement. The workpapers do not say whether this decision was made by Andersen, Enron, or jointly.

In the first quarter of 2001, Enron stock held by JEDI declined in value by approximately $94 million. Enron did not record its share of this loss—approximately $90 million. Enron's internal accountants decided not to record this loss based on discussions with Andersen. According to the Enron accountants, they were told by Andersen that Enron was not recording increases in value of Enron stock held by JEDI and therefore should not record decreases. We do not understand the basis on which Enron recorded increases in value of Enron stock held by JEDI in 2000 and prior years, and are unable to reconcile that recognition of income with the advice apparently provided by Andersen in 2001 concerning not recording decreases in Enron stock value.

G. Enron's Repurchase of Chewco's Limited Partnership Interest

In March 2001, Enron repurchased Chewco's limited partnership interest in JEDI and consolidated JEDI into its consolidated financial statements. Fastow was personally involved in the negotiations and decision-making on this repurchase. As described below, the repurchase resulted in an enormous financial windfall to Kopper and Dodson (who collectively had invested only $125,000). Much of the payout to these individuals is difficult to justify or understand from Enron's perspective, and at least $2.6 million of the payout appears inappropriate on its face. Moreover, Kopper received most of these benefits—by coincidence or design—shortly before he purchased Fastow's interests in the LJM partnerships (described below in Section III). Because Fastow and Kopper declined to be interviewed by us concerning the Chewco repurchase, we do not have the benefit of their responses to the serious issues addressed in this section.

1. Negotiations

During the first quarter of 2000, senior personnel in Enron's Finance area came to the conclusion that JEDI was essentially in a liquidation mode, and had become an expensive off-balance sheet financing vehicle. They approached Fastow, who agreed with their conclusion. The next step was to determine an appropriate buyout price for Chewco's interest in JEDI.

The discussions concerning the buyout terms involved, among others, Fastow, Kopper, and Jeffrey McMahon (then Senior Vice President, Finance and Treasurer of Enron).[17/] Because JEDI's assets had increased in value since 1997, on paper Chewco's limited partnership interest had become valuable. On the other hand, Kopper and Dodson had invested only $125,000 in Chewco.

McMahon told us that, in light of the circumstances, he proposed to Fastow that the buyout be structured to provide a $1 million return to the Chewco investors.[18/] According to a document McMahon identified as the written buyout analysis he provided to Fastow, this would give the investors a 152% internal rate of return on their investment and a return on capital multiple of 7.99. McMahon said that Fastow received the proposal, said he would discuss it with Kopper, and later reported back to McMahon that he had negotiated a payment of $10 million. McMahon also said that Fastow told him that Skilling had approved the $10 million payment. McMahon's recollection of events is consistent with a handwritten memorandum addressed to "Andy" (in what we are told is Kopper's handwriting) that analyzes McMahon's written proposal and refers to Enron's purchasing Chewco's interest for $10.5 million. McMahon said he told Fastow

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17/ During a brief interview, Fastow told us that he had *not* participated in these negotiations because, in light of Kopper's having become his partner in the general partner of LJM2, he believed it would have been inappropriate. Fastow's statement is contrary to information we obtained from interviews of several people familiar with the negotiations, all of whom said he was personally involved. Moreover, Fastow's statement is inconsistent with the handwritten memorandum, addressed to "Andy," that is discussed in the text below. We showed a copy of the memorandum to Fastow during the brief interview, but he declined to respond to any questions about it.

18/ McMahon also said he believed at the time that Dodson was the outside equity investor in Chewco, and that Kopper was representing Dodson in the buyout discussions.

that $10 million would be inappropriate and, if that was the agreement, it would be better for Enron to continue with the current JEDI structure and not buy out Chewco's interest.

By mid-2000, Enron had decided to purchase Chewco's interest on terms that would provide a $10.5 million return to the Chewco investors. Chewco had already received $7.5 million in cash (net) from JEDI, so Chewco would receive an additional cash payment at closing of $3 million.[19] By this point, McMahon had left the Treasurer's position and the Finance group. We were unable to locate any direct evidence about who made the ultimate decision on the buyout amount. Skilling told us that he had no involvement in the buyout transaction, including being advised of or approving the payment amount.

