of ordinary transactions with outside parties.[75] But these were not normal transactions. There was little point in relying on Audit and Compliance Committee review as a control over these transactions if that review did not have more depth or substance.[76]

Review of Fastow's Compensation. Committee-mandated procedures required reviewing Fastow's compensation from LJM1 and LJM2. This should have been an important control. As much as any other procedure, it might have provided a warning if the transactions were on terms too generous to LJM1 or LJM2. It might have indicated whether the representation that Fastow would not profit from increases in the price of Enron stock was accurate. It might have revealed whether Fastow's gains were inconsistent with the understanding reported by a number of Board members that he would be receiving only modest compensation from LJM, commensurate with the approximately three hours per week he told the Finance Committee in May 2000 he was spending on LJM matters.

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[75] Or. St. § 60.357(2) (1999) ("a director is entitled to rely on information, opinions, reports or statements including financial statements and other financial data, if prepared or presented by: . . . [o]ne or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented [and] legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence . . . .").

[76] The need for careful scrutiny became even greater in May 2000, when Fastow asserted to the Finance Committee that transactions between Enron and the two LJM entities had provided earnings to Enron during 1999 of $229.5 million. Enron's total net income for the two quarters of 1999 in which the LJM partnerships had been existence was $549 million. The following year, Enron's 2000 Form 10-K disclosed that it had generated some $500 million of revenues in 2000 (virtually all of it going directly to the bottom line) from the Raptor transactions alone, thereby offsetting losses on Enron merchant investments that would otherwise have reduced earnings. These were very substantial contributors to Enron's earnings for each of those periods.

We have seen only very limited information concerning Fastow's compensation from the LJM partnerships. As discussed above in Section IV, we have seen documents indicating that Fastow's family foundation received $4.5 million in May 2000 from the Southampton investment. We also have reviewed some 1999 and 2000 Schedules K-1 for the partnerships that Fastow provided. At a minimum, the K-1s indicate that Fastow's partnership capital increased by $15 million in 1999 and $16 million in 2000, for a total of over $31 million, and that he received distributions of $18.7 million in 2000.

The Board's review apparently never occurred until October 2001, after newspaper reports focused attention on Fastow's involvement in LJM1 and LJM2. (The information Fastow provided orally to members of the Board in October 2001 is generally consistent with the figures discussed above.) The only references we have found to procedures for checking whether Fastow's compensation was modest, as the Board had expected, are in the minutes of the October 6, 2000 meeting of the Finance Committee. There, Fastow told the Committee (in Skilling's presence) that Skilling received "a review of [Fastow's] economic interest in [Enron] and the LJM funds," and the Committee then unanimously agreed that the Compensation Committee should review Fastow's compensation from LJM1 and LJM2. Although a number of members of the Compensation Committee were present at this Finance Committee meeting, it does not appear that the Compensation Committee thereafter performed a review. Moreover, Skilling said he did not review the *actual* amount of Fastow's LJM1 or LJM2 compensation. He said that, instead, he received a handwritten document (from Fastow) showing only that Fastow's economic stake in Enron was substantially larger than his economic stake in LJM1 and LJM2.[77]

Some witnesses expressed the view that direct inquiry into Fastow's compensation would have been inappropriate or intrusive, or might have compromised the independence of LJM. We do not understand this reticence, and we disagree. First, the Board apparently *did* require inquiry into Fastow's compensation, but it either was not done or was done ineffectively. Second, we do not believe that requiring Fastow to provide a copy of his tax return from the partnerships, or similar information, would have been inappropriate. The independence of LJM was not predicated on Fastow's independence from Enron; rather, it was predicated on the existence of a structure within LJM that created limited partner control because Fastow *was* technically viewed as being controlled by Enron. Thus Enron's scrutinizing Fastow's compensation was not inconsistent with the independence of LJM.

B. <u>Oversight by Management</u>

Management had the primary responsibility for implementing the Board's resolutions and controls. Management failed to do this in several respects. No one

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[77] Skilling reasoned that Fastow's comparatively larger economic stake in Enron relative to his interest in the LJM partnerships would create an incentive for Fastow to place Enron's interests ahead of those of LJM1 and LJM2. This was the objective of the exercise, as Skilling saw it. While we understand this explanation, we do not believe that the reasoning is valid. Even if Fastow's economic interest in Enron were far greater than his interest in LJM1 and LJM2, his potential benefits from even one transaction that favored LJM1 or LJM2—in which he had a direct and substantial stake—might far outweigh any detriment to him as a holder of stock or options in Enron, on which the transaction could be expected to have minimal financial impact.

accepted primary responsibility for oversight, the controls were not executed properly, and there were apparent structural defects in the controls that no one undertook to remedy or to bring to the Board's attention. In short, no one was minding the store.

