transactions with Enron. As noted earlier, the two members of the Special Investigative Committee who have participated in this review of the Board's actions believe this decision was fundamentally flawed. The Board substantially underestimated the severity of the conflict and overestimated the degree to which management controls and procedures could contain the problem.

After having authorized a conflict of interest creating as much risk as this one, the Board had an obligation to give careful attention to the transactions that followed. It failed to do this. It cannot be faulted for the various instances in which it was apparently denied important information concerning certain of the transactions in question. However, it can and should be faulted for failing to demand more information, and for failing to probe and understand the information that did come to it. The Board authorized the Rhythms transaction and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented, including the statement to the Finance Committee in May 2000 that the proposed Raptor transaction raised a risk of "accounting scrutiny." We do note, however, that the Committee was told that Andersen was "comfortable" with the transaction. As complex as the transactions were, the existence of Fastow's conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure (whether through one of its Committees or through use of outside consultants) that they were fair to Enron.

The Audit and Compliance Committee, and later the Finance Committee, took on a specific role in the control structure by carrying out periodic reviews of the LJM transactions. This was an opportunity to probe the transactions thoroughly, and to seek outside advice as to any issues outside the Board members' expertise. Instead, these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function. The Compensation Committee was given the role of reviewing Fastow's compensation from the LJM entities, and did not carry out this review. This remained the case even after the Committees were on notice that the LJM transactions were contributing very large percentages of Enron's earnings. In sum, the Board did not effectively meet its obligation with respect to the LJM transactions.

The Board, and in particular the Audit and Compliance Committee, has the duty of ultimate oversight over the Company's financial reporting. While the primary responsibility for the financial reporting abuses discussed in the Report lies with Management, the participating members of this Committee believe those abuses could and should have been prevented or detected at an earlier time had the Board been more aggressive and vigilant.

<u>Outside Professional Advisors</u>. The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions. Andersen has admitted that it erred in concluding that the Rhythms transaction was structured properly under the SPE non-consolidation rules. Enron was required to restate its financial results for 1999 and 2000 as a result. Andersen participated in the structuring and accounting treatment of the Raptor transactions, and charged over $1 million for its services, yet it apparently failed to provide the objective accounting judgment that should have prevented these transactions from going forward. According to Enron's internal accountants (though this apparently has been disputed by Andersen), Andersen also reviewed and approved the recording of additional equity in March 2001 in connection with this restructuring. In September 2001, Andersen required Enron to reverse this accounting treatment, leading to the $1.2 billion reduction of equity. Andersen apparently failed to note or take action with respect to the deficiencies in Enron's public disclosure documents.

According to recent public disclosures, Andersen also failed to bring to the attention of Enron's Audit and Compliance Committee serious reservations Andersen partners voiced internally about the related-party transactions. An internal Andersen e-mail from February 2001 released in connection with recent Congressional hearings suggests that Andersen had concerns about Enron's disclosures of the related-party transactions. A week after that e-mail, however, Andersen's engagement partner told the Audit and Compliance Committee that, with respect to related-party transactions, "[r]equired disclosure [had been] reviewed for adequacy," and that Andersen would issue an unqualified audit opinion. From 1997 to 2001, Enron paid Andersen $5.7 million in connection with work performed specifically on the LJM and Chewco transactions. The Board appears to have reasonably relied upon the professional judgment of Andersen concerning Enron's financial statements and the adequacy of controls for the related-party transactions. Our review indicates that Andersen failed to meet its responsibilities in both respects.

Vinson & Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions discussed in the

Report. It also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements and the footnotes to the financial statements in Enron's periodic SEC filings.[2/] Management and the Board relied heavily on the perceived approval by Vinson & Elkins of the structure and disclosure of the transactions. Enron's Audit and Compliance Committee, as well as in-house counsel, looked to it for assurance that Enron's public disclosures were legally sufficient. It would be inappropriate to fault Vinson & Elkins for accounting matters, which are not within its expertise. However, Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process.

