On June 18, 1999, Fastow presented the proposal to Lay and Skilling, and received approval to bring it to the Board. Ten days later, on June 28, Fastow presented the proposal to the Board at a special meeting (described above in Section III.A.). The minutes indicate that Fastow identified the "appreciated" value in the Enron shares subject to the forward contracts, and explained that the value would be transferred to LJM1 in exchange for a note receivable. This would permit LJM1 to enter into a swap with Enron to hedge Enron's position in Rhythms. Fastow's presentation materials described the anticipated value to Enron and the extent of Fastow's economic interest in LJM1, and stated (on two different slides) that Fastow would not receive "any current or future (appreciated) value of ENE stock."[27] The minutes indicate that Fastow also told the Board that an outside accounting firm would render a fairness opinion stating that the value Enron would receive in the transaction exceeded the value of the forward contracts Enron was transferring to LJM1. The Board voted to approve the transaction at the same time it approved Fastow's role in LJM1.

B. Structure of the Transaction

The Rhythms transaction closed on June 30, 1999. The parties to the transaction were Enron, LJM1, and LJM Swap Sub L.P. ("Swap Sub"). Swap Sub was a limited partnership created for purposes of the transaction and was intended to be a non-consolidated SPE. An entity controlled by Fastow, LJM SwapCo., was the general

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27/ Fastow's presentation said that he would be the general partner of LJM1. To implement the restriction against his benefiting from Enron stock, the LJM1 partnership agreement provided that all distributions of the proceeds from Enron stock would be to the limited partners of LJM1.

partner of Swap Sub. LJM1 was the limited partner of Swap Sub and was meant to provide the required 3% outside equity at risk. We do not know why Swap Sub was used, although a reasonable inference is that it was used to shield LJM1 from legal liability on any derivative transactions with Enron.

As finally structured, the transaction had three principal elements:

First, Enron restructured the forward contracts, releasing 3.4 million shares of Enron stock that it then transferred to LJM1. At the closing price on June 30, these shares had a value of approximately $276 million. Enron, however, placed a contractual restriction on most of the shares that precluded their sale or transfer for four years. The restriction also precluded LJM1 and Swap Sub from hedging the Enron stock for one year. The restriction did not, however, preclude LJM1 from pledging the shares as security for a loan. The value of the shares was discounted by approximately $108 million (or 39%) to account for the restriction. In exchange for these Enron shares, LJM1 gave Enron a note (due on March 31, 2000) for $64 million.

Second, LJM1 capitalized Swap Sub by transferring 1.6 million of the Enron shares to Swap Sub, along with $3.75 million in cash.[28/]

Third, Enron received from Swap Sub a put option on 5.4 million shares of Rhythms stock. Under the option, Enron could require Swap Sub to purchase the

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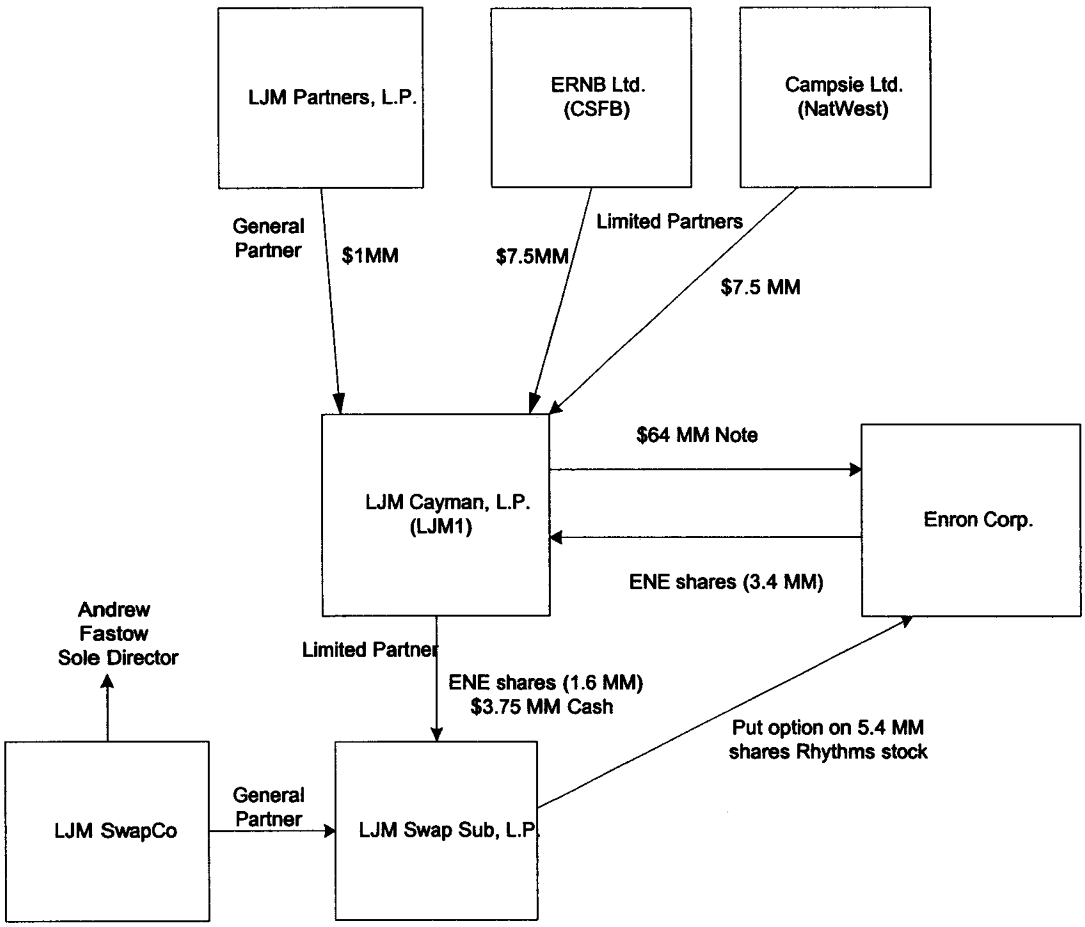
[28/] LJM1 obtained the cash by selling an unrestricted portion of the 3.4 million Enron shares transferred by Enron to LJM1.