The most fundamental management control flaw was the lack of separation between LJM and Enron personnel, and the failure to recognize that the inherent conflict was persistent and unmanageable. Fastow, as CFO, knew what assets Enron's business units wanted to sell, how badly and how soon they wanted to sell them, and whether they had alternative buyers. He was in a position to exert great pressure and influence, directly or indirectly, on Enron personnel who were negotiating with LJM. We have been told of instances in which he used that pressure to try to obtain better terms for LJM, and where people reporting to him instructed business units that LJM would be the buyer of the asset they wished to sell. Pursuant to the Services Agreement between Enron and LJM, Enron employees worked for LJM while still sitting in their Enron offices, side by side with people who were acting on behalf of Enron. Simply put, there was little of the separation and independence required to enable Enron employees to negotiate effectively against LJM2.

In many cases, the safeguard requiring that a transaction could be negotiated on behalf of Enron only by employees who did not report to Fastow was ignored. We have identified at least 13 transactions between Enron and LJM2 in which the individuals negotiating on behalf of Enron reported directly or indirectly to Fastow.

This situation led one Fastow subordinate, then-Treasurer Jeff McMahon, to complain to Skilling in March 2000. While McMahon's and Skilling's recollections of their conversation differ, McMahon's contemporaneous handwritten discussion points, which he says he followed in the meeting, include these notations:

- "LJM situation where AF [Andy Fastow] wears 2 hats and <u>upside comp is so great</u> creates a conflict I am right in the middle of."
- "I find myself negotiating with Andy [to whom he then reported] on Enron matters and am pressured to do a deal that I do not believe is in the best interests of the shareholders."
- "Bonuses <u>do</u> get affected -- MK [Michael Kopper], JM [Jeff McMahon]"[78/]

McMahon's notes also indicate he raised the concern that Fastow was pressuring investment banks that did business with Enron to invest in LJM2.

Skilling has said he recalls the conversation focusing only on McMahon's compensation. Even if that is true, it still may have suggested that Fastow's conflict was placing pressure on an Enron employee. The conversation presented an issue that required remedial action: a solution by Management, a report to the Board that its controls were not working properly, or both. Skilling took no action of which we are aware, and shortly thereafter McMahon accepted a transfer within Enron that removed him from contact with LJM. Neither Skilling nor McMahon raised the issue with Lay or the Board.

Conflicts continued. Indeed, the Raptor transactions, which provided the most lucrative returns to LJM2 of any of its transactions with Enron, followed soon after McMahon's meeting with Skilling. The Raptor I transaction was designed by Ben

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78/ McMahon says this was a reference to his perception that Kopper, who had worked closely with Fastow, had received a very large bonus, while McMahon felt he had been penalized for his resistance with respect to LJM.

Glisan—McMahon's successor as Treasurer—who reported to Fastow, and by others in Fastow's Global Finance Group. Another Enron employee responsible for later Raptors was Trushar Patel. He was in the Global Finance Group and married to Anne Yaeger Patel, an Enron employee who assisted Fastow at LJM2. Both Yaeger Patel and Glisan also shared in the Southampton Place partnership windfall, during the same period the Raptor transactions were in progress.

The Board's first and most-relied-on control was review of transactions by the Chief Accounting Officer, Causey, and the Chief Risk Officer, Buy. Neither ignored his responsibility completely, but neither appears to have given the transactions anywhere near the level of scrutiny the Board understood they were giving. Neither imposed a procedure for identifying all LJM1 or LJM2 transactions and for assuring that they went through the required procedures. It appears that some of the transactions, including the "buybacks" of assets previously sold to LJM1 or LJM2, did not even come to Causey or Buy for review. Although Buy has said he was aware that changes were made to the Raptors during the first quarter of 2001, he also said he was not involved in reviewing those changes. He should have reviewed this transaction, like all other transactions with LJM2.

Even with respect to the transactions that he did review, Causey said he viewed his role as being primarily determining that the appropriate business unit personnel had signed off. Buy said he viewed his role as being primarily to evaluate Enron's risk.[79] It

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[79] Buy and a subordinate who assisted him on certain of the transactions have said that in cases where Enron was selling to LJM2 an interest in an asset that Enron had acquired, they checked to see that the sale price was consistent with the acquisition price.

does not appear that Causey or Buy had the necessary time, or spent the necessary time, to provide an effective check, even though the Board was led to believe they had done so.

Skilling appears to have been almost entirely uninvolved in overseeing the LJM transactions, even though in October 2000 the Finance Committee was told by Fastow—apparently in Skilling's presence—that Skilling had undertaken substantial duties.[80] Fastow told the Committee that there could be no transactions with the LJM entities without Skilling's approval, and that Skilling was reviewing Fastow's compensation. Skilling described himself to us as having little or no role with respect to the individual LJM transactions, and said he had no detailed understanding of the Raptor transactions (apart from their general purpose). His signature is absent from many LJM Deal Approval Sheets, even though the Finance Committee was told that his approval was required. Skilling said he would sign off on transactions if Causey and Buy had signed off, suggesting he made no independent assessment of the transactions' fairness. This was not sufficient in light of the representations to the Board.