***Enron Employees Who Invested in the LJM Partnerships*.** Michael Kopper, who worked for Fastow in the Finance area, enriched himself substantially at Enron's expense by virtue of his roles in Chewco, Southampton Place, and possibly LJM2. In a transaction he negotiated with Fastow, Kopper, and his co-investor in Chewco received more than $10 million from Enron for a $125,000 investment. This was inconsistent with his fiduciary duties to Enron and, as best we can determine, with anything the Board—which apparently was unaware of his Chewco activities—authorized. We do not know what financial returns he received from his undisclosed investments in LJM2 or Southampton Place. Kopper violated Enron's Code of Conduct not only by purchasing his personal interests in Chewco, LJM2, and Southampton, but also by secretly offering an interest in Southampton to another Enron employee.

2/ Because of the relationship between Vinson & Elkins and the University of Texas School of Law, the portions of the Report describing and evaluating actions of Vinson & Elkins are solely the views of Troubh and Winokur.

Ben Glisan, an accountant and later McMahon's successor as Enron's Treasurer, was a principal hands-on Enron participant in two transactions that ultimately required restatements of earnings and equity: Chewco and the Raptor structures. Because Glisan declined to be interviewed by us on Chewco, we cannot speak with certainty about Glisan's knowledge of the facts that should have led to the conclusion that Chewco failed to comply with the non-consolidation requirement. There is, however, substantial evidence that he was aware of such facts. In the case of Raptor, Glisan shares responsibility for accounting judgments that, as we understand based on the accounting advice we have received, went well beyond the aggressive. As with Causey, the fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact. Moreover, Glisan violated Enron's Code of Conduct by accepting an interest in Southampton Place without prior disclosure to or consent from Enron's Chairman and Chief Executive Officer—and doing so at a time when he was working on Enron's behalf on transactions with LJM2, including Raptor.

Kristina Mordaunt (an in-house lawyer at Enron), Kathy Lynn (an employee in the Finance area), and Anne Yaeger Patel (also an employee in Finance) appear to have violated Enron's Code of Conduct by accepting interests in Southampton Place without obtaining the consent of Enron's Chairman and Chief Executive Officer.

* * *

The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, selfenrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. Our review indicates that many of those consequences could and should have been avoided.

The Special Investigative Committee of the Board of Directors of Enron Corp. submits this Report of Investigation to the Board of Directors.

INTRODUCTION

As directed by the Board, this Report addresses transactions between Enron and investment partnerships created and managed by Andrew S. Fastow, Enron's former Executive Vice President and Chief Financial Officer ("CFO"), and other Enron employees who worked for Fastow.

Many of the transactions we reviewed are extraordinarily complex. The Committee has done its best, given the available time and resources, to conduct a careful and impartial investigation. We have prepared a Report that explains the substance of the transactions and highlights their most important accounting, corporate governance, management oversight, and public disclosure issues. An exhaustive investigation of these related-party transactions would require time and resources beyond those available to the Committee. In light of the Board's expressed desire for a prompt explanation of these transactions, and pressing requests from governmental authorities to both the Committee and the Company, we provide this Report without further delay. We believe that the information and analysis it provides is a substantial first step in reviewing and understanding these transactions, and serves as an important starting point for further governmental or other investigations.

The Committee's mandate was specific and focused, so we need to explain what we did *not* do. We were not asked, and we have not attempted, to investigate the causes of Enron's bankruptcy or the numerous business judgments and external factors that contributed it. Many questions currently part of public discussion—such as questions relating to Enron's international business and commercial electricity ventures, broadband communications, transactions in Enron securities by insiders, or management of employee 401(k) plans—are beyond the scope of the authority we were given by the Board.

Formation of the Committee. On October 16, 2001, Enron announced its earnings for the third quarter of 2001. The announcement included an unexpected after-tax charge against earnings of $544 million "related to losses associated with certain investments, principally Enron's interest in The New Power Company, broadband and technology investments, and early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity." In a conference call with securities analysts that day, Enron Chairman Kenneth Lay said that Enron's shareholders' equity was being reduced by $1.2 billion in connection with "the early termination" of "certain structured finance arrangements with a previously disclosed-entity." Both the $544 million charge and the reduction of shareholders' equity related to transactions between Enron and LJM2 Co-Investment, L.P. ("LJM2"), a partnership created and managed by Fastow. The immediate response from the investment community and the media was intense and negative.

On October 22, Enron announced that the Securities and Exchange Commission ("SEC") had requested that Enron voluntarily provide information about the related-party transactions with LJM2 that had been addressed in Enron's earnings announcement. Two days later, on October 24, Enron announced that Fastow would be on a leave of absence and would be replaced as CFO.