Rhythms shares at $56 per share in June 2004. The put option was valued at approximately $104 million.

A diagram of the Rhythms transaction is set forth below:



Enron obtained a fairness opinion from PricewaterhouseCoopers ("PwC") on the exchange of the 3.4 million restricted Enron shares for the Rhythms put and the $64 million note. PwC opined that the range of value for the Enron shares was $170-$223 million, that the range of value for the Rhythms put and note was $164-$204 million, and that the consideration received by Enron therefore was fair from a financial point of view.[29]

C. Structure and Pricing Issues

1. Nature of the Rhythms "Hedge"

The "hedge" that Enron obtained on its Rhythms position affected the gains and losses Enron reported on its income statement but was not, and could not have been, a true economic hedge. Attempting to use the "trapped" value in the forward contracts, Enron transferred to LJM1, and LJM1 transferred to Swap Sub, 1.6 million shares of the restricted Enron stock. Swap Sub's ability to make good on the Rhythms put rested largely on the value of the Enron stock. If Enron stock performed well, Swap Sub could perform on the put even if Rhythms stock declined—although the losses would be absorbed by the value in the Enron stock. But if Enron stock and Rhythms stock both declined, Swap Sub would be unable to perform on the put and Enron's hedge on Rhythms would have failed. In either case, this structure is in sharp contrast to a typical

[29] The transaction as initially closed on June 30 was somewhat different. In late July or early August, the parties adjusted the terms by reducing the term of the Rhythms put option and increasing the note payable to Enron. None of the people we interviewed were able to explain why these changes were made, although some assumed that PwC may have required the changes in order to issue its fairness opinion. When the Board approved the transaction, it included in its resolution the statement: "Kenneth Lay and Jeffrey Skilling are hereby appointed as a Committee of the Board . . . to determine if the consideration received by the Company is sufficient in the event of a change in the terms of such transaction from those presented to the Board." We found no evidence that any of the changes implemented in July or August were presented to Lay or Skilling for approval.

economic hedge, which is obtained by paying a market price to a creditworthy counterparty who will take on the economic risk of a loss.

There are substantial accounting questions raised by using an SPE as a counterparty to hedge price risk when the primary source of payment by the SPE is an entity's own stock—although Andersen apparently approved it in this case. Those accounting issues are of central concern to the Raptor transactions. A detailed discussion of those issues is set out in Section V below relating to the Raptors.

2. SPE Equity Requirement

In order to satisfy the SPE requirement for non-consolidation, Swap Sub needed to have a minimum of 3% outside equity at risk. At its formation on June 30, 1999, Swap Sub had negative equity because its liability (the Rhythms put, valued at $104 million) greatly exceeded its assets ($3.75 million in cash plus $80 million in restricted Enron stock). On this basis alone, there is a substantial question whether Swap Sub had sufficient equity to satisfy the requirement for non-consolidation.

Our review of whether Swap Sub met the 3% requirement was limited by the absence of information. We were unable to interview either Glisan (who was primarily responsible for Enron's accounting of the transaction) or Andersen. We do not know what analysis they relied on to conclude that Swap Sub was properly capitalized.

Andersen indicated recently that it made an error in 1999 in analyzing whether Swap Sub qualified for non-consolidation. In his December 12, 2001, Congressional testimony, Andersen's CEO said:

> In evaluating the 3 percent residual equity level required to qualify for non-consolidation, there were some complex issues concerning the valuation of various assets and liabilities. When we reviewed this transaction again in October 2001, we determined that our team's initial judgment that the 3 percent test was met was in error. We promptly told Enron to correct it.

Andersen did not explain further the nature of the error. Our review of the workpapers that Andersen made available indicates that at least some of the analyses were performed using the unrestricted value, rather than the discounted value, of the Enron stock in Swap Sub. This may be the error to which Andersen refers.

On November 8, 2001, Enron announced that Swap Sub was not properly capitalized with outside equity and should have been consolidated. As a result, Enron said it would restate prior period financial statements to reflect the consolidation retroactive to 1999, which would have the effect of decreasing Enron's net income by $95 million in 1999 and $8 million in 2000.

3. Pricing and Credit Capacity

We encountered sharply divergent recollections about how Enron priced the Rhythms put option and analyzed the credit capacity of Swap Sub. Vincent Kaminski, head of Enron's Research Group—which handled sophisticated option pricing and modeling issues—told us that he was very uncomfortable with the transaction and brought his concerns to Richard Buy (head of Enron's Risk Assessment and Control ("RAC") Group), his supervisor. Kaminski says that, based on the quantitative analysis performed by his group, he strongly recommended to Buy that Enron not proceed with the transaction. Kaminski recalls that he gave Buy three reasons: (1) the transaction involved an obvious conflict of interest because of Fastow's personal involvement in

LJM1; (2) the payout was skewed against Enron because LJM1 would receive its benefit much earlier in the transaction; and (3) the structure was unstable from a credit capacity standpoint because the SPE was capitalized largely with Enron stock. Buy told us that he does not recall any discussions with Kaminski (or Kaminski's group being involved in the transaction). Buy says that at some point his group evaluated the credit capacity, found that it was too low, and recommended changes in the structure that improved it.