It does not appear that Lay had, or was intended to have, any managerial role in connection with LJM once the entities became operational. His involvement was principally on the same basis as other Directors. By the accounts of both Lay and

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This appears to be the one point in the review process at which there was an appropriate examination of the substance of the transactions; in fact, the price of the assets sold by Enron to LJM2 does not appear to have been where the problems arose.

[80] The minutes of the October 6, 2000 meeting of the Finance Committee report Fastow saying that "Buy, Causey and Skilling review all transactions between the Company and the LJM funds." The minutes state that Skilling, along with Buy and Causey, "attended the meeting." Skilling told us that he may not have been present for Fastow's remarks.

Skilling, the division of labor between them was that Skilling, as President and COO (later CEO) had full responsibility for domestic operational activities such as these. Skilling said he would keep Lay apprised of major issues, but does not recall discussing LJM matters with him. Likewise, the Enron employees we interviewed did not recall discussing LJM matters with Lay after the entities were created other than at Board and Board Committee meetings, except in two instances after he resumed the position of CEO in August and September of 2001 (the Watkins letter, discussed in Section VII.C, and the termination of the Raptors, discussed in Section V.E.). Still, during the period while Lay was CEO, he bore ultimate management responsibility.

Still other controls were not properly implemented. The LJM Deal Approval Sheet process was not well-designed, and it was not consistently followed. We have been unable to locate Approval Sheets for some transactions. Other Approval Sheets do not have all the required signatures. The Approval Sheet form contained pre-printed check marks in boxes signifying compliance with a number of controls and disclosure concerns, with the intention that a signature would be added to certify the accuracy of the pre-printed check-marks. Some transactions closed before the Approval Sheets were completed. The Approval Sheets did not require any documentation of efforts to find third party, unrelated buyers for Enron assets other than LJM1 or LJM2, and it does not appear that such efforts were systematically pursued. Some of the questions on the Approval Sheets were framed with boilerplate conclusions ("Was this transaction done strictly on an arm's-length basis?"), and others were worded in a fashion that set unreasonably low standards or were worded in the negative ("Was Enron advised by any third party that this transaction was not fair, from a financial perspective, to Enron?"). In practice, it appears the LJM Deal Approval Sheets were a formality that provided little control.

Apart from these failures of execution, perhaps the most basic reason the controls failed was structural. Most of the controls were based on a model in which Enron's business units were in full command of transactions and had the time *and* motivation to find the highest price for assets they were selling. In some cases, transactions were consistent with this model, but in many of the transactions the assumptions underlying this model did not apply. The Raptor transactions had little economic substance. In effect, they were transfers of economic risk from one Enron pocket to another, apparently to create income that would offset mark-to-market losses on merchant investments on Enron's income statement. The Chief Accounting Officer was not the most effective guardian against transactions of this sort, because the Accounting Department was at or near the root of the transactions. Other transactions were temporary transfers of assets Enron wanted off its balance sheet. It is unclear in some of the cases whether economic risk ever passed from Enron to LJM1 or LJM2. The fundamental flaw in these transactions was not that the price was too low. Instead, as a matter of economic substance, it is not clear that anything was really being bought or sold. Controls that were directed at assuring a fair price to Enron were ineffective to address this problem.

In sum, the controls that were in place were not effectively implemented by Management, and the conflict was so fundamental and pervasive that it overwhelmed the controls as the relationship progressed. The failure of any of Enron's Senior Management to oversee the process, and the failure of Skilling to address the problem of Fastow's influence over the Enron side of transactions on the one occasion when, by

McMahon's account, it did come to his attention, permitted the problem to continue unabated until late 2001.

C. The Watkins Letter

In light of considerable public attention to what has been described as a "whistleblower" letter to Lay by an Enron employee, Sherron Watkins, we set out the facts as we know them here. However, we were not asked to, and we have not, conducted an inquiry into the resulting investigation.

Shortly after Enron announced Skilling's unexpected resignation on August 14, 2001, Watkins sent a one-page anonymous letter to Lay.[81/] The letter stated that "Enron has been very aggressive in its accounting—most notably the Raptor transactions." The letter raised serious questions concerning the accounting treatment and economic substance of the Raptor transactions (and transactions between Enron and Condor Trust, a subsidiary of Whitewing Associates), identifying several of the matters discussed in this Report. It concluded that "I am incredibly nervous that we will implode in a wave of accounting scandals." Lay told us that he viewed the letter as thoughtfully written and alarming.

81/ Watkins, through her counsel, declined to be interviewed by us. From other sources, we understand that she is an accountant who spent eight years at Andersen, both in Houston and New York. She joined Enron in October 1993, working for Fastow in the corporate finance area. Over the next eight years, she worked in several different positions, including jobs in Enron's materials and metals operations, Enron International, and broadband. She left Enron as part of a downsizing in the spring of 2001, but returned in June 2001 to work for Fastow on a project of listing and gathering information about assets that Enron may want to consider selling.