The Board of Directors established a Special Committee on October 28, consisting of three directors who were not employees of Enron. The Board authorized the Committee to conduct an investigation of the related-party transactions that were the subject of the SEC inquiry. In the weeks that followed, two new members were added to the Board: Dean William C. Powers, Jr. of the University of Texas School of Law and Raymond S. Troubh. Powers and Troubh, neither of whom had been a member of the Board at the time of the transactions under investigation, were appointed to the Committee (later renamed the Special Investigative Committee) and Powers was named Chairman. Two of the previously-appointed Directors stepped down so that the new Directors would constitute a majority. As constituted after these changes, the Committee's members are Powers, Troubh, and Herbert S. Winokur, Jr.[3/]

3/ Powers became Dean of the University of Texas Law School on September 1, 2000. He has been on the faculty since 1977. James Derrick, Enron's General Counsel, served on the Law School Foundation Board of Directors and the Executive Committee of the Law Alumni Association. He resigned from both positions when Powers was appointed to the Enron Board. He had previously been President of the Law Alumni Association. In 1998, Enron pledged a $250,000 gift to the Law School; the final payment was made in January 2001. Enron has also provided $2,250 in matching money for gifts made to the Law School by Enron employees. Vinson & Elkins has been a major financial supporter of the Law School. The portions of the Report describing and evaluating actions of Vinson & Elkins are solely the views of Troubh and Winokur.

Winokur has been a member of the Board of Directors of Enron since 1985. He was Chairman of the Finance Committee during the time period relevant to this Report and participated in the decisions of the Board and the Finance Committee that are addressed in the Report. The portions of the Report describing and evaluating actions of the Board and its Committees are solely the views of Powers and Troubh.

The Committee engaged Wilmer, Cutler & Pickering as its legal counsel. Wilmer, Cutler engaged Deloitte & Touche LLP to provide accounting assistance.[4] The Committee has relied on Wilmer, Cutler for legal advice and Deloitte & Touche for advice on accounting issues.

On November 8, 2001, Enron filed a Current Report on Form 8-K providing additional information about the previously announced charges, and about its business transactions with LJM2 and another limited partnership in which Fastow had been the general partner (LJM Cayman, L.P., known as "LJM1"). Enron also announced its intention to restate its prior period financial statements for the years ending December 31, 1997 through 2000, and the quarters ending March 31 and June 30, 2001. On November 19, 2001, Enron filed its quarterly report on Form 10-Q, which provided additional information about the restatement. On December 2, 2001, Enron and certain of its subsidiaries filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code.

4/ Wilmer, Cutler has performed certain legal services distinct from this Report and unrelated to any issues addressed in this Report for Enron or its subsidiaries in the last five years. These consist of the representation of an Enron subsidiary before the United States Supreme Court in *Enron Power Marketing, Inc. v. Federal Energy Regulatory Commission*, ___ U.S. ___, 121 S. Ct. 2587 (2001), and the representation of Enron in connection with consideration by the European Commission of a merger of two outside entities. Deloitte & Touche has previously performed certain accounting and tax services for Enron, and certain limited tax-related services for Chewco Investments, not relating to the issues discussed in this Report. It also conducted a peer review of Arthur Andersen LLP in late 2001, including an expanded scope review of Andersen's Houston office, although this peer review did not cover Andersen's work for Enron.

The Committee's Investigation. Our investigation was a private internal inquiry. We requested and received voluntary production of documents from many people inside and outside of Enron. Many people also cooperated by providing information through interviews and otherwise. The Committee's counsel reviewed more than 430,000 pages of documents and interviewed more than 65 people, several more than once. Counsel interviewed nine current Enron Directors, more than 50 current and former Enron employees, and some of Enron's outside professional advisors.

There were some practical limitations on the information available to the Committee in preparing this Report. Although the Board directed that Enron employees cooperate with us, we had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former Enron employees who (we were told) played substantial roles in one or more of the transactions under investigation—including Fastow, Michael J. Kopper, and Ben F. Glisan, Jr.—declined to be interviewed either entirely or with respect to most issues. Fastow provided a limited number of documents and submitted to a brief interview, during which he declined to respond to most questions.[5/]

5/ In addition, largely because of time constraints and resource limitations resulting from the Company's bankruptcy, there are certain Enron-related materials the Committee has not been able to review (or review fully). At present, it is impossible to determine whether those materials contain important information. For example, the Committee has had little or no access to e-mails that are still being retrieved from archive tapes. Our counsel has informed us that, based on experience in other investigations, review of e-mails of this type may provide information that could be relevant to our analysis and conclusions.