D. Adjustment of the "Hedge" and Repayment of the Note

After the transaction closed on June 30, Enron accounting personnel realized that the put option from Swap Sub on Rhythms stock was not reducing Rhythms-related volatility in Enron's income statement to the degree desired.[30] In an effort to improve the hedge, Enron entered into four more derivative transactions on Rhythms stock (put and call options) with Swap Sub at no cost to either party. The options were put in place on July 13, less than two weeks after the closing. They were designed to get the economics of the hedge closer to a swap. Analysts in Kaminski's group modeled the hedge to help Glisan determine how the options should be structured and priced.

On December 17, 1999, three months before it was due, LJM1 paid the $64 million note plus accrued interest. The source of this payment is unclear. LJM1 had only $16 million in initial equity. In September 1999 (as described below in SectionVI.A.1.), LJM1 purchased an interest in the Cuiaba project from Enron for $11.3 million. There is

[30] Because the put provided one-sided protection, Enron was exposed to income statement volatility when Rhythms' price increased and subsequently decreased. In addition, Enron was subject to income statement volatility from the time value component of the put option.

some evidence that LJM1 may have obtained additional capital to make the December payment.[31] There also is evidence that LJM1 may have sold some of the restricted Enron stock to finance the $64 million repayment.[32] Unless the restriction was released, such sales would have been in violation of LJM1's agreement with Enron. The restriction agreement did permit LJM1 to use the shares as collateral for a loan, and it is possible that LJM1 repaid the $64 million note by borrowing against the shares.

Regardless of how LJM1 obtained the funds to repay the $64 million note, LJM1 retained significant value in the 3.6 million Enron shares (post-split) it was holding.[33] Even assuming LJM1 liquidated shares to pay the note (which at the closing price on December 17 would have required selling 1.6 million shares), LJM1 would have retained 2 million (post-split) Enron shares having an unrestricted value of $82 million on December 17.

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[31] In a document titled "Ben Glisan, Jr. FY 99 - Accomplishments," Glisan identified: "LJM1 Liquidity—Transaction resulted in additional partnership capital being invested into LJM so that an [sic] $64 MM loan from ENE could be repaid." Because Glisan declined to be interviewed on this subject, we do not know the meaning of this reference.

[32] In addition, on December 17, the reported trading volume in Enron stock was 5.1 million shares, approximately twice the normal volume. To our knowledge, the only evidence of the restriction on LJM1's Enron stock is the letter agreement between the parties.

[33] LJM1 had received 3.4 million (pre-split) shares and had transferred 1.6 million to Swap Sub. There was a 2-for-1 split in August 1999. That left 1.8 million (pre-split), or 3.6 million (post-split), shares in LJM1.

E. Unwinding the Transaction

In the first quarter of 2000, Enron decided to liquidate its Rhythms position. This decision was based on several factors: (1) the expiration of the lock-up on Rhythms stock; (2) the intervening decline in the value of Rhythms stock; and (3) the continuing volatility of the Rhythms position and the hedge. Skilling made this decision. Even after the additional options had been put in place in July 1999, Enron's earnings continued to fluctuate as the position and options were marked to market.

During this period, Enron's accounting staff focused on the credit capacity of Swap Sub. Kaminski told us that, in February or March of 2000, the accounting group asked him to analyze the credit capacity of the Rhythms structure. Kaminski and his analysts reviewed the structure and determined there was a 68% probability that the structure would default and would not be able to meet its obligations to Enron on the Rhythms put. Kaminski says that, when he relayed this conclusion to the accounting group, they said they had suspected that would be the result. Causey told us that he did not recall this quantification of the likelihood of credit failure, but he did remember discussions about credit risk. He also told us he recalled considering the possibility that Enron might need to establish a credit reserve, but was not sure whether a reserve had been created. Our review did not identify any evidence that such a reserve was established.

1. Negotiations

Once Enron decided to liquidate the Rhythms position, it had to terminate the derivatives with Swap Sub. Causey had principal responsibility for implementing the termination. In late February or early March 2000, Causey approached Fastow about unwinding the transaction.

On March 8, 2000, as the negotiations were underway, Enron gave Swap Sub a put on 3.1 million shares (post-split) of Enron stock at $71.31 per share. Swap Sub did not pay any option premium or provide any other consideration in exchange for the put. On March 8, the closing price of Enron stock was $67.19 per share; the put was therefore "in the money" to Swap Sub by $4.12 per share (or approximately $12.8 million intrinsic value) on the day it was executed.[34/] Causey told us he believes the put was given to Swap Sub to stabilize the structure and freeze the economics so that the negotiations could be completed.

Causey said that, at the outset, Fastow emphasized that he had no interest in the Enron stock owned by LJM1 and Swap Sub. Causey took this to mean that Fastow had no residual interest in the unwind of the transaction. Causey says Fastow told him that he was negotiating with his limited partners on the appropriate terms to unwind the transaction. Fastow subsequently came back to Causey with a proposal that Swap Sub receive $30 million from Enron in connection with the unwind. Causey and others saw their responsibility as determining whether that price would be fair to Enron. After analysis, they concluded that it was fair and Enron agreed to the proposal.

34/ We were told that the put was agreed to by Enron when the current market price was $71.31, but the price went down before the put documentation was executed.