Lay gave a copy of the letter to James V. Derrick, Jr., Enron's General Counsel. Lay and Derrick agreed that Enron should retain an outside law firm to conduct an investigation. Derrick told us he believed that Vinson & Elkins ("V&E") was the logical choice because, among other things, it was familiar with Enron and LJM matters. Both Lay and Derrick believed that V&E would be able to conduct an investigation more quickly than another firm, and would be able to follow the road map Watkins had provided. Derrick says that he and Lay both recognized there was a downside to retaining V&E because it had been involved in the Raptor and other LJM transactions. (Watkins subsequently made this point to Lay during the meeting described below and in a supplemental letter she gave to him.) But they concluded that the investigation should be a preliminary one, designed to determine whether there were new facts indicating that a full investigation—involving independent lawyers and accountants—should be performed.

Derrick contacted V&E to determine whether it could, under the legal ethics rules, handle the investigation. He says that V&E considered the issue, and told him that it could take on the matter. Two V&E partners, including the Enron relationship partner and a litigation partner who had not done any prior work for Enron, were assigned to handle the investigation. Derrick and V&E agreed that V&E's review would not include questioning the accounting treatment and advice from Andersen, or a detailed review of individual LJM transactions. Instead, V&E would conduct a "preliminary investigation," which was defined as determining whether the facts raised by Watkins warranted further independent legal or accounting review.

Watkins subsequently identified herself as the author of the letter. On August 22, one week after she sent her letter, she met with Lay in his office for approximately one hour. She brought with her an expanded version of the letter and some supporting documents. Lay recalls that her major focus was Raptor, and she explained her concerns about the transaction to him. Lay believed that she was serious about her views and did not have any ulterior motives. He told her that Enron would investigate the issues she raised.[82]

V&E began its investigation on August 23 or 24. Over the next two weeks, V&E reviewed documents and conducted interviews. V&E obtained the documents primarily from the General Counsel of Enron Global Finance. We were told that V&E, not Enron, selected the documents that were reviewed. V&E interviewed eight Enron officers, six of whom were at the Executive Vice President level or higher, and two Andersen partners. V&E also had informal discussions with lawyers in the firm who had worked on some of the LJM transactions, as well as in-house counsel at Enron. No former Enron officers or employees were interviewed. We were told that V&E selected the interviewees.

After completing this initial review, on September 10, V&E interviewed Watkins. In addition, V&E provided copies of Watkins' letters (both the original one-page letter and the supplemental letter that she gave to Lay at the meeting) to Andersen, and had a follow-up meeting with the Andersen partners to discuss their reactions. V&E also conducted follow-up interviews with Fastow and Causey.

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[82] Andersen documents recently released by a Congressional committee indicate that, on August 20, Watkins contacted a friend in Andersen's Houston office and orally communicated her concerns.

On September 21, the V&E partners met with Lay and Derrick and made an oral presentation of their findings. That presentation closely tracked the substance of what V&E later reported in its October 15, 2001 letter to Derrick. At Lay's and Derrick's request, the V&E lawyers also briefed Robert Jaedicke, the Chairman of the Audit and Compliance Committee, on their findings. The lawyers made a similar presentation to the full Audit and Compliance Committee in early October 2001.

V&E reported in writing on its investigation in a letter to Derrick dated October 15, 2001. The letter described the scope of the undertaking and identified the documents reviewed and the witnesses interviewed. It then identified four primary areas of concern raised by Watkins: (1) the "apparent" conflict of interest due to Fastow's role in LJM; (2) the accounting treatment for the Raptor transactions; (3) the adequacy of the public disclosures of the transactions; and (4) the potential impact on Enron's financial statements. On these issues, V&E observed that Enron's procedures for monitoring LJM transactions "were generally adhered to," and the transactions "were uniformly approved by legal, technical and commercial professionals as well as the Chief Accounting and Risk Officers." V&E also noted the workplace "awkwardness" of having Enron employees working for LJM sitting next to Enron employees.

On the conflict issues, V&E described McMahon's concerns and his discussions with Fastow and Skilling (described above), but noted that McMahon was unable to identify a specific transaction where Enron suffered economic harm. V&E concluded that "none of the individuals interviewed could identify any transaction between Enron and LJM that was not reasonable from Enron's standpoint or that was contrary to Enron's best interests." On the accounting issues, V&E said that both Enron and Andersen acknowledge "that the accounting treatment on the Condor/Whitewing and Raptor transactions is creative and aggressive, but no one has reason to believe that it is inappropriate from a technical standpoint." V&E concluded that the facts revealed in its preliminary investigation did not warrant a "further widespread investigation by independent counsel or auditors," although they did note that the "bad cosmetics" of the Raptor related-party transactions, coupled with the poor performance of the assets placed in the Raptor vehicles, created "a serious risk of adverse publicity and litigation."

V&E provided a copy of its report to Andersen. V&E also met with Watkins to describe the investigation and go over the report. The lawyers asked Watkins whether she had any additional factual information to pass along, and were told that she did not.