Moreover, we have not had access to information and materials in the possession of many of the relevant third parties. Arthur Andersen LLP ("Andersen") permitted the Committee to review some, but not all, of its workpapers relating to Enron. It did not provide copies of those workpapers or allow the Committee to interview knowledgeable Andersen personnel. Representatives of LJM1 and LJM2 (collectively, "the LJM partnerships") declined to provide documents to the Committee and, in light of a confidentiality agreement between those entities and their limited partners, the Committee has not had access to materials in the possession of the limited partners.

There also may be differences between information obtained through voluntary interviews and document requests and information obtained through testimony under oath and by compulsory legal process. In particular, there can be differences between the quality of evidence obtained in informal interviews (such as the ones we conducted) and information obtained in questioning and cross-examination under oath. Moreover, given the circumstances surrounding Enron's demise and the many pending governmental investigations, some of the people we interviewed may have been motivated to describe events in a manner colored by self-interest or hindsight. We made every effort to maintain objectivity. When appropriate, our counsel used cross-examination techniques to test the credibility of witnesses. Within these inherent limitations, we believe that our investigation was both careful and impartial, and that the evidence developed is a reasonable foundation on which to base at least preliminary judgments.[6]

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[6] Many of the transactions discussed in this Report are extraordinarily complex. In order to enhance the reader's understanding, we have taken several steps:

First, the Report uses certain conventions. The term "Enron" refers either to Enron Corp. or any of its subsidiaries or affiliates, unless the context requires greater precision. Dollar amounts or share amounts are approximate unless the precise figure is important. Each person is identified by his or her full name (and title, where relevant) the first time he or she is mentioned, and thereafter by last name only. No disrespect is intended. There were literally hundreds of people who were involved, in one way or another, in the transactions we reviewed. To avoid confusion, we refer to all but a few of the most substantial participants by title, position, or function rather than by name. The Report also omits certain details of transactions where we considered it appropriate in order to make the substance of the transaction more understandable to the non-expert reader.

Second, where we believed it would be helpful, we have included in the text of the report diagrams of the transactions being discussed. The diagrams omit certain details in order to make the structure and transaction more understandable.

Third, we have included in the Appendix both a glossary of certain terms and a timeline showing relevant events. Those are not intended to be exhaustive or all-inclusive, but rather as summaries of relevant information.

Fourth, the historical financial data presented in this Report do not reflect the effects, if any, of the announced restatement of prior period financial statements, unless otherwise indicated.

I. BACKGROUND: ENRON AND SPECIAL PURPOSE ENTITIES

During the late 1990s, Enron grew rapidly and moved into areas it believed fit its basic business plan: buy or develop an asset, such as a pipeline or power plant, and then expand it by building a wholesale or retail business around the asset. During the period from 1996 to 1998, we are told, approximately 60% of Enron's earnings were generated from businesses in which Enron was not engaged ten years earlier, and some 30% to 40% were generated from businesses in which Enron was not engaged five years earlier.

Much of this growth involved large initial capital investments that were not expected to generate significant earnings or cash flow in the short term. While Enron believed these investments would be beneficial over a period of time, they placed immediate pressure on Enron's balance sheet. Enron already had a substantial debt load. Funding the new investments by issuing additional debt was unattractive because cash flow in the early years would be insufficient to service that debt and would place pressure on Enron's credit ratings. Maintaining Enron's credit ratings at investment grade was vital to the conduct of its energy trading business. Alternatively, funding the investments by issuing additional equity was also unattractive because the earnings in the early years would be insufficient to avoid "dilution"—that is, reducing earnings per share.

One perceived solution to this finance problem was to find outside investors willing to enter into arrangements that would enable Enron to retain those risks it believed it could manage effectively, and the related rewards. These joint investments typically were structured as separate entities to which Enron and other investors contributed assets or other consideration. These entities could borrow directly from outside lenders, although in many cases a guaranty or other form of credit support was required from Enron.