2. Terms

Enron and Swap Sub entered into a letter agreement dated March 22, 2000, setting out the terms of the unwind. At the same time, Enron agreed to loan $10 million to Swap Sub. We were told that Fastow informed Causey that he was going to buy out one of his LJM1 limited partners for that amount, and Swap Sub agreed that it would repay the loan with the proceeds of the unwind. The unwind terms were: (1) termination of the options on Rhythms; (2) Swap Sub's returning to Enron the 3.1 million (post-split) Enron shares that it had received from LJM1 but keeping the $3.75 million cash that it had received from LJM1; and (3) Enron's paying $16.7 million to Swap Sub.[35] The letter agreement was executed by Causey for Enron and by Fastow for Swap Sub and for "Southampton, L.P.," which was described in the letter as the owner of Swap Sub. The final agreement (which made no material change in the terms) was effective as of April 28, 2000.

3. Financial Results

The unwind transaction resulted in a huge windfall to Swap Sub and LJM1. Enron did not seek or obtain a fairness opinion on the unwind. We have not identified any evidence that the Board or any Board Committee was informed of the transaction. Lay told us he was unaware of the transaction. Skilling told us he was aware that Enron had sold its Rhythms position, but was not aware of the terms on which the hedge was

[35] The $16.7 million payment was calculated as follows: $30 million per the agreement between Fastow and Causey, plus $500,000 for accrued dividends on the Enron stock, less $3.75 million cash in Swap Sub, less $10.1 million principal and interest on the loan.

unwound. We have not located any Enron Deal Approval Sheet ("DASH"), an internal document summarizing the transaction and showing required approvals, concerning the unwind.[36/]

Swap Sub. Because of the decline in price of Rhythms stock, the Rhythms options were substantially in the money to Enron when the structure was unwound. Enron calculated the options as having a value of $207 million. In exchange for terminating these options (and receiving approximately $27 million cash), Swap Sub returned Enron shares having an unrestricted market value of $234 million. Enron's accounting personnel determined that this exchange was fair, using the unrestricted value of the shares.

The Enron shares, however, were *not* unrestricted. They carried a four-year contractual restriction. Because of the restriction, at closing on June 30, 1999, those shares were given a valuation discount of 38%.[37/] Although some of the discount would have amortized from June 1999 through March 2000, a substantial amount should have remained. For example, assuming straight-line amortization of the restricted discount over four years, at the closing price on March 22, 2000, there would have been approximately $72 million of the discount left at the time of the unwind. If an appropriate valuation discount had been applied to the shares at that time, the value

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36/ Enron policy required the RAC Group to prepare a DASH for every business transaction that involved an expenditure of capital by Enron. The DASH had to be approved by the relevant business unit, the Legal Department, RAC, and Senior Management before funds could be distributed.

37/ The PwC fairness opinion given in connection with the initial transaction concluded that a restriction discount of 20% to 40% was reasonable.

Enron gave up (the $207 million in Rhythms options plus $27 million in cash) exceeded the value Enron received ($161 million in restricted Enron shares) by more than $70 million. It is difficult to understand why Enron's accounting personnel did not use the discounted value of the restricted shares to assess the fairness of the exchange.[38]

When Enron unwound the Raptor vehicles (discussed below in Section V.E.), as part of the accounting for the transaction, Andersen *required* Enron to use the discounted value of Enron shares it received. Andersen reviewed the Rhythms unwind in 2000, but apparently raised no questions about Enron bringing the stock back at its unrestricted value.

LJM1. After LJM1 transferred Enron shares to Swap Sub in June 1999, LJM1 retained 3.6 million (post-split) Enron shares that it had received as part of the initial transaction. Those shares were not addressed in the April 2000 unwind; LJM1 was simply permitted to retain them. We have not been able to determine what happened to those shares between June 1999 and April 2000 (although, as noted above, it is possible that LJM1 sold some or all of the shares in December 1999 to generate funds to pay the $64 million note). At the closing of the initial transaction in June 1999, those shares had a discounted value of $89 million. If LJM1 still held the shares on April 28, 2000, they had an undiscounted value (at closing price) of $251 million, and a smaller discounted value. Even assuming LJM1 used some of the shares to repay the $64 million note in

[38] Causey told us he did not recall whether Enron had used the unrestricted value of the shares in connection with the unwind. He and others in the Accounting Group told us they were focused primarily on the value of what Enron was receiving, not the value of what Swap Sub was getting or giving up, and from Enron's perspective the restriction (if the shares were in Enron's hands) was not important.

December 1999, being permitted to retain the balance after the unwind provided LJM1 with an enormous economic benefit if those shares were sold or hedged.

F. <u>Financial Participation of Enron Employees in the Unwind</u>

Unbeknownst to virtually everyone at Enron, several Enron employees had obtained, in March 2000, financial interests in the unwind transaction. These include Fastow, Kopper, Glisan, Kristina Mordaunt, Kathy Lynn, and Anne Yaeger Patel. Fastow's participation was inconsistent with his representation to the Board that he would not receive any "current or future (appreciated) value" of Enron stock in the Rhythms transaction. We have not seen evidence that any of the employees, including Fastow, obtained approval from the Chairman and CEO under the Code of Conduct to participate financially in the profits of an entity doing business with Enron. Each of the employees certified in writing their compliance with the Code. While every Code violation is a matter to be taken seriously, these violations are particularly troubling. At or around the time they were benefiting from LJM1, these employees were all involved in one or more transactions between Enron and LJM2. Glisan and Mordaunt were involved on Enron's side.

Contemporaneously with the March 22, 2000 letter agreement between Enron and Swap Sub (setting out the terms of the unwind), the Enron employees signed an agreement for a limited partnership called "Southampton Place, L.P." As described in the March 20, 2000 partnership agreement, Southampton's purpose was to acquire a portion of the interest held by an existing limited partner of LJM1. The general partner of Southampton was an entity named "Big Doe, LLC." Kopper signed the agreement as a member of Big Doe.[39] The limited partners were "The Fastow Family Foundation" (signed by Fastow as "Director"), Glisan, Mordaunt, Lynn, Yaeger Patel, and Michael Hinds (an LJM2 employee). The agreement shows that the capital contributions of the partners were $25,000 each for Big Doe and the Fastow Foundation, $5,800 each for Glisan and Mordaunt, and smaller amounts for the others—a total of $70,000.

