transaction, but we have not been able to confirm Fastow's calculation.) Enron recorded $570 million total in pre-tax earnings ($549 million after tax) for that period.

There is some evidence that Enron employees agreed, in undocumented side deals, to insure the LJM partnerships against loss in three of these transactions. There are also plausible, more innocent explanations for Enron's repurchases. What seems clear is that the LJM partnerships were not simply potential buyers of Enron assets on par with other third parties. Rather, Enron sold assets to the LJM partnerships that it could not, or did not wish to, sell to other buyers. The details of six transactions follow.

A. Illustrative Transactions with LJM

1. Cuiaba

In September 1999, Enron sold LJM1 a 13% stake in a company building a power plant in Cuiaba, Brazil. This was the first transaction between Enron and LJM1 after the Rhythms hedge. This sale, for approximately $11.3 million, altered Enron's accounting treatment of a related gas supply contract and enabled Enron to realize $34 million of mark-to-market income in the third quarter of 1999, and another $31 million of mark-to-market income in the fourth quarter of 1999. In August 2001, Enron repurchased LJM1's interest in Cuiaba for $14.4 million.

As of mid-1999, Enron owned a 65% stake in a Brazilian company, Empresa Productora de Energia Ltda ("EPE"), with a right to appoint three directors. A third party owned the remainder, with a right to appoint one director. Enron's Brazilian business unit wanted to reduce its ownership interest, but had difficulty finding a buyer, in part because the plant was experiencing significant construction problems. In June 1999, Glisan, who reported to Fastow, advised the employee handling the sale effort that LJM1 would purchase an interest in EPE.

This employee negotiated the transaction with LJM1 on behalf of Enron. It is indicative of the confusion over roles that a second employee, whom the first employee believed was negotiating on behalf of LJM1, says she too was functioning as an Enron employee. The second employee, who worked in Enron Global Finance and reported to Fastow, said she believed she was an intermediary between the other Enron employee and Fastow, and that Fastow negotiated for LJM1.

The transaction was effective September 30, 1999. The terms were that LJM1 would pay Enron $11.3 million for a 13% interest in EPE and certain redeemable preference shares in an Enron subsidiary. LJM1 also would have the right to appoint one member of EPE's Board of Directors. LJM1 granted Enron the exclusive right to market LJM1's interest to other buyers. If the sale occurred before May 9, 2000, LJM1's return would be capped at 13%, and Enron would keep any excess amount. If the sale occurred after May 9, 2000, LJM1's return would be capped at 25%.[63/]

Enron took the position that, as a result of the decrease in its ownership interest, it no longer controlled EPE and was not required to consolidate EPE in its balance sheet. This permitted Enron to mark-to-market a portion of a gas supply contract one of its

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[63/] The date at which the cap increased was later extended to August 9, 2000, for a $240,000 fee paid to LJM1.

subsidiaries had with the project, enabling Enron to realize a total of $65 million of mark-to-market income in the second half of 1999.

After the sale to LJM1, the Cuiaba project encountered serious technical and environmental problems. Despite the fact that the value of the interest purchased by LJM1 likely declined sharply due to these problems, Enron bought back LJM1's interest on August 15, 2001, for $14.4 million. The price was calculated to provide LJM1 its maximum possible rate of return. This was not required by the terms of Enron's agreement with LJM1, which had set a maximum, not a minimum, amount that LJM1 could earn on its investment.

We were told two reasons why Enron paid this amount. The Enron employee who negotiated the buy-back said that it had become critical to Enron to gain back the board seat controlled by LJM1. He said that LJM1 had not appointed a director due to liability concerns, which left only three board members. Disputes had arisen between Enron and the third party because of cost overruns, and the third party's director could stymie action merely by leaving Board meetings and denying the Board a quorum. Skilling told us that he was not surprised that Enron bought the interest back because personnel in Enron's Brazilian subsidiary had made misrepresentations to LJM1 in connection with the original sale, and that he would have authorized a buyback with any outside party under these circumstances.

On the other hand, the Enron employee reporting to Fastow who participated in the negotiation of the original transaction told us that Fastow had told her there was a clear understanding that Enron would buy back LJM1's investment if Enron were not able to find another buyer for the interest. We are not able to resolve the differences in recollections. LJM1's equity investment could not have been "at risk" within the meaning of the relevant accounting rule if Enron had agreed to make LJM1 whole for its investment. In that case, Enron would have been required to consolidate EPE, and could not have recognized the mark-to-market gains from the gas supply contract.

2. ENA CLO

On December 22, 1999, Enron North America ("ENA") pooled a group of loans receivable into a Trust. It sold approximately $324 million of Notes and equity, providing the purchasers certain rights to the cash flow from repayment of the loans. The securities representing these rights are known as collateralized loan obligations ("CLO's"). There were different classes, or "tranches," of these securities, representing an order of preference in which the tranches were entitled to repayment. The tranches were rated by Fitch, Inc., and marketed to institutional investors by Bear Stearns.