Enron's treatment of the entities for financial statement purposes was subject to accounting rules that determine whether the entity should be consolidated in its entirety (including all of its assets and liabilities) into Enron's balance sheet, or should instead be treated as an investment by Enron. Enron management preferred the latter treatment—known as "off-balance-sheet"—because it would enable Enron to present itself more attractively as measured by the ratios favored by Wall Street analysts and rating agencies. Enron engaged in numerous transactions structured in ways that resulted in off-balance-sheet treatment. Some were joint ventures. Others were structured as a vehicle known as a "special purpose entity" or "special purpose vehicle" (referred to as an "SPE" in this Report). Some involved both.

From the early 1990s through 2001, we understand that Enron used SPEs in many aspects of its business. We have been told that these included: synthetic lease transactions, which involved the sale to an SPE of an asset and lease back of that asset (such as Enron's headquarters building in Houston); sales to SPEs of "financial assets" (a debt or equity interest owned by Enron); sales to merchant "hedging" SPEs of Enron stock and contracts to receive Enron stock; and transfers of other assets to entities that have limited outside equity.

There is no generally accepted definition of SPEs to distinguish them from other legal entities, although the staff of the Financial Accounting Standards Board ("FASB") has used the concept of entities whose activities and powers are significantly limited by their charter or other contractual arrangement. An SPE may take any legal form, including a corporation, partnership, or trust. At the margin, it may be difficult to determine whether an entity is or is not an SPE; key considerations in the accounting literature include how long the entity is intended to be in existence, and the restrictions placed on its activities.

The accounting literature provides only limited guidance concerning when an SPE should be consolidated with its sponsor for financial statement purposes. Much of the literature developed in the context of synthetic lease transactions, in which an SPE acquires property or equipment and leases it to a single lessee. The accounting objective of these lease transactions was to finance the acquisition of an asset while keeping the corresponding debt off of the acquiring company's balance sheet. SPEs later came to be used in other non-leasing transactions, largely to obtain similar accounting results. Over time, in part because of SEC staff concerns that there was no standard practice in dealing with the consolidation of SPEs, the FASB Emerging Issues Task Force released several statements attempting to clarify the relevant principles. By the late 1990s, several generally recognized consolidation principles had been established.

To begin, "[t]here is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies . . . ." FASB, Accounting Research Bulletin No. 51, Consolidated Financial Statements (1959). Ordinarily, the majority holder of a class of equity funded by independent third parties should consolidate (assuming the equity meets certain criteria dealing with size, ability to exercise control, and exposure to risk and rewards). If there is no independent equity, or if the independent equity fails to meet the criteria, then the presumption is that the transferor of assets to the SPE or its sponsor should consolidate the SPE.

This presumption in favor of consolidation can be overcome only if two conditions are met:

First, an independent owner or owners of the SPE must make a substantive capital investment in the SPE, and that investment must have substantive risks and rewards of ownership during the entire term of the transaction. Where there is only a nominal outside capital investment, or where the initial investment is withdrawn early, then the SPE should be consolidated. The SEC staff has taken the position that 3% of total capital is the *minimum* acceptable investment for the substantive residual capital, but that the appropriate level for any particular SPE depends on various facts and circumstances. Distributions reducing the equity below the minimum require the independent owner to make an additional investment. Investments are not at risk if supported by a letter of credit or other form of guaranty on the initial investment or a guaranteed return.

Second, the independent owner must exercise control over the SPE to avoid consolidation. This is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors. Accountants often look to accounting literature on partnership control rights for guidance in making this evaluation.

Of the many SPEs utilized by Enron over the past several years, some were involved in the transactions between Enron and related parties that are the subject of this

Report. We have only looked at these SPEs. The unconsolidated SPEs involved in Enron's related-party transactions present issues on both aspects of the non-consolidation test: whether any outside investor had more than 3% residual capital at risk in the entities, and whether any investor other than Enron exercised sufficient control over the entities to justify non-consolidation. We discuss these issues below in connection with specific entities and transactions.

II. CHEWCO

Chewco Investments L.P. is a limited partnership formed in 1997. Transactions between Enron and Chewco are a prologue for Enron's later dealings with the LJM partnerships. Chewco is, to our knowledge, the first time Enron's Finance group (under Fastow) used an SPE run by an Enron employee to keep a significant investment partnership outside of Enron's consolidated financial statements.