2. Buyout Transaction

The buyout was completed in March 2001, when Enron and Chewco entered into a Purchase Agreement (dated March 26, 2001) for repurchasing Chewco's interest. (It is not clear why the transaction did not close until the first quarter of 2001.) The contract price for the purchase was $35 million, which was determined by taking:

- The $3 million cash payment that had been agreed to in 2000; plus

[19] The $7.5 million consisted of several elements: (1) distributions from JEDI that funded the Big River and Little River reserve accounts and interest on those amounts; (2) distributions from JEDI and advances under the revolving credit agreement that funded Chewco's working capital reserve and interest on those amounts; (3) the $400,000 fee paid in December 1998; and (4) other net cash distributions from JEDI, some of which had been used to repay the subordinated loan and equity loans from Barclays and part of the outstanding balance on the revolving credit agreement.

- $5.7 million to cover the remaining "required payments" due to Enron under the JEDI partnership agreement (as discussed above in Section II(F)(2));[20] plus

- $26.3 million to cover all but $15 million of Chewco's outstanding $41.3 million obligation under the revolving credit agreement with JEDI.

At closing, pursuant to a letter agreement with Chewco, Enron kept the $5.7 million and wired $29.3 million to Chewco; Chewco then paid down $26.3 million on the revolving credit agreement and retained the remaining $3 million.

Chewco was not required to pay off the entire $41.3 million balance on the revolving credit agreement. Instead, it paid only $26.3 million, and the remaining $15 million was converted to a term loan due in January 2003. The $15 million was left outstanding because, in December 1999, Chewco had paid $15 million *to LJM1* to purchase certificates in Osprey Trust.[21] Although not disclosed in either the Purchase Agreement or the term loan agreement, Enron and Chewco agreed (1) to make the terms of the loan agreement (maturity date, interest rates) match those of the Osprey Trust certificates, and (2) that Chewco would be required to use the principal paid from the Osprey Trust certificates to repay the $15 million term loan, and would retain any yield paid on the certificates (which it could use to pay interest on the term loan). Enron did

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[20] The $5.7 million payment is referred to in the Purchase Agreement as being for unspecified "breakage costs." There is some evidence that this generic description was used because it was less likely to draw attention from Andersen during their review of the transaction. Because Andersen did not permit us to review workpapers from 2001 or interview their personnel on this matter, we do not know what review Andersen conducted. Enron's records show that it paid $25,000 in fees to Andersen in connection with the Chewco buyout.

[21] Osprey Trust is a limited partner, along with Enron, in Whitewing Associates.

not, however, require that the Osprey Trust certificates serve as collateral for the $15 million loan. The loan is unsecured and non-recourse to Kopper and Dodson.[22]

3. Returns to Kopper/Dodson

As a result of the buyout, Kopper and Dodson received an enormous return on their $125,000 investment in Chewco. In total, they received approximately $7.5 million (net) cash during the term of the investment, plus an additional $3 million cash payment at closing. Even assuming Chewco incurred some modest expenses that were not reimbursed at the time by Enron or drawn down on the revolving credit line, this represents an internal rate of return of more than 360%.

This rate of return does not take into account the $1.6 million in management fees received by Kopper. It also does not reflect the fact that the buyout was tax-free to Chewco, as described below.

4. Tax Indemnity Payment

One of the most serious issues that we identified in connection with the Chewco buyout is a $2.6 million payment made by Enron to Chewco in mid-September 2001. Chewco first requested the payment after the buyout was consummated—under a Tax Indemnity Agreement between Enron and Chewco that was part of the original 1997 transaction. There is credible evidence that Fastow authorized the payment to Chewco

[22] In effect, if Chewco does not repay the unsecured loan when it comes due in 2003, it will amount to a forgiveness by Enron of $15 million in advances under the revolving credit agreement (which funded, among other things, the payment of management fees to Kopper). We understand that Chewco made the first semi-annual interest payment under the term loan in a timely manner in August 2001.

even though Enron's in-house counsel advised him unequivocally that there was no basis in the Agreement for the payment, and that Enron had no legal obligation to make it.

When Chewco purchased the JEDI limited partnership interest in 1997, Enron and Chewco executed a Tax Indemnity Agreement. Agreements of this sort are not unusual in transactions where anticipated cash flows to the limited partner may be insufficient to satisfy the partner's current tax obligations. On its face, the Agreement compensates Chewco for the difference between Chewco's current tax obligations and its cash receipts during the partnership. Chewco subsequently requested payments, and Enron made payments, for that purpose prior to 2001.