The lowest-rated tranches—those with last claim on the repayments of the loans in the pool—were extremely difficult to sell. It is our understanding that no outside buyer could be found. Eventually, the lowest tranche of Notes was sold to an affiliate of Whitewing (an investment partnership in which Enron is a limited partner) and LJM2. The equity tranche, which was last in line on claims to the funds flow, was bought by LJM2 for $12.9 million. LJM2 paid a total of $32.5 million for its investment. The investors in Whitewing (in which LJM2 also held an interest) were required to approve its purchase of the Notes. An Enron employee who worked on the transaction told us that the head of the ENA finance group told one of the Whitewing investors that if the Notes defaulted, Enron would find a way to make the investor whole.

Two days before LJM2 paid $32.5 million for its interests in the CLO's Notes and equity, another Whitewing affiliate loaned LJM2 $38.5 million. This loan agreement was signed on behalf of the Whitewing affiliate by an Enron employee who had assisted in the effort to sell the CLO tranches. The employee told us she does not recall the loan transaction. We are unable to determine whether the loan was intended to fund LJM2's acquisition of the CLO securities, although the amount and timing is suggestive. This may cast doubt on the economic substance of LJM2's investment.

This CLO sale did not result in recognition of income by Enron because Enron carried the loans at fair value. However, because the loans were sold without recourse to Enron, Enron was no longer subject to the credit exposure. The loans in the CLO Trust performed very poorly; shortly after being transferred into the CLO Trust, several loans defaulted. On September 1, 2000, Enron provided credit support to the CLO Trust by giving it a put option with a notional value of $113 million. Enron did not charge the CLO Trust a premium for this option. A substantial portion of the risk related to this put option—which did not exist until September 1, 2000—was "hedged" in Raptor I, effective August 3, 2000.

The put option proved insufficient to support the CLO because the loan portfolio continued to deteriorate. In order to protect its reputation in the capital markets, in May and July 2001 Enron repurchased all of the outstanding Notes at par plus accrued interest. Enron also repurchased LJM2's equity stake at cost.

This transaction provides additional evidence (1) of a general understanding that LJM2 was available to purchase assets that Enron wished to sell but that no outside buyer wished to purchase; (2) that Enron would offer the financial assistance necessary to enable LJM2 to do this; and (3) that Enron protected LJM2 against suffering any loss in its transactions with Enron.

3. Nowa Sarzyna (Poland Power Plant)

On December 21, 1999, Enron sold to LJM2 a 75% interest in a company that owned the Nowa Sarzyna power plant under construction in Poland. Enron did not want to consolidate the asset in its balance sheet. While Enron had intended to sell the asset to a third party or transfer it to an investment partnership it was attempting to form, Enron was unable to find a buyer before year-end. Enron settled on LJM2 as a temporary holder of the asset. LJM2 paid a total of $30 million, part of it in the form of a loan and part an equity investment. Enron recorded a gain of approximately $16 million on the sale.

When this transaction closed, it was clear this would be only a temporary solution. The credit agreement governing the debt financing of the plant required Enron to hold at least 47.5% of the equity in the project until completion. Enron was able to obtain a waiver of that requirement, but only through March 31, 2000. It was unable to obtain a further waiver and, after the plant malfunctioned during a test, Enron was unable to find a buyer for LJM2's interest. On March 29, 2000, Enron and Whitewing bought out LJM2's equity interest and repaid the loan for a total of $31.9 million. This provided LJM2 approximately a 25% rate of return.

4. MEGS

On December 29, 1999, Enron sold to LJM2 a 90% equity interest in a company, MEGS LLC, that owned a natural gas gathering system in the Gulf of Mexico. Enron had attempted to sell this interest to another party, but was unable to close that transaction by year-end. Closing the transaction by the end of the year would enable Enron to avoid consolidating the asset for year-end financial reporting purposes. LJM2 purchased a $23.2 million note of MEGS for $25.6 million and an equity interest in MEGS for $743,000.

The parties apparently expected to find a permanent buyer within 90 days. The terms of the sale gave Enron an exclusive right to market the LJM2 interest for that period of time, and capped LJM2's return on any such sale at a 25% rate of return.

We were told that early reports indicated that the gas wells feeding the gathering system were performing above expectations. On March 6, 2000, Enron (though a different subsidiary) repurchased LJM2's interests. It paid LJM2 an amount necessary to give it the maximum allowed return. Subsequently, Enron recorded an impairment on the gas wells in 2001 due to diminished performance.

The decision to buy back LJM2's interests in MEGS was reflected on a DASH. Jeff McMahon, then Enron's Treasurer, at first declined to sign. Under the signature block he wrote: "There were no economics run to demonstrate this investment makes sense. Therefore, we cannot opine on its marketability or ability to syndicate." McMahon told us he did not see any sense in Enron purchasing this asset, which would simply add to Enron's balance sheet and provide only a very modest return.