Enron's dealings with Chewco raise many of the same accounting and corporate governance issues posed by the LJM transactions we discuss below. Like the LJM partnerships, Chewco's ownership structure was a mystery to most Enron employees, including many who dealt with Chewco on behalf of Enron. Like LJM, the transactions between Enron and Chewco resulted in a financial windfall to an Enron employee. Some of this financial benefit resulted from transactions that make little apparent economic or business sense from Enron's perspective. But there is also an important distinction: The participation of an Enron employee as a principal of Chewco appears to have been accomplished without any presentation to, or approval by, Enron's Board of Directors.

Chewco played a central role in Enron's November 2001 decision to restate its prior period financial statements. In order to achieve the off-balance sheet treatment that Enron desired for an investment partnership, Chewco (which was a limited partner in the partnership) was required to satisfy the accounting requirements for a non-consolidated SPE, including having a minimum of 3% equity at risk provided by outside investors. But Enron Management and Chewco's general partner could not locate third parties willing to invest in the entity. Instead, they created a financing structure for Chewco that—on its face—fell at least $6.6 million (or more than 50%) short of the required third-party equity. Despite this shortfall, Enron accounted for Chewco as if it were an unconsolidated SPE from 1997 through March 2001.

We do not know why this happened. Enron had every incentive to ensure that Chewco met the requirements for non-consolidation. It is reasonable to assume that Enron employees, if motivated solely to protect Enron's interests, would have taken the necessary steps to ensure that Chewco had adequate outside equity. Unfortunately, several of the principal participants in the transaction declined to be interviewed or otherwise to provide information to us. For this reason, we have been unable to determine whether Chewco's failure to qualify for non-consolidation resulted from bad judgment or negligence, or whether it was caused by Enron employees putting their own economic or personal interests ahead of their obligations to Enron.

When the Chewco transaction was reviewed closely in late October and early November 2001, both Enron and Andersen concluded that Chewco was an SPE without sufficient outside equity, and that it should have been consolidated into Enron's financial statements. As a result, Enron announced in November that it would restate its prior period financial statements from 1997 through 2001. The retroactive consolidation of Chewco—and the investment partnership in which Chewco was a limited partner—had a huge impact. It decreased Enron's reported net income by $28 million (out of $105 million total) in 1997, by $133 million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000. It also increased Enron's reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000.

A. **Formation of Chewco**

In 1993, Enron and the California Public Employees' Retirement System ("CalPERS") entered into a joint venture investment partnership called Joint Energy Development Investment Limited Partnership ("JEDI"). Enron was the general partner and contributed $250 million in Enron stock. CalPERS was the limited partner and contributed $250 million in cash. Because Enron and CalPERS had joint control, Enron did not consolidate JEDI into its consolidated financial statements.

In 1997, Enron considered forming a $1 billion partnership with CalPERS called "JEDI II." Enron believed that CalPERS would not invest simultaneously in both JEDI and JEDI II, so Enron suggested it buy out CalPERS' interest in JEDI. Enron and CalPERS attempted to value CalPERS' interest (CalPERS retained an investment bank) and discussed an appropriate buyout price.

In order to maintain JEDI as an unconsolidated entity, Enron needed to identify a new limited partner. Fastow initially proposed that he act as the manager of, and an investor in, a new entity called "Chewco Investments"—named after the Star Wars character "Chewbacca." Although other Enron employees would be permitted to participate in Chewco, Fastow proposed to solicit the bulk of Chewco's equity capital from third-party investors. He suggested that Chewco investors would want a manager who, like him, knew the underlying assets in JEDI and could help manage them effectively. Fastow told Enron employees that Jeffrey Skilling, then Enron's President and Chief Operating Officer ("COO") had approved his participation in Chewco as long as it would not have to be disclosed in Enron's proxy statement.[7]

Both Enron's in-house counsel and its longstanding outside counsel, Vinson & Elkins, subsequently advised Fastow that his participation in Chewco would require (1) disclosure in Enron's proxy statement, and (2) approval from the Chairman and CEO under Enron's Code of Conduct of Business Affairs ("Code of Conduct").[8] As a result, Kopper, an Enron employee who reported to Fastow, was substituted as the proposed manager of Chewco. Unlike Fastow, Kopper was not a senior officer of Enron, so his role in Chewco would not require proxy statement disclosure (but would require approval under Enron's Code of Conduct).