With the benefit of hindsight, and the information set out in this Report, Watkins was right about several of the important concerns she raised. On certain points, she was right about the problem, but had the underlying facts wrong. In other areas, particularly her views about the public perception of the transactions, her predictions were strikingly accurate. Overall, her letter provided a road map to a number of the troubling issues presented by the Raptors.

The result of the V&E review was largely predetermined by the scope and nature of the investigation and the process employed. We identified the most serious problems in the Raptor transactions only after a detailed examination of the relevant transactions and, most importantly, discussions with our accounting advisors—both steps that Enron determined (and V&E accepted) would not be part of V&E's investigation. With the exception of Watkins, V&E spoke only with very senior people at Enron and Andersen.

Those people, with few exceptions, had substantial professional and personal stakes in the matters under review. The scope and process of the investigation appear to have been structured with less skepticism than was needed to see through these particularly complex transactions.[83/]

83/ We note that by the time of Watkins' letter—August 2001—all of the Raptor transactions were complete with the exception of their termination, which occurred in September 2001.

VIII. RELATED-PARTY DISCLOSURE ISSUES

Enron, like all public companies, was required by the federal securities laws to describe its related-party transactions to shareholders and to members of the investing public in several different disclosure documents: the periodic reports filed with the SEC on a quarterly and annual basis, and the annual proxy solicitation materials sent to shareholders. We found significant issues concerning Enron's public disclosures of related-party transactions.

Overall, Enron failed to disclose facts that were important for an understanding of the substance of the transactions. The Company did disclose that there were large transactions with entities in which the CFO had an interest. Enron did not, however, set forth the CFO's actual or likely economic benefits from these transactions and, most importantly, never clearly disclosed the purposes behind these transactions or the complete financial statement effects of these complex arrangements. The disclosures also asserted without adequate foundation, in effect, that the arrangements were comparable to arm's-length transactions. We believe that the responsibility for these inadequate disclosures is shared by Enron Management, the Audit and Compliance Committee of the Board, Enron's in-house counsel, Vinson & Elkins, and Andersen.

A. Standards for Disclosure of Related-Party Transactions

The most basic standards governing Enron's disclosure to investors and to the market are familiar: companies must not make untrue statements of material fact, or omit material facts necessary to make the statements made, in light of the circumstances in which they were made, not misleading. Specific guidelines also govern disclosure of transactions with related parties in proxy statements and periodic SEC filings, and in financial statement footnotes.

Item 404 of SEC Regulation S-K sets out the requirements for disclosing related-party transactions in the non-financial statement portions of SEC filings, including proxy statements and the annual reports on Form 10-K. (As many public companies do, Enron addressed the disclosure requirements of Item 404 in its 10-Ks by incorporating the discussion from the proxy statement by reference.) Item 404(a) requires disclosure of, among other things, transactions exceeding $60,000 in which an executive officer of the company has a material interest, "naming such person and indicating the person's relationship to the registrant, the nature of such person's interest in the transaction(s), the amount of such transaction(s) and, where practicable, the amount of such person's interest in the transaction(s)." The instructions to this section provide: "The materiality of any interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case. The importance of the interest to the person having the interest, the relationship of the parties to the transaction with each other and the amount involved in the transactions are among the factors to be considered in determining the significance of the information to investors."

Public companies must also provide financial statements in periodic quarterly and annual SEC filings. Statement of Financial Accounting Standards No. 57 sets forth the requirements under generally accepted accounting principles ("GAAP") concerning disclosures of related-party transactions in financial statements. Simply put, the financial statements must disclose material related-party transactions, and must include certain specific information: "(a) The nature of the relationship(s) involved; (b) A description of the transactions, . . . and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements; (c) The dollar amounts of transactions . . . [and] (d) Amounts due from or to related parties . . . ." The standard provides that, "[i]n some cases, aggregation of similar transactions by type of related party may be appropriate," and that, "[i]f necessary to the understanding of the relationship, the name of the related party should be disclosed." SEC Regulation S-X, § 4-08(k), provides that "[r]elated party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows." These disclosures are typically provided in a footnote to the consolidated financial statements.

Following the original release of FAS 57, public companies and their professional advisors and auditors have received little guidance from the accounting profession or the SEC concerning how these standards should be applied to disclosures of particular types of transactions. Enron Management and its auditors and outside counsel were required to make many judgment calls in deciding what entities qualified as a "related party," and when and how to report transactions with them. Indeed, in light of the Enron experience, the "Big-5" accounting firms petitioned the SEC on December 31, 2001, for guidance in preparing disclosures in annual reports in several areas, including "relationships and transactions on terms that would not be available from clearly independent third parties." On January 22, 2002, the SEC issued a statement urging companies, among other things, to "consider describing the elements of the transactions that are necessary for an understanding of the transactions' business purpose and economic substance, their effects on the financial statements, and the special risks or contingencies arising from these transactions." The SEC emphasized, however, that its guidance was meant "to suggest statements that issuers should consider in meeting their *current* disclosure obligations" and "does not create new legal requirements, nor does it modify existing legal requirements" (emphasis added).