5. <u>Yosemite</u>

In November 1999, Enron and an institutional investor paid $37.5 million each to purchase all the certificates issued by a trust called "Yosemite." In late December, Enron determined that it needed to reduce its holdings of the Yosemite certificates from 50% to 10% before the end of the year. This was so that it could avoid disclosing its ownership of the certificates in its "unconsolidated affiliates" footnote to its 1999 financial statements on Form 10-K. The plan, apparently, was for an affiliate of Whitewing, called "Condor," ultimately to acquire the Yosemite certificates Enron was selling. But for reasons that are unclear—and that none of the Enron employees who we interviewed could explain—Enron did not feel it could sell the certificates directly to Condor. Enron needed to find an intermediate owner of the certificates.

With only a short time before year-end, the Enron employees responsible for selling the Yosemite certificates believed they had no real option other than to offer the certificates to LJM2. They approached LJM2, which apparently insisted on a very large fee—$1 million or more—for LJM2 to purchase the certificates before reselling them to Condor. The Enron employees, believing that some fee was appropriate for LJM2's services, offered $100,000. Fastow then called one of the employees to complain that he was negotiating too hard about the fee, and that he was holding up a transaction that was important for Enron to complete before year-end. The employee went to McMahon, his supervisor. McMahon says he confronted Fastow about pressuring the employee. Following this discussion, LJM2 retreated and the deal closed with Enron paying the fee it originally offered.

Even apart from Fastow's intervention, the transaction itself is unusual in several respects. First, it was widely understood that LJM2 was involved simply to hold the Yosemite certificates briefly before selling them to another entity. The LJM2 Approval Sheet (which was not prepared until February 2000) clearly states, with emphasis in the original, that "*LJM2 intends to sell this investment to Condor within one week of purchase.*" Second, the legal documents show Enron selling the certificates to LJM2 on December 29, 1999, and then LJM2 selling the certificates to Condor the next day, December 30, 1999—thus disposing of the certificates before year-end. It is not clear how this would achieve Enron's financial disclosure goals. Finally, the *actual* transaction does not appear to have occurred in late December 1999 but, instead, on February 28, 2000. The transaction involved Condor loaning $35 million to LJM2, which then immediately used the proceeds to purchase the Yosemite certificates from Enron, which LJM2 immediately passed on to Condor, which resulted in the original loan to LJM2 being repaid. In other words, Condor bought the certificates from Yosemite, with the money and certificates passing—ever so briefly—through LJM2. For that, LJM2 earned $100,000 plus expenses.

6. Backbone

In the late 1990s, Enron Broadband Services ("EBS") embarked on an effort to build a nationwide fiber optic cable network. It laid thousands of miles of fiber optic cable and purchased the rights to thousands of additional miles of fiber. In mid-May 2000, EBS decided to sell by the end of the second quarter a portion of its unactivated "dark" fiber. There was substantial pressure to close the transaction so that

EBS could meet its second quarter numbers. With the quarter-end approaching, the EBS business people felt they had no choice other than to approach LJM2.

The proposed terms called for EBS to remarket the fiber after LJM2 purchased it, and capped LJM2's return on the resale at 18%. Initially, Kopper negotiated on behalf of LJM2. But as the negotiations were nearing a conclusion in late June, Fastow inserted himself in the process. He was angry that EBS proposed to sell LJM2 dark fiber that was not certified as usable, and that it might take as long as a year for it to be certified. He first confronted EBS' general counsel, Kristina Mordaunt, the former general counsel to Fastow's group and his recent partner in the Southampton Place partnership. Fastow complained to her that EBS was the most difficult business unit with which to negotiate. Fastow then complained directly to two of the lead negotiators for EBS, telling them that EBS was putting LJM2 in a difficult position by selling it uncertified fiber.

Fastow's involvement caused great distress for the EBS team. They understood that their job was to get the best deal possible for Enron, but driving a hard bargain for Enron drew the ire of Enron's CFO. The EBS team went to Causey and Ken Rice, the CEO of EBS, for assistance. Together, they decided to accommodate Fastow's concern by sweetening EBS' original offer by providing LJM2 with a 25% capped return if EBS did not resell the fiber within two years. Ultimately, the transaction closed on those terms, with LJM2 promised an 18% capped return if Enron resold the fiber within two years, and a 25% capped return if Enron sold the fiber after two years. The additional term did not come into play because the fiber was sold within two years.

The EBS business people involved in the transaction believe they obtained a good result for EBS notwithstanding Fastow's intercession. Enron recorded a $54 million gain as a result of the transaction with LJM2. Moreover, we are told that all the fiber ultimately was sold later for cash (or letters of credit) to substantial industry participants. Nonetheless, the episode illustrates well the fundamental dilemma of the Company's CFO serving concurrently as the managing partner of a business transacting with the Company.