Enron ultimately reached agreement with CalPERS to redeem its JEDI limited partnership interest for $383 million. In order to close that transaction promptly, Chewco was formed as a Delaware limited liability company on very short notice in early November 1997. As initially formed, Kopper (through intermediary entities) was the sole member of both the managing member and regular member of Chewco. Enron's counsel, Vinson & Elkins, prepared the legal documentation for these entities in a period of

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[7] Skilling told us that he recalled Fastow's proposing that the Chewco outside investors be members of Fastow's wife's family, and that Skilling told Fastow he did not think that was a good idea.

[8] Enron's Code of Conduct provided that no full-time officer or employee should "[o]wn an interest in or participate, directly or indirectly, in the profits of any other entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company."

approximately 48 hours. Enron also put together a bridge financing arrangement, under which Chewco and its members would borrow $383 million from two banks on an unsecured basis to buy CalPERS' interest from JEDI. The loans were to be guaranteed by Enron.

Enron employees involved in the transaction understood that the Chewco structure did not comply with SPE consolidation rules. Kopper, an Enron employee, controlled Chewco, and there was no third-party equity in Chewco. There was only debt. The intention was, by year end, to replace the bridge financing with another structure that would qualify Chewco as an SPE with sufficient outside equity. Ben F. Glisan, Jr., the Enron "transaction support" employee with principal responsibility for accounting matters in the Chewco transaction, believed that such a transaction would preserve JEDI's unconsolidated status if closed by year end.

While Chewco was being formed, Enron and Chewco were negotiating the economic terms (primarily the profit distribution "waterfall") of their JEDI partnership. Kopper was the business negotiator for Chewco. During the negotiations, Fastow contacted Enron's business negotiator (who reported to him) and suggested that he was pushing too hard for Enron and that the deal needed to be closed. Enron's negotiator explained to Fastow the status of the discussions with Kopper, that he believed it was his job to obtain the best economic terms for Enron, and that accepting Kopper's current position would (based on Enron's economic modeling) result in greater benefits to Chewco than would be required if the negotiations continued. We were told that Fastow indicated he was comfortable closing the transaction on the terms then proposed by Kopper. Enron's negotiator told us he was uncomfortable with this discussion and

Fastow's intervention, and believes that Enron could have improved its position if he had been permitted to continue the negotiations.

B. Limited Board Approval

The Chewco transaction was presented to the Board's Executive Committee on November 5, 1997, at a meeting held by telephone conference call. The minutes of the meeting reflect that Skilling presented the background of JEDI, and that Fastow explained that Chewco would purchase CalPERS' interest in JEDI. Fastow described Chewco as an SPE not affiliated with either Enron or CalPERS. According to the minutes, he "reviewed the economics of the project, the financing arrangements, and the corporate structure of the acquiring company." He also presented a diagram of the proposed permanent financing arrangement, which involved (1) a $250 million subordinated loan to Chewco from a bank (Enron would guarantee the loan); (2) a $132 million advance to Chewco from JEDI under a revolving credit agreement; and (3) $11 million in "equity" contributed by Chewco. Neither the diagram nor the minutes contains any indication of the source of this equity contribution. The Committee voted to approve Enron's guaranty of the bridge loan and the subsequent subordinated loan. The minutes of the meeting of the full Board on December 9 show that these approvals were briefly reported by the Committee to the Board at that meeting.

Enron's Code of Conduct required Kopper to obtain approval for his participation in Chewco from the Chairman and CEO. Lay, who held both positions at this time, said he does not know Kopper and is confident that he was neither informed of Kopper's participation nor asked to approve it under the Code.[9] Skilling, who was President and COO, said that Fastow made him aware that Kopper would manage Chewco. Skilling told us that, based on Fastow's recommendation, he approved Kopper's role in Chewco. Skilling's approval, however, did not satisfy the requirements of the Code of Conduct. Skilling also said he believes he discussed Kopper's role in Chewco with the Board at some point.

We have located no written record of the approval Skilling described or any disclosure to the Board concerning Kopper's role. Although the minutes show that Kopper was on the Executive Committee's November 5 conference call when the Chewco loan guaranty was discussed and approved, the minutes do not reflect any mention of Kopper's personal participation in the Chewco transaction. Other than Skilling, none of the Directors we interviewed (including Lay and John Duncan, Chairman of the Executive Committee) recalls being informed of, or approving, Kopper's role in Chewco.