B. Enron's Disclosure Process

Enron's related-party disclosures in its proxy statements, as well as in the financial statement footnotes in its periodic reports, resulted from collaborative efforts among Enron's Senior Management, employees in the legal, accounting, investor relations, and business units, and outside advisors at Andersen and Vinson & Elkins. Nevertheless, it appears that no one outside of Enron Global Finance, the entity principally responsible for the related-party transactions, exercised significant supervision or control over the disclosure process concerning these transactions.

The initial drafts of the footnotes to the financial statements in the periodic reports on Forms 10-Q and 10-K were prepared by Enron corporate accountants in the Financial Reporting Group. The Director of Financial Reporting circulated drafts to a large group of people, including Rex Rogers, an Enron Associate General Counsel responsible for securities law matters, in-house counsel at Enron Global Finance, the transaction support groups who worked on the transactions at issue, the Investor Relations Department, and Vinson & Elkins and Andersen. Vinson & Elkins informed us that they may not have seen all of the filings in advance. The Financial Reporting Group collected comments from the various reviewers, made changes, and distributed revised versions. This process was repeated until all outstanding issues had been resolved. We were told that Causey, Enron's Chief Accounting Officer, was the final arbiter of unresolved differences among the various contributors to the financial reporting process. Causey told us that, while he signed the public filings and met with Andersen engagement partner Duncan to resolve certain issues, he relied on the Financial Reporting Group, lawyers, and transaction support staff for the disclosures. The Audit and Compliance Committee reviewed drafts of the financial statement footnotes and discussed them with Causey. During the relevant period, Skilling reviewed the periodic filings after the accountants and lawyers had agreed on the proposed disclosures. Causey signed the Forms 10-Q and 10-K as the Chief Accounting Officer. All of the Directors and Fastow signed the 10-Ks as well.

Preparation of the related-party transaction disclosures followed this general pattern, with one major exception: we were told that, because the related-party transactions were often extremely complex, the Enron Corp. accountants and lawyers responsible for financial reporting relied heavily on—and generally deferred to—the officers and employees in Enron Global Finance who were closer to the transactions and actually knew the details. The Financial Reporting Group circulated drafts of the related-party footnotes internally, and both Andersen and Vinson & Elkins commented on these disclosures. Causey, who was charged by the Board with approving the transactions with the LJM partnerships, paid attention to the related-party transaction footnotes, and we were told that he made the final decisions on their contents. Skilling said that he consistently looked at the discussions of related-party transactions.

While accountants took the lead in preparing the financial statement footnote disclosures, lawyers played a more central role in preparing the proxy statements, including the disclosures of the related-party transactions. This process was organized by

Associate General Counsel Rogers and lawyers working for him, with substantial advice from Vinson & Elkins. James Derrick, Enron's General Counsel, reviewed the final drafts to look for obvious errors, but otherwise had little involvement with the related-party proxy statement disclosures. He said that he relied on his staff, Vinson & Elkins, and Andersen to make sure the disclosures were correct and complied with the rules. Enron's in-house counsel say they relied on advice from Vinson & Elkins in deciding whether the proposed disclosures were adequate, particularly with respect to related-party transactions.

As with the financial statement footnotes, drafts of the proxy statements were circulated repeatedly to a wide group. The Financial Reporting Group checked the draft proxy statements to make sure that the amounts reported in the proxies were supported by the information in the financial statements, but generally was not otherwise involved in the drafting. Senior Management and the Board of Directors were given an opportunity to comment on proxy statement drafts, and they appear to have paid comparatively more attention to the proxy statements than to the financial statements in the periodic reports. We were told that members of the Board focused particular attention to the disclosures about themselves, and were not directed specifically to the related-party disclosures by Management. Lay was generally involved in the disclosure process only to the same extent as the outside directors.

There was no systematic procedure in place for ensuring identification of all transactions with related parties that needed to be disclosed in financial statement footnotes or proxy statements. In the case of the financial statement footnotes, the Financial Reporting Group included transactions of which it was aware in the first draft, and relied on the comment process to identify any transactions that had not been included. For the proxy statements, the lawyers and accountants with Enron Global Finance generally provided the lists of relevant transactions. It does not appear that the LJM Approval Sheets or files in the legal department were consulted to ensure that all of the transactions in the period were covered by the related-party disclosures (although, as noted above, it also does not appear that the Approval Sheets were complete).

C. Proxy Statement Disclosures

1. Enron's Disclosures

The "Certain Transactions" sections of Enron's proxy statements in 2000 and 2001 included disclosures of transactions with the LJM partnerships.