Our understanding of Southampton is limited because, other than Mordaunt, none of the employees would agree to be interviewed in detail on the subject. Mordaunt said that she was approached by Kopper in late February or early March 2000. Kopper told her that management personnel of one of LJM1's limited partners had expressed an interest in buying out part of their employer's interest, and that Fastow and Kopper were forming a limited partnership to purchase part of the interest. Mordaunt says that Kopper assured her that LJM1 was not doing any new business with Enron. In a brief interview conducted at the outset of our investigation, Glisan told us that he was approached by Fastow with a proposal similar to what Mordaunt described as advanced by Kopper.[40]

We have not seen evidence that any of the employees sought a determination from the Chairman and CEO that their investment in Southampton would not adversely affect Enron's best interests. Mordaunt told us that she did not consider seeking consent because she believed LJM1 was not currently doing business with Enron, and that the

[39] As described above in Section III, Big Doe also was a limited partner of LJM2's general partner.

[40] Yaeger Patel's legal counsel informed us that she had been told by her "superiors" that she would receive a "bonus" for her work at LJM, and that the bonus was paid to her and other LJM employees by allowing them to purchase a small interest in Southampton.

partnership was simply buying into a cash flow from a transaction that had been negotiated previously. (She also suggested, with the benefit of hindsight, that this judgment was wrong and that she did not consider the issue carefully enough at the time.)[41/] Glisan told us that he asked LJM1's outside counsel, Kirkland & Ellis, whether the investment would be viewed as a related-party transaction with Enron, and was told that it would not. Neither Glisan nor Kirkland & Ellis consulted with Enron's counsel.[42/]

We do not know whether Southampton actually purchased part of the LJM1 limited partner's interest.[43/] It does appear from other documents, including the March 22 letter agreement between Enron and Swap Sub, that Southampton became the indirect owner of Swap Sub.[44/] We do not know how this ownership interest was acquired or what consideration, if any, was paid.

41/ In late October 2001, after there was considerable media attention devoted to the LJM partnerships, Mordaunt voluntarily disclosed the fact of her investment to Enron.

42/ Yaeger Patel's legal counsel informed us that she was told by her "superiors" and "internal company counsel advising LJM" that all necessary approvals or waivers for her LJM activities had been obtained.

43/ Our inquiry did identify some evidence that Chewco (described above in Section II) may have transferred $1 million to the account of Campsie, Ltd., an LJM1 limited partner, in March 2000 at or around the time of the unwinding of the Rhythms transaction.

44/ The letter agreement indicates that Southampton, L.P., of which Southampton Place is the general partner, owns 100% of the limited partner interests in Swap Sub and 100% of Swap Sub's general partner. At the time of the initial Rhythms transaction, the closing documents indicated that LJM1 was the limited partner of Swap Sub. Based on our interviews, none of the Enron employees involved in the Rhythms unwind noticed that Southampton appeared to have replaced (or supplemented) LJM1 as a limited partner.

Even based on the limited information we have, the Enron employees received massive returns on their modest investments. We have seen documents indicating that, in return for its $25,000 investment, the Fastow Family Foundation received *$4.5 million* on May 1, 2000. Glisan and Mordaunt separately told us that, in return for their small investments, they each received approximately *$1 million* within a matter of one or two months, an extraordinary return. Mordaunt told us that she got no explanation from Kopper for the size of this return. He said only that Enron had wanted to terminate the Rhythms options early. We do not know what Big Doe (Kopper), Lynn, or Yaeger Patel received. The magnitude of these returns raises serious questions as to why Fastow and Kopper offered these investments to the other employees.

In 2000, Glisan was involved on behalf of Enron in several significant transactions with LJM2. Most notably, he was a major participant in the Raptor transactions. He presented the Raptor I transaction to the Board, and was intimately involved in designing its structure. Enron approval documents show Glisan as the "business unit originator" and "person negotiating for Enron" in the Raptor I, II, and IV transactions. Glisan signed each of those approval documents. In May 2000, Glisan succeeded McMahon as Treasurer of Enron. Glisan told us that Fastow never asked him for any favors or other consideration in return for the Southampton investment.

Mordaunt is a lawyer. She was involved in the initial Rhythms transaction as General Counsel, Structured Finance. Later in 1999, she became General Counsel of Enron Communications (which later became Enron Broadband Services). To our knowledge, Mordaunt was involved in one transaction with LJM2 in mid-2000. She acted as Enron's business unit legal counsel in connection with the Backbone transaction (which involved LJM2's purchase of dark fiber-optic cable from Enron and is discussed below in Section VI.B.1.). She signed the internal approval sheet. She told us she was never asked for, and never provided, anything in return for the Southampton investment.

Kopper, Lynn, and Yaeger Patel all were Enron employees in the Finance area. All three are specifically identified in the Services Agreement between Enron and LJM2 as employees who will do work for LJM2 during 2000 and receive compensation from both Enron and LJM2. At the time of their departures from Enron, Kopper was a Managing Director, Lynn was a Vice President, and Yaeger Patel was a non-officer employee.