C. SPE Non-Consolidation "Control" Requirement

If Enron controlled Chewco, the accounting rules for SPEs required that Chewco be consolidated into Enron's consolidated financial statements. This principle raised two relevant issues: (1) did Kopper control Chewco, and (2) did Kopper, by virtue of his position at Enron, provide Enron with control over Chewco? With respect to the first question, as formed in November, Kopper controlled Chewco. Kopper was the sole

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[9] The minutes of the November 5 Executive Committee meeting reflect that Lay joined the meeting "during" Fastow's presentation concerning Chewco.

member of Chewco's managing member, and had complete authority over Chewco's actions.

In December 1997, Enron and Kopper made two changes to the Chewco structure that were apparently designed to address the control element. First, Chewco was converted to a limited partnership, with Kopper as the manager of Chewco's general partner. The new Chewco partnership agreement provided some modest limits on the general partner's ability to manage the partnership's affairs. Second, an entity called "Big River Funding LLC" became the limited partner of Chewco. The sole member of Big River was an entity called "Little River Funding LLC." Those entities had been part of the bridge financing structure and, at the time, Kopper had controlled them both. But by an assignment dated December 18, Kopper transferred his ownership interest in Big River and Little River to William D. Dodson.[10/] This transfer left Kopper with no formal interest in Chewco's limited partner.

The assessment of control under applicable accounting literature was, and continues to be, subjective. In general, there is a rebuttable presumption that a general partner exercises control over a partnership. The presumption can be overcome if the substance of the partnership arrangement provides that the general partner is not in control of major operating and financial policies. The changes to the Chewco structure and limitations on the general partner's ability to manage the partnership's affairs may

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10/ It is presently common knowledge among Enron Finance employees that Kopper and Dodson are domestic partners. We do not have information concerning their relationship in December 1997 or what, if anything, Enron Finance employees knew about it at that time.

have been sufficient to overcome that presumption, but the issue is not free from doubt. In addition, even if Kopper did control Chewco, it is not clear whether Enron would be deemed to control Chewco. Although Kopper may have been able to influence Enron's actions concerning Chewco, he was not a senior officer of Enron and may not have had sufficient authority within the company for his actions to be considered those of Enron for these purposes.

D. SPE Non-Consolidation "Equity" Requirement

In order to qualify for non-consolidation, Chewco also had to have a minimum of 3% outside equity at risk. As formed in early November, however, Chewco had no equity. There had been efforts to obtain outside equity—including preparing a private placement memorandum and making contact with potential investors—but those efforts were unsuccessful.

In November and December of 1997, Enron and Kopper created a new capital structure for Chewco, which had three elements:

- $240 million unsecured subordinated loan to Chewco from Barclays Bank PLC, which Enron would guarantee;
- $132 million advance from JEDI to Chewco under a revolving credit agreement; and
- $11.5 million in equity (representing approximately 3% of total capital) from Chewco's general and limited partners.

Kopper invested approximately $115,000 in Chewco's general partner, and approximately $10,000 in its limited partner before transferring his limited partnership interest to Dodson. But no third-party investors were identified to provide outside equity.

Instead, to obtain the remaining $11.4 million, Enron and Kopper reached agreement with Barclays Bank to obtain what were described as "equity loans" to Big River (Chewco's limited partner) and Little River (Big River's sole member).

The Barclays loans to Big River and Little River were reflected in documents that resembled promissory notes and loan agreements, but were labeled "certificates" and "funding agreements." Instead of requiring Big River and Little River to pay interest to Barclays, the documents required them to pay "yield" at a specified percentage rate. The documentation was intended to allow Barclays to characterize the advances as loans (for business and regulatory reasons), while allowing Enron and Chewco simultaneously to characterize them as equity contributions (for accounting reasons). During this time period, that was not an unusual practice for SPE financing.

In order to secure its right to repayment, Barclays required Big River and Little River to establish cash "reserve accounts." The parties initially made an effort to maintain the "equity" appearance of the transaction—by providing that the reserve accounts would be funded only with the last 3% of any cash distributions from JEDI to Chewco, and that Barclays could not utilize those funds if it would bring Chewco's "equity" below 3%. But Barclays ultimately required that the reserve accounts be funded with $6.6 million in cash *at closing*, and that the reserve accounts be fully pledged to secure repayment of the $11.4 million.

In order to fund the reserve accounts, JEDI made a special $16.6 million distribution to Chewco. In late November, JEDI had sold one of its assets—an interest in