Finally, this transaction is notable for one other reason. It is the only LJM transaction in which Lay signed the DASH and LJM2 Approval Sheet.

B. Other Transactions with LJM

Enron engaged in several other transactions in 1999 and 2000 with the LJM partnerships. A majority of these transactions involved debt or equity investments by LJM in Enron-sponsored SPEs. These SPEs owned, directly or indirectly, a variety of operating and financial assets. These transactions also included direct or indirect investments by LJM in Enron affiliates. The effect on Enron's financial statements from these transactions varied. The dates, amount of LJM's investments, and summary descriptions of these transactions are provided in the following table:

Date	Amount (in millions)	Transaction	Description
September 1999	$15	Purchase of Osprey Trust certificates	Purchase of equity in limited partner of Whitewing
December 1999	$3	Investment in Bob West Treasure	Purchase of a portion of Enron's equity in an entity that provided financing for the acquisition of natural gas reserves
January 2000	$0.7	Investment in Cortez	Purchase of equity in an SPE that held the voting rights to 25% of TNPC common stock
March 2000	$12.5	Investment in Rawhide	Purchase of equity in an SPE, which was a monetization of a pool of Enron North America and Enron International assets
May 2000	$11.3 (1)	Blue Dog	Sale of call option to Enron on contracts to purchase two gas turbines
June 2000	$10	Investment in Margaux	Purchase of equity in an SPE, which was a monetization of European power plant investments
July 2000	$42.9 (2)	Coyote Springs	Sale of put option agreement with a utility that had previously purchased Enron's right to acquire a gas turbine
July 2000	$50	Investment in TNPC	Purchase of warrants exercisable for stock of TNPC in a private placement offering
July 2000	$26	Purchase of Osprey Trust certificates	Purchase of equity in an affiliate of Whitewing
October 2000	$6.5	Purchase of Osprey Associates certificates	Purchase of equity in an affiliate of Whitewing

December 2000	$8 (3)	Investment in Fishtail	Purchase of equity in an SPE that would receive preferred economics of Enron's pulp and paper trading business
December 2000	$1	Investment in JGB Trust (Avici)	Provide equity in an SPE, which was used to monetize Enron's equity investment in Avici, which was being hedged in Raptor I
December 2000	$1.8	Investment in LAB Trust (Catalytica)	Provide equity in an SPE, which was used to monetize Enron's equity investment in Catalytica, which was being hedged in Raptor I
(1) Amount represents the notional amount under the option agreement. Enron paid $1.2 million for this option. The option was subsequently exercised by Enron.			
(2) Amount represents the notional amount under the option agreement. The utility paid a premium of $3.5 million to LJM2 for this option. Subsequently, the utility assigned its rights to acquire the turbine to an Enron subsidiary. (3) Amount represents the equity in an SPE that held the rights to paper and pulp trading operations for 5 years. Enron monetized its retained interest and recorded a $115 million gain.			

VII. OVERSIGHT BY THE BOARD OF DIRECTORS AND MANAGEMENT[64/]

Oversight of the related-party transactions by Enron's Board of Directors and Management failed for many reasons. As a threshold matter, in our opinion the very concept of related-party transactions of this magnitude with the CFO was flawed. The Board put many controls in place, but the controls were not adequate, and they were not adequately implemented. Some senior members of Management did not exercise sufficient oversight, and did not respond adequately when issues arose that required a vigorous response. The Board assigned the Audit and Compliance Committee an expanded duty to review the transactions, but the Committee carried out the reviews only in a cursory way. The Board of Directors was denied important information that might have led it to take action, but the Board also did not fully appreciate the significance of some of the specific information that came before it. Enron's outside auditors supposedly examined Enron's internal controls, but did not identify or bring to the Audit Committee's attention the inadequacies in their implementation.

A. Oversight by the Board of Directors

Enron's Board of Directors played a role in approving and overseeing the related-party transactions. This section examines the involvement of the Board and its Committees, where they were involved, in (1) the Chewco transaction, (2) permitting

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64/ The portions of this Section describing and evaluating actions of the Board and its Committees are solely the views of Powers and Troubh.

Fastow to proceed with LJM1 and LJM2 despite his conflict of interest, (3) creating the Raptor vehicles, and (4) overseeing the ongoing relationship between Enron and LJM.[65]

1. The Chewco Transaction

We found no evidence that the Board of Directors (other than Skilling) was aware that an Enron employee, Kopper, was an investor in or manager of Chewco.[66] Because substantial Enron loan guarantees were required to permit Chewco to acquire CalPERS' interest in JEDI, the Chewco transaction was brought before the Executive Committee of the Board (by conference call) on November 5, 1997. Fastow made the presentation. According to the minutes of the meeting, Fastow reviewed "the corporate structure of the acquiring company." The minutes and the interviews we conducted do not reveal any disclosure to the Executive Committee of Kopper's role, and they do not indicate that the Executive Committee (or Lay) was asked for or made the finding necessary under Enron's Code of Conduct to permit Kopper to have a financial interest in Chewco. Both Fastow and Kopper participated in the telephonic meeting. Each had an obligation to bring Kopper's role to the Committee's attention. Fastow and Kopper have declined to be interviewed on this subject.