After the closing of Enron's buyout of Chewco in March 2001, Kopper requested an additional payment under the Tax Indemnity Agreement. Kopper claimed that Chewco was due a payment to cover any tax liabilities resulting from the negotiated buyout of Chewco's partnership interest. Enron's in-house legal counsel (who had been involved in the 1997 negotiations) consulted with Vinson & Elkins (who also had been involved in the negotiations) concerning Chewco's claim. Both concluded that the Agreement was not intended to cover, and did not cover, a purchase of Chewco's partnership interest. In-house counsel communicated this conclusion to Kopper.

The amount of the indemnity payment in dispute was $2.6 million. After further inconclusive discussions, Kopper told Enron's in-house counsel that he would consult with Fastow. Fastow then called the counsel, who says he told Fastow unequivocally that the Agreement did not require Enron to make any payment to Chewco. In a subsequent conversation, Fastow told Enron's counsel that he had spoken with Skilling and that

Skilling (who Fastow said was familiar with the Agreement and the buyout transaction) had decided that the payment should be made. As a result, in September 2001, Enron paid Chewco an additional $2.6 million to cover its tax liabilities in connection with the buyout. Skilling told us he does not recall any communications with Fastow concerning the payment. Fastow declined to respond to questions on this subject.

H. Decision to Restate

In late October 2001, the Enron Board (responding to media reports) requested a briefing by Management on Chewco. Glisan was responsible for presenting the briefing at a Board meeting on short notice. Following the briefing, Enron accounting and legal personnel (as well as Vinson & Elkins) undertook to review documents relating to Chewco. This review identified the documents relating to the funding of the Big River and Little River reserve accounts in December 1997 through the $16.6 million distribution from JEDI.

Enron brought those documents to the attention of Andersen, and consulted with Andersen concerning the accounting implications of the funded reserve accounts. *After* being shown the documents by Enron and discussing the accounting issues with Enron personnel, Andersen provided the notice of "possible illegal acts" that Andersen's CEO highlighted in his Congressional testimony on December 12, 2001.

Enron's accounting personnel and Andersen both concluded that, in light of the funded reserve accounts, Chewco lacked sufficient outside equity at risk and should have been consolidated in November 1997.[23] In addition, because JEDI's non-consolidation depended on Chewco's status, Enron and Andersen concluded that JEDI also should have been consolidated in November 1997. In a Current Report on Form 8-K filed on November 8, 2001, Enron announced that it would restate its prior period financials to reflect the consolidation of those entities as of November 1997.

23/ When presented in late October 2001 with evidence of the $6.6 million cash collateral in the reserve accounts, Glisan apparently agreed that the collateral precluded any reasonable argument that Chewco satisfied the 3% requirement, but claimed that he had been unaware of it at the time of the transaction.

III. LJM HISTORY AND GOVERNANCE

A. Formation and Authorization of LJM Cayman, L.P. and LJM2 Co-Investment, L.P.

Enron entered into more than 20 distinct transactions with the two LJM partnerships. Each transaction theoretically involved a transfer of risk. The LJM partnerships rarely lost money on a transaction with Enron that has been closed, so far as we are aware, even when they purchased assets that apparently declined in value after the sale. These transactions had a significant effect on Enron's financial statements. Taken together, they resulted in substantial recognition of income, and the avoidance of substantial recognition of loss. This section discusses the formation and authorization of these partnerships. It also addresses their governance insofar as it is relevant to Enron's ability to avoid consolidating them for financial statement purposes. The Board decisions described in this section are addressed in greater detail in Section VII, below.

LJM1. On June 18, 1999, Fastow discussed with Lay and Skilling a proposal to establish a partnership, subsequently named LJM Cayman, L.P. ("LJM1"). This partnership would enter into a specific transaction with Enron. Fastow would serve as the general partner and would seek investments by outside investors. Fastow presented his participation as something he did not desire personally, but was necessary to attract investors to permit Enron to hedge its substantial investment in Rhythms NetConnections, Inc. ("Rhythms"), and possibly to purchase other assets in Enron's merchant portfolio. Lay and Skilling agreed to present the proposal to the Board.