Enron described the establishment of LJM1 and LJM2 in its May 2000 proxy statement. Each was described as "a private investment company that primarily engages in acquiring or investing in energy and communications related investments." Concerning LJM1, Enron disclosed that "Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron, is the managing member of LJM1's general partner. The general partner of LJM1 is entitled to receive a percentage of the profits of LJM1 in excess of the general partner's proportion of the total capital contributed to LJM1, depending upon the performance of the investments made by LJM1." Essentially the same disclosure was repeated with respect to LJM2. The proxy statement did not give the amount of compensation Fastow had received, or specify the compensation formula in any more detail.

The 2000 proxy statement discussed the Rhythms transaction with LJM1 by describing the details of the "effect" of "a series of transactions involving a third party and LJM Cayman, L.P." The disclosures identified the number of shares of Enron stock and other instruments that changed hands, but did not describe any purpose behind the transactions. The disclosures said that, "[i]n connection with the transactions, LJM1 agreed that Mr. Fastow would have no pecuniary interest in such Enron Common Stock and would be restricted from voting on matters related to such shares."

The proxy statement next disclosed that, "[i]n the second half of 1999, Enron entered into eight transactions with LJM1 and LJM2," and then described them in general terms:

> In six of these transactions, LJM1 and/or LJM2 acquired various debt and equity securities of certain Enron subsidiaries and affiliates that were directly or indirectly engaged in the domestic and/or international energy business. The aggregate consideration agreed to be paid to Enron pursuant to these six transactions was approximately $119.3 million. In the seventh transaction, LJM2 paid $12.9 million for an equity interest in an Enron securitization vehicle (that owned approximately $300 million of merchant assets) and loaned $19.6 million to such vehicle. In the eighth transaction, LJM2 borrowed $38.5 million from an Enron affiliate, which loan was outstanding at year end.

The 2000 proxy statement also included representations concerning the arm's-length nature of the transactions with LJM. Concerning LJM1, Enron stated that "[m]anagement believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties." With respect to LJM2, Enron included the same representation and added that "[t]hese transactions occurred in the ordinary course of Enron's business and were negotiated on an arm's-length basis with senior officers of Enron other than Mr. Fastow."

Enron's 2001 proxy statement again identified Fastow as the managing member of LJM2's general partner and repeated the assertion that the transactions with LJM2 "occurred in the ordinary course of Enron's business and were negotiated on an arm's length basis with senior officers of Enron other than Mr. Fastow." The transactions themselves were discussed in two groups, and for each Enron combined a general description of the purpose of the transactions with an aggregated summary of the terms. Concerning the acquisition by LJM2 of Enron assets, the proxy statement said:

> During 2000, [Enron] entered into a number of transactions with [LJM2] . . . primarily involving either assets Enron had decided to sell or risk management activities intended to limit Enron's exposure to price and value fluctuations with respect to various assets . . . . In ten of these transactions LJM2 acquired various debt and equity securities, or other ownership interests, from Enron that were directly or indirectly engaged in the domestic and/or international energy or communication business, while in one transaction LJM2 acquired dark fiber from an Enron subsidiary. The aggregate consideration to be paid to Enron pursuant to these eleven transactions was approximately $213 million. Also during 2000, LJM2 sold to Enron certain merchant investment interests for a total consideration of approximately $76 million.

Concerning the derivative transactions with LJM2, the proxy statement said:

> Also, during 2000, Enron engaged in other transactions with LJM2 intended to manage price and value risk with regard to certain merchant and similar assets by entering into derivatives, including swaps, puts, and collars. As part of such risk management transactions, LJM2 purchased equity interests in four structured finance vehicles for a total of approximately $127 million. Enron, in turn, contributed a combination of assets, Enron notes payable, restricted shares of outstanding Enron stock (and the restricted right to receive additional Enron shares) in exchange for interests in the vehicles. Enron and LJM2 subsequently entered into derivative transactions through these four vehicles with a combined notional amount of approximately $2.1 billion.

2. Adequacy of Disclosures

Given the circumstances in which Enron now finds itself, it is difficult to avoid coloring a review of prior disclosure documents with the benefit of 20/20 hindsight. We have tried to avoid that impulse. Indeed, there were substantial disclosures regarding most of the related-party transactions at issue here, including their magnitude and even some of the "mechanics" of the transactions. Any reader of those disclosures should have recognized that these arrangements were complex, the dollar amounts involved were substantial, and the transactions were significant for evaluating the Company's financial performance. Nevertheless, the disclosures were fundamentally inadequate.

Fastow's Compensation. The failure to set forth Fastow's compensation from the LJM transactions and the process leading to that decision raise substantial issues. Item 404 of Regulation S-K required the disclosure "where practicable" of "the amount of [Fastow's] interest in the transactions." We have been told that there was significant discussion, both within Enron Management and with outside advisors, about whether Enron could avoid disclosing Fastow's compensation from the related parties in the face of that fairly clear language. The consensus of people involved in drafting the proxy disclosures was to accommodate the strong desire of Fastow (and others) to avoid disclosure if there was a legitimate basis to do so.