65/ We have not seen any evidence that any member of the Board of Directors had a financial interest in any of the partnerships that are discussed here.

66/ Skilling said he was aware that Kopper had a managerial role in Chewco, but not that Kopper had a financial interest. He said he believes he disclosed this to the Board at some point, but we found no other evidence that he did. We also saw no evidence that the Board, other than possibly Skilling, was aware of Enron's repurchasing Chewco's interest in JEDI or of the associated tax indemnity payment.

2. Creation of LJM1 and LJM2

The Board understood that LJM1 and LJM2, both recommended by Management, presented substantially different issues. The Board discussed the advantages and disadvantages of permitting Fastow to manage each of these partnerships. The Board also recognized the need to ensure that Fastow did not profit unfairly at Enron's expense, and adopted substantial controls. Nevertheless, these controls did not accomplish their intended purpose.

LJM1. LJM1 came before the Board on June 28, 1999. The Board believed it was addressing a specific, already-negotiated transaction, rather than a series of future transactions. This was the Rhythms "hedge." It was presented as a transaction that would benefit Enron by reducing income statement volatility resulting from a large investment that could not be sold. The Board understood that (1) the terms were already fixed, (2) Enron would receive an opinion by PricewaterhouseCoopers as to the fairness of the consideration received by Enron, and (3) Fastow would not benefit from changes in the value of Enron stock that Enron contributed to the transaction. The Board saw little need to address controls over already-completed negotiations. Indeed, the Board's resolution specified that Lay and Skilling—neither of whom had a conflict of interest—would represent Enron "in the event of a change in the terms of [the Rhythms] transaction from those presented to the Board for its consideration."[67/]

[67/] In fact, there were subsequent changes in the Rhythms transaction, including the additional put and call options in July 1999 and the change in the LJM1 payment from $50 million to $64 million. We found no evidence that either Lay or Skilling was

When it approved LJM1, the Board does not appear to have considered the need to set up a procedure to obtain detailed information about Fastow's compensation from or financial interest in the transactions. This information should have been necessary to ensure that Fastow would not benefit from changes in the value of Enron stock, as Fastow had promised. Even though the Board was informed that "LJM may negotiate with the Company regarding the purchase of additional assets in the Merchant Portfolio," it did not consider the need for safeguards that would protect Enron in transactions between Enron and LJM1. In fact, LJM1 did purchase an interest in Cuiaba from Enron in September 1999.

LJM2. In the case of LJM2, the proposal presented to the Board contemplated creation of an entity with which Enron would conduct a number of transactions. The principal stated advantage of Fastow's involvement in LJM2 was that it could then purchase assets that Enron wanted to sell more quickly and with lower transaction costs. This was a legitimate potential advantage of LJM2, and it was proper for the Board to consider it.[68]

Nevertheless, there were very substantial risks arising from Fastow's acknowledged conflict of interest. First, given Fastow's position as Enron's CFO, LJM2 would create a poor public appearance, even if the transactions had been immaculate and

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advised of or approved these changes, despite the Board's resolution requiring their approval of any changes.

[68] The Board was apparently not informed of the involvement of other Enron employees in LJM2, including Kopper's financial stake and the extent of the role played by other Enron employees under the Services Agreement between Enron and LJM2.

there had been sound controls. The minutes do not reflect discussion of this issue, but our interviews indicate that it was raised. During the rising stock market, analysts and investors generally ignored Fastow's dual roles and his conflict of interest, but when doubts were cast on Enron's transactions with LJM1 and LJM2 in connection with Enron's earnings announcement on October 16, 2001, this appearance became a serious problem.

Second, Fastow's position at Enron and his financial incentives and duties arising out of LJM1 and LJM2 could cause transactions to occur on terms unfair to Enron or overly generous to LJM1 and LJM2.[69/] The Board discussed this issue at length and concluded that the risk could be adequately mitigated. The Directors viewed the prospective LJM2 relationship as providing an additional potential buyer for assets in Enron business units. If LJM2 offered a better price than other buyers on asset purchases or other transactions, Enron would sell to LJM2. This could occur because Fastow's familiarity with the assets might improve his assessment of the risk, or might lower his transaction costs for due diligence. In our interviews, several Directors cited these benefits of permitting Fastow to manage LJM2. If a better price was available elsewhere, Enron could sell to the higher bidder. Based on Fastow's presentation, the Directors envisioned a model in which Enron business units controlled the assets to be sold to

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69/ The presentation to the Board on LJM1 discussed the structure by which Fastow would be compensated, and therefore provided the Board with a basis for forming an expectation about the level of his compensation. The presentation to the Board on LJM2 did not. It provided only that "LJM2 has typical private equity fund fees and promote [sic]," targeted at "$200 + million institutional private equity." When LJM2 was initially approved, it does not appear that there was discussion at the Board level about a much larger fund and the levels of compensation Fastow would receive, although it was discussed later.