At a Board meeting on June 28, 1999, Lay called on Skilling, who in turn called on Fastow, to present the proposal. Fastow described the structure of LJM1 and the hedging transaction (which is described in Section IV below). Fastow disclosed that he would serve as the general partner of LJM1 and represented that he would invest $1 million. He described the distribution formula for earnings of LJM1, and said he would receive certain management fees from the partnership.[24] He told the Board that this proposal would require action pursuant to Enron's Code of Conduct (an action within Lay's authority) based on a determination that Fastow's participation as the managing partner of LJM1 "will not adversely affect the interests" of Enron.

After a discussion, the Board adopted a resolution approving the proposed transaction with LJM1. The resolution ratified a determination by the Office of the Chairman that Fastow's participation in LJM1 would not adversely affect the interests of Enron.

LJM1 was formed in June 1999. Fastow became the sole and managing member of LJM Partners, LLC, which was the general partner of LJM Partners, L.P. This, in turn, was the general partner of LJM1. Fastow raised $15 million from two limited partners, ERNB Ltd. (which we understand was affiliated with CSFB), and Campsie Ltd. (which

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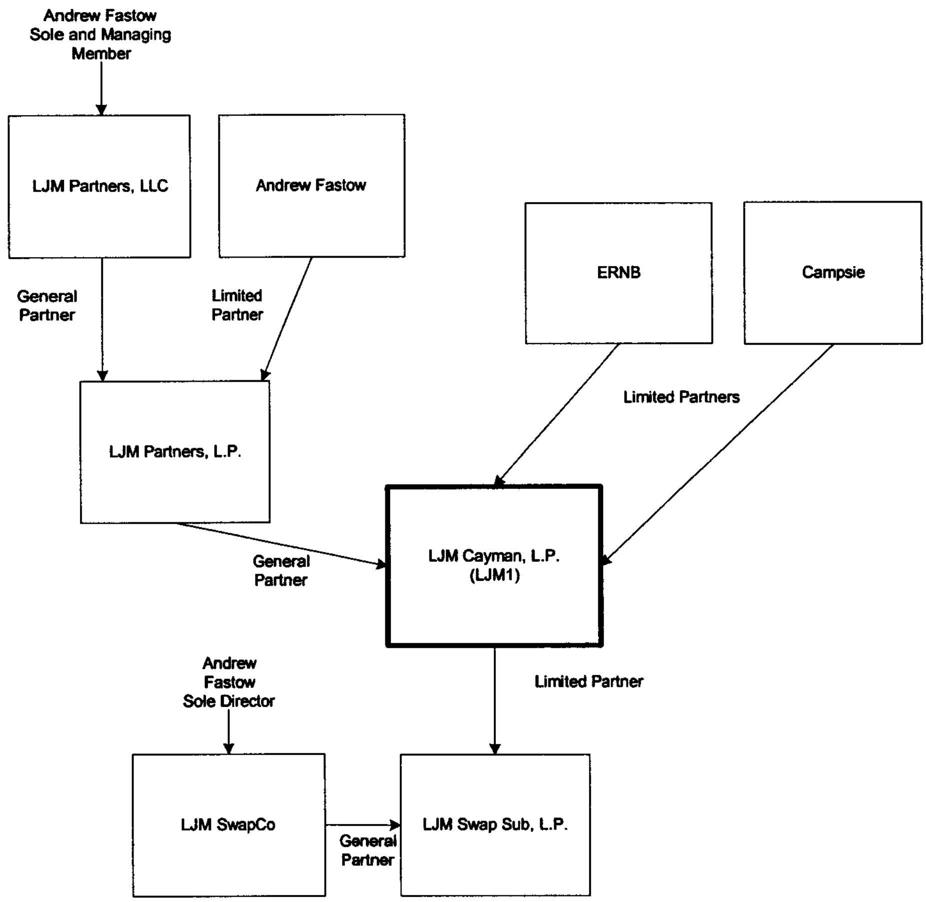
[24] The hedging transaction Fastow proposed included the transfer of restricted Enron stock to LJM1. The Board was told that all proceeds from appreciation in the value of Enron stock would go to the limited partners in LJM1, and not to Fastow; that 100% of the proceeds from all other assets would go to Fastow until he had received a rate of return of 25% on his invested capital; and that of any remaining income, half would go to Fastow and half would be divided among the partners (including Fastow) in proportion to their capital commitments.

we understand was affiliated with NatWest). The following is a diagram of the LJM1 structure:



LJM1 entered into three transactions with Enron: (1) the effort to hedge Enron's position in Rhythms NetConnections stock, (2) the purchase of a portion of Enron's interest in a Brazilian power project (Cuiaba), and (3) a purchase of certificates of an SPE called "Osprey Trust." The first two of these transactions raise issues of significant concern to this investigation, and are described further below in Sections IV and VI.