V. THE RAPTORS

The transactions between Enron and LJM2 that had the greatest impact on Enron's financial statements involved four SPEs known as the "Raptors." Expanding on the concepts underlying the Rhythms transaction (described in the preceding Section of this Report), Enron sought to use the "embedded" value of its own equity to counteract declines in the value of certain of its merchant investments. Enron used the extremely complex Raptor structured finance vehicles to avoid reflecting losses in the value of some merchant investments in its income statement. Enron did this by entering into derivative transactions with the Raptors that functioned as "accounting" hedges. If the value of the merchant investment declined, the value of the corresponding hedge would increase by an equal amount. Consequently, the decline—which was recorded each quarter on Enron's income statement—would be offset by an increase of income from the hedge.

As with the Rhythms hedge, these transactions were not true economic hedges. Had Enron hedged its merchant investments with a creditworthy, independent outside party, it may have been able successfully to transfer the economic risk of a decline in the investments. But it did not do this. Instead, Enron and LJM2 created counter-parties for these accounting hedges—the Raptors—but Enron still bore virtually all of the economic risk. In effect, Enron was hedging risk with itself.

In three of the four Raptors, the vehicle's financial ability to hedge was created by Enron's transferring its own stock (or contracts to receive Enron stock) to the entity, at a discount to the market price. This "accounting" hedge would work, and the Raptors would be able to "pay" Enron on the hedge, as long as Enron's stock price remained strong, and especially if it increased. Thus, the Raptors were designed to make use of forecasted future growth of Enron's stock price to shield Enron's income statement from reflecting future losses incurred on merchant investments. This strategy of using Enron's own stock to offset losses runs counter to a basic principle of accounting and financial reporting: except under limited circumstances, a business may not recognize gains due to the increase in the value of its capital stock on its income statement.

When the value of many of Enron's merchant investments fell in late 2000 and early 2001, the Raptors' hedging obligations to Enron grew. At the same time, however, the value of Enron's stock declined, decreasing the ability of the Raptors to meet those obligations. These two factors combined to create the very real possibility that Enron would have to record at the end of first quarter 2001 a $500 million impairment of the Raptors' obligations to it. Without bringing this issue to the attention of the Board, and with the design and effect of avoiding a massive credit reserve, Enron Management restructured the vehicles in the first quarter of 2001. In the third quarter of 2001, however, as the merchant investments and Enron's stock price continued to decline, Enron finally terminated the vehicles. In doing so, it incurred the after-tax charge of $544 million ($710 million pre-tax) that Enron disclosed on October 16, 2001 in its initial third quarter earnings release.

Enron also reported that same day that it would reduce shareholder equity by $1.2 billion. One billion of that $1.2 billion involved the correction of accounting errors relating to Enron's prior issuance of Enron common stock (and stock contracts) to the Raptors in the second quarter of 2000 and the first quarter of 2001; the other $200 million related to termination of the Raptors.

The Raptors made an extremely significant contribution to Enron's reported financial results over the last five quarters before Enron sought bankruptcy protection—*i.e.*, from the third quarter of 2000 through the third quarter of 2001. Transactions with the Raptors during that period allowed Enron to avoid reflecting on its income statement almost $1 billion in losses on its merchant investments. Not including the $710 million pre-tax charge Enron recorded in the third quarter of 2001 related to the termination of the Raptors, Enron's reported pre-tax earnings during that five-quarter period were $1.5 billion. We cannot be certain what Enron might have done to mitigate losses in its merchant investment portfolio had it not constructed the Raptors to hedge certain of the investments. Nonetheless, if one were to subtract from Enron's earnings the $1.1 billion in income (including interest income) recognized from its transactions with the Raptors, Enron's pre-tax earnings for that period would have been $429 million, a decline of 72%.

The following description of the Raptors simplifies an extremely complicated set of transactions involving a complex structured finance vehicle through which Enron entered into sophisticated hedges and derivatives transactions. Although we describe these transactions in some depth, even the detail here is only a summary.

A. Raptor I

1. Formation and Structure

In late 1999, at Skilling's urging, a group of Enron commercial and accounting professionals began to devise a mechanism that would allow Enron to hedge a portion of its merchant investment portfolio. These investments were "marked to market," with changes recorded in income every quarter for financial statement purposes. They had increased in value dramatically. Skilling said he wanted to protect the value of these investments and avoid excessive quarter-to-quarter volatility. Due to the size and illiquidity of many of these investments, they could not practicably be hedged through traditional transactions with third parties.

With the logic and seeming success (at that time) of the Rhythms hedge fresh in mind, Ben Glisan, who became Enron's Treasurer in May 2000, led the effort. Accountants from Andersen were closely involved in structuring the Raptors.[45] Attorneys from Vinson & Elkins also were consulted frequently, particularly on securities law issues, and also prepared the transaction documents.

The first Raptor (Raptor I), created effective April 18, 2000, was an SPE called Talon LLC ("Talon"). Talon was created solely to engage in hedging transactions with Enron. LJM2 invested $30 million in cash and received a membership interest. Through a wholly-owned subsidiary named Harrier, Enron contributed $1,000 cash, a $50 million promissory note, and Enron stock and Enron stock contracts with a fair market value of approximately $537 million.[46] Because Talon was restricted from selling, pledging or hedging the Enron shares for three years, the shares were valued at about a 35% discount