LJM2 (or alternative potential buyers) and would be negotiating on behalf of Enron. Because each business unit's financial results were at stake, the Board assumed they had an incentive to insist that the transactions were on the most favorable terms available in the market. This was a plausible assumption, but in practice this incentive proved ineffective in ensuring arm's-length dealings.

Moreover, several Directors stated that they believed Andersen would review the transactions to provide a safeguard. The minutes of the Finance Committee meeting on October 11, 1999 (apparently not attended by representatives of Andersen) identify "the review by Arthur Andersen LLP" as a factor in the Committee's consideration of LJM2. Andersen did in fact (1) provide substantial services with respect to structuring and accounting for many of the transactions, (2) review Enron's financial statement disclosures with respect to the related-party transactions (including representations that "the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties"), and (3) confirm Andersen's involvement in representations to the Audit and Compliance Committee at its annual reviews of the LJM transactions. The Board was entitled to rely on Andersen's involvement in these respects. In addition, one would reasonably expect auditors to raise questions to their client—the Audit and Compliance Committee—if confronted with transactions whose economic substance was in doubt, or if controls required by the Board of Directors were not followed, as was the case here.[70]

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[70] We are unable to determine why Andersen did not detect the various control failures described below. At its meeting with the Audit and Compliance Committee on May 1, 2000, an Andersen representative identified related-party transactions as an area

Further, the Board adopted, or was informed that Management had adopted, a number of controls to protect Enron's interests. When the LJM2 proposal was brought to the Finance Committee and the Board in October 1999, two specific controls were recommended and adopted:

- Enron's Chief Accounting Officer, Rick Causey, and Chief Risk Officer, Rick Buy, would review and approve all transactions between Enron and LJM2.
- The Audit and Compliance Committee of the Board would annually review all transactions from the last year "and make any recommendations they deemed appropriate."

In addition, the Board noted that Enron had no "obligation" to engage in transactions with LJM. The Board also was told that disclosures of individual related-party asset sales was "probably" required in periodic SEC filings and proxy solicitation materials, which would mean involving Enron's internal lawyers, outside counsel at Vinson & Elkins, and Andersen to review the disclosures.

Additional controls were added, or described as having been added, at later meetings. A year later, on October 6 and 7, 2000, respectively, the Finance Committee and the full Board considered a proposal with respect to a new entity, LJM3.[71/] Fastow informed the Directors, in a meeting at which Skilling, Causey and Buy were present,

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to be given "high priorit[y] due to the inherent risks that were present." Moreover, in the engagement letter between Andersen and Enron dated May 2, 2000, the engagement partner wrote that Andersen's work would "consist of an examination of management's assertion that the system of internal control of Enron as of December 31, 2000, was adequate to provide reasonable assurance as to the reliability of financial statements. . . ." Because Andersen declined to permit its representatives to be interviewed, we do not know what, if any, steps Andersen took in light of these observations.

71/ LJM3 was never created.

that additional controls over transactions between Enron and LJM1 and LJM2 had been put in place. These included:

- Fastow expressly agreed that he still owed his fiduciary responsibility to Enron.
- The Board or the Office of the Chairman could ask Fastow to resign from LJM at any time.
- Skilling, in addition to Buy and Causey, approved all transactions between Enron and the LJM partnerships.
- The Legal Department was responsible for maintaining audit trails and files on all transactions.
- A review of Fastow's economic interest in Enron and LJM was presented to Skilling.

One Director also proposed that the Finance Committee review the LJM transactions on a quarterly basis. Another Director proposed that the Compensation and Management Development Committee review the compensation received by Fastow from the LJM partnerships and Enron. Both proposals were adopted by the Finance Committee.

Finally, the Finance Committee (in addition to the Audit and Compliance Committee) was informed on February 12, 2001, of still more procedures and controls:

- The use within Enron of an "LJM Deal Approval Sheet"—in addition to the normal DASH—for every transaction with LJM, describing the transaction and its economics, and requiring approval by senior level commercial, technical, and commercial support professionals. (This procedure had, in fact, been adopted by early 2000.)
- The use of an "LJM Approval Process Checklist" that included matters such as alternative sales options and counter-parties; a determination that the transaction was conducted at arm's length, and any evidence to the contrary; disclosure obligations; and review not only by Causey and Buy but also by Skilling.
- LJM senior professionals do not ever negotiate on behalf of Enron.
- People negotiating on behalf of Enron "report to senior Enron professionals apart from Andrew Fastow."