For the 2000 proxy statement, the issue was discussed among members of Enron's Senior Management, its in-house counsel, its lawyers at Vinson & Elkins, and Andersen. In the end, the proxy statement simply noted that the general partner of LJM1 and LJM2, of which Fastow was the managing member, was entitled to a share of the profits in excess of its proportional capital investment in the partnership. The rationale, as memorialized in a memorandum written by Jordan Mintz, the General Counsel of Enron Global Finance, was that the "where practicable" language of Item 404 (referred to above) provided the basis for not setting forth the amount of Fastow's compensation from LJM. Because the majority of transactions between Enron and LJM1 or LJM2 were "open" during the proxy reporting period—that is, the ultimate and final determination of obligations and payments remained uncertain—the in-house and outside counsel concluded it was not "practicable" to determine what Fastow had earned as the managing member of the general partner.

The same rationale applied to the multiple "open" transactions in place at the time the 2001 proxy statement was prepared, although it was acknowledged that some of the transactions had closed in 2000 or early 2001 and the rationale would have little force once most of the transactions closed. The lawyers apparently did little if any investigation into what proportion of the transactions remained open at the time of the 2001 proxy statement filing.

The Rhythms transaction had terminated in early 2000, however, and the lawyers understood that Fastow had received compensation from LJM1 for that transaction. Enron therefore needed a different basis or theory to support the decision not to disclose. The Enron lawyers and Vinson & Elkins began with the assumption that the 2000 proxy statement had already met all disclosure requirements related to the Rhythms transaction, even without reference to the economic interest of Fastow. The 2001 proxy would have covered the compensation Fastow received from the unwind in 2000 of the Rhythms position. The lawyers reasoned that the Rhythms transaction had terminated in 2000 "pursuant to terms allowed for under the original agreement" entered into in 1999. Because the prior proxy statement had addressed the disclosure requirements relating to the Rhythms transaction, they decided that no financial information regarding what Fastow earned in the transaction had to be disclosed in 2001—notwithstanding that it was now more "practicable" to do so.

It turns out that the factual premise on which the lawyers based this analysis in the Memorandum—that "there was no new transaction involving LJM1 and Enron in the year 2000"—was wrong. In fact, Enron gave an in-the-money put option to LJM Swap Sub in 2000 in connection with the unwinding of the Rhythms transaction. Even without this new put option, however, it was questionable to say that the termination simply "occurred under conditions permitted in the original agreement." That statement was true to the extent that nothing in the original agreement prohibited an early termination, but the agreement did not prescribe a termination process or terms. At least some lawyers involved in the disclosure process knew that the unwind of the Rhythms transaction had been carefully negotiated in 2000.

Beyond this factual problem, the non-disclosure rationale seems to have missed the point. Although the precise amount of compensation to which Fastow ultimately was entitled may still have been subject to adjustment, the magnitude of the amount was knowable and should have been disclosed. Furthermore, the instructions to Item 404 provide that "[t]he amount of the interest of any person [subject to disclosure] . . . shall be computed without regard to the amount of the profit or loss involved in the transaction(s)." This instruction, in addition to the basic purpose of the proxy disclosure rules on the interests of Management in transactions with the Company, seems to have been lost. Enron had an obligation to disclose the "amount of [Fastow's] *interest* in the transaction(s)" (emphasis added), not just his income. The lawyers apparently searched for and embraced a technical rationale to avoid that disclosure.

It appears that the in-house Enron lawyers and Vinson & Elkins agreed with these disclosure decisions, although Mintz wrote that "[t]he decision not to disclose in this instance was a close call; arguably, the more conservative approach would have been to disclose." The memorandum he wrote suggests that "other pertinent (and competing) issues" that Fastow had raised led or contributed to the non-disclosure decision, which was only possible because of a quirk of timing. As the memorandum said, "[i]t was, perhaps, fortuitous that the RhythmsNet transaction extended over two proxy filing years and our knowledge of certain facts was delinked by two separate filings; thus, we have relied on two different arguments for avoiding financial disclosure for you as the LJM1 general partner in 1999 and 2000." We have been told that a number of people expressed varying degrees of skepticism about the rationales for not disclosing the amount of Fastow's compensation, but that none objected strongly.[84/]

[84/] Mintz did warn Fastow that it was highly likely that his compensation from the LJM transactions would have to be disclosed in Enron's 2002 proxy statement. It is unclear to what extent this warning contributed to Fastow's decision to sell his interest in LJM2 in the third quarter of 2001. In May 2001, Mintz also retained an outside law firm (Fried, Frank, Harris, Shriver & Jacobson from Washington, D.C.) to examine Enron's relationship with the LJM partnerships, Enron's prior disclosures, and the disclosures that might be required even after Fastow sold his interest in LJM2. In June 2001, Fried, Frank provided a summary of the relevant standards, raised some questions concerning prior disclosures, and made some preliminary recommendations for future filings in light of Fastow's decision to sell his interest in LJM2. From what we have seen, Fried, Frank did not take particular issue with the prior disclosure decisions concerning Fastow's compensation.