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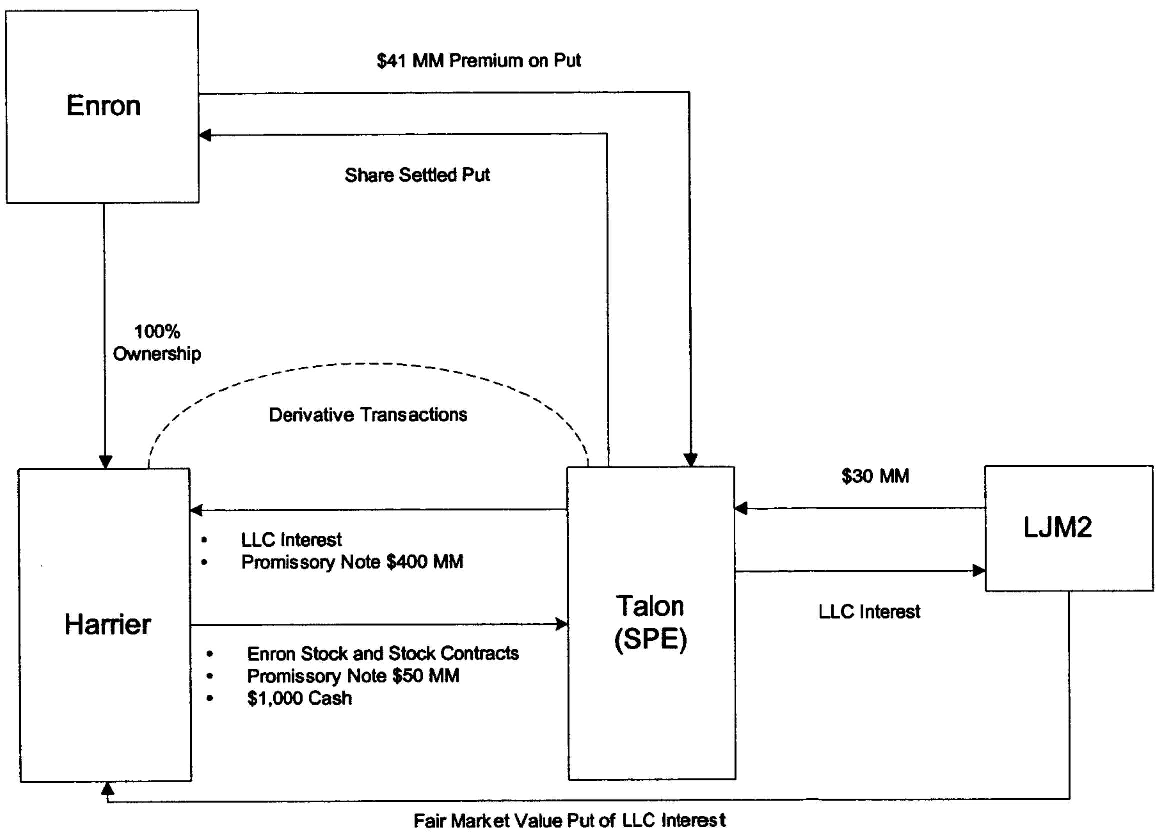
[45] Enron's records show that Andersen billed Enron approximately $335,000 in connection with its work on the creation of the Raptors in the first several months of 2000.

[46] The stock in Raptor I came from shares of Enron stock received from restructuring forward contracts Enron had with an investment bank, which released shares of Enron stock. (This was the same source as the Enron stock used in the Rhythms transaction.) The Enron "stock contract" in Raptor I consisted of a contingent forward contract held by a wholly-owned Enron subsidiary, Peregrine, under which it had a contingent right to receive Enron stock on March 1, 2003 from another entity, Whitewing, if the price of Enron stock exceeded a certain level.

to their market value. This valuation was supported by a fairness opinion provided by PwC. In return for its contribution, Enron received a membership interest in Talon and a revolving promissory note from Talon, with an initial principal amount of $400 million. Through a series of agreements, LJM2 was the effective manager of Talon.

A very simplified diagram of Raptor I appears below:



Once Talon received the contributions from Enron and LJM2, it had $30 million of "outside" equity to meet the 3% outside equity requirement for SPE treatment as an unconsolidated entity. Enron calculated that Talon theoretically could enter into derivatives with Enron up to approximately $500 million in notional value. By Enron's calculation, it also had what appeared to be a capacity to absorb losses on derivative contracts up to almost $217 million. This credit capacity consisted of LJM2's $30 million investment plus the $187 million value of the 35% discount on the Enron stock and stock contracts. Enron concluded that Talon could sell the Enron stock at its unrestricted value to meet Talon's obligations.

There was an additional important requirement before Talon could enter into hedging transactions with Enron. It was understood by those who structured Talon—although it is not reflected in the Talon documents or Board presentations—that Talon would not write any derivatives until LJM2 received an initial return of $41 million or a 30% annualized rate of return, whichever was greater, from income earned by Talon. Put another way, before hedging could begin, LJM2 had to have received back the entire amount of its investment plus a substantial return. This allowed LJM2 effectively to receive a return of its capital but, from an accounting perspective, leave $30 million of capital "at risk" to meet the 3% outside equity requirement for non-consolidation. If LJM2 did not receive its specified return in six months, it could require Enron to purchase its interest in Talon at a value based on the *unrestricted* price of Talon's Enron stock and stock contracts. These terms were remarkably favorable to LJM2, and served no apparent business purpose for Enron. Moreover, because Talon's Enron stock and stock contracts would have to decline in value by $187 million before Talon incurred any loss, LJM2 did not bear first-dollar risk of loss, as typically required for SPE non-consolidation. After LJM2 received its specified return, Enron then was entitled to 100% of any further distributions of Talon's earnings.[47] Thus, by the time any hedging began,

[47] During Talon's existence, this changed slightly. After LJM2 received its initial $41 million return, it made an additional equity investment of $6 million and was entitled to receive a 12.5% return on that additional contribution, to the extent Talon had sufficient earnings.

LJM2 would have received a return that substantially exceeded its initial investment while retaining only a limited economic stake in the ongoing venture—principally the return of its original investment upon Talon's liquidation. In fact, Fastow told his limited partners in LJM2 that the Raptors were "divested investments" after LJM2 received its specified $41 million return.