- Global Finance Commercial, Legal and Accounting Departments monitor compliance with procedures and controls, and regularly update Causey and Buy.
- Internal and outside counsel are regularly consulted regarding disclosure obligations and review any such disclosures.

These controls were a genuine effort by the Board to satisfy itself that Enron's interests would be protected.

At bottom, however, the need for such an extensive set of controls said something fundamental about the wisdom of permitting the CFO to take on this conflict of interest. The two members of the Special Committee participating in this review of the Board's actions believe that a conflict of this significance that could be managed only through so many controls and procedures should not have been approved in the first place.

3. Creation of the Raptor Vehicles

The Board authorized Raptor I in May of 2000. The Board was entitled to rely on assurances it received that Enron's internal accountants and Andersen had fully evaluated and approved the accounting treatment of the transaction, but there was nevertheless an opportunity for the members of the Board to identify flaws and pursue open questions.[72/]

72/ The Board cannot be faulted for lack of oversight over the most troubling Raptor transactions: Raptor III and the Raptor restructuring. With the possible exception of Skilling, who says he recalls being vaguely aware of these particular events, the members of the Board do not appear to have been informed about these transactions. Neither the minutes nor the witnesses we interviewed indicate that Raptor III was ever brought to the Board or its Committees. This may have been because no Enron stock was issued. Raptor III also does not appear to have been disclosed at the February 2001 meetings of the Audit and Compliance Committee or the Finance Committee. The list presented at the February 2001 meetings refers generally to "Raptors I, II, III, IV," but the Finance Committee had reason to believe the transactions referred to as Raptors III and IV were

Raptor I was presented to the Finance Committee on May 1, 2000. It was presented to the Board the following day. The Committee and Board were not given all of the details, but they were given a substantial amount of information. They understood this transaction to be another version of the Rhythms transaction, which they had approved the previous year and believed to have performed successfully. They were informed that the hedging capacity of Raptor I came from the value of Enron's own stock, with which Enron would "seed" the vehicle. They were informed that Enron would purchase a share-settled put on approximately seven million shares of its own stock. Handwritten notes apparently taken by the corporate secretary suggest that the Committee was informed that the structure "[d]oes not transfer economic risk but transfers P&L volatility." At least some members of the Committee understood that this was an accounting-related transaction, not an economic hedge. On a list the Committee (and, it appears, the Board) was shown about the risks posed by the Raptor vehicle, the first risk was of "[a]ccounting scrutiny." The list said that this risk was mitigated by the fact that the "[t]ransaction [was] reviewed by CAO [Causey] and Arthur Anderson [sic]."

We believe that each of these elements should have been the subject of detailed questioning that might have led the Finance Committee or the Board to discover the fundamental flaws in the design and purpose of the transaction. The discussion, if accurately described by the handwritten notes, suggested an absence of economic substance: a hedge that does not transfer economic risk is not a real hedge. While it is often the case that *sales* to SPEs transfer only limited economic risk, a *hedge* that does

substantially identical to Raptor I. Raptor III, as described earlier in this Report, was not presented to or authorized by the Board.

not transfer economic risk is not a meaningful concept. Enron's purchasing a "put" on its own stock from Talon (Raptor I)—a bet against the value of that stock—had no apparent business purpose. The statement that the first risk to be considered was that of "[a]ccounting scrutiny" was a red flag that should have led to the Board's referring the proposal to the Audit and Compliance Committee for careful assessment of any controversial accounting issues, and should have led that Committee to conduct a probing discussion with Andersen.

The involvement of Enron's internal accountants, and the reported (and actual) involvement of Andersen, gave the Finance Committee and the Board reason to presume that the transaction was proper. Raptor was an extremely complex transaction, presented to the Committee by advocates who conveyed confidence and assurance that the proposal was in Enron's best interests, and that it was in compliance with legal and accounting rules. Nevertheless, this was a proposal that deserved closer and more critical examination.

4. Board Oversight of the Ongoing Relationship with LJM

Two control procedures adopted by the Board (and indeed sound corporate governance) called for specific oversight by Committees of the Board. These were periodic reviews of the transactions and of Fastow's compensation from LJM.[73/]

73/ Enron's Board of Directors met five times each year in regular meetings, and from time to time in special meetings. The regular meetings typically involved committee meetings as well. The Finance Committee and the Audit and Compliance Committee each generally met for one to two hours the afternoon before the Board meeting.

Committee Review. In addition to the meetings at which LJM1 and LJM2 were approved, the Audit and Compliance Committee and the Finance Committee reviewed certain aspects of the LJM transactions. The Audit and Compliance Committee did so by means of annual reviews in February 2000 and February 2001. The Finance Committee did so by means of a report from Fastow on May 1, 2000 and an annual review in February 2001.

The Committee reviews did not effectively supplement Management's oversight (such as it was). Though part of this may be attributed to the Committees, part may not. The Committees were severely hampered by the fact that significant information about the LJM relationship was withheld from them, in at least five respects:

First, in each of the two years in which the February annual review occurred, Causey presented to the Committees a list of transactions with LJM1 and LJM2 in the preceding year. The lists were incomplete (though Causey says he did not know this, and in any event a more complete presentation may not have affected the Committee's review): the 1999 list identified eight transactions, when in fact there were ten, and the 2000 list of transactions omitted the "buyback" transactions described earlier. Knowledge of these "buyback" transactions would have raised substantial questions about the nature and purpose of the earlier sales.

Second, Fastow represented to the Finance Committee on May 1, 2000, that LJM2 had a projected internal rate of return on its investments of 17.95%, which was consistent with the returns the Committee members said they anticipated for a "bridge" investor such as LJM2. In contrast, at the annual meeting of LJM2 limited partners on

October 26, 2000, Fastow presented written materials showing that their projected internal rate of return on these investments was 51%. While some of this dramatic increase may have been attributable to transactions after May 1—in particular the Raptor transactions—there is no indication that Fastow ever corrected the misimpression he gave the Finance Committee about the anticipated profitability of LJM2.

Third, it appears that, at the meeting for the February 2001 review, the Committees were not provided with important information. The presentation included a discussion of the Raptor vehicles that had been created the preceding year. Apparently, however, the Committees were not told that two of the vehicles then owed Enron approximately $175 million more than they had the capacity to pay. This information was contained in a report that was provided daily to Causey and Buy, but it appears that neither of them brought it to either Committee's attention.

Fourth, it does not appear that the Board was informed either that, by March of 2001, this deficit had grown to about $500 million, or that this would have led to a charge against Enron's earnings in that quarter if not addressed prior to March 31. Nor does it appear that the Board was informed about restructuring the Raptor vehicles on March 26, 2001, or the transfer of approximately $800 million of Enron stock contracts that was part of that transaction. The restructuring was directed at avoiding a charge to earnings. While these transactions may or may not have required Board action as a technical matter, it is difficult to understand why matters of such significance and sensitivity at Enron would not have been brought to the attention of the Board. Causey and Buy, among others, were aware of the deficit and restructuring. Skilling recalls being only vaguely aware of these events, but other witnesses have told us that Skilling, then in his first quarter as CEO, was aware of and intensely interested in the restructuring.

Fifth, recent public disclosures show that Andersen held an internal meeting on February 5, 2001, to address serious concerns about Enron's accounting for and oversight of the LJM relationship. The people attending that meeting reportedly decided to suggest that Enron establish a special committee of the Board of Directors to review the fairness of LJM transactions or to provide for other procedures or controls, such as competitive bidding. Enron's Audit and Compliance Committee held a meeting one week later, on February 12, 2001, which was attended by David B. Duncan and Thomas H. Bauer, two of the Andersen partners who (according to the public disclosures) had also been in attendance at the Andersen meeting on February 5. We are told (although the minutes do not reflect) that the Committee also conducted an executive session with the Andersen representatives, in the absence of Enron's management, to inquire if Andersen had any concerns it wished to express. There is no evidence that Andersen raised concerns about LJM.

There is no evidence of any discussion by either Andersen representative about the problems or concerns they apparently had discussed internally just one week earlier. None of the Committee members we interviewed recalls that such concerns were raised, and the minutes make no mention of any discussion of the subject. Rather, according to the minutes and to written presentation materials, Duncan reported that "no material weaknesses had been identified" in Andersen's audit and that Andersen's "[o]pinion regarding internal control ... [w]ill be unqualified."[74/] While we have not had access to either Duncan or Bauer, the minutes do not indicate that the Andersen representatives made any comments to the Committee about controls while Causey was reviewing them, or recommended forming a special committee to review the fairness of the LJM transactions, or recommended any other procedures or review.

The Board cannot be faulted for failing to act on information that was withheld, but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships. The Board had agreed to permit Enron to take on the risks of doing business with its CFO, but had done so on the condition that the Audit and Compliance Committee (and later also the Finance Committee) review Enron's transactions with the LJM partnerships. These reviews were a significant part of the control structure, and should have been more than just another brief item on the agenda.

In fact, the reviews were brief, reportedly lasting ten to fifteen minutes. More to the point, the specific economic terms, and the benefits to LJM1 or LJM2 (or to Fastow), were not discussed. There does not appear to have been much, if any, probing with respect to the underlying basis for Causey's representation that the transactions were at arm's-length and that "the process was working effectively." The reviews did provide the Committees with what they believed was an assurance that Causey had in fact looked at the transactions—an entirely appropriate objective for a Board Committee-level review

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74/ The written materials included "Selected Observations" on financial reporting. "Related party transactions" were one of five areas singled out in this section. Andersen's comments were that "Relationship issues add scrutiny risk to: [j]udgmental structuring and valuation issues [and] [u]nderstanding of transaction completeness" and "Required disclosures reviewed for adequacy."