LJM2. In October 1999, Fastow proposed to the Finance Committee of the Board the creation of a second partnership, LJM2 Co-Investment, L.P. ("LJM2"). Again, he would serve as general partner through intermediaries. LJM2 was intended to be a much larger private equity fund than LJM1. Fastow said he would raise $200 million or more of institutional private equity to create an investment partnership that could readily purchase assets Enron wanted to syndicate.

This proposal was taken up at a Finance Committee meeting on October 11, 1999. The meeting was attended by other Directors and officers, including Lay and Skilling. According to the minutes, Fastow reported on various benefits Enron received from transactions with LJM1. He described the need for Enron to syndicate its capital investments in order to grow. He said that investments could be syndicated more quickly and at less cost through a private equity fund that he would establish. This fund would provide Enron's business units an additional potential buyer of any assets they wanted to sell.

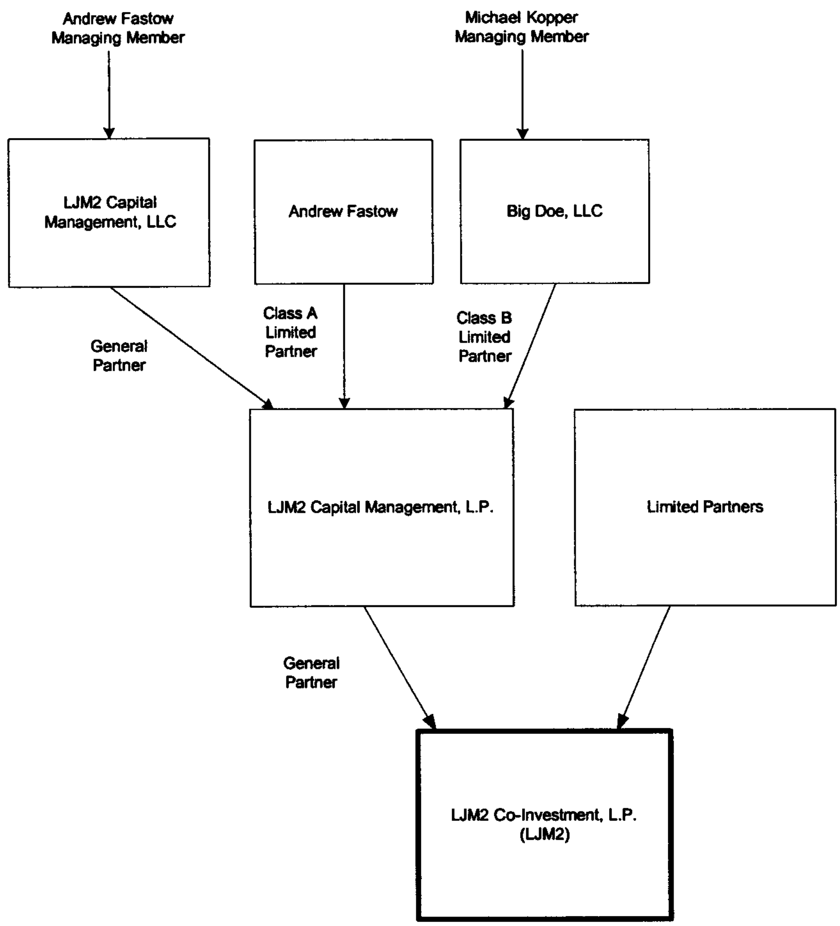
The minutes and our interviews reflect that the Finance Committee discussed this proposal, including the conflict of interest presented by Fastow's dual roles as CFO of Enron and general partner of LJM2. Fastow proposed as a control that all transactions between Enron and LJM2 be subject to the approval of both Causey, Enron's Chief Accounting Officer, and Buy, Enron's Chief Risk Officer. In addition, the Audit and Compliance Committee would annually review all transactions completed in the prior year. Based on this discussion, the Committee voted to recommend to the Board that the Board find that Fastow's participation in LJM2 would not adversely affect the best interests of Enron.

Later that day the Chairman of the Finance Committee, Herbert S. Winokur, Jr., presented the Committee's recommendation to the full Board. According to the minutes, he described the controls that had been discussed in the Finance Committee and noted that Enron and LJM2 would not be obligated to engage in transactions with each other. The Board unanimously adopted a resolution "adopt[ing] and ratify[ing]" the determination of the Office of the Chairman necessary to permit Fastow to form LJM2 under Enron's Code of Conduct.

LJM2 was formed in October 1999. Its general partner was LJM2 Capital Management, L.P. With the assistance of a placement agent, LJM2 solicited prospective investors as limited partners using a confidential Private Placement Memorandum ("PPM") detailing, among other things, the "unusually attractive investment opportunity" resulting from the partnership's connection to Enron. The PPM emphasized Fastow's position as Enron's CFO, and that LJM2's day-to-day activities would be managed by Fastow, Kopper, and Glisan. (We did not see any evidence that the Board was informed of the participation of Kopper or Glisan; Glisan later claimed his inclusion in the PPM was a mistake.) It explained that "[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities" and that it "expects to benefit from having the opportunity to invest in Enron-generated investment opportunities that would not be available otherwise to outside investors." The PPM specifically noted that Fastow's "access to Enron's information pertaining to potential investments will contribute to superior returns." The drafts of the PPM were reviewed by Enron in-house lawyers and Vinson & Elkins. Both groups focused on ensuring that the solicitation did not appear to come from Enron or any of its subsidiaries.

We understand that LJM2 ultimately had approximately 50 limited partners, including American Home Assurance Co., Arkansas Teachers Retirement System, the MacArthur Foundation, and entities affiliated with Merrill Lynch, J.P Morgan, Citicorp, First Union, Deutsche Bank, G.E. Capital, and Dresdner Kleinwort Benson. We are not certain of this because LJM2 declined to provide any information to us. We further understand that the investors, including the general partner, made aggregate capital commitments of $394 million. The general partner, LJM2 Capital Management, L.P., itself had a general partner and two limited partners. The general partner was LJM2 Capital Management, LLC, of which Fastow was the managing member. The limited partners were Fastow and, at some point after the creation of LJM2, an entity named Big Doe LLC. Kopper was the managing member of Big Doe.[25/] (In July 2001, Kopper resigned from Enron and purchased Fastow's interest in LJM2.) The following is a diagram of the LJM2 structure:

25/ In his capacity as an Enron employee, Kopper reported to Fastow throughout the existence of LJM2 until his resignation in July 2001. We have seen no evidence that Kopper obtained the required consent to his participation in LJM2 under Enron's Code of Conduct. Kopper certified his compliance with the Code in writing, most recently in September 2000.



In April 2000, Enron and LJM Management L.P. entered into a "Services Agreement" under which Enron agreed to have its staff perform certain tasks (for a fee), including opening and closing accounts, executing wire transfers, and "Investment Execution & Administration." The Services Agreement described these activities as "purely ministerial," and contemplated that LJM would pay market rates. That same month, Causey and Fastow signed an agreement regarding the use of Enron employees by LJM1 and LJM2. The employees would continue to be "regular, full-time" Enron employees for benefits purposes, but the LJM partnerships would pay the bonuses, and in some cases the base salary. LJM would also pay the costs. The memorandum describing this agreement says that "[i]t is understood that some activities conducted by LJM2 employees will also be for the benefit of Enron," and that in such cases Causey and Fastow would "reasonably agree upon allocation of costs to Enron and LJM2." This understanding was memorialized in a second Services Agreement dated July 17, 2000. We were unable to determine what LJM2 actually paid for any services under these agreements.

The LJM partnerships entered into more than 20 distinct transactions with Enron. A substantial number of these transactions raise issues of significant concern, and are described further in Sections IV, V, and VI of this Report.

B. LJM Governance Issues

The structures of LJM1 and LJM2—in which Fastow controlled the general partner of each partnership—raise questions about non-consolidation by Enron of the LJM partnerships and certain entities (described in more detail below) in which one of the LJM partnerships was an investor. In each case, Enron could avoid consolidation under relevant accounting rules only if the entity was controlled by an *independent* third party with substantive equity and risks and rewards of ownership. The first question, then, is whether Fastow controlled LJM1 and LJM2. If so, Enron arguably would control LJM1 and LJM2, and Enron would be required to consolidate them on its financial statements.

As described above, the criteria for determining control with respect to general partners are subjective. Nevertheless, the accounting rules indicate that a sole general partner should *not* be viewed as controlling a limited partnership if the partnership agreement provides for the removal of the general partner by a reasonable vote of the limited partners, without cause, and without a significant penalty. Similarly, other limits on the authority of the general partner, such as requiring approval for the acquisition or sale of principal assets, could be viewed as giving the limited partners sufficient control for non-consolidation.

Both LJM1 and LJM2 present substantial questions about whether Fastow was in effective control. Fastow was the effective general partner of both partnerships, and had management authority over them. On the other hand, both partnership agreements limited the general partner's investment authority, and required approval of certain investment decisions by the limited partners. Moreover, the LJM2 partnership agreement provided for removal of the general partner, without cause, by a recommendation of an Advisory Committee and a vote of the limited partners (initially limited partners with 75% in interest, later reduced to two-thirds). Given the role of the limited partners (which were somewhat different for LJM1 and LJM2, and in the case of LJM2 changed over time), arguments could be made both for and against consolidation based on Fastow's control of the partnerships. Andersen's workpapers include a discussion of the limited partner oversight in LJM2 and changes in June 2000 to strengthen the rights of limited partners to remove the general partner and members of the Advisory Committee.

We have reviewed these issues in detail, and have concluded that there are no clear answers under relevant accounting standards. Fastow declined to speak with us about these issues. As we have noted, the limited partners of both LJM1 and LJM2, citing confidentiality provisions in the partnership agreements, declined to cooperate with our investigation by providing documents or interviews.

IV. RHYTHMS NETCONNECTIONS

The Rhythms transaction was Enron's first business dealing with the LJM partnerships. The transaction is significant for several reasons. It was the first time that Enron transferred its own stock to an SPE and used the SPE to "hedge" an Enron merchant investment. In this respect, Rhythms was the precursor to the Raptor vehicles discussed below in Section V. Rhythms also provided the first—and perhaps most dramatic—example of how the purportedly "arm's-length" negotiations between Enron and the LJM partnerships resulted in economic terms that were skewed toward LJM and enriched Fastow and other investors. In the case of Rhythms, those investors included several Enron employees who were secretly offered financial interests by Fastow and who accepted them in apparent violation of Enron's Code of Conduct.

A. Origin of the Transaction

In March 1998, Enron invested $10 million in the stock of Rhythms NetConnections, Inc. ("Rhythms"), a privately-held internet service provider for businesses using digital subscriber line technology, by purchasing 5.4 million shares of stock at $1.85 per share. On April 7, 1999, Rhythms went public at $21 per share. By the close of the trading day, the stock price reached $69.

By May 1999, Enron's investment in Rhythms was worth approximately $300 million, but Enron was prohibited (by a lock-up agreement) from selling its shares before the end of 1999. Because Enron accounted for the investment as part of its merchant portfolio, it marked the Rhythms position to market, meaning that increases and decreases in the value of Rhythms stock were reflected on Enron's income statement.

Skilling was concerned about the volatility of Rhythms stock and wanted to hedge the position to capture the value already achieved and protect against future volatility in income. Given the size of Enron's position, the relative illiquidity of Rhythms stock, and the lack of comparable securities in the market, it would have been virtually impossible (or prohibitively expensive) to hedge Rhythms commercially.

Enron also was looking for a way to take advantage of an increase in value of Enron stock reflected in forward contracts (to purchase a specified number of Enron shares at a fixed price) that Enron had with an investment bank.[26/] Under generally accepted accounting principles, a company is generally precluded from recognizing an increase in value of its own stock (including forward contracts) as income. Enron sought to use what it viewed as this "trapped" or "embedded" value.

Fastow and Glisan developed a plan to hedge the Rhythms investment by taking advantage of the value in the Enron shares covered by the forward contracts. They proposed to create a limited partnership SPE, capitalized primarily with the appreciated Enron stock from the forward contracts. This SPE would then engage in a "hedging" transaction with Enron involving the Rhythms stock, allowing Enron to offset losses on Rhythms if the price of Rhythms declined. Fastow would form the partnership and serve as the general partner.

26/ Enron originally entered into these contracts to hedge economically the dilution resulting from its employee stock option programs. The contracts had become significantly more valuable due to an increase in the price of Enron stock.