To create the required $41 million of income for distribution to LJM2, Enron purchased from Talon a put option on Enron stock for a premium of $41 million. The put option gave Enron the right to require Talon to purchase approximately 7.2 million shares of Enron common stock on October 18, 2000, six months after the effective date of the transaction, at a strike price of $57.50 per share. The closing price of Enron stock was $68 per share when Enron purchased the put. As long as Enron's share price remained above $57.50, the put option would expire worthless to Enron, and Talon would be entitled to record the $41 million premium as income. It could then distribute $41 million to LJM2, but continue to treat Talon as an adequately capitalized, unconsolidated SPE.[48]

Enron's purchase of the put option for $41 million was unusual for two reasons. First, from an economic perspective—rather than merely a means to pay LJM2—the put option was a bet by Enron that its own stock price would decline substantially. Second, the price of the put was calculated by a method appropriate only if the transaction were

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48/ Economically, this $41 million distribution reflected a return of and on LJM2's initial investment, but for accounting purposes the distribution was a return *on* the original investment. Thus, LJM2 technically still had $30 million equity in Talon. Nevertheless, Fastow told his LJM2 investors in April 2001 that after settlement of the Enron puts, "LJM2 had already received its return of and on capital."

between two fully creditworthy parties. In fact, Talon was not sufficiently creditworthy. Other than the Enron stock and stock contracts, it had only $71 million of assets —the $30 million LJM2 investment and the $41 million premium— to meet its obligations on the put, but it had written a put on more than 7 million shares of Enron stock. If the Enron stock price declined below approximately $47 per share (about $10 per share below the strike price), Talon would owe Enron the entire $71 million, and Talon would be unable to meet its remaining obligations. Thus, the put provided only about $10 per share of price protection to Enron, and for that reason was worth substantially less than $41 million. The transaction makes little apparent commercial sense, other than to enable Enron to transfer money to LJM2 in exchange for its participation in vehicles that would allow Enron to engage in hedging transactions.

As it turned out, Enron did not have to wait six months for the put to expire and for hedging transactions to begin. At Fastow's suggestion, Causey, on behalf of Enron, and Fastow, on behalf of Talon and LJM2, settled the option early, as of August 3, 2000. Since Enron stock had increased in value and the period remaining on the put option had dwindled, the option was worth much less. Talon returned $4 million of the $41 million option premium to Enron, but nevertheless paid LJM2 $41 million. That left LJM2 with little further financial interest in what happened to Talon. This distribution resulted in an annualized rate of return that LJM2 calculated in a report to its investors at 193%. Enron also paid LJM2's legal and accounting fees, and a management fee of $250,000 per year. With LJM2 having received a $41 million payment, Talon was now available to begin entering into hedging transactions with Enron.

2. <u>Enron's Approval of Raptor I</u>

Although the deal-closing documents were dated April 18, 2000, the transaction did not receive formal approval from Enron's Management or Board until several weeks later.

The approval of Raptor I by Enron's Management is reflected in two documents, an "LJM2 Approval Sheet" and an Enron Deal Summary. Both were executed between May 22 and June 12, 2000, long after the transaction closed. The LJM2 Approval Sheet very briefly describes the transaction and the distribution "waterfall" of Talon's earnings (including the initial $41 million payment to LJM2), and reports that Kopper—a Managing Director of Enron—negotiated on behalf of LJM2. The Approval Sheet was signed by Glisan, Causey and Buy, but the signature line for Skilling was blank.[49/] The LJM2 Approval Sheet refers to an "attached" DASH. A Deal Summary is attached, which is largely identical to the Approval Sheet, but added: "It is expected that Talon will have earnings and cash sufficient to distribute $41 million to LJM2 within six months, yielding an annualized return on investment to LJM2 of 76.8%" This document was signed only by Glisan and Scott Sefton, the General Counsel of Enron Global Finance, Fastow's group.

Glisan and Causey presented Raptor I to the Finance Committee of the Board on May 1, 2000, with Lay, Skilling, and Fastow in attendance. According to the minutes, Glisan described Raptor as "a risk management program to enable the Company to hedge

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[49/] We discuss Skilling's role in the management and oversight of transactions with the LJM partnerships in Section VII, below.

the profit and loss volatility of the Company's investments." He explained that Enron and LJM2 would establish "a non-affiliated vehicle ... as a hedge counter-party to selected investments," explained how Talon would be funded, and explained "the level of hedging protection Talon could initially provide."

Although the minutes do not contain any detail regarding what Glisan told the Committee, it appears that his remarks were guided by a three-page written presentation provided to the Committee entitled "Project Raptor: Hedging Program for Enron Assets." The materials stated that Talon would be capitalized with $400 million in "excess [Enron] stock." It also stated that, "[i]nitially, [the] vehicle can provide approximately $200 million of P&L [profit and loss] protection to ENE. As ENE stock price increases, the vehicle's P&L protection capacity increases as well." The materials also disclosed LJM2's investment and expected return: "LJM2 will provide non-ENE equity and will be entitled to 30% annualized return plus fees," with Enron entitled to all upside after LJM2 received its return. The materials did not disclose that LJM2's contractually specified return was the *greater* of a 30% annualized return *or* $41 million.

The Finance Committee was also given information strongly suggesting, if not making perfectly clear, that the Raptor vehicle was not a true economic hedge. Notes on the presentation materials, apparently taken at the meeting by Enron's Corporate Secretary to assist her in preparing the minutes, state: "Does not transfer economic risk but transfers P&L volatility."[50/]

50/ This thought was repeated in a May 2000 presentation describing the Raptor hedging program prepared by Enron Global Finance for Enron Broadband